ANZ AUSTRALIAN MARKETS WEEKLY

ANZ ECONOMICS & MARKETS RESEARCH

25 bps from the RBA firms up as this year's Melbourne Cup favourite

Contents

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Macroeconomic update: Inflation eases but pressure points remain

- Headline inflation is easing but the key core measure remains stubbornly high.
- Inflation pressures are currently concentrated in non-tradeable and essential services.

Interest rate markets: RBA to move gradually

- The RBA has built a good case for monetary policy normalisation, based on the outlook for the economy and inflation.
- Q3's CPI data support the case for another 25 bps rise on Tuesday next week.
- In rate markets, curve flattening is over in the near term. The main risk will now come from further weakness in US markets.

FX: time for a breather

- The Aussie dollar sells of recent highs as a positive sentiment dries up and risk aversion returns to financial markets.
- However over the short/medium term fundamental drivers will take the AUD higher.

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MACROECONOMIC UPDATE: INFLATION EASES BUT PRESSURE POINTS REMAIN

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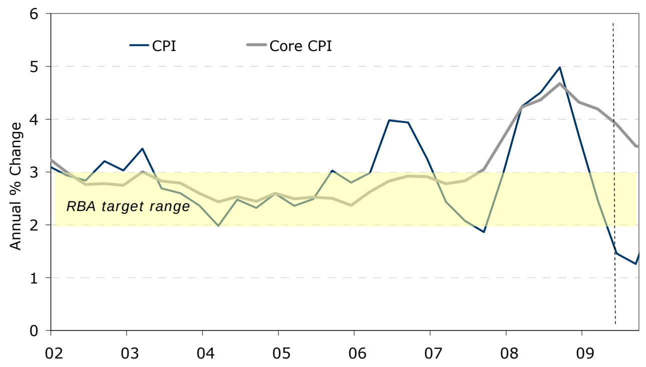
- Headline inflation is easing but the key core measure remains stubbornly high.
- Inflation pressures are currently concentrated in non-tradeable and essential services.

Inflation is subsiding gradually…

This week's release of Q3 CPI data confirmed that Australian inflation is easing only gradually, despite the subdued economic growth and very low inflation rates prevailing internationally.

Headline inflation accelerated in Q3, quarter on quarter, but eased in annual terms to 1.3%, easily the lowest annual headline rate since 1999. This quarter, outright price falls were seen in significant household goods and services such as all food items (-0.8%), fruit and vegetables (-5.5%), pharmaceuticals (-4.4%) and audio-visual equipment (-2.2%) and financial services (-2.3%).

CORE INFLATION IS SUBSIDING ONLY SLOWLY



While this is all good news on some levels, it belies a stubbornly high core (or underlying) inflation rate, particularly given the stage Australia is currently at in this economic cycle – that is, over the worst and into recovery mode, but still slow and vulnerable. The RBA's preferred core measure of inflation (and therefore the measure to watch most closely) eased only slightly in Q3 to 0.8% QoQ (from 0.9% in Q2) and 3.5% p.a. (from 3.9% in Q2). So although there is certainly some easing in inflation pressures, the crucial core measure remains well above the RBA's target inflation range of 2-3% p.a. over the cycle.

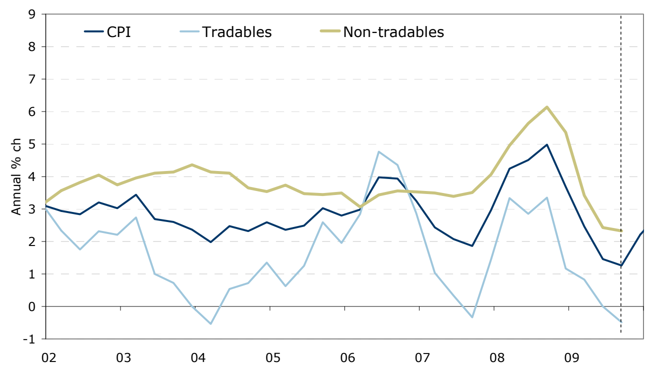
This CPI result is unlikely to push the RBA to a 50bps rate rise next at its November meeting next Tuesday, but neither does it reduce the case for a 25bps rise (see our 'Interest rate markets' analysis below).

… but inflation details are a concern

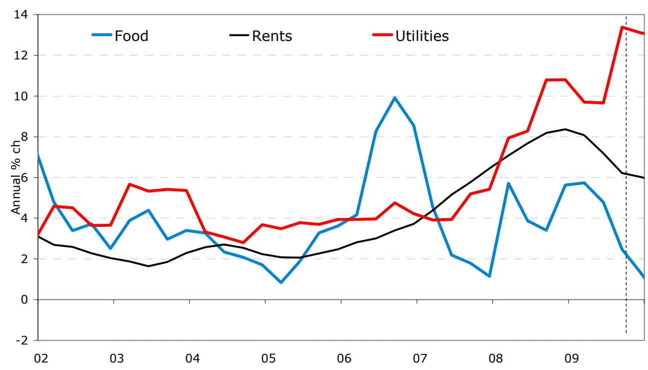
This quarter's CPI data reveal more devils than usual in the details. Imported inflation pressures are currently minimal due to the weak global economy and high AUD, with tradeables down 0.5% p.a.

In contrast, non-tradeables (domestically sourced goods and services) are up 2.3% p.a. And within this group, inflation pressures are highest among essential services such as utilities and housing. Utility price rises reflect rising commodity prices and local regulatory issues, while rent increases reflect our tight residential housing market. These components – and their underlying causes - are not very 'elastic' in the short term. They are therefore not as responsive to interest rate rises, a fact well known to the RBA.

INFLATION IS ALL IN THE NON-TRADEABLES SECTOR



INFLATION IS HIGHEST IN HOUSING AND UTILITIES



Sources: ABS and ANZ

INTEREST RATE MARKETS: MARKETS PARE BACK RATE EXPECTATIONS

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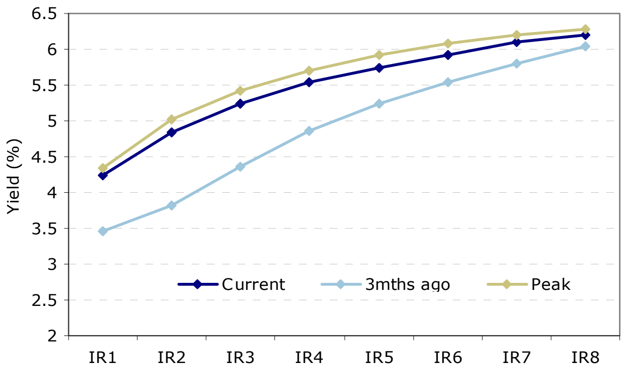
CPI data supports gradual RBA moves

The CPI numbers released yesterday support the view that the RBA will continue to remove extra-ordinary policy settings with a rate hike next Tuesday. RBA Governor Glenn Stevens has made it clear that rates are on their way up to a more "normal" setting.

However, there has been a significant change in market expectations since the CPI was released. The failure of the data to surprise on the upside has pared back expectations of a 50bp move, with the possibility of a 50bp hike decreased from 40% to roughly 25%.

BANK BILL FUTURES



Source: ANZ & Bloomberg

The chart above illustrates the extent to which expectations of a higher interest rate environment have heightened over the last 3 months and the recent paring back from their peaks that has been extended following the release of the CPI data yesterday.

For example, the Sep-10 90 day bank bill futures contract peaked on the 19th October at 5.8% and has now since come back to levels around 5.5%. Despite the recent moves, it still remains very much a front-loaded tightening cycle, particularly when compared with expectations 3-months ago.

Whilst a 25bp move next week seems very likely, there is still a high degree of uncertainty over the speed of the tightening cycle and just how far it will extend. Our view is that we are more likely to see a more gradual tightening cycle. After a 25bp move on Tuesday, we think there is a case to expect the RBA to move again until February when we foresee another 25bp of tightening.

A combination of tight financial conditions, the strength of the currency, lingering uncertainty over the global outlook, and a risk that higher rates will weigh on consumption at the start of next year, all give reason for the RBA to adhere to a gradual approach to moving interest rate settings.

Curve flattening may be over

Any further correction for the AUD now appears to be driven by the change in the trajectory of the normalisation process. This would appear to argue for the long awaited correction in the 1-year forward 1-year swap rate. This rate has just about reached a major re-tracement target at the major rally over 2008-09 that lies above 6.30%, so this does look to offer some opportunity for a near-term correction. The high over September of around 5.85% would look to be within range if the AUD does head below 0.90, although a longer-perspective highlights that the AUD has over-extended on this measure and could correct faster than the rates market.

And if the momentum of the correction for shorter-dated swaps does start to stall, then expect some of the recent pronounced curve flattening at the front of the curve to also start stalling. Normalisation has already driven 2s3s swap curve flatter. But with rates set to move more gradually, there are now grounds to expect this process to stall in the near-term.

FX: TIME FOR A BREATHER

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- However over the short/medium term fundamental drivers will take the AUD higher.

After looking comfortable at low 90c levels through last week, a bout of risk aversion globally and a read on local inflation that did nothing for rates market has seen the AUD come off this week. Along with equities markets the AUD started to look tired through last week after peaking just over 93c. The pull back this week has long been foreshadowed as gains in financial markets get ahead of the economic recovery. Buyers are likely to remain active at current levels below 89c, providing good support.

AUD / USD Key levels: 0.8940-0.9320

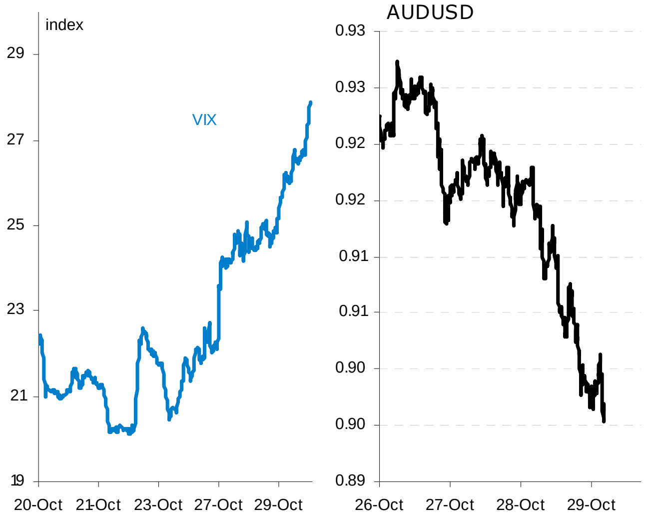
Aussie dollar pulls back on risk

This week has been a timely reminder that all things that go up must come down. And it appears no different for the Australian dollar. The currency is now 3.5c off the 2009 high in just over a week as a dip in investor confidence as seen a rush into the US dollar. Get used to it. As a funding the currency the US dollar will grind down as money is borrowed in the US and invested in other currencies. But this happy rhythm will occasionally get upset by a sudden shift in expectations and sentiment and the trade will be reversed quickly.

It was one of these shifts a pull back in investor sentiment on the back of soft US economic data has seen equities sell off 3-4% so far this week and the VIX index has jumped off a 14-month low of 20.7 to reach 27.9 as of last night, jumping one point in the last hour of trade. Credit default swap spreads has also widened. Compounding the move in sentiment has been strong USD demand at the US$123bn of Treasury auctions this week. And on the domestic front a neutral read on inflation saw the prospect of the RBA being more aggressive on rates next week pared back.

However, we doubt that the carry trade is over just yet. US rates remain low and look like staying low for at least another six months. The carry currency interest rates are high and look like rising although the RBNZ and the BoC both seem most concerned at the flight of their respective currencies recently. As for the Australian dollar, the RBA is firmly in tightening mode and appear happy to let the currency do some of the work for them of the inflation front.

FIGURE 1: VIX UP BUT AUD DOWN



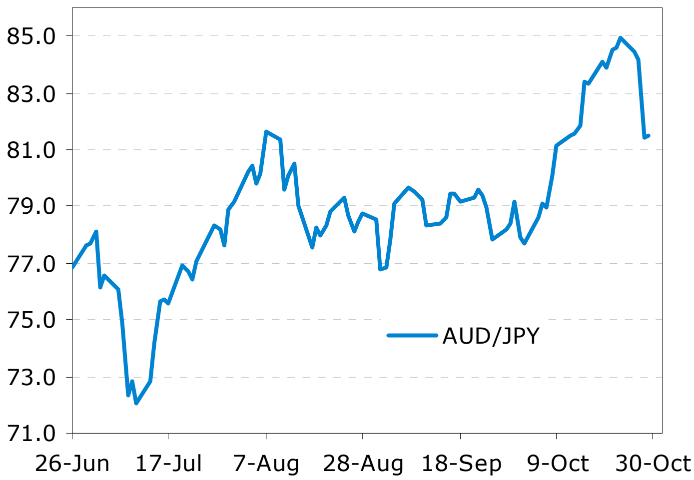
Source: Bloomberg, ANZ

While we are sceptical how far the Australian dollar can ultimately go in this cycle, we doubt we will see a clear turning point until one of two conditions is met. Commodity prices move into a cyclical downswing taking Australia's term of trade with it. This most likely needs a slowdown in commodity demand out of China which we cannot see for at least 12 months. Secondly, the US dollar must rally on a sustained basis. We don't think this is likely until the US economic recovery is entrenched and the US interest rate structure (Fed funds through 10yrs) is higher. This is probably six months away at least.

Using these factors as a benchmark we believe the Australian dollar will remain well supported right through the first half of 2010. What we are concerned about is how high it can go. The currency looks overvalued against the terms of trade and commodity prices and vulnerable to a pull-back. On the interest rate front, we believe the RBA will disappoint market expectations and be more gradual in the early phase of the tightening cycle than implied by market prices.

Just as everybody is fine-tuning their forecast for parity with the US dollar is likely that the currency could take a breather in the short-term. We can't call the Aussie down but there is a good chance that the currency could weaken further and trade at 86/94c range over the course of our summer ahead.

FX: AUD CROSS VIEW

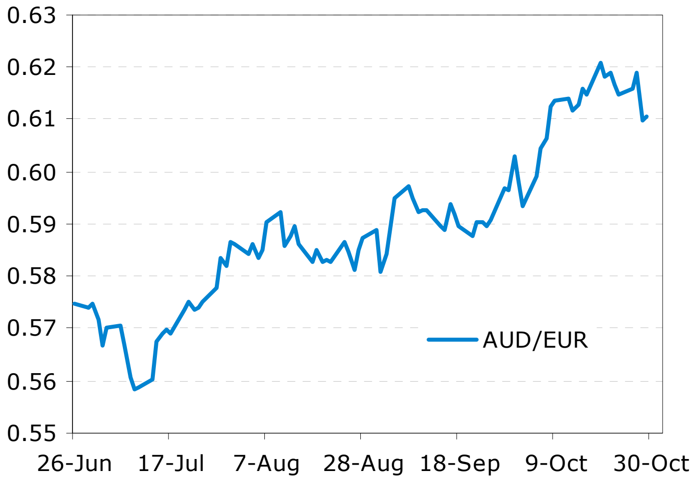


AUD/JPY

Key levels: 80.00 – 87.40

AUD/JPY seems to have lost its sparkle this week as the recent strength in the JPY leads the currency pair back below 82.00. The cross shed 3.9% of its value this week as investors flock back to the safe haven appeal of the JPY. Expects dips below 80.00 to be well supported by the 100 day moving average and rallies finding resistance at the topside of our range at 87.40.

With the BoJ holding their policy meeting tomorrow the market will be looking at the accompanying minutes released next week for further direction. Look out for headlines figures on employment and CPI out on Friday morning.

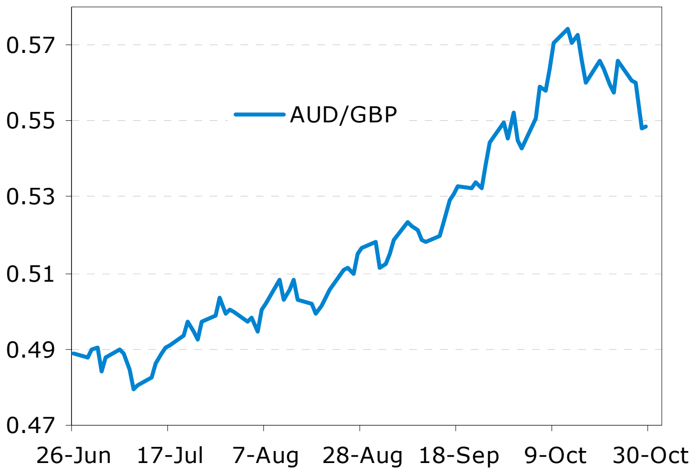


AUD/EUR

Key levels: 0.5930 – 0.6280

The AUD/EUR has turned downward with Norway the first European central bank to reverse its easing cycle and increasing interest rates, boosting the value of the EUR. If the market is met with renewed AUD strength AUDEUR could test 0.6280 on the top side.

With a busy economic calendar out of Europe over the next 7 days, expect increased volatility for this cross. Watch out for the bigger data releases, CPI estimate, employment figures, PMI manufacturing and PPI. Better than expected results out of Europe could see AUD/EUR test 0.5930 on the lower end of our range.

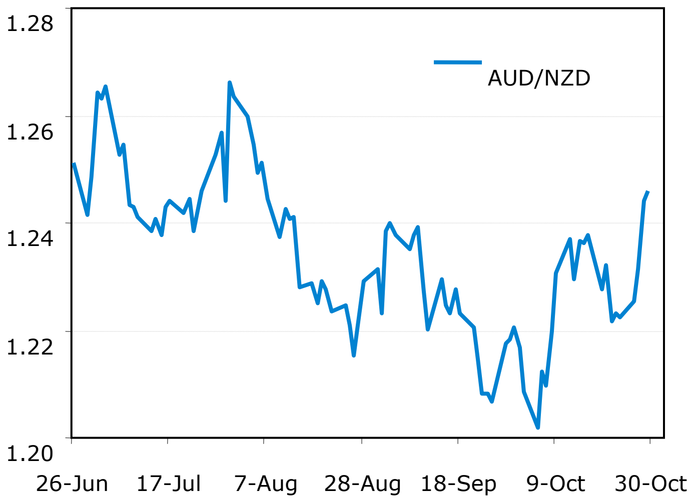


AUD/GBP

Key levels: 0.4930 – 0.5550

Despite weak GDP figures released out of the U.K late last week, the GBP seems to defy odds and continues to strengthen against the AUD with the cross dipping back below 0.5500. Rallies should be capped to 0.5500 for the currency pair in the week ahead.

Look out for next weeks PMI manufacturing figures and consumer confidence, both being key indicators to the forward direction of the U.K economy. Any sign of economic recovery could extend the pounds recent gains and see AUD/GBP move towards our bottom end of our range at 0.4930.



AUD/NZD

Key levels: 1.2140– 1.2850

This morning's dovish RBNZ statement boosted the AUD/NZD up 1.4% in what would have otherwise been a rather ordinary week for the currency pair with the cross trading above 1.2490 for the first time since August earlier this year. If the cross slips we could see a further correction down to 1.2080, with gains capped at the higher end of our range 1.2850.

With no data scheduled for release out of New Zealand until employment figures on Thursday morning of next week expect risk appetite to be a major driver in the direction of the NZD.

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	1.7	2.2	2.5
	Underlying*	4.4	3.8	2.9	2.5
Wages		4.2	3.6	2.9	3.3
Labour market					
Employment (annual % change)		2.2	0.2	1.3	2.2
Unemployment rate (%)		4.3	5.7	6.5	6.3
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	Sep10f	Dec 10f
RBA cash rate	3.25	3.50	4.00	4.00	4.00	4.00
90 day bill	3.92	3.90	4.35	4.25	4.25	4.25
3 year bond	5.04	5.15	5.35	5.25	5.05	5.30
10 year bond	5.52	5.45	5.60	5.55	5.45	5.60
3s10s yield curve	0.48	0.30	0.25	0.30	0.40	0.30
3 year swap	5.61	5.60	5.80	5.70	5.50	5.75
10 year swap	6.16	6.05	6.20	6.10	6.00	6.15

International interest rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep10f	Dec 10f
RBNZ cash rate	2.50	2.50	2.50	2.50	3.00	4.00
NZ 90 day bill	2.80	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	0.94	1.20	1.50	1.75	2.00	2.35
US 10 year note	3.41	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*.

Australian exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep10f	Dec 10f
A$/US$	0.8987	0.92	0.95	0.94	0.92	0.90
NZ$/US$	0.7192	0.74	0.75	0.74	0.71	0.70
A$/¥	81.21	81.0	81.7	82.7	82.8	82.8
A$/€	0.6103	0.62	0.62	0.62	0.61	0.60
A$/£	0.5486	0.56	0.58	0.58	0.56	0.55
A$/NZ	1.2497	1.24	1.27	1.27	1.30	1.29
A$/CA$	0.9692	0.95	0.96	0.97	0.96	0.95
A$/CHF	0.9216	0.94	0.96	0.98	0.97	0.96
A$/CNY	6.1381	6.28	6.49	6.42	6.27	6.12
A$ Trade weighted index	69.60	69.2	70.6	70.5	69.5	67.7

International cross rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep10f	Dec 10f
US$/¥	90.37	88.0	86.0	88.0	90.0	92.0
€/US$	1.4725	1.49	1.53	1.52	1.50	1.49
€/¥	133.07	131	132	134	135	137
£/US$	1.6382	1.63	1.64	1.63	1.64	1.65
€/£	0.8989	0.91	0.93	0.93	0.91	0.90
US$/CA$	1.0784	1.03	1.01	1.03	1.04	1.05
US$/CHF	1.0255	1.02	1.01	1.04	1.05	1.07
US$ index	76.37	75.1	73.4	74.2	75.1	75.7

Asia exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep10f	Dec 10f
US$/CNY	6.8296	6.83	6.83	6.83	6.82	6.80
US$/HKD	7.7502	7.75	7.75	7.76	7.77	7.77
US$/IDR	9681	9500	9500	9625	9500	9250
US$/INR	47.50	47.0	46.5	46.0	46.0	45.0
US$/KRW	1196	1125	1100	1150	1175	1050
US$/MYR	3.4270	3.41	3.34	3.37	3.40	3.40
US$/PHP	47.770	47.0	46.0	46.5	46.0	45.0
US$/SGD	1.4019	1.40	1.39	1.40	1.41	1.41
US$/THB	33.490	33.00	33.00	33.00	32.50	32.50
US$/TWD	32.558	31.50	31.00	31.30	31.50	30.30
US$/VND	17859	18500	18500	18500	18500	19300
Pacific exchange rates						
PGK/US$	0.3839	0.374	0.392	0.381	0.395	0.386
FJD/US$	0.5254	0.534	0.545	0.540	0.530	0.523

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