



Wednesday 6 June 2007

Interest rate forecasts

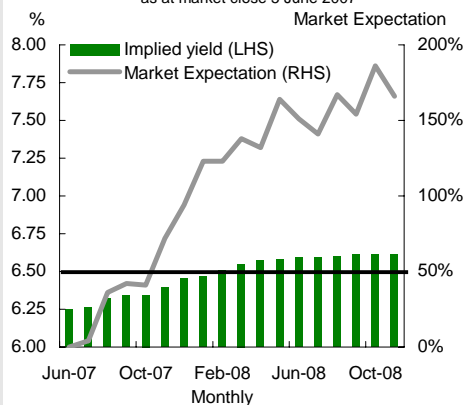
(% pa; end period)	6 Jun 07	3 mths	6 mths
Cash	6.25	6.25	6.25
90 day bills	6.36	6.50	6.50
10-year bonds	6.12	6.00	6.00
Variable mortgage rate*	8.05	8.05	8.05
3-year fixed mortgage*	7.50	7.50	7.50
Prime rate#	10.22-10.60	10.3-10.6	10.3-10.6

* Average of lenders # Four major banks

Source: Reuters, Cannex, June 2007

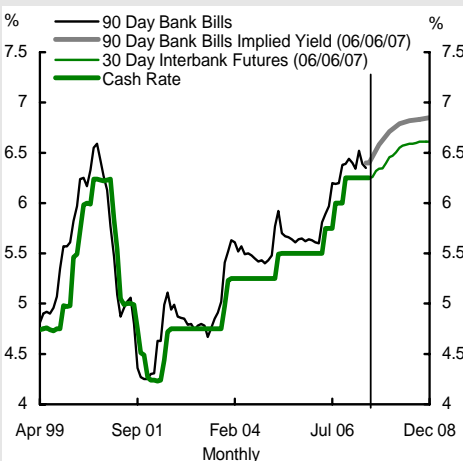
A rate hike was not expected until late 2007/early 2008

SFE 30 day interbank cash futures implied yield curve and mkt expectations of a 25bp increase in the cash rate as at market close 5 June 2007



Source: SFE, June 2007

But markets are becoming increasingly nervous on the back of strong data



Source: Datastream, Reuters, June 2007

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June interest rate outlook

Event

- The Reserve Bank of Australia (RBA) announced no change to monetary policy settings following its June Board Meeting.

Impact

- After revising down its forecast for underlying inflation in its May Statement on Monetary Policy, the RBA decided to leave the cash rate unchanged at 6.25% at its June Board meeting. While strong GDP growth has increased the chances that the RBA will be forced to tighten policy further in 2007, we still think this is more likely to occur around the end of the year.

Analysis – It’s more a question of when?

- In its May Statement on Monetary Policy, the RBA revised down its underlying inflation forecast from 2.75% to 2.5% for 2007. On the back of falling petrol prices and fruit prices, the headline inflation rate is forecast to dip to as low as 1.75% by mid-2007 and then rise to 2.25% by year end. This underpins the RBA’s decision not to raise rates in June and also the initial perception that the RBA would not raise rates until early 2008.
- However, data suggesting that GDP growth is rebounding strongly has fuelled speculation that the RBA may be forced to come back into play much sooner than had been anticipated. On the back of the March quarter GDP data, the 90-day bank bill futures suggest that the market is now contemplating two rate hikes by 1Q08.
- However, overshadowed by the overwhelming strength of GDP growth, the consumption deflator (a measure of inflation) is running at a low 2.2%YoY. This suggests that the RBA hasn’t fallen behind the curve, and is the main impediment preventing the RBA from tightening policy in the near future.
- However, with fiscal stimulus about to start hitting the economy, hopes that the rural sector will rebound in the second half of 2007 and resource exports likely to pick up pace, the risks are clearly skewed to growth becoming even faster. And therefore, the medium-term (i.e. 2008) inflation outlook may once again breach the RBA’s inflation comfort zone.
- With domestic demand very strong, capacity utilisation stretched, labour scarce, and little evidence to suggest that the 2006 rate hikes adversely affected the economy, some analysts might conclude that its not so much a question of “will they or wont they” but more a question of ‘when’ a tightening will take place.
- For this reason, markets will closely scrutinise RBA Governor Stevens’ comments on economic conditions and prospects on the 14th of June to get an idea of how the RBA is likely to respond to the very strong economic backdrop.
- We suspect that the RBA will reiterate the strength in the Australian economy and as such retain a firm tightening bias. However, they are unlikely to act on this bias until they receive more evidence that strong domestic demand is set to put upward pressure on prices.



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