Global Markets Research

Fixed Income: Weekly Strategy

14 May 2012

Bond rally well-supported by Budget, but front-end lagging

- The AUD front-end bond curve is unusually inverted, but this situation is likely to persist for the time being.
- Budget surplus & reduced supply contributing to tighter spreads to offshore bonds and increased swap spreads.
- Australian AAA secure, but we must remain top of the debt class given other metrics (e.g. Current Account Deficit).

Global and local developments continue to underpin strong demand for Australian bonds. Yields on 3Y and 10Y futures made new record lows and are 6-12bp down on last Monday's post-US payrolls and EU elections levels. The US 10Y Treasury yield is down another 5bp to 1.82% and continues to underperform the Aussie 10Y – benefitting our spread contraction trade.

High grade bonds continue to benefit from the ongoing political dead-lock in Greece. Weekend talks among major Greek parties broke down and there is still no clear majority that can form a Government. So they look like going back to the polls. There is thus still a risk that an anti-austerity coalition can renege on the EU/IMF bailout plans – many wonder if this portends future developments elsewhere in Europe. Political risk is most pressing in Greece, but they're not the only focus. At the weekend, Germany's ruling party suffered a defeat in an election in the country's largest state. Meanwhile, Spain continues to press ahead with a deeply unpopular austerity program…

Global economic data continues to support bonds, particularly Chinese data for April. The most worrying aspect for Australian investors is the miniscule 0.3% y/y growth in Chinese imports. But April IP, retail sales and credit growth were all weak too. We suspect this might dampen the market's usual positive response to the PBoC's 50bp reduction in China's reserve requirement ratio over the weekend.

Australian trade data was also softer than expected. The March trade deficit widened to $1.6bn from a revised deficit of $0.8bn (was $0.5bn). The January to March trade figures imply a 0.8% drag on Q1 GDP. But real Q1 retail sales were much stronger than expected (+1.8%), implying consumer spending will make up most of the difference.

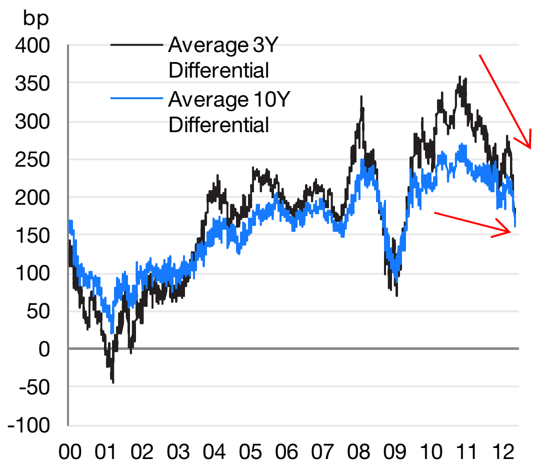
The April jobs data was also surprising. Total employment grew 15.5k and the jobless rate dropped 0.3%pts to 4.9%, helped by falling workforce participation. On the release, the figures drove a modest sell-off in front end rates and led to a small uplift in RBA cash rate pricing. However, as Alex Stanley explains on Page 3, the Aussie front end is likely to stay well bid and the curve is likely to continue to behave differently to previous easing cycles.

Thanks to leaks and telegraphing the Federal Budget wasn't a surprise. Our overall read (Page 7) is that the combination of fiscal tightening and diminishing new ACGB supply is supportive of Australian bonds. But the widening trade deficit means we have to stay 'top of class'.

Ahead this week, the machinations of EU politics will stay in focus. But the market will also look to numerous key US data releases, including: CPI, retail sales, industrial production and FOMC minutes. In Australia, the focus will be on the May RBA minutes, consumer confidence, wage cost data and South Australia and Tasmania's Budgets.

Contents:

Average daily yield spread between Australia and other developed AAA sovereigns*



**S&P LT ratings, includes: Norway, Switzerland, Canada, UK and Germany*

Source: CBA, Bloomberg

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Key Positions

The continuing rally in the Australian 10Y has been good for our portfolio of recommendations. Our main exposure remains the Aust-US 10Y spread. We revised the target and stop on that trade in last Wednesday's *Fixed Income Daily*.

Our NZD 6M OIS trade abruptly reversed course after the NZ and Australian data improved. Our trade hit the revised stop last week and we exit for 10bp of profit.

Trading strategy is very difficult in the current environment. 2-3 year rates are below what they "should" be and are pricing a continuing stream of bad news in Europe (See page 3.). So far, though, Europe has been happy to oblige and with no functioning Government in Greece and the Spanish banking system looking weaker the bad news could continue for weeks. Although the domestic Australian data has been ignored for the last couple of weeks, this strength in data should eventually impact market pricing - either through continued strong data prints (another sub-5% unemployment rate, for example) or via the RBA, who may not choose to validate aggressive cash-rate pricing. (Retail Sales, in particular, assists the GDP forecasts.)

The long and short of the rally, though, is that it can continue for as long as the bad news from Europe continues.

Key Trades

Trade	Entry	Curent	Profit	Target	Stop	Comment
Buy the TCV Jun-20 vs NSWTC May-20	0.5bp (16-Nov-11)	0bp	-0.5bp	10bp	-5bp	**Hold:** TCV's AAA is safe and the funding task is modest. NSW is subject to some rating risk.
Buy the ACGB Apr-23 versus the Apr-20.	31bp (12-Jan-12)	30bp	+1bp	20bp	37bp	**Hold:** RV analysis reveals the Apr-23 is cheap against the Apr-20.
Pay the 5Y in the AUD 2Y/5Y/10Y butterfly	+1.5bp (23-Jan-12)	+0.5bp	-1bp	+12bp	-5bp	**Hold:** RV scan suggests butterfly is too low.
Buy a 6M put on the Oct-14 bond at a strike of 4.10%	5bp premium (9-Feb-12)	2.73%				**Hold:** Protection against a large sell-off.
Buy a 20bp OTM conditional bull steepener. (2.9 times 3.31% call on Apr-15 and 1.0 times 3.89% call on Jul-22. Implicit slope 58bp).	6bp premium (9-Feb-12)	Current yields: 2.63 and 3.29, for 66bp slope	Slope +8, premium - 6 = +2bp total			**Hold:** The bullish side of a pair of trades to protect against tail risks.
Buy the ACGB Jul-22 vs the UST Feb-22	217bp (15-Feb-12)	147bp	+65bp (incl carry of -5bp, FX adjusted)	**130bp**	**165bp**	**New Target and Stop:** Australian bonds continue to outperform, though we are growing wary of a short-term pull back. See Daily Wrap of 9 May for discussion of target and stop. Carry is negative because the US 10Y is sold at around 2% via rolling repo for a return of near-enough to zero.
Buy the ACGB Aug-15 linker vs the Oct-15 (BEI to widen). Receive fixed in ZCS at 2.65%, creating	250bp (30-Mar-12)					**Adjusted Trade:** We have deliberately transformed the trade by receiving ZCS against it. The trade is now a (close to) a 14bp per annum annuity.
Sell the June IR futures against OIS	30bp (11-Apr-12)	30bp	0bp		20bp	**Hold:** A pre-emptory defence against an all-out credit contagion.
Receive the 6M NZD OIS	2.45% (30-Apr-12)	2.35%	+10bp	**2.15%**	**2.35%**	**Profit taken at revised stop:** The stronger NZ (and Aussie) data caused a sell-off in NZD front end.

Front end rates are behaving differently in this easing cycle

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- The market is pricing a sub-3% cash rate within the next year and there are few identifiable catalysts to stand in the way of that pricing.
- Expectations for a prolonged easing cycle and strong foreign demand for bonds are restraining 2-3Y Aussie rates and leading to wider front end swap spreads.
- The front-end bond curve is unusually inverted for an easing cycle, but this situation is likely to persist for the time being.

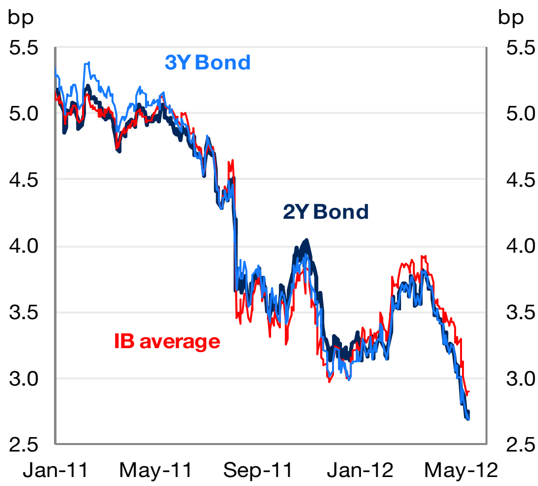
Recent developments in Aussie front end rates

The market is pricing a cash rate of below 3% within the next year. Before the May RBA meeting, many players in the Aussie market expressed disbelief that cash could fall below 3%. But the surprise 50bp cut by the RBA and the shaky sentiment offshore means that few can now confidently rule out the possibility of another 100bp of cuts.

Notwithstanding a surprising set of employment figures last week, the view for substantial policy easing is generally supported by a weaker pulse in global and local economic data. Indeed, the RBA themselves revealed in the SOMP a 1% forecast range for this year's real GDP trajectory, highlighting the extent of downside risks to the economic outlook.

Market expectations for aggressive RBA easing are now playing out differently across the front end of the curve than in past easing cycles. In particular, 2-3Y bonds have been particularly strong in this cycle. Figure 1 illustrates the recent disconnect between 2-3Y bond yields and short term money market expectations for cash (Figure 1).

Figure 1: Cash rate expectations and front end bond yields*



Source: CBA, Bloomberg

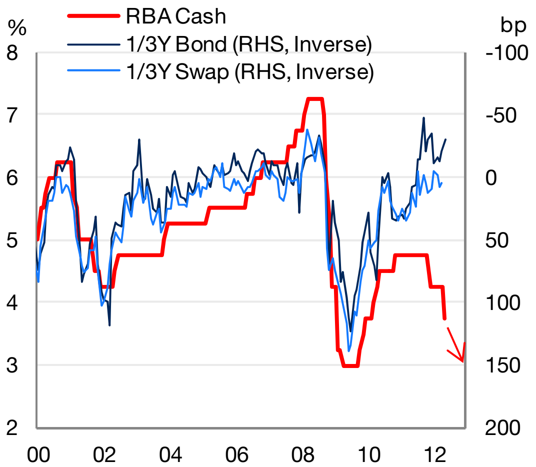
**IB average of 6m, 12m & 18m contracts*

Front end of the curve behaving differently

The front end curve shape is different to past easing cycles

The strength of the rally in the 2-3Y part of the bond curve has changed the dynamics of front end rates. In particular, one thing that stands out about the current easing cycle, relative to the past, is the flatness at the front part of the bond curve. Ordinarily, RBA rate cuts lead to a steeper front end curve, but that hasn't been the case in this easing cycle. Figure 2 shows that the current level of the 1/3Y curve is more consistent with historical periods when the RBA was on hold or tightening.

Figure 2 : Cash Rate & 1/3Y Curves (monthly)



Source: CBA, Bloomberg

Part of the explanation for this flatness at the front end of the curve is that the RBA have cut rates more gradually than in past easing cycles. In Figure 3, we illustrate the cash and 1/3 curve relationship in 3 month difference terms. It becomes clear that the pace of adjustment in

RBA policy is much slower now than in the last 3 easing cycles. Especially compared with the dramatic easing cycle in 2008.

The 1/3Y curve is flat compared with past easing cycles.

The flatness of the 1/3Y bond and swap curves partly reflects the market's view that the current policy easing cycle will be a prolonged affair. That view was evident after the surprise 50bp cut from the RBA in May only drove a small steepening (less inversion) in the 1/3Y bond curve. The 50bp cut also caused the 3/10Y curve to steepen slightly. Broadly, the 1/3Y and 3/10Y curve shape has diverged over the last year (Figure 4). The 2-3Y bond yields are now the inflection point for whole curve and this stands out historically (Figure 5).

Impact of global demand for Australian bonds on front end rates

Strong foreign demand may be helping drive lower 2-3Y ACGB yields.

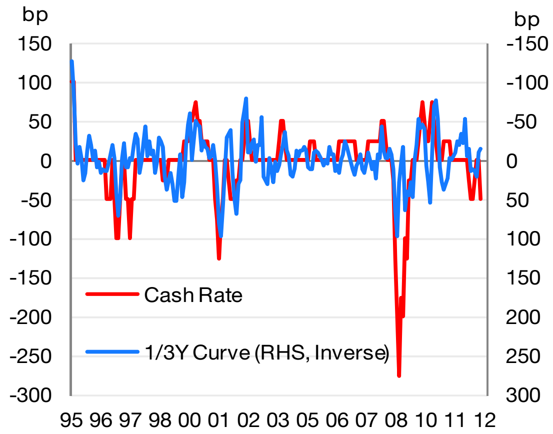
Strong foreign demand for Australian bonds is a key factor behind the historically low level of yields across the Australian curve. The dynamics of this demand may also have implications for the different evolution of the front end curve shape in this cycle, relative to past easing cycles.

Figure 6 shows that foreign investors were clearly less active, in a relative sense, in the Australian market in past easing cycles than they are today. The AUD was also less stable in the 2008/09 cycle – which suggests some capital flight out of Australia, and potentially Australian bonds. This time around, Australia's perceived riskiness is much lower, as the sovereign CDS spreads in Figure 7 illustrate.

While Figures 6 and 7 show that Australian bonds are more favourable now relative to the last easing cycle, they don't directly imply anything new about the shape of the curve. That is, they don't indicate that new foreign demand is contributing to the greater than normal strength in 2-3Y bonds relative to other parts of the curve. Indeed, proving that offshore investors exhibit a "preferred habitat" bias is difficult. However, we posit a few key factors that suggest a preference among foreign investors for the front end of the Aussie curve, especially the 3Y point:

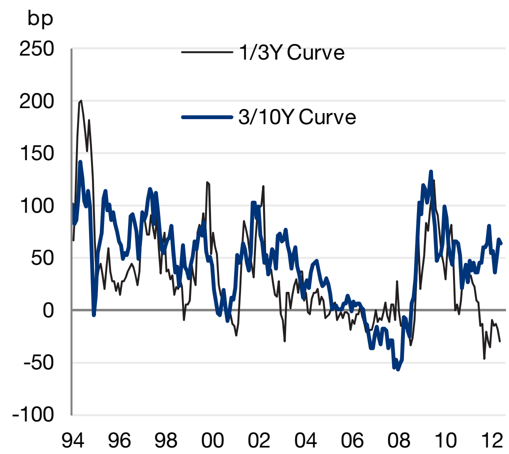
- The 3Y offers strong liquidity as these bonds are either in or very near to the 3Y futures basket
- New investors may be less keen to take on longer duration risk if they're taking currency risk.
- While the Australian 3Y bond yield is at a record low, it's still 170bp higher, on average, than the 3Y yield of AAA rated peers. Australia's 3Y yield advantage has compressed relative to the 10Y,

Figure 3 : Cash Rate & 1/3Y Bond Curve (3m change)



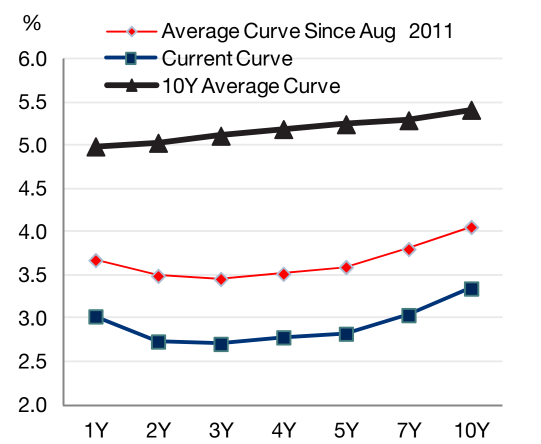
Source: CBA, Bloomberg

Figure 4: ACGB Curves



Source: CBA, Bloomberg

Figure 5: The 2-3Y part of the curve is the new inflection point (ACGB curve)



Source: CBA, Bloomberg

but is still marginally higher (Figure 8).

Implications for swap spreads

A flatter front end swap curve could be driving a wider 3Y swap spread.

Historically, flatter curves lead to wider swap spreads (Figure 9). However, disentangling curve flatness from other drivers of swap spreads is challenging. For instance, swap spreads have tended to widen in the last two easing cycles because of shifting market perceptions of bank credit risk. That risk looked to be the primary driver of wider swap spreads in late 2011. However, spreads failed to tighten noticeably in early 2012, as the LTRO's helped ease pressure on other measures of bank credit risk. That suggests curve flatness and the strong demand for 2-3Y ACGBs is likely to be playing a part in the current wider level of front end swap spreads.

Outlook for front end rates

Front end rates are likely to remain low for the time being.

Last week, we published updated forecasts for Aussie rates (*Weekly Strategy,* May 7). So we don't wish to re-cover that ground in great depth.

In short, we don't see much scope for the front end to rise drastically, even from these low levels. At least not while the general read of Australian economic data points to further easing and the growth outlook remains subject to considerable downside risks. Yesterday's employment figures haven't changed our view on the RBA. Further cuts are likely. And pricing for a year-ahead cash rate of 3% or under is likely to persist for the foreseeable future. Especially against the backdrop of a weakening US and China economic data pulse and renewed concerns over stability in Europe.

However, there will come a point when support for bonds offered by the RBA policy outlook and global risk sentiment will subside. When that happens, we expect the front end curve to re-steepen and the 2-3Y part of the curve to lead the sell-off in Aussie rates. This suggests reflation trades such as short 3Y or a 1/3Y curve steepener. However, at present there isn't a strong enough catalyst to change RBA expectations or shift investor preferences away from Aussie bonds, so we're holding off short positions in the front end at this time.

Figure 6: Foreign Ownership and the AUD

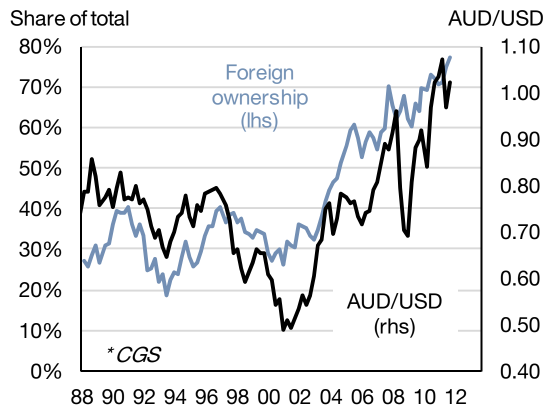


Figure 7: 5Y Sovereign CDS spreads

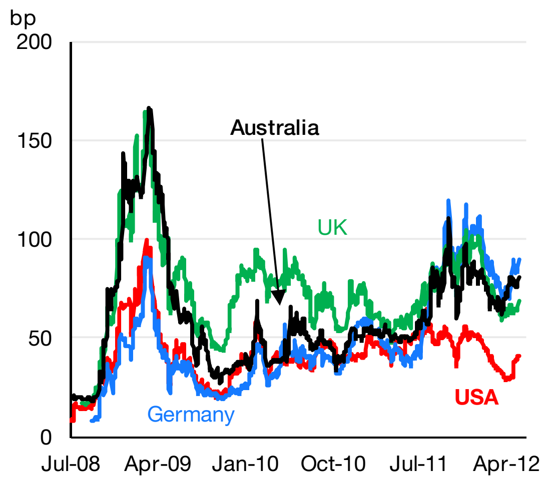
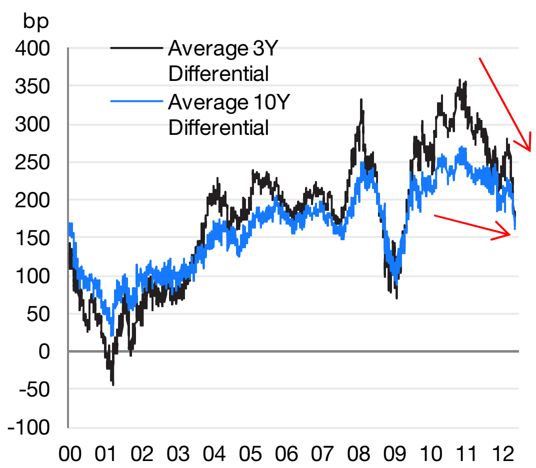


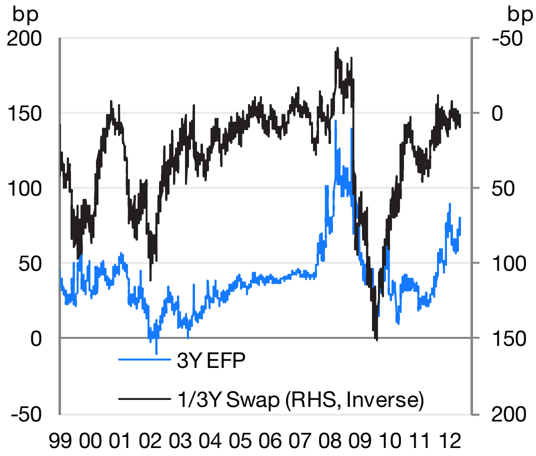
Figure 8: Average daily yield spread between Australia and other developed AAA sovereigns*



**S&P LT ratings, includes: Norway, Switzerland, Canada, UK and Germany*

Source: CBA, Bloomberg

Figure 9: 1/3Y curve and 3Y swap spread



Source: CBA, Bloomberg

2012-13 Budget: Ongoing support for Aussie bonds
(Updated version of a note first published 9 May)

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- A $1.5bn surplus has been delivered as expected.
- Fiscal tightening is less than it appears, but still supportive for lower interest rates and bond yields.
- New bond issuance falls from $44bn to $9bn, underpinning the AAA rating despite a wider current account deficit

The 2012-13 Budget delivered an underlying cash surplus of $1.5bn. The result had been well telegraphed and consequently had virtually no impact on financial markets.

The swing in the budget balance from 2011-12 to 2012-13 is a record 3% of GDP. We judge this overstates the degree of fiscal tightening due to various accounting tools essentially aimed at shifting expenses out of 2012-13 into other years. Some of that has been pulled forward into the final weeks of 2011-12 – in fact, the June cash splurge and last week's 50bp rate cut could generate a spurt in retail sales in coming months that markets react to.

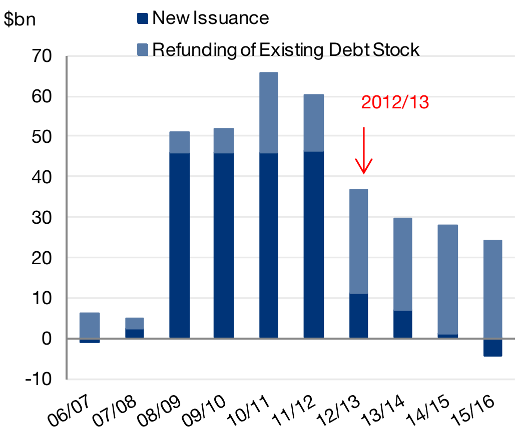
In our view, however, the Budget is clearly favourable for the Aussie bond market. We estimate the true swing in the Budget to be around 2% of GDP. Legitimate fiscal tightening is much less. But that will still bear down on the weak non-mining part of the economy, which the Government estimates will grow by just 2%. Unemployment is also headed higher on the Government's numbers and core inflation is set to remain low. The market should keep pricing multiple rate cuts in this environment. The RBA ultimately cut the cash rate 250bps in the two years after the last concerted fiscal consolidation in Australia in 1996.

The Budget also serves to highlight the divide between Australia and advanced economy peers. Most are years away from producing budget surpluses and stabilising their call on debt markets. The fact this is happening right now in Australia all but guarantees the AAA/Aaa rating is here to stay, as affirmed by S&P and Moody's this evening. That should boost demand for our bonds. But the supply of paper is also reduced, with new issuance down from $44bn to just $9bn in 2012-13. We think that points to a narrower premium over US Treasuries (forecasting 130bps for 10-years) and wider swap spreads than in the past.

Table 1: General government fiscal position

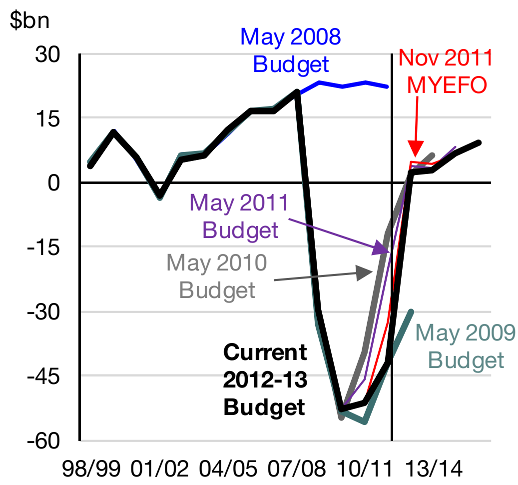
	2011-12	2012-13	2013-14	2014-15	2015-16
Revenue	336.4	376.1	402.2	424.8	449.6
%of GDP	22.8%	24.2%	24.6%	24.7%	24.8%
Expenses	373.7	376.3	398.5	416.4	439.0
%of GDP	25.3%	24.2%	24.4%	24.2%	24.3%
Operating balance	-37.3	-0.2	3.7	8.4	10.5
%of GDP	-2.5%	0.0%	0.2%	0.5%	0.6%
Fiscal balance	-42.0	2.5	2.6	7.0	9.5
%of GDP	-2.8%	0.2%	0.2%	0.4%	0.5%
Underlying cash balance	-44.4	1.5	2.0	5.3	7.5
Headline cash balance	-48.4	-8.7	-6.8	-0.1	2.0
Net debt	142.5	143.3	144.9	140.1	131.6
%of GDP	9.6%	9.2%	8.9%	8.1%	7.3%

Figure 1: CGS Issuance



Source: CBA, AOFM

Figure 2: General government fiscal balance



Source: Budget Papers, CBA,

Budget numbers at a glance

The underlying cash deficit for 2011-12 was $44.4b and the underlying cash surplus for 2012-13 is $1.5b. The number had been pre-released and was not a surprise. The accrual-based fiscal estimate was identical at $1.5b.

The fiscal balance has improved sharply, helped by a relatively high GDP forecast of +3.25% and the deferring of some major expenditure items (notably in Defence).

Cuts and Spending to "Spread the Boom"

There is $15.6bn of new expenditure in the Budget. A significant share is spent on aged care services and other measures aimed at redistributing wealth back to low and middle income households ("Spreading the Boom"). The key savings are based around delaying major purchases, particularly in defence. New savings initiatives total $22.3bn.

The Government continues to invest in financial assets for policy purposes (e.g. the NBN), which causes the headline cash balance to be a deficit of -$8.7bn. The headline cash balance came in at a deficit of $48.4b in 2011-12, near, but slightly higher than our expectations. CGS issuance is therefore higher than we had expected by about $4b in 2011-12 and $2bn in 2012-13.

According to the budget forecasts, Net Debt as a proportion of GDP has now peaked at 9.6% of GDP in 2011-12. It is expected to slowly fall from here, to 9.2% in 2012-13 and 7.3% by the end of the forecasts in 2015-16. In dollar terms, net debt rises slightly from $142.5b in 2011-12 to $144.9bn in 2012/13, before falling away to $131.6bn in 2015/16.

Debt issuance in 2011-12 will be higher

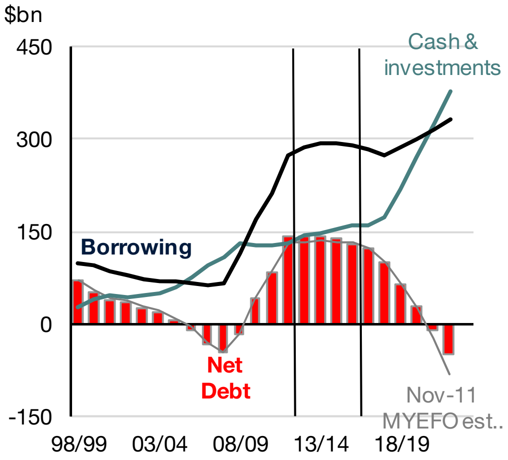
The total issuance of CGS in 2011-12 is higher than we had been expecting at $58b (up from a revised $54b at MYEFO). The 2012-13 debt issuance is expected to be $36.6b in total, but the character of the issuance will change substantially from this year. (See Figure 1.) Replacing maturing bonds will make up the bulk of issuance from here out.

There will be only $9bn of net nominal issuance in 2012-13, supplemented by a hefty $25.6bn of maturities for a total nominal issuance of $36.60bn. The Government also intends to issue $2bn of linkers in 2012-13.

Total issuance and net issuance slowly fall away over the out years, with maturities contributing the bulk of issuance. Net issuance is actually negative in 2015-16 (only just).

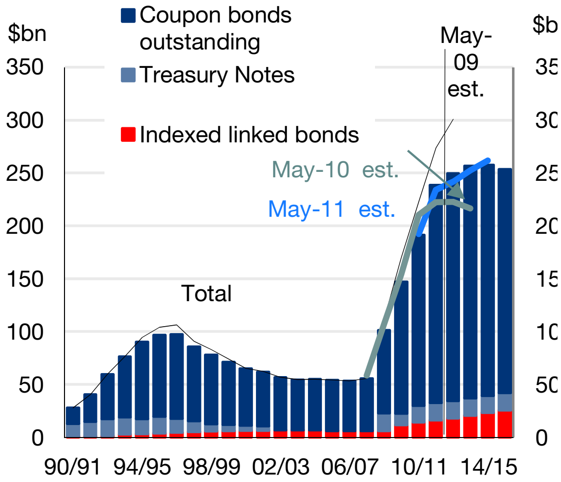
Total CGS on issue is expected to rise to $255b and then plateau. (See Figure 4.)

Figure 3: Composition of C'wealth net debt



Source: Budget Papers, CBA

Figure 4: Total bonds outstanding will plateau



Source: Budget, CBA, AOFM

Little change to Government policies on debt

The Government's stated aims for the bond market have not been altered in this budget. The Government continues to point to the overall liquidity of the market and the liquidity of the 3Y and 10Y bond futures as the primary objective.

Last year, the Government described a specific set of further policy objectives as well, in light of recommendations made by an expert panel. The specific policies recommended by the expert panel:

- a commitment to issue sufficient bonds to maintain liquidity in 3Y and 10Y bond futures;
- incrementally lengthen the yield curve to assist markets to hedge longer dated interest rate risks;
- keep bonds outstanding between 12-14% of GDP;
- ensure 10-15% of the CGS market will be inflation-linked.

Last year's proposal to ensure debt markets remain liquid is still the strategy, if not policy

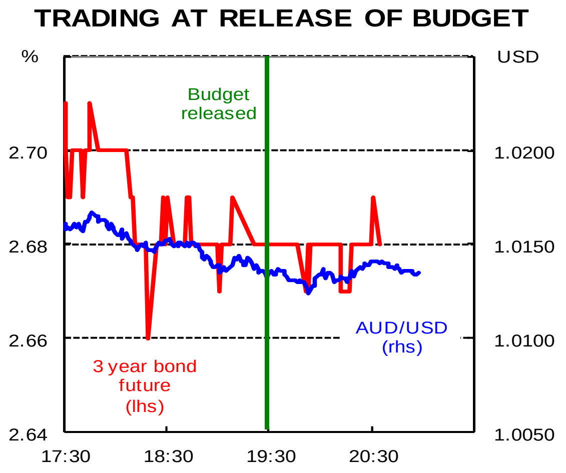
These policies were not restated this year, but the general formulation of the discussion remained similar. The 2012-13 Budget continues to point to the expert panel's advice as driving bond market policy, suggesting an implicit affirmation despite the lack of an explicit adoption of the policy.

The Budget notes that the volume of bonds subject to the debt limit is not forecast to rise above the current $250bn limit at any year-end point. However, the limit is very close and intra-year breaches of the $250bn limit are likely. The Government will seek to raise the debt limit to $300b. This may drive some political argy-bargy, but seems the most rational outcome and should eventually pass. Although the Coalition has been making political hay out of the increase to the debt limit, the minor parties and independents have made a commitment not to block supply. We suspect that commitment will extend to raising the debt limit too.

Likely debt issuance strategies

Despite the surplus of $1.5bn, the Headline cash balance was a little lower than expected. Investments in financial assets for policy purposes (including the NBN) subtract $12b from the underlying figure, while Future Fund earnings return $3bn. This leaves a headline cash balance of -$8.7bn.

Figure 5: Market reaction to the budget



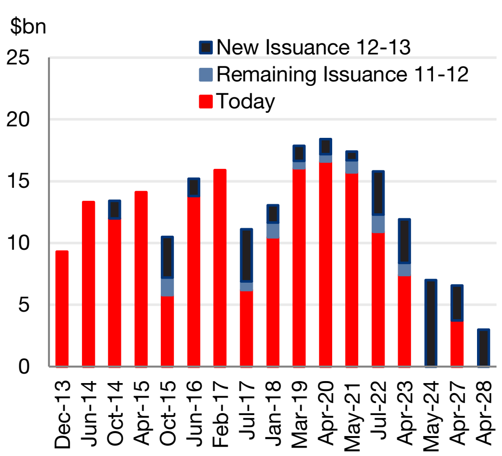
Source: CBA, Bloomberg

Table 2 Major nominal debt issuance numbers

Year	Balance of 2011-12	2012-13
Projected net Issuance	8.17	11
Maturities	0	25.60
Total Issuance	8.17	36.60

Source: CBA, Treasury, Bloomberg

Figure 6: Possible 2012-13 CGS issuance



Source: Budget, CBA, AOFM

Net new nominal issuance is only $9bn in 2012-13. Total issuance is $36b.

There is slight discrepancy between net bond issuance and net cash flow. The Government is forecasting $9bn of nominal issuance and $2bn of Linker issuance, for a total of $11bn. That total is slightly larger than the projected cash deficit, as is common. The discrepancy may be due to changes in Treasury notes outstanding, investments or simply rounding. Most figures are quoted in billions.

The $9bn figure for 2011-12 is very low. As Figure 6 shows, there is nearly as much net issuance planned between now and 30 June as in the entirety of 2012-13. The projected 2012-13 net issuance is well down on the revised total for 2011-12 of $44bn (included in the budget).

To meet the need to issue bonds in 2011-12, the AOFM announced on Friday that they would return to two auctions per week (Wednesday and Friday).

The AOFM also indicated, as we had expected, that a new 2024 bond would be issued sometime in the first quarter of 2012-13 (i.e. the September quarter). Slightly surprisingly, the AOFM indicated that the second new bond line in 2012-13 is also likely to be a very long, 15Y, bond line. We have assumed the new 15Y is a 2028. (See Figures 6 and 7.)

The Government committed to keeping $10bn of Treasury notes on issue at all times to maintain liquidity, despite the surplus. This is, in all likelihood, a practical necessity. Multiple ACGB bond lines now exceed $10bn on issue and some are near $15b. The intra-year cash flows of the AOFM will probably still be quite lumpy for a time yet. Until the Government builds a large volume of "savings" (previous surpluses), the AOFM will likely need to issue Treasury Notes to manage the lumpiness of the cash flows.

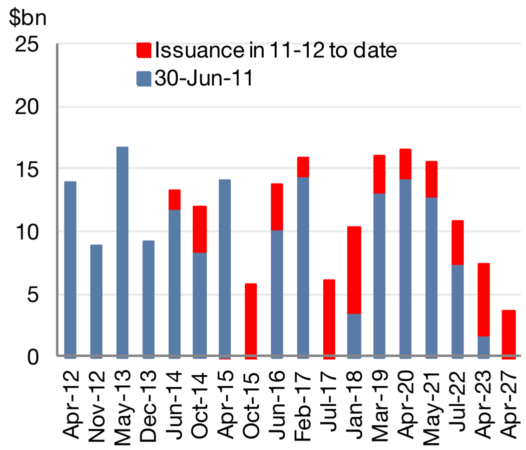
Long-term impact on market pricing

Long-term, the reduced net supply will increase swap spreads.

As we flagged some months ago, it's also worth noting that the fiscal tightening and Australia's safe-haven status may well be lowering the term premium for Australian bonds. We can already see that shorter-dated paper is trading below levels we would normally associate with cash rate expectations (Figure 9). Swap spreads also appear to be holding wider than our usual indicators of financial risk would indicate (Figure 10).

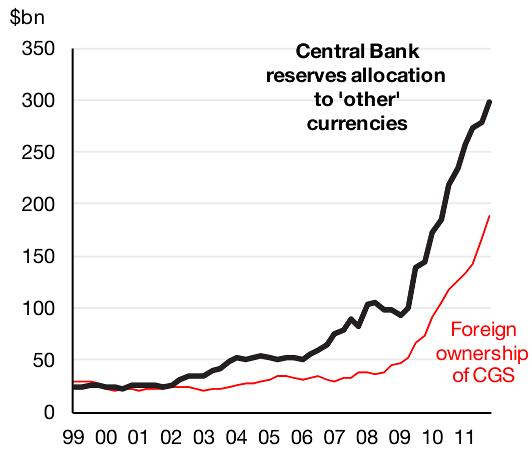
A steeper curve is not conducive to tighter swap spreads either, though household and corporate hedging flows are a much less important driver of swap spreads now than prior to the GFC. We may see receiving pressure from those investors caught on the hop by last week's RBA rate cut, but, overall, we expect

Figure 7: 2011-12 Issuance to Budget



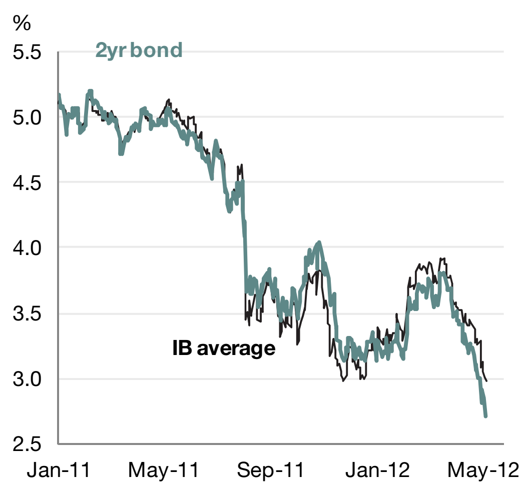
Source: CBA, AOFM

Figure 8: Foreign ownership of CGS



Source: RBA, IMF, CBA

Figure 9: Coverage Ratios of bond tenders



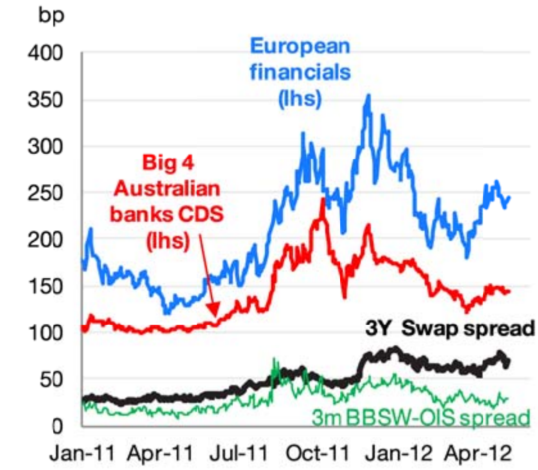
Source: CBA, Bloomberg

only a gradual tightening of swap spreads from here.

ead

The reduced supply of Australian bonds should help the Aus-US 10Y bond spread to keep tightening. Our recent new forecasts suggest the spread can get as tight as 150bp by June and 130bp by December. This contraction is mostly predicated on the recovery in the US, but the reduced supply of bonds helps too.

Figure 10: Swap spreads vs financial risk



Source: CBA, Bloomberg

The AAA Rating is secure

Both S&P and Moody's quickly commented that the budget did not affect Australia's AAA rating. We did not expect it would, given that the budget has long been expected to forecast a return to surplus. Australia has an extremely low level of net debt. Figure 11 shows that key indicators of economic and fiscal health remain consistent with other top tier AAA nations.

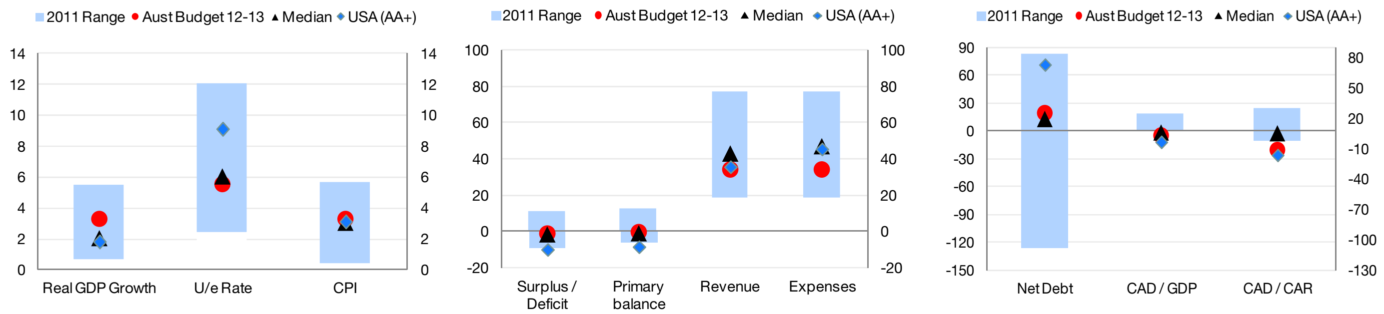
Any risk to Australia's rating is more likely to be in the current account deficit or through the banking system than through government fiscal actions. The Government has revised its forecasts for the current account deficit (CAD)

Figure 11: S&P AAA rating metrics

Economic indicators

Fiscal metrics (% of GDP)

Debt ratios

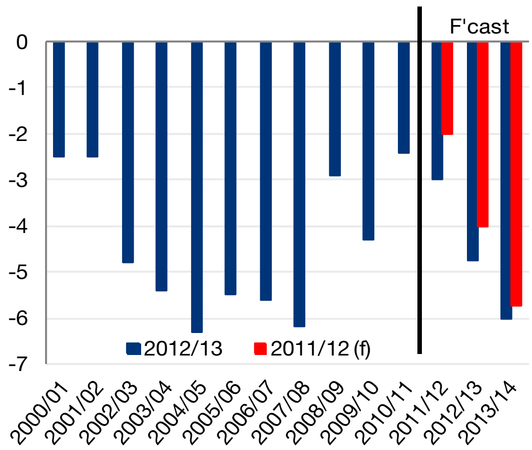


higher in this Budget. It is projected to rise to 4¾% of GDP in 2012-13 and then to 6% of GDP in 2013-14 from under 3% last year. The third panel in Figure 11 shows how this is taking Australia outside of the range previously populated by AAA countries (though not higher than in years gone by).

the

The CAD therefore presents a risk to the rating. The Government is at pains to demonstrate that this largely reflects the nature of the current import-intensive mining boom in Australia, rather than fiscal profligacy. The investment will, of course, deliver an export revenue stream in later years that should result in substantial improvement in Australia's external rating indicators.

Figure 12: Government forecasting a larger current account deficit (FY, % of GDP)



Other (more positive) implications of a larger current account deficit

The Budget revealed a doubling of the Government's forecast for the current account deficit. The Government now expects the current account deficit to rise from 3% of GDP this year to 6% of GDP by 2013-14 (Figure 12).

The public sector will account for less funding of the CAD

The expectation of a wider deficit is primarily driven by a weaker outlook for the trade balance. So the trajectory in Figure 12 isn't particularly surprising, in light of the big trade deficits reported for Q1. The Government essentially projects a continuation of the Q1 trend. A continued fall in the terms of trade should be underpinned by an ongoing decline in key commodity prices. On the other side of the equation, booming resources investment points to a surge in imports.

The funding of the current account deficit is of great interest to debt markets. A projected widening of the deficit adds to Australia's reliance on foreign capital inflows, as savings struggle to keep pace with investment demand.

The more interesting aspect to a wider current account deficit forecast is judging the composition of the attendant foreign financing flows. It's well known that foreigners have been keen buyers of CGS over the last year. Figure 12 shows that these inflows into the Government sector, via the CGS market, were enough to more than fund the current account deficit. Meanwhile, the private sector has taken a back seat as investors have preferred less risky assets and as post-GFC deleveraging ran its course.

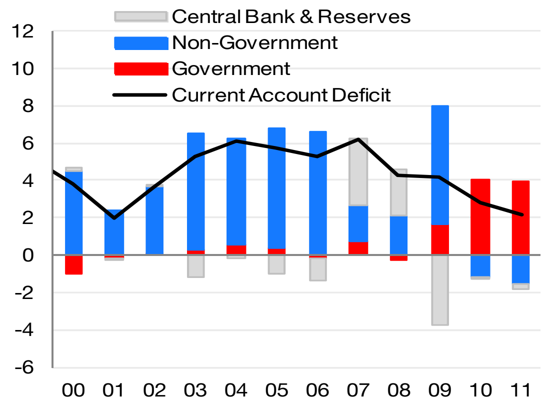
The arithmetic suggests more capital markets issuance into offshore markets in 2012-13

However, over the coming years, the composition of foreign capital inflows is likely to shift more towards the private sector. The Budget clearly points to a step-down in new CGS supply. Net foreign purchases should dissipate given they own 80% of CGS outstanding.

Higher foreign capital flows into the private sector also depend on borrowing requirements of various private borrowers. Figures 13 and 14 clearly show that banks were the main source of foreign investment flows for most of the last decade. But that issuance has slumped due to tepid loan growth and greater reliance on deposit funding for regulatory and ratings reasons. Notwithstanding the recent surge in covered bond issuance, it's not clear that the banking sector will quickly regain its place as the main destination for foreign investment inflows. Deposits are not only rising as a consequence of Basel 3 regulation. A rapid increase in household savings is also playing a role in driving the surge in deposit funding by banks (Figure 15).

In the absence of stronger Government and bank issuance, a greater portion of the current

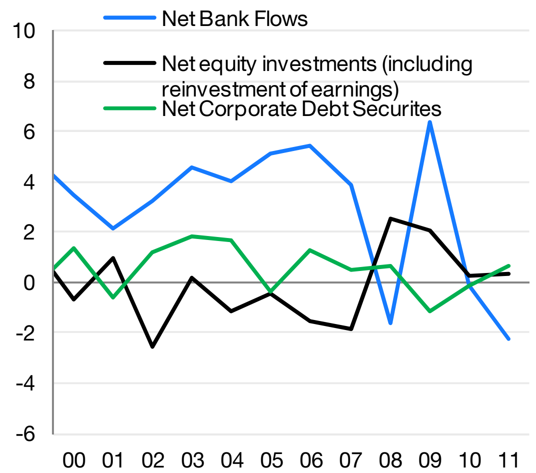
Figure 13: Net capital account inflows (year end, % of GDP)*



Source: CBA, ABS

**Includes net derivatives*

Figure 14: Private net capital inflows (year-end, % of GDP)*

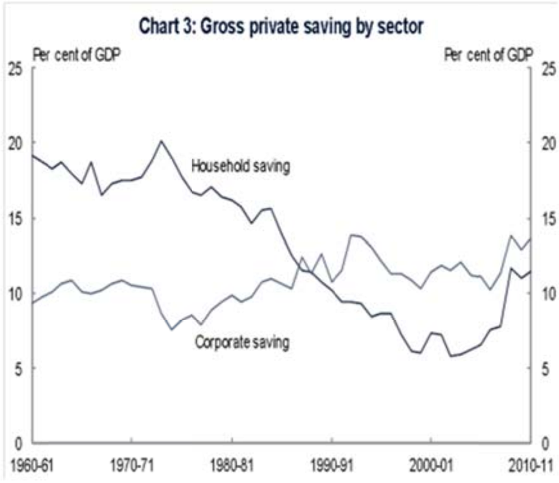


Source: CBA, ABS

**Bank flows Include derivatives*

account financing task falls to equity investments and other net corporate bond issuance. Net equity investment inflows could increase to fund the mining investment boom (through retained earnings). But, based on the trend apparent over recent quarters, we think there will be scope for corporate bonds to play an even greater role in financing Australia's current account deficit.

Figure 15: Household savings on the rise



Source: Budget papers

Table: Funding Requirement and Debt Issuance

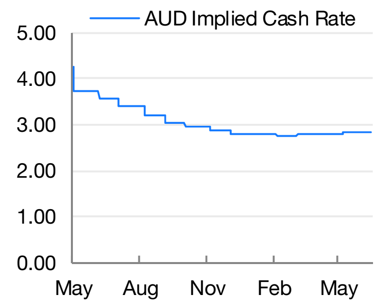
	2006/07 (a)	2007/08 (a)	2008/09 (a)	2009/10 (a)	2010/11 (a)	2011/12 (a)	2012/13 (f)	2013/14 (f)	2014/15 (f)	2015/16 (f)
NET FUNDING REQUIREMENT:										
Headline Budget deficit	-26.7	-28.2	31.3	56.5	51.1	48.4	8.7	6.8	0.1	-2.0
Bond maturities	6.1	2.9	5.1	7.9	18.8	14.1	25.6	22.6	26.8	23.9
Other redemptions	0	0.2	0.0	2.8	0.0	0.0	0.0	0.0	0.0	0.0
Miscellaneous	-0.1	0.1	0.1	0.1	0.1	0.1	2.5	0.1	0.1	0.1
Sub Total	**-20.7**	**-25.0**	**36.5**	**67.3**	**70.0**	**62.6**	**36.8**	**29.5**	**27.0**	**22.1**
Investments	24.4	20.8	17.3	0.0	-5.0	-1.0	0.0	0.0	0.0	0.0
Deposits at RBA	1.6	9.1	-3.0	-7.0	-2.6	0.0	0.0	0.0	0.0	0.0
Total	5.3	4.9	50.8	60.3	62.4	61.6	36.8	29.5	27.0	22.1
FINANCED BY										
Debt issuance										
- Treasury bonds	5.2	5.0	34.1	53.7	56.0	58.0	34.8	27.0	25.5	17.1
- Indexed bonds				7.1	3.4	2.0	2.0	2.5	2.5	2.5
- Treasury notes (net)			16.7	-6.1	6.0	0.3	0.0	0.0	0.0	0.0
Total	**5.2**	**5.0**	**50.8**	**54.7**	**65.4**	**60.3**	**36.8**	**29.5**	**28.0**	**19.6**
- net change	-0.9	2.1	45.7	45.9	45.8	46.2	11.2	6.9	1.2	-4.3
MEMO:										
Coupon bonds outstanding	47.2	49.4	78.4	124.7	161.1	206.0	215.2	219.6	218.2	211.4
Indexed linked bonds	6.0	6.0	6.0	11.4	14.0	16.0	18.0	20.5	23.0	25.5
Treasury Notes			16.7	11.0	16.1	16.4	16.4	16.4	16.4	16.4
Commonwealth holdings	5.0	5.0								
Total	**53.2**	**55.4**	**101.1**	**147.1**	**191.2**	**238.4**	**249.6**	**256.5**	**257.6**	**253.3**
Net debt	-29.2	-44.8	-16.1	42.3	84.6	142.5	143.3	144.9	140.1	131.6

Source: Budget Papers, AOFM, RBA, CBA estimates

Cash Rate Pricing

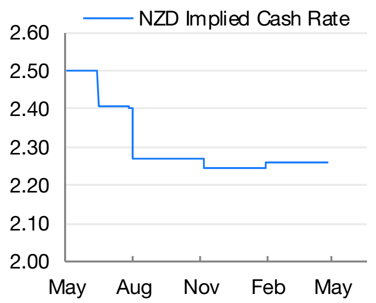
Australian Cash Rate Pricing

	Rate	Cum. % chance of +25bp
Current	3.75	0
5-Jun-12	3.58	-267
3-Jul-12	3.39	-343
7-Aug-12	3.18	-427
4-Sep-12	3.03	-488
2-Oct-12	2.94	-524
6-Nov-12	2.87	-554
4-Dec-12	2.80	-582
5-Feb-13	2.75	-599
5-Mar-13	2.80	-581



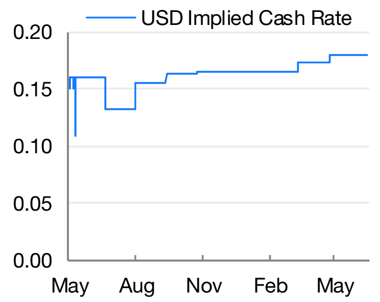
New Zealand OCR Pricing

	Rate	Cum. % chance of +25bp
Current	2.50	0
14-Jun-12	2.40	-38
26-Jul-12	2.40	-39
1-Aug-12	2.27	-92
7-Nov-12	2.25	-101
31-Jan-13	2.26	-97



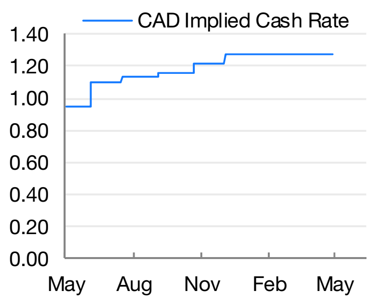
US Fed Funds Pricing

	Rate	Cum. % chance of +25bp
Current	0.16	0
20-Jun-12	0.13	-11
31-Jul-12	0.16	-2
12-Sep-12	0.16	1
24-Oct-12	0.17	2
11-Dec-12	0.17	2
30-Jan-13	0.17	2
13-Mar-13	0.17	5
25-Apr-13	0.18	8
1-Aug-13	0.19	14



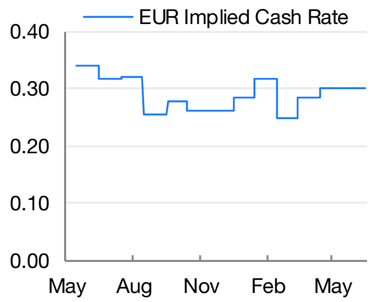
Candian Rate Pricing

	Rate	Cum. % chance of +25bp
Current	0.95	0
5-Jun-12	1.10	58
17-Jul-12	1.13	73
5-Sep-12	1.15	81
23-Oct-12	1.22	106
4-Dec-12	1.28	131
6-Sep-13	1.28	131



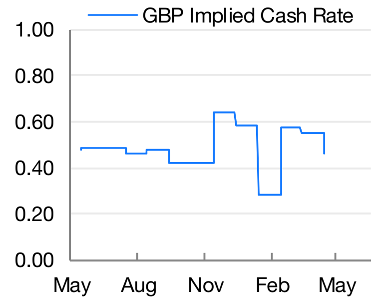
EUR EONIA Pricing

	Rate	Cum. % chance of +25bp
1W repo	0.13	
6-Jun-12	0.34	82
5-Jul-12	0.32	73
2-Aug-12	0.32	75
6-Sep-12	0.26	49
4-Oct-12	0.28	57
8-Nov-12	0.26	52
6-Dec-12	0.26	51
7-Feb-13	0.25	73
7-Mar-13	0.28	46



UK SONIA Pricing

	Rate	Cum. % chance of +25bp
Current	0.48	0
7-Jun-12	0.48	0
5-Jul-12	0.48	0
2-Aug-12	0.46	-8
6-Sep-12	0.48	-2
4-Oct-12	0.42	-23
8-Nov-12	0.42	-24
6-Dec-12	0.64	63
27-Jan-12	0.47	-3
15-May-13	0.46	-8



Source: All data sourced from Bloomberg. Rates displayed are calculated using IB Futures (Australia), FF Futures (US) and OIS in all other currencies.

CBA Forecasts:

Cash rate	14-May	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
US	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Australia	3.75	3.75	3.50	3.50	3.50	3.50	3.50	3.50
New Zealand	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.50
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Germany	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Canada	1.00	1.00	1.00	1.00	1.25	1.25	1.50	1.75
2-yr bond yield	**14-May**	**Jun-12**	**Sep-12**	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**
US	0.26	0.25	0.30	0.35	0.40	0.60	0.80	1.00
Australia	2.67	2.70	2.70	2.80	2.90	3.00	3.10	3.20
New Zealand	2.58	2.50	2.40	2.50	2.70	2.80	3.20	3.70
United Kingdom	0.40	0.40	0.50	0.50	0.60	0.80	1.00	1.30
Germany	0.09	0.10	0.20	0.30	0.40	0.60	0.80	0.90
Japan	0.11	0.10	0.15	0.20	0.20	0.25	0.25	0.30
Canada	1.30	1.20	1.20	1.30	1.30	1.40	1.60	1.80
10-yr bond yield	**14-May**	**Jun-12**	**Sep-12**	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**
US	1.82	2.00	2.20	2.50	2.70	2.90	3.00	3.20
Australia	3.28	3.50	3.60	3.80	3.85	3.90	3.95	4.00
New Zealand	3.75	3.80	4.00	4.10	4.20	4.40	4.50	4.60
United Kingdom	1.96	2.00	2.10	2.20	2.30	2.50	2.60	2.60
Germany	1.50	1.50	1.60	1.80	1.90	2.10	2.20	2.40
Japan	0.85	0.90	1.00	1.10	1.10	1.10	1.20	1.20
Canada	1.97	2.20	2.40	2.60	2.80	3.00	3.00	3.00

Currencies	14-May	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
AUD/USD	1.00	1.08	1.08	1.09	1.10	1.08	1.08	1.08
AUD/JPY	80.13	91.80	97.20	100.28	104.50	102.60	102.60	102.60
AUD/EUR	0.78	0.85	0.82	0.81	0.80	0.80	0.80	0.81
AUD/GBP	0.62	0.69	0.68	0.67	0.67	0.67	0.68	0.68
AUD/CAD	1.00	1.07	1.06	1.06	1.06	1.04	1.05	1.06
AUD/NZD	1.28	1.27	1.26	1.24	1.22	1.23	1.23	1.23
USD/JPY	80.03	85.00	90.00	92.00	95.00	95.00	95.00	95.00
EUR/USD	1.29	1.27	1.32	1.35	1.37	1.35	1.35	1.33
GBP/USD	1.61	1.56	1.59	1.62	1.64	1.62	1.60	1.60
USD/CAD	1.00	0.99	0.98	0.97	0.96	0.96	0.97	0.98
NZD/USD	0.78	0.85	0.86	0.88	0.90	0.88	0.88	0.88

Calendar – May 2012

Monday	Tuesday	Wednesday	Thursday	Friday
Central Bank Meetings AU RBA (1 May) EZ ECB (3 May) UK BOE (10 May) JP BoJ (23 May) CA Bank of Canada (5 June) NZ RBNZ (14 June) US FOMC (20 June)	1 **AU AI-Group PMI, Apr, Index, (49.5)** **AU RP Data house prices, Mar, m%ch, (0.2)** **AU ABS House price index, QI, q%ch, (-1.0)** **AU RBA cash rate, %, 4.00, (4.25)** **AU 2012/13 Vic State Budget** **AU 2012/13 NT State Budget** NZ Avg Hourly Earnings, QI, q%ch, (0) NZ Labour Cost - Priv Sect, QI, q%ch, (0.7) CH PMI Manufacturing, Apr, Index, (53.1) UK PMI manufacturing, Apr, Index, (52.1) US ISM manufacturing, Apr, Index, (53.4) US Total vehicle sales, Apr, mn, (14.3)	2 EU Unemployment rate, Mar, %, (10.8) EU/GE PMI manufacturing, Apr, Index, (46/46.3) UK PMI construction, Apr, Index, (56.7) UK Net consumer credit, Mar, £bn, (0.4) US Factory orders, Mar, m%ch, (1.3)	3 **AU CBA/Ai-Group Perf of Serv Index, Apr, Index, (47)** NZ Employment growth, QI, m%ch, (0.1) NZ Unemployment Rate, QI, %, (6.3) CH Non-Manuf PMI Apr, Index, (58) EU PPI, Mar, m/y%ch, (0.6/3.6) EU ECB announces interest rate, %, 1.00, (1.00) UK PMI services, Apr, Index, (55.3) US ISM non-manufacturing, Apr, Index, (56)	4 **AU RBA Statement on Monetary Policy, May** EU PMI services/composite, Apr, Index, (47.9/47.4) EU Retail sales, Mar, m/y%ch, (0.0/-2.1) GE PMI services, Apr, Index, (52.6) US Non-farm payrolls, Apr, '000, (120) US Unemployment rate, Apr, %, (8.2) US Avg hrly earnings, Apr, m/y%ch, (0.2/2.1)
7 **AU Ai-Group PCI, Apr, Index, (36.2)** **AU Build approv, Mar, m%ch, 2.0, (-7.8)** **AU NAB Bus conf/cond, Apr, Index, (3/4)** **AU ANZ Job ads, Apr, m%ch, (1.0)** **AU Retail trade, Mar, m%ch, 0.4, (0.2)** **AU Retail sales ex inflation, QI, q%ch, 1.0, (0.4)** GE Factory orders, Mar, m/y%ch, (0.3/-6.1) US Consumer credit, Mar, $bn, (8.7) CA Building permits, Mar, m%ch, (7.5)	8 **AU Trade balance Mar, $bn, -2.0, (-0.5)** **AU 2012/13 Federal Budget** GE Industrial production, Mar, m/y%ch, (-1.3/-1.0) UK RICS house price balance, Apr, %, (-10.0) CA Housing starts, Apr, '000, (215.2)	9 NZ Credit card spending, Apr, m%ch, (-0.2) JP Leading / Coincident Index, Mar, Index, (96.3/95.0) GE Trade bal, Mar, €bn, (14.7) US Wholesale inventories, Mar, m%ch, (0.9)	10 **AU Labour Force, Apr** **employment, '000, 5.0, (44.0)** **unemployment rate, %, 5.2, (5.2)** **participation rate, %, 65.4, (65.4)** NZ Business PMI, Apr, Index, (54.5) CH Trade balance Apr, US$bn, (5.4) JP Curr a/c total/adjusted, Mar, ¥bn, (1177.8/854.1) EU ECB Monthly report, May UK Industrial production, Mar, m/y%ch, (0.4/-2.3) UK Total trade balance, Mar, £bn, (-3.4) UK BoE announces rates, %, 0.50, (0.50) US Trade balance, Mar, $bn, (-46.0) CA Trade balance Mar, C$, (0.3)	11 NZ Food prices, Apr, m%ch, (-1.0) CH PPI/CPI, Apr, y%ch, (-0.3/3.6) CH Industrial production, Apr, y%ch, (11.9) CH Retail sales, Apr, y%ch, (15.2) EU Euro Commission economic outlook released, May GE CPI, Apr UK PPI Input/Output/core, Apr, y%ch, (5.8/3.6/2.5) US Producer price index Apr, m/y%ch, (0/2.8) US Uni. Of Michigan confidence, May, Index CA Net change in employment, Apr, '000, (82.3) CA Unemployment rate, Apr, %, (7.2)
14 **AU Housing Finance, Mar** **No. of own-occupiers, %, -2.0, (-2.5)** **Value of all loans, %, -1.0, (-4.0)** **AU RBA Dep.Gov. Lowe speaks in Melbourne** NZ PSI, Apr, Index, (53.9) NZ Retail sales ex inflation, QI, q%ch, (2.2) JP Domestic CGPI, Apr, m/y%ch, (0.6/0.6) EU Industrial production Mar, m/y%ch, (0.5/-1.8)	15 **AU RBA Board Minutes, May** **AU Motor veh. sales, Apr, m/y%ch, (4.0/4.0)** JP Industrial production, Mar JP Consumer confidence, Apr, Index, (40.3) EU GDP, QI, q/y%ch, (-0.3/0.7) EU/GE ZEW survey (econ. sentiment), May, (13.1/23.4) GE GDP, QI, q%ch, (-0.2) US CPI, Apr, m/y%ch, (0.3/2.7); Core, m/y%ch, (0.2/2.3) US Empire manufacturing, May, Index, (6.6) US Retail sales, Apr, m%ch, (0.8) US Business inventories, Mar, m%ch, (0.6) US NAHB housing market index, May, Index,(25)	16 **AU MI/WBC Consumer Sent, May, Index, (94.5)** **AU WPI QI, q/y%ch, 0.9/3.6, (1.0/3.6)** JP Machine orders, Mar, m/y%ch, (4.8/8.9) EU CPI, Apr, m%ch, (1.3); Core, y%ch, (1.6) EU Trade balance Mar, €bn, (3.7) UK ILO unemployment rate (3mths), Mar, %, (8.3) UK Bank of England Inflation Report, May US Housing starts, Apr, '000, (654) US Building permits, Apr, '000, (764) US Industrial production, Apr, m%ch, (0) US Capacity utilisation, Apr, %, (78.6) US FOMC Minutes, April	17 **AU MI Unemp.Expt, May, Index, (142.3)** **AU MI Consumer Inflation Expectat, May, %, (3.3)** **AU AWE Feb, q/y%ch, 0.8/3.9, (0.5/4.3)** **AU 2012/13 Tas State Budget** NZ Producer prices, inputs/outputs, QI, q%ch, (0.5/0.1) JP Housing loans, QI, y%ch, (2.2) JP GDP, QI, q%ch, (-0.2) JP Capacity utilisation, Mar, m%ch, (-1.7) US Philadelphia Federal Index, May, Index, (8.5) US Leading indicators, Apr, m%ch, (0.3) CA Wholesale sales, Mar, m%ch, (1.6)	18 GE Producer prices, Apr, m/y%ch, (0.6/3.3) CA CPI, Apr, m/y%ch, (0.4/1.9)
21 NZ Credit card spending, Apr, m/y%ch, (0.3/5.2) EU Construction output, Mar, m/y%ch, (-7.1/-12.9)	22 EU OECD Economic outlook, May UK CPI, Apr, m/y%ch, (0.3/3.5); Core, y%ch, (2.5) US Richmond Fed, May, Index, (14) US Existing home sales, Apr, mn/m%ch, (4.48/-2.6)	23 **AU DEWR skilled vacancies, Apr** JP Trade bal total/adj, Apr, ¥bn, (-82.6/-621.3) JP BoJ target rate EU Current account, Mar, €bn, (-1.3) UK Bank of England minutes, May US New home sales, Apr, '000/m%ch, (328/-7.1) CA Leading indicators, Apr, m%ch, (0.4) CA Retail sales, Mar, m%ch, (-0.2)	24 **AU HIA Housing Affordability Index, QI, Index, (58.5)** NZ Trade balance, Apr EU PMI services/composite/manufacturing, May, Index GE GDP, QI GE PMI services/manufacturing, May, Index GE IFO - Business climate, May, Index, (109.9) UK Retail sales, Apr, m/y%ch, (1.8/3.3) UK GDP, QI, q/y%ch, (-0.2/0.0) UK Total bus investment, QI, q/y%ch, (-3.3/1.6) US Durable goodes orders, Apr, m%ch, (-4.2)	*25* JP CPI, Apr US Uni. Of Michigan confidence, May, Index
28 **AU RBA Gov. Stevens speaks in Sydney**	29 **AU HIA new home sales Apr** JP Retail sales, Apr GE CPI, May US S&P/Case-Shiller home price index, Mar, (134.2) US Dallas Fed, May	30 **AU Retail trade, Apr** **AU Prelim. construction work done, QI, q%ch, 1.0, (-4.6)** NZ Building permits, Apr GE Retail sales, Apr UK Net consumer credit, Apr US Pending home sales, Apr CA Teranet House Prices, Mar, y%ch, (6.1)	31 **AU Building approvals, Apr** **AU Capex, QI, q/y%ch, 3.0/24.3, (-0.3/30.0)** **AU Private sector credit, Apr** **AU 2012/13 SA State Budget** NZ NBNZ Business confidence, May JP Industrial/Vehicle production, Apr JP Construction orders/Housing Starts, Apr US GDP, QI CA Current account, QI, CA$, (-10.3)	***Early June*** AU Business Indicators, QI 2012 (4 June) AU RBA cash target, June (5 June) AU Balance of Payments, QI 2012 (5 June) AU GDP, QI 2012 (6 June) AU Labour Force, May (7 June) AU Trade Balance, April (8 June) AU Housing Finance, April (8 June)

Note: Figures in brackets represent previous result (if available). All information is preliminary and subject to revision. Chief Economist: Michael Blythe ph: 9118-1101 Economist: James McIntyre: 9118-1100

Key Views

United States

	Tactical (<1 mth)	**Strategic** (>3 mths)
Policy rate	0.1%	0.1%
10yr bond	1.70%	2.10%
2/10 curve	175bp	185bp
USD/JPY	80.00	83.00
EUR/USD	1.2700	1.3000

The US data has hit a soft patch, but the overall trend still seems to be pointing to recovery. Despite the weaker payrolls print, the unemployment rate continues to trend down, having fallen from 9.0% last September to 8.1% in April. US inflation remains stronger than Fed forecasts limiting room for breakevens to fall and putting a floor under yields..

The FOMC has slightly lowered their unemployment forecasts, raised 2012 GDP forecasts and increased CPI forecasts, but did not change the forward guidance on rates. The Fed does not expect to tighten rates until the end of 2014. Amid a recovery, that stance points to strong performance by risky assets, ultimately at the expense of defensive bonds. The market should start to question the appropriateness of Fed policy at some point. The performance of bonds over March indicates how quickly US bond yields can shift higher once the mood starts to turn.

As the main safe haven currency, the USD is likely to trend higher again this week reflecting the concerns over the global economy. Chinese economic data has been soft in April, while concerns about Eurozone continue. Over coming months we expect two key themes to support a firmer USD: (1) Uncertainty stemming from the Eurozone should maintain a level of USD support; and (2) The US economy is out-performing most of the G7, such as the Eurozone, UK and Japan. Despite the recent re-strengthening in JPY, over the longer-term we expect JPY to resume its drift lower, as the JPY adjusts to various structural factors.

Australia

	Tactical (<1 mth)	**Strategic** (>3 mths)
Policy rate	3.75%	3.50%
10yr bond	3.20%	3.60%
3/10 curve	80bp	85bp
10yr EFP	80bp	80bp
10yr v US	150bp	140bp
AUD/USD	0.9800	1.0300

The RBA cut rates by 50bp in May, citing a lower inflation outlook. The banks have not passed on the full amount, but mortgage rates have now dropped appreciably compared to October and so have met the criteria set down by the RBA in the May Statement. We expect the RBA to step back and watch further incoming data, before cutting again in August.

The potential for further rate cuts later in 2012 and capital flight from Europe will keep Australian bonds well bid. Bonds look expensive versus the cash-rate outlook, but seem unlikely to sell-off until the European situation settles. We look for the 10Y AUS-US spread to narrow and for the slope of the curve to range-trade.

We believe AUD/USD may fall below parity in the short-term. The uncertainty of the European governments' commitment to austerity following elections in France and Greece is likely to weigh on investor risk appetite. In addition, recent Chinese economic data has been softer than expected. In response, the People's Bank of China has cut the required reserve ratio (RRR) for the second time this year, by 50bpt. Concerns about global growth are negative for AUD/USD. However, beyond the near-term weakness, we expect the AUD to be supported by stabilising global growth, particularly in China; and subsequently firm commodity prices, and robust demand for Australian AAA-rated bonds.

New Zealand

	Tactical (<1 mth)	**Strategic** (>3 mths)
Policy rate	2.50%	2.50%
10yr bond	3.70%	4.00%
2/10 curve	110bp	130bp
10yr v US	180bp	200bp
10yr v AU	40bp	50bp
NZD/USD	0.7600	0.8200
AUD/NZD	1.2850	1.2560

The RBNZ recently indicated that conditions have improved, but the relatively high NZD and delays to the Christchurch rebuild mean there is no urgency to hike rates. The weak GDP, low inflation and increased unemployment rate reinforce that conclusion. CBA expects the RBNZ to eventually lift rates, but no hike is likely until at least 2013. For the time being, we expect the market to continue pricing rate cuts.

The RBNZ's key concern at the March and April OCR meetings was the strength in the NZD. The RBNZ highlighted that *"should the exchange rate remain strong without anything else changing, the RBNZ would need to reassess the outlook for monetary policy settings".* NZD has eased over recent weeks, reflecting softer than expected Q1 labour market and retail trade data, as well as softening global dairy prices, and global growth concerns. NZD softness may continue in the short term. However, over the year ahead, we think improvement in the global growth outlook, driven by Asia, should support New Zealand-specific commodity prices. These developments, coupled with reinsurance inflows related to the Christchurch earthquake should support the NZD.

Unless otherwise noted, all data is sourced from Australian Bureau of Statistics material (www.abs.gov.au).

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