Bulletin

18 May 2011

Consumer sentiment edges lower

- **The Westpac-Melbourne Institute Index of Consumer Sentiment fell 1.3% in May from 105.3 in April to 103.9 in May.**

This is a modest adjustment to the Index but the result is still sending a subdued message about the state of the consumer today. This is the lowest level of the Index since June 2010, a month which followed three consecutive rate hikes by the Reserve Bank in March, April and May.

In the current period, interest rates have been steady since November last year with the Reserve Bank remaining on hold again in May. However the Bank did significantly change its rhetoric in May. This change prompted a number of commentators, including Westpac, to move forward their forecast timing for the next rate increase to next month. Coverage of that development may have unnerved consumers.

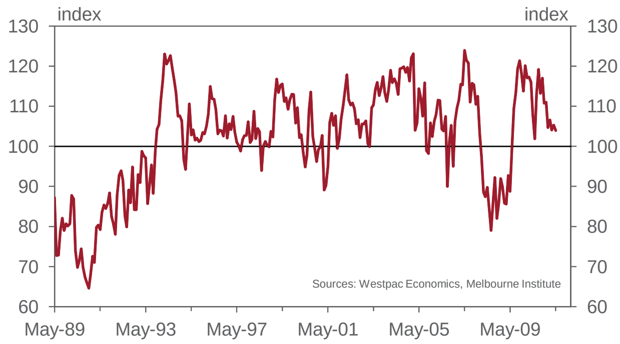
The survey was conducted after the announcement of the Federal Budget. Opinion polls and responses to a special question in this survey pointed to the Budget being poorly received with respect to respondents' assessments of their own finances. The special question in the Westpac–Melbourne Institute survey showed that 36% of respondents expected that the Budget would worsen their family finances over the next 12 months and only 7% expected it would improve their finances. The balance indicated no change. That compares with a similar question relating to the Budget in 2010 where 27% expected the Budget to worsen their finances with 11.5% expecting an improvement.

Consistent with this result, we saw some disturbing movements in the components of the Index. The comparison of family finances to a year ago fell by 4.1% while expectations for family finances over the next 12 months fell by 6%.These components represent 2 of the 5 components of the overall Index. If we track an Index of family finances by combining these 2 components we note that the Family Finances Index is at its lowest level since July 2008 and there has only been one other read of the Index (June 2008) which has been lower since the early 1990's when families struggled in the aftermath of Australia's last recession.

The Family Finances component of the Index is signalling a more disturbing picture of the household sector than the overall index. For example, the overall index is 17% higher than the average read in 2008 whereas the Family Finances Index is 6% lower than its average in 2008.

Other components of the Index performed much more solidly in May. The outlook for economic conditions over the next 5 years rose by 3.5%. The one year outlook for the economy fell by 3.2%, while whether now is a good time to purchase a major household item rose by 1.7%. The strength of the Australian dollar, which briefly touched USD 1.10 since the last survey and ongoing reports of Australia's benefitting from the commodity boom are likely to be boosting long term confidence in the economy. The high dollar with its associated impact on the prices of imported goods may explain why respondents see buying opportunities although concerns about their finances are holding back actual purchases.

Consumer Sentiment



There was also a little more confidence in housing. "Time to Buy a Dwelling" Index rose by 2% although that index is still 1.7% below its average level over the previous 6 months.

In Reserve Bank Governor's Statement following the Board meeting in May; the Statement on Monetary Policy for May; and the minutes for the Board meeting for May the Bank has significantly strengthened its rhetoric on the outlook for interest rates. It is now using the language which has, in the past, been used in the month leading up to a rate hike. Combining this with its assessment that the dominant inflation risks are associated with the investment outlook and boost to incomes associated with the mining boom we decided to bring forward our call for the next rate hike from the September quarter to next month. A rate hike next month will be a brave decision and, of course a central bank will never be locked in to a set of fixed rules particularly associated with the language it uses in its reports and statements. For example, over the last 10 years the Bank has only raised rates once (March 2008) when Consumer Sentiment has been below the current level.

Nonetheless, we expect that the Bank is still likely to raise rates by next month. However, we have also argued that such a move is unlikely to be the beginning of a sequence of moves with the next hike not being required until the June quarter next year.

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