

Australia the great performer

03 September 2009

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Macroeconomic update: Acceleration

- The Australian economy continues to outperform. Real GDP expanded by 0.6% in Q2 2009, an acceleration from 0.4% growth in Q1. Non-farm GDP expanded by 1.1% in Q1, the strongest performance since Q1 2007.
- Furthermore, a rise in household savings and another fall in non-farm inventories suggests a more optimistic outlook for household consumption and production in H2.

Interest rate markets: RBA helps to cap market rates with a surprisingly dovish statement.

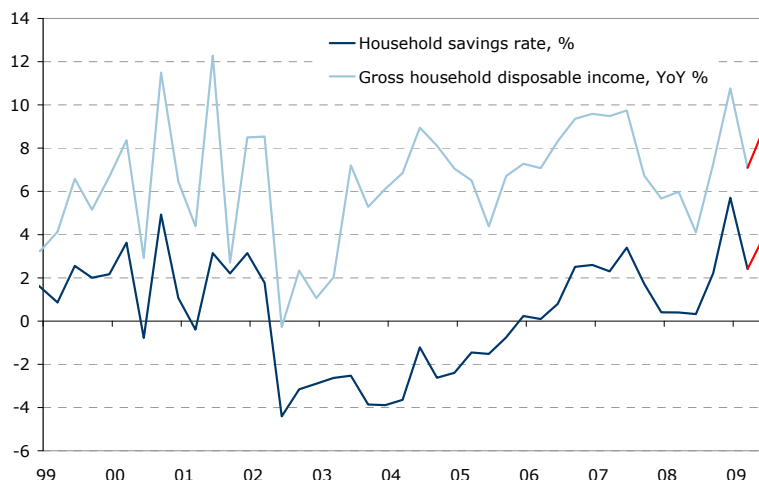
- There was no explicit shift towards a hawkish bias in the accompanying Statement from the RBA board as widely expected by financial markets.
- Nevertheless, the RBA does appear to be gradually upgrading its outlook for the domestic economy and inflation, raising the risk that rate hikes will commence before the year-end. Risk for short-term market rates still looks to be up.

FX: AUD awaits a change in rates

- The AUD/USD has continued to trade well within its established 0.81 – 0.85 range.
- On the whole, more upside than downside risks confronts AUD/USD this coming week. However, downbeat data outcomes and a bearish ECB monetary policy statement (due tonight) could see AUD/USD retrace lower to 0.8250 and then 0.8180.

Chart of the week: Household savings rebuild

Figure 1: Australian household savings rate and gross household disposable income growth, to Q2 2009



Source: ABS.

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Macro update: Acceleration

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- Furthermore, a rise in household savings and another fall in non-farm inventories suggests a more optimistic outlook for household consumption and production in H2.

Australian economic outperformance

Real GDP expanded by 0.6% in Q2 2009 following a 0.4% increase in Q1 2009. This was higher than market expectations (+0.2%) and our forecast of 0.4%. The yearly rate of growth increased to 0.6% from 0.3% in Q1 2009. This was one of the strongest performances for the advanced economies in Q2 (the Japanese economy expanded by 0.9% although this followed a 3.1% contraction in Q1). Australian GDP has now expanded by 1.0% in the past two quarters following a 0.7% contraction in Q4 2008. Overall therefore, the Australian economy has managed to expand on average through the worst global economic downturn since the 1930s.

Non-farm GDP expanded by 1.1% in Q1, the strongest performance since Q1 2007. The farm sector on the other hand contracted sharply, with farm GDP down 15.8% in Q1 following a 2.6% fall in Q4. GDP per capital also managed to grow for the first time since Q1 2008, if only slightly (0.1% QoQ).

Importantly the composition of growth is shifting away from net exports toward underlying domestic demand. Domestic demand rose 0.8%, following a fall of 1.1% in Q1, while net exports subtracted 0.2ppt from growth. This is a marked shift from Q1 2009 and Q4 2008 in which net exports added 2.2ppts and 1.7ppts to growth respectively. (This is despite Australian exports holding up much better than expected, largely due to Australia's trade links into China.) This highlights the positive impact of monetary and fiscal policy initiatives in keeping a floor under demand and confidence in this economy.

	QoQ growth		YoY growth	Cont'n to
	(%)		(%)	QoQ growth
	Jun-09	Mar-09	Jun-09	Jun-09
Household consumption	0.8	0.5	1.7	0.5
Dwelling investment	-5.5	-4.0	-10.9	-0.3
Business investment ¹	2.0	-6.5	-0.9	0.3
Public demand ¹	0.8	-0.6	2.6	0.2
Domestic demand	0.8	-1.1	0.7	0.8
Change in inventories	-	-	-	0.2
Gross national expenditure	1.0	-0.9	-0.4	1.0
Exports	1.0	2.0	-0.2	0.2
Imports	2.1	-7.6	-13.1	-0.5
Net exports	-	-	-	-0.2
Real GDP (E)	0.7	1.2	2.9	-
Statistical discrepancy	-	-	-	-0.1
Real GDP (A)	0.6	0.4	0.6	-

The expenditure side of the national accounts shows the clear impetus to growth from fiscal policy initiatives. Machinery and equipment investment expanded 5.6% in response to the government business tax incentives, particularly for small business. Household consumption also expanded 0.8%, the strongest increase since December 2007. The rise in household consumption however was weaker than expected (with retail sales rising 2.0% in the quarter); instead households increased their savings with the savings rate rising sharply to 4.0% from 2.4% in the previous quarter.

Infrastructure spending added to growth from both government and non-government sources. Engineering construction rose 5.2% and government investment expanded 0.8%. There was also a 0.2ppt contribution from inventories despite a large subtraction from non-farm industries as foreshadowed in Monday's business indicators release. Instead, farm inventories boosted growth substantially.

On the downside, building construction subtracted significantly from growth, with dwelling construction down 5.5% and non-residential building construction down 8.8%. Looking forward, non-residential building approvals are expected to fall further given the 55% decline in residential building approvals, although the recent pick up in residential building approvals is a positive sign for housing construction. Net exports subtracted 0.2ppt from growth with imports (+2.1%) expanding faster than exports (+1.0%).

Looking forward...

There is still a risk that some of the strength in private spending is due to a bring-forward of activity related to fiscal policy initiatives, particularly for household consumption and machinery and equipment investment which both added significantly to growth in Q2. However we are becoming increasingly confident that any unwinding in H2 will not be as severe as initially thought. The rise in the household savings ratio puts the consumer in a better fiscal position for the future by repairing balance sheets and should support household consumption going forward. In addition, the sharp fall in non-private inventories suggests that stock levels will have to be replenished going forward which should boost production. An improvement in non-mining profits in Q2 is also a positive signal for business investment.

Government policy actions also continue to be a critical factor supporting the economy and today's report suggests that as the initial fiscal stimulus to household and business fades, a more enduring effect from infrastructure programs may take hold; engineering construction rose strongly, as did public investment. These sectors will become increasingly important over the year ahead.

These numbers are likely to see the RBA and Treasury revise up forecasts for the economy further. The RBA's latest forecast in August had assumed Q2 growth of just 0.2 to 0.3% and the positive signals for H2 growth discussed above should lead to upward revisions to Q3 and Q4 growth. The good news is that the government's deficit will be much smaller than expected at the time of the May budget. The bad news is that interest rates will have to rise, with the risk rising that rate hikes will commence before the end of the year.

Data wrap

- The **TD Inflation Gauge** was flat in August to be up 1.7% over the year.
- **HIA new home sales** rose 0.1% in July.
- **Private sector credit** expanded 0.2% in July, with falls in business (-0.3%) and personal credit (-0.2%) offset by higher housing credit (+0.6%).
- **Company gross operating profits** fell 7.8% in Q2, largely due to lower mining sector profits.
- **Private non-farm inventories** fell 3.4% in Q2.
- The **AIG Performance of Manufacturing Index** surged to 51.7 in August from 44.5 in July.
- The **current account deficit** widened to \$13.3bn in Q2 from \$6.3bn in Q1. Net exports subtracted 0.2ppt from growth with export volumes up 1% and import volumes up 2.1%.
- **Residential building approvals** were up 7.7% in July after gaining 9.9% in June.
- The RBA left the **cash rate** unchanged at 3% (see page 4).
- **Real GDP** expanded by 0.6% in Q1 to be 0.6% higher over the year.

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Interest rate markets: Surprisingly dovish RBA comments caps rates, for now.

- There was no explicit shift towards a hawkish bias in the accompanying Statement from the RBA board as widely expected by financial markets.
- Nevertheless, the RBA does appear to be gradually upgrading its outlook for the domestic economy and inflation, raising the risk that rate hikes will commence before the year-end. Risk for short-term market rates still looks to be up.

The RBA Statement released yesterday to announce official cash rates were being kept on hold was very brief in terms of the discussion of future monetary policy, although there was a slight change in language to state that the Board "will continue to adjust monetary policy so as to foster sustainable growth in economic activity and inflation consistent with the target." Earlier Statements said they would "continue to monitor economic developments how economic and financial conditions unfold ..."

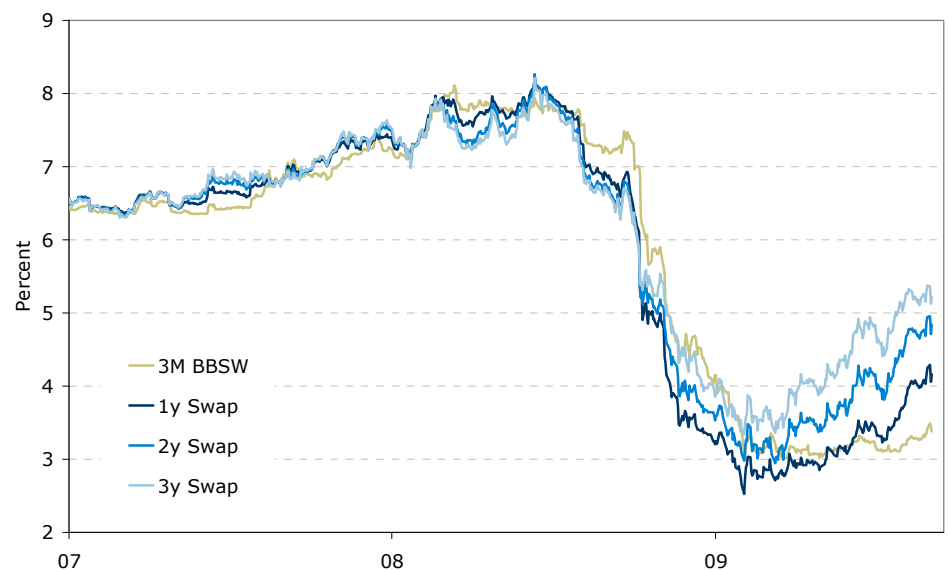
Perhaps more importantly, the RBA appears a little more optimistic about the domestic economic outlook and inflation. The Statement does re-iterate that demand may weaken in certain areas which may have experienced a bring-forward due to policy initiatives. But at the same time, they also point out that "growth is likely to firm going into 2010." In particular, "it now appears that investment may not be as weak over the year ahead as earlier expected."

With growth holding up better than expected, the RBA now appears less concerned about the downside risks to inflation: "Underlying inflation should continue to moderate in the near term, but the likelihood of inflation being persistently below the target now looks low." This removes a clear impediment to future rate hikes.

With the RBA not shifting to an explicitly hawkish bias in today's Statement, a rate hike as soon as October appears unlikely. Nevertheless, discussion about the reduced downside risks to inflation and business investment the probability of monetary policy tightening before the end of the year is rising.

At this stage, we believe the RBA will need to see further evidence on how the household sector performs in H2 to make this decision. But should retail sales and employment data continue to hold firm in coming months, then there is a serious probability that rate hikes could commence from November.

Figure 2: Short-term swap rates



Source: ANZ & Bloomberg

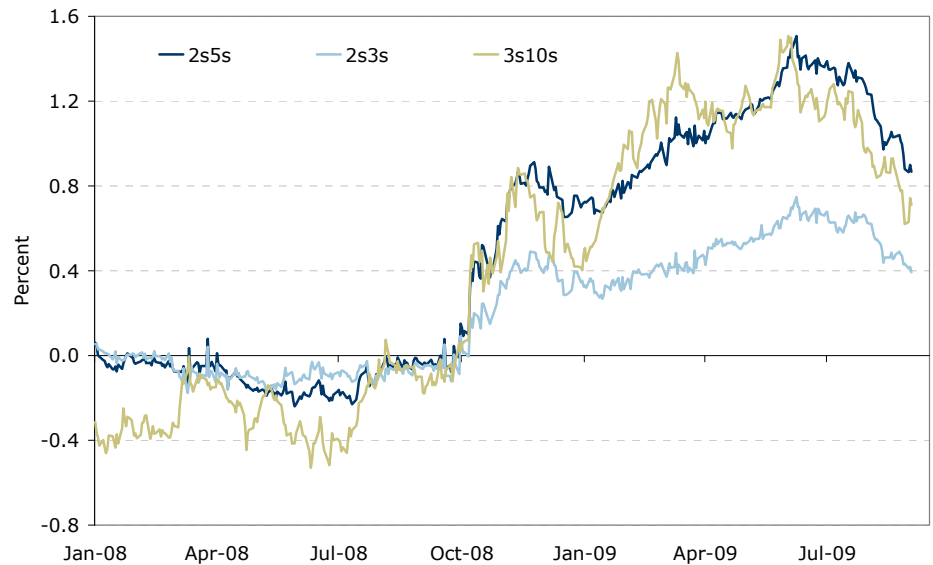
Rates markets were clearly looking for more explicit guidance on the timing of the possible move away from "emergency" monetary policy settings. Short-term interest rates fell relatively sharply to reflect skewed market positioning going into the RBA announcement. But the eventual move back to more normal settings remains more a

matter of timing and the continued run of stronger than expected data continues to highlight that there is still a risk that rates start to rise before the end of the year.

The performance of shorter-date swap yields is highlighted above. There is a clear fan pattern across the front of the curve as longer-yields have risen more sharply. But note how BBSW rates are now starting to rise. While we are not expecting the RBA to get rates back towards 5.0% by the end of next year, market yields are still well below pre-crisis levels. Price action to help cap yields below recent highs in response to the RBA stance can also be seen on the chart.

There is clearly a risk that shorter-dated yields could rise further once the RBA decides to "adjust" policy. This has already prompted some significant flattening of swap spreads, as highlighted in Figure 3 below.

Figure 3: Swap Curves



Source: ANZ & Bloomberg

This chart captures the movement in spreads between 2 and 5-year swaps, 2 and 3-years and 3 and 10-year swaps. All appear to be in flattening mode as markets start to look at the normalisation of policy settings. If these curves are to continue to flatten, it looks more likely to come from a rise in short-term rates, but focus is back on the RBA to start validating longer-term market expectations.

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FX: AUD awaits a change in rates

AUD/USD Key levels: 0.8180 – 0.8460

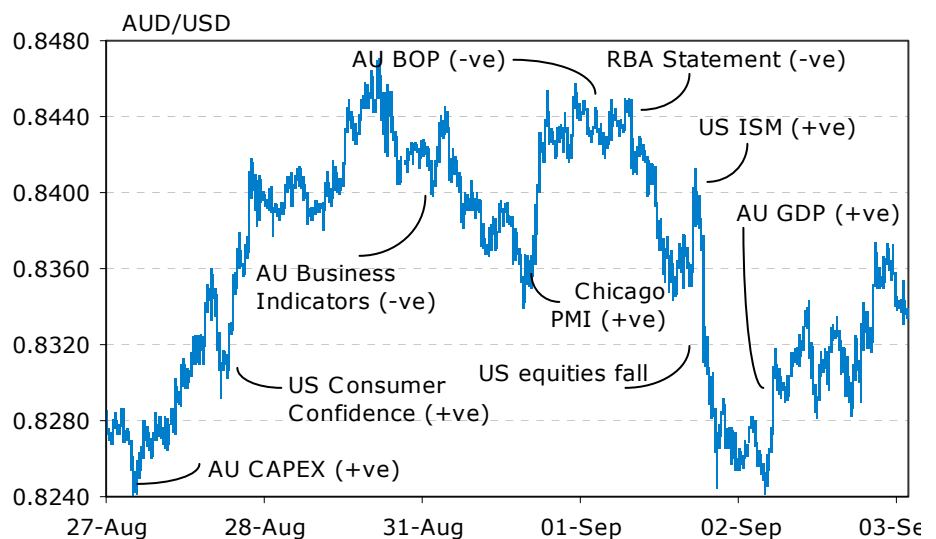
The AUD/USD has continued to trade well within its established 0.81 – 0.85 range. On the whole, more upside than downside risks confronts AUD/USD this coming week: AUD sellers should beware of stronger results in US non-farm payrolls and Australian retail sales and employment data which could see the currency break above 0.8380 and head toward 0.8460. However, downbeat data outcomes and a bearish ECB monetary policy statement (due tonight) could see AUD/USD retrace lower to 0.8250 and then 0.8180.

RBA disappointment weighs on the AUD

What a ride the past week has been. Despite the domestic and international data results printing to the upside overall, it was RBA Governor Glenn Stevens' statement following Tuesday's policy meeting that made the biggest impact on the AUD. The market's disappointment in Stevens' less hawkish than hoped for statement weighed heavily on the AUD, triggering a fall of over 2 US cents to below 0.8250. While yesterday's Q2 GDP result was better than expected, it provided only a small (and temporary) upside boost to AUD/USD.

The AUD/USD has spent the month consolidating within its now higher 0.81-0.85c range. This is unsurprising, with global asset markets taking a breather after strong July and August gains. True, the global and local economic data flow has been largely good, but this appears to have been sufficiently priced into most markets, including the AUD. While we retain our view that continued global recovery will see the AUD appreciate over the next twelve months, we remain wary of intermittent interruptions (such as this week's action) to the rally. Yesterday's improvement in GDP and the shift in the finer detail (higher household saving, lower inventories) suggest that the outlook for the Australian economy in H2 is now brighter. All in all, this means that our core outlook is for AUD/USD to remain well supported at or above 0.80 over the coming months.

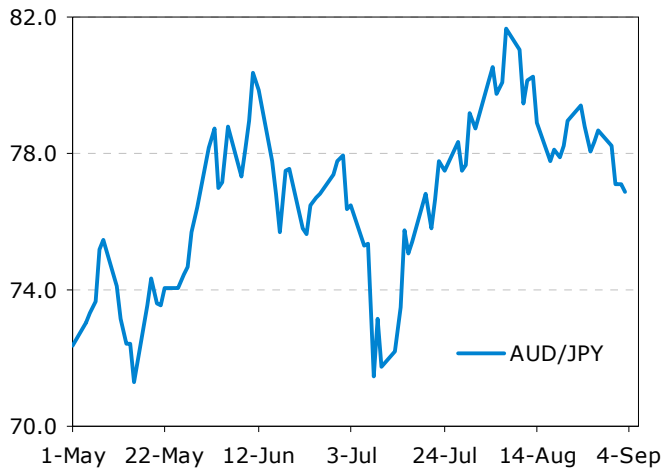
Figure 4: The week that was – movers and shakers for AUD/USD



Source: ANZ, Bloomberg

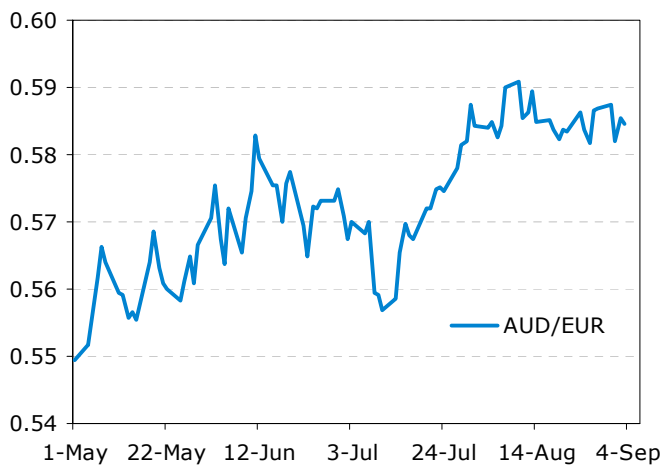
In the very near term, there are a few triggers that may move AUD/USD out of its broad 81 – 85 cent range. On the downside, the most immediate risk is the 'September effect' on equity markets which could see AUD/USD re-test recent lows around 80 cents (see the *ANZ Australian Markets Weekly* from 20 August for further details). In the short term, next week's July retail sales and August employment data will be keenly watched for upside surprises that will add to the building case for a rise in the cash rate as early as November. Although not our core view at this stage (we still expect the first rate rise in February 2010), it is nonetheless a real and growing risk. Any signs that the Australian economy continues to grow at a solid clip in Q3 would be very supportive for the AUD/USD, and could see it trade back up towards recent highs around 0.8480.

AUD cross view



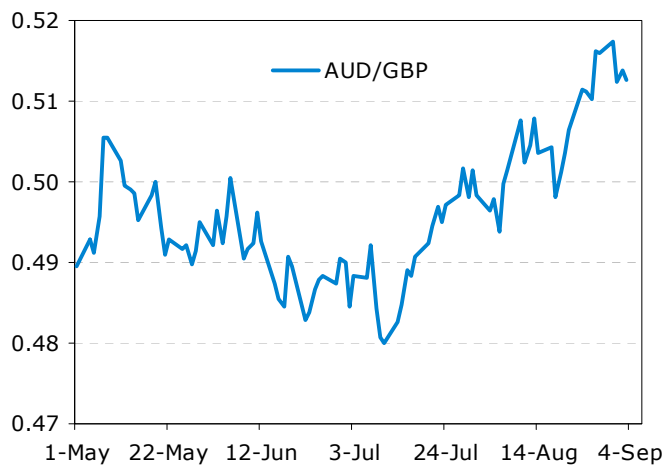
AUD/JPY Key levels: 75.30 – 79.60

- The strengthening of the JPY following the Japanese public's decisive election of the DJP last weekend has weighed heavily on AUD/JPY. While we do not expect USD/JPY to decline much further, we could see AUD/JPY continue to trade below recent peaks over the next few weeks.
- A raft of economic data due for release next week could see volatility in this cross pick up. In Japan, look for headlines on the trade balance, economic confidence, the leading index and machine tool orders. Combined with some important Australian data results, we expect AUD/JPY to be supported above 75.30, with rallies towards 79.60.



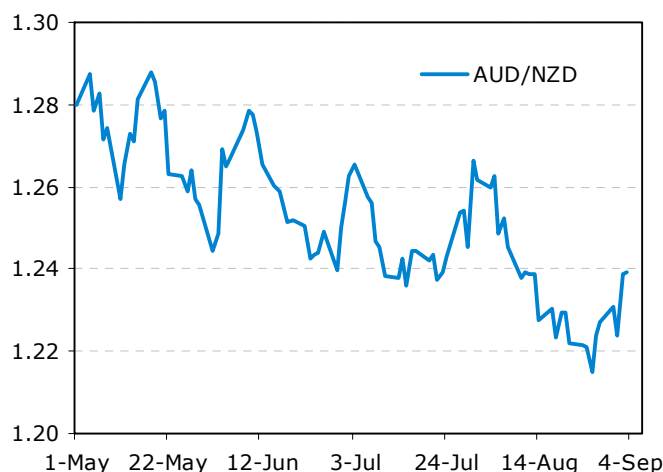
AUD/EUR Key levels: 0.5780 – 0.5910

- The AUD/EUR has remained particularly stable over the past month, comfortable in its higher trading range broadly between 0.58 – 0.59. The 50-day moving average is providing good downside support at the moment, and we see intraday dips over the coming week limited to 0.5780. Resistance around 0.5910 could make it difficult for the cross to repeat recent highs.
- Tonight's ECB interest rate decision is the key risk event over the coming week. Any tough talk by ECB President Trichet of a move towards tighter policy would boost EUR and see AUD/EUR slide towards downside support at 0.5780.



AUD/GBP Key levels: 0.4980 – 0.5200

- AUD/GBP continued to hit new 13-year highs last week, reaching a fresh peak just shy of 0.52 on GBP weakness. Upside surprises in the Australian data flow next week could see the AUD/GBP 0.52 level tested. The 50-day moving average of 0.4980 is the first downside support level.
- The primary focus next week will be on the BoE's rate decision. Last month the BoE surprised the market by expanding its gilt-purchasing program, so it's likely the Bank will sit on its hands this month and assess the effectiveness of its work thus far. Also keep an eye on UK production data due for release over the coming week.



AUD/NZD Key levels: 1.2150 - 1.2540

- AUD/NZD has bounced convincingly from its 4½-month low of 1.2127, and is currently trading close to 1.24. On the topside, we initially target 1.2540 as the first level of resistance, then 1.2660. Look to AUD/NZD breaking 1.2150 if its recent downtrend is to be continued.
- The market is keenly awaiting next week's RBNZ policy decision. A few forecasters have pencilled in a 25bp cut in rates to 2.25%, and while the RBNZ maintains an easing bias, we think a change in policy is unlikely. If the RBNZ were to ease policy, we would expect a heavy sell-off in NZD, and AUD/NZD to rally strongly.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.4	-0.3	1.2	3.6
Household consumption	2.6	1.3	1.5	3.0
Dwelling investment	2.8	-7.6	5.3	5.9
Business investment	13.9	-3.4	-1.5	5.0
Public demand	6.2	2.6	6.9	4.2
Domestic final demand	4.8	0.3	2.5	3.8
Inventories (contribution to GDP)	-0.7	-0.3	0.5	0.1
Gross National Expenditure (GNE)	4.1	0.0	3.0	3.9
Exports	3.8	0.9	0.6	4.5
Imports	11.3	-10.4	5.4	9.5
Net Exports (contribution to GDP)	-1.8	2.8	-1.1	-1.2
Gross Domestic Product (GDP)	2.4	0.9	1.6	3.3
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	-0.1	-0.3	1.8
Unemployment rate (%)	4.3	5.9	7.3	7.2
External sector				
Current account balance: A\$ bn	-54.5	-40.7	-49.3	-59.1
% of GDP	-4.6	-3.4	-3.9	-4.4

*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	3.25	3.50	3.75
90 day bill	3.38	3.40	3.45	3.55	3.80	4.30
3 year bond	4.84	5.00	5.00	5.15	5.10	5.20
10 year bond	5.39	5.70	5.60	5.65	5.60	5.80
3s10s yield curve	0.54	0.70	0.60	0.50	0.50	0.60
3 year swap	5.20	5.30	5.30	5.45	5.40	5.67
10 year swap	5.91	6.10	5.95	5.95	5.90	6.35
International interest rates						
RBNZ cash rate	2.50	2.50	2.50	2.50	2.50	2.50
NZ 90 day bill	2.77	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	0.90	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.31	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
Australian exchange rates						
A\$/US\$	0.8339	0.82	0.80	0.80	0.83	0.84
NZ\$/US\$	0.6729	0.66	0.64	0.59	0.59	0.60
A\$/¥	76.92	79.54	80.00	84.00	89.64	92.40
A\$/€	0.5846	0.58	0.58	0.58	0.59	0.60
A\$/£	0.5126	0.51	0.50	0.49	0.51	0.50
A\$/NZ\$	1.2392	1.24	1.25	1.36	1.41	1.40
A\$/CA\$	0.9214	0.90	0.86	0.84	0.87	0.88
A\$/CHF	0.8847	0.89	0.91	0.91	0.94	0.95
A\$/CNY	5.696	5.60	5.46	5.46	5.67	5.73
A\$ Trade weighted index	65.80	65.61	64.14	64.78	67.23	67.70
International cross rates						
US\$/¥	92.24	97.0	100.0	105.0	108.0	110.0
€/US\$	1.4264	1.42	1.38	1.38	1.40	1.40
€/¥	131.58	138	138	145	151	154
£/US\$	1.6268	1.61	1.60	1.62	1.64	1.67
€/£	0.8768	0.88	0.86	0.85	0.85	0.84
US\$/CA\$	1.1049	1.10	1.07	1.05	1.05	1.05
US\$/CHF	1.0609	1.09	1.14	1.14	1.13	1.13
US\$ index	78.41	78.9	80.5	80.7	80.2	80.2
Asia exchange rates						
US\$/CNY	6.831	6.83	6.83	6.83	6.83	6.82
US\$/HKD	7.751	7.75	7.75	7.75	7.76	7.77
US\$/IDR	10165	10250	9750	9500	9625	9250
US\$/INR	48.96	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1250	1260	1125	1175	1150	1100
US\$/MYR	3.54	3.55	3.50	3.48	3.45	3.40
US\$/PHP	48.90	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.44	1.47	1.46	1.45	1.44	1.44
US\$/THB	34.06	34.00	34.00	34.00	34.00	33.50
US\$/TWD	32.91	33.10	32.50	32.00	31.50	31.00
US\$/VND	17825	17800	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.374	0.395	0.374	0.392	0.381	0.395
FJD/US\$	0.498	0.483	0.472	0.469	0.476	0.480

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