

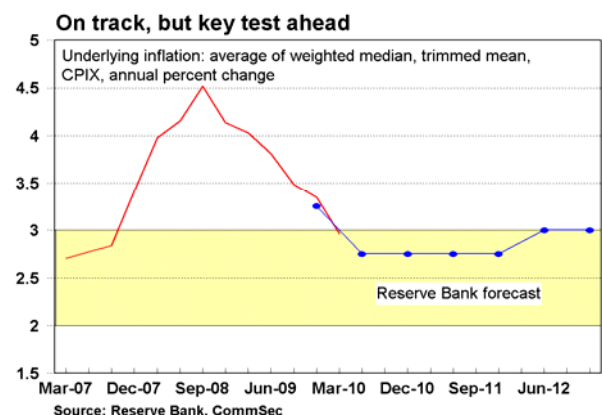
RBA sets the scene for a rate hike

RBA Board minutes; ABARE Australian Commodities; Airfares

- Minutes of the last Reserve Bank Board meeting echo's the sentiments of the Governors speech yesterday and adds further weight to the likelihood of an interest rate hike.
- Board members remained quite comfortable with current interest rate settings, however "observed that previous investment booms and increases in the terms of trade had posed significant challenges for economic policy and that high levels of resource utilisation was likely to put pressure on inflation".
- The Australian Government's chief commodity forecaster, ABARE, expects commodity export receipts to rise by 26 per cent in 2010/11 to a record \$215 billion in 2010/11. The surge in exports can be largely attributed to the higher coal and iron ore volumes. The latest forecast on commodity exports is 6.1 per cent higher than the estimate made three months ago.
- Australians are travelling more, especially on key business routes like Melbourne-Sydney, and the key message is to shop around for the best deals because airfares are creeping higher. All but discount airfares are now higher than a year ago according to latest data from the Bureau of Infrastructure, Transport and Regional Economics.

What does it all mean?

- The latest Reserve Bank minutes have added further weight to the Reserve Bank Governors speech yesterday. While board members were comfortable with current interest rate setting, they took a look back in the past and discussed previous investment booms and the resulting challenges on the economic policy. The limited spare capacity in the economy is also another reason that the central bank has been giving veiled threats about inflation and the possibility of another rise in the cash rate.
- Effectively the Reserve Bank is softening up households and businesses to get used to the idea of a further interest rate hike in the next couple of months. Rates are currently at a neutral setting but the Reserve Bank is making noises about moving to a more restrictive stance as the economy gears up for the second leg of the commodity boom.
- Board members are clearly more optimistic on the recovery in the global economy, highlighting the sustainable recovery in China, the Asian region in general and improved economic conditions in Europe. Domestically the limited spare capacity in the economy in particular in the labour market is likely to play a crucial role in how quickly interest rates are raised going forward. And given that the domestic recovery is only in its infancy, CommSec would expect labour shortages are likely to become more prominent over the coming year.
- Looking forward, CommSec believes that the October meeting is certainly a "live" call. However we would argue that the Reserve Bank would best served waiting out until the inflation data is released in late October before pulling the interest rate trigger. The weak trading environment for retailers would add weight to the argument for interest rates to remain on hold over the next month.
- The latest forecasts from ABARE underline the fact that



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a recovery is taking place not just in the domestic economy but also in a global sense. Commodity export revenue is expected to surge by 26 per cent in 2010/11 courtesy of a significant pick up in mining volumes – in particular in iron ore and coal. It should be noted that ABARE believes that contract prices on most commodities are likely to remain around current level.

- Interestingly the sharp lift in export receipts is despite the assumption that the Australian dollar is expected to average around US90 cents over 2010/11 rather than the US87 cents that was previously forecast in the June quarter release.
- Farmers are also expected to benefit with production and income tipped to increase over the coming year. In particular the eastern states have recorded one of the best starts to a winter cropping season for many years. At the same time livestock farmers are likely to benefit from an average five per cent increase in the saleyard price over 2010/11. The historic low US beef herd is certainly good news for Australian farmers with beef exports to the US now expected to rise by around 14 per cent in the coming year.
- The outlook for commodities is certainly more optimistic than even just three months ago. While coal and iron ore prices are expected to remain stagnant, the pickup in export volumes is the key driver. Recent economic growth data has highlighted the strength of the Asian region and as the global economic recovery gains traction, demand for Australian mineral exports will gain momentum.

What do the figures show?

Minutes from the April 2010 Reserve Bank Board meeting

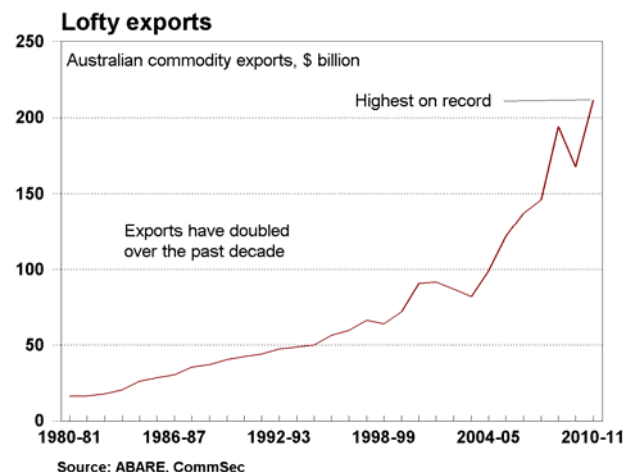
Key Comments:

“Members observed that previous investment booms and increases in the terms of trade had posed significant challenges for economic policy, and that high levels of resource utilisation were likely to put pressure on inflation.”
“The central scenario remained for the Australian economy to grow at trend pace, or a bit above, over the next few years.”

- **Consolidating housing market:** *“Conditions had cooled in the established housing market, partly reflecting the return of mortgage rates to more normal levels. At the national level, prices had been broadly unchanged since April, with the top end of the market tending to be softer than the rest of the market. Auction clearance rates in Sydney and Melbourne had been around average levels recently, after having been considerably above average earlier in the year. Housing loan approvals were estimated to have been broadly flat in July and were well below their peak in late 2009”*
- **Business investment:** *“While business investment fell slightly in the quarter, the capital expenditure survey for the June quarter showed a significant upgrading of investment intentions from what was already a positive outlook. Members discussed the factors underpinning this increase, including high commodity prices, strong corporate profitability and above-average levels of capacity utilisation. Members expected that the boost to investment in the resources sector would stimulate activity elsewhere in the economy, even though there was a significant imported component in the planned LNG projects”.*
- **Wage growth:** *“The main news on prices and wages had been the release of the June quarter wage price index, which showed that wage growth in the private sector had remained relatively modest, though it had picked up a little over the first half of 2010. In contrast, growth in public-sector wages had continued at a firm pace. Business surveys and liaison suggested that a gradual pick-up in wage growth was expected over the next year.”*
- **Inflation:** *“Several measures of inflation expectations had eased a little over recent months to be around average levels. Similarly, business surveys reported that the share of businesses planning to increase their prices over coming months was around average.”*

ABARE Commodity Report

- The Australian Government’s chief commodity forecaster, **ABARE**, has revised up commodity export receipts for the 2010-11 compared with 2009-10. Exports are expected to rise from the 23.6 per cent forecast in the June quarter to 26.0 per cent in September. Export earnings are expected to total \$215 billion in 2010-11.
- The 6.1 per cent upgrade in forecasts for the coming financial year is largely due to the stronger prices for coal and iron ore commodities as well as the assumed recovery in world economic growth. The volatility in the Australian dollar will have a significant impact on these forecasts and ABARE has upgraded its view of the strength in the Australian dollar now expecting it to average US90 cents in 2010/11, up from its June



forecast of US87 cents.

- Export earnings from energy and minerals are forecast to be \$180 billion in 2010/11, compared with \$138.5 billion in 2009/10. Expected higher export shipments for a range of commodities including copper, gold and iron ore are the main reasons for the higher forecast. Also the increase is supported by higher export earnings for metallurgical coal and thermal coal, which are forecast to increase by 41 per cent and 33 per cent respectively. Total mine production is expected to rise 12 per cent in 2010/11 compared with 2009/10 estimates. Australia's gold exports are estimated to rise by 38 per cent in 2010-11 to 18 billion.
- Farm export earnings are forecast to be around \$31.4 billion in 2010/11, an increase of 10 per cent from an estimated \$28.5 billion in 2009/10. The volume of farm production is tipped to rise by 8.1 per cent in 2010/11 after falling by 1.1 per cent in 2009/10.
- Australian wheat production is forecast to increase by 16 per cent in 2010–11 to 25.1 million tonnes. Wheat growers in eastern Australia have experienced the best seasonal conditions in many years.

Domestic airfares

- Australians are travelling more, especially on key business routes like Melbourne-Sydney, and the key message is to shop around for the best deals because airfares are creeping higher.
- All but discount airfares are now higher than a year ago according to latest data from the **Bureau of Infrastructure, Transport and Regional Economics**.
- Business class fares in September were up 6.5 per cent on a year ago, the fastest annual rate in 21 months (since December 2008)
- Full economy airfares are up 5.9 per cent on a year ago, the fastest annual pace since February 2010.
- Restricted economy fares are up 0.4 per cent on a year ago, actually an improvement on the 1.6 per cent annual gain in August.
- But discount airfares are still down on a year ago. In September best discount fares were down 11.1 per cent on a year ago, a bigger decline than the 3.6 per cent annual fall to August. Discount fares have been falling in annual terms since April 2009. But the smoothed 13-month average discount fare index bottomed at 66.2 in May 2010 and now stands at 74.9.

What is the importance of the economic data?

- The **Reserve Bank releases minutes of its monthly Board meeting** a fortnight after the event. The minutes give a guide to Reserve Bank thinking on interest rate settings.
- The **Australian Bureau of Agricultural and Resource Economics (ABARE)** releases its Australian Commodities publication four times a year. The latest estimates assist in assessing conditions for the rural and resources sector and companies leveraged to these industries.
- The **Bureau of Infrastructure, Transport and Regional Economics (BITRE)** release data on airfares on a monthly basis. The figures are useful in getting a gauge on airline profitability. The data is also useful in monitoring consumer spending trends.

What are the implications for interest rates and investors?

- There is no pressing need for the RBA to raise interest rates in two weeks time. However given the latest round of commentary a rate hike is certainly on the cards over the next two months. The previous rate hikes have allowed the Reserve Bank an added degree of flexibility, and waiting on the inflation data late October before raising rates could be the best possible outcome.
- The resources sector is well placed for the longer term. There are strong signs of a sustainable recovery in Asia. And the recent weakness of the US dollar will also support the demand for Australian commodities (given that most are priced in US dollars) over the mid-term. Longer term forecasts suggest an insatiable appetite for commodities from emerging economies like China and India, which will help to shore up the Australian economy over coming years

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