

THE AUSTRALIAN ECONOMY CONTINUES TO OUTPERFORM

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ECONOMICS UPDATE: This week's data gives The RBA a green light

- A strong read on housing finance data earlier in the week combined with elevated reads for business and consumer confidence were capped off today by a significant upside surprise from the employment numbers.
- This week's strong data clinches the argument as to whether the RBA should raise rates in December, with a 25bp rise now seemingly assured. We have now changed our cash rate forecast to include this hike, raising the short term peak in rates to 4.25% in March before an extended pause through much of 2010.

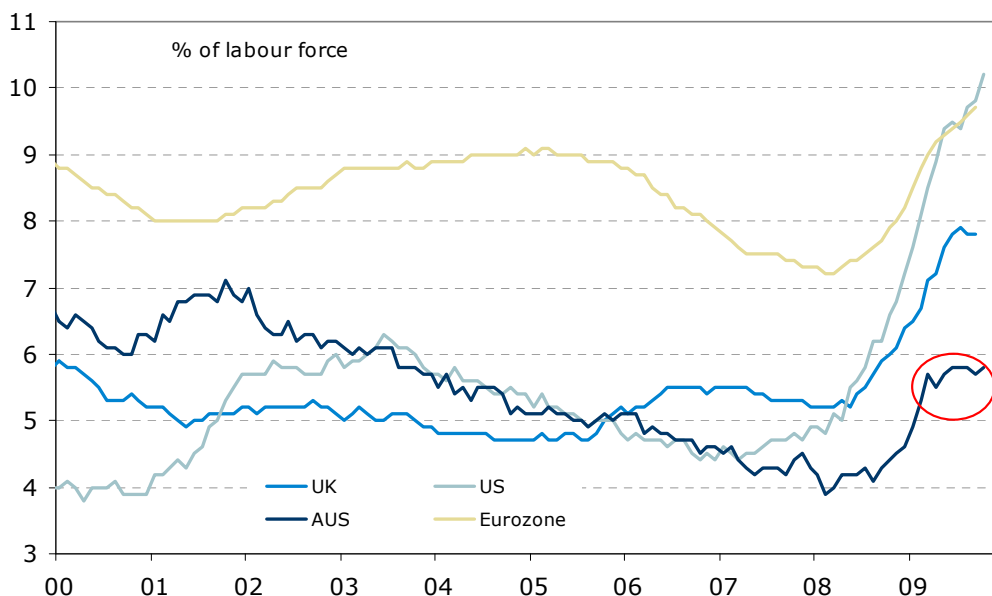
FX: AUD Rally Returns On Improvement In Risk Appetite

- A renewal in risk appetite, solid local economic data and increased market confidence of an RBA rate hike in December have boosted the AUD/USD to new 2009 highs at around 0.9360.
- There has been a substantial rally in the EUR/USD since the depths of the global financial crisis were reached in late 2008. Indeed, since the trough in equity markets in mid-March 2009, moves in the currency have been akin to those seen in the AUD/USD, with the EUR/USD improving to 1.50 in recent weeks, over 20% above its March trough below 1.25.
- Unlike the solid and improving Australian economic landscape, there remain a number of headwinds to the Euro zone outlook.

CHART OF THE WEEK

Australia's unemployment rate remains well below most, if not all, other advanced economies.

Figure 1. International unemployment rate comparison



Source: ABS, Bloomberg and ANZ

ECONOMIC UPDATE

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THIS WEEK'S DATA GIVES THE RBA A GREEN LIGHT

- This week's strong data clinches the argument as to whether the RBA should raise rates in December, with a 25bp rise now seemingly assured.

This week has brought another raft of positive economic data, reflecting an Australian economy that continues to surprise on the upside. On this basis, the economic evidence seems almost overwhelming in suggesting that the RBA will raise interest rates another 25bps at their December meeting. In our view, the pace of economic recovery means the RBA will have no hesitation in continuing its course of gradually removing monetary policy stimulus. We expect a 25bps hike in December to be followed up by further increases in February and March pushing the cash rate to 4.25%.

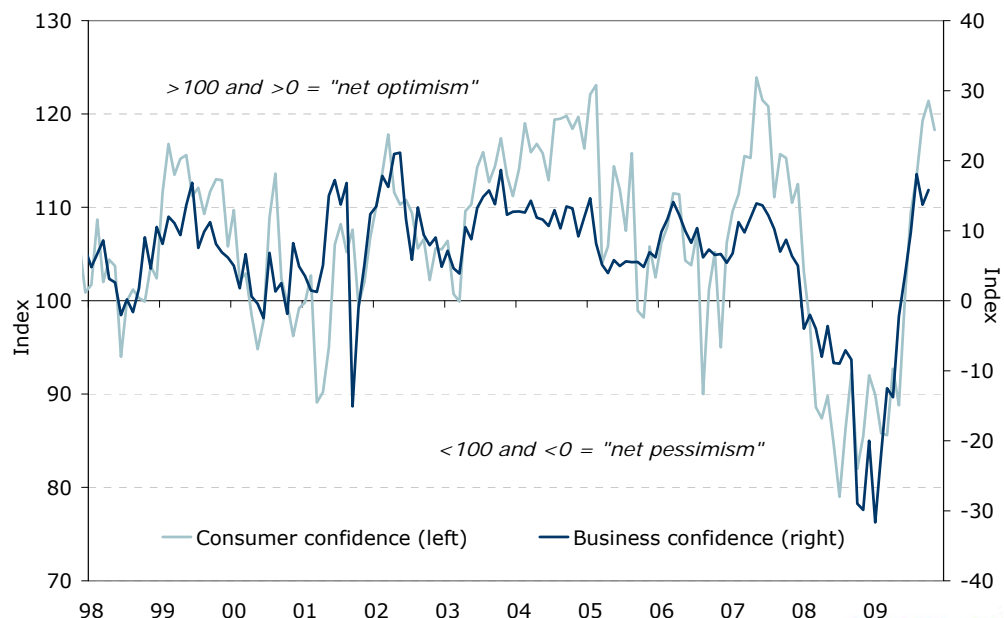
At this point we think the RBA will pause to assess the impact of tighter policy. Given their forecasts for a return to near trend growth in 2010 we think the focus of this reassessment will be on whether or not inflation continues to decelerate. An annual core inflation rate that only just gets back into the top half of the 2-3% target band raises the risk the RBA will have to be more aggressive next year. But as it stands both ANZ and the RBA have core inflation getting to the mid-point of the band or a touch below which should give the RBA room to move. The other key concern will be the pace of the economic recovery in other advanced nations, in particular the US. Persistently weak growth in these parts of the world could potentially impinge on recovery in not only the Australian economy but those of our major trading partners.

DATA REMAINS STRONG

Monday brought housing finance data that showed a gain of 5.1% in September, largely reflecting a surge in first homebuyer activity. FHB numbers were up 10.1% in the month with potential buyers getting in before the Government's boost to the First Home Buyer Grant starts to be wound back. However, upgraders and investor numbers were also up a very solid 4.2%. Although very strong, these figures would not have fazed the RBA. A pullback in the property market will inevitably come in the next few months as first homebuyers become less active as both grants are wound back and affordability deteriorates. More cautious activity from upgraders should see levels of finance approvals remain relatively elevated but remove some of the upward pressure on dwelling prices.

Confidence measures were also released this week. Consumer confidence for November eased 2.5% to 118.3 with the Cup Day rate hike pushing the index off last month's peak. Strong confidence bodes well for the economy going forward. However, we anticipate the very high levels of confidence will not necessarily translate fully into expanding retail consumption. This is due to the absence of household income growth or any further cash handouts supporting spending.

Figure 2. Business and Consumer confidence remain elevated post-hikes



ECONOMIC UPDATE

Business indicators also proved resilient to rate hikes. Business confidence was up 2 points to +16, remaining above long-term averages and consistent with expanding business investment. Business conditions surged during the month from +3pts to +12pts on the back of rises in profitability, employment, and stocks and export sales. Capacity utilisation rose strongly to 82.1% from 79.9% and, along the improvement in the employment sub-index, bodes well for the labour market going forward - a fact that was more than reflected in the October labour force figures.

JOBS GROWTH MOVES BACK INTO POSITIVE TERRITORY

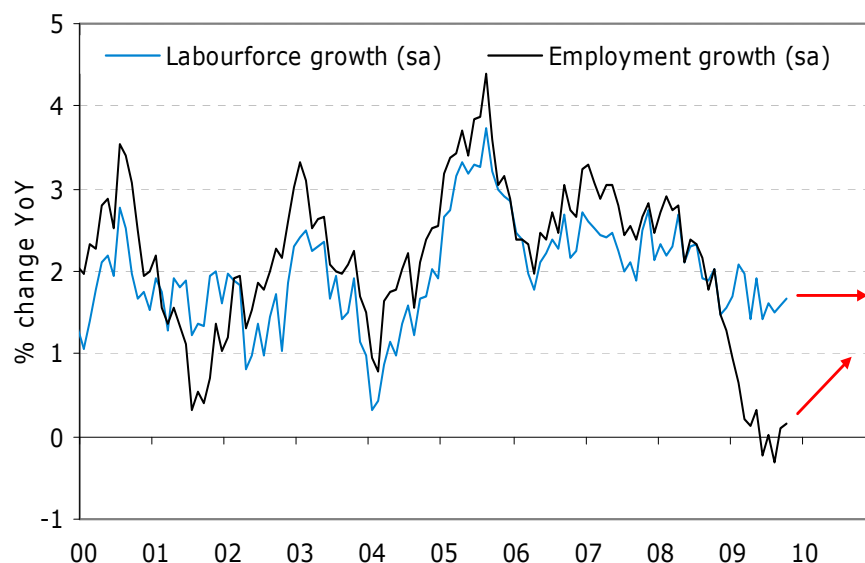
The monthly labour force numbers again surprised the market today. Total employment grew 24.5K in October (up 0.2% MoM and 0.2% YoY), well beyond consensus expectations for a fall of 10K. Almost all of this month's increase in jobs was in part time work, up 21.9K rather than full time work which were up only 2.9K.

Both September and October 2009 delivered surprisingly good national jobs growth, particularly for such an early stage in this recovery cycle. While jobs growth is still weak in absolute terms (and is zero in trend terms), the direction is now clearly up. As always, some of the detail beneath the headlines is not so positive; full-time employment is still 1.7% lower than a year ago and total aggregate hours worked are still 1.3% lower than a year ago. So although the headcount is up, the total amount of work (and by implication the total amount being earned as real wages and salaries), is not. Such 'under-employment' is however, far preferable to outright unemployment.

The unemployment rate remained relatively stable in October, drifting from 5.7% to 5.8%. It has now been in this range for the past 6 months. Despite positive jobs growth, this month saw an additional 11,000 people become unemployed, pushing the total 171,000 (or 34%) higher than at the same time last year. The reason for this increase in unemployment has been continuing labour force growth (due to strong population growth and relatively high participation rates), at a time when jobs growth has been negative or weak.

In the past two months for example, 64,000 jobs were added nationally, but 71,000 more people joined the labour force. Looking forward, labour force growth is likely to stay stronger than jobs growth for at least the next 6 months, a situation that will see the unemployment rate drift up toward 6.5% by mid-2010, before jobs growth accelerates to a rate that can bring it down again. This long time lag between improving economic conditions and subsiding unemployment is a normal feature of recovery from recessions (or even from near-recessions). As such, it should not be considered a cause for concern to either the RBA or to policy-makers.

Figure 3. Jobs growth must catch up to labour force growth before unemployment can begin to fall



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AUD/USD RALLY RETURNS ON IMPROVEMENT IN RISK APPETITE

A renewal in risk appetite, solid local economic data and increased market confidence of an RBA rate hike in December have boosted the AUD/USD to new 2009 highs around 0.9360. With little on the domestic data front next week, look to offshore events to dominate AUD/USD moves. US consumer confidence data for November, and advance retail sales and industrial production data for October will be the key highlights for AUD/USD direction over the week ahead. AUD/USD sellers should keep an eye on our topside target of 0.9400-10, while buyers may wish to take advantage of dips below 0.9180 and towards the sub-0.90 level if the offshore economic action disappoints.

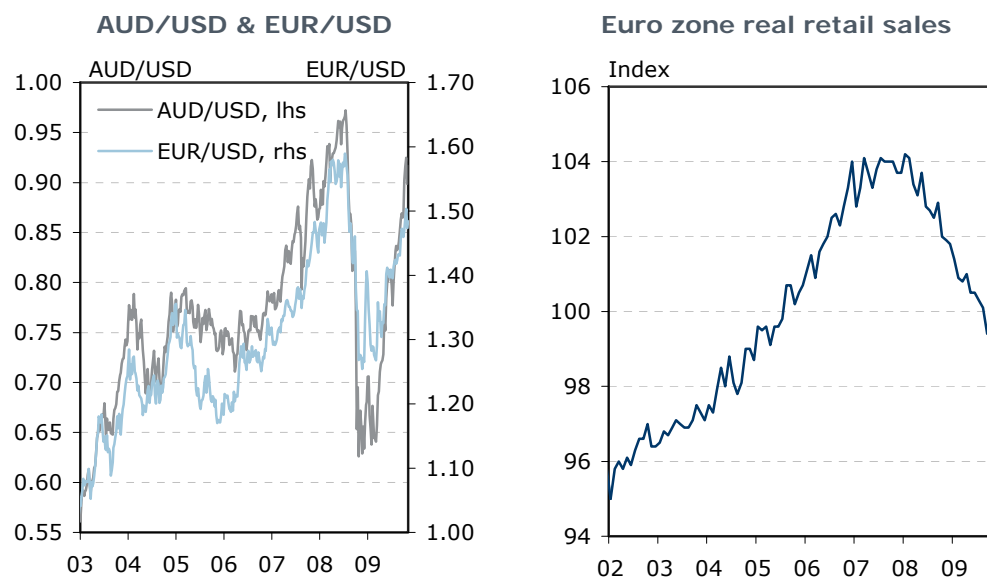
AUD/USD Key Levels: 0.8990 – 0.9410

EUR/USD rides the reflation wave, but AUD/USD to outperform

There has been a substantial rally in the EUR/USD since the depths of the global financial crisis were reached in late 2008. Indeed, since the trough in equity markets in mid-March 2009, moves in the currency have been akin to those seen in the AUD/USD, with the EUR/USD improving to 1.50 in recent weeks, over 20% above its March trough below 1.25. The major drivers of this move have been clear, with a weaker USD driven by a turnaround in risk appetite supporting a rebound in global equities and other risk assets, combined with higher Euro zone interest rates relative to those in the US.

But unlike the solid and improving Australian economic landscape, there remain a number of headwinds to the Euro zone outlook. While there has been a bounce back in manufacturing surveys to (mildly) expansionary levels of activity, this improvement has not translated through to the consumer sector. The level of real retail sales in the Euro zone has been falling since early 2008 and is yet to show signs of recovery, with real spending now down to mid-2005 levels. A major reason is persistent weakness in the labour force, with the unemployment rate worsening to 9.7% in September (and to a staggering 19.3% in Spain). Consumer confidence also remains subdued, tracking well below its long-run average. Further, the extent of issues still to surface in the European banking system remains unclear (due to different regulatory requirements to those in the US and Australia) – a higher cost of credit will most likely result from an expected rise in capital requirements, and subsequently weaken the anticipated economic recovery.

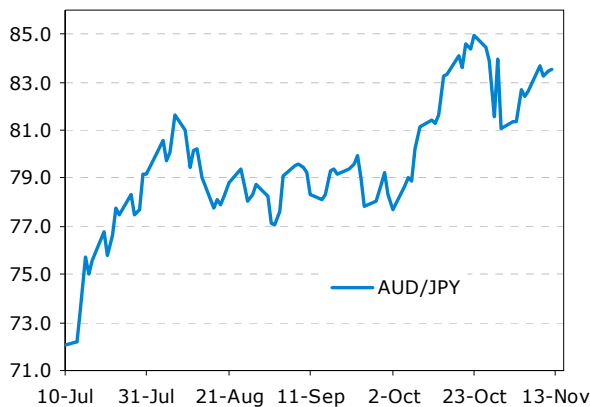
Figure 4. AUD & EUR are pro-cyclical currencies, but Euro zone consumers are still not spending like their Australian counterparts



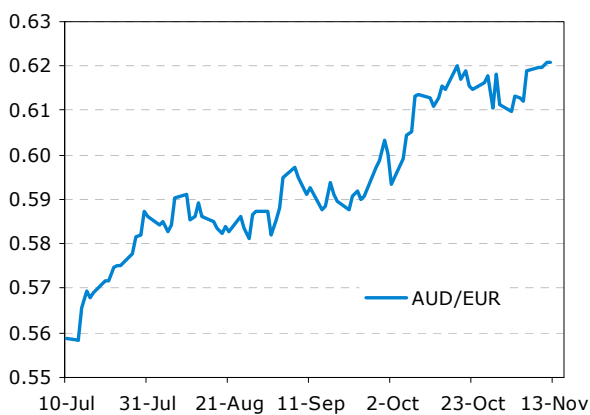
Sources: Bloomberg and ANZ.

So while the EUR/USD may continue to benefit from the global reflation trade in the near-term, the challenging fundamentals facing the Euro zone economy over the medium to longer-term should ultimately weigh on the currency. We forecast EUR/USD will dip below 1.40 in H2 2010 as a result. Meanwhile, the outperformance of the AUD/USD is expected to persist, with AUD/EUR projected to appreciate into the mid-0.60s over H1 2010.

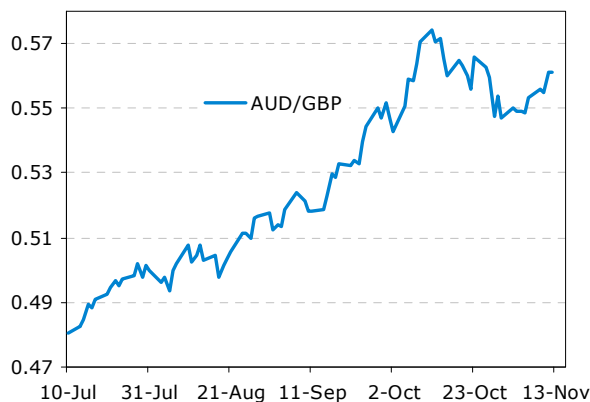
AUD CROSS VIEW

**AUD/JPY Key levels: 81.50 – 85.10**

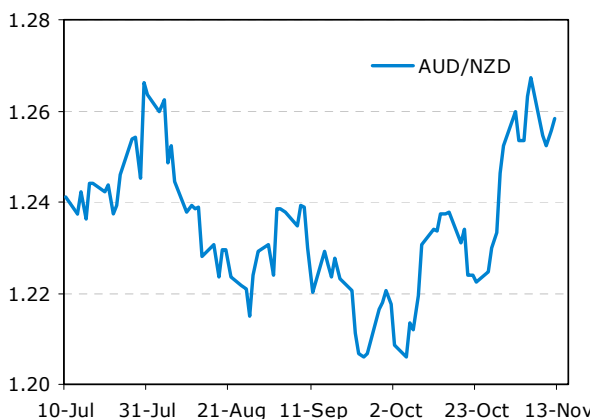
- It has been one-way traffic for the AUD/JPY this week, surging 2% despite the release of strong Japanese machine orders data (machine orders are a leading indicator of capital spending). Rallies in this cross may find resistance at the topside of our range around 85.10, with solid downside support found at 81.50.
- A busy week on the Japanese data front kicks off tomorrow with industrial production and consumer confidence. But the market's interest will be most keenly focused on next week's Q3 GDP results and commentary from the BoJ following its interest rate decision.

**AUD/EUR Key levels: 0.6140 – 0.6340**

- With weaker than expected Euro zone retail sales figures countered by stronger Australian economic data this week, the AUD/EUR has rallied to a fresh 20-month high. Persistent attempts to break above 0.62 have paid off, with the cross currently trading around 0.6230. Dips next week should be limited to 0.6140.
- Euro zone Q3 GDP data will be a key driver of direction for AUD/EUR over the coming week. Market disappointment following a weaker than expected figures, combined with persistent AUD momentum could see the cross extend toward 0.6390. Also watch the release of trade balance, inflation, current account figures.

**AUD/GBP Key levels: 0.5540 – 0.5740**

- It has been onwards and upwards for the AUD/GBP, the cross gaining over 2% in the last seven days. The GBP floundered after the BoE released a weak UK economic outlook and failed to rule out the possibility of further quantitative easing.
- BoE minutes, and UK retail sales and CPI figures due for release next week will be key for direction of the cross. Better than expected data may give GBP/USD a boost and see AUD/GBP test the lower end of our range at 0.5545. However, should the data disappoint and the BoE's minutes have a dovish tone, we may see the cross head towards 0.5740.

**AUD/NZD Key levels: 1.2490– 1.2790**

- Strong figures released from New Zealand's Fonterra group early this week boosted the NZD, prompting AUD/NZD to fall sharply below 1.25. But weaker than expected NZ employment and retail sales data, combined with upbeat Australian employment data has caused the cross to steadily regain over half of these losses to be trading back above 1.26.
- Q3 PPI is the key economic release out of NZ next week. Support at AUD/NZD1.2490 should be expected to hold if stronger than expected data are released, with spikes limited to 1.2790 on any upside surprises.

FORECASTS

Australian Economic indicators		2008	2009f	2010f	2011f
Economic activity (annual % change)					
Private final demand		4.4	-0.2	1.8	4.1
Household consumption		2.6	1.4	1.6	3.1
Dwelling investment		2.8	-7.4	4.8	5.4
Business investment		13.9	-3.1	1.1	7.0
Public demand		6.2	2.6	7.0	4.4
Domestic final demand		4.8	0.4	3.0	4.2
Inventories (contribution to GDP)		-0.7	-0.4	0.7	-0.1
Gross National Expenditure (GNE)		4.1	0.1	3.7	4.1
Exports		3.8	1.2	1.8	4.6
Imports		11.3	-9.6	6.9	9.5
Net Exports (contribution to GDP)		-1.8	2.6	-1.1	-1.2
Gross Domestic Product (GDP)		2.4	1.0	2.6	3.2
Prices and wages (annual % change)					
Inflation:	Headline CPI	4.4	1.9	2.3	2.5
	Underlying*	4.4	3.8	2.9	2.5
Wages		4.2	3.6	2.9	3.3
Labour market					
Employment (annual % change)		2.2	0.2	1.4	2.2
Unemployment rate (%)		4.3	5.7	6.4	6.2
External sector					
Current account balance:		-54.5	-48.2	-54.6	-60.7
% of GDP		-4.6	-4.0	-4.3	-4.5

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
RBA cash rate	3.50	3.75	4.25	4.25	4.25	4.25
90 day bill	4.03	4.15	4.60	4.50	4.50	4.50
3 year bond	5.06	5.15	5.35	5.25	5.05	5.30
10 year bond	5.59	5.45	5.60	5.55	5.45	5.60
3s10s yield curve	0.53	0.30	0.25	0.30	0.40	0.30
3 year swap	5.67	5.60	5.80	5.70	5.50	5.75
10 year swap	6.21	6.05	6.20	6.10	6.00	6.15

International interest rates

RBNZ cash rate	2.50	2.50	2.50	2.50	3.00	4.00
NZ 90 day bill	2.83	2.80	2.80	2.80	3.63	4.47
US Fed funds note	0.25	0.25	0.25	0.50	1.00	1.75
US 2 year note	0.80	1.20	1.50	1.75	2.00	2.35
US 10 year note	3.44	4.20	4.40	4.55	4.50	4.55
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.25
ECB refinance rate	1.00	1.00	1.00	1.00	1.00	1.25
UK repo rate	0.50	0.50	0.50	0.50	0.50	1.00

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

FORECASTS

Foreign exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
Australian exchange rates						
A\$/US\$	0.9345	0.90	0.94	0.96	0.92	0.90
NZ\$/US\$	0.7410	0.70	0.72	0.73	0.71	0.70
A\$/¥	83.89	84.6	85.5	84.5	82.8	82.8
A\$/€	0.6230	0.63	0.64	0.65	0.64	0.64
A\$/£	0.5631	0.56	0.57	0.58	0.56	0.55
A\$/NZ\$	1.2611	1.29	1.31	1.32	1.30	1.29
A\$/CA\$	0.9757	0.97	0.98	0.98	0.96	0.95
A\$/CHF	0.9410	0.95	0.97	0.97	0.95	0.96
A\$/CNY	6.3795	6.15	6.42	6.56	6.20	5.99
A\$ Trade weighted index	71.70	71.3	73.5	74.7	72.1	70.2
International cross rates						
US\$/¥	89.77	94.0	91.0	88.0	90.0	92.0
€/US\$	1.5000	1.44	1.46	1.48	1.43	1.41
€/¥	134.65	135	133	130	129	130
£/US\$	1.6597	1.62	1.64	1.66	1.64	1.65
€/£	0.9038	0.89	0.89	0.89	0.87	0.85
US\$/CA\$	1.0441	1.08	1.04	1.02	1.04	1.05
US\$/CHF	1.0069	1.05	1.03	1.01	1.03	1.07
US\$ index	75.00	78.1	76.5	75.1	77.2	78.2
Asia exchange rates						
US\$/CNY	6.8266	6.83	6.83	6.83	6.74	6.66
US\$/HKD	7.7501	7.75	7.75	7.76	7.77	7.77
US\$/IDR	9397	9100	9300	9500	9300	9000
US\$/INR	46.46	47.0	46.5	46.0	46.0	45.0
US\$/KRW	1158	1125	1100	1150	1175	1050
US\$/MYR	3.3804	3.41	3.34	3.37	3.40	3.40
US\$/PHP	46.670	47.0	46.0	46.5	46.0	45.0
US\$/SGD	1.3863	1.40	1.39	1.40	1.41	1.41
US\$/THB	33.290	33.00	33.00	33.00	32.50	32.50
US\$/TWD	32.295	31.90	31.50	31.90	31.50	30.50
US\$/VND	17867	18000	18200	18350	18500	19300
Pacific exchange rates						
PGK/US\$	0.3830	0.374	0.392	0.381	0.395	0.386
FJD/US\$	0.5305	0.520	0.534	0.542	0.527	0.519

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