Ongoing instability in financial markets in November saw central banks cut interest rates further and introduce new measures aimed at easing credit market conditions. The Reserve Bank (RBA) cut its cash rate by 75 basis points in early November, and another aggressive interest rate cut is expected tomorrow. Given the ongoing global financial crisis, softer Australian economic data and anecdotal evidence suggesting economic conditions will worsen in coming months, we expect the RBA to cut interest rates by 75 basis points. This would take the official interest rate down to 4.50%, although a larger 100 basis point rate cut remains a possibility.

Bond yields in Australia and internationally fell sharply over the past month given interest rate cuts from the major central banks, expectations of more rate cuts over the next month, and slower economic growth over the medium term. Given weaker economic data over the past month and the ongoing financial market turmoil, the Federal Reserve is expected to cut interest rates further from the current 1% level. The Bank of England meets this week and is expected to cut by 100 basis points, to 2%; a larger interest rate cut can’t be ruled out. The European Central Bank also meets this week and given a decline in inflation and confirmation earlier this month that the Euro zone is in recession, there is scope for the ECB to cut rates more aggressively again. This month official interest rates in the Euro zone will be cut to at least 2.75%.

The Aussie dollar has finished November slightly weaker and is now trading around US 64.70 cents. The souring global economic outlook, heightened risk aversion and local rate cuts weighed on the local currency. Weaker commodity prices also weighed on the currency, although the gold price was much stronger for the month. The CRB commodity price index fell almost 10% for the month, while gold was up by more than 12%.

Domestic economic data softened over the past month; quarterly retail sales volumes stagnated in the September quarter and housing activity indicators generally fell. Employment was stronger, due to gains in part-time employment, although forward indicators and anecdotal reports of job cuts suggest this will weaken in coming months.
GENERAL ECONOMIC OUTLOOK – WORLD and AUSTRALIA

In a recent speech, RBA Governor Glenn Stevens highlighted that the world faces the most serious international financial crisis since the 1930s. The RBA has said that this deep financial crisis presents negative implications for the Australian economy.

In explaining its surprise 100bp rate cut on October 7, the RBA said that there is “now present the risk that demand and output could be significantly weaker than earlier expected”. This was followed by another aggressive 75 basis point rate cut on November 5, when the RBA said “on balance, it appears likely that spending and activity will be weaker than earlier expected.” Although the stimulus from gains in the terms of trade is still coming through, the expansionary impact of this is likely to taper off given the broad declines in commodity prices. The latter as well as greater downside risks to growth imply a downward influence on inflationary pressures.

The ongoing credit crisis means we continue to expect more aggressive easing from the RBA. Since the Reserve Bank began its current easing cycle in September, rates have been lowered a hefty 200bp. The RBA first cut rates by 25bp in September. They then surprised the market by lowering them a very large 100bp in October as the financial crisis escalated. The last time the RBA cut rates by this much in a single move was in the middle of 1992, which was also around the time of the last recession. The RBA then followed this up with a 75 basis point rate cut in November. Looking forward, in our view, there is still scope for further easing. We expect the RBA to cut to a further 75 basis points tomorrow (with some possibility of a cut of 100bp in size), followed by more rate cuts early next year, taking the official cash rate to 3.75% by end June.

In the previous easing cycle, the RBA cut interest rates by a total of 200 basis points to 4.25% and in the easing cycle in 1996-97, the RBA eased by 250 basis points to 5%. We think conditions will be worse through this easing cycle, necessitating a total of 350 basis points in interest rate cuts (including the 200 basis point cut delivered so far).

In its last easing cycle the US Federal Reserve cut official interest rates by 550 basis points to 1%, and in its current easing cycle the Fed has lowered interest rates by 425 basis points to 1% with further interest rate cuts likely.

The global economic outlook has deteriorated significantly over the past month, with many of the developed economies now in recession. In its latest World Economic Outlook (WEO) report, the IMF cautioned that, “The world economy is decelerating quickly – buffeted by an extraordinary financial shock and by still-high energy and commodity prices – and many advanced economies are close to or moving into recession.” The IMF expects world growth to slow to 2.2% in 2009, well below the 3% level seen by the IMF as the threshold for world recession. This is 1.7 percentage points lower than what was forecast in July. It is also lower than the 3.7% pace of growth expected this year and 5.0% in 2007. In recent weeks, a recession has been confirmed in some of the major economies, including the UK, the Euro zone and Japan, and it is also likely the US economy is already in recession, although this is yet to be declared by the US NBER, the official arbiter.
The credit crisis and economic woes in developed economies have already been felt in Asia, and this is expected to accelerate. Chinese economic data has shown that even this economic powerhouse hasn’t been spared. Annual GDP growth slowed for the fifth consecutive quarter in Q3 to 9.0%, down from the 12.6% peak reached in Q2 2007.

Analysts had expected a much higher reading of 9.7%pa and only expected the current 9.0%pa pace to be reached in Q2 2009. Given China’s status as our second most important export destination, this will have important flow-on effects for Australia, where signs of an economic slowdown have already begun to emerge. Current forecasts are for Chinese economic growth to slow to 8.60% in Q1 2009 and 8.40% in Q2 2009. There is also a real risk that China slows to under 7%pa during this period given the guide that industrial production figures are providing.

Consumer spending in Australia showed signs of a significant downturn in the June quarter, with household spending falling 0.1% for the quarter, the first decline in fifteen years. Since then, retail sales have been tepid, rising at an annual rate of just 1.6% in September, in an environment of 4.7% core consumer price inflation. Bank lending growth has contracted significantly, with housing lending rising 8.6% over the year to October, other personal lending down 0.1% and business lending up 13.2% in the year to October, which fails to capture the most recent deterioration in economic sentiment.

Looking forward, household consumption spending is likely to remain subdued following the very sharp losses in the stock market and much slower employment growth. The hefty interest rate cuts, fiscal stimulus, lower petrol prices and weak Australian dollar [which would help boost exports] could provide some support. But sentiment is likely to be shaky for some time amid this uncertainty. Household spending was already weak in the June quarter. It was unchanged in the quarter, to be, in annual terms, growing at about 2-year lows. In the last recession of the early 1990s, household spending was virtually unchanged in most quarters.

Australian employment conditions, which are a lagging economic indicator, are expected to take a turn for the worse in coming months based on leading indicators of employment and the economic slowdown. The RBA projected an increase of 1% but said it could be even greater than this given the deeper financial crisis. In the last two recessions (of the early 1990s and early 1980s), the unemployment rate increased by around 5 percentage points to greater than 10% in the span of 2-3 years [although structural unemployment was higher during these periods]. Our forecast is for the unemployment rate to rise to around 6% in H2 2009 and peak at 8-9% in 2010, from its current level of 4.3%. As employers tend to delay hiring intentions until they are clearer on economic conditions and prospects, the peak in the jobless rate could occur well after a recovery has started in the economic cycle.

Private business spending has remained reasonably strong, rising by 0.6% in the September quarter. This left the annual rate at a still strong 15.9%. Looking ahead, however, business-spending plans for the future were revised lower, due to the slower economic environment and difficult and/or costly funding. Providing a dampener will be the deeper financial crisis, the sharp falls in commodity prices from their peaks, much lower business confidence and the fact that our major trading partner, China and other emerging economies have shown signs of slower growth. Accordingly, we expect business spending to slow and show a deeper slowdown next year when the work in the pipeline dries up.
The stimulus from gains in the terms of trade is still coming through. But the RBA has cautioned that the expansionary impact of this is likely to taper off given the broad declines in commodity prices. Massive increases in contract prices for iron ore and coal earlier this year have benefited the outlook for international trade since April this year. The increase in the price of these commodities led to an average trade surplus of $175 million over the six months to September. Meanwhile, the average of the twelve months preceding April 2008 came in at a trade deficit of $2,000 million each month. On the imports side, fuel imports are now slowing as the price of oil plunges, while consumption imports are being curbed by the slowdown in domestic demand. Slowing imports and now more competitive exports (via the weaker AUD) will help towards improving the trade balance. However, this risks being offset by lower export prices as commodity prices continue to fall.

There is a lot of uncertainty surrounding the property market at present. Home loan approvals for owner-occupiers have plunged by 26.9% over the year to September, indicating weak sales volumes and a tendency for house prices to flatten out. Building approvals have also been weak (down by 23.5% from its peak in November 2007) despite the high population growth and shortage of dwellings across the nation. The housing sector looks rather somber in the short-term but the strong underlying housing fundamentals paints a more positive outlook for the medium term.

Helping to provide a boost to the economy will be the Rudd Government’s recent large $10.4bn fiscal stimulus package (estimated to be around 1.0% of GDP). This was designed to limit the downside risks from the credit crisis. This package contains five broad measures:

- $4.8bn for an immediate down payment on long term pension reform ($1400 for singles and $2100 for couples)
- $3.9bn in support for payments for low and middle-income families ($1000 for each eligible child)
- $1.5bn investment to help first-home buyers purchase a home (tripling of the first home owners grant for new homes to $21k and doubling for those who buy established homes to $14k)
- $187m to create 56,000 new training places in 2008-09, and accelerate the implementation of the Government’s three nation-building funds and bring forward the commencement of investment in nation building projects to 2009.

Also working in Australia’s favour is the health of our banking system, relative to that of the US and Europe, as well as the government’s fiscal surplus. Australia’s budget surplus is expected to be around 1.3% of GDP this year, compared with deficits in many of the major economies. This leaves a handy war chest for the government to support the economy, which will be put to good use with the government’s recent bank guarantee. However, if the budget does move into deficit, it is at least from a position of surplus in the preceding years.
On October 12, the Australian government announced measures to help boost investor confidence. Prime Minister Kevin Rudd had pledged to, effective immediately, guarantee all $700bn worth of deposits in banks, credit unions and building societies and will also guarantee all term wholesale funding by Australian banks and deposit-taking financial institutions operating in international credit markets. Meanwhile, the amount the government will spend on residential mortgage-backed securities was doubled to $8bn to ensure the Australian mortgage market has access to enough funds.

Despite some concerns surrounding this confidence boosting measure, the large fiscal stimulus should still help mend confidence via its expansionary effect on the slowing economy. We expect GDP to average close to 1% in financial year 2008/09 and around 1.5% for next year after around 2.2% growth this calendar year.

Another key implication of the government’s stimulus package is that the RBA may not need to cut rates as much as they might have otherwise. Nonetheless, we still expect a 75 basis point rate cut from the RBA in December, followed by a series of rate cuts next year. This means interest rates could reach at least 3.75% by the end of Q2 2009. There is an inverse correlation between interest rates and the unemployment rate as shown by the chart on page 2. This supports our forecast for a much higher unemployment rate in the year ahead, as previously discussed.

In conclusion, it has been confirmed that several of the major economies tipped into recession in the September quarter, while economic growth in China has eased to an alarmingly lackluster pace. The Australian economy faces a difficult time as the impact from the global financial crisis drags on consumer spending, although the turmoil is yet to even be reflected in employment. Although unemployment will rise in Australia over the coming year, Australia remains well placed given the relative health of the banking system compared to the US and Europe, the stimulus to date from the improved terms of trade, aggressive rate cuts from the RBA and the likely cushioning from the Government’s fiscal stimulus package.
The wage price index rose by 0.9% in the September quarter. The annual rate held steady at 4.1% for the third consecutive quarter. This is below the RBA’s 4.5% line-in-the-sand, indicating wages growth remains contained. Industries with the largest quarterly increase in wages were personal and other services (+2.1%), property and business services (+1.9%) and communication services (+1.5%).

Retail sales (in volume terms) rose by only 0.1% in the September quarter. This follows a decline in retail sales in the two previous consecutive quarters and lowers the annual rate of growth to 1.0%. The industry breakdown showed that clothing and soft goods [+1.6%] and department stores [+1.1%] had the strongest growth in the quarter. Meanwhile, cafes, restaurants and takeaway food services were the weakest [-1.8%].

Private Capital expenditure (CAPEX) in volumes terms rose by 0.6% in the September quarter, lifting the annual rate to 15.9%. The quarterly increase was due to a 6.6% increase in ‘building and structures’ investment, while ‘equipment, plant and machinery’ investment fell by 2.4% in the quarter. Business spending intentions were revised lower, but still remain reasonably firm. The industry breakdown shows that mining continues to make a solid contribution (+7.1%), while manufacturing was weaker by 0.7%.

The number of people employed rose by 34.3k in October, while the unemployment rate held steady at 4.3%. The monthly outcome was attributed to a large increase of 43.5k in part-time employment as full-time employment fell by 9.2k. Employment growth shifted higher to 2.1% in the month, however this is well below the 3% rate recorded earlier this year. Forward-looking indicators show that employment conditions are likely to slow in the period ahead.
Private sector credit rose by 0.6% in November, lowering the annual rate to 9.7%, from 10.0% in October. Housing credit growth came in at 0.5% for the month and 8.6% for the year. Weak house lending suggests that housing construction and house prices will remain under pressure. Business credit rose by 1.1% in October, to be 13.2% higher over the year. Meanwhile, 'other personal' credit fell sharply by 1% in the month, and 0.1% over the year.

The number of home loans to owner-occupiers fell by 2.7% in September. Over the year to September, housing finance has declined by 26.9%. The value of investment loans fell by 1.1% in September, to be 22.8% lower over the year. Meanwhile, the proportion of homebuyers opting for a fixed rate loan fell to just 3.3% of all new loans in September. This indicates that buyers are expecting further rate cuts in the period ahead.

Building approvals plunged by 7.2% in September, to be 21.6% lower over the year. This month’s decline was made up of a 14.6% drop in the ‘other dwellings ’ component (which includes apartments and flats) and a 3.8% fall in housing approvals. Tight financial conditions along with share market losses and low housing affordability have been a major hurdle in the housing market. However, the underlying housing fundamentals should help cushion the slowdown in housing activity.

The trade balance came in at a surplus of $1,460 million in September. The trade surplus was the result of a 7.5% increase in exports and 7.0% rise in imports during the month. The large increase in exports was primarily due to a large increase in non-rural goods. The increase in non-rural goods was the result of a 19.5% increase in metal ores and minerals and a 13.7% increase in coal exports. Imports also increased as a result of the large rise in fuels and lubricants.
In Australia, the RBA surprised markets for the second consecutive month by carrying out a larger than expected rate cut. The central bank lowered the official cash rate by 75bp, more than the 50bp reduction expected by most. This follows a very aggressive 100bp interest rate reduction in October. The RBA has not cut rates by this much and in such a short period since around the time of the last recession, in the early 1990s. Accordingly, it illustrates the seriousness of the current situation and the greater downside risks it presents to the Australian economy. Indeed, the RBA has cautioned that even the aggressive rate cuts to date, the large fiscal stimulus and the weak Australian Dollar (which is beneficial for exports) will not be enough to prevent the current slowdown. In other words, they would merely cushion the slowdown but not cancel it out. The RBA expects the economy to slow significantly in the next six months, from the current 2.7% pace to 1.5% in June 2009. This would represent a pace of growth well below the long-term average of 3.5%. Looking ahead, in our view, there is still scope for more monetary easing by the RBA. We expect a rate cut of 75bp at tomorrow’s monetary policy meeting. We also would not rule out the chance of a larger 100bp cut with credit conditions still yet to show a significant improvement. Thereafter, we project further easing so that interest rates reach a low point of 3.75% by end Q2 2009.

Elsewhere, major central banks also continued to lower rates aggressively to prevent a deeper slowdown in their economies. China, in particular, slashed rates by 108bp, marking the largest cut in 11 years. The People’s Bank of China was, perhaps, responding to concerns of a sharper than expected slowdown in the Chinese economy. Leading indicators, in particular, suggest that there is a real risk of the Chinese economy slowing to sub 7.0% per annum in the months ahead from the current 9.0% pace. Anything under 8.0% represents a more marked slowdown in China and would be a key risk for Australia. Other central banks, which lowered rates aggressively this month, were the Bank of England (-150bp) and the European Central Bank (-50bp). The data in the Euro zone of late has been very weak and supports calls for more aggressive monetary policy loosening by the ECB this week.

With no end in sight yet to the financial crisis, government bond yields across the globe continued to move lower. Short-dated yields fell as central banks remained in an aggressive policy-easing mode. Also contributing to the fall in yields were safe haven flows with market volatility still at historically high levels. In November, the Australian bond yield fell by 106bp, in the UK they fell 71bp, while Euro Zone and US yields were 40bp and 56bp lower, respectively.
Currency Markets

Australian Dollar

The Australian dollar traded in a narrower range in November versus October, but finished the month lower. Over the month it moved in a range of around 9 US cents versus more than 20 US cents in October. Its behaviour is still, however, considered to be erratic as in the past, the typical monthly trading range in the AUD has averaged around 3 US cents. Over the month, the AUD moved lower by around 1.30 US cents to trade around 65.50 US cents. The AUD also continued to depreciate versus the Japanese yen. In November, AUD/JPY moved 5.0% lower, on the heels of a 22.0% plunge in October. The currency pair is now trading at a 7-year low of around 62 Yen.

Looking ahead, we continue to see downside risks for the local currency. It is still too early to call an end to heightened market volatility. So in other words, with risk aversion still well above the average of the last few years, this should continue to see an unwinding of carry-trades and safe-haven flows away from the AUD and into currencies such as the yen. The RBA is also now clearly in an aggressive rate cut cycle. This diminishes the AUD’s status as a high-yielding currency. Meanwhile, the AUD’s status as a commodity currency also suggests a lower currency level. The global economy is clearly slowing, with forecasters having consistently downgraded their growth forecasts given the deeper financial crisis. We retain our forecast for the AUD to move down to 61 US cents by end year and US 59 cents by end March 2009. Thereafter, we expect the AUD to recover to its long-term average of around 71 US cents by end 2009.

Global Currencies

The US dollar fell further against the Yen, by 3.0% to around 95.47 Yen in November. Safe-haven flows and de-leveraging continue to benefit the Japanese currency. The US dollar has also been pushed higher by safe-haven and repatriation flows, albeit to a lower extent compared to the yen. In November, the greenback rose 4.2% against Sterling and was up a slight 0.3% versus the euro. Against the currencies of the G6 countries, the USD appreciated 1.0% in the month. Past recessions and crises reveal the USD typically appreciates around six months after a US downturn or crisis. The USD has indeed, benefited in prior months via the de-leveraging process, the repatriation of funds and earlier and more responsive monetary-policy action from the US Federal Reserve compared to the Bank of England and European Central Bank. However, we are not favourable on the USD in the medium term. The growing twin deficits in the US should ensure that the USD outlook is only favourable in the short-term.
Commodity Markets

Oil

The price of oil fell a further 20% in November to trade around the $US55.4 level. This is more than $US90 lower from the peak of above $US147 reached in July and down 40% from year ago levels. Deteriorating global growth prospects remain a major downside influence for oil prices. The price of oil has, however, improved slightly in recent weeks. Some of the reasons behind this have been speculation that OPEC will cut output again to support prices as well as bold measures by top policy makers to help boost economic conditions.

Gold & Base Metals

The price of gold rose 12.8% in November to around $US815 an ounce. Gold’s safe-haven status continues to protect this asset from downside pressure faced by other commodities. Nonetheless, gold is still about $200 lower from its peak of above $1000 reached early this year. Compared to year ago levels it is down about 30%

Base metal prices moved lower again in November. The LMEX index (a basket of six base-metal prices) fell 20% in the month to be about 56% lower from the peak reached in March this year.

Share Markets

Australia

Australian equities fell by 7.0% in November as financial and economic uncertainties continued to grip markets. Among the hardest hit were consumer discretionary stocks [-14.6%] and financials [-9.4%]. Meanwhile, energy and materials also fell in the month by 4.6% and 3.2%, respectively. But losses were comparatively more subdued given the improvement in commodity prices in recent weeks. Ongoing aggressive action by global central banks and governments to prevent a deeper global slowdown has been the reason behind the stabilisation in commodity prices.

International Markets

Top policy makers across the globe have continued to introduce bold action to help mend financial conditions. But financial market volatility remains at historically high levels. The VIX Volatility Index [a measure of risk aversion] is currently hovering around 56 pts. Although it is lower from the all-time peak of 89.53 pts reached in October, it is still significantly above the 5-year average of 17 points. Accordingly, global stock markets continued to post losses. The Dow Jones fell by 5.0%, the UK FTSE fell by 2.0%, the Nikkei was down 0.8%, while the German Dax dropped 6.4%.
Recent Australian Data

Red – Indicates the result was **weaker** than consensus expectations
Blue – Indicates the result was **stronger** than consensus expectations
Black – Indicates the result was **in line** with consensus expectations

November 2008
- TD-MI Inflation Gauge: –0.6% m/m, Previous: –0.2% 1/12
- WMI Consumer Confidence: 4.3% m/m, Previous: –11% 12/11

October 2008
- Private Sector Credit: 0.6% m/m, Consensus: 0.5% 28/11
- NAB Business Confidence: –29 pts, Previous: –8 pts 11/11
- Employment Change: 34.3k, Consensus: –10k 6/11
- TD-MI Inflation Gauge: –0.2% m/m, Previous: 0.4% 3/11
- WMI Consumer Confidence: –11% m/m, Previous: 7% 8/10

September 2008
- Company Profits: 5.2% q/q, Consensus: 4.0% 1/12
- CAPEX: 0.6% q/q, Consensus: 0.8% 27/11
- Retail Sales [volumes]: 0.1% q/q, Consensus: 0.5% 17/11
- Wage Cost Index: 4.1% q/q, Consensus: 4.2% 12/11
- Housing Finance: –2.7% m/m, Consensus: –2.5% 10/11
- Building Approvals: –7.2% m/m, Consensus: –1.2% 5/11
- Trade Balance: $1.46bn, Consensus: $0.6bn 5/11
- House Price Index: –1.8% q/q, Consensus: –0.5% 3/11
- Retail Sales (trend): 0.2% m/m, Consensus: 0.2% 3/11
- Private Sector Credit: 0.7% m/m, Consensus: 0.4% 31/10
- Consumer Price Index: 1.2% q/q, Consensus: 1.0% 22/10
- Producer Price Index: 2.0% q/q, Consensus: 1.2% 20/10
- NAB Business Confidence: –8 pts, Previous: –7 pts 14/10

August 2008
- Employment Change: 2.2k, Consensus: 0k 9/10
- TD-MI Inflation Gauge: 0.4% m/m, Previous: 0.1% 3/10
- WMI Consumer Confidence: 7.0% m/m, Previous: 9.1% 10/9

July 2008
- Housing Finance: –2.2% m/m, Consensus: –1.0% 8/10
- Trade Balance: $1.36bn, Consensus: $0.2bn 2/10
- Retail Sales: 0.3% m/m, Consensus: 0.1% 30/9
- Building Approvals: –3.7% m/m, Consensus: –1.0% 30/9
- Private Sector Credit: 0.5% m/m, Consensus: 0.5% 30/9
- Employment Change: 14.6k, Consensus: 5.0k 11/9
- NAB Business Confidence: –7 pts, Previous: –9 pts 9/9
- WMI Consumer Confidence: 9.1% m/m, Previous: –6.7% 13/8
- TD-MI Inflation Gauge: 0.1% m/m, Previous: 0.4% 1/9

Upcoming Data and Events – Australia & US

### Australian Data / Events Underlined

**December 2**
- AU Current Account, Q3
- AU Retail Sales, Oct
- AU RBA Rate Decision
- US Fed’s Plosser speaks

**December 3**
- AU AiG Performance Services, Nov
- AU GDP, Q3
- US ADP Employment, Nov
- US Productivity, Q3
- US ISM Non-Manufacturing, Nov
- US Fed’s Beige Book

**December 4**
- AU Trade Balance, Oct
- AU Building Approvals, Oct
- US Factory Orders, Oct

**December 5**
- AU AiG Performance Construction, Nov
- US Nonfarm Payrolls, Nov

**December 8**
- AU ANZ Job Ads, Nov

**December 9**
- AU RBA Governor Stevens speaks
- AU Business Survey, Nov
- US Pending Home Sales, Oct

**December 10**
- AU WMI Consumer Sentiment, Dec
- AU Housing Finance, Oct
- US Wholesale Inventories, Oct

**December 11**
- AU Inflation Expectations, Dec
- AU Employment Change, Nov
- US Trade Balance, Oct

**December 12**
- US PPI Core, Nov
- US Retail Sales, Nov
- US Michigan Confidence, Dec
## Forecasts

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<td>AUD/EUR</td>
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<td>AUD/NZD</td>
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<td>AUD/SGD</td>
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<td>0.9200</td>
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Source: historical data from Bloomberg
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