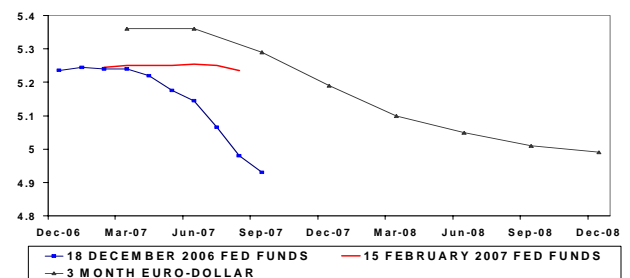


US & East Asian Interest Rates

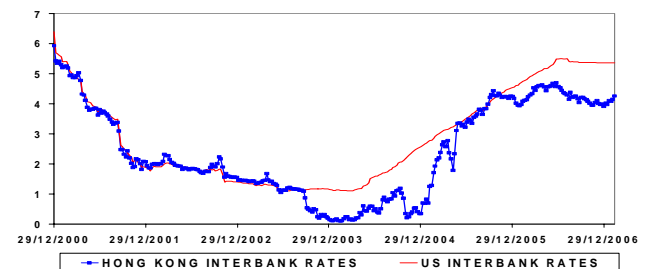
Key trends

- Although the Fed is still warning that its main concern relates to higher than anticipated inflation and that it is prepared to lift interest rates if that seems a real risk, it has kept interest rates unchanged at 5¼% since July last year. **We do not expect the Fed to lift rates any further but nor do we expect it to start cutting them in the near future.**
- Interbank rates have finally risen in Hong Kong with 3-month HIBOR rising from the 4% or so it had averaged between October 2006 and January 2007 to near 4¼%. As US\$ interbank rates have remained around 5.36%, that has reduced the differential between US\$ and HK\$ 3-month interbank rates from the exceptionally high 140 bps seen through late-2006 and early-2007 to a still high 110 bps.
- The S\$ has been at the stronger end of its policy band since April 2006. In nominal terms, it is currently trading at around S\$1.54:US\$1, some 6% stronger than at the start of the year, and market analysts are suggesting that the prospect of an intervention by the MAS is preventing a break out of the S\$ from its current range.
- Although the Bank of Japan (BOJ) has made it clear that it intends to "normalise" its still very low interest rates, it has also emphasised that it plans to do so gradually. We think that the BOJ will increase short-term rates from their current 0.25% to 1% by the end of the year and 1¼% by the end of 2008.

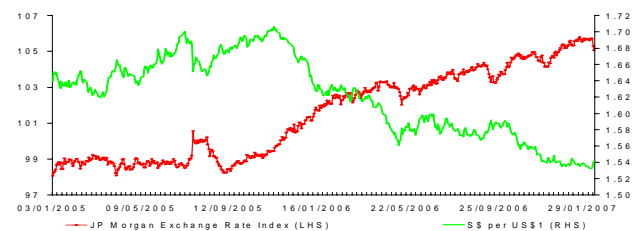
US Short-Term Rate Pricing



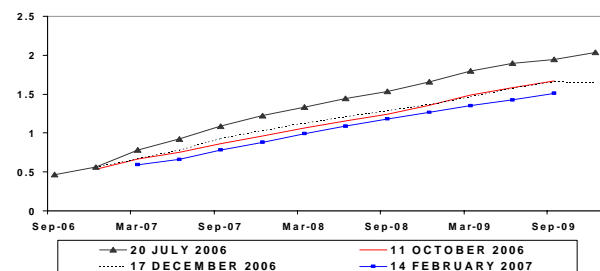
US\$ & HK\$ 3-month Interbank Rates



S\$ Exchange Rates



Futures Pricing 3-month Euro-Yen

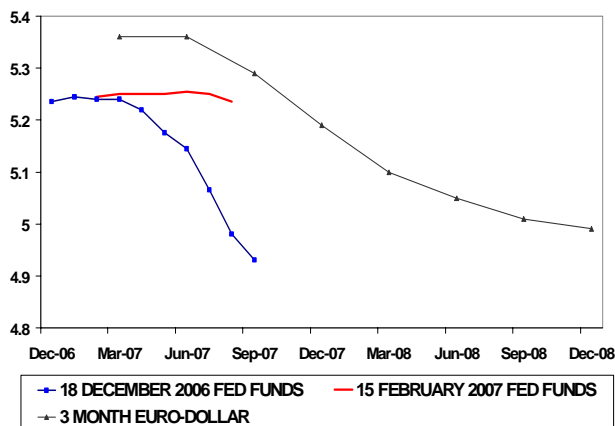


United States

Although the Fed is still warning that its main concern relates to higher than anticipated inflation and that it is prepared to lift interest rates if that seems a real risk, it has kept interest rates unchanged at 5¼% since July last year. We do not expect the Fed to lift rates any further but nor do we expect it to start cutting them in the near future.

Market pricing has shifted in recent months away from an expectation of Fed rate cuts through the first half of the year to a view that the Fed funds rate will stay little changed out to September and the trading in 3-month LIBOR has also put back the timing of rate cuts. We have done the same - postponing the anticipated timing of the first rate cut from June to October with two more 25 bps cuts expected in late-2007 and early-2008.

Chart 1: US Short-Term Rate Pricing

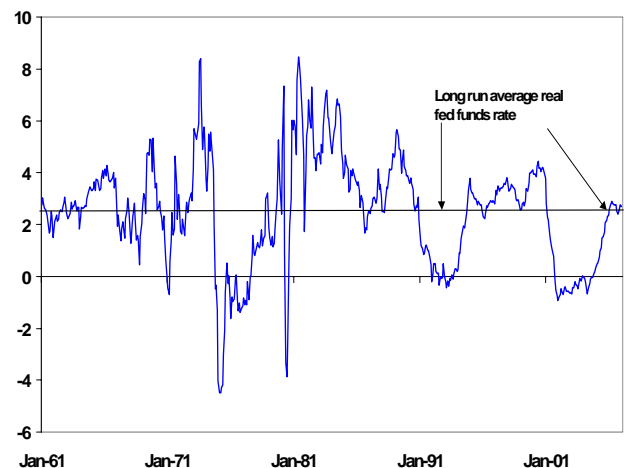


The latest economic forecasts are consistent with the Fed not needing to act soon on rates and rate cuts occurring some way out in time. The Fed's own forecasts put core inflation at just over 2% yoy in late-2007, slowing to just under 2% by late-2008 - just within the 2% ceiling that some Fed officials have said they are comfortable with. Economic growth is expected to remain moderate - the Fed forecasts between 2½% and 3% through both 2007 and 2008 - so there

is no urgent need to cut rates to curb a sharply deteriorating economy. Market economists have much the same view with core inflation predicted at around 2% through the next few years and growth staying around 2¾% to 3% annually.

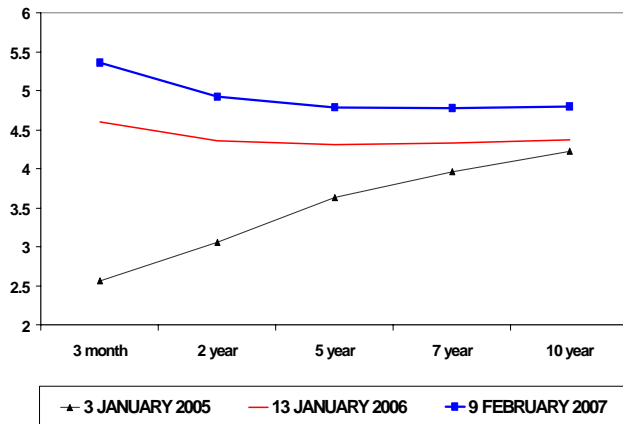
Although the Fed has lifted its short-term interest rate by over 400 bps from its low point, real short-term interest rates in the US are still only just over their long-term average - so policy is only slightly restrictive. This helps explain why we are only seeing a slowing in economic growth to what is still a moderate level rather than a harder economic landing. It also explains why core inflation is predicted to only subside slowly - as the modestly restrictive monetary policy is only putting moderate downward pressure on both growth and inflation.

Chart 2: Real Short-Term US Rates



Although 10-year bond rates have risen considerably since late-2006, the yield curve remains downward sloping. The Fed's survey of market economists sees the 10-year bond rate rising from its current 4.7% to 5% by the end of the year and staying there through the first half of 2008 - meaning that the yield curve will by then be slightly upward sloping.

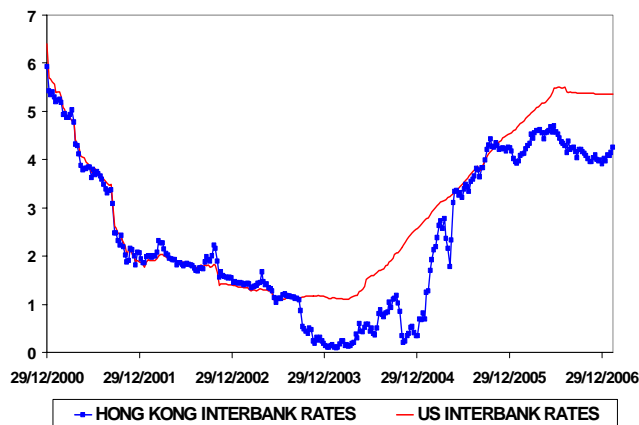
Chart 3: US Yield Curve



Hong Kong

Interbank rates have finally risen in Hong Kong with 3-month HIBOR rising from the 4% or so it had averaged between October 2006 and January 2007 to near 4¼%. As US\$ interbank rates have remained around 5.36%, that has reduced the differential between US\$ and HK\$ 3-month interbank rates from the exceptionally high 140 bps seen through late-2006 and early-2007 to a still high 110 bps.

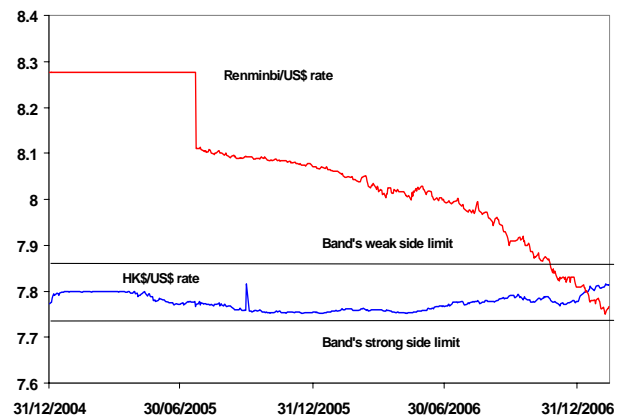
Chart 4: US\$ & HK\$ 3-month Interbank Rates



The HK\$ has been weak within its trading band at the same time as interbank rates have risen. Speculators are seen as having unwound their positions in the HK\$ as the yuan has

continued rising and the HKMA has recently said that the HK\$ is no longer being used as a proxy for trading the yuan with the Chinese currency strengthening through the HK\$ peg level.

Chart 5: Exchange Rates versus US\$



The HKMA has reaffirmed that it has no intention of altering the linked exchange rate regime. Joseph Yam told the Legislative Council that the link to the US\$ was still “the cornerstone of Hong Kong’s monetary and financial stability”, the US\$ remained the most appropriate anchor for the HK\$ and using the renminbi in its place was “neither appropriate nor technically feasible”.

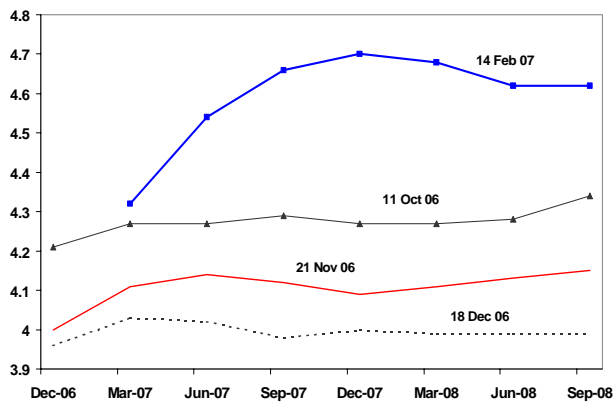
The weakness in the HK\$ reflects the still large interest rate differential with local banks investing in higher yielding US\$ assets and paying depositors in lower yielding HK\$ savings accounts. Although its public position is that the HK\$ is still trading comfortably within its trading band and that it has not intervened to prop up the HK\$, the HKMA has been asking local banks about what is going on in the currency market.

The HKMA has also told the Legislative Council that the recent relationship between local interest rates and the currency has been unusual and pointing out that it has the “justification, room, ability and the tool” to “smooth” out

the linkage between interest rates and the currency but it sees no need to do so for now.

The 25 bps jump in 3-month HIBOR rates has certainly altered sentiment in the futures market. At the end of last year, the HIBOR futures was pricing-in the continuation of 3-month rates at around the then current rate of 4% out to late-2008. Now the market is pricing in rates of 4½% by mid-year and 4¾% by year-end. The Consensus of economists, however, sees rates dropping back to 4.1% by mid-year and staying there.

Chart 6: Futures Pricing 3-month HIBOR



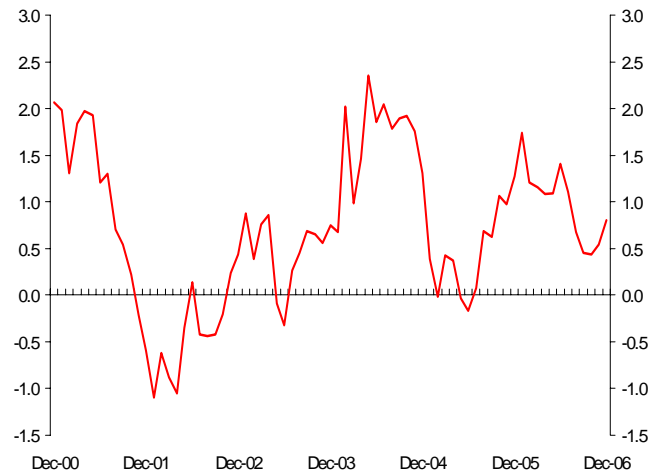
Singapore

The Monetary Authority of Singapore (MAS) operates monetary policy by managing the local currency within an undisclosed trading band in order to hold down inflation. To this end, MAS reaffirmed the policy in mid-October of a modest and gradual appreciation of the S\$ nominal effective exchange rate (NEER) policy band, with the aim of containing CPI inflation to 1-2%.

Inflationary pressures remain well contained under the present policy stance. Headline CPI averaged 1% in 2006, up from 0.5% in 2005 as a result of stronger pass through effects from higher oil prices. The MAS sees tighter labour market conditions and the lagged effects of commodity

price increases continuing to underpin domestic price pressures in 2007.

Chart 7: Consumer Prices (% yoy)

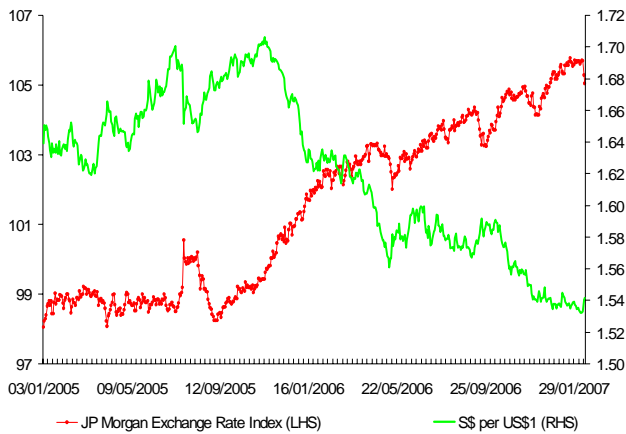


However, falling oil prices should take some pressure off the headline rate this year, which is forecast to be in the 0.5-1.5% range (Consensus is 1.2%), while the underlying measure is expected to be 1-2%. With economic growth also running ahead of expectations in the December quarter (6.6% yoy), MAS is likely to keep allowing a gradual appreciation of the S\$ when it next reviews policy in April.

The S\$ has been at the stronger end of its policy band since April 2006. In nominal terms, it is currently trading at around S\$1.54:US\$1, some 6% stronger than at the start of the year, and market analysts are suggesting that the prospect of an intervention by the MAS is preventing a break out of the S\$ from its current range.

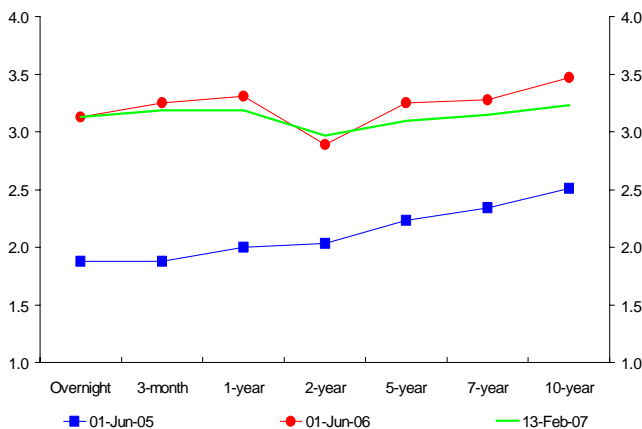
The appeal of the S\$ is being underscored by a relatively strong domestic economy and strong equity-related capital inflows. The S\$ is expected to continue appreciating this year and next. The Consensus sees it at S\$1.523:US\$1 at the end of May 2007, strengthening to S\$1.488:US\$1 by February 2008 and S\$1.472:US\$1 in February 2009.

Chart 8: S\$ Exchange Rates



The 3-month S\$ interbank rate has been unchanged at 3.1875% since mid-December, but is down from 3.3125% in mid-November. The February Consensus sees rising slightly to 3.3% by May 2007 and falling slightly to 3.2% in February 2008. At the longer-end of the curve, 10-year bonds have risen from a low of 3% in early-January to around 3¼% now. Essentially, we are seeing a very flat yield curve.

Chart 9: Singapore Yield Curve



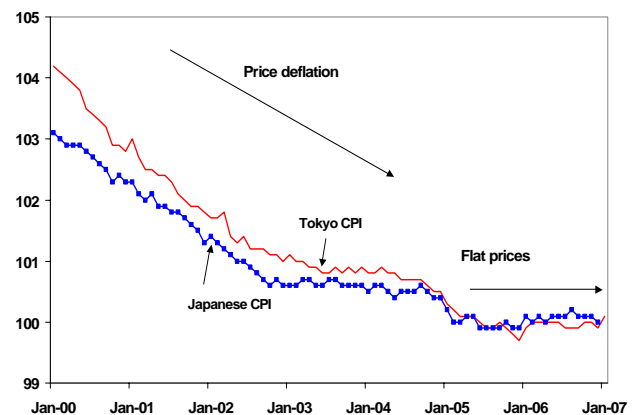
Japan

Although the Bank of Japan (BOJ) has made it clear that it intends to “normalise” its still very low interest rates, it has also emphasised that it plans to do so gradually. The central bank sets interest rates in a “forward looking” manner -

which means that it focuses on where inflation should be in the future and what the balance of future price risks might be - rather than by just looking at what inflation is doing now.

This forward looking strategy explains why the BOJ is able to even consider lifting interest rates at the minute. The bank’s objective is to maintain “price stability” which it defines as CPI inflation between 0 and 2% and most members of the bank’s interest rate setting committee think that it is around 1%. However, core inflation across the country was only 0.1% yoy in December, while the Tokyo figure for January was about 0.2% yoy. Current inflation is, therefore, well below target level and shows no need for urgent rate increases.

Chart 10: Consumer Price Levels



The BOJ is, however, convinced that price pressures are going to accelerate over the next year and that there are upward risks to both consumer and asset prices. In its October statement, the Bank of Japan predicted that core CPI inflation would accelerate from 0.3% in fiscal 2006 to 0.5% in fiscal 2007 and it has also highlighted the risk that persistent low interest rates could trigger excessive investment in equipment and real estate. It is that medium-term view that is driving the BOJ’s determination to lift rates back to more “normal” levels.

We think that the BOJ will increase short-term rates from their current 0.25% to 1% by the end of the year and 1¾% by the end of 2008. The process of tightening will be gradual and cautious, not least for fear of stalling growth and opening the bank to political criticism. The markets are pricing in rate rises as well. We think the next 25 bps rate hike will come in the March quarter.

across the curve. The outlook for the curve is for more upward movement, but for it to become slightly less steep with another 75 bps of tightening expected at the short end alongside around 30 bps increase at the long end (with both NAB and the Consensus expecting 10-year bonds to rise from 1.7% now to 2.0% by early-2008).

Chart 11: Futures Pricing 3-month Euro-Yen

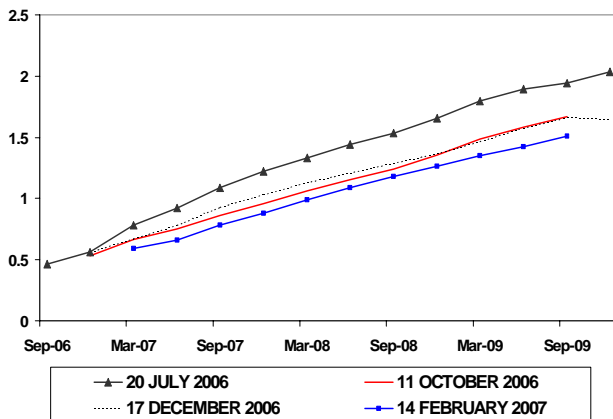
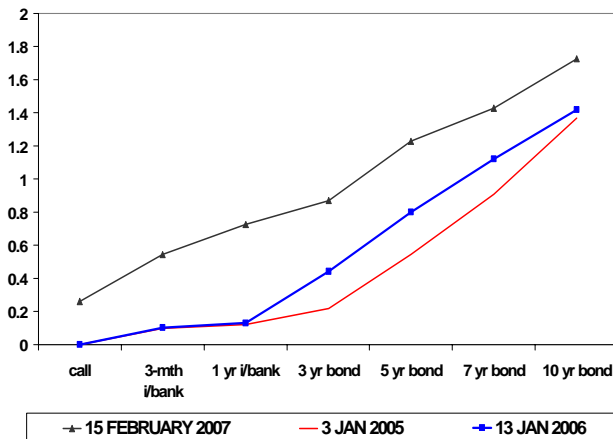


Chart 12: Japanese Yield Curve



The yield curve remains quite steep in Japan and it has also experienced a parallel upward shift over the last year. Most of that movement occurred through the first half of last year and recently there has not been as much movement

Macroeconomic, Industry & Markets Research

Australia

Alan Oster	Group Chief Economist	+ (61 3) 8641 3464
Jacqui Brand	Personal Assistant	+ (61 3) 8641 4179
Jeff Oughton	Head of Economics - Australia & Industry	+ (61 3) 8641 3469
James McKinlay	Economist - Australia	+ (61 3) 8641 4304
Dean Pearson	Senior Economist - Industry & Commodities	+ (61 3) 8641 3474
Gerard Burg	Economist - Minerals & Energy	+ (61 3) 8641 3984
John Sharma	Economist - Property, Business Services, TMTs	+ (61 3) 8641 3473
Ian Gordon	Economist - Transport, Healthcare, Retailing	+ (61 3) 8641 3472
Dean Wickenton	Economist - Manufacturing	+ (61 3) 8641 3672
Skye Dixon	Economist - Agribusiness	+ (61 3) 8641 3442

Tom Taylor	Head of Economist - International	+ (61 3) 8641 3475
Robert De Iure	Economist - Country Risk	+ (61 3) 8641 3445
Carolyn Fraser	Economist - International	+ (61 3) 8641 3694
Vacant	Economist - International	+ (61 3) 8641 3848

Robert Henderson	Chief Economist Markets - Australia	+ (61 2) 9237 1836
David de Garis	Senior Economist - Markets	+ (61 2) 9237 1180
Spiros Papadopoulos	Senior Economist - Markets	+ (61 3) 8641 0978

New Zealand

Tony Alexander	Chief Economist - BNZ	+ (64 4) 474 6744
Stephen Toplis	Head of BNZ Market Economist	+ (64 4) 474 6905
Craig Ebert	Senior Economist, Markets	+ (64 4) 474 6799
Dean Ford	Market Economist	+ (64 4) 474 6923

London

Tom Vosa	Head of Market Economics - UK	+ (44 20) 7710 1573
Kris Bernie	Dollar Bloc	+ (44 20) 7710 2910

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