

Local green shoots

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Macro Update: Property market a bright spot

- The Australian housing market has been the one of the few bright spots in an economic environment plagued by pessimism.
- This is in stark contrast to residential property markets around the world which have retreated consistently over a sustained period
- So why has the Australian market been so blessed, good luck? Good management? Good policy?

Interest Rates: Risk of curve flattening

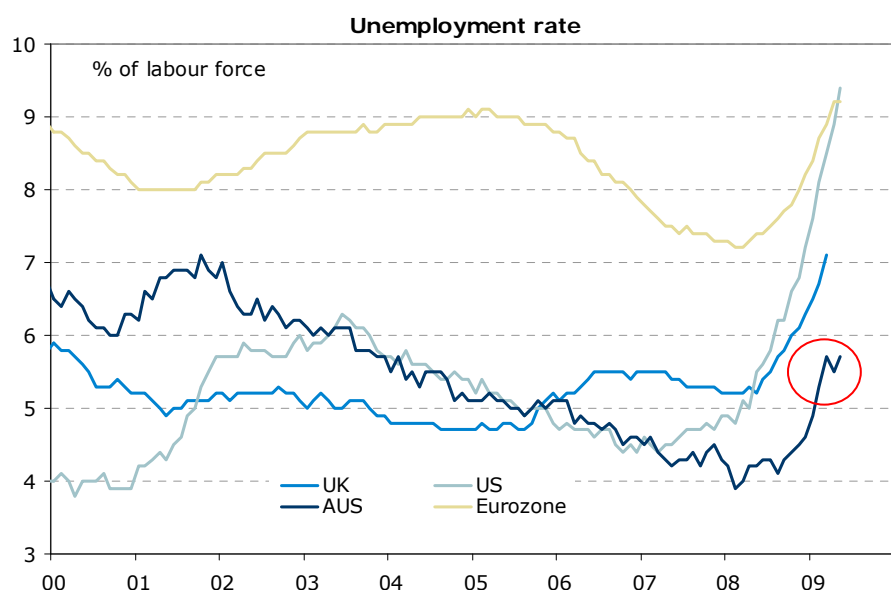
- The bond market sell-off continues to gather pace, particularly in Australia. The focus of the sell-off is shifting from concerns about rising supply pushing up long rates towards expectations of an economic recovery and a turn around in the monetary policy cycle pressuring the short end.
- A steeper curve now looks less likely in light of some significant moves in US bond markets in recent weeks and shift in focus for local rates.

FX: Upgrade to AUD forecasts

- The economic and financial market environment has continued to improve significantly in the last month, leading to an upward revision to our forecasts for the AUD and the AUD/USD.
- We now expect the AUD/USD to trough at 0.73 in the second half of 2009 before grinding higher to return to 0.80 by end-2010 with a further appreciation towards 0.82 by mid-2010.

Chart of the week

Figure 1: Australian labour market outperforming peers



Source: Bloomberg

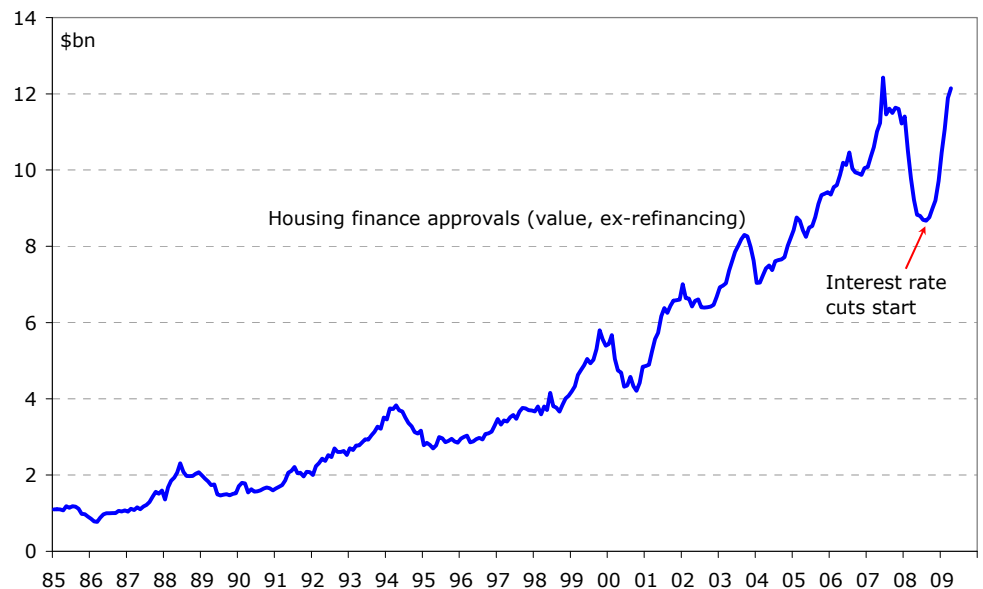
Macro Update: Property market a bright spot

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Why is the Australian housing market recovering?

The Australian housing market has been the one of the few bright spots in an economic environment plagued by pessimism. Housing finance figures out this week again confirmed this to be the case. The number of approvals rose 0.9% in April to be well over 20% up in the last 7-months led by an influx of first homebuyers. In value terms, approvals were up 2.1% ex-refinancing and a solid 8.9% to investors. Recent data suggest a very soft landing for the property market, with the limited price falls over the past year now beginning to reverse. This is in stark contrast to property markets around the world which have been treating over a prolonged period - the UK and US markets are prime examples with weak demand and price falls entrenched for more than 12 months.

Figure 2: Housing finance approvals recover as rates are cut



Source: ANZ, Bloomberg

So why has the Australian property market been so blessed, good luck? Good management? Good policy? The truth is probably a bit of each. Firstly, the commodities boom saw the Australian economy, as well as government and household finances, in better shape than most entering the downturn. This was due primarily due to the expansive growth in emerging Asia, in particular China. We didn't do anything especially clever here; we have just traded on Australia's mineral riches.

Secondly, the Australian banking system was much better placed to weather the financial storm that was the sub-prime crisis. Further, domestic lending practices have been conservative in contrast to overseas and the sub-prime sector in Australia is very small (less than 1%). As such we have not seen the dramatic increases in delinquencies that have emerged in other countries, which have led to forced sales and served to exacerbate the falls in house prices.

Last but not least is good policy. The Reserve Bank in particular has taken significant pre-emptive steps to cut interest rates and support the economy. Further, more than most other countries, the high proportion of variable rate loans means that Australian monetary policy flows more directly through to borrowers and mortgage holders supporting both existing and potential homebuyers. We anticipate that the RBA is currently playing a wait and see

game and will be at the ready to cut rates further should the economy need additional support going forward.

A combination of these factors has led to the local housing market being amongst the tightest in the world. It is simple supply and demand. On the supply-side, building activity has been weak and the shortage of home building has characterised the sector for some time. On the demand side, demographic data released last week showed population growth accelerated to 1.9% through the year to December 2008 (a record for the current series which begins in June-1981). Within this overseas migration hit a record 253,000 over the past 12 months, a direct addition to demand in the property market.

It is therefore unsurprising to see actual demand increasing because of improved affordability and that many new-entrants are seizing this opportunity to enter the housing market. First home buyers accounted for a record 28% of new approvals in April's data and this should persist not only because of the first homebuyers grant but also historically low interest rates.

The risks...

The recovery in the property sector clearly has its risks. This was highlighted in today's labour force figures with a rise in the unemployment rate to 5.7%, higher than 12 months ago but not as yet as sharp an increase as seen in other countries (see chart of the week). Certainly a continued rise in the unemployment rate and large scale job losses would have some negative impact on the property market in terms of activity.

However, today's labour force figures reinforce a recent trend. So far the rise in the unemployment rate has been more because of labour force growth, i.e. more people wanting a job rather than large employment falls (people losing jobs). This has been due to continued population growth and rising labour market participation. Since the peak in employment in November 2008 employment has fallen, in trend terms, by 2,900 a month whereas the labour force has increased just over 21,000 people per month. So it is no wonder the unemployment rate has risen. The overwhelming story *so far* is the economy has not been able to absorb the number of people wanting jobs rather than wholesale job shedding. For the property market, delinquencies and forced sales the former is the lesser evil.

Highlighting this, our forecasts unemployment is set to rise by around 450,000 people. However, of this just over 185,000 will lose their jobs over the next 18 months. The remainder of the increase comes from very strong population growth adding to the labour force. Unemployment from the latter will perhaps defer purchase, but not lead to forced sales. A back of the envelope calculation taking into account job losses, household size, rates of owner-occupation and the proportion of mortgage-holders suggests that forced sales may account for 4-5% of sales over the next 18-months. This proportion is unlikely to have a significant detrimental downward impact on median prices over this period.

What can we expect for property going forward? If consumer confidence figures for June were any indicator the next few months at least should be fine. The index rose 12.7%, the most in 22 years, to reach 100.1. The time to buy a house index in the survey rose another 2.5% to 145.8, the highest level since late-2001. We should also see investors return to the market as sentiment improves and a gradual return of 'upgraders' at the expense of first homebuyers. We in no way are foreshadowing a boom but remain confident that the residential property market can at the very least consolidate through the coming period of economic softness in the next 12 to 18 months.

Data wrap

- **NAB Business Confidence and condition** measures for May improved to -2 and -14 respectively
- **ANZ Job advertisements** fell 0.2% in May.
- **WBC-MI consumer confidence** jumped 12.7% in June to reach 100.1.
- **Consumer inflation expectations** rose to 2.8% in June.
- **Housing finance** approval numbers were up 0.9% in April.
- **Employment** fell 1,700 in May, pushing the **unemployment rate** up to 5.7%.

Interest Rate Markets: Risk of curve flattening

- The bond market sell-off continues to gather pace, particularly in Australia. The focus of the sell-off is shifting from concerns about rising supply pushing up long rates towards expectations of an economic recovery and a turn around in the monetary policy cycle pressuring the short end.
- A steeper curve now looks less likely in light of some significant moves in US bond markets in recent weeks and shift in focus for local rates.

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US bonds continue to sell off

The US bond market sell-off has entered a new phase over the past week. The sharp rise in 2-year yields represents the end of a 2-year downtrend and a 6-month period of narrow range-trade based on the notion that quantitative easing from the US Federal Reserve would anchor short-term rates. And concerns continue to mount over the willingness of global investors and central banks to scale back holdings of Treasuries.

The break higher for US 2-year yields suggests risk is now for the curve to start flattening despite the continued rise in the US unemployment rate. US 10-year yields have also risen sharply to head towards the 4.0% level as part of the “normalisation” of market rates.

The power of the US sell-off has driven local bond yields sharply higher. The market now sees little scope for the RBA to cut rates in coming months with the focus now clearly on the scope for rates to start normalising here next year. We would need to see a very sharp rise in unemployment to alter these dynamics. 3-year bond yields are now testing 4.40% while 10-years are above 5.60%.

The FOMC meeting on June 24 should provide further guidance on the policy measures being considered as the initial steps to unwind QE. Policy makers appear ready to move away from such unconventional measures as soon as possible. However, the backing up in yields that is pushing up 30-year mortgage rates (and higher petrol prices) represents additional headwinds for the household balance-sheet adjustment process.

Figure 1: Three/Ten-year yield differential – the yield curve



Source: ANZ & Bloomberg

Solid local data prompts reassessment

The improvement in local data culminating in today’s better than expected labour force data and the rebound in business and consumer confidence has prompted a reassessment of the outlook for further RBA rate cuts. Taken with the change in US dynamics, these factors appear to have dented previously strong momentum which had been steepening the local yield curve – the difference between 3 and 10-year bond yields.

This differential has narrowed by more than 30bps over the past few days. Momentum appears to be building for some further flattening of this spread to threaten the major trend upwards as short-term yields rise more quickly as part of the normalisation of short-term rates.

Risks for the curve now look more skewed towards a move back to trend, with the curve finding support above 100bps after the recent failure to break above 140bps. A move below 100bps would signal that the major steepening trend has come to an end.

The momentum in the yield curve is matched by bearish price action in outright yields. The Australian 3 year swap rate, at 4.90%, is now 150bps off the cyclical low reached in early February. With markets all but removing any expectation for further RBA easing in this cycle, a further substantial sell-off in short term yields in Australia will need to be associated with expectations of monetary policy tightening.

At present will retain our forecast for further rate cuts later but acknowledge that the recent run of Australian economic data brings this into question. At the very least the RBA will be on hold for many months. In the short term, market momentum is strongly bearish for the rates markets and if this continues it is highly likely that the market will begin to price in rate cuts as the primary near-term policy risk.

In our view, any expectation that the next move in rates will be a hike is likely to be based on some combination of the following factors:

- The expected peak in unemployment is be revised to 7% from 8.5% (the government's latest forecast). The recent employment numbers add some wait to that argument although leading indicators of employment still point to a more substantial rise.
- The Chinese growth recovery is sustained and our export prices and volumes remain elevated. We are still concerned that much of the strength in bulk export prices and volumes in recent months is due to stock building rather than end user demand.
- That household have already achieved a new (higher) desired savings rate and that we do not see further increases in the household savings ratio. Strong equity markets and stable house prices might lend support to this view.
- Investors and non-first home buyers return to the market as the recent surge in first home buyer demand fades over the second half of the year.
- An unexpectedly early economic recovery does not generate inflationary pressures. Inflation is currently running above 4%. Does this mean monetary policy is too easy?

These are the sorts of issues that will drive another leg of the bear market in rates. We believe a rate hike is a low probability but realise that the market can/will overshoot.

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FX: Upgrade to AUD forecasts

Recommendation

The AUD/USD has settled into a higher trading range for now. Medium-term, AUD appears poised for a sharp move in either direction (we favour downwards), but the timing is uncertain. For now, importers should look to top up cover above 0.8120 while exporters could take advantage of dips below 0.7890.

Overview

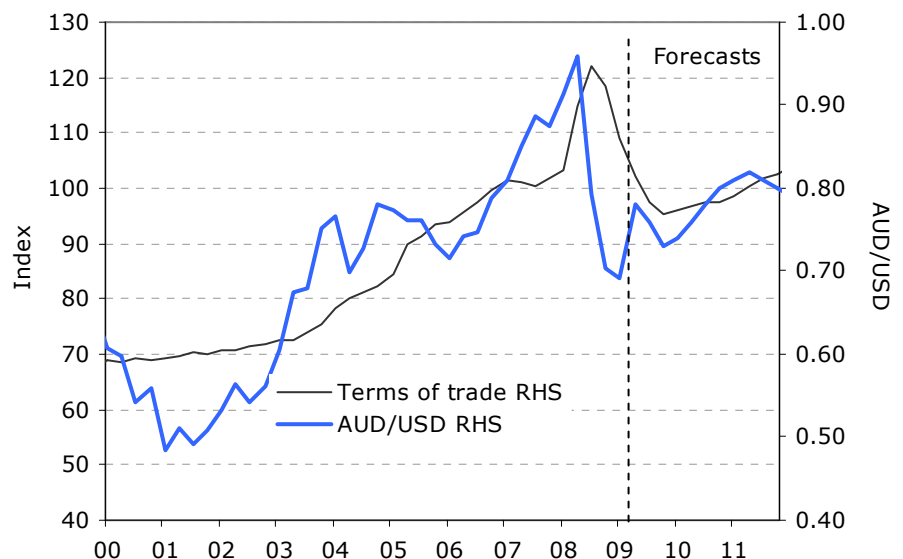
The economic and financial market environment has continued to improve significantly in the last month, leading to an upward revision to our forecasts for the AUD and the AUD/USD. We still favour AUD/USD weakness over the second half of this year, as current strong global growth expectations take a reality check and as the Australian economy pulls back after a strong start to the year. Nevertheless, with the global financial sector healing, the global economy likely to continue a gradual recovery and commodity prices expected to remain above historical averages, it now appears unlikely that the AUD/USD, one of the world's great pro-cyclical currencies, will sustain a break below its post-float average of 0.72.

We now expect the AUD/USD to trough at 0.73 in the second half of 2009 before grinding higher to return to 0.80 by end-2010 with a further appreciation towards 0.82 by mid-2010.

This is a significant upward revision from our previous view. Partly this reflects a more rapid healing of the global financial system than we expected. But our view on the traditional drivers of the AUD/USD has also been revised up significantly. Of most importance, our forecasts for end-2009 commodity price have been upgraded by 18%. Our 2010 commodity price forecasts have also been raised, including a 5% upgrade to iron ore prices and a 10% upgrade to coal prices, Australia's all-important bulk commodity exports.

Medium-term FX forecasts always have significant risks but these are heightened at turning points in the economic cycle, such as now. Having soared 28% off its early-March lows, the AUD appears poised for some consolidation before another significant break out. While we favour a weaker AUD going into year-end, we could just as easily construct a scenario whereby AUD/USD appreciates towards 0.90, should a continued sharp improvement in global industrial production and commodity demand and/or further out-performance in the Australian economy drive more appetite for risky assets. The highly uncertain outlook for the USD also remains a key risk for AUD direction. We therefore continue to advise clients to avoid unmanageable exposures to AUD swings over a 12-18 month horizon.

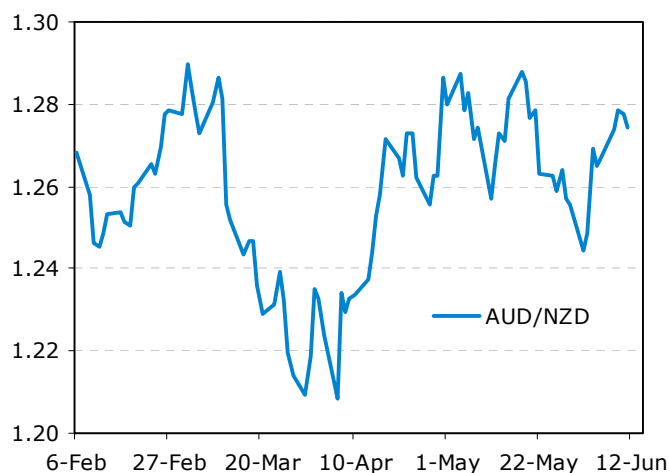
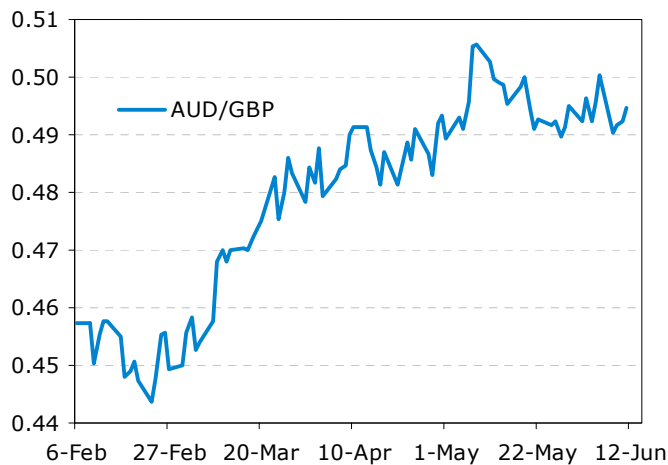
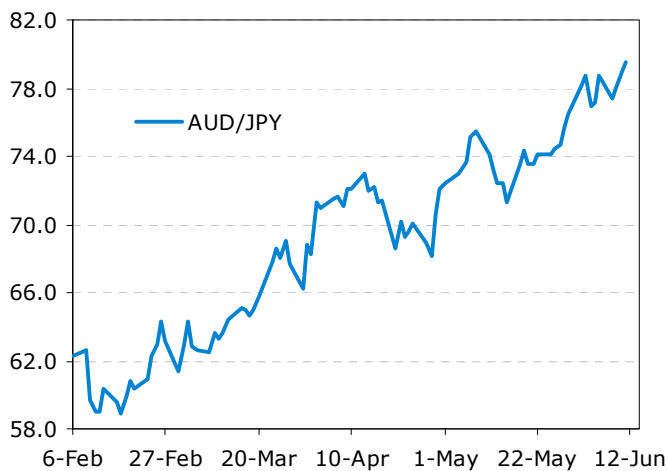
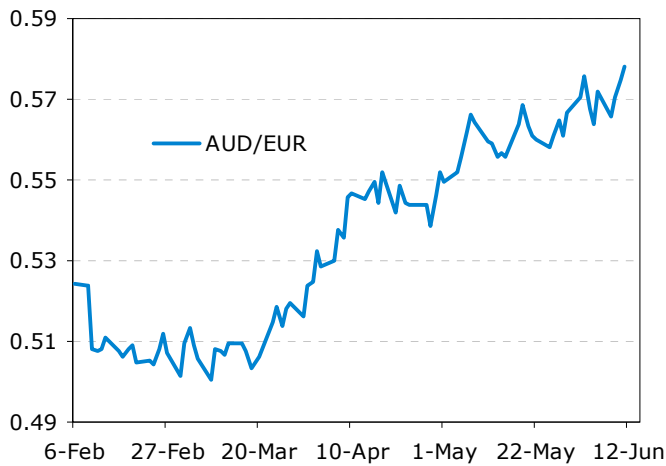
Figure 2: A higher terms of trade supports a higher AUD/USD



Source: ANZ, Bloomberg

AUD/USD Key levels: 0.7750 – 0.8250. A move above 0.8180 sets the AUD/USD up for a stab at 0.8250 and then a run towards 0.8380. On the downside, we look for strong support at 0.7750 if AUD/USD sustains a fall below 0.7880.

AUD cross view



AUD/EUR Key levels: 0.5650 – 0.5870

- AUD/EUR has rallied over 15% since risk appetite returned to the financial markets in mid March. This week the cross posted a new post-Lehman's peak above 0.5780, and it is fast targeting a key retracement level at 0.5870. Our revised forecasts now target the cross to return to its long-term average level above 0.59 over coming months. Good support exists above 0.5650.
- Tonight's ECB June report is likely to provide further insight into the ECB's medium-term economic outlook and could have an impact on EUR. Also beware of next week's ZEW economic sentiment survey and construction output data.

AUD/JPY Key levels: 74.0 – 79.5

- Despite making a number of attempts this week, AUD/JPY was unable to maintain a break through our topside target of 79.5. While the cross is forecast to consolidate lower at around 76.5 after the recent move higher, the short term risk is for a breakthrough 79.5 and towards 81.5. Upward trend momentum is solid, with the 100-day moving average poised to cross the 200-day MA.
- While global risk appetite and the fortunes of the USD are likely to remain the key drivers of the JPY in the near term, watch out for Japanese consumer confidence data released next week and BoJ commentary following its June policy

AUD/GBP Key levels: 0.4880 – 0.5050

- GBP/USD remained a key outperformer on global FX markets this week, pushing back towards this month's high above 1.6650 after briefly dipping over 5% to around 1.58. Nonetheless, AUD/USD continues to keep pace, with AUD/GBP remaining well supported, now trending sideways in a narrow 0.4900-0.5050 range.
- Uncertainty in the UK political environment may keep GBP/USD capped below recent peaks for the moment, potentially limiting near-term falls in the AUD/GBP. Beware of this week's release of UK inflation, unemployment, and retail sales data, as well as the minutes from the BoE's latest

AUD/NZD Key levels: 1.2490 - 1.2940

- As forewarned last week, today's decision by the RBZN to leave interest rates on hold at 2.50% gave a 110 pip boost to the NZD/USD to around 0.6360, pushing AUD/NZD as much as 1½% lower before recovering back above 1.27.
- Rallying above last week's key topside level to above 1.2850, the key upside target for the cross remains at April's high of 1.2940. Strong upward momentum has been maintained thus far this month, with the 50-day moving average kicking higher. This week, key economic risk events will be the release of NZ retail sales and PMI data, and in Australia, the RBA's June board minutes.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	4.1	-2.0	-1.5
Household consumption	4.3	2.2	0.9	0.9
Dwelling investment	2.7	2.5	-6.8	8.4
Business investment	13.8	13.8	-9.3	-13.7
Public demand	2.8	5.3	2.1	6.6
Domestic final demand	5.4	4.4	-1.1	0.3
Inventories (contribution to GDP)	0.6	-0.6	-0.2	0.3
Gross National Expenditure (GNE)	5.9	3.8	-1.3	0.6
Exports	3.3	3.9	-1.5	-3.3
Imports	11.4	10.3	-11.9	0.7
Net Exports (contribution to GDP)	-1.7	-1.5	2.6	-0.8
Gross Domestic Product (GDP)	4.0	2.3	0.0	0.4
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	1.7	2.2
Underlying*	3.1	4.5	3.7	2.7
Wages	4.0	4.3	3.6	3.2
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-0.9
Unemployment rate (%)	4.4	4.2	6.2	8.0
External sector				
Current account balance: A\$ bn	-67.7	-51.0	-41.2	-62.6
% of GDP	-6.2	-4.3	-3.5	-5.1

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

Australian interest rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
RBA cash rate	3.00	3.00	2.50	2.00	2.00	2.00
90 day bill	3.26	3.20	2.30	2.30	2.30	2.35
3 year bond	4.53	4.15	4.10	4.00	4.20	4.30
10 year bond	5.59	5.65	5.50	5.20	5.30	5.30
3s10s yield curve	1.06	1.50	1.40	1.20	1.10	1.00
3 year swap	4.91	4.50	4.40	4.30	4.50	4.60
10 year swap	6.07	6.15	5.90	5.55	5.60	5.60
International interest rates						
RBNZ cash rate	2.50	2.50	2.25	2.00	2.00	2.00
NZ 90 day bill	2.82	2.85	2.43	2.35	2.35	2.35
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.25
US 2 year note	1.35	1.35	1.10	1.00	1.25	1.50
US 10 year note	3.93	4.76	3.85	3.70	3.75	3.90
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.10
ECB refinance rate	1.00	1.00	0.75	0.75	0.75	0.75
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	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
Australia and NZ exchange rates						
A\$/US\$	0.8094	0.78	0.76	0.73	0.74	0.76
NZ\$/US\$	0.6360	0.64	0.58	0.55	0.54	0.54
A\$/¥	79.27	76.44	79.80	73.00	77.70	82.08
A\$/€	0.5770	0.57	0.60	0.58	0.59	0.60
A\$/£	0.4934	0.49	0.49	0.48	0.47	0.49
A\$/NZ\$	1.273	1.22	1.31	1.33	1.37	1.41
A\$/CA\$	0.8943	0.88	0.87	0.88	0.87	0.87
A\$/CHF	0.8725	0.87	0.87	0.82	0.86	0.85
A\$/CNY	5.531	5.33	5.19	4.99	5.05	5.18
A\$ Trade weighted index	64.90	63.14	62.86	59.69	60.54	62.94
International cross rates						
US\$/¥	97.9	98	105	100	105	108
€/US\$	1.403	1.38	1.26	1.25	1.26	1.26
€/¥	137.4	135	132	125	132	136
£/US\$	1.640	1.58	1.55	1.53	1.56	1.56
€/£	0.8551	0.87	0.81	0.82	0.81	0.81
US\$/CA\$	1.105	1.13	1.15	1.20	1.18	1.15
US\$/CHF	1.078	1.12	1.14	1.12	1.16	1.12
US\$ index	79.98	81.4	87.0	87.2	87.1	87.2
Asia exchange rates						
US\$/CNY	6.834	6.83	6.83	6.83	6.82	6.82
US\$/HKD	7.752	7.75	7.76	7.76	7.76	7.76
US\$/IDR	10065	10750	10250	9750	9500	10500
US\$/INR	47.44	50.00	48.50	48.00	47.00	47.50
US\$/KRW	1250.25	1325	1225	1150	1100	1225
US\$/MYR	3.5025	3.60	3.60	3.55	3.50	3.50
US\$/PHP	47.67599	48.50	49.00	48.00	48.00	47.00
US\$/SGD	1.451	1.52	1.53	1.52	1.51	1.51
US\$/THB	34.08	35.50	36.00	35.50	35.00	35.00
US\$/TWD	32.74	32.70	32.00	31.50	31.00	31.00
US\$/VND	17795	17800	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.374	0.32	0.32	0.35	0.35	0.36
FJD/US\$	0.482	0.43	0.42	0.41	0.40	0.40

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