

UOB Economics Projections	2008	2009	2010F	2011F
GDP	2.4	1.3	3.2	3.4
CPI (average, y/y)	4.4	1.9	2.6	2.7
Unemployment rate (%)	4.3	5.6	5.0	4.5
Current account (% of GDP)	-4.4	-4.2	-5.2	-4.8

- *Indicators continue to point that the economic recovery in Australia is panning out broadly. We have revised higher our forecast for GDP growth for 2010 to 3.2% from 2.6% previously and looking at growth in 2011 to be at 3.4%.*
- *Being a sentiment-driven currency, one of the major drivers for the Australian dollar would be the general condition of risk appetite in the broader market. We also expect that further rate hikes in the year will provide some direction for the Aussie until the normalizing of global cash rates erodes the yield advantage.*
- *The Reserve Bank of Australia will keep walking its path upwards, continuing to bring interest rates "closer to average". We are in the view that the OCR will be at least 4.50% by the middle of this year.*

Australian Economy Expected to Continuously Grow

The Australian economy continued its expansion in the December quarter – real GDP climbed 0.9% from a revised 0.3% in the third quarter. The economy grew 2.7% from a year earlier. This is the fastest pace in almost two years in the final quarter of 2009.

Consumer confidence gained 0.2% to 117.3 points, according to a Westpac Banking Corp. and Melbourne Institute survey of 1,200 consumers conducted between March 1 and March 7. Business confidence increased in February for a second month. According to a National Australia Bank Ltd. survey of 580 companies between February 22 and February 26, the confidence index gained 4 points to 19, matching November's seven-year high. And manufacturing expanded at the fastest pace in more than two years in February. The performance of manufacturing index increased 2.8 points from January to 53.8, according to the Australian Industry Group and PricewaterhouseCoopers.

Employment has been far stronger-than-expected, rising by almost 200,000 in the past five months, and driving the jobless rate down to 5.3% from a peak of 5.8% last year. Consumer and business confidence are both buoyant. The Treasury has revised its forecasts for the jobless rate to hit 6.7% by late 2010 compared to an earlier forecast for 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.

In our view, these indicators continue to point that the economic recovery is panning out broadly, as government related stimulus and an increase in investment expectations supported economic growth. Given the strength and resilience of the Australian economy, we have revised higher our forecast for GDP growth for 2010 to 3.2% from 2.6% previously and looking at growth in 2011 to be at 3.4%. We have also brought lower our forecasts for unemployment rate to reach 5.0% by the end of this year, and 4.5% by the end-2011.

Aussie Still the Favourite

Having rallied hard over most of 2009, AUD's strength was less prominent in the first quarter of this year, although risk appetite has generated AUD/USD support and has kept the pair within its medium term range. From highs of 0.9328 attained in mid-January, the pair was sent down to lows of 0.8579 in early February before making its way higher to trade around the 0.9100-0.9200 region.

The support was in part due to interest rate differentials between Australia and the rest of the world. Rates in Australia clearly stood out among the rest of the industrialized nations (with Japan at 0.1%; UK at 0.5%; Europe at 1.0% and the US near zero). The AUD is also a

Australia

commodity currency and upward trending commodity prices, which currently accounts for 63% of price action, has also helped limit downside risks. In particular, gold prices have reached fresh highs for this year.

Although the precise timing of the emergence of risk aversion trade is always uncertain, one cannot deny that the Australian dollar is a sentiment-driven currency after all. Hence, one of the major drivers for the Australian dollar would be the general condition of risk appetite in the broader market. As we have witnessed, a run of negative sentiment accumulated in the early part of February had actually sent the AUD to a low-point. And whilst a general rise in the demand for yield can lead the currency to further gains; the current differentials have long been priced into each exchange rate. Interestingly though, despite four rate hikes since October last year, the pair has not climb very much higher.

Having said that, we expect that further rate hikes in the year will still provide some direction for the Australian dollar until the normalizing of global cash rates which will then erode the yield advantage. Watch out, too, for any concerns about the sustainability of China's growth story, given the close correlation between the two. We are looking for the AUD/USD to trade comfortably around the 0.9400-levels by the end of the second quarter.

The RBA Comfortably Moving North

The Reserve Bank of Australia raised its benchmark interest rate to 4.25% at the April 6 meeting. The latest move marks the fifth rate hike in six meetings. Last year, it became the first central bank out of the G-20 nations to increase interest rates since the onset of the global financial crisis, lifting the cash rate by 25 basis points at each of its October, November and December meetings in 2009. There was no meeting in January this year; and having ordered a freeze in rates in February, the meeting in March was the first time

that the Bank increased its cash rate for this year.

Indeed, the Australian economy is in much better shape than was expected when rates were slashed to a historic low of 3.00% a year ago, validating the rate hikes so far. Yet, weaker figures of late were being brushed aside by RBA Governor Glenn Stevens. Australian home-building approvals fell for a second month in February after the government reduced grants to first-time buyers. Retail sales also unexpectedly tumbled in February, declining by 1.4%. This confirms the view that concerns about inflation and house-price increases are of greater priority to policymakers in Australia. Inflation hit 2.1% in the quarter to December, much higher from the 1.3% in the previous three months. And a gauge of Australia's inflation rose in March at five times the pace of the previous month. Consumer prices climbed 0.5% from 0.1% in February.

Having said that, fears over the sovereign debt crisis in the Eurozone were a key topic among the Bank's board members (during the March meeting) who fear it could have serious implications on Australia's economy. Some members of the board had reportedly expressed apprehension particularly over the financial crisis in Greece which they believe could affect Australia's economy. Nevertheless, the minutes of the RBA's March 2 meeting said that "Members concluded that the evidence that had become available recently had confirmed that it remained appropriate for interest rates to move gradually towards normal levels, and that it was time to make take another step in that direction".

Going forward, we think the RBA will keep walking its path upwards, continuing to bring interest rates "closer to average". We are in the view that the OCR will be at least 4.50% by the middle of this year. After all, being ahead of the other central banks, they could well afford, to wait and receive more confirmation on how the economy was responding to the tightening so far.