

## Australian recession averted?

6 August 2009

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### Macroeconomic Update: GDP looks good in Q2

- The economic landscape changed a little this week a flurry of data suggesting economic growth and the labour market will be more resilient than expected.
- As such, the very expansionary setting of monetary policy may be becoming inappropriate and this raises a real risk the RBA will start to raise rates earlier than expected, possibly by the end of this year.

### Rate markets: a slow march to normal rates

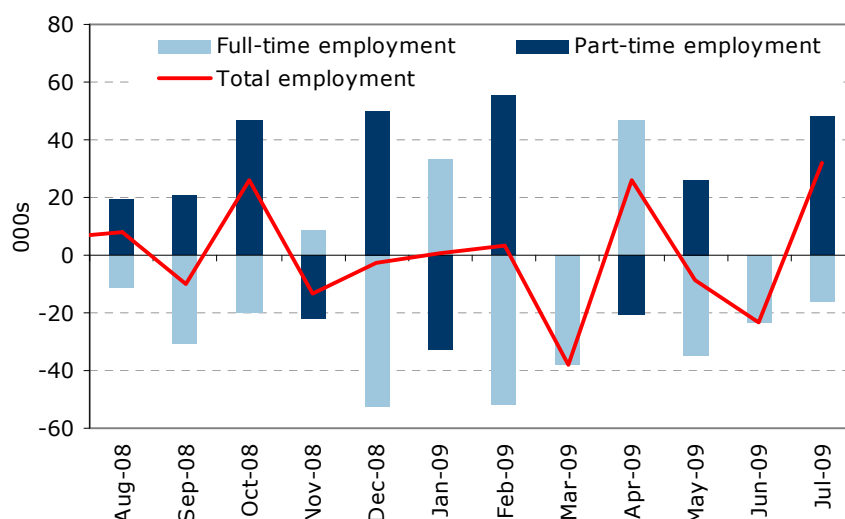
- The strength of recent economic data highlights the possibility of a near-term move towards a more neutral cash rate setting.
- With market rates now having moved a long way however, some consolidation appears overdue. A more circumspect RBA in coming days could slow the normalisation of outright yields and limit further curve flattening from here.

### FX: AUD forecasts revised higher

- The AUD has moved into a higher trading range of 80 to 84.5 US cents. We expect some short-term consolidation, but remain wary.
- In the short-term, there is a significant risk that the AUD could extend its recent gains.

### Chart of the week

**Figure 1: Under-employment instead of unemployment. 189,400 full-time jobs lost, 190,700 part-time jobs gained, year to July '09**



Sources: ABS

## Macroeconomic Update: GDP looks good in Q2

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### Solid data brings the RBA into play – hiking rates

The economic landscape changed a little this week a flurry of data suggesting economic growth and the labour market will be more resilient than expected. The downside is that this will bring the prospect of interest rate hikes from the RBA more firmly into view. The current stance of monetary policy, that is very stimulatory, has gone a long way to shoring up the Australian economy – in a global environment where most advanced nations were or still are in recession. But now it would seem that with core inflation still stubbornly high, it may be time to tap the brake pedal rather than keeping the foot firmly to the floor. The economy has seemingly avoided the severe recession that was in prospect at the start of the year and as such the very expansionary setting of monetary policy may be becoming inappropriate.

This raises a real risk the RBA will raise rates to a more neutral stance, possibly commencing by the end of this year. Nevertheless, we remain conscious of the uncertainty still surrounding the Australian and global outlook, with any rate rises from here likely to be more gradual than currently priced in by the market.

Stepping back a bit to the start of the week - the RBA started things off by leaving interest rates on hold at 3% and importantly removing any reference to further rate cuts by dropping the phrase that suggested the economic outlook “...allows some scope for further easing of monetary policy if needed.” The easing bias for rates is now gone. But equally, there was no talk of rate hikes in the statement which was broadly interpreted as neutral. Indeed, the RBA remained very cautious, highlighting a “sluggish” period of growth in the near term.

However, the RBA’s expected period of inactivity may be a little more short-lived than even they first thought due to partial economic indicators continuing to perform better than expected. This week’s economic data suggests another solid quarterly economic performance in Q2 (see below).

### Partial indicators point to solid GDP growth in Q2

The first piece data released this week was house prices that rose sharply in the June quarter (+4.2%). This result was a real kick in the guts for the housing doomsayers with the forecast collapse in prices just not happening. On the flip-side, solid prices have now fuelled fears that a bubble is forming in the housing market and that rates should be raised to prevent it – prompted by comments from the RBA Governor last week. We disagree on both fronts, median house prices are still below levels seen in 2008 and the current price ‘surge’ will dissipate as first homebuyers fade from the market as grants are wound back. Secondly, raising interest rates would weaken buyer’s demand for housing, true, but would also weigh heavily on developer sentiment and be to the detriment of supply, which is the real problem facing the housing market (and should be tackled by governments not central banks).

Retail numbers were also released. The June nominal sales figures weren’t too flash, falling 1.4%, in contrast to the market expectations of a 0.5% rise. However, quarterly volumes data (sales ex-prices) were up a solid 2.0%, again beating the market expectation. Motor vehicle sales were also up in the quarter. This suggests household consumption in the quarter will be very solid and add to GDP growth in Q2.

Trade data was next. The deficit improved to \$441mn in June, narrowing from the previous month’s deficit of \$737mn, on the back of solid export growth and flat imports. This brought the quarterly deficit (on a BOP basis) to around \$1.7bn. However, with trade volumes the story is more positive. Import volumes are expected to have fallen 2% in the June quarter and export volumes are expected to have eased around 0.5%. This suggests net exports will again add to GDP growth, not as much as in Q1 but something around ¼% to ½%.

Further, some solid import volumes for consumer and intermediate goods suggest we will see an addition to inventories this quarter, after sharp run downs in the previous quarters – again supporting growth.

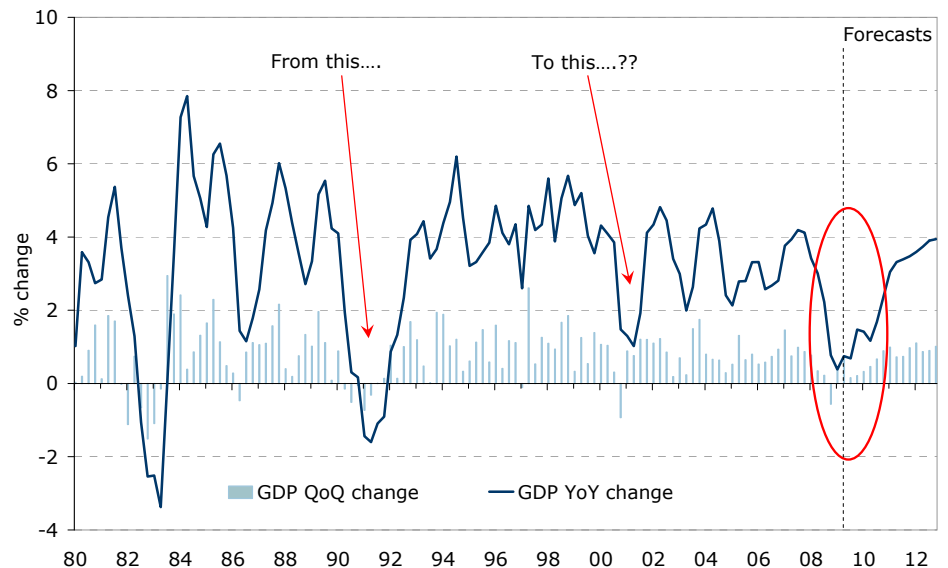
Yet before we get too carried away, the trade data also highlights two potential downside risks to the current run of positive news. Firstly, capital good import volumes were very weak in the quarter highlighting that business investment intentions remain very soft. Perhaps they will not turn out to be as weak as initially thought with business confidence rebounding solidly. However, we still expect weak private sector investment to be a drag on growth in Q2 and going forward; there has been no hard data yet to deter us from this view.

Also, the trade data is now showing the impact of weaker bulk commodity prices. We think that the deficit this has created will persist into 2010, dragging on incomes for not only business but the government and household sectors as well.

The run of data ended today with what can only be described as a fantastic result in the labour market with the economy actually adding jobs in the month – defying all predictions. There was another shift between full-time and part-time employment reflecting more flexible employment options and the fact that businesses do not want to shed jobs only to have to re-hire people down the track. But this is still better than job losses. The unemployment rate stayed at 5.8%, we expect it to peak at just over 7% in mid-late 2010.

The recent better than expected data is increasingly backing the contention that the current economic experience will be more like the downturn of 2000-01, rather than the full blown recessions of the 1980's and 1990's. This in itself seems astounding given we have gone through the worst financial crisis in history and an unprecedented, synchronised global recession. We still anticipate a patchy economic performance in the back-half of 2009 but downside risks seem to be dissipating fast. Is it all just too good to be true...?

**Figure 2: Historical GDP Growth**



Source: ANZ & Bloomberg

### Data wrap

- **AIG Performance of Manufacturing index** improved to 44.5 in July.
- **AIG Performance Services** eased in July to 44.1.
- **ANZ Jobs Ads** fell 1.7% in July to be down 52% in the year.
- **Retail sales** fell 1.4% in June, but volumes rose 2.0 in the quarter.
- **House prices** rose 4.2% QoQ in June to be only 1.5% down in the year.
- The **cash rate** was kept on hold at 3% at the August RBA meeting.
- **Trade balance** improved to \$441mn in June on solid exports.
- **Employment** gained 32,200 in July.
- The **unemployment rate** remain unchanged at 5.8% in July.

## Rates markets: a slow march to normal rates

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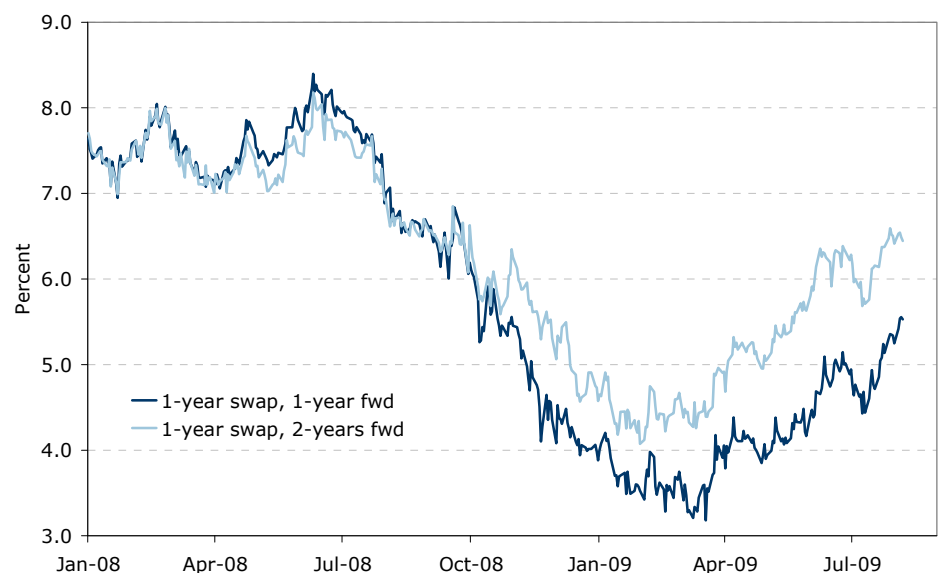
- The strength of recent economic data highlights the possibility of a near-term move towards a more neutral cash rate setting.
- With market rates now having moved a long way however, some consolidation appears overdue. A more circumspect RBA in coming days could slow the normalisation of outright yields and limit further curve flattening from here.

A neutral tone emerged after the RBA board meeting this week. While the RBA removed its explicit easing bias, pointed comments on “sluggish” economic conditions suggested the board might be more cautious about moving to a less accommodative policy stance. Furthermore, the AUD has continued to appreciate with the trade weighed index now up more than 25% since the start of February. And the Bank has also dropped the previous reference to business loan rates being below average in light of the recent rise in market rates. So the market is doing at least some of the work to unwind exceptionally accommodative conditions for the Bank. The extent of the normalisation of market rates can be seen in the rise of forward swap rates – see figure 2. This is now well advanced in the more forward looking rates.

The RBA comments were made prior to today’s labour force data, which takes the hard economic data a little closer towards current market pricing for a rapid recovery and a normalisation in rates. The risk therefore is clearly for rates to head back to a less accommodative stance more quickly than our current forecast.

The dilemma for the RBA is how to remove such policy stimulus when the economic outlook (both globally and in Australia) remains highly uncertain and the recovery still fragile. Any move towards neutral therefore is likely to be relatively slow and gradual. Indeed, with market rates now having moved a long way, some consolidation appears overdue. A more circumspect RBA in tomorrow’s quarter Statement on Monetary Policy or at the Governor’s Parliamentary Testimony next week could slow the normalisation of outright yields and limit further curve flattening from here.

**Figure 2: The market already anticipates normal rates**



Source: ANZ & Bloomberg

Outside Australia, the data remains mixed, with US incomes and consumption likely to remain subdued for a considerable period of time. There is also better news for Treasuries in that total bond issuance for the July-Sept period is down by around \$100bn on the previous quarter to \$US406bn due to repayment of TARP funds and improved fiscal dynamics. Bond tenders here in Australia have been going extremely well in recent weeks.

Consequently, we would not look for a full reversal in bond yields back toward pre-crisis levels seen in the middle of last year. There still look to be some significant hurdles before the RBA can start to remove their accommodative stance. But three-year swap yields have now returned to levels seen last November above 5.0%. It now looks unlikely we will see levels much below here, as long as the market remains so firmly focused on an eventual normalisation of official cash rates.

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## FX: AUD forecasts revised higher

### Recommendation

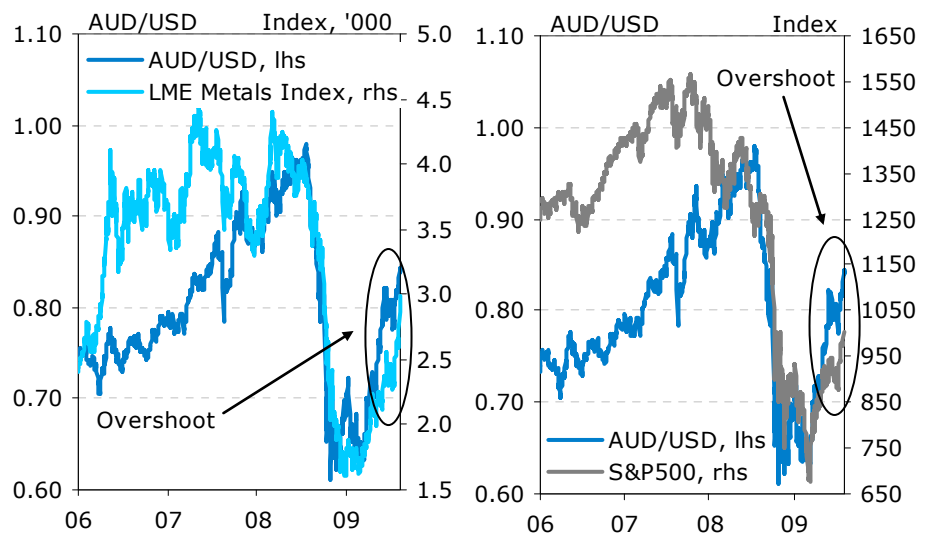
The AUD/USD has moved sharply into a higher trading range. We expect some short-term consolidation, but remain wary that upcoming US employment data and the RBA SoMP may provide a catalyst for further AUD gains. Importers may wish to take advantage of AUD/USD moves above 0.8450, while AUD buyers should look to opportunities on dips to 0.8350.

### Upside risks to AUD/USD over the remainder of the year

The AUD has moved into a higher trading range of 80 to 84.5 US cents. This week saw AUD/USD surge through a key retracement level to a 10½-month high of 0.8471, some 10% above its July low of 0.7703. AUD drivers have also broken through key levels: the broad USD Index (DXY) has declined to a new post-Lehman collapse low; base metal prices have rallied 25% over the past month; and the S&P500 is on the verge of cracking 1014, the 38.2% retracement level between the index's 2007 high and 2008 low. These moves have prompted us to upwardly revise our AUD forecasts. We now expect AUD/USD at 0.80c by end-2009 and 0.86c by end-2010.

In the short-term, there is a significant risk that the AUD could extend its recent gains. A key determinant will be the direction of global equity markets. To date, the AUD has led the recovery in other financial markets. Hence, while the AUD has rebounded to late-2007 levels, the US equity market is yet to recover to pre-Lehman collapse levels. Further 'catch up' in US equities would likely keep the AUD very well bid. Further upside to the AUD outlook has been added from ANZ's upward revisions to Australia's terms of trade (TOT), which is now expected to flatline, rather than fall, in H2. Moreover, if commodity prices continue to surprise on the upside, then the TOT may start to climb higher over H2. The realisation of these upside risks could easily take AUD/USD into a higher 0.85 – 0.90 range by the end of the year.

**Figure 1: AUD/USD overshoots price moves in underlying drivers**

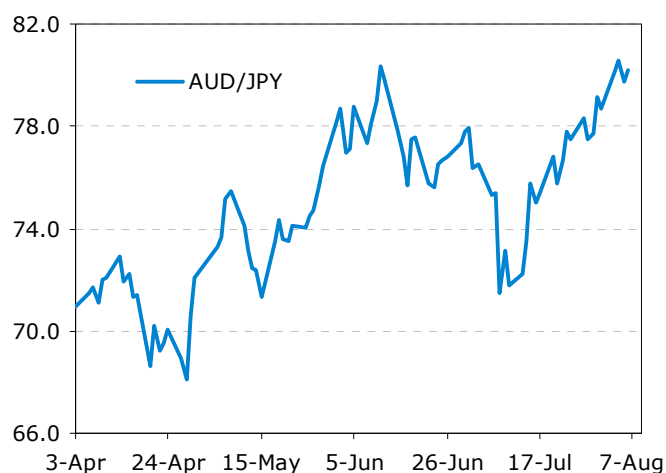


Source: ANZ, Bloomberg

That said, we are conscious that the AUD has overshoot its drivers. If our global view pans out and we see a stabilisation, rather than a continued V-shaped recovery in high-frequency indicators, then we expect markets to consolidate. In this environment, AUD/USD at 80 cents, a value arguably around 'fair value' is the likely scenario. On the downside, the risk is that as the AUD has overshoot on its move higher, then it could easily undershoot if markets capitulate. That said, recent moves suggest strong support would now be 77 cents (well above our previously forecast support level of 73 cents).

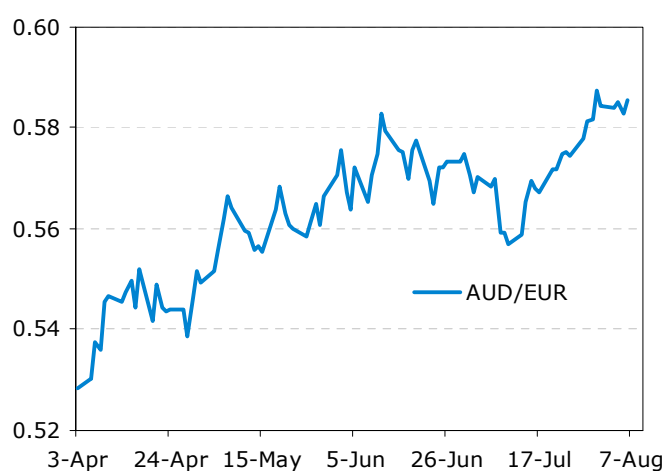
**AUD/USD Key levels: 0.8250 – 0.8500.** A sustained push through this week's high of 0.8371 is required for AUD/USD to test 0.8500. On the downside, a break through support at 0.8380 needs to be maintained to see AUD/USD lower to 0.8250.

## AUD cross view



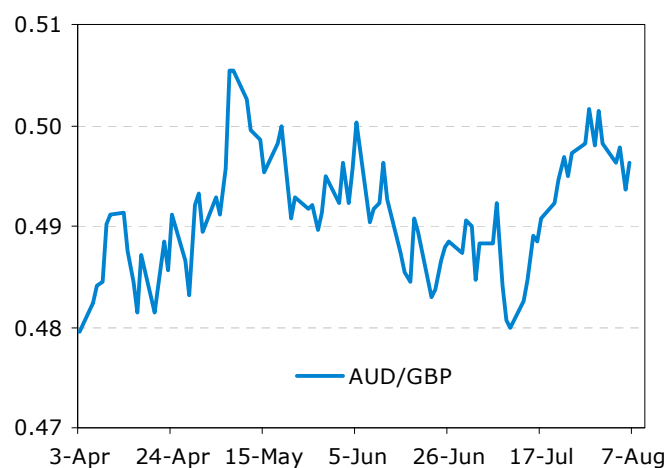
### AUD/JPY Key levels: 77.00 – 82.90

- The AUD's surge this week has seen AUD/JPY again trade above last week's topside target of 79.40. The risk over the coming week is for continued outperformance of AUD versus JPY.
- A continuation of the positive Australian dataflow could see AUD/JPY move higher to 81.50 then 82.90. While consolidation is possible, good downside support exists at the 50-day moving average of 77.00. Better than expected Japanese machine tool orders could generate additional upside for AUD/JPY, while releases from the BoJ (including a policy announcement on Tuesday) round out the key risk events.



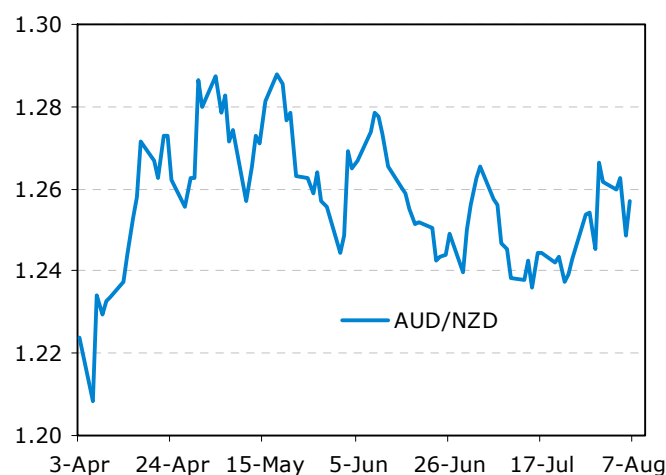
### AUD/EUR Key levels: 0.5730 – 0.5920

- Attempts by AUD/EUR to rally above last week's topside target of 0.5880 were limited. A sustained move above this key fibo level is required for the cross to push higher to 0.5920. Continued AUD strength should limit dips in the cross to 0.5730.
- Tonight's ECB policy meeting could see AUD/EUR dip from recent highs if President Trichet gives markets a more optimistic statement. Next week's Euro zone Q2 GDP release risks weighing on EUR/USD if it prints worse than expected. A better than expected read would be broadly supportive of AUD/EUR, and any downside moves should be limited to around 0.5730.



### AUD/GBP Key levels: 0.4870 – 0.5040

- AUD/GBP ground lower over the past week as the surging AUD failed to keep pace with GBP's rally. Last week's high around 0.5040 remains the key topside target, while dips should be initially limited to 0.4920 and then lower around 0.4870.
- Although some commentators expect the BoE to announce an extension of its gilts purchases following tonight's policy meeting, we think that the bank sit on its hands for another month given recent improvement in the more high-frequency UK economic data. If the BoE does extend QE, look to GBP/USD to push back towards 1.6830, and lift AUD/GBP initially towards 0.4900.



### AUD/NZD Key levels: 1.2430 - 1.2680

- The rally in AUD continues to (frustratingly) drag NZD higher. Last week's key level of 1.2680 provided strong resistance for AUD/NZD despite the strong Australian dataflow countered by a solid 1% uptick in the NZ unemployment rate.
- Out in NZ next week we have the July NZ PMI and retail sales data for June which should provide some interest. However Australian events, combined with developments in global investor sentiment, are likely to persist dominating moves in the cross. Another week of range trading is likely. We see upside moves being limited to AUD/NZD1.2680, and dips to around 1.2430.

## ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
<b>Economic activity (annual % change)</b>				
Private final demand	4.1	-1.0	1.4	4.1
Household consumption	2.2	1.9	1.9	3.2
Dwelling investment	2.5	-6.8	8.4	10.3
Business investment	13.8	-7.9	-3.3	4.9
Public demand	5.3	1.9	6.8	4.3
Domestic final demand	4.4	-0.4	2.6	4.1
Inventories (contribution to GDP)	-0.6	-0.2	0.3	0.1
Gross National Expenditure (GNE)	3.8	-0.5	2.9	4.2
Exports	3.9	1.2	0.2	4.5
Imports	10.3	-12.3	4.1	10.1
Net Exports (contribution to GDP)	-1.5	3.2	-0.8	-1.3
<b>Gross Domestic Product (GDP)</b>	<b>2.3</b>	<b>0.8</b>	<b>1.7</b>	<b>3.3</b>
<b>Prices and wages (annual % change)</b>				
Inflation: Headline CPI	4.4	1.8	2.6	2.1
Underlying*	4.4	3.7	2.4	2.1
Wages	4.3	3.6	2.9	3.3
<b>Labour market</b>				
Employment (annual % change)	2.2	-0.1	-0.3	1.8
Unemployment rate (%)	4.3	5.9	7.3	7.2
<b>External sector</b>				
Current account balance: A\$ bn	-51.0	-37.1	-52.2	-63.2
% of GDP	-4.3	-3.1	-4.2	-4.8

\*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	3.28	3.10	3.25	3.30	3.40	3.75
3 year bond	4.99	4.70	4.60	4.85	4.80	5.20
10 year bond	5.66	5.50	5.40	5.55	5.50	5.80
3s10s yield curve	0.67	0.80	0.80	0.70	0.70	0.60
3 year swap	5.27	5.00	4.90	5.15	5.10	5.67
10 year swap	6.13	5.90	5.75	5.85	5.80	6.35
<b>International interest rates</b>						
RBNZ cash rate	2.50	2.50	2.50	2.50	2.50	2.50
NZ 90 day bill	2.77	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	1.22	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.74	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
<b>Australian exchange rates</b>						
A\$/US\$	0.84	0.82	0.80	0.80	0.83	0.84
A\$/¥	80.20	80.36	80.00	84.00	89.64	92.40
A\$/€	0.59	0.58	0.58	0.58	0.59	0.60
A\$/£	0.50	0.50	0.48	0.47	0.48	0.49
A\$/CA\$	0.90	0.90	0.86	0.84	0.87	0.88
A\$/CHF	0.90	0.92	0.91	0.91	0.93	0.94
A\$/CNY	5.76	5.60	5.46	5.46	5.67	5.73
A\$ Trade weighted index	66.50	65.80	64.18	64.64	67.38	67.61
<b>International cross rates</b>						
US\$/¥	95.1	98.0	100.0	105.0	108.0	110.0
€/US\$	1.44	1.42	1.38	1.38	1.40	1.40
€/¥	137	139	138	145	151	154
£/US\$	1.70	1.65	1.68	1.70	1.72	1.73
€/£	0.85	0.86	0.82	0.81	0.81	0.81
US\$/CA\$	1.07	1.10	1.07	1.05	1.05	1.05
US\$/CHF	1.06	1.12	1.14	1.14	1.12	1.12
US\$ index	77.7	79.6	80.7	81.0	80.5	80.6
<b>Asia exchange rates</b>						
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	9893	10250	9750	9500	10000	9500
US\$/INR	47.66	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1222	1225	1125	1175	1225	1100
US\$/MYR	3.50	3.55	3.50	3.48	3.45	3.40
US\$/PHP	47.78	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.43	1.48	1.46	1.45	1.45	1.44
US\$/THB	33.98	35.00	34.50	34.00	34.00	33.50
US\$/TWD	32.73	32.50	32.00	31.50	31.00	30.30
US\$/VND	17813	17800	18500	18500	18500	18500
<b>Pacific exchange rates</b>						
PGK/US\$	0.386	0.350	0.350	0.350	0.360	0.360
FJD/US\$	0.499	0.464	0.450	0.450	0.454	0.460



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