

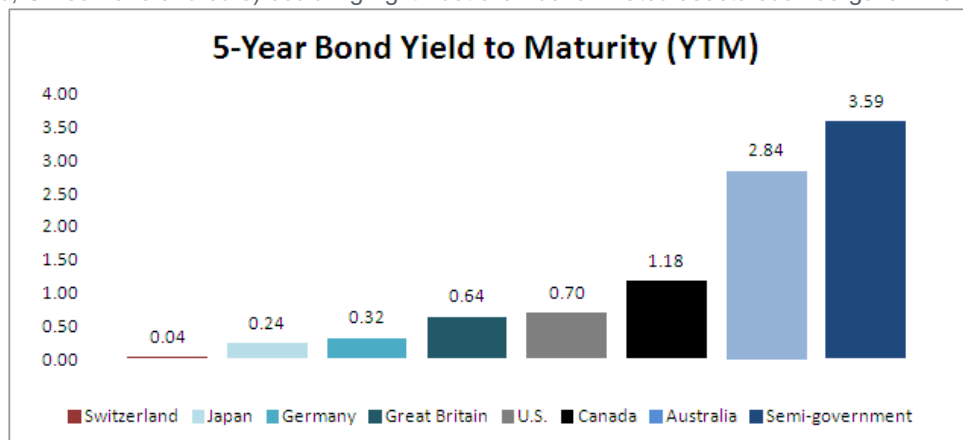
AUSTRALIA: HIGHER YIELD POTENTIAL AND FASTER ECONOMIC GROWTH

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Through the first quarter of 2013, eight out of ten [G10](#) currencies depreciated against the U.S. dollar. With the Japanese yen leading the downward charge, investors in most developed markets sought the perceived safety of the U.S. dollar. Two notable exceptions to the broad-based depreciation were the Australian and the New Zealand dollar. We believe investors will continue to be attracted to Australian debt, as it currently offers the highest yields of any AAA-rated [sovereign](#) in the world.¹

- o Increased Sponsorship: Official reserve currency status
- o Highest Yields among Highly Rated Developed Market Sovereigns²
- [Semi-government](#) and [supranational](#) debt provide additional opportunities to enhance yield relative to sovereign debt
- o Deepening of Trade Relations with China
- Reduced transaction costs [slippage](#)
- o Regional Economies Projected to Grow at Faster Rates
- Policy flexibility, should the Australian economy moderate

Reserve Currency Status Confirmed In an update to a [story we mentioned in February](#), the International Monetary Fund (IMF) has confirmed that the Australian dollar (along with the Canadian dollar) will be reported as a separate holding in the quarterly Currency Composition of Official Foreign Exchange Reserves (COFER) beginning in June 2013. While Australian officials have dismissed this as a “classification change,” we believe the Australian dollar joining other reserve currencies (among them U.S. dollar, British pound, Swiss franc and euro) could highlight Australian-denominated assets such as government



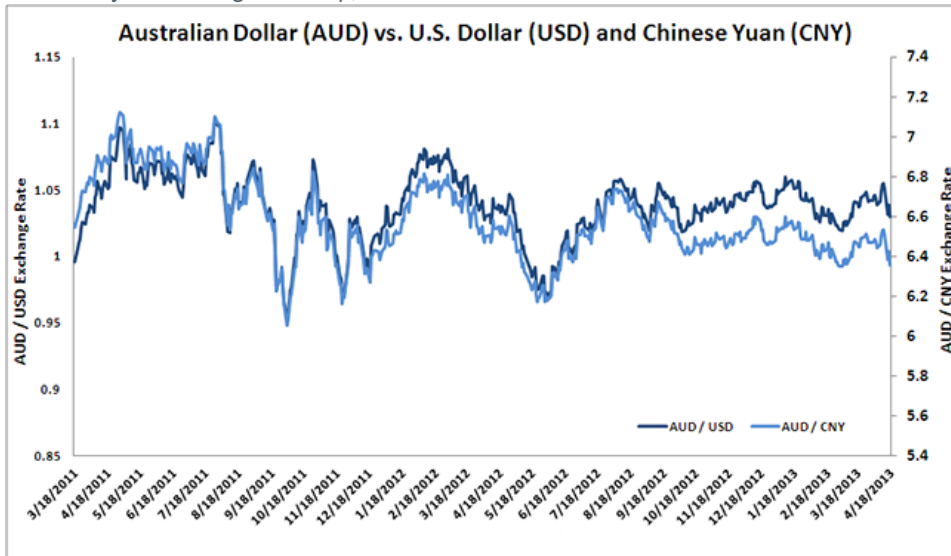
5-year bonds selected for ease of comparison. Semi-government debt represented by Queensland Treasury Corporation. Source: Bloomberg, April 18, 2013. Past performance is not indicative of future results.

bonds to individual investors.

Australian Yields Compare Favorably to Other Reserve Currencies As shown by the chart above, Australian government debt continues to offer a significant yield premium compared to other reserve currencies. Despite the rally in yields last year, Australian markets still provide attractive levels of income compared to most developed market peers. Among reserve currencies, Australian yields are significantly higher than those of Germany, Switzerland or Canada (the only countries rated AAA or equivalent by all [three major ratings agencies](#)). In addition to Australian government debt, a deep and [liquid market](#) of high-credit quality semi-government debt can offer additional opportunities for yield enhancement. Last year, we touched on the possibility of [Chinese sovereign wealth funds](#) increasing allocations to semi-government debt to take advantage of these higher yields. As of March 31, 2013, 89% of the US\$648 billion in Australian debt outstanding was rated AA+ or better by S&P, Moody’s and Fitch.⁴

Direct Currency Trading with China As Australia’s largest trading partner,

China and its economic growth can have a significant impact on the Australian economy. Recently, Chinese economic growth moderated to 7.7%, disappointing many investors. While some believe this announcement supports the case for a broader slowdown, we are not so pessimistic. A development we believe to be beneficial for both countries has to do with how they trade with one another. On April 11, 2013, direct trade between the Australian dollar and the Chinese yuan occurred for the first time in history. Previously, trade between the two countries required an intermediate trade in U.S. dollars. By eliminating this step, trade should become more efficient due to lower transaction costs and slippage.



Source: Bloomberg, April 18, 2013. Note: AUD/USD left-scale, AUD / CNY right-scale. Higher numerical values correspond to Australian dollar appreciation against the U.S. dollar or Chinese yuan.

More efficient trade is a clear positive for both economies, but what effects could this have on investor portfolios? For the past six months, many analysts have voiced concern about the strength of the Australian dollar against the U.S. dollar. However, the United States is only Australia's third-largest trading partner.⁵ Interestingly, the Australian dollar is trading 11% below its two-year high against the Chinese yuan. While the value of the Australian dollar may not be as attractive as it was this time last year (5% higher than the two-year low), we do not believe we are approaching a period of prolonged currency weakness. With many economists in Australia concerned about the effects of currency strength on exports, it is interesting that the currency's strength is near its two-year average when compared to the currency of Australia's largest export market, China. Putting these figures in perspective, it is worth noting that even in the face of currency strength, Australia's economy expanded at the fastest pace of any developed market in 2012.⁶

Regional Economic Leadership and the Potential for Interest Rate Cuts Despite recent concerns about a continuation of recession in the eurozone, economies in Asia are projected to grow at the fastest rates in the world. For 2013, economists at the IMF currently expect the Australian economy to expand by approximately 3%, a by-product of strong intra-Asian trade. However, should exports unexpectedly cool, Australian policymakers have a higher degree of flexibility compared to central banks in Europe and the U.S. With short-term rates currently at 3.0%, the Reserve Bank of Australia could cut rates to lower borrowing costs. Recently, Prime Minister Julia Gillard signaled this option, should global economic growth slow. Ultimately, we believe that investors will continue to search for higher-yielding opportunities around the world. Given the current environment, we believe allocations to Australian debt could provide investors with attractive levels of income combined with diversification away from the U.S. dollar. ¹Standard & Poor's, March 31, 2013 ²Source: Bloomberg, March 31, 2013. ³Source: Wall Street Journal, March 6, 2013. ⁴Proxied by the Citigroup Australia Broad Investment Grade (AusBIG) Index, March 31, 2013 ⁵Source: Australian Government Department of Foreign Affairs and Trade, October 2012. ⁶Source: IMF, April 16, 2013.

Important Risks Related to this Article

S&P and Fitch ratings assist investors by evaluating the credit worthiness of many bond issues. AAA to BBB ratings are typically issued to those securities considered investment grade. The rating is not a recommendation to buy or sell a particular bond. For information on S&P rating agency's methodology go to: <http://www.standardandpoors.com/home/en/us>. For information on Fitch rating agency's methodology go to: <http://www.fitchratings.com> Diversification does not eliminate the risk of experiencing investment losses.

For more investing insights, check out our [Economic & Market Outlook](#)

Sovereign : A national government.

Semi-government : state and territory governments in Australia who help fund public infrastructure investments and manage regional balance sheets.

Supranational : Organization (such as the World Bank or the International Monetary Fund) formed by two or more non-governmental organizations aimed at promoting economic development.

Slippage : The difference between the expected price of conducting a transaction compared to the actual execution price.

Three major ratings agencies : Includes Standard & Poor's, Moody's, and Fitch.

Liquid market : A market in which it is easy to execute a trade with minimal price impact.

Credit quality : A measure of a borrowers potential risk of default.