Week Commencing August 27, 2007

HSBC

# AUSTRALIA & NEW ZEALAND WEEKLY

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# Back to the real economy

## Australian numbers point to weak quarter

No doubt there will be flare-ups as new losses are disclosed by financial institutions and as more poor American families default on their mortgages, but as the financial panic of recent weeks subsides attention will return to the economic numbers. For Australia it will be a crowded week, with several key releases. The most interesting will be Thursday's business investment survey for the second quarter. Boosted by the first time inclusion of Telstra, business investment rose 9.1% in the first quarter. Even without Telstra the gain would have been 4.7%, still a big move after two quarters of insignificant change in the investment level. Capital goods imports have remained flat for three quarters, however, which inclines us to think the business investment gain for the second quarter cannot have been much more than 2% - and mostly in construction rather than equipment. A 2% increase in the volume of business investment, if true for non residential investment as a whole, would contribute a meagre 0.3% to GDP growth in the June quarter. As usual the more important aspect of the release will be business plans for investment over the coming year. Over the last few surveys these plans have shown investment leveling off in the second half of this year and picking up next year, a pattern which would contribute to what we expect to be quite strong demand pressures through 2008.

The other important Australian release this week is the second quarter current account deficit. The trade deficit was $3.7bn during the quarter, so an income deficit of round $12.1bn would take the overall current account deficit to $15.9bn compared to $15.4bn last time. The weakness is in exports. Even by value exports were up only 3.2% in the four quarters to June, and this in the midst of the biggest commodity price boom since the Korean War. Imports are up 4.4% over the same period. For the June quarter exports were down 3.4%, and imports up 0.7%. Deflated for price increases in the quarter (which were tiny) export volumes were down 3.7% and imports up 0.7%. All up net exports may thus have reduced Q2 GDP growth by 0.8%. Given the small contribution likely from business investment, the detraction likely from net exports and the fact that retail volumes fell slightly in the period, the GDP result for the quarter is beginning to look very modest indeed. There are other numbers to come before the GDP release on Wednesday September 5 but our guess right now is that GDP might be up only 0.3% for the quarter and 3.4% for the financial year. This will be quietly welcomed by Prime Minister John Howard, who will rightly think it takes some off some of the pressure for another 25bp rate increase before an expected October or November election.

# The global financial turmoil

## Beginning to discriminate

As we wrote in a comment piece for the Australian Financial Review last week, every financial crisis is the same, and all of them are different. Their similarity is that market liquidity evaporates, their distinction is that it evaporates for a different reason. In all of them we move through a period of uncomprehending fear before beginning to make distinctions and identify the peculiar characteristics of the episode.

It's only in the last week or so for example that it has become more clearly apparent that the distinctiveness of the contemporary episode of global financial turmoil is not really the compression of credit spreads in recent years, or the misleading abundance of the liquidity provided by the current account surpluses of China, Japan and OPEC, or even the increased degree of leveraging.

All of these characteristics of the last few years were important in the suddenness and magnitude of the turbulence. The widening of credit spreads, the winding down of carry trade positions and so forth have caused some of the more dramatic changes in share prices, exchange rates and yields.

But if price changes were all, it would not have required the intervention of central banks.

The distinctively new characteristic is the reluctance of financial institutions to trade asset backed securities. Whether household mortgages or slices of corporate debt, these instruments have found their way into portfolios in all financial markets, and are an important source of bank funding. Spooked by the relatively small amount of asset backed securities that may be tainted by US subprime mortgage delinquencies, trading volumes plummeted.

There are certainly big changes in all financial market prices, reflecting a new appreciation of risk. There is a lot more volatility. But most financial markets are now operating more or less normally. This is true for foreign exchange and share markets and also for most debt markets.

In Australia for example the overnight market between banks is trading normally. Bank bill rates have increased, but trading continues. The market for single name commercial paper has seen an increase in rates, but is liquid. So far as we can tell banks are lending money for buying houses, for credit cards, for cars and for businesses in the usual way, though with increased rigour and vigilance. It is certainly true that last week banks and other financial institutions were experiencing difficulty borrowing for more than a month or so, but this is because of uncertainty about pricing rather than concerns about creditworthiness.

There is lots of volatility in most markets, but the one which last week was still not functioning in a normal way is for paper issued by banks to fund their conduits, or the roughly $60 billion in vehicles for investing in residential and corporate debt. That market is very quiet indeed. The assets involved, however, are mostly triple A rated Australian residential mortgages - some of the safest assets available. It is difficult to imagine that market remaining comatose for very long.

In the US the turmoil is very much greater, not least because of the size and diversity of the financial system, and because it is the epicentre of the subprime mortgage defaults. Even there, however the area of greatest concern is the asset backed securities market rather than corporate debt or interbank funding through the federal funds market. And while the problems are much bigger in the US, the response of the central bank has been adroit. The Fed has not only supplied generous liquidity to the market in federal funds, but also invited individual depositary institutions to approach it for funding for up to 30 days (and then renewable), using as collateral a wide variety of financial assets including subprime mortgages.

The market turmoil will likely continue for several more weeks, and even when volatility declines there will still be intermittent irruptions as hedge funds and financial institutions disclose losses and new subprime mortgage defaults are reported. But so far at least no major financial institution has failed, the widening of spreads has not been beyond the range of recent experience, the currency moves have been less than in past dislocations, and share prices have gone up as well as down.

There may well be more to come, and as two economists reminded an aptly-timed Reserve Bank conference on “Financial Structure and Resilience” last week, “if people believe there is going to be a panic then that can be self fulfilling”. But at least the issue of the market in asset backed securities is now identifiable, and separable from the functioning of the global financial system as a whole. If we are lucky markets continue to remake the very large distinctions between different forms of asset backed paper. In Australia the reluctance of the market to take up triple A rated Australian residential mortgages will recede. The US market will begin to discriminate between known risks in asset backed paper, and unknown risks. When that happens we will be on our way back from incipient panic to a more usual state of financial market mayhem. Markets will then likely discover the problem they are left with is the one they began with – around $100bn in losses from impaired US sub prime mortgages.

**John Edwards**

# Weekly Calendar

## Week commencing Monday August 27, 2007

| Country/ Region | Event or Economic Release | | Period | HSBC | Market F'casts Cons | Actual Previous |
|---|---|---|---|---|---|---|
| **Monday August 27, 2007** | | | | | | |
| UK | Public holiday, Summer Bank Holiday | | | | | |
| US | Existing home sales (15:00 BST) | Month | Jul | 5.70m | 5.70m | 5.75m |
| **Tuesday August 28, 2007** | | | | | | |
| AU | Conference Board Leading Index | | Jun | | | 0.2% |
| GER | CPI | Month | Aug, prelim | 0.0% | -0.1% | 0.4% |
| GER | IFO (09:00 BST) | Index | Aug | 104.9 | 105.2 | 106.4 |
| US | Consumer confidence (15:00 BST) | Month | Aug | 104.0 | 105.3 | 112.6 |
| US | FOMC minutes (19:00 BST) | | 7 Aug | | | |
| **Wednesday August 29, 2007** | | | | | | |
| AU | HIA New Home Sales | | Jul | | | -0.8% |
| AU | Construction Work Done | | Q2 | | | 2.7% |
| **Thursday August 30, 2007** | | | | | | |
| AU | Private Capital Expenditure | | Q2 | 2.0% | | 9.1% |
| AU | Current Account Balance | AUD | Q2 | -15.9bn | | -15.4bn |
| NZ | NBNZ Business Confidence | | Aug | | | -38.5% |
| NZ | Building Permits | | Jul | -3.0% | | -15.8% |
| JP | Retail sales (00:50 BST) | Large stores | Jul | -3.7% | | 0.9% |
| | | Retail trade | Jul | -1.0% | -0.9% | -0.4% |
| JP | Shoku Chukin Bank survey (06:00 BST) | Business sentiment | Aug | 48.2 | | 48.4 |
| UK | Nationwide house prices (07:00 BST) | Month | Aug | 0.5% | 0.4% | 0.1% |
| | | Year | | 9.7% | 9.6% | 9.9% |
| UK | Consumer credit and mortgages (09:30 BST) | Consumer credit (GBPbn) | Jul | 0.4 | 0.8 | 0.9 |
| | | New mortgages (000's) | | 105 | 112 | 114 |
| UK | CBI distributive trades (11:00 BST) | Reported sales (% net bal) | Aug | +10 | | +18 |
| US | GDP (13:30 BST) | Quarter annualised | Q2, prelim | 4.0% | 4.0% | 3.4% |
| | | GDP deflator | | 2.7% | 2.7% | 2.7% |
| US | Initial jobless (13:30 BST) | Week (000's) | Wk 25 Aug | 330 | 320 | 322 |
| US | OFHEO House price index (15:00 BST) | Quarter | Q2 | -0.25% | | 0.50% |

# Weekly Calendar (continued)

## Week commencing Monday August 27, 2007

| Country/ Region | Event or Economic Release | | | Period | HSBC | Market F'casts Cons | Actual Previous |
|---|---|---|---|---|---|---|---|
| **Friday August 31, 2007** | | | | | | | |
| AU | Retail Sales | | | Jul | 0.4% | | 1.4% |
| AU | Trade Balance | | AUD | Jul | -1.5bn | | -1.8bn |
| AU | Private Sector Credit | | | Jul | 1.2% | | |
| JP | All household spending (00:30 BST) | | Real (Year) | Jul | -0.1% | 0.6% | 0.1% |
| JP | CPI (00:30 BST) | ***All Japan*** | Total - month | Jul/Aug | -0.1% | | -0.1% |
| | | | Total - year | | 0.0% | -0.1% | -0.2% |
| JP | Industrial production (00:50 BST) | | Month | Jul, prelim | -1.6% | 0.0% | 1.3% |
| | | | Year | | 1.9% | 3.4% | 1.9% |
| JP | Construction orders (06:00 BST) | | Year | Jul | 35.0% | | 26.4% |
| EMU | HICP (10:00 BST) | | Year | Aug, flash | 1.8% | 1.8% | 1.8% |
| UK | Gfk consumer confidence (10:30 BST) | | Balance | Aug | -7 | -8 | -6 |
| US | Personal income and spending (13:30 BST) | | Personal income | Jul | 0.3% | 0.3% | 0.4% |
| | | | Personal spending | | 0.3% | 0.4% | 0.1% |
| | | ***Core PCE deflator*** | Month | | 0.23% | 0.2% | 0.1% |
| | | | Year | | 2.0% | 2.0% | 1.9% |
| US | Chicago PMI (14:45 BST) | | Month | Aug | 53.0 | 53.0 | 53.4 |
| US | Factory orders (15:00 BST) | | Month | Jul | 0.7% | 0.7% | 0.6% |
| US | University of Michigan confidence (15:00 BST) | | Month | Aug, final | 82.0 | 83.0 | 83.3 |

**Source:- Dow Jones, Reuters, Bloomberg**

**Notes:- p=preliminary, r=revised, n.f.=not forecast, n.s.a.=not seasonally adjusted, ann.=annualised, bn=billion, m=million**

# Monthly Economic Calendar

## Week commencing Monday September 03, 2007

| Monday September 03, 07 | Tuesday September 04, 07 | Wednesday September 05, 07 | Thursday September 06, 07 | Friday September 07, 07 |
|---|---|---|---|---|
| AU AiG Performance of Mfg Index (AUG)<br>AU TD Securities Inflation (AUG)<br>AU ANZ Job Advertisements (AUG)<br>AU Company Operating Profit (2Q)<br>AU Building Approvals (JUL)<br>AU AiG Performance of Mfg Index (AUG)<br>UK PMI Manufacturing (AUG)<br>JN Capital Spending (2Q)<br>EC PMI Manufacturing (AUG F) | AU Reserve Bank Rate-Setting Board Meeting<br>AU AiG Performance of Service Ind (AUG)<br>UK BRC August Retail Sales Monitor<br>EC Euro-Zone PPI (JUL)<br>EC Euro-Zone Retail Sales (JUL)<br>EC Euro-Zone GDP (2Q P) | AU RBA CASH TARGET (SEP)<br>AU Gross Domestic Product (2Q)<br>UK Nationwide Consumer Confidence (AUG)<br>UK Bank of England's Monetary Policy Committee Meets<br>US ISM Manufacturing (AUG)<br>US Construction Spending (JUL)<br>US Domestic Vehicle Sales (AUG)<br>US MBA Mortgage Applications (SEP 1 ) | AU Unemployment Rate (AUG)<br>UK BOE Announces Rates (SEP 7 )<br>US Pending Home Sales (JUL)<br>US Fed's Beige Book<br>US Initial Jobless Claims (SEP 2 )<br>US Nonfarm Productivity (2Q F)<br>US Unit Labor Costs (2Q F) | AU AiG Perf of Construction Index (AUG)<br>AU Home Loans (JUL)<br>AU Investment Lending (JUL)<br>US ISM Non-Manufacturing (AUG)<br>US Change in Manufact. Payrolls (AUG)<br>US Average Hourly Earnings (AUG) |
| **Monday September 10, 07** | **Tuesday September 11, 07** | **Wednesday September 12, 07** | **Thursday September 13, 07** | **Friday September 14, 07** |
| AU Home Loans (JUL)<br>JN Gross Domestic Product (2Q F) | AU NAB Business Confidence (AUG)<br>NZ ANZ-Business NZ PMI (AUG)<br>UK Total Trade Balance (JUL)<br>US Trade Balance (JUL)<br>JN Machine Orders (JUL) | AU Westpac Consumer Confidence (SEP)<br>US MBA Mortgage Applications (SEP 8 )<br>JN Domestic CGPI (AUG)<br>JN Current Account Total (JUL) | AU Consumer Inflation Expectation (SEP)<br>AU Dwelling Starts (2Q)<br>NZ RBNZ Official Cash Rate (SEP 13)<br>NZ Retail Sales (JUL)<br>UK RICS House Price Balance (AUG)<br>UK Retail Sales (AUG)<br>US Initial Jobless Claims (SEP 9 )<br>US Continuing Claims (SEP 2)<br>EC ECB Publishes Sep. Monthly Report | US Current Account Balance (2Q)<br>US Advance Retail Sales (AUG)<br>US Industrial Production (AUG)<br>US Capacity Utilization (AUG)<br>JN Industrial Production (JUL F)<br>EC Euro-Zone CPI (AUG) |
| **Monday September 17, 07** | **Tuesday September 18, 07** | **Wednesday September 19, 07** | **Thursday September 20, 07** | **Friday September 21, 07** |
| US Empire Manufacturing (SEP) | AU Preliminary BoP Imports (AUG)<br>UK CPI (AUG)<br>US Producer Price Index (AUG)<br>US PPI Ex Food & Energy (AUG)<br>US Fed's Open Market Committee Meets on Interest Rates, Economy<br>US Net Long-term TIC Flows (JUL)<br>JN BoJ Monetary Policy Meeting<br>EC ZEW Survey (Econ. Sentiment) (SEP) | AU Westpac Leading Index (JUL)<br>UK Bank of England Minutes<br>US NAHB Housing Market Index (SEP)<br>US FOMC Rate Decision Expected (SEP 19)<br>US MBA Mortgage Applications (SEP 15)<br>US Consumer Price Index (AUG)<br>US Housing Starts (AUG)<br>US Building Permits (AUG)<br>JN BOJ Target Rate (SEP 19)<br>JN BOJ Monthly Report | AU HIA New Home Sales (AUG)<br>AU Reserve Bank Monthly Bulletin<br>NZ Current Account Balance (2Q)<br>UK BSA Mortgage Approvals (AUG)<br>US Initial Jobless Claims (SEP 16) | NZ Visitor Arrivals (AUG)<br>US Philadelphia Fed. (SEP) |

# Monthly Economic Calendar (continued)

## Week commencing Monday September 03, 2007

| Monday September 24, 07 | Tuesday September 25, 07 | Wednesday September 26, 07 | Thursday September 27, 07 | Friday September 28, 07 |
|---|---|---|---|---|
| | NZ Westpac NZ Consumer Confidence (3Q)<br>UK Total Business Investment (2Q F)<br>US S&P/CaseShiller Home Price (JUL)<br>JN BoJ Monetary Policy Meeting Minutes for August | AU Conference Board Leading Index (JUL)<br>AU DEWR Skilled Vacancies (SEP)<br>NZ Trade Balance (AUG)<br>UK GDP (2Q F)<br>UK Current Account (2Q)<br>US Consumer Confidence (SEP)<br>US Richmond Fed Manufact. Index (SEP)<br>US Existing Home Sales (AUG)<br>US ABC Consumer Confidence (SEP 24)<br>US MBA Mortgage Applications (SEP 22)<br>US Durable Goods Orders (AUG) | NZ Building Permits (AUG)<br>NZ NBNZ Business Confidence (SEP)<br>UK BBA Loans for House Purchase (AUG)<br>US Initial Jobless Claims (SEP 23) | NZ GDP (2Q)<br>UK GfK Consumer Confidence Survey (SEP)<br>US New Home Sales (AUG)<br>US New Home Sales (AUG)<br>US Fed's Evans Gives Opening Remarks at Globalization Conference<br>US Personal Income (AUG)<br>US Personal Spending (AUG)<br>US PCE Deflator (AUG)<br>US Chicago Purchasing Manager (SEP)<br>JN Overall Hhold Spending (AUG)<br>JN Natl CPI (AUG)<br>JN Industrial Production (AUG P)<br>JN Retail Trade (AUG)<br>AU TD Securities Inflation (SEP)<br>JN Construction Orders (AUG) |

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