

Australia & New Zealand

UOB Economics Projections - Australia	2007	2008	2009F	2010F
GDP	4.0	2.4	0.4	2.6
CPI (average, y/y)	2.4	4.4	1.7	2.3
Unemployment rate (year-end)	4.4	4.2	5.8	6.2
Current account (% of GDP)	-6.3	-4.3	-4.2	-5.2

UOB Economics Projections - New Zealand	2007	2008	2009F	2010F
GDP	3.1	-1.0	-1.5	2.2
CPI (average, y/y)	2.4	4.0	2.3	2.8
Unemployment rate (year-end)	3.7	4.2	6.8	7.3
Current account (% of GDP)	-8.2	-9.0	-6.9	-6.2

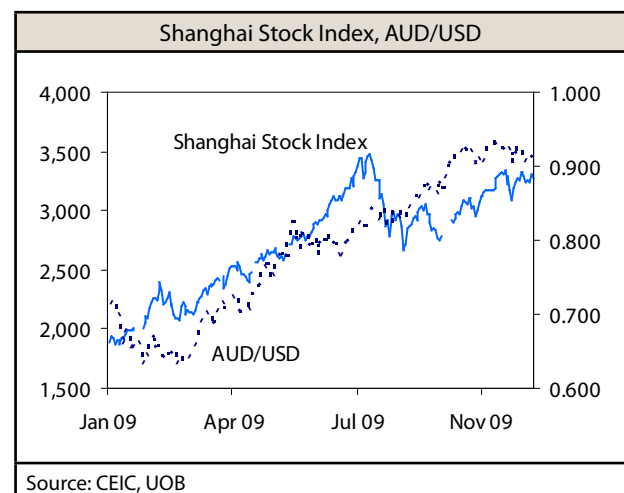
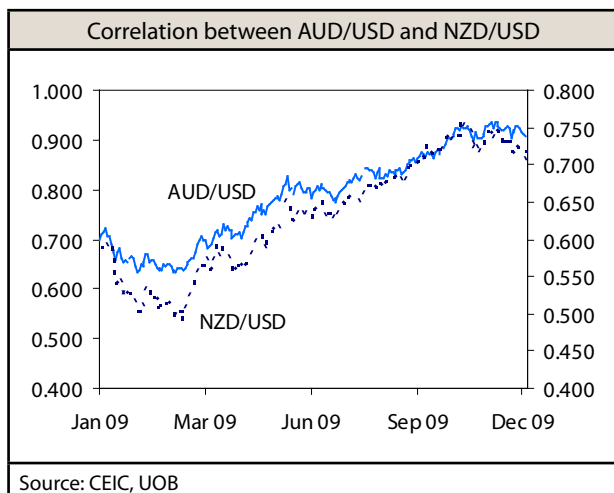
- The antipodean currencies have been driven by actual and expected interest rate differentials, as well as commodity prices. The use of the Australian currency as a proxy for China has also pulled the AUD higher.
- Going into 2010, the lack of real price follow-through would mean that the antipodean currencies may need fresh catalyst to spur further gains. Nevertheless, we expect that sentiment remains positive for both these currency pairs.
- We have accelerated our forecast for the “normalization” process, expecting the Reserve Bank of Australia (RBA) to move rates up to 4.0% by March rather than by July-August next year. Meanwhile, we maintain our view that the RBNZ will start moving rates north in the second quarter next year.

Antipodeans Looking Tired

At the time of our last quarterly report, AUD/USD and NZD/USD were trading around the 0.8790- and 0.7200-levels respectively, enjoying themselves in the upward rally that began since March this year on risk appetite. Today, AUD/USD is seen trading around the 0.9000-mark, while trades back around the 0.7200-level for the NZD/USD.

Looking back, the Australian dollar has been the most bullish among the G10 currencies, rising about 3.0%

against the US dollar in the last quarter. At various stages, AUD/USD went above the 0.9300-level and briefly reached 0.9406 on November 16. Actual and expected interest rate differentials were clearly one of the main drivers for the currency’s surge. Despite the unfavourable international environment where major developed nations have emphasized that interest rates at their side will stay at record lows for some time, the RBA had moved interest rates upwards by 75bps from October to December this year. The rise in commodity prices has also pulled up the



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antipodean currencies. Front-month gold hit a record of \$1217.40 an ounce in early December and oil prices, after surging to a record of \$81.37 per barrel in mid-October, had hovered close to the \$80/bbl mark for most of the quarter.

In addition, markets are using the Australian currency as a proxy for China. There has been a tendency for the AUD to move in parallel with the Shanghai stock exchange index in the past year or so, as investors use the currency as a back-door way of gaining exposure to Chinese equities. Offshore funds are also buying Australian assets as a proxy into China because of demand for Australia's exports. On September 18, a Chinese central bank official acknowledged that the Australian dollar serves as a proxy for the yuan and tends to strengthen on bullish news about the Chinese economy. Market News International quoted Zheng Hong (director of the exchange rate section within the monetary policy department of the People's Bank of China (PBoC)) as saying, "The Australian dollar is a shadow currency of the yuan. When the Chinese economy is good, iron ore demand is strong and the Australian dollar appreciates". It was reportedly the first time a PBoC official has made such an explicit acknowledgement of that linkage.

Going forward, though, given how well the AUD/USD and NZD/USD have performed in 2009, the lack of real price follow-through would mean that they may need fresh catalyst to spur further gains. Take the NZD/USD for example: although the pair has held up reasonably well – attaining highs of 0.7635 in the early part of 4Q – it has since lost steam. There seems to be also very little net movement over the past month in the AUD/USD.

One of the main reasons would be the partial cooling off in enthusiasm for the RBA to hike rates since it has already begun doing so. Hence, it seems very likely that all the "good" news and positive surprises that had led to the appreciation has now faded in the backdrop. And even the Australia authorities have also begun to watch a little more closely on the appreciation of the AUD. At the October monetary policy meeting, RBA Governor Glenn Stevens highlighted that "the exchange rate has appreciated considerably over the past year, which will dampen pressure on prices and constrain growth in the tradeables sector". Since then, the topic on exchange rate was brought up subsequently at every policy meeting.

Consequently, sentiment in the antipodean currencies should still be positive going into 2010 and support is likely to remain intact on the back of the diverging outlook for policy at home and abroad as well as on commodity prices. However, we expect some of the shine to be taken off both

these currencies next year. We are looking for AUD/USD and NZD/USD to trade comfortably around the 0.940- and 0.760- levels respectively by the middle of next year.

Australia Skips the Recession

Australia's real GDP increased by 0.4% in the first quarter and by 0.6% in the second quarter, a rebound from a 0.7% contraction in the final quarter of 2008. And latest figures released on December 16 showed that 3Q GDP data coming in at 0.2% q/q (0.5% y/y), slightly below expectations for a 0.4% q/q (0.7% y/y) and from a prior reading of 0.6% q/q (0.6% y/y).

The shakeout in the job market has also been less dramatic than expected, with companies opting to hoard labour and reduce hours worked rather than resorting to retrenchments. The Australian unemployment rate had hovered around 5.8% since June, dipping to 5.7% in September as well as in November (where latest figures have shown that the number of people in full-time work rose by 30,800 to a seasonally adjusted 7,627,000). Retail sales climbed 0.3% in October, from -0.2% in September, as households spent more at department stores and restaurants. And business confidence for the region rose in November to the highest level in more than seven years. The sentiment index climbed 3 points to 19, the most since May 2002. The Treasury has revised its forecasts for the jobless rate to hit 6.7% by late 2010. Earlier this year in May, the Treasury had forecasted unemployment rate to hit a peak of 8.5%. On growth, the RBA is expecting real GDP to climb 3.25% next year and in 2010.

These positive developments have been largely on the back of RBA Governor Glenn Stevens's decision to slash borrowing costs by a record 4.25 percentage points between September 2008 and April 2009 to a half-century low of 3.0%. Growth was also boosted in the first half of 2009 by more than A\$20 billion in cash handouts to households from Prime Minister Kevin Rudd's government. The Commonwealth government – is moving into the next phase – and the RBA believes that Rudd's A\$22 billion on infrastructure would see the nation's economic growth accelerating in 2010.

While it is comforting to know that spending by consumers and businesses have responded well to the sizeable policy stimulus, it does raise the question on how economic activity is going to fare as the stimulus is being wound back. Besides, there remain pockets of weakness in the Australian economy with latest figures showing Australian consumer confidence falling 3.8% to 113.8 points, according to a Westpac Banking Corp. and Melbourne Institute survey

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of 1,200 consumers conducted between November 30 and December 6. Nevertheless, given the strength and resilience of the Australian economy, we have revised higher our forecast for GDP growth for 2009 to 0.4% from 0.2% previously and looking at growth in 2010 to be at 2.6% compared to 2.4% previously. We have also brought lower our forecasts for unemployment rate to reach 5.8% by the end of this year, and 6.3% by the end-2010.

RBA Climbs the Ladder

The latest move by the RBA on December 1 – by 25bps to 3.75% – was the third 25bps-hike in a row, and the first time that the Bank had lifted interest rates for three continuous months since rates were first announced in 1990. RBA Governor Glenn Stevens - in the monetary statement – highlighted that “In Australia, the downturn was relatively mild, and measures of confidence and business conditions suggest that the economy is in a gradual recovery”. Although it was acknowledged that the effects of government stimulus were beginning to fade, Stevens added that public infrastructure spending was stoking demand and prospects for business investment were strengthening.

Stevens had repeatedly stated that he only slashed rates to historic-lows for fear of an economic crisis; and since the Australian economy averted a recession and there are signs that conditions have been better-than-expected, such stimulus is no longer needed. These were in similar vein to the concluding paragraph of the December statement whereby “With the risk of serious economic contraction in Australia having passed, the Board has moved... to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker”.

Yet, the hawkish comments that accompanied the decision sent the Australian dollar lower immediately, probably because the outcome was in line with expectations and had prompted some profit-taking. And speculation that the RBA may slow its pace of tightening when it comes back next year, were also seen weighing on the currency pair.

A “material adjustment” was what the RBA had described the three rate hikes so far, from the much spoken-of “emergency level” of 3.00%. We did not seem to get any sense of urgency from the December post-meeting statement that it is in any hurry to move rates upwards. In fact, the minutes of the December 1 meeting (released on December 15) hinted that there may be pauses in 2010. The RBA had said that “The question for members was

whether it was more appropriate to take a further step at this meeting or to hold the cash rate steady pending a further evaluation of developments” in February. And RBA Deputy Governor Ric Battellinio had said (a day after the minutes were released) that Australia’s monetary policy is “now back in the normal range”. The board does not meet in January and the next meeting is scheduled for February 2, 2010.

In our opinion, a break in January would mean that the RBA could take the time to assess the impact of the three rate hikes on the economy. We have accelerated our forecast for the “normalization” process, expecting the cash rate to reach 4.0% by March rather than by July-August next year, and subsequently reaching 4.5% by mid 2010. Following that, although we see further rate hikes in the pipeline, the moves should not come too aggressive.

New Zealand Economy Continues to Recover

The New Zealand economy grew by 0.1% in the second quarter – the first expansion after six quarters – after a 0.8% contraction. Year-on-year, real GDP shrank by 2.1% in 2Q from a decline of 2.6% in 1Q. Besides improvement on the global front, indicators have shown that the domestic economy is showing signs of recovery in the last quarter. The performance of services index was 56.0 in November from 49.9 the previous month, according to the Bank of New Zealand Ltd. and Business New Zealand, a Wellington-based employer group. This implies that services industries including retail, property and health, are expanding.

On December 8, Finance Minister Bill English had said that the economy is improving and may grow faster than forecast in his May budget (where the government had forecast the economy to contract 1.7% in the year ending March 31. One week later, he released fresh forecasts, saying that GDP is projected to increase 2.4% in the year to March 2011 and 3.2% the following year. The Treasury expects a 0.4% contraction in the 12 months to March 2010. This was an improved number from the 1.7% contraction back in May. The unemployment rate is also expected to peak at 7.0% early next year rather than at about 8.0% as previously forecast. The RBNZ has also revised its forecasts – expecting the New Zealand economy to expand 1.9% in the first quarter of 2010 from a year earlier, better than the 1.3% pace predicted back in September. The Bank has also added that annual growth will accelerate to 4.2% by the first quarter of 2011.

Yet, there are still concerns about the pace of the economy’s

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recovery. Sales at supermarkets, which make up a fifth of all spending, stalled in October, falling by a seasonally adjusted 1.1% from September. And manufacturing sales adjusted to remove inflation dropped 1.4% in 3Q from the previous three months while home construction shrank for an eighth straight quarter, falling 5.4%. The household sentiment index declined to 116.9 from a four-year high of 120.3 in the third quarter. RBNZ Governor Alan Bollard had said that consumer spending was not moving fast enough to fan inflation and for him to raise interest rates. 3Q GDP numbers for New Zealand will be rolled out on Dec 23.

English had also highlighted that “the imbalances in the economy are not unwinding as quickly as we would like”. One of the issues surrounding the likely pace and shape of the recovery would be the New Zealand currency. The rise in the NZD has largely offset the gains seen in the outlook for trade as the higher exchange rate has put substantial pressure on some exporters (particularly those not selling commodities). Policymakers in New Zealand see this as an obstacle to rebalance the local economy. Despite that, we believe that the RBNZ will play a balancing role going forward. On the one hand, they would be open to a higher NZD especially when the rate hike process begins but on the other hand, they would – like they have always been – intervening verbally and talking down their currency.

RBNZ’s Carries Forward Plan to Raise Rates

The RBNZ kept the official cash rate unchanged at 2.50% on December 10. It was not so much the rate decision itself but the tone of the statement which moved markets. The highlight was that the RBNZ said it will raise the benchmark interest rate sooner than it previously indicated, easing away from the October 29 pledge (to keep rates unchanged until the second half of 2010).

In the statement, RBNZ Governor Alan Bollard said that “In New Zealand, the economy continues to recover, reflecting improved world growth, higher export commodity prices, increased government spending and housing strength”. Nevertheless, he acknowledged that “there remains considerable uncertainty about the durability of the expansion”.

On interest rates, in terms of its “communications” with markets, the RBNZ has so far reiterated that rates will be kept at 2.5% for a considerable period. However, we have witnessed the gradual change (in terms of the wording and tone) of the monetary policy statement. Looking back at the September statement, the RBNZ had concluded by saying that it expects to “keep the OCR at or below the current level through until the latter part of 2010”. Then in October, the words “or below” were omitted, signaling its move away from any traces of an easing bias; whereby the statement left off with “we see no urgency to begin withdrawing monetary policy stimulus, and we expect to keep the OCR at the current level until the second half of 2010”. But in the December statement, Bollard ended off saying that “If the economy continues to recover, conditions may support beginning to remove monetary stimulus around the middle of 2010.”

We had expected that at some point, the RBNZ will probably indicate the need to “normalize” rates. And it seems that we were right to think that it was going to take a “gradual” approach in terms of setting up markets for a rate hike, preferring to prepare markets well before it lays the groundwork for any rate hikes. Bollard is required to keep annual inflation between 1.0% and 3.0%; and according to the RBNZ, CPI will rise 1.4% next year and accelerate to 2.6% in 2011.

Prices of New Zealand’s commodity exports jumped the most in 23 years in November, led by dairy prices, according to an ANZ National Bank index published last week. Meanwhile, auction prices for milk powder sold by Fonterra Cooperative Group Ltd., the world’s largest dairy exporter, have risen to a 16-month high, prompting the Auckland-based company to increase its payment to its local suppliers. House prices in New Zealand have increased 9.4% since a low in January and property sales in October surged 36.0% from a year earlier, according to the Real Estate Institute. But it does seem that Bollard is less concerned for now by the increase in prices because lending to consumers remains subdued. We maintain our view that the RBNZ will start moving rates north in the second quarter next year.