

Australia

UOB Economic Projections	2009	2010	2011F	2012F
GDP	1.3	2.7	2.1	4.2
CPI (average, y/y %)	1.9	2.9	3.5	2.8
Unemployment rate (%)	5.6	5.2	5.0	4.5
Current account (% of GDP)	-4.2	-2.6	-1.7	-3.0

- *While the latest GDP report was indeed better than expected, the overall impression of the Australian economy in recent months has been less than formidable, and economic data is still showing signs of further weakness.*
- *The RBA will be watching domestic inflation as well as the global financial turmoil very closely. We see them remaining on hold for the rest of the year.*
- *The Aussie saw a painfully volatile quarter. Going forward, underlying risk appetite trends and its own interest rate expectations will be key catalysts to guiding the currency.*

Australian Economy Bounces Back After Flood, Cyclones

The Australian economy bounced back into positive growth in the second quarter. Real GDP rose by 1.2% after the revised 0.9% fall in the March quarter. The annual rate of economic growth was at 1.4%, up from 1.0% in Q1. According to the Australian Bureau of Statistics, one of the major reasons for the pick-up in growth was from a rise in business inventories and household spending. However, trade performance was a drag on growth because the Queensland floods are still reducing the volume of exports, even though the numbers showed Australia was receiving record prices for resources.

Moreover, despite the nation's ability to stay out of the spotlight, it still faces uncertainties given the problems in Europe and the US. As RBA Governor Glenn Stevens pointed out in a recent speech, the negative sentiment sweeping global markets will have an effect on the locals; not so much on the large-scale investment plans in the resources sector, but on households and firms which could dampen demand.

Besides, underlying inflation appeared to be turning out higher. The central bank's two preferred measures of annual inflation accelerated to 2.7% in the second quarter, after a 2.3% gain in the first quarter. And the country's unemployment rate rose to a 10-month high of 5.3% in August as full-time employment slumped. The key question for the outlook is whether the pace of increase in the unemployment rate accelerates from here amid rising inflationary pressures. We have revised lower our GDP forecast for 2011 to 2.1%.

RBA Treading Carefully For Now

The RBA left the cash rate unchanged at its September board meeting. This is the ninth straight month that the Bank has

left its benchmark interest rate steady at 4.75%. Although the market has been factoring up to 90bps of policy easing by year-end, nothing from the accompanying September statement suggests that they are on a rate-cut mode.

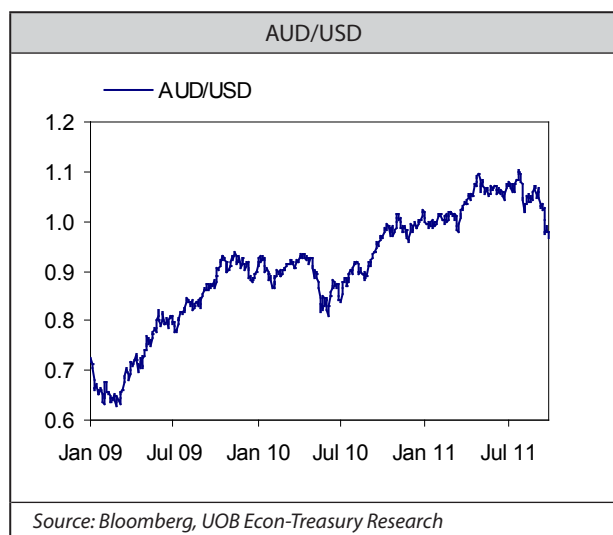
Yet, significant in the commentary were the references of Eurozone sovereign debt problems and US growth prospects, suggesting that they are becoming more concerned about the outlook for these two regions in particular. Nevertheless, the Bank added that whilst the near-term growth outlook for Australia continues to look weaker than expected; beyond the near-term, growth is still expected to be at trend or higher unless the world economic outlook continues to deteriorate. The outlook for inflation was another key concern highlighted by the RBA. It added that "a key question will be the extent to which softer global and domestic growth will work, in due course, to contain inflation". The CPI report for the third quarter will be released on October 26.

Of course, we do note that the RBA meeting came before some key economic data. Despite reassuringly strong GDP numbers for Q2, the August employment report showed that the Australian economy has been slowing into the third quarter. Typically, the trend in the unemployment rate often holds significance to RBA moves. Indeed, it was partly due to the July employment data that markets were looking for easing from the RBA this year. The key question is whether this is just a modest rise of the unemployment rate or that it will rise significantly from here. We know that the RBA has been very concerned about rising unit labour costs and it seems that with the unemployment rate at around 5%, as it was in the first half of 2011, the labour market was already tight enough to be putting too much upward pressure on

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wages. Thus the RBA would be welcoming some weakening in the labour market, although too much would not be ideal.

Besides, the minutes released from the September meeting turned out a tad more hawkish than expected, which cited that “members considered that the current setting of monetary policy left the board well placed to respond to evolving global and domestic economic conditions”. Going forward, domestic inflation as well as the global financial turmoil will be the key issues the RBA will consider in its decision. We see them remaining on hold for the rest of the year.



A Volatile Aussie In A Volatile Environment

AUD/USD saw a painfully volatile quarter. One which saw the pair powered up to 1.1081 record-highs before being dragged all the way to below the 0.9600-levels. Underlying

risk appetite trends will be key to guiding the currency pair. And, that is where the currency found much of its negative pressure.

While the latest Australian GDP was indeed better than expected, the overall impression of the Australian economy in recent months has been less than formidable, and economic data is still showing signs of further weakness. The latest employment numbers is a testament to this fact. The Housing Association in Australia is also sending a much less positive message and has been urgently pressing the government for stimulus measures in an effort to prevent a major decline in building activity.

Similarly, the currency is influenced by its own interest rate expectations. Rate investors have been betting that concerns over global growth would push the RBA into easing policy. However, we get the sense that it is more likely to remain on the sidelines rather than cut interest rates. Hence, we think that the AUD potentially may find further support if the substantial cuts priced in for the RBA are partially unwound in coming months. Besides, the AUD still remains attractive in a world where the Fed has stated that interest rates will remain near zero for potentially two years and the BoJ as well as the SNB are flooding the market with liquidity.

In addition, it seems that market participants continue to favor the antipodean as a viable alternative in a backwards market environment where safe haven currencies are no longer attractive and the higher yielding currencies are considered the new safe haven option. Taking these factors into consideration, we still see support in the AUD/USD, although current price action suggests that upside is limited. We are looking for the pair to hover at the lower end of its current range of around 0.950 by the end of the year.