

We have revised our RBA view - low point now 2.5%

We have revised our forecast for the employment profile and accordingly slightly adjusted our interest rate view. While we still expect that the RBA will keep rates on hold through 2010 we no longer expect that 2% will be the low point in the cycle for the cash rate. We have raised that low point to 2.5%, now expecting the RBA to limit its rate cuts to 2 x 25 bp's cuts over the course of the remainder of 2009. These cuts are likely to be spaced with 2/3 month gaps.

Reasons for these changes are:

1. We now expect that the point beyond which the unemployment rate will stop rising quickly will be much earlier in 2010 than previously expected. That is because our lead indicators of employment growth have bottomed out 3–6 months earlier than originally expected (detailed research report to follow). Previously, we expected that the unemployment rate could be rising by around 1 ppt in the first half of 2010 whereas we now expect that the increase will be limited to around 0.5% with minimal increase in the second half of 2010. We have lowered the expected peak in the unemployment rate to 8.1% compared to 8.6% previously.

The period of sharpest increase in the unemployment rate (around 2 ppt's) will be concentrated in the second half of 2009 and it will be at that time that we expect the Bank will recognise the need to restore some confidence with some further monetary easing. If it decides not to move around that time then it is very unlikely that it would move later in the month.

We expect that pressure on the Bank to cut more extensively in the earlier months of 2009 was resisted since the Bank planned to retain some flexibility to be seen to be acting when the unemployment rate is rising quickly. That period is likely to be centred around the second half of 2009.

With unemployment not increasing as rapidly through 2010 as previously expected, the risk of an earlier than previously expected beginning to the rate hike cycle has increased but on balance we expect that other factors including continuing weak global economic conditions and sluggish domestic spending (growth rate in 2010 expected to be 1%) will contain the need to raise rates. While not increasing the unemployment rate will be hovering around 8%; business investment will still be contracting and the output gap will therefore remain wide allowing plenty of scope for an acceleration in growth in 2011 to be required just to close the output gap let alone pressure inflation.

We would only see the unemployment rate remaining around that 8% level in the first half of 2011.

2. We had expected that, given the muted response by the banks to the RBA's 0.25% rate cut in April, (only passed on 10 bp's to variable mortgage rates) the RBA may have decided that traction could only be achieved by a larger rate cut. We had pencilled in a 50 bp cut around September. However, the strong response of finance approvals to the rate cuts (up 30%) and some precautionary comments from the Governor in a recent speech warning against excesses in the First Home Buyer segment (an extraordinary 70% of the growth in finance approvals) makes it likely that the urgency to further stimulate the housing markets has passed for now.

The concern is that whereas the overall response of approvals to the rate cuts has been stronger than in previous rate cut cycles (hardly surprising given the extent of the cuts) the larger more stable components – Upgraders and investors – have lagged in this cycle. It has been largely driven, at this stage, by FHB's who are likely to be dropping off as prices in their price brackets rise and the increased Grant is phased out from September.

Our recent survey showed that those respondents in higher age brackets and higher incomes remain deeply concerned about the outlook for house prices which may constrain their preparedness to participate in the housing recovery.

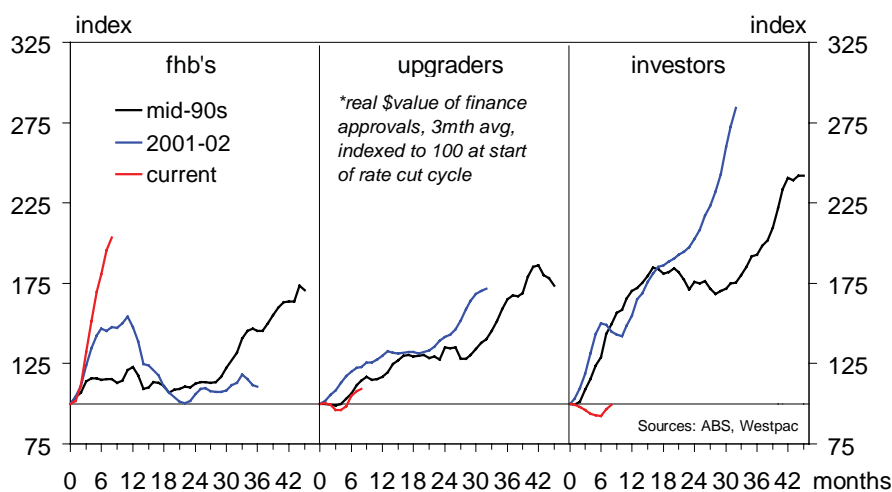
Not so for business. The RBA should be worried about the expected sharp contraction in business investment as the credit crisis and excess capacity weigh on investment plans.

In a recent report, the RBA points out that small business borrowing rates have been reduced by 230 bp's compared to 385 bp's for standard variable mortgage rates. Further, given that the markets have not priced in future rate cuts, any rate cut from the RBA would be largely priced into the bank bill rate. That would immediately help variable rate business borrowers and lower the funding costs of banks where wholesale funding costs and some retail deposit rates are directly linked to the bank bill rate or the cash rate.

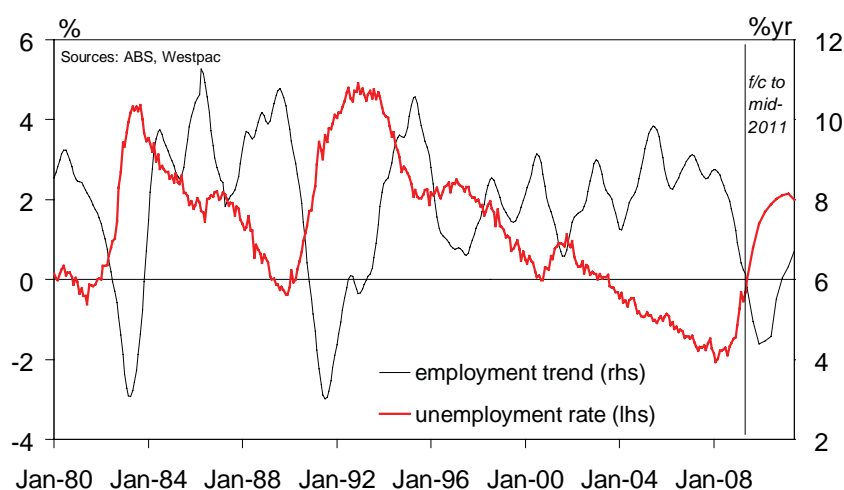
3. We expect that the pace of consumer spending will slow to a trickle in the second half of 2009. The fading of the fiscal stimulus package; a contraction in labour incomes as unemployment rises and hours worked contracts; and reduction in consumer confidence (as the unemployment rate rises) will all weigh heavily on consumer spending. Concerns with the tractability of the recovery which to date has been supported by the fiscal stimulus and record rate cuts may also result in further rate cuts.

Bill Evans, Chief Economist

Housing finance upturns: comparison



Employment growth & unemployment rate



Interest rate forecasts

| | Latest (Jun 25) | Sep 09 | Dec 09 | Mar 10 | Jun 10 | Sep 10 |
|----------------------------|-----------------|--------|--------|--------|--------|--------|
| Cash | 3.00 | 2.75 | 2.50 | 2.50 | 2.50 | 2.50 |
| 90 Day Bill | 3.24 | 3.00 | 2.75 | 2.75 | 2.75 | 2.75 |
| 3 Year Swap | 4.96 | 4.50 | 4.25 | 4.25 | 4.50 | 5.00 |
| 10 Year Bond | 5.65 | 5.00 | 4.75 | 5.00 | 5.50 | 5.75 |
| 10 Year Spread to US (bps) | 195 | 150 | 150 | 125 | 125 | 100 |

International

| | | | | | | |
|-----------------|-------|-------|-------|-------|-------|-------|
| Fed Funds | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 |
| US 10 Year Bond | 3.70 | 3.50 | 3.25 | 3.75 | 4.25 | 4.75 |
| ECB Repo Rate | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |