

# Quarterly Economic Report

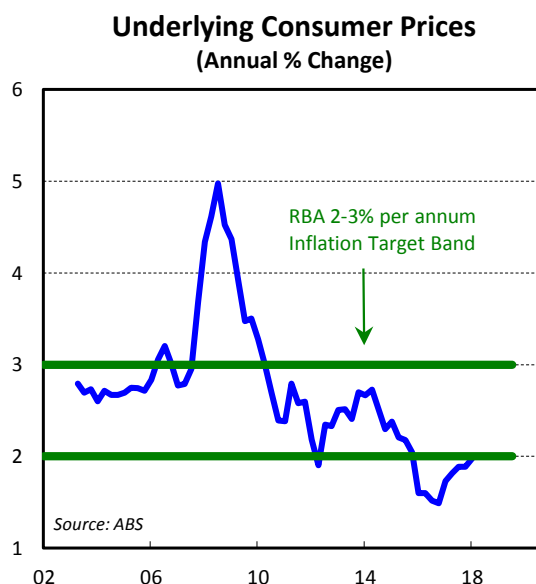
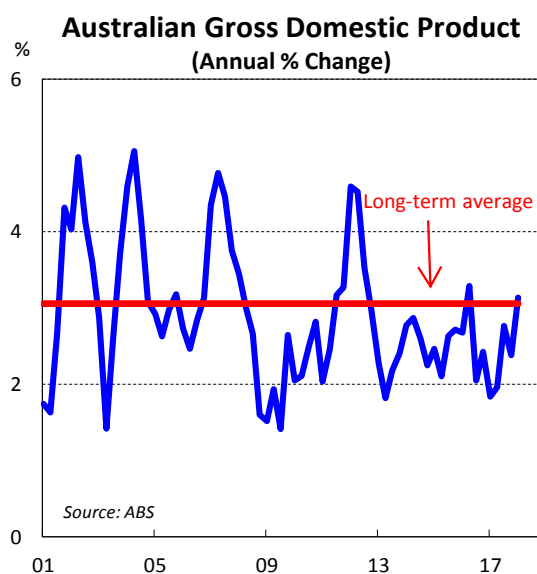
Thursday, 5 July 2018



Bank of Melbourne

## Trade Tensions on the Radar

- The global economy continues to grow at a healthy clip, although risks to the global economic outlook have increased in recent months. Trade-war fears have escalated.
- The pace of domestic economic growth picked up in the first quarter of this year, lifting the annual pace to 3.1%. We expect growth of around 3.0% in 2018 and 2.9% in 2019.
- Weak wages growth and subdued inflation suggest the first RBA rate hike will take time to come to fruition. The risks are that the RBA does not start a rate-hike cycle until early 2020, reflecting the rise of global-trade concerns and short-term funding issues.
- Short-term funding markets worldwide are starting to feel the effects of soaring US dollar Libor rates. This rise in Libor rates, if sustained, will tighten financial conditions in Australia as it is more costly to obtain dollar-based funding.
- US 10-year bond yields broke above 3% on May 9 this year, but have since retreated. Over the next 12-18 months, we expect US long-term rates to be higher, but in the nearer term, yields may tread water. The upside for bond yields could be capped by the ongoing trade tensions. We expect US bond yields to drag Australian long-term rates higher.
- Growing downside risks to global growth, particularly with rising global-trade tensions, and an escalation of risk aversion have placed downward pressure on the AUD over recent months. Given that uncertainty surrounding global trade negotiations is likely to persist for some time, we have downgraded our Australian dollar forecasts. We now expect the Australian dollar to end 2018 at 74 US cents and end 2019 at 76 US cents.



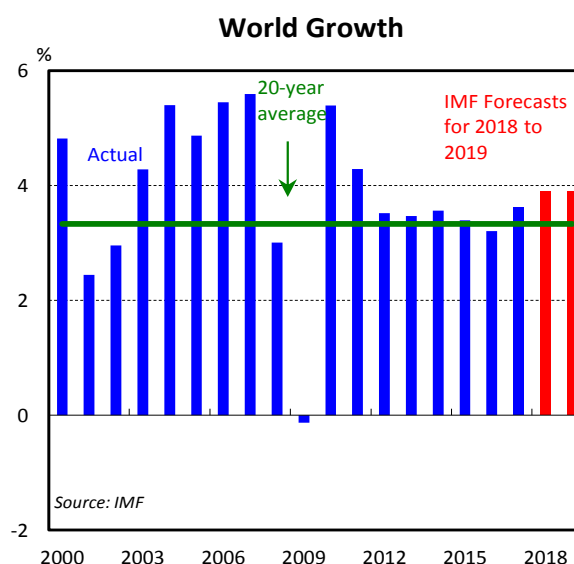
## Global Economic Outlook

The global economy continues to grow at a healthy clip. The International Monetary Fund (IMF) has forecast global growth of 3.9% in 2018 and in 2019. This projection is up from the previously estimated growth rates of 3.8% in 2017 and 3.2% in 2016. Changes to US tax policy and increased fiscal spending are expected to have a positive impact on US economic growth in the short term.

There are, however, risks to the outlook for global growth and these risks have increased in recent months. Financial markets are currently focused on trade discussions between the US and its trading partners amid concerns about a trade war. US President Trump's announcements of tariffs on imports into the US have been matched by counter-moves from Chinese authorities. Fluctuating hopes of a resolution to trade tensions continue to impact the outlook for global economic growth.

The pace of US economic activity is solid. In the year to the March quarter 2018, economic growth averaged 2.5%, which was the highest annual average since the year to the December quarter 2015. The pace of economic growth in the US is expected to pick up further this year as tax cuts and fiscal spending provide stimulus to the US economy in the short term.

Inflation remains low in the US, despite ongoing jobs creation and a falling rate of unemployment. The core personal consumption expenditure (PCE) deflator, the Fed's preferred measure of inflation, rose by 1.8% in the year to April. Although it has lifted from its 2017 lows, inflation remains stubbornly below the Fed's 2% inflation target. The US labour market has added more than 2.3 million new jobs over the past year and the unemployment rate has fallen to 3.8%. This is the equal lowest unemployment rate since April 2000 (during the time of the technology bubble), and before that in December 1969. Despite solid job gains, wages growth has not picked up significant pace. Structural changes from technology are possibly constraining wages growth and the Phillips Curve (which depicts the inverse relationship between unemployment and wages) might be flatter than in the past. Trends in initial jobless claims suggest the US unemployment rate is likely to fall further, which should lead to a further increase in wages inflation.



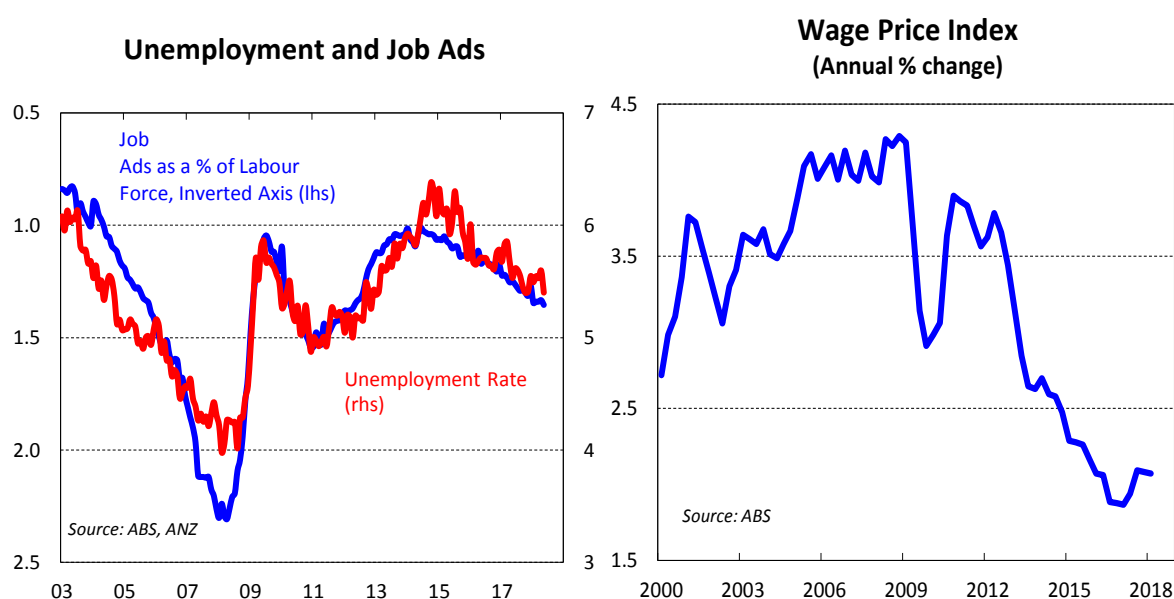
After growing at a robust pace of 6.9% in 2017, Chinese authorities announced a target of about 6.5% for GDP growth this year. The growth target got off to a solid start, with GDP growth of 6.8% in the year to the first quarter of 2018, which was an unchanged pace from the previous quarter. Having a lower growth target this year should allow Chinese authorities to address several other concerns, including high levels of debt and environmental objectives. Measures to slow the property market had an impact. Property price growth has slowed markedly from a year ago. The most recent data, however, showed signs of a rebound in property price growth.

China's high levels of corporate debt remain a key risk for the economy. The growth in debt has slowed in recent years; nonetheless, debt is at a high level and continues to rise. In its April Financial Stability Review, the RBA indicated reforms had had "some success in containing the build-up of risks", although it noted much would depend on how they are implemented and enforced. Chinese authorities have a wide range of tools available to manage this risk.

## Domestic Economic Outlook

Australian GDP growth rose at a lacklustre 2.2% pace over 2017. The pace of economic growth picked up in the first quarter of this year, lifting the annual pace to 3.1%. We expect growth at a pace of around 3.0% in 2018 and 2.9% in 2019. The business sector is a brightening spot in the domestic economy. Business conditions and confidence are above their long-run average levels and business-investment plans are higher in the forthcoming years. In this encouraging environment, company profits have strengthened and hiring has lifted.

Employment growth was very strong in 2017. There was the creation of 415k net new jobs or an average of 34.4k per month. The pace of jobs growth, however, has eased somewhat this year, with an average 12.4k new jobs created in the first five months. Over the year to May, there were a total of 303.9k new jobs. Almost 60% of these jobs were full-time. The remainder were part-time positions. With the strong lift in employment, the unemployment rate has edged down to 5.4% in May, from 5.5% a year earlier.



The RBA has estimated that an unemployment rate at 5.0% would equate to an economy at full employment, but more recently has highlighted the risk that it could be lower. In recent years, some other developed economies are considered to be near or below full-employment with little discernible impact on wage growth. In Australia over the past year, the newly created jobs have drawn more people into the jobs market. Those who were previously “discouraged” job seekers are taking up the newly created positions or beginning to actively look for work. This was reflected in the workforce participation rate, which has lifted to 65.5% in May, from 65.0% a year earlier. The degree to which there are more of these discouraged job seekers will dictate the impact of further job creation and a potential decline in the workforce participation rate on wage growth.

Wage growth edged up in the year to the March quarter, but at just 2.1% remains very low. The ongoing softness in wage growth reflects the spare capacity in the labour market, changes to collective wage bargaining, globalisation of the workforce and the impact of technology on the workplace. Wages growth is currently one of the most important indicators for the outlook for monetary policy. In a speech in early February, RBA Governor Lowe said “a lift in wage growth is likely to be necessary for inflation to average around the midpoint of the 2–3 per cent medium-term inflation target.”

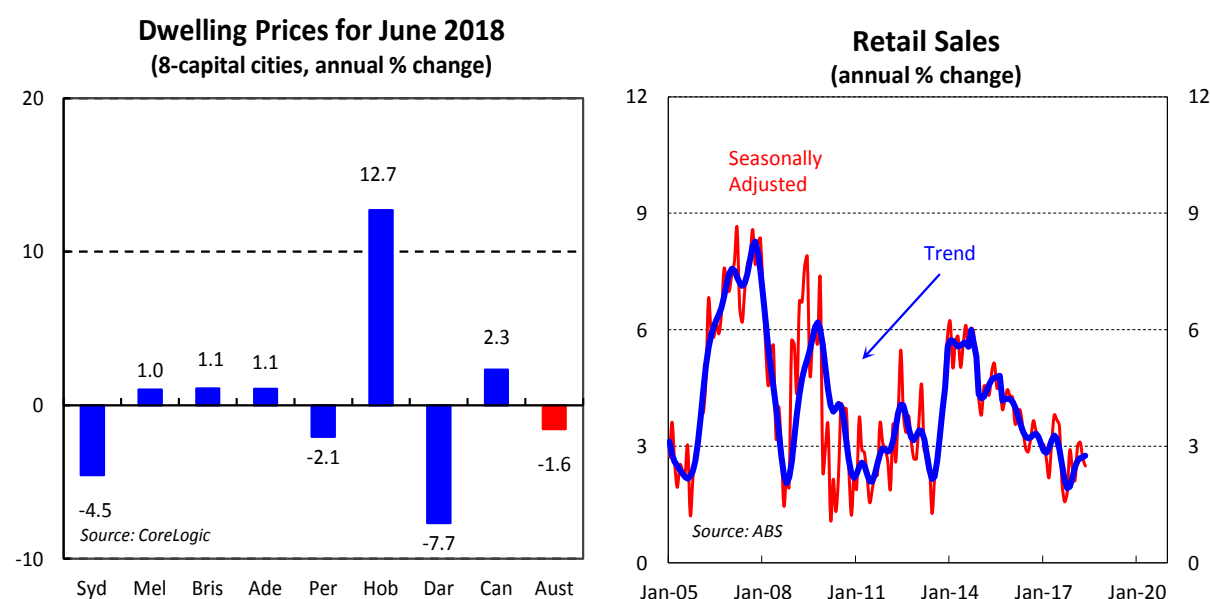
The unemployment rate is falling and leading indicators of employment suggest it will continue to

do so. Over time we expect the lower unemployment rate to gradually drive wages growth higher. Inflation remains low. The headline consumer price index (CPI) rose by only 1.9% in the year to the March quarter. The more closely watched average of the two underlying CPI measures rose by 2.0% over that period, which is at the lower end of the RBA's 2-3% per annum inflation target band. Inflation is expected to remain low by the RBA over the medium term.

The housing market has continued to cool, led by Sydney. Dwelling prices for the combined 8 capital cities have declined for eight consecutive months, according to CoreLogic data. In the year to June, capital city dwelling prices fell by 1.6%, a reversal from the peak growth rate of 11.4% in the year to May 2017.

Building approvals are trending downwards, but remain at an elevated level on a historical comparison. It suggests residential construction will continue at an above average level this year. Dwelling investment has been a strong growth driver in the economy in recent years. Growth in dwelling investment, however, tapered towards the end of 2017. Despite the pipeline of residential construction over the next year, dwelling investment is expected to detract from economic growth in 2018.

Housing lending has declined over the past year, consistent with other indicators on housing, including auction clearance rates and prices. The decline is more noticeable for lending to investors. Regulatory measures to curb investor demand are continuing to have an impact. The moderation in house prices and government incentives are attracting first-home buyers back into the market.

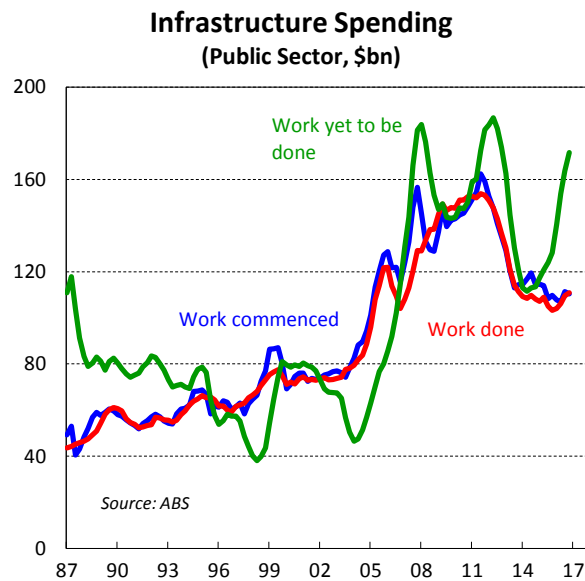
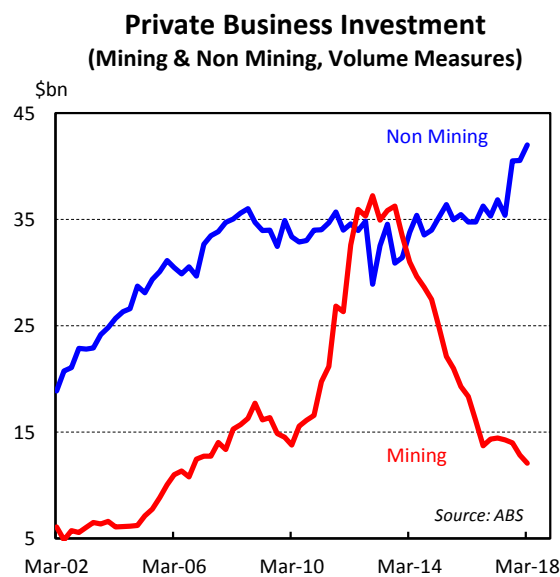


The housing market is expected to soften further over the coming year, with prices moderating, especially in Sydney and Melbourne. The extent of the downturn will be cushioned, however, by solid job creation, strong population growth and ongoing accommodative monetary policy, as interest rates remain on hold.

Consumers have been optimistic over the last seven months, but we continue to have doubts that consumer spending growth will pick up significantly. The pace of growth in retail sales remains soft, below its long-term average. High levels of household debt and slow wages growth are keeping constraining consumer spending, although solid labour market gains are expected to be supportive.

Following a protracted period of weakness with an unwinding of the mining investment boom,

business investment has found its feet over the past year. In annual terms, business investment turned positive in the second half of 2017. Gains in businesses capital expenditure plans point to moderate gains in business investment. Elevated business conditions and solid global economic growth also suggest an ongoing positive outlook for business investment.



Government investment had a strong year in 2017 and that is expected to continue this year as infrastructure projects drive economic growth. This government spending on infrastructure is spilling over into the private sector.

## Outlook for Cash, Bond Yields and Short-Term Money Market Rates

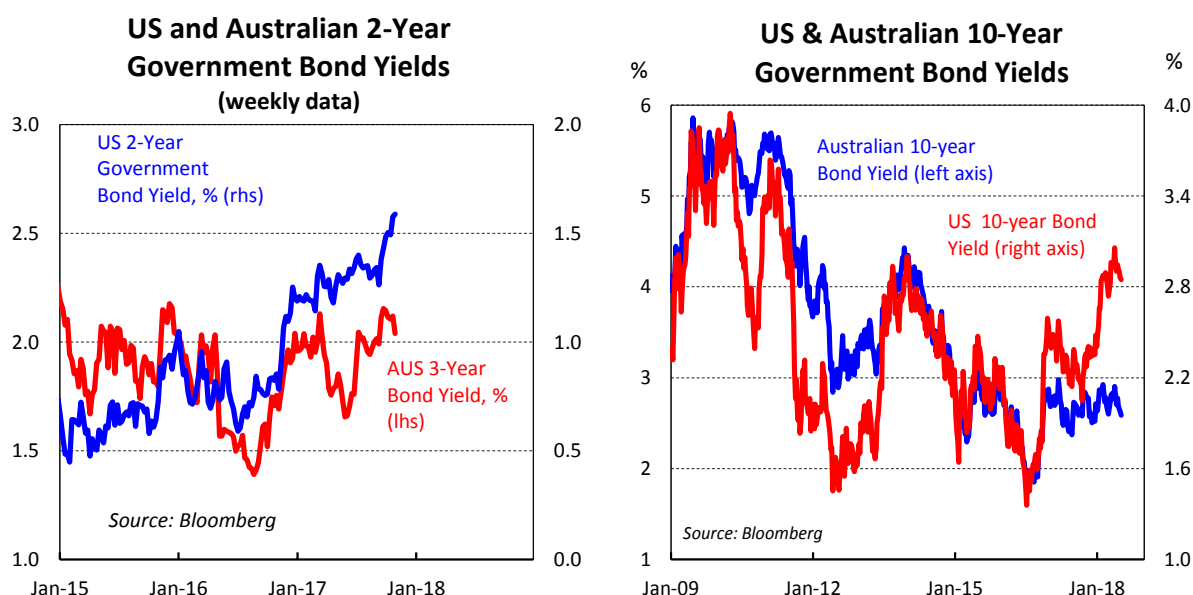
### US Bond Yields

US 10-year bond yields broke above 3.00% on April 25 this year, but since late May have retreated and look set to stick to a 2.75-3.10% range over the next few months.

The retreat in long-term US bond yields has been driven primarily by rising fears over global trade wars. Ructions in emerging economies and problems in Italy have also caused investors to reassess the global growth outlook.

The US is set to impose tariffs on US\$36 billion of imports from China on July 6. Tariffs over the remaining \$16 billion are undergoing a short public review period and might go into effect shortly after. US President Trump is also considering a 10% tariff on an extra \$200 billion of Chinese imports.

Trump has already imposed tariffs on steel and aluminium imports from some countries and has threatened a 20% tariff on car imports from the European Union (EU). Countries are retaliating to Trump's trade decisions. For example, China is scheduled to impose their retaliatory tariffs on the US from July 6.



Recently, there has been news reports that the US also wishes to withdraw from the World Trade Organisation (WTO). Congressional approval is required for such a withdrawal. These developments have led to an escalation of trade tensions and have contributed to concerns of a slowing in global trade and global growth.

The momentum in the US economy has continued, despite the escalation in trade tensions. It means the US Federal Reserve is likely to keep raising rates and means the retreat in US bond yields should be limited. US economic data continues to remain robust. The unemployment rate in the US fell to a historically low rate of 3.8% in May, which is below the natural rate.

We expect the US Federal Reserve to continue to be pre-emptive and hike the Federal funds rate two more times this year and twice more next year. Financial markets are pricing in two more this year, but only one more next year. So there is room for US bond yields to move higher if our forecast proves correct.

Over the next 12-18 months, we expect US long-term rates to be higher, but in the nearer term, yields may tread water. The upside for bond yields might be capped by the ongoing trade tensions.

We would see bond yields not resuming their trend higher if trade fears escalated and started to cause a pullback in US economic activity; to date, there is very little evidence of this.

### **Australian Bond Yields**

Australian bond and swap yields across the mid part of the yield curve to the longer end are highly influenced by the direction and movement in US government bond yields. US bond yields have risen by 148 to 210 basis points across maturities 1 to 10 years since bottoming in July 2016 (1-year yields bottomed earlier in October of 2015). This rise in US bond yields has dragged Australian bond and swap yields higher, across 3- year to 10-year maturities. Australian 3-year to 10-year maturities have risen by 66-78 basis points since bottoming in August of 2016.

We expect US bond yields to drag Australian long-term rates higher. Australian bond yields will not move up by as much as US rates because the risks of higher inflation in Australia are less.

The shorter end of the Australian bond yield curve is influenced by market participants' expectations on what the RBA will do.

### **Cash Rate**

Economic growth drivers in the Australian economy are shifting, from the consumer and housing construction to public infrastructure and business investment. Exports are also adding to growth. Uncertainty around the outlook for consumer spending amid weak wages growth and high household indebtedness is a key issue in the mind of RBA policymakers. Falling house prices might add another layer of vulnerability to the consumer.

Moreover, weak wages growth is leaving inflation subdued and suggesting the first RBA rate hike will take time to come to fruition.

The risks are that the RBA does not start a rate-hike cycle until early 2020. We previously were of the view that the RBA would hike in the middle of 2019, but the rise of global trade concerns and short-term funding issues have contributed to our forecast being pushed out to early 2020.

With the RBA slow to raise rates, shorter-dated bond yields are likely to grind only slowly higher over the next six months. They will mostly be in a holding pattern until it becomes clearer to financial markets when the timing of the next RBA move will be.

Financial markets have been pushing out the timing of a RBA rate hike since late last year. Financial markets, using overnight-indexed swap pricing as a guide, are attaching a 68% probability of a rate hike from the RBA by the end of next year. This probability is 39% for June next year.

### **Short-Term Money Market Rates**

Short-term funding markets worldwide are starting to feel the effects of soaring US dollar Libor rates. The surge in this key global short-term financing indicator is not flashing a warning signal like it was during the credit crunch. It is mostly due to technical issues. Nonetheless, it's still making funding more costly for borrowers in Australia and other countries outside of the US.

This rise in Libor rates, if sustained, will tighten financial conditions in Australia by making it more costly to obtain dollar-based funding. Australian financial institutions rely on some of their funding from this source. Banks generally source funding from three main sources: deposits (60%), short-term money markets (15-20%) and longer-term offshore markets (15-20%). It is one of the reasons we also expect the RBA will take longer to start a rate-hike cycle.

The Libor increase is due in part to the deluge of Treasury-bill issuance since the US debt ceiling was raised in February 2018. The USD 3-month Libor rate has risen to 2.34%, the highest since late 2008. There has been a relentless rise in the USD 3-month Libor rate starting in 2016, but the

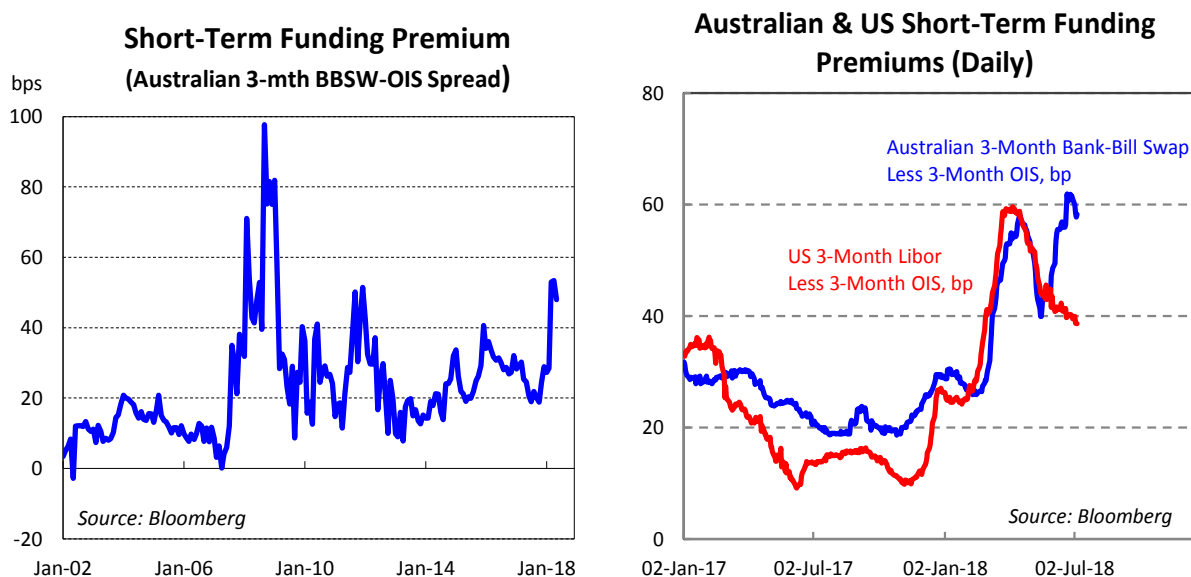


trend higher has received new impetus in 2018. This trend is spilling over into local rates.

The rise in US Libor rates is underpinned by the US Federal Reserve tightening monetary policy. The Fed has raised rates twice this year and six times in the current tightening cycle. More rate hikes are likely.

The US tax overhaul passed by the US Congress in December is also having an impact. The overhaul encourages US companies to repatriate money. So US companies have been active in buying bonds from the short-term money market, as these resemble cash the closest. It means the demand for short-term bonds is greater, pressuring these rates, including those of Libor, higher.

The concern is that the blowout in short-term funding costs may have more room to run. One proxy of bank borrowing costs - the spread on Libor over a risk-free rate known as the overnight index swap – has risen sharply. The Australian spread between the three-month bank bill swap and Libor has blown out to 62 basis points on 21 June 2018, the widest since 8 August 2011. In recent trading sessions, this spread has narrowed modestly to 58 basis points.



This spread has only traded at around these current levels on a few other occasions, including in 2016 when money market reforms dramatically reduced demand for short-dated bank debt, in 2011 on concerns about European bank exposures to risky sovereign debt and during the global financial crisis of 2007-2009.

The RBA have recently explained that the short-term wholesale interest rates have increased in recent months partly due to developments in the US, but have also stated that other factors are also at work. Since early June, the short-term money market spread in the US has contracted, but in Australia the spread has remained wide. The RBA has left open ended the question of whether these non-US-related factors will persist by stating it “remains to be seen the extent to which these factors persist”.

It is possible that a domestic factor involves private sector credit growing at a faster than the pace of deposits, leaving financial institutions to seek greater funds from short-term money markets. If this explanation holds true, then it is possible that short-term rates in Australia will hold at a higher level in the year ahead compared with the past.



## Australian Dollar Outlook

A multitude of factors have placed downward pressure on the Australian dollar in recent months. These include a lift in downside risks to global growth, particularly with rising global trade tensions. In addition, there has been an overall escalation of risk aversion in financial markets and some concerns about inflation, particularly in the US. The US federal funds target rate also moved above the Australian cash rate on June 14 for the first time since late 2000. It begs the question of what interest-rate differentials mean for the AUD outlook.

These factors points to an increased downside risk for the Australian dollar. We examine these risks and assess the implications for our currency forecasts.

### Is the Global Economy Still on Track?

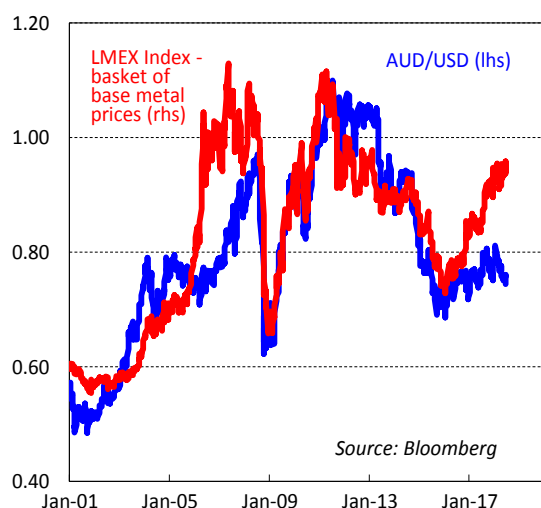
Indicators on global economic activity are suggesting some easing in momentum, but are still pointing to a relatively firm expansion. The IMF is expecting global growth of 3.9% in 2018 and 2019, although consensus forecasts are expecting slightly slower growth of 3.8% and 3.7%, respectively.

Escalating trade tensions between the US and other parts of the world has posed a downside risk for the global economy.

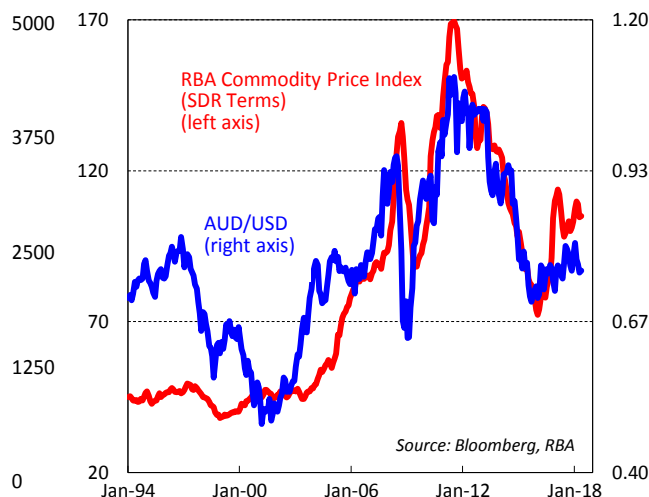
While the tariffs themselves may not have a significant direct impact on economic growth, the tensions have raised uncertainty for businesses around the world. Further, there is a risk that the dispute could become prolonged or take a turn for the worse.

The uncertainty over trade has the potential to dampen confidence and dent the recovery underway in the global economy.

**AUD & Base Metal Prices**



**AUD & RBA Commodity Price Index**



### Commodity Prices

Commodity prices have recently come under some downward pressure as a result of recent trade tensions and the downturn in financial market sentiment. Nonetheless, prices of most commodities have held up reasonably well, and prices of some commodities, such as oil, have trended upwards over recent months. Indeed, the outlook for commodity prices provides some upside risk to the Australian dollar. That being said, the relationship between commodity prices and the Australian dollar has broken down somewhat since the beginning of this year. While this

relationship could reassert itself overtime, this divergence suggests that other factors are currently keeping the AUD under downward pressure in the near term. Moreover, trade tensions suggest downside risk to global growth and, therefore, demand for commodities.

### Is the Yield Differential Back in Play?

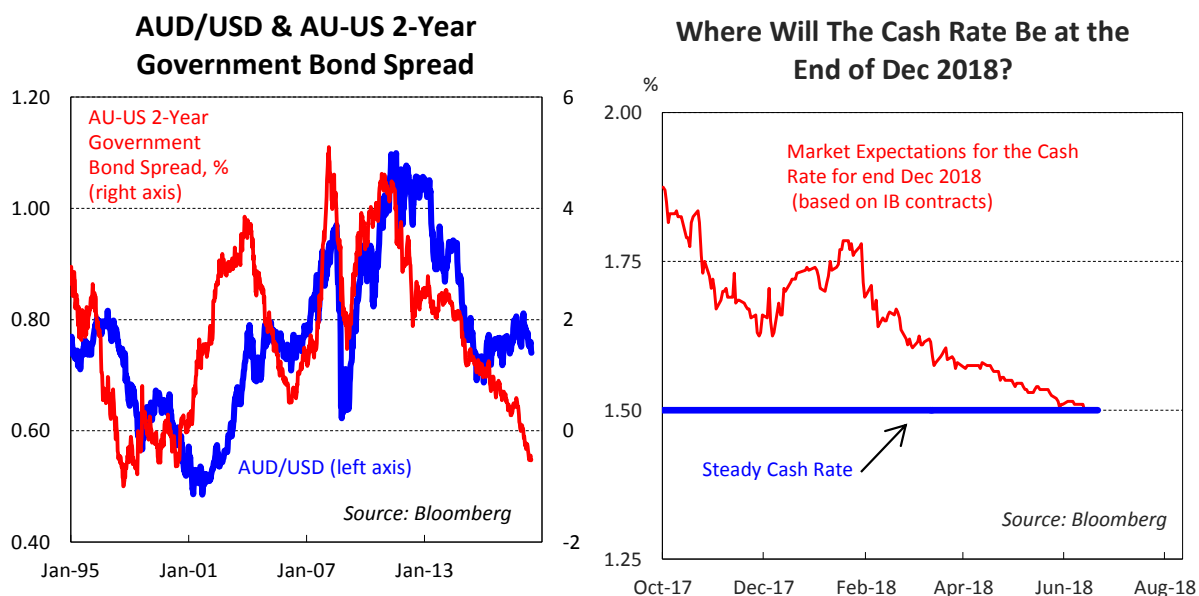
Another likely factor behind the recent Australian dollar depreciation and the resurgence in the US dollar has been concern over rising US government bond yields. The differential between US and Australian two-year government bond yields has been narrowing as a trend since early 2011, and has turned negative (US yields have exceeded Australian yields) since January 26 this year.

Additionally, the risk of rising inflation has come onto investors' radar. This is particularly the case for the US, where the labour market is becoming increasingly tight. A US unemployment rate of 3.8% suggests that wage inflation is at risk of picking up at a more rapid pace. Inflation has moved towards the Federal Reserve's 2% target. Nonetheless, we believe that there are structural factors keeping wages and inflation low and we do not expect that inflation will become a threat.

The Federal Reserve is still on track, however, to lift the Federal funds rate further this year.

The US economy has become a standout in the world economy. US economic growth has regained strength towards the June quarter of this year, while growth in other major economies, including Europe, China and Japan, has lost some momentum in the first half of this year. It has helped to lift the US dollar index to an eleven-month closing high of 95.31 on June 28.

In contrast, the RBA is not expected to lift official interest rates any time soon. The Australian economy is on course for growth at a little above trend. However, jobs growth has slowed since the turn of the year. The unemployment rate has held within the range of 5.4-5.6% for thirteen consecutive months, suggesting ongoing spare capacity within the labour market. It also suggests that wage growth or inflation is unlikely to pick up anytime soon. Financial markets have pushed out the timing for the first rate hike from the RBA significantly and suggest little chance of a rate hike by the end of this year, after being nearly fully priced in January 2018.



### Risk Aversion Linger

Since earlier in the year, risk aversion has crept back into financial markets. The US S&P500 index has been volatile ever since the index hit a record high on January 26 and has yet to revisit those highs. A key measure of equity market volatility (based on options), the SPX Volatility Index or VIX

as it is commonly known, spiked to its highest since August 2015 in February. It has remained elevated relative to its below-average levels throughout 2017.

When financial markets become risk averse, the Australian dollar tends to come under downward pressure. A major factor behind the lift in risk aversion is the increased downside risks to the global outlook due to fears of a global trade war. However, there have been other factors which have kept markets on edge. These include geopolitical tensions, concern about rising bond yields, inflation and emerging markets. Ultimately, the withdrawal of monetary stimulus around the world may be preventing equity markets from scaling to new highs. Further, financial markets were probably due for a reappraisal of risk. In recent years, volatility has become unusually low in recent times and valuations in US equity markets had become stretched.

## **Conclusion**

We see a great deal of uncertainty surrounding the outlook for the Australian dollar. Key fundamentals, commodity prices and interest rates, are not providing a clear gauge on the direction of the AUD. Moreover, the inclination for US President Trump to backflip on policies suggests that there is significant uncertainty to the global economy and, therefore, the Australian dollar outlook.

There has been a clear shift in the way financial markets are reacting to information since the turn of the year. Over 2018, the relationship between commodity prices and the Australian dollar has broken down somewhat. A likely explanation for this breakdown is a shakeup in financial market sentiment, increased attention on inflation and concern over rising interest rates. In a risk-averse environment, the Australian dollar tends to come under downward pressure.

Additionally, the widening interest-rate differential between Australia and the US, which has posed a downside risk for some years, might be now having more of an impact in pressuring the Australian dollar lower. The US economy is also once again a standout in the world and performing relatively strongly in comparison to other economies. This comparative strength has assisted in propping up the US dollar against other major currencies.

A key question for the currency outlook is whether some of the recent drivers bringing down the Australian dollar have a longer-lasting impact.

Given that uncertainty surrounding global trade negotiations is likely to persist for some time and given that we do not expect the risk aversion in financial markets to subside substantially over the near term, we have downgraded our Australian dollar forecasts.

We now expect the Australian dollar to end 2018 at 74 US cents and end 2019 at 76 US cents.

## Forecasts

End Period:	2018				2019			
	Q1	Q2	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)	Q3 (f)	Q4 (f)
<b>Interest Rates:</b>								
RBA Cash Rate, %	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day BBSW, %	2.02	2.11	2.00	1.95	1.90	1.90	1.95	2.00
3 Year Swap, %	2.19	2.16	2.35	2.45	2.50	2.60	2.70	2.80
10 Year Bond, %	2.60	2.63	2.85	3.00	3.10	3.20	3.30	3.40
<b>USD Exchange Rates:</b>								
AUD-USD	0.7679	0.7405	0.7400	0.7400	0.7500	0.7500	0.7600	0.7600
USD-JPY	106.28	110.76	110.00	110.00	108.00	108.00	106.00	106.00
EUR-USD	1.2324	1.1684	1.1800	1.1800	1.2000	1.2200	1.2400	1.2400
GBP-USD	1.4015	1.3207	1.3200	1.3400	1.3400	1.3800	1.4000	1.4200
USD-CHF	0.9540	0.9906	0.9900	0.9900	0.9800	0.9800	0.9700	0.9700
USD-CAD	1.2900	1.3133	1.3100	1.3100	1.3000	1.2800	1.2600	1.2600
NZD-USD	0.7237	0.6768	0.6800	0.6800	0.7500	0.7500	0.7500	0.7500
USD-CNY	6.2755	6.6210	6.6000	6.6000	6.5000	6.5000	6.4000	6.4000
USD-SGD	1.3115	1.3624	1.3600	1.3600	1.3500	1.3500	1.3400	1.3400
<b>AUD Exchange Rates:</b>								
AUD-USD	0.7679	0.7405	0.7400	0.7400	0.7500	0.7500	0.7600	0.7600
AUD-EUR	0.6230	0.6340	0.6270	0.6270	0.6250	0.6150	0.6130	0.6130
AUD-JPY	81.60	82.00	81.40	81.40	81.00	81.00	80.60	80.60
AUD-GBP	0.5480	0.5610	0.5610	0.5520	0.5600	0.5430	0.5430	0.5350
AUD-CHF	0.7330	0.7340	0.7330	0.7330	0.7350	0.7350	0.7370	0.7370
AUD-CAD	0.9910	0.9720	0.9690	0.9690	0.9750	0.9600	0.9580	0.9580
AUD-NZD	1.0610	1.0940	1.0880	1.0880	1.0000	1.0000	1.0130	1.0130
AUD-SGD	1.0071	1.0089	1.0064	1.0064	1.0125	1.0125	1.0184	1.0184

\* Note that the AUD cross exchange rates have been rounded.

	2016-17	2017-18 (f)	2018-19 (f)	2017	2018 (f)	2019 (f)
GDP, %	2.1	2.8	2.9	2.2	3.0	2.9
CPI (Headline), %	1.7	1.9	2.0	1.9	1.9	2.2
CPI (Underlying), %	1.6	1.9	2.1	1.8	2.0	2.2

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