

Investing Opportunities in Australia

October 2011

- *Short-term interest rates are unlikely to fall as markets are pricing*
- *Bond yields will rise but by less than global yields*
- *The dollar is extremely high but may not be overvalued*

Australia's economy escaped very lightly from the global recession in 2008/2009, helped by the continuing surge in commodity prices. More recently, the natural disasters of 2010/2011 have contributed to a slowdown. Both the household sector and the government sector are well placed to expand expenditure so, if commodity prices remain elevated, the current slowdown in economic growth may prove temporary. Even if some capacity constraints emerge, inflation should remain contained as international competitive pressures remain strong (see table of key forecasts).

The Reserve Bank of Australia started normalising monetary policy in 2009 and has moved monetary conditions towards the tighter end of "neutral". The very high level of the currency has also contributed to the overall tightening of monetary conditions. In recent months, concerns about the global outlook have fuelled expectations that official interest rates will be lowered substantially in the coming months (see top chart). Such an outcome is possible but seems unlikely unless the outlook deteriorates markedly. The risks are heavily skewed towards a slower pace of interest rate reductions or, perhaps more likely, no reductions at all.

Australian 10-year bond yields have fallen sharply in the past couple of months mirroring the decline in yields in other countries. The yield curve is now inverted and bond yields are near the multi-decade lows reached during the 2008/2009 global recession (see middle chart). Real yields are also low by historical standards. With bond yields being low relative to short-term interest rates and low in both real and nominal terms, a rise in bond yields seems much more likely than a fall. Nevertheless, because Australian bond spreads are wide by historical standards, yields will probably only rise when global bond yields are rising and Australian yields are likely to increase by less than those in many other countries.

Following a spectacular depreciation in the final months of 2008, the Australian dollar rebounded equally spectacularly in 2009. Since then, it has risen further and in trade-weighted terms, the AUD was at a multi-decade high before declining in the past month (see bottom chart). The current high level almost certainly reflects the influences of the high terms of trade and the relatively high Australian interest rates. It is not certain that the currency is overvalued, even at current levels, but if global interest rates rise relative to Australian interest rates, this could place the dollar under some downward pressure.

In recent months, equities have declined sharply in line with most other global markets. The return during the past year has been a loss of more than -5%. The uncertainties in the economic outlook suggest that highly positive equity returns are unlikely over the coming year but if the terms of trade remain high, the corporate sector should remain in a solid position.

Key Forecasts			
	Dec-11	Dec-12	Dec-13
GDP	2	3	2
CPI	3	3	3
Cash rate	4.75	5.75	6.00
10 year	5.00	6.50	6.50
AUD/USD	1.00	0.90	0.83
AUD/YEN	80	90	90
NZD/AUD	0.80	0.78	0.78

