Westpac
InstitutionalBank

Westpac Market Insights

Australia, G3 and New Zealand

September 2009

Contents

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Internet: www.westpac.com.au
Email: economics@westpac.com.au

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Executive summary

Global activity data has surprised on the upside in late Q2 and early Q3. Equity markets and other growth assets have seen strong price growth in the year to date and leading indicators are pointing north. Has the IMF's Great Recession ended already? No it hasn't: what we are experiencing is no more than the intersection of inventory adjustment on the one hand and policy stimulus on the other. We explore this hypothesis in the **Hot Topics** section. Central banks seem divided on the issue of growth sustainability, with the more optimistic among them looking for the right moment to unwind 'emergency' policy settings. The more pessimistic group continue to fret about the state of financial system balance sheets and post-stimulus letdown.

Australia: The economy expanded by 0.6% in the June quarter, another resilient outcome following the confidence boosting positive growth of the March quarter. Aided by fiscal stimulus measures, both household and business spending held up well in Q2, while exports remain resilient. Near-term risks from the withdrawal of the cash element of fiscal stimulus are real, but we are becoming more confident that 2010 will see both an improved rate of growth, and an improvement in its composition.

New Zealand: Consistent with the global trend, business confidence surged again in August, with general conditions at the highest level since May 1999 and own-activity expectations at their highest since March 2005. Milk prices have been improving rapidly and house sales are on a pronounced recovery arc. The RBNZ is nervous that the currency may temper the revival to an excessive degree. Our opinion is that this risk is overblown.

United States: The US economy is expected to expand in Q3, the first time the economy has grown since June 2008. However, we have no real confidence in the resilience of underlying demand. Household incomes remain under stress as labour and property income declines while credit conditions remains restrictive even if the reality of households' requirement to de-leverage was not as pressing as it currently is. The most recent data, while continuing the more upbeat tone, do not change our position.

Europe: Activity was stronger than anticipated in the June quarter, with Germany and France recording positive growth and the overall region contracting just 0.1%. While there are any number of reasons to be gloomy about Europe's medium term prospects, for the moment, inventory adjustment and fiscal stimulus have come together to end the period of maximum contraction. There is still plenty of bad news to come from the real economy (and from bank balance sheets) but the worst appears to have passed.

Japan: The Democratic Party of Japan (DPJ) have won an historic landslide victory in the lower house elections ending the Liberal Democratic Party's (LDP) half century long near-monopoly on power. In contrast to the Indian and Indonesian elections earlier this year, where the market applauded strong mandates being handed to incumbents, the market decided that change is more positive for Japan than continuity.

China: Rumours and hearsay continue to dominate market thinking inside and outside China. Since we last went to press the equity market has come under considerable stress, losing 26% from its early August peak. The main thrust of our argument has been that while it was natural for the prudential authorities to be voicing concerns regarding the pace of lending growth, this was a very different thing to the monetary authorities expressing misgivings about the overall policy stance. Those fretting excessively about the pace of second half loan growth were presumably also sitting in a bunker on top of a mound of baked bean tins at midnight on December 30, 1999.

Asia: The region beat forecasters' expectations for June quarter GDP almost right across the board, in an echo of the ill–starred resilience exhibited in the June quarter of 2008. While we do not think there is another crisis of historical magnitude just around the corner, we are nonetheless cautious about getting carried away with this apparently sturdy update on regional momentum.

Summary of world GDP growth

Real GDP %ann	2004	2005	2006	2007	2008	2009f	2010f
United States	3.6	2.9	2.8	2.1	0.4	–2.8	1.4
China	10.1	10.4	11.6	13.0	9.0	8.5	9.4
Japan	2.7	1.9	2.4	2.2	–1.0	–5.8	1.8
East Asia ex –China	6.0	5.1	5.6	5.9	5.0	–0.8	4.7
Europe	1.9	1.8	3.1	2.7	0.6	–4.1	0.2
Emerging ex–East Asia	6.6	6.1	6.7	6.7	5.9	–0.5	2.8
Australia	3.9	2.8	2.7	4.0	2.4	0.7	2.5
New Zealand	4.5	2.7	1.9	3.2	0.2	–2.1	2.6
World	**4.9**	**4.5**	**5.1**	**5.0**	**3.5**	**–0.7**	**2.4**

Sources: IMF, Westpac Economics. Aggregates weighted at purchasing power parity exchange rates from ICP 2005.

Australian dollar

We see the AUD …

There has been little net movement in the Australian dollar over the month. At the time of our last report AUD/USD was trading around 83.8¢ and as we go to press today it is sitting at around 84¢. At various stages of the month it touched 84½¢ and briefly reached 82¢ on the downside. By the standards of the Australian dollar, particularly over the last twelve months, it has been a very stable month indeed.

… fading into year end …

We are currently expecting a pull back in AUD to around 80¢ before the end of the year. The success of this view will depend on two key developments. The first is the profile of Australian interest rates. The second is the global appetite for risk.

On Australian rates, we expect that the market's super confident stance that the RBA will be raising rates by a total of 50 bps before the end of the year will eventually prove to be a little aggressive (see full commentary overleaf). This expectation is definitely priced into money markets and currency markets seem to have a similar opinion. Thus the current level of the exchange rate is vulnerable to any revision of that view.

… as yields fall modestly …

We will not have long to wait to see whether this delay is likely. The market's current assessment of the Australian economy, from which they deduce their rate hikes, is that the momentum that has built up in confidence and spending is sustainable. That assumes that activity will be resilient to the wind down in tax incentives and direct cash transfers that were central to the growth performance in the first half of the year.

… on a delayed RBA hike.

The major test of this assumption will be the July and August retail sales figures, both of which will be released before the next Board meeting. Other challenges may come from the Westpac–MI Consumer Sentiment Index, which has faithfully reflected the updraft in aggregate confidence. It will be released on September 9. The August employment report is due on September 11. We are expecting negative headline outcomes on all four of these updates, potentially cooling the RBA's current enthusiasm for higher rates.

As ever …

Another theme which we expect is even more important for the near term outlook for the AUD will be whether global investors moderate their appetite for risk. Last week we had a flavour of the impact of a reversal in global risk appetite. The Dow Jones Industrial index lost 186 points in a single session, with financial stocks trading particularly poorly. The Australian dollar fell 2¢ in sympathy to 82½¢. In contrast, the stronger than expected Australian Q2 GDP outcome was only able to elicit a ¾¢ upward move in the currency. It seems very likely that all the good news stories out of Australia (and the region) are now very well owned by the investor community, which raises the bar in terms of the magnitude of positive surprises that are required to generate further appreciation. On the other hand, the currency is vulnerable to retracement if cracks appear in the equity market edifice.

… the state of investor risk appetite …

The Dow has strung together four consecutive days of losses for the first time since May; the Shanghai composite index has lost around 20% from its recent peak; the VIX index is up 10%; US long bond yields shed 15bps; and gold is up 5%. Each of these developments could be individually unnerving for the 'risk seekers'. If these stories continue to accumulate, there is potential for a material rebalancing of investment appetite away from risk assets. However, with the northern hemisphere summer drawing to an end, equity markets will be wary of large shifts in risk appetite as the $US2 trillion of 'uninvested' funds decides whether to chase the market.

… will have much to say …

Our basic view is that a correction in global share markets to a valuation level that more adequately captures the underlying pace of recovery would set a base for a strong upcycle in the Australian dollar in 2010. Australia will still be the first major market to raise rates even if there is a delay to February. Steady upward movement through the 80¢ range remains our call for 2010. Global risk appetite should be able to recover from the short term set back we foresee over the remainder of 2009.

… about trading in the Aussie.

The difficulty with communicating this view is that markets are herding creatures unsuited to pricing the complexities of the current environment. As we argue on page 12, the intersection of inventory adjustment and fiscal stimulus will be with us for a little while. The market seems fixated on the movements in high frequency data, while ignoring the slow moving pace of financial balance sheet deterioration. When the former begins to flag, as it will, the reminder of the latter reality will be an uncomfortable jolt for market psychology.

Bill Evans, Chief Economist

Australian dollar

Chart 1.

AUD/USD & AUD/JPY

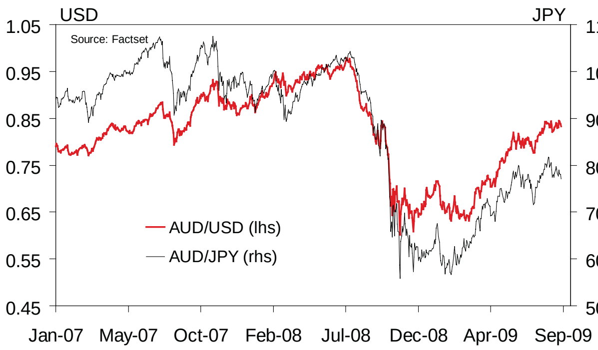


Chart 2.

AUD/EUR & AUD/NZD

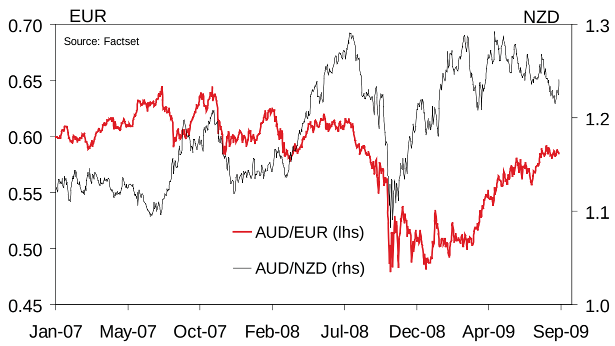


Chart 3.

The AUD & Chinese equities

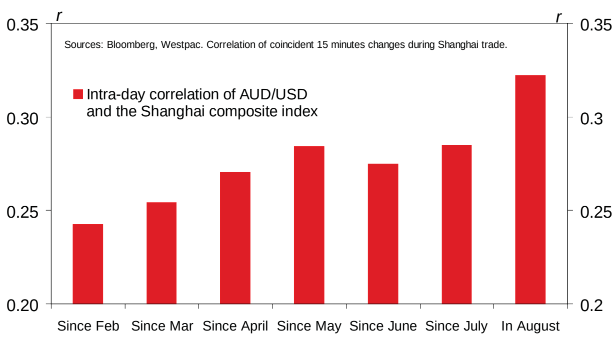


Chart 4.

Australian commodity price forecasts

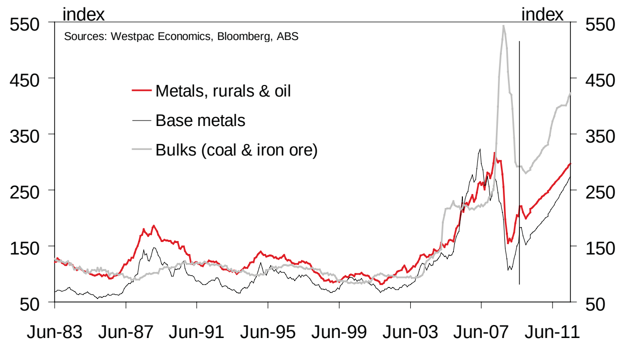


Chart 5.

The Australian dollar: actual versus fitted

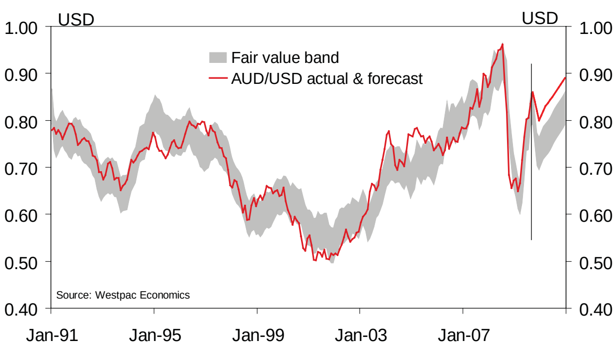
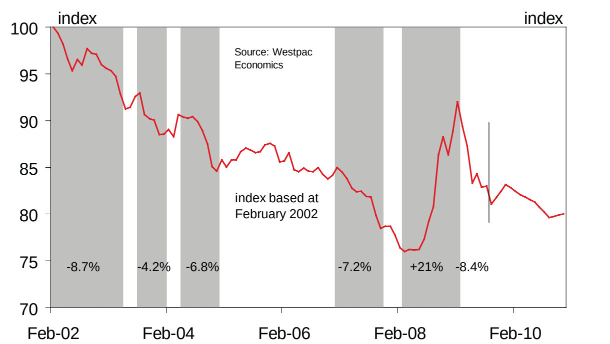


Chart 6.

Broad nominal USD trade weighted index



Australian interest rates

Firmer activity data ...

Following the stronger than expected GDP growth print for the June quarter, the market is confident that the RBA will have raised its cash rate by 50bps by year's end. That expectation includes a near 50% probability of a 25bp tightening in October. Overall the cash rate is expected to be 125 to 150bps higher by June next year. We think that the rise by mid next year will be more like 50 to 75bps with the first move not eventuating until February. However, we know that the RBA assesses that the current "emergency" level of rates as inappropriate. Rate increases will only be averted in 2009 if the data over the course of the year indicates that the economy has slowed markedly as the fiscal handouts are phased out.

... has the market pricing hikes ...

When the Bank does start to move we assess that the first 100bps of rate hikes will be relatively comfortably absorbed by the economy, consistent with the emergency designation. However, with the variable mortgage rate starting at around 5.25%, increases beyond 6.25% are likely to generate sharp responses in confidence and spending. That is why we expect the cycle to be measured; we see rates up by around 100bps by the end of 2010 on the way to a peak around 5½% to 6% - well below the extremely restrictive 7¼% peak in the last cycle.

... of 50bps by December.

Every Reserve Bank Board meeting from now on carries the real risk that the Bank will begin its tightening cycle. Between the September and October meetings the Board will receive an extensive range of domestic data - two reads on retail sales; two reads on building approvals; business and consumer confidence; two reads on job ads; official employment figures; new home sales; housing finance and the other monthly data series.

An imminent hike is possible ...

Perhaps the major question that the Bank would like to clarify is how resilient will retail sales be to the cessation of the government's transfer payments and the contraction of labour incomes? Note that the June retail sales report showed a 1.4% fall following two very strong readings in April and May. Is the June report signalling an emerging downtrend in consumer spending? Or is it just a correction to the excessive strength in April and May. The July and August retail sales reports will help settle that uncertainty. Our view is that retail sales will fall in both July and August, although the size of these declines will be muted by the drawdown of saved cash handouts from Q2 (see analysis on page 10).

... but we feel February ...

The next updates of business and consumer confidence will be important. Recall that the increase in the Westpac-MI Consumer Sentiment Index over the last three months is the strongest on record. Obviously the rate of change is unsustainable – but what about the level? It seems extraordinary that, for instance, the "5 year outlook" component in the Index is at the highest level ever. With the huge uncertainty enveloping the global economy it seems bizarre that the 5 year outlook could be so strong. Indeed, the expectations component of the Index is near a record high. Certainly it is much higher than the current conditions index. With Consumer and Business Confidence moving so closely together a solid correction to the former would be important information for the timing of the rate hike decision. Recall that the August Board Minutes referred to the risk of tightening too early and choking off confidence and spending before it had gathered sufficient momentum.

... is the most likely ...

More information on the leading indicators for jobs growth will also inform the discussion. We are forecasting actual job losses of 100,000 through the end of this year. Speculation has been that the Bank will be prepared to raise rates even though the unemployment rate is still rising. That is reasonable since by definition jobs growth will need to recover to the growth pace of the increase in the labour force to lower the unemployment rate. With the participation rate not falling due to the normal "discouraged worker effect" (possibly because older workers are staying in the work force in response to the deterioration in their wealth) and the 2% increase in the population (double a few years ago) the employment growth rate needed to bring the unemployment rate down is unlikely to be reached until 2011. That would be way too late for the currently edgy Reserve Bank.

... jumping off point.

A sterner test is whether the Bank would be prepared to raise rates while employment was actually contracting. Trend employment growth has only just moved into negative territory (–0.1% annual and –0.3% quarterly annualised) and we expect jobs to actually fall for the remainder of this year. We expect a 30,000 loss of jobs in August alone. The Treasurer has also referred to the possibility of the banks raising mortgage rates independently of any moves by the RBA. Such action might eliminate the need for the RBA to move while at the same time avoiding increases in business rates.

Bill Evans, Chief Economist

Australian interest rates

Chart 1.

Australian interest rates

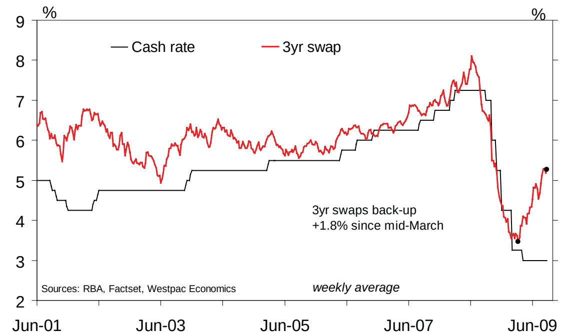


Chart 2.

Australian 3yr swap: spread to cash

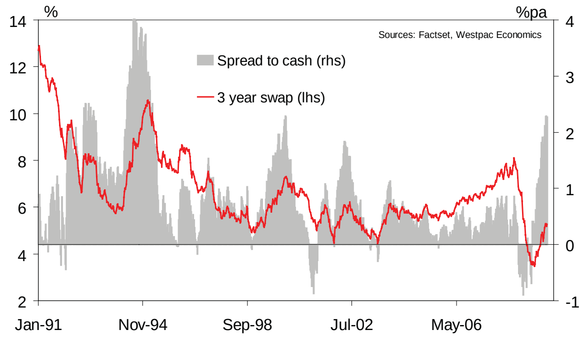


Chart 3.

Australia US 10 yr spread

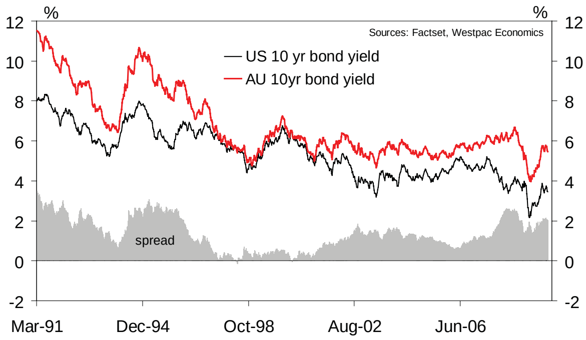


Chart 4.

A return of confidence

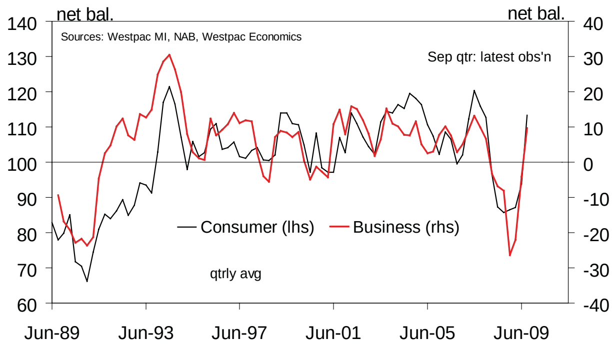


Chart 5.

Business conditions rebound

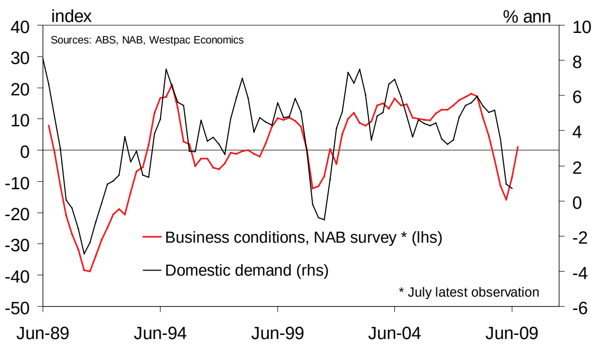
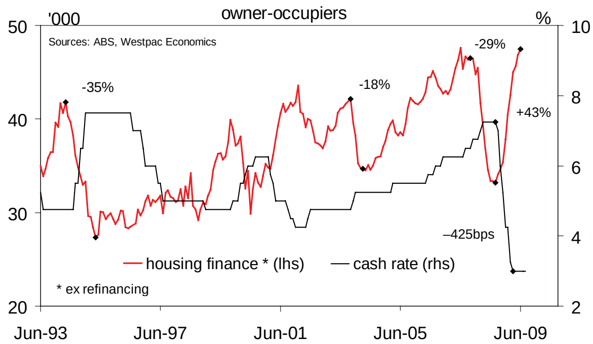


Chart 6.

Housing finance at historic high



Australia: strengthening prospects for 2010

A resilient start to 2009 ...

The Australian economy's performance over the first half of this year has exceeded expectations. Despite an air of pessimism at the start of the year, consumer and business spending has responded to the very sizeable policy stimulus. While this is reassuring it does raise the question how will activity fare as the stimulus is wound back? In the very near-term, the economy is likely to hit an air pocket. Beyond that, our analysis points to an upward trajectory and the real prospect of above trend growth over the second half of next year. We have upgraded our 2010 GDP growth forecast to 2.5% year average (up from 1.8%) and expect 3.8% growth through the year.

... via public support for private spending.

The starting point is more favourable than anticipated, with GDP increasing by 0.4% in the March quarter and by 0.6% in the June quarter, a healthy rebound from a 0.7% contraction in the final quarter of 2008. The story behind this strength is now well understood. Exports have defied the global downturn, boosted by a rebound in farm output and the resurgence of China, while private demand has rebounded. Net exports added a startling 2.2ppts to growth in the March quarter. In addition, private demand bounced in the June quarter, rising 0.8% after the –1.3% of the March quarter.

Once stimulus wanes ...

Consumer spending rose 1.3% over the first half of this year, after stalling through much of 2008. There has been a speedy return of confidence with consumers feeling more secure in their jobs. Significantly, firms have opted to reduce hours worked rather than making widespread retrenchments. Also, while the global downturn has hit wage income growth, disposable income growth has held up strongly (chart 3). This reflects greatly reduced debt servicing costs and the $20bn cash transfer from the Commonwealth Government over seven months. As for business investment, after an understandably large fall in the March quarter (–6.5%), it defied current weak fundamentals to increase in the June quarter. Notably, a temporary tax incentive triggered a near 6% rise in equipment spending after a 10% slump in the March quarter.

... some loss of momentum is likely ...

Near-term prospects are for the economy to hit an air pocket. GDP growth is forecast to be just 0.2% in both the September and December quarters on the expectation that private demand will lose altitude over this period. Consumer spending could contract a touch in the September quarter and business spending on machinery and equipment is also expected to dip after the June quarter 'bring forward'. However, inventory rebuilding will be supportive of activity over this period – mirroring the global trend. There was an unintended inventory run-down in the June quarter with business caught out by the strength of spending. A modest rise in inventory levels, say of 0.6%, in the September quarter would add 1.5ppts to growth. Even if some of this stock rebuilding is via higher imports the process will be a net positive for activity.

... but even so, prospects for 2010 ... .

Conditions are set to firm and expand at a healthy clip through 2010. The key growth engines will be a turnaround in housing construction from declines to a sharp recovery and a substantial acceleration in public sector investment. New dwelling construction could easily rise by 20% through next year, on a par with the experience in the year following the 1991 downturn. Indeed, the strength of housing finance points to upside risks - even with the prospect of an easing in the first home buyers segment. As for the fiscal stimulus it is moving into the next phase. The Commonwealth Government has budgeted to spend $8.6bn on building schools in 2009/10 and $5bn in 2010/11. This spend-up is expected to see annual growth in total public demand (20% of the economy) accelerate from 2.6% now to over 6% through 2010.

... have firmed, with housing, public works ...

On the private consumption front, we expect a 3% rise through 2010. This looks readily achievable given that population growth is running close to 2% and the scope for households to tap savings accumulated over the last year – partly from the unspent portion of cash hand outs. The article overleaf provides a more detailed assessment.

... and upgraded (if modest) capex plans ...

... all contributing positively.

One last piece of the puzzle is that while we saw the risk that business investment would be a major headwind to growth both in 2009 and 2010, particularly given current high levels, we now see the prospect of a stabilisation next year. Profitability in the broader economy has improved with the resilience of domestic demand and the international outlook for 2010 is considerably more upbeat than anticipated six months ago. Indeed, with a return of business confidence and upgrades to investment plans in the most recent CAPEX survey there is some upside to this view. One major plus is that rising global energy demand has returned to centre stage. That suggests that the outlook for private infrastructure activity in 2010 is for a consolidation at historically high levels rather than the risk of a sizeable downturn.

Andrew Hanlan, Senior Economist

Australia: strengthening prospects for 2010

Chart 1.

Australia's economy

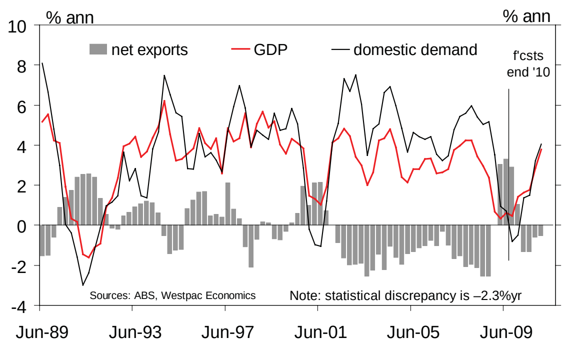


Chart 2.

Australia: the domestic growth mix

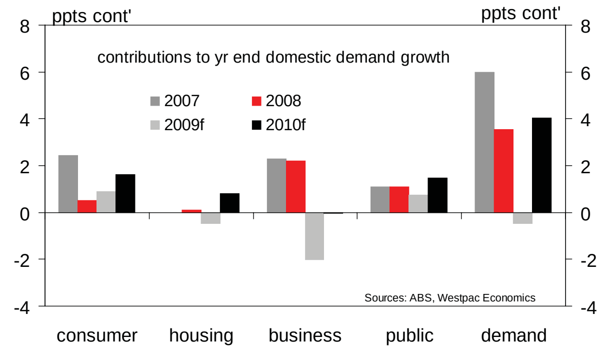


Chart 3.

H'hold incomes supported by stimulus

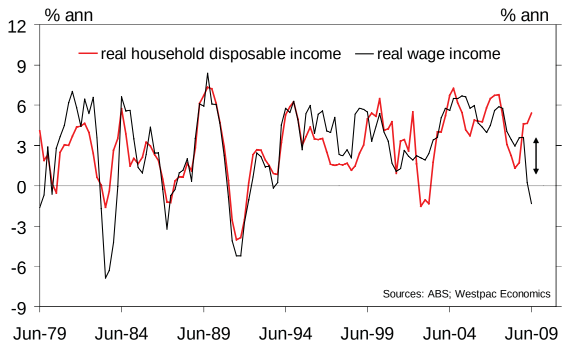


Chart 4.

Labour hoarding

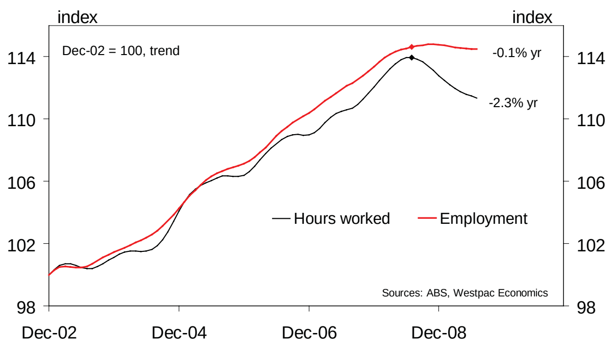


Chart 5.

2009/10 CAPEX plans upgraded

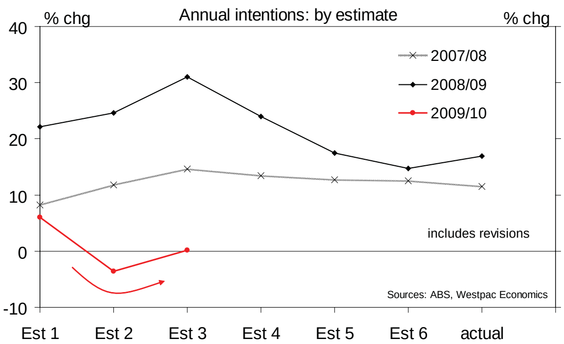
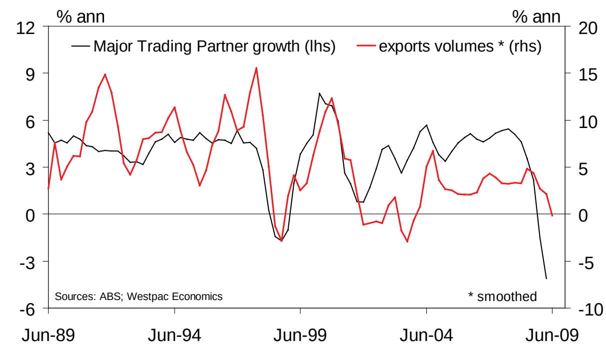


Chart 6.

Exports defy gravity



Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.

Australian consumers: coming or going?

Consumer spending …

The path of consumer demand over the next few months will be of intense interest for Australian economy-watchers. Accounting for two thirds of domestic expenditure, consumer spending is always of importance, but right now it is absolutely pivotal to the sustainability of Australia's fledgling recovery and the RBA's policy response. Indeed, the minutes to the board's August meeting singled out the pace of household spending as a key source of uncertainty, according it a note in the all-important penultimate paragraph.

… has been elevated by policy support …

The story so far should be familiar but is worth recapping. Households came under intense pressure in 2008, first from an aggressive tightening in monetary policy that saw mortgage rates hit 9.6% combined with record high fuel prices, and then from the trauma of the global financial crisis. Consumer sentiment slumped, falling 30% in seven months to levels usually only seen during recessions. Retail sales stalled flat, with through-the-year growth decelerating sharply from 9.6%yr in February to just 1% in November.

… and a letdown is surely coming …

Massive policy easing ensued. Interest rates were slashed from 13 year highs to 40 year lows. Critically, the Federal Government also responded quickly with an $8.7bn package of direct fiscal payments to pensioners and low income families paid out in December. This was followed by an even bigger $42bn package that included a second tranche of $12.7bn in direct fiscal payments to a wider range of recipients paid out over a longer period (March to July). To put this cash into perspective, monthly retail sales in Australia are just under $20bn.

… but to what degree?

The policy easing and the fiscal payments in particular successfully 'gerrymandered' demand into the March quarter, preventing a second successive fall in GDP and averting the technical recession tag. The second payments went a long way towards sustaining the rise into the June quarter. The pay-off in terms of consumer sentiment has been huge. The news that recession had been avoided drove a 13% bounce in sentiment in April that went on to become the biggest five month rally in the survey's history (back to 1973).

30% of handouts were saved …

But what now? The direct 'cash infusion' is over with a fallback in spending already apparent in monthly retail sales (down 1.4%mth in July). However, consumer sentiment continued to climb through July-August, pointing increasingly to an underlying cyclical improvement in spending.

… and that hoard might be accessed …

Importantly, consumers as a whole still have a substantial reserve 'up their sleeve'. The August Westpac-Melbourne Institute Consumer Sentiment Survey included an additional question to gauge how much of the one–off fiscal payments had been spent. Of those that had received a payment, 62.2% said they had spent all of it; 7.8% said they had spent more than half; 9.8% said they had spent less than half; and 20.2% reported spending none at all.

… to support Q3 sales.

These responses give us a rough idea of how much of the $21.4bn in Federal payments to households since November last year may still be sitting in a notional 'reserve'. If we assume payments were evenly spread across respondents and that actual spending is normally distributed around the range mid-points, the implied unspent portion of the stimulus is $6.3bn, or 29.5%. This figure tallies with estimates Westpac has compiled using official statistics. Specifically, assuming a baseline for 'regular' new savings and that 90% of the reduction in mortgage rates is initially absorbed into higher principal repayments (i.e. rebuilding mortgage buffers) this gives a 'residual' estimate of saved fiscal payments. Accumulating these measures from mid 2008 suggests the unspent stimulus as at the end of June was about $5bn.

On balance, we expect a modest 0.2% fall …

While these estimates are rough, the clear implication is that there is still a substantial unspent portion of the stimulus; equivalent to 3 to 3½% of quarterly consumer spending or 9 to 10% of quarterly retail sales. What consumers will choose to do with these funds is unclear. However, there is scope for a sizeable 'drawdown' over the second half of 2009 allowing them to maintain spending at high levels despite a fall back in disposable income as policy boosters drop out.

… in overall consumption in Q3.

Overall, we still expect the policy 'let down' to be a significant drag in Q3, with retail forecast to slip in the months ahead and total consumption to decline 0.2% in Q3 as a whole before the recovery regains traction towards year end. We suspect this and some slippage in confidence will be enough to stay the RBA's hand on rates until next year. However, the upbeat consumer mood and substantial fiscal 'reserve' to draw on could see more resilient spending. A flat or positive result for retail and sustained consumer optimism could tip the balance for the Bank.

Matthew Hassan, Senior Economist

Australian consumers: coming or going?

Chart 1.

Govt spending on social security & welfare

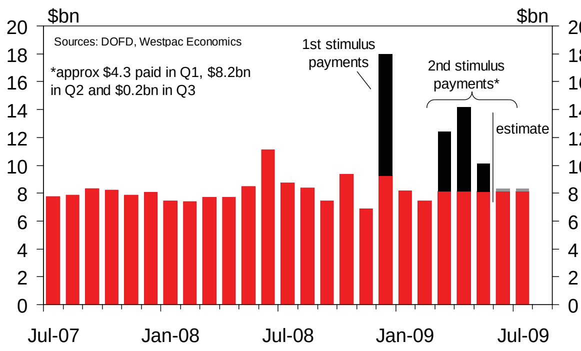


Chart 2.

Consumer sentiment vs consumption

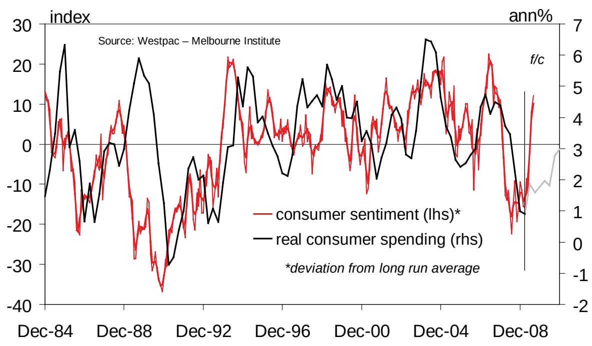


Chart 3.

Fiscal stimulus: how much spent?

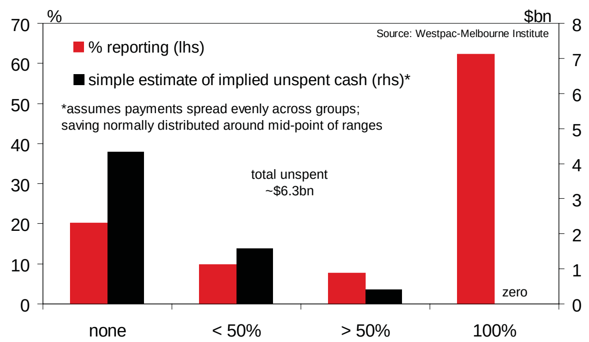


Chart 4.

New saving

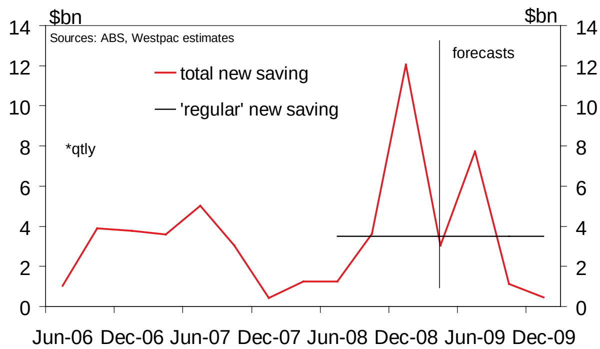


Chart 5.

Households: estimated 'reserve'

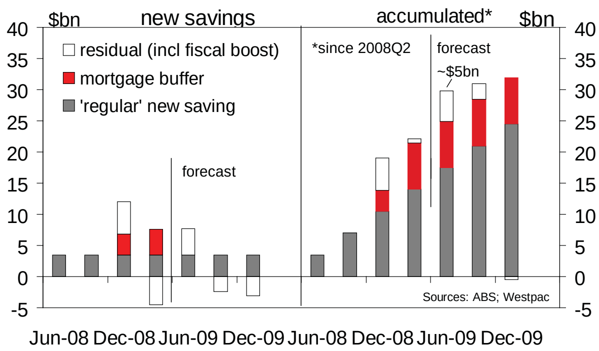
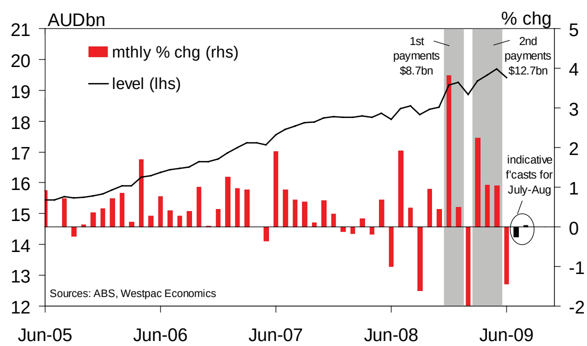


Chart 6.

Monthly retail sales



Stimulus, stocks, autos: sweet spot economics

The intersection of fiscal stimulus ...

Global activity data has surprised on the upside in late Q2 and early Q3. Japan and Germany recorded positive growth in Q2 after extraordinarily steep contractions in Q4 and Q1. The US economy shrank at a 1% annualised pace in Q2 and looks set to expand in Q3. Emerging Asia has made real strides. Has the IMF's Great Recession ended already? The short answer is no.

... and inventory adjustment ...

What we are experiencing is no more than the intersection of inventory adjustment on the one hand and policy stimulus on the other. Each is a temporary phenomenon that assures nothing beyond their all-too-finite duration. The two will come together for a time that in economic terms is equivalent to the average life span of the Lepidoptera in biological ones. This is a sweet spot, to be sure, but not one to ask very much of in terms of medium term traction.

... in sectors like autos ...

The intersection of the inventory cycle and fiscal stimulus is most pronounced in the auto sector. Car sales are the classic 'deferred discretionary durables purchase' that consumers withdraw from as their job anxiety increases, creating an air pocket in demand. In economies where the auto sector is an important employer, the temptation to offer a fiscal palliative is very strong. Hence we have the various "cash for clunkers" programs that provide incentives for consumers to upgrade their vehicles, and a number of policies encouraging a pull forward of business spending on transport equipment.

... is producing activity outcomes ...

In the panic of late last year and the early months of 2009 de-stocking across the manufacturing sector was unbelievably savage. The lack of working capital available from the embattled financial system (trade finance in particular) clearly amplified the problem. Businesses found themselves in a situation where inventories were piling up and shipments were falling precipitously. Imagine a game of hot potato where at each point of the production and distribution chain firms are desperately attempting to offload inventories downstream while cancelling orders from upstream and you will get a feel for the chaos of Q4. Obviously this is a zero sum game. From a global perspective it doesn't matter where in the chain the inventories were sitting – they were a clear and present drag on current and future output regardless. This phenomenon was most pronounced in economies that have a strong international trade presence in the manufactured durables industries, with the bellwether being autos.

... that flatter underlying demand.

Global auto sales (a measure summing North America, the EU, Japan, China, Korea, India, Brazil, Australia and New Zealand) ran at around 38.7 million units in 2007. In calendar 2008, that had fallen to 37.2 million. But that figure under-estimates the pace at which sales evaporated in Q4. Sales ran at an annualised pace of just 32 million from September '08 to February '09. In the US, the inventory to shipments ratio for transport equipment surged to 2¼ in June from an average around 1¼ in the 2003 to 2007 period. In Japan, shipments of autos were growing at 6.8%yr in July 2008. By December they were down 21%yr and by April they had collapsed by 60%yr. Korean auto shipments were down 40%yr in January. German export orders for vehicles plunged –47%yr in the same month. Sales of vehicles in China also fell sharply. Capacity utilisation across the sector understandably went into freefall.

The letdown could be quite a jolt ...

Fiscal incentives have assisted producers to reduce inventory. Annualised sales levels have recovered, but excluding the massive rebound in China they remain below 2007 levels (ex China, 2007 sales were roughly 30 million, versus an annualised level of 28.6 million for the March to June period). Re-stocking activity in this sector, and others, are assisting production to recover in the short term. It will even push global GDP growth back into positive territory in the second half. What it does not do is assure firms that demand will remain at current levels or above next year.

... for both activity and psychology.

The apparent stabilisation of demand, courtesy of policy, has stemmed the bleeding. But a tourniquet does not provide a healing function. Strong medicine is needed before the patient can rebound in a healthy and sustainable way. For an industry like autos, that means further concentration, balance sheet consolidation and the retirement of excess capacity – and that means job losses and contracting investment. That is what we have to look forward to on the other side of the sweet spot.

The markets are infatuated with the graceful flight and striking colouring of the recent data flow. "It's a butterfly" they say, admiring its beauty on the wing. "Yes it is" we reply sombrely, shielding our eyes as it tragically descends to earth after its all too fleeting moment in the sun.

Huw McKay, Senior international economist

Stimulus, stocks, autos: sweet spot economics

Chart 1.

Global auto sales have bounced

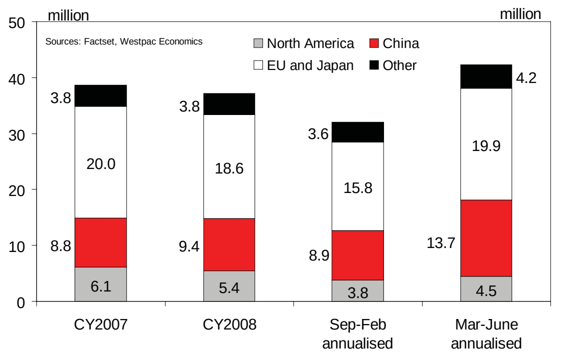


Chart 2.

US inventory to shipments ratios

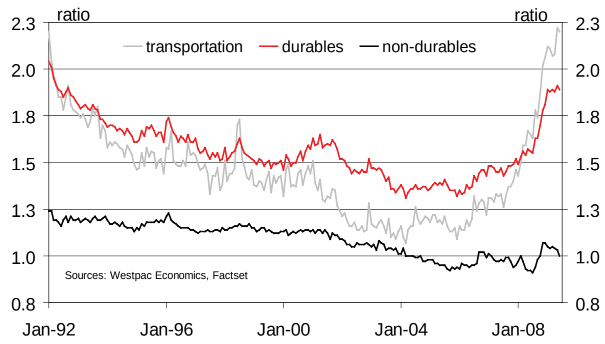


Chart 3.

Inventory-to-shipments: Japanese cars

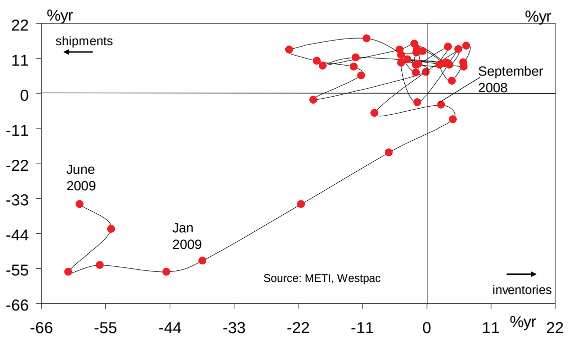


Chart 4.

Korea's inventory-to-shipments cycle

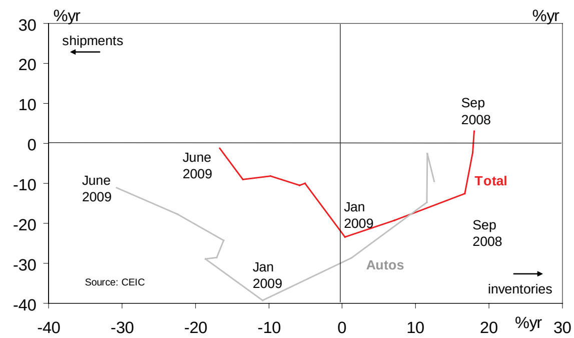


Chart 5.

US growth: inventories a go-go

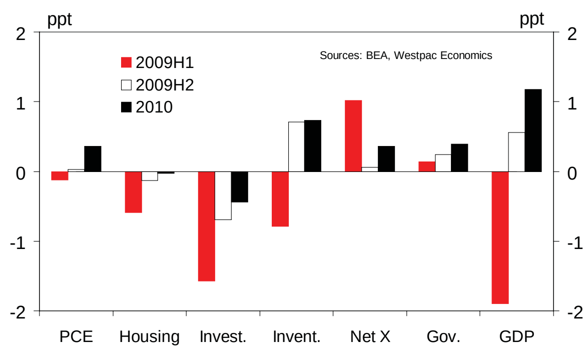
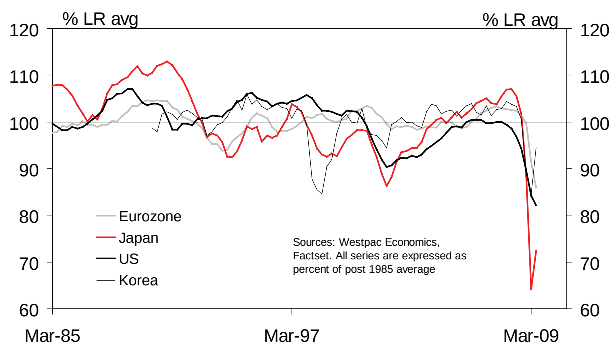


Chart 6.

Capacity utilisation: no capex recovery



Australia's housing recovery to consolidate

Upturn continues ...

Latest data continues to show housing markets in the midst of a solid upturn; albeit one that remains uneven across segments and patchy in terms of building activity.

... and is strengthening and broadening ...

The last month has seen Australia's housing recovery continue to strengthen and broaden. Finance approvals (ex refinance) are now up 43% from their 2008 lows. House prices have recovered all of the ground lost last year with most capital city medians pushing new highs. Latest weekly auction clearance rates are holding at healthy levels heading into the all-important spring selling season. The main laggard so far – dwelling approvals – is also showing more convincing signs of an upturn; now up 27.7% from their January low. There is still evidence of a credit crunch effect in some segments – high density apartment approvals in particular – but we suspect the sluggish upturn in this measure is mainly just a delayed response – First Home Buyers in particular require a signed contract to be eligible for Government bonus payments and would have had more urgency in securing finance than building approval.

Although the recovery has been broad-based, there remain some important divergences.

South-east leading the way ...

NSW is at the vanguard. Finance approvals are up 35% from late 2008 lows, with prices over the last six months rising at their fastest pace since 2002 (a rollicking 28.9%yr annualised pace). Subdued price growth over the previous six years meant aggressive rate cuts produced a more dramatic improvement in affordability than elsewhere. On our measures, early 2009 saw Sydney housing at its most affordable since January 2002. Importantly, the resurgence is also feeding into new building. Dwelling approvals have been slow to pick up but finance for the construction and purchase of newly built dwellings is up a whopping 80% on 2008 lows.

Victoria continues to show the most resilience. House prices barely corrected in 2008 – slipping just 2.5% peak to trough – and are already 3.2% above their previous peak. Meanwhile dwelling approvals, which remained above long run averages last year, are already back at five year highs.

... resource states trailing.

In contrast, Queensland's housing sector has been much harder hit. Prices remain below their 2008 peak. There has been a notably larger hit to building with new dwelling investment slumping 25% over the year to June 2008. While that comes from historic highs in 2007, high density 'apartment' approvals have seen a spectacular collapse: down 86% in value terms; eviscerated by the credit crunch impact on developer finance. Despite this, housing finance approvals have responded positively to low rates and first home buyer incentives, suggesting a recovery may at least be soon at hand for owner-occupier-led activity.

WA's housing market has been notably weaker than the rest but is now regaining its footing. Finance approvals surging strongly since February and prices finally showing signs of stabilising.

Still a highly segmented picture.

It remains a highly segmented picture within state markets as well. Sub-markets dominated by first home buyers are seeing a much stronger performance than the rest while activity and prices have been weaker at the upper end of the market, in investor-led segments without first home buyer overlap, and in more 'discretionary' sub-markets like holiday homes.

Looking ahead, there are some significant wind shifts set to come through.

Consolidation looks likely as first home buyers exit ...

Firstly, first home buyer demand will start to wind down as the boost from the Government's additional bonus scheme ends. The scheme is being phased down from September 30. Demand from this segment already appears to have peaked and will clearly fall back, most likely to below pre-November levels. How well overall activity and prices hold up in the face of this wind-down depends crucially on how much both 'upgrader' and investor demand expands to fill the gap. The latter is likely to be a particularly important swing factor. For upgraders to fill the gap on their own, finance approvals would need to rise another 25% to all-time highs. At this stage, we expect a smooth transition with demand consolidating at relatively high levels overall. But if investors stay sidelined it could be a bumpier 12 months.

... and rate rises temper demand.

The second key shift will be on rates. We expect the Reserve Bank to start tightening policy by early next year with rates rising 1% by December 2010. This will clearly temper demand, although past experience suggests housing markets are resilient to initial rate rises, especially when activity is also being supported by a shortage of dwelling stock. Indeed, the bigger issue medium term is the extent to which the housing upturn feeds into new building as opposed to just prices. This is an altogether harder question to answer but will be a major factor determining both the path of the housing upturn and the policy response from the RBA.

Matthew Hassan, Senior Economist

Australia's housing recovery to consolidate

Chart 1.

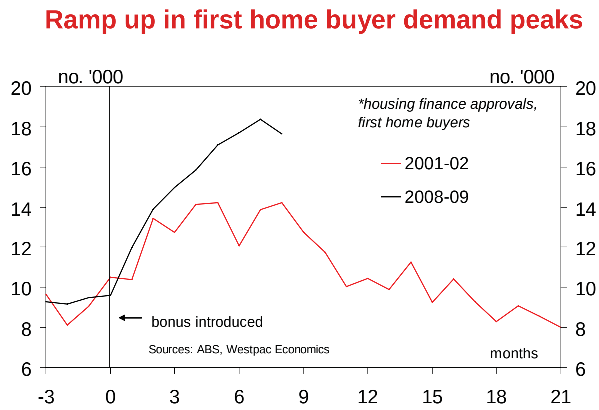


Chart 2.

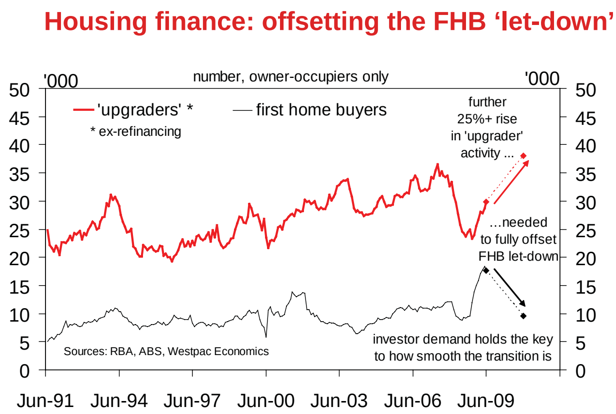


Chart 3.

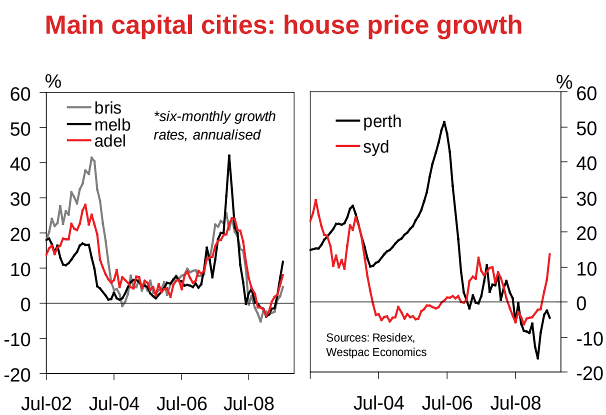


Chart 4.

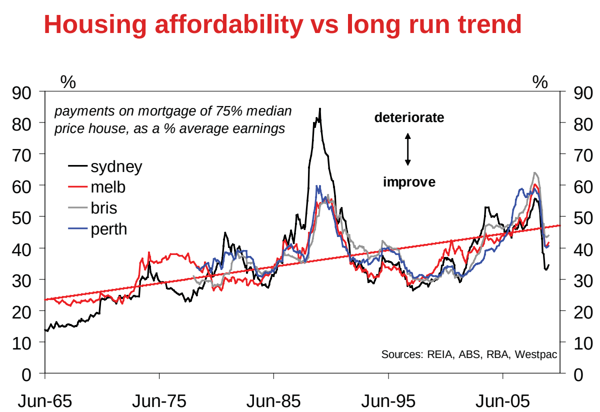


Chart 5.

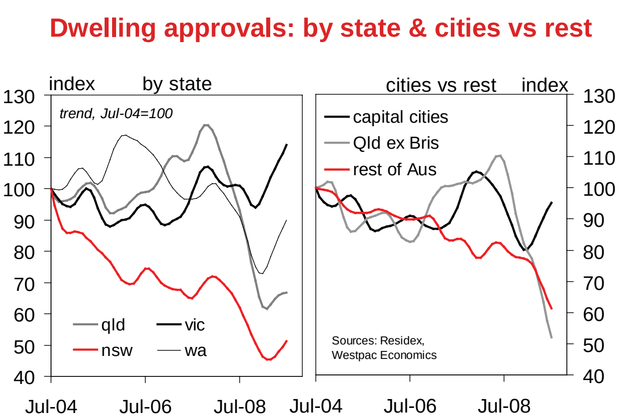
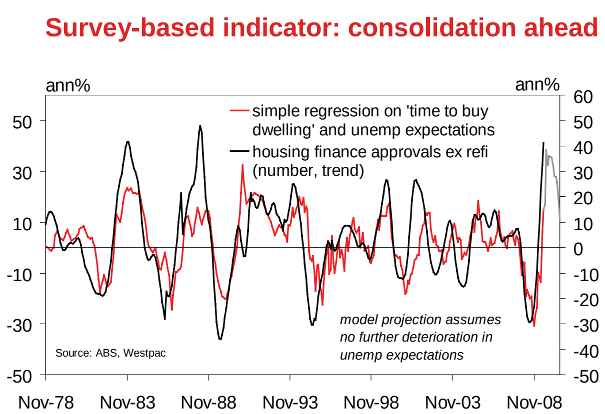


Chart 6.



Shares: Aussie profits turn the corner

Economic data flows to the upside …

When we last wrote on share markets – back on 11 August – we talked of *"Share markets: more good news on the outlook"* and highlighted that the earnings outlook for Australia is on the improve. Events of the last month reinforced the assessment that conditions in Australia are surprising to the high side. Indeed, profitability in the broader economy took a turn for the better in the June quarter. US economic data has also showed a firmer tone. While these positive fundamental developments are a plus, technicals point to the risk of a near-term corrective pull-back.

… as US economic recovery begins in Q3.

Wall Street managed a break to the high side from late July as the earnings season exceeded expectations. That saw the S&P500 move above the broad range in place since last November (see first chart). The upward move has been reinforced by additional evidence that the US economy is in recovery. We're expecting US GDP to increase by 0.6% in the September quarter. That follows four consecutive quarters of contraction, with a cumulative decline of almost 4%, and a virtual absence of growth over the two quarters prior.

The ISM's for August highlight that the US economy is emerging from recession as monetary and fiscal stimulus gain traction. The manufacturing sector is in expansionary mode, with the production sub-index jumping to 62 in August, the third reading above 50. Moreover, new orders climbed to 65. As for the construction & services ISM, the activity sub-component moved above 50 in August after ten months of contraction. Also, the US housing market has turned the corner, with pending home sales increasing for the sixth consecutive month in July.

Policy makers committed to stimulus policies.

Another plus for 2010 outlook is that policy makers are committed to stimulus policies, as clear from the recent G20 Finance Ministers meeting. As discussed previously, there are two routes to deleveraging: the more painful adjustment via the "savings route", and the "inflation route". It is clear that Ministers would prefer to err of the side of providing too much stimulus for too long, arguing that a withdrawal of stimulus now risked repeating the mistakes of the 1930s. The G20 Finance Ministers agreed that co-operative and co-ordinated exit strategies are some way off.

Concerns about US financial sector balance sheets will persist, even with the US recovery beginning in the September quarter and thereby improving general profit conditions. The structural damage in the financial sector has yet to be fully repaired and cyclical strains have yet to peak. With unemployment climbing to 9.7% in August and set to rise further until economic growth returns to trend, household's debt servicing ability is under pressure.

But beware - risk of technical pull-back.

Risks of a technical corrective pull-back are upper most in investor minds. Markets have arguably already priced in the US recovery news, with the S&P500 up 50% from March lows. After such a strong run and the experience of earlier post-recession periods points to the risk that markets could give back as much as 10% or more before moving forward again.

The Australian share market has followed the broad trends evident on Wall Street. The S&P200 also made a break to the high side in July and is now 41% above March lows. The 1 year forward P/E ratio has been trading close to 17 since July – which is a little above the historic average (see chart). The sectors that have rallied hardest since March are Industrials, 61%; Financials, 61% and Consumer Discretionaries, 54%. Perhaps a little surprisingly, given the resurgence of China, Resources have underperformed the Index over this period, managing a gain of just 33%.

Australia: we've upgraded our 2010 growth forecasts.

We have upgraded our Australian economic growth forecast for 2010. We now expect year average GDP growth to be around 2.5% and growth through 2010 to be closer to 4% than to 3%. With consumers and business now confident, the prospects are for a stronger spending environment next year. The shake out in the labour market has been less dramatic than anticipated, with business opting to hoard labour and reduce hours worked rather than make widespread retrenchments. The fiscal and monetary stimulus has contributed greatly to this by boosting / bringing forward retail sales and business investment. See the article *"Australia: strengthening prospects for 2010"* for a more detailed discussion. Also notable, official company profits data showed that profitability in the broader economy improved in the June quarter, associated with the lift in domestic spending. The Reserve Bank, in response to these developments, has strongly signalled an intention to lift interest rates. Markets anticipate that the first move could be as soon as October. We anticipate that the cash rate will be at 4% by the end of 2010, still some way below the historic average of 5.5%.

Andrew Hanlan, Senior Economist

Shares: Aussie profits turn the corner

Chart 1.

Global markets: ripe for a correction?

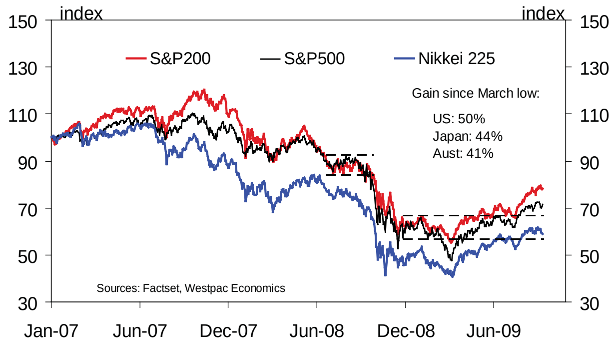


Chart 2.

Australian share market: 1yr forward PE

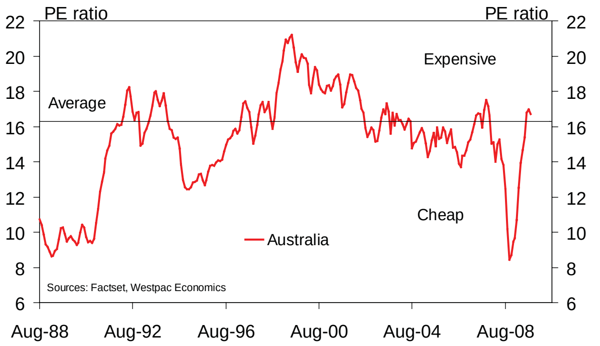


Chart 3.

Australia: sectoral performance

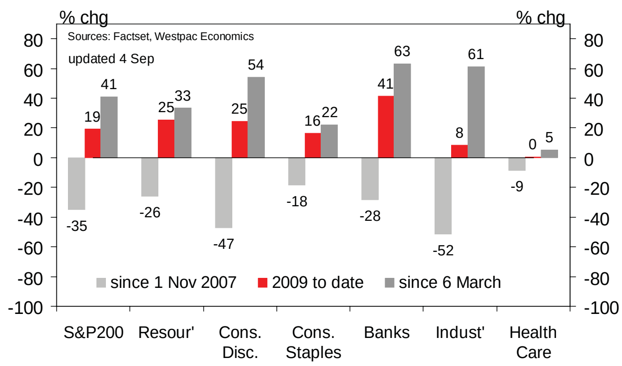


Chart 4.

Australia: sectoral performance

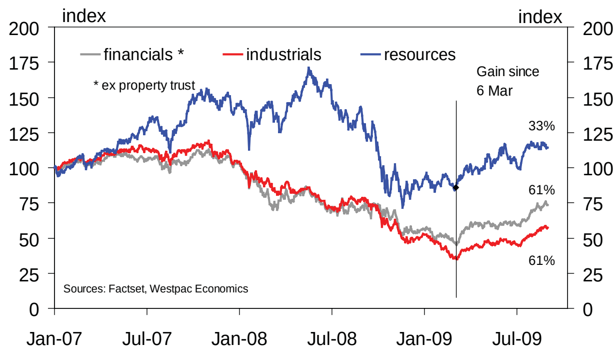


Chart 5.

Profitability: a turn for the better

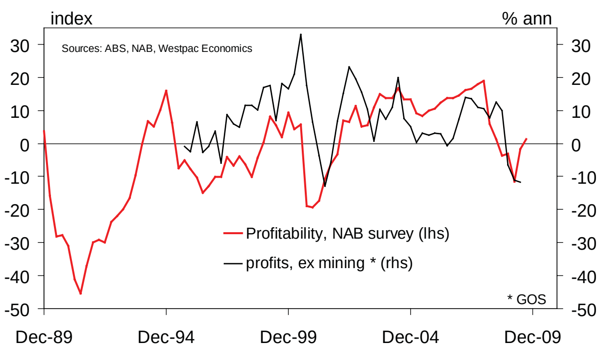
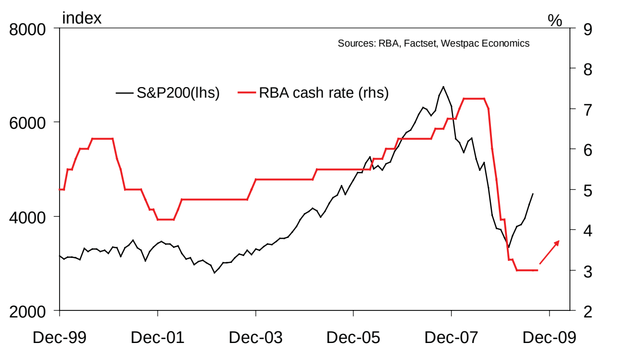


Chart 6.

RBA to begin "normalising" rates



United States

GDP will expand in Q3 ....

The US economy is expected to expand in Q3, the first time the economy has grown since June 2008. However, we have no real confidence in the resilience of underlying demand. Household incomes remain under stress as labour and property income declines while credit conditions remains restrictive even if the reality of households' requirement to de-leverage was not as pressing as it currently is. The most recent data, while continuing the more upbeat tone, do not change our position.

... for the first time since 2008Q2.

This month the S&P Case-Schiller house price index surprised with a second gain in two months. While it is clear we have passed the worst for the correction in US house prices, and that prices may now be forming a base, it is far from clear that any sustainable price gains can be made from here. First the stock of homes for sale, that is both new and existing homes, is at 4.4 million, the high level since November last year. We also know that banks continue to tighten credit standards and that households remain as worried as they have ever been about household finances. If we adjust the very optimistic "is now a good time to buy a dwelling" index from the Uni. of Michigan consumer sentiment survey, with the pessimistic "personal finance compared to a year ago" then the housing sentiment index is hugging the recessionary lows some 40% below long run average.

Housing is improving ...

As far as we can see there is no reason yet to get excited about the housing sector and it appears that the market agrees with us. The Case-Schiller house price futures curve has lifted slightly but it is still pricing a 10% fall in house prices over the next 12 months before prices start to recover in the second half of 2010. In the past, the curve has underestimated the magnitude of the fall in house prices. The risk is clearly that the market may be becoming more negative just as the recovery gains momentum. Give tight credit conditions in the US and the poor state of household balance sheets, we would rather err on the side of the futures market.

... but the supply overhang remains.

New home sales have started to rise off the lows as the market clears the stock of unsold homes and affordability improves with falling house prices. And new home prices continue to fall which is consistent with anecdotes of developers discounting prices to move stock. This movement in new homes, plus the stock of new homes falling to the lowest level since early 1993 does suggests we may see a rebound in dwelling activity some time soon. While we accept that it appears that construction activity may have found a base, a solid recovery is still some way off. As we have noted earlier, the total number of homes for sale is still above 4 million, hardly a shortage that requires further stock to be created. In addition, the number of dwellings being constructed continued to fall in July. While house sale are a leading indicator of construction activity, the lags can be long. In the early 1990s recession, new home sales bottomed in January 1991 and rose solidly from there while the number of dwellings under construction did not start to rise until May 1993.

The labour market is consolidating ...

The US labour market is providing both some promising signs that we may have passed the worst while reminding us of just how deep and savage this recession has been. So far, the US economy has shed almost 7 million jobs generating the largest proportional rise in the unemployment rate since the Great Depression. And it is not only the magnitude of job losses that has been so phenomenal - but also the contraction in hours worked. In the year to July non-farm payrolls have fallen 4.2% while total hours worked have collapsed 6.7%yr. Firms have slashed their investment outlays (down around 20%yr in Q2) and naturally jobs and hours worked have followed. To see a meaningful turnaround in the labour market, other than just the welcome relief of some stability, the investment environment also has to turn around in a more positive manner.

... after a gut wrenching contraction.

This is not to say there may not be some good news out there. During the month media anecdotes report that temporary jobs may have reach a turning point with reports of a possible lift in temporary hirings. To July, temp workers in the non-farm payrolls survey were down 26%yr and down 35%yr from the last 2006 peak. But in the last three months temp workers have fallen just 2.4% suggesting a turning point has been reached. We will be watching the August non-farm payrolls with interest as temporary employment tends to move more dramatically in the early stages of a cycle than both total employment and hours worked. However, as the late 1970s, early 1980s demonstrates such a recovery does not guarantee a double dip has been avoided.

Justin Smirk, Senior Economist

United States

Chart 1.

US house price futures still have a dip

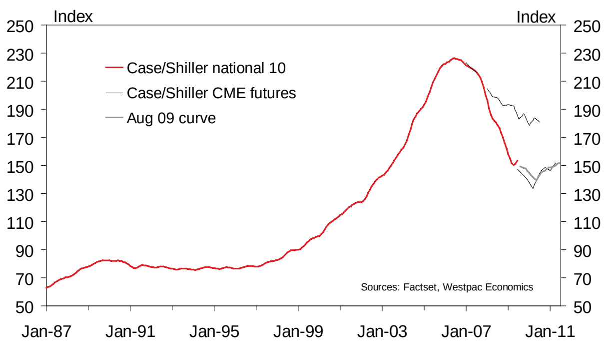


Chart 2.

Homes sales pointing to a turning point

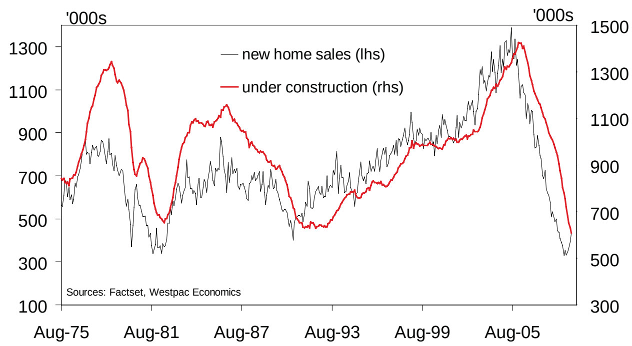


Chart 3.

Temp workers nearing a turning point

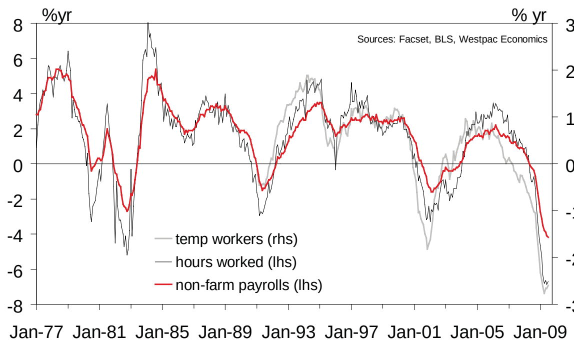
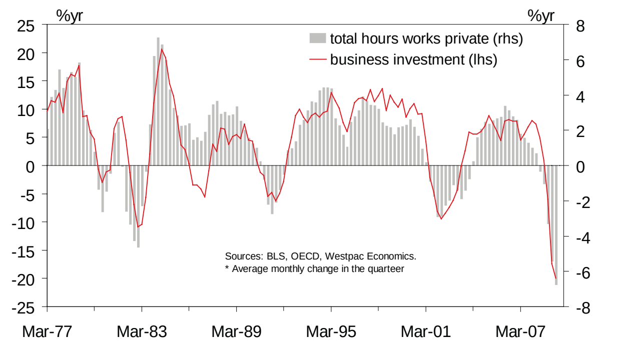


Chart 4.

US hours worked collapsing



Macroeconomic variables

	2008				2009							
Monthly data	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**
Consumer prices %yr	4.9	3.7	1.0	–0.1	–0.2	0.1	–0.4	–0.6	–1.0	–1.2	–1.9	–
Unemployment rate %	6.2	6.6	6.8	7.2	7.6	8.1	8.5	8.9	9.4	9.5	9.4	–
Non–farm payrolls chg '000	–321	–380	–597	–681	–741	–681	–652	–519	–303	–443	–247	–
Industrial production %mth	–4.0	1.3	–1.3	–2.3	–2.2	–0.8	–1.6	–0.7	–1.1	–0.4	0.5	–
New homes sales %mth	–1.8	–6.2	–4.6	–4.1	–12.0	7.6	–6.2	3.9	4.9	9.1	9.6	–
ISM manufacturing composite	43.4	38.7	36.6	32.9	35.6	35.8	36.3	40.1	42.8	44.8	48.9	52.9
ISM non–manufacturing composite	50.0	44.6	37.4	40.1	42.9	41.6	40.8	43.7	44.0	47.0	46.4	48.4
Retail sales %yr	–1.5	–5.0	–8.4	–10.6	–9.1	–8.0	–9.5	–10.0	–9.8	–8.9	–8.3	–
UoM Consumer Sentiment	70.3	57.6	55.3	60.1	61.2	56.3	57.3	65.1	68.7	70.8	66.0	63.2
Trade balance USDbn	–60.1	–59.4	–43.2	–41.9	–36.6	–26.1	–28.5	–28.8	–26.0	–27.0	–	–

Quarterly data	**Mar–08**	**Jun–08**	**Sep–08**	**Dec–08**	**Mar–09**	**Jun–09**
Real GDP % saar	–0.7	1.5	–2.7	–5.4	–6.4	–1.0
Current account USDbn	–179.3	–187.7	–184.2	–154.9	–101.5	–92.2

Sources: Government agencies, Bloomberg, Factset

Europe & the United Kingdom

Eurozone activity ...

We were quite surprised that Germany and France were among the first of the OECD economies to emerge from recession (along with Japan), with both recording growth of 0.3% in Q2, whereas the US and UK were still contracting. The broader eurozone still declined, because of ongoing weakness in Italy, the Netherlands and Spain, although the –0.1% pace effectively signals that the economy of the single currency area has bottomed out, after the steep contraction of the prior two quarters. Significantly, the private sector PMI surveys paint a similar picture, with the composite index rising to just above the neutral 50 level in August, indicating the economy was no longer contracting by the middle of Q3.

... has bottomed ...

Does the apparent end of the European recession mean the economy is now recovering? There is, as yet, scant evidence pointing to Euroland economic growth in the current quarter. The European Central Bank remains concerned that M3 growth has continued to decelerate and credit to the private sector is growing at just 0.6%yr, the lowest since consistent statistics began nearly two decades ago. The Q2 GDP breakdown showed that household spending, supported by car scrappage schemes, turned modestly positive for the first time since early 2008. But with the German car scheme now drawing to a close and the French scheme continuing for several years and thus expected to drive diminishing additional growth in auto output, the boost to spending has a limited shelf life. A steeper fall in imports than in exports meant that net exports added 0.7 ppts to GDP whereas inventory de-stocking lopped an equivalent amount off the growth bottom line. Hopes of an inventory rebuild in Q3 persist, but that cannot form the basis of a sustained growth recovery.

... but the ECB is cautious.

The ECB described rates as “appropriate” after the September Council meeting and gave no hint whatsoever about the timing of any policy retightening, which we expect to still be at least a year away. Although the ECB acknowledges “increasing signs of economic stabilisation”, ECB chief Trichet expects “more of a bumpy road ahead” with respect to the growth outlook. Slight upward revisions to the ECB staff forecasts for growth this year and next mainly reflected the favourable impact of less weak Q2 GDP. On the inflation side revisions reflected recent higher commodity prices. Although not made explicit at the September 3 press conference, the ECB does not appear to have materially revised its view that Euroland economic growth will not resume before 2010. Trichet would not exclude the possibility of a positive quarter before mid 2010, but any such outcome came with no guarantees of sustainability, he warned.

The UK will grow in Q3 ...

The UK economy will probably post modestly positive growth in Q3 (data not due till late October) based on recent gains in industrial production, retail sales and some business surveys, as well as the sharp narrowing in the trade deficit. House prices remain a recent bright spot, now higher on most measures than at the start of the year, though the number of transactions remains historically low. However the UK spending/production numbers have also been supported by a version of the ubiquitous car scrappage scheme which started in May but is now nearly two thirds complete. Business investment collapsed more than 10%, and employment fell by more than a quarter million in Q2. Both represent the steepest falls yet for those indicators in this downcycle: evidence that the business sector is still cutting back aggressively. Indeed the sustainability of any GDP growth up-turn must remain in question while credit growth continues to slow. In July, mortgage outstandings *fell* by nearly half a billion pounds (for the first time since current records began in the early 1990s) as new loan approvals were more than offset by repayments - a sign that households remain very cautious about their debt levels. There was also a record level of repayment of consumer loan outstandings. Credit card usage was at its lowest level for the year so far.

... but a rate hike is more than a year away.

The minutes to the Bank of England’s August policy meeting and the Bank’s latest quarterly projections, published August 12, make it fairly clear that the Bank shares these concerns about the fragility of any recovery in UK economic activity. “There was significant doubt over the extent to which the recovery would be sustained ... the balance of risks remained weighted to the downside. But the Committee judged that the probability of activity contracting for a further sustained period had fallen.” The Bank’s inflation central projection - below the 2% target until the end of the forecast horizon in 2012 based on market interest rate expectations - was a clear signal that the market was prematurely anticipating BoE retightening by early 2010. Indeed the decision to expand the QE program by £50bn was not unanimous, with the usually hawkish Governor and two others preferring a £75bn extension. These developments point to a considerable period - a further year or more on our forecasts - during which the BoE will leave rates steady at 0.50% and hold off on unwinding its QE asset purchases.

James Shugg, Senior Economist, London

Europe & the United Kingdom

Chart 1.

Euroland GDP bottomed out in Q2

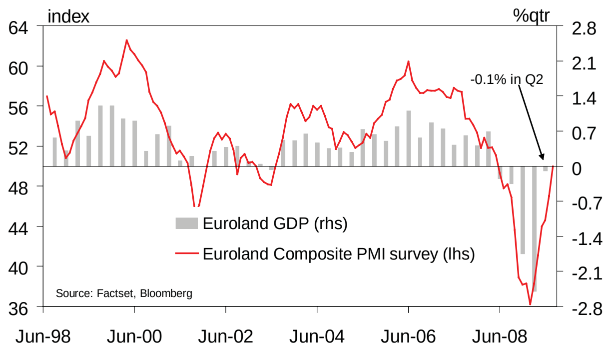


Chart 2.

Euro consumers less pessimistic

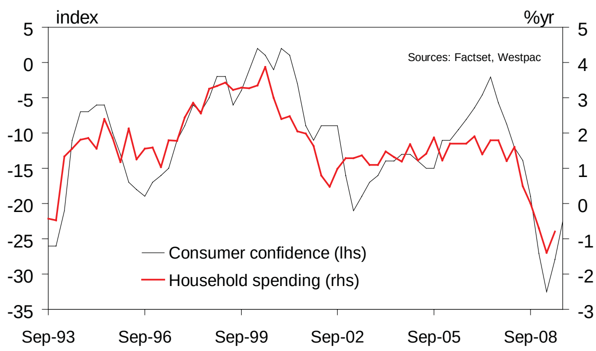


Chart 3.

Euro CPI and M3 growth now "too low"

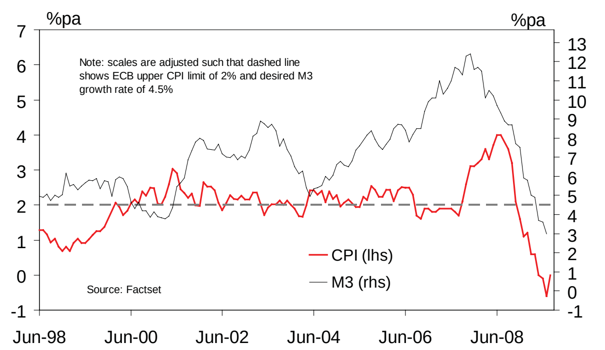
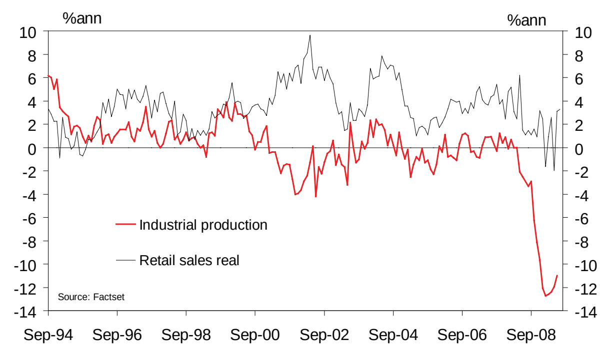


Chart 4.

UK industry & retail turning the corner



Macroeconomic variables

	2008				2009							
Europe	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**
Eur Consumer prices %yr	3.6	3.2	2.1	1.6	1.1	1.2	0.6	0.6	0.0	–0.1	–0.7	–0.2
Eur Unemployment Rate % (ILO)	7.7	7.8	8.0	8.2	8.6	8.8	9.0	9.2	9.3	9.4	9.5	–
Eur Industrial Production %yr	–2.5	–5.9	–9.1	–12.4	–16.5	–19.2	–19.2	–21.2	–17.6	–17.0	–	–
Eur Retail Sales Volumes %yr	–0.6	–2.0	–2.1	–1.7	–2.3	–4.5	–2.8	–1.9	–3.1	–2.0	–1.8	–
Eur Consumer Confidence	–19	–24	–25	–30	–31	–33	–34	–31	–28	–25	–23	–22
Eur Current Account Balance EURbn	–7.5	–10.2	–18.1	–15.0	–21.7	–12.7	–10.0	–6.1	–0.1	–5.3	–	–
United Kingdom												
UK Consumer Price Index %yr	5.2	4.5	4.1	3.1	3.0	3.2	2.9	2.3	2.2	1.8	1.8	–
UK Unemployment Rate % (ILO)	5.8	6.0	6.1	6.3	6.5	6.7	7.1	7.2	7.6	7.8	–	–
UK Industrial Production %yr	–2.9	–6.3	–8.2	–9.7	–12.1	–12.7	–12.6	–12.4	–11.9	–11.1	–	–
UK Retail Sales Volumes %yr	1.1	1.6	0.9	3.2	2.5	–1.6	0.9	2.5	–1.9	3.1	3.3	–
UK Consumer Confidence	–32	–36	–35	–33	–37	–35	–30	–27	–27	–25	–25	–25

Quarterly data	**Q4:07**	**Q1:08**	**Q2:08**	**Q3:08**	**Q4:08**	**Q1:09**	**Q2:09**
Eur GDP %qtr/%yr	0.4/2.2	0.8/2.2	–0.3/1.5	–0.3/0.5	–1.8/–1.7	–2.5/–4.9	–0.1/–4.7
UK GDP %qtr/%yr	0.5/2.4	0.8/2.5	–0.1/1.8	–0.7/0.5	–1.8/–1.8	–2.4/–4.9	–0.7/–5.5
UK Current Account Balance £bn	–5.2	–2.6	–6.1	–7.6	–8.8	–8.5	–

Source: Official agencies.

Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.

Japan

The DPJ ...

The Democratic Party of Japan (DPJ) led by Yukio Hatoyama won an historic landslide victory in the lower house elections on the weekend of August 29 and 30 ending the Liberal Democratic Party's (LDP) half century long near-monopoly on power. The election result essentially reverses the seat allocations that prevailed after the Koizumi landslide. In contrast to the Indian and Indonesian elections earlier this year, when the market applauded strong mandates being handed to incumbents, the market decided that change is positive for Japan, rather than continuity.

... will form a new government ...

Exit polls indicate that the DPJ will directly control 308 seats of the 480 in the lower house, a 64% share. That is good, but not great, as it means that the DPJ is still short of the critical two-thirds independent majority in the lower house that is needed to get things done smoothly in Japan. Japan's bicameral system requires legislation to pass both houses in the first instance. However, if legislation is rejected by the upper house, a subsequent two thirds majority in the lower house is sufficient to enact. So, to achieve smooth passage of government bills, either a majority in both houses is required, or a two thirds majority in the lower.

... after a massive protest vote ...

The DPJ is already the largest single party in the upper house (the result of the LDP's disastrous performance in the 2007 upper house elections), but it does not have a majority. Market watchers will recall the DPJ's use of its strong position in the upper house to run a recalcitrant and counter-productive nay-saying strategy to the appointment of the Bank of Japan Governor and his deputies. So it will need to make a lower house coalition to get to the 67% threshold.

... against the LDP.

What sort of policy agenda will the DPJ pursue? The DPJ are essentially a leftwing interventionist party. However, they are not blatantly anti-market. Reform or deregulation are decisions to be made on a case by case basis, rather than mindlessly pursued. As a long term opposition party, the DPJ are mainly defined by what they attacked most strongly, rather than any hard edged advocacy of certain points of view. Most memorably, the DPJ has attacked the endemic links between big business, the government and the bureaucracy that characterised LDP rule. Indeed, the only previous occasion of an LDP lower house election loss, in 1993, was related to bureaucratic corruption scandals.

The DPJ's manifesto ...

The DPJ's left wing roots come out in their vocal criticism of free trade agreements (FTAs, or as the METI calls them, EPAs, or economic partnership agreements). The DPJ is pandering to the consumer associations' naïve posturing on food safety issues, while simultaneously aiming to subsidize small scale farming. They are the champion of the weak – assuring pensions for low income earners, standing up for SMEs by speaking out against the bullying of subcontractors, setting higher minimum wages, and promising free high school and university education. Overtime allowances are to be raised and discriminatory treatment of non-tenured or part time employees vis-à-vis full timers is to be made illegal.

... is both reformist ...

The DPJ is also on the record as stating that the Japanese contribution to the 'War on Terror', which is principally the refuelling effort in the Indian Ocean, should cease. The US' troop presence in Japan will also be reviewed; a hawkish stance will continue to be adopted towards the DPRK; alongside a greater effort to integrate into Asia.

... and regressive.

The DPJ response to Japan's ageing demographic is to provide increased cash handouts of ¥550k per child born (versus ¥300k currently) and to provide ¥26k per month from birth to graduation from junior high. The DPJ hopefully assumes that "all expenses related to childbirth" will be covered by its enhanced baby bonus. Experience elsewhere indicates that this will eventuate become an income transfer for the medical profession.

Managing the bureaucracy will be key.

They also seek to reduce the inefficiency and corruption related to the practice of *amakudari* (re-employment of retired bureaucrats in private sector sinecures) and opaque tendering operations for public works (bid rigging or *dango*). The public service will be none too impressed by these desires and will fight tooth and nail to dilute or shelve the legislation. If the public service is uncooperative it will be difficult for the DPJ, an inexperienced government, to execute policy on the ground. This may become a serious issue as Hatoyama's premiership proceeds.

Huw McKay, Senior International Economist

Japan

Chart 1.

Distribution of lower house seats

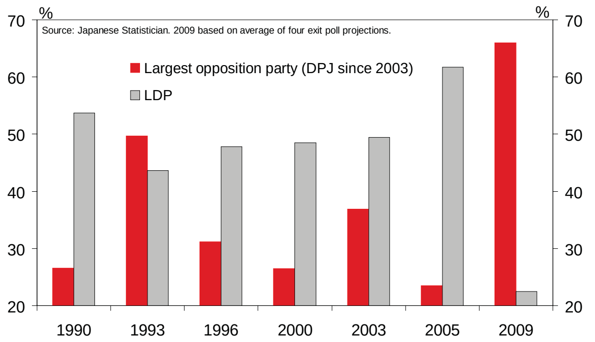


Chart 2.

Public investment in the current decade

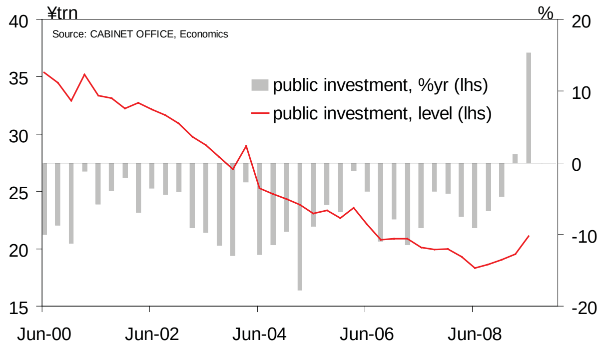


Chart 3.

The Japanese labour market

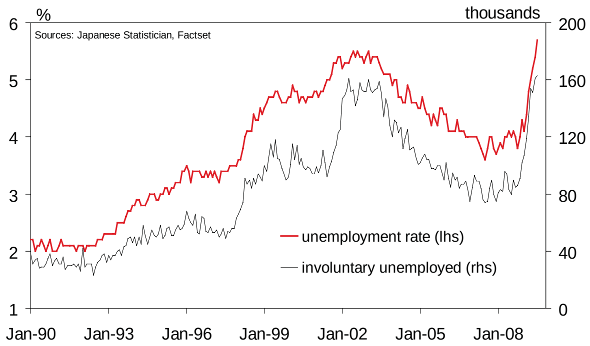
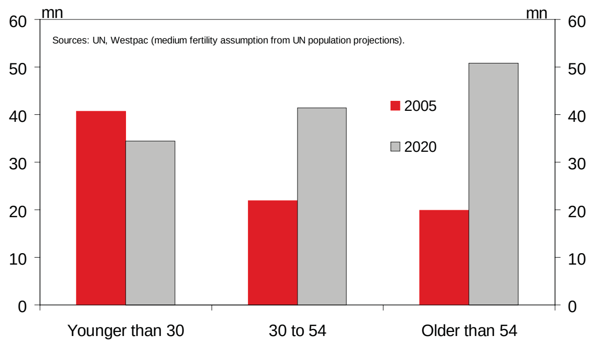


Chart 4.

Japan's demographics are a major challenge



Macroeconomic variables

	2008				2009						
Monthly data	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**
Consumer prices (ex fresh food) %yr	2.3	1.9	1.0	0.2	0.0	0.0	–0.1	–0.1	–1.1	–1.7	–2.2
Corporate goods prices* %yr	2.6	1.8	0.4	–0.7	–1	–1.3	–1.8	–1	–2	–2.6	–3.3
Unemployment rate %	4.0	3.8	4.0	4.3	4.1	4.4	4.8	5.0	5.2	5.4	5.7
Tertiary activity index %mth	–0.5	0.2	–2.1	–2.5	–1.2	–3.3	–1.6	2.2	0.7	0.1	–
Retail sales %yr	–0.3	–0.7	–0.9	–2.7	–2.4	–5.7	–3.8	–2.8	–2.7	–2.9	–2.5
Housing starts mn saar	1.126	1.027	0.954	1.001	0.957	0.866	0.888	0.779	0.758	0.749	0.746
Industrial production %mth	0.1	–3.4	–7.0	–8.4	–10.1	–9.4	1.6	5.9	5.7	2.3	1.9
Machinery orders (core) %mth	3.8	–5.3	–12.2	–2.7	–3.8	0.6	–1.3	–5.4	–3.0	9.7	–
Exports %yr	1.5	–7.9	–26.8	–35.0	–45.7	–49.4	–45.5	–39.1	–40.9	–35.7	–36.5
Trade Balance ¥bn	–78	–241	–330	–143	–372	–11	–19	122	249	374	195

Quarterly data	**Q1:08**	**Q2:08**	**Q3:08**	**Q4:08**	**Q1:09**	**Q2:09**
Real GDP %qtr/%ann	0.8/1.3	–1.1/0.6	–1.0/–0.3	–3.5/–4.5	–3.1/–8.3	0.9/–6.5
Tankan large manuf. confidence – level	11	5	–3	–24	–58	–48
Tankan large non–manuf. confidence – level	12	10	1	–9	–31	–29

Sources: Government agencies, Bloomberg. GDP numbers frequently revised. * Domestic final use goods.

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New Zealand

The trends that defined July …

Regular readers may experience *déjà vu* this month, as the main economic developments through August were almost identical to those in July. The economy continues to trace out a path of gradual recovery, though the strength of the currency could pose some challenges.

… firming confidence & improving activity …

Business confidence surged again in August, with general conditions at the highest level since May 1999 and own-activity expectations at their highest since March 2005. The latter is a useful indicator for current quarter GDP, and the latest readings are consistent with growth of around 0.7% in Q3, which is markedly stronger than our current forecast of 0.2% (though we made a –0.4% allowance for the potential impact of swine flu, which has proven to be minimal to date). Sceptics might argue that the improved outlook for the year ahead simply reflects a view that things can't get any worse than they already are. But that's fine for our purposes, since GDP growth will be coming from a low base as well.

… were just as evident in August.

Retail sales were up 0.1% in June, holding on to the 1.3% gain in May that was partly due to the early onset of winter weather. Sales volumes in the June quarter rose by 0.4%, ending a string of six quarterly declines that has left per capita sales volumes down 8.7% from their peak. Stronger electronic card transactions in July and consumer confidence in August suggest that retail spending has maintained its momentum more recently.

Housing activity is on the rise …

House sales rose further in July on top of a strong increase in June, and are up 34% compared to a year ago. The median sale price was flat on a year earlier, and days to sell fell to 36, the quickest turnover pace in nearly two years. The housing market continues to benefit from record-low mortgage rates and a shortage of listings as fewer people emigrate to Australia – stronger demand and lower supply is a recipe for higher prices. There was also evidence that the building industry is starting to respond to the developing shortage in housing, with dwelling consents rising 5% in July to be up 20% from the record lows seen at the start of this year.

… and dairy prices have jumped.

There has even been something to cheer about for the export sector. The latest online auction by dairy co-op Fonterra saw a 24% jump in whole milk powder prices, building on a similarly impressive 26% rise in the August auction. The previous auction result reduced the downside risk to our forecast of a $4.70/kg payout for the current season; with the latest result there's now clear risk to the upside, though there's still much that could happen between now and the end of the season in May.

The rising NZD …

There are still some questions about the likely pace and shape of the recovery, one of them being the influence of the New Zealand dollar. Our view has been that the rise in the currency since March is pre-empting the recovery rather than threatening it – and details such as the recent milk powder auctions provide some support for that view.

… will temper this good news …

There's another related question about the role of the exchange rate in monetary policy. The RBNZ's statement in July seemed to give a strong signal that further rate cuts are on the cards if the NZD doesn't fall back as they had projected. This isn't something that can be easily dismissed as jawboning, because the exchange rate plays a significant role in their forecasting framework – in fact, we've perhaps underappreciated how important it is. Their inflation model has evolved over the years, and the current version has more of a 'cost-push' flavour than in the past, with less weight on the output gap and more on current inflation and the currency.

… which seems to worry the RBNZ …

Now we should emphasise that we don't share this view – in recent history, the inflationary impact of excess demand has clearly trumped the disinflationary effects of a stronger currency. But if we take the RBNZ's framework as given, it suggests they will be looking to maintain an easy policy stance for some time to come.

… more than we think it ought to.

We expect the *Monetary Policy Statement* later this month to reiterate that the OCR is likely to remain at current levels until the latter part of 2010. The RBNZ will be keen to hose down any market speculation that they will take their lead from the RBA – the fact is that easy monetary conditions are more appropriate for an economy that has seen six straight quarters of declining GDP (based on our forecast of a 0.4% drop in Q2, to be published at the end of this month).

Michael Gordon, Markets Economist, New Zealand

New Zealand

Chart 1.

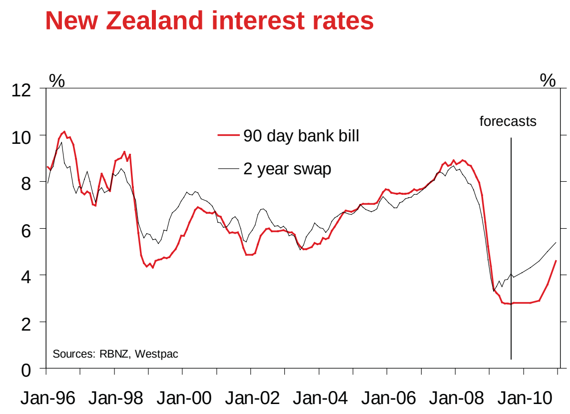


Chart 2.

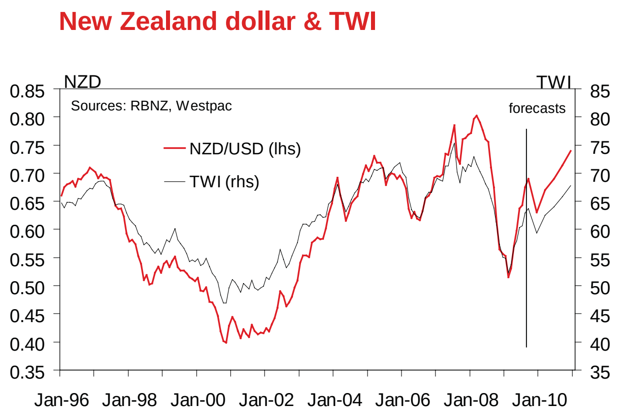


Chart 3.

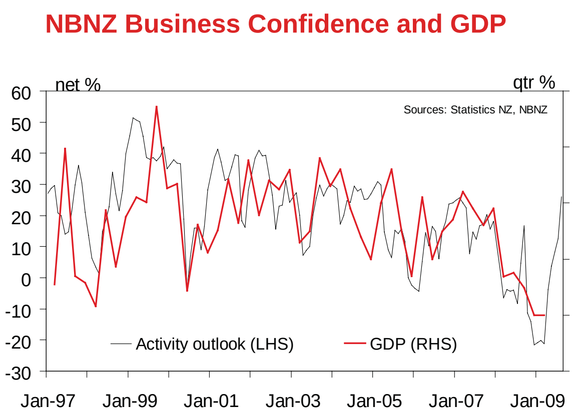
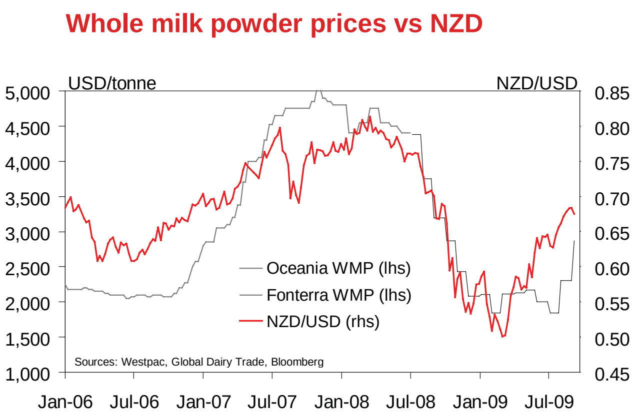


Chart 4.



Key New Zealand indicators

	2008				2009						
Monthly data	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**
REINZ house sales %mth s.a	0.9	–2.0	–15.9	26.3	–5.6	13.0	6.6	22.7	–12.1	6.3	7.4
New Residential Building Permits % yr	–17.8	–43.8	–46.6	–35.2	–53.4	–43.5	–30.4	–57.5	–25.1	–20.3	–15.4
Trade Balance NZDmn	–1,252	–994	–594	–341	–102	483	438	322	905	–332	–163

Quarterly data	**Q3:07**	**Q4:07**	**Q1:08**	**Q2:08**	**Q3:08**	**Q4:08**	**Q1:09**	**Q2:09**
Westpac McDermott Miller Consumer Confidence	113.5	110.0	96.5	81.7	104.8	101.3	96.0	106.0
Retail Trade %yr	5.1	3.4	–0.1	–2.4	–3.6	–3.7	–6.8	–4.0
Employment %yr	1.6	2.4	–0.2	0.8	1.0	1.0	0.8	–0.9
Unemployment Rate %	3.6	3.5	3.8	4.0	4.3	4.7	5.0	6.0
PPI Inputs %yr	1.9	4.3	7.3	12.3	13.6	9.7	4.7	–1.2
Real GDP %qtr	0.6	0.9	–0.3	–0.2	–0.5	–1.0	–1.0	–
Real GDP %yr	3.4	3.6	2.1	1.0	–0.2	–2.0	–2.7	–
CPI %yr	1.8	3.2	3.4	4.0	5.1	3.4	3.0	1.9
Current Account Balance % GDP	–8.7	–8.2	–8.0	–8.4	–8.7	–9.0	–8.5	–

Sources: Government agencies, Westpac Economics.

Corporate directory

Westpac Economics

Sydney
Level 2, 275 Kent Street
Sydney NSW 2000
Telephone (61–2) 8254 8372
Facsimile (61–2) 8254 6934

Bill Evans
Chief Economist
Global Head of Economics & Research

Andrew Hanlan
Senior Economist

Matthew Hassan
Senior Economist

Huw McKay
Senior International Economist

Justin Smirk
Senior Economist

Anthony Thompson
Senior Economist

Wellington
Vodafone on the Quay
Level 15, 157 Lambton Quay
Wellington, New Zealand
Telephone (64–4) 381 1413
Facsimile (64–4) 381 1406

Brendan O'Donovan
Chief Economist, New Zealand

Sharon Zöllner
Market Economist

Michael Gordon
Markets Economist

Donna Purdue
Economist

Doug Steel
Senior Economist

Dominick Stephens
Research Economist

London
63 St. Mary Axe
London EC3A 8LE
United Kingdom
Telephone (44–20) 7621 7061
Facsimile (44–20) 7621 7527

James Shugg
Senior Economist

Financial markets Australia

Sydney
Level 2, 275 Kent Street
Sydney NSW 2000
Telephone (61–2) 8254 9470
Facsimile (61–2) 8254 6933

Melbourne
Level 9, 360 Collins Street
Melbourne VIC 3000
Telephone (61–3) 9602 1900
Facsimile (61–3) 9602 1760

Brisbane
Level 14, 260 Queen Street
Brisbane QLD 4000
Telephone (61–7) 3227 2100
Facsimile (61–7) 3227 2055

Adelaide
Level 19, 91 King William Street
Adelaide, SA 5000
Telephone (61–8) 8230 2119
Facsimile (61–8) 8230 2137

Perth
Level 16, 109 St George's Terrace
Perth WA 6000
Telephone (61–8) 9426 2522
Facsimile (61–8) 9426 2261

New Zealand

Financial markets New Zealand

Wellington
Vodafone on the Quay
Level 15, 157 Lambton Quay
Wellington, New Zealand
Telephone (64–4) 381 1413
Facsimile (64–4) 473 7879

Auckland
Level 15
188 Quay Street
Auckland, New Zealand
Telephone (64–9) 363 1299
Facsimile (64–9) 367 3838

International

London
63 St. Mary Axe
London EC3A 8LE England
Telephone (44–20) 7621 7670
Facsimile (44–20) 867 7512

New York
Level 39, 575 Fifth Avenue
New York NY 10017–2422 USA
Telephone (1–212) 551 1820
Facsimile (1–212) 551 1997

Hong Kong
23/F Entertainment Building
30 Queen's Road
Central, Hong Kong
Telephone (85–2) 2842 9888
Facsimile (85–2) 2840 0591

People's Republic of China
Room 701, 708, Jin Mao Tower
No 88 Century Avenue
Pudong, P.R. China 200121
Telephone (8621) 6165 7688
Facsimile (8621) 5047 5008

Singapore
77 Robinson Road
#19–01, Robinson 77
Singapore 068896
Telephone (65) 6530 9898
Facsimile (65) 6532 6781

Port Moresby
Level 9, Deloitte Towers
Douglas Street
Port Moresby PNG
Telephone (67–5) 322 0888
Facsimile (67–5) 322 0841

Fiji Islands
Westpac House
73 Gordon Street
Suva, Fiji Islands
Telephone: (679) 330 0666
Facsimile: (679) 330 0718

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Publication enquiries, Westpac Economics, Telephone (61–2) 8254 8720, economics@westpac.com.au