

ECONOMIC RECOVERY AND RATE RISES TO CONTINUE IN Q4

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INSIDE:

Economic update..... 2
 FX..... 4
 AUD Cross View 5
 Forecasts 6

CONTRIBUTORS

Warren Hogan,
Acting Chief Economist
 +61 2 9227 1562
 Warren.Hogan@anz.com

Shane Lee,
Senior Economist
 +61 2 9226 4632
 Shane.Lee@anz.com

Julie Toth,
Senior Economist
 +61 3 9273 6252
 Julie.Toth@anz.com

Dr Alex Joiner,
Economist
 +61 3 9273 6123
 Alex.Joiner@anz.com

Amber Rabinov,
Economist
 +61 3 9273 4853
 Amber.Rabinov@anz.com

Melissa Fenech,
Research Analyst
 +61 3 9273 1590
 Melissa.Fenech0@anz.com

ECONOMICS UPDATE: RBA'S CONFIDENCE IN OUR RECOVERY STRENGTHENS

- RBA minutes confirm recovery is now established and rates must move accordingly.
- Wages and prices growth moderates, but underlying pressures remain of concern.
- Quarterly SME surveys indicate Australia's small businesses are now starting to catch up to their bigger counterparts, in terms of confidence and expectations.

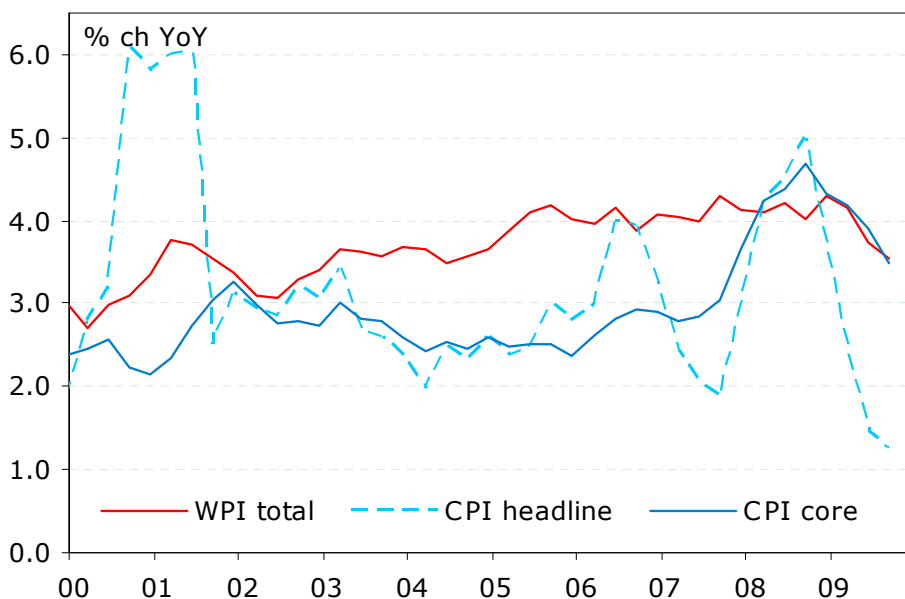
FX: MOMENTUM SLOWS FOR AUD/USD

- AUD/USD maintained its 0.9200 – 0.9400 range this week. A break above 0.94 failed to hold after rates markets pared back expectations of a December rate hike in response to the RBA Minutes, released on Tuesday.
- Next week, look for releases of US personal spending and income data, durable goods orders, and housing figures (all for October) to provide direction for AUD/USD - any upside surprises could see the cross reattempt a break higher.
- Seasonal factors could lend support to AUD into the New Year.

CHART OF THE WEEK

Inflation pressures remain, with wages growth and core inflation moderating only slowly.

FIGURE 1. PRICES (CPI) AND WAGES (WPI) GROWTH



Source: ABS

Julie Toth
Senior Economist
+61 3 9273 6252
Julie.Toth@anz.com

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RBA CONFIRMS IT IS KEEN TO REMOVE MONETARY STIMULUS

Minutes released by the RBA this week confirm it believes the risk of economic recession has now abated to the point where recovery seems assured. Indeed, inflation and capacity constraints are already emerging as the key issues for the Australian economy going forward, just as they were before the GFC started this recession cycle in 2007.

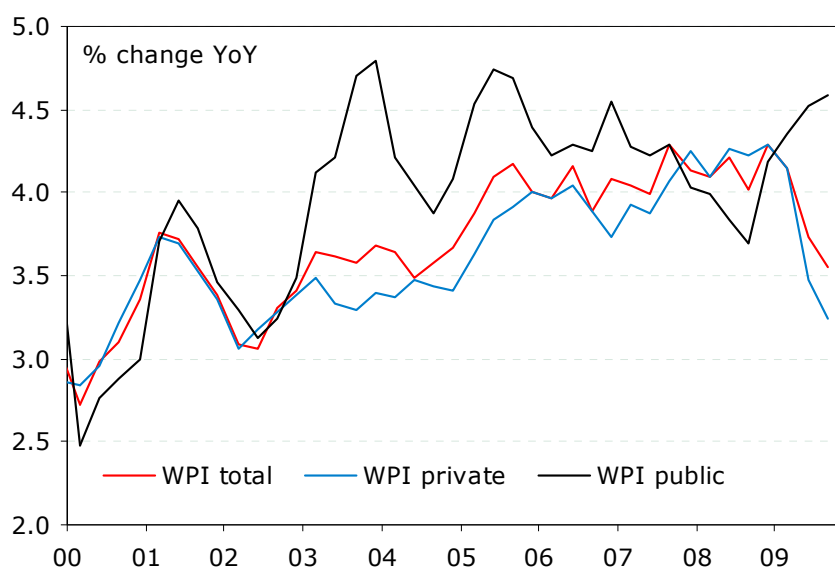
The data flow through Q3 and into Q4 confirm this view of the Australian economy, although the RBA is still very conscious of the continuing risk of raising interest rates off their 'emergency' setting too fast, and removing monetary stimulus before the economy is ready. The Minutes highlight particular concerns around the reaction of households to rate rises in the short term. This concern is well founded, given the recent small falls in indicators such as sentiment and retail spending following the RBA's first two rate rises.

The key implication of the recovery for monetary policy is that *"...if economic conditions evolved as expected, further gradual adjustment in the cash rate would most likely be appropriate over time, though the pace of the adjustment remained an open question"*. We believe that the accelerating pace of economic recovery indicated by the latest data releases (and especially by the latest labour market data) implies the 'appropriate pace' (i.e. timing) of monetary policy adjustment is sooner rather than later. After two moves already this year, there is room for one more 25 bps rise in December, plus two further rises in February and March next year. This will take the cash rate back to 4.25% by the end of Q1 2010, and well on the way toward a more 'neutral' setting (especially given the wider margins to lending rates due to continuing fallout from the GFC). We believe a lengthy pause will be necessary next year however, to allow the economy to catch up and adjust, and for the desired deflationary effects of the rate rises to flow through.

WAGES PRESSURES MODERATING, BUT STILL RELATIVELY STRONG

Wages growth softened slightly in Q3 to 0.7% QoQ. It has now decelerated over the last 3 quarters, from its recent peak in Dec 2008 (1.3% QoQ). In annual growth terms, the WPI slowed to 3.6% this quarter, down from its recent peak of 4.3% in Dec 2008. This slowdown in wages growth was expected. It reflects slowing (but still elevated) inflation, and a weaker (but still relatively healthy) labour market.

FIGURE 2. PRIVATE SECTOR WAGES GROWTH IS MODERATING



Source: ABS

ECONOMIC UPDATE

Wages growth strengthened slightly in the private sector in Q3 (to 0.7% from 0.6% in Q2) and weakened slightly in the public sector (to 1.0% from 1.1% in Q2) in seasonally adjusted terms. The acceleration in private sector wages growth provides a further indication of improvement in the private sector labour market in Q3. It also reflects the fact that national net jobs growth turned positive in Q3 (0.1% QoQ), after two quarters of net contraction earlier in 2009. The easing of wages growth in the public sector will be good news for public finance, although wages growth remains significantly elevated in the public sector compared to the private sector, and is tracking at its highest level in 3 years, in annual growth terms.

Relative to inflation, total WPI continues to track closely to the RBA's core measure of inflation, which is currently sitting around 3.5%. Both are significantly higher than headline inflation, which is around 1.3% (see 'chart of the week', p. 1). These wages and inflation data will do nothing to dissuade or delay the RBA from returning monetary policy toward a more 'normal' (i.e. tighter) setting. If anything, these data have further confirmed that underlying inflation is still a sleeping issue for the Australian economy.

SMALL BUSINESS BEGINS TO CATCH UP

One characteristic of downturns is that small to medium sized businesses are often hit harder and for longer than their larger competitors. This has been a feature of the current downturn both in Australia and internationally. It reflects a number of factors including the sectors in which small businesses tend to be concentrated (retail, construction, hospitality and household services), access to capital, 'fat' reserves (in the form of profits and liquid investments) and levels of confidence and risk aversion.

While conditions for small businesses in the US and elsewhere are continuing to lag significantly, the latest ACCI quarterly survey of Australian small businesses indicates they are already turning the corner, in terms of confidence, actual conditions and expectations. Many of the component indexes of actual trading conditions remained at 'net contraction' levels (below 50 points), including sales revenue (48.8), profits (41), employment (46.0) and investment in buildings (43.7), but all were improving and moving much closer to neutral levels. The only component index to actually move positive (over 50) in the September quarter was investment in plant and equipment, at 50.4 points. This probably reflects small businesses' continuing response to the temporarily increased tax incentives to invest in this area.

Among the pricing indexes, small business wages and non-wage labour costs were expanding but selling prices were still falling, indicating continuing pressure on margins and profits. The total current conditions index improved to 49.1 points, from its cyclical low of 37.9 a year ago.

More encouragingly, expected performance surged into firmly optimistic territory at 55.6 points, its highest reading since Sep 1999 and well above the 5 year average of just 45.4 (that is, net pessimism). This indicates newfound high hopes for the year ahead among small businesses, as has already been seen in more general business surveys and among larger businesses. It provides pleasing evidence that the recovery (in confidence and expectations, if not yet in actual trading conditions) is spreading further afield than just our larger corporate companies in mining, finance and business services, with important spin-offs for jobs and investment.

DATA WRAP

- The **ACCI small business survey** of business conditions rose 6.7 points in the September quarter to 49.1 (its highest level since March 2008), but it remains in negative territory (under 50 points) and below its five year average (50.9 points).
- The **Westpac leading index** for September improved by 0.9% MoM, with the previous month revised up to 1.3% growth MoM (from 1.1%).
- **Wages** (the Labour Price Index) in September grew by 0.7% QoQ and 3.6% YoY.
- **Average Weekly Earnings** (AWE) in August grew by 0.9% QoQ and 5.2% YoY.

Amber Rabinov,
Economist

+61 3 9273 4853
Amber.Rabinov@anz.com

Melissa Fenech,
Research Analyst

+61 3 9273 1590
Melissa.Fenech0@anz.com

MOMENTUM SLOWS FOR AUD/USD

AUD/USD maintained its 0.9200 – 0.9400 range this week. A break above 0.94 failed to hold after rates markets pared back expectations of a December rate hike following a weaker than expected tone in the minutes from the RBA's November policy meeting. Next week, look for releases of US personal spending and income data, durable goods orders, and housing figures (all for October) to provide direction for AUD/USD - any upside surprises could see the cross reattempt a break higher. Over the coming week, we see initial support at AUD/USD 0.9220, then lower to 0.9160 and 0.9100. A sustained push through resistance at 0.9290 then 0.9360 is required to see AUD/USD retest 0.9400-10.

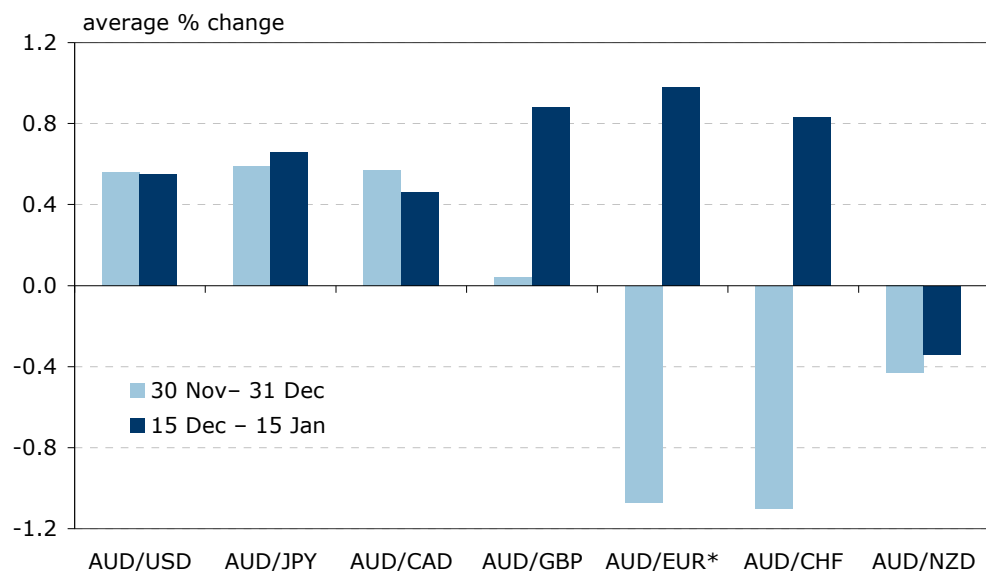
AUD/USD Key Levels: 0.9100 – 0.9410

Seasonal factors could lend support to AUD into the New Year

The AUD/USD made a break higher this week to briefly touch within a whisker of last week's topside target of 0.9410. But the move was short-lived, with market positioning continuing to play a key role in slowing upward momentum in the currency. Since mid-September, participants have trimmed their long AUD/USD positions, taking profits as new peaks have been made. While we believe that profit taking is likely to continue over the next month or two (yielding a small recovery in the USD), the AUD is expected to outperform on the other major crosses due to seasonal support over the New Year.

We have analysed how the AUD has performed over the year end holiday period since 1990. We first investigated changes in AUD over the month of December to pick up any end-of-year patterns, and then the mid-December through to mid-January period which typically represents the key holiday period for financial markets. Interestingly, there appears to be a particularly strong seasonal effect on the AUD over this holiday slowdown period, with the currency having a tendency to gain at least ½% against the major crosses over this time. In particular, the seasonal holiday effect on AUD is strongest versus the European currencies. In general, the AUD loses ground versus the EUR and CHF (the AUD/GBP barely changes) over December, an occurrence perhaps related to the corporate repatriation of funds (most likely from the US) due to calendar year-end reporting requirements.

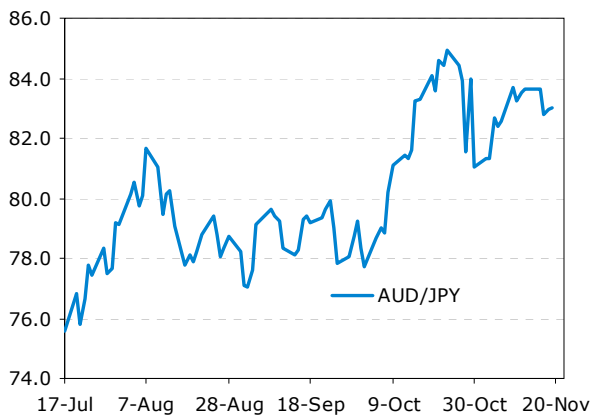
FIGURE 3. AUD SEASONAL PATTERNS 1990 – 2008



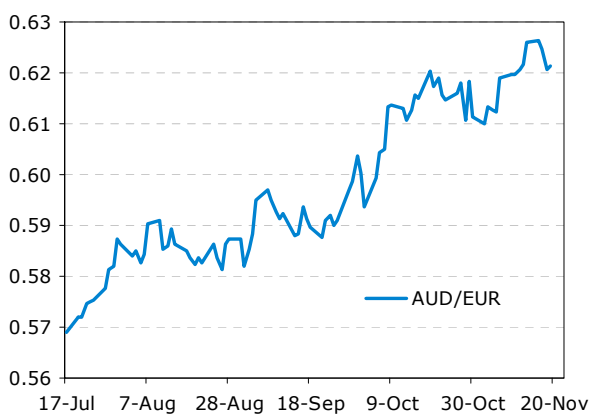
*Constructed EUR prior to 2000. Sources: Bloomberg and ANZ.

The existence of this largely positive seasonal pricing pattern for the AUD means that while we expect the USD to enjoy a temporary resurgence into the Antipodean summer, we may only see a minor correction in AUD/USD towards the 90c level before recovering into Q1 2010. The one exception to this theme is the AUD/NZD: note the tendency for this cross to depreciate over both December and the holidays, suggesting that anticipated moves higher in AUD/NZD will continue to frustrate in the near term.

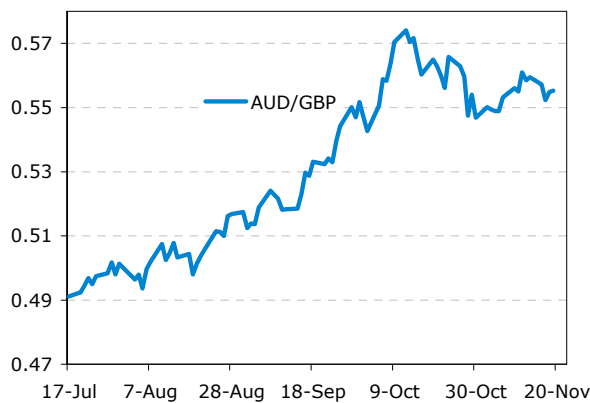
AUD CROSS VIEW

**AUD/JPY Key levels: 81.50 – 83.85**

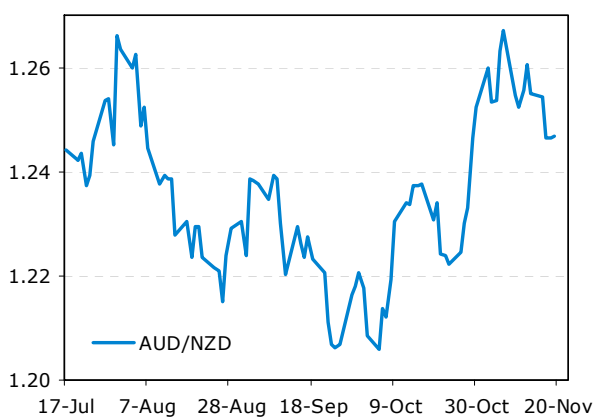
- While the release of weak Japanese machine tool orders went largely unnoticed by the market this week, stronger than expected Japanese GDP gave the Yen an extra boost and caused the AUD/JPY cross to fall by 1.2%. Rallies in this currency pair may find resistance at the topside of our range around 83.85, with solid downside support found at 81.50.
- The main focus of next week will be the BoJ's interest rate announcement, followed by their monthly report. Outside of these releases the JPY's direction will be largely influenced by the flows of the market.

**AUD/EUR Key levels: 0.6140 – 0.6340**

- Weaker than expected Euro zone GDP results saw the AUD/EUR rally above 0.6260, a new 21-month for the cross. However a more subdued performance from the Euro against the greenback caused the AUD/EUR to push lower, currently trading at levels similar to that of this time last week. If the AUD experiences a new bout of strength, gains should be capped at 0.6340 and dips limited to 0.6140.
- With little data scheduled for release from European and Australian markets in the next week the cross will be looking to economic releases out of the US for direction and will be vulnerable to the movements of the EUR/USD.

**AUD/GBP Key levels: 0.5500 - 0.5740**

- The AUD/GBP was unable to hold on to last weeks gains with the currency pair softening by more than 2%, however the cross did manage to regain some of the weeks earlier losses after the BoE meeting minutes released showed the indecisiveness of the central banks board on quantitative easing policy that was extended earlier this month.
- UK Retail sales and GDP data releases will be key to the direction for the cross next week. Better than expected data may give the sterling a boost and see AUD/GBP test the lower end of our range at 0.5500. If the data disappoints, we may see the cross head towards 0.5740.

**AUD/NZD Key levels: 1.2350– 1.2650**

- Even with soft New Zealand retail sales and a decline in housing sales data, the kiwi dollar managed to find strength against the AUD with the currency pair softening 1.3% and finding good support at 1.2450. Expect the cross to find down side resistance at 1.2350 and gains capped at 1.2650.
- A quiet week on the economic calendar for New Zealand until Thursday of next week with the release of NBNZ's business confidence for the month of November. Leading up to the data released expect risk appetite in the market to provide direction to the currency pair.

FORECASTS

Australian Economic indicators		2008	2009f	2010f	2011f
Economic activity (annual % change)					
Private final demand		4.4	-0.2	1.8	4.2
Household consumption		2.6	1.4	1.5	3.0
Dwelling investment		2.8	-7.0	7.3	8.0
Business investment		13.9	-3.4	0.2	7.0
Public demand		6.2	2.5	6.9	4.3
Domestic final demand		4.8	0.4	2.9	4.3
Inventories (contribution to GDP)		-0.7	-0.4	0.7	-0.1
Gross National Expenditure (GNE)		4.1	0.0	3.6	4.2
Exports		3.8	3.4	4.1	4.6
Imports		11.3	-8.4	8.2	9.5
Net Exports (contribution to GDP)		-1.8	2.8	-1.0	-1.3
Gross Domestic Product (GDP)		2.4	1.1	2.7	3.2
Prices and wages (annual % change)					
Inflation:	Headline CPI	4.4	1.9	2.3	2.5
	Underlying*	4.4	3.8	2.9	2.5
Wages		4.2	3.6	2.9	3.3
Labour market					
Employment (annual % change)		2.2	0.2	1.4	2.2
Unemployment rate (%)		4.3	5.7	6.4	6.2
External sector					
Current account balance:		-54.5	-54.0	-66.4	-73.9
% of GDP		-4.6	-4.5	-5.3	-5.5

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

Australian interest rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
RBA cash rate	3.50	3.75	4.25	4.25	4.25	4.25
90 day bill	3.94	4.15	4.60	4.50	4.50	4.50
3 year bond	4.83	5.15	5.35	5.25	5.05	5.30
10 year bond	5.41	5.45	5.60	5.55	5.45	5.60
3s10s yield curve	0.58	0.30	0.25	0.30	0.40	0.30
3 year swap	5.41	5.60	5.80	5.70	5.50	5.75
10 year swap	6.04	6.05	6.20	6.10	6.00	6.15

International interest rates

RBNZ cash rate	2.50	2.50	2.50	2.50	3.00	4.00
NZ 90 day bill	2.78	2.80	2.80	2.80	3.63	4.47
US Fed funds note	0.25	0.25	0.25	0.50	1.00	1.75
US 2 year note	0.74	1.20	1.50	1.75	2.00	2.35
US 10 year note	3.35	4.20	4.40	4.55	4.50	4.55
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.25
ECB refinance rate	1.00	1.00	1.00	1.00	1.00	1.25
UK repo rate	0.50	0.50	0.50	0.50	0.50	1.00

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

FORECASTS

Foreign exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
Australian exchange rates						
A\$/US\$	0.9240	0.90	0.94	0.96	0.92	0.90
NZ\$/US\$	0.7376	0.70	0.72	0.73	0.71	0.70
A\$/¥	82.32	84.6	85.5	84.5	82.8	82.8
A\$/€	0.6197	0.63	0.64	0.65	0.64	0.64
A\$/£	0.5535	0.56	0.57	0.58	0.56	0.55
A\$/NZ\$	1.2526	1.29	1.31	1.32	1.30	1.29
A\$/CA\$	0.9780	0.97	0.98	0.98	0.96	0.95
A\$/CHF	0.9365	0.95	0.97	0.97	0.95	0.96
A\$/CNY	6.3090	6.15	6.42	6.56	6.20	5.99
A\$ Trade weighted index	70.90	71.2	73.5	74.7	72.1	70.1
International cross rates						
US\$/¥	89.09	94.0	91.0	88.0	90.0	92.0
€/US\$	1.4911	1.44	1.46	1.48	1.43	1.41
€/¥	132.84	135	133	130	129	130
£/US\$	1.6694	1.62	1.64	1.66	1.64	1.65
€/£	0.8932	0.89	0.89	0.89	0.87	0.85
US\$/CA\$	1.0584	1.08	1.04	1.02	1.04	1.05
US\$/CHF	1.0135	1.05	1.03	1.01	1.03	1.07
US\$ index	75.23	78.0	76.4	75.0	77.1	78.1
Asia exchange rates						
US\$/CNY	6.8275	6.83	6.83	6.83	6.74	6.66
US\$/HKD	7.7501	7.75	7.75	7.76	7.77	7.77
US\$/IDR	9488	9100	9300	9500	9300	9000
US\$/INR	46.49	47.0	46.5	46.0	46.0	45.0
US\$/KRW	1159	1125	1100	1150	1175	1050
US\$/MYR	3.3825	3.41	3.34	3.37	3.40	3.40
US\$/PHP	46.900	47.0	46.0	46.5	46.0	45.0
US\$/SGD	1.3893	1.40	1.39	1.40	1.41	1.41
US\$/THB	33.185	33.00	33.00	33.00	32.50	32.50
US\$/TWD	32.191	31.90	31.50	31.90	31.50	30.50
US\$/VND	17877	18000	18200	18350	18500	19300
Pacific exchange rates						
PGK/US\$	0.3840	0.374	0.392	0.381	0.395	0.386
FJD/US\$	0.5317	0.520	0.534	0.542	0.527	0.519

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AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

100 Queen Street, Melbourne, Victoria, 3000, Australia

Telephone +61 2 9226 4647 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom

Telephone +44 20 3229 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of FINRA [www.finra.org] and SEC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000

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