

Economy and rates on the up

15 October 2009

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Macroeconomic update: jobs and confidence returning

- Jobs growth is looking positive, with several forward indicators picking up.
- But unemployment will still rise from here, largely for demographic reasons.
- Business and consumer confidence is rebuilding nicely – a necessary (but not sufficient) condition to future business investment, jobs and activity.

Interest rates: RBA to continue hiking

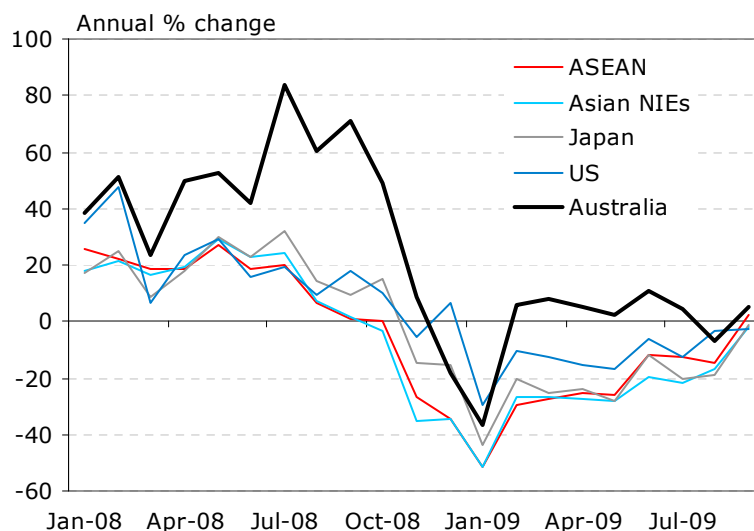
- Solid confidence data gives the RBA no reason for pause at their November meeting, however a December hike may rely on data flow.
- The RBA will likely continue to tighten policy into early next year before pausing to assess the impact on the domestic economy.

FX: Upside risks to AUD/USD build further

- The AUD/USD moved to a new 14-month high this week as investor sentiment was boosted by a solid kick-off to the US Q3 corporate reporting season, better than expected Chinese economic data and upbeat comments from RBA Governor Stevens.
- With the RBA's October board minutes the only domestic economic release of note next week, look to offshore events, particularly the US company earnings announcements, to continue to dominate AUD/USD moves.

Chart of the week: Chinese imports strengthen

Figure 1: Chinese imports from selected source countries/regions



Source: Bloomberg.

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Macro update: jobs and confidence returning

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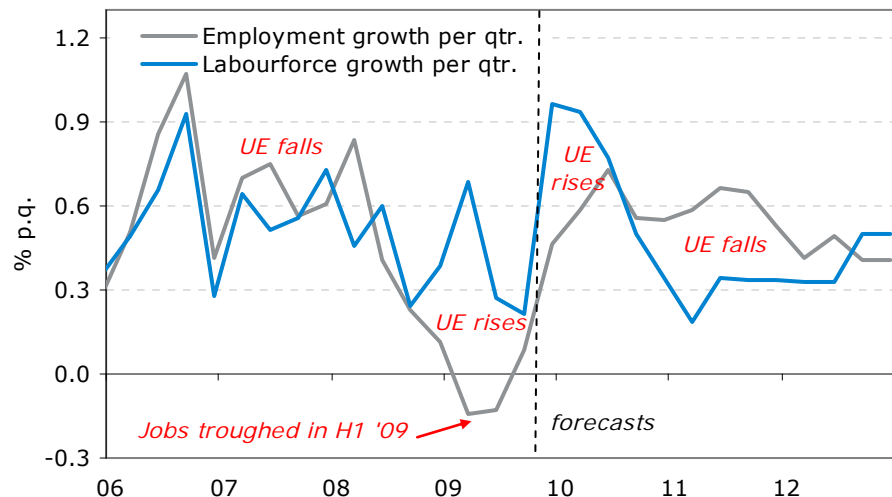
Jobs growth is picking up ...

Net employment growth (total jobs) fell in Q1 and Q2 2009 but showed a surprise recovery in Q3. This recovery phase has begun earlier than most economists had expected at this point in the cycle, given the normal time lags that operate in the labour market and given the significant overhang of 'underemployment' (i.e., people working fewer hours than they are willing and able to work) that has also built up over the past 12 months.

Forward indicators point to jobs growth accelerating from here. The ANZ Job Ads series has now grown for two consecutive months (albeit off an exceedingly low base), as has the DEWR skilled vacancy survey. The employment components of the latest business surveys (nab's monthly business survey and the AiG's three quarterly performance of industry surveys) have also ticked up nicely and the WBC-ACCI measure of unemployment expectations has eased. Indeed, general confidence is rebuilding well among both businesses and consumers (see below).

Naturally, risks remain (albeit at ever decreasing probabilities) that another shock could cause a secondary wave of job losses. Following the (much larger) falls in employment in 1990 for example, there were several false starts and large dips in jobs growth. We expect a smoother jobs recovery path this time around, for policy reasons and for cyclical reasons; this slowdown has simply not been as long or as severe in its local labour effects as was the 1990 recession.

Figure 2: Jobs growth bottomed in H1 2009 and turned positive in Sep Qtr. Labourforce growth has stayed strong and is about to hit another peak



Sources: ABS and ANZ

... but unemployment is still an issue for 2010

Unfortunately, even assuming jobs growth returns quickly to its recent, pre-downturn pace, unemployment numbers and the unemployment rate are still expected to rise through 2009-10. This is largely for demographic rather than economic reasons. Put simply, Australia's labourforce (supply) is growing at a faster pace than even a healthy rate of jobs growth (demand) can absorb.

The underlying reason for the current surge in the adult population (aged 15+) – and therefore the labourforce – is stronger net migration flows (a rising birthrate is also adding to total population growth, but clearly not immediately to the adult population). The growth is coming from both inflows and outflows, with more migrant workers arriving (130,000 skilled labour arrivals in 2008-09, compared with around 100,000 in each of the previous three years), more New

Zealanders arriving permanently (27,600 in 2008-09 compared to 19,000 two years earlier), more long-term residents returning (110,000 in each of 2007-08 and 2008-09, compared to 100,000 p.a. in each of the previous two years) and rapidly slowing long-term resident departures (averaging around 7,000 per month by mid-2009, compared to 8,500 per month a year earlier). These net additions mean adult population growth is currently accelerating. ABS population projections (adjusted for the latest net migration data) indicate adult population growth will peak at 663,000 people (or 3.8%) in the year to June 2010.

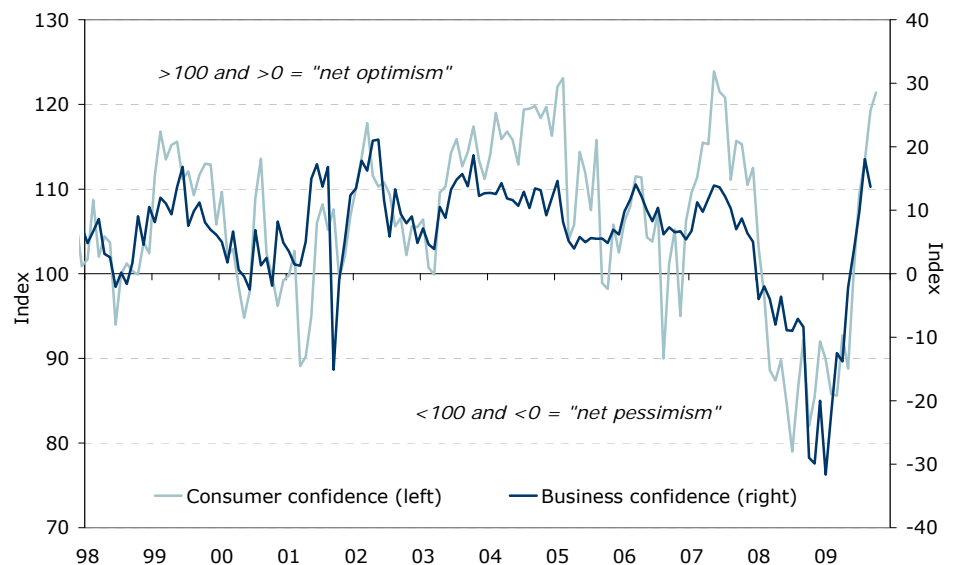
With such strong growth in the adult population, even a weakening participation rate will see our labourforce grow by around 330,000 (3%) over the year to June 2010 — a similar growth rate to the last big growth spurt in 2005-06.

In contrast, even if there are no further economic hiccups and jobs growth returns quickly to its long-term average (around 0.5% per quarter), we can hope to add only around 200,000 net jobs by June 2010. This demand shortfall would add 130,000 people to the ranks of the unemployed and push the unemployment rate to 6½%. After this peak in mid-2010, continuing jobs growth and decelerating labourforce growth should see unemployment fall, and the unemployment rate wind back to around 5.2% by the end of 2011.

Confidence returns in spades

A key factor in starting this jobs recovery earlier than was originally anticipated has been the early return of confidence among both businesses and consumers. Confidence is of course a necessary but not sufficient condition to recovery. Net optimism tends to lead to growing orders, activity and demand, but it can also over-state current conditions. Currently, businesses appear to be scaling back their retrenchment plans, but have not yet begun to re-hire *en masse*.

Figure 3: Business and consumer confidence indexes indicate net optimism



Sources: nab and Westpac-MI.

A similar process can be seen in business investment intentions, with capital investments that were put on the backburner last year now being dusted off and re-examined. This process is most apparent in the mining sector, where international demand for Australian commodities shifted geographies (from Japan to China) but never really fell away. With mining accounting for a very large portion of total investment, and generating important downstream demand for equipment and infrastructure (and upstream activity in processing and manufacturing), this resurgence in mining investment is good news indeed.

Data wrap

- **Business confidence** slid 4.4 points to 13.7, but remained above average.
- **Consumer confidence** reached a two year high of 121.4 points.
- **Inflation expectations** stayed steady at 3.5%.

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Interest rate markets: RBA to continue hiking

- Solid confidence data gives the RBA no reason for pause at their November meeting, however a December hike may rely on data flow.
- The RBA will likely continue to tighten policy into early next year before pausing to assess the impact on the domestic economy.

RBA to keep raising rates

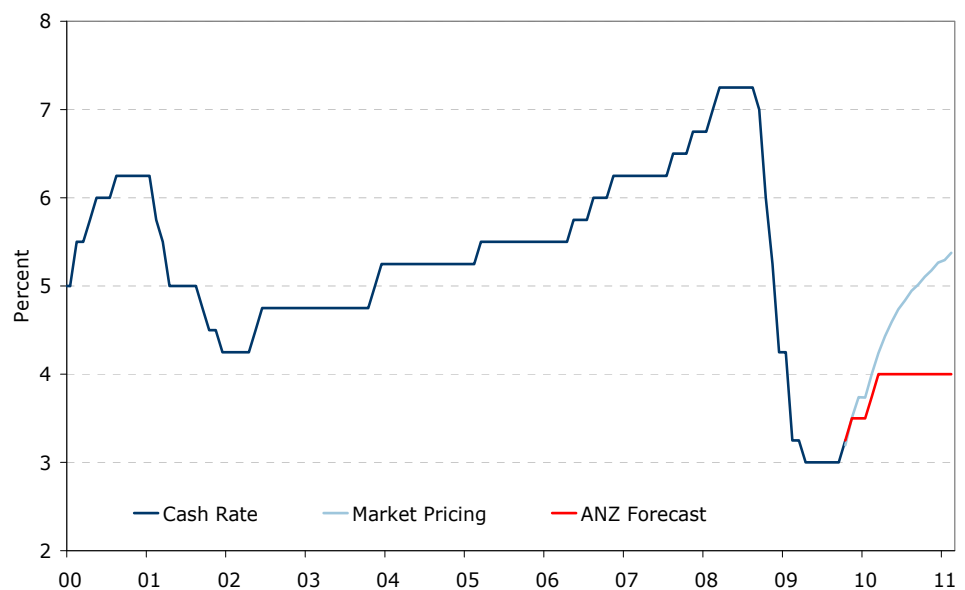
The recent flattening of the Australian 3s10s curve is likely to remain a feature of the market in coming months. This has been driven by the relatively aggressive path markets have priced in for the RBA to follow now that the normalisation of official rates has commenced. Pricing has the RBA raising rates a further 200bps by the end of next year. This would mean eight 25bps hikes in the next 14 meetings.

We have no real quarrel with this pricing in the short term, since the RBA needs to get rates off current emergency levels and they will probably get to 4% by March next year. This fact was reiterated by RBA Governor Stevens in comments made today that the RBA can not be "timid" in raising rates now that the economic emergency has passed. Higher interests, yes, but still an expansionary setting that is supportive of the economy. In terms of lending rates, official rates at this level are broadly equivalent to policy settings during the economic downturns (but not recessions) of 1997 and 2002.

In the short term we expect the RBA to raise rates 25bps in November and another 25 bps in February. The risk is they will also go in December. Yet because rates have been raised earlier than expected, sharp increases in rates of 50bps or more are likely to be avoided in favour of a more gradual path.

Data released this week seemingly gives the green light to a November hike. Confidence data released this week showed that consumers shrugged off the initial rate rise, apparently accepting that higher rates are reflective of a domestic economy that has outperformed pretty much all other advanced nations. Business conditions and confidence measures eased marginally but remain elevated with good signs on forward orders and employment measures – certainly nothing for the RBA to worry about. The next significant read for the RBA will be September quarter inflation data due in late October. 'Core' inflation is likely to again be only gradually easing, so again no reason for the RBA to relax on rates in November.

Figure 4: Market pricing of normalisation remains aggressive



Source: RBA and ANZ

But November is also loaded with other data releases. The focus will be on whether the retail sales and labour market figures can again surprise on the upside. We think these data will be looked at closely at RBA deliberations for a December increase. On the one hand, household income growth is expected to be weak, weighing on retail sales. On the other however, confidence is high so another gain is a real chance. It is doubtful labour market data will come in as strongly as last month, but trend data suggests any further deterioration in employment is likely to be limited. And this is supported by leading indicators, such as the turnaround in ANZ job Ads.

Late November also brings business indicators data leading up to GDP figures that are also likely to be solid or at least not as weak as was thought only a few months ago. Should these data come in on expectations or better, the RBA will likely again look to raise rates in December.

After initial moves in rates we anticipate the RBA will look to reassess the domestic economic environment through mid-2010, leaving rates on hold for a relatively prolonged period. This is in contrast to market pricing that favours a consistent and unbroken path to normalisation. Next year will likely bring solid but still below trend growth as well as a peak in the unemployment rate. But the RBA Governor stressed today that the path to normalisation will involve "... *important matters of judgement in the timing and pace of how that is done*".

Of key concern will be the pace of broad-based recoveries in the global economy. The pace of hikes through mid-2010 will be also be tempered by monetary policy settings that are "...*encouraging the sustainability of the expansion*" and, later in the year, renewed focus on targeting inflation. Once the latter becomes more prominent in the RBA's thinking as the economic growth gathers pace, we anticipate then policy will be tightened further to a 'normal' level of around 5-5¼%. Not really a restrictive stance but certainly one appropriate for an economy likely to be expanding at around trend growth.

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FX: Upside risks to AUD/USD build further

AUD/USD Key levels: 0.8980 – 0.9330

The AUD/USD moved to a new 14-month high this week as investor sentiment was boosted by a solid kick-off to the US Q3 corporate reporting season, better than expected Chinese economic data and upbeat comments from RBA Governor Stevens. With the RBA's October board minutes the only domestic economic release of note next week, look to offshore events, particularly the US company earnings announcements, to continue to dominate AUD/USD moves. AUD/USD sellers should beware of spikes to 0.9260 and then towards 0.9330, while buyers may wish to pounce on dips below 0.9070-80 and towards 0.8980.

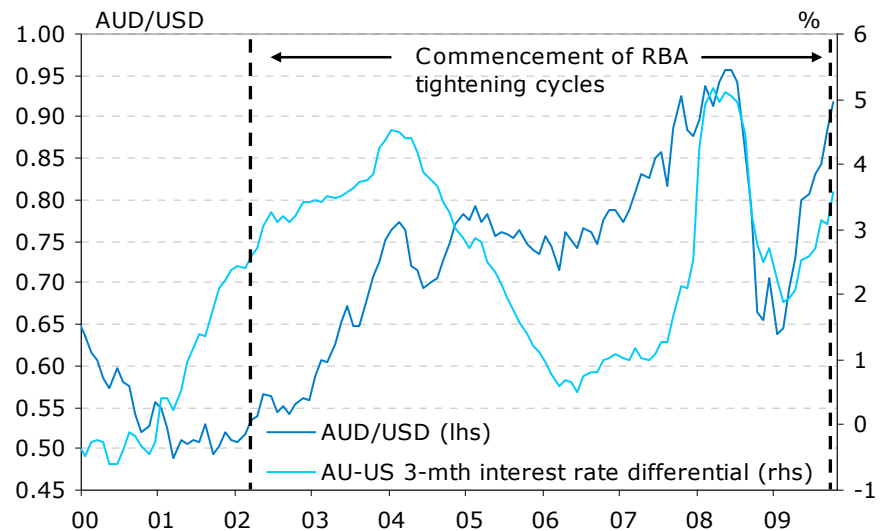
Major AUD/USD drivers all point up this week

Upside risk to the AUD/USD gained momentum this week, with a number of key events contributing to the currency's rally to a 14-month high above 92 cents. Overall risk sentiment has been boosted by a good start to the US Q3 corporate reporting season (albeit on the back of low expectations), and has pushed the broad USD Index to a new 2009 low. Similar results in last quarter's earnings reports saw AUD/USD push convincingly above 0.80, and we could see trade maintained above 0.90 if comparable results ensue.

Stronger than expected Chinese economic data this week added further steam to the market. In particular, the surge in commodity imports in September suggests that Chinese investment-led growth is tracking more strongly than expected – note that foreign direct investment jumped 18.9% through the year to September. Iron ore imports surged 30% in the month, implying further upside for Australian export growth.

Interest rate expectations have also had a big influence on AUD/USD moves. With the RBA becoming the first G20 central bank to start raising policy rates from 'emergency' levels last week, interest rate markets have priced in a relatively aggressive path for interest rate normalisation. The result has been a widening in interest rate differentials between Australia and the US, providing additional encouragement for capital flows into Australia.

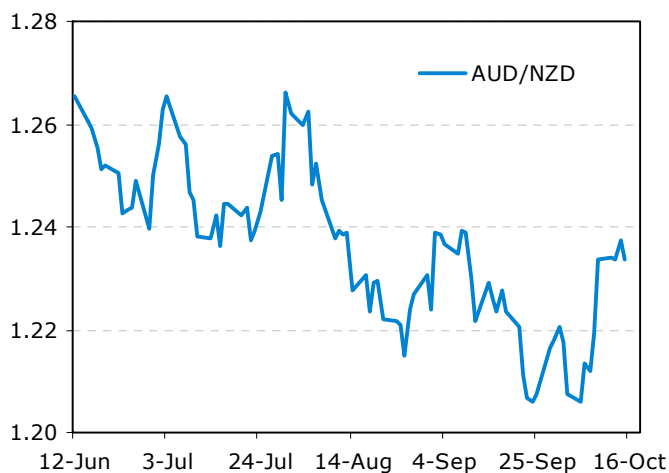
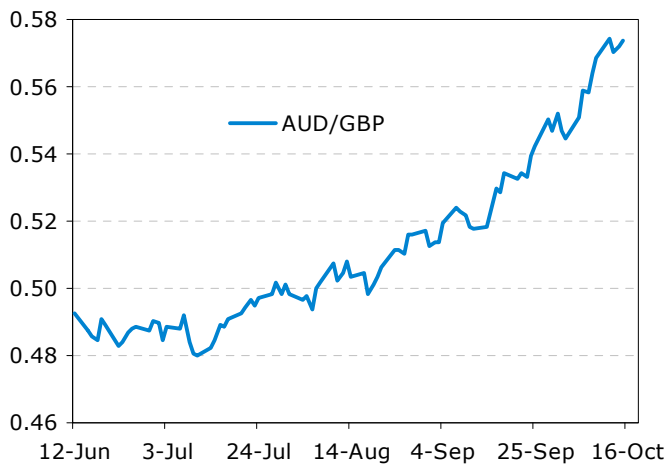
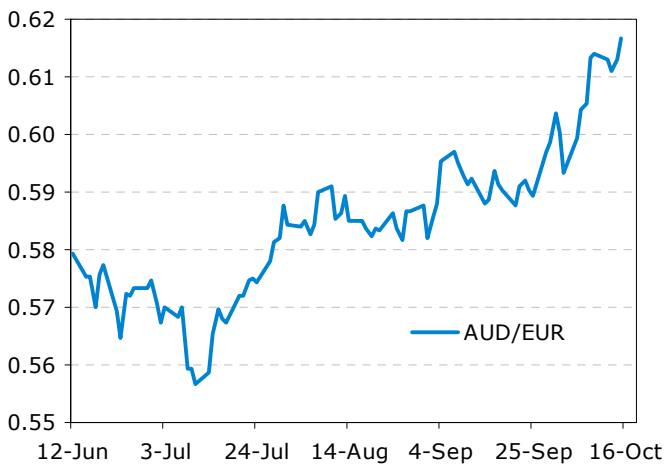
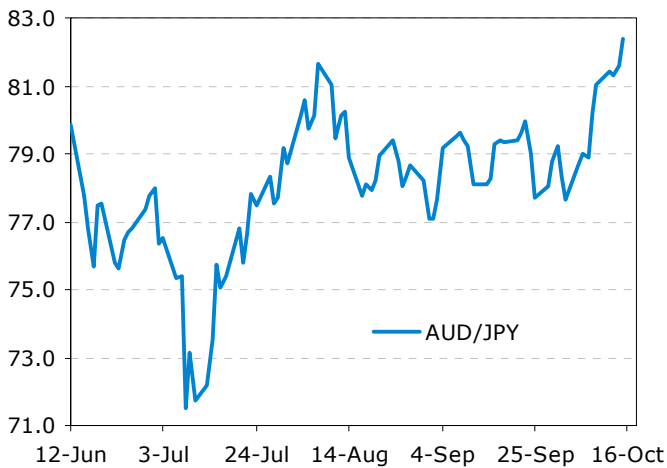
Figure 5: AU-US interest-rate differential an important driver of AUD/USD



Source: ANZ, Bloomberg

With the fundamental drivers all signalling for a higher AUD/USD, the market is beginning to set its sights on last year's post-float high of AUD/USD0.9850. Granted, the upside risks to the AUD/USD continue to build, however there are a number of risks on the horizon that may prove to be significant headwinds to the AUD's continued rise. Chiefly, a sooner than expected rise in global policy rates or a bump in the road of Chinese economic recovery could limit the AUD's climb towards its July 2008 peak.

AUD cross view



AUD/JPY Key levels: 78.10 – 84.00

- A strengthening in the JPY following official comments that the government would not intervene in the currency to support local exporters has been more than offset a surge in AUD that has boosted AUD/JPY to one-year highs. AUD/JPY needs to hold above 81.50 to maintain current upward momentum. The 100-day moving average of 78.10 should provide good support.
- A raft of economic data due for release in Japan next week could see volatility in this cross pick up. Look for headlines on Japanese industrial production, trade balance figures and machine tool orders.

AUD/EUR Key levels: 0.6050 – 0.6240

- The AUD/EUR looks comfortable in its higher trading range above 0.6000. Current levels around 0.6160 are a 1½-year high for the cross. While the 50-day moving average continues to provide good downside support, this week's sharp rise should keep breaks lower limited to 0.6050.
- Economic releases out of Europe will dominate the cross over the coming week. The data flow kicks off tonight with Euro zone CPI for September released, and continues next week with trade balance, construction output, current account and industrial orders data. Better than expected results could keep AUD/EUR capped below 0.62.

AUD/GBP Key levels: 0.5520 – 0.5830

- AUD/GBP continues to rally to unprecedented levels as the AUD gains further momentum, with a fresh high of 0.5769 reached. Dips should be limited to 0.5520 for the currency pair in the week ahead. If the bullish tone in the AUD continues, AUD/GBP could test the topside of 0.5830.
- With UK retail sales and GDP being released next week, expect to see increased volatility in this cross. Watch out for the release of minutes from this month's BoE policy meeting. Any hint that quantitative easing could be extended would see the GBP come under further pressure and push AUD/GBP towards our topside target of 0.5830.

AUD/NZD Key levels: 1.2170 – 1.2470

- There were tentative signs that the downtrend in AUD/NZD may have been broken this week, with a two-month high around 1.2440 reached. The 50-day moving average looks to be forming downside support at 1.2260 - if broken, look to further retracement towards 1.2170. A break through the topside barrier of 1.2470 would further solidify a recovery in the cross.
- There are no major data to be released in New Zealand over the coming week, but debate around the tone of discussion at the RBNZ's next policy meeting will be key to the behaviour of the NZD and the AUD/NZD cross.

ANZ economic and financial market 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	2.7	3.3
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.8	2.4	2.1
Underlying*	4.4	3.7	2.4	2.1
Wages	4.2	3.6	2.9	3.3
Labour market				
Employment (annual % change)	2.2	0.2	1.9	2.4
Unemployment rate (%)	4.3	5.7	6.5	5.5
External sector				
Current account balance: A\$ bn	-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	3.25	3.50	4.00	4.00	4.00	4.00
90 day bill	3.85	3.90	4.35	4.25	4.25	4.25
3 year bond	5.14	4.95	4.95	5.10	5.25	5.40
10 year bond	5.57	5.25	5.20	5.30	5.45	5.60
3s10s yield curve	0.43	0.30	0.25	0.20	0.20	0.20
3 year swap	5.67	5.40	5.40	5.55	5.70	5.85
10 year swap	6.23	5.85	5.80	5.85	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	2.84	2.80	2.80	2.80	3.63	4.47
US Fed funds note	0.25	0.25	0.25	0.25	0.50	0.75
US 2 year note	0.92	1.00	1.10	1.50	2.00	2.35
US 10 year note	3.42	4.00	4.00	4.30	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*.

Foreign exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
Australian exchange rates						
A\$/US\$	0.9210	0.89	0.92	0.91	0.89	0.87
NZ\$/US\$	0.7471	0.71	0.72	0.71	0.69	0.68
A\$/¥	82.41	78.3	79.1	80.1	80.1	80.0
A\$/€	0.6159	0.60	0.61	0.61	0.60	0.59
A\$/£	0.5737	0.53	0.55	0.55	0.54	0.53
A\$/NZ\$	1.2328	1.25	1.28	1.28	1.29	1.28
A\$/CA\$	0.9406	0.95	0.95	0.95	0.93	0.91
A\$/CHF	0.9326	0.92	0.94	0.96	0.93	0.93
A\$/CNY	6.2867	6.08	6.28	6.22	6.07	5.92
A\$ Trade weighted index	70.40	68.5	70.0	70.0	68.9	67.1
International cross rates						
US\$/¥	89.48	88.0	86.0	88.0	90.0	92.0
€/US\$	1.4954	1.48	1.52	1.50	1.48	1.47
€/¥	133.81	130	131	132	133	135
£/US\$	1.6052	1.67	1.67	1.65	1.64	1.65
€/£	0.9315	0.89	0.91	0.91	0.90	0.89
US\$/CA\$	1.0212	1.07	1.03	1.04	1.04	1.05
US\$/CHF	1.0127	1.03	1.02	1.05	1.05	1.07
US\$ index	75.29	75.4	73.7	74.7	75.6	76.3
Asia exchange rates						
US\$/CNY	6.8259	6.83	6.83	6.83	6.82	6.80
US\$/HKD	7.7501	7.75	7.75	7.76	7.77	7.77
US\$/IDR	9325	9500	9500	9625	9500	9250
US\$/INR	45.86	47.0	46.5	46.0	46.0	45.0
US\$/KRW	1157	1125	1100	1150	1175	1050
US\$/MYR	3.3473	3.41	3.34	3.37	3.40	3.40
US\$/PHP	46.255	47.0	46.0	46.5	46.0	45.0
US\$/SGD	1.3859	1.40	1.39	1.40	1.41	1.41
US\$/THB	33.445	33.00	33.00	33.00	32.50	32.50
US\$/TWD	32.209	31.50	31.00	31.30	31.50	30.30
US\$/VND	17854	18500	18500	18500	18500	19300
Pacific exchange rates						
PGK/US\$	0.3832	0.374	0.392	0.381	0.395	0.386
FJD/US\$	0.5276	0.523	0.534	0.528	0.519	0.512

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