



Australian Markets Weekly

A weekly outlook for Australia, key global economies and markets

National
Australia
Bank

4 May 2015

AAA downgrade quite unlikely; negative outlook possible

- The likelihood of Australia's AAA credit rating being downgraded anytime soon is quite low. Australia's net debt position remains modest and the economy retains economic, monetary, and fiscal flexibility
- That said, the deterioration in the fiscal position in recent years has been fairly substantial – outside of the two World Wars and the depression, it's the second largest deterioration since Federation. This does at least raise the possibility that a ratings agency could send a lower level "negative watch" warning
- The directional risks for markets from such an event are fairly obvious – A\$ and shares lower and perhaps bond yields higher. But we'd be wary of overstating the size of the moves which are likely to be fairly modest.

Ahead of next week's Commonwealth Budget, there has been speculation on whether Australia's AAA sovereign credit rating is at risk. There are several aspects to consider here. First the likelihood and second the implications.

Likelihood of a downgrade? Quite unlikely but a negative watch more possible

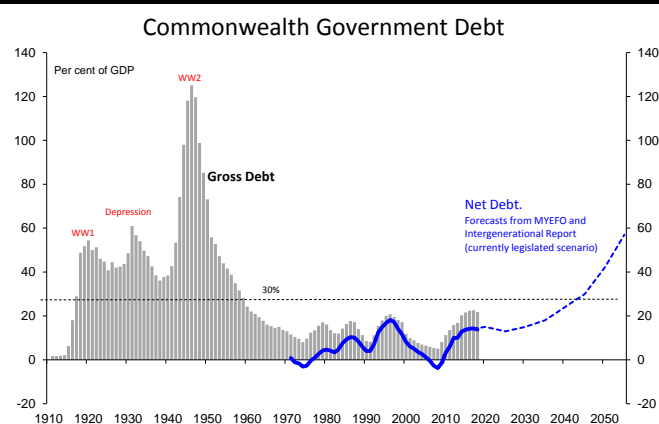
Next week's Budget is expected to confirm Commonwealth's fiscal position is under both cyclical and structural pressure. Weaker revenues on the back of the lower terms of trade and a cyclically-soft economy are the main near-term factors, but it is also well known that Australia (like other advanced countries) has a longer-term structural fiscal problem driven primarily by an ageing population. Over the next few decades, government revenue will need to increase and/or expenditures be curbed. There's no news here.

Last year's Commonwealth Budget made an attempt to start on the path of medium-term repair but of course much of that reform never passed through the parliament. In fact both sides of politics talk about finding this credible/quality path back to surplus - good news from a ratings perspective. The bad news from a ratings perspective is that they can't agree on what this path should be. The political stalemate in the US was a significant aspect of the US's credit rating downgrade.

The good news for Australia is the fiscal starting point remains quite good in an absolute sense and even better from a relative perspective – i.e. when compared to other rich countries.

Chart 1 gives a very long perspective on the Commonwealth's debt position, from Federation in 1901 to a forecast out to 2055 from the Government's latest Intergenerational Report (IGR) put out in March – the IGR projects the Governments fiscal position based on currently legislated policy.

Chart 1: Debt levels over the longer term



Source: Australian Budget, Intergenerational Report, A history of public debt in Australia, Katrina Di Marco, Mitchell Pine and Wilson Au-Yeung

These projections suggest that net debt will peak a bit over 14% of GDP in the next few years before 1) falling modestly out to 2025 and then 2) rising sharply to reach 57% of GDP by 2055. The latter forecast mainly reflects increased spending on health and pensions as a result of the ageing population.

By way of comparison, the net debt position of the US is currently 85%.

The other relevant metric is that the ratings agency Standard and Poor's said a year ago that "we could also lower the ratings if significantly weaker than expected budget performance leads to net general government debt rising above 30% of GDP." There is little risk of this in the foreseeable future without a further significant downturn in the Australian economy.

So given Australia retains economic and monetary flexibility, and that the Commonwealth's net debt is likely to remain well below 30% over the next decade or more, we reckon the Government still has fiscal room left before they would trigger a downgrade.

It seems they are going to use some of this wiggle room, with newspaper reports suggesting next week's Budget is likely to have larger 2014/15 and 2015/16 deficits, as well as a slower path back to surplus. Coming back from NY in recent weeks (where he chatted to the key ratings agencies) Treasurer Hockey implied that the ratings agencies wanted to see a "quality" trajectory back to surplus in order for Australia to retain the AAA rating. Encouragingly, the Prime Minister and

Key markets over the past week

	Last	% chg week		Last	bp / % chg week
AUD	0.7826	-0.4	RBA cash	2.25	0
AUD/CNY	4.87	0.1	3y sw ap	2.22	1
AUD/JPY	93.9	0.7	ASX 200	5,819	-2.7
AUD/EUR	0.699	-3.0	WTI oil	58.9	3.7
AUD/NZD	1.040	1.2	Gold	1,182.7	-1.7

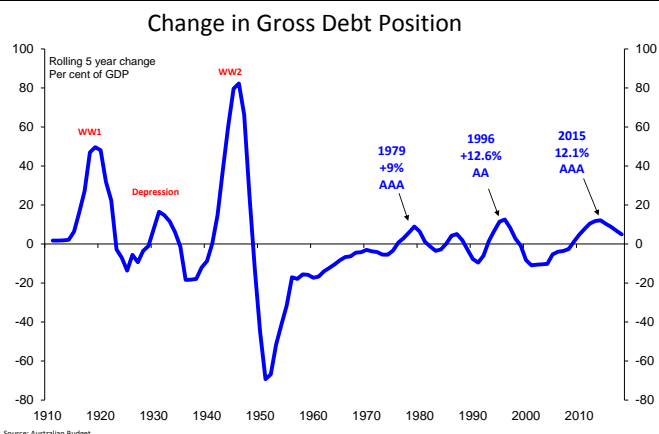
Source: Bloomberg

Treasurer have talked in recent days about finding a “credible” and “quality” path back to surplus.

The significant recent deterioration makes a Negative outlook possible

While we doubt there is any immediate threat to the AAA rating we are not sanguine either. While the overall fiscal position still looks healthy, the recent deterioration has been sharp. In fact, outside of the two world wars and the depression this has been almost equal to the previous sharpest fiscal deterioration in the early to mid-1990s – see chart below. Then Australia’s credit rating was AA according to S&P.

Changes in Federal Gross Debt



So a lower level “negative outlook” warning is at least possible. Negative outlook would be saying the fiscal path for now is on a downward trend but there is no obligation for the ratings agency to downgrade or even review the AAA rating.

Should the Government be able to pass legislation to put the Budget on a medium term path towards surplus (and ironically a negative watch may help get some political traction) then an actual downgrade could still easily be averted.

All the ratings agencies typically come out with an updated assessment of the Budget immediately after the Budget, so we’ll know a lot more about their current thinking on May 13.

Implications of Australia losing its AAA rating

A negative watch would surely cause some short-term volatility - downward movements in the \$A, shares, and perhaps an up-tick in bond yields. But as this is not a downgrade we expect the impact would be modest and unlikely to persist.

An actual downgrade would have wider ramifications. There would be implications for the level of Australian Government bond yields as well as other \$A bond and swap yields. There would likely also be implications for other highly rated entities in Australia, like the AAA Semi Governments and the Banks.

But again we’d be careful about overstating the impact.

For example, many factors drive bond yields. The key ones are the outlook for inflation, growth and the RBA’s cash rate. The credit rating, and risk of default, is another factor - in reality the difference in credit risk between AAA and AA+ is very tiny. When the United States lost its AAA rating bond yields actually fell on the day, as the poor state of economy and an expectation the Fed would need to cut the funds rate further

over-powered the credit rating downgrade. The other aspect is that by the time the US was downgraded most had got used to the idea – so it was already “in the price.”

If you can do an “all other things equal” analysis, and try and isolate the credit rating impact, some economic literature reckons a one-notch downgrade is worth about 12 basis points on bond yields.

The potential flow-on to the ratings of the banks and State Governments if the Commonwealth was to lose the AAA could be more important. The major banks enjoy a two-notch rating uplift due to the ‘High Likelihood’ of Sovereign Support. And semi-government credit ratings are capped by the sovereign rating. So we should acknowledge there is a downstream risk but for now there seems little point in speculating about an event that we still think is quite unlikely.

Summary

While Australia’s fiscal position has deteriorated in recent years we reckon the ratings agencies will continue to judge it worthy of a AAA rating, particularly if next week’s Commonwealth Budget shows a credible/quality path back to surplus. That said, the scale of the fiscal deterioration in recent years has been substantial and does at least raise the possibility that a ratings agency could send a lower level “negative watch” warning. The directional risks for markets from such an event are fairly obvious – A\$ and shares lower and perhaps bond yields higher. But we’d be wary of over-stating the size of the moves which are likely to be fairly modest.

This week

There will be intense focus this week on tomorrow’s RBA Board meeting outcome on Tuesday and whether the RBA will cut the cash rate to 2.00%. If Peter Martin’s article from last week’s Fairfax press is right, then the RBA Board will consider a recommendation to cut. But the question is whether the Board (including very senior members of the RBA staff will accede). While recognising the risk of a move, NAB would argue that the Bank should again hold fire, given emerging more favourable economic trends (including today’s job ads and building approvals).

Whether they cut or not, the 2.30pm Media Release will require some refinement. For the global economy, there are opposing forces: the RBA is set to recognise the softness in the US economy in recent months (though may be inclined to discount it as possibly temporary), while for China also acknowledging there has likely been some further softness but with some policy steps taken to support growth. Europe’s economic growth looks to have stabilised, notwithstanding the continued uncertainties over Greece.

We will, of course, be interested to see what qualitative references the Bank makes to any forecast revisions for the Australian economy, including for growth and inflation, the detail of which will be included in Friday’s Statement on Monetary Policy. We do not expect any material change to its inflation outlook and we would expect some modest upgrade in the description of the Australian economy’s performance in recent months, even if the outlook remains somewhat fragile.

Finally, we'll be looking to see the description of the Bank's forward guidance. If the Bank cuts, it's likely they will not shift back fully to their previous outlook for "a period of stability in interest rates". But neither will they wish to dissuade the market that yet more easing might yet be required, in time. This will require something of a balancing act to leave markets with the impression that they would be prepared to ease, but only if required.

Before the RBA Board meeting is the release of the weekly ANZ-Roy Morgan Consumer Confidence and then the March International Goods and Services Trade report. The trade deficit is expected to shrink to \$A-1.0bn from \$A-1.256bn, benefiting from a 4% fall in already published merchandise imports, a counter to the fall in commodity price receipts.

Wednesday sees the HIA Home Sales report for March first up, followed by the March retail sales report, the Statistician also publishing Q1 retail volumes that forms 31.7% of household consumption and 17.5% of GDP. We expect a second quarter of 1.5% growth in retail volumes, a sign that consumer spending over the past six months is showing signs of making a more material contribution to Australia's growth transition to the non-resource economy. Ahead of the ABS Retail Trade

data, NAB's Online Retail Sales index for March is being released on Tuesday, while the NAB Business Survey, configured on a sample of ASX 300 companies is set for release on Thursday.

As for the most sensitive market data, the crescendo is Thursday's labour force report. After positive employment surprises, we are alert to the statistical probability/likelihood of some payback in this report. NAB's forecast is for a flat outcome, the market expecting meagre growth of 3.0K and also an unemployment rate of 6.2%, up from 6.1%. The real surprise would be a higher than expected outcome or even a steady 6.1% unemployment rate (or lower). Also on the calendar are the AiG PSI Services (Tuesday) and PCI Construction (Thursday) indexes for April.

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Calendar of Economic Releases

Country	Economic Indicator	Time Period	NAB			Previous	GMT	AEST
			Forecast	Consensus	Actual			
Monday, 4 May 2015								
JN	National Holiday - Golden Week Holiday Period							
AU	TD Securities Inflation MoM/YoY	Apr				0.4%/1.5%	0.30	10.30
NZ	ANZ Commodity Price	Apr	-3.5%			4.6%	1.00	11.00
AU	ANZ Job Advertisements MoM	Apr				-1.4%	1.30	11.30
AU	Building Approvals MoM	Mar	2.0%	-2.0%		-3.2%	1.30	11.30
CH	HSBC China Manufacturing PMI	Apr F		49.4		49.2	1.45	11.45
GE	Markit/BME Germany Manufacturing PMI	Apr F		51.9			7.55	17.55
US	Factory Orders	Mar		2.1%		0.20%	14.00	0.00
US	Fed's Evans Speaks on Economy and Monetary Policy in Indiana (V)						16.25	2.25
Tuesday, 5 May 2015								
JN	National Holiday - Golden Week Holiday Period							
AU	ANZ Roy Morgan Weekly Consumer Confidence Index	May-03					23.30	9.30
AU	AiG Perf of Services Index	Apr				50.2	23.30	9.30
NZ	QV House Prices YoY	Apr				7.7%	0.00	10.00
AU	Trade Balance	Mar	-1000M	-1000M		-1256M	1.30	11.30
AU	NAB Online Retail Sales Index	Mar					1.30	11.30
AU	RBA Cash Rate Target	May-05	2.25%	2.00%		2.25%	4.30	14.30
CA	Bank of Canada's Wilkins speaks in Montreal						16.30	2.30
UK	Markit/CIPS UK Construction PMI	Apr				57.8	8.30	18.30
EC	European Commission Economic Forecasts						9.00	19.00
CA	Int'l Merchandise Trade	Mar				-0.98B	12.30	22.30
US	Trade Balance	Mar		-\$39.8B		-\$35.4B	12.30	22.30
US	Markit US Services PMI	Apr F		57.8		57.8	13.45	23.45
UK	Halifax House Prices MoM / 3mths/year	Apr		0.3%/7.8%		0.4%/8.1%	14.00	0.00
US	ISM Non-Manf. Composite	Apr		56.2		56.5	14.00	0.00
US	Fed's Williams Speaks at Pacific Community Ventures on Jobs						19.10	5.10
Wednesday, 6 May 2015								
JN	National Holiday - Golden Week Holiday Period							
NZ	Dairy Auction	May				-3.6%		
NZ	Average Hourly Earnings QoQ	1Q		0.9%		0.4%	22.45	8.45
NZ	Unemployment Rate	1Q	5.4%	5.5%		5.7%	22.45	8.45
NZ	Employment Change QoQ/YoY	1Q	0.9%	0.7%/1.2%		1.2%/3.5%	22.45	8.45
NZ	Participation Rate	1Q	69.4%	69.4%		69.7%	22.45	8.45
NZ	Pvt Wages Exc Overtime QoQ	1Q	0.3%	0.4%		0.5%	22.45	8.45
US	Fed's Kocherlakota Holds Open Forum in Marshall, Minnesota (NV)						0.00	10.00
AU	HIA New Home Sales MoM	Mar				1.1%	1.00	11.00
AU	Retail Sales MoM	Mar	0.5%	0.4%		0.7%	1.30	11.30
AU	Retail Sales Ex Inflation QoQ	1Q	1.5%	0.9%		1.5%	1.30	11.30
CH	HSBC China Composite/Services PMI	Apr				51.8/52.3	1.45	11.45
EC	Markit Eurozone Services PMI	Apr F		53.7			8.00	18.00
UK	Markit/CIPS UK Services PMI	Apr		58.6		58.9	8.30	18.30
EC	Retail Sales MoM	Mar		-0.2%		-0.2%	9.00	19.00
US	ADP Employment Change	Apr		185K		189K	12.15	22.15
US	Nonfarm Productivity	1Q P		-1.8%		-2.2%	12.30	22.30
US	Unit Labour Costs	1Q P		4.0%		4.1%	12.30	22.30
US	Fed's Yellen Speaks on Panel in Washington						13.15	23.15
CA	Key Purchasing Managers Index SA	Apr				47.9	14.00	0.00
US	Fed's George Speaks on Credit Markets Panel in Washington						17.15	3.15
US	Fed's Lockhart Speaks on Monetary Policy in Louisiana						17.30	3.30
Thursday, 7 May 2015								
UK	General Election							
AU	AiG Perf of Construction Index	Apr				50.1	23.30	9.30
AU	Employment Change	Apr	12K	5.0K		37.7K	1.30	11.30
AU	Unemployment Rate	Apr	6.2%	6.2%		6.1%	1.30	11.30
AU	Participation Rate	Apr	64.8%	64.8%		64.8%	1.30	11.30
AU	NAB Quarterly ASX 300 Survey	1Q					1.30	11.30
JN	Markit Japan Services PMI	Apr				48.4	1.35	11.35
CA	Building Permits MoM	Mar				-0.9%	12.30	22.30
US	Initial Jobless Claims	Mar					12.30	22.30
US	Consumer Credit	Mar				\$15.516B	19.00	5.00
Friday, 8 May 2015								
JN	Bank of Japan April 7-8 meeting minutes						23.50	9.50
AU	RBA Statement on Monetary Policy						1.30	11.30
GE	Industrial Production SA MoM	Mar		0.4%		0.2%	6.00	16.00
GE	Trade Balance	Mar		+20.0B		19.2B	6.00	16.00
UK	Trade Balance	Mar		-£2300		-£2859	8.30	18.30
CA	Housing Starts	Apr				189.7K	12.15	22.15
US	Change in Nonfarm Payrolls	Apr		230K		126K	12.30	22.30
CA	Unemployment Rate	Apr				6.8%	12.30	22.30
CA	Net Change in Employment	Apr				28.7K	12.30	22.30
US	Unemployment Rate	Apr		5.4%		5.5%	12.30	22.30
US	Average Hourly Earnings MoM/YoY	Apr		0.2%/2.3%		0.3%/2.1%	12.30	22.30
CH	Trade Balance	Apr		\$34.25B		\$3.08B	14.00	0.00
CH	Imports/Exports YoY	Apr		-9.8%/2.9%		-12.7%/-15.0%	14.00	0.00
Upcoming Central Bank Interest Rate Announcements								
Australia, RBA		5-May	2.25%	2.00%		2.25%		
UK BOE		11-May	0.50%	0.50%		0.50%		
Japan, BoJ		22-May	0.0%-0.1%	0.0%-0.1%		0.0%-0.1%		
Canada, BoC		27-May				0.75%		
Europe ECB		3-Jun	0.05%	0.05%		0.05%		
New Zealand, RBNZ		11-Jun	3.50%			3.50%		
US Federal Reserve		18-Jun				0%-0.25%		

GMT: Greenwich Mean Time; AEST: Australian Eastern Standard Time

Forecasts

Economic Forecasts

	Annual % change				Quarterly % change											
	2013	2014	2015	2016	2013				2014				2015			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Australia Forecasts																
Household Consumption	1.7	2.5	2.7	2.9	0.3	0.3	0.8	0.5	0.6	0.6	0.6	0.9	0.5	0.6	0.7	0.7
Underlying Business Inves	-4.5	-6.1	-8.5	-9.9	-5.7	-1.2	1.2	-3.1	-2.5	-1.1	-1.2	-1.2	-2.2	-3.6	-2.9	-2.5
Residential Construction	0.3	7.9	8.4	9.2	-2.0	2.7	-0.2	0.9	5.7	1.1	-1.2	2.5	2.6	2.6	2.6	3.0
Underlying Public Spendin	0.3	0.8	0.2	1.1	2.8	-0.1	-0.6	1.3	0.3	0.6	-1.4	0.4	0.2	0.2	0.2	0.2
Exports	6.2	6.8	6.5	7.7	0.9	3.7	-0.4	1.4	4.1	-1.6	3.6	1.0	1.9	1.4	1.6	1.8
Imports	-1.8	-1.7	-3.1	-1.1	-2.5	2.1	-1.3	-1.0	-1.3	2.0	-0.7	-2.5	-0.5	-0.7	-0.4	-0.1
Net Exports (a)	1.6	1.7	2.0	1.9	0.7	0.3	0.2	0.5	1.1	-0.7	0.9	0.7	0.5	0.4	0.4	0.4
Inventories (a)	-0.3	0.0	-0.1	0.1	-0.2	0.4	-0.3	-0.2	-0.4	0.9	0.1	-0.8	0.1	0.1	0.1	0.0
Domestic Demand - qtr%					-0.2	0.2	0.5	0.2	0.4	0.5	-0.4	0.6	0.2	0.1	0.2	0.4
Dom Demand - ann %	0.4	1.2	0.9	1.2	0.5	0.0	0.6	0.7	1.3	1.5	0.7	1.2	1.0	0.6	1.2	0.9
Real GDP - qtr %					0.3	0.7	0.4	0.7	1.1	0.5	0.4	0.5	0.6	0.7	0.7	0.8
Real GDP - ann %	2.1	2.7	2.4	3.2	2.0	2.1	1.9	2.2	3.0	2.7	2.7	2.5	2.0	2.2	2.6	2.8
CPI headline - qtr %					0.4	0.4	1.2	0.8	0.6	0.5	0.5	0.2	0.2	0.5	0.8	0.9
CPI headline - ann %	2.4	2.5	1.8	3.1	2.5	2.4	2.2	2.7	2.9	3.0	2.3	1.7	1.3	1.4	1.8	2.5
CPI underlying - qtr %					0.5	0.6	0.6	0.9	0.6	0.7	0.4	0.6	0.6	0.5	0.6	0.7
CPI underlying - ann %	2.4	2.6	2.4	2.7	2.3	2.4	2.3	2.6	2.7	2.8	2.5	2.3	2.4	2.2	2.4	2.5
Wages (Pvte WPI -ann %)	2.9	2.5	2.4	2.4	3.1	3.0	2.7	2.5	2.6	2.4	2.5	2.5	2.4	2.4	2.4	2.4
Unemployment Rate (%)	5.7	6.0	6.3	6.3	5.6	5.7	5.7	5.9	5.8	5.9	6.1	6.2	6.2	6.2	6.4	6.4
Terms of trade	-3.9	-7.5	-8.4	-1.2	0.7	0.4	-1.9	0.4	-2.1	-3.9	-3.5	-1.8	-3.2	-0.8	-1.0	-1.1
G&S trade balance, \$Abn	-10.2	-9.1	-7.8	19.1	-3.7	-2.3	-3.3	-0.9	1.7	-4.5	-3.9	-2.4	-3.3	-2.2	-1.5	-0.8
% of GDP	-0.7	-0.6	-0.5	1.1	-1.0	-0.6	-0.8	-0.2	0.4	-1.1	-1.0	-0.6	-0.8	-0.5	-0.4	-0.2
Current Account (% GDP)	-3.3	-2.8	-2.9	-1.3	-3.5	-3.3	-3.5	-3.0	-2.2	-3.4	-3.0	-2.4	-3.3	-3.0	-2.8	-2.6

Source: NAB Group Economics; (a) Contributions to GDP growth

Exchange Rate Forecasts

	4-May	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Majors						
AUD/USD	0.7833	0.78	0.76	0.74	0.73	0.73
NZD/USD	0.7527	0.72	0.71	0.70	0.69	0.68
USD/JPY	120.07	123	124	125	126	126
EUR/USD	1.1189	1.03	1.02	1.00	1.00	1.01
GBP/USD	1.5160	1.41	1.38	1.33	1.33	1.35
USD/CNY	6.2187	6.28	6.25	6.20	6.20	6.18
USD/CAD	1.2172	1.25	1.24	1.22	1.21	1.20

Australian Cross Rates

	4-May	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
AUD/JPY	94.1	96	94	93	92	92
AUD/EUR	0.7001	0.76	0.75	0.74	0.73	0.72
AUD/GBP	0.5167	0.55	0.55	0.56	0.55	0.54
AUD/NZD	1.0407	1.08	1.07	1.06	1.06	1.07
AUD/CNY	4.8711	4.90	4.75	4.59	4.53	4.51
AUD/CAD	0.9534	0.98	0.94	0.90	0.88	0.88
AUD/CHF	0.7311	0.79	0.78	0.78	0.77	0.77

Interest Rate Forecasts

	4-May	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Aust rates						
RBA Cash rate	2.25	2.25	2.00	2.00	2.00	2.00
3 month bill rate	2.17	2.28	2.15	2.15	2.15	2.20
3 Year Swap Rate	2.21	2.2	2.4	2.4	2.6	2.7
10 Year Swap Rate	3.01	3.0	3.2	3.1	3.4	3.4
Offshore Policy Rates						
US Fed funds	0.25	0.25	0.50	0.75	0.75	1.25
ECB refi rate	0.05	0.05	0.05	0.05	0.05	0.05
BoE repo rate	0.50	0.50	0.50	0.50	0.75	1.00
BoJ overnight call rate	0.06	0.10	0.10	0.10	0.10	0.10
RBNZ OCR	3.50	3.50	3.50	3.50	3.50	3.75
China 1yr lending rate	5.35	5.20	5.20	5.20	5.20	5.20
China Reserve Ratio	18.5	19.5	19.5	19.5	19.5	19.5
10 Year Benchmark Bond Yields						
Australia	2.68	2.6	2.8	2.8	3.0	3.0
United States	2.11	2.25	2.50	2.50	2.8	2.8
Europe/Germany	0.37	0.3	0.4	0.6	0.7	0.8
UK	1.84	1.8	2.0	2.1	2.2	2.4
New Zealand	3.48	3.5	3.8	3.8	4.0	4.0

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP

Dec year	2013	2014	2015	2016	20 Yr Avg
Australia	2.1	2.7	2.4	3.2	3.4
US	2.2	2.4	2.7	2.7	2.6
Eurozone	-0.4	0.9	1.4	1.8	1.5
UK	1.7	2.8	2.6	2.3	2.4
Japan	1.6	-0.1	0.8	1.3	0.8
China	7.7	7.4	7.1	6.9	9.2
India	6.3	7.2	7.7	7.9	6.6
New Zealand	2.3	3.3	2.9	1.8	3.0
World	3.3	3.3	3.4	3.5	3.5

Commodity prices (\$US)

	4-May	Jun-15	Dec-15	Jun-16	Dec-16
WTI oil	58.91	52	60	65	70
Gold	1183	1180	1070	1060	1060
Iron ore	56	58	61	58	54
Hard cok. coal	112	110	95	93	97
Thermal coal	62	68	68	62	62
Copper	6408	5900	6260	6200	6170
Japan LNG	13.9	12.0	11.0	11.0	11.0

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