

MONTHLY ECONOMIC OUTLOOK

July 2008

Tuesday, 1st July 2008

- The Aussie hit a new post-float high at the end of June – inching closer towards parity. So this month we look at the likelihood of the Aussie dollar reaching parity versus the US dollar. We examine supportive factors for the Aussie, such as the rising terms of trade and attractive interest rate differentials. We also consider some of the threats and headwinds the Aussie faces; these include a peak in domestic interest rates and an end to the US easing cycle. Downside risks to world economic growth from high oil prices are also growing.
- As expected, the RBA held rates steady at their last two meetings in both June and July. Stronger domestic Q1 GDP data saw markets upgrade expectations of another rate hike from the RBA, despite other softer economic data. However, following the release of less hawkish monetary policy meeting minutes and statement in mid June and July 1, respectively, market participants scaled back their rate-hike expectations. We retain our long-held view that the RBA will (narrowly) avoid having to raise interest rates again this year.
- The month of June saw a significant change in rhetoric from the major central banks. There were hawkish comments from various central-bank officials, particularly about the growing upside risks to inflation. It led markets to price in a probability of tightening rather than easing in the US, UK and Eurozone economies. Concerns about higher inflation have seen financial markets price in around two Fed rate hikes this year and a rate hike from the ECB as early as this week.
- The world oil price continued to rise over the past month, hitting a new all-time high above US\$140 per ounce near the end of June. Not surprisingly, inflation remained a key concern of financial markets. Australia's CPI inflation for the June quarter, due for release on July 23rd, will be closely watched for its interest rate implications. We are forecasting underlying inflation to edge down to an annual rate of 4.2%, from 4.3% in the March quarter, still well above the RBA's 2-3% target band.

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WILL THE AUSSIE DOLLAR REACH PARITY?

The Aussie dollar has gained almost 13% over the past year and it struck a new post-float high of USD0.9668 on June 30. Recently some commentators have suggested the Aussie dollar could reach one US dollar later this year. In this month's article, we look at how likely this is, and what we see as the major risks to this view.

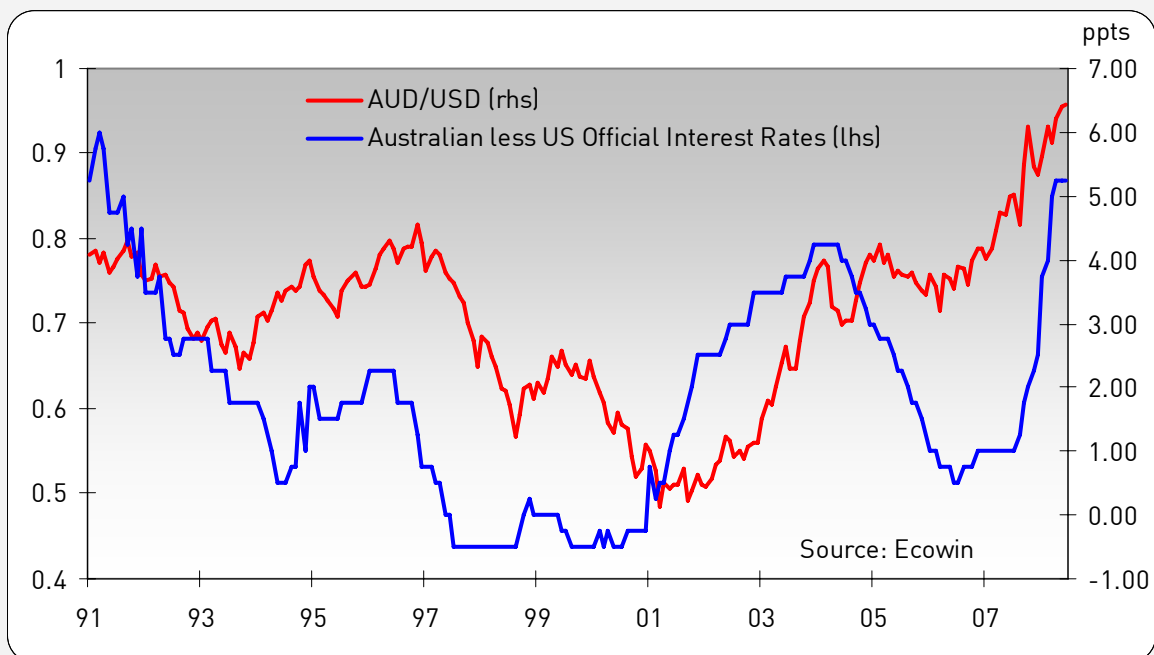
Supportive factors for a stronger local currency include the rising terms of trade and attractive interest rates differentials. However, markets have little room to price much more tightening in locally and with an end to the US easing cycle, any further upside in the Aussie dollar may be a grind. The momentum behind the AUD, however, means we cannot rule out parity.

Interest Rates

The Reserve Bank of Australia (RBA) lifted the cash rate twice this year in 25bp steps to take the cash rate to 7.25%. The US Federal Reserve in contrast has cut rates by 225bp this year to take the Fed funds rate to 2%. The difference between the Australian and US official interest rates, the cash rate spread, which establishes the base structure for all other rates stands at 525bp – the widest in 17 years (as shown in the chart below). Among the 'G-10' currencies (AUD, NZD, EUR, JPY, USD, SEK, NOK, CAD, CHF and GBP), Australia has one of the highest cash rates and 2-year government bond yields (second only to New Zealand, however, New Zealand carries a lower sovereign rating).

We forecast the RBA to remain on hold for the rest of this year. Recent economic activity data, including employment and retail sales, continues to reveal that domestic demand is slowing. Australia's rising terms of trade means we can not rule out a rate hike, however, we do not believe the RBA will tap on the brakes amid clear signs of the domestic economy slowing and some signs of re-surfacing credit worries.

AUD/USD AND OFFICIAL INTEREST RATE DIFFERENTIALS



In the early half of June, financial markets were priced for the possibility of two rate hikes from the RBA this year. This probability has been wound back as activity data continued to paint a picture of a slowing domestic economy. The minutes from the RBA's June 4 meeting and the statement from the RBA's July 1 meeting were also more dovish than markets expected. We believe that markets have little room to price much more tightening in locally with domestic data likely to continue to trend lower.

We also expect that the Fed is done or near done cutting rates with some nascent improvement in activity data amid inflationary pressures. Financial markets are expecting the Fed to begin normalising rates (i.e. raising rates) possibly as soon as September. We are not convinced that the Fed will start hiking so soon but we do think that tightening could start before the end of the year or early next year.

So while interest-rate differentials should remain wide and supportive for the AUD, we do not expect the widest levels to be revisited, reducing the degree of appeal for the AUD. It means the risks are that the AUD may find any further appreciation akin to a grind.

US Dollar Outlook

US data continues to suggest the US economy remains weak. But aggressive policy action from the Fed should start to feed through to the US economy in this half of the year, as monetary policy operates with a lag. The USD should more strongly anticipate this recovery and appreciate through the remainder of this year. However, the USD recovery will remain volatile. This view is not without its risks, with the USD still vulnerable to growing concerns over credit and financials in the US, encouraging speculation the Fed may not be able to raise interest rates as early as previously thought. However, remarks over the past month from US Treasury officials suggest that the US administration may be trying to breath fresh life into the "strong USD policy" - as a means of talking the USD higher with the aim of containing inflationary pressures. So we think that downside potential for the USD should be reasonably limited. The USD's downside may also be limited by market players wary of possible co-ordinated intervention to support (or stabilise) the USD.

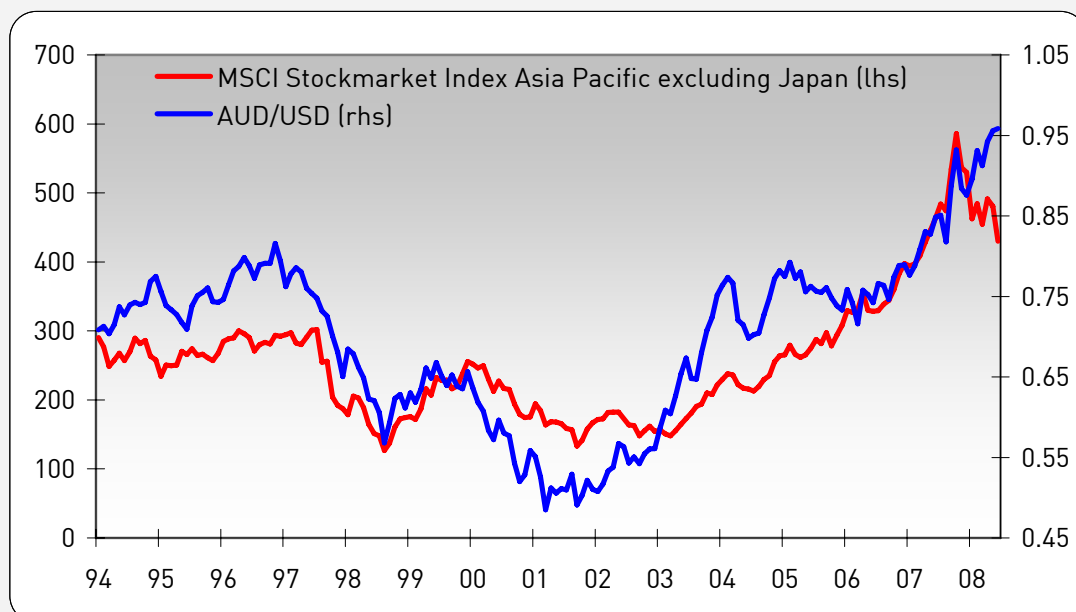
Looking back at past US recessions and how the USD performed during the six months prior to the onset of the recession and twelve months after the start of the recession may give an indication of the USD's path. What is evident from the past four US recessions is that the USD tends to recover from its trough at around six months after the start of the recession (irrespective of the duration of the recession).

While a peak in local rates and an appreciating USD may cap the AUD's gains, there are key factors underpinning the AUD. These factors mean we can't completely rule out the Aussie reaching parity, especially in the short term. If the AUD stretches for parity we believe it is more likely to occur in the next few months.

Terms of Trade

One of the important factors driving demand higher for the AUD is Australia's rising terms of trade (ratio of export prices to import prices). The expansion of China is a key structural change underway in the global economy and a key driver of Australia's rising terms of trade. Commonwealth Treasury and the RBA expect a 20% increase in the terms of trade this year, after a 40% rise in recent years. Large price rises for Australia's commodities, such as the recent agreement for an up to 96.5% iron ore price rise for China's Baosteel, secured by Rio Tinto, are driving this rise. Importantly, further rises in the terms of trade are giving an income injection to the Australian economy and providing support to the AUD over the medium to long term. One consequence is the AUD should average at a rate that is relatively high in its post-float history. The floor in the AUD should also be higher than in the past.

AUD/USD AND ASIAN STOCKMARKET PERFORMANCE

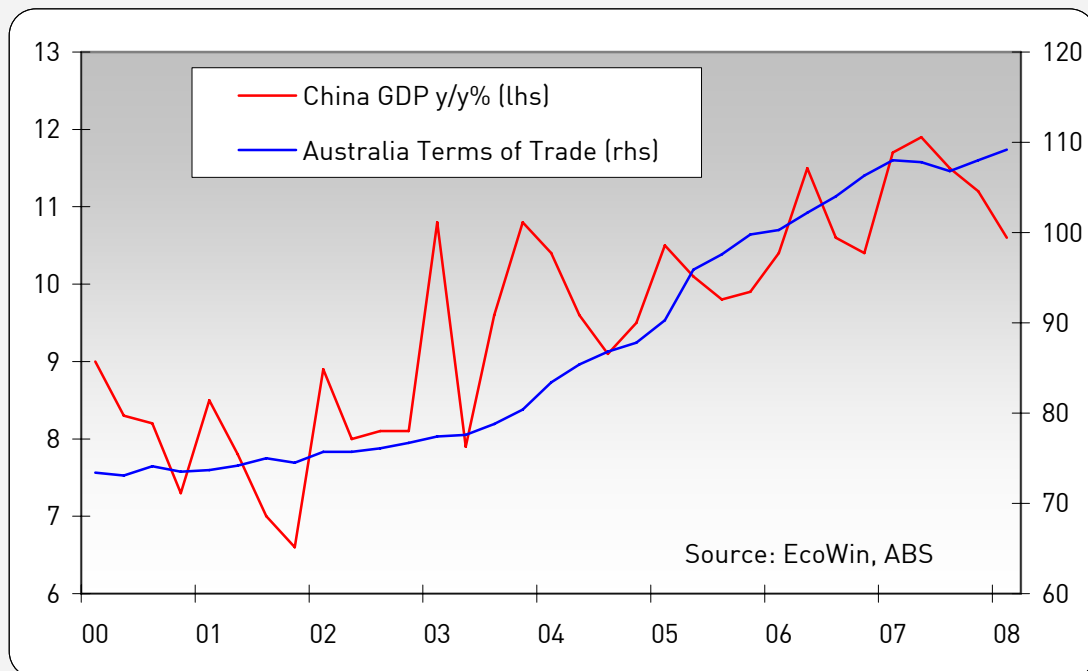


Asian Economic Outlook

Australia's terms of trade is driven by the expansion of China and the rest of Asia. The AUD's performance is closely tied, by financial and trade linkages, to Asia. More than 60% of Australia's exports are destined for Asia (over 30% to Japan and China alone). It means the AUD's performance is closely influenced by Asian economic growth.

Surging oil prices threaten to eventually drag on Asian and world economic growth prospects. The IMF expects growth in this region to hold up, but further downgrades to growth in this region and the world economy remain a risk to the AUD's outlook. It is because the AUD is a 'bellwether' to world growth and is affected by risk appetites. The growing risk to world economic growth is the rising oil price. The world price of oil continues to record new highs and in the near term could breach US\$150 a barrel. High oil prices are causing many central banks to find themselves stuck between a proverbial rock and a hard place; that is, making decisions over higher inflationary pressures but weakening economic growth. Ultimately, higher oil prices should result in demand adjustments. Whether world economic growth can withstand a further slowing will depend heavily on the resilience of emerging economies.

CHINA'S GDP AND AUSTRALIA'S TERMS OF TRADE



Current Account Gap

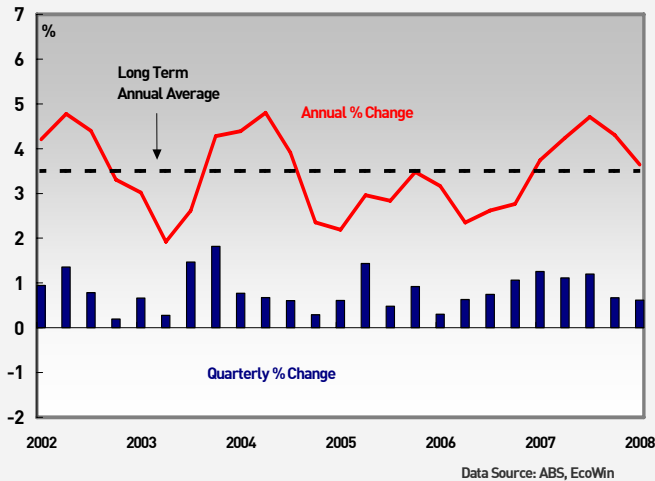
Australia's large current account deficit (at 6.3% of GDP) is also a consideration. While current account imbalances are not dominating currency direction now, Australia's large and growing current account deficit remains a threat. Typically, current account gaps correct over the medium term via a weakening exchange rate.

Forecasts

The risks for the AUD in the short-term lie to the upside while over the medium term, the risks lie to the downside. In the short term, parity cannot be ruled out. Over the medium term, we continue to look for the AUD's gains to be tempered. From a technical perspective, the underlying upward trend for AUD/USD that extends from October 2001 remains intact. It suggests long-term support for the AUD is between USD0.8000-0.8100. We envisage that the Aussie dollar based on these technicals and fundamentals will spend much of its time trading above this long-term support level over the medium term.

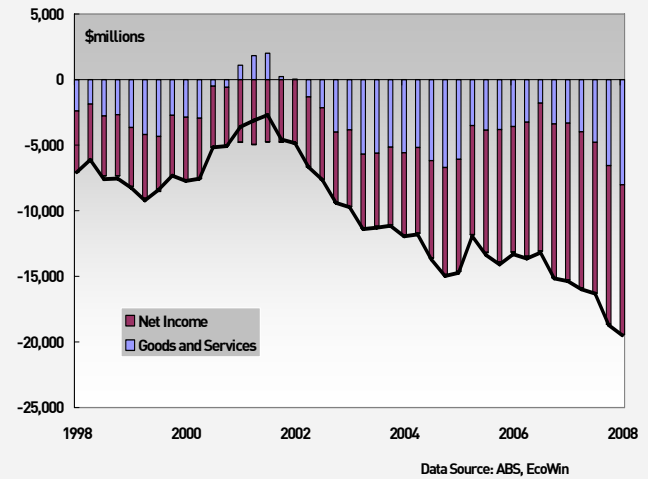
Australian Economic Data

Gross Domestic Product



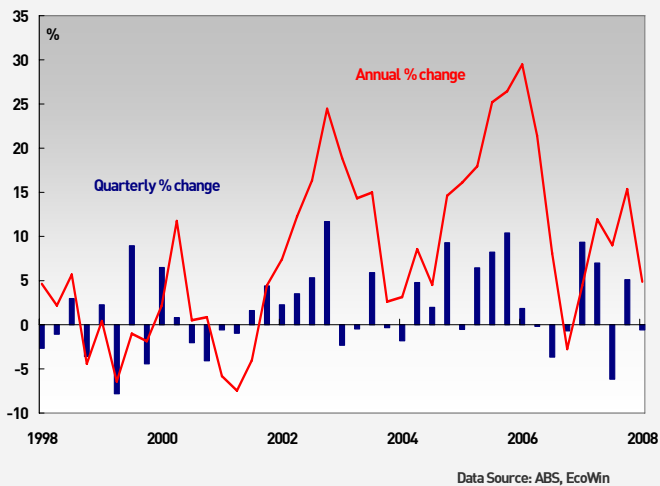
GDP rose by 0.6% in the March quarter, lowering the annual rate of growth to 3.6%. The economy appears to be slowing gradually, with the trend series showing a slowdown in the last 3 quarters. Interestingly, growth outcomes between industries varied sharply. The construction and property and business services sectors both had solid increases in growth, whereas 5 other sectors in the economy contracted in the quarter.

Current Account



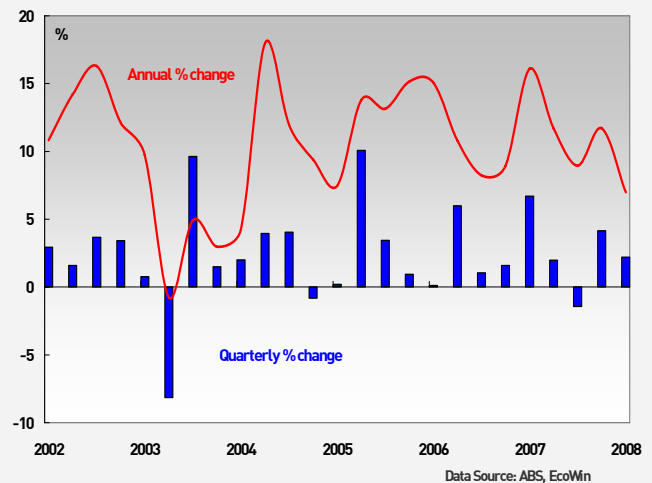
The current account deficit deteriorated to \$19.5 billion in the March quarter. The goods and services deficit worsened by \$1.5 billion in the month – largely the result of an increase in fuel imports. Adverse weather conditions in WA and QLD also contributed to the deficit. Australia's current account deficit is approximately 6.3% of GDP, which is a great concern considering that we are in the midst of a commodity boom.

Private Capital Expenditure



Private capital expenditure (CAPEX) printed under market expectations. It fell by 2.5% over the March quarter, leading to an easing in the annual rate of growth to 4.6%. An industry breakdown shows that there is still a solid pipeline in mining investment. The forward-looking investment intentions series shows that overall business investment will remain at a moderate pace in the year ahead.

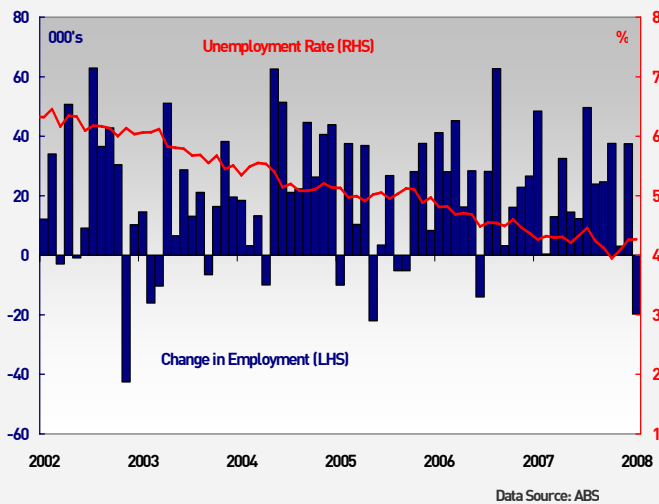
Company Profits



Company gross operating profits rose by 2.2% in the March quarter. The annual rate remains healthy at 7.0%, but is lower than the 11.7% annual rate seen in 2007. The largest quarterly increases in profits were in the mining (9.0%) and transport and storage (8.9%) industries. Business inventories were up by 0.9% in the quarter, with the retail trade and manufacturing sectors being the largest contributors.

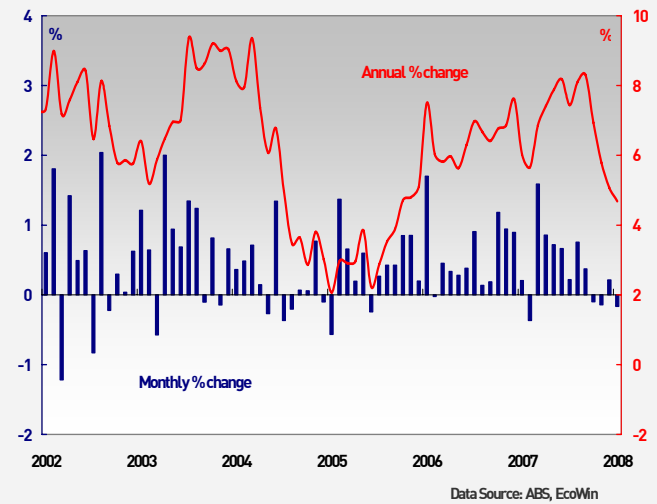
Australian Economic Data

Employment



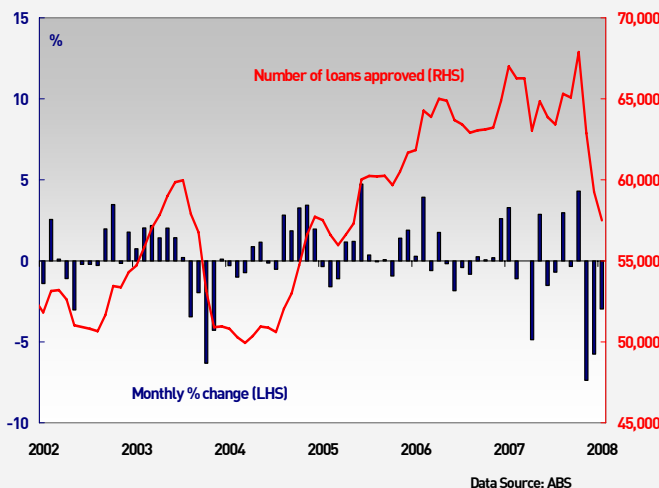
The number of people employed dropped by 19,700 in May, with losses in both full-time and part-time jobs. It left the unemployment rate unchanged at 4.3% due to a decrease in the workforce participation rate. The modest loosening in labour market conditions follows weak job vacancies and job advertisements data in previous months. Employment is expected to ease further in line with an overall slowing in domestic demand.

Retail Sales



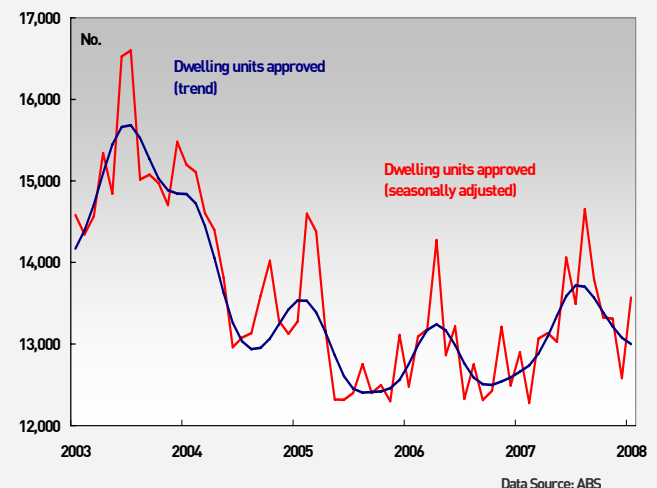
Retail sales fell by 0.2% in April, following three months of weak retailing figures. As a result, the annual rate of growth eased to 4.7%, from a revised 5.1% in March. There are clear signs that tighter financial conditions, including higher petrol prices, are dampening discretionary spending. In trend terms, retail activity has been slowing since August 2007 and was flat in the most recent month.

Housing Finance



Housing finance dropped by 3.0% in April, to be 14.2% lower over the year. The weakness in housing finance during the month was attributed to a decline in finance for new homes and established dwellings. Meanwhile, finance for the construction of dwellings rose in April. The value of investment home loans rebounded this month, rising by 1.4%, only partially offsetting the declines in the previous two months.

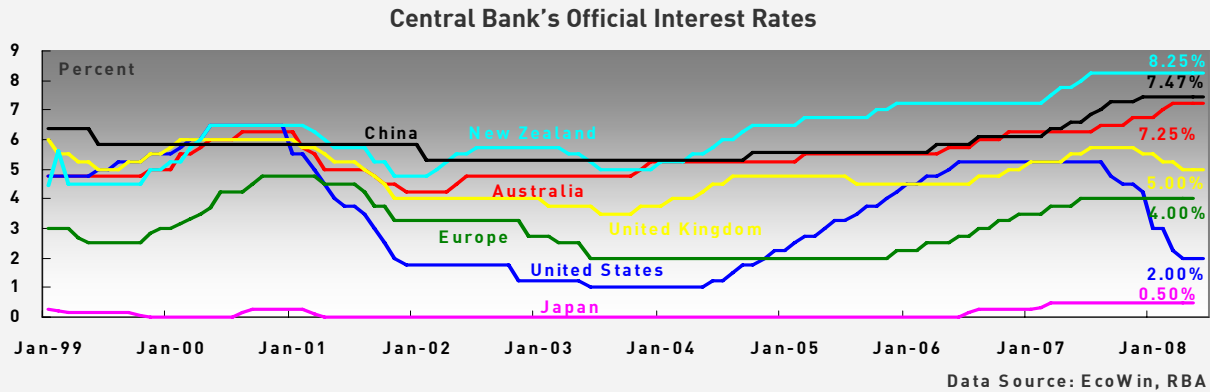
Building Approvals



Building approvals lifted by 7.8% in April, reversing some of the losses recorded in the previous months. April's outcome was boosted by unit approvals, which jumped by 17.5%, whereas house approvals increased by a modest 1.3%. Non-residential approvals softened over the month (falling by 2.9%), but remain moderate over the year (up by 9.5%).

Interest Rate Markets

Central Bank Outlook



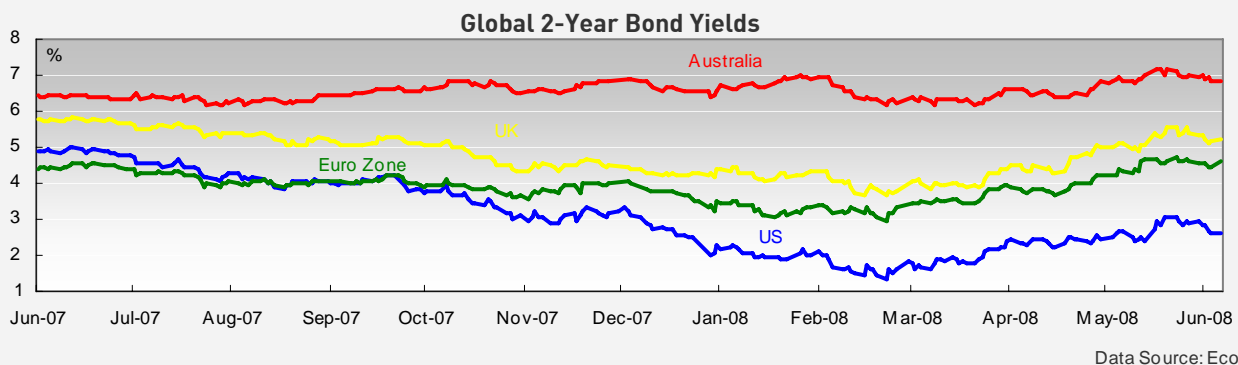
The key development in central bank news over the last month was the sharp turnaround in market monetary policy expectations, with the likelihood of rate rises in the US, UK and Euro Zone now greater than rate cuts. This has occurred as skyrocketing oil prices caused major central banks to step-up the hawkish interest rate rhetoric.

In the US, the concern is that the stimulus stemming from the Fed's aggressive series of rate cuts could aggravate pre-existing inflationary pressures. Hence, the consensus is that the Fed is done easing and could start hiking rates in the second half of this year. This month, however, saw the Fed leave interest rates steady and indicate that they are in no hurry to raise rates. Financial markets are currently fully priced for a 25bp rate hike by October and some chance of an additional 25bp increase by the end of the year.

In the Euro Zone, the consensus is that the European Central Bank will raise rates by 25bp in July. ECB officials have suggested it will be a one-off tightening. Markets are also pricing in the chance of a rate hike in the UK after the nation's inflation rate soared to a 16-year high of 3.3% in May. It is well above the Bank of England (BoE)'s 2.0% target and required the BOE to write an explanation letter to Treasury. But recent weak UK housing data reveals that a rate hike is not a sure bet.

Locally, the release of less hawkish monetary policy meeting minutes and statement in mid June and July 1, respectively, from the RBA led market participants to scale back their rate-hike expectations. We retain our long-held view that the RBA will (narrowly) avoid having to raise interest rates again this year. Financial markets are now pricing in a 58% chance of a 25bp rate hike to 7.50% by December, off the peak of around 170% on June 10. Markets are less certain of a nearer term rate hike (i.e. one occurring by August). Current pricing is hovering at just under 20%, after the RBA suggested in its July 1 statement that it might look through high inflation in the short term because it still expects inflation to ease over the medium term.

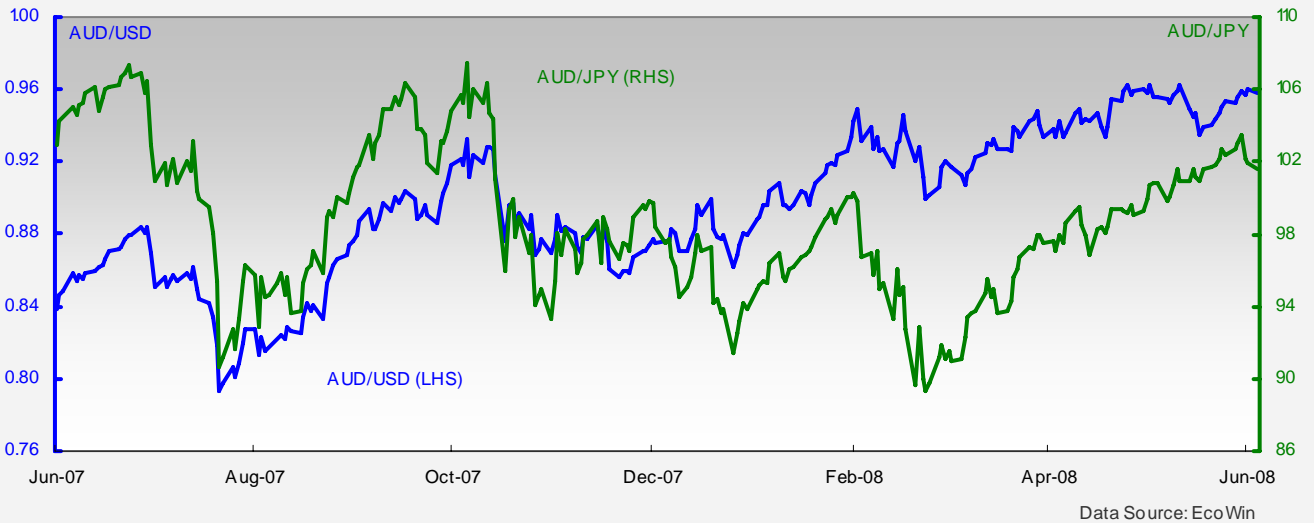
Bond Yields



The turnaround in market monetary policy expectations towards rate hikes rather than rate cuts in major countries have pushed global short-term bond yields higher. US 2-year bond yields are now up 13bp in the month, UK yields rose 13bp while that in the Euro Zone gained 22bp. Domestic 2 year yields were, however, relatively unchanged as markets discounted the chance of a near-term interest rate hike.

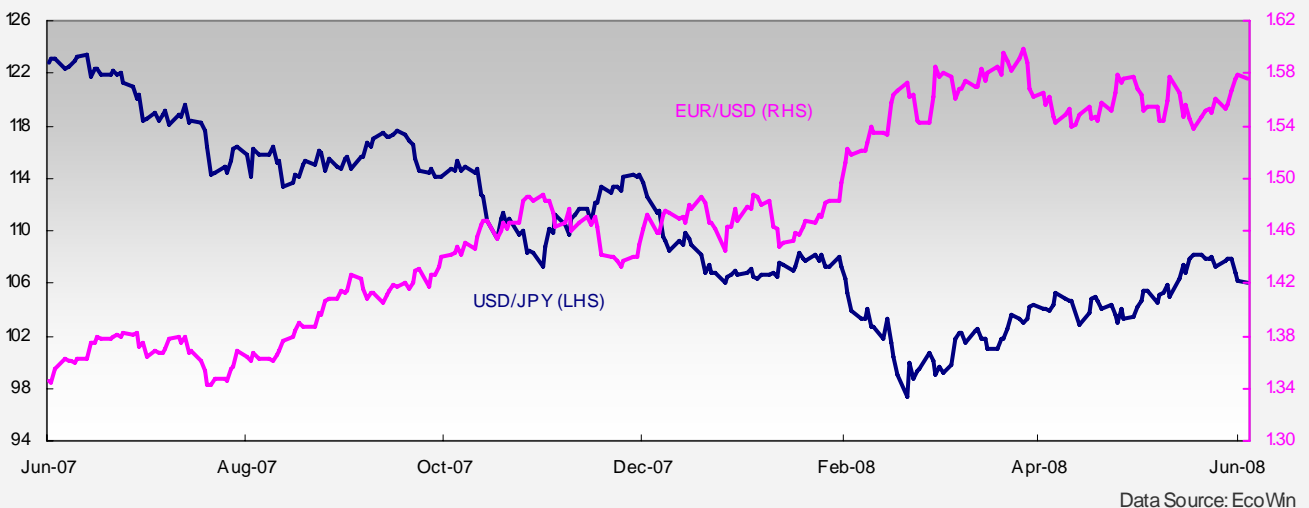
Currency Markets

Australian Dollar



The Aussie dollar continued to gain ground to reach a new post-float high of USD0.9668 on June 30. The AUD lifted by 0.3% against the USD. The USD has been under selling pressure since mid June as markets pushed back the timing of rate-hike expectations for the Fed. It was not all a weak USD story for the AUD, however. The AUD also appreciated in trade-weighted terms – by 0.8% in June. Australia’s attractive interest rates and rising terms of trade are giving fundamental support to the AUD. The AUD lifted by 0.9% against the Japanese yen and 3% against the NZD (the latter has been sold off as expectations for rate cuts before the end of the year in NZ grow). But the AUD lost ground against the EUR [-1%] and British pound [-0.2%], as markets moved to price in rate hike expectations in these economies.

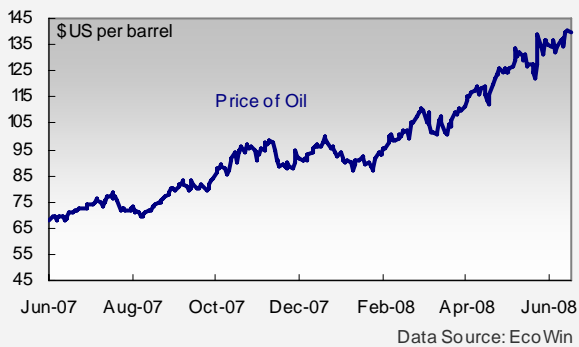
Global Currencies



The USD posted broad-based declines in June, as markets pushed back the timing of Fed rate hikes. The FOMC statement on June 25 failed to signal that rate hikes in the US were imminent. The language of the statement appeared to confirm that the Fed had done cutting rates. Over June, the US dollar gained 0.7% against the Japanese yen and 2.8% against the Canadian dollar. But the greenback was down against the GBP (0.5%), Swiss franc (2%), and British pound (0.5%). Major currencies remain volatile. Interest-rate expectations continue to be important drivers of the direction of currencies together with oil prices. Higher oil prices generally affect the USD and JPY more due to their high dependency on oil imports.

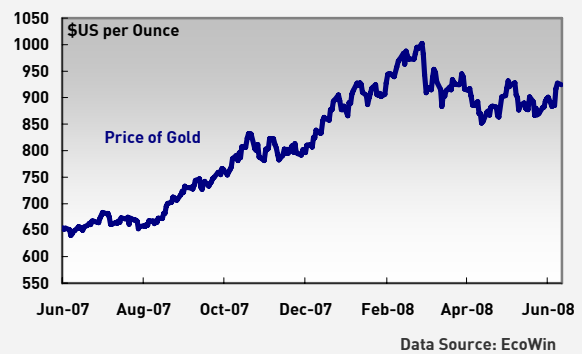
Commodity Markets

Oil



The oil price rose yet again this month, by a hefty 7.0% (+98.7% y/y) to now trade above \$US140 per barrel. Earlier this week, oil had breached \$US143 per barrel for the first time ever as the USD depreciated. Speculative demand and ongoing supply concerns were also major positive contributors. This is despite continued global growth uncertainties and, recently, China's surprise decision to raise regulated fuel prices by up to 18%. Locally, Q2 petrol prices (to date) gained around 8%, indicating that it will remain a key contributor to headline inflation. The RBA expects petrol prices to add about 0.25ppt to the change in the CPI in Q2 and Q3.

Gold

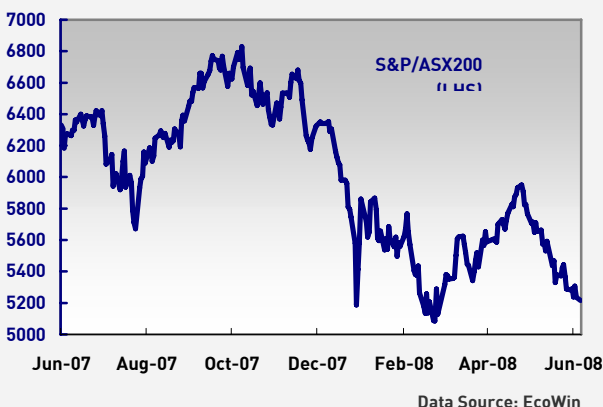


The price of gold was flat in June on a month earlier, but is up nearly 36% on a year ago. The gold price remains at a high level. Major upward factors on the gold price have been the weaker US dollar and gold's status as a hedge against inflation. Investor activity in gold is also firm.

While the gold price is at elevated levels, it is now more than 10% off its peak recorded in mid March of more than US\$1,000 per ounce. Since this time, investor interest has been more volatile as market expectations over the direction of US interest rates and the USD have waxed and waned.

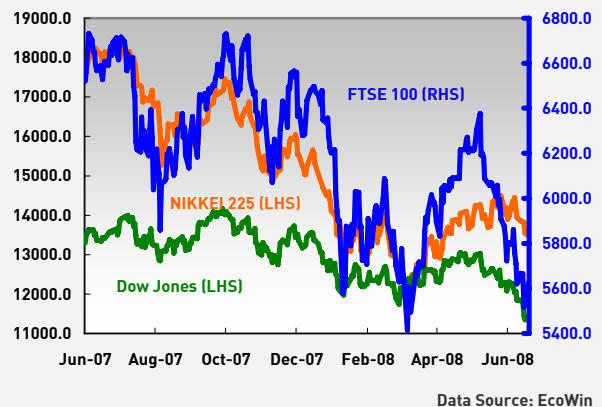
Share Markets

Australia



Inflation (and hence rate hike worries) and renewed concerns over the health of the US financial sector on potential write-downs were major negatives for domestic shares this month. Financial stocks, not surprisingly, were hard hit, with the financials sub index falling by 12.3% in the month. It was partly offset by a 6.9% rise in energy stocks amid much higher oil prices. The broader S&P/ASX200 closed down 6.4% in June and 14.4% lower over the year.

International Markets



New record highs in the oil price and news of potential write-downs kept dark clouds over the outlook for US equities. The US Dow Jones was hard-hit (-9.6% m/m, -15.5% y/y), narrowly missing bear market territory (i.e. a fall of 20% or more from its all-time peak). Other major stock indices have not been spared from the carnage; UK's FTSE was down 6.6% (-12.4% y/y) and the Hong Kong's Hang Seng fell 8.1% (+9.3% y/y). The Japanese Nikkei eked out a small gain of 0.6% (-21.8% y/y).

Recent Australian Data

Red – Indicates the result was **weaker** than consensus expectations

Blue – Indicates the result was **stronger** than consensus expectations

<p>June 2008 WMI Consumer Confidence –5.6%, Previous 2.7% 11/6</p> <p>May 2008 Private Sector Credit 0.6% m/m, Consensus 0.6% 30/6 Job Vacancies 3.4% q/q, Previous –2.5% 26/6 Employment Change –19.7k, Consensus 13.5k 12/6 NAB Business Confidence –4 pts, Previous –8 pts 10/6 TD-MI Inflation Gauge 0.3% m/m, Previous 0.5% 2/6 WMI Consumer Confidence 2.7% m/m, Previous –1.3% 21/5</p> <p>April 2008 Conf. Board Leading Index 0.3% m/m, Previous –0.4% 25/6 Housing Finance –3.0% m/m, Consensus –2.0% 10/6 Trade Balance –1.0bn, Consensus –1.7bn 5/6 Building Approvals 7.8% m/m, Consensus –0.5% 3/6 Retail Sales –0.2% m/m, Consensus 0.2% 2/6 Private Sector Credit 0.4% m/m, Consensus 0.8% 30/5 NAB Business Confidence –8 pts, Previous –4 pts 12/5 Employment 25.4k, Consensus 10.0k 8/5 TD-MI Inflation Gauge 0.5% m/m, Previous 0.4% 5/5 WMI Consumer Confidence –1.3% m/m, Previous –9.1% 9/4</p> <p>March 2008 Gross Domestic Product 0.6% q/q, Consensus 0.3% 4/6 Current Account –19.5bn, Consensus –20.5bn 3/6 Company Profits 2.2% q/q, Consensus 1.5% 2/6 CAPEX –2.5% q/q, Consensus 3.0% 29/5 Conf. Board Leading Index –0.4% m/m, Previous –0.2% 29/5</p>	<p>Wage Cost Index 0.9% q/q, Consensus 1.1% 14/5 Housing Finance –6.1% m/m, Consensus –0.8% 12/5 Trade Balance –2.7bn, Consensus –2.9bn 6/5 House Price Index 1.1% q/q, Consensus 0.0% 5/5 Retail Sales 0.5% m/m, Consensus 0.3% 2/5 Building Approvals –5.7% m/m, Consensus –1.0% 1/5 Private Sector Credit 0.8% m/m, Consensus 0.8% 30/4 Consumer Price Index 1.3% q/q, Consensus 1.1% 23/4 Producer Price Index 1.9% q/q, Consensus 1.0% 21/4 Export Price Index 3.5% q/q, Previous 3.0% 18/4 Employment 14.8k, Consensus 10k 10/4 NAB Business Confidence –4 pts, Previous –2 pts 8/4 TD-MI Inflation Gauge 0.4% m/m, Previous 0.3% 31/3 WMI Consumer Confidence –9.1% m/m, Previous –5.3% 12/3</p> <p>February 2008 Average Weekly Wages 1.1% q/q, Previous 0.8% 15/5 Conf. Board Leading Index –0.2% m/m, Previous –0.5% 29/4 Housing Finance –5.9% m/m, Consensus 0.5% 14/4 Building Approvals 0.1% m/m, Consensus 0.3% 7/4 Trade Balance –3.3bn, Consensus –2.5bn 7/4 Retail Sales –0.1% m/m, Consensus 0.3% 4/4 Private Sector Credit 0.7% m/m, Consensus 1.1% 31/3 Job Vacancies –2.5% q/q, Previous 5.5% 27/3 Employment 36.7k, Consensus 15k 13/12 NAB Business Confidence –2 pts, Previous –4 pts 11/3 WMI Consumer Confidence –5.5% m/m, Previous –8.3% 13/2</p>
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Upcoming Data and Events

Australian Data / Events Underlined

<p>July 2 <u>AU Retail Sales, May</u> <u>AU Building Approvals, May</u> US Factory Orders, May US ADP Employment, Jun</p> <p>July 3 <u>AU Trade Balance, May</u> US Non-farm Payrolls, Jun US ISM Non Manufacturing Index, Jun</p> <p>July 7 <u>AU Job Advertisements, Jun</u></p>	<p>July 8 <u>AU NAB Business Survey, Jun</u> US Fed Chairman Bernanke speaks US Pending Home Sales, May</p> <p>July 9 <u>AU Consumer Confidence, Jul</u> <u>AU Housing Finance, May</u></p> <p>July 10 <u>AU Consumer Inflation Expectation, Jul</u> <u>AU Employment Change, Jun</u></p> <p>July 11 US Trade Balance, May US Michigan Confidence, Jul</p>	<p>July 15 <u>AU RBA Minutes of 1 July Meeting</u> US PPI Core, Jun US Retail Sales, Jun US Empire Manufacturing, Jul US Business Inventories, May</p> <p>July 16 <u>AU RBA Governor Stevens Speech</u> US CPI Core, Jun US Long-Term TICS Flows, May US Industrial Production US NAHB Housing, Jul US Fed Minutes of Meeting</p>
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Forecasts

End Period:	2007		2008		2009			
	Q3	Q4	Q1	Q2	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)
GDP q/q, %	1.2	0.7	0.6	0.7(f)	0.7	0.7	0.8	0.9
GDP y/y, %	4.7	4.3	3.6	3.2(f)	2.7	2.7	2.9	3.1
Headline CPI q/q, %	0.7	0.9	1.3	1.2(f)	0.7	0.7	1.0	0.6
Headline CPI y/y, %	1.9	3.0	4.2	4.2(f)	4.2	4.0	3.6	3.0
RBA Cash, %	6.50	6.75	7.25	7.25	7.25	7.25	7.25	7.25
90-Day BBSW, %	6.89	7.24	7.86	7.84	7.80	7.75	7.60	7.50
3 Year Bond, %	6.44	6.89	6.13	6.70	6.70	6.60	6.50	6.40
10 Year Bond, %	6.15	6.33	6.05	6.45	6.50	6.40	6.30	6.25
AUD/USD	0.8879	0.8752	0.9131	0.9586	0.9400	0.9200	0.9000	0.8700
USD/JPY	114.8	111.71	99.69	106.21	110.00	112.00	114.00	116.00
EUR/USD	1.4267	1.4590	1.5788	1.5755	1.5400	1.5000	1.4700	1.4400
GBP/USD	2.0473	1.9849	1.9837	1.9923	1.9500	1.9300	1.9100	1.8900
USD/CHF	1.1640	1.1335	0.9931	1.0211	1.0600	1.0700	1.0800	1.0900
NZD/USD	0.7579	0.7661	0.7860	0.7622	0.7200	0.7000	0.6800	0.6700
USD/CAD	0.9923	0.9984	1.0254	1.0215	1.0300	1.0500	1.0600	1.0700
AUD/JPY	101.93	97.74	91.04	101.82	103.40	103.04	102.60	100.92
AUD/EUR	0.6223	0.5998	0.5784	0.6084	0.6104	0.6133	0.6122	0.6042
AUD/GBP	0.4337	0.4408	0.4603	0.4811	0.4821	0.4767	0.4712	0.4603
AUD/CHF	1.0336	0.9920	0.9068	0.9789	0.9964	0.9844	0.9720	0.9483
AUD/NZD	1.1715	1.1429	1.1618	1.2578	1.3056	1.3143	1.3235	1.2985
AUD/CAD	0.8811	0.8736	0.9364	0.9790	0.9682	0.9660	0.9540	0.9309
AUD/CNY	6.6632	6.3958	6.4027	6.5664	6.3544	6.1272	5.8995	5.6115
AUD/SGD	1.3187	1.2603	1.2562	1.3018	1.2690	1.2328	1.2060	1.1658

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