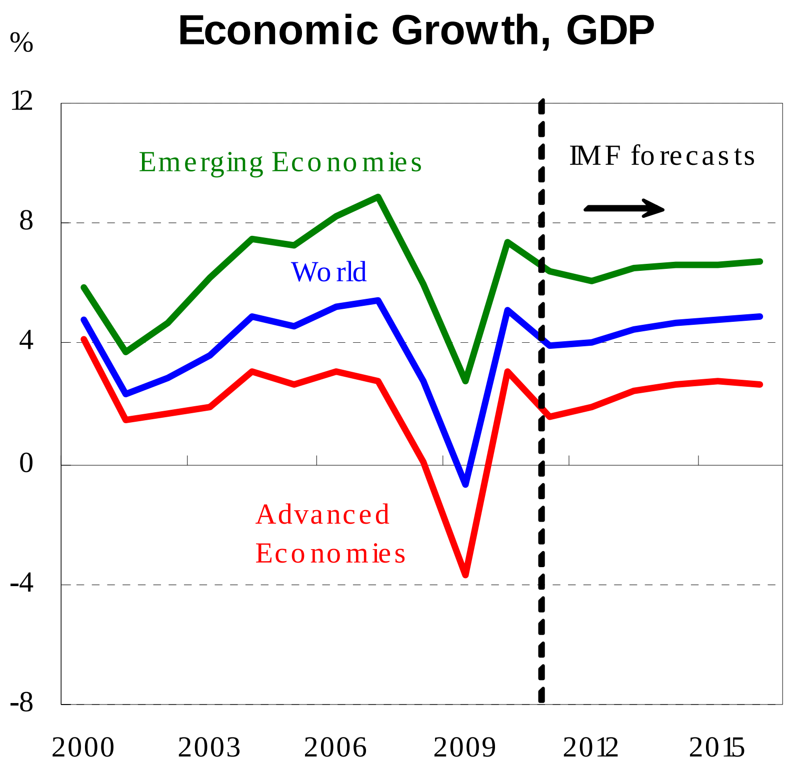
Recent Developments in Financial Markets

St.George Banking Group Economics
29 September 2011

Themes

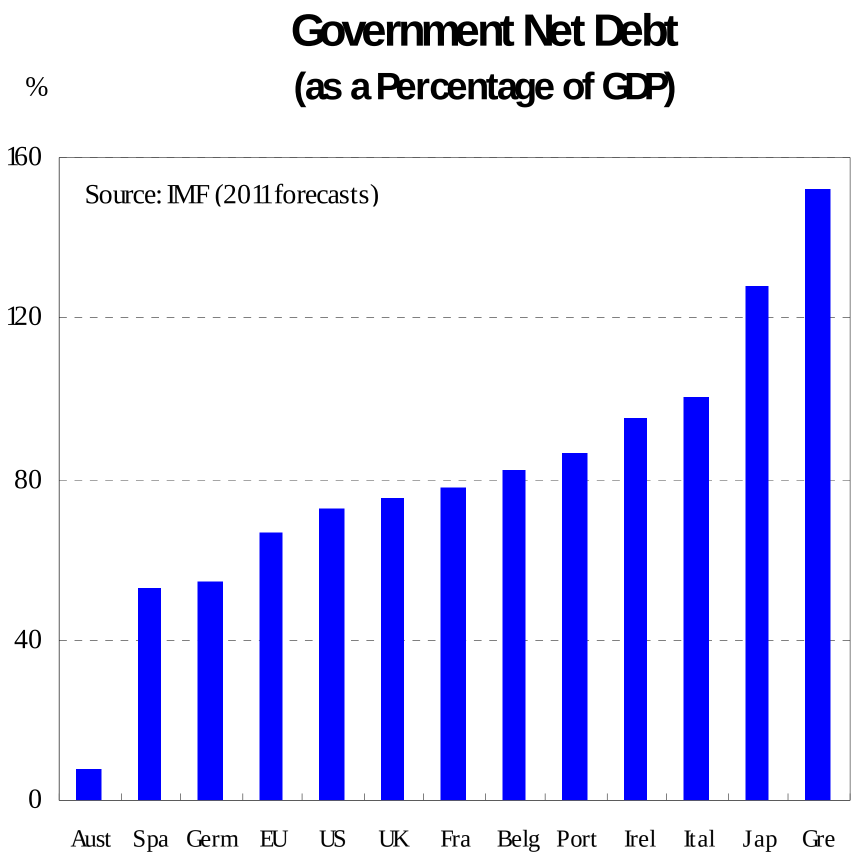
- Growth is stalling in the US and Europe.
- Containing the fallout from a likely Greek default is presenting a challenge.
- A slow response by policy makers in Europe and US is unsettling investors.
- There is a risk the possible flow on effects to the banking sector will cause a further slowing in the global economy.
- Confidence remains fragile, risk aversion is high and financial markets remain volatile.

Weaker Global Growth Outlook



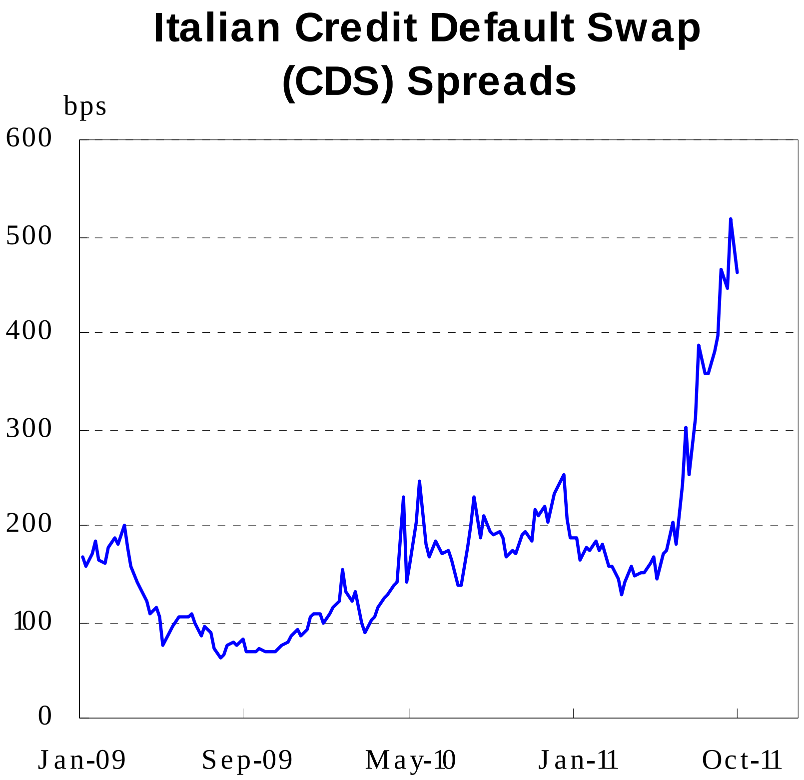
- **The IMF recently downgraded the world growth forecasts to 4% for 2011 and 2012. It comes after 5.1% growth in 2011.**
- **These forecasts are still above the long-run average.**
- **Forecasts assume:**
  - **Appropriate action from policymakers in Europe and the US.**
  - **Volatility in global financial markets does not escalate.**
- **We believe the forecasts are optimistic and expect global growth to be closer to 3%.**

Sovereign Debt in the Limelight



- **Worries about the sovereign debt levels in the US and in parts of Europe and the lack of political will to address these concerns have underscored financial market jitters.**

European Sovereign Debt – Contagion Fears Rise



- **Challenges lies in managing the fallout from a likely Greek default:**
  - **Risk of spreading to a banking crisis.**
  - **Contagion to other peripheral debt.**
- **Italy is in the firing line – its bond market is the world's third largest and exposure is widespread.**
- **There's a need to adopt policies to allay European sovereign debt concerns and prevent further rises in the government bond yields of Italy and the peripheral European economies.**

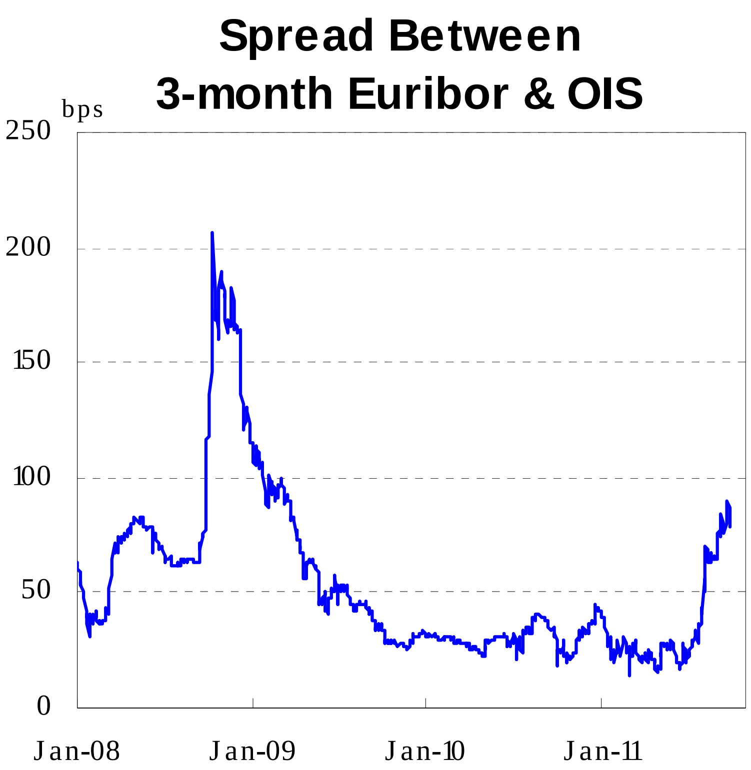
Europe Sovereign Debt – Measures Taken So Far

- **Greece, Portugal and Ireland have received funding packages.**
- **A second rescue package announced in July 2011 for Greece has required private debt holders to share the burden of restructure.**
- **The European Central Bank (ECB) has been purchasing Italian and Spanish bonds since August 2011.**
- **There was agreement by leaders of the European Union in July 2011 to expand the powers of the European Financial Stability Facility (EFSF) to:**
  - **Purchase bonds of distressed governments in secondary market.**
  - **Provide financing to recapitalise financial institutions.**
  - **Provide financial assistance of up to €440bn.**

But More Needs to be Done

- **Expansion of EFSF powers agreed in July 2011 still needs to be ratified by national parliaments of the 17 Member States; some obstacles include Germany which votes tonight and Slovakia which votes mid to late October.**
- **EFSF needs more funds to reassure investors.**
- **A larger write-down for Greek debt is seen as necessary.**
- **Rumoured plans include:**
  - **Recapitalisation of banks either privately or by the EFSF.**
  - **Bolster the EFSF to €1 to 2 trn – officials to work on a way to leverage the EFSF (expand the fund by issuing debt backed by ECB).**
  - **A "managed" Greek default comprising of losses of 50% on the private sector.**
  - **European Central Bank (ECB) to cut rates by at least 50bps.**
- **Lack of political will is hindering the process and adding to uncertainty that appropriate measures will be taken.**

Growing Worries about European Banks



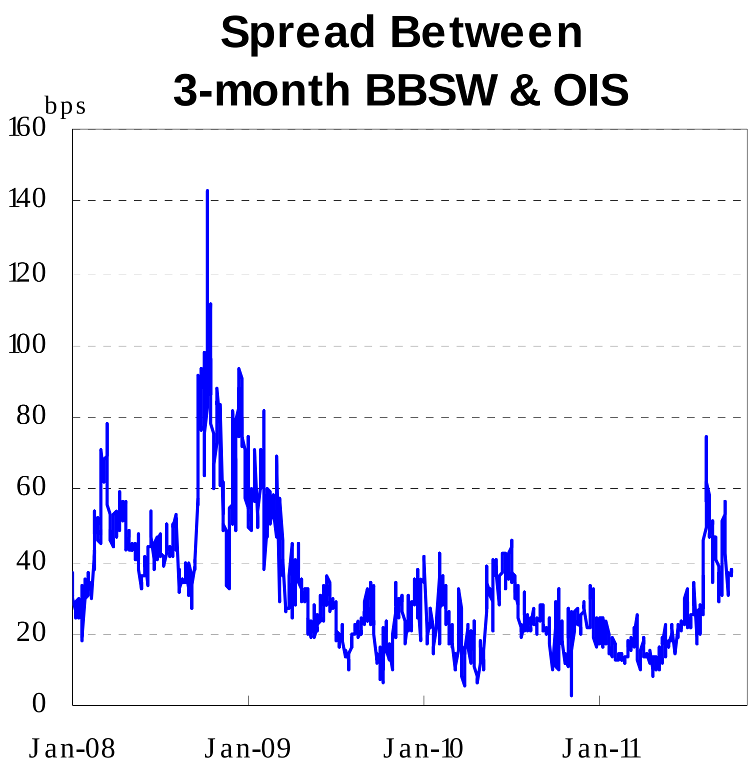
- **Potential exposures to peripheral sovereign debt is causing a tightening of credit markets for European Banks.**
- **The spread between the 3-month Euribor and OIS contracts has risen to around 80bps, the highest since early 2009.**
- **The ECB and four other major central banks have recently announced co-ordinated 3-month US dollar liquidity facilities.**
- **Conditions are still better than during the GFC period.**
- **There is a risk of greater funding strains if sovereign debt problems worsen.**

Exposures to Peripheral Debt

FOREIGN BANK CLAIMS ON ($bn, end 2010)		TOTAL	Eur Banks	NON EU BANKS
GREECE	Total	145.8	136.3	9.5
	Public Sector	54.2	52.3	1.9
	Banks	10.9	8.9	2
IRELAND	Total	462.3	377.6	84.7
	Public Sector	19.5	15.4	4.1
	Banks	85.1	70.5	14.6
PORTUGAL	Total	202.3	194.6	7.8
	Public Sector	34.6	32.4	2.2
	Banks	43.4	40.4	2.9
SPAIN	Total	708.6	632.2	76.4
	Public Sector	102	88.1	13.9
	Banks	225.9	199.3	26.6
ITALY	Total	867.3	783.9	83.4
	Public Sector	261.6	220.6	41.1
	Banks	147.7	129	18.7

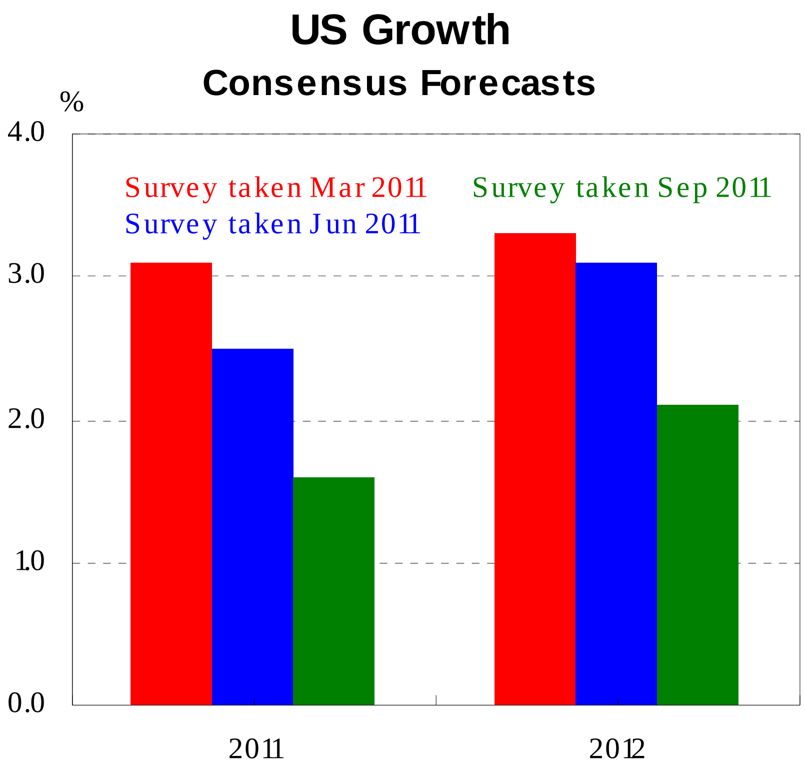
Source: OECD

Australian Banks are Well Placed



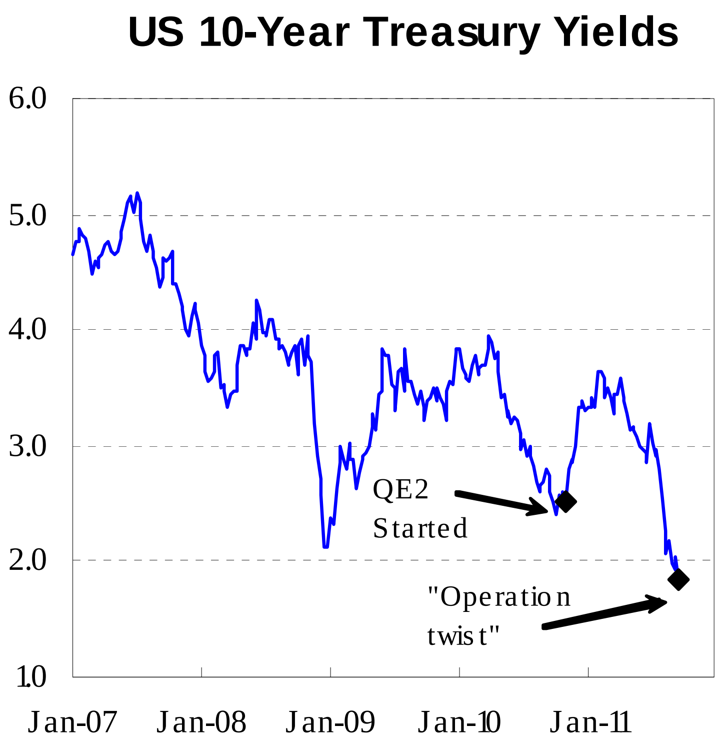
- Australian banks have reported no exposure to Greek sovereign debt and little to other peripheral debt.
- Wholesale funding has tightened modestly as reflected in the widening of spreads between 3-month BBSW and OIS.
- The spread is nowhere as wide as that experienced during the GFC.
- Banks in Australia and globally have improved capital and liquidity positions since the GFC.
- Further, according to the RBA September board minutes, Australian banks haven't had a need to issue bonds given strong deposit inflows and slow balance sheet growth.

The Other Eye of the Storm – The US



- **Economic data in recent times has indicated a loss of momentum in the US economy. Some fears of a double-dip recession have emerged.**
- **US growth forecasts have been progressively downgraded this year (refer to chart on the left).**
- **We believe risks to growth are greater in Europe than in the US.**
- **But downside risks remain.**

Possible Circuit Breakers – Monetary Policy

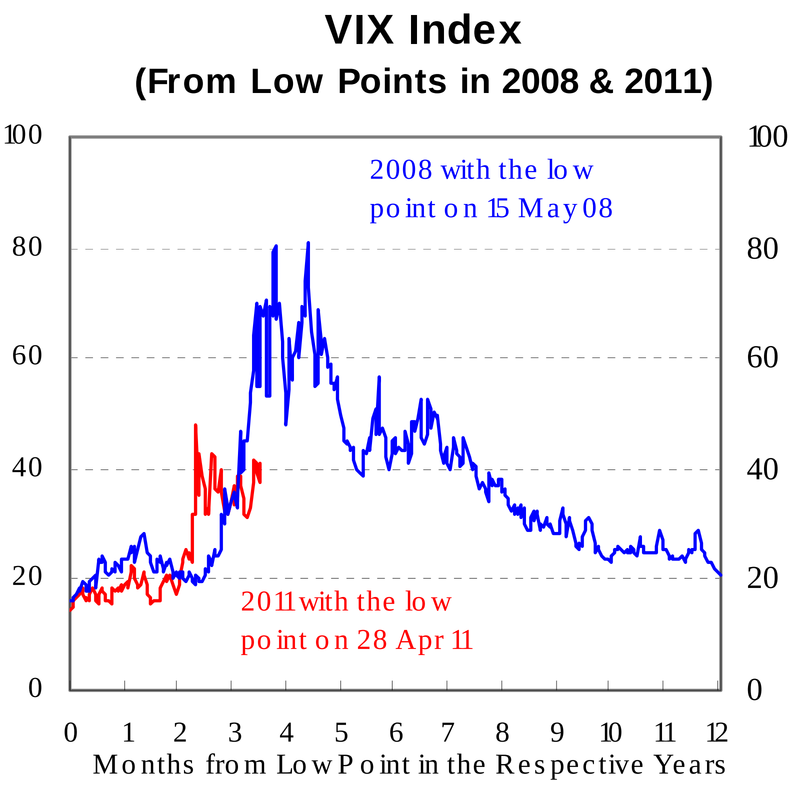


- Limited scope for monetary policy.
- Demand for borrowing is low while there is still reluctance to lend.
- "Operation Twist" (purchase of long-term bonds with sale of short-term bonds) announced at last FOMC meeting on 22 Sept is likely to have only a modest effect.
- Some analysts argue QE3 could be more effective to stimulate growth.

Possible Circuit Breakers – Fiscal Policy

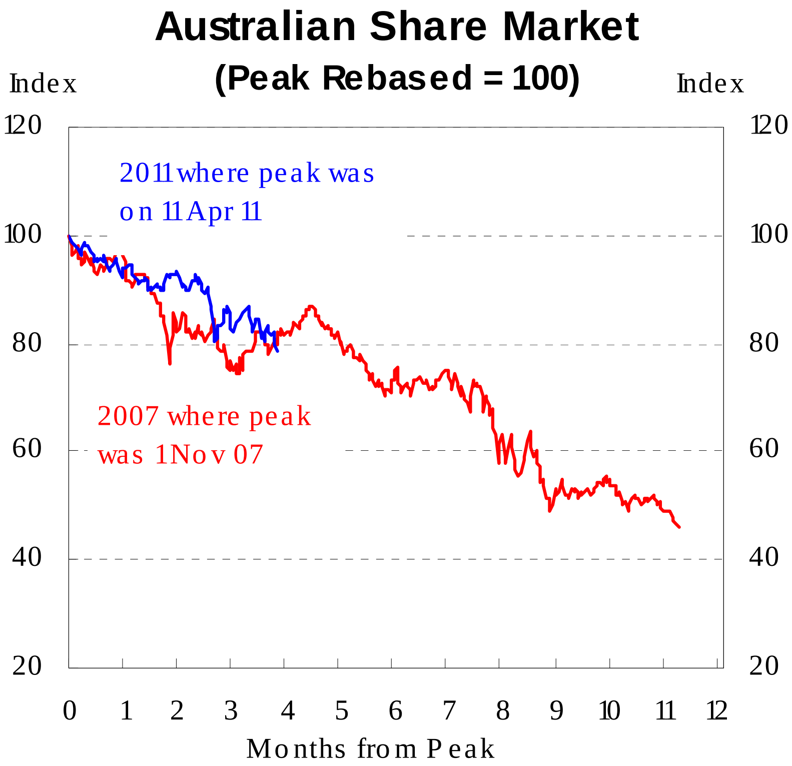
- A US$447bn jobs package could provide a boost to growth and jobs – yet to be passed by Congress.
- Compromise among the political parties has proved difficult.
- Fiscal policy will require achieving balance between supporting short-term growth and reducing the deficit over the longer-term.
- Standard & Poor's downgraded the US debt long-term debt rating from AAA to AA+ on August 5, reflecting worries about the ability of the political process to address the 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.

Investor Nervousness is High



- The higher the VIX index, the higher risk aversion is.
- Uncertainty and risk aversion is currently high, highlighting the fragile state of investor confidence.
- But it is not as high as during the heights of the GFC.

Share Markets are in Turmoil

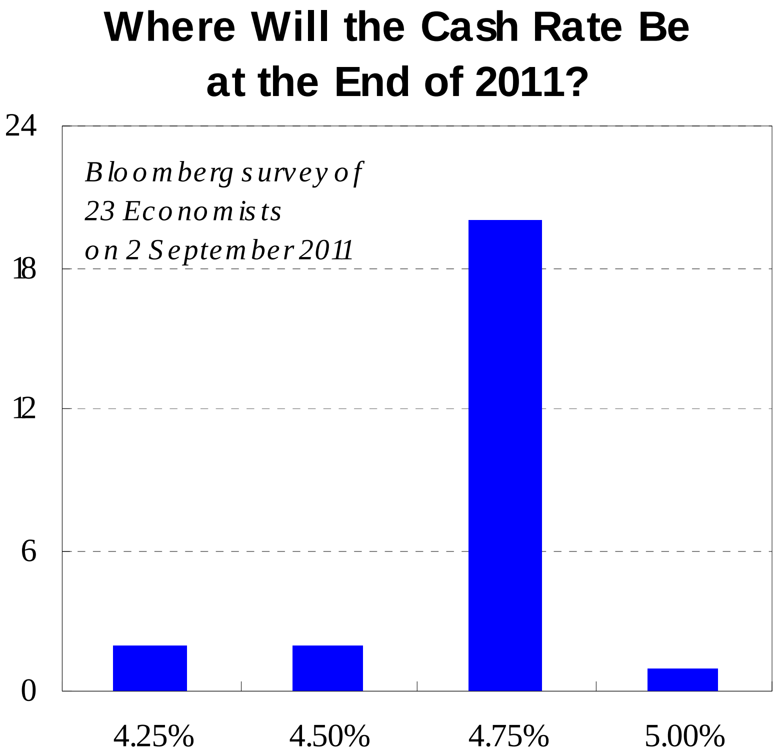


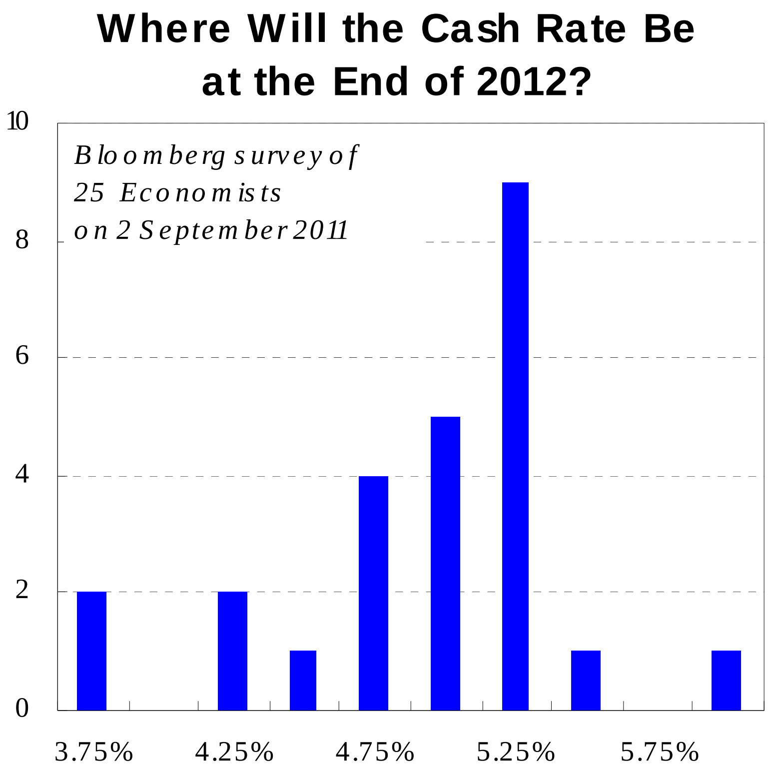
- The Australian share market from the close on 26 September fell 22.3% since the 2011 peak of 4,971 recorded on 11 April.
- A bear market is usually defined as a fall of 20% or more from peak to trough.
- Falls in share markets affect wealth and confidence, which can have knock-on effects to the economy.

Rate Direction in Australia

- The future direction of monetary policy is increasingly hinging on developments offshore.
- The RBA appears to be in wait-and-see mode.
- Ongoing volatility in financial markets and deterioration of global developments mean that a rate cut cannot be ruled out.
- Any tangible evidence of negative effects emerging in Asia will open the door wider for rate cuts locally.

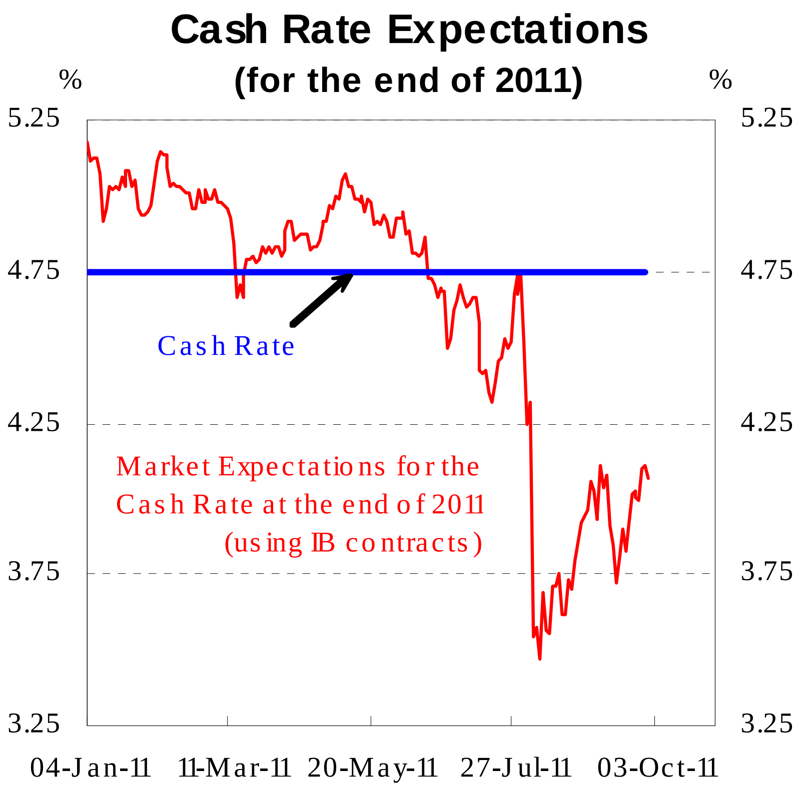
Cash Rate Poll Results





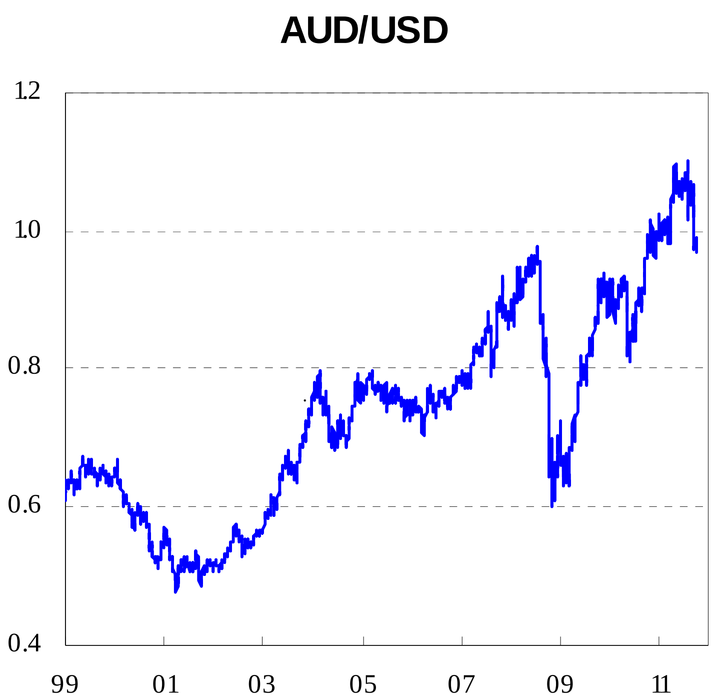
- **A survey taken on 2 September 2011, revealed that the median consensus among economists was for rates to remain on hold this year and to rise next year.**

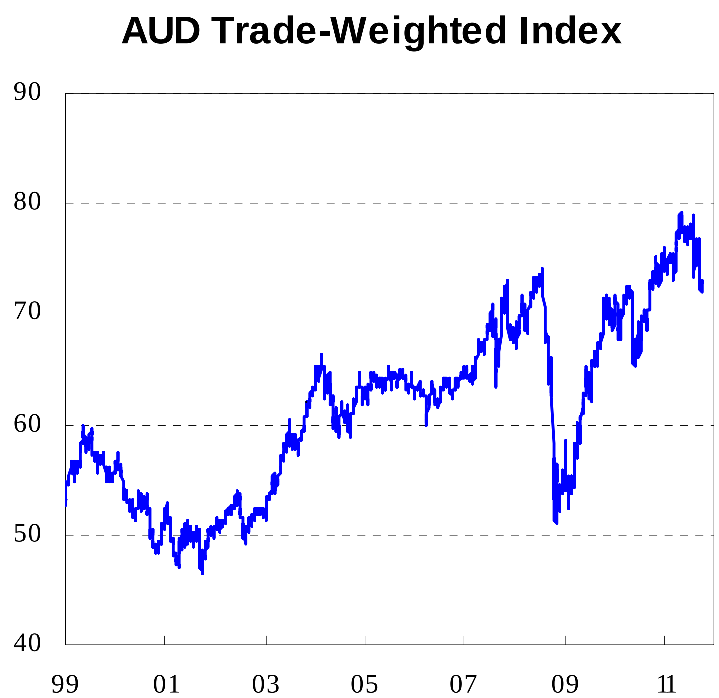
Financial Markets Expecting the RBA to Cut Rates



- **Financial markets are fully pricing in 50bps 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 but it is not a lay down misère at the time of writing.**

Impact on AUD

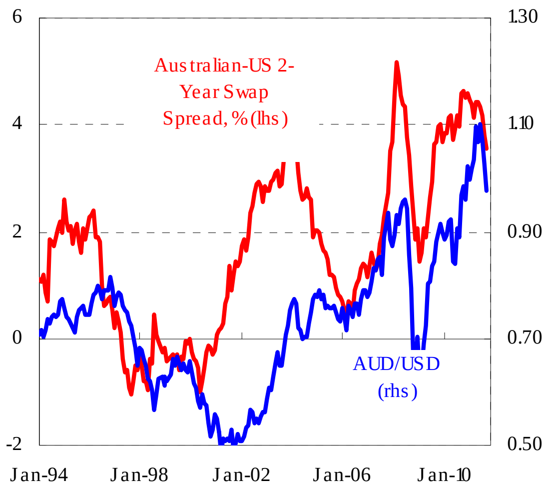




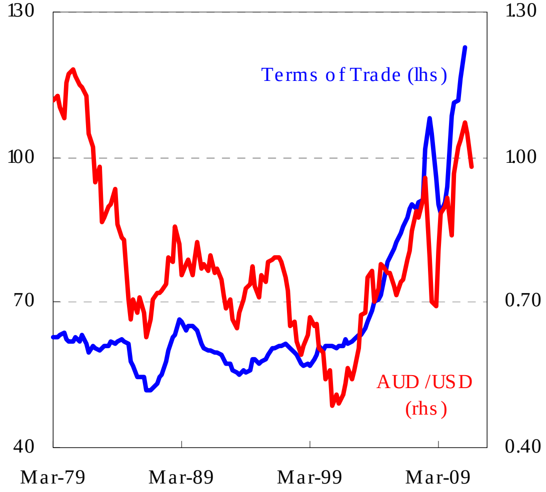
- Heightened risk aversion is generally negative for the AUD. Falls in commodity prices and a reassessment of the global growth outlook also put selling pressures on the AUD.
- The AUD has held up better this year during bouts of risk aversion compared with past episodes.

Fundamentals are Supportive of AUD

AUD & 2-Year Swap Spread

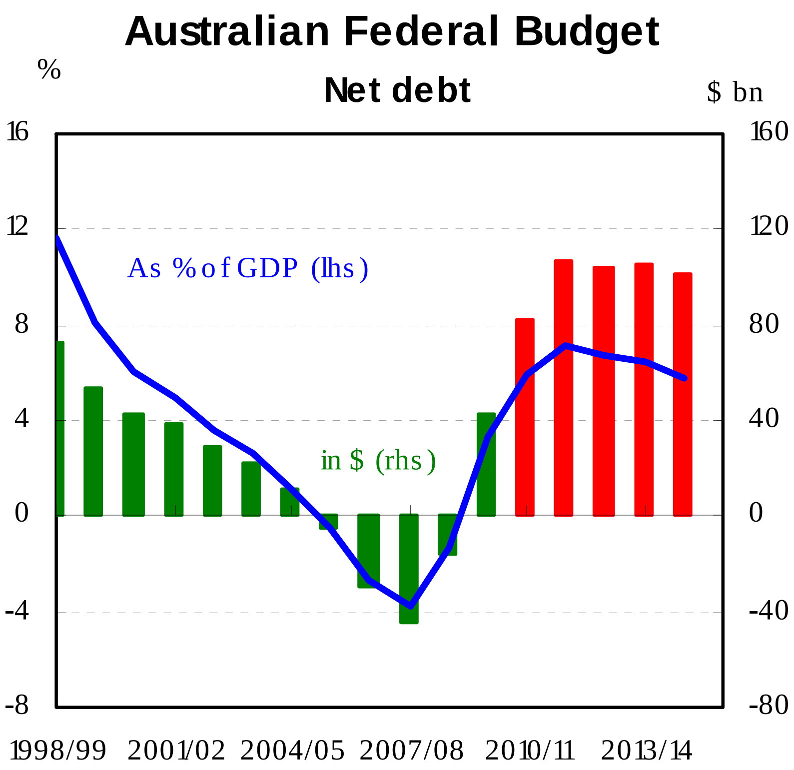


AUD & the Terms of Trade



- Giving the AUD support, however, is Australia's:
  - Attractive interest rates.
  - High terms of trade.
  - Strong fiscal position.
  - Relatively firm economy
- Results of a recent Reuters poll show a wide range of forecasts of 0.80-1.20 by end 2012.
- Median expectations is for 1.04 while our forecast is at 1.01 for the end 2012.

Australia’s Fiscal Position is Healthy



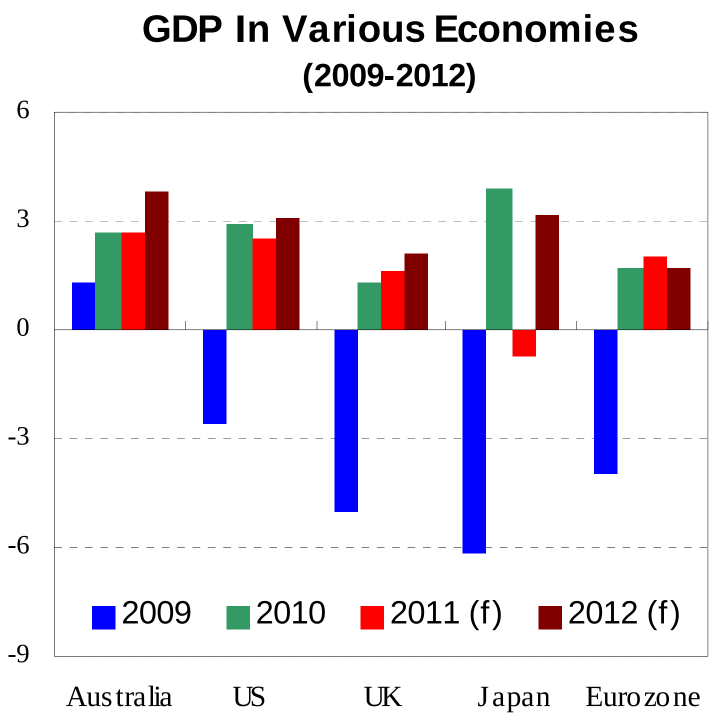
- **Australia’s government net debt at 5.9% of GDP is small compared to other developed countries.**
- **Expected to peak at 7.2% of GDP.**
- **Australia has scope to use fiscal (and monetary) stimulus if necessary.**

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.

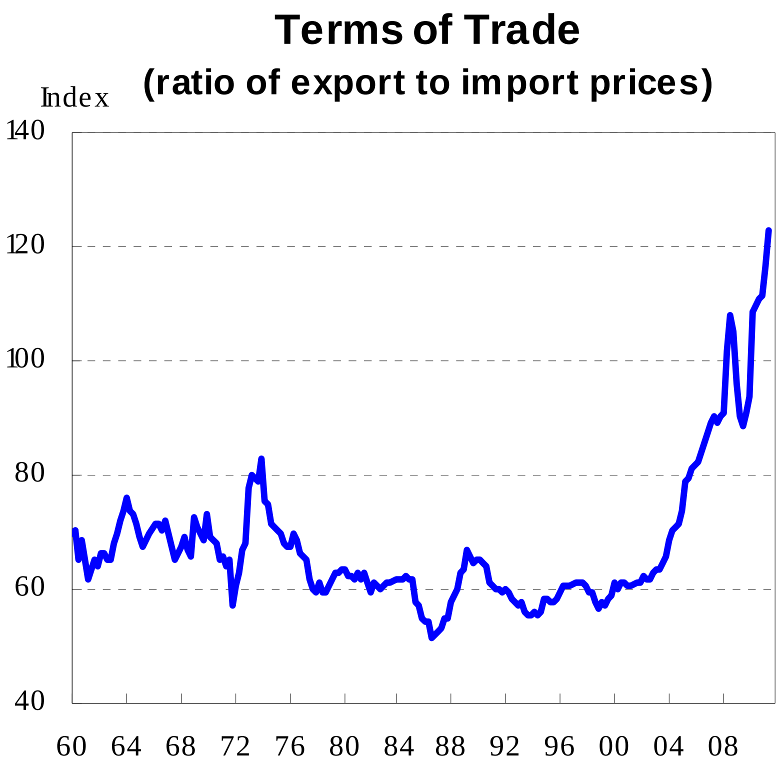
Australia's Economic Fundamentals Attractive



Forecasts as at 11 July 2011

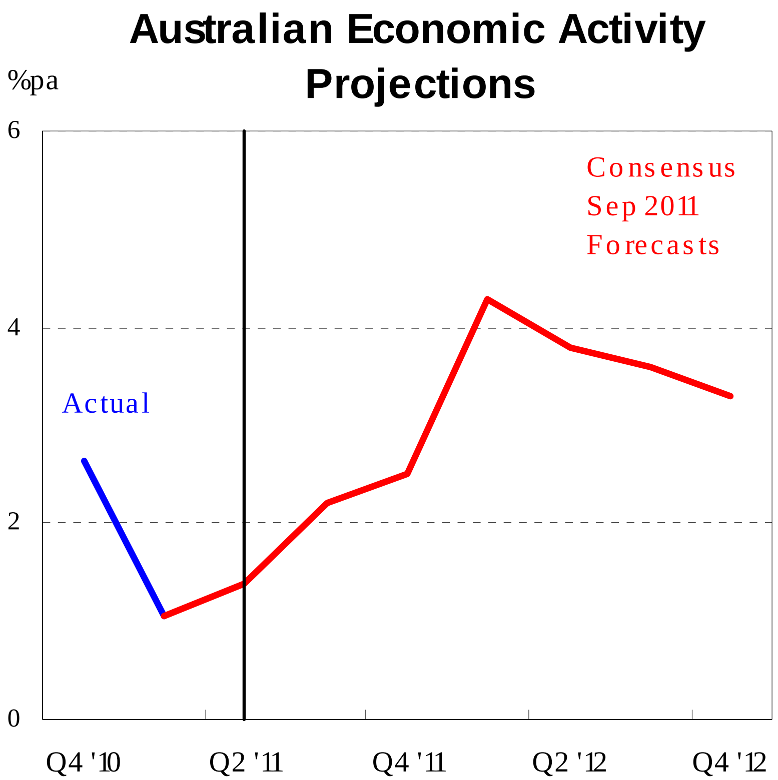
- **Indeed, the Australian economy is in the midst of a "once in a century economic event". That is reflected in a rising terms of trade.**
- **It helped the Australian economy withstand the GFC better than other advanced economies.**

The Terms of Trade Injection



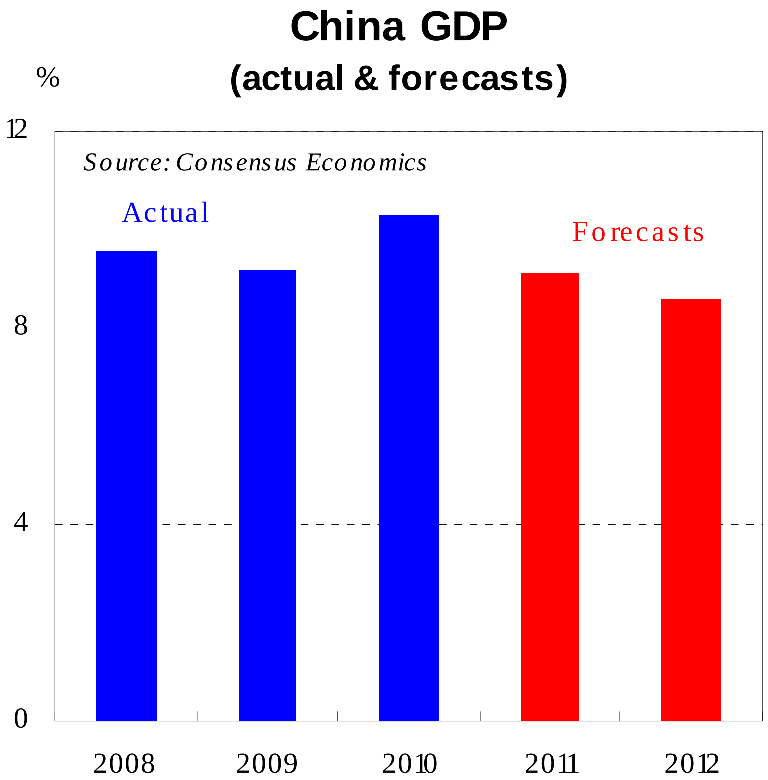
- The terms of trade (ToT) measures the relativity of export and import prices.
- It is at a record high and helping to underpin income and economic activity in Australia.
- It is estimated that the ToT is giving an extra boost of income to production that is around 15% of annual GDP.

Australian GDP Forecasts



- **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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