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Economics, Commodities and Markets

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CONTENTS

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EXECUTIVE SUMMARY

GLOBAL OUTLOOK

For the global economy, 2013 is expected to represent a medium-term cyclical low point for growth, while at the same time marked the start of a synchronised recovery in the advanced economies. We expect economic activity to accelerate in 2014 and 2015, largely on the back of stronger growth in the G3. Although some emerging economies have come under pressure in 2013 and early 2014, we expect stable-to-stronger growth in 2014.

G3 OUTLOOK

Our core view remains that the fundamental backbone of the US economy is strengthening as the balance sheets of both households and government improve. Although the US economy slowed sharply in late 2013/early 2014, we expect this is primarily weather related. The European economic recovery is becoming more sustainable as it is broadening by both expenditure drivers and geography. However, we expect the recovery is likely to remain fragile. A key risk facing Europe is the prospect of further disinflation or deflation. Japan should achieve good economic growth this year but the government needs to focus on structural reform to enhance and sustain long-term growth prospects.

AUSTRALIA OUTLOOK

The transition of growth from mining investment to non-mining growth drivers is now underway. Interest rate sensitive sectors are picking up and the lower AUD is also helping to support domestic spending, assisted by stronger global growth. Prospects for a recovery in non-mining business investment are also improving, however, the timing of a turnaround remains a key uncertainty.

CHINA OUTLOOK

China's official GDP growth target remains unchanged at 7.5%, but the Chinese authorities said this is a "flexible target". In our view, a 7.5% growth target requires policy easing. However, shadow banking activities could re-emerge if monetary conditions are too relaxed. The CPI inflation target also remains unchanged at 3.5%. As the output gap remains negative, inflationary pressures will likely be manageable this year.

EMERGING ASIA OUTLOOK

The timing of the Lunar New Year and severe weather in the US are currently making it difficult to get a clean read on data. However, we believe underlying momentum is intact and a cyclical upswing is underway in Emerging Asia which will be supported by more even external demand in 2014. Importantly, India and Indonesia appear to have achieved current account deficit stability. However, inflationary pressures are likely to pick up in 2014 and tightening cycles in some Emerging Asia countries are forecast to commence in H2 2014.

NEW ZEALAND OUTLOOK

The New Zealand economy is firmly in a broad-based economic expansion, buoyed by high commodity prices, kind weather, still-low interest rates and an earthquake rebuild. The RBNZ has started lifting the OCR: likely the only developed nation to do so in 2014.

FOREIGN EXCHANGE OUTLOOK

We expect peripheral currencies to underperform against the core over time. In our view, the key driver of peripheral currencies this cycle is the global cost of capital. Two influences in particular have become key: the interest rate structure in the US and China. We expect the USD is likely to be strong against the periphery once US and Chinese interest rates increase.

COMMODITY MARKETS OUTLOOK

Commodity markets started 2014 in a mixed fashion, with seasonality having a greater-than-normal impact. In addition, underlying demand from China has been unconvincing, culminating in a sharp sell-off in copper and iron ore prices in mid-March. However, we expect key Chinese demand to pick up in the second quarter. Moves in China commodity inventories and monthly PMIs will be the best activity bellwethers to watch.

Warren Hogan
Chief Economist, ANZ

GLOBAL UPSWING ON TRACK

A global economic cyclical upswing still appears to be on track in early 2014 despite softer momentum in the US and China at the start of the year. Global growth bottomed in 2013 at 3% and is expected to rebound towards 4% by 2015.

In the past few months, economic data has been mixed in the major economies. In the US a harsh winter has impacted incomes and activity, making it hard to see the cyclical rebound in the monthly data. In Asia, particularly in China, the earlier than normal Lunar New Year celebrations are also playing havoc with recent data.

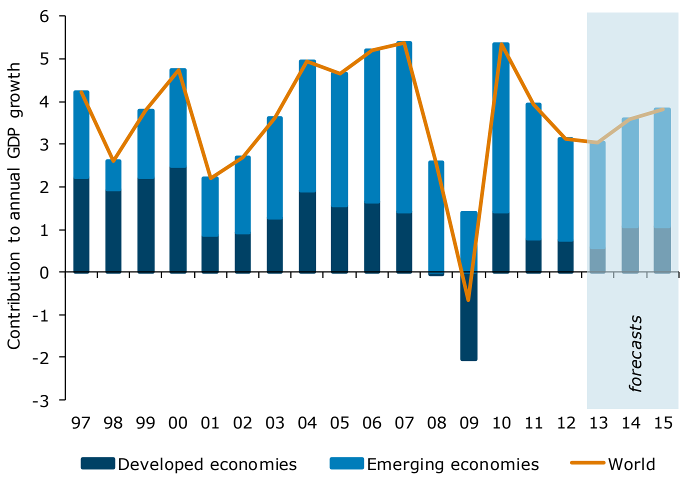
While we are confident that the US recovery remains intact, we are less certain of the trajectory for Chinese growth.

Risks and concerns on the outlook for China are rising. Modernising and deregulating economic structures are a high priority for China's government and we believe the government is committed to the reform process. The financial system is struggling to cope with the large and increasingly sophisticated economy it must serve. Financial reforms are a key focus for the Chinese leadership. Great uncertainty surrounds the shadow banking system and the financial system remains vulnerable to a correction to elevated house prices.

Amid all the uncertainties and reforms across China, the government is committed to maintaining strong growth of around 7.5% to ensure that new entrants to the labour force are given the opportunity to secure employment. To meet the growth target the government will need to ease policy, which in turn could increase systemic risks to the financial system. That said, we are confident that the authorities will be able to manage the financial risks associated with shadow banking activities and rising housing prices.

Increased volatility was a feature of Chinese financial markets in 2013 and we expect this trend to continue in 2014 as authorities move to liberalise their financial sector. This increased volatility will remain a source of anxiety for global financial markets and of course provide fodder for those worrying about a hard landing in China. However, we believe these risks will be effectively managed over the medium term. Our central case remains for economic growth of 7.2% in 2014 and 7.3% in 2015.

FIGURE 1. GLOBAL GDP GROWTH



Source: IMF, Consensus Economics, ANZ Research

Emerging economies (EM) as a whole are weathering the prospect (and actuality) of tighter US dollar liquidity well. While capital flows to EM were volatile in 2013, there wasn't evidence of a generalised economic crisis to these economies. To be sure, some EM have come under pressure. These countries tend to be the ones with poor macro fundamentals and less than prudent policy settings (eg large fiscal deficits and/or large current account deficits). On the other hand, the economies with sound fundamentals and policies seem to be coping well. There is no sign of contagion (or sudden stop) to EM more generally. We expect this to continue to be the case in 2014 based on our view that US 10-year yields (the benchmark for the global cost of capital) should rise just gradually. The adverse risk to this scenario would be that US 10-year yields rise sharply. This could prove highly disruptive to capital flows, particularly to EM.

The two most vulnerable EM Asian economies, India and Indonesia, were under some duress mid 2013 but more recently appear to be adjusting in a more orderly fashion to tighter US dollar liquidity. Policymakers in these vulnerable economies have made sensible adjustments in H2 2013 that seem to have shored up investor confidence and thus limited the risk of disorderly capital flight from these economies. In addition, the two vulnerabilities of twin current account and fiscal deficits are improving due to the pre-emptive policy actions taken over 2013.

The positive economic impact of stronger growth in advanced economies now appears to be flowing through to EM. World trade expanded strongly in the H2 2013 and we expect solid momentum to be maintained in 2014 despite some modest short-term disruption owing to severe weather in the US. This increase in global demand will provide a boost to most EM economies. In the case of Asia, this should reinforce a cyclical improvement in domestic demand.

The economies of Australia and New Zealand also appear to be on track for stronger growth over the next two years. New Zealand's economy is lifting strongly on the back of better global growth and an uptick in domestic construction activity. Indeed, the RBNZ has been the first central bank from an advanced economy to tighten monetary policy this cycle. We expect further interest rate increases in New Zealand over 2014.

In Australia there is increasing evidence of an improvement in non-mining economic activity. Although we still see mining investment dropping considerably over the next two years, we have become more confident that other sectors will offset some of this hole which should see Australia maintain a reasonable rate of economic growth. In recent times we have had signs that this non-mining economic recovery is starting to result in job creation. Forward indicators of labour demand have been improving since late 2013 and the February employment report showed a big lift in employment and upward revisions to past months. We expect the RBA to remain on the sidelines in 2014, with rate hikes likely starting in early 2015.

Warren Hogan
Chief Economist, ANZ

US – HOW FAR FROM NORMAL?

The US economy slowed sharply in late 2013/early 2014 according to a wide range of activity indicators (Figure 1). Some loss of momentum was to be expected given that an unsustainable inventory build-up bolstered growth in the H2 2013. However, the extent and breadth of the slowing has been far more abrupt than many had expected.

Adverse weather is clearly having a detrimental impact. Not only have temperatures been well below long-term averages, the amount of snowfall has been above normal levels. Both these factors have had a disruptive influence on activity across both geography and industry. In the Fed's latest Beige Book it was clear that severe weather was having a negative impact across the country. The report mentioned that the weather was causing significant supply-chain disruptions. Thus the impact of the weather could be lasting, making it more challenging than usual to assess the underlying pulse of the US economy in the coming months.

That said, the fundamental backbone of the US economy is strengthening. In particular, the balance sheets of both households and the government are getting healthier. This should provide a platform for stronger and more sustained growth than in recent years. We are forecasting growth of 3% this year, a step up from the tepid 2¼% average since the end of the Great Recession.

Another key development is the USD180bn y/y increase in household debt in Q4 2013. This was the first annual increase in the stock of credit since 2008. The rise in borrowing was driven by a number of factors, including:

> healthier household balance sheets;

> solid employment growth (which is bolstering incomes); and

> less stringent lending standards amid improved creditworthiness.

THINGS TO WATCH

Debate on the amount of spare capacity in the US labour market is rising as the unemployment rate falls. Like the Fed, we think there is still ample spare capacity.

A pick-up in wages will be key as to whether inflation in Japan can lift in a sustained fashion. The Bank of Japan remains some way away from achieving its 2% inflation target.

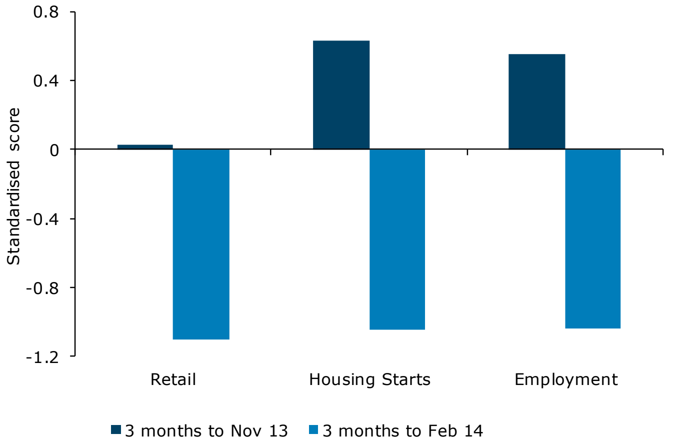
Disinflation risks in the euro area remain high despite euro area growth becoming more balanced.

This outcome is encouraging, even if we assume that households take a cautious approach about accumulating more debt compared to the past. Even if households don't take on extra debt, the meager fact that they aren't deleveraging anymore would remove a major headwind for the economy.

The government sector will also be less of a drag in 2014. As a share of GDP, the fiscal deficit is expected to be 3.0% in 2014, down from 4.1% in 2013 and 6.8% in 2012.

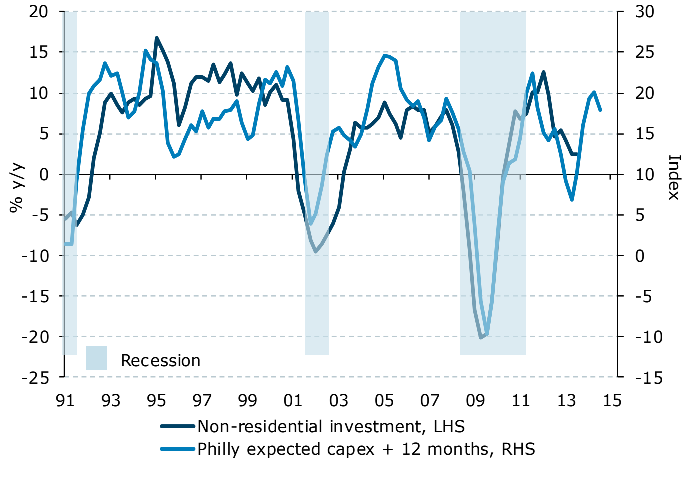
We remain optimistic on investment prospects, both residential and business. On the latter, conditions appear ripe for a pick-up. After years of spending restraint, the US capital stock is growing at the slowest rate in decades. At the same time, businesses are experiencing healthy profit margins and face near-record low borrowing rates. More investment will be required if profitability is to be maintained longer-term. Although forward-looking indicators of capex have been volatile of late, they are pointing to a pick-up (Figure 2).

FIGURE 1. SELECTED ACTIVITY INDICATORS (DEVIATION FROM 12 MONTH TREND) - WEATHER IMPACT?



Source: BEA, ANZ Research

FIGURE 2. US PHILADELPHIA CAPEX INTENTIONS AND NON-RESIDENTIAL INVESTMENT



Source: Bloomberg, ANZ Research

Housing starts remain below the level deemed necessary as implied by the household formation rate. In particular, they are currently running under 1m annualised - about 30% below what is needed. This suggests that residential investment should continue to increase in the coming years. However, the contribution from housing investment to GDP growth is likely to ease relative to the last couple of years. Indeed, it would be hard for housing starts to sustain the 20% y/y rate of growth it averaged over 2012 and 2013.

Residential construction activity is likely to be subpar in the early part of 2014 owing to cold weather. Indeed, housing starts have fallen sharply, pointing to some cooling. This slowing should be temporary and we expect a rebound on better weather.

FED MONETARY POLICY

Expectations about the normalisation of Fed monetary policy are likely to feature prominently this year. The FOMC started the year winding back its asset purchase program (QE3). Fed officials have indicated that further measured reductions (of around USD10bn) can be expected at each meeting this year unless there is a material change to the outlook. This suggests that tapering of QE3 should finish before the end of the year.

The FOMC continues to reiterate that an increase in the fed funds rate (FFR) is some way off. This guidance is based on the Fed's view that the labour market remains far from normal. In other words, the central bank believes there is still a sizeable amount of spare capacity in the labour market. This is based on an assessment of a broad suite of labour market indicators, including a large pool of long-term unemployed, and an elevated number of part-time workers for economic reasons (Figure 3).

There is considerable debate about how much spare capacity the US labour market has. This debate is critical, as a judgment on the amount of spare capacity is an important input for forecasting how the FFR will evolve. In addition, the outlook for growth is also important, as this will determine when this spare capacity is used up.

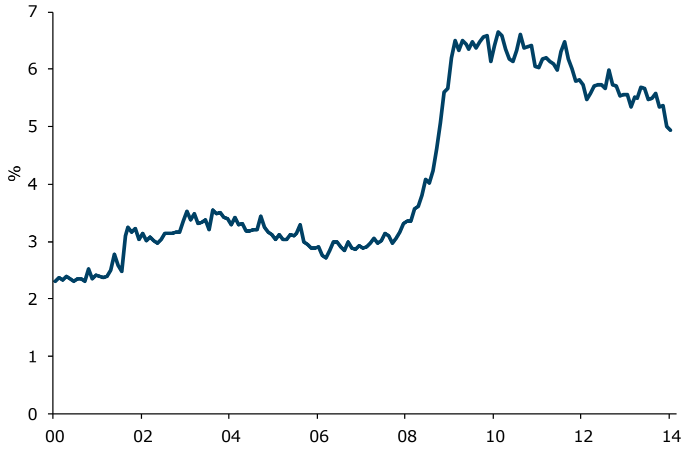
Our central case for 2014 GDP growth (of 3%) is little different to the Fed and Consensus. Thus the judgment on the amount of spare capacity will be the factor differentiating analysts' expectations about the future path of the FFR in 2014.

Measuring the output gap is difficult given it is a nebulous concept. Indeed, how close an economy is to full employment is never really known until after the fact. There are a variety of labour market indicators that analysts look at to determine the size of the output gap. Traditionally these measures look at the deviation between the unemployment rate and the natural rate (NAIRU). However, there is a wide range of unemployment measures to choose from (eg headline, short duration, and the underutilisation rate).

The current headline rate of unemployment (6.7% in February 2014) is only about 1 pp above what is regarded as the natural rate. This suggests the output gap isn't far off from being closed. However, we favour looking at the underutilisation rate to assess the amount of spare capacity. This measure remains far from normal (Figure 4). This suggests the Fed has time on its side before considering any rate rise. However, we are not complacent on this view. We intend to monitor closely not just a suite of labour market indicators, but also a range of inflation and inflation expectation measures. As stated earlier, if history is a guide, closure of an output gap is never clear until the economy is past that point.

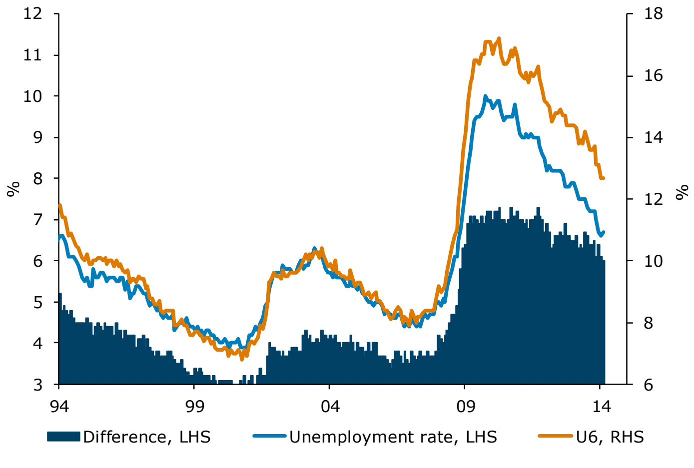
Expectations about the normalisation of Fed monetary policy are likely to feature prominently this year

FIGURE 3. WORKING PART TIME FOR ECONOMIC REASONS (% OF WORKERS)



Source: BLS, ANZ Research

FIGURE 4. UNEMPLOYMENT (U3) AND THE UNDERUTILISATION (U6) RATE



Source: Bloomberg, ANZ Research

JAPAN – WILL WAGES TAKE OFF?

Japan's economy has been accelerating in early 2014 following a brief slowing in H2 2012 (Figure 5). Rushed demand ahead of the increase in the consumption tax rate in April is driving this pick-up. In particular, durable consumption goods (eg cars), housing investment, and industrial production are up sharply. Public spending also continues to rise, largely owing to measures in the government's fiscal stimulus package *Emergency Economic Measures for the Revitalisation of the Japanese Economy*.

Although there is currently a bring-forward of spending there will be a sharp unwind after the consumption tax hike. In addition, longer-term spending will be dampened permanently as the tax hike reduces household purchasing power. Some government officials have expressed anxiety about the extent of the decline in activity just after the increase. These worries reflect the experience of 1997 following the last increase. At that time, the economy slipped into recession (Figure 5). Although some attributed this to the higher consumption tax, there were also a number of other events (eg Asian financial crisis) at that time that had a major negative impact on activity.

In order to safeguard against such an adverse event occurring this time, the government has decided to implement a short-term stimulus plan. The package consists of JPY5.5trn in fiscal spending, and tax expenditure measures of JPY1.0trn. These measures will primarily boost public and private investment and also provide some support to private consumption expenditure. In sum, the package is set to boost real GDP in FY2014 by around 0.8 pp, almost equivalent to the drag to spending from the consumption tax hike.

2014 is likely to be a watershed period for Abenomics that determines the success or otherwise of this strategy in reinvigorating Japan's long-term prospects. In particular, the government needs to elevate the importance and urgency of implementing policy measures related to the third arrow of Abenomics (growth strategy). This arrow is largely about promoting private investment and increasing labour productivity. Both of these are important ingredients for enhancing and sustaining long-term growth prospects.

In late 2013 the government passed legislation key to the Japan Revitalisation Strategy, which was outlined in June 2013. The measures announced in December included:

> Legislation on National Strategic Special Zones,

> The Industrial Competitive Enhancement Act, and

> An amendment to the Electricity Business Act.

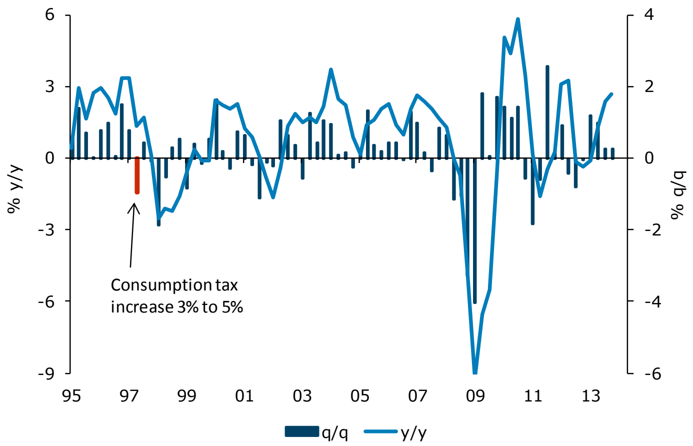
This year the government is expected to focus on the heavily regulated areas of employment, agriculture, and health care.

The first two arrows of Abenomics have already led to an improved environment for business investment. In particular, a weaker yen has improved the profit margins of large multinational companies. In addition, financing conditions for businesses are highly favourable: the equity market has been buoyant, real interest rates have fallen (owing to a sharp lift in inflation expectations), and financial institutions appear to be more willing to lend.

One of the main criticisms directed at Abenomics when it was launched was that the strategy amounted to taking growth off other countries via a weaker JPY. We didn't share that view. Indeed, we have long held the view that if Abenomics is successful in lifting Japan out of its long-term funk, then this would be positive for the global economy.

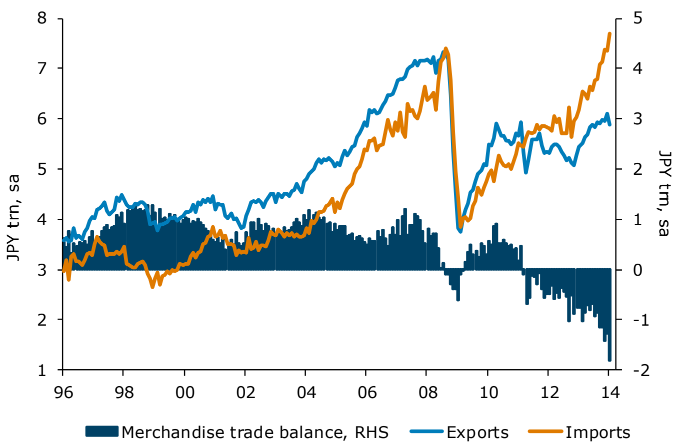
2014 is likely to be a watershed period for Abenomics that determines the success or otherwise of this strategy in reinvigorating Japan's long-term prospects

FIGURE 5. GDP GROWTH



Source: Bloomberg, ANZ Research

FIGURE 6. JAPAN TRADE BALANCE



Source: Bloomberg, ANZ Research

Almost one year on, and after a sizeable depreciation in the JPY, the trade data don't suggest that Japan's exports have benefited from a weaker JPY. Probably the converse is closer to the mark. The trade deficit has blown out (Figure 6) as import values - particularly energy - have risen much more sharply than export values, as the former are more sensitive to changes in the JPY. In addition, Japan's real export volumes have been flat over the past year despite a weaker JPY.

Moreover, we have consistently argued that Japanese producers would continue to stick with their long-term strategy of shifting production offshore. Having a weaker JPY doesn't square with such a strategy. A recent survey from Japan's Cabinet Office *Financial Year 2013 Annual Survey of Corporate Behaviour* shows that businesses have revved up their intentions to boost production offshore even though the JPY has weakened substantially over the past year (Figure 7). This suggests that Japanese firms continue to believe that good investment opportunities lay abroad despite a weaker currency.

Critical to the BoJ's monetary policy outlook this year will be how inflation evolves given the central bank is committed to achieving its 2% target by FY2015. Although inflation and inflation expectations have lifted sharply over the past year, much of this has been owing to JPY weakness and thus is unlikely to be sustainable. In our opinion there are two key elements to the inflation outlook this year: the prospect for demand and the output gap, and wages.

We have our reservations about how much inflation can be generated from either source in the short-to medium-term. Although the output gap is closing, it remains large, thus any demand-led inflation pressures remain some way off.

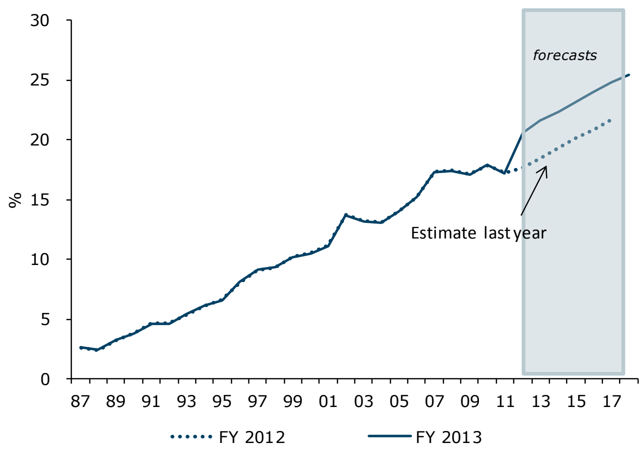
There has been much talk of a pick up in wages and many are hopeful the upcoming Shunto ("spring") wage negotiations can deliver significant wage increases. This may be a possibility for large firms (more than 500 employees) as decent profit margins mean these institutions are well placed to provide wage increases on the order of 2% - 3%. However, these employers only account for 20% of Japan's workforce. Small-to medium-sized firms employ the vast majority of the workforce, and these institutions aren't as well placed to deliver wage increases.

Thus we think wages are unlikely to deliver anything near the quantum increase required to get inflation up near the central bank's 2% y/y price target. As a consequence, the BoJ will be under pressure to adopt further easing measures if it is to achieve its inflation target in its desired timeframe. We expect this pressure to intensify early in H2 2014.

At a minimum, the BoJ will shortly need to provide details on its intentions for asset purchases (and the expansion of the monetary base) in 2015 as the central bank has only provided a timeline out to the end of 2014. This is because the BoJ is committed to continue with its Quantitative and Qualitative Monetary Easing program until its 2% inflation target is achieved. Its current projections do not have this occurring until FY2015.

Our baseline view is for Japan's GDP to grow by 1.8% in 2014 and 1.5% next year. The risks to the view are evenly balanced.

FIGURE 7. PROPORTION OF PRODUCTION DONE OFFSHORE



Source: Cabinet Office, ANZ Research

FIGURE 8. ORDINARY TIME EARNINGS EXCLUDING BONUSES

Source: Bloomberg, ANZ Research

EURO AREA – IMPROVING PROSPECTS, BUT DISINFLATION LOOMS

The euro area economic recovery, which began in Q2 2013, is becoming more sustainable as the recovery is broadening by both expenditure drivers and geography. That said, the recovery remains fragile and vulnerable to downside risks. After declining by 0.6% in 2013, we forecast euro area GDP to rise by 0.8% in 2014 and 1.5% in 2015.

There has been a gradual pick up in domestic demand in recent quarters and this trend should continue over the next few years. This recovery has come despite an ongoing contraction in credit growth. Recent data and lending surveys suggest that the credit shrinkage is moderating and that the appetite for debt may soon pick up. This would be a positive for domestic demand. At the very least, it would remove a major headwind to growth for the euro area.

Perhaps the biggest risk facing the euro area is the prospect of further disinflation or deflation

The January 2014 ECB bank lending survey (BLS) is positive both from a demand [for] and supply [of] credit perspective. On the latter, although banks continue to tighten standards, the degree of tightening has eased significantly in recent quarters. The main factor contributing to ongoing stringency is a negative perception about the economic outlook. However, the mood with regard to the outlook has improved substantially with banks becoming far less pessimistic. Banks expect to ease standards in Q1 2014 for the first time since 2007.

The BLS also highlights that demand for loans by enterprises and households continue to contract. However, demand is expected to be positive in Q1 2014. If this does eventuate, it would be a major positive for business fixed investment and residential construction (Figure 9).

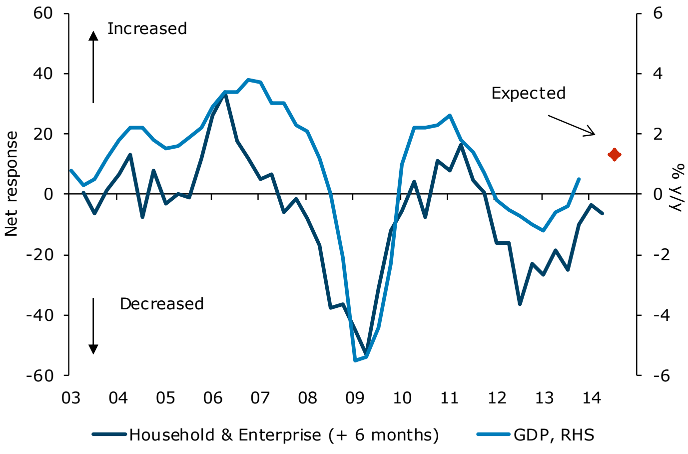
The fiscal stance of euro area governments is expected to be broadly neutral this year after several years of drag, thus removing another major headwind for growth.

The euro area recovery is expected to be broad-based across regions in 2014, with the European Commission (EC) forecasting a notable strengthening in some of the vulnerable periphery countries (eg Ireland, Italy, Spain, and Portugal). In 2014, the EC is forecasting only Cyprus and Slovenia to register negative annual GDP growth rates. This compares to eight member countries (or almost half the euro area) registering negative growth in 2013. By 2015 all economies are expected to be growing again.

Although the risks to growth are becoming more balanced, they remain to the downside. The main risk is the failure to deliver on structural, fiscal, and institutional reform. This would have adverse implications for long-term growth prospects and could result in a protracted period of high structural unemployment. For example, a failure of the euro area wide banking union (including the precursory Asset Quality Review) to clean up the banking system's balance sheet would be a negative for financial and macro stability. Indeed, it would undermine confidence and have a detrimental impact on risk premia and growth prospects. This would likely prolong the current credit contraction and thus crimp a much hoped for recovery in investment.

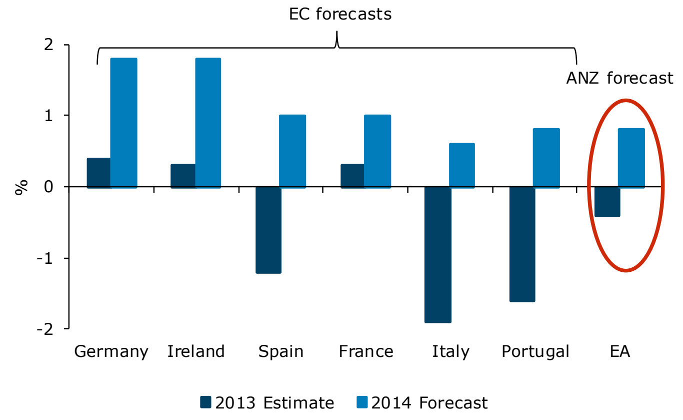
Perhaps the biggest risk facing the euro area is the prospect of further disinflation or deflation. Inflation in the euro area has been trending downwards since the end of 2011, averaging 2.5% in 2012 and 1.4% in 2013. The decline in inflation is due to both temporary and longer-lasting factors. Temporary factors include higher indirect taxes and administered prices (linked to fiscal consolidation needs in many euro area countries) and elevated energy prices in 2012 and into 2013. These effects are now waning and thus dampening current inflation.

FIGURE 9. EURO AREA GDP AND CREDIT DEMAND



Source: Bloomberg, ECB, ANZ Research

FIGURE 10. EURO AREA GDP BY COUNTRY – 2013 AND 2014



Source: Bloomberg, EC, ANZ Research

On the cost side, slowing unit labour costs (ULC) have been a major factor behind the disinflation trend — according to the EC, ULC rose by 1.0% y/y in Q3 2013 down from 2.1% y/y in Q3 2012. Labour costs are expected to remain weak for both cyclical and structural reasons. Typically ULC ease in the initial stages of a recovery, as output recovers more rapidly than either employment or wages growth.

There is also a structural part to the labour cost story, as reform efforts in many euro area countries are aimed at fixing or lowering nominal wages in order to improve competitiveness. On this score, a concerning development of late is the slowing in German nominal wage growth – in Q3 2013 wages were growing by 1.5% y/y versus 3.5% y/y one year ago. This is problematic given the sizeable competiveness gap between Germany and most other euro area countries, in favour of the former (Figure 11). As a consequence, this will add pressure on the other euro area economies to cut back further on wages.

The current disinflation trend is also being driven by a large negative output gap (Figure 12). Recent analysis from the EC suggests the sensitivity of inflation to the output gap appears to have risen sharply, particularly in the vulnerable countries. Perhaps an indication that output gaps matter more when they are large and negative. The assumption that the output gap will close only slowly suggests spare capacity will keep inflation subdued for some time. However, it's unclear whether this spare capacity will add any further disinflationary impulse.

Our baseline scenario for the euro area is for a lengthy period of subdued inflation owing to a persistent output gap. We think the risk of outright deflation is relatively low. Indeed, such an outcome seems unlikely amid an ongoing recovery and stable long-term inflation expectations. For outright deflation to occur, some adverse shock to demand would need to happen, or for long-term inflation expectations to become de-anchored.

We expect the ECB to vigilantly monitor both inflation and inflation expectations for some time. For now, the central bank appears comfortable with the view that the euro area recovery will continue to unfold while inflation should gradually gravitate towards its price stability objective. Thus any further policy action from the ECB in the near-term seems unlikely. That said, the central bank stands ready to act and is prepared to deploy both conventional and unconventional policy measures.

Although our base case is for the euro area to avoid deflation, a prolonged period of low inflation will bring with it some risks. In particular, low inflation:

> increases the real value of both public and private debt, which will make it more challenging for countries with large external liabilities to get their debt back on a sustainable path; and

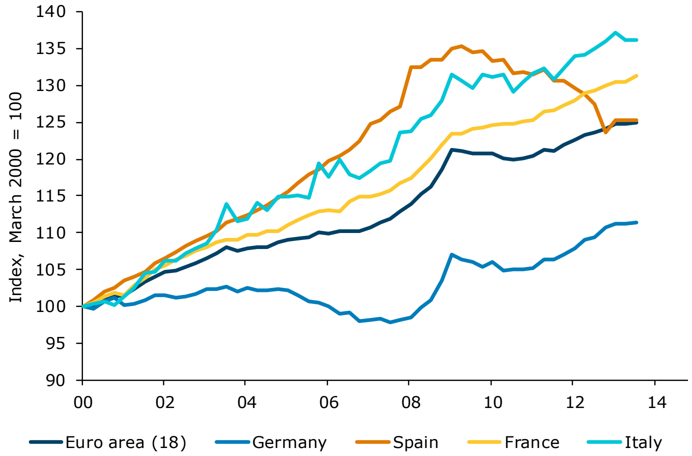
> results in higher real interest rates, which will deter investment and thus be a drag on economic activity.

The inflation situation in the euro area bears close monitoring. The experience of Japan highlights why central banks need to be vigilant against the risk of deflation.

Tom Kenny
Senior Economist

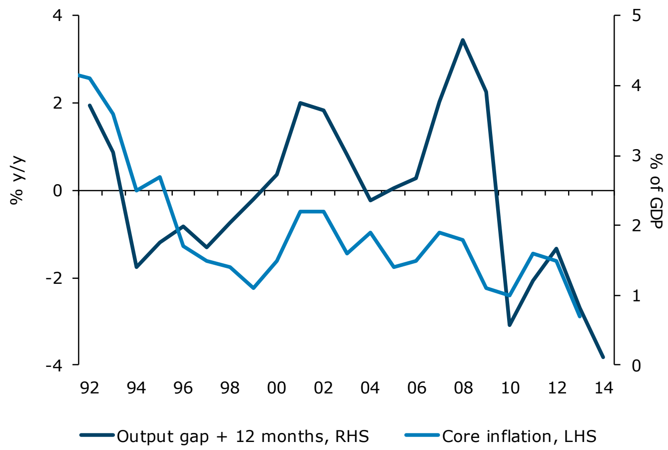
For now, the ECB appears comfortable with the view that the euro area recovery will continue to unfold while inflation should gradually gravitate towards its price stability objective

FIGURE 11. EURO AREA UNIT LABOUR COSTS



Source: EC, ANZ Research

FIGURE 12. OUTPUT GAP AND INFLATION



Source: EC, ANZ Research

AUSTRALIA OUTLOOK

TRANSITION TO NON-MINING ON TRACK

The transition to non-mining growth drivers in the Australian economy now looks to be occurring. The economy is responding well to low interest rates, with housing picking up strongly and consumer spending responding to higher house prices and a lift in consumer confidence. The lower AUD is also helping to support domestic spending, assisted by stronger global growth.

INTEREST RATE SENSITIVE SECTORS PICKING UP

Easy monetary policy is having the desired effect on the economy. Building approvals have risen strongly, and while actual dwelling construction is taking longer than expected to pick up, the strength in approvals points to a strong rise in residential construction this year.

Equity and house prices are rising strongly, the latter helping to lift consumer confidence, which is now feeding into stronger consumer spending. Retail sales rose solidly through H2 2013 and that strength has been sustained into early 2014. This recovery has been reflected in a pickup in broader measures of household consumption, which have accelerated modestly over the past year. This has seen the savings rate fall to just under 10% from the mid 2012 high of 12.4%.

Prospects for recovery in the non-mining business sector are also improving. Non-residential building approvals have risen strongly since mid 2013, especially in office and accommodation, and particularly in NSW. Business surveys show a similar strengthening since mid last year in both conditions and confidence, as well as capital spending plans. These indicators suggest that momentum in this sector is beginning to turn around, and if sustained, would provide upside risk to our non-mining business investment forecasts in late 2014 and 2015. However, we have yet to see firm evidence of a flow through to actual spending, and businesses are clearly reluctant to commit to spending or hiring before the pickup in conditions becomes lasting. So the timing of the turnaround in non-mining business investment continues to be a key uncertainty for the outlook.

THINGS TO WATCH

Transition to non-mining sectors the key theme for the economy in 2014.

Interest rate sensitive sectors picking up, but non-mining investment needs to lift. Watch business confidence and conditions for confirmation of an improvement in the business environment.

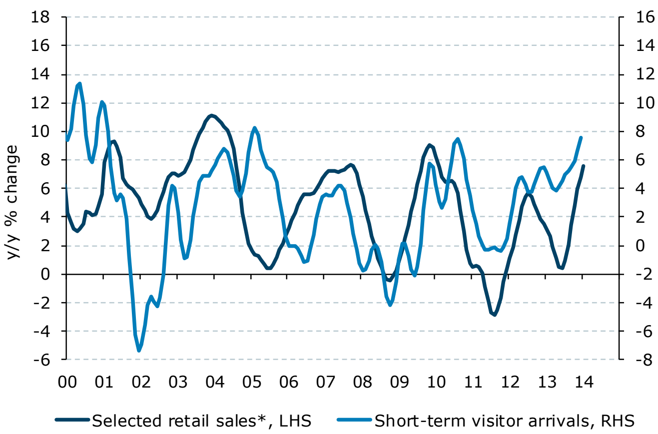
A key risk is that the fall in the terms of trade is larger than we expect.

LOWER AUD AIDING THE TRANSITION

The lower AUD should continue to help with the rebalancing of growth drivers in the economy. Interestingly, the unusual combination of a depreciating currency and improving global growth looks to be giving a larger-than-expected boost to the economy. Tourist arrivals have picked up sharply, driven by continuing strength in arrivals from China, Malaysia, Singapore, Hong Kong, and India, and by emerging recoveries in arrivals from Australia's large traditional source markets of NZ, the US, and the UK, as each of these economies strengthen. China is now Australia's second largest tourism market: in recent months, Chinese tourists have accounted for over one in ten tourists visiting Australia.

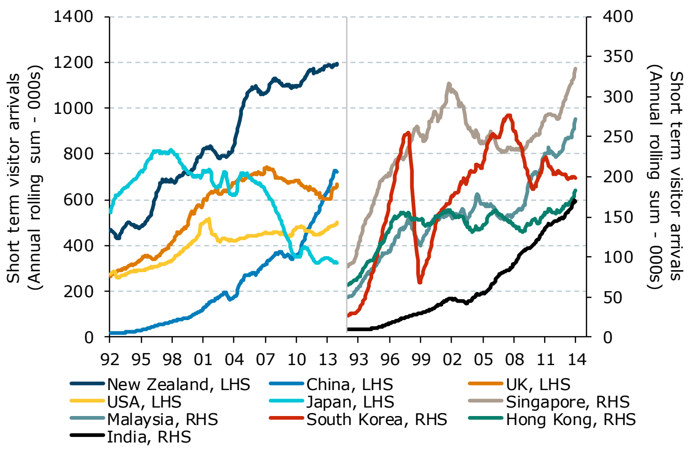
The tourism and retail sectors are also benefitting from a value boost as well as the increase in volumes. International tourists typically have a fixed budget in their home currencies and the 11% decline in the TWI over the past twelve months will have increased the AUD spending power of the over 6½ million foreign visitors to our shores. This recovery in tourism is evident in a number of indicators, and is likely part of the story behind the recent strengthening of retail sales.

FIGURE 1. TOURISM AND RETAIL SALES GROWTH



*Department stores; cafes, restaurants and takeaways; and clothing, footwear & personal accessories.
Source: ABS, ANZ Research

FIGURE 2. TOURIST ARRIVALS



Source: ABS, ANZ Research

MINING MOVING INTO PRODUCTION PHASE

The windback in resources investment is already dragging on growth and will continue to weigh on the economy over the next few years. The benefits of the substantial growth in mining investment, however, are apparent in the strength in exports as the resources boom moves into the production phase. Iron ore exports should continue to grow strongly given Australia's low cost of production, while gas exports due to start coming onstream late this year are largely contracted. The outlook for thermal coal exports is not as rosy, given that the price is now below the cost of production for many of Australia's producers. Both export volumes and values have grown strongly for some time now, and the trade balance moved into surplus in Q4 2013. We expect that ongoing strength in exports, combined with weak imports (as investment in the mining sector winds back sharply) will see (i) a strong contribution to growth from net exports, (ii) the trade balance move sharply into surplus over coming years, and (iii) the current account move towards balance.

Our expectation is for only a slow recovery in these indicators over 2014 and hence no upward move in cash rates before 2015

LABOUR MARKET WEAKNESS CONTINUES

Overall labour market conditions remained weak at the start of 2014. The unemployment rate reached 6% in January and employment is falling slightly in trend terms. Hours worked however, have gradually trended higher over the past year. Moreover, a range of indicators of labour demand have stabilised or improved modestly: both job ads and capacity utilisation have turned around recently, and suggest that the unemployment rate may soon stabilise. We look for employment to begin to strengthen over the next six months, with manufacturing job losses associated with the car industry shutdown likely to weigh on jobs growth further out in 2016-17.

MONETARY POLICY ON HOLD

The RBA has dropped its mild easing bias, signalling at the February board meeting that the most likely course of events was a period of stability in interest rates. Underpinning this expectation is a forecast by the Bank that the economy will continue to record sub-trend growth and rising unemployment in 2014, with above-trend growth not expected to return before 2016. This profile is not dissimilar to ANZ's forecasts.

Our expectation is that the cash rate will remain on hold throughout 2014. The strength in the housing sector suggests that monetary policy is now clearly stimulatory for the economy and can do little further to deal with the forthcoming reduction in mining investment over 2014 and 2015, with the Governor acknowledging recently that "it cannot be assumed that a shortfall in demand can necessarily be made good in short order by monetary policy". Moreover, the unexpected strength in inflation in the second half of 2013, while likely to be overstated, essentially precludes further easing.

A number of the more reliable short-term macro indicators such as job ads and capacity utilisation have improved. The trajectory of each of these indicators will be important to monitor over coming months to assess when the cash rate will begin to move higher. Our expectation is for only a slow recovery in these indicators over 2014 and hence no upward move in cash rates before 2015. An extended period with a low and stable cash rate of 2.5% (until 2015) seems likely on our current forecast outlook for Australian and global growth.

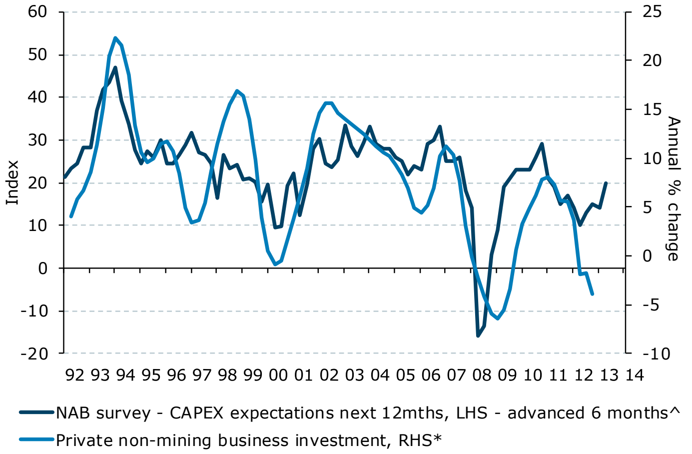
RISKS TO THE OUTLOOK

The key growth risks on the downside would be the failure of non-mining business investment to pick up substantially, which would see growth in domestic demand remain very weak. More broadly, a sharp slowdown in China which saw commodity prices sharply lower is also a risk. On the upside, a stronger global economy, which seems to be emerging, or a faster turnaround in non-mining business investment would support growth, as would a lower AUD.

Felicity Emmett
Senior Economist

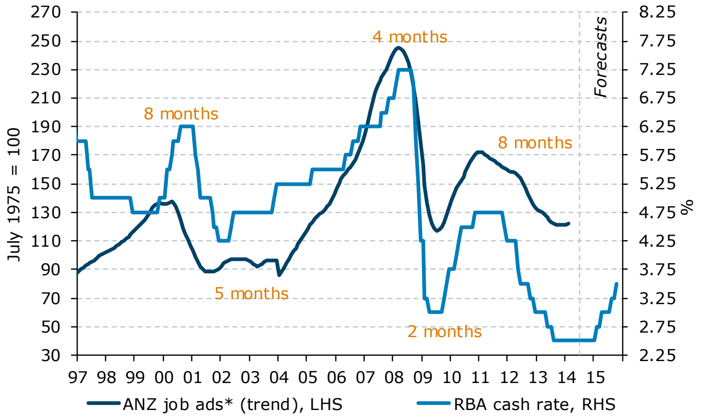
Ivan Colhoun
Chief Economist, Australia

FIGURE 3. NAB CAPEX EXPECTATIONS AND NON-MINING INVESTMENT



^ While the NAB CAPEX intentions series includes mining, it is underweight this sector.
* Derived series
Source: ABS, NAB, ANZ Research

FIGURE 4. ANZ JOB ADS AND THE CASH RATE



Time between beginning of upward/downward trend in job ads and hike/cut in cash rate

* Newspaper job ads until 2004 and total job ads since 2004.
Source: RBA, ANZ Research

CHINA NPC: A 7.5% GROWTH TARGET REQUIRES POLICY EASING

The annual session of China's 12th National People's Congress (NPC) opened on 5 March in Beijing. Premier Li Keqiang delivered his first government work report to the NPC.

KEY POINTS

The GDP growth target remained unchanged at 7.5%, but the Chinese authorities said this is a "flexible target". Notably, China raised the target of newly created jobs to 10m (from 9m in the previous year), and uplifted the importance of the job creation target to the same level as the growth target. Both indicate that China is gradually shifting the policy emphasis to employment.

Analysing the main contributions to GDP growth, the government lowered the growth target for both fixed asset investment and foreign trade by 0.5ppt to 17.5% and 7.5%, respectively. However, the government maintained the growth target for retail sales at 14.5%, suggesting that China will focus more on boosting domestic consumption. China will also expand the value-added tax reform to the railway and telecommunication industries.

In addition, the government aims to reduce energy consumption per unit of GDP by 3.9% in 2014, compared with 3.7% in the previous year, reflecting China's intention to improve the quality of growth. In order to achieve this target, the government aims to reduce 270m tons of steel production capacity, and 420m tons of cement production capacity this year.

The CPI inflation target is unchanged at 3.5%. As the output gap remains negative, inflationary pressures will still be manageable this year. Pricing reforms will continue. The prices of public utilities and energy products will be largely determined by the market, which will help not only improve the efficiency of resource allocation, but also achieve the environmental protection target.

China maintains a proactive fiscal policy and a prudent monetary policy. The PBoC set the M2 growth target at 13% - unchanged from last year. M2 had grown rapidly by 15% y/y since May 2013, and was eventually followed by a 'cash crunch' and liquidity tightness throughout the second half of last year. Our view is that 13% M2 growth is sufficient to deliver growth above 7%, if the money is guided to flow into the real sector.

Meanwhile, the fiscal deficit target has been uplifted by 0.1ppt to 2.1% of nominal GDP. From this perspective, fiscal policy could provide some impetus to the overall economy.

In addition, China could implement the reform policies as follows:

> Financial reform, led by interest rate liberalisation, will continue to develop at a fast pace. China will likely implement the deposit insurance scheme this year, and the Chinese authorities will experiment with capital account liberalisation policies in the Shanghai Free Trade Zone (FTZ).

THINGS TO WATCH

China's GDP growth target remains unchanged at 7.5%, but the Chinese authorities said this is a "flexible target".

A 7.5% growth target requires policy easing. However, shadow banking activities could re-emerge if monetary conditions are too relaxed.

We maintain our forecast that China's economy will grow by 7.2% in 2014, down from 7.7% last year.

In the meantime, we expect China could accelerate the reform in exchange rate policies and introduce a two-way flexibility in the exchange rate. Notably, Premier Li said that China will enlarge the USD/CNY trading band, but did not specify the timing.

The government will keep a balance between facilitating financial reform and preventing systematic risks. We think that the Chinese authorities will continue to monitor the risks embedded in the shadow banking system and local government financing platforms. Some new policy initiatives, such as allowing the local governments to access capital markets more freely and setting up special vehicles to deal with the bad debt, could be implemented this year.

FIGURE 1. ECONOMIC TARGETS SET BY NPC

	2014 TARGETS	2013 TARGETS
GDP GROWTH	7.5%	7.5%
CPI INFLATION	3.5%	3.5%
M2 GROWTH	13.0%	13.0%
URBAN REGISTERED UNEMPLOYMENT RATE	4.6%	4.6%
FIXED ASSET INVESTMENT	17.5%	18.0%
RETAIL SALES	14.5%	14.5%
FOREIGN TRADE	7.5%	8.0%
FISCAL SPENDING	RMB15.4trn (+10.0% y/y)	RMB14.0trn (+10.0% y/y)
FISCAL DEFICIT	RMB1.35trn	RMB1.2trn
FISCAL DEFICIT (% OF GDP)	2.1%	2.0%
CENTRAL GOVERNMENT FISCAL DEFICIT	RMB900bn	RMB850bn
LOCAL GOVERNMENT FISCAL DEFICIT	RMB400bn	RMB350bn
PUBLIC HOUSING STARTS	7.0m Units	6.3m Units

Source: NPC

> The Chinese authorities will continue to simplify the administrative approval procedures, reduce extravagance, and intensify anti-corruption efforts. In the meantime, the government will encourage state-owned enterprises (SOEs) to participate more actively in market competition and give more discretion to the top management group of the SOEs.

> Urbanisation will focus on 'people'. Chinese authorities will likely hold the first urbanisation work conference in May and release China's urbanisation blueprint for the next decade. In addition, China will continue to improve the social safety net, and the government will maintain a proactive fiscal policy and invest more into the pension and healthcare system.

China's economy is likely to gain 7.5% in the first half of 2014

A 7.5% GROWTH TARGET REQUIRES EASING

From the Chinese authorities' perspective, delivering reasonable growth will help alleviate the concern of a sharp economic slowdown. However, forward-looking data suggest that China's growth momentum continues to moderate, which implicitly calls for significant policy easing as the authorities commit to a 7.5% growth target.

For example, China's official PMI declined for the third consecutive month, to 50.2 in February, the lowest level since last June. The private-sector based HSBC PMI also remained below the benchmark level of 50 for two straight months. In the meantime, crude steel output stayed at a low level, and iron ore inventories in ports and steel mills continued to build up.

We note that all the provinces and municipalities set growth targets at or above 7.5%, which will add to pressure on the central bank to ease its monetary policy as well.

Indeed, we do see some signals of policy easing. The recent weakening of the RMB and the sharp drop in the short-tenor market interest rates indicate that the PBoC could have fine-tuned its tight monetary policy since the 'cash crunch' last June.

FINANCIAL RISK IS MOUNTING

However, monetary policy easing will carry some risks if it is not managed well. Shadow banking activities could re-emerge if monetary conditions are too relaxed, which likely would bring systematic risks to the financial system. China's financial sector has witnessed a deleveraging process since the 'cash crunch' as access to funds had become very difficult in the past three quarters. Nonetheless, the cost of funds has declined sharply following the Chinese New Year, with the seven-day repo rate dropping to 3.3-3.5% recently, compared with 4.7% on average from June 2013 to January 2014. If liquidity conditions continue to improve, off-balance-sheet activities will likely emerge again, and the overcapacity problem could deteriorate.

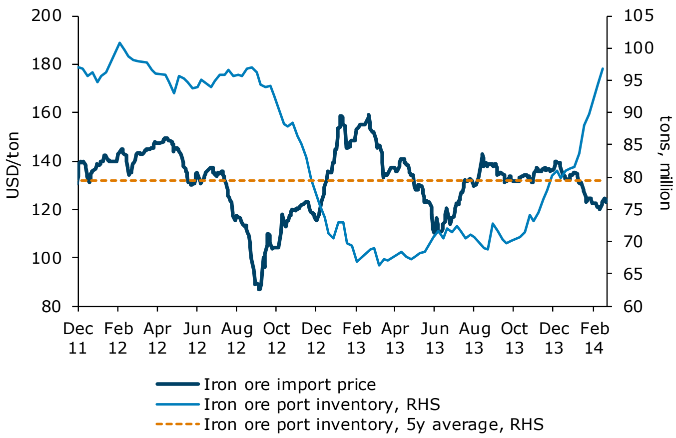
In fact, financial risks have been accumulating with the development of shadow banking. Notably, the first default case in the corporate bond market recently occurred in China, and has heightened the risks in the financial system. Shanghai Chaori Solar Energy Science & Technology, a Chinese maker of solar cells, recently announced it will not be able to pay the RMB89.8m (AUD14.6m) annual interest on an RMB1bn bond which was issued two years ago. This raised concerns over the trust industry which holds over RMB10trn in assets and is largely associated with the low-credit-rating companies.

GDP FORECAST

As China's growth target has become flexible, and the downside risks remain, we maintain our forecast that China's economy will grow 7.2% in 2014, down from 7.7% last year. China's economy is likely to gain 7.5% in the first half of 2014, largely due to a low base during the same period of 2013, but gradually slow to 7.0% in Q3 and Q4. Investment growth could slow to 19.0-19.5% this year, down from 19.6% in the prior year. Retail sales are expected to climb up to 13.5% this year, up from 13.1% in the previous year. We see some upside in the trade sector, due to the improved demand from the advanced economies. Overall trade growth could be 8-10% this year, up from 7.6% in 2013.

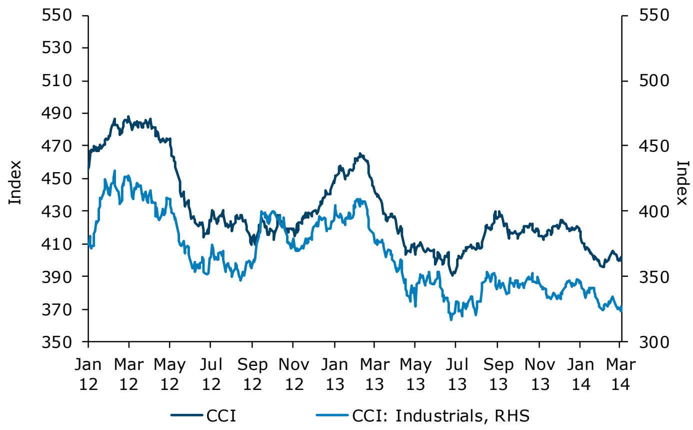
Li-Gang Liu
Chief Economist, Greater China

FIGURE 1. CHINA IRON ORE IMPORT PRICE AND PORT INVENTORY



Source: CEIC, Markit, ANZ Research

FIGURE 2. ANZ CHINA COMMODITY PRICE INDEX



Source: CEIC, ANZ Research

SOME LOSS OF VISIBILITY AT THE START OF THE YEAR

We expect a cyclical upswing is likely falling into place across Emerging Asia. However, events through the first quarter appear to be reducing visibility on that. The year started with the promise of a broadening global recovery but was somewhat muted by another round of troubles in the emerging markets space - led by Argentina and those emerging markets with the largest twin-deficits. The relative immunity of India and Indonesia to these wobbles was notable and is a testament to the credible current account deficit stabilising policies both economies pursued over 2013. Still, with the Lunar New Year factory shutdown having shifted the timing of production and exports and the weather disruptions in the US economy occurring at the same time, it may be March or April before a truer picture emerges on the strength of the Emerging Asian economies. We are of the view that underlying economic momentum in the region may be firmer than the consensus currently expects (Figure 1).

THINGS TO WATCH

2013 was a volatile year for Emerging Asia. More even external demand should be a positive in 2014.

Weather disruptions in important final markets such as the US and the timing of the Chinese New Year holiday are clouding visibility.

Inflation risks and policy direction are becoming clearer with tightening cycles in Emerging Asia forecast to commence in H2 2014.

THE RETURN OF INFLATION

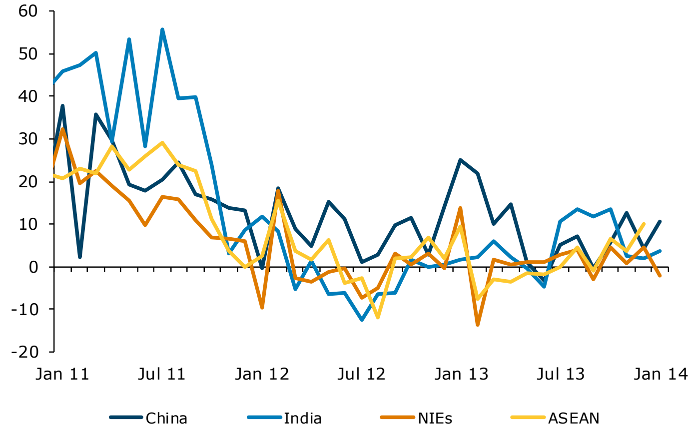
The overall macro backdrop at the beginning of the year remains conducive to two things.

1. Growth broadening and firming across Asia over the year ahead; and
2. As growth is likely to exceed lower potential growth rates for the first time since the 2007-08 crisis, inflation may possibly accelerate.

With the exception of the Philippines (which has clearly bucked the regional trend) potential growth rates in Asia are significantly lower now than they were before the 2007-08 crisis. As a function of the capital stock and the size of the labour force (and the innovations with which they are combined), lower potential growth rates across Asia are clearly a function of slower investment in capacity in the post-crisis world.

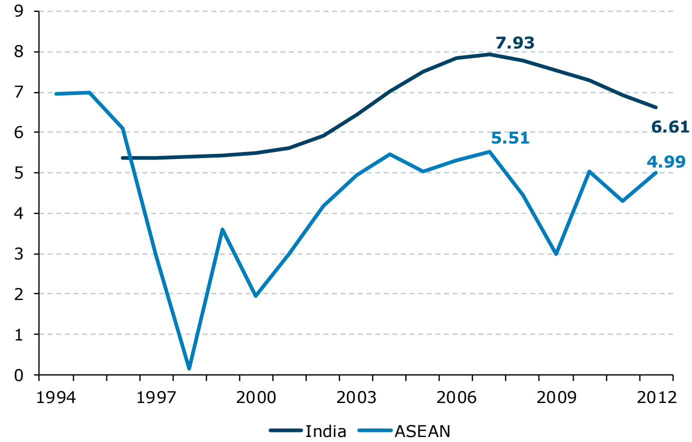
For most of the ASEAN, we believe potential growth is at least 0.5ppt lower, whilst for India the decline in potential growth is probably closer to 1.5ppt and 2.0ppt lower. On our growth forecasts for 2014-15, we expect actual growth in the majority of the South and South-East Asian economies to breach these new lower potential growth rates over the course of 2014-15. From an output gap perspective - and without consideration to the likely evolution of heavily-weighted food and energy prices - structural inflation pressures are likely to pick up in 2014-15. This is one of the key reasons we believe forward-looking central banks and policymakers across Asia will need to move policy to a less-expansionary setting in the second half of 2014 (Figure 2).

FIGURE 1. ASIAN EXPORT GROWTH FIRMING AT THE END OF 2013, A TREND WE EXPECT TO CONTINUE INTO 2014



Source: CEIC, ANZ Research

FIGURE 2. POTENTIAL GROWTH RATES HAVE FALLEN ACROSS ASIA IN RECENT YEARS



Source: IMF, ANZ Research

FDI INFLOWS EMERGING AS AN OFFSET

We expect Foreign Direct Investment (FDI) inflows into the ASEAN may be underestimated and will provide an offset (to some extent) of the anticipated withdrawal of liquidity associated with tapering. FDI flows would reflect expectations of solid medium-term growth prospects in the region.

Excess liquidity associated with accommodative monetary policy in developed economies has either found its way into the real sector (excess capacity in China) or into the financial sector (asset prices in other Asian economies). In short, it has affected the supply side or demand side of economies. The reversal of these policies will thus primarily have financial or real sector effects. We would expect the unwind of financial sector effects to be more easily manageable. In short, we do not believe this is a structural economic imbalance in Asia that tapering will expose.

POLITICAL CYCLES AND POLICY IN 2014

Democracy will have a headline moment with over one billion people going to the polls across Asia in April 2014. Over 800 million people are eligible to vote in the Indian elections and nearly 200 million people in the Indonesian election – the world's largest and third largest democracies respectively. Typically, macroeconomic policy is eased in the period leading up to an election as politicians seek to retain office. However, the prudent and sensible conduct of policy has been evident across India and Indonesia in 2013, with policymakers focussed solely on stabilising current account deficits and reducing inflation by slowing domestic demand, despite the fact that deliberately engineering a slowdown in domestic demand is typically not the policy choice undertaken in election years. The medium-term direction on economic policy leads us to conclude that fiscal policy is unlikely to provide additional support to economic growth across Asia this year despite political elections.

Fiscal policy is unlikely to provide additional support to economic growth across Asia this year despite political elections

Indeed, the opposite appears to be occurring. Fiscal policy has been tightened by reducing subsidies in India, Indonesia, and Malaysia, and planned fiscal spending has been delayed in Thailand due to lingering political uncertainty. Against earlier expectations, fiscal policy will not be slipping this year.

OVERALL POLICY STANCE SUPPORTIVE

The overall policy stance perhaps remains mixed at this stage. Fiscal policy is tightening, as evidenced by examples such as the on-going and much-needed windback of subsidies. Currencies have also weakened, which provides an offsetting easing of monetary conditions.

Fiscal policy has been tightened by reduced subsidies in India, Indonesia, and Malaysia, though political cycles may interrupt much needed policy tightening (particularly in India and Indonesia). We also note the potential for elections to be brought forward in Thailand.

RISKS: CAPITAL FLOWS AND INFLATION

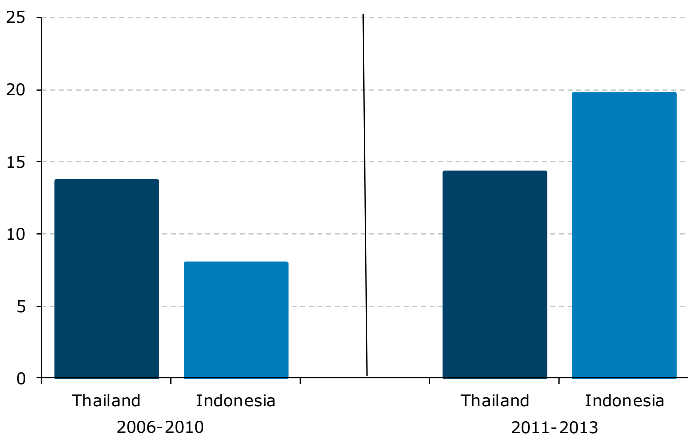
The main risk to our forecast remains market positioning and sentiment on capital flows. It is important to note that most periods of capital outflows over the past year have been aligned with uncertainties on the China growth outlook or weakness in the China growth numbers. The fact that China has reaffirmed a 7.5% growth target suggests that authorities in China may take additional policy measures to support growth. In our view, growth in the US and China pose a much smaller risk.

Within Asia the possible risk of contagion effects from disorderly adjustments in currencies or local markets in India and Indonesia now appear to have been reduced significantly, with both economies having achieved current account deficit stability and inflation cycles that have peaked.

On balance, we believe 2014 is a year when more even global demand will provide greater visibility to corporates and production and investment should correspondingly expand.

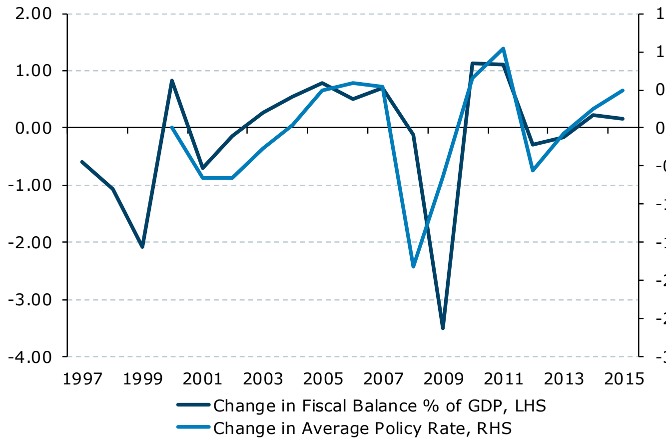
Glenn B. Maguire
Chief Economist, Asia-Pacific

FIGURE 3. FDI INFLOWS REMAIN STRONG



Source: CEIC, Bloomberg, ANZ Research

FIGURE 4. POLICY IS LIKELY TIGHTENING



Source: CEIC, Bloomberg, ANZ Research

NO ROOM FOR COMPLACENCY

The New Zealand economy is firmly in a broad-based economic expansion. Buoyed by high commodity prices, kind weather, still-low interest rates, and an earthquake rebuild, GDP growth is strengthening and is now sweeping employment and investment along for the ride. Confidence is sky-high across the board. But the economy is not bullet proof. Monetary policy is being tightened. The NZD remains at eye-watering levels. Commodity prices will always be vulnerable to global ructions, and global risks persist. The economy is still carrying a heavy debt burden. And the housing market remains a financial stability headache despite evidence that the Reserve Bank's speed limits on higher-risk lending are gaining some traction. Although the nation is set to rocket up the OECD growth charts this year, vulnerabilities and risks remain, and complacency is likely to be punished in time.

THINGS TO WATCH

The RBNZ has started lifting the OCR: likely the only developed nation to do so in 2014. The growth and inflation outlook demands it, but New Zealand can ill afford to be too far out of step with global peers.

New Zealand's commodity prices have doubled, but they could halve. That's certainly not our forecast but a risk scenario it would be wise to consider.

The Reserve Bank has successfully taken some steam out of housing. There is no oversupply, but prices are still out of line with incomes and rents.

ON A ROLL

The New Zealand economy is in the midst of a broadening expansion. Real GDP growth of 1.4% in the Q3 last year is expected to have been followed by growth of around 1% in Q4. And with both business and consumer confidence at extreme highs, the stage is set for continuing strong growth throughout this year.

Encouragingly – and arguably unlike other nations – the activity is underpinned by real income growth, not just stimulatory monetary conditions, though these are certainly playing their part. Strong global prices and a spectacular rebound in production mean total dairy incomes are expected to be NZD4bn higher than the previous year – a lift equating to around 2% of the size of the entire nominal economy. That's a hefty stimulus, and is part of the reason why the Government is now more confident about returning the books to surplus promptly. The labour market recovery has been a little sluggish, but the unemployment rate has fallen from a post-GFC peak of 7.2% to 6% as of end 2013, and indicators point to further improvement. Lifting employment plus steady growth in wages equates to decent labour income growth for the household sector.

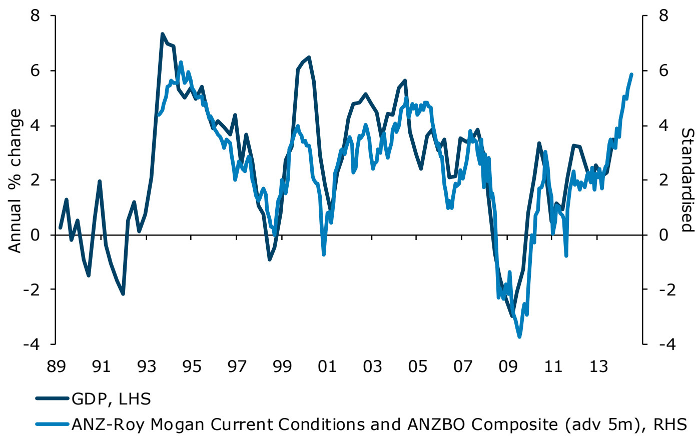
Another comforting fact is that a decent contribution to growth over the next couple of years will come from rebuilding Christchurch after the quakes which struck three years ago. Much of this rebuild effort is paid for from either the Government's previously saved funds for such a purpose (the Earthquake Commission) or international reinsurance funds. Escalating costs could see some construction delayed, but it's as close to a guaranteed growth pipeline as is likely to be seen in practice.

RUTS IN THE ROAD

Unfortunately, the fact that growth has a solid income base and a core of pre-paid construction does not mean the outlook is bullet proof. Various threats on the horizon mean New Zealanders would do well to be a little cautious in their borrowing and investing decisions, despite the undeniable feel-good factor on the streets.

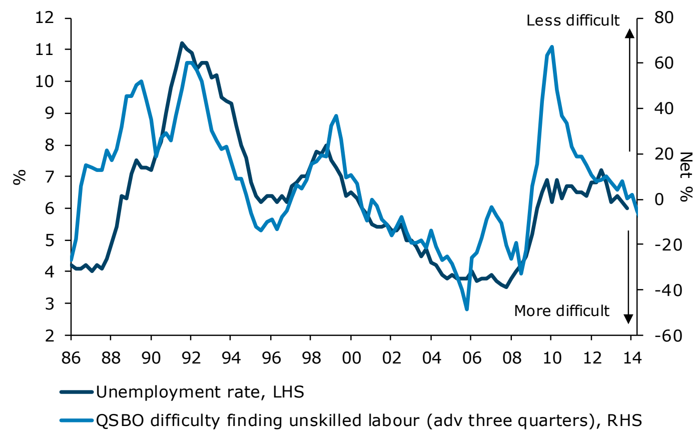
While New Zealand might be having what is – on the whole – a regular business cycle, the rest of the world generally is not. Extremely easy monetary conditions around the world have underpinned growth, but at the cost of imbalances emerging in credit and asset markets that may not unwind as smoothly as they built up.

FIGURE 1. GDP GROWTH VS CONFIDENCE COMPOSITE



Source: ANZ, Roy Morgan, Statistics NZ

FIGURE 2. UNEMPLOYMENT RATE



Source: NZIER, Statistics NZ, ANZ Research

Parts of China's financial sector are looking vulnerable to a real estate market correction, US equities have been defying gravity for years now, and even New Zealand's own commodity prices appear to have gotten a lift every time the US Federal Reserve launched a new round of Quantitative Easing – and must therefore be seen to be vulnerable to an unwinding of this stimulus. Some emerging markets look ill-prepared for a return to business as usual. Europe hasn't solved its fundamental problems of too much government debt and a currency union that in the absence of a fiscal union will tend to exacerbate imbalances and encourage crises.

Furthermore, New Zealand has its own home-grown risks. The first is a traditional one that comes with upswings: inflation. While much of the rest of the world is fretting about the possibility of falling into deflation, inflation indicators in New Zealand have turned upwards as the economic expansion persists and broadens. The Reserve Bank had made it clear that they would not sit idly by, and the Official Cash Rate was hiked 25bps in March to 2.75%, with RBNZ forecasts suggesting 100bps of hikes in total to come over the next year. The RBNZ will be waiting with bated breath to see the impact on the NZ dollar, as will exporters. However, previous experience has taught the Bank that kicking off a tightening cycle too cautiously, with a nervous eye on currency impacts, tends to just make interest rates – and thus the currency – a one-way bet down the track.

Second, and perhaps more importantly, New Zealand faces a number of financial stability risks:

1. Debt across the economy remains high as the legacy of a borrow-and-spend binge from the previous decade;
2. Credit growth is rising again (as there is nothing like a good old-fashioned housing boom to make consumers forget their newfound prudence); and
3. New Zealanders' poor savings record is reflected in an international balance sheet that makes for fairly grim reading.

The freely floating exchange rate may be New Zealand's get-out-of-jail-free card, but there is no question we will have a more comfortable time of it if we are not forced to play it. In the context of a necessary construction boom to not only rebuild Christchurch but also to alleviate housing shortages in fast-growing Auckland, consumption must be the sacrificial lamb if important balances are not to blow out. If consumers do not show restraint, then the Reserve Bank will have to restrain them.

The housing market is a key part of both the risk and opportunity outlook for New Zealand. The nation regularly features near the top of the list in global comparisons of overvalued housing markets. That New Zealand does not have a widespread oversupply of housing, and that net migration is rising strongly, are both comforting thoughts when it comes to the risk of a disorderly adjustment.

The housing market is a key part of both the risk and opportunity outlook for New Zealand

Nonetheless, it is incontrovertibly true that house prices in New Zealand are extremely elevated relative to both incomes and rents. The Reserve Bank has responded by putting speed limits on the growth of high loan-to-value mortgage lending. The fact that the lower end of the housing market has slowed more than the rest of the market supports the argument that the measures are having an impact.

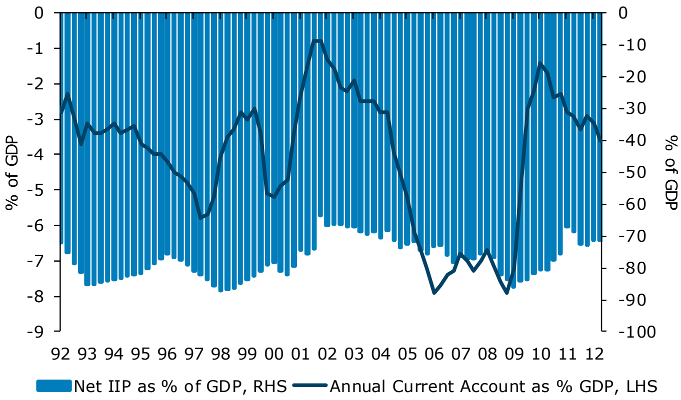
But with broader inflation pressures now beginning to emerge across the economy, the limitations of the macroprudential measures (in terms of the impact on aggregate inflation pressure) are clear. The key tool of monetary policy in New Zealand remains the Official Cash Rate.

THE ROAD GOES EVER ON

New Zealand is a small open economy that will always be vulnerable to the vagaries of global growth and financial markets. It would therefore be unwise to let our current economic outperformance lull us into a false sense of security. But with sound institutions, a freely floating exchange rate, rapidly growing ties to the fastest-growing regions of the world, and the world's highest food-growing capacity relative to population size, New Zealand is well placed to face the challenges ahead.

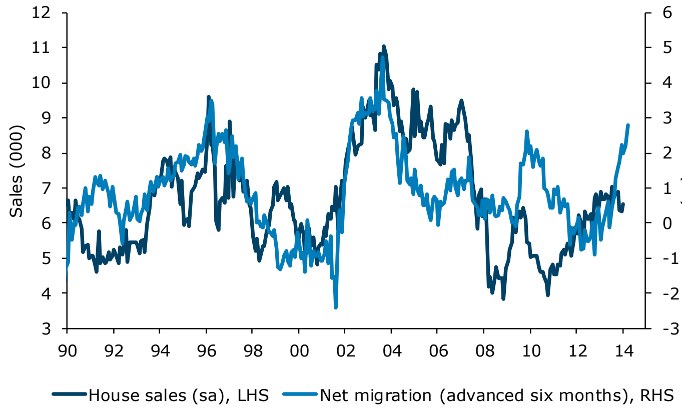
Sharon Zöllner
Senior Economist, New Zealand

FIGURE 3. CURRENT ACCOUNT AND IIP POSITION



Source: Statistics NZ, ANZ Research

FIGURE 4. NET MIGRATION VERSUS HOUSE PRICE INFLATION



Source: Statistics NZ, REINZ, ANZ Research

COST OF CAPITAL IS KEY

We continue to frame our analysis on currency markets using a core vs periphery framework, rather than one which is USD-centric. Figure 1 presents our ANZ Reversification Currency Index. That index measures the performance of an equally weighted basket of core currencies (USD, EUR, JPY, and GBP) against an equally weighted basket of peripheral currencies (CNY, INR, RUB, BRL, MXN, KRW, IDR, TRY, TWD, and AUD).

While the US economy is likely to recover further this year, and more strongly than many others, we continue to expect European currencies to outperform. Even the yen has outperformed the periphery in some cases. Since May 2013 the yen has outperformed our equally weighted Asian currency index, while AUD/JPY peaked in April 2013.

Within the core, Japan's monetary policy stance is likely to keep the yen weak, while in Europe the UK's robust domestic recovery and Europe's strong external surplus are likely to see the USD remain under pressure there. The consensus on EUR has remained consistently bearish, with little evidence of capitulation in that view.

However, the most debated area is the periphery. In our view the key driver of peripheral currencies this cycle is the global cost of capital. As such, rather than something within the periphery having shifted to drive the weakness of recent quarters, it is an external driver which has shifted. Two influences in particular have become key: the interest rate structure in the US and China.

The negative influence of higher US rates on peripheral assets has become self-evident over recent quarters. In fact, the influence has been so strong, particularly as the US 10 year bond yield approaches 3%, that it must raise questions about the ability of bond yields to push substantially through that level.

Conversely, the positive influence on peripheral currencies of declining rates in the US and China has been evident more recently. Even against a backdrop where data in China have surprised on the downside, there is some sense that the US recovery may be stalling. Meanwhile, as China-centric commodity prices have been declining, peripheral asset markets (and the AUD in particular) have traded with an improved tone.

THINGS TO WATCH

Chinese and US interest rates remain a key driver of peripheral currency performance.

Peripheral currency performance is amplified by an improving US trade deficit.

China is likely to return as a competitor for capital.

In addition, we are continuing to monitor the US trade balance quite closely. Interestingly during this cycle, the US recovery has been occurring with a shrinking trade deficit - the large export kicker the US normally sends to the rest of the world is missing. Even excluding the US's oil trade position, which is benefitting from the shale boom, the core trade balance has not deteriorated at all over recent years as the US recovery has gathered steam (Figure 2). This is unusual, and suggests that the US export benefit in this cycle won't be as widespread as might normally be the case.

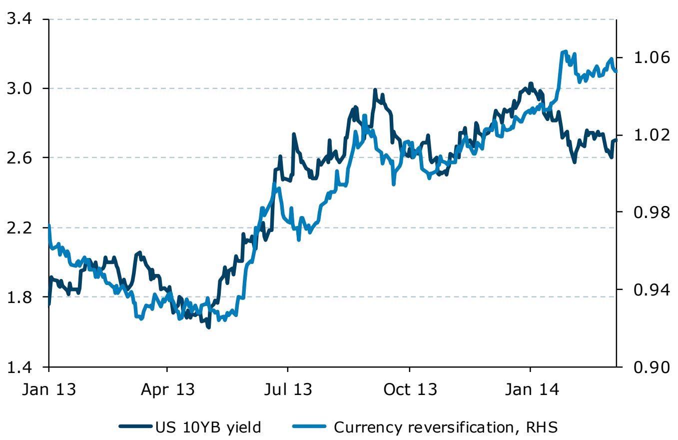
We continue to expect peripheral currencies to underperform against the core over time. And the USD is likely to be strong against the periphery once US and Chinese interest rates increase.

AUD: FURTHER DOWNSIDE

The outlook for the AUD remains unfavourable despite the recent improvements in the domestic economy. Going forward, international dynamics are set to dominate. While global growth will likely continue to improve, the distribution of risk factors will evolve in a less favourable fashion for the AUD.

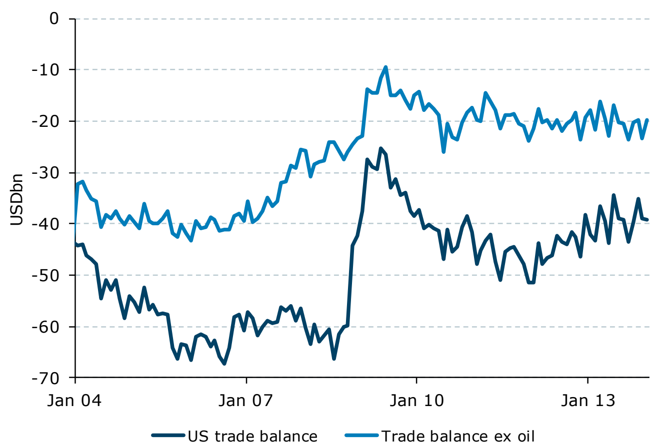
From 2009 - 2013 markets were focussed on investing where monetary policy was 'standard', where real rates remained positive, and where fiscal balances were healthy. In this environment the AUD outperformed its fundamentals.

FIGURE 1. ANZ CURRENCY REVERSIFICATION INDEX



Source: Bloomberg, ANZ Research

FIGURE 2. US TRADE BALANCE



Source: Bloomberg, ANZ Research

Going forward these factors will be less of a focus. More attention will be placed on calibrating the success and consequences of the transition of growth in China, the risks surrounding its shadow banking system, and the consequences of US growth outperformance. On these metrics the AUD ranks less favourably so the risk premium on the AUD is likely to widen once again.

In addition, the trajectory of the terms of trade will be key for the AUD. ANZ is forecasting only a marginal decline over the year to come, however risks are skewed to the downside.

NZD: SHIFTING DRIVERS

The NZD will remain elevated in this quarter, however, as behind the scenes its drivers are changing from local factors to global. While New Zealand's economic outlook is 'best-in-class', it is also well-known and understood by markets. Given this, it is hard to envisage the New Zealand story providing further positive surprises - particularly with the RBNZ beginning to tighten policy.

With this more neutral domestic setting, global factors will increasingly drive NZD performance. Accordingly, our central scenario has the NZD falling gradually, with the solid domestic economic outlook cushioning the fall as the US and global economic recovery gathers momentum. The closing of the relative economic gap as global growth accelerates will see the NZD 'relatively' weaker.

Offshore inflows into the NZ asset market were a key support for the NZD in 2013. Data shows offshore holders have held holdings steady, but that inflows have ceased. Events that drove inflows in 2013 (such as the inclusion of NZ linkers into global indices and the partial privatisation of NZ power companies) have now mostly concluded, leaving further allocation decisions to be determined by global factors.

The ability of the NZ economy to positively surprise - and hence the currency to track domestic influences - will be curtailed by the commencement of the RBNZ hiking cycle. The RBNZ appears determined to remove the 'punch bowl' from domestic drivers of NZD strength, leaving just global factors to impact the currency. ANZ's view is for developed economies such as the US, UK, and Europe to close the economic performance gap, thus lowering the NZD.

AUD/NZD: THE LOW IS IN

The NZD's appreciation against the AUD over the past year has been nothing short of spectacular. A good portion of the move was grounded in fundamentals – namely, the relative commodity price trends and the perceived risks around the relative domestic growth outlooks. However, while these factors explain the direction of recent moves, neither of them justify the severity.

This overshoot is evident when considering a wide range of cyclical indicators, from relative house price trends to relative unemployment rates, all of which suggest the cross should be at a level closer to historical averages between 1.15 and 1.20.

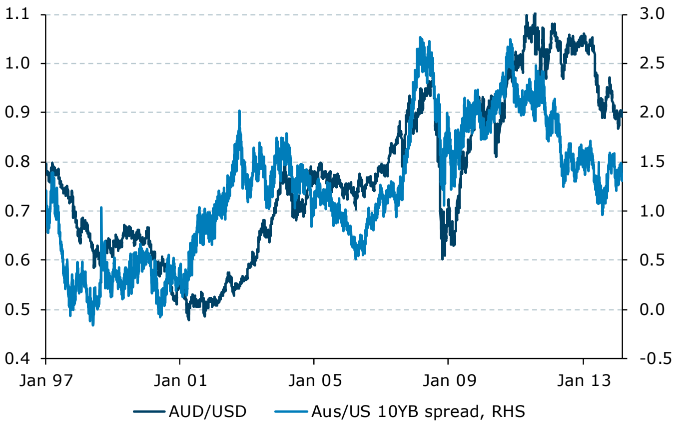
STRONGER ASIAN GROWTH WON'T BENEFIT ASIAN CURRENCIES

In our view, a stronger growth outlook in Emerging Asia for 2014, driven by a supportive external demand backdrop, will not lead to a strengthening in Asian currencies. With the US economy recovering and the US Federal Reserve starting the process of policy normalisation, we expect the USD to become more attractive relative to Asian currencies. This is especially so given our economists' view that potential growth rates in Asia have fallen in recent years, with India and Indonesia at the forefront of this dynamic.

The implication of a lower potential growth rate (both in absolute terms as well as relative to the US) is that investors can expect lower relative risk-adjusted returns in Emerging Asia. The shift in portfolio flows out of Emerging Asia towards developed markets last year, when Fed tapering was first discussed, looks set to continue as investors price out the Emerging Market growth premium.

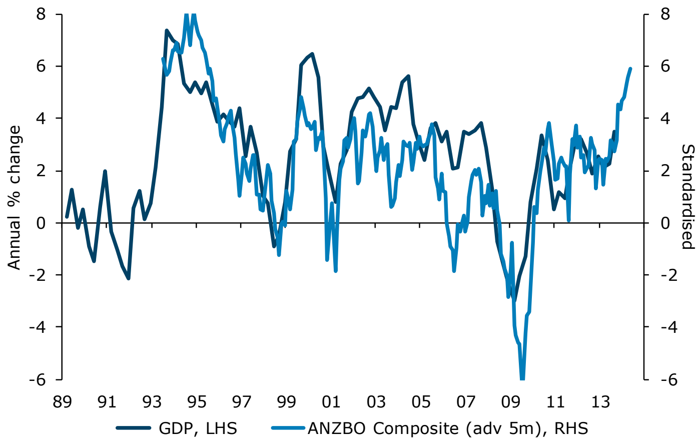
Even strong current account surpluses will offer limited scope to prevent depreciation. Korea's strengthening current account surplus is commonly seen as a positive for the currency. This is true to some extent. But it was the large foreign equity inflows last year which led to won strength. With Korean equities looking expensive from a valuation perspective, and similarly for the currency relative to the yen, we see prospect for an unwinding of the foreign equity flows, leading to won weakness this year. Even the Philippines, with its sound fundamentals, will see its currency decline as asset prices look rich (currency, equities, and bonds), leading to reduced foreign capital inflows.

FIGURE 3. EASING LIQUIDITY WILL RECONNECT AUD TO LONG TERM FINANCIAL ANCHORS



Source: Bloomberg, ANZ Research

FIGURE 4. ANZ NZ BUSINESS CONFIDENCE VS GDP



Source: Statistic NZ, ANZ Research

Political developments are also an additional source of potential headwinds for some currencies. Political protests in Thailand have been weighing on the baht, while India's general election is being held in April-May, where a change in government is being touted. Indonesia holds its legislative election in April and the presidential election in July. Unlike Thailand, there is no political risk premium being priced into the rupee or rupiah at this stage. But markets could start to factor that in as we approach the polling date.

The only Asian currency we forecast to appreciate for the rest of this year is the Chinese renminbi, despite recent weakness in the currency. Unlike mid 2012, the weakness this time was not market driven, but rather was engineered by the PBoC, who is attempting to generate increased volatility, wean the market away from the one-way appreciation mindset, and shift the spot rate closer towards the central parity rate. This preparation has now led to the daily fluctuation band being widened from 1% to 2%. With strong capital inflows and limited outflows, we see the renminbi eventually reverting back into appreciation mode.

For 2014, we are forecasting a depreciation of 2.7% in Asian currencies, based on our USD/Asia index. But on a real exchange rate basis, the depreciation is a more muted 1.3%, compared to last year's 4.6% fall. When we look at the longer-term picture of the USD/Asia real exchange rate, what is striking is the extent to which Asian currencies have appreciated against the USD since 2002, and how muted the depreciation has been to date. Therefore, the risk for this year could be the extent that Asian currencies depreciate should the US economy surprise on the upside.

EUR AND GBP: ECONOMIC RECOVERY SUPPORTIVE

The euro area's economic recovery, while fragile, is becoming more established and broad-based, which is constructive for the euro. We maintain the view that further gains in economic activity, combined with the implementation of economic reform, enhanced competitiveness, rising balance of payments surplus, and repair of the banking sector will be supportive for the currency.

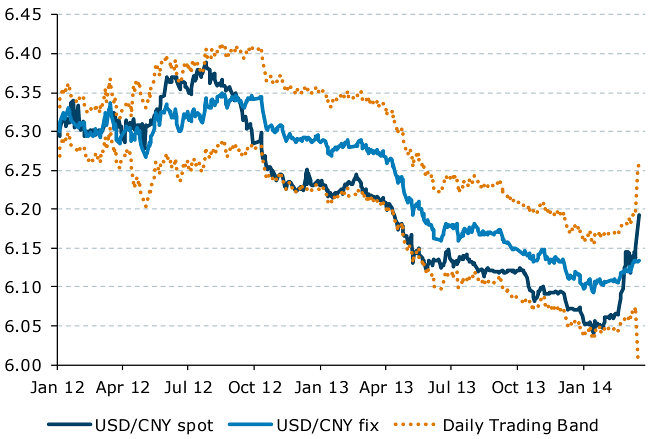
The euro area economy grew 0.3% q/q in Q4 2013, the third consecutive quarterly gain, and PMIs and other lead indicators point to further expansion over coming quarters. Furthermore, there are emerging signs that the nadir in inflation, credit, and monetary aggregates may be occurring.

The ECB has repeatedly stated that while inflation is low, it does not believe that outright deflation on an EU18 basis is a central case risk. While not to dismiss the powerful relative price adjustments taking place in the euro area, there are tentative signs of a basing in inflation. Headline inflation is also being capped by low energy prices (-2.3% y/y in February) and this may remain the case for the foreseeable future. But the 0.2ppt rise in core inflation to 1.0% in February provided encouragement that prices growth has found a base. This is supported by trends in money supply growth, with M3 picking up to 1.2% y/y in January versus 1% in December. The intensity of deleveraging in the banking sector is also slowly easing, with the contraction in credit to the non-financial sector slowing to 2.9% y/y in January from 3% y/y in December and 3.8% y/y in November. These are some of the key factors behind the ECB Governing Council's decision to leave policy unchanged in March.

For the UK, the pace of economic recovery has been noticeably stronger than that of the EU18 and as such, the strength in sterling has been more pronounced. We believe this is a trend that will persist, particularly following the Bank of England's (BoE) move to 'phase two' of its forward guidance policy. Indeed, up until recently the BoE has been relatively quiet on sterling's strength given the help it provides in keeping inflation down and anchoring inflation expectations. While the stronger pound does not appear to be generating a significant drag on the trade balance for now, BoE officials have warned that additional gains in the currency could restrain the economic recovery.

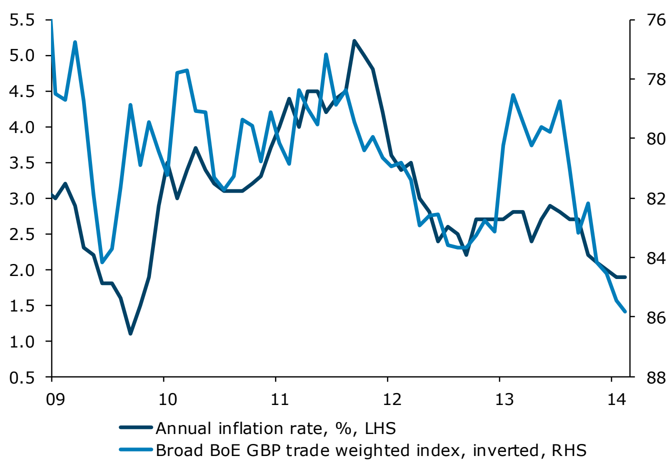
The ECB has repeatedly stated that while inflation is low, it does not believe that outright deflation on an EU18 basis is a central case risk

FIGURE 5. USD/CNY SPOT VERSUS FIX



Source: Bloomberg, ANZ Research

FIGURE 6. GBP PLAYS AN IMPORTANT ROLE IN CONTAINING UK INFLATION



Source: Bank of England, UK Office for National Statistics, Bloomberg

JPY: GLOBAL DRIVERS NOW DOMINANT

There are a number of reasons to suspect that most of the domestic Japanese reasons for yen depreciation have been priced by the currency. USD/JPY appears to be broadly where it should be based on the relative size of the BoJ and Fed's balance sheets, inflation expectations in the inflation bond market are now over 2% in the five year sector, and the yen is very cheap on most long-term valuation measures.

Consider also that the correlation between the yen and the Nikkei and US bond yields has changed substantially this year (Figure 7). The yen's correlation with the Nikkei has remained quite meaningful over the past two years – typically ranging as high as +40%. More recently however, it has declined to almost zero. While this has occurred in the past, at present it is occurring at the same time as the correlation with US bond yields is rising substantially.

These observations imply that global factors have become key to calling the JPY. They suggest that USD/JPY will remain range-bound while the US bond market is uncertain about the pace of the US recovery. Further out however, our forecast of 110 appears achievable on the view that the recovery in the core economies, particularly the US, is likely to result in higher global interest rates. That move should be negative for very low yielders such as the yen.

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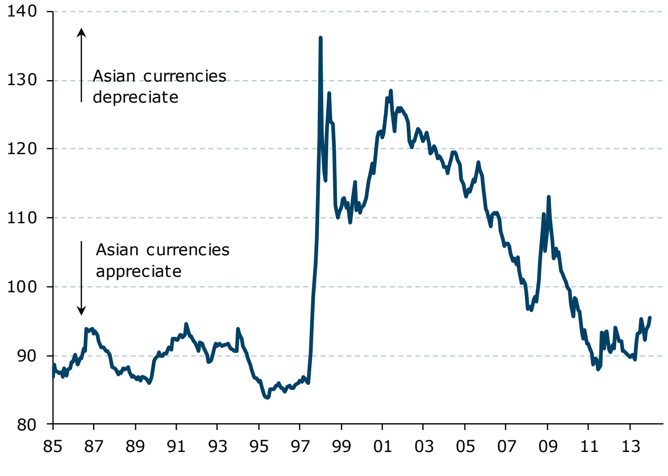
Sam Tuck
Senior FX Strategist

Daniel Been
Senior FX Strategist

Amber Rabinov
Strategist

Khoon Goh
Senior FX Strategist

FIGURE 7. USD/ASIA REAL EXCHANGE RATE



Source: Haver, Bloomberg, ANZ Research

WATCHING AND WAITING

Commodity markets started 2014 in a mixed fashion, with seasonal factors having a greater-than-normal impact. Seasonally, energy and agricultural markets were buoyed by one of the coldest US winters in 30 years, while dryness in parts of Brazil rallied sugar and coffee markets. An earlier Chinese New Year than in 2013 was also a factor to the weak start for commodities. However, seasonal factors aside, underlying demand from China has been unconvincing, culminating in a sharp sell-off in copper and iron ore prices in mid-March on tightening credit conditions and a crackdown on rampant arbitrage activities bringing in hot money via commodity trade channels.

Domestic banks in China are reported to have reduced credit availability not only to the real estate market, but also to steel mills. Banks appear to be reducing their exposure to the steel sector by requesting some mills repay 20% of outstanding loans. Near-term this may keep prices under pressure as reduced credit to the sector worsens already tight cash flows, limiting buying activity on a hand-to-mouth basis. The other concern is that the forced repayment in loans will cause iron ore stockpiles at ports to be liquidated, as stocks used as collateral for loans are sold to repay debt.

However, we do expect key Chinese demand to pick up in the second quarter along with some easing in credit conditions. Participants will move into the busier and warmer second quarter construction season, which should start to draw-down high inventory levels. Visible moves in Chinese steel and base metal stockpiles will be the best bellwether for activity. China's PMIs in March and April are also likely to be important for market confidence.

The market will be looking for a marked improvement in China's PMI for the northern hemisphere spring, after a disappointing read in recent months. If China's PMIs fail to convince the market that a normal seasonal pick-up is in train, then commodity markets are likely to struggle through Q2.

THINGS TO WATCH

Now waiting for stronger Q2 demand to arrive.

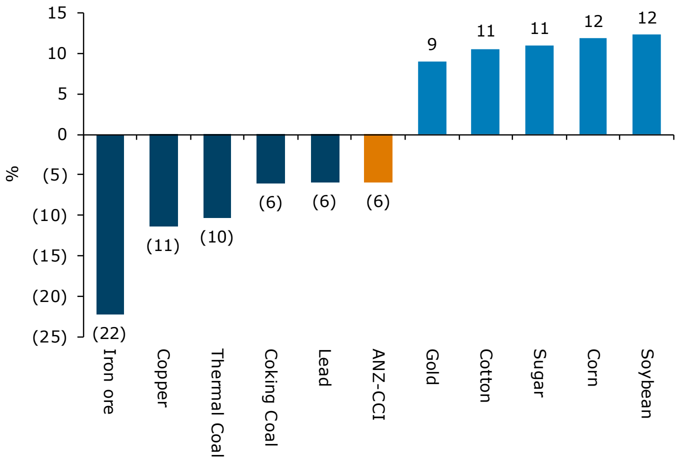
Moves in China commodity inventories and monthly PMIs will be the best bellwether.

Investment fund positions are low and may have priced in too much downside risk in Chinese growth.

Investment funds have so far remained largely sidelined in commodity markets this year. A lack of global inflation and growth concerns around a range of emerging economies are headwinds limiting any broad appeal towards commodities. This is particularly evident in CFTC positioning for the leading commodity of copper, where rising short positions in recent months illustrate still cautious sentiment. However, investment fund positions are low and may have priced-in too much downside risk in Chinese growth. If the authorities can stick to and deliver current growth targets, funds will have to cover short commodity positions. This would be most apparent in the China-demand-exposed base metals and bulk markets.

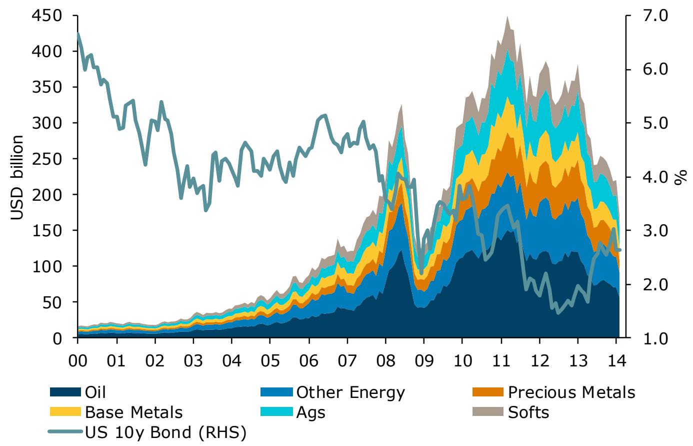
For 2014, our preferred commodity picks are in the base metals and energy markets, where tighter supply conditions or strong leverage to better-developed market growth should support prices. For copper, most of the perceived risk from inventory financing activity from China has been priced in with copper falling to a four year low. We see mild upside for copper prices over the months ahead as Chinese seasonal demand improves. We expect oil prices to hold steady around current levels, supported by increased construction activity from China in the spring.

FIGURE 1. MAJOR MOVERS YEAR-TO-DATE



Source: ANZ Research

FIGURE 2. INVESTMENT FUND COMMODITY POSITIONS



Source: ANZ Research

In agriculture markets, the political uncertainty in the Black Sea region is likely to push additional wheat and corn sales to the US, while in sugar further downgrades to Brazil's production remain a real risk.

BULKS (COAL AND IRON ORE)

Recent falls in bulk commodity prices, stemming from concerns around the Chinese steel industry, look a little overdone, but a more relaxed Chinese policy stance will be needed to improve the outlook. Tight liquidity conditions in China, rising environmental costs, and low seasonal demand for steel inputs are not helping.

However, we feel a bit more upbeat about the coming months with an improvement in seasonal demand on the horizon and declining Chinese steel inventories to prop up oversold steel, and ultimately iron ore and coking coal prices. Coking coal looks the more positive, with rising seaborne supply holding back much better iron ore prices. We expect iron ore prices to move back towards USD120/t in the coming months.

Negative sentiment around the Chinese steel industry has seen iron ore underperform year-to-date, with a slower physical start to the year as the main reason. We remain comfortable that physical demand will lift in Q2, which should see Chinese traders look to re-stock inventory in Q3. Stronger Australian supply in the second half of 2014 should see iron ore prices consolidate towards the end of the year.

The thermal coal market appears a little difficult. A mild winter has left Chinese coal stocks at higher than normal levels. Supply will be the main price determinant and the level of Chinese coal output is likely to be the strongest bellwether. Reports suggest high cost supply shut-ins are once again occurring, although improving transport infrastructure suggests other producers will mop up the left over market share. Indian restocking ahead of the mid-year monsoon season may be a positive, but the price-sensitive market is only likely to dabble if the entry point is low enough. Prices are likely to be range bound between USD75-80/t.

> Our preferred commodity picks are in the base metals and energy markets, where tighter supply conditions or strong leverage to better-developed market growth should support prices

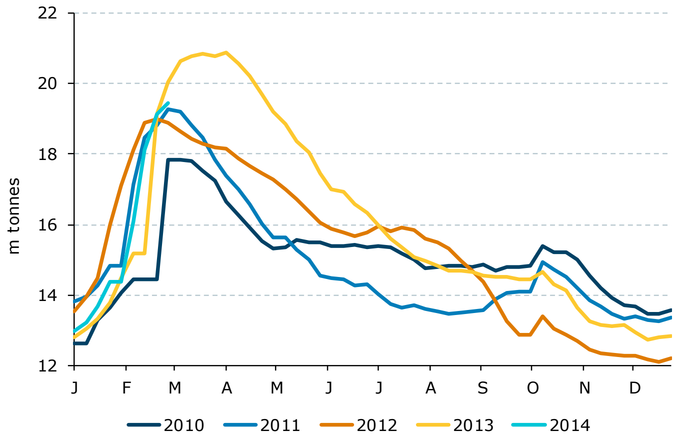
PRECIOUS METALS

Precious metal prices have had a strong start in 2014, though we expect the near-term could see some downside to gold prices as Chinese physical demand has waned. We see the potential for a downward correction in gold prices below USD1,300/oz, notwithstanding the clear 'safe-haven' bid that has supported prices recently. Silver prices will continue to track gold, and PGMs are being supported by industrial action in South Africa and continued geopolitical worries in Russia and the Ukraine.

The fundamentals of physical gold demand should come to the fore in 2014, with the market looking comfortable around the tapering of the US Federal Reserve's asset purchase program. However, Chinese gold demand has slowed significantly in response to higher prices this year, evident in the sharp contraction between the Shanghai and London gold prices in recent weeks. Offsetting this has been a stabilisation in exchange traded fund positions. Long comex investors are also returning while shorts have started to cover positions. If sustained, this would characterise a major shift in the negative sentiment that prevailed through most of 2013.

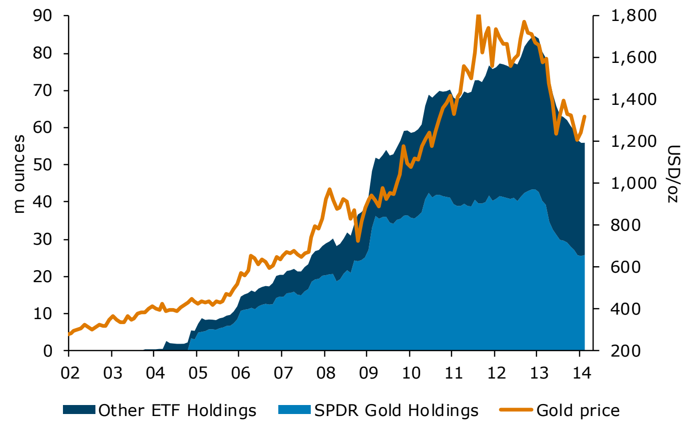
In the PGMs, renewed concerns over the reliability of South African supplies have boosted both platinum and palladium prices, up 6.0% and 4.0% respectively so far this year. In particular, the platinum market remains sensitive to further supply disruptions. Impala Platinum's force majeure declaration in late February is evidence of this. The leverage of both platinum and palladium to the global manufacturing cycle (autos) and looming supply deficits should see both metals well-supported over the next 12 months. Platinum markets remain heavily affected by industrial action in South Africa, with continued non-resolution compounding the problem.

FIGURE 3. CHINA STEEL INVENTORIES



Source: Bloomberg, ANZ Research

FIGURE 4. GOLD PRICE AND ETF HOLDINGS



Source: Bloomberg, ANZ Research

CRUDE OIL

A return of stronger Middle-East crude oil supply will hold down crude oil prices in 2014, though this has been partially offset by a much colder-than-expected US winter. Further out, the oil markets will be more aligned with better US growth and continued debottlenecking of US crude oil supply out of Cushing. The current high level of investor long positions could be concerning for the market if they are convinced to take profits. This leaves WTI with more relative downside risk compared to Brent crude, particularly with the US winter now passing. Continued geopolitical risks in Venezuela, Northern Africa and the Ukraine should support Brent crude.

Market conditions for US oil have been particularly strong through the early part of the year, with WTI outperforming Brent by 3.5% year-to-date. But with the West Texas benchmark coming off a two-year high, heavily bought fund positions, and the US winter passing, we see relative downside risk for the US WTI. Crude oil stocks are expected to build until June, but will be balanced by stronger gasoline demand as the US moves toward its summer driving season.

Brent has come under near-term pressure from soft European seasonal demand and fresh concerns regarding China’s economy. This should pass as China’s construction activity picks up in the back half of March. OPEC output fell below 30 million b/d in January for the first time since October 2010, with Libya in particular suffering another bout of supply disruptions. Global geopolitical tensions (Venezuela, Northern Africa, and the Ukraine) will continue to support Brent, while the progress of Iranian nuclear disarmament discussions may be something to look out for later in the year.

Global demand conditions remain strong, as evidenced by OPEC, the Energy Information Administration (EIA), and the International Energy Agency (IEA) raising their 2013-14 consumption projections due to better demand from OECD countries. The agencies lifted forecasts between 1-1.3% from their January numbers, with global demand now expected to be between 91-93 million barrels per day this year. This is consistent with Chinese imports, which rallied to a record 28.2mt in January, up 12% y/y.

BASE METALS

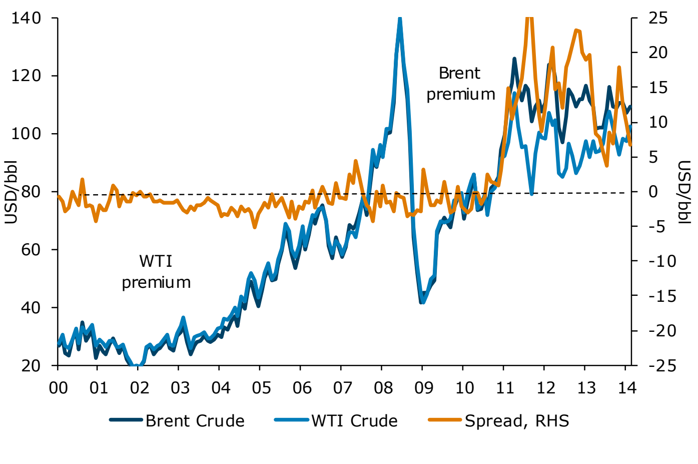
Heavily hinged to unconvincing Chinese growth, base metal prices have underperformed, with sentiment still cautious. However, supply-side fundamentals are causing prices to diverge, with better-performing nickel and zinc offsetting weaker copper and aluminium prices. Copper prices have lagged as funds maintain cautious positioning in US copper futures, despite declining LME stocks over the past 12 months. But an offsetting increase in Shanghai stockpiles and concerns regarding inventory financing activity from China have been priced in, with copper falling to a four year low. We see mild upside for copper prices over the months ahead as Chinese seasonal demand improves.

Nickel prices have recovered off a heavily oversold base amid tightness in supply that was sparked by the Indonesian export ban. Nickel, along with bauxite, are the two most affected commodities, with Indonesia supplying 13% of the world's mined nickel and 19% of the world's bauxite. While it is still unclear whether the restrictions will be modified or watered down, most mining participants have stopped supplying, which suggests that nickel prices should continue recovering.

Zinc has also attracted strong support as LME stockpiles continue to slide. An open China arbitrage fuelled refined zinc imports in the past few months, but like copper, not all of it is destined for end-use, as ongoing tight liquidity conditions attract a high level of inventory financing activity. We would expect some profit taking to kick in over the months ahead as Chinese liquidity conditions improve and short covering dissipates.

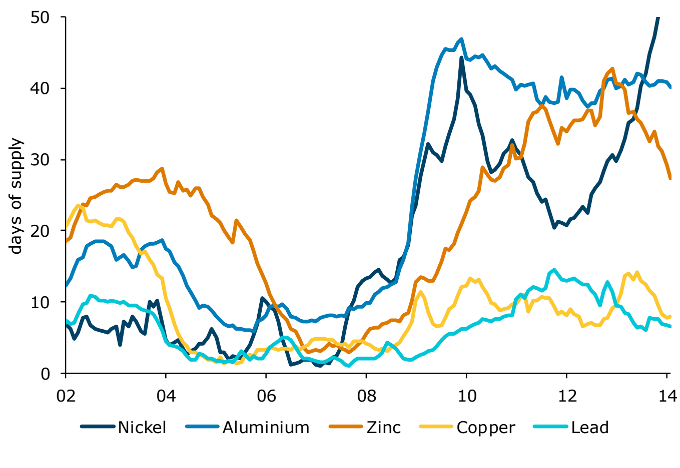
Aluminium prices should remain under pressure as ongoing hoarding of inventories for financing activities continues. This comes at a time when the industry is showing scant supply discipline and operating at lower than expected margins. Main supplier China is operating at much higher domestic aluminium prices, buffering the domestic producers from lower international LME prices. Artificially high physical premiums, due to long load-out times from LME warehouses, has also pushed LME cash prices lower than we would have expected, keeping price gains hard to come by.

FIGURE 5. WTI AND BRENT OIL PRICE PERFORMANCE



Source: Bloomberg, ANZ Research

FIGURE 6. LME STOCKPILES



Source: LME, ANZ Research

AGRICULTURAL COMMODITIES

Prices for several agricultural commodities are likely to have bottomed in the current quarter, after three years of declining prices. Stocks for agricultural commodities have improved over this period, but are still less than adequate in grain and oilseed markets. This has left current supply disruptions providing near-term support for Q2 prices.

Wheat prices are likely to remain above 620USc/bu in coming months, after setting a seasonal low in January. Wheat prices also fell relative to corn in Q1, with wheat no longer expensive versus corn. This leaves marginal downside for wheat prices while corn prices remain supported. Uncertainty over northern hemisphere winter wheat crops and potentially lower exports from the Black Sea region are also supportive factors. Increased yield uncertainty is also particularly apparent in the US Hard Red Winter (HRW) wheat belt.

Sugar prices continue to find support on dryness in Brazil, with further mild gains still possible as the weather outlook in Brazil's centre-south region adds to market concerns of deteriorating cane yields. Rainfall in the last month in the key cane producing region in Brazil was again underwhelming and a substantial recovery in soil moisture seems unlikely in the months ahead. This leaves scope for further downgrades to Brazil's 2014 and 2015 centre south cane production in the months ahead. A planned delay to the start of the 2014 harvest to compensate for lower growth rates in recent months could run the risk of the entire crop not being harvested before the wet season commences.

Cotton market pricing remains sharply divided between old and new crop, with the price spread between May and December 2014 contracts higher than 11USc/lb in February. While this spread is at an extreme, it is justified as near-term supply remains tight amid lower US production and strong export sales. In contrast, new crop pricing reflects an expected sharp contraction in China's cotton imports in the second half of the calendar year, as China ceases accumulating stockpiles, just as a larger cotton crop from the US is also likely.

The second half of 2014 is likely to be the first time in three years where the very poor underlying fundamentals in cotton are fully reflected in prices. Without the price distortions from China, we view December 2014 prices a sell above 80USc/lb and overvalued by as much as 15% at this level.

US beef prices are forecast to remain at record highs in the quarter ahead. Supplies of readily marketable cattle in the US are extremely tight, with cattle on feed greater than 120 days 20% lower than this time last year. However, with this year's seasonal rally in prices occurring earlier than normal, further gains are likely to be hard fought. But the full extent of how US consumers are reacting to higher beef prices will not be known until the key demand period in April and May. The net long speculative position in US live cattle futures has stabilised at a record high, representing nearly 30% of total open interest. This leaves prices vulnerable to a sharp correction if funds decide to liquidate.

> Prices for several agricultural commodities are likely to have bottomed in the current quarter

In Australia, the beef sector has been characterised by a lack of rainfall in the key cattle producing states of Queensland and NSW over the past two months. Cattle turn-off has remained strong, with weekly slaughtering on the east coast of Australia hitting an all-time high in February. The long-term weather forecast is also providing reason to be increasingly cautious that the Australian cattle herd can rebuild in 2014. An equal chance (~45%) of a neutral or negative Southern Oscillation Index (SOI) by August, the latter consistent with an El Niño, should give cause for concern. Historically, an El Niño has meant drier-than-normal conditions, particularly in south eastern Australia. Importantly, the chances of a wetter-than-normal spring in eastern Australia are low, which is likely to limit the extent of buyers restocking cattle later in the year.

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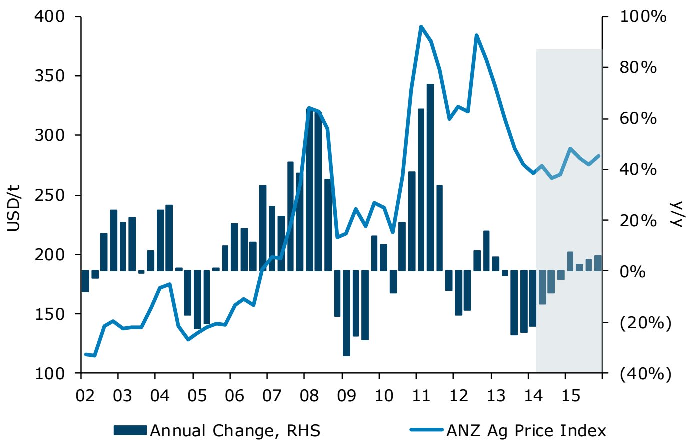
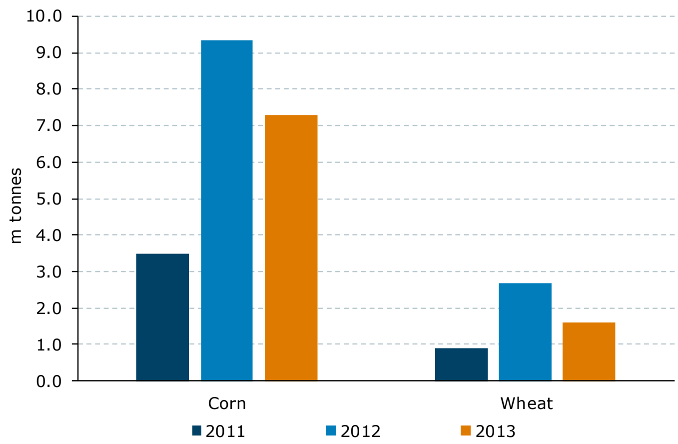
FIGURE 7. AGS PRICE INDEX



Source: ANZ Research

FIGURE 8. UKRAINE WHEAT AND CORN EXPORTS JAN-JUN



Source: ANZ Research

CHINA'S DELEVERAGING AND ASSET MARKETS

This piece was originally published on 4 February 2014 as an FX Insight. While China has eased liquidity conditions over recent weeks, with consequent beneficial effects on Asian financial markets, this is likely to prove transitory.

KEY POINTS

> China's deleveraging process is likely to be substantially different from the 'garden variety' deleveragings that most global investors have experienced.

> This deleveraging is policy driven, growth is still quite strong, the institutional setup is robust and financial liberalisation is occurring in concert.

> In addition, policymakers still exert substantial control over both sides of the national balance sheet. This point, in particular, suggests that an acute adjustment in leverage is unlikely.

> Collectively, these factors imply quite different market outcomes.

> One key issue relates to how China manages one of its key sources of systemic stability - namely opaqueness, with a desire to allocate credit via market forces.

> Certainly, how far interest rates move will depend substantially on how much credit risk is ultimately allowed to be priced. If credit risk remains opaque and subject to a perception of some sort of official backstop, then rates will likely need to overshoot to the topside.

> While an abrupt adjustment is unlikely domestically, developments in China do pose risks to other markets. In fact, with capital flows in China already dwarfing foreign interest in other Asian markets, and with China now offering yields that are higher than a number of its regional peers, financial developments in China are likely to pose a larger risk for third markets, than for China itself.

Over the past year Chinese financial markets have decoupled somewhat from domestic cyclical economic conditions, while at the same time appearing to have a more substantial influence on regional asset markets.

In this piece we provide some structure around the changes in China's domestic financial markets and the implications for regional asset prices.

WHY THIS MATTERS FOR ASIA

It has become increasingly difficult to argue that developments in China's financial markets are relevant for China only. Despite China's portfolio account remaining heavily controlled, China's cross border flows have increased to the point where they now dwarf flows in some of the investor-relevant economies in the region. Consider Figures 1 and 2, which present data from China's balance of payments. (Note that the data for Q3 2013 is the sum of the four quarters to September 2013.)

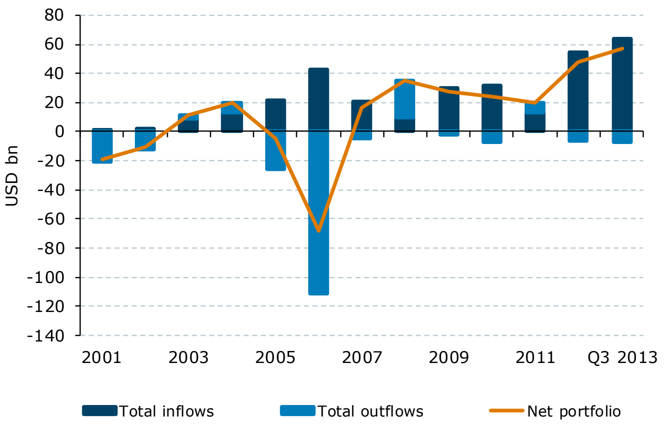
UPDRAFT WILL NOT BE UNIFORM

By Q3 2013 annual portfolio inflows to China had totalled USD64bn, well above 2012's USD54bn and 2007's pre-crisis peak of USD43bn. Notably, resident portfolio outflows only totalled a paltry USD7.3bn, suggesting that domestic capital continues to mainly be allocated within China.

In addition, there have been some very large currency and deposit flows in recent years. In 2012 these recorded an outflow of USD164bn. While in that year net flows were outflows, rather than inflows, the most relevant message is that they were very sizeable. These statistics also do not consider, for instance, the large capital flows disguised in the trade account.

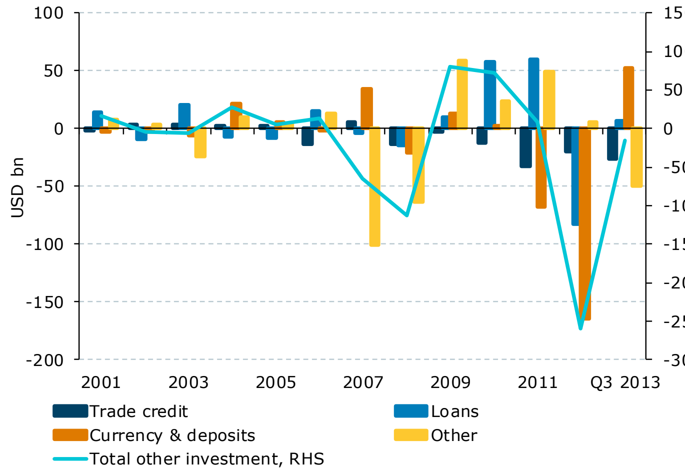
Overall debt levels are high for an economy at China's stage of development, but not for an economy where underlying growth is still very strong.

FIGURE 1. CHINA PORTFOLIO FLOWS



Source: CEIC, Bloomberg, ANZ Research

FIGURE 2. CHINA OTHER INVESTMENT FLOWS



Source: CEIC, Bloomberg, ANZ Research

To put these numbers in context: total foreign ownership of the Indonesian government bond market at the 2013 peak was only USD31bn, and foreign ownership of Malaysian bonds peaked at USD78bn. Comparing these stocks of foreign ownership with the flow in China's balance of payments suggests that even a modest shift in China's attractiveness relative to the region could have very substantial impacts on the capital available elsewhere.

China's deleveraging cycle is becoming more relevant not only because cross-border flows in China have been large and occurring at a time when China's capital account is opening rapidly, but also because it is changing the nature of China as a financial entity.

Consider for instance, that China's five year government bond yield now exceeds that of Asia's high-grade markets of Australia, New Zealand, Korea, Taiwan, and Singapore (Figure 3). This has not occurred previously.

A DELEVERAGING TEMPLATE

Our particular focus therefore, is to examine China's leverage cycle against the backdrop of China's significant and growing external financial market linkages. Certainly it seems clear now that the leverage cycle in China has passed an inflection point. Rather than leverage being built and bank finance expanding, deleveraging is now a more appropriate assessment of the situation. This is not to suggest that the overall stock of credit in China needs to fall sharply, but for some specific sectors in China, the build-up of leverage seems quite mature.

Consider the local government sector: local government debt in China was recently published at 20% of GDP. India's local government debt is 22% of GDP - recalling that India is considered to be a high debt economy. At 40% of GDP, China's overall stock of published debt is at levels which might be viewed as moderate, rather than low. Consider also the IMF's analysis that China's stock of credit is quite mature given China's stage of development (Figure 4).

The cycles of recent years have sparked a number of studies which provide examples of what a typical deleveraging cycle might look like, and against which we might compare developments in China. Consider the following examples: Reinhart and Rogoff's '*This time is different*' (2009), Ray Dalio's '*An in-depth look at deleveragings*' (February 2012) and McKinsey's '*Debt and deleveraging: Uneven progress on the path to Growth*' (January 2012).

Dalio perhaps presents the neatest summary of what a 'garden variety' deleveraging might look like. The difficulty with using these studies as templates for the China situation however, is that the episodes covered in the literature are generally 'crisis-like' in the sense that they typically involve recessions, substantial currency depreciations, very substantial (eventual) monetary easing, and ultimately declining debt levels as the economy recovers.

This style of outcome is far from our central case. Overall debt levels are high for an economy at China's stage of development, but not for an economy where underlying growth is still very strong. The asset side of China's national (and government) balance sheet remains very strong, and significant sources of liquidity remain trapped in the banking system through high reserve ratios. These factors suggest we need to modify the standard template.

DELEVERAGING WITH CHINESE CHARACTERISTICS

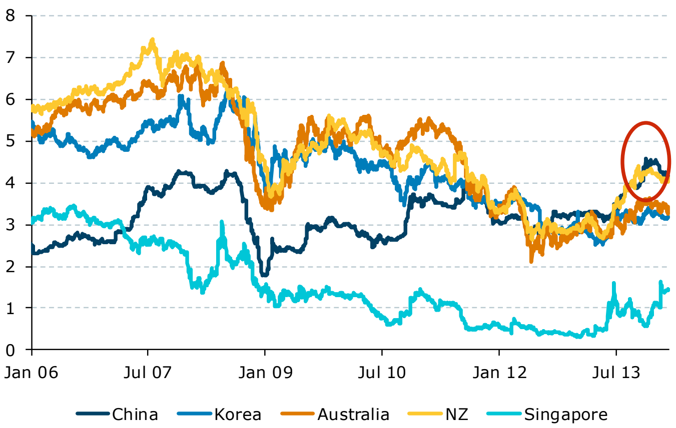
Most of the garden variety deleveragings considered in the historical studies began exogenously. If growth begins to surprise on the downside, stimulus may initially be added to try and keep things going for longer. But the combination of weaker growth and deleveraging lead to negative growth and escalating debt levels (relative to the value of assets), resulting in a crisis. The highest profile deleveragings fit this mould - such the Asian crisis, the 2008 US sub-prime crisis, and the 2011-12 European crisis. This deleveraging cycle in China, however, began under the instruction of policy.

Certainly there is plenty of circumstantial evidence that the liquidity cycle of late has not been driven by typical cyclical factors. For example, bond yields in China typically rise in response to the inflation cycle. Yet over the past half-year, yields have risen sharply with inflation quite stable and well-contained (Figure 5).

Importantly this also implies a greater degree of policymaker control. Recognising a leverage or liquidity issue once it has begun to adjust, with the resulting need to calibrate policy with a lag, is clearly sub-optimal relative to the policy choices that China is making. Relatedly, China more than most, likely has the institutional setup to deal with deleveraging.

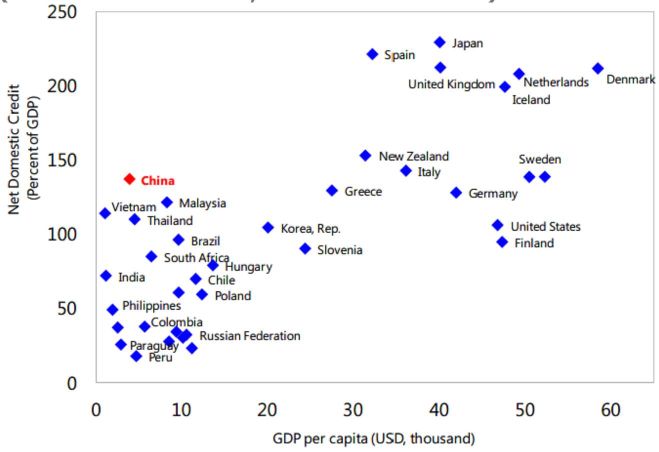
Dalio suggests that "deleveragings are typically badly managed because they come along about once in every lifetime and policy makers haven't studied them". China, conversely, has an institutional arrangement which is more focussed on control, and which has been provided

FIGURE 3. FIVE YEAR BOND YIELDS



Source: CEIC, Bloomberg, ANZ Research

FIGURE 4. NET DOMESTIC CREDIT AND GDP PER CAPITA (SELECT ECONOMIES, 2007-11 AVERAGE)



Source: CEIC, Bloomberg, ANZ Research

with plenty of templates for what not to do in recent years. In addition, policymakers in China have much greater control over both sides of the national balance sheet (ie both the debtors and creditors in the economy).

This policymaker control implies a less abrupt adjustment in leverage as a central case, and a much less indiscriminate demand for liquidity. It is also a critical difference with the sort of deleveragings to which markets have become accustomed.

Related to the policy driver, but important to identify separately, is that China's deleveraging has begun while growth, albeit slowing, is still strongly positive. In a typical deleveraging cycle, the end of the process entails among other things, a decline in the overall level of credit and leverage in the system. It's certainly not obvious that China's objective is to reduce the amount of credit in the system. One suspects that a credit reallocation away from property, the unregulated financial sector, and other speculative activities, towards those sectors that have more productive potential is closer to the aim. More broadly, it seems likely that China wishes increasingly to ensure that lending occurs on commercial grounds, rather than as a result of regulatory arbitrage, and against a backdrop of punitively low interest rates.

In addition, in China deleveraging for some sectors is occurring at the same time as a process of financial reform. Certainly in a garden variety deleveraging financial repression is often the policy response.

Consider in recent years the Western world's re-regulation of banks, periodic limits on specific types of financial transactions (such as shorting bans), and the favouritism shown to borrowers over savers by the introduction of QE. In fact it could be argued that the reform and deleveraging efforts are inextricably linked. The build-up in China of leverage in sectors with official sanction is being addressed through both administrative control on those sectors, and with efforts to ensure the financial system increasingly allocates credit using market mechanisms.

When considered in isolation, that process of financial reform in China is likely to result in higher interest rates. Certainly China seems to have managed to run an economy at very high rates of growth (10%+ in real IP terms over the last decade) with interest rates at very low levels (Figure 6). The benchmark one year deposit rate has not been above 4.14% (the 2008 high) since 1999, and the one year lending rate in the last decade peaked at 7.5% in 2008.

THE MARKET OUTCOMES

In a garden variety deleveraging, policy is typically eased progressively faster, yields for the safest assets fall, and yields of the riskiest assets rise (at least initially), and the exchange rate depreciates. Our objective is to consider how closely China might mirror this typical stylised pattern, taking into account the idiosyncrasies of the particular domestic circumstances in China. Figure 7 presents our key conclusions.

FIGURE 5. AN UNUSUAL POLICY CYCLE

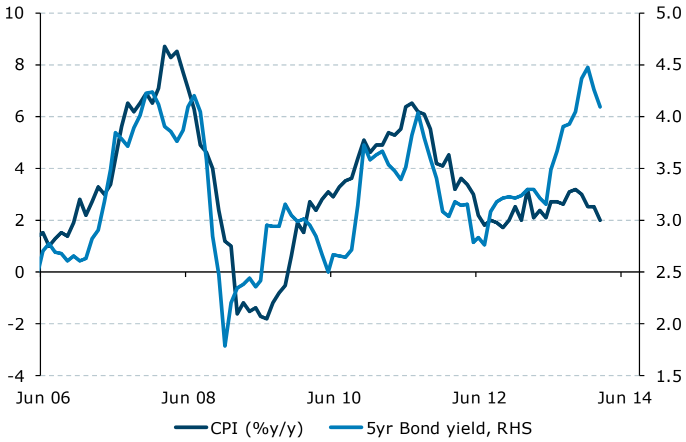


FIGURE 6. CHINA INTEREST RATES AND IP

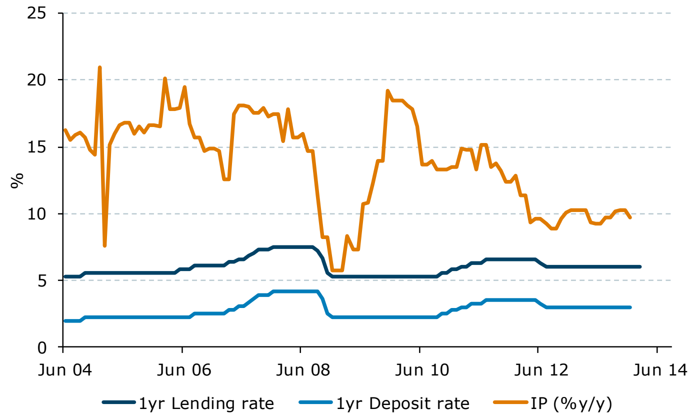
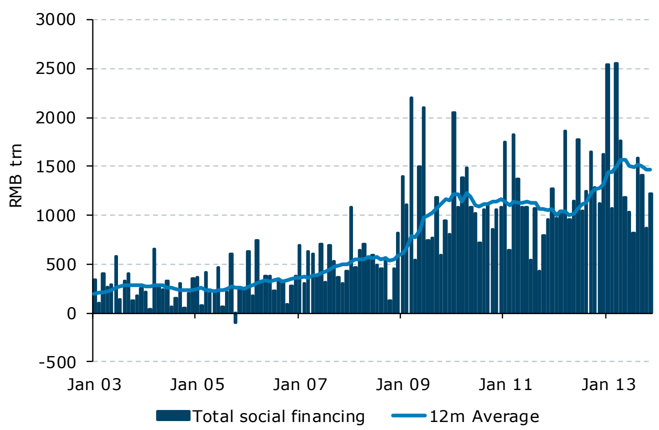


FIGURE 7. KEY CONCLUSIONS

		GARDEN VARIETY DELEVERAGING	CHINA'S DELEVERAGING
MONETARY POLICY	Trend	Easier	Tighter
CASH RATES	Trend	Lower	Higher
TERM RATES	Govt	Lower	Higher
	Credit spreads	Wider	Wider for favoured sectors
			Potentially narrower for others
EXCHANGE	Spot	Depreciation	Appreciation
	Forwards	Ambiguous	Narrower on demand
			Wider on parity

FIGURE 8. TOTAL SOCIAL FINANCING



Source: CEIC, Bloomberg, ANZ Research

CASH

A deleveraging process almost by definition results in an increased demand for cash. The periodic short-end squeezes in China since mid 2013 are indicative of that. Some commentators are calling for more meaningful injections of liquidity to counteract the squeezes. In a garden variety deleveraging cycle, that makes sense. As the deleveraging process would have already overwhelmed the growth cycle, adding liquidity aims to both ease the deleveraging process and stabilise the economy.

In China's case however, there is a complication. As China's deleveraging is policy-induced, adding liquidity counteracts the goal of the policy action itself. Certainly it is difficult to argue that the deleveraging efforts to date have had a particularly large impact. Consider for instance that total social financing is still running close to the average of much of the post-crisis period of approximately RMB1trn per month (Figure 8), and property prices are still rising in many cities.

Over 2013 the largest volatility was at the short end

As such, rather than periodic cash squeezes being offset by easier policy, it seems more likely that policy acts largely to attempt to smooth an overall trend towards tighter liquidity. Certainly this has been the experience thus far in China. The seven day repo typically traded between 2% and 4% over 2012 (Figure 9). The rate has shifted higher to trend consistently at 5%.

TERM RATES

In a garden variety deleveraging cycle term rates for government and credit borrowers can behave in very different ways. Government rates would generally be expected to move lower, at least outside a genuine run on the currency, due to policy easing and a flight for safety. For credit borrowers, spreads against government rates would likely widen because perceived credit quality deteriorates. For credit yields which of these forces dominate can change, both over time and depending on the particular circumstances at the time.

For China, however, this ambiguity does not exist. In the first instance government rates are likely to increase, both because of tighter liquidity and as a result of the financial liberalisation process. In simple terms, financial liberalisation is likely to impose costs on those sectors which have been substantial borrowers at below-market rates and have had ready access to credit.

In parallel, it is likely to convey benefits to those sectors which have been savers at below-market rates, or in fact have been unable to access credit where there is demand. In China it is difficult to envisage another sector which has benefitted from the low interest rates of recent years as much as the government sector.

Consider, for instance in late January over ten Chinese provinces, autonomous regions, and municipalities lowered their budget for transportation investment in 2014. According to the China Business News, the lowered transport infrastructure investment was largely due to the level of debts and financing difficulties faced by local governments.

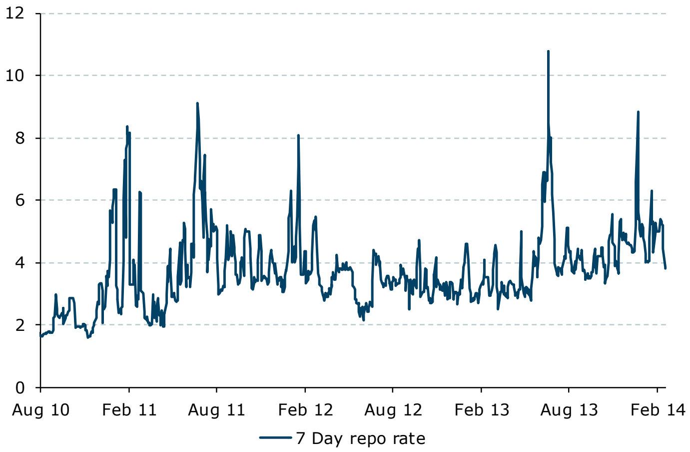
The upshot of all this is that credit borrowers might generally be expected to suffer a double-whammy (at least initially): benchmark government rates are higher, and this is compounded by a widening in credit spreads. The performance of the Chinese equity market in recent times provides another gauge of some of these effects.

In the fullness of time though, some sectoral winners will likely emerge from this process. Those sectors that have been starved of capital will find access improving over time as credit is increasingly allocated on a market basis and as implicit government guarantees for borrowers either become explicit or are removed. Also, higher deposit rates are likely to benefit the savers in the economy.

It will take some time for these winners to emerge. Not least because a more level playing field for credit access would seem something of a pre-condition, and also given the likelihood that by virtue of a historical lack of access to liquidity, the sectors set to benefit are underdeveloped.

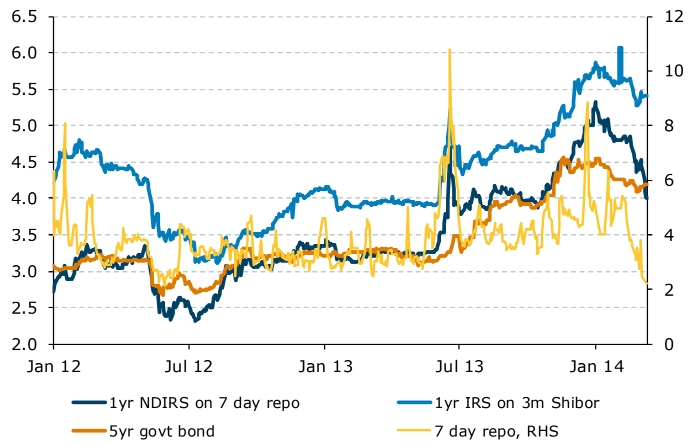
Thus far in China there is substantial evidence of these effects in operation. Figure 10 presents the seven day repo fix, the five year government bond, and a range of one year rates. Over 2013 the largest volatility was at the short end. Term government rates, however, while less volatile, have tended to show a stronger trend. In fact the pattern thus far has been for short end squeezes to be largely temporary, but the coincident increase in long-end rates to be largely permanent.

FIGURE 9. SEVEN DAY REPO RATE



Source: CEIC, Bloomberg, ANZ Research

FIGURE 10. CHINA INTEREST RATES



Source: CEIC, Bloomberg, ANZ Research

For credit more broadly, there is ample evidence of a generalised rise in the cost of borrowing under way for existing borrowers. Figure 11 presents data on credit spreads from ChinaBond, suggesting that for A-rated borrowers and above, borrowing costs have increased substantially. Credit spreads have widened in tandem with a rising benchmark rate.

China's corporate bond market is not as developed as elsewhere in Asia. As a share of each country's GDP the markets of Korea, Malaysia, Singapore, Hong Kong, and even Thailand are larger (Figure 12). In addition, the market is quite concentrated, with the top 10 issuers accounting for 32% of bonds outstanding. As a broad signal however, the message seems clear.

How far rates move will depend substantially on how much credit risk is ultimately allowed to be priced. Consider for instance, recent speculation about the potential default of an RMB3bn onshore trust product, and the eventual agreement which will reportedly honour the trust's commitments. In our view, if credit risk remains opaque and subject to a perception of some sort of government backstop, then rates may well need to rise substantially further.

Certainly in such an environment banks would seem incentivised to continue lending, with less creditworthy borrowers likely to be less sensitive to higher rates. In addition, originators of financial products will likely compete to present the highest yield products, which will entail taking on progressively more investment risk.

In addition, without a genuine credit discovery process, rising rates may well just drive leverage into the more opaque corners of the financial system.

As such, absent the perception that borrowers and lenders will genuinely be able to lose money, demand in the economy for the poorest quality financial products and lending to the highest risk borrowers will likely increase as interest rates rise. The increase in yields on wealth management products over the past year provides some evidence that this effect may be in operation (Figure 13).

FOREIGN EXCHANGE

For the RMB, the market outcome is likely to reflect the interplay of a range of forces, including higher carry, cross-border financial reform, the repricing of credit risk in China and the reform of currency policy itself. With regard to currency policy there is substantial evidence that the emphasis of reform and liberalisation within domestic financial markets is being reflected in the approach to the RMB.

Consider, for instance, comments from Deputy PBoC Governor Yi Gang who was reported by the China Securities Times on 9 January as suggesting that "China

FIGURE 11. CREDIT SPREADS FROM CHINABOND

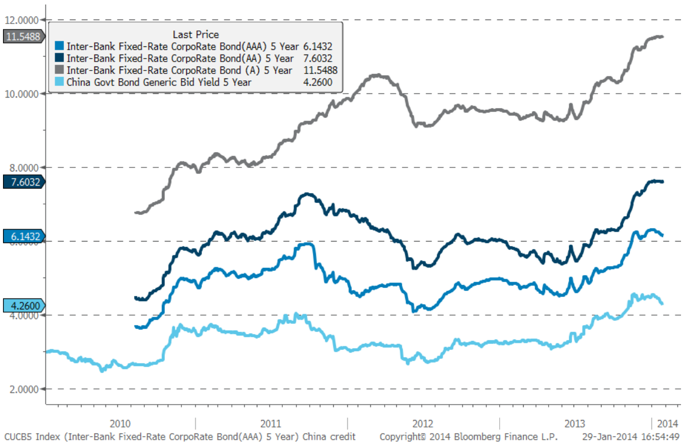


FIGURE 12. LOCAL CURRENCY BOND MARKETS

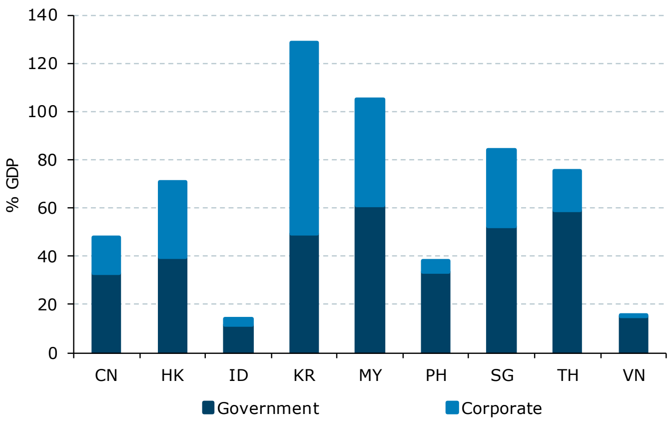


FIGURE 13. YIELD ON WEALTH MANAGEMENT PRODUCTS

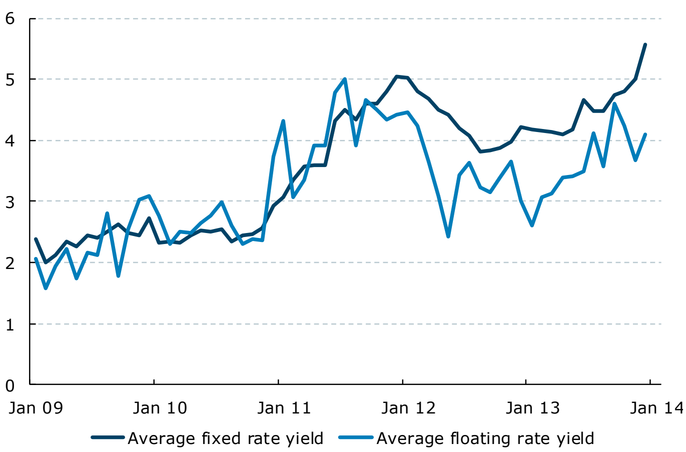
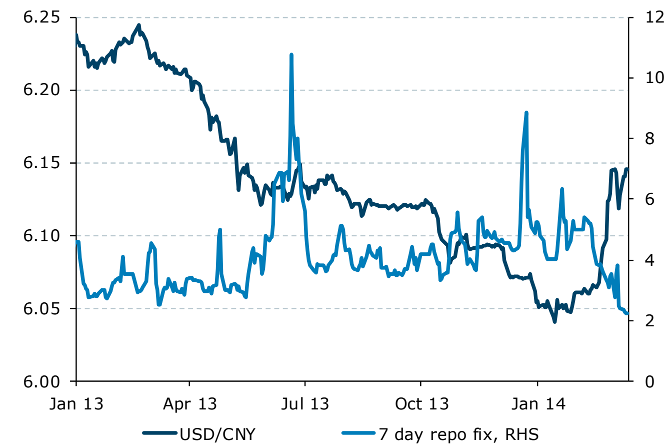


FIGURE 14. RMB AND RATES



Source: CEIC, Bloomberg, ANZ Research

should reconsider its foreign exchange management strategy as the marginal cost to accumulate foreign reserves exceeds its marginal income." Certainly to date the acceleration in domestic financial reform and a more permissive approach to the exchange rate have occurred largely in lockstep, suggesting that the appreciation trend in the currency is likely to persist for the time being.

In addition, there seems to be a strong interplay between these two streams. The appreciative impact on the exchange rate as interest rates rise is well understood, but consider also that it may be that the liquidly squeezes in China are at least partly due to developments on the FX front. Both the June and October increases in money market rates occurred around the same time as strong RMB appreciation moves halted (Figure 14). In the June episode, the initial low in USD/CNY was on 27 May; the low in money market rates was on 9 May and money market rates broke 5% on 6 June. More recently, the initial low in USD/CNY was on 23 October, and the low in money market rates was on 22 October. Subsequently money market rates have declined, but the impact on long end rates has been more sustained.

There is some evidence, therefore, that money market rates come under upward pressure whenever the liquidity that comes from FX intervention wanes. At the very least this suggests that how market rates trade relative to the currency is an issue which bears watching closely. More broadly, the decline in the FX forward (points) seems to be at odds with the rise in Chinese interest rates (Figure 15).

Certainly the compression in the forwards is understandable in the context of the recent strength of carry-related demand for the CNY. However, not only does it seem at odds with the rise in onshore interest rates, but it also does not necessarily fit with the reform push. Certainly over time, as efforts concerning capital account liberalisation, the Shanghai Free Trade Zone, and RMB internationalisation progress further, the FX forward should become increasingly fungible with China's interest rate curves.

Moreover, while our central view is that China will manage its deleveraging cycle without the run on liquidity that has occurred elsewhere in recent years, there is obviously some uncertainty around this view. The FX forwards are effectively pricing that risk at zero, suggesting some clear upside in the forwards relative to current levels.

CONCLUSIONS AND BROADER MARKET IMPLICATIONS

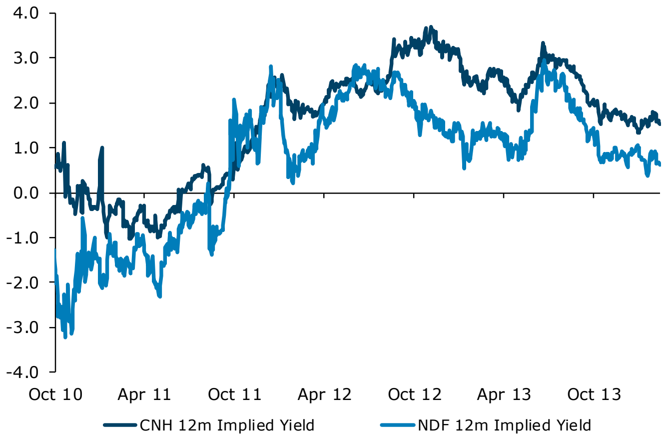
China is undergoing a deleveraging process as well as a process of financial liberalisation. The combination of these influences, coupled with the particular characteristics present in China, suggests that this will look little like a garden-variety deleveraging cycle. Squeezes in front end rates are likely to have more permanence, term government rates are likely to remain under upward pressure, and credit for existing borrowers will become more expensive. At the same time, credit-worthy borrowers currently denied ready access to funding may well discover that access improves in time.

In addition, we assess the risk of a dislocatory adjustment in credit to be low. The combination of the opaqueness of China's governance structure, as well as policymakers having substantial control over both domestic creditors and debtors, suggests that acute credit risks can be absorbed when required. How this balances against the underlying desire to move towards a market-driven credit allocation system remains an open question. And certainly in our view, unless credit risk is fundamentally realised in the system, interest rates will likely need to overshoot their equilibrium rate to the topside to generate the reduction in leverage that seems to be a policy aim.

In our assessment, therefore, China's deleveraging cycle poses greater risks for regional asset markets than for China itself. Cross-border financial flows in China have grown substantially in recent years, suggesting that shifts in capital flows are increasingly relevant for the region and not just China itself. Moreover, with Chinese government bond yields now higher than many markets in Asia, and the RMB one of the few currencies on an appreciating track, China has become a genuine competitor for capital in the region. Further financial reform in China can only exacerbate this trend, suggesting that the decorrelation between the CNY and Asian currencies will likely persist (Figure 16). This highlights our view that Asian markets will continue to weaken under the pressure of a higher global cost of capital.

Richard Yetsenga
Head of Global Markets Research, ANZ

FIGURE 15. CNH/NDF IMPLIED YIELDS



Source: Bloomberg, ANZ Research

FIGURE 16. ASIAN CURRENCIES AND CNY

Source: Bloomberg, ANZ Research

THE RISE OF THE INDONESIAN CONSUMER

Indonesia is one of the region's systemically important economies and is on track to become systemically important globally. With nearly 250 million people, it has the world's fourth largest population, and is the third largest democracy after the US and India. The size of Indonesia is just one aspect of its promise. Indonesia's demographics are incredibly favourable with more than 60% of the population aged 20-65, or working age. The working age population of Indonesia is three times that of South Korea's entire population. Another 27% of Indonesia's population is aged below 15, meaning the economy has enormous potential for labour productivity gains as this cohort moves through education and brings a better-developed skillset into the labour force.

INDONESIA'S POWERFUL AGGREGATE INCOME FORMATION POTENTIAL

Based on 2013 figures, around 54% of Indonesia's population is aged less than 25 years of age. Indeed, around 37% of the population is aged less than the standard input into labour force calculations, the working age population aged between 20 and 65. As Figure 1 shows, the distribution of Indonesia's population under the age of 20 is progressively more skewed towards the younger cohorts. Assuming unchanged participation rates, an additional 4.5-5 million people look set to enter the working age population each year for the next 10-15 years.

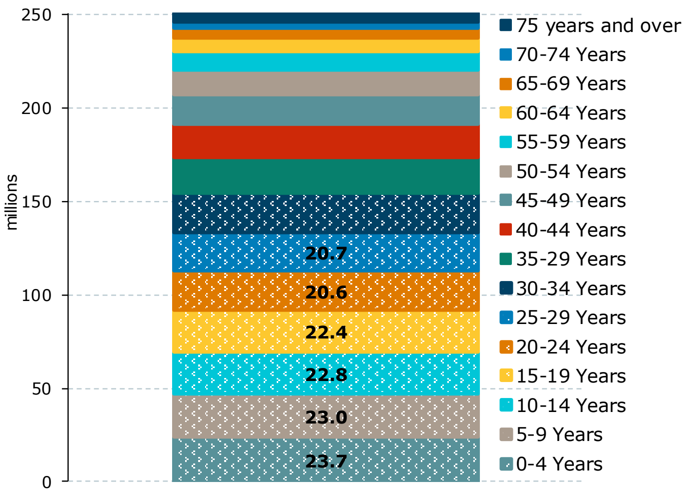
The growing size of the working age population, and the labour force with it, is just one part of the equation. The average earnings of the labour force are increasing at a fast clip. Monthly minimum wages increased by around 20% in 2013 and announced increases for 2014 were above 20% - the strongest pace of minimum wages growth in over a decade.

Though the absolute level of wages remains quite low, the strong growth in minimum wages provides a floor under wage growth, and tends to trickle up into stronger wage gains throughout the labour force. If we look at total average wages for Indonesia, in 2013 these increased by 16%, and are expected to post a similar gain in 2014.

As the size of the working age population is growing by approximately 4.5-5.0 million people per year (and given labour force participation), a slightly lower increase in the labour force, multiplied by a wage structure that is increasing by 16-20% per year, aggregate income formation dynamics in the Indonesian economy are profoundly powerful at this time.

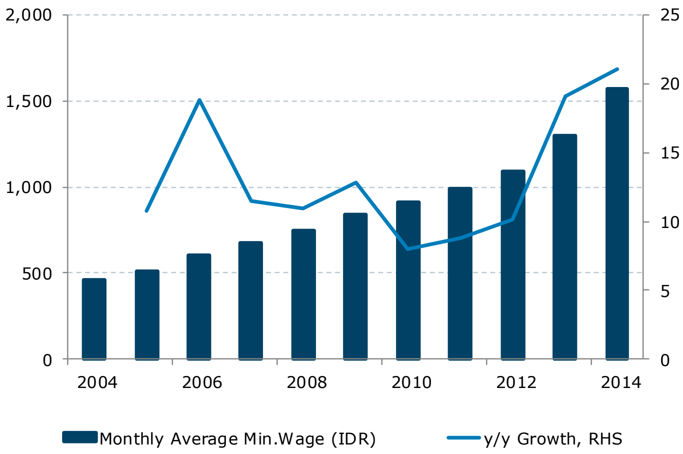
> Given these profound structural changes, ANZ is partnering with Roy Morgan Research to launch a monthly consumer confidence for Indonesia

FIGURE 1. INDONESIA'S YOUTHFUL POPULATION



Indonesia has a population of 133m people aged under 25 years of age. That is 54% of the population, one of the most favourable demographic profiles in Asia.
Source: CEIC, ANZ Research

FIGURE 2. STRONG MINIMUM WAGE GAINS



Source: CEIC, ANZ Research

THE EMERGENCE OF AN INDONESIAN CONSUMER CLASS

With aggregate income formation dynamics so strong, the proportion of the population moving into what we will call the 'consuming class' is growing very strongly. Definitions of what constitutes a middle-class household in Asia are highly variable. Indeed, we stress that local circumstances need to be taken into account given the size of domestically focussed markets and highly varying relative purchasing power profiles. For instance, Mastercard has used the $5,000 per annum income level as the threshold at which discretionary spending starts to pick up. Others, such as the Asian Development Bank (ADB), believe that discretionary spending starts to occur at much lower levels, even as little as $2 per day in some economies, but more generally from a level of $10 per day.

As the broad rule of thumb is that a per capita income of $5000 per day is the level at which wide-spread motor vehicle ownership becomes possible in the emerging markets, we lean towards the Asia Development Bank's lower benchmarks. Typically, a motor vehicle is the second largest durable good purchased by a household after the family home in developed economies, and more often than not the single largest durable good purchase by a household or individual in a developing economy. As such, we believe the tipping point for discretionary spending is probably occurring at much lower levels than has been previously estimated.

For Indonesia, we believe that a genuine discretionary dynamic is occurring at lower levels of income, at around $5 per day. Based on our calculations, Indonesia's average wages moved sustainably through the $5 per day mark in 2010, and hence the beginning of a broad-based discretionary spending capability within the Indonesian economy has only been a recent phenomenon. As Indonesia's wages are growing around 20% per year, the economy is moving firmly and durably into the discretionary spending space.

I THINK THEREFORE I AM: INDONESIA'S HIGH PROPENSITY TO CONSUME

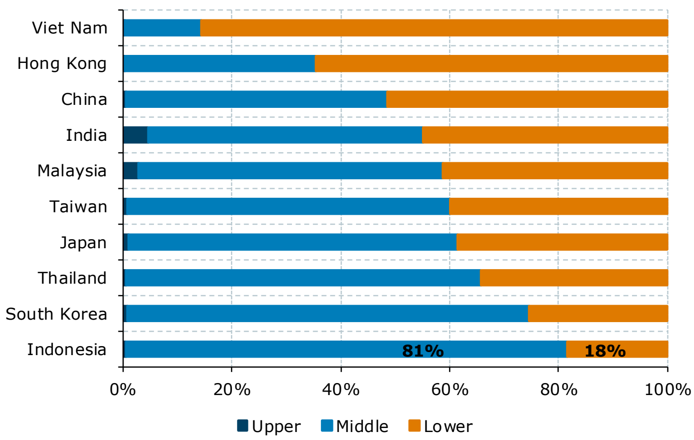
A particularly interesting dynamic, is the proportion of Indonesians who already identify as 'middle class'. This point reinforces our view that discretionary spending dynamics are kicking in at lower levels in Indonesia than has been seen in other emerging economies.

This point is highlighted by the subjective components of the 2010 World Values Survey (2010 is the year we believe Indonesia's average income levels moved into the discretionary spending area). When asked to which social class individuals believed they belonged, Indonesia was the economy with the highest proportion of respondents who already identified as 'middle class'. Approximately the same proportion of Indonesians identified as 'middle class' as South Koreans, despite a significant difference in actual per capita income levels.

Though a subjective survey, there are important economic implications to the high proportion of Indonesians who already identify as 'middle class'. The first is that the propensity to consume is likely to be higher than it would be in a population cohort who did not identify as middle class. These aforementioned cohorts are likely to have more cautious spending behaviours and perhaps a higher tendency to save, rather than consume.

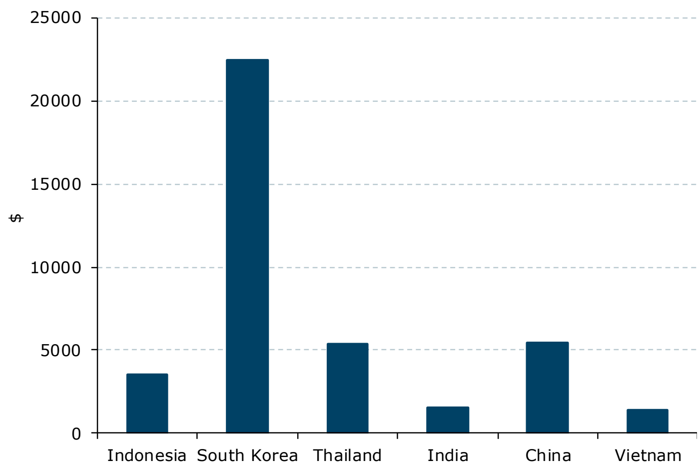
The second is that the perceptions-based survey is probably indirectly capturing the differing purchasing power levels of varying economies. Compared to the more expensive, mature economies such as South Korea and Japan, a relatively lower labour and price cost structure in Indonesia would mean that purchasing power may be relatively higher, enabling a larger proportion of the population to perceive themselves as 'middle class', even though on a relative and absolute basis, income levels still appear rather low.

FIGURE 3. I THINK THEREFORE I AM. THIS IS AN ASPIRANT POPULATION



Source: World Values Survey, ANZ Research

FIGURE 4. RELATIVE INCOME LEVELS IN INDONESIA ARE LOW



Source: World Values Survey, ANZ Research

THE 'CONSUMING CLASS' WILL BE AN IMPORTANT STABILISER OF THE INDONESIAN ECONOMY

This rapidly emerging 'consuming class' will come to be a significant stabiliser in the Indonesian economy. We estimate there are now around 75 million people in the 'consuming class' in Indonesia, and forecast this number to double to 150 million people over the next 10 years. Over the next decade then, Indonesia will add approximately seven million people to the consuming class each year.

Private consumption already accounts for 55% of the Indonesian economy and this share is set to rise. As the consuming class continues to grow, demand for homes, durable goods, electronics, motor cycles, and motor vehicles will expand strongly with it. Consumer spending will also start to make itself more in demand for services such as education and financial services. Overall, consumption as a share of GDP is likely to rise as the 'consuming class' in Indonesia grows.

More importantly, as consumption tends to be stickier than income, a rising share of consumption points to greater stability in the Indonesian growth profile going forward.

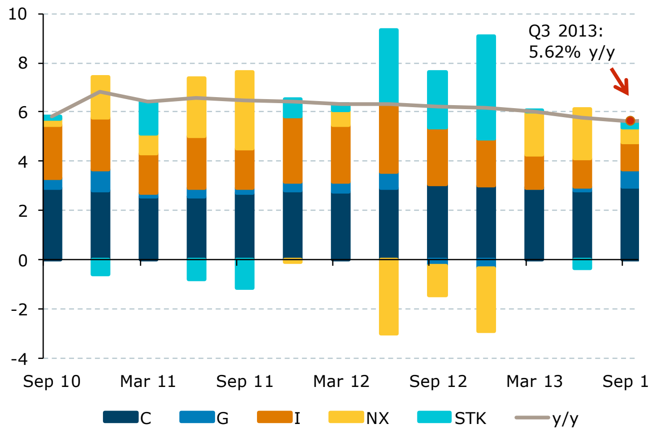
CONCLUSION: AN ACCURATE MEASURE OF CONSUMER SENTIMENT IS NOW REQUIRED

Where the Indonesian consumer goes, the Indonesian economy will increasingly follow. Over half of Indonesia's GDP now comes from private consumption and this share will only grow in coming years. The Indonesian economy has unique characteristics which suggest a consuming class is emerging faster than many expected, but more importantly the propensity of that class to spend on discretionary consumer goods and services appears to be particularly high.

We are confident that the ANZ-Roy Morgan Indonesian Consumer Confidence Survey will become a vital tool for policymakers, multinational corporations, small-to-medium enterprises, and Indonesia economy watchers alike to monitor and analyse this increasingly important economy.

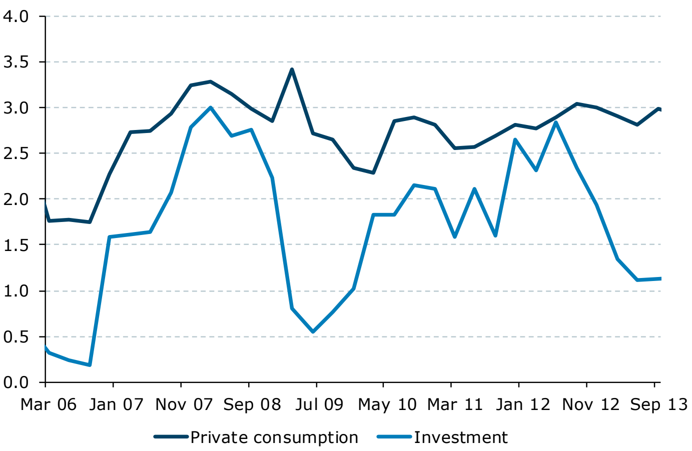
Glenn B. Maguire
Chief Economist, Asia-Pacific

FIGURE 5. CONSUMPTION ACCOUNTS FOR 55% OF GROWTH …



Source: CEIC, ANZ Research

FIGURE 6. ….AND IS MUCH LESS VOLATILE THAN INVESTMENT



Source: CEIC, ANZ Research

FORECASTS

COMMODITIES

COMMODITY	Unit	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15
Base metals								
Copper	USD/t	7,374	7,270	7,490	7,710	7,930	7,930	7,710
Aluminium	USD/t	1,754	1,720	1,760	1,810	1,830	1,940	1,980
Lead	USD/t	2,190	2,120	2,180	2,250	2,310	2,380	2,380
Nickel	USD/t	13,829	14,550	14,770	15,210	15,870	16,530	17,190
Zinc	USD/t	2,053	1,980	2,030	2,090	2,180	2,270	2,310
Precious metals								
Gold	USD/oz	1,206	1,280	1,350	1,400	1,450	1,470	1,480
Silver	USD/oz	19.5	21.0	22.5	23.3	24.2	24.5	24.7
Platinum	USD/oz	1,369	1,380	1,463	1,492	1,529	1,558	1,590
Energy								
WTI Crude	USD/bbl	98	101	103	100	102	105	105
Dated Brent	USD/bbl	111	110	111	108	110	112	112
Bulks								
Iron Ore Spot (CIF China)	USD/t	134	123	120	122	120	118	118
Iron Ore Contract (FOB Aust)	USD/t	124	118	113	111	111	110	108
Coking coal - Premium Hard	USD/t	152	143	132	138	145	150	155
Coking coal - Semi soft	USD/t	106	104	100	104	110	114	117
PCI coal	USD/t	120	116	110	113	117	120	123
Newc Thermal Coal (Spot)	USD/t	85	78	81	82	85	86	89
Newc Thermal Coal (JPY Contract)	USD/t	95	95	83	83	83	83	90
Agriculture								
Corn	USc/bu	430	440	480	450	440	510	520
Wheat	USc/bu	660	590	620	630	640	670	650
Soybeans	USc/bu	1300	1330	1240	1160	1200	1240	1160
Soybean Oil	USc/lb	40	39	39	40	40	41	41
Palm Oil	MYR/t	2530	2640	2500	2500	2500	2450	2450
Sugar	USc/lb	17.7	16.1	16.8	16.2	17.0	18.9	17.6
Beef	USc/lb	132	141	138	129	138	130	123
Cotton	USc/lb	87	93	85	81	80	82	81
Wool	AUD/kg	10.4	9.9	11.0	10.0	9.5	10.7	11.0

Hard commodity forecasts are end of period prices and ags/softs forecasts are average quarterly prices.
Source: ANZ Research

CONSUMER PRICE INDEX INFLATION (YEAR-AVERAGE)

					Forecasts	
Country/region	**Average[1]**	**2011**	**2012**	**2013e**	**2014**	**2015**
World[2]	4.8	3.7	2.9	3.1	3.4	3.5
US	2.9	3.1	2.1	1.5	1.8	2.2
Euro area	2.7	2.7	2.5	1.4	1.2	1.5
Japan	0.6	-0.3	0.0	0.3	2.5	1.7
UK	2.6	4.5	2.8	2.6	2.3	2.1
China	5.1	5.4	2.7	2.6	3.3	3.5
Australia	2.8	3.3	1.8	2.4	3.0	2.8
New Zealand	2.3	4.0	1.1	1.1	1.9	2.4
Developed Economies	2.5	2.6	1.9	1.4	1.7	1.9
East Asia[3]	5.3	5.2	2.8	2.8	3.4	3.5
South Asia[4]	7.4		7.5	6.3	5.9	5.7
Emerging Economies[1]	9.5	6.7	5.2	4.9	5.2	5.2

[1] Long-term average from 1995

[2] Excludes much of Africa and the Middle East

[3] Includes China, Korea, Taiwan, Indonesia, Thailand, Hong Kong, Malaysia, Singapore, Philippines, Vietnam

[4] Includes India, Pakistan, Bangladesh, Sri Lanka

Source: Consensus Economics, Thomson Reuters Datastream, ANZ Research

FORECASTS

GROSS DOMESTIC PRODUCT (YEAR-AVERAGE % CHANGE)

	1990-2007				Forecasts	
	Average	2011	2012	2013e	2014	2015
World (PPP)[1]	3.6	3.6	3.1	3.0	3.6	3.8
US	3.0	1.8	2.2	1.9	3.0	2.7
Euro area	2.2	1.5	-0.6	-0.4	0.8	1.5
Japan	1.2	-0.6	1.9	1.7	1.8	1.5
UK	2.6	1.0	0.3	1.4	2.3	2.3
Canada	2.7	2.6	1.7	1.8	2.2	2.5
Australia	3.4	2.6	3.6	2.4	3.2	3.2
New Zealand	3.0	1.9	2.6	2.7	3.7	3.1
Developed Economies	2.5	1.4	1.2	1.2	2.1	2.1
East Asia[2]	4.9	7.6	6.5	6.5	6.3	6.5
China	10.0	9.3	7.8	7.7	7.2	7.3
Hong Kong	4.2	4.9	1.4	2.9	3.5	3.5
Indonesia	4.9	6.5	6.2	5.8	5.8	6.2
Malaysia	6.5	5.1	5.6	4.7	5.0	5.3
Philippines	3.7	3.9	6.6	7.2	7.3	6.5
Singapore	6.8	5.2	1.3	4.1	3.5	3.5
South Korea	5.8	3.6	2.0	2.8	3.7	3.4
Taiwan	5.5	4.1	1.3	2.0	3.6	4.1
Thailand	5.2	0.1	6.4	2.9	2.2	4.8
Vietnam	7.5	5.9	5.0	5.3	5.6	5.8
India	6.1	7.7	4.0	4.7	5.0	5.0
Latin America[3]	3.5	4.6	2.9	2.5	2.5	3.1
Brazil	2.3	2.7	0.9	2.2	2.0	2.3
Mexico	3.2	3.9	3.9	1.2	3.4	4.0
Argentina	3.8	8.9	1.9	3.8	0.2	1.1
Emerging Economies	5.8	6.9	5.1	5.1	5.2	5.5

[1] Excludes much of Africa and the Middle East

[2] Includes China, Korea, Taiwan, Indonesia, Thailand, Hong Kong, Malaysia, Singapore, Philippines, Vietnam

[3] Forecasts sourced from Latin America Consensus Economics

Source: Consensus Economics, Thomson Reuters Datastream, ANZ Research

FORECASTS

RATES (%)

	Mar 14*	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15
Europe							
Refinance rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3m euribor	0.30	0.30	0.30	0.30	0.30	0.30	0.30
10y bund	1.55	2.10	2.30	2.50	2.50	2.50	2.50
UK							
Base rate	0.50	0.50	0.50	0.50	0.75	0.75	1.00
3m libor	0.52	0.52	0.52	0.52	0.52	0.52	0.52
10y gilt	2.66	2.60	2.80	3.00	3.40	3.40	3.40
Canada							
Discount rate	1.00	1.00	1.00	1.00	1.00	1.25	1.50
3m libor	1.17	1.17	1.17	1.17	1.17	1.17	1.17
10y bond	2.39	2.50	2.70	2.90	2.90	2.90	2.90
Japan							
Target rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3m tibor	0.21	0.21	0.21	0.21	0.21	0.21	0.21
10y JGB	0.63	0.63	1.10	1.20	1.20	1.20	1.20
US							
Fed funds rate	0.25	0.25	0.25	0.25	0.25	0.50	0.75
3m libor	0.23	0.40	0.40	0.50	0.60	0.80	1.10
6m libor	0.33	0.50	0.50	0.60	0.80	1.00	1.30
2y note	0.34	0.60	0.70	0.90	1.00	1.20	1.50
5y note	1.53	1.90	1.90	2.00	2.00	2.20	2.50
10y note	2.65	3.20	3.40	3.50	3.50	3.60	3.80
30y bond	3.60	3.90	4.10	4.30	4.40	4.60	4.80

*Note: March 2014 rates are current rates, not market forecasts.

Australia	Mar 14*	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15
RBA cash rate	2.50	2.50	2.50	2.50	2.75	3.00	3.25
90-day bank bills	2.67	2.65	2.65	2.65	2.90	3.15	3.40
3y bond	2.87	3.40	3.70	3.80	3.90	4.20	4.30
10y bond	4.04	4.45	4.65	4.70	4.80	5.00	5.10
3y swap	3.11	3.80	4.10	4.20	4.30	4.60	4.70
5y swap	3.65	4.30	4.50	4.60	4.80	4.90	5.10
10y swap	4.41	4.95	5.15	5.20	5.30	5.40	5.60
10y spread to US	1.38	1.25	1.25	1.20	1.30	1.40	1.30
3s10s bond curve	1.16	1.05	0.95	0.90	0.90	0.80	0.80
New Zealand							
NZ OCR	2.75	3.25	3.25	3.50	3.75	3.75	4.00
90-day rate	3.14	3.50	3.50	3.92	4.00	4.00	4.40
180-day rate	3.26	3.60	3.55	3.95	4.05	4.05	4.45
10y bond	4.90	5.04	5.20	5.20	5.15	5.20	5.35
NZ-US 10 year spread	1.90	1.84	1.78	1.72	1.66	1.60	1.54

*Note: March 2014 rates are current rates, not market forecasts.

RATES CONTINUED (%)

	Mar 14*	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15
G4							
US	0.25	0.25	0.25	0.25	0.25	0.50	0.75
Euro area	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Japan	0.0-0.1	0.0-0.1	0.0-0.1	0.0-0.1	0.0-0.1	0.0-0.1	0.0-0.1
UK	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Commodity							
Canada	1.00	1.00	1.00	1.00	1.00	1.25	1.50
Australia	2.50	2.50	2.50	2.50	2.75	3.0	3.25
New Zealand	2.75	3.25	3.25	3.50	3.75	3.75	4.0
Emerging Asia							
China	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Hong Kong	0.50	0.50	0.50	0.50	0.50	0.75	1.00
India	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Indonesia	7.50	7.50	7.50	7.50	7.50	7.50	7.50
Malaysia	3.00	3.00	3.25	3.50	3.50	3.50	3.50
Philippines	3.50	3.50	3.75	4.00	4.00	4.00	4.00
South Korea	2.50	2.50	2.50	2.75	2.75	3.00	3.00
Taiwan	1.875	1.875	1.875	2.000	2.125	2.250	2.375
Thailand	2.00	2.00	2.00	2.00	2.25	2.25	2.25
Vietnam	6.5	6.5	6.5	6.5	6.5	7.00	7.00

Source: Relevant Central Banks, Bloomberg, ANZ Research

*Note: March 2014 rates are current rates, not market forecasts.

FORECASTS

FOREIGN EXCHANGE RATES

	CURRENT	FORECASTS					FORWARDS		
	18 Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	3-mths	6-mths	12-mths
EUR/USD	1.3933	1.39	1.40	1.42	1.42	1.43	1.39	1.39	1.39
GBP/USD	1.6637	1.70	1.72	1.73	1.75	1.75	1.67	1.66	1.66
USD/JPY	101.72	107	110	110	110	110	102	102	101
EUR/GBP	0.83738	0.82	0.81	0.82	0.81	0.82	0.84	0.84	0.84
EUR/CHF	1.21610	1.25	1.26	1.28	1.30	1.30	1.21	1.21	1.21
USD/CHF	0.8729	0.90	0.90	0.90	0.92	0.91	0.87	0.87	0.87
AUD/USD	0.9078	0.84	0.84	0.84	0.84	0.84	0.90	0.90	0.89
NZD/USD	0.8562	0.81	0.80	0.78	0.78	0.77	0.85	0.84	0.83
USD/CNY	6.1840	6.15	6.12	6.08	6.05	6.02	6.20	6.20	6.22
USD/IDR	11289	11500	11750	12000	12200	12300	11480	11675	12075
USD/INR	61.190	62.5	63.5	64.0	64.2	64.3	62.5	63.8	66.2
USD/KRW	1068.05	1080	1090	1100	1110	1110	1073	1077	1084
USD/MYR	3.2685	3.32	3.38	3.45	3.47	3.48	3.30	3.32	3.36
USD/PHP	44.638	45.2	45.7	46.0	46.3	46.5	44.7	44.8	44.8
USD/SGD	1.2644	1.28	1.29	1.30	1.31	1.32	1.27	1.27	1.26
USD/THB	32.190	33.4	33.7	34.0	34.2	34.3	32.4	32.5	32.8
USD/TWD	30.325	30.3	30.4	30.5	30.6	30.6	30.3	30.2	30.0
USD/VND	21098	21200	21350	21450	21550	21650	21222	21390	21918
USD/HKD	7.7658	7.77	7.77	7.78	7.78	7.79	7.76	7.76	7.76

Source: Bloomberg, ANZ Research

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