HD (ED) ANZ Global: Aust bond futures rally across curve in US

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Overnight Markets Update

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US Treasuries rallied overnight following weaker-than-expected US retail sales data, with moves particularly pronounced in the belly and long end of the curve. The curve flattened with the 2-year bond yield easing 2bps to 0.38% and the 10-year bond yield declining 5bps to 2.61%.

Australian bond futures also rallied across the curve but underperformed US Treasuries at the long end. The implied 3-year yield declined 4bps to 2.85% and the implied 10-year yield fell 4bps to 3.80%.

US equities were little changed overnight. The S&P 500 advanced in early trade briefly breaching 1,900 for the first time, before retreating later in the session to finished unchanged at 1,897. The Dow Jones rose a marginal 0.1% to 16,715, while the Nasdaq eased 0.3% to 4,130.

European equities rose slightly on the back of solid corporate earnings results. The German DAX gained 0.5% to 9,754, the Euro Stoxx 50 closed 0.1% higher at 3,212 and the FTSE 100 increased 0.3% to 6,873.

Australian SPI futures rose 0.1% to 5,492.

In currency markets, the USD managed to maintain its recent gains despite weaker-than-expected economic data driving US yields lower. Gains were focused against the EUR following weaker ZEW expectations data there, and reports that the German Bundesbank stood ready to support the ECB in embarking on an unconventional policy path. That said, the USD held up strongly across the board, with JPY also unable to regain strength.

The AUD also failed to rally against the USD but retraced the small losses seen after the soft **Chinese** activity data yesterday. Last night's Commonwealth Budget had little impact on the AUD as many major measures had been pre-announced and policy expectations had already adjusted.

Indicative trading levels: AUD/USD 0.9357, AUD/EUR 0.6828, AUD/GBP 0.5561, AUD/NZD 1.0851, AUD/JPY 95.69, AUD/CNY 5.8280, EUR/USD 1.3703, GBP/USD 1.6826, USD/JPY 102.27.

Oil prices rose overnight. WTI futures reached a two-week high, rising 1.2% to USD101.87 per barrel on forecasts of falling US crude inventories as production increases. Brent futures gained 0.8% to USD109.35 per barrel.

The spot **gold** price fell 0.1% to USD1,293.5 per ounce.

Base metals prices declined overnight. **Copper** (-0.6%) fell for the first time in four sessions following disappointing economic data released yesterday for **China**. Aluminium (-0.3%), nickel (-1.4%), **lead** (-0.5%) and zinc (-0.9%) also declined. Meanwhile, thermal **coal** futures gained 0.1% to USD78.5 per tonne and spot **iron ore** closed 0.3% higher at USD103.0 per tonne.

Agricultural commodities broadly gained overnight. Corn (+0.7%), soybeans (+1.3%), sugar (+2.9%), palm oil (+0.5%), canola (+2.8%) and cocoa (+1.3%) all rose, while wheat (-0.4%) and cotton (-0.4%) declined.

Key drivers

Global equities edged higher overnight in sight of record highs despite some softer economic data releases.

Indeed, the S&P 500 touched above 1,900 for the first time but did not hold this level into the close, while key European equity indices reached six-year highs.

However, US governmentbonds rallied strongly across the curve, following weaker-than-expected US retail sales data. Australian bond futures followed suit, rallying around 4bps across the curve to reverse an initial sell off earlier in the session after the Australian Budget was not as hard hitting as expected in the near term (see below). There were also rumours last night the Bundesbank would support the ECB in a package of stimulus measures, raising speculation of policy action at the central bank's next meeting in June. * In the United States, the key economic release was April retail sales data which disappointed.

Headline retail sales rose 0.1% m/m (mkt: +0.4% m/m), with retail spending for the 'control' group - which feeds directly into GDP - falling 0.1% m/m.

ANZ's international economists' view is this could suggest some hesitancy in household spending as Q2 gets under way and is illustrative of the patchy nature of the recovery. Despite this, there were upward revisions for March, with the upward trend in underlying sales remaining intact. * In Europe, the ZEW survey for the euro area fell to 55.2 in May from 61.2. The steady decline in ZEW expectations suggests that our key euro area lead indicators have peaked in level terms and could gradually consolidate and step down through 2014. It is worth noting that the situation in Ukraine and Russia may have exaggerated the fall in expectations in May. * In China, monthly economic data for April disappointed. Retail sales rose 11.9% y/y (mkt: +12.2% y/y), fixed asset investment increased 17.3% y/y (mkt: +17.7% y/y), and industrial production growth was 8.7% y/y (mkt: +8.9% y/y). ANZ's China economists believe that if this trend were to be extended into May and June, China's Q2 GDP growth could remain below 7.5% y/y. As a result, their view is that it is time for the People's Bank to support the economy by cutting Reserve Requirement Ratios (RRRs). * In Australia yesterday, the Government unveiled a mild tightening of fiscal policy in the 2014-15 Budget (with a deficit of AUD30bn forecast for 20114-15) and it set the ball rolling on its long-term aspiration of returning the Budget balance to surplus of at least 1% of GDP within a decade.

Most of the savings announced in the Budget will impact beyond the next election due in 2016 with the biggest changes to impact beyond the four-year estimate period.

The additional near-term tightening of fiscal policy contained in the Budget will be quite modest, and had already been broadly factored into our growth forecasts, but will increase from 2015-16.

This Budget will be a mild headwind for the recovery in the non-mining economy that is now getting under way. While estimating the overall effect on the economy from fiscal policy is very uncertain, we expect it to have a modest drag on growth, on average, of roughly .25-.5ppts per annum.

The biggest changes in this Budget are around the structure of government payments and receipts with a reduction in welfare, health and education spending as well as the first steps in reforming retirement income arrangements. Many of the biggest Budget savings in the medium to long term are from shedding spending commitments in health and education to the State governments, opening the way to major reforms of the taxing and spending mix within the Federation. * In an interesting first gauge of the likely impact on consumers from the Budget, the ANZ-Roy Morgan consumer confidence index fell a further 2.4% in the week ending 11 May.

Confidence declined almost 11% over the past three weeks when various policy leaks began receiving significant media attention.

Also released yesterday, momentum in housing finance continued to softened in March, falling 1.0% m/m (ANZ: -1.5% m/m; mkt: +1.0% m/m). However, finance remains only marginally below last month's peak and 18.3% higher than year-ago levels.

The Northern Territory's 2014-15 budget also showed an improvement with a balanced budget expected from next financial year due to improved expectations of revenues, especially the GST. The budget projects a general government operating surplus of AUD63m in 2014-15, from an expected deficit of AUD208m at the mid-year update in December last year.

The surplus is expected to improve to AUD99m in 2015-16 (from a previous forecast of a AUD94m deficit). A small surplus of AUD69m is expected in 2016-17 and a AUD1m surplus is projected for 2017-18.

Today, there are no key data releases for Australia.

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