
Recent Developments in Financial Markets

Economics
8 August 2011



Themes

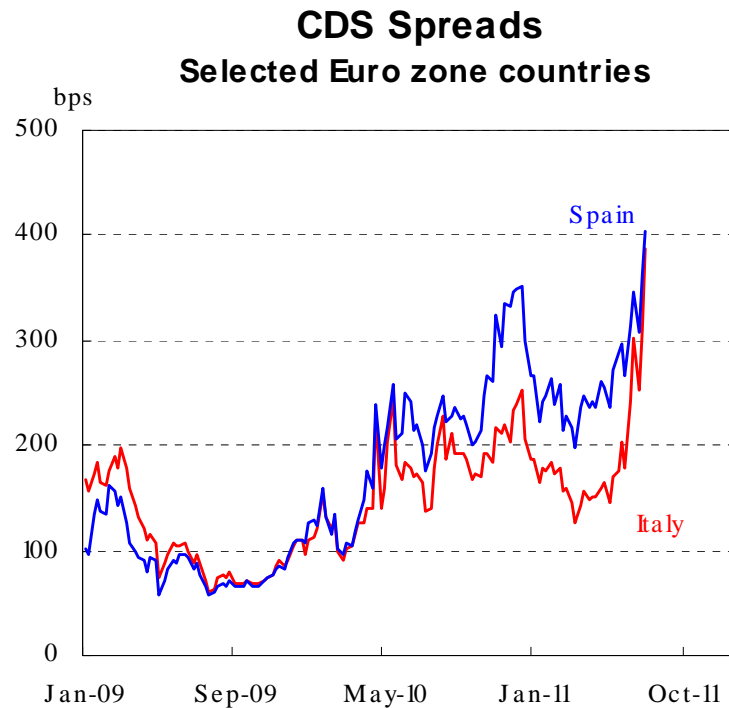
- **Debt concerns in both the Euro zone and the US have increased pessimism in the global economy.**
- **The downgrade by Standard & Poor's of the US long-term sovereign rating from AAA to AA+ on August 6 added to market nervousness and pessimism.**
- **Confidence remains fragile, risk aversion is high and financial markets remain volatile.**
- **There is fear that these developments will cause a further slowing in the global economy.**

Centre of Storm – Europe and US



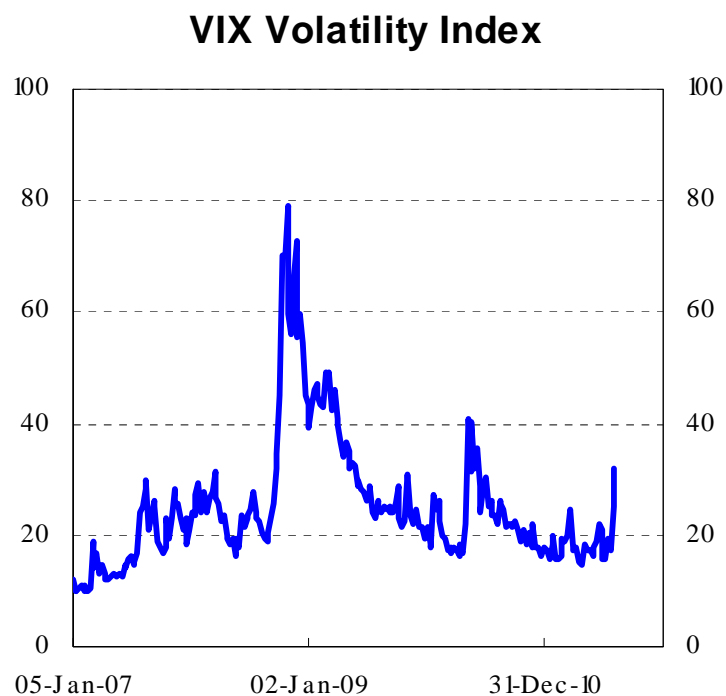
- **The US has been battling debt and growth concerns.**
- **Economic data in recent times has indicated a loss of momentum in the US economy. Some fears of a double-dip recession have emerged.**
- **Standard & Poor's downgraded the US debt long-term debt rating from AAA to AA+ on August 5, reflecting worries about the budget deficit and climbing debt burden. The S&P also placed the US on negative outlook, meaning further downgrades to its credit rating can't be ruled out within 2 years.**

Centre of Storm – Europe and US



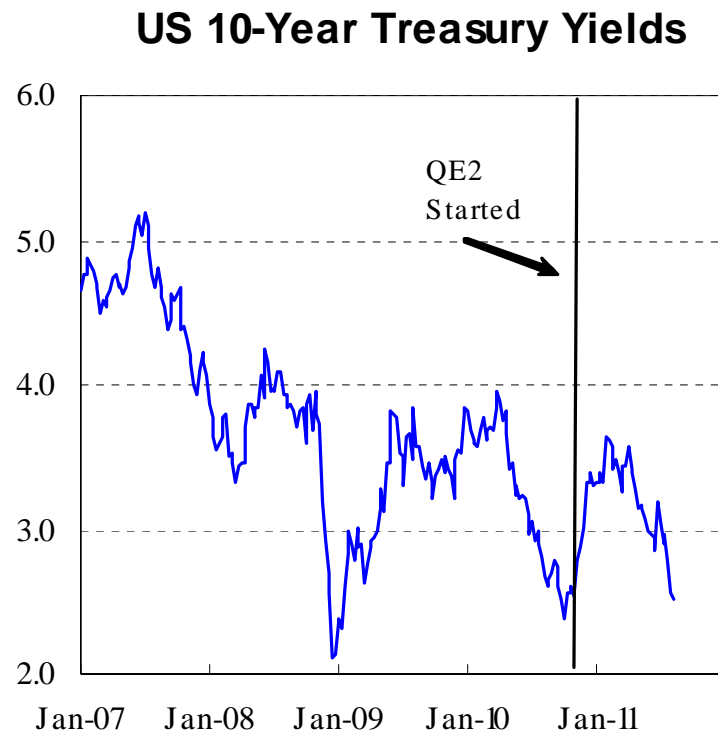
- **Recent sell off in Italian and Spanish debt highlights the fragile nature of investor confidence towards heavily-indebted countries.**
- **The level of indebtedness in Italy and Spain have started to spook investors.**
- **The European Central Bank (ECB) has suggested it will buy Italian and Spanish bonds if needed.**

Investor Nervousness is High



- **Uncertainty and risk aversion is high, highlighting the fragile state of investor confidence.**
- **The higher the VIX index the higher risk aversion is.**
- **Uncertainty is not conducive to decision making.**

Possible Circuit Breakers – US QE3

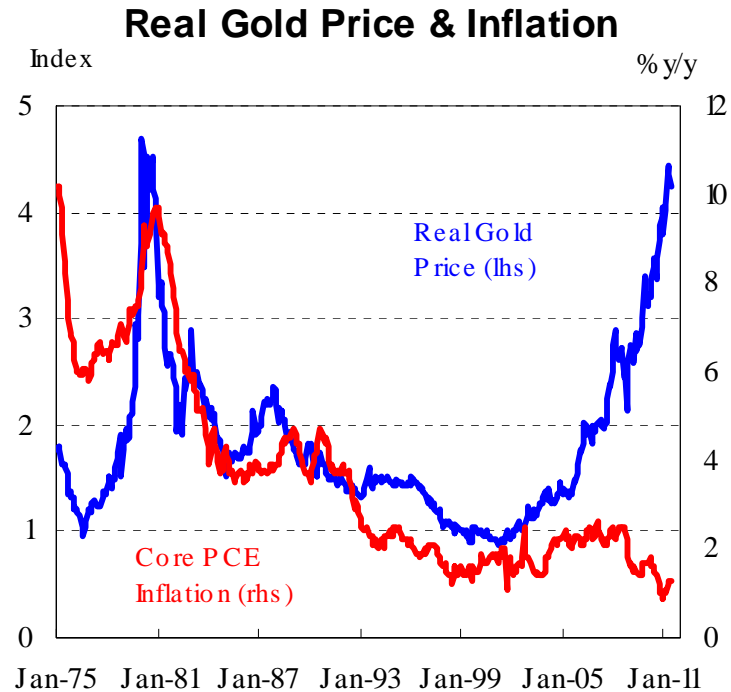


- **US Federal Reserve meets on Tuesday 9 August (or Wednesday morning 4:15am AEST).**
- **Speculation is rife that a third round of quantitative easing will be announced.**
- **These expectations are perhaps stemming losses in some markets today.**
- **QE2 was announced the last time long-term yields were around these levels.**

Group of Seven Stands Ready

- **The Group of Seven (G7) industrialised nations have pledged in a statement published on 8 August 2011 that they will take whatever actions are needed to steady financial markets.**
- **The G7 have stated they will stay in close contact and are “ready to take action to ensure stability and liquidity in financial markets”.**

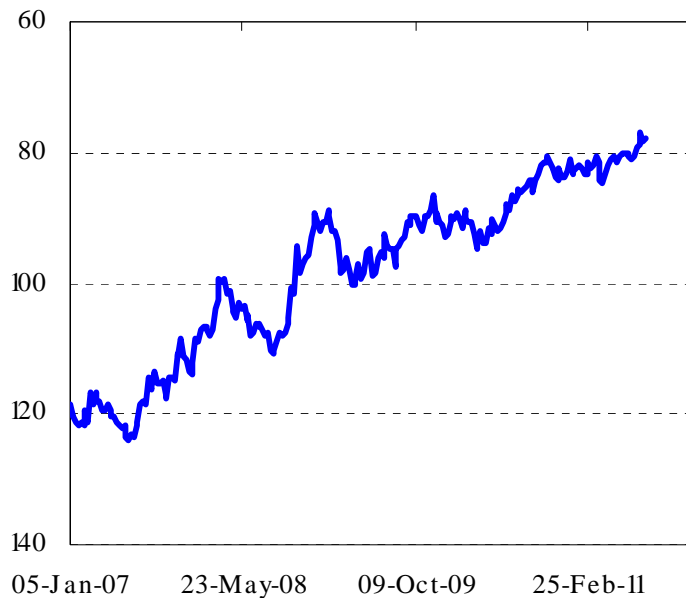
Gold Rising on Safe-Haven Flows



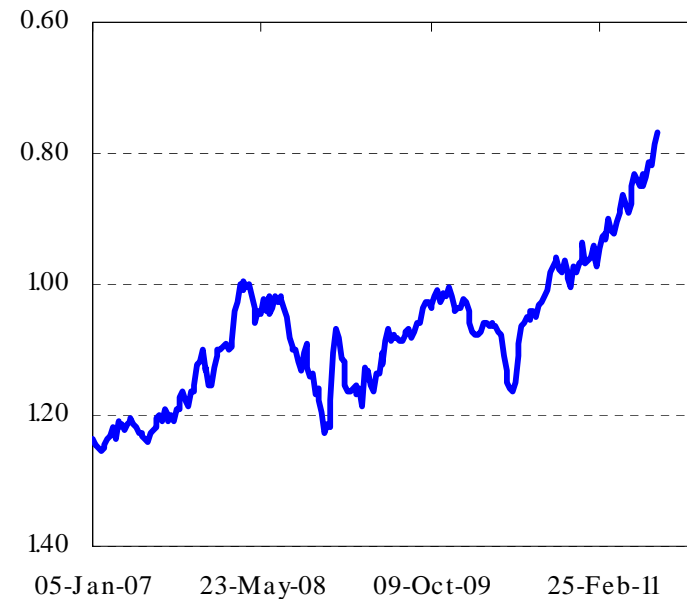
- Investors have flocked to the relative safe-haven of gold.
- The gold price has rallied to new record highs above US\$1,700. The real gold price (i.e. adjusted for inflation) is the highest in over 30 years.

Impact on Currencies

**USD/JPY Exchange Rate
(Inverse Scale)**



**USD/CHF Exchange Rate
(Inverse Scale)**



- **JPY and CHF have been beneficiaries as the Japanese repatriate funds and safe-haven flows benefit the CHF.**
- **Markets remain wary of currency intervention from Japanese authorities.**

Share Markets are in Turmoil



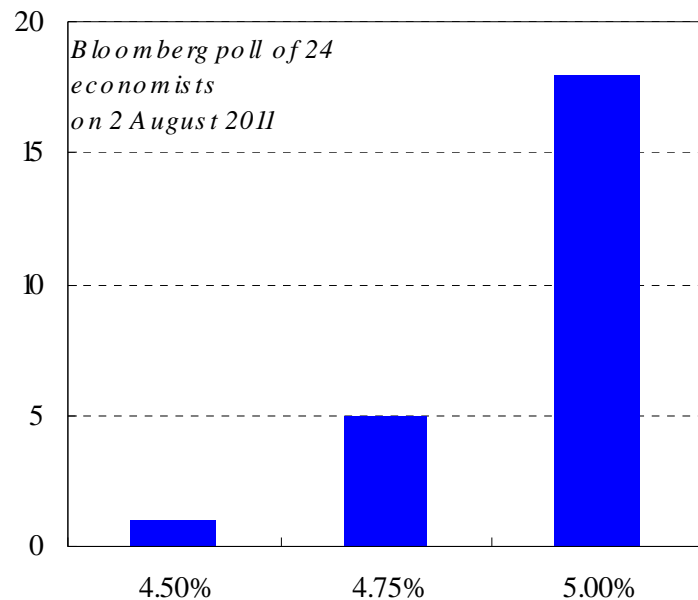
- The Australian share market at today's close has fallen 19.8% since the 2011 peak of 4,971 recorded on 11 April.
- A bear market is usually defined as a fall of 20% or more from peak to trough.
- Falls in share markets affect wealth and confidence, which can have knock-on effects to the economy.

Rate Direction in Australia

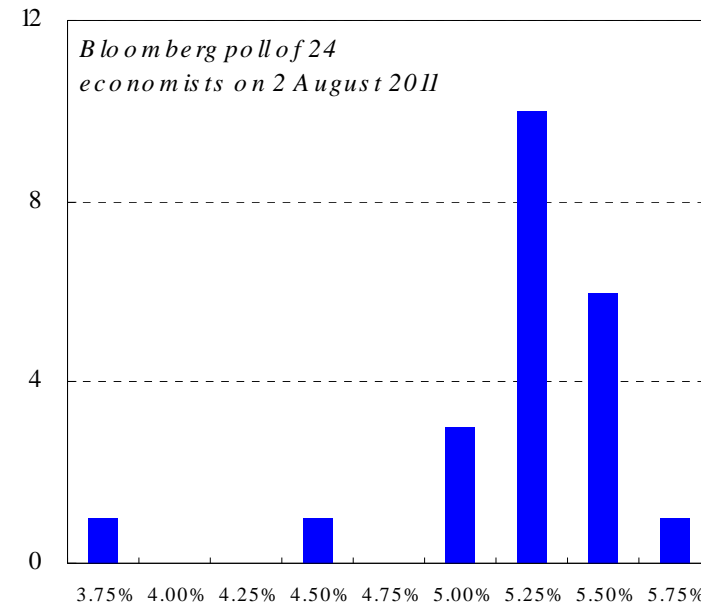
- **On domestic conditions alone, it is difficult to project the RBA cutting rates. However, the RBA must consider both domestic and offshore conditions.**
- **With uncertainty gripping financial markets, the risk to the global economy is clearly tilted to the downside.**
- **It means the RBA will not be tightening policy any time soon, despite last week's projections from the RBA that underlying inflation will reach the top of the RBA's 2-3% per annum target band at the end of this year.**
- **Any continuation of the carnage in global markets and a further deterioration in global sentiment opens the door for rate cuts locally.**

Poll Results

Where Will the Cash Rate Be at the End of 2011?

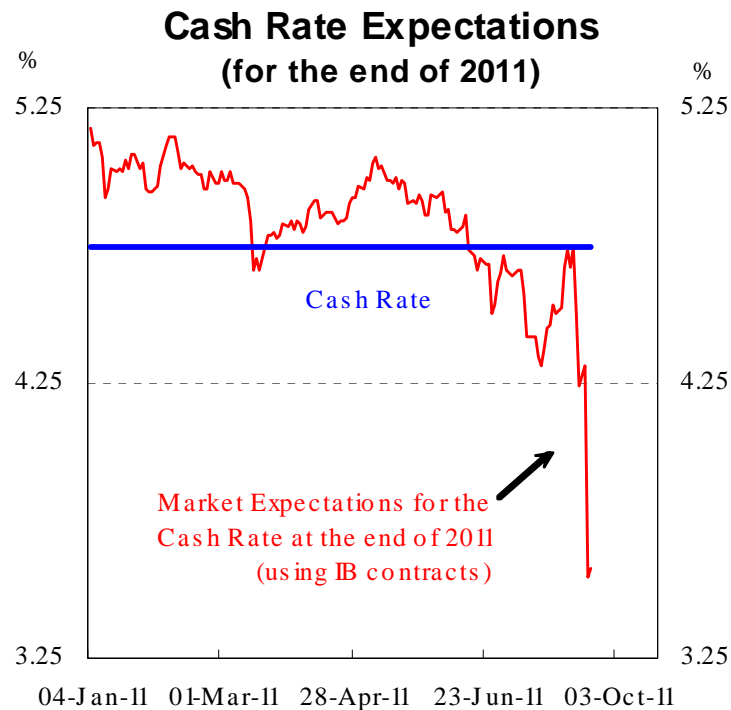


Where Will the Cash Rate Be at the End of 2012?



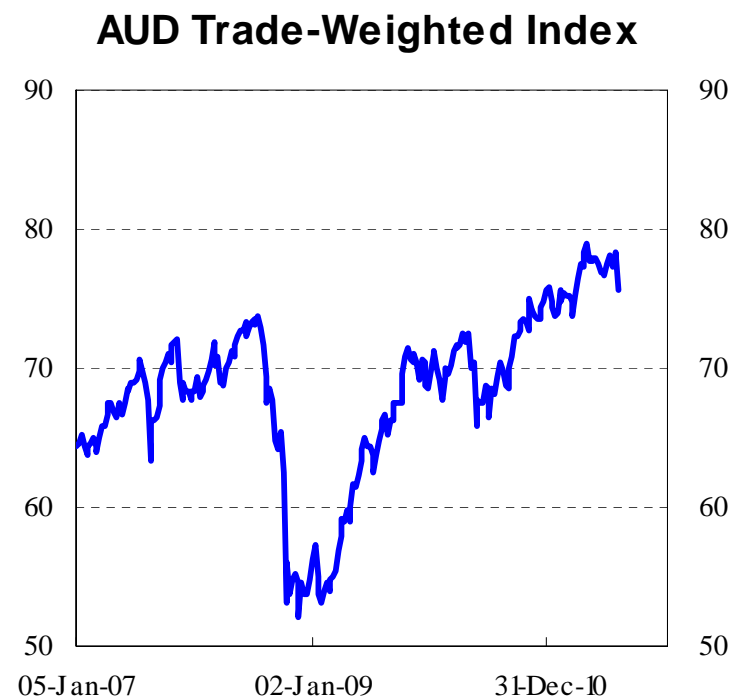
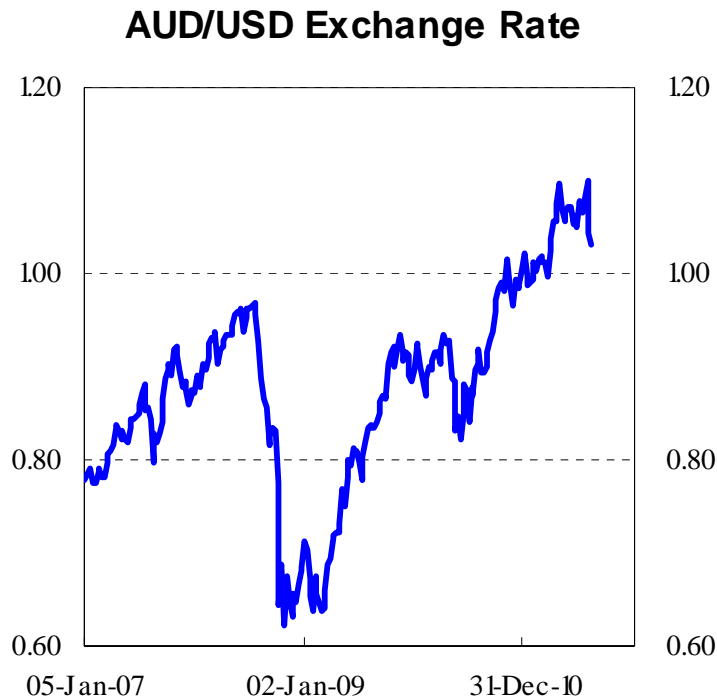
- **As late as 2 August 2011, poll results revealed that the median consensus among economists was for more tightening in Australia.**

Financial Markets Expecting the RBA to Cut Rates



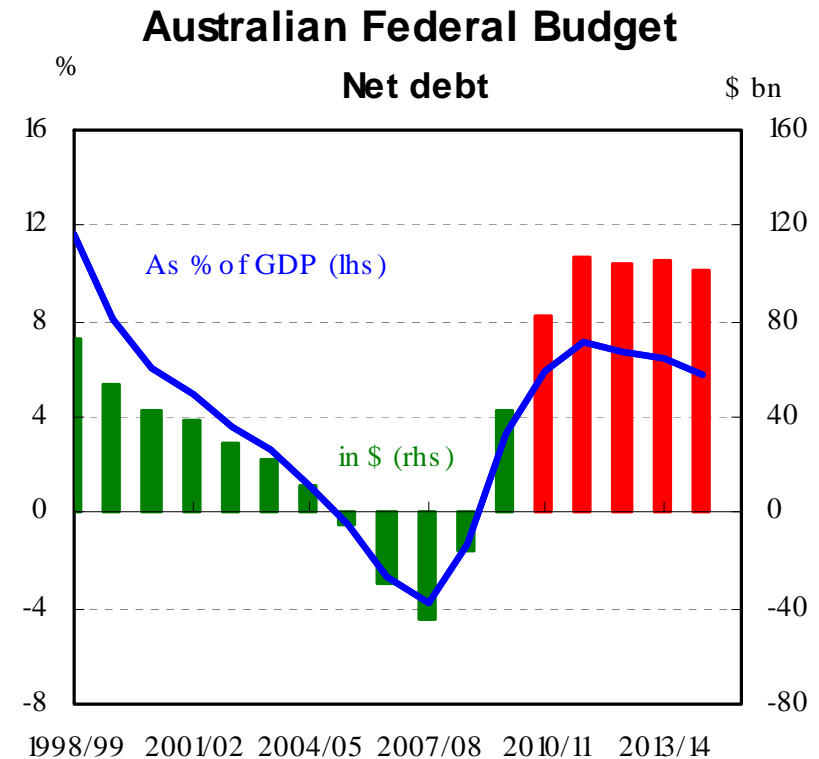
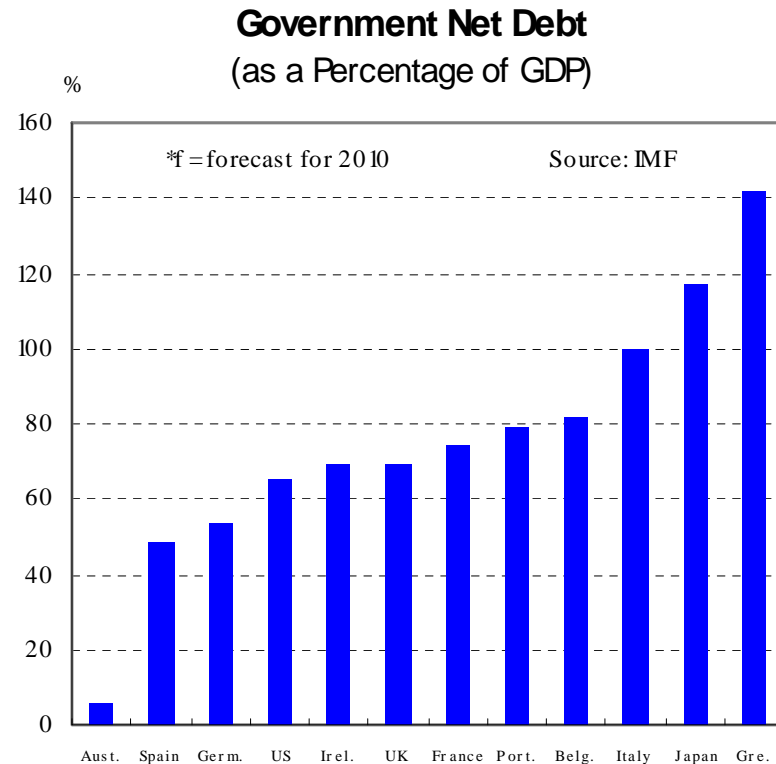
- Financial markets are fully pricing in 100bp or 1% of rate cuts from the RBA by the end of this year.
- We are watching global developments closely.
- RBA rate cuts in this current environment cannot be ruled out.

Impact on AUD



- **Heightened risk aversion is negative for the AUD. Falls in commodity prices and a reassessment of the global growth outlook is also negative.**
- **The AUD has held up better this year during bouts of risk aversion compared with past episodes. This episode might be different.**

Australia's Fiscal Position is Healthy



- Australia's government net debt at 5.9% of GDP is small compared to other developed countries. Australia has scope to use fiscal (and monetary) stimulus if necessary.**



AAA-rated countries by S&P

Australia

Austria

Canada

Denmark

Finland

France

Germany

Guernsey

Hong Kong

Isle of Man

Liechtenstein

Luxembourg

Netherlands

New Zealand

Norway

Singapore

Sweden

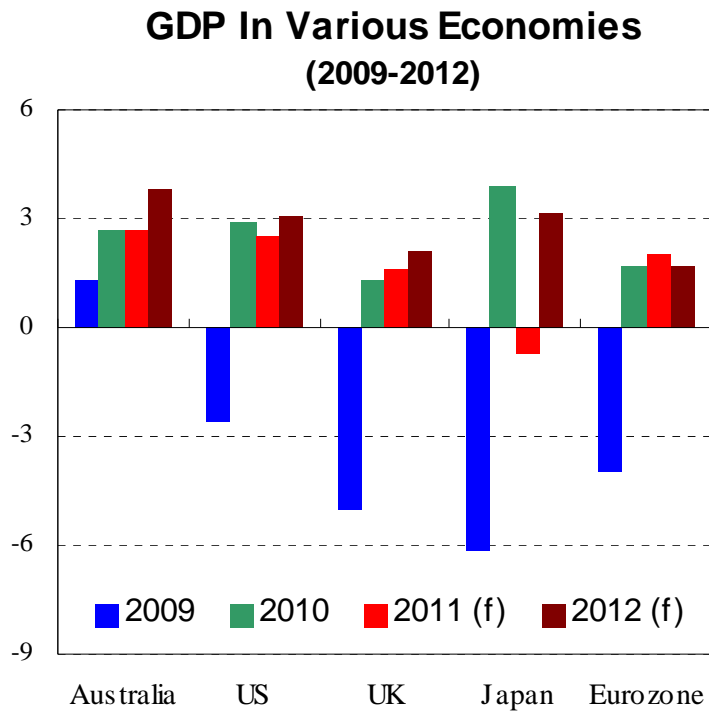
Switzerland

United Kingdom

- **Australia is in the elite AAA club. Australia's low net debt position, attractive sovereign debt rating and sound underlying economic fundamentals makes Australia better placed.**



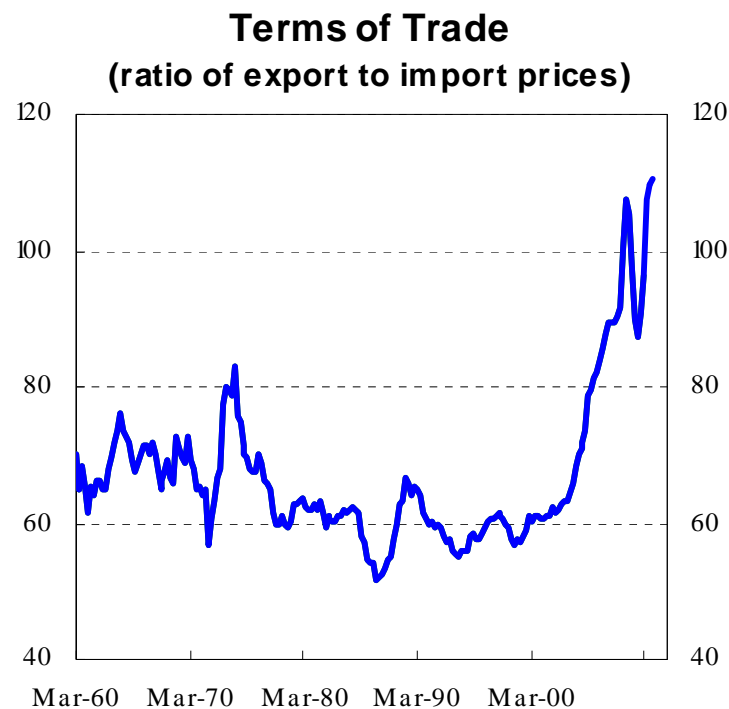
Australia's Economic Fundamentals Attractive



Forecasts as at 11 July 2011

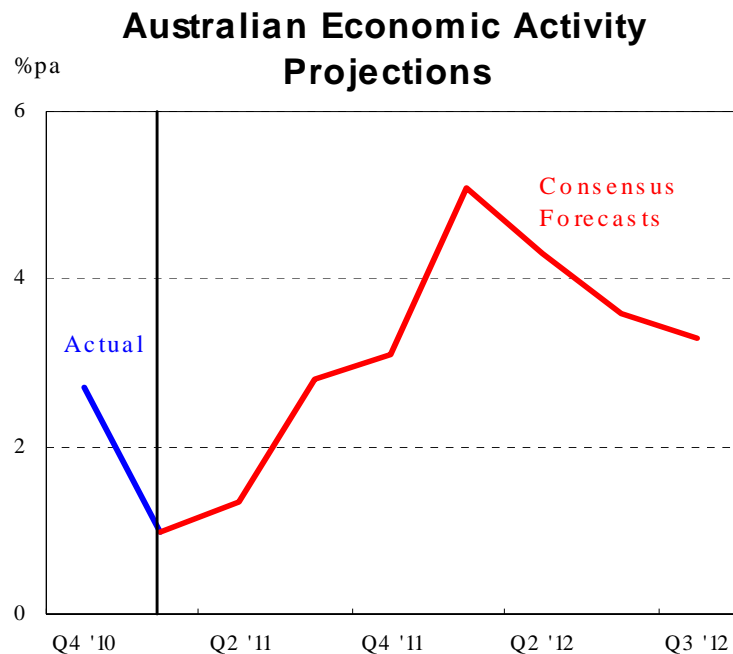
- Indeed, the Australian economy is in the midst of a “once in a century economic event”. That is reflected in a rising terms of trade.
- It helped the Australian economy withstand the GFC better than other advanced economies.

The Terms of Trade Injection



- **The terms of trade (ToT) measures the relativity of export and import prices.**
- **It is at a record high and helping to underpin income and economic activity in Australia.**
- **It is estimated that the ToT is giving an extra boost of income to production that is around 15% of annual GDP.**

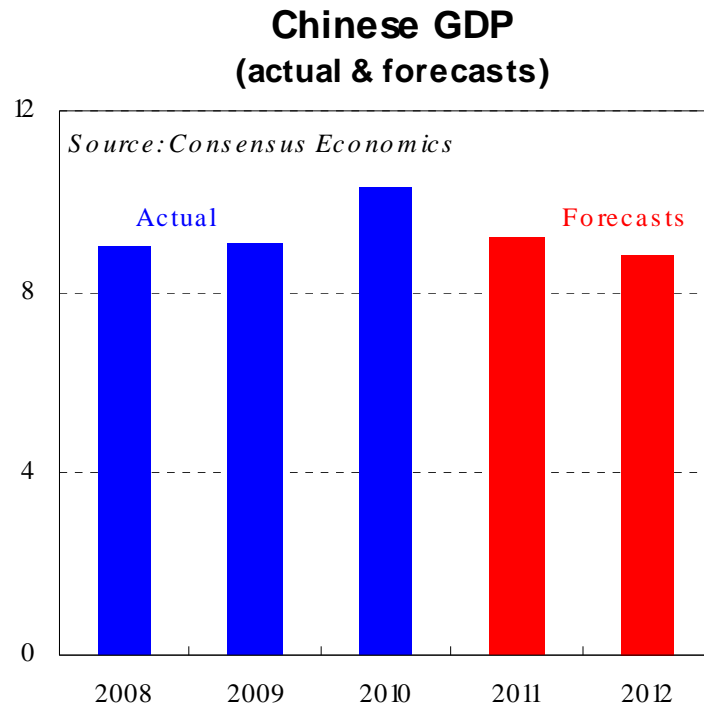
Australian GDP Forecasts



Source: Consensus Economics Survey June 2011

- **Australian economic activity is forecast to accelerate and be running above the long run average in 2011-12 and 2012-13.**
- **Any further downgrades to the global growth outlook could shave Australian growth forecasts. Much might depend on how current developments affect China.**

Links to China



- **The impact on Australia will also be measured by the impact of recent developments on China, Australia's main trading partner.**
- **China's economy is expected to moderate this year.**
- **But the US and Europe are key export markets for China.**

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