

## Australia

UOB Economics Projections – Australia	2008	2009	2010F	2011F
GDP	2.4	1.3	3.2	3.4
CPI	4.4	1.9	2.6	2.7
Unemployment Rate (year-end)	4.3	5.6	5.0	4.5
Current Account (% of GDP)	-4.4	-4.2	-5.2	-4.8

- *Although economic data has been a tad softer, the Australian economy is by far among the most resilient when compared with other developed economies, and the broader economic story is still one of recovery.*
- *The price action in the last couple of months suggests that the broad trend in risk appetite is the dominant catalyst driving the AUD/USD; and there seems to be little reason to think that prices will not continue to track movements in broad risk sentiment in the near term.*
- *The latest decision revealed the board's considerable discussions on the conditions in Europe, as it flags downside risks to growth as the sovereign debt crisis plays out. We think that policy rates in Australia are likely to stay at the current level (for now) as the Reserve Bank of Australia (RBA) monitors closely the developments in financial markets worldwide.*

### Economic Activity Softens

Global financial markets have turned particularly ugly in recent months and the outlook for the global economy has turned murky. That, in turn, has raised concerns about the impact on the Australian economy, which – averting a recession – has outpaced that of other advanced economies by an incredible 4.5% in 2009. Although economic numbers of late have been a tad softer, the Australian economy is by far among the most resilient when compared with other developed economies; and the good news is that we think it will continue to remain doing so.

Australia's real GDP growth slowed to 0.5% in 1Q10 from an upwardly revised 1.1% increase in 4Q09. Year-on-year, the economy grew by 2.7%. The latest figures show government investment in infrastructure including schools surged 11.6% in the first quarter from the previous three months, the biggest increase in six years, while household spending growth slowed to 0.6% from 0.9% in the fourth quarter. Following the latest release in growth numbers, Treasurer Wayne Swan said that the positive outcome for the quarter provides tentative signs that a self-sustaining private sector recovery is in prospect. RBA Governor Glenn Stevens said the "high level" of the nation's terms of trade, a measure of income from exports, will ensure the Australian economy grows "about trend" over the year ahead.

Besides, the nation's unemployment rate is further evidence of a very strong economy. Australian employers were seen adding workers in May for a third straight month, underscoring the central bank's assessment that economic growth will accelerate this year as a mining investment

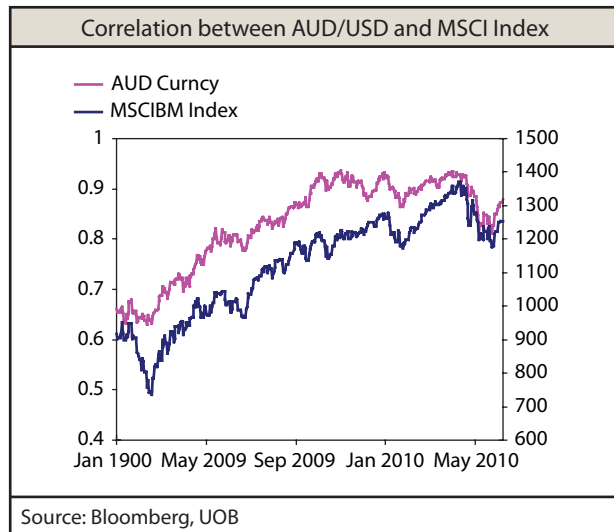
boom stokes hiring. The number of people employed gained 26,900 from April; and the jobless rate fell to 5.2% from 5.4%.

These numbers on the labour market front could hopefully help offset the impact of the RBA's 150bps of interest rate hikes since October, which have prompted some consumers to cut spending. The RBA predicts the nation's economic growth rate will almost double in the next two years to 4.0%, pushing underlying inflation toward the top of its 2.0% to 3.0% target range. We maintain our forecast for GDP growth for 2010 to 3.2% and looking at growth in 2011 to be at 3.4%. Unemployment rate is projected to reach 5.0% by the end of this year, and 4.5% by the end-2011.

### Broad Trend in Risk Appetite will be Dominant Catalyst

Over the past quarter, volatility has picked up considerably in the AUD/USD, just as it has for most currency pairs and for most financial instruments in general, given the spike in risk aversion amid the European sovereign debt crisis. The AUD/USD, from highs of 0.9389 (attained on April 12) had plunged to lows of 0.8067 in late May. Although the pair has since climbed to higher grounds, now trading around the 0.8700-levels, the price action in the last couple of months suggest that the broad trend in risk appetite across global financial markets is the dominant catalyst driving the exchange rate.

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As highlighted in the previous quarterly, the precise timing of the emergence of risk aversion trade is always uncertain. Financial market headwinds and fear does not bode well for the risk-sentiment currency and plainly leaves risks to the downside unless we see substantial improvement in financial market risk sentiment. Hence, it will thus be critical to watch other risk barometers to see any significant improvement in the coming months.

Furthermore, the interest rate outlook going forward is less flattering. While the relatively high cash interest rate currently offered by the RBA is well above those maintained by its counterparts in other advanced economies, its ability to remain as a supporting factor for the exchange rate is not convincing. This implies that, unlike the second half of 2009, widening interest rate differentials are unlikely to be a bullish catalyst for the AUD/USD going forward.

Nevertheless, we still hold a positive view for the AUD/USD on a fundamental basis, although it is quite clear that gains will not be rosy. This means that going forward, it will probably not be a smooth ride for the AUD/USD, with expected bouts of downsides and short squeezes along the way. Assuming that financial markets stabilise, we look for the AUD/USD to trade comfortably around the 0.8500-levels by the end of the third quarter to about 0.8600 by the end of the year.

### The RBA Takes a Breather

The RBA paused an aggressive series of interest rate rises at the June meeting, keeping the overnight cash rate target unchanged at 4.50%. The Bank now appears to have a neutral policy bias, with Governor Glenn Stevens presenting a balanced statement to accompany the decision. He indicated that "interest rates to borrowers are around their average levels of the past decade, which is a significant adjustment from the very expansionary settings reached a year ago".

Indeed, the Australian central bank has been one of the most aggressive central banks in the world to withdraw some of the extraordinary stimulus, having raised the cash rate by 150 basis points since October last year as the economy rapidly recovered from the global downturn. Yet, the RBA is displaying caution regarding its overall monetary policy outlook, showing that it is sensitive to the broader problems in Europe. A pronounced slowdown in Europe could pose an indirect risk to Australia given its close ties with China, for which Europe is the largest export market.

On the domestic front, there seems to be very little in the Q1's economic numbers, with signs of slowing as higher borrowing costs and the end of government stimulus weigh on domestic demand, to suggest the RBA will need to come back to the table anytime soon. As such, with early indications of policy gaining traction amidst another bout of financial market turbulence, we expect them to remain sidelined for now, continuing to see the current rate as the equilibrium point to which future policy will be set around while it monitors closely the developments in financial markets worldwide, and at the same time, signs of domestic growth.

Having said that, whilst it may pause again in July to assess the water; beyond that, we still think that the RBA would prefer to have rates closer to 5.0% by the end of the year unless a severe financial crisis threatens the market.