

Economy stronger, monetary policy to get tighter

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Macroeconomic Update: return to optimism

- Surging business and consumer confidence suggests that the Australian economy may be on a higher equilibrium path.
- The more optimistic outlook implies current monetary policy settings are increasingly looking overly expansionary, requiring the cash rate to be raised "towards" a more normal setting.
- Rates hikes are not expected to commence until early 2010 and are expected to be gradual given the uncertainty about how the economy (and in particular household spending) will fare in coming months as direct fiscal stimulus is withdrawn and the still fragile nature of the global economic and financial backdrop. This stands in contrast with current market pricing for hikes of over 200bp by end-2010 commencing by then end of this year.

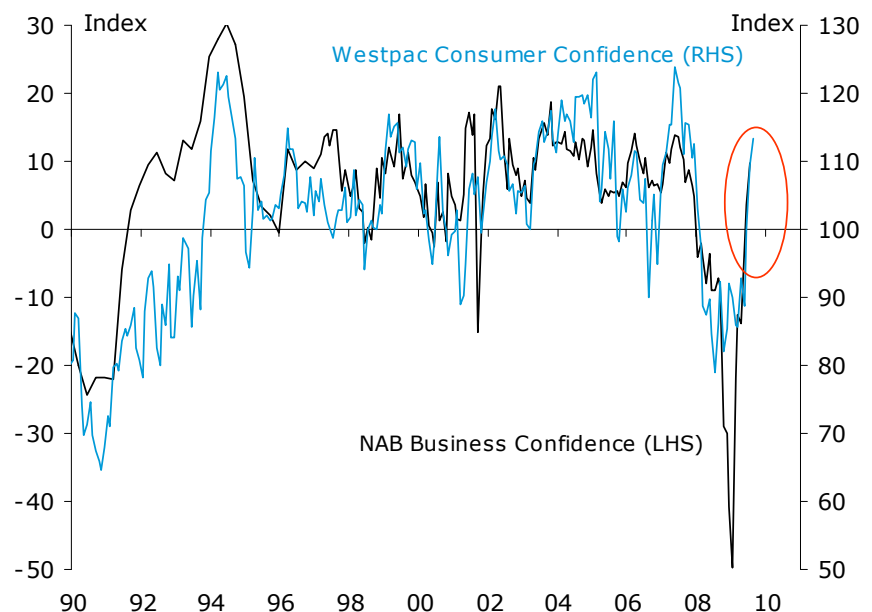
Rate markets: strong data fuels rates

- The strength of recent data has seen markets price in 2.25% worth of official interest rate hikes by December 2010.
- We believe that risks to the economy remain relatively balanced, suggesting that current market pricing may be too aggressive at this point.

FX: H2 headwinds arise for further AUD rises

- The AUD moved into consolidation mode this week, after a stellar run in recent months. This was largely in response to data suggesting that the recovery in the Chinese economy, while remaining strong, has slowed.
- Central bank and Treasury communications form the key domestic directional risks for the AUD over the coming week.

Chart of the week: local business and consumer confidence is recovering rapidly



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Macroeconomic Update: return to optimism

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Solid data will bring RBA back into play, but not until 2010

The positive data flow continued this week, with both consumer and business confidence continuing to surge (see chart of the week). Business confidence has now improved to +10, with optimists clearly outweighing pessimists, and the level of the index is well above its 10-year average of +5.8. Consumer confidence also built on recent gains, rising 3.7% in August and a massive 30% since the start of the year (and 40% since its cyclical low a year ago).

More importantly, measures of actual business conditions also moved into positive territory in July for the first time since May 2008. Profitability turned positive for the first time in a year and trading conditions and forward orders moved more solidly into positive territory also, providing evidence that business activity is starting H2 on a better growth path than looked likely 6 months ago. Business employment intentions improved but are still adding to a net negative, providing a good reminder of the risks and vulnerabilities that still lie ahead.

Last week we discussed the recent strength in Australian economic indicators and the likelihood of GDP growth being positive in Q2. Building on this theme, the surge in business and consumer confidence this week make us increasingly confident that the Australian economy may be on a higher equilibrium path than was envisaged only a few months ago (either by us or by policy makers).

This more optimistic outlook suggests current monetary policy settings will increasingly seem overly expansionary, relative to actual economic conditions. Remember that the cash rate was decreased to 3% at a time (albeit very recent) when global growth was collapsing and Australia was expected to experience a relatively severe recession. This setting is now arguably creating some imbalances in the Australian economy, particularly in relation to the housing market.

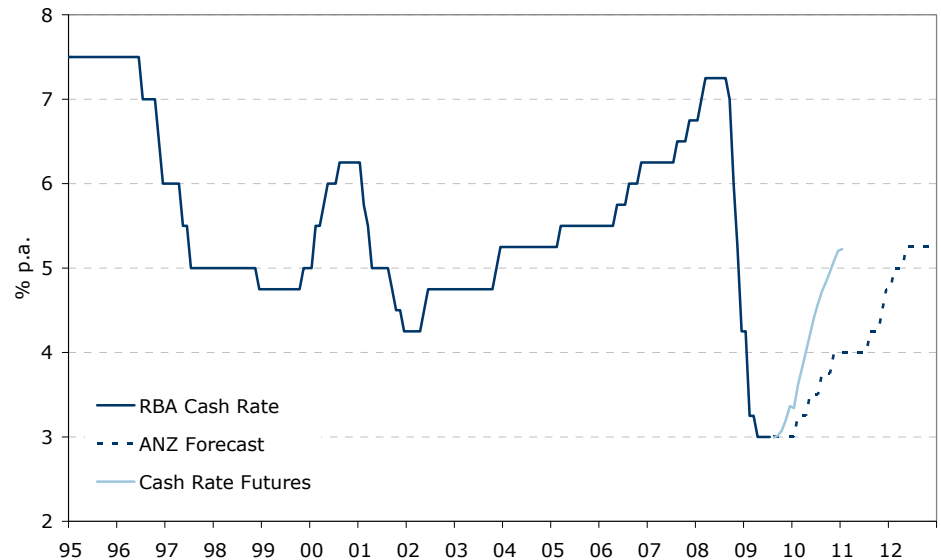
As an additional point, this week's data on wages and inflation expectations reminded us that inflation cannot be ignored in the current, more positive growth environment. Yes, wages growth is easing in line with inflationary pressures, but the slowdown has been *very* gradual to date, due to the resilience of the labour market. And inflation expectations have already started to head up again, with the level of expected inflation now rising 3 months in a row, and the proportion of those surveyed who expect higher inflation over the next 12 months rising to 76%, from around 50% in January. Wages and prices growth are clearly proving to be more 'sticky' than we previously expected.

On this basis, we now expect the cash rate to be gradually returned to a more "normal" (less expansionary) setting. ANZ is now forecasting the RBA to start raising the cash rate from February 2010 in small 25bp increments, reaching 4% by the end of 2010. We then expect the RBA to pause for around 6 months as it assesses how the economy has responded and waits for economic growth to return toward its long-run trend or potential rate of 3¼%, before starting to hike again in mid-2011. The cash rate will then track up toward 5.25% by mid-2012.

Although this is a notable change in view, our new forecast is still much less aggressive than current market pricing (see chart 1 below). Cash rate futures are priced for more than a 25bp hike by end-2009 and for a sharp shift up in the cash rate to almost 4.5% by June 2010 and over 5% by December 2010. We think such a rapid series of rate hikes is unlikely given the uncertainty about

how the economy will fare in coming months, as direct fiscal stimulus is withdrawn. In particular, the RBA is still expecting household consumption to go backwards in H2 as household incomes are pulled back. The still-fragile nature of the global economic and financial backdrop also indicates that when rate hikes come, they will be relatively small and will be implemented more gradually.

Chart 1: cash rate expectations (ANZ versus the market)



Sources: ANZ, Bloomberg

Market pricing seems to be inconsistent with this (upwardly revised) outlook. By December 2010, the RBA is expecting GDP growth of just 2¼%, which is well below trend. In contrast, the market is expecting the cash rate to have almost returned to neutral by then; a neutral cash rate is somewhere between 5.5% and 6% (or perhaps a touch lower, given current high levels of household debt).

But we should never say never. There is of course scope for the RBA's economic forecasts to be revised upwards again, which would raise the risk of an even earlier beginning to rate hikes. Key indicators to watch will be retail sales and the labour market, both of which have been remarkably resilient to date, but which are expected to consolidate in the second half of 2009. Chinese economic indicators will also be critical, given that Chinese demand for Australia's resource exports has also been a key contributor to gross domestic income growth in H1.

Data wrap

- **Housing finance commitments** grew 1.1% in number and 0.3% in value in June. Owner occupied housing finance grew by 1% but investor loans fell 1.8%. The proportion of loans going to 1st home buyers eased to 27.1%.
- **NAB's Business Conditions** rose 3 points to 1.0 in August, its first positive reading since May 2008. **Business confidence** shot up 6.2 points to 9.7, its highest level since August 2007. **Employment intentions** improved to -4.9.
- The **Wage Price Index (WPI)** grew at a stable rate in Q2, at 0.8% growth in the quarter, but it slowed to 3.8% in annual growth terms.
- The Westpac monthly **consumer confidence** survey improved by 3.7% in August to its highest level since August 2007.
- **Average weekly ordinary time earnings** for full-time adult employees (AWOTE) grew by 1.2% in Q2, to be up 6.1% from last year.
- **Average weekly total earnings** for all employees (AWE) grew by 0.6% in Q2, to be up 3.8% from a year ago.
- MI's **consumer inflation expectations** ticked up to 3.5% in August, from 3.2% last month, the 4th consecutive monthly rise. The proportion of those surveyed who think inflation will rise over the next 12 months jumped up to 76%, from 69% in July and around 50% in January.

Rates markets: Strong data fuels rates

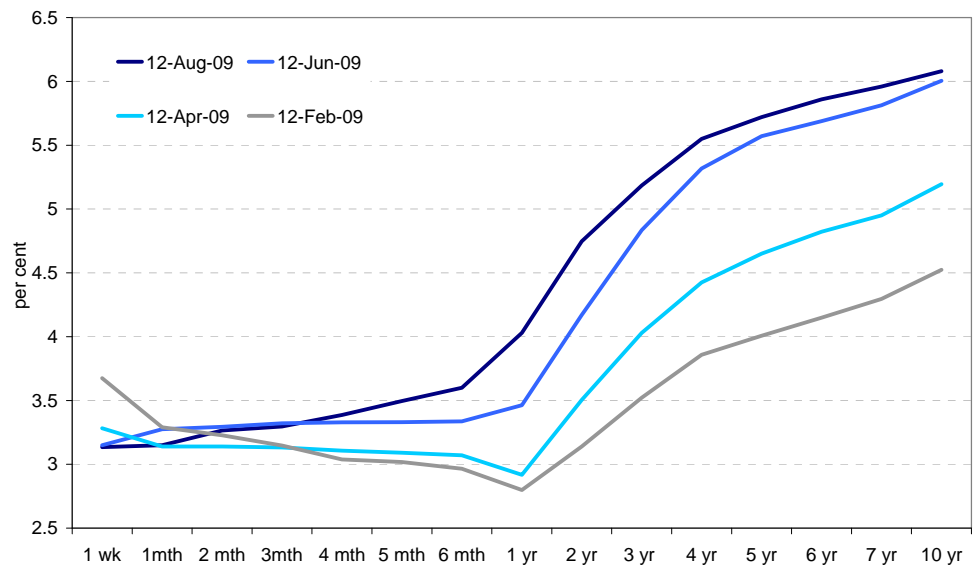
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- The strength of recent data has seen markets price in 2.25% worth of official interest rate hikes by December 2010.
- We believe that risks to the economy remain relatively balanced, suggesting that current market pricing may be too aggressive at this point.

The recent run of positive data combined with the dropping of the RBA's explicit easing bias has well and truly broken the shackle in rates markets. The market is convinced that the RBA will increase the official cash rate from the current expansionary setting towards a neutral stance. Much of the data out this week has done nothing to deter this view with more solid housing figures and further increases in both business and consumer confidence (the former at a 2-year high).

On the back of this strong data, futures markets currently have over 225bp of RBA hikes priced in by December 2010. Swap rates across the curve have moved significantly to price in a 'normalisation' of official rates. In our view, the sharp rise in the swap rates, especially from a 1 year tenor outwards, has made hedging further along the curve increasingly unattractive. The meat of the curve for 1-5 year money in particular has steepened considerably (see chart 2) as expectations of the timing of rate hikes has been brought forward and the magnitude of rate rises increased.

Figure 2: The market anticipates a normalisation of rates



Source: ANZ & Bloomberg

We believe that current market pricing for a 'normalisation' of rates may be too aggressive. Given the current stock of household debt market pricing of 225bps of hikes by December 2010 would result in \$91bn being added to their interest burden. Should this transpire, this would only add to the already existing risks of softer consumption going forward. And would further compound the downside risks to the economy still posed by weaker labour market outcomes, stagnant household incomes and a soft business investment environment over this period.

Shorter term fixing may still hold some value, especially against any upside surprise from the economic data that may see further rate hikes priced into this year. Further along the curve we expect to see increased fixing on dips, yet moves lower are likely to be short-lived given the market seems determined to price in a normalisation of interest rates despite risks the domestic economy in H2 still being balanced. Recently, this behaviour has been characterised by an upward channel for term rates marking progressively higher-lows. With June quarter GDP numbers due early September likely to be solid, any disappointment in labour force data later that month or weaker data out of the US may be opportunities to pay into any brief rally. Going forward, the easing of wages growth and below trend GDP growth through H2 may give currently persistent inflation enough downward momentum to give the RBA further breathing space before raising official rates which could see the rise in term rates start to lose some momentum. But perhaps this is only for those who can hold their nerve until then.

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FX: H2 headwinds arise for further AUD rises

Recommendation

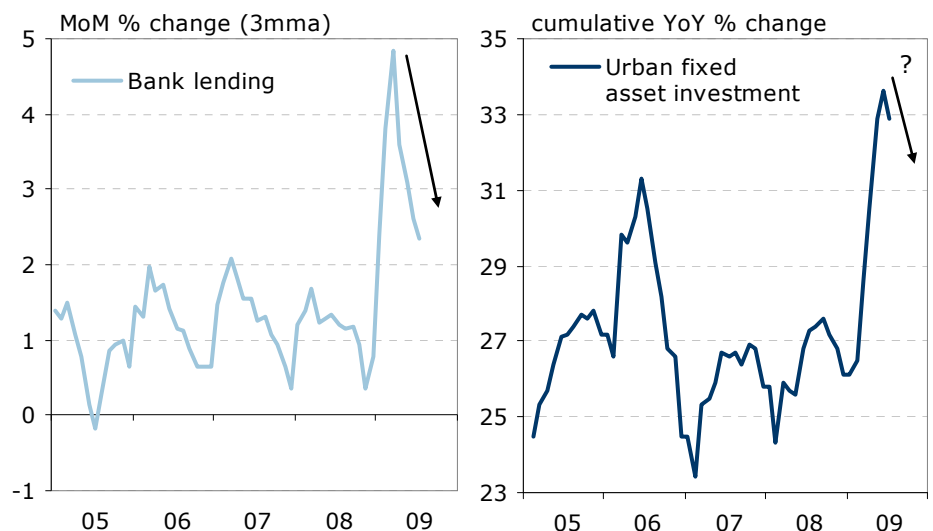
AUD moved into consolidation mode this week. Central bank and Treasury communications form the key domestic directional risks over the coming week. Also beware of tonight's Q2 Euro zone GDP release which could see AUD/USD pulled higher with EUR/USD if the data print in line with today's better than expected German and French results. AUD/USD buyers are advised to take advantage of dips towards 0.8250, with strong exporter buying expected to see AUD/USD well supported above this level. At the extreme, look to dips to 0.8120. AUD/USD sellers should remain alert to upside surprises in US data releases this week which could see AUD/USD move back toward 0.8430.

Slowing recovery in China points to headwinds for AUD in H2

We have written a lot this year about how significant the fortunes of the Chinese economy are in driving AUD direction. This week we received data suggesting that the recovery in the Chinese economy, while remaining strong, has slowed. In turn, AUD/USD quickly sold off, dipping to a two-week low close to 0.8180. However, given the stellar rise of the AUD and indeed of accelerating growth in China, some consolidation is not a big surprise.

The data highlight the risks that while the Chinese economy should continue to grow, the recent acceleration in growth will likely slow over the second half of this year. This is a subtle turn that will create considerable headwinds for the AUD. The charts below highlight the risks that China's strong growth trajectory, and with it the AUD's stellar rise, looks ripe for consolidation. The strong rise in Chinese domestic bank lending which had hitherto spurred the sharp recovery is now slowing, partly on government directive. This is already showing up in slower momentum in some activity indicators, such as growth in Chinese fixed asset investment which unexpectedly declined in July. Likewise, the spectacular rise in Chinese commodity imports, a key support for the AUD's rise in recent months, looks unsustainable, especially if the view that part of this rise reflects restocking holds true. If these indicators slow as expected, an AUD/USD back towards (and possibly below) 0.80 looks much more likely than a stab towards 0.85 over the coming months.

Figure 1: A slowing in the momentum of China's economic recovery

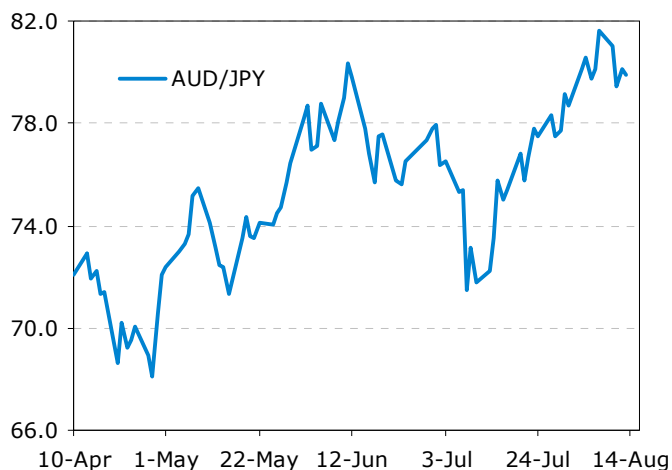


Source: ANZ, Bloomberg, Thomson Datastream.

Despite these headwinds, let's not forget that a number of key drivers will also help to support the AUD and prevent it from falling significantly from current levels. Importantly, the change in ANZ's view that the RBA will begin raising the cash rate earlier in 2010 than previously forecast should see AUD/USD remain well supported above 0.8000 over the coming months.

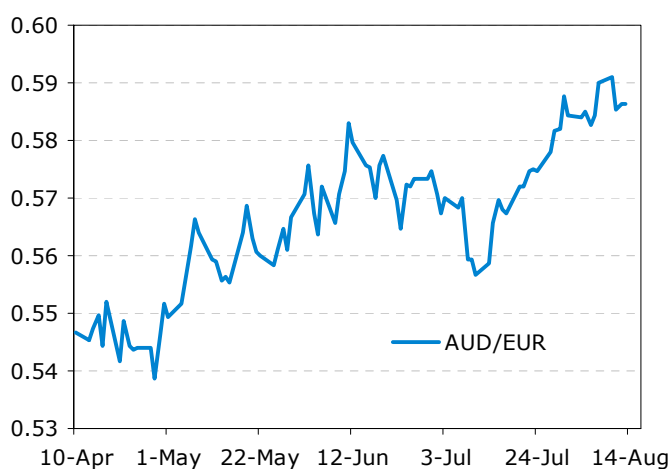
AUD/USD Key levels: 0.8120 – 0.8430. A mild downward trend in AUD/USD has become established. A sustained fall through 0.8250 is required for AUD/USD to retest 0.8120. On the upside, a break through the long-run 0.8380 fibo level could see AUD/USD attempt another break above 0.8430.

AUD cross view



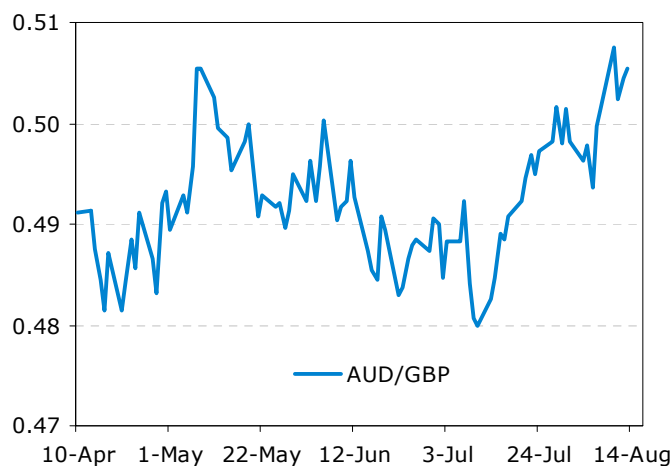
AUD/JPY Key levels: 77.80 – 82.00

- The strong upwards momentum in AUD/JPY evident over the last four weeks has slowed and a consolidation in the cross has mapped similar moves in AUD/USD. Strong downside support should limit dips to early July's pullback to 77.77.
- Japanese Q2 GDP due for release on Monday could prove to be an interesting driver for this cross. Upside risks to the market forecast of 1% quarterly growth would be slightly AUD positive and if realised we could see AUD/JPY test recent highs around 82. Japanese retail investor net longs in AUD/JPY also appear to be extending again, suggesting some upside to the cross.



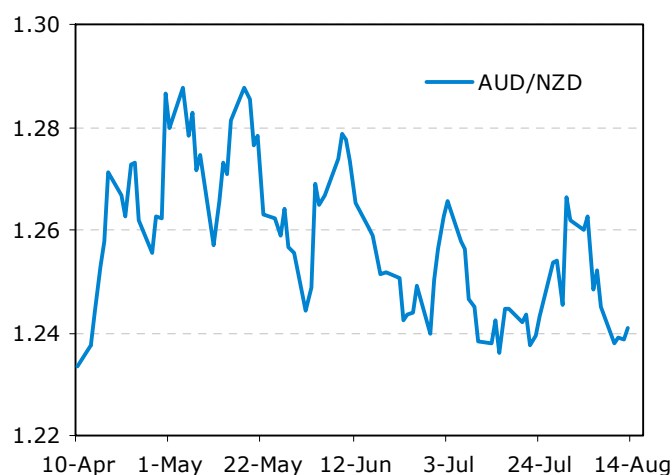
AUD/EUR Key levels: 0.5780 – 0.5920

- AUD/EUR strength has eased in line with moves in AUD/USD. Topside resistance around 0.5920, a significant retracement level between 2008's cyclical high and low, should persist this week.
- Tonight's Q2 Euro zone GDP release is a key risk event for the cross. A better than expected 0.5% quarterly contraction would likely boost EUR/USD and pull AUD/USD up with it given the two currencies' strong correlation. However the overall impact on the AUD/EUR should be limited. Next week's releases of Euro area investor confidence and purchasing managers' indices should provide further direction.



AUD/GBP Key levels: 0.4910 – 0.5090

- AUD/GBP cracked a new 13-year high of 0.50932 this week following the BoE's unexpected expansion of its gilt purchase program. The cross appears to be very comfortable within its recent 0.48 – 0.51 trading range, but has the potential to make new highs in the short-term given the different policy stances of the BoE and RBA. Look for a retest of 0.5090 over the coming week.
- Minutes from last week's BOE policy meeting are a clear event highlight. The market will be looking for further insight into possible future moves by the BoE. Any inkling that another QE extension could be on the cards would be AUD/GBP positive.



AUD/NZD Key levels: 1.2340 - 1.2600

- AUD/NZD remains firmly locked into a consolidating trend. A clear short-term base appears to have formed around 1.2340 and this level should persist as the floor for any dips over the coming week. Topside peaks have been trending lower and we see 1.2600 as the limit to any bounces higher in the cross this week.
- NZ retail sales data for June to be released tomorrow could surprise on the upside if our NZ economists' forecast of 0.1% monthly growth (versus market expectations of a 0.3% fall) plays out. This would be NZD supportive and could see AUD/NZD push initially lower towards 1.2380.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.1	-1.1	1.1	3.9
Household consumption	2.2	1.8	1.6	3.0
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	4.2
Domestic final demand	4.4	-0.4	2.4	4.0
Inventories (contribution to GDP)	-0.6	-0.2	0.3	0.1
Gross National Expenditure (GNE)	3.8	-0.6	2.7	4.1
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	3.3
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	3.28	3.10	3.25	3.30	3.40	3.75
3 year bond	4.95	4.70	4.60	4.85	4.80	5.20
10 year bond	5.70	5.50	5.40	5.55	5.50	5.80
3s10s yield curve	0.75	0.80	0.80	0.70	0.70	0.60
3 year swap	5.25	5.00	4.90	5.15	5.10	5.67
10 year swap	6.20	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	2.80	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	1.17	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.73	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\$	0.84	0.82	0.80	0.80	0.83	0.84
NZ\$/US\$	0.67	0.66	0.64	0.59	0.59	0.60
A\$/¥	80.72	80.36	80.00	84.00	89.64	92.40
A\$/€	0.59	0.58	0.58	0.58	0.59	0.60
A\$/£	0.51	0.50	0.48	0.47	0.48	0.49
A\$/NZ\$	1.24	1.24	1.25	1.36	1.41	1.40
A\$/CA\$	0.91	0.90	0.86	0.84	0.87	0.88
A\$/CHF	0.90	0.90	0.91	0.91	0.94	0.95
A\$/CNY	5.73	5.60	5.46	5.46	5.67	5.73
A\$ Trade weighted index	66.40	65.23	63.59	64.24	66.95	67.18
International cross rates						
US\$/¥	96.2	98.0	100.0	105.0	108.0	110.0
€/US\$	1.42	1.42	1.38	1.38	1.40	1.40
€/¥	137	139	138	145	151	154
£/US\$	1.65	1.65	1.68	1.70	1.72	1.73
€/£	0.86	0.86	0.82	0.81	0.81	0.81
US\$/CA\$	1.09	1.10	1.07	1.05	1.05	1.05
US\$/CHF	1.08	1.10	1.14	1.14	1.13	1.13
US\$ index	78.7	79.2	80.4	80.6	80.1	80.2
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	9945	10250	9750	9500	10000	9500
US\$/INR	48.15	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1237	1225	1125	1175	1225	1100
US\$/MYR	3.52	3.55	3.50	3.48	3.45	3.40
US\$/PHP	47.92	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.44	1.48	1.46	1.45	1.45	1.44
US\$/THB	34.05	35.00	34.50	34.00	34.00	33.50
US\$/TWD	32.88	32.50	32.00	31.50	31.00	30.30
US\$/VND	17812	17800	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.379	0.350	0.350	0.350	0.360	0.360
FJD/US\$	0.498	0.482	0.471	0.468	0.475	0.479



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