

Rates to rise sooner or later

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Macroeconomic update: RBA move before Xmas?

- Strong retail sales data and RBA commentary fuel market expectations of an interest rate increase this year.

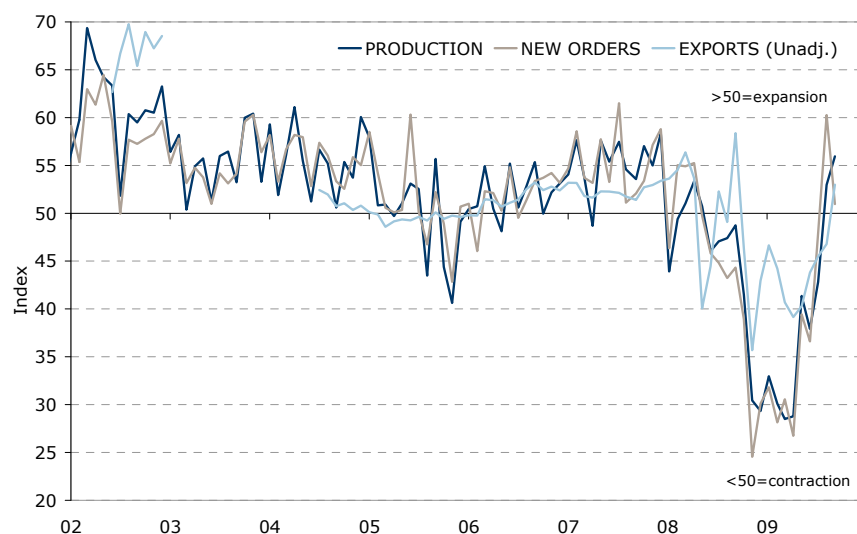
FX: AUD gains continue and could force an early test of 0.90c

- The rise of the AUD and the fall of the USD appear set to continue, since the AUD/USD has become an emblem of global risk appetite within major currencies.
- The IMF's latest quarterly Currency Composition of Official Foreign Exchange Reserves (COFER), shows a notable shift away from USD as a store of official allocated reserves.

Chart of the week: manufacturing turns a corner

- AiG's PMI for September showed a second consecutive month of industry 'expansion' (index values above 50), after a year of 'contraction' (index values below 50).
- Capacity utilisation has risen to 73.6%, its highest in a year, but employment is still indicating a net contraction (49.7).

Figure 1: Performance of Manufacturing Index, to Sep 2009



Source: AiG

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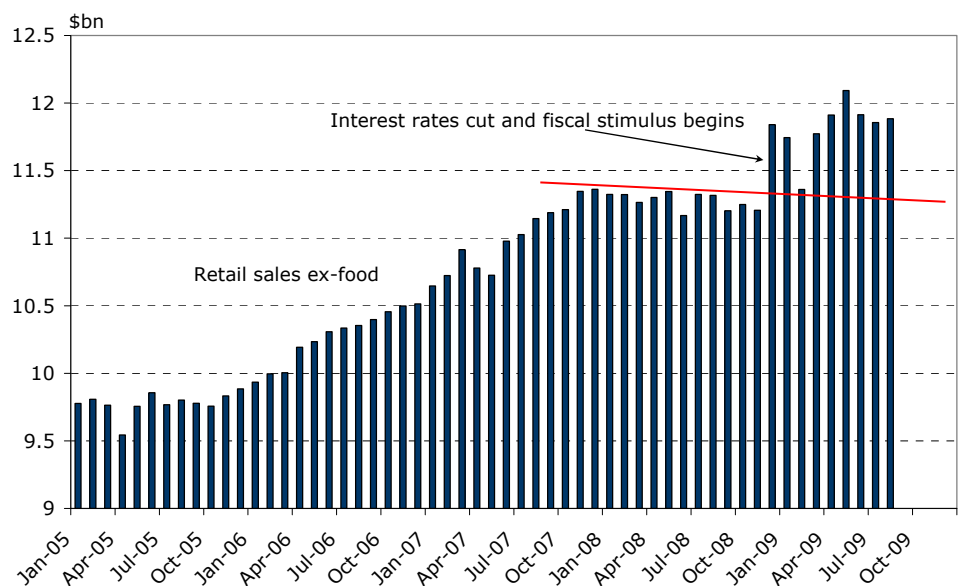
Confident consumers continue to spend

Data out this week was again solid, led by the 0.9% gain in retail sales - a result almost twice the market expectation. The result was a good one for large and small business alike with sales in department stores, cafes & restaurants and food retailing up 2.4%, 1.9% and 1.8% respectively. Another positive was that sales were up across all states (except the NT).

These data show that the current high levels of consumer confidence look like they have resulted in punters continuing to spend even in the absence of cash handouts and a weaker labour market. The national accounts figures released earlier this month showed the savings ratio increased in the quarter. The solid retail result in August may have been driven by households spending some of the saved portion of the governments handouts. Nonetheless, yesterday's data was a powerful signal to the RBA that high levels of confidence may be able to weather interest rate hikes sooner rather than later.

But risks to spending remain. Household incomes will be weak in coming quarters. There is no employment growth, no cash handouts and wages growth is either slowing or has stopped through the second half of the year. So what is going to keep people spending? Confidence, maybe, but it is fragile thing and a couple of rate hikes this year and higher petrol prices would shake it.

Figure 2: Retail sales – set up for a fall?



Source: ANZ, Bloomberg

On the plus-side for confidence, Australia's economy has weathered the economic storm and further asset prices continue to rise. The All Ords index posted a 20% gain in the quarter the biggest rise since the market bounced in the late-1980's. House prices too have continued to rise. According to RPdata-Rismark, national dwelling prices were 1.9% higher in August and are up a very solid 7.9% in the first 8 months of 2009. Median prices nationally are now 3.8% higher than peaks reached in early 2008. The gains were led by Melbourne and Sydney up 2.7% and 2.1% respectively in August and 11.6% and 8.6% over the year to date. We think that the scaling back of the boost to the FHOB will take some steam out of the market going forward. We don't think house price gains are central to the case for the RBA to raise rates but recent strong gains likely add to the case hikes may be brought forward into this year.

Other activity data out this week also pointed to signs of recovery. Building approvals fell marginally, down 0.1% in the month, disappointing market expectations. However, the news was not all bad. Detached housing approvals

were up another 3.1% in the month continuing along a solid upward trend, recording the eighth consecutive monthly gain. It was the highly volatile other dwellings sector, down 12% in the month, that weighed on the overall number. The strength of the upswing in housing approvals is likely to give the RBA confidence that modest increases in interest rates should not overly impact approval levels. Additions to housing supply are crucial going forward if we are to avoid a crippling shortage of housing in this country that will drive ongoing gains in house prices and see affordability deteriorate significantly.

RBA – rates are going up - but when?

This week’s solid data and the RBA Governors testimony on Monday have fuelled market expectations that rates will rise sooner rather than later. The Governor’s testimony makes it clear they are looking to next year when the economy is widely tipped to post modest growth, with Stevens stating *“What interest rates should do is respond to the outlook for the economy and inflation in a timely fashion”*.

But what does that mean for the short term? The solid partial indicators and RBA communications of recent weeks have continued to fuel expectations of a rate hike or hikes before Christmas. Indeed, the only recent downer has been July’s weaker than expected employment result. However, even a still-soft labour market may not deter the RBA from hiking official rates this year, *“Whether that turns out to mean that they start to rise before unemployment stops rising remains to be seen”*.

Further, Stevens suggests that the unemployment rate may peak at *“six point something”* suggesting that that RBA is confident that the prospect of large and sustained falls in employment will be avoided. As such labour market data released next week will go some way to confirming this view. Another more modest fall in employment is tipped but a better than expected result, will see market pricing again move higher. The RBA also meets next week (before the labour market data) and although the likelihood of a rate hike is slim at best it is unlikely the accompanying commentary will do anything to talk down the current hawkishness of current market expectations.

Figure 3: Market pricing of rate hikes in next 3-months



Source: ANZ, Bloomberg

Data wrap

- **Conference Board Leading index** for July increased 0.7%, but June’s reading revised down from +0.9% to +0.6%.
- **Retail Sales** grew 0.9% in August in monthly nominal terms. July’s sales growth was revised up slightly from -1.0% to 0.9%.

- **Private Sector credit** grew 0.2% in August, MoM and 2.7% YoY. Personal credit growth showed its first positive monthly growth since Jan 2008 but business credit continued to decline.
- **Building approvals** fell 0.1% in August (MoM) and were flat in annual terms. Growth for July was revised down from 7.7% to 6.6% (MoM). Detached house approvals grew by 3.1% (MoM) but other dwellings (flats and apartments) fell by 12%.
- **Rismark/RP data** showed the national median residential property price grew by 1.9% in August (MoM), taking the price gain for 2009 to date to 7.9%.
- **AiG's Performance of Manufacturing Index** rose to 52.0 in September, its second consecutive month indicating net expansion (above 50 points).

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FX: AUD gains continue and could force an early test of 0.90c

The rise of the AUD and the fall of the USD appear set to continue

AUD/USD has become an emblem of global risk appetite within major currencies. Consequently the side-lining of equities which has occurred since mid-September has coincided with a consolidation in AUD/USD.

This consolidation through the second half of September was tightly contained within a 0.8590-0.8790 range, which managed to hold well above the underlying uptrend: the clear rising support for this trend is shown in the attached chart. This tight consolidation was broken yesterday, spurred by the shift in rate expectations in Australia post the robust Australian Retail Sales data (see macroeconomic update above). The break above 0.88c may have been capped by a rising resistance trend line (currently 0.8870), but a standard flip of the preceding consolidation would imply a 2 figure rally off 0.8790 into mid-October and so force an early push towards the psychological 0.90c level.

US Fed officials, even when speaking specifically on exit strategies as Kohn did yesterday, keep restating a mantra of highly accommodative rates remaining until the nascent recovery has been assured. If stock markets manage to resume their uptrend, the differing growth and near term interest rate profiles between US and Australia will no doubt push the AUD/USD through the rising trend resistance.

One major technical caveat to near term AUD strength is that momentum indicators, such as daily RSIs and Slow Stochastics (not shown), are displaying notable divergence (failing to make new highs as AUD/USD pushes higher). This means that further gains need to maintain traction and dips need to be closely monitored against a fall back into the consolidation pattern. A close below 0.8790 could undermine the potential upsurge and indicate more protracted range trading.

Late September saw a burst of quarter-end JPY buying which drove USD/JPY precariously close to 88.00 and created concerns that the 0.8710-15 lows of Dec/Jan could be under threat. The incoming DPJ initially appeared comfortable with a rising JPY and markets focussed upon potential repatriation of retained overseas profits (before a possible retraction of tax incentives for so doing) and discussion of more general flows to support domestic assets. However, the increasing deflationary pressures from a rising JPY and the pressure that it puts on the export sector finally saw the new Finance Minister Fujii counter his initial comments and state that aggressive moves would induce intervention and the recent rally of JPY was seen as aggressive.

Whilst the focus may have been on USD/JPY, AUD/JPY has held perfectly during this period of JPY strength.

76.50 represents 50% of the rally seen since the 70.75 low of mid-July. It has now held on three occasions over the past two months and AUD/JPY is now pushing towards the upper end of its 76.50-0.80 range.

As with AUD/USD, a close above 0.8000 should see a swift retest of August's 0.8200 high within a potential flip of the preceding range, so targeting a move towards 83.50.

However, at present the range remains intact and so confirmation of a break of the range should be awaited rather than anticipated on a trading basis.

Figure 4: AUD / USD in 2009



Source: Bloomberg

Figure 5: AUD / JPY in 2009



Source: Reuters

IMF COFER

The IMF released its quarterly Currency Composition of Official Foreign Exchange Reserves (COFER) yesterday. Although China does not disclose the composition of its reserves (therefore some USD2.5Trn of the total USD6.8Trn of global reserves are not disclosed, with China accounting for around USD2.2Trn), the remaining reserve data still provide a clear indication of reserve allocations.

The past quarter has seen a fall in the value of USD reserves of some 6%. Given that the reserves are quoted in USD terms, the rise in non USD reserves will obviously be partly explained by this. However, EUR (by far the largest non USD component) reserves grew by over 11%. Therefore there has, as has been much vaunted anecdotally, been a notable shift away from USD.

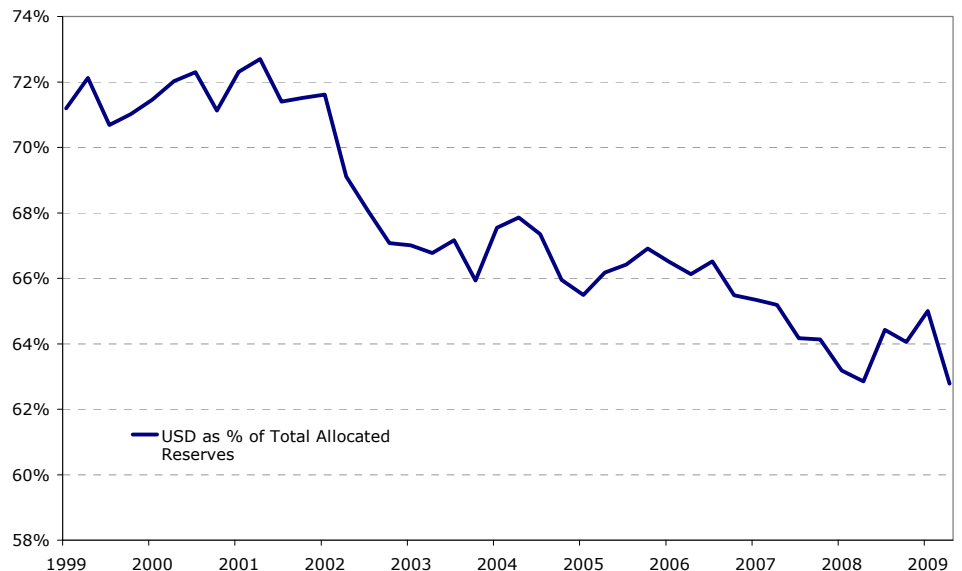
- Overall reserves grew some USD310bn in 2Q to USD6.80Trn, of which allocated (as in disclosed) reserves grew USD210bn to USD4.27Trn.
- Reserves in USD grew from USD2.64Trn to USD2.68Trn
- Reserves in EUR grew from USD1.05Trn to 1.17Trn

Therefore the percentage of reserves in USD fell from 65% in 1Q to 62.8% in 2Q and those in EUR rose from 25.9% to 27.5%.

The market will hail this as a vindication of the increasing trend away from USD in reserves. The USD percentage has fallen from over 72% in 2001 to a low of 62.8% in Q2 2008. The global crisis saw a rise in the value of USD and also a rise in USD in reserves to 65% in Q1 2009. Therefore the slump back to 62.8% in 2Q 2009 can be partly explained by the stabilisation of markets and the consequent slide back in the value of USD.

Forthcoming releases of the IMF's COFER will therefore be key in determining whether there is a more pronounced shift in the decline of the world's former favourite reserve currency.

Figure 6: USD share of allocated reserves



Source: Bloomberg.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.4	-0.4	1.3	3.8
Household consumption	2.6	1.4	1.6	3.0
Dwelling investment	2.8	-7.6	5.3	5.9
Business investment	13.9	-3.7	-1.4	5.6
Public demand	6.2	2.6	7.1	4.4
Domestic final demand	4.8	0.3	2.6	3.9
Inventories (contribution to GDP)	-0.7	-0.3	0.6	0.0
Gross National Expenditure (GNE)	4.1	0.0	3.2	3.9
Exports	3.8	1.1	1.4	4.6
Imports	11.3	-9.6	6.9	9.5
Net Exports (contribution to GDP)	-1.8	2.6	-1.2	-1.3
Gross Domestic Product (GDP)	2.4	0.8	1.6	3.2
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.8	2.5	2.0
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	0.0	-0.3	1.8
Unemployment rate (%)	4.3	5.9	7.2	7.1
External sector				
Current account balance: A\$ bn	-54.5	-48.4	-55.8	-62.1
% of GDP	-4.6	-4.0	-4.4	-4.6

*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	3.00	3.00	3.25	3.50	3.75	4.00
90 day bill	3.35	3.45	3.55	3.80	4.30	4.30
3 year bond	4.79	5.00	5.15	5.10	5.20	5.25
10 year bond	5.28	5.60	5.65	5.60	5.80	5.85
3s10s yield curve	0.49	0.60	0.50	0.50	0.60	0.60
3 year swap	5.36	5.30	5.45	5.40	5.67	5.72
10 year swap	5.99	5.95	5.95	5.90	6.35	6.40
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	0.25	0.50	0.75
US 2 year note	0.94	1.00	1.25	1.50	2.00	2.25
US 10 year note	3.31	4.00	4.15	4.30	4.50	4.45
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*.

Foreign exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
Australian exchange rates						
A\$/US\$	0.88	0.89	0.92	0.91	0.89	0.87
NZ\$/US\$	0.72	0.71	0.72	0.71	0.69	0.68
A\$/¥	79.2	78.3	79.1	80.1	80.1	80.0
A\$/€	0.60	0.60	0.61	0.61	0.60	0.59
A\$/£	0.55	0.53	0.55	0.55	0.54	0.53
A\$/NZ\$	1.22	1.25	1.28	1.28	1.29	1.28
A\$/CA\$	0.94	0.95	0.95	0.95	0.93	0.91
A\$/CHF	0.91	0.92	0.94	0.96	0.93	0.93
A\$/CNY	6.01	6.08	6.28	6.22	6.07	5.92
A\$ Trade weighted index	68.4	68.5	70.2	69.8	68.3	66.9
International cross rates						
US\$/¥	90.0	88.0	86.0	88.0	90.0	92.0
€/US\$	1.46	1.48	1.52	1.50	1.48	1.47
€/¥	132	130	131	132	133	135
£/US\$	1.60	1.67	1.67	1.65	1.64	1.65
€/£	0.92	0.89	0.91	0.91	0.90	0.89
US\$/CA\$	1.07	1.07	1.03	1.04	1.04	1.05
US\$/CHF	1.04	1.03	1.02	1.05	1.05	1.07
US\$ index	76.8	75.5	73.8	74.8	75.7	76.4
Asia exchange rates						
US\$/CNY	6.83	6.83	6.83	6.83	6.82	6.80
US\$/HKD	7.75	7.75	7.75	7.76	7.77	7.80
US\$/IDR	9643	9750	9500	9625	9250	9000
US\$/INR	47.8	48.0	47.0	47.5	47.0	47.0
US\$/KRW	1179	1125	1175	1150	1100	1050
US\$/MYR	3.46	3.50	3.48	3.45	3.40	3.40
US\$/PHP	47.2	48.0	48.0	47.0	47.0	46.0
US\$/SGD	1.41	1.46	1.45	1.44	1.44	1.43
US\$/THB	33.49	34.00	34.00	34.00	33.50	33.50
US\$/TWD	32.12	32.50	32.00	31.50	31.00	30.30
US\$/VND	17841	18500	18500	18500	18500	19300
Pacific exchange rates						
PGK/US\$	0.374	0.374	0.392	0.381	0.395	0.386
FJD/US\$	0.518	0.523	0.534	0.528	0.519	0.512

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