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Observation Deck

Client Strategy and Solutions Weekly Colour

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At a glance:

	Real GDP YoY	CPI YoY	Unemployment	CBR
Australia	2.7%	2.8%	5.0%	4.8%
New Zealand	1.5%	1.5%	6.4%	3.0%
Singapore	12.5%	3.8%	2.1%	0.0%
Japan	5.3%	0.1%	5.1%	0.1%
China	9.6%	5.1%	0.0%	5.8%
Germany	3.9%	1.7%	7.5%	1.0%
France	1.7%	1.8%	9.8%	1.0%
UK	2.7%	3.7%	7.9%	0.5%
US	3.2%	1.5%	9.4%	0.3%

Change

NAB's GDP Growth Forecasts: (Annual change in %)

	2009	2010	2011	2012
Australia	1.2	2.6	3.6	3.8
US	-2.6	2.8	2.6	3.2
Eurozone	-4.1	1.7	1.8	1.8
UK	-5.0	1.8	2.1	2.1
Japan	-5.2	2.8	2.1	2.3
China	9.1	10.0	9.1	9.1
India	6.7	8.8	7.9	7.2
New Zealand	-1.7	2.0	3.8	3.4
World	-0.7	4.6	4.4	4.1

*Contribution to real GDP

The Week in Review

International

- The detail of January's US Empire State manufacturing survey was much stronger than the modest improvement in the headline activity index to 11.9, from 9.9, suggests. New orders rebounded to 12.4, from 2.0, shipments jumped to a 10-month high of 25.4, from 7.1, and employment improved to 8.4, from -3
- US consumers have started the year in a more downbeat mood, suggesting that the recent acceleration in consumption growth is built on shaky foundations. The fall in the University of Michigan measure of confidence, to 72.7 in January from 74.5 in December, is probably even worse than it looks. This measure of confidence is not seasonally-adjusted and it usually rises in January
- China's property prices rose 6.5%yoy to December, down from 7.7%yoy in November and below expectations of 7.0%. This was the smallest rise in 13 months and comes after China tightened monetary policy last week
- UK CPI (Dec) rose by 1%, much higher than forecasts of 0.6%, taking the annual rate to 3.7%yoy

Australia/NZ

- Australian employment rose just 2,300 in December (vs. forecast +25k), after the strong 54,600 increase in November. The unemployment rate fell to a 2-year low of 5.0% from 5.2%, as the participation rate fell to 65.8% from 66.0%
- Australian DEWR skilled vacancies experienced a 21.6% decline in January in seasonally-adjusted terms, the largest decline in the 20-year history of the series
- Australian motor vehicle sales in December rose 0.8% to be down 3.1%yoy, after a rise of 0.2% in November
- Headline inflation as reported in the TD-MI Inflation Gauge, rose 0.2% in December after a 0.4% increase in November showing fresh fruit and vegetables prices were already well on the rise before the floods hit SE Queensland, a key centre for horticulture in Australia.
- The Australian Westpac-MI Consumer Confidence Index fell 5.7% in January to 104.6, the largest fall in seven months, on concern about the impact of the Queensland floods
- The REINZ Monthly Housing Price Index decreased by 0.6% in December, from November, and was down 1.6%yoy

The Week Ahead

International

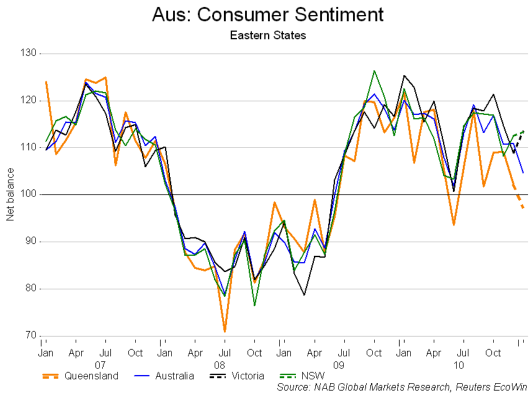
- US: Building permits, housing starts, consumer confidence
- EU: PMI manufacturing and services, consumer confidence
- UK: Retail sales, public finances, unemployment, GDP

Australia / New Zealand

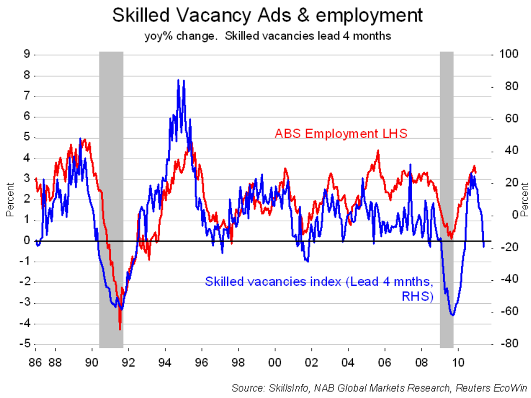
- Aus: PPI, CPI, Import and Export prices

Fact! Standard & Poor's estimates that banks around the world will need to issue US$1 trillion in Contingent Convertible Bonds ("Cocos") over the next five to ten years to comply with new Basel III bank capital standards. Cocos are "burden sharing" debt instruments that convert into equity when the issuer gets into financial trouble.

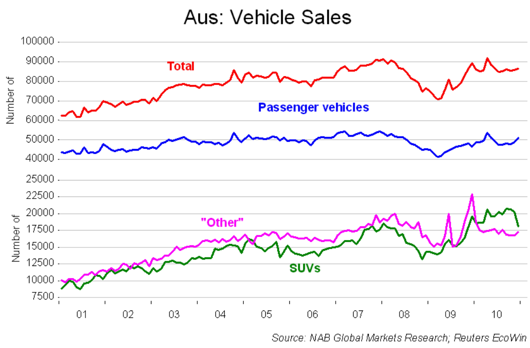
Consumer confidence in Australia's Eastern States impacted by the floods



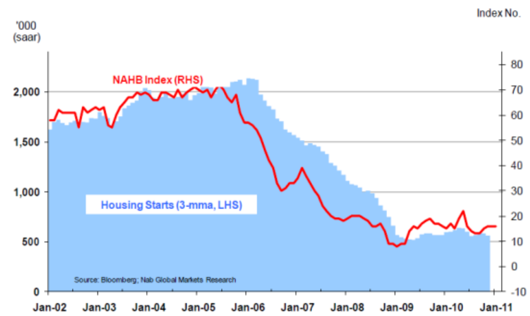
Australian skilled vacancies fall and employment growth begins to stall



Australian motor vehicle sales flat-line as "SUV" sales decline



US housing still sluggish



Q & A

Q: What are forward exchange contracts (FEC)?

A: Forward exchange contracts ("FECs") are contracts, usually between a bank and a customer, to exchange one currency into another at future date and a pre-agreed exchange rate. For example, XYZ bank may agree to sell US$100,000 and buy A$105,400 from its customer, ABC Corp, in 12 months' time.

FECs are typically used by companies, investors and borrowers wanting to reduce or hedge foreign exchange rate risk.

Banks will typically quote customers forward currency rates, which are similar to spot currency rates (i.e. the exchange rate for settlement within the next two business days), but adjusted to reflect the cost to the bank of borrowing in one currency and lending in another. Forward currency rates can be either higher or lower than spot currency rates depending on interest rates in the respective currencies. Because they are influenced by interest rates, forward currency rates are not indicative, or a prediction, of where spot exchange rates may be in the future.

With US one-year interest rates about 4.6% lower than Australian one-year interest rates, a 12-month US Dollar to Australian Dollar FEC is currently priced at around US$0.9500 which is approximately 4.6% lower than the current spot rate.

With interest rates significantly higher in Australia than in other major currencies such as US Dollars, Yens, Pounds and Euros, it actually pays investors to hedge their foreign currency investments by locking in more favourable forward currency rates compared to current spot currency rates.

FECs come in different forms, some are fixed dated where the currency exchange must take place on an agreed date, whereas other allow for some flexibility in the date on which the currency exchange takes place. FECs with more flexible settlement dates are useful where someone may be receiving some funds in another currency from the sale of an asset, but they are not certain of the exact date that the funds will be received, only that it will be received within a pre-determined time frame e.g. between four months and six months' time.

FECs can be terminated or "closed out" prior to maturity, effectively by entering into a reversing FEC with the same bank. For example, a customer initially takes out a 12-month FEC to buy Australian Dollars and sell US Dollars and then six months later decides to close out the transaction, which effectively involves entering into a six-month FEC to buy US Dollars and sell Australian Dollars. Any gain or loss on the original FEC would usually be paid in Australian dollars at the time of close out.

Fund managers that hedge their foreign investments often use rolling FECs to try to hedge their foreign investments which may fluctuate in value. For example, they may use rolling one-month FECs. At the end of the month when the FEC is due to expire, they pay or receive the gain or loss on the FEC to or from the bank (depending on where the spot exchange rate is relative to the original forward exchange rate) and then enter into a new one-month FEC for an amount that may take into account any change in the value of the foreign investments.

Because banks are entering into legally-binding contracts for the exchange of funds in the future, bank customers wanting to enter into FECs must undergo a credit assessment by the bank, or provide collateral to the bank, to ensure that they have the financial capacity to settle the FECs on the due date.

Market Wrap

European stocks rallied over the week on hopes that the two day EU Finance Ministers meeting in Brussels would ease sovereign debt issues. Across the Atlantic, the US shrugged off slides in Apple and Citi to finish higher over the week as materials gained in the wake of data confirming manufacturing strength, and companies such as JP Morgan Chase reported stronger-than-expected results for the full year.

With the rise in equity prices, long term government bond yields rose in most major markets, whilst gold and US dollars were weaker and oil continued its recent rise.

	Last	% Change 5Day	% Change 1M	% Change 3M	% Change YTD	% Change 1Y
Global Equity Markets						
Australia - ASX200	4,832	2.29	1.45	3.80	1.84	-0.59
Japan - Nikkei 225	10,546	0.32	2.35	10.56	3.10	-2.03
Hong Kong - Hang Seng	24,352	0.94	7.21	2.47	5.71	12.33
Shanghai A&B	2,738	-2.96	-5.39	-8.80	-2.51	-15.68
Singapore - STI	3,252	0.21	3.13	1.86	1.93	11.63
New Zealand - NZX50	3,346	0.34	1.17	2.70	1.12	3.67
US Dow Jones	11,838	1.72	3.01	7.83	2.25	10.37
US S&P 500	1,295	1.99	4.11	11.07	2.97	12.59
Nasdaq	2,766	2.14	4.65	13.50	4.26	19.20
Canada - TSX	13,559	1.18	2.71	7.86	0.86	15.27
Mexico - Bolsa	38,151	0.32	0.41	10.74	-1.04	17.49
India - Sensex	19,113	-2.16	-3.79	-4.36	-6.81	9.30
Brazil - Bovespa	70,920	0.70	4.32	1.51	2.33	1.45
UK - FTSE100	6,056	0.71	3.15	6.18	2.65	9.85
France - CAC40	4,013	3.90	3.76	5.40	5.46	0.08
Germany - DAX	7,143	2.91	2.31	10.06	3.32	19.53
Spain - IBEX	10,583	10.45	6.92	-2.86	7.35	-11.97
Italy - MIB	21,591	6.15	7.58	1.68	7.03	-8.92

	Last	5Day	1M	3M	YTD	1Y
Global Rates						
Australia - 10Y Govt	5.63	0.11	0.06	0.49	0.09	0.14
US - 10Y Govt	3.37	0.01	0.05	0.90	0.08	-0.32
UK - 10Y Gilt	3.66	0.11	0.10	0.70	0.26	-0.28
EURO - 10Y Govt	3.12	0.19	0.09	0.73	0.15	-0.13
Japan - 10Y Govt	1.26	0.08	0.06	0.37	0.13	-0.08
Global Currency & Commodity						
AUD/US	1.0036	0.0070	0.0101	0.0350	-0.0197	0.0804
JPY/US	82.2100	-0.7900	-1.5600	0.6300	1.0900	-8.9400
NZD/AUD	1.2959	-0.0081	-0.0427	-0.0053	-0.0155	0.0405
EUR/US	1.3449	0.0318	0.0318	-0.0278	0.0065	-0.0839
GBP/US	1.6011	0.0245	0.0498	0.0304	0.0399	-0.0351
Gold (Spot)	1,373.45	-14.40	-2.00	41.40	-47.33	235.25
WTI Crude	91.38	2.13	3.36	8.30	0.00	13.38

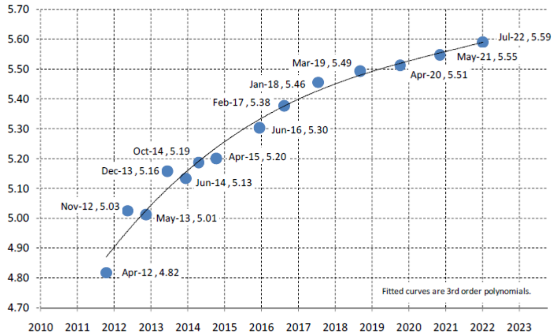
***as of January 19, 2011 Source: Bloomberg**

Australian Interest Rate and Currency Corner

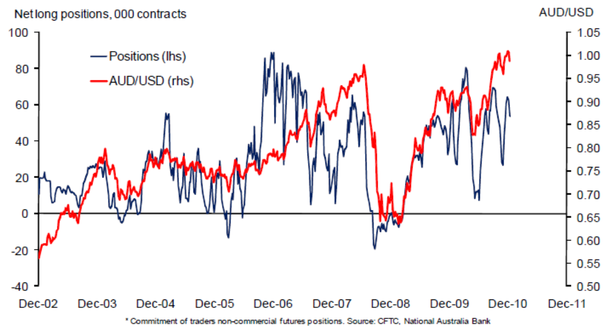
During 2011 we expect the Australian economy to accelerate, capacity to tighten, and inflation pressures to build, which should see the RBA lift the current 4¾% cash rate another 50bps over 2011 to 5¼%. While the floods have altered the growth trajectory somewhat (less growth now and more growth later in the year as the re-build picks-up) the floods have not eased inflation pressures. If anything, inflation pressures have been boosted due to a spike in food prices because of interrupted supply and, more importantly, the re-build of housing and infrastructure is likely add to growth and inflation pressures later in 2011.

We expect the AUD to appreciate further against all the major currencies through to around the middle of 2011 but the currency is in the final 5%-10% of its cyclical climb given the RBA is roughly 80% through its tightening cycle. We continue to believe that China will successfully engineer a soft economic landing with inflation brought under control, and GDP rising by a solid 9% in 2011 and 2012. As a result, we expect that Australia's terms of trade will remain elevated in coming years, supporting a continuing strong AUD.

Australian Government Bond Yield Curve

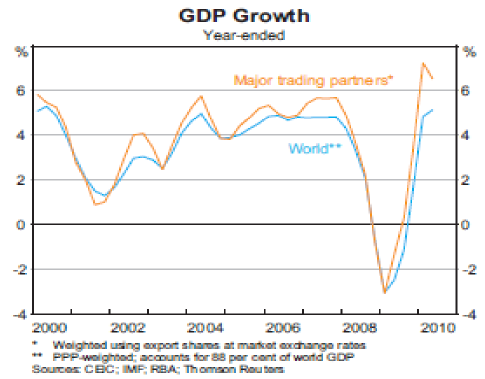


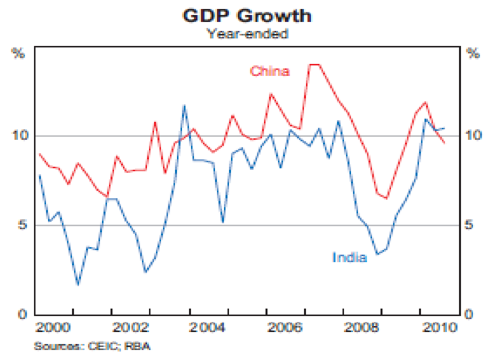
AUD Speculative Positions

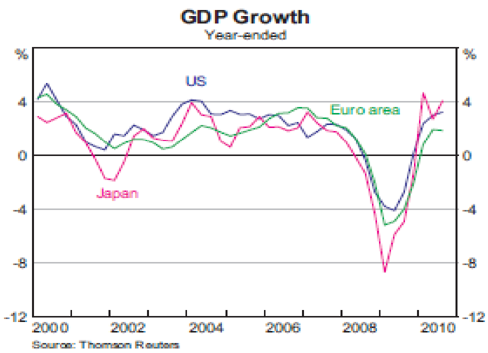


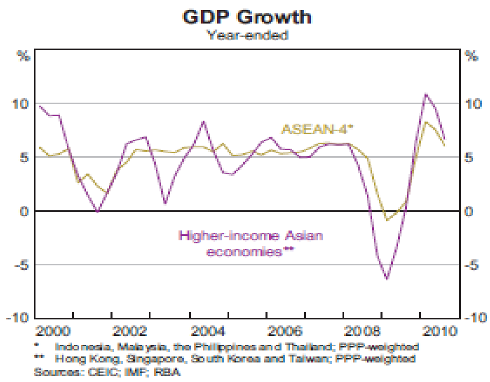
Main Economic Indicators for the World Economy (RBA)

World Economy









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