

Onwards and upwards yet?

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Macroeconomic Update: No more rate cuts

- With the RBA viewing the downside risks to the domestic economy as having diminished, further official interest rate cuts now seem unlikely, with rates expected to stay on hold for a prolonged period.
- Evidence of a more resilient domestic economy has prompted us to upgrade our GDP forecasts to 0.3% growth for 2009 and 1.1% for 2010 and to scale back our unemployment rate forecasts to now peak at 7½% in mid-2010.

Rate markets: Further normalisation for yields

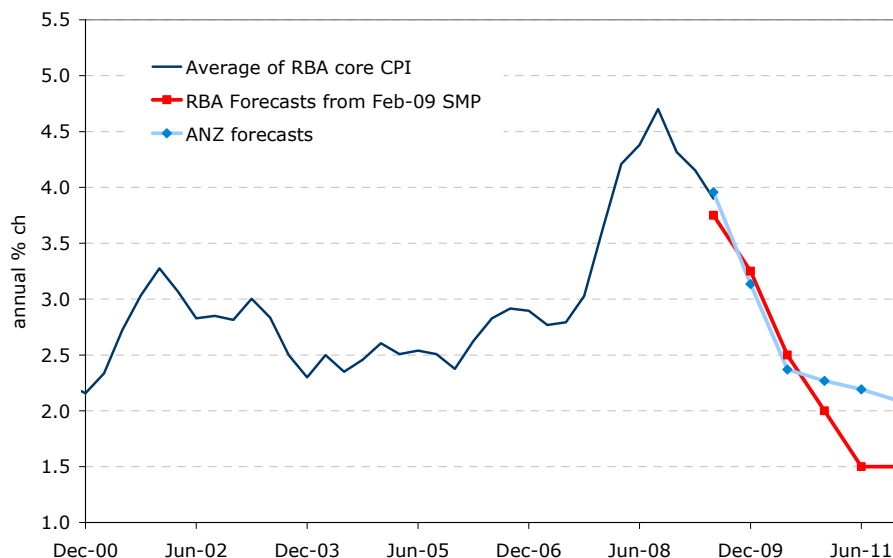
- This week's clear signal that the RBA is on hold has prompted a rise in shorter-dated yields and flattened the yield curve. But yields should not rise too far in the near-term.
- Yield differentials with the US have widened to reflect very different economic and policy outlooks. These are likely to persist for some time.

FX: Upside risk to medium-term AUD outlook

- Attempts to push the AUD/USD above 0.8180 have been short lived. The AUD requires a positive market event to provide a significant boost higher in the short term.
- The upgrade to our Australian cash rate view, stronger commodity prices and the continued decline in the broad USD Index are all creating upside risks for the AUD in the medium term.

Chart of the week

Figure 1: Downward pressures on inflation will persist



Sources: RBA, ABS, ANZ.

Macroeconomic Update: No more rate cuts

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The easing cycle may be at an end...

The continued resilience of the Australian economy through 2009 thus far has seen the chance of further official interest rate cuts from the Reserve Bank slowly ebb away. The strong position of the economy going into the downturn; the solid banking sector; pre-emptive fiscal and monetary policy stimulus and a resurgent China have all contributed to this relative out-performance, compared to other advanced economies.

As highlighted by the RBA in the Minutes of the July Board meeting, the surprisingly strong run of data has reduced the downside risks confronting the domestic economy. It has also prompted us to reassess our outlook for official interest rates, with further rates cuts now unlikely. We anticipate that the RBA will keep rates on hold at 3% for an extended period of time while we negotiate what will be, despite the run of solid data, a time of heightened economic uncertainty through the rest of 2009 and into 2010.

In line with a more positive view, we have upgraded our GDP forecasts to 0.3% growth for 2009 and 1.2% for 2010, before resuming something around 3-3½% growth in following years. Further, we have scaled back our unemployment rate forecasts to now peak at 7½% in mid-2010. The recent weight of evidence to support a solid outlook for the Australian economy, when compared to the collapse seen in most other comparable advanced nations, has become compelling:

- Our **trade performance** has been better than expected with Chinese demand for commodities holding up. Even though export prices have fallen sharply and a trade deficit is in prospect for Q2, volumes are likely to perform better. While there remain some questions as to whether China can continue to stockpile Australian commodities at such a rapid pace going forward, the recent strength in Chinese GDP, industrial production and steel output is encouraging.
- **Business confidence** and conditions have improved sharply in recent months. This implies the expected slump in business investment will be less of the drag on growth going forward than first thought. Importantly, stronger business confidence and forward orders should also help employment levels.
- **Consumer confidence** has roared back to the highest level since late-2007, and is currently sitting above the key 100 'optimistic' level. Cash handouts and low interest rates have supported retail sales well, again in stark contrast to the collapse of sales in other economies. This is of supreme importance at the moment, since the retailers are the biggest employers in the country.
- The **housing market** has held up extraordinarily well, in contrast to those preaching collapse, and has all but recovered a modest easing of prices through late 2008 and early 2009. This has supported household confidence and is increasingly stimulating building activity. Sure, much of the recovery has been driven by first homebuyers in response to government incentives, but increasingly 'upgraders' and investors are getting back into the act also.
- These factors have supported a **very solid labour market performance** under the circumstances. Employment levels have been surprisingly strong with falls being limited so far to around 40,000 this year, or around 0.4% of the labour force. The relatively limited rise in the unemployment rate so far has been prompted by a very strong expansion of the labour force, driven primarily by record inward migration and a high participation rate. Further, it seems that the business sector is in much better shape this time around (cf.

1990s). Perhaps with crippling skills shortages that characterised the lead up to the downturn still in mind, businesses are seemingly much more flexible with employee arrangements. Reduced hours and offers of unpaid leave may not be ideal but it is a whole lot better than losing your job outright.

...but talk of hikes is, at this stage, premature.

Despite the prevalence of 'green shoots' in the domestic economy, there remain significant challenges ahead for the Australian economy. In particular, the still fragile state of the labour market suggests significant uncertainty around the outlook for household incomes and household spending. This leads us to believe that the Reserve Bank will be in no hurry to raise interest rates in the short term. As such we anticipate rate hikes will not occur until late 2010 and even then rising only to neutral rather than restrictive levels into 2011. Our rationale is as follows:

- First and foremost is **the unemployment rate, which is expected to keep rising until mid-2010**. It would be unprecedented for the RBA to tighten policy while the labour market is still deteriorating — if it did so, the blow to confidence would be severe. Indeed, it may be appropriate for the RBA to "target" the unemployment rate, given the downward momentum of inflation.
- With economic growth well below trend in 2009 and 2010, **the resulting output gap and wage restraint is keeping prolonged downward pressure on inflation** (notwithstanding yesterday's relatively sticky outcome for Q2). This should ensure the core measure returns to the target band and can be relegated as a secondary concern for policy settings. Indeed, weaker than expected inflation will give the RBA scope to cut rates further to support the labour market if needs be.
- **Calls to slow the housing market using monetary policy are unfounded**. Prices have recovered and seem to be rising, driven largely by first homebuyers. However, heat will be taken out of the market by the winding back of the FHOG boost and a return to a more orderly and sustainable performance from the housing market is in prospect. Besides, the RBA hardly wants to jeopardise the fledgling turnaround in the building sector; dwelling investment will be a key plank supporting economic recovery in coming years.
- Although confidence has improved **the business sector is not out of the woods yet**. The downturn in the economy will impact heavily on profitability and therefore impair the ability of the sector to expand, invest and employ.
- **Falls in commodity prices will see gross domestic income contract sharply** in 2009-10, detracting from profits and government revenues alike and thus curtailing the public and private sectors ability to add to spending and investment going forward.
- China and commodity exports alone cannot be relied upon to shore up Australia's trade prospects. **Recovery in the advanced economies of the world still seems some way off** and these countries still account for just under 50% of Australia's exports by destination. This is particularly important for exports of non-resources and services (especially tourism) that are more reliant on these markets for growth. The solid performance of the Australian dollar has also made conditions for such exporters more challenging.

All in all, we believe current policy settings are about right. If anything, the RBA will remain on a slight easing bias as we negotiate the next 12 months, ready to support the economy if necessary.

Data wrap

- The (final stage) **producer price index fell** 0.8% (2.1%YoY) in the June quarter, intermediate and preliminary stage prices fell 1.9% and 2.7% respectively.
- **Motor vehicle sales** jumped 5.7% in June, due largely to govt tax incentives.
- **DEWR skilled vacancies** fell 1.7% in July.
- **Headline CPI inflation** came in at 0.5% in the June quarter, with the RBA's core measure decelerating to 0.8%.

Rate markets: Further normalisation for yields

- This week's clear signal that the RBA is on hold has prompted a rise in shorter-dated yields and flattened the yield curve. But yields should not rise too far in the near-term.
- Yield differentials with the US have widened to reflect very different economic and policy outlooks. These are likely to persist for some time.

Market yields have continued to normalise.

The yield curve has flattened and spreads to the US have widened as RBA policy is now more clearly on hold. But upward pressure on yields should be limited as it still looks to be premature to expect rate hikes anytime soon.

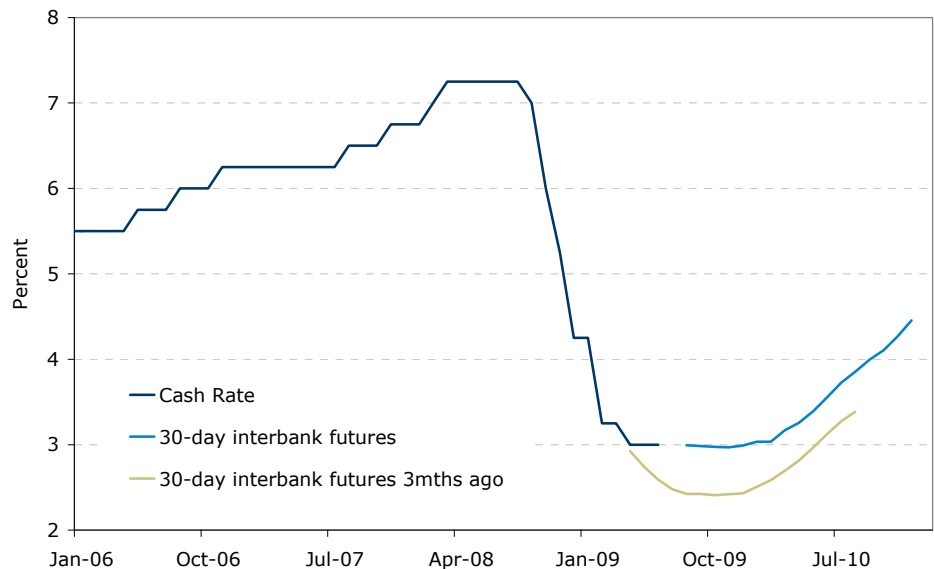
The major event for the domestic market this week has been the release of the RBA Board Minutes from the July 7th meeting. These revealed a greater sense of comfort with the current state of the economy, since the main theme of the RBA's assessment was that downside risks to the outlook had "diminished." The Bank also said that activity was not as weak as expected, while demand was also more resilient.

This would appear to set the scene for an upgrade to RBA forecasts when they are released in the Statement on Monetary Policy on 7th August. RBA Governor Stevens will deliver a speech on the "challenges of economic policy" next Tuesday lunchtime that can be expected to lay further groundwork for the anticipated upgrade to their forecasts.

A defensive posture looks appropriate should the RBA sound a greater level of concern over recent strength in the housing sector so shorter-dated market yields are likely to remain under upwards pressure ahead of these events.

The hurdle to further easing now looks to be very high. While it is now more likely that the next move in rates will be up, the market is looking for the Bank to start normalising policy in the first half of 2010 – see the chart below.

Figure 2: RBA cash rate and market expectations



Source: ANZ & Bloomberg

The chart above highlights the extent to which expectations of further easing of policy have been unwound in recent months, but also that any tightening of policy will still be relatively mild considering the extent of the policy adjustment in response to the credit crisis. We now appear to have seen the low in yields for this cycle.

We do not expect to see the RBA start to lift rates until late in 2010 considering the fading impact of the fiscal boost, the drag from weak business investment,

weak inflationary pressures and the fact that unemployment will continue to rise over the forecast horizon. This should help to moderate upward pressure on term yields, at least in the near-term.

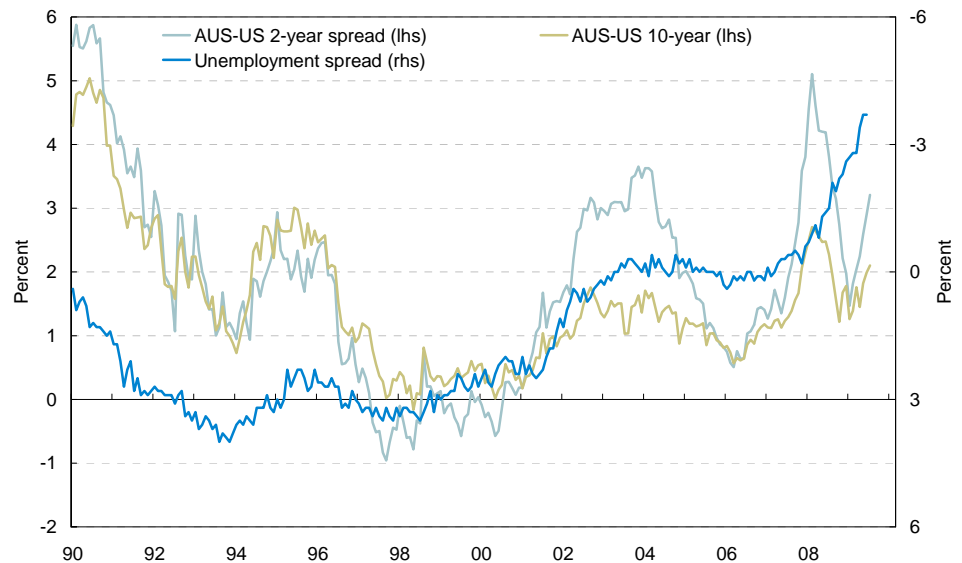
Furthermore, the correlation between bond and stock markets remains high. While US stocks have rallied over the past week on generally better Q2 earnings results we are yet to see a sustained break higher for equity markets. And the message from Fed Chairman Bernanke in testimony to Congress this week was that US rates are set to remain low for a long time, especially as the peak in US unemployment is now expected to be above 10%. This highlights historically high levels of spare capacity in the US economy.

This is helping to anchor US 10-year government bond yields around the 3.5% level ahead of the next round of bond tenders for 2, 5 and 7-year bonds next week.

The better performance for longer-dated US bond yields and removal of RBA rate cut expectations here has served to flatten the local yield curve. The spreads between 3 and 10-year bond yields is back around 70bps after trading above 140bps in May. But the curve should not flatten too much further from here with the RBA on hold for the foreseeable future.

The sharp contrast in relative economic performance and bias to policy has pushed out AUS-US yield spreads as can be seen in the chart below. The difference between the US rate of unemployment of 9.5% and our unemployment rate of 5.8% is nearly 4.0%. This measure of relative economic performance only got to 3.0% in the early 1980s recession.

Figure 3: AUS-US rate spreads and unemployment rates



Source: ANZ & Bloomberg

The AUS-US10-year bond spread has moved back above the 200bps level - the 2008 high was above 270bps - while the 2-year spread is back above 300bps. These movements would appear to have contributed to the \$A's rally against the \$US, particularly at a time when global markets are looking for higher yielding places to park funds over the Northern holiday season. And these spreads look unlikely to narrow anytime soon considering the relative policy and economic outlooks.

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FX: Upside risk to medium-term AUD outlook

Recommendation

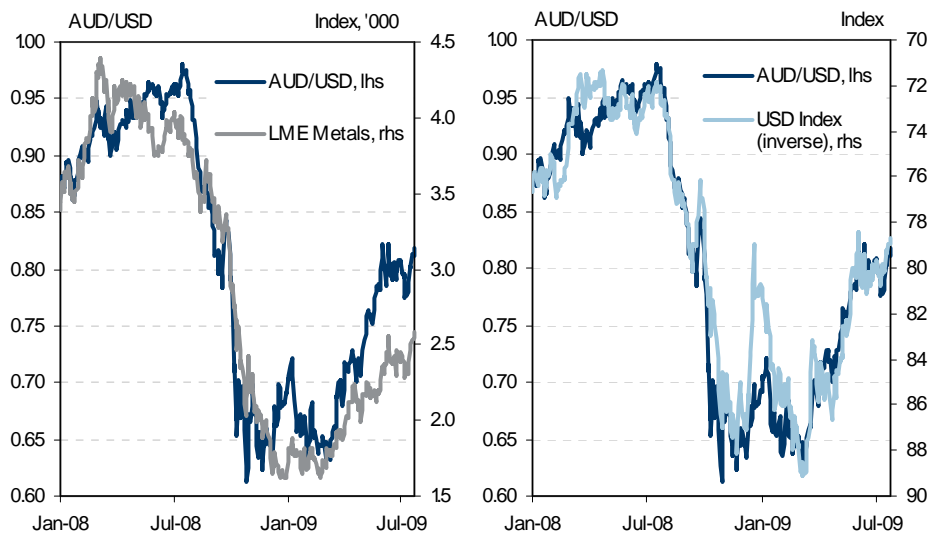
Last week's anticipated move through AUD/USD 0.80 did eventuate but now appears to be running out of steam. Attempts to push above 0.8180 have been short lived, and require a positive market event to provide a significant boost higher. Spikes above AUD/USD 0.8180 provide good opportunities for AUD sellers, while buyers should keep an eye open for dips below 0.81. A number of key US economic data releases, a speech by RBA Governor Stevens, and US corporate reports are likely to provide the main triggers for AUD direction.

Change in cash rate outlook puts upside risk on AUD view

The risks to our medium-term AUD outlook received a lift this week with changes to our cash rate forecast (see *Macroeconomic Update*). We now suspect it is unlikely that further cuts will be made to the cash rate in the current cycle. While AUD fair-value modelling suggests that changes in interest rates have only limited impact on the currency, the upgrade to our rates view nevertheless implies upside risk to our year-end forecast of 73 US cents of approximately half-to-one US cent.

However, what is likely to have a greater impact in raising our projected AUD track are the recent higher moves in commodity prices and the continued decline in the broad USD Index. Since the end of June, base metal prices (which have a positive impact on the AUD) have gained over 8%, while the USD Index (which has an inverse relationship with the AUD) has declined 1.6%. Taken together, these moves suggest AUD/USD at 0.8150 is around 'fair value.' This is 2½ cents above our end-July forecast of 0.79. If these recent moves in the USD and commodity prices aren't fully reversed by end-month, they will present an upside risk of 2-3 US cents on our end of year AUD/USD forecast. Moreover, with the cash rate likely to remain on hold for some time, this means that for the AUD over the medium term, commodity prices and the USD, not yields, will be relied upon to provide any sustained move to a higher trading range.

Figure 4: Base metal prices and USD Index strong influences on AUD/USD

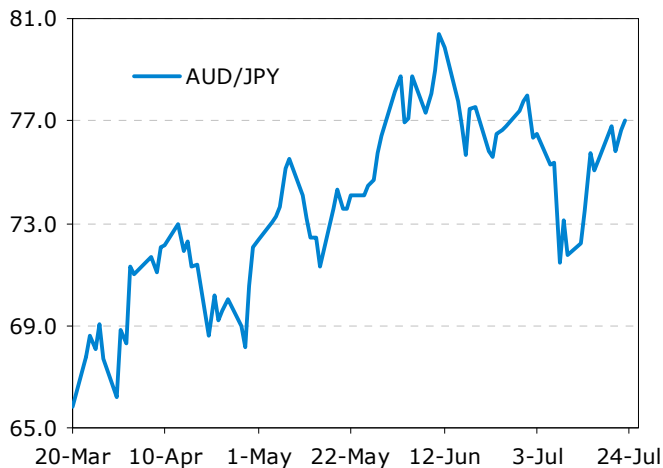


Source: ANZ, Bloomberg

The risk of a higher AUD/USD over the medium term is likely to have different effects on the major AUD crosses. An environment of stronger than expected commodity prices and a weaker USD Index would likely correspond with better than currently anticipated global economic performance and continued improvement in investor risk appetite. Under this scenario, AUD is likely to outperform JPY on weaker 'safe-haven' flows. The likelihood that stronger global growth would spur market enthusiasm for a potential UK recovery would see AUD under-perform GBP. And we expect that AUD/EUR would enjoy stable trade as improved confidence generates similar support for EUR as for AUD.

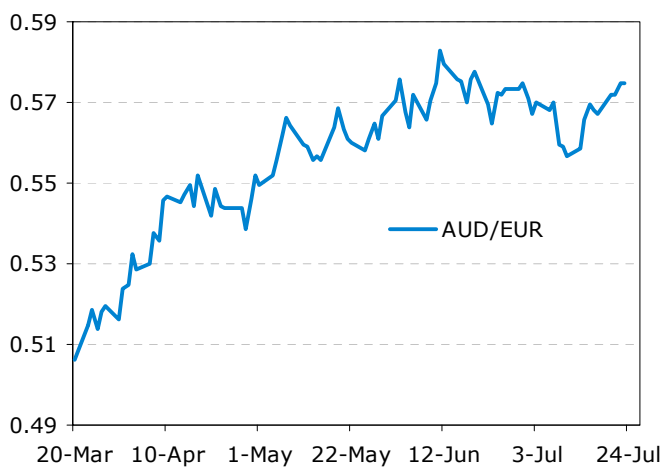
AUD/USD Key levels: 0.7950 – 0.8200. A sustained push through 0.8180 is required for AUD/USD to test the June high of 0.8264. On the downside, a break through support at 0.8110 could see AUD/USD test 0.7950.

AUD cross view



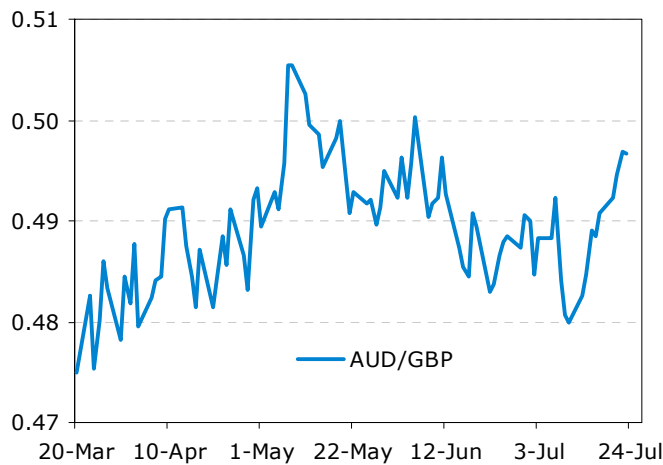
AUD/JPY Key levels: 72.80 – 78.40

- Further hunger for risk saw AUD/JPY break through last week's topside target of 76.50. While this cross is starting to look comfortable around 77, it will struggle to trade significantly above this level without a further strong rally in global equities. A re-build in AUD/JPY margin trades, which have been pared back in recent weeks, could be another trigger higher for this cross.
- With these factors as drivers, we are cautious for AUD/JPY to potentially trade within a wide range. Topside moves will likely run into initial resistance of 78.40. The 100-day moving average of 72.80 should provide strong downside support.



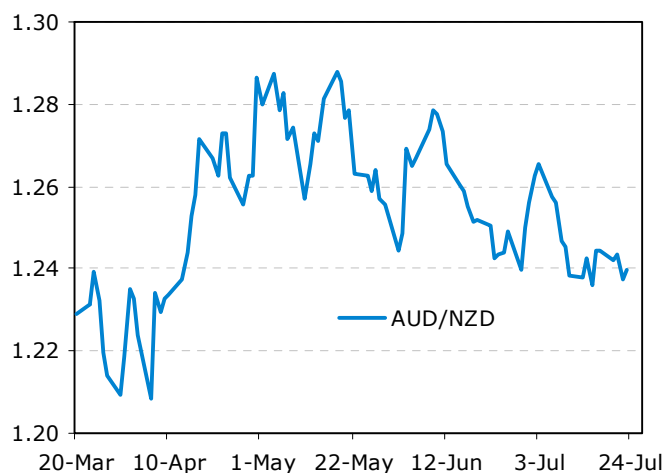
AUD/EUR Key levels: 0.5670 – 0.5800

- AUD/EUR drifted higher this week as the AUD was able to slightly outperform a powering EUR.
- The EUR has been a major beneficiary of USD weakness in the last week, but tonight's Euro zone PMI data will be an important test. A better than expected result could well provide the final push for EUR/USD to break above its 2009 high (1.4338). If so, AUD/EUR has a good chance of touching 58.
- On the downside, we see 0.5670 as the first line of support. A reversal in global equities or commodity prices would be the likely catalyst.



AUD/GBP Key levels: 0.4810 – 0.5030

- AUD/GBP surged this week as renewed concerns about the dire state of UK public finances hit the GBP. Resistance at 50 was tried and failed. Without an outright surge in the AUD, we expect this topside to hold for now.
- UK Q2 GDP on Friday looks set to be the big driver of AUD/GBP this week. The market is looking for the rate of contraction to ease to 0.3%. A worse than expected outcome should easily see the cross test its topside targets. A better than expected result meanwhile should see AUD/GBP weaker. But with AUD likely to benefit on any positive global news, look to initial support at 0.4810.



AUD/NZD Key levels: 1.2350 - 1.2590

- The NZD continues to surprise markets, hitting a 2009 high of NZD/USD0.66 less than a week after Fitch downgraded New Zealand's foreign currency outlook. The outperformance of the NZD has seen AUD/NZD continue to drift lower, albeit within its still tight range.
- We remain wary that this cross will remain under downward pressure if risk appetite continues to improve next week. Local factors that could interrupt the NZD's stellar rise are tomorrow's USDA monthly dairy price data and next Thursday's RBNZ (rates on hold but expect the bank to again try to talk down the NZD).

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.1	-1.4	0.0	3.4
Household consumption	2.2	1.2	1.3	2.9
Dwelling investment	2.5	-6.8	8.4	10.3
Business investment	13.8	-7.4	-7.9	2.4
Public demand	5.3	1.9	6.3	3.8
Domestic final demand	4.4	-0.7	1.4	3.5
Inventories (contribution to GDP)	-0.6	-0.1	0.3	0.1
Gross National Expenditure (GNE)	3.8	-0.8	1.6	3.6
Exports	3.9	-0.2	-1.5	3.8
Imports	10.3	-11.6	1.4	8.2
Net Exports (contribution to GDP)	-1.5	2.8	-0.6	-1.0
Gross Domestic Product (GDP)	2.3	0.3	1.1	3.0
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.7	2.5	2.0
Underlying*	4.4	3.7	2.4	2.1
Wages	4.3	3.6	2.9	3.2
Labour market				
Employment (annual % change)	2.2	-0.2	-0.4	1.8
Unemployment rate (%)	4.3	6.0	7.4	7.4
External sector				
Current account balance: A\$ bn	-51.0	-39.1	-58.2	-66.8
% of GDP	-4.3	-3.3	-4.7	-5.1

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

Australian interest rates	Current	Sep 09f	Dec 09f	Mar 10f	Jun 10f	Sep 10f
RBA cash rate	3.00	3.00	3.00	3.00	3.00	3.00
90 day bill	3.14	3.10	3.25	3.30	3.40	3.75
3 year bond	4.66	4.70	4.60	4.85	4.80	5.20
10 year bond	5.58	5.50	5.40	5.55	5.50	5.80
3s10s yield curve	0.93	0.80	0.80	0.70	0.70	0.60
3 year swap	4.93	5.00	4.90	5.15	5.10	5.67
10 year swap	6.04	5.90	5.75	5.85	5.80	6.35
International interest rates						
RBNZ cash rate	2.50	2.50	2.50	2.50	2.50	2.50
NZ 90 day bill	2.78	2.80	2.80	2.80	2.80	2.80
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.94	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.55	4.25	4.00	4.15	4.30	4.50
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.25
ECB refinance rate	1.00	1.00	1.00	1.00	1.00	1.00
UK repo rate	0.50	0.50	0.50	0.50	0.50	0.50

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

Foreign exchange rates	Current	Sep 09f	Dec 09f	Mar 10f	Jun 10f	Sep 10f
Australia and NZ exchange rates						
A\$/US\$	0.82	0.76	0.73	0.74	0.76	0.78
NZ\$/US\$	0.66	0.58	0.55	0.54	0.54	0.55
A\$/¥	77.11	74.48	73.00	77.70	82.08	85.80
A\$/€	0.57	0.56	0.56	0.57	0.58	0.59
A\$/£	0.50	0.48	0.46	0.46	0.48	0.48
A\$/NZ\$	1.24	1.31	1.33	1.37	1.41	1.42
A\$/CA\$	0.90	0.87	0.88	0.87	0.87	0.90
A\$/CHF	0.87	0.85	0.83	0.84	0.85	0.87
A\$/CNY	5.59	5.19	4.99	5.05	5.19	5.32
A\$ Trade weighted index	64.80	62.29	59.98	61.22	63.26	64.28
International cross rates						
US\$/¥	94.2	98.0	100.0	105.0	108.0	110.0
€/US\$	1.42	1.35	1.30	1.30	1.31	1.32
€/¥	134	132	130	137	141	145
£/US\$	1.65	1.59	1.58	1.60	1.60	1.62
€/£	0.86	0.85	0.82	0.81	0.82	0.81
US\$/CA\$	1.10	1.15	1.20	1.18	1.15	1.15
US\$/CHF	1.06	1.12	1.14	1.14	1.12	1.12
US\$ index	78.7	82.5	85.0	85.2	84.9	84.6
Asia exchange rates						
US\$/CNY	6.83	6.83	6.83	6.83	6.83	6.82
US\$/HKD	7.75	7.75	7.75	7.75	7.76	7.77
US\$/IDR	10065	10250	9750	9500	10000	9500
US\$/INR	48.42	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1248	1225	1125	1175	1225	1100
US\$/MYR	3.54	3.60	3.55	3.50	3.50	3.45
US\$/PHP	48.13	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.44	1.52	1.51	1.50	1.50	1.49
US\$/THB	33.99	36.00	35.50	35.00	35.00	34.50
US\$/TWD	32.81	32.50	32.00	31.50	31.00	30.30
US\$/VND	17808	18500	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.384	0.350	0.350	0.350	0.360	0.360
FJD/US\$	0.491	0.464	0.450	0.450	0.454	0.460

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