

Australian Q2 growth coming in stronger

27 August 2009

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Macroeconomic update: Q2 better than expected

- This week's construction and business investment data surprised on the upside suggesting GDP growth for the second quarter will be even stronger than first thought. Further, higher investment intentions also remove a key downside risk to the economic growth going forward.
- Nevertheless, question marks remain around growth in the second half of the year and as such we think the RBA will not commence raising the cash rate until early 2010.

Interest rate markets: the removal of IWT on Commonwealth government bonds

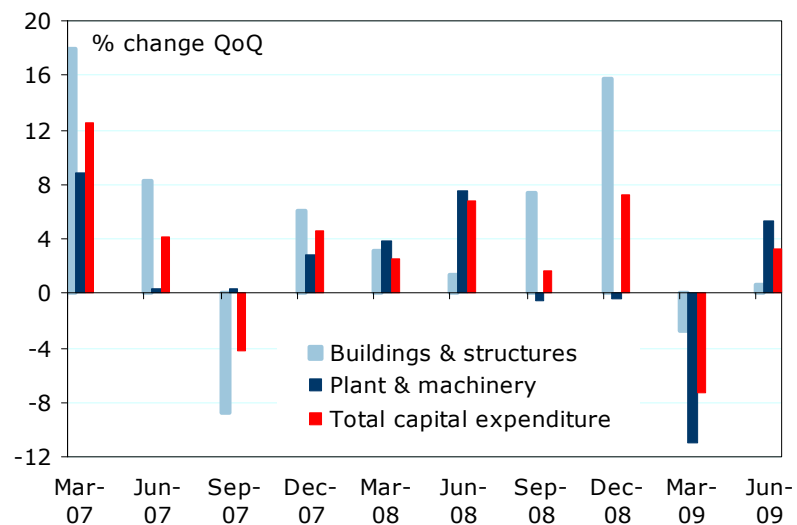
- The announcement of the removal of the 10% interest withholding tax (IWT) on Commonwealth government bonds is a positive development which should in the medium term argue for relatively lower yields on local bonds.

FX: The AUD/NZD's slide

- Upward momentum in AUD/USD became exhausted this week as the economic data flow catches up with premiums already priced into markets.
- An upside surprise on next week's Q2 GDP result is unlikely to cause a break out of recent ranges, but could still see AUD/USD spike as high as 0.8430.

Chart of the week: Capital expenditure rebounds

Figure 1: Q2 private capital expenditure recovers from Q1's slump



Source: ABS.

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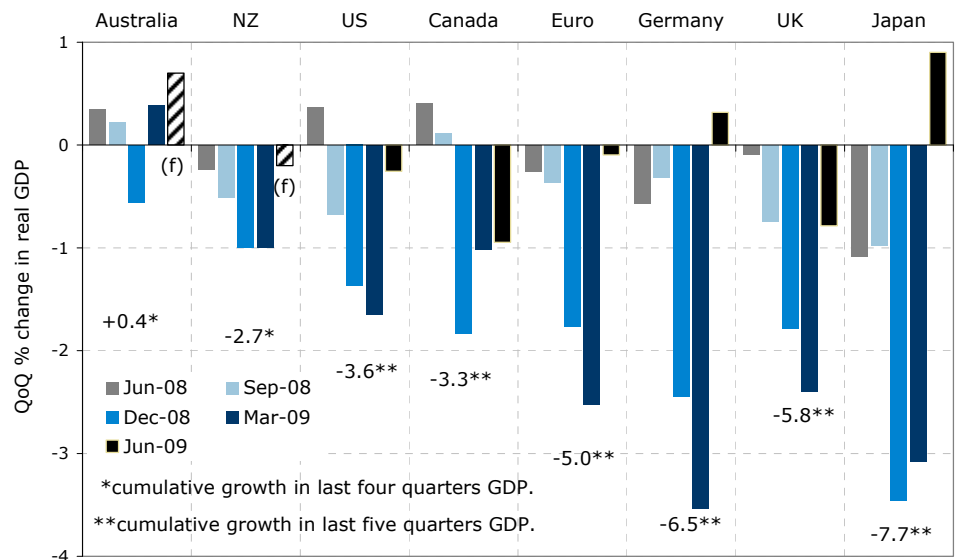
Macro update: Q2 better than expected

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Aussie economy to outperform in Q2

Well-timed monetary and fiscal policy, combined with the 'China effect' supporting resource exports is ensuring the Australian economy continues to outperform most, if not all, advanced economies through this global recession. This was confirmed this week with two partial indicators that feed directly into next week's GDP figures both surprising on the upside. Consequently, there seems to be significant upside risks to what is already shaping up to be a solid quarter's growth for June.

Figure 2: Advanced economy performances – Quarterly GDP growth



Source: ANZ & Bloomberg

Construction work done in the June quarter surprised on the upside, recording only a marginal 0.1% contraction, in contrast to the 3.0% fall the market had expected. Residential and non-residential building was predictably weak with approvals levels still mired at relatively low levels. As a result, building activity fell 5.7% in the quarter. However, this was largely offset by a 5.7% rise in engineering construction. A trend emerging through the year is that construction by the public sector has expanded 22.9% in the year, compared to private sector growth of just 0.6%. We expect this to continue with government infrastructure spending a key to fiscal stimulus in H2. Also a clear trend is that most construction is now taking place in Western Australia and Queensland, the states benefiting most from continued exposure to China.

Capital expenditure data also surprised the market, expanding 3.3% in the June quarter, in contrast to the market expectation of 5.0% contraction. The turnaround in business confidence has translated into better outcomes for the economy with labour retention and now investment both being much stronger than expected. Investment in building & structures was soft, up only 0.7% with 5.3% growth occurring in the equipment, plant & machinery sector. That latter buoyed by government tax incentives. Again, unsurprisingly, there is a China theme here. In the quarter, investment growth was driven largely by Victoria and Western Australia. Through the year, the WA story is even stronger with investment levels in that state accounting for 30% of total, by far the highest of any state and heavily centred around the mining sector (despite the latter falling in recent quarters).

More partials are released early next week leading up to the national accounts and we are expecting more positive news from the trade sector. The balance of payments figures are expected to show net exports will again be supportive of GDP growth. This won't be to the significant extent seen in the previous two quarter, when it was the main driver of growth, but still a solid positive. Unsurprisingly import volumes are expected to be weak in Q2. This is despite domestic household consumption supporting solid consumer good import volumes. Very weak capital good, 'other' good and services imports more than offset these gains. Again it is the export side that has held up and again it is the 'China effect' that is largely responsible. Iron ore export volumes (representing around 40% of Australia's resource exports) to China increased over 25% in the June quarter and added a further 15% in July alone, reaching yet another record level as steel production gathers pace.

We already have data suggesting growth in retail sales volumes was strong in the quarter driven by the government's cash handouts and low interest rates. And services surveys indicate that this sector also has rebounded sharply. As such, household consumption (that accounts for 55% of GDP) will have been solid in the quarter and will be a key driver of GDP growth next week.

While the expenditure side of the national accounts seems quite solid, growth on the income side is expected to be weaker. We anticipate the marginal rise in compensation of employees, due to softer employment growth and decelerating wages growth, will be offset by a significant fall in profit growth. Much of the latter is due to falls in bulk commodity prices impacting mining profits and a slowdown in financial corporation profit growth.

The production side of the accounts will likely be supported by restocking of inventories (as will the expenditure side). We anticipate that much of this will have occurred in the retail sector with consumer good import volumes strong in the quarter. A sharp fall in capital good import volumes and solid business investment suggest restocking will be limited across other sectors. We will get a more solid read on profits and inventories next week leading up to GDP. As for now, we started this week with a forecast of 0.7% GDP growth for the June quarter and we end it with clear upside risks to this forecast. As it stands as much as 1% growth in the quarter is a real possibility - in the absence of any significant downside surprise in the remaining lead-up data. Further, we may also see Q1 GDP growth revised upwards slightly from 0.4%.

Much stronger growth than anyone expected in the second quarter may see rates markets firm up their already aggressive pricing of cash rate hikes. Especially given markets have drifted back a touch since the labour market data earlier this month saw 225bps of hikes priced in by 2010. However, weak household incomes in H2, combined with the impact of a sharp reversal in the terms of trade, foreshadow that growth in the second half will be weaker than the first. As such we also think that RBA will not be in the hurry to 'normalise' the level of interest rates as the market pricing suggests. The 'emergency' 3% cash rate level is not as low as it appears with cost of fund increases implying higher mortgage and business lending rates than would have been the case a few years back. The RBA's communications suggest to us that they think the biggest policy mistake that could be made right now would be to 'choke off' the economic recovery. This is especially true given the forecast deceleration of inflation gives the RBA no compelling reason or need to raise rates rapidly, especially as the labour market remains so fragile. As such we anticipate rates will only start to rise in early 2010 and be relatively gradual when they to come.

Data wrap

- **Motor vehicle sales** fell 6.9% in July after rebounding 5.8% last month.
- **DEWR Skilled Vacancies** rose 1.0% in August.
- **Construction work done** contracted only 0.1% in the June quarter.
- **Conference Board leading** index rose 0.9% in June.
- **CAPEX** data for the June quarter showed a 3.3% rise.

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Interest rate markets: The removal of IWT on Commonwealth government bonds

- The announcement of the removal of the 10% interest withholding tax (IWT) on Commonwealth government bonds is a positive development which should in the medium term argue for relatively lower yields on local bonds.

A positive development

The announcement of the removal of the 10% Interest Withholding Tax on Commonwealth government bonds should increase the potential pool of investors to buy Australian government bonds as well as equalise the treatment of ACGBs with corporate and Semi bonds (that are already IWT-free). IWT removal will clearly improve the attractiveness of CPI-linked or capital indexed bonds that pay coupons quarterly and is probably where we will see new investors most clearly.

As was the case with the government guarantee for State government bonds there is still a degree of uncertainty regarding the passage and timing of the legislation through Parliament. But one would expect passage before the AOFM looks to resume issuance of CPI linked bonds possibly in late September or early October.

IWT removal should, in the medium term, argue for relatively lower yields on local bonds. The IWT move and expectations for tighter policy also argue for a flatter curve as longer-dated bonds become more attractive. This is also more likely to remove the relative advantage of other bonds such as Semis that currently enjoy IWT-exemption.

Upward pressure on near term rates

In the near term, the bias remains for higher outright yield at the front end of the curve ahead of the start of the expected normalisation of policy by the RBA in coming months. The board meets next week and is widely expected to leave interest rates unchanged. While recent anecdotes of strong activity in the housing sector supports arguments for a quick move toward policy normalisation, the first real opportunity for a move on rates looks to be October when the RBA has at hand more data on the performance of household spending. The last RBA Minutes reflected a more circumspect tone on the risks posed by a relatively quick removal of policy accommodation.

Today's Private New Capital Expenditure series confirmed that major investment plans are now starting to be brought forward. Indeed, recent announcements in the resources sector suggest we could see a major increase in planned investment at some stage and the values could be huge. But the RBA have already signalled that this is expected.

The RBA focus here, stable equity markets, more encouraging news from US and European manufacturing data and more upbeat comments from policy-makers all suggest that the bias for short-dated yields remain to the upside in the near term. This will add to curve flattening pressure.

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FX: The AUD/NZD's slide

AUD/USD Key levels: 0.8120 – 0.8430

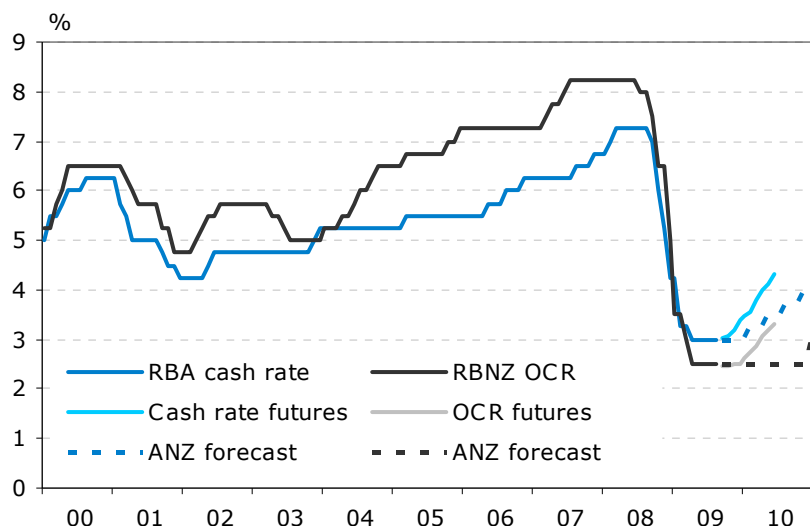
Upward momentum in AUD/USD became exhausted this week as the economic data flow catches up with premiums already priced into markets. An upside surprise on next week's Q2 GDP result is unlikely to cause a break out of recent ranges, but could still see AUD/USD spike as high as 0.8430 (with profit taking likely on rallies to 0.8380). AUD buyers should take advantage of moves towards 0.8180 (with dips to 0.8120 possible) if US equities remain muted.

Why is the NZD outperforming the AUD?

Over the past four weeks, the AUD/NZD has declined over 4% from above 1.2650 to around 1.2150. This move lower has been counter to the trading direction suggested by traditional fundamental drivers, such as rate differentials. Instead, the move appears to be largely driven by market positioning. Investors whose portfolios had been underweight NZD have been buying this currency as an alternative vehicle for exposure to the Asian economic growth upswing. This play has already been one of the major drivers of AUD over the past few months (and has seen investor portfolios become overweight AUD). Divergent short-term outlooks for the Australian and NZ economies – with NZ expected to emerge from recession in Q3 while economic growth in Australia is expected to slow in Q3 after a very strong Q2, may also be providing a short-term drag on AUD/NZD. Also note that the recent NZD outperformance of AUD comes despite the NZD being a much less liquid market than AUD, as well as the NZD finding less buying support than the AUD from speculative markets (such as on the IMM and Japan's TFX). The latter suggests there is scope for even more NZD outperformance in the short term.

Divergent fundamentals still suggest AUD/NZD will appreciate by end-2009 and into 2010. In particular, there are now stark differences in the monetary policy outlook for Australian and NZ. The RBNZ maintains an easing bias, and while it is unlikely to act on this bias, rate hikes are still a long way off. In contrast, the RBA maintains a neutral bias and rate hikes are clearly on the horizon, with the RBA looking to adopt "a less expansionary policy stance". Interest rate markets have already moved to price in 131bp worth of interest rate hikes in Australia by June 2010 versus just 81bp in NZ over the same time period.

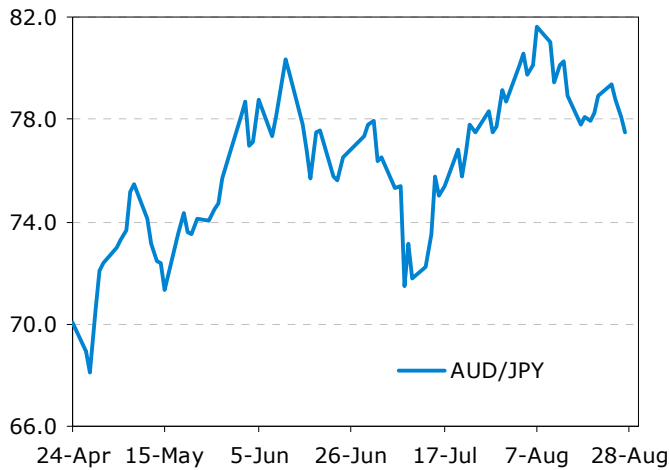
Figure 3: A widening interest rate differential should support AUD/NZD



Source: ANZ, Bloomberg

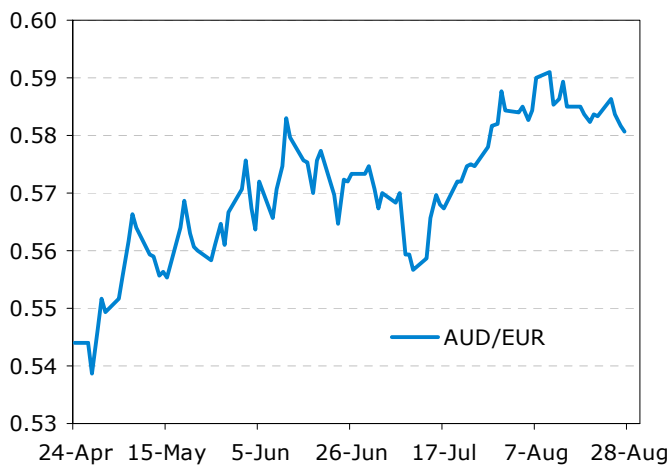
While we feel that a rebound in AUD/NZD is imminent, the risk in the near-term is that the cross could drop further to 1.2050 (and even lower towards 1.1910 on a technical basis) as investors continue to pare back long AUD/NZD positions. The divergent economic fundamentals between Australia and NZ are expected to reassert their influence by the end of 2009, with AUD/NZD to head towards the mid-1.20s and then into the low 1.30s in early 2010.

AUD cross view



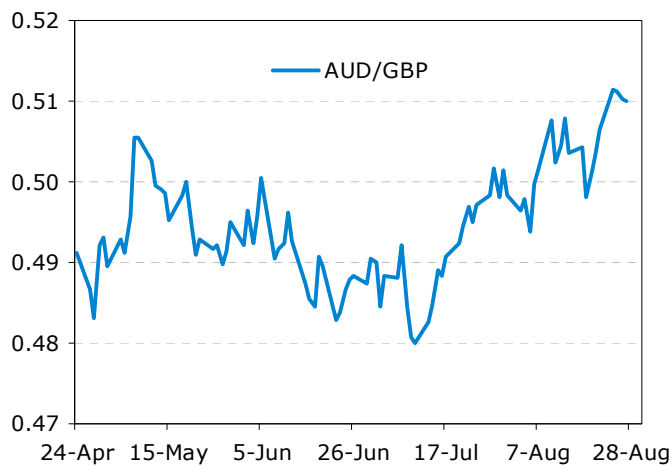
AUD/JPY Key levels: 75.70 – 80.40

- The small unwinding of risk appetite on global markets over the past week has weighed on the AUD/JPY. The cross has found good downside support around the 50-day moving average of 77.40, but could move towards our downside target of 75.70 over the coming week if the global data flow continues to leave markets uninspired.
- Next week's Australian Q2 GDP result is the key risk event for this cross. An upside surprise would be AUD supportive and see AUD/JPY rally towards 80.40. A raft of Japanese data for July including IP, employment, retail sales and consumer prices are also due for release over the coming week.



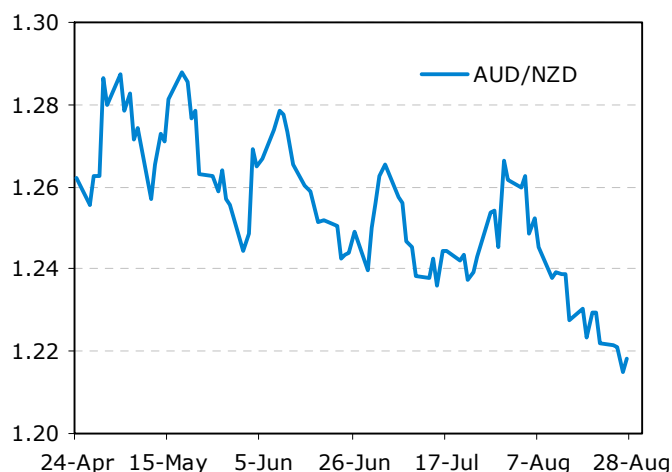
AUD/EUR Key levels: 0.5770 – 0.5880

- The AUD/EUR has become stuck in a mild downwards groove and again briefly dipped below 0.58 this week. Downside dips towards 0.5770 are possible next week, while upside moves could be limited to the 200-day MA of 0.5880.
- The ECB's September policy meeting is the most significant event on the Euro zone calendar next week. With Q2 GDP surprising on the upside, and the French and German economies having emerged from recession, ECB President Trichet may soon begin to contemplate a tightening of policy. Any hint of such a move would boost EUR and could see AUD/EUR slide towards 0.5770.



AUD/GBP Key levels: 0.4950 – 0.5150

- AUD/GBP rallied to yet another 13-year high above 0.51 this week as concerns regarding the health of the UK economy weighed heavily on GBP. The cross now looks very comfortable above 0.50, and could push to yet another new 2009 high next week if sentiment continues to move against GBP.
- August PMI surveys should provide evidence that the UK economy is beginning to recover and therefore lend support to GBP/USD. While this would likely be AUD/GBP negative, it looks like a difficult task to budge the cross significantly below 0.50 over the coming week.



AUD/NZD Key levels: 1.2050 - 1.2430

- AUD/NZD sunk to a new 4½-month trough below 1.2150 this week on strong Kiwi buying by investors with NZD underweight portfolios. Solid support at 1.2150 has seen the cross bounce back towards 1.22, although the near-term risk is for a further slide towards 1.2050 as investors continue to move out of long AUD/NZD positions.
- Business confidence and commodity price data are the key economic releases in NZ over the coming week. However, international flows should persist in being the dominant driver of AUD/NZD. The first topside target for the cross this week is 1.23, with spikes towards 1.2430.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.1	-1.0	1.0	3.6
Household consumption	2.2	1.8	1.6	3.0
Dwelling investment	2.5	-6.2	6.5	5.9
Business investment	13.8	-7.9	-3.3	4.9
Public demand	5.3	1.9	6.8	4.2
Domestic final demand	4.4	-0.4	2.3	3.7
Inventories (contribution to GDP)	-0.6	-0.2	0.3	0.1
Gross National Expenditure (GNE)	3.8	-0.5	2.6	3.8
Exports	3.9	1.2	0.2	4.5
Imports	10.3	-12.3	4.1	9.5
Net Exports (contribution to GDP)	-1.5	3.2	-0.8	-1.1
Gross Domestic Product (GDP)	2.3	0.8	1.5	3.2
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.8	2.6	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	-0.1	-0.3	1.8
Unemployment rate (%)	4.3	5.9	7.3	7.2
External sector				
Current account balance: A\$ bn	-51.0	-36.3	-49.0	-58.2
% of GDP	-4.3	-3.0	-3.9	-4.4

*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	3.25	3.50	3.75
90 day bill	3.35	3.40	3.45	3.55	3.80	4.30
3 year bond	4.73	5.00	5.00	5.15	5.10	5.20
10 year bond	5.30	5.70	5.60	5.65	5.60	5.80
3s10s yield curve	0.57	0.70	0.60	0.50	0.50	0.60
3 year swap	5.15	5.30	5.30	5.45	5.40	5.67
10 year swap	5.90	6.10	5.95	5.95	5.90	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	1.04	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.42	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
Australian exchange rates						
A\$/US\$	0.8279	0.82	0.80	0.80	0.83	0.84
NZ\$/US\$	0.6789	0.66	0.64	0.59	0.59	0.60
A\$/¥	77.54	80.36	80.00	84.00	89.64	92.40
A\$/€	0.5813	0.58	0.58	0.58	0.59	0.60
A\$/£	0.5108	0.50	0.48	0.47	0.48	0.49
A\$/NZ\$	1.2196	1.24	1.25	1.36	1.41	1.40
A\$/CA\$	0.9100	0.90	0.86	0.84	0.87	0.88
A\$/CHF	0.8850	0.90	0.91	0.91	0.94	0.95
A\$/CNY	5.657	5.60	5.46	5.46	5.67	5.73
A\$ Trade weighted index	65.50	65.45	63.85	64.46	67.22	67.43
International cross rates						
US\$/¥	93.66	98.0	100.0	105.0	108.0	110.0
€/US\$	1.4243	1.42	1.38	1.38	1.40	1.40
€/¥	133.40	139	138	145	151	154
£/US\$	1.6208	1.65	1.68	1.70	1.72	1.73
€/£	0.8788	0.86	0.82	0.81	0.81	0.81
US\$/CA\$	1.0991	1.10	1.07	1.05	1.05	1.05
US\$/CHF	1.0689	1.10	1.14	1.14	1.13	1.13
US\$ index	78.64	79.1	80.3	80.5	80.0	80.1
Asia exchange rates						
US\$/CNY	6.832	6.83	6.83	6.83	6.83	6.82
US\$/HKD	7.751	7.75	7.75	7.75	7.76	7.77
US\$/IDR	10165	10250	9750	9500	10000	9500
US\$/INR	48.95	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1249	1225	1125	1175	1225	1100
US\$/MYR	3.54	3.55	3.50	3.48	3.45	3.40
US\$/PHP	48.91	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.45	1.48	1.46	1.45	1.45	1.44
US\$/THB	34.03	35.00	34.50	34.00	34.00	33.50
US\$/TWD	32.93	32.50	32.00	31.50	31.00	30.30
US\$/VND	17821	17800	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.375	0.395	0.374	0.392	0.381	0.395
FJD/US\$	0.497	0.483	0.472	0.469	0.476	0.480

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