

## Labour market holds up, rates and FX don't

15 January 2009

### Macro Update: Labour market holds up, for now

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- However, a look at the composition of employment data by industry is worrying, with the country's largest employers (by sector) highly cyclical and vulnerable during the gathering economic downturn.

### Interest Rate Markets: Yields hit fresh lows

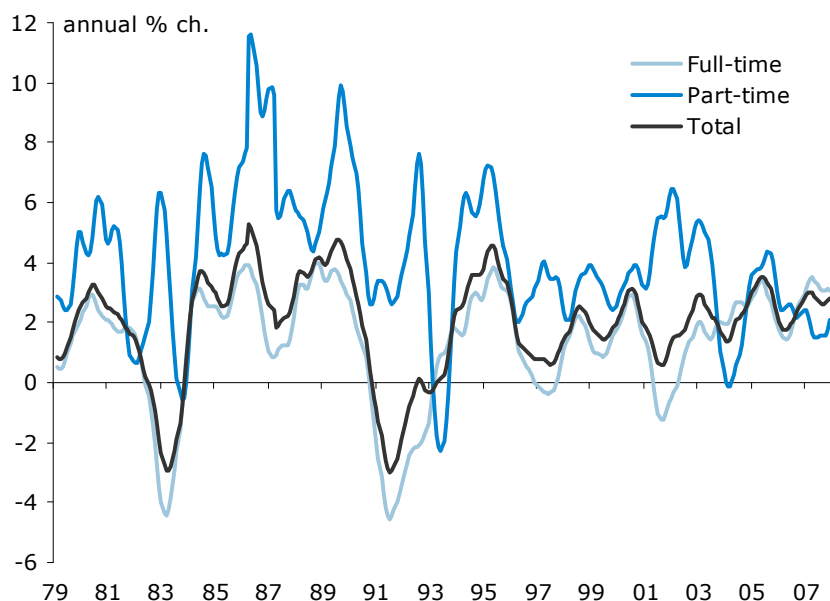
- Australian interest rates hit fresh 40 year lows this week as concerns intensified over global and local growth prospects. The market now expects the RBA to cut its official interest rate to below 3.0% by June-09, including a 75bps cut in February.
- The rally in local interest rate markets continues to present good opportunities for hedging medium-term floating debt. S&P's decision this week to place a negative outlook on a range of countries with large current account deficits is a reminder of the upside risks to yields and swap spreads from Australia's external imbalances.

### FX: AUD's wide trading range

- The AUD/USD looks set to return to its October-December trading range of 0.6350-0.6850, with thin liquidity exacerbating large intra-day moves.

### Chart of the week

Figure 1: Annual Employment growth: by composition



Source: ANZ and Bloomberg

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## Macro Update: Labour market holds up, for now

- To date, the weakness foreshadowed by forward looking indicators of the labour market has not been fully reflected in the official labour market data.
- While a significant adjustment still lies ahead, there are good reasons to believe the unemployment rate will not rise as much as in previous downturns.
- However, a look at the composition of employment data by industry is worrying, with the country's largest employers (by sector) highly cyclical and vulnerable during the gathering economic downturn.

### How high will unemployment eventually go?

Prospects for Australia's labour market came into focus this week. ANZ job advertisements have been falling for 8 consecutive months and dropped 9.7% alone in December. Newspaper job advertisements have now dropped a massive 33% in the past three months, the largest three-monthly fall in the history of the series which commenced in 1975.

**The weakness foreshadowed by such forward-looking indicators has not yet been fully reflected in the official labour force statistics.** Total employment dropped just 1.2K in December, although the warning signals are there with a rotation away from full-time towards part-time employment evident (see Chart of the week). This is common during economic downturns, as employers prefer to cut back workers' hours as a first measure, and is often associated with sharply weaker aggregate employment growth.

How the labour market evolves going forward will be critical in determining the extent and duration of Australia's economic slowdown. In the near term, all forward-looking indicators point to further weakening, most notably the ANZ job ads series, which at the moment suggests small monthly falls in employment of around 5,000 per month for the next 3 to 6 months.

**There are some reasons to believe that the unemployment rate will not rise as much as during the recessions of the early 1980s and early 1990s,** when the unemployment rate rose by at least 5%. Importantly, business balance sheets are healthier (on average) than prior to previous downturns, with debt-to-equity ratios lower and interest cover ratios higher. In addition, this downturn has not been preceded by a sharp rise in real wages. That is, workers have not on the whole priced themselves out of a job.

**However, a look at the composition of employment by industry is not particularly encouraging either,** with the largest industries (by employment) highly cyclical and vulnerable during an economic downturn (with the exception of the health sector). The top employers by industry as of November were retail (14% of total employment), property and business services (11.9%), health (10.6%), manufacturing (10.0%) and construction (9.3%).

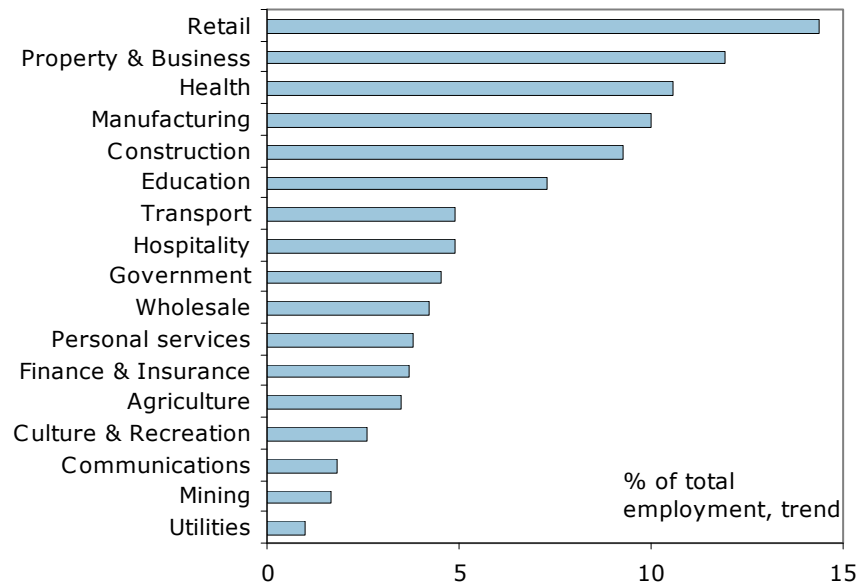
Looking firstly at **retail employment**, the outlook will hinge on the response of Australian household spending to large interest rate cuts, lower petrol prices and government cash handouts. Retail sales seem to have stabilised or even improved in recent months, but it remains to be seen whether this improvement will last amidst the destruction of household wealth stemming from the equity market and concern about the jobs outlook itself.

Employment in **property and business services** led the downturn in employment during the slowdown in 2000 and 2001 surrounding the tech wreck, as companies exposed to the finance sector were unable to hold on to staff. This industry also looks highly vulnerable in 2009 given lower expected profitability which will see a broad range of industries cut back on services from other businesses. Lower turnover (and potentially falling prices) in residential and non-residential real estate will also weigh on this sector.

**Construction** of both residential and non-residential properties is also likely to fall going forward, and is likely to translate into weaker employment. Sharply

lower building approvals now suggest a fall in residential dwelling investment of 4% in 2009 and reduced access to finance in commercial property suggests a similar fall is likely for investment in non-residential construction.

**Figure 2: Employment by industry (as at November 2008)**



Source: ABS

**Manufacturing employment** is also highly exposed to weakening global demand, although some support will come from the now more competitive level of the Australian dollar for exporters and import-competing firms, as well as from the government's latest assistance package to the motor vehicle industry. However manufacturing employment is already down 2.4% over the year to November and we have not yet seen the full ramifications of the unusually synchronised downturn in global growth.

Recent job loss announcements in the media have been concentrated on the mining and finance sectors. While these are undoubtedly bad news, it is important to point out that these industries are relatively small employers (making up 1.7% and 3.7% respectively) and are unlikely to drive the slowdown in employment overall; that will fall to the other larger sectors mentioned above.

Overall, it seems that Australia will experience a significant adjustment in the labour market. ANZ is forecasting a rise in the unemployment rate to 6% by the end of 2009 and to 6.5% by the middle of 2010, with the risks to these forecasts tilted to the upside. This will be milder increase in unemployment than during the recessions of the early 1980s and 1990s, although will be a painful period for many.

### Data wrap

Key points to note from this week's economic releases are:

- The **ANZ Job Advertisements Series** fell 9.7% in December, reflecting a 13.9% fall in newspaper ads and a 9.5% fall in internet job ads. Over the year to December, total job ads were down 29.9%, with newspaper ads down 51.8% lower and internet ads down 28.1%.
- **Housing finance data** showed a 1.3% rise in the number of approvals for owner occupiers in the month of November. The value of approvals for owner occupiers also rose (+1.4%), although this was offset by a 6.1% drop in the approvals for investors which saw the total value of housing loan approvals down by 0.9%. The proportion of first homebuyers seeking approvals jumped to 23.6%, the highest proportion since January 2002.
- **Labour force data** showed a fall in employment of 1.2K in December, with full-time employment dropping 43.9K and part-time employment up 42.8K. The unemployment rate rose to a 2-year high 4.5% notwithstanding another small fall in the participation rate to 65.0%.

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## Interest Rate Markets: Yields hit fresh lows

- Australian interest rates hit fresh 40 year lows this week as concerns intensified over global and local growth prospects. The market now expects the RBA to cut its official interest rate to below 3.0% by June-09, including a 75bps cut in February.
- ANZ's forecast is for the RBA to cut interest rates by 50bps to 3.75% in February and to 3% by Sep-09. Recent poor local data confirms the risks are for a bigger cut in February. However expectations for further cuts to below 3.0% by mid-09 looks too aggressive given the impact of the government's fiscal boost is still washing through households.
- Local swap spreads have widened this week on heightened risk aversion. S&P has downgraded or put on negative outlook/watch a number of countries with large current account deficits. While Australia's rating was affirmed, our CAD remains a key vulnerability to foreign investor flight.

### Recommendation

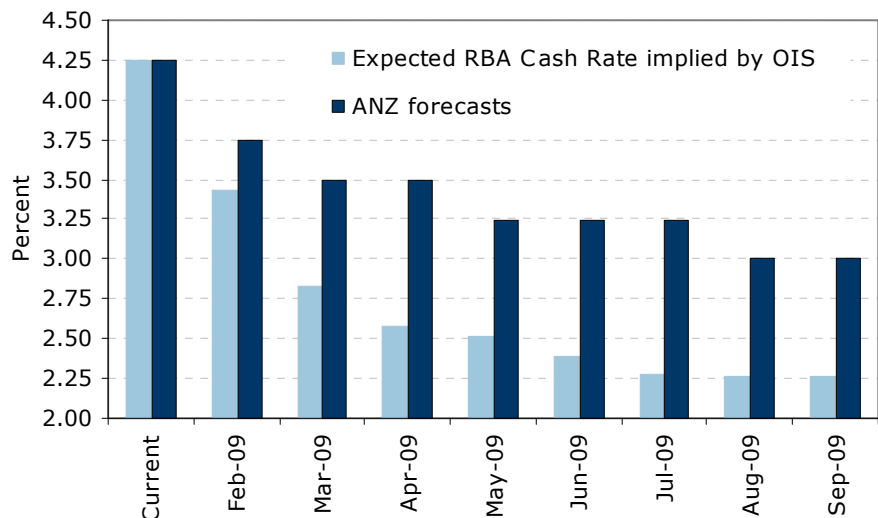
A significant rally in local rates market this week has provided further opportunities to hedge floating rate debt for the medium-term.

### Overview

Australian interest rates plumbed fresh 40-year lows this week as concerns intensified over global and local growth prospects. The implied yield on the Australian Government 3-year bond has fallen nearly 40bps to 3.02% and the implied yield on the Australian Government 10-year bond has fallen around 25bps to just 3.88%. Despite some widening in swap spreads, swap rates have also been dragged lower; The Australian 3-year swap rate has fallen more than 30bps to a fresh low of 3.559%.

A solid rally in US treasuries, as the economic data there continues to print worse than expected, has pulled local bonds higher. Indeed, Australian bonds have outperformed US treasuries. This mainly reflects the fact that the RBA, with its official cash rate at 4.25%, still has significant scope to cut interest rates. In contrast, the Fed has already cut its Fed funds rate as low as possible (to a target of 0 to 0.25%) and is now moving to other policy options to spur lending growth, collectively referred to by Chairman Bernanke this week as "credit easing".

**Figure 3: Market expectations are for deep rate cuts**



Source: ANZ and Bloomberg

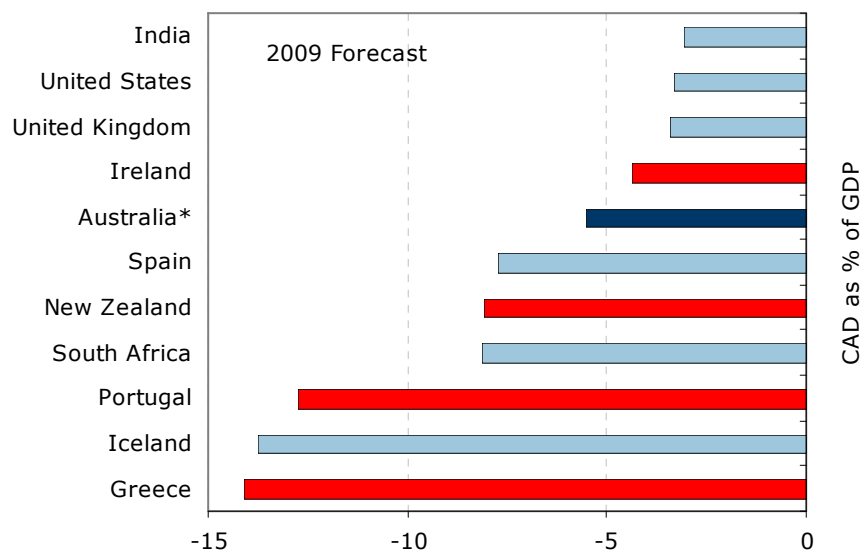
Following this week's poor local and global data, the OIS market is now pricing the RBA to cut its official cash rate by 75bps at its February Board meeting. The market is then looking for further aggressive easing, to take the cash rate below 3.0% by June. While our current forecast is for the RBA to cut the cash rate by 50bps at February, we agree that the recent run of poor data increases the risk for a bigger cut. However, as outlined before, with monetary policy now at a clearly stimulatory stance and the AUD weakening again, we expect the RBA will adopt a more measured approach as real rates drop below zero. Moreover, fiscal policy has provided good support to the household sector in December and should continue to buffer household incomes over Q1. If the RBA were to cut rates below 3.0%, we expect that would most likely be a H2, not H1 story, and would most likely be prompted by a faster and sharper rise in the unemployment rate than the central bank anticipates. As such, as outlined last week, we continue to see the current record low levels of interest rates as presenting opportunities for hedging medium-term floating rate debt.

**Local swap spreads widen**

Local swap spreads have come off their lows this week, albeit to levels that are still well below last year's record wides. The 2-year swap spread has widened from a low of 17bps in early January to now be back at 30bps. The 5-year swap spread has widened by almost 10bps over this period to 98bps. This has occurred despite the fall in bond yields and a further normalisation of interbank markets offshore. In the US, the spread between 3-month interbank and OIS rates has narrowed to a 5-month low of around 90bps this week.

The widening of local swap spreads is not surprising given the return of risk aversion this week. Markets were also reminded of Australia's external vulnerabilities. S&P reviewed a range of countries with large current account deficits, downgrading Greece, putting Spain and Portugal on watch negative, Ireland on negative outlook and changing New Zealand's foreign currency outlook to negative. S&P confirmed Australia's AAA rating and indeed we would be surprised to see Australia's credit rating threatened. Nevertheless, as commodity contract prices crash this year, Australia's current account deficit is on track to re-widen from 3% of GDP towards 6%. The burden of funding this swelling deficit, and the likelihood that the Commonwealth budget will fall into deficit for at least this year, is a significant upside risk to both bond yields and swap spreads in the year ahead.

**Figure 4: A still large current account deficit keeps Australia vulnerable**



Source: ANZ and IMF, \*ANZ forecasts, otherwise IMF forecasts

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## FX: AUD's wide trading range

### Recommendation

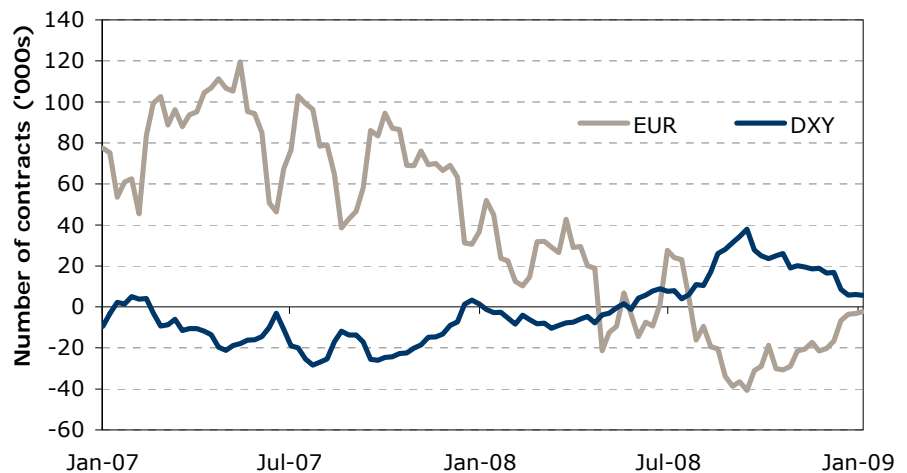
Volatility has returned to the spot market, and is likely to remain over the coming week. Thin liquidity is exacerbating large intra-day moves, and warrants caution. The AUD/USD looks set to return to its October-December trading range of 0.6350-0.6850. AUD/NZD is one cross with prospects to grind higher.

### Overview

The AUD has sold off against the USD since last week, reaching a low of AUD/USD 0.6562 after last week's high of 0.7268. Behind this sell-off is a strong rally in the USD, caused by a number of factors. First, poor November data out of the EU led the market to increase its expectations for interest rate cuts by the European Central Bank. Second, Standard & Poor's announced it will review and likely downgrade the sovereign credit ratings of Spain and Portugal; Ireland's rating outlook was moved to negative; and Greece's rating was cut to A-/A-2 (with a stable outlook) from A-/A-1 on 14<sup>th</sup> January. This deepened concerns about the outlook for the Euro area, and took EUR/USD from a high of 1.3963 last week to a low of 1.3093 this week. Also contributing to USD strength has been a sell-off in the global equity markets, which are down 5-7% from last week's highs. The GBP faltered in this environment, and JPY strengthened marginally.

While the USD is prone to strengthen during times of financial market stress, we view this current rally as having solid legs. Unlike the sharp USD rally of September-November that was driven by a sudden demand for cash and liquidity squeeze, offshore market conditions are improving as evidenced by the continued declines US\$ LIBOR yields. Further, the market has a flat position in the EUR and in the USD index broadly; there is no forced position unwinding. Rather, this rally is the result of a shifting fundamental view that conditions outside the US are worsening more than had previously been expected, bringing the USD to be viewed favourably on a relative basis.

**Figure 5: Market is flat in USD index (DXY) and EUR**

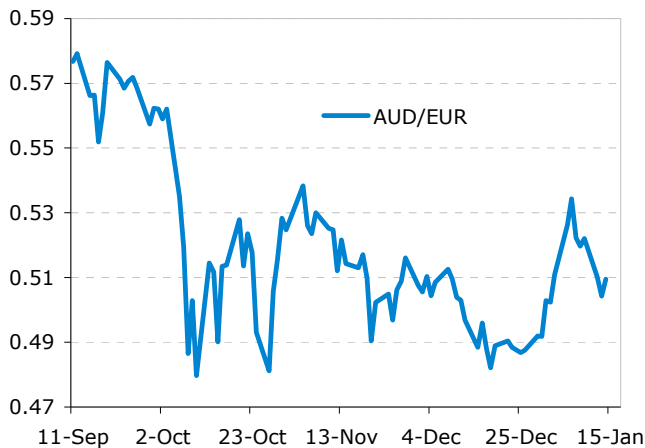


Source: IMM

With this latest sell off, we now view AUD/USD as close to fair value in a range of 0.63-0.66. We expect a wide trading range with intra-day volatility to dominate, but for the overall direction of the AUD to remain on a downward bias. Two important short-term supports for the AUD are the increased offshore debt issuance by Australian banks, and the tentative stabilising of commodity prices. Weighing on the AUD, however, are the fluctuations in the global share markets – creating shifty investor appetite – as well as uncertainty over the outlook for iron ore prices in 2009 as negotiations get underway.

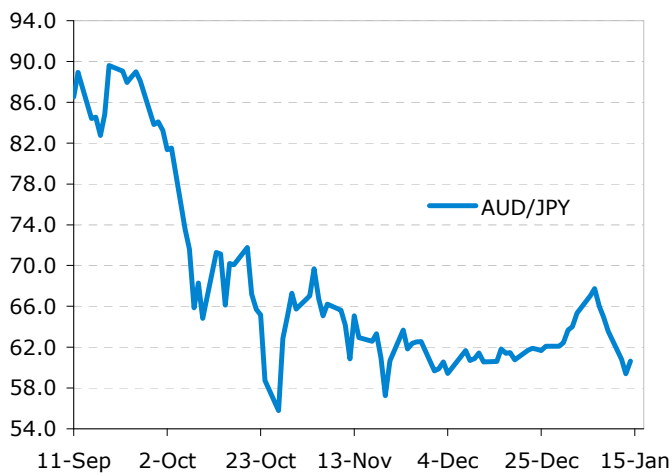
**AUD/USD Key levels: 0.6400 – 0.6870.** The AUD needs to get past 0.6870 to re-establish any base above 0.7000. There is strong support around 0.6400 to avoid moving back toward the October lows of 0.6009.

## AUD cross view



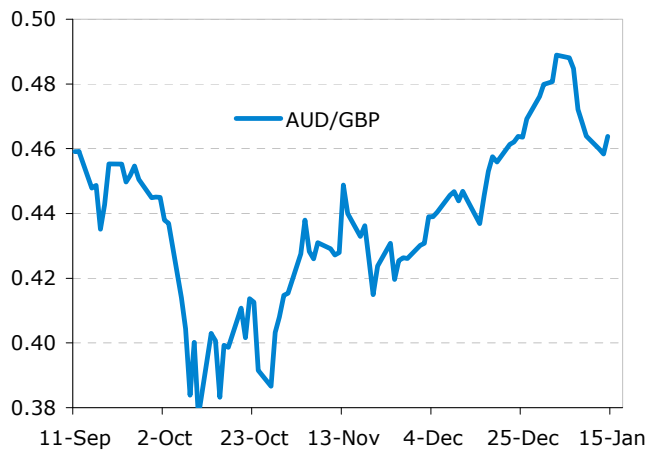
### AUD/EUR Key levels: 0.4980 – 0.5260

- EUR/USD sold off on weaker data and S&P downgrades, but bounced off 1.32. The ECB rate decision is tonight; a data-heavy calendar for the US may mean further upside than downside for EUR in the short term, toward EUR/USD1.36.
- Though the AUD was highly correlated with the EUR throughout the second half of 2008, it has held in well during this recent EUR selloff.
- A move down in AUD/EUR failed to break below the 0.5000 level and 0.4980 remains strong support, while 0.5260 is resistance.



### AUD/JPY Key levels: 57.10 – 68.75

- The selloff in equity markets took AUD/JPY back below the key level of 60, but only briefly.
- The market's strong net long position in JPY combined with the BOJ's intervention at USD/JPY87-88 in November is making it difficult for the JPY to rally much further against the USD, even in a declining share market environment.
- As such, AUD/JPY57.10 remains a useful support level, while topside remains 68.75 for this volatile cross.



### AUD/GBP Key levels: 0.4400 – 0.4720

- The BOE cut its benchmark interest rate by 50 bps as expected last week. GBP has not benefited from the bounce in the EUR, and GBP/USD remains under pressure with risks to the downside. One support for the GBP is that the market is short.
- With the AUD weakening, the rally in AUD/GBP has levelled out but AUD has not lost much ground. An important base seems to have formed around the 0.4500 level, just above the 50-day moving average.
- Topside resistance can be expected at 0.4720.



### AUD/NZD Key levels: 1.1940-1.240

- The AUD/NZD rallied hard this week on poor NZ data that saw the market price in a 75-100 bps cut from the RBNZ on 29 January.
- Adding to the NZD's woes was S&P's decision to move its outlook on NZ's sovereign foreign currency debt rating from stable to negative. This does not imply any immediate action, however.
- The news was enough to take NZD/USD down five cents, to a low of 0.5336. The AUD/NZD had a big move up to 1.2192, and it looks as though 1.24 may be achievable in the coming weeks.

## ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
<b>Economic activity (annual % change)</b>				
Private final demand	6.0	3.7	-1.0	1.4
Household consumption	4.3	2.1	0.3	1.4
Dwelling investment	2.7	0.9	-4.2	17.8
Business investment	13.9	12.4	-3.2	-4.5
Public demand	2.7	5.7	3.7	2.4
Domestic final demand	5.4	4.1	0.0	1.6
Inventories (contribution to GDP)	0.6	-0.2	-0.1	0.0
Gross National Expenditure (GNE)	5.9	3.9	-0.1	1.6
Exports	3.3	5.1	-1.5	3.1
Imports	11.4	11.8	-2.4	1.3
Net Exports (contribution to GDP)	-1.7	-1.6	0.3	0.3
<b>Gross Domestic Product (GDP)</b>	<b>4.0</b>	<b>2.3</b>	<b>0.4</b>	<b>2.1</b>
<b>Prices and wages (annual % change)</b>				
Inflation: Headline CPI	2.3	4.4	2.9	2.9
Underlying*	3.1	4.5	3.5	2.8
Wages	4.1	4.2	3.6	3.5
<b>Labour market</b>				
Employment (annual % change)	2.8	2.2	-0.2	0.4
Unemployment rate (%)	4.4	4.3	5.6	6.5
<b>External sector</b>				
Current account balance: A\$ bn	-68.2	-52.0	-66.9	-83.6
% of GDP	-6.3	-4.4	-5.5	-6.6

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

Australian interest rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
RBA cash rate	4.25	3.50	3.25	3.00	3.00	3.00
90 day bill	3.92	4.00	3.75	3.70	3.75	3.75
3 year bond	2.80	3.40	3.40	3.45	3.60	4.00
10 year bond	3.86	4.15	4.40	4.35	4.40	4.80
3s10s yield curve	1.06	0.75	1.00	0.90	0.80	0.80
3 year swap	3.59	4.05	3.95	3.95	4.10	4.55
10 year swap	4.27	4.65	4.90	4.85	4.90	5.50
<b>International interest rates</b>						
RBNZ cash rate	5.00	3.50	3.25	3.25	3.25	3.25
NZ 90 day bill	4.35	3.79	3.60	3.52	3.50	3.50
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.69	0.60	0.70	0.75	1.00	1.50
US 10 year note	2.18	2.90	3.20	3.75	3.80	4.20
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.50
ECB refinance rate	2.50	1.75	1.50	1.50	1.50	1.75
UK repo rate	1.50	1.00	0.75	0.75	0.75	1.00

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

Foreign exchange rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
<b>Australia and NZ exchange rates</b>						
A\$/US\$	0.6572	0.63	0.58	0.56	0.54	0.54
NZ\$/US\$	0.5344	0.52	0.47	0.45	0.44	0.45
A\$/¥	58.40	61.74	58.00	56.56	55.08	56.70
A\$/€	0.4994	0.50	0.48	0.50	0.50	0.50
A\$/£	0.4501	0.43	0.41	0.40	0.39	0.39
A\$/NZ\$	1.230	1.21	1.23	1.24	1.23	1.20
A\$/CA\$	0.8191	0.76	0.70	0.69	0.70	0.71
A\$/CHF	0.7338	0.76	0.72	0.75	0.76	0.77
A\$/CNY	4.493	4.31	3.98	3.84	3.69	3.69
A\$ Trade weighted index	54.00	52.82	49.50	48.56	47.12	47.06
<b>International cross rates</b>						
US\$/¥	88.9	98	100	101	102	105
€/US\$	1.316	1.25	1.20	1.12	1.08	1.08
€/¥	117.0	123	120	113	110	113
£/US\$	1.460	1.46	1.43	1.41	1.40	1.40
€/£	0.9014	0.86	0.84	0.79	0.77	0.77
US\$/CA\$	1.246	1.20	1.20	1.24	1.30	1.32
US\$/CHF	1.116	1.20	1.24	1.34	1.40	1.42
US\$ index	84.32	87.8	90.6	95.3	98.1	98.7
<b>Asia exchange rates</b>						
US\$/CNY	6.836	6.84	6.86	6.86	6.84	6.84
US\$/HKD	7.758	7.76	7.77	7.80	7.80	7.80
US\$/IDR	11182	16000	14600	14200	13500	12400
US\$/INR	49.13	50.00	49.00	49.00	48.00	48.00
US\$/KRW	1373.85	1475	1500	1450	1400	1350
US\$/MYR	3.591	3.60	3.64	3.74	3.80	3.80
US\$/PHP	47.29499	50.26	52.50	54.10	55.20	55.00
US\$/SGD	1.497	1.54	1.58	1.62	1.66	1.66
US\$/THB	34.90	35.80	37.60	39.40	39.40	38.75
US\$/TWD	33.32	34.00	35.20	36.00	36.00	36.00
US\$/VND	17481	17400	17800	18100	18500	18500
<b>Pacific exchange rates</b>						
PGK/US\$	0.379	0.37	0.37	0.36	0.35	0.35
FJD/US\$	0.550	0.53	0.51	0.49	0.48	0.48

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