Markets Economics Weekly

Week Beginning 9 January

6 January 2006

Inside:

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Economic Update

- ANZ expects further tightening of monetary policy in 2006. At the moment we have a 25bp move pencilled in for the middle of the year. The risks, in our view, are for an earlier and larger adjustment.
- Recent housing data suggests the domestic economic cycle may regain momentum in 2006. With labour markets already tight and wage inflation running above 4%, upside inflation risks remain a threat to the RBA's policy target.
- In January the ABS will release a number of economic updates critical to the economic outlook. These include the December Labour force report next week and the quarterly inflation numbers towards the end of the month.
- This week the PBoC announced some changes to the RMB trading regime. We think these changes open the way for more RMB volatility and a more rapid pace of appreciation in the RMB.

FX Update

- The AUD has performed well over the last week, thanks to a weaker USD and a strong performance by the metals complex.
- We think USD0.7550 or thereabouts will likely cap AUD strength in the short term, although the near term risk to this view is a stronger than expected domestic employment outcome (released on Thursday).
- Those clients who are sympathetic to the view that the AUD will not make sustained gains from current levels should look to enter an enhanced put spread with a one-month expiry.

Interest Rate Update

- Australian swap yields have fallen over the last few weeks, largely driven by a rally in the US Treasury market.
- We think the recent decline in Australian interest rates offers a good opportunity for clients to protect against a rise in yields.
- At current levels, paying fixed 3-year swap or purchasing a collar or cap on shorter-dated swaps appear to be appropriate strategies.

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Labour market and CPI data, both released in January, will be important for the policy outlook this year.

The month of January will see the release of economic data potentially important to the Australian economic and monetary policy outlook. Labour market and inflation results will be the focus for markets. They will also be critical when policymakers determine the appropriate stance of monetary policy on 7 February at the first RBA board meeting of the year. With the economy running at a high rate of capacity usage, and despite recent strength in investment intentions, it is unlikely the RBA will tolerate a further decline in unemployment that threatens the wage and inflation outlook.

We think the domestic economy is probably growing at around 3% per annum at present. Unless the underlying momentum in economic activity slows below 3% and wages pressures stablise at or below a 4% annual rate, the prospect is for a further tightening of monetary policy by the middle of the year.

Next week's labour force outcome will be an important update on labour market conditions. The market expects a small rise of 10k.

Next week the ABS will release the December Labour force report which will provide an important update on labour market conditions. Employment growth has all but stalled since the middle of 2005 after an extremely strong period in 2004/05. Despite softer monthly outcomes the unemployment rate remains just 0.1 percentage point off 30-year lows of 5%. Continued weakness in employment growth will take pressure of an otherwise very tight labour market. ANZ expects a further small decline in employment of 10,000 in December, which will go along way to keeping the RBA on the sidelines. However, the consensus is more like +10,000. All-important will be the unemployment rate. Any dip back to the cyclical low of 5% will concern markets and policy makers alike.

Later in the month the ABS release the quarterly inflation data. First up will be the PPI report on Monday 23 January. Pipeline price pressures remain elevated and have been putting considerable pressure on profit margins in 2005. More important will be the December quarter CPI which is due on Wednesday 25 January. Headline inflation should remain at the top of the RBA target band despite a small decline in petrol prices in the quarter.

The key will be the various measures of core inflation. Using the average of the RBA's trimmed mean and weighted median measure, core inflation was running in the middle of the target band in the year to September with quarterly results of around 0.6% over the past year. Any pick-up in these measures toward 0.8% or 0.9% will be a concern for the RBA.

Any rise in core inflation in Q4 will mean that the real cash rate has fallen. We do not think this is especially appropriate, particularly with wages growth of 4% and a pick-up in housing sector activity.

From a policy perspective, the current short-term interest rate is generally regarded as being neutral to economic activity. A cash rate of 5.5% with inflation at 2.5% gives an approximate real rate of 3%. The RBA has stated that a neutral real rate is somewhere between 3% and 3.5% over the long run. If core inflation rises to 3% and the cash rate remains at 5.5%, the real interest rate will fall to 2.5%. This is unambiguously on the accommodative side of neutral.

With the latest housing finance and building approvals data suggesting a pick-up in housing activity over the last three or four months of 2005, it is our view that monetary policy should not be set to a accommodative stance. Indeed, with wages growth above 4% the issue could well be whether monetary policy should be set to a restrictive setting. All this suggests that the risks to monetary policy remain firmly skewed towards further tightening in 2006.

More changes to the RMB trading regime allow for greater volatility

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This week, the People's Bank of China issued a statement that initiated a number of changes in the foreign exchange market. News headlines drew attention to that fact that over the counter trading had commenced, whereas previously the State Administration for Foreign Exchange (SAFE) was the only possible counterparty for foreign exchange transactions in China.

The PBoC has introduced a new procedure for establishing cental parity in the USD/CNY exchange rate.

However, the most important part of last week's announcement concerned the fixing of the central parity for the exchange rate. Since the 21 July revaluation, central parity has been established by an end-of-day fixing rate for the USD/CNY– announced by SAFE – which then becomes central parity for the exchange rate on the following day. The USD/CNY rate is not allowed to deviate more than +/-0.3% from central parity in intra-day trading, and all other exchange rates stay within a band of +/-3.0%.

According to the announcement, there is now a new procedure for establishing central parity.

Central parity is now announced at 9:15 am on the day of trading and is determined by CFETS (China Foreign Exchange Trading System) as the weighted average of quotes given to CFETS by market makers from 9:00 am on that trading day (excluding highest and lowest offers).

Theoretically, this change means that the exchange rate now has the potential for unlimited fluctuation from one day to the next. For example, there is now no formal restriction to keep the rate from closing today at USD/CNY8.06 and opening tomorrow at USD/CNY7.8. Previously, the fact that the central parity was fixed according to the previous day's trading prevented this from happening.

Recent changes to the RMB trading regime opens the way for more RMB volatility and a more rapid pace of appreciation in the RMB, in our view.

In practice, it seems logical to assume that the authorities will continue to maintain stability in the exchange rate and prevent rapid movements day to day. Nonetheless, it is an important change that opens up the way for greater foreign exchange volatility in the future.

In addition, given the recent weakness in the US dollar, there is now the possibility for a more rapid pace of appreciation of the RMB in the coming weeks. Our currency forecast calls for an end of January rate of USD/CNY8.04 and an end of March rate of USD/CNY7.99.

Finally, the PBOC release explicitly stated that cross rates between the CNY and the yen, euro and Hong Kong dollar are determined by the market according to the rate of exchange for these currencies against the USD. This confirms our long-held view that the reference basket of currencies that was announced as part of the 21 July 2005 reform has a negligible impact on the day-to-day management of the exchange rate.

GDP growth in China looks to have been revised upwards in 2005.

Away from the currency news, the National Development and Reform Commission said it believes GDP growth reached 9.8% last year, considerably higher than the 9.5% growth previously announced for the first three quarters. If confirmed by the statistics office, this figure implies either that growth was 11% YOY in the fourth quarter (unlikely) or that the authorities could considerably revise growth rates for at least a few of the previous quarters (more likely). We await further data on the GDP series revision that was announced in December.

FX Update

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Table 1 Foreign Exchange Forecasts

	Current	Mar-06	Jun-06	Sep-06
AUD/USD	0.7476	0.74	0.71	0.69
EUR/USD	1.2112	1.12	1.10	1.15
GBP/USD	1.7561	1.63	1.59	1.65
USD/JPY	115.90	123.00	119.00	115.00
AUD/NZD	1.0892	1.09	1.15	1.19

Source: ANZ Investment Bank and Bloomberg

- **The AUD has performed well over the last week, thanks to a weaker USD and a strong performance by the metals complex.**
- **We think USD0.7550 will likely cap AUD strength in the short term, although the near term risk to this view is a stronger than expected domestic employment outcome (released on Thursday).**
- **Those clients who are sympathetic to the view that the AUD will not make sustained gains from current levels should look to enter an enhanced put spreadwith a one month expiry.**

The AUD has benefited from a weak USD and gains in metal prices.

Broad based USD weakness has been evident this week. The release of minutes from the Fed's 13 December meeting triggered the decline. The Fed did not rule out tightening rates further, but did imply the need to raise rates far from current levels is not strongly apparent.

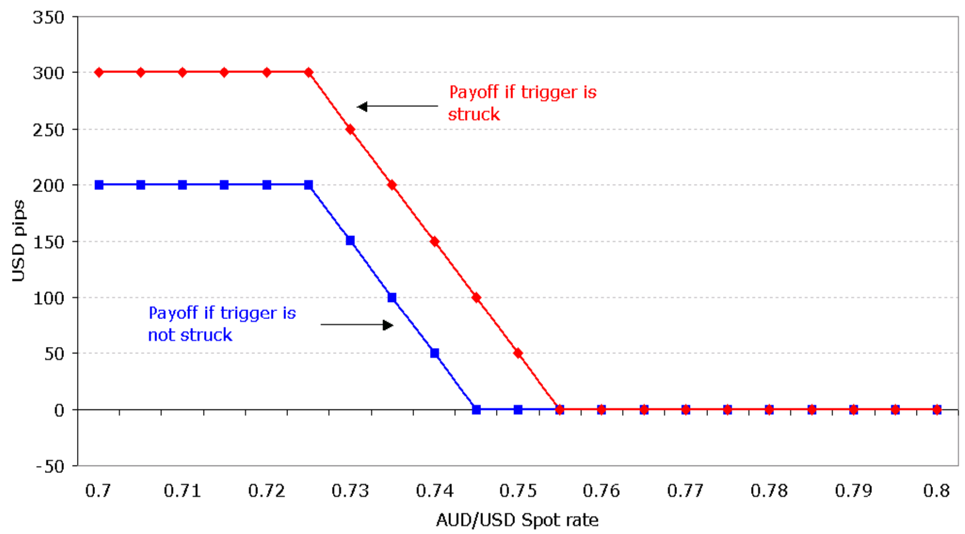
The AUD has performed well amidst the generalised USD weakness. The AUD was up 2% against the USD. The AUD outperformed its $-bloc counterparts this week as well, up 1.6% against the NZD and 2.0% against the CAD. A strong performance by metals for most of this week was the likely source of AUD outperformance.

However, we think short term gains should be capped around USD0.7550/70.

We expect the AUD will struggle to make substantial gains over the following week. Technically the AUD is testing the topside but remains in a bearish trend channel. This trend has been fairly well respected since the AUD/USD peak in March last year. Any break of this trend has seen the AUD extend at most half a US cent (for example, September 2005). So even if resistance is broken, the currency is only likely to trade to USD0.7550/70. We do not forecast a sustained extension above this level.

Investors sympathetic to this view should consider an enhanced put structure on the AUD with 1-month expiry and USD0.7578 trigger.

Figure 1: Payoff diagram – 1 month expiry enhanced put spread with USD0.7578 trigger



Source: ANZ Investment Bank

A positive metals outlook will not be enough in itself for the AUD to make a concerted push above 0.7550. Continued strength in metals, weaker US data

The main risk to our short term AUD view would be a stronger than expected employment outcome on Thursday.

and anticipation of a domestic rate hike are all required for such an extension. Of these drivers, gold remains favourable for the AUD, but we think it is too early to call for a deterioration in US economic data. Domestic interest rate support for the currency will probably require a stronger than expected CPI reading for Q4 (not due until 25 January).

As such, we think gains in the AUD will be capped at around 0.7550. Near term, the main risk to this view would be a stronger than expected domestic employment result (released on Thursday).

This view is consistent with our forecasts for Q1 and the broader direction for the AUD (see Table 1). Investors sympathetic to our near term AUD view should consider an enhanced put spread with a one month expiry. For example, the client pays 78 USD pips to enter a trade which is structured such that the payoff depends upon whether the AUD reaches a trigger level. In this example, the trigger is set at USD0.7578.

Figure 1 shows the two payoff structures. The client benefits in the event that the AUD does not make sustained gains above current levels, but the size of the payoff is dependent upon whether or not the trigger is struck. The worst case scenario is if the AUD makes a sustained rally from current levels. In this instance the trade expires worthless.

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Interest Rate Update

Table 2 Interest Rate Forecasts

	Current	Mar-06	Jun-06	Sep-06
RBA Cash Rate	5.50	5.50	5.75	5.75
90 Day Rate	5.57	5.60	5.90	5.90
3y Bond	5.17	5.50	5.50	5.35
10y Bond	5.19	5.50	5.40	5.25

Source: ANZ Investment Bank and Bloomberg

- **Australian swap yields have fallen over the last few weeks, largely driven by a rally in the US Treasury market.**
- **We think the recent decline in Australian interest rates offers a good opportunity for clients to protect against a rise in yields.**
- **At current levels, paying fixed 3-year swap or purchasing a collar or cap on shorter-dated swaps appear to be appropriate strategies.**

Australian swap yields have rallied in the last few weeks. Events in offshore markets have been the major drivers of the move.

Over the Christmas and New Year period, interest rates continued to fall. The 3-year swap rate is now almost 25bps below its mid December peak, at 5.59%. The 10-year swap rate is currently 27bps below its mid December peak, at 5.68%.

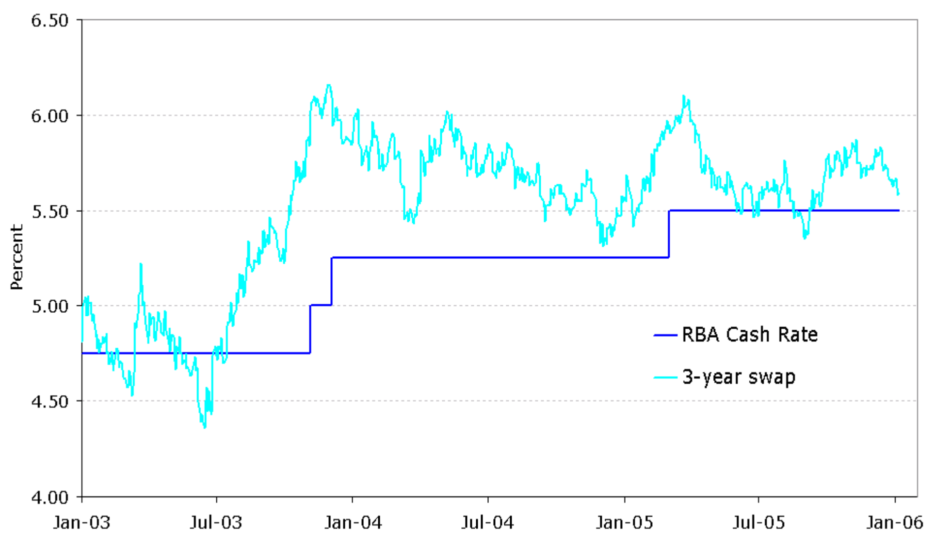
The Christmas and New Year period has been a quiet time for economic data and events in Australia, and as such, the fall in domestic swap rates has largely been driven by events in offshore markets. In particular, the US Treasury market has continued to rally, with the US 10-year note breaking below 4.4%. Some softer than expected data (such as the December ISM Manufacturing survey) and more dovish commentary from the Federal Reserve have been the main drivers of the rally.

We think the recent rally in domestic swap rates provides some good opportunities for investors to protect against a rise in rates, especially at the front-end of the curve. We are of the view that there is a reasonable chance that the RBA may be required to tighten monetary policy as soon as March this year. If so, then front-end swap rates should under-perform as the market anticipates an upward adjustment in the cash rate.

We think the recent move in swap yields presents a good opportunity to protect against a rise in interest rates.

If history is any guide, a 25bp rate rise from the RBA could see the 3-year swap reach at least 6.0%. This is 40bps above the current 3-year swap level, and suggests that clients could benefit by paying fixed swap in the 2- to 3-year part of the curve. Alternatively, clients could look to protect against a rise in rates by purchasing a cap or collar structure on shorter dated swap maturities.

Figure 2: Australian 3-year swap yield and the RBA cash rate



Source: ANZ Investment Bank and Bloomberg

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Data Previews

Monday 9 January: AUS ANZ Job Ads (December)

ANZ: nf, Mkt.: na, Last: 0.4%

ANZ Job Ads (Dec): The ANZ Job Advertisements series has demonstrated a flat trend in the monthly growth rate over the past four months, suggesting that the loss of momentum in the demand for labour may be stabilising.

Monday 9 January: AUS Retail Sales (November)

ANZ: 0.4%, Mkt.: 0.3%, Last: 0.5%

Economic conditions improved in November, with petrol prices falling 6.7% and employment rising by 28,000 jobs. In addition, consumer sentiment surveys showed a rise in consumer confidence in November, and growth in personal credit was solid. Although growth in retail sales has dropped back from the unsustainable levels of 2004, trade is still healthy. Following October's 0.5% monthly increase in retail sales, we are forecasting sales to increase by 0.4% in the month, taking through the year growth to 3.8%.

Tuesday 10 January: AUS Trade Balance (November)

ANZ: -$2.0b, Mkt.: -$1.8b, Last: -$1.3b

The overall trade position remains lacklustre. While the deficit declined to $1.3bn in October, it has not improved since the one off narrowing in April this year on the back of higher contract prices for iron ore and coal. Another disappointing result is expected for November, driven by much higher imports stemming from temporary distortions associated with the recent introduction of the new customs cargo system. ANZ forecasts to trade balance to widen to $2bn in November.

Thursday 12 January: AUS Labour Force (December)

Employment - ANZ: -10k, Mkt.: 9k, Last: 28k

Unemployment Rate - ANZ: 5.2%, Mkt.: 5.1%, Last: 5.1%

Participation Rate - ANZ: 64.3%, Mkt.: 64.4%, Last: 64.4%

Whilst the seasonally adjusted labour market data have been particularly volatile in recent months, the trend data provide a clearer picture. The monthly trend rate of employment growth peaked in December 2004 and has decelerated throughout 2005, with trend growth having in fact stalled since September. We believe this course is set to continue in December's data, and are forecasting a drop of 10,000 in employment in the month. This will take the annual (seasonally adjusted) rate of jobs growth to 2.0%, down from the August peak of 4.2%. With the participation rate anticipated to fall slightly to 64.3%, the unemployment rate is likely to rise to 5.2%.

Data and Event Calendar

Date	Country	Data/Event	ANZ	Mkt.	Last	Time (GMT)
9 Jan	AU	Retail Sales (Nov)	0.4%	0.3%	0.5%	00.30
		ANZ Job Advertisements (Dec)	nf	na	0.4%	00.30
	GE	Current Account (Nov)	nf	€6.8b	na	07.00
	US	**Atlanta Fed President Guynn speaks to Rotary Club of Atlanta**	**-**	**-**	**-**	17.40
		Kansas City Fed's Hoenig speaks on the Economy in Kansas City	**-**	**-**	**-**	18.00
		Consumer Credit (Nov)	nf	$4.8b	-$7.2b	20.00
		UST 5-year note and 10-year TIPS announcement	**-**	**-**	**-**	-
10 Jan	AU	Trade Balance (Nov)	-$2.0b	-$1.8b	-$1.3b	00.30
	JP	Household Spending (Nov)	nf	1.6%	2.0%	05.00
		Finance Minister Tanigaki speaks on the Japanese Economy	**-**	**-**	**-**	**18.00**
	GE	ZEW Survey – Economic Sentiment (Jan)	nf	64.0	na	10.00
		ZEW Survey – Current Situation (Jan)	nf	-38.5	na	10.00
	US	Wholesale Inventories (Nov)	nf	0.4%	0.2%	15.00
	CA	Housing Starts (Dec)	nf	222.5k	220.4k	13.15
		Building Permits (Nov)	nf	-1.2%	1.2%	13.30
11 Jan	AU	WBC Consumer Confidence (Jan)	nf	na	104.7	23.30
		Job Vacancies (Nov)	nf	0.7%	-3.9%	00.30
	JP	Leading Economic Index (Nov P)	nf	60.0%	81.8%	05.00
		Coincident Index (Nov P)	nf	66.7%	90.0%	05.00
	UK	Nationwide Consumer Confidence (Dec)	nf	na	101	00.01
		Bank of England MPC meets	**-**	**-**	**-**	**-**
		Trade Balance (Nov)	nf	-GBP5.0b	-GBP4.6b	09.30
	US	**UST 5-year note auction**	**-**	**-**	**-**	**-**
12 Jan	AU	MI Consumer Inflationary Expectations (Jan)	nf	na	4.6%	00.00
		Employment (Dec)	-10k	9k	28k	00.30
		Unemployment Rate (Dec)	5.2%	5.1%	5.1%	00.30
		Participation Rate (Dec)	64.3%	64.4%	64.4%	00.30
	EU	Euro-zone GDP (Q3 P)	nf	0.6%	na	10.00
		ECB rate announcement	**2.25%**	**2.25%**	**2.25%**	12.45
	UK	Industrial Production (Nov)	nf	0.7%	-1.0%	09.30
		Manufacturing Production (Nov)	nf	-1.6%	-0.9%	09.30
		BoE rate announcement	**4.5%**	**4.5%**	**4.5%**	12.00
	US	Trade Balance (Nov)	nf	-$65.9b	-$68.9b	13.30
		Import Price Index (Dec)	nf	0.3%	-1.7%	13.30
		Jobless Claims (weekly)	nf	328k	291k	13.30
		UST 10-year TIPS auction	**-**	**-**	**-**	-
	CA	Merchandise Trade (Nov)	nf	na	$7.2b	13.30

Continued over page

Date	Country	Data/Event	ANZ	Mkt.	Last	Time (GMT)
12 Jan cont.	CA	**BoC Deputy Governor Kennedy speaks on Canada's Monetary Policy Framework**	-	-	-	18.00
13 Jan	NZ	Building Permits (Nov)	nf	na	-6.7%	21.45
	JP	Machine Orders (Nov)	nf	5.4%	4.8%	05.00
	UK	Coincident Indicator Index (Nov)	nf	na	0.0%	15.30
		Leading Indicator Index (Nov)	nf	na	-0.3%	15.30
	US	PPI (Dec)	nf	0.4%	-0.7%	13.30
		- ex food and energy	nf	0.2%	0.1%	13.30
		Retail Sales (Dec)	nf	0.8%	0.3%	13.30
		- ex autos	nf	0.4%	-0.3%	13.30
		Business Inventories	nf	0.4%	0.3%	15.00
		Fed Governor Fisher speaks in San Antonio	-	-	-	18.00
	CA	New Motor Vehicle Sales (Nov)	nf	3.0%	3.3%	13.30

Local Time. All $ values in local currency unit. Na = not available, nf = no ANZ forecasts. Survey sources: Dow Jones, Reuters, Bloomberg (note: all surveys are preliminary and subject to change).

Foreign Exchange Forecasts						
AUD-NZ Rates	**Current**	**Mar-06**	**Jun-06**	**Sep-06**	**Dec-06**	**Mar-07**
AUD/USD	0.75	0.74	0.71	0.69	0.68	0.67
NZD/USD	0.69	0.68	0.62	0.58	0.60	0.58
AUD/JPY	86.78	91.02	84.49	79.35	75.48	77.05
AUD/EUR	0.62	0.66	0.65	0.60	0.57	0.55
AUD/GBP	0.43	0.45	0.45	0.42	0.40	0.39
AUD/NZD	1.09	1.09	1.15	1.19	1.13	1.17
AUD/CAD	0.87	0.87	0.85	0.86	0.84	0.84
AUD/CHF	0.95	1.01	0.98	0.92	0.86	0.84
AUD TWI	64.5	61.7	59.2	56.9	55.0	54.4
International FX Crosses						
USD/JPY	116.19	123.00	119.00	115.00	111.00	115.00
EUR/USD	1.21	1.12	1.10	1.15	1.20	1.22
EUR/JPY	140.47	137.15	130.90	132.25	133.20	140.30
GBP/USD	1.75	1.63	1.59	1.65	1.69	1.74
EUR/GBP	0.69	0.68	0.69	0.70	0.71	0.70
USD/CAD	1.16	1.17	1.20	1.24	1.23	1.26
USD/CHF	1.28	1.37	1.38	1.33	1.27	1.26
USD Index	89.46	88.68	89.52	87.99	85.54	86.01
Asia FX Rates						
USD/CNY	8.07	7.97	7.91	7.84	7.78	7.77
USD/HKD	7.75	7.77	7.79	7.78	7.78	7.77
USD/IDR	9595	9748	9665	9583	9500	9548
USD/INR	44.73	46.00	43.00	42.50	42.00	42.14
USD/KRW	993	1025	1040	1050	1030	1028
USD/MYR	3.76	3.72	3.71	3.69	3.68	3.64
USD/PHP	52.71	56.00	55.50	55.00	54.50	55.13
USD/SGD	1.65	1.73	1.70	1.68	1.67	1.66
USD/THB	40.25	43.00	42.50	42.00	41.50	41.38
USD/TWD	32.21	33.38	33.94	34.50	33.00	32.73
USD/VND	15908	16175	16250	16325	16400	16655
Pacific FX Rates						
PGK/USD	0.33	0.321	0.320	0.320	0.315	0.317
FJD/USD	0.58	0.569	0.551	0.542	0.546	0.539
Interest Rate Forecasts						
Australia						
RBA cash rate	5.50	5.50	5.75	5.75	5.75	5.75
90 day bill	5.63	5.60	5.90	5.90	5.80	5.80
3 year bond	5.17	5.50	5.50	5.35	5.40	5.45
10 year bond	5.19	5.50	5.40	5.25	5.30	5.40
3s10s yield curve	0.01	0.00	-0.10	-0.10	-0.10	-0.05
3 year swap	5.60	5.90	5.90	5.75	5.85	5.90
10 year swap	5.68	5.95	5.85	5.70	5.80	5.90
New Zealand						
RBNZ cash rate	7.25	7.25	7.25	7.00	6.50	6.00
90 day bill	7.66	7.40	7.40	7.07	6.57	6.15
United States						
Fed funds rate	4.25	4.50	4.50	4.50	4.50	4.25
2 year note	4.32	4.50	4.30	4.15	4.00	3.95
10 year note	4.36	4.50	4.50	4.40	4.30	4.25
International						
Japan call rate	0.15	0.00	0.00	0.00	0.25	0.25
ECB refinance rate	2.25	2.50	2.50	2.50	2.50	2.50
UK repo rate	4.50	4.50	4.50	4.50	4.50	4.50

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