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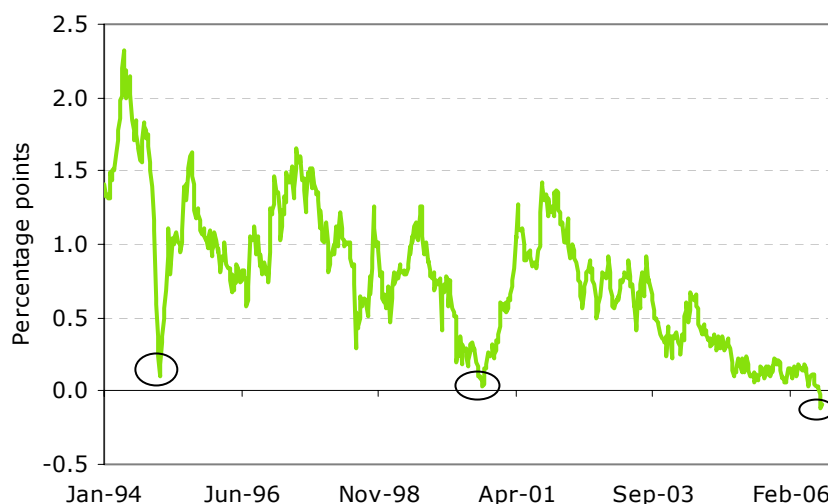
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Strategy Update

- Recent domestic data highlight that inflationary pressures remain and that the domestic economy retained considerable momentum heading into the August rate hike.
- We continue to believe the RBA will implement another 25bp tightening by the end of the year. At this point, the risks appear to favour a follow up rate hike in early 2007.
- With the likelihood of a rate hike in Australia by year end and yields 20bps off their peaks, we favour initiating short positions in the front end of the curve.
- We continue to recommend curve flattening positions in 3s10s, and believe that the market is underestimating potential for the 3s10s curve to reach -25bps and beyond.
- We remain constructive on the US Treasury market over coming months, but acknowledge the risk of a near term correction. If the Fed is truly finished tightening, then we think US 10-years can rally to 4.50%.

Figure 1: AUS 2s10s swap curve - new lows



Source: ANZ Investment Bank and Bloomberg; weekly data

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Monetary policy in Australia is not yet restrictive.

Strategy Update

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RBA likely to tighten by year end

A strong rally in the UST market and a growing expectation that the Fed is finished raising rates has seen a degree of complacency creep into the local market and analyst commentary about the prospect for further rate rises.

While it is true that the RBA does take global developments into account in its policy setting, the focus for policy makers will remain very much on inflation risks domestically. And while the US economy looks like it is modestly slowing (rather than heading for recession), we think domestic factors will remain at the forefront of policy deliberations.

A run of strong data recently has well and truly placed rate rises back on the agenda in Australia. To recap:

- Building approvals, a key leading indicator of domestic activity, registered an 8.3% rise in the month of July. Both apartment and house approvals recorded strong gains.
- The TD-MI monthly inflation gauge registered a rise of 0.6% in August, with both measures of core inflation up 0.5% in the month. The 3-month annualized trimmed mean is running just shy of 4%, suggesting broad inflation pressure continues to impact the economy.
- The WBC-ACCI Q3 survey of industrial trends suggests that the manufacturing sector continues to perform well, despite two rate hikes.
- Auction clearance rates in Sydney were in the low 60s in the first weekend of the Spring selling season.

None of these data suggest that the upside risks to monetary policy have abated at all in recent months. Indeed, recent data for the month of July (retail sales and credit aggregates) have confirmed that the May rate hike appeared to have little impact upon domestic economic activity.

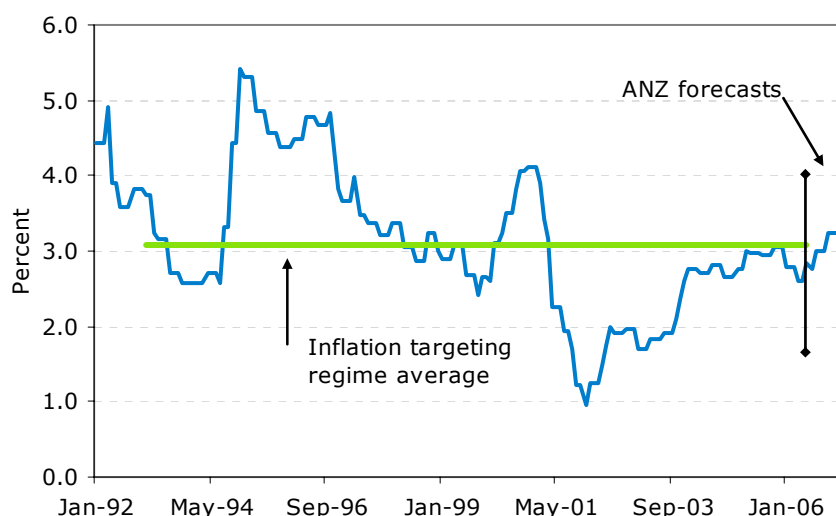
We continue to believe the RBA will raise rates again, likely in November. This will see the nominal cash rate reach 6.25%, the same level at which cash rates peaked in the 1999/2000 cycle. But if core inflation remains around 3% (as expected by the RBA), then the real cash rate should only reach 3.25% by year end. This is just 25bps above its long term average, and well below the peak of 4% in the 1999/2000 cycle (see Figure 2).

This is presumably what the RBA Governor was referring to when he noted in his Parliamentary testimony that:

"...we are probably near the top of the neutral band, but you could not really make a case that they (interest rates) are restrictive or contractionary yet...We are either at neutral or at the top end of the neutral band."

With core inflation expected to remain elevated around 3% for this year and most of next year, this analysis highlights that the risks towards monetary policy lie towards more than just one rate hike – especially if the RBA desire policy to become genuinely restrictive.

Figure 2: The real cash rate - a long run perspective



Source: ANZ Investment Bank and Bloomberg

It is also worth noting that the broader macroeconomic policy environment has become more complicated. Capacity constraints imply that the economy (and hence the outlook for inflation) is now more sensitive to fiscal policy than in the past. If fiscal policy continues to have a stimulatory impact on the economy (something we consider likely given that there will be a federal election in the second half of 2007), then there is a chance that one more rate hike won't be enough to quell domestic demand and contain inflationary pressure.

Take profit on long positions; initiate shorts in the front end

The upshot of this view is that we see further upside for yields in 2006, especially at the front end of the curve. The prospect of at least one more rate rise in the next three months implies that yields have not yet reached their cyclical peak. We think the recent rally offers a good opportunity to shorten duration. 3-years are now close to the top of the 93.95 to 94.20 range we identified a couple of weeks ago.

Our expectation of a range bound market in the 10-year part of the curve has been thwarted by a combination of significant leveraged account buying and a rallying UST market. Short-term, we think 10-years should find good resistance around the 94.40 level. We would look to sell 10-years at 94.35 or above, but note that 10s will remain vulnerable to a further rally in the US market. We therefore favour short positions in the front end of the Australian yield curve.

US 10-year yields have fallen around 50bps from their highs in late June. An expectation that the Fed is finished tightening, forecasts of slower growth and some soft housing data have driven the rally. End of month index lengthening also appears to have supported the market. As Figure 3 illustrates, the US market – especially the 2-year note – can rally significantly after the last tightening. So far, the market is behaving in a similar fashion to the 1994/95, 1997 and 1999/00 experiences.

While there is probably potential for a near term correction in the US Treasury market, we remain constructive on the US market over the next few months. A similar analysis to Figure 4 suggests that the UST market has further upside, assuming the Fed is finished tightening.

Fiscal policy is complicating the broader macro environment at present. Capacity constraints mean that the economy is now more sensitive to changes in fiscal policy.

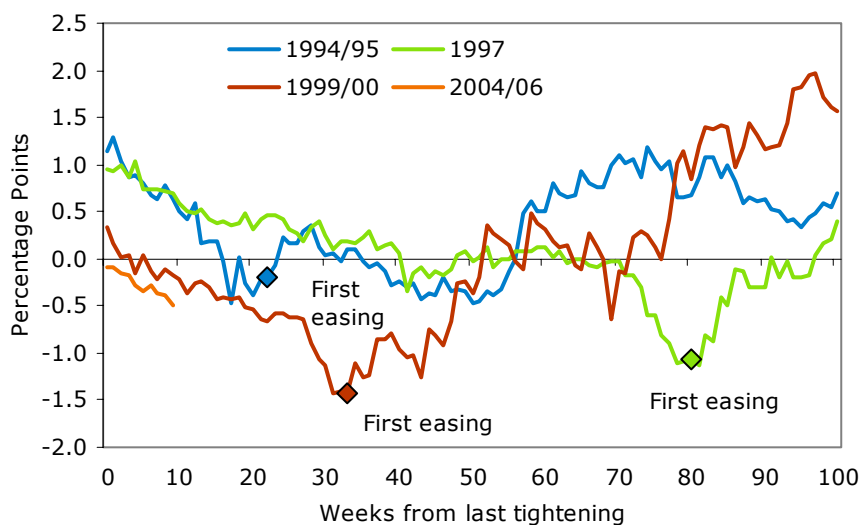
We favour short positions in the front end of the Australian yield curve.

We remain constructive on the US market over the next few months, assuming the Fed is finished tightening.

However, we acknowledge the risk of a mild correction in the near term.

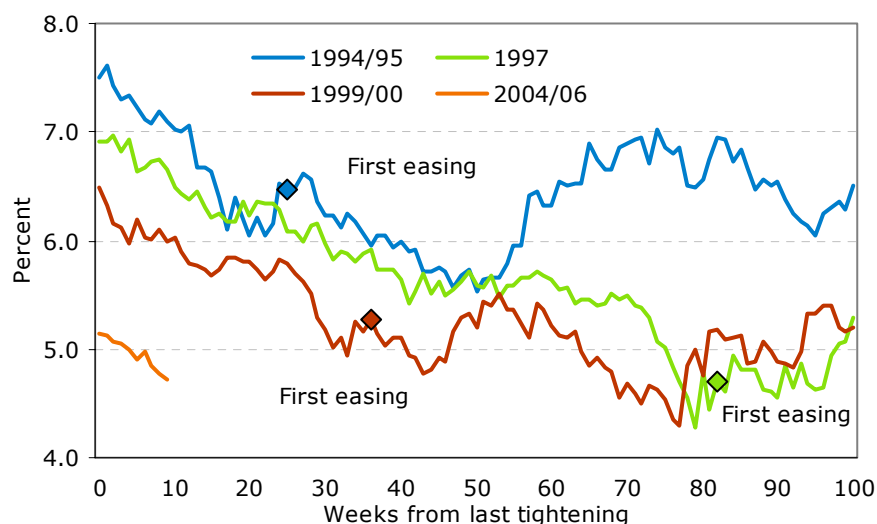
There is still scope for the 3s10s curve to flatten further.

Figure 3: 2s/Funds spread and the end of the tightening cycle



Source: ANZ Investment Bank and Bloomberg

Figure 4: US 10-year yields and the end of the tightening cycle



Source: ANZ Investment Bank and Bloomberg

3s10s curve to flatten further

It might sound like a broken record, but we don't think the 3s10s curve has reached a trough just yet. The prospect of at least one more rate hike from the RBA and the potential for the US 10-year yield to fall further means that there will be little cause for a strategic steepening of the yield curve anytime soon.

Technically, the 3s10s curve remains well within a flattening trend, with the bottom of the channel lying somewhere between -30bps and -40bps. The long term flattening trend is consistent with the RBA's elongated tightening cycle (now at least four and a quarter years in the making).

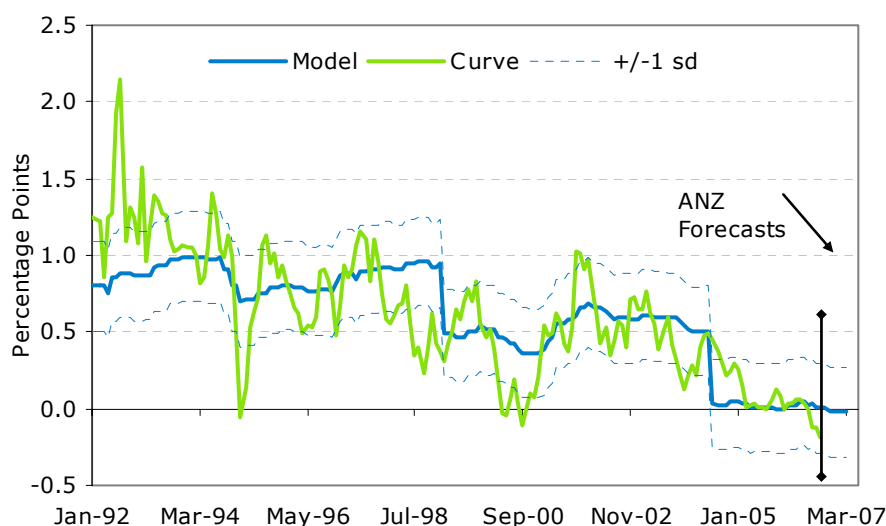
Our model of the 3s10s curve suggests that the fair value for the curve will remain flat to slightly negative over the next six months or so. For the curve to reach one standard deviation below fair value, it needs to reach -30bps. We note that in previous tightening cycles (1994/95 and 1999/00), the curve flattened beyond the one standard deviation level.

Figure 5: 3s10s curve (daily data) - long term flattening trend

Source: ANZ Investment Bank and Bloomberg

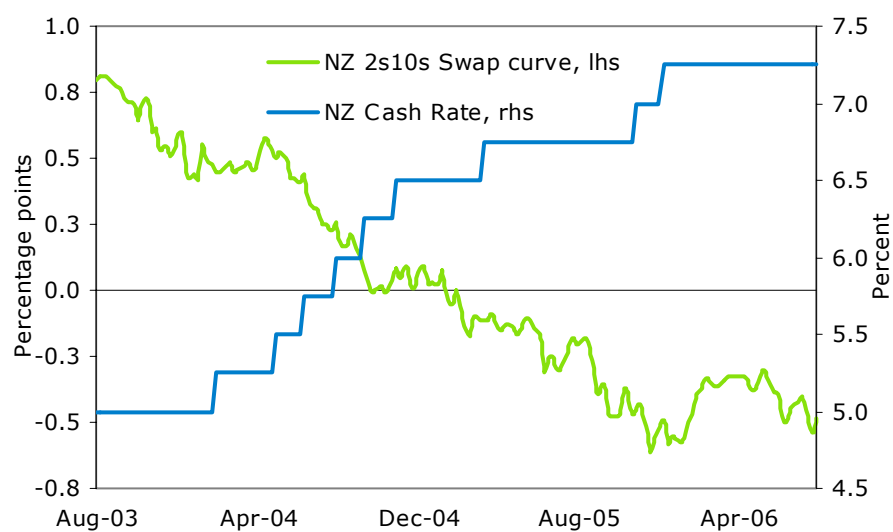
We would look for any steepening in the curve to the -10bps level to re-initiate or add to curve flattening positions. Technically, we note that the curve could theoretically steepen back towards -5bps while still remaining within a longer term flattening trend. Any near term steepening of the curve will either be driven by a rallying AUS front-end (on some softer domestic data?) or a short term corrective sell-off in the US 10-year yield. We see the latter scenario as the more likely outcome.

Use any short term steepening to add to flatteners.

Figure 6: 3s10s yield curve model

Source: ANZ Investment Bank, Bloomberg and RBA

We favour 3s10s curve flatteners as they allow the investor exposure to rising short term rates and a flatter curve (RBA rate hikes), but also allow the investor to benefit should the US market continue to rally. With the forwards pricing in no further flattening over a one year horizon, we think the market is underestimating potential for a flatter curve. In this respect, the New Zealand experience is illustrative.

Figure 7: The NZ experience - a higher cash rate and flatter curve

Source: ANZ Investment Bank and Bloomberg

Interest Rate Forecasts

Figure 8: Interest rate forecasts

	Current	Dec-06	Mar-07	Jun-07	Sep-07
United States					
Fed funds rate	5.25	5.25	5.25	5.25	5.25
2-year note	4.77	4.65	4.50	4.40	4.35
10-year note	4.74	4.65	4.60	4.60	4.75
2s10s spread (bps)	-3	0	10	20	40
Australia					
RBA cash rate	6.00	6.25	6.25	6.25	6.25
90-day rate	6.22	6.33	6.33	6.33	6.33
3-year bond	5.85	5.95	5.80	5.70	5.85
10-year bond	5.65	5.65	5.60	5.60	5.85
3s10s curve (bps)	-20	-30	-20	-10	0
10-year spread to US (bps)	91	100	100	100	110
3-year swap spread (bps)	43	42	42	42	42
10-year swap spread (bps)	51	50	47	47	47
New Zealand					
NZ OCR	7.25	7.25	7.25	7.00	6.50
90-day rate	7.49	7.40	7.40	7.10	6.60
3-year bond	6.50	5.95	5.98	5.90	5.40
10-year bond	5.81	6.40	6.40	6.40	6.10
3s10s curve (bps)	-69	45	52	60	70
10-year spread to US (bps)	107	116	140	120	135
Foreign Exchange					
AUD/USD	0.7704	0.73	0.70	0.71	0.72
NZD/USD	0.6459	0.58	0.55	0.53	0.53
AUD/NZD	1.1926	1.26	1.27	1.34	1.36
USD/JPY	115.85	111.00	109.00	108.00	105.00
EUR/USD	1.2839	1.30	1.33	1.30	1.28
GBP/USD	1.9039	1.92	1.90	1.88	1.84
USD/CHF	1.2316	1.22	1.18	1.19	1.20

Source: ANZ Investment Bank and Bloomberg

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