

AUD supported higher as economy looks up

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Macroeconomic Update: Rate cuts off the agenda. Are rate rises on?

- Comments from RBA Governor Stevens this week raised the risk that the cash rate may be raised sooner than we are currently expecting in late 2010.
- The RBA will likely upgrade its economic forecasts and perhaps remove its easing bias next week. Retail sales and house price data should continue to highlight the relative resilience of Australian households, although labour force data will provide a better gauge of whether this will continue going forward.

Rate markets: Shift lower for the curve

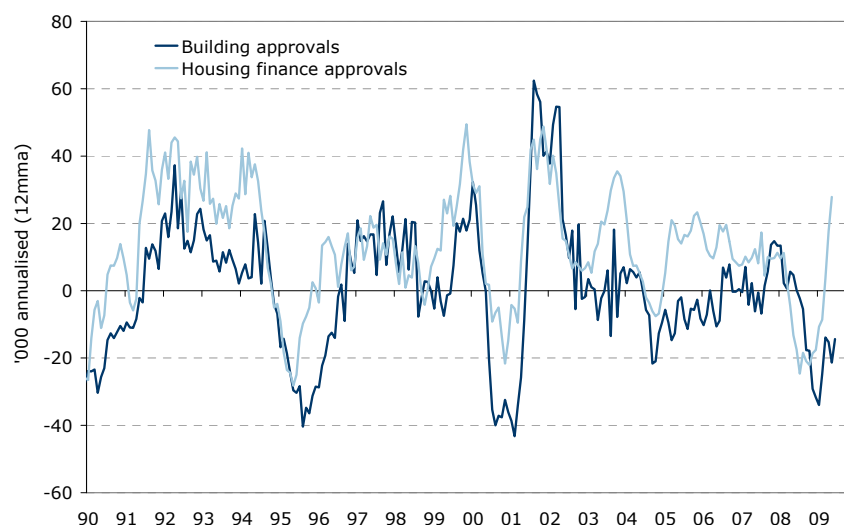
- Further normalisation of outright yields, a flatter curve and wider AUS-US spreads are a logical outcome of the shift in RBA focus.
- Market rates have moved along way, but the bias is for short-dated yields to remain under upward pressure.

FX: Next week's data to support AUD/USD

- The shift up in the AUD's trading range over the past two weeks will be well supported by the local data flow over the coming week. The resilience of the household sector, combined with an expected upgrade of the RBA's economic forecasts should see AUD/USD continue to trade within an 0.81 – 0.83 range.
- Friday's US GDP release presents one of the more significant downside risks to AUD in the near term.

Chart of the week

Figure 1: Housing demand rising much more rapidly than supply



Sources: ABS

Macroeconomic Update: Rate cuts off the agenda. Are rate rises on?

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RBA Governor more upbeat...

RBA Governor Glenn Stevens this week gave a more optimistic assessment of Australia's economic prospects. The Governor is increasingly confident that the Australian is not in the midst of *"one of the more serious ones [downturns] in the post-war era, in contrast to the experiences of so many other countries."* He also views the downside risks to the economic outlook as now more balanced rather than being tilted to the downside. In particular, the biggest downside risk to the Australian outlook six months ago - the loss of confidence in our medium-term prospects (both from households and businesses) - has turned around.

... highlighting the risk that rates could rise earlier than anticipated

The upbeat tone from Stevens was expected given the recent outperformance of the Australian economy. Indeed, we have recently upgraded our economic outlook and removed rate cuts from our forecasts (see last week's ANZ Markets Weekly). However, the speech contained two surprises, both of which do raise the risk that rates could rise earlier than we are currently anticipating in late 2010.

Firstly, Stevens mentioned in the Q&A that there is no rule to suggest the RBA cannot raise rates before unemployment peaks. This would be unprecedented, and in our view is still unlikely given that any economic recovery will remain on a tentative footing until employment stops falling. Stevens also expects inflation to keep falling meaning there is still no inflationary justification for the RBA to raise rates. Nevertheless, Stevens' comments do highlight risk of a move to a less accommodative stance earlier barring any new downside surprises.

The second surprise was Stevens' strong warning around the risks associated with rising house prices and the potential for households to over-leverage amidst a still uncertain economic backdrop. He is worried that the lower cost of housing finance due to lower interest rates be translated into higher demand and not sufficiently increase housing supply, putting upward pressure on prices (see Chart on page 1). Data released today illustrated his point; building approvals still remain 14.3% lower over the year, despite some pickup in approvals for detached houses, while data from RP Data - Rismark showed a 2.1% increase in house prices in Q2.

In Stevens' words, it would be *"very disappointing, indeed quite disturbing"* if Australia could not add to the housing supply at a time when weaker labour demand and lower raw material prices should allow us to do so without running up prices. Not only would this shortage reduce access to affordable shelter, but it would *"pose elevated risks of problems of over-leverage and asset price deflation down the track"*. ie. Stevens is worried that the circumstances are being set up for falling house prices down the track, particularly if employment falls as expected, putting pressure on household balance sheets. Over-leveraging and over-inflated house prices were after all a key reason for the US sub-prime mortgage crisis and global financial crisis.

Stevens' housing comments have garnered considerable debate amongst our team this week. Rising interest rates would certainly take some heat out of housing demand, although our core view is that the reduction in the first home owners' grant from October will go some way towards this anyway, particularly against a backdrop of rising unemployment. However, it is not clear whether hiking rates would be the panacea for the growing housing imbalance, particularly if it impacts negatively on sentiment amongst housing developers and leads to reduced supply. Further, even if the RBA believes that hiking rates would be a solution, the central bank has been very reluctant to address housing market imbalances in the past and has preferred to simply *"lean into them"*. But perhaps Stevens will take a different approach to previous Governors (his

extremely strong wording this week certainly suggests so), particularly if the broader economic outlook does not take an unexpected turn for the worse?

A busy week coming up

We will receive further guidance from the RBA next week when it decides on the cash rate on Tuesday and releases its quarterly *Statement on Monetary Policy (SoMP)* on Friday. Rates will most certainly be on hold, and there is now a considerable chance the RBA will remove its explicit easing bias. The SoMP will also contain upward revisions to the RBA's forecasts for the next 12-18 months reflecting the much stronger Q1 outcome and recent improvements in confidence measures which point to diminished downside risks, particularly for business investment and employment. Compare the RBA forecasts for GDP and inflation with our latest forecasts below. A smaller output gap, with growth holding up better than expected, should also lead to some upward revision to the RBA's inflation forecasts, most likely in late 2010 and 2011 given the long lags involved.

Figure 1: RBA and ANZ forecasts

		Jun-09	Dec-09	Jun-10	Dec-10	Jun-11	Dec-11
GDP	RBA May	-1¼	-1	½	2	3¼	3¾
	ANZ Latest	¼	½	¾	2	3	3¼
Non-farm GDP	RBA May	-1½	-1	½	2	3¼	3¾
	ANZ Latest	0	¾	½	2	3	3¼
CPI	RBA May	1½	2¼	2½	2½	1½	1½
	ANZ Latest	1½	2	2½	2¼	2	1¾
Underlying CPI	RBA May	3¾	3¼	2½	2	1½	1½
	ANZ Latest	4	3	2½	2¼	2¼	2

Source: RBA, ANZ

Also for release will be a raft of economic data which will continue to highlight both negative and positive influences. House price and retail sales data for June are likely to highlight the relative resilience of the Australian household sector (both expected to post healthy rises), although the July job advertisement and employment figures will give us further guidance on whether this strength is likely to be carried over into H2. While the monthly labour force figures are notoriously volatile, another fall in employment would be more convincing evidence that employment is now on a downward trend as we are forecasting. (ANZ is expecting a 18K drop in employment in July, slightly smaller than last month's 21.4K fall, which will see the unemployment rate jump up to 6.1%).

Stevens did highlight that lower interest rates, cash handouts and declining petrol prices are outweighing the impact of unemployment fears for households at the moment. Nevertheless, we remain concerned that this equation may change as falls in employment gather pace. This is a key underpinning of our current view that household income growth will slow as the year progresses, making it difficult for household consumption to expand at its recent pace, particularly as the earlier monetary and fiscal stimulus starts to wear off. Trade data will also continue to highlight the significant drag on national income underway from the unwinding of the commodities boom, and the challenge this presents for business investment and government revenues. A fall in export earnings is expected to see the trade deficit almost double to \$1bn.

Data wrap

- The **NAB Quarterly Business Survey** showed an improvement in business confidence and conditions, although both remain negative.
- **HIA New Home Sales** rose by 0.5% in June after falling 5.6% in May.
- **Building Approvals** rose by 9.3% in June, partly retracing May's 11% fall.
- **RP Data – Rismark** house price data showed a 2.1% increase in Q2, with prices up 0.4% in June, 0.8% in May and 0.9% in April.

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Rates markets: Shift lower for the curve

- Further normalisation of outright yields, a flatter curve and wider AUS-US spreads are a logical outcome of the shift in RBA focus.
- Market rates have moved along way, but the bias is for short-dated yields to remain under upward pressure.

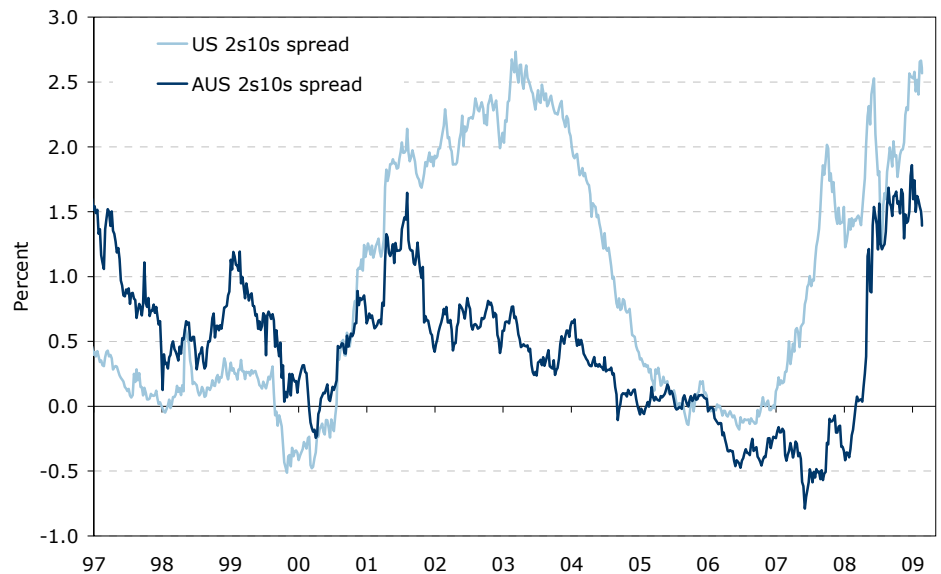
Risks around the outlook for market rates still appear skewed to the upside in light of the continued evolution of the RBA policy stance at present, absent some major new shock to the global outlook or weaker than expected local economic data.

Putting the important comments from the RBA Governor this week in context (see Macroeconomic Update on page 2), we have seen India warn of rising inflation this week and concerns are growing over excessive stock and housing sector speculation in China as a result of a huge increase in credit creation. Reports that bank lending might be cut triggered a sharp fall for Chinese stock markets yesterday. And central bankers around the world are talking in a more focused way on exit strategies. Fed Governor Yellen said this week that the Fed stands ready to act "decisively and appropriately" to tighten policy.

Furthermore, there has also been a major public relations offensive undertaken by senior members of the Australian government over the past week to warn of higher rates and more difficult times ahead. The atmospherics suggest there is at least an understanding that the case for the removal of extra-ordinary policy settings has been strengthened in recent weeks.

A key conclusion is that the curve can continue to flatten in this environment unless global stock market weakness becomes more pronounced. We had previously expected the 3s10s curve to hold above the 70bps level, but now see a risk that this could extent towards 50bps to the downside.

Figure 2: AUS and US 2s10s curves



Source: ANZ & Bloomberg

And to put this view in a longer-term context, the local 2s10s curve has started to flatten from historically high levels – see figure 2 above - and still has scope for a significant move to just get back towards more normal levels. We have also seen the US 2s10s curve start to flatten. Wider AUS-US spreads might stall this week before the record supply of Treasury issuance is absorbed.

The flatter curve has been driven by a sharp sell-off in shorter-dated bonds back towards 5.0% and 9-months highs. This is halfway back to the highs seen above 7.0% in June 2008. This move has pushed three-year swaps to new highs for this normalisation process back above the 5.0% level. Any near-term consolidation below this level would represent another opportunity to lock in funding levels.

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FX: Next week's data to support AUD/USD

Recommendation

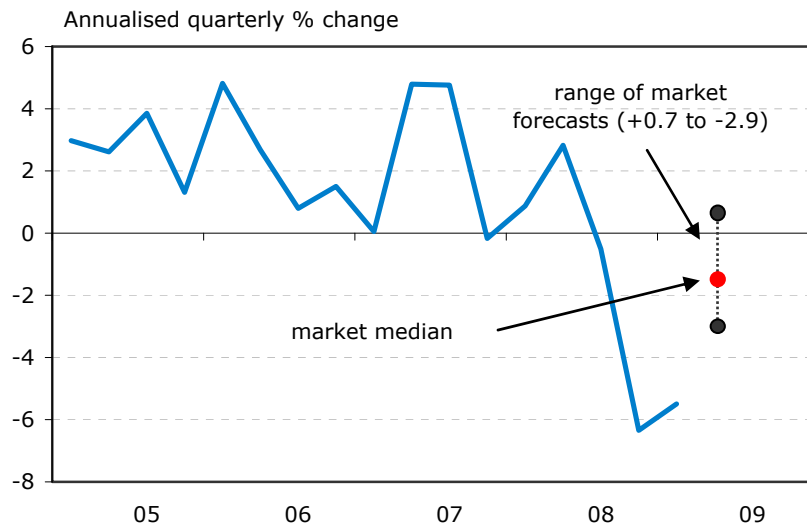
A busy week ahead with central bank meetings and important economic data releases should, on balance, provide good upside support to AUD. The risk is for AUD's outperformance against JPY and EUR to also continue. Importers may wish to take advantage of moves in AUD/USD above 0.8280, while exports may find good AUD buying opportunities around 0.8110.

AUD to maintain stronger profile over the coming week

What a wild ride the AUD has had this week, surging to AUD/USD 0.8339 before dipping as low as 0.8126 less than 36 hours later. This afternoon's solid rebound to back around 81.8 cents suggests that the shift up in the AUD's trading range over the past two weeks will be well supported by the local data flow over the coming week (see *Macroeconomic Update*). The resilience of the household sector, combined with an expected upgrade of the RBA's economic forecasts should see AUD/USD continue to trade within an 0.81 – 0.83 range. We also see more upside risk to AUD versus JPY and EUR over the near term, although AUD/GBP could struggle to regain this week's 10½-week high above 0.5040.

Friday's US GDP release presents one of the more significant downside risks to AUD in the near term. In the current environment with market sentiment still fragile, markets would normally interpret a Q2 GDP print below market forecasts (-1.5% quarterly annualised) as a negative for the global growth outlook, and would move to reduce exposure to 'riskier assets.' This would imply a sell-off in the AUD in line with a reversal in recent 'riskier' asset price rises that have taken place in anticipation of improving economic fundamentals. While last quarter's worse than expected US GDP data saw limited reaction on currency markets, the release was followed by a run of better than expected higher frequency activity numbers which provided some offset to the downbeat GDP report.

Figure 1: A slowing in the decline of US GDP is expected in Q2

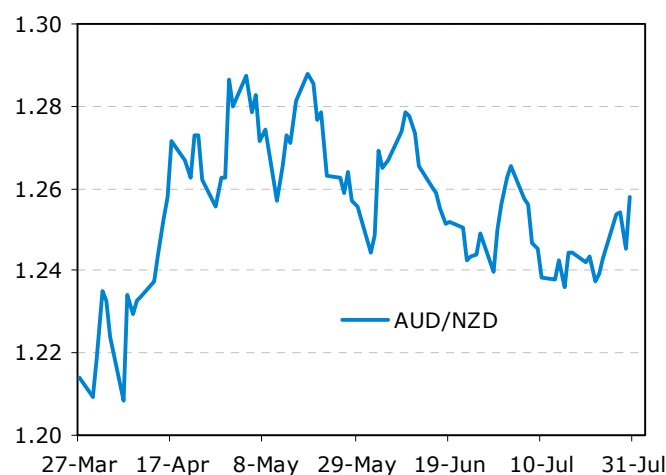
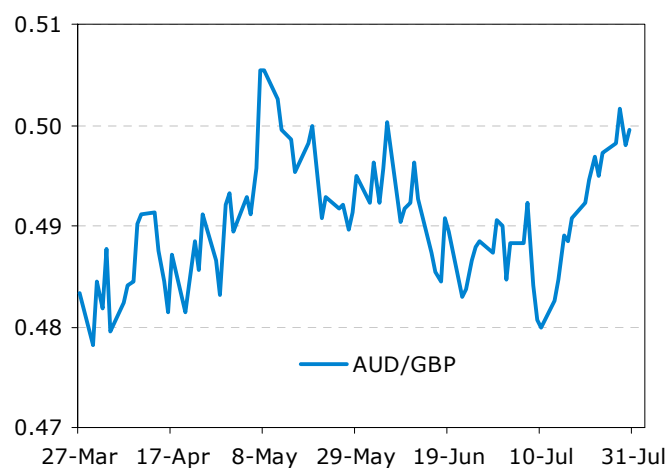
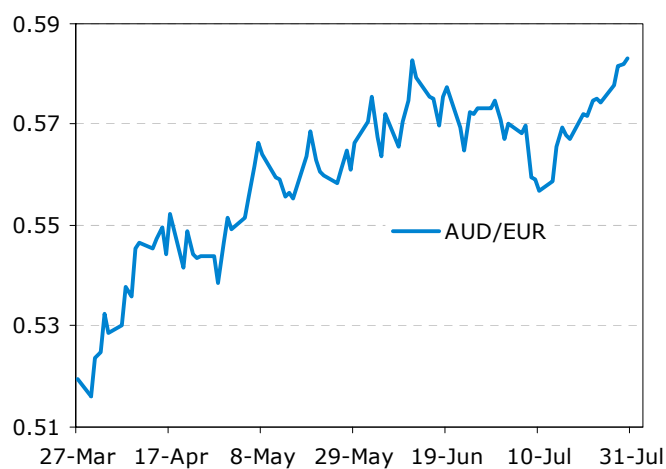
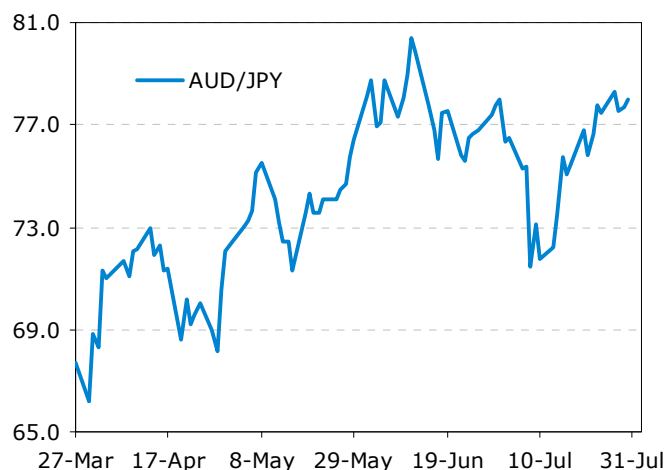


Source: ANZ, Bloomberg

For now, the medium-term risks to the AUD remain to the downside. One important theme is that markets could turn against countries (such as Australia and China) that are at risk of exiting stimulatory policies before other parts of the world a this would lead to a potential slowing in their growth trajectories. For China, this means (for now) instructing banks to reduce lending. In Australia we will already see fiscal policy start to be withdrawn from H2 (as the First Home Owners Grant reduces and cash-handouts to households end), which should take pressure off the RBA to feel the need to raise rates in the near-term.

AUD/USD Key levels: 0.7950 – 0.8280. A sustained push through 0.8220 is required for AUD/USD to retest 0.8280. On the downside, a break through support at 0.8110 could see AUD/USD move lower to 0.8050 then 0.7950.

AUD cross view



AUD/JPY Key levels: 73.50 – 79.40

- AUD/JPY pushed above last week's topside target of 78.40 on continued improvement in risk appetite. Good support has formed around 76.90-77.00, with dips over the coming week likely to be limited to the 100-day moving average of 73.50.
- The risk over the coming week is for the AUD to continue to outperform JPY. The Australian data flow is expected to provide good upside support for AUD, while persistent gains on global bourses should see trade solidify at current higher levels. A tentative turnaround in Japanese retail speculator positioning would add support to AUD/JPY if net longs show further improvement.

AUD/EUR Key levels: 0.5670 – 0.5880

- AUD/EUR soared this week to a 10½-month high and above last week's topside target of 0.5800. The move higher sees the cross well placed to rally further towards a key fibbo level of 0.5880.
- The risk of a more optimistic ECB statement following next week's policy meeting, combined with a stronger than expected flash CPI read, could weigh on AUD/EUR. However, the risks to the short-term outlook appear well balanced, with a solid run of high-frequency Australian macro data to keep AUD well bid. Good support on the downside should see dips limited to 0.5670.

AUD/GBP Key levels: 0.4870 – 0.5070

- AUD/GBP made a solid push higher this week to peak at 0.5040, although a rapid turnaround in risk appetite saw the cross quickly beaten back to below 0.50. Despite a much worse than expected UK Q2 GDP read, GBP/USD remains well supported above 1.6350.
- With little action expected from the Bank of England at next week's policy meeting, the UK's July purchasing managers' indices are likely to provide the key risk to GBP. Rallying some 5% over the past three weeks, AUD/GBP may struggle to retouch its 2009 high of 0.50655. Dips should be limited to 0.4870.

AUD/NZD Key levels: 1.2430 - 1.2680

- Last week's key level of 1.2590 provided strong resistance for AUD/NZD this week despite the RBA becoming more optimistic while the RBNZ became more dovish.
- We are finally beginning to favour this cross higher in the short-term, but admit the ride up could be frustrating. Next week's Australian data flow should provide AUD with additional support, which would allow this cross a run up to its June high of 1.2688. A sustained break of this level is required to bring 1.27 back into favour. On the downside, 1.2430 should provide initial solid support. The risk for the NZD next week is NZ employment.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.1	-1.4	0.0	3.4
Household consumption	2.2	1.2	1.3	2.9
Dwelling investment	2.5	-6.8	8.4	10.3
Business investment	13.8	-7.4	-7.9	2.4
Public demand	5.3	1.9	6.3	3.8
Domestic final demand	4.4	-0.7	1.4	3.5
Inventories (contribution to GDP)	-0.6	-0.1	0.3	0.1
Gross National Expenditure (GNE)	3.8	-0.8	1.6	3.6
Exports	3.9	-0.2	-1.5	3.8
Imports	10.3	-11.6	1.4	8.2
Net Exports (contribution to GDP)	-1.5	2.8	-0.6	-1.0
Gross Domestic Product (GDP)	2.3	0.3	1.1	3.0
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.7	2.5	2.0
Underlying*	4.4	3.7	2.4	2.1
Wages	4.3	3.6	2.9	3.2
Labour market				
Employment (annual % change)	2.2	-0.2	-0.4	1.8
Unemployment rate (%)	4.3	6.0	7.4	7.4
External sector				
Current account balance: A\$ bn	-51.0	-39.1	-58.2	-66.8
% of GDP	-4.3	-3.3	-4.7	-5.1

*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	3.18	3.10	3.25	3.30	3.40	3.75
3 year bond	4.87	4.70	4.60	4.85	4.80	5.20
10 year bond	5.65	5.50	5.40	5.55	5.50	5.80
3s10s yield curve	0.78	0.80	0.80	0.70	0.70	0.60
3 year swap	5.16	5.00	4.90	5.15	5.10	5.67
10 year swap	6.12	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	2.79	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	1.18	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.69	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
Australia and NZ exchange rates						
A\$/US\$	0.82	0.76	0.73	0.74	0.76	0.78
NZ\$/US\$	0.65	0.58	0.55	0.54	0.54	0.55
A\$/¥	77.98	74.48	73.00	77.70	82.08	85.80
A\$/€	0.58	0.56	0.56	0.57	0.58	0.59
A\$/£	0.50	0.48	0.46	0.46	0.48	0.48
A\$/NZ\$	1.26	1.31	1.33	1.37	1.41	1.42
A\$/CA\$	0.89	0.87	0.88	0.87	0.87	0.90
A\$/CHF	0.89	0.85	0.83	0.84	0.85	0.87
A\$/CNY	5.60	5.19	4.99	5.05	5.19	5.32
A\$ Trade weighted index	65.10	62.29	59.98	61.22	63.26	64.28
International cross rates						
US\$/¥	95.1	98.0	100.0	105.0	108.0	110.0
€/US\$	1.41	1.35	1.30	1.30	1.31	1.32
€/¥	134	132	130	137	141	145
£/US\$	1.64	1.59	1.58	1.60	1.60	1.62
€/£	0.86	0.85	0.82	0.81	0.82	0.81
US\$/CA\$	1.09	1.15	1.20	1.18	1.15	1.15
US\$/CHF	1.09	1.12	1.14	1.14	1.12	1.12
US\$ index	79.3	82.5	85.0	85.2	84.9	84.6
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	9995	10250	9750	9500	10000	9500
US\$/INR	48.49	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1237	1225	1125	1175	1225	1100
US\$/MYR	3.54	3.60	3.55	3.50	3.50	3.45
US\$/PHP	48.15	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.45	1.52	1.51	1.50	1.50	1.49
US\$/THB	34.05	36.00	35.50	35.00	35.00	34.50
US\$/TWD	32.85	32.50	32.00	31.50	31.00	30.30
US\$/VND	17815	18500	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.386	0.350	0.350	0.350	0.360	0.360
FJD/US\$	0.489	0.464	0.450	0.450	0.454	0.460

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