

Leading Index continues to point to above trend growth

- The annualised growth rate of the Westpac–Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months into the future, was 6.3% in January well above its long term trend of 2.7%. The annualised growth rate of the Coincident Index rose to 3.9%, also above its long term trend of 3.2%.

After rising sharply over the second half of 2009, the Leading Index continues to point to strong momentum carrying into 2010. Although the annualised growth rate in the Index held steady in January – ending the rapid month to month acceleration seen since May last year – it remains well above its long run average, on a par with previous cyclical highs. Moreover there are now clear signs that the pick-up foreshadowed by the Leading Index is showing through in actual activity with the annualised growth rate in the Coincident Index rising back above trend for the first time since September 2007.

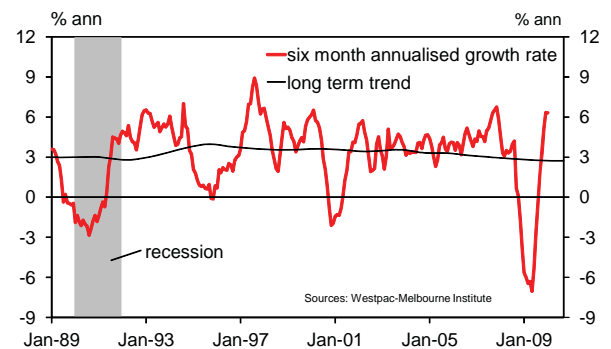
In terms of the components of the Index, the remarkable growth turnaround from -0.4% in August 2009 to 6.3% in January has been driven by: industrial commodity prices (+2.5 ppt's); US industrial production (+2.4 ppt's); real corporate profits (+1.4 ppt's); productivity (+1.1 ppt's); domestic labour market conditions (+0.4 ppt's) and dwelling approvals (+0.2%). These positives were partially offset by contractions in the real money supply (-1.1 ppts), partly reflecting tighter credit conditions, and the share price index (-0.1 ppt's).

The level of the Leading Index rose by 0.5 points (0.2%) in January. Two of the four monthly components of the Index fell, one held steady and one rose. The share price Index fell 6.2% in January, although the All Ordinaries has since regained most of that loss. Dwelling approvals also fell by 7% in January after several strong monthly gains. The real money supply component was flat and US industrial production rose 0.9%.

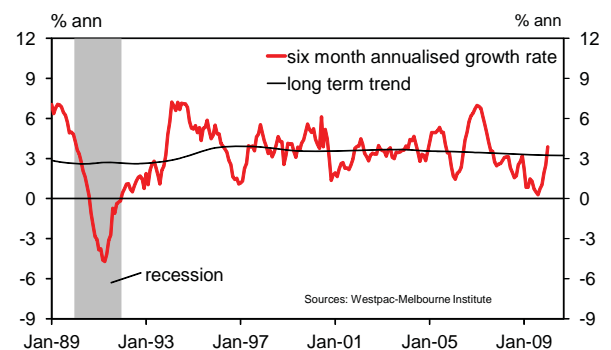
The Coincident Index, a companion measure that provides a gauge of the current pace of activity, is also now showing clear signs of acceleration. The annualised growth rate in the Index has risen from 0.3% in August to 3.9% in January, the fastest pace since July 2007, when GDP growth was running at 5%yr.

The Reserve Bank Board next meets on April 6. The minutes to the Board's March meeting show members saw further gradual moves in rates towards more normal levels as appropriate. Domestic indicators were seen as pointing to a strengthening in activity, with the Board even noting that "growth might already have been running at or close to trend". This is certainly the message coming

Westpac-MI Leading Index



Westpac-MI Coincident Index



from the January Leading and Coincident Indexes. That said there is still less urgency to the 'gradual' tightening moves than there was to the initial moves to unwind 'emergency' rate settings late last year. With rates now much closer to neutral (we assess that the Bank now believes rates are only around 50bp's below neutral), recent wage outcomes suggesting inflation is more likely to remain well contained near term and some residual uncertainty about surprisingly weak housing finance data, we expect the RBA to again opt for a pause in April. However, we continue to expect a resumption in the gradual tightening in May with a further 25bp rate hike and a final hike taking the cash rate to 4.50% in Q3. We expect labour market conditions and consumer confidence to be the key factors shaping policy this year with the former determining the pace of policy tightening and an expected sharp pull-back in the latter providing the signal for an extended pause.

Matthew Hassan, Senior Economist