



Extract from ANZ Quarterly - Global Outlook

December 2011

Executive Summary

US

The US continues to recover slowly but remains vulnerable to any disruptions in Europe and fiscal drag next year. Its ability to enact important stimulus packages may continue to be hampered by domestic political resistance. We are also cautiously optimistic about Japan's outlook, following solid Q3 GDP growth, a boost from reconstruction and increased resilience to its currency strength. Europe, however, is a serious concern and its outlook has deteriorated sharply in recent months with PMI and other indicators suggesting that a recession is imminent. Political/policy incompetence, an ageing population, increased capital requirements for its banks, and loss of local confidence in the financial system all point towards a protracted slump.

Australia

Australia's reliance on offshore funding means it is susceptible to a global event such as further fracturing in the euro zone (EZ). The concentration of its growth base around resource industries means Australia would also be affected by any further falls in Chinese demand. Recent drops in commodity prices highlight this exposure. We believe Australia's economy will continue to grow despite these risks.

Asia

Economic growth in China has eased and authorities have begun to ease monetary policy. Whether this slowing develops into a hard landing will, to a large extent, depend on policy responses and the performance of a softening property market. We expect China to implement some significant policy reforms in 2012 in response to global and domestic challenges. Interest rate liberalisation, revisiting the deposit rate ceiling and enlarging the RMB trading band would all be welcome reforms.

Emerging Asia is experiencing a slowdown, with European events affecting the region primarily through lower growth and trade and balance of payments financing. Inflation remains high across the region but its momentum is fading, suggesting there will be scope for policy makers to ease settings shortly. In the face of global developments, intraregional trade is reasonably robust and countries like Indonesia continue to outperform.

New Zealand

A range of complementary and conflicting forces continue to play through the NZ economy, only now there is the additional factor of downside risk to the global outlook. This risk could manifest itself in five ways: a crisis of confidence, softening demand from China, changes in commodity prices, changes in the NZD, and higher costs of credit. At present the NZ economy is performing quite well, albeit fitfully, and we forecast it to expand modestly, averaging 2.5% per year for the next two years.

USD

Despite the USD's shaky fundamentals, we expect its current rally to become increasingly broad as the credit crunch gathers steam. Medium-term, however, we still favour a less prominent role for the USD. European issues will affect currency markets via deleveraging European banks, tighter trade finance conditions, possible knock-on weakness in the US, and redemptions. In these circumstances, the outlook for the AUD, KRW, IDR and MYR is weaker, while the USD, CNY, SGD and PHP will all perform relatively well.

Most commodities will have a slow start to 2012 but the medium-to-long-term fundamentals are still solid. Price volatility will continue as there are enough financial unknowns to trigger pockets of risk aversion. Again, much depends on China's policy response to its domestic slowdown.



Handled well, domestic demand will reignite and bulk prices will barely dip.

Our first feature article examines the impact of speculative investment on commodity markets. Commodities have emerged as a genuine investor asset class as investors seek an 'inflation hedge' and greater exposure to emerging markets. This has added an 'equity style' short-term volatility to many exchange traded commodity markets. As a result commodity prices can now be more easily driven away from fundamentals, which create opportunities for investors with a sound knowledge of underlying supply and demand dynamics.

The second feature article identifies the factors that have driven elevated returns in the Australian sovereign bond market and the relatively low volatility in that market. We assess whether these features can be sustained, particularly if there is any intensification of European balance sheet risk.

Ivan Colhoun

Acting Chief Economist, ANZ

Global Outlook

It's (still) all about Europe

Financial markets have become even more volatile over the past three months. Concerns have continued to grow about:

- the sustainability of sovereign finances in a number of European countries;
- the slow policy progress toward a solution; and
- the potential for a disorderly resolution, with severe consequences for already weakened economies and financial systems in other advanced economies.

Reflecting these concerns, bond yields have declined sharply except in European countries where markets are questioning the sustainability of sovereign debt. Commodity prices have also generally fallen, with the exception of oil, while interestingly, equity markets have been volatile about a mainly flat trend. Late in the quarter these uncertainties saw pressures re-emerge in funding markets with issuance volumes declining and pricing deteriorating. There was continuing commentary about the potential for countries to exit the Euro or the complete demise of the Euro. Is the world on the cusp of a second global financial crisis (GFC)? There are a number of scary parallels to 2007-08, but also a number of important differences, at least to date. The most obvious parallels are:

- the existence of a significant and in both cases slowburning negative economic and financial shock (namely the sub-prime crisis in 2007-08 and the sovereign debt crisis of 2010-11);

- and the extent to which the Chinese economy in particular, but other large parts of the globe also, remained decoupled from the initial negative developments in the US and European economies. The 'scariness' of the current situation is no doubt amplified by the relative lack of room to manoeuvre on both monetary and fiscal policy in the major advanced economies.

Things to watch

Global growth remains desynchronised relative to 2008-09, with the US and Japan recovering.

Downside risks continue to mount in Europe with the region and the world at risk of a disorderly financial shock. China's growth is also slowing.

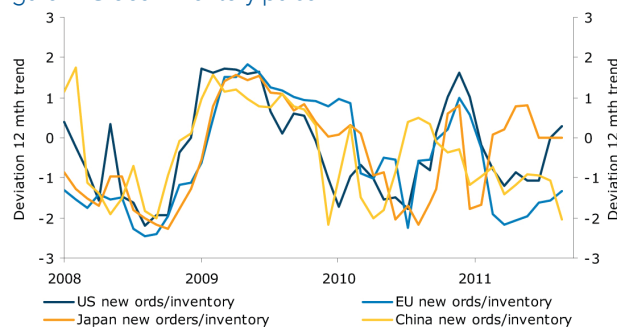
Bond and credit markets have the greatest ability to desynchronise markets and economies to the downside.

However, there are a number of important differences so far compared to 2007-08. These include:

- Global growth is considerably less synchronised than during the GFC (see Figure 1). While European indicators have clearly weakened and China's economy is slowing moderately, the US economy continues to recover, (albeit more slowly than desired by the authorities), while the Japanese economy is being boosted by reconstruction from the tragic tsunami of earlier this year.

As shown, with inventories generally lean, the ratio of new orders to inventories (a reliable and important lead indicator of the highly cyclical global industrial production cycle) is evolving in a quite different and much desynchronised manner to date than in 2008 across the four major economic regions of the world.

Figure 1. Global inventory pulse



Sources: Bloomberg, ANZ



There are the first signs of a very modest improvement in the US housing market, also an extremely important cyclical sector (Figure 2). Encouragingly we are unlikely to see a repeat of the significant contraction in US housing construction and prices that we saw over 2006-08.

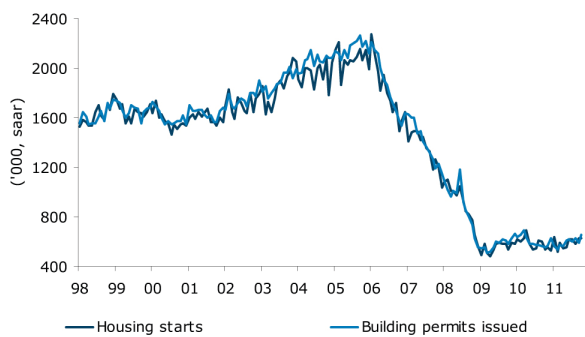
- Corporate profitability remains relatively strong across the globe and especially in the US (Figures 3 and 4); and
- until very recently, funding markets had continued to function though pressures have escalated recently especially for European institutions.

The net result, to date, has been that the deterioration in most leading economic indicators has been significantly less severe than experienced 2008-09, but that European indicators are weak.

The next step is to ask, what were the circumstances and/or transmission mechanisms that caused the downturn during the GFC to become synchronised and consequently deeper? And what are the risks of a re-run of this experience?

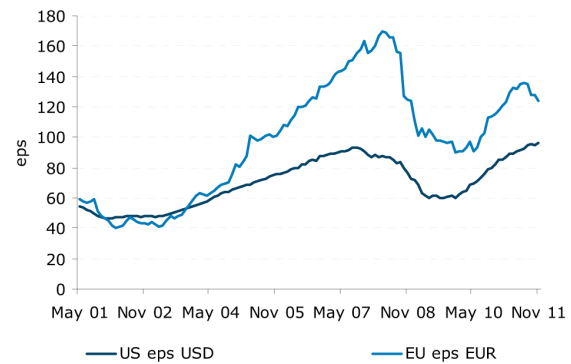
As most of the previous charts have shown and as Figure 5 illustrates, the collapse of Lehman Brothers, and the associated spike in funding pressures, were the two key events that synchronised negative financial market and economic momentum globally in 2008 and caused the sharp retrenchment in activity in Q3 and Q4 of 2008. Figure 6 shows the substantial deterioration in global PMIs after the September 2008 collapse of Lehman Brothers.

Figure 2. US housing permits



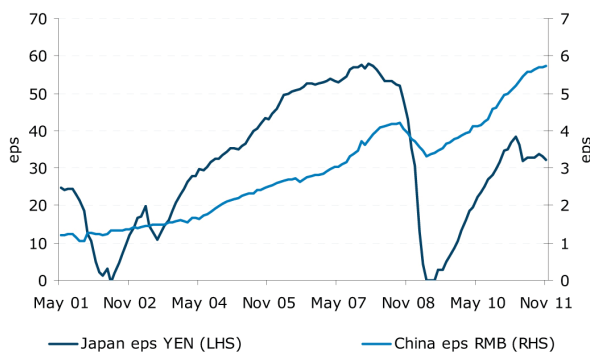
Source: Datastream

Figure 3. Corporate profitability



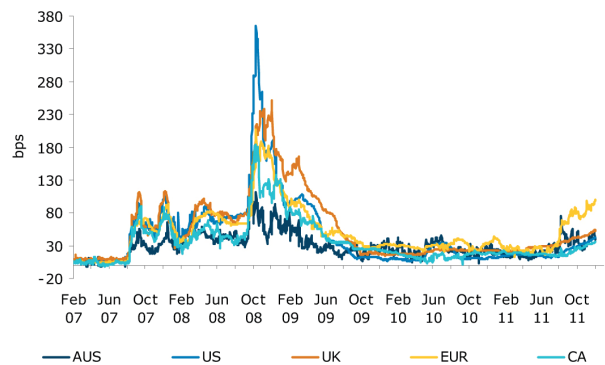
Source: Datastream

Figure 4. Corporate profitability



Source: Datastream

Figure 5. Three month swap versus OIS



Source: Bloomberg

At face value, and as argued in the G3 outlook and other sections of this report, there are grounds for cautious optimism considering how the macroeconomic data is evolving. However, attention must be paid to developments in sovereign debt yields and funding as it was the financial linkages and contagion that ultimately proved so damaging to growth in the second half of 2008. In light of this, the beginnings of the recent sell-off in former safe haven long bond markets is troubling (Figure 7). Equally, a continuing slowdown in Chinese growth is a worrying signal of what may be ahead.

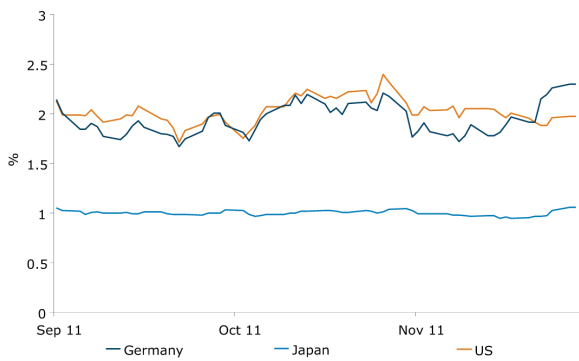
Despite all of the above, the Australian and New Zealand economies continue to perform relatively well, largely due to low

levels of net government debt and record commodity prices. Markets in Australia however are discounting further significant interest rate easing, implicitly factoring a major negative credit and economic shock. New Zealand markets have also moved to fully discount a further interest rate reduction by the RBNZ.

Taken together, the outlook remains relatively challenging. Markets and economies will remain volatile for the foreseeable future, until a more satisfactory resolution can be achieved in Europe.

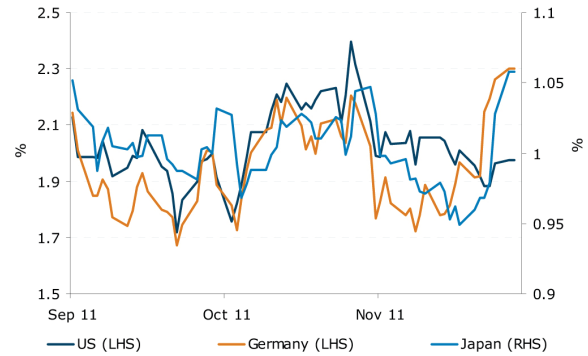
Source: ANZ Economics & Global Markets Research.

Figure 6. PMIS around Post Lehman's collapse



Source: Bloomberg

Figure 7. 10 year bond yields



Source: Bloomberg

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