

## A question of timing

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### Macroeconomic update: When and what is normal?

- The balance of risks in the economy seem relatively evenly poised and as such we think the RBA will only act in the next few months if the economy outperforms current expectations.

### Interest rate markets: Curve flattening stalls

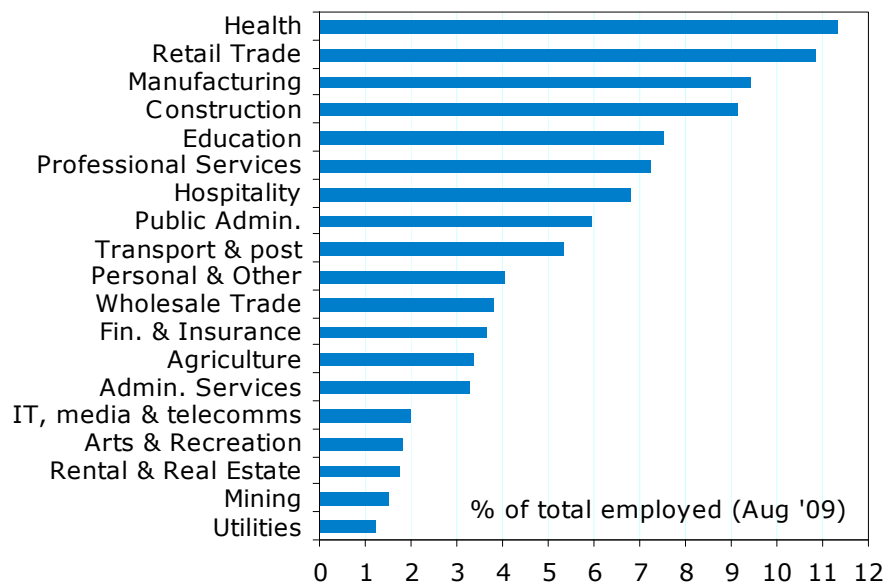
- The market continues to reassess the scope for an early normalisation of policy rates. But the issue remains more a question of timing.
- There is limited scope for yield curve to flatten much further for now.

### FX: AUD/USD set to rally above 90c in 2010

- We now expect the AUD/USD to rally to 0.92 in Q1 next year and remain elevated in the high 0.80s to low 0.90s range over 2010.
- A major driver of our stronger AUD profile is an expected persistence of cyclical and structural forces that been working to weaken the USD over the past six months.
- For the AUD, the most important factor over the year ahead will be the strength of our commodity exports, and in large part this will be a China story.

### Chart of the week: Retail no longer Australia's largest employer

Figure 1: Australian employment by industry (% of total)



Source: ABS.

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## Macro update: When and what is normal?

- The balance of risks in the economy seem relatively evenly poised and as such we think the RBA will only act in the next few months if the economy outperforms current expectations.

### Does the RBA need to raise rates this year?

The minutes from the RBA's September meeting added no clarity to the debate around when the first hike on the way to a 'normalised' level of interest rates will take place. This "wait and see" approach would seem appropriate given the still elevated levels of uncertainty around the domestic and global economic recoveries over H2 2009. Further to our minds at the moment, the RBA still lacks a compelling reason to raise rates sooner, i.e. this year, rather than later. True, the "emergency" scenario is no longer in play but a repeat of H1 economic growth in H2 is nowhere near guaranteed.

A reason may still emerge for the RBA to act in coming months, yet most believe the Australian economy will post very moderate growth in the back half of this year. The balance of risks in the economy seem relatively evenly poised across many major sectors and we think the RBA will only act earlier if the economy continues to outperform current expectations. What will be key is whether sharp gains in confidence made in the first half of the year will translate into activity in the second.

- Weakness in business profits and investment is still expected. This is despite relatively solid June quarter growth. CAPEX numbers suggest the investment track going forward will not be as weak as first expected, but will still likely be relatively soft. However, recent sharp gains in business confidence do give hope that this outlook may have some upside risk.
- Household income growth will be sluggish at best as wage and employment growth remain soft and this will weigh on consumption going forward. Further, there are no government handouts supporting consumption in H2. We will have to wait and see whether the spike in consumer confidence is enough to kick-start spending and support it going forward. Retail sales in June and July were both weak, although RBA liaison points to some improvement in August.
- The fall in the terms of trade will weigh on gross domestic income going forward. However, we have likely experienced the majority of the falls in the terms of trade over recent quarters. On a positive, the strength of China's demand for Australian commodities has surprised most. However, the high Australian dollar and still soft global demand outside of Asia creates headwinds for non-resources exports and will see volumes growth soft fairly soft in coming quarters. Net exports are unlikely to support GDP growth in H2 like they did in H1.

Given the likelihood of very modest economic growth as the fragile economy recovers through the second half of this year, the labour market, retail sales and inflation are key indicators to the timing of the RBA's first move to normalise official interest rates. We believe the inflation outlook buys the RBA a bit of time. A significantly negative output gap, decelerating wages growth and a relatively high Australian dollar should keep the current downward momentum in the annual rate of inflation in train. Modest economic growth this year and next, (that will be well below a potential rate around 3¼%p.a.) should do nothing to derail this expectation.

### The labour market, and not the housing market, will be the key

So this raises the question: if the RBA doesn't have to raise rates earlier, then why would they? The labour market is important here and currently some weakness is still expected. Further, the unemployment rate is still rising and will continue to do so. Given the benign outlook for inflation, it would seem the RBA is in a position to take the edge off this increase, by holding off on rate hikes for a few months. (You can be sure the government would be appreciative heading into an election year). Our call on rates, in the absence of a strong and sustained turnaround in the labour market, remains for the first hike to come early next year.

Some suggest the recent rise in house prices will be the catalyst (interestingly some former housing doomsayers have now converted to a housing bubble story). This seems unlikely; median prices have only now recovered to levels seen in 2008 and much of this rise has been driven by subsidised first homebuyers. From end-September the boost the FHOG is scaled back and by the end of December it will be gone. This will no doubt dampen what has been frenetic buyer demand going forward. Upgraders and investors will increasingly support market activity, yet price gains in the next six months are unlikely to match what has happened over the past six months, largely solving any perceived problem for the RBA.

### So what does normal look like?

So when the RBA does commence raising rates, what does a "normal" level of rates look like? The average level over the inflation targeting period of around 5¼ -6% has been suggested as a level when policy will move from expansionary to restrictive (RBA Governor Stevens suggests somewhere above 5% in his recent parliamentary testimony). However, we believe there are short and long term dynamics here that may foreshadow a 2002-2007 type of tightening cycle in coming years - that is more gradual increases over a longer period.

In the short term rates rises are likely to be fairly measured with the RBA erring on the side of caution and 'feeling out' the impact of each rise in rates. Particular attention will be paid to the impact of hikes on household finances as incomes stagnate. Since June last year households have continued to leverage (unlike virtually all other advanced economies), adding \$65 billion to household debt levels. Close to 172,000 new first homebuyers have been granted finance over the past 12 months suggesting there are a lot people with very new and large debt burdens.

Further, due to the global financial crisis a specific level of the cash rate now does not reflect the same mortgage or business lending rate than it would have pre-crisis. That is to say higher funding costs for lenders have led to a larger gap between official and lending rates. These funding cost issues persist and are likely to be factored into the RBA's thinking when raising rates.

Over the longer term, two recent seismic shifts in the Australian economy suggest that any neutral level of official interest rates may need to be higher than at the beginning of the inflation targeting period. Firstly, the terms of trade shifting structurally higher than ever before, supported by the expected resumption of commodity price gains over the medium to long term. Even now, despite massive recent falls in the terms of trade we are still only back to levels seen in late-2007 - at the time record highs. With the two largest developing nations, China and India, only in the early stages of a commodity hungry industrialisation process, it is difficult to see much downside commodities prices over the medium to long-term. A resumption of terms of trade increases will again see gross national income growth supportive of the economy - just like the resources boom from 2002-08.

Secondly, structurally higher labour force participation should allow households to service higher debt levels and consume simultaneously despite elevated interest rates. Recently much of the acceleration in the rise of the participation rate has been due to record overseas migration levels to Australia. In part, this has been to address skill shortages and despite the downturn levels of migration so far, participation has not significantly come off recent highs. Also, longer term trends will see levels of participation continue to trend higher. The two most prominent are: females entering the work force, which has been climbing rapidly for decades; and people working longer as life expectancy continues to increase.

Whatever happens, Australia's economic out-performance has seemingly raised more questions about the future of appropriate fiscal and monetary policy settings than a recession would have.

### Data wrap

- **Dwelling starts** for the June quarter were down 3.7%
- The **WBC Leading index** gained 1.1% in July, after a 0.9% rise in June.
- **Merchandise imports** (on a BOP basis) fell 4% in August.

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## Interest rate markets: Curve flattening stalls

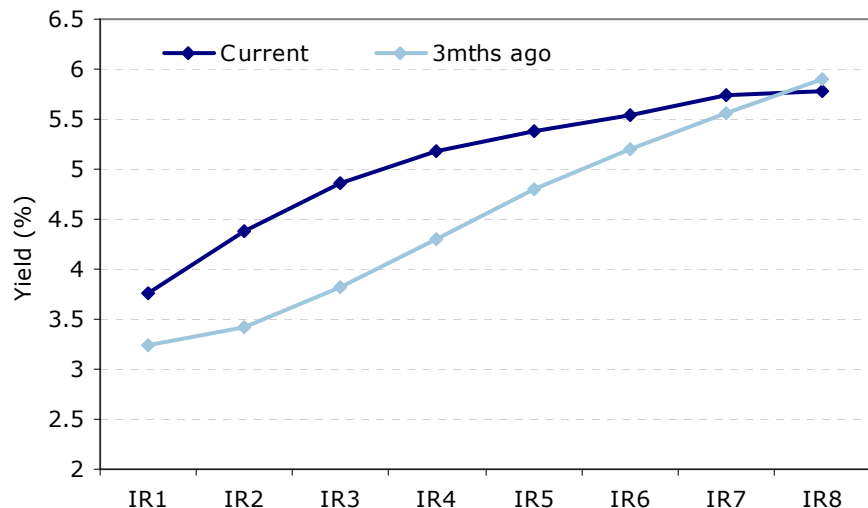
- The market continues to reassess the scope for an early normalisation of policy rates. But the issue remains more a question of timing.
- There is limited scope for yield curve to flatten much further for now.

The market has continued to reassess the outlook for the RBA in light of the more neutral tone of the RBA in recent commentary and weaker than expected economic data of late. The tone from the RBA is tentative. The Minutes of the September RBA board meeting revealed that the Bank still thought it was "too soon to be confident" of a modest sustained recovery for the global economy.

The Minutes also returned to the theme that borrowing costs are starting to rise again as a headwind facing corporate borrowers while the availability of credit remains an issue for developers and a "brake" on activity.

There is clearly still a case for a move to less accommodative settings. Futures markets are still pricing a relatively sharp move higher in rates over the year ahead, even with the recent reassessment of the case for an early move to more normal policy settings as can be seen in the chart below. (These are 3-month futures contracts on bank bills).

**Figure 2: Bank Bill interest rate (IR) futures strip**



Source: ANZ & Bloomberg

The maturity of \$14bn of ACGB, Semis and corporate bonds this week has left investors with spare cash to invest which is helping to cap longer-term market rates while the change in tone from the RBA and weaker data has seen the AUS-US spread narrow relatively sharply.

The currency has also underpinned investor sentiment as the AUD continues to appreciate against a weaker USD despite the changed rate outlook. This will underpin the outright demand for bonds that will cap market yields in the near-term and limit the scope for curve to steepen too far from current levels.

But curve flattening based on the idea that policy is about to become preemptive here now looks out of place for now. The impetus to further curve flattening from a policy perspective is now weak with October seemingly out of play for a move on rates and a limited run of data to build a more powerful case over the next month that would be needed to prompt the start of the normalisation process. The 2-year/5-year swap spread is back out to 91bps from a recent low around 80bps. The curve had previously narrowed from a high around 156bps seen in June.

So the central issue for the rate outlook is now one of timing, not whether the RBA will move away from emergency settings. Once could argue that the longer the bank waits, the more aggressive will be the move towards more normal rate levels. Once that starts, expect to see yield curves flatten once again.

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## FX: AUD/USD set to rally above 90c in 2010

### AUD/USD Key levels: 0.8550 – 0.8880

The AUD/USD took another leg up this week, hitting a peak above 0.8750 on Thursday. External forces will continue to provide direction over the coming week, with the US Fed Reserve meeting the key focus. After such a rapid move, AUD/USD buyers may wish to take advantage of any profit taking that could see AUD/USD fall to 0.8660 then lower towards 0.8550. However, AUD/USD sellers should beware of a continuation in strong momentum that could see AUD/USD surge above the next key resistance level at 0.8770 and towards 0.8880.

### Strong China outlook and a weak USD see AUD forecast raised

The economic and financial market environment has found renewed vigour over the past few weeks. The balance of risks to our AUD outlook have moved significantly to the upside, and with the USD environment continuing to deteriorate, this has led us to upgrade our AUD forecast. We now expect the AUD/USD to rally to 0.92 in Q1 next year and remain elevated in the high 0.80s to low 0.90s range over 2010.

A major driver of our stronger AUD profile is an expected persistence of cyclical and structural forces that been working to weaken the USD over the past six months. From a cyclical perspective, a sluggish US economy, low interest rates and a rapid expansion of the monetary base will continue to encourage capital outflow. The USD has achieved 'funding currency' status with zero interest rates and ample liquidity across the financial system. Investors are borrowing money in USDs, usually on very short terms to buy into 'risky' trades; in essence a carry trade. It is this dynamic that will see short-term fluctuations in the USD highly correlated with risk appetite (which continues to build).

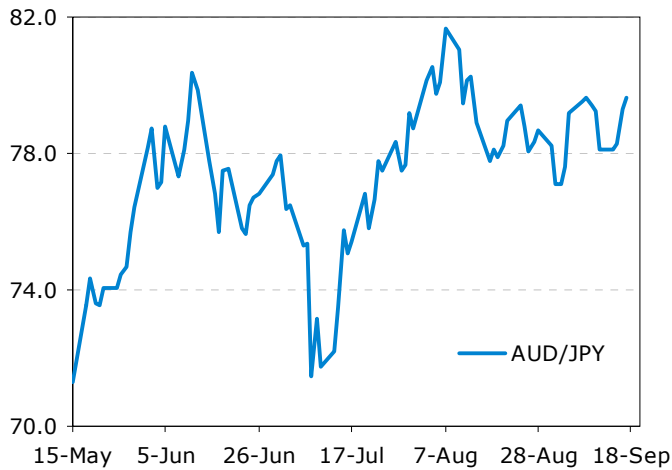
For the AUD, the most important factor over the year ahead will be the strength of our commodity exports, and in large part this will be a China story. While the AUD will benefit from reserve diversification and USD weakness, the core determinant of the AUD's value, in the absence of a significant shock to risk aversion, will be prospects for China, in particular the demand for our main bulk commodity exports. Note that the Chinese authorities are committed to investment-led (commodity-intensive) growth for the foreseeable future. And while there are some question marks over the sustainability of this composition of Chinese economic growth, we doubt that this compositional issue will be an impediment until late in 2010.

Relative returns also favour the AUD, with short-term interest rates high by global standards and likely to rise further. While we expect current market expectations for interest rates to be disappointed by a less hawkish RBA over the year ahead, the impact on the currency will be short-term and largely immaterial. The AUD will continue to benefit from high actual and expected returns on underlying assets whether they be in short-term money markets, on term debt structures or in the equity markets. Another factor supporting the AUD is the high quality of Australia's financial system, which should continue to underpin a strong inflow of debt and equity capital looking for yield.

On this basis, we expect the AUD to continue the gradual appreciation witnessed this year, most clearly against a weakened USD but also on major crosses. Our expectation is for the AUD/USD to get above 90c early next year, although no one could rule out more significant strength. Indeed, it is highly likely that calls for the AUD/USD to move to parity will come back into frame within months; this in itself will give extra zing to the rally. While a weaker USD or more persistent Chinese growth recovery could well drive the AUD back to recent highs near parity, the still prominent risk to the global recovery mean that parity with the USD remains a risk rather than a central case.

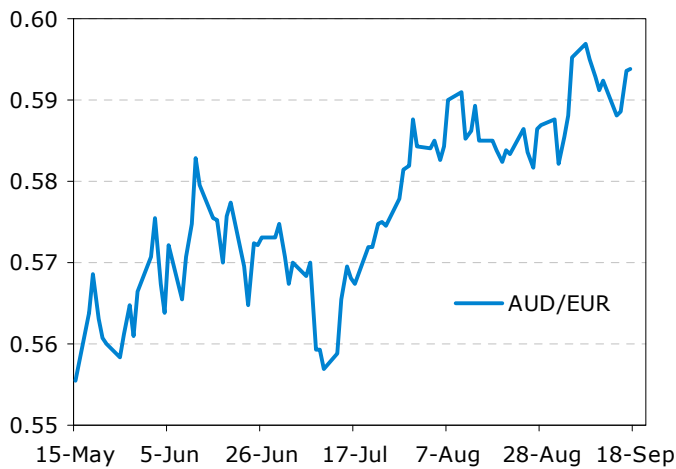
And risks remain. As we saw last year, the AUD is as exposed to a global financial shock as any currency, and a surge in demand for USD assets would put significant downward pressure on that cross. China is also a risk factor. Any disruption to Chinese growth or more importantly, the commodity intensive infrastructure build, would also have negative repercussion for the AUD.

## AUD cross view



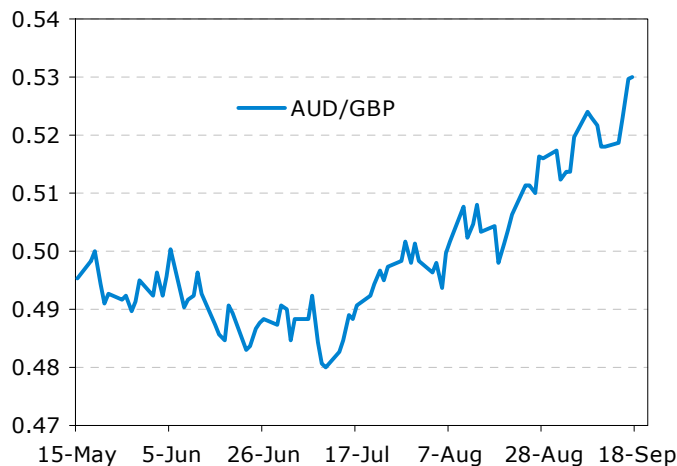
### AUD/JPY Key levels: 76.90 – 81.50

- AUD/JPY remained firmly in its broad 76.50-82.00 range trade this week as the AUD and JPY both benefited from a continued weakening in the USD. It is unlikely that we will see this cross break out of its current range over the coming week. Downside support remains firm above the 100-day moving average, currently at 76.90.
- Look to next week's Japanese merchandise trade data for August to potentially provide some volatility in AUD/JPY. In the medium term, this week's forecast revisions suggest AUD will outperform JPY over 2010, with AUD/JPY expected to trade in the low 80s for much of the year.



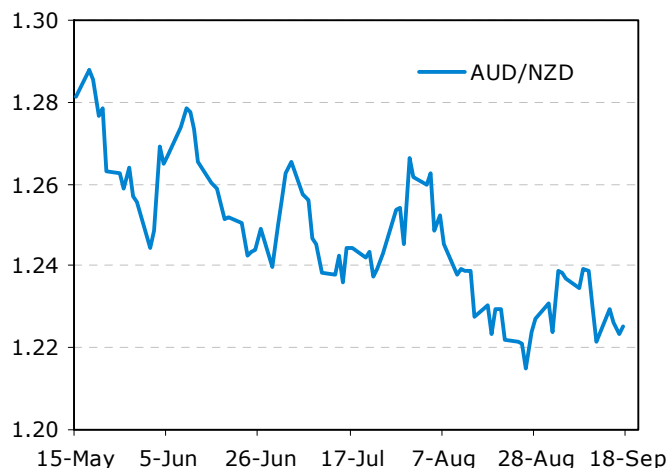
### AUD/EUR Key levels: 0.5830 – 0.6050

- The AUD has outperformed the EUR this week. Continued momentum could see the cross push convincingly through resistance at AUD/EUR0.5980 and make a run for 0.6050. Look to the cross remaining well supported above 0.5830 (50-day moving average) over the coming week as firm buying interest keeps AUD elevated.
- Euro zone trade numbers for July and purchasing managers' indices for September are the key data highlights. With the 20-day rolling correlation between AUD/USD and EUR/USD currently at 0.93, disappointing data results are likely to have only a limited impact on the AUD/EUR cross.



### AUD/GBP Key levels: 0.5130 – 0.5325

- AUD/GBP now has the early 1996 high of 0.5325 firmly in its sights. Continued strong demand for AUD could see the cross easily reach this level and move higher still. Downside dips are likely to be limited initially to 0.5240, then lower at 0.5130.
- An upside surprise in tonight's UK retail sales result could weigh on AUD/GBP, although strong global demand for AUD means that any impact will likely be only temporary. Over the coming months, a rally in AUD/USD to above 90c, combined with a GBP/USD capped below recent peaks around 1.70, is forecast to see AUD/GBP appreciate to 0.55 by early 2010.



### AUD/NZD Key levels: 1.2150 - 1.2420

- NZD continued to outperform this week as USD weakness and reserve demand from global central banks boosted NZD/USD. For AUD/NZD, we need to see a convincing break above 1.2420 before we are satisfied that the cross's current downtrend has been broken.
- Q2 current account and GDP data for NZ will be key drivers for AUD/NZD next week. Better than expected results will likely see the cross retest recent dips below 1.2150. But AUD/NZD is forecast to recover above 1.25 by year's end as NZ's large external imbalance and concerns about its credit quality provide a headwind to the NZD.

## ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
<b>Economic activity (annual % change)</b>				
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
<b>Gross Domestic Product (GDP)</b>	<b>2.4</b>	<b>0.8</b>	<b>1.7</b>	<b>3.2</b>
<b>Prices and wages (annual % change)</b>				
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
<b>Labour market</b>				
Employment (annual % change)	2.2	0.0	-0.3	1.8
Unemployment rate (%)	4.3	5.9	7.2	7.1
<b>External sector</b>				
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	3.38	3.45	3.55	3.80	4.30	4.30
3 year bond	4.69	5.00	5.15	5.10	5.20	5.25
10 year bond	5.32	5.60	5.65	5.60	5.80	5.85
3s10s yield curve	0.64	0.60	0.50	0.50	0.60	0.60
3 year swap	5.26	5.30	5.45	5.40	5.67	5.72
10 year swap	6.01	5.95	5.95	5.90	6.35	6.40
<b>International interest rates</b>						
RBNZ cash rate	2.50	2.50	2.50	2.50	3.00	4.00
NZ 90 day bill	2.76	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	0.98	1.00	1.25	1.50	2.00	2.25
US 10 year note	3.47	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
<b>Australian exchange rates</b>						
A\$/US\$	0.8767	0.89	0.92	0.91	0.89	0.87
NZ\$/US\$	0.7151	0.71	0.72	0.71	0.69	0.68
A\$/¥	79.84	78.32	79.12	80.08	80.10	80.04
A\$/€	0.5946	0.60	0.61	0.61	0.60	0.59
A\$/£	0.5307	0.53	0.55	0.55	0.54	0.53
A\$/NZ\$	1.2259	1.25	1.28	1.28	1.29	1.28
A\$/CA\$	0.9313	0.95	0.95	0.95	0.93	0.91
A\$/CHF	0.9035	0.92	0.94	0.96	0.93	0.93
A\$/CNY	5.984	6.08	6.28	6.22	6.07	5.92
A\$ Trade weighted index	67.80	68.52	70.24	69.83	68.33	66.86
<b>International cross rates</b>						
US\$/¥	91.09	88.0	86.0	88.0	90.0	92.0
€/US\$	1.4743	1.48	1.52	1.50	1.48	1.47
€/¥	134.30	130	131	132	133	135
£/US\$	1.6518	1.67	1.67	1.65	1.64	1.65
€/£	0.8925	0.89	0.91	0.91	0.90	0.89
US\$/CA\$	1.0623	1.07	1.03	1.04	1.04	1.05
US\$/CHF	1.0306	1.03	1.02	1.05	1.05	1.07
US\$ index	76.17	75.5	73.8	74.8	75.7	76.4
<b>Asia exchange rates</b>						
US\$/CNY	6.826	6.83	6.83	6.83	6.82	6.80
US\$/HKD	7.750	7.75	7.75	7.76	7.77	7.80
US\$/IDR	9645	9750	9500	9625	9250	9000
US\$/INR	48.01	48.00	47.00	47.50	47.00	47.00
US\$/KRW	1205	1125	1175	1150	1100	1050
US\$/MYR	3.47	3.50	3.48	3.45	3.40	3.40
US\$/PHP	47.77	48.00	48.00	47.00	47.00	46.00
US\$/SGD	1.41	1.46	1.45	1.44	1.44	1.43
US\$/THB	33.66	34.00	34.00	34.00	33.50	33.50
US\$/TWD	32.37	32.50	32.00	31.50	31.00	30.30
US\$/VND	17834	18500	18500	18500	18500	19300
<b>Pacific exchange rates</b>						
PGK/US\$	0.373	0.374	0.392	0.381	0.395	0.386
FJD/US\$	0.514	0.523	0.534	0.528	0.519	0.512

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