

Economic research note

Issued by Property and Alternative Investments division

Monthly snapshot of the Australian economy

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Executive summary

- The Australian economy continues to perform well with ongoing positive momentum in domestic demand. However, a shifting global growth profile presents risk to domestic growth.
- Historically low levels of unemployment have been sustained along with continued growth in the participation rate. Employment growth in the economy remains strong.
- Strength in the AUD/USD exchange rate has been underpinned by respective central bank interest rate differentials and strong commodity prices (albeit below all time highs). However, a softening in commodity prices has contributed to the AUD retreat against other major currencies.
- RBA commentary suggests the 25bps rate rise in February is unlikely to ease price inflation in the short-term. In the absence of a moderation in domestic demand, the tightening bias is set to continue with an easing of monetary policy unlikely in 2008.
- The performance of global equity markets has weighed heavily on the Australian Stock Market. This has been caused in part by concerns that global growth will moderate due to mounting evidence of a recession in the US.
- If the RBA's tightening bias continues it will have a negative impact on housing supply for the already tight property sector. We see active fiscal policy as a solution to this problem.

1. Introduction

The economy is considered a key driver of underlying performance for many asset markets including property and infrastructure markets. Consequently, this information feeds through in the formulation of house views for selected asset markets.

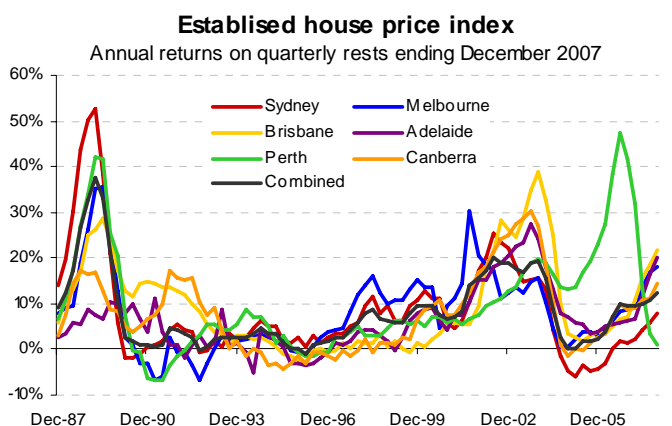
The Reserve Bank of Australia (RBA) raised the Official Cash Rate (OCR) by 25 basis points (bps) in early February; the OCR is now 7.00%. Further tightening in monetary policy by the RBA has been driven, in the most part, by continued strength in domestic household demand. This is despite a 2.5 percentage point increase in the OCR since May 2002.

While Australian economic growth will continue to be supported by Australia's leverage to demand from developing countries (via commodity exports), this will be offset by the impact of slowing global growth which, in turn, will put downward pressure on commodity prices. Any softer than expected development in the Asian region will provide added downside risk to commodity prices.

Price pressures are set to remain high in the short term and are expected to moderate in 2009, with minutes from the RBA's board meeting alluding to the potential for a further rate rise to stabilise short-term price pressures. There is a danger that the rate rise, occurring in the midst of a worsening global growth environment, could damage Australian economic growth but we remain more concerned about inflation.

2. Key economic indicators

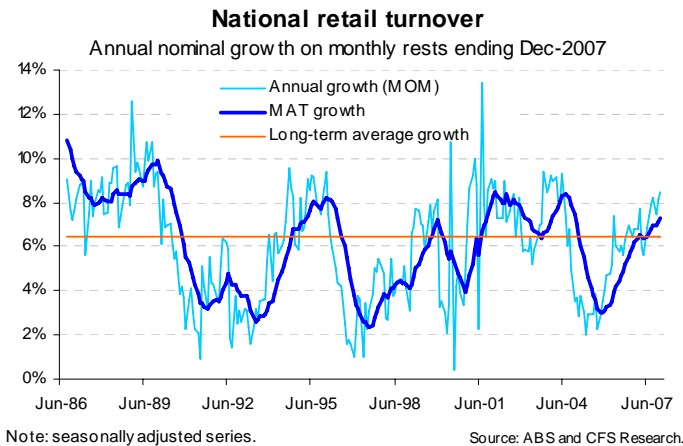
Housing sector



Source: ABS and CFS Research.

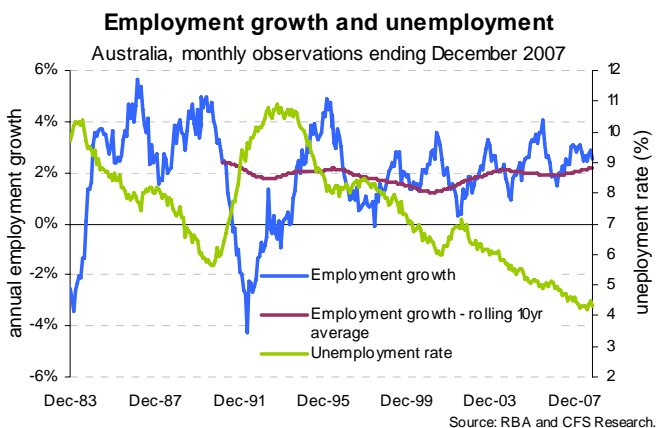
- House prices for major Australian cities increased by 3.2% on a weighted average basis in the December quarter 2007. On an annual basis house prices increased 12.3%.
- After significant price increases in 2006 the Perth housing market continued to moderate with low single-digit growth. Notably, Adelaide and Brisbane established house prices achieved annual growth of 20% for the year.
- Excess demand conditions and plummeting building approvals will place upward pressure on prices in 2008.

Retail spending



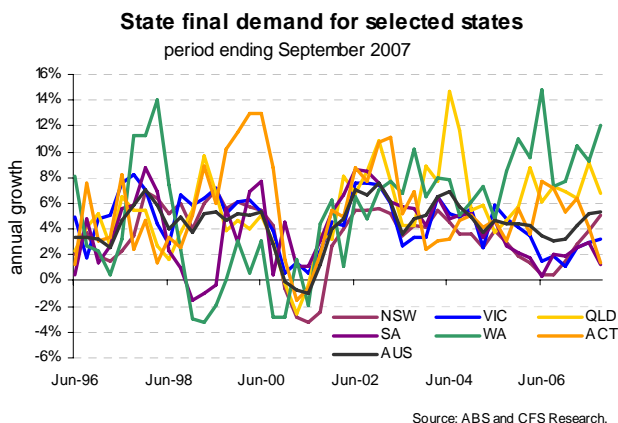
- Annual nominal retail sales grew by 8.4% to December 2007. This result represents a healthy state for the retail sector and continued strength in domestic demand.
- Retail turnover has been on an upward trend since June 2005 and remains in a strong position despite increasing fuel costs and the burden of higher mortgage repayments.
- The strong annual retail sales growth, led by sales in household goods, underpinned the RBA's decision to raise interest rates.

Labour market



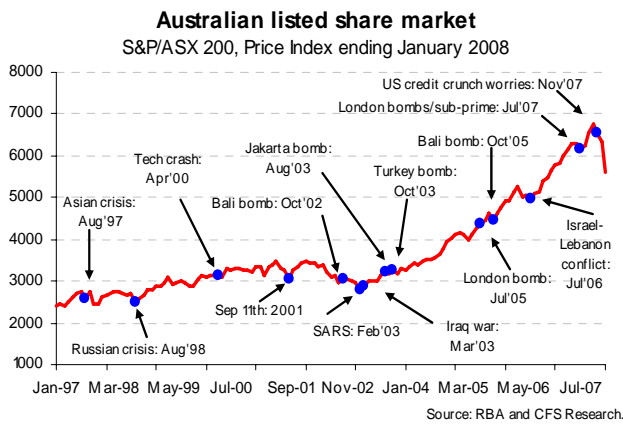
- The labour market remains tight with the national unemployment rate near 30 year lows at 4.3%.
- The unemployment rate has been steadily declining since the early 1990's, highlighting the strength of the economy. The declining unemployment rate has been associated with an increase in the participation rate since 2004. This rising participation is partly due to solid labour market conditions.
- The strong total employment growth experienced since June 2006 has been maintained with annual growth of 2.5% as at December 2007.

State economic growth



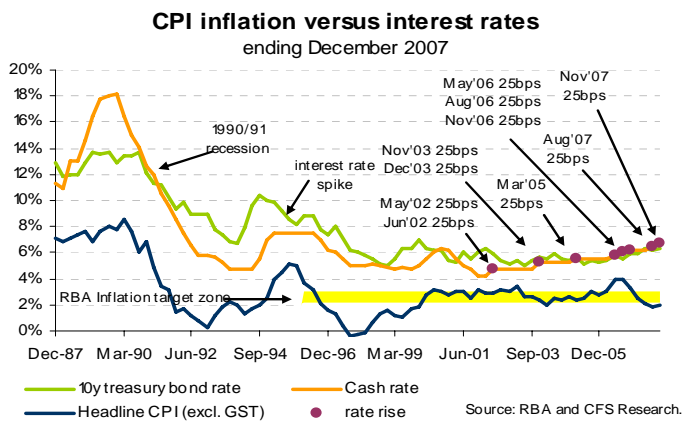
- The Australian economy has maintained the growth momentum that began in June 2006. Notably, this growth has been led by a recovery in NSW state final demand (SFD) to an annual rate of 5%.
- The chart shows the important contribution of the Western Australian and Queensland economies, with annual growth in SFD of 12% and 6.8% respectively, to Australia's growth. Continued decline in resource prices poses a risk to this growth which has been leveraged to demand from Brazil, Russia, India and China (BRIC).

Listed stock market



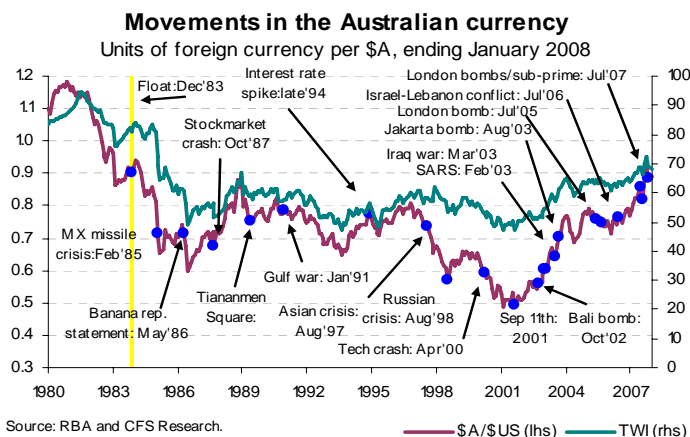
- The S&P/ASX200 has declined by 17% from its peak in October 2007.
- The performance of global equity markets, particularly in the US, has weighed heavily on the Australian Stock Market. This has been caused in part by concerns that global growth will moderate due to mounting evidence of a US recession.
- Companies with high gearing appear to have suffered from a contraction in equity valuations, caused in part by the global credit crunch. Further write-downs in sub-prime related investments by notable US investment banks contributed to the significant volatility experienced recently.

Interest rates



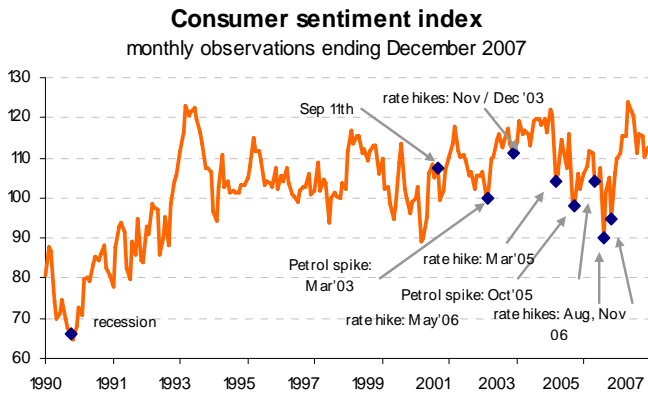
- On 30 January 2008 the FOMC lowered its target for the federal funds rate by 50bps to 3.00%; this followed a 75bps cut on 22 January 2008. On 4 February 2008 the RBA increased the official cash rate by 25bps to 7.00% (not included in chart).
- The RBA has maintained its tightening bias since May 2002. Strong domestic demand and commodity price pressures have contributed to inflation remaining at the upper end of the RBA's target zone.
- Inflationary price pressures caused in-part by continued drought conditions and rising energy prices, have emerged over the course of the current tightening cycle. While the RBA has accepted that short-term inflation will remain above its comfort zone, it expects these pressures to "moderate" in the medium term.

Exchange rates



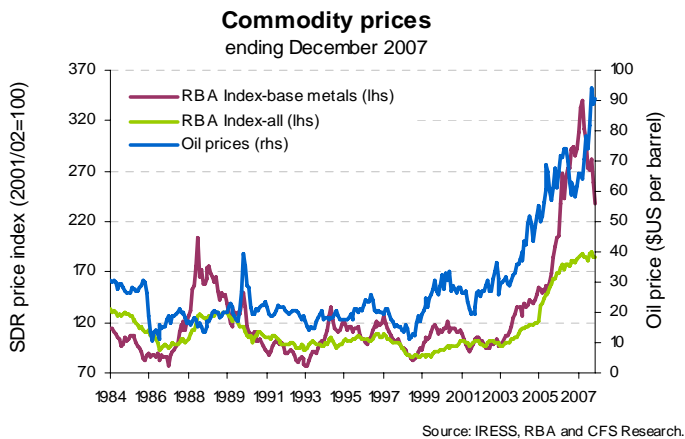
- The AUD maintained its range in the high 80's against the USD during January. This is despite declines against other major currencies.
- The AUD continued its retreat against the JPY, due in part to further unwinding of JPY "carry-trades". This marks a 10.5% decline for the AUD against the JPY since October 2007.
- Recent AUD weakness against most major currencies has been caused by continued volatility in global financial markets and a decline in base metal prices. Key risks to the AUD's current levels are contracting interest rate differentials and a fall in demand from BRIC for raw materials which will have a negative impact on commodity prices.

Consumer sentiment



- The chart shows what little impact successive interest rate rises have had on consumer sentiment, as measured by the Westpac-Melbourne Institute of consumer sentiment.
- Sustained momentum in this index, a key indicator of consumer demand, will be of concern for the RBA who have indicated that “a significant slowing in demand from its recent pace is likely to be necessary to reduce inflation over time.” Strong retail sales do little to ease this short-term inflation risk.

Commodity prices



- In gauging the movement in commodity prices the chart shows the RBA’s Index of Commodity Prices (ICP) since 1984 on an SDR basis. The ICP index has been driven in recent months by high oil prices.
- Despite continued positive momentum in the crude oil price, the index declined in December led by falls in base metal prices caused, in part, by downside risk to global commodity demand.
- Special Drawing Rights (SDR’s) are a weighted measure of international currencies published by the IMF.

3. Research team

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