

Inflation pressures resurface

22 October 2009

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Macroeconomic update: inflation slows only moderately

- We expect headline CPI growth of around 0.7% in the September quarter, taking the annual inflation rate down to 1.0%. We expect underlying CPI to stay at 0.8% in Q3, taking the annual underlying rate of inflation from 3.9% to 3.5% — still well above the RBA's target range of 2 to 3%.
- If underlying CPI growth turns out to be more than 0.8% in Q3, this will significantly increase the risk of a 50bp cash rate increase at the RBA's November board meeting.
- Inflationary pressures are likely to persist, despite the economic slowdown, with core inflation falling only slowly through 2010.

Interest rates: curve stays positive

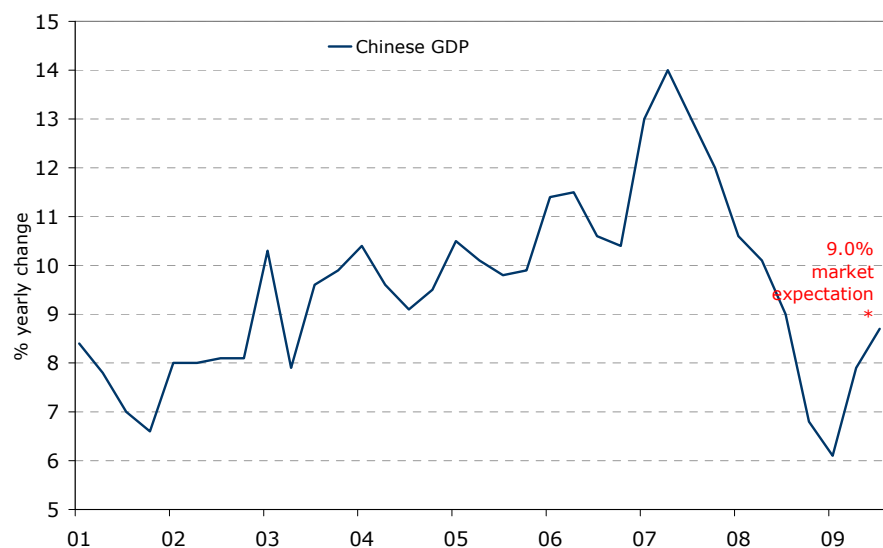
- The market continues to reassess the scope for the extent of policy normalisation. We still think 25bps is more likely next month.
- Without a stronger case for restrictive policy, the yield curve is likely to remain positive.

FX: China links continue to support AUD/USD

- The AUD/USD is looking very comfortable trading above the 90c level. While upward momentum is looking a little tired, risk still remains heavily skewed to the upside.
- China is now Australia's most important trading partner. The 'China story' is not just a current upside influence on the AUD, but a longer-term theme.

Chart of the week: Chinese GDP growth

Figure 1: Chinese GDP growth up in Q3, but weaker than expected



Source: Bloomberg.

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Macro update: inflation slows only moderately

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Underlying inflationary pressures remain persistent

Underlying inflationary pressures remain stubbornly persistent. The number of components of the CPI with inflation rates greater than 2.5% has been above 64% since the second quarter of 2008, although it appears to have peaked. Price falls have been apparent in childcare, petrol, deposits and loans, clothing and some food prices since the September quarter last year.

Details of the trimmed CPI in the June quarter of 2009 indicate that several food and clothing items have put downward pressure on the underlying CPI, while rent, utilities and services have been driving the underlying CPI up.

Looking further forward, the spare capacity created in the economy by the downturn should begin to ease these broad inflationary pressures. The nab survey of industrial capacity utilisation for example, fell from a recent peak of 85.1% in October 2007 to 78.9% in March 2009, although since then it has recovered back to 80%. The rise of the \$A in recent weeks should help ease inflationary pressures at the retail level to some extent as well.

On the other hand, recent labour productivity performance in the economy suggest that inflationary pressures may remain of concern over the longer term, particularly if stronger than expected productivity growth helps to close the output gap. The pace of labour productivity growth at this stage of the slowdown has been weaker than at the same stage of previous downturns in over the past 28 years. This is a little surprising, given the large fall in hours worked since the labour market began to soften. It may indicate that firms expect the demand for labour to pickup reasonably quickly and are willing to sacrifice short-term productivity gains for the longer-term benefits of retaining skilled labour.

Productivity growth is likely to be weaker over the medium term

Growing demand for Australian resources from Asia's rapidly industrialising economies and ageing local urban infrastructure were both major drivers of the strong growth in business investment prior to the downturn. While the global recession disrupted many mining and infrastructure projects planned for the near-term, it did not affect longer-term pipeline of projects aimed at resources demand from Asian or local urban infrastructure needs to the same extent, and most of these projects have continued. Such projects have longer-term impacts on the economy because of the length of time involved in planning and construction. And the firms involved have tended to retain their employees, in preparation for the next upswing in investment.

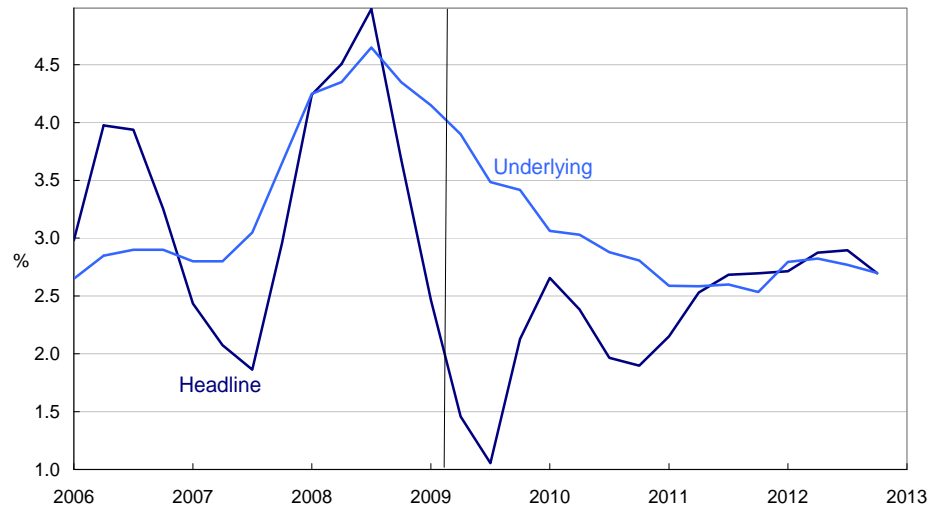
Due to the long time lags between planning and completing such facilities, it is only after the new productive capacity has begun to actually increase total output, that productivity growth can begin its cyclical upswing. During the (extended) construction phase however, productivity growth will remain weak.

This longer term productivity outlook poses problems for policy makers. Given that the downturn in Australia has been relatively mild and that capacity was stretched to meet demand before it commenced, it is likely the spare capacity created by the downturn will diminish relatively quickly as growth accelerates. As that spare capacity (in access to capital, industrial production or the labour market) diminishes, any additional demand will translate into inflationary pressures reasonably quickly and bring the RBA directly into play.

Inflation outlook

From here, we expect underlying inflation to ease back to 2.5% by the end of 2011 before it begins to rise to 2.8% by the end of 2012 (Figure 3). This forecast is based on growth remaining below potential (2.7%) during 2010 before picking up to around trend in 2011. We expect productivity growth to remain weak, and nominal wages growth to remain modest. Clearly, there is currently upward pressure on the \$A and this may lower inflation over the forecast period. However, oil prices are widely expected to rise with the global economic recovery and this will place upside risks to our inflation forecasts. Headline inflation is more volatile than underlying inflation. We expect it to have troughed at 1.0% in the September quarter 2009, rising to 2.7% in Q1 2010.

Figure 2: Inflation forecasts



Sources: ABS and ANZ.

Implications for Monetary Policy

The Q3 CPI is the key data release ahead of the November board meeting. We a 0.8% gain in the underlying CPI won't attract a 50bp tightening, but it may indeed be a close call. The bank clearly wants to normalise interest rates quickly, and the household sector seems unphased by last month's 25bp tightening – both of these factors support a 50bp increase. Moreover, since the last board meeting, retail trade and labour market data have been strong.

The Minutes from the October board meeting highlighted the banks concern about bringing underlying inflation back to target over the medium term. However, the Minutes also mentioned the bank's view that economic prospects for developed economies were "still uncertain and that the possibility of another downturn in some of these countries could not be ruled out". The Minutes also noted the dampening influence of the exchange rate rise on activity and inflation and the fading fiscal stimulus over the near term. Indeed, since the last board meeting, the \$A has rallied from \$US0.890 to around \$US0.92. These factors probably support a more cautious 25bp move.

Data wrap

- The **Westpac-MI Leading Index** increased by 1.1% in August, the third consecutive monthly increase.
- National **new motor vehicle sales** grew 2.9% in September, to be just 2.0% lower than the same month last year.

Interest rate markets: curve stays positive

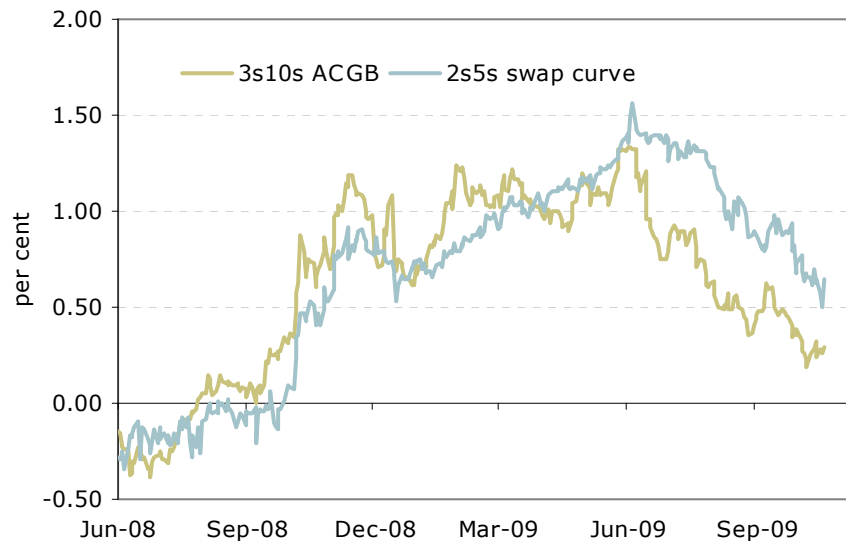
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- The market continues to reassess the scope for the extent of policy normalisation. We still think 25bps is more likely next month.
- Without a stronger case for restrictive policy, the yield curve is likely to remain positive.

Yields remain under upward pressure ahead of the next step of the RBA's moves to return monetary policy to more "normal" settings. We think this means another 25bps hike next month as long as the CPI data next week does not surprise with a high number. Three-year swap yields are now at the highest levels in a year and are approaching the 6.0% level. The market is clearly backing up in anticipation of a more extended normalisation process from the RBA.

We are now at levels that appear more consistent with normal or even a return to more restrictive longer-term policy settings. We think the case for a move to restrictive policy is weak at present, but there is clearly a market risk for yields to continue to head modestly higher from here. Higher effective borrowing costs and the headwinds from a surging currency represent significant headwinds on growth and suggest the RBA do not have to lift cash rates so far to gain traction in addressing medium-term inflation risks and imbalances in the economy.

Figure 3: Inflation forecasts



Source: ANZ & Bloomberg

The shape of the yield curve is an important guide to assess expectations with regard to policy settings and the general profile for growth. The move to normalise rates has triggered significant flattening of yield curves since the middle of the year as economic strength has become more apparent— see figure XX above. And the major flattening trends still appear to be in force.

The major flattening of the government curve has preceded moves at the front of the swaps curve. There still looks to be some scope for front-end curves to flatten further, primarily via rising short-term rates as RBA tightening continues. This is significant as it weakens the argument for borrowers to put off fixing longer-term exposures as they benefit from favourable carry.

But without a case for a move to restrictive policy, yield curves are unlikely to go negative. So we would expect the curve above to retain a mildly positive, particularly as we expect RBA policy moves to be gradual and to stall before getting back to neutral levels around 5.0%.

Should these curves continue to flatten and the 3s10s curve goes negative, it would be an early indicator that restrictive policy was becoming a more likely outcome and a warning that swap yields might rise significantly further.

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FX: China links continue to support AUD/USD

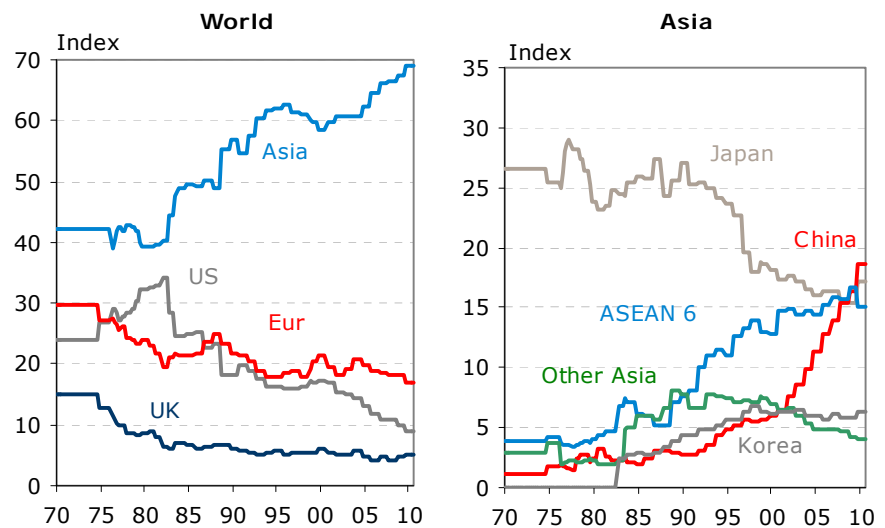
AUD/USD Key levels: 0.9020 – 0.9470

The AUD/USD is looking very comfortable trading above the 90c level. While upward momentum is looking a little tired (suggesting some consolidation in further moves higher over the coming week), risk still remains heavily skewed to the upside. The key economic risk event next week will be the Australian Q3 CPI numbers. As detailed above, a stronger than expected result would suggest a more aggressive path for future RBA rate hikes and lend significant upside support to the AUD/USD. If attempts by the AUD/USD to break above 0.9330 hold, AUD sellers should look to moves toward 0.9470. AUD buyers should beware of solid downside support that is likely to limit any dips lower to 0.9020.

It helps to have a big, healthy friend...

FX markets awaited today's Chinese data release with bated breath. The key event, Q3 GDP, printed close to expectations, rising 8.9% in the year through to September, up from 7.9% in the June quarter. This continuing recovery in the Chinese economy has been a key driver of this year's AUD/USD rally. As we mentioned last week, Chinese imports of commodities from Australia have surged in recent months, helping to support Australian export growth and in turn, the AUD/USD. And this trend is likely to continue – Chinese industrial production improved 13.9% over the year to September, up from annual growth of 12.3% in August, and reflective of the Chinese authorities' commitment to investment-led (commodity intensive) growth over the year ahead.

Figure 4: Australian two-way trade weights

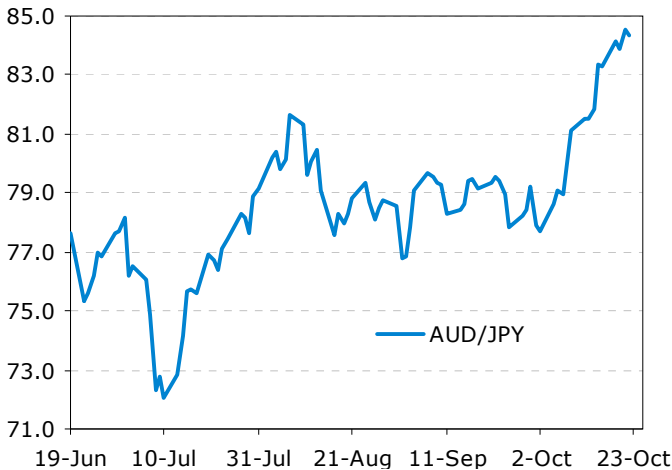


Source: ANZ, RBA

The 'China story' is not just a current upside influence on the AUD, but a longer-term theme that will likely contribute to a higher average spot trading level over the years to come. Over the past 20 years, trade between the two countries has expanded rapidly such that China is now Australia's most important trading partner. With Australia's economy increasingly tied to that of its fast-growing Asian neighbour rather than to traditional partners such as Europe, this should continue to provide a significant boost to Australian growth. Indeed, combined with the impact of a structurally weaker USD, we estimate that the long-run 'equilibrium' trading level for the AUD/USD is likely to move higher to around AUD/USD0.75-77, significantly above the currency's post-float average of 0.72.

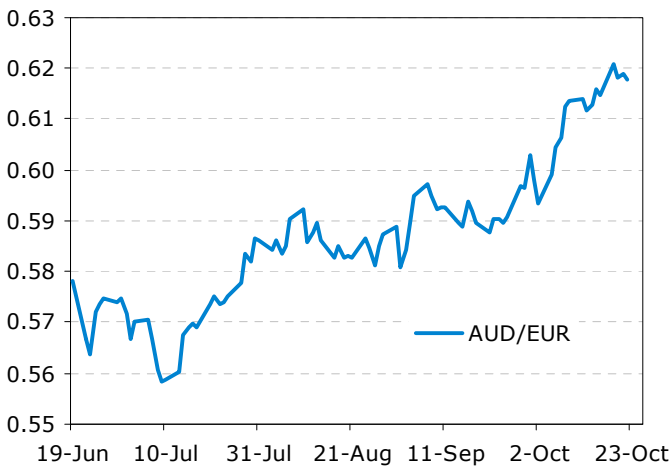
In the near term, the risks continue to point to further upside for the AUD/USD. However, at this stage we view calls for the AUD/USD to rally above parity overdone – speculators' positioning on the IMM appears to have reached a plateau, while current interest rate market pricing for the future path of the cash rate looks too aggressive, and recent AUD/USD gains have been far ahead of the recovery in another significant driver, commodity prices. On balance, this implies that while the AUD may not reach parity with the USD, it should remain well supported above the 90c level over the months ahead.

AUD cross view



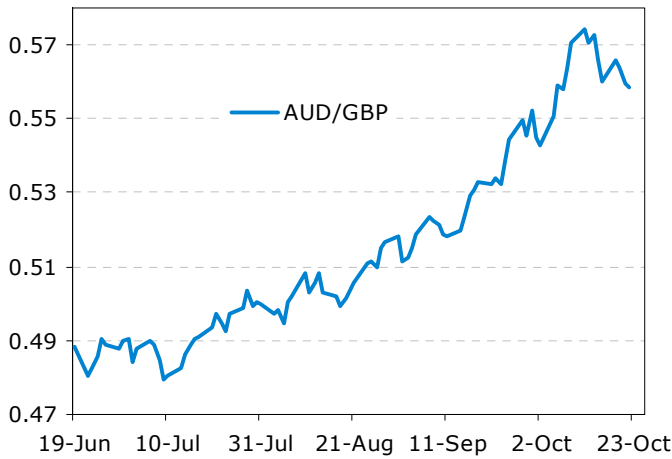
AUD/JPY Key levels: 83.50 – 86.20

- AUD/JPY continues to gain momentum trading above 84.80 during the week, with the strengthening AUD taking the currency pair to a 13-month high. If the AUD/JPY stays above 84.00 we should see the cross target the topside of 86.20 with further downside resistance found at 83.50.
- The Australian Q3 CPI release will be the key fundamental driver of this cross next week. The risk of a solid result could give the AUD/JPY another boost. Japanese data including retail trade and the purchasing managers' index could add some additional volatility to trading.



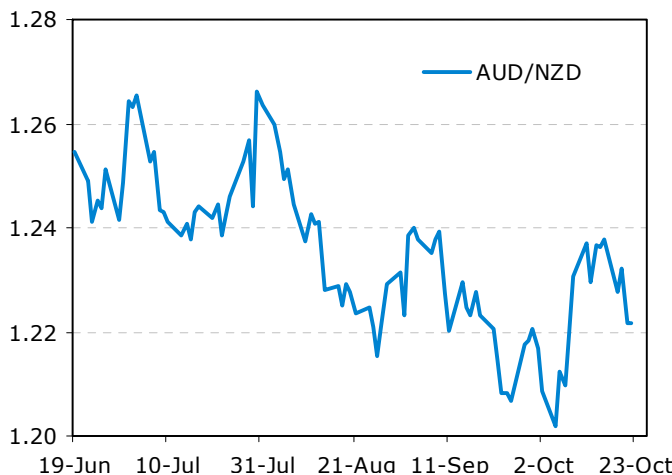
AUD/EUR Key levels: 0.5960 – 0.6270

- The AUD/EUR is holding up extremely well above 0.6100. Showing no sign of retreating, the cross tested 0.6200 numerous times over the last week. The 50-day moving average continues to provide good downside support at 0.5960. On the topside AUD/EUR needs to hold above 0.6180 to extend further gains and break 0.6270.
- Data out of Europe kicks off tonight with Euro zone current account, followed by the PMI surveys for October and industrial new orders on Friday night. Better than expected results could boost EUR/USD back above 1.50 and see AUD/EUR capped below 0.6180.



AUD/GBP Key levels: 0.5410 – 0.5680

- The GBP/USD seems to have finally found some relief as market confidence improves on signs that the Bank of England will not further extend its quantitative easing programme. This has caused the AUD/GBP to slip from its unprecedented 24-year highs and trade back below 0.5600. Any rallies in this currency pair should find initial resistance around 0.5680 in the week ahead.
- September UK retail sales due out tonight and tomorrow's Q3 GDP will be key drivers for FX markets. Signs of a stronger than expected recovery would add to the GBP/USD's recent gains and see AUD/GBP push towards 0.5410.



AUD/NZD Key levels: 1.2060– 1.2330

- Last week's strengthening of the AUD/NZD seems to have stalled with the cross dipping back to around 1.2240, a 1½% decline since Monday. Should the downward trend gain momentum we could see the cross slip as low as 1.2080, with gains capped at the higher end of our range around 1.2330.
- While investor risk appetite will continue to play a major role in the direction of the NZD/USD over the coming week, look to market chatter around the RBNZ policy rate announcement on Thursday to keep the currency (and the AUD/NZD cross) on its toes.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.4	-0.2	1.8	4.1
Household consumption	2.6	1.4	1.6	3.1
Dwelling investment	2.8	-7.4	4.8	5.4
Business investment	13.9	-3.1	1.1	7.0
Public demand	6.2	2.6	7.0	4.4
Domestic final demand	4.8	0.4	3.0	4.2
Inventories (contribution to GDP)	-0.7	-0.4	0.7	-0.1
Gross National Expenditure (GNE)	4.1	0.1	3.7	4.1
Exports	3.8	1.2	1.8	4.6
Imports	11.3	-9.6	6.9	9.5
Net Exports (contribution to GDP)	-1.8	2.6	-1.1	-1.2
Gross Domestic Product (GDP)	2.4	1.0	2.6	3.2
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.8	2.4	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	0.2	1.3	2.3
Unemployment rate (%)	4.3	5.7	6.5	6.2
External sector				
Current account balance: A\$ bn	-54.5	-48.2	-54.6	-60.7
% of GDP	-4.6	-4.0	-4.3	-4.5

*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	3.25	3.50	4.00	4.00	4.00	4.00
90 day bill	3.86	3.90	4.35	4.25	4.25	4.25
3 year bond	5.25	5.15	5.35	5.25	5.05	5.30
10 year bond	5.64	5.45	5.60	5.55	5.45	5.60
3s10s yield curve	0.39	0.30	0.25	0.30	0.40	0.30
3 year swap	5.80	5.60	5.80	5.70	5.50	5.75
10 year swap	6.26	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	0.97	1.20	1.50	1.75	2.00	2.35
US 10 year note	3.40	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*.

Foreign exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
Australian exchange rates						
A\$/US\$	0.9219	0.92	0.95	0.94	0.92	0.90
NZ\$/US\$	0.7526	0.74	0.75	0.74	0.71	0.70
A\$/¥	84.29	81.0	81.7	82.7	82.8	82.8
A\$/€	0.6154	0.62	0.62	0.62	0.61	0.60
A\$/£	0.5558	0.56	0.58	0.58	0.56	0.55
A\$/NZ\$	1.2247	1.24	1.27	1.27	1.30	1.29
A\$/CA\$	0.9671	0.95	0.96	0.97	0.96	0.95
A\$/CHF	0.9298	0.94	0.96	0.98	0.97	0.96
A\$/CNY	6.2940	6.28	6.49	6.42	6.27	6.12
A\$ Trade weighted index	71.20	69.2	70.6	70.5	69.5	67.7
International cross rates						
US\$/¥	91.43	88.0	86.0	88.0	90.0	92.0
€/US\$	1.4979	1.49	1.53	1.52	1.50	1.49
€/¥	136.96	131	132	134	135	137
£/US\$	1.6587	1.63	1.64	1.63	1.64	1.65
€/£	0.9031	0.91	0.93	0.93	0.91	0.90
US\$/CA\$	1.0490	1.03	1.01	1.03	1.04	1.05
US\$/CHF	1.0086	1.02	1.01	1.04	1.05	1.07
US\$ index	75.31	75.1	73.4	74.2	75.1	75.7
Asia exchange rates						
US\$/CNY	6.8274	6.83	6.83	6.83	6.82	6.80
US\$/HKD	7.7501	7.75	7.75	7.76	7.77	7.77
US\$/IDR	9485	9500	9500	9625	9500	9250
US\$/INR	46.66	47.0	46.5	46.0	46.0	45.0
US\$/KRW	1190	1125	1100	1150	1175	1050
US\$/MYR	3.3900	3.41	3.34	3.37	3.40	3.40
US\$/PHP	47.130	47.0	46.0	46.5	46.0	45.0
US\$/SGD	1.3963	1.40	1.39	1.40	1.41	1.41
US\$/THB	33.465	33.00	33.00	33.00	32.50	32.50
US\$/TWD	32.391	31.50	31.00	31.30	31.50	30.30
US\$/VND	17857	18500	18500	18500	18500	19300
Pacific exchange rates						
PGK/US\$	0.3834	0.374	0.392	0.381	0.395	0.386
FJD/US\$	0.5338	0.534	0.545	0.540	0.530	0.523

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