



ECONOMICS & MARKETS RESEARCH

ANZ AUSTRALIAN MARKETS WEEKLY

AUSTRALIAN RATES ON HOLD FOR NOW, BUT FOR HOW LONG?

04 FEBRUARY 2010

INSIDE

Economic Update	2
AUD Cross View	5
Forecasts	6

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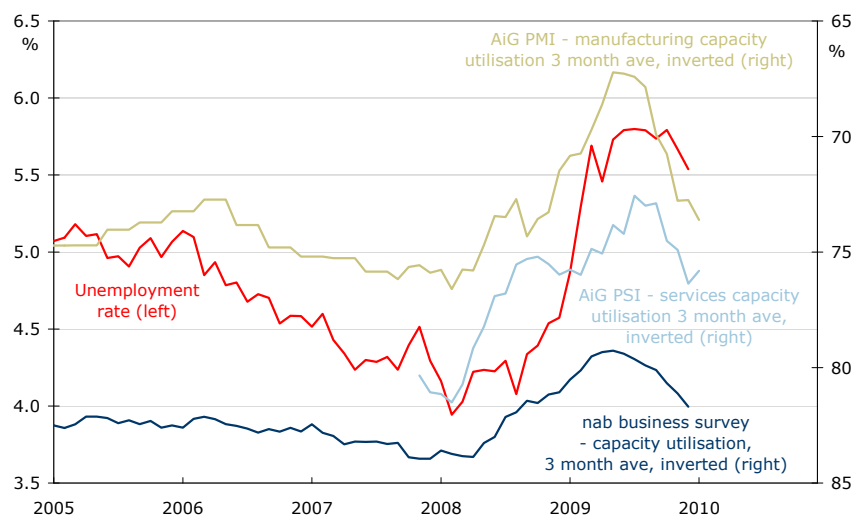
ECONOMIC UPDATE: RBA BIDES ITS TIME

- the RBA left rates on hold in February and is apparently waiting to see further evidence of a sustainable recovery, particularly from the business sector.
- January's run of positive economic activity data continued this week, albeit with a few indications that momentum may be slowing.
- Domestic inflation pressures and capacity constraints are building, so the RBA will not be able to wait long before its next move in this tightening cycle.

CHART OF THE WEEK: CAPACITY UTILISATION CONTINUES TO TIGHTEN

Business surveys indicate that capacity utilisation rates have increased relatively rapidly in recent months, even in manufacturing. However the trend may be decelerating a touch. The latest AiG surveys indicate capacity utilisation in January was 73% in manufacturing and 74% in services, both down slightly from December and November. The latest nab survey indicates a capacity utilisation rate of 81.6% for all types of businesses in December. All three survey measures are back to the same levels seen in mid to late 2008. The latest unemployment rate is 5.5%.

FIGURE 1. UNEMPLOYMENT AND CAPACITY UTILISATION RATES



Sources: ABS, National Australia Bank (nab) and Australian Industry Group (AiG).

ECONOMIC UPDATE

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RBA BIDES ITS TIME ...

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- Domestic inflation pressures and capacity constraints are building, so the RBA will not be able to wait long before its next move in this tightening cycle.

... BUT IT CANNOT AFFORD TO WAIT TOO LONG

The RBA left the cash rate at 3.75% this week, despite ongoing strength in domestic growth data through January. This came as a big surprise to rate and currency markets.

The message from the RBA was that although rates are going up, the rise will be gradual and measured. With the economy heading back to potential growth rates and ever-decreasing spare capacity (see figure 1), we see a 'neutral' policy setting as most likely by the second half of the year. Our estimate is that this requires an RBA cash rate of around 4.5% to 5.0% by year end. With the current rate still sitting at 3.75%, we expect a 25bp rate increase next month unless global market weakness intensifies and/or the domestic data quickly reveals a serious loss of momentum in early 2010. So far, we have not seen much hard evidence of either occurring.

After the last rate hike in December, the RBA said it would wait to see how the economy was reacting to the three rate rises in 2009 before moving again. Most economists (including ourselves) and the market thought the surprisingly strong data (particularly on confidence, retail, employment and resources-related investment) released over the past six weeks had provided enough evidence of a positive reaction.

This week, the RBA said that even after this positive data run, it still wants to see more evidence on reactions to the previous three rate hikes (and noting additional increases by lenders after the December move). In particular, it is concerned that the improvement in economic conditions has been uneven to date. The RBA has confidence that households are doing well due to "...strong labour market outcomes and a recovery in net worth." However, it remains more cautious on businesses who continue to deliberate and, smaller businesses especially, to face tighter credit conditions. At the moment the RBA remain confident that inflation will get into the target band, but it also noted this week that "...inflation has risen somewhat recently as temporary factors that had been holding it down are now abating." To us this is a key risk going forward.

The RBA's current caution with further rate hikes in 2010 is due to several factors: the increased margin between official and lending rates due to the financial crisis; the higher indebtedness of households; the need to assess the impact of materially tighter policy; the fledgling nature of the domestic recovery; and the fragile nature of the global recovery. Further, the nature and level of a 'neutral rate' in this tightening cycle is an increasingly uncertain concept; it is likely the RBA will know the exact level of the 'neutral rate' once it gets closer to it rather than well before. This suggests to us the RBA will be increasingly careful on the pace of its rate hikes as they move higher.

To us the risk to this cautious rate view is clearly inflation and the fact that core inflation has persisted through the downturn and remains uncomfortably high, still outside the upper band of the RBA's target. In November's RBA Statement of Monetary Policy the RBA forecast economic growth near or at trend at 3.25 in the December quarter. But given the persistence of core inflation when the economy was weak, a trend rate of growth is arguably not the best environment to keep the downward momentum in inflation going. The November SoMP had a forecast of 3.25% for inflation in the year to the December quarter but the actual rate came in at 3.4%.

In the current economic environment the RBA's forecast of 2.25% for core inflation now seems ambitious. Inflation pressures are building from a rapidly closing output gap, with labour market pressures risking tgeh reacceleration of wages. On the other side of the ledger, there is seemingly limited further upside to the Australian dollar to help keep imported inflation low. We expect the RBA to raise its forecasts for inflation in February's SoMP (released on Friday 5 Feb). And as inflation forecasts are lifted closer to the top end of the target band, the less margin for error the RBA will have and the more they may need to do on rates in the short term, or in layman's language, bigger rises sooner.

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MORE POSITIVES FROM THIS WEEK'S DATA

Although some of the headlines from this week's data appeared to be setbacks (particularly the falls in nominal retail trade in December and January's Job Ads), the overall picture of the Australian economy was generally a positive one.

This week saw the ANZ Job Ads series, a forward indicator of employment growth (generally 'leading' jobs growth by 3 to 6 months), stumble in January, with an 8.1% drop in total job advertisement numbers. This came after 2 months of very strong growth however, and in trend terms, the series continued to grow (+1.0% MoM). Other forward indicators of economic activity also lost ground this week, with the nab survey of business confidence and the AiG's performance of manufacturing and performances of services indexes all losing some of the positive momentum gained in recent months. The nab survey of actual business conditions remained unchanged at a relatively strong level.

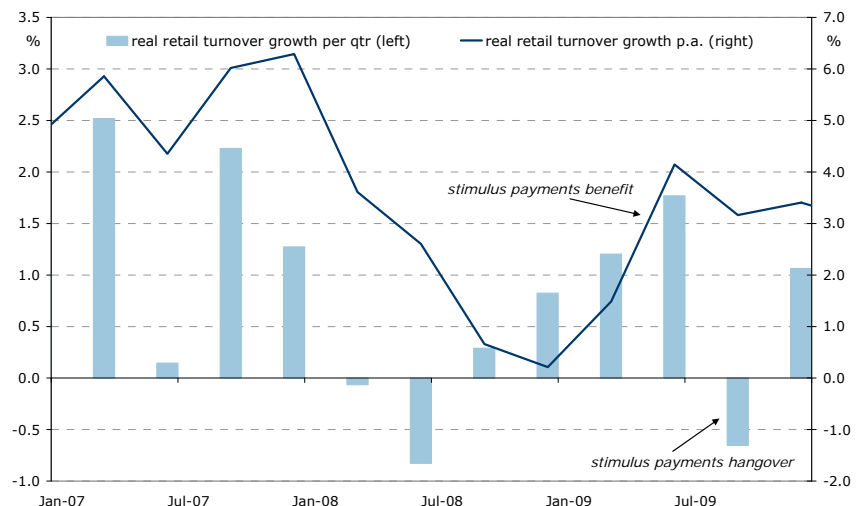
On the prices front, both the TD securities inflation gauge (for the month of January) and the ABS house price index (for Q4) came in loud and strong. The inflation gauge accelerated to 0.8% (although the annual rate stayed steady at 2.6%), adding weight to the already risky domestic inflation outlook. Certainly, neither measure provided any indication of flagging demand from households through to the end of 2009.

Apart from the RBA rate decision on Tuesday, the other big surprise for Australian markets this week was undoubtedly the disappointing headline number for retail trade growth in December, which recorded a surprise fall of 0.7% in seasonally adjusted monthly terms. At the same time, November's growth was revised up, from an already strong 1.4% to 1.5% MoM. Reading through the huge degree of seasonal volatility in this monthly data series, it seems the usual Christmas shopping spree came early this year. The quarterly retail trade volumes data (that is, inflation adjusted) tell the story more clearly. Q4 was a good period for retailers and, with only one quarter of decline this year (Q3), Q4 showed that the sector has quickly recovered from its post-stimulus payments hangover, despite fears earlier this year that it would linger well into 2010 (see figure 2).

And although shopping may have slowed in December, residential building approvals did not. They grew another 2.2% in December, after spiking up 5.9% in November, despite the twin drags of monetary policy tightening and the end of the first home buyers' boost.

In other data this week, the trade balance blew out again in December, with imports values (+6%) growing more strongly than exports (+4%) and setting in train the prospect of an entrenched trade deficit through 2010. The good news under this headline was that first, both resources and rural export values continued to grow strongly despite a weak global market, and second, the month's imports growth was wholly driven by intermediate and capital goods growth (+11% and +7%) rather than by consumption goods imports (-1%). Despite the deficit, this augurs well for future export earnings as well as for the business investment upturn so keenly awaited by the RBA.

FIGURE 2. RETAIL TRADE GROWTH RECOVERS LOST GROUND IN Q4



Source: ABS.

ECONOMIC UPDATE

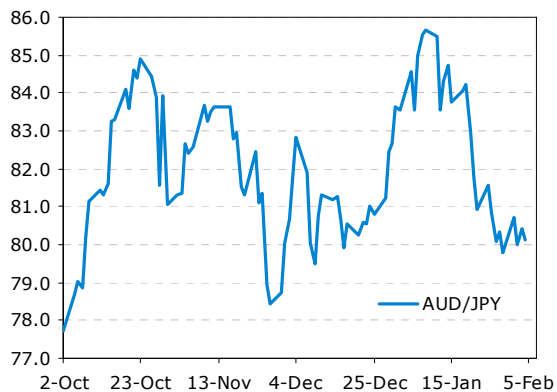
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DATA WRAP

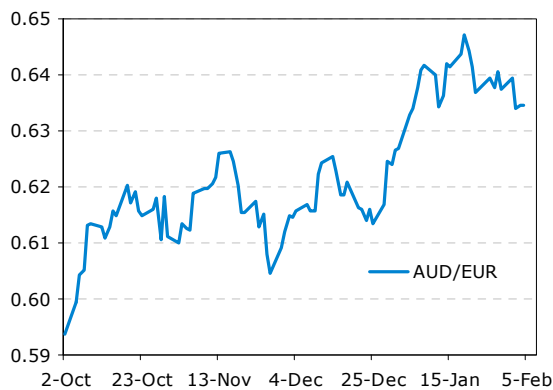
- The **Australian Industry Group (AiG)'s Performance of Manufacturing Index** fell to 48.5 points in January, from 51.0 points in December (scores above 50 are net positive in this data series).
- **TD Securities inflation gauge** accelerated to 0.8% in January MoM, from 0.3% in December, but the annual inflation rate stayed steady at 2.6%.
- **ANZ Job Advertisements** in January fell 8.1% MoM, to be down 25.9% from the same month a year ago. In trend terms, Job Ads were up 1.0% MoM.
- The **ABS national house price index** for Q4 increased 5.2% QoQ and 13.6% YoY.
- The **RBA commodity price index** for January fell 11.7% this month.
- The **nab business conditions index** was stable at 10 points in December (scores above zero are net positive in this data series).
- The **nab business confidence index** tumbled to 8 points in December from 19 points in November (scores above zero are net positive in this data series).
- The **RBA cash rate** remained unchanged at 3.75%.
- The **Australian Industry Group (AiG)'s Performance of Services Index** fell to 47.4 points in January, from 50.0 points in December (scores above 50 are net positive in this data series).
- The **FCAI's total new vehicle sales** fell 15.6% in January MoM, but were up 11.6% YoY (unadjusted data).
- **Australia's trade balance** widened to \$2.2bn in December, with export values up 4% and import values up 6%.
- **Monthly nominal retail sales** fell by 0.7% MoM in December. November sales growth was revised up from 1.4% to 1.5% MoM.
- **Real (volume) retail sales** increased by 1.1% in Q4 (1.2% nominal growth QoQ).
- **The number of residential building approvals** increased by 2.2% in December MoM, to be up 53.3% YoY.
- The **value of total building approvals** fell 3.7% MoM in December.

AUD CROSS VIEW



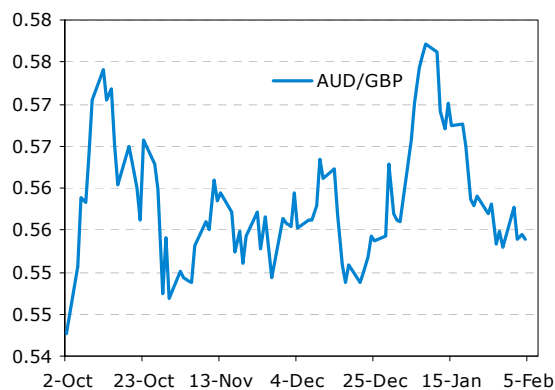
AUD/JPY KEY LEVELS: 82.60 – 79.00

- A weakening Aussie dollar and unstable global markets has seen the AUD/JPY fall a further 2% in the last seven days with the cross testing the key support level of 80.00 several times. The AUD/JPY will continue to remain volatile in response to contractionary comments from China and sensitive to the markets risk appetite.
- Japan will be releasing its current account figures next week, but we expect Australian data and trade flows to be key in directing the AUD/JPY. Better than expected figures from Australia may see the cross rally towards 82.60, with the cross finding downside support at 79.00.



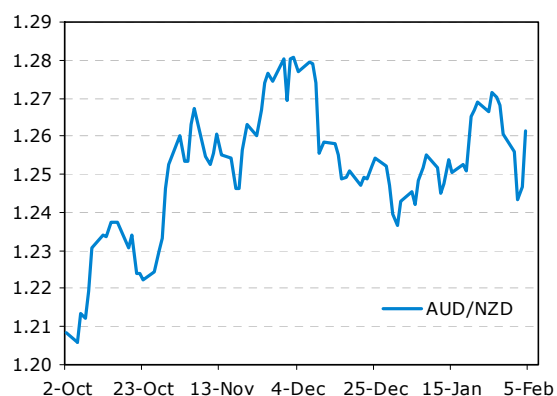
AUD/EUR KEY LEVELS: 0.6250 – 0.6440

- A weak performance by the AUD has seen the AUD/EUR slip 1.5% this week. With Portugal announcing mounting sovereign debt issues, the market will be looking for clarity around the depth of the credit issue. Should the EU announce a bail-out package for its struggling members (Greece and Portugal), we may see the AUD/EUR rally with gains finding resistance at 0.6440.
- The ECB will announce any changes to current monetary policy settings tonight. While it is widely expected interest rates will remain on hold, the market will be looking to the accompanying statement for any change in tone or hints that the current expansionary setting is being removed. A hawkish statement from the ECB may see the cross test downside support levels at 0.6250.



AUD/GBP KEY LEVELS: 0.5450– 0.5780

- The AUD/GBP has been largely range-trading this week. The currency pair made its biggest move on the back of the RBA's decision to leave interest rates on hold, losing 1.3% before the cross recouped its losses. The cross will remain volatile to the markets' appetite for the AUD and for Australian data this week. Strong AUD demand and positive data may see the cross extend towards 0.5780.
- The BoE is meeting tonight, and is widely expected to keep interest rates on hold. However a change in tone or a hint of future policy direction will influence the direction of the AUD/GBP. A hawkish statement from the BoE may see the AUD/GBP test downside support at 0.5450.



AUD/NZD KEY LEVELS: 1.2450 – 1.2700

- Weaker than expected employment data out of NZ saw the AUD/NZD cross rally, gaining back 1.5% of the week's earlier losses. With the RBA choosing to pause this week and keep Australian interest rates on hold at 3.75%, the market will be on data watch. Look out for Australian employment figures next Thursday - strong employment numbers could see the AUD/NZD extend towards 1.2700.
- With a quiet week ahead on NZ's economic calendar, expect the AUD/NZD to be guided by overseas markets and the AUD. Any further shocks to the market and/or diminished risk appetite may find the cross testing support levels at 1.2450.

FORECASTS

AUSTRALIAN ECONOMIC INDICATORS	2008	2009 F	2010 F	2011 F
Economic activity (annual % change)				
Private final demand	4.1	0.2	2.8	4.6
Household consumption	2.4	1.4	1.8	3.0
Dwelling investment	2.6	-5.5	9.5	6.0
Business investment	12.4	-2.2	3.4	9.2
Public demand	6.7	2.1	7.0	4.6
Domestic final demand	4.5	0.7	3.7	4.6
Inventories (contribution to GDP)	-0.4	-0.5	0.6	-0.1
Gross National Expenditure (GNE)	4.3	0.1	4.3	4.5
Exports	3.8	1.1	2.3	5.4
Imports	11.4	-7.7	9.5	9.2
Net Exports (contribution to GDP)	-1.6	2.0	-1.5	-0.9
Gross Domestic Product (GDP)	2.2	0.9	3.0	3.4
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.8	2.3	2.8
Underlying *	4.4	3.7	2.9	2.7
Wages	4.1	3.6	2.9	3.3
Labour market #				
Employment (annual % change)	2.2	0.3	2.0	2.1
Unemployment rate (annual average %)	4.3	5.6	5.6	5.2
External sector				
Current account balance: A\$bn	-54.3	-50.3	-58.1	-55.9
% of GDP	-4.4	-4.0	-4.4	-4.0

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

Actual labour market data for 2008 and 2009, forecasts for 2010 and 2011.

AUSTRALIAN INTEREST RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
RBA cash rate	3.75	4.00	4.25	4.50	4.75	4.75
90 day bill	4.12	4.35	4.75	4.85	5.00	5.00
3 year bond	4.49	4.70	5.00	5.05	5.30	5.55
10 year bond	5.45	5.30	5.50	5.45	5.60	5.75
3s10s yield curve	0.96	0.60	0.50	0.40	0.30	0.20
3 year swap	5.12	5.15	5.45	5.50	5.75	6.00
10 year swap	6.04	5.90	6.05	6.00	6.15	6.30
INTERNATIONAL INTEREST RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
RBNZ cash rate	2.50	2.50	3.00	3.75	4.00	4.00
NZ 90 day bill	2.78	2.80	3.63	4.22	4.30	4.30
US Fed funds note	0.25	0.25	0.25	0.25	0.75	1.25
US 2 year note	0.87	1.20	1.50	1.75	2.20	2.65
US 10 year note	3.69	4.10	4.30	4.25	4.40	4.45
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.10
ECB refinance rate	1.00	1.00	1.00	1.00	1.50	1.75
UK repo rate	0.50	0.50	0.50	0.50	1.00	1.25

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



FORECASTS

FOREIGN EXCHANGE RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
Australian exchange rates						
A\$/US\$	0.8814	0.92	0.94	0.92	0.90	0.87
NZ\$/US\$	0.6984	0.72	0.71	0.69	0.68	0.67
A\$/¥	80.12	84.6	84.6	83.7	82.8	81.8
A\$/€	0.6346	0.65	0.65	0.64	0.64	0.62
A\$/£	0.5540	0.56	0.57	0.56	0.55	0.52
A\$/NZ\$	1.2620	1.28	1.32	1.33	1.32	1.30
A\$/C\$	0.9354	0.96	0.96	0.96	0.95	0.92
A\$/CHF	0.9335	0.95	0.95	0.95	0.96	0.95
A\$/CNY	6.0173	6.28	6.42	6.20	5.99	5.72
A\$ Trade weighted index	68.70	71.4	72.8	71.5	69.4	67.0
International cross rates						
US\$/¥	90.90	92.0	90.0	91.0	92.0	94.0
€/US\$	1.3888	1.42	1.44	1.43	1.41	1.40
€/¥	126.25	131	130	130	130	132
£/US\$	1.5910	1.64	1.66	1.64	1.65	1.66
€/£	0.8730	0.87	0.87	0.87	0.85	0.84
US\$/C\$	1.0613	1.04	1.02	1.04	1.05	1.06
US\$/CHF	1.0591	1.03	1.01	1.03	1.07	1.09
US\$ index	79.40	77.8	76.5	77.3	78.2	78.8
Asia exchange rates						
US\$/CNY	6.8270	6.83	6.83	6.74	6.66	6.58
US\$/HKD	7.7670	7.75	7.76	7.77	7.77	7.76
US\$/IDR	9320	9300	9500	9300	9000	8800
US\$/INR	46.06	46.5	46.0	46.0	45.0	44.5
US\$/KRW	1153	1100	1150	1175	1050	1000
US\$/MYR	3.4145	3.34	3.37	3.40	3.40	3.35
US\$/PHP	46.135	46.0	46.5	46.0	45.0	45.0
US\$/SGD	1.4120	1.39	1.40	1.41	1.41	1.40
US\$/THB	33.100	33.00	33.00	32.50	32.50	32.50
US\$/TWD	31.983	31.50	31.90	31.50	30.50	30.00
US\$/VND	18477	18500	18500	18500	19300	19300
Pacific exchange rates						
PGK/US\$	0.3775	0.392	0.381	0.395	0.386	0.372
FJD/US\$	0.5129	0.545	0.540	0.530	0.523	0.510

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