



Commonwealth Bank of Australia

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The Economic Backdrop

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Important Information



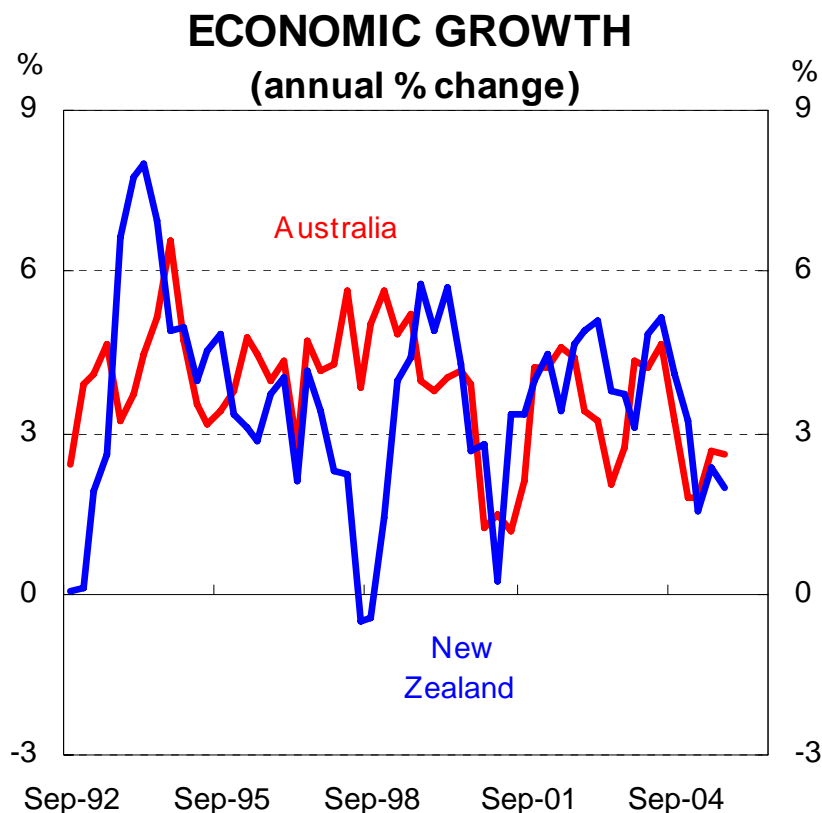
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At the Frontier?

Full ahead or dead stop?

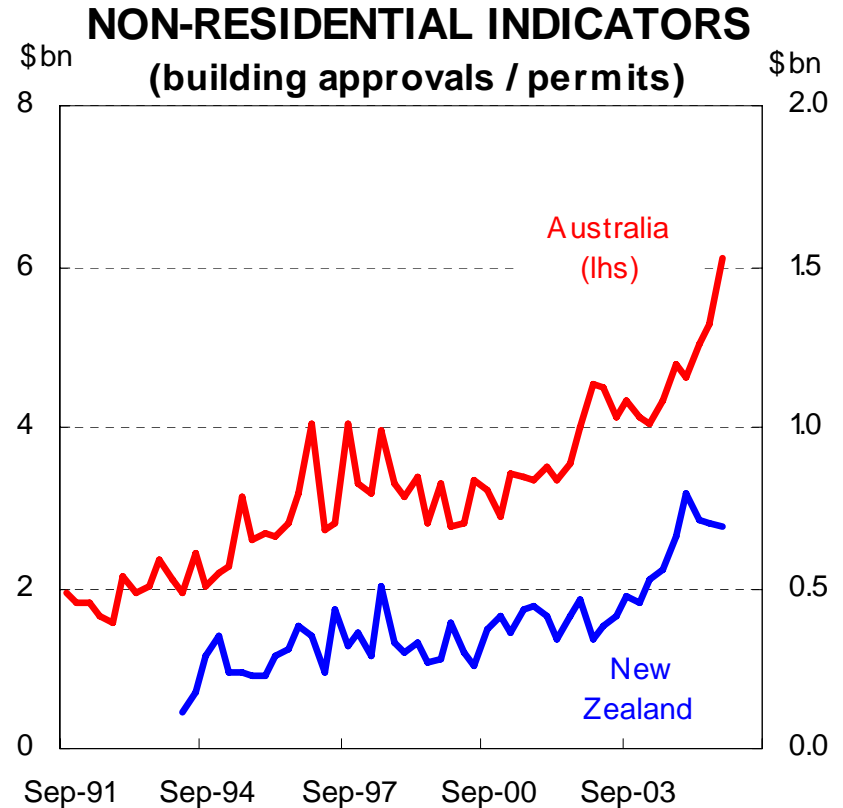
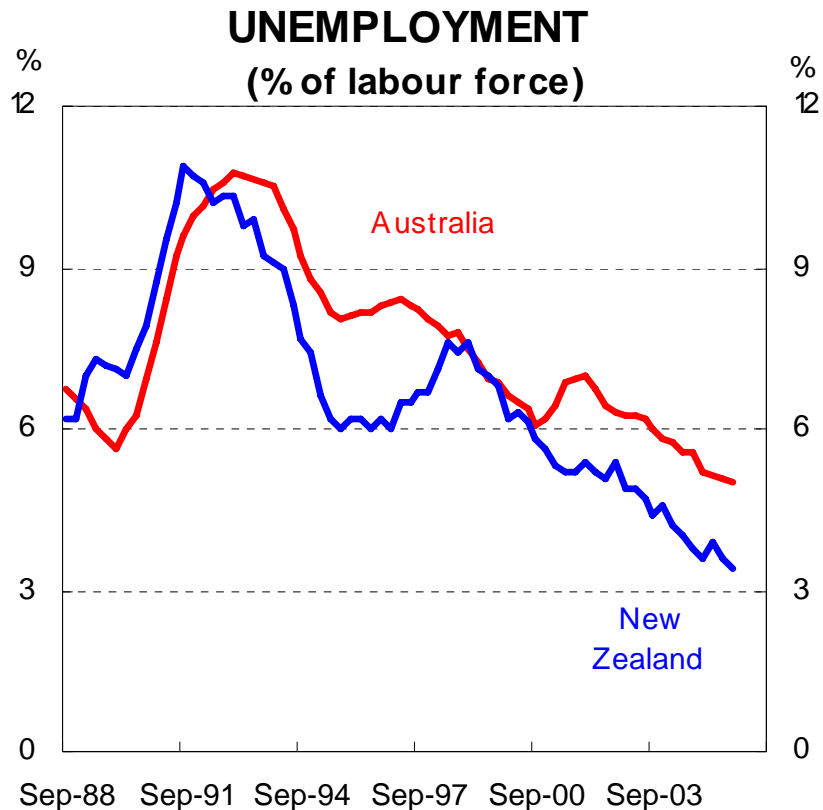


- Growth rates at the bottom end of the range of recent years.
- High oil prices, rising interest rates, higher currencies etc part of the story.
- But also indications that capacity constraints are biting.



At the Frontier?

Squaring the circle

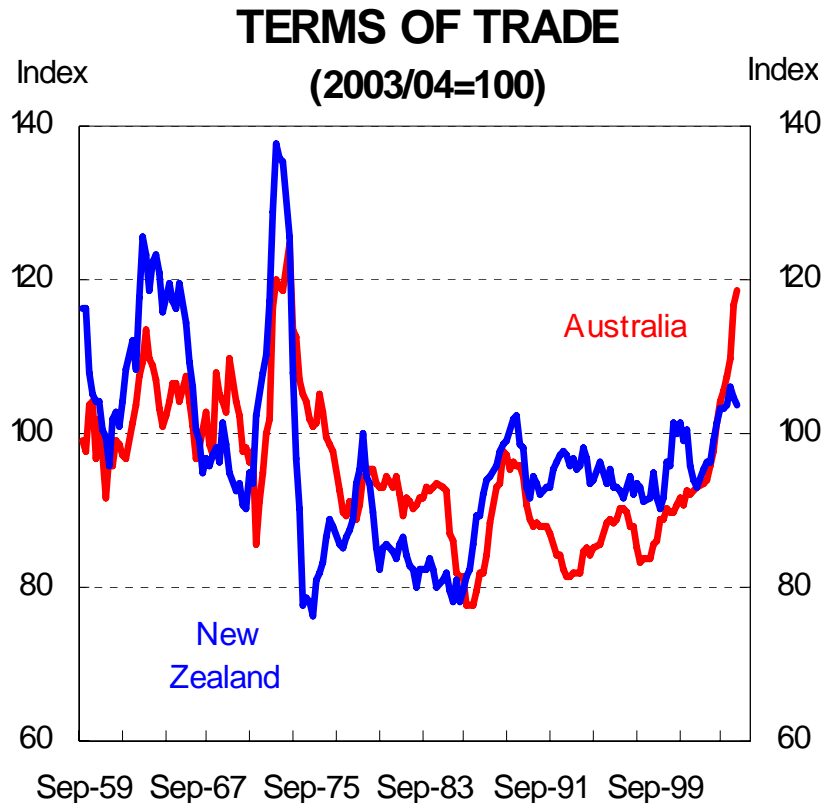


- Difficult to squeeze *additional* output from existing capital/labour inputs.
- Rising business investment part of the correction process.



The Terms-of-Trade Supercharger

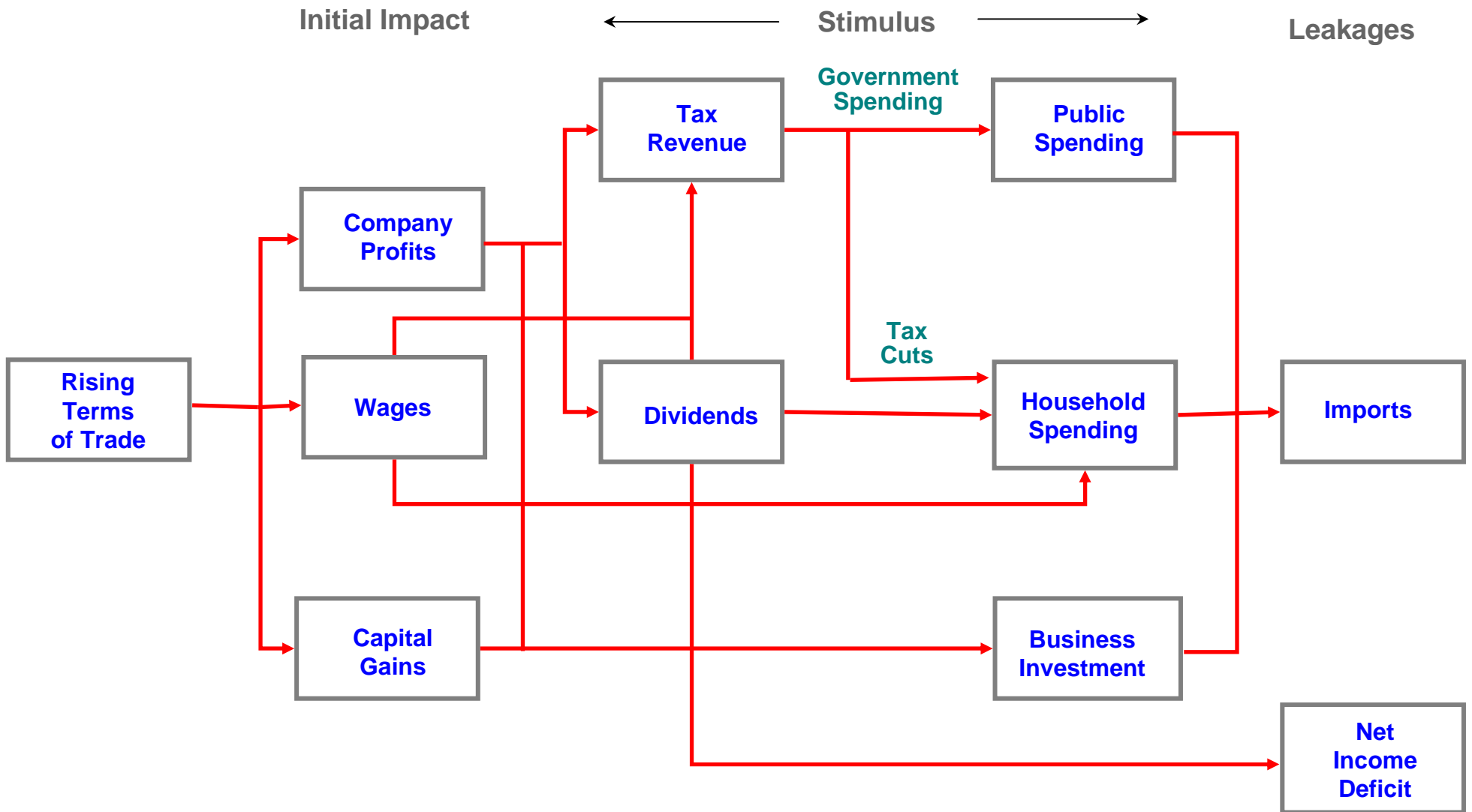
Fattening the wallet



- The terms-of-trade (ratio of export prices to import prices) at highest levels since mid 1970s.
- Rising incomes keeping *spending* strong even as capacity constraints slow *production*.

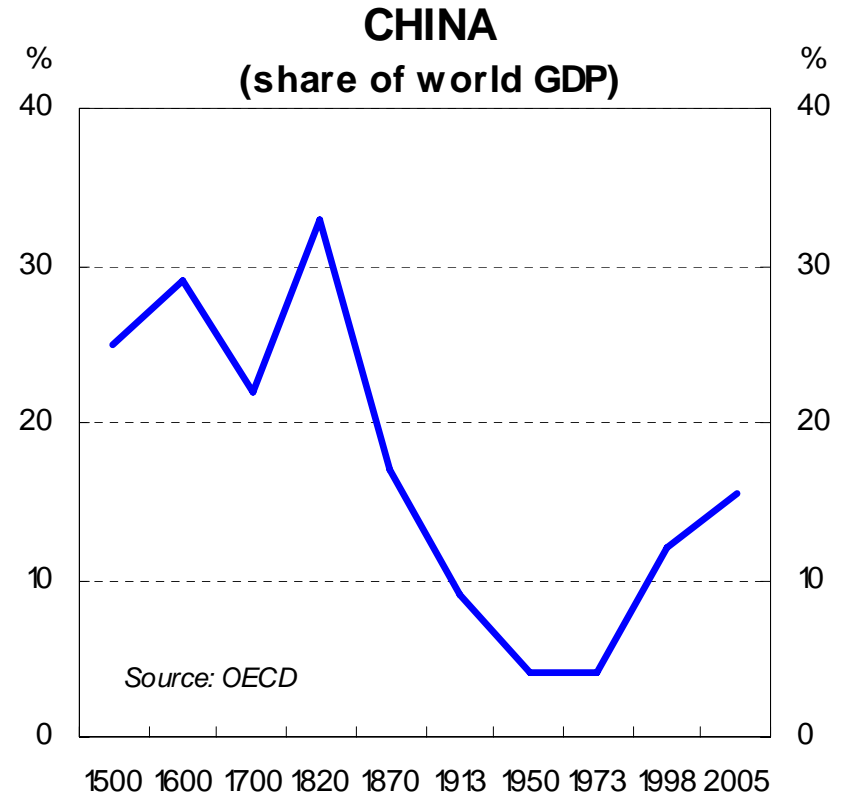
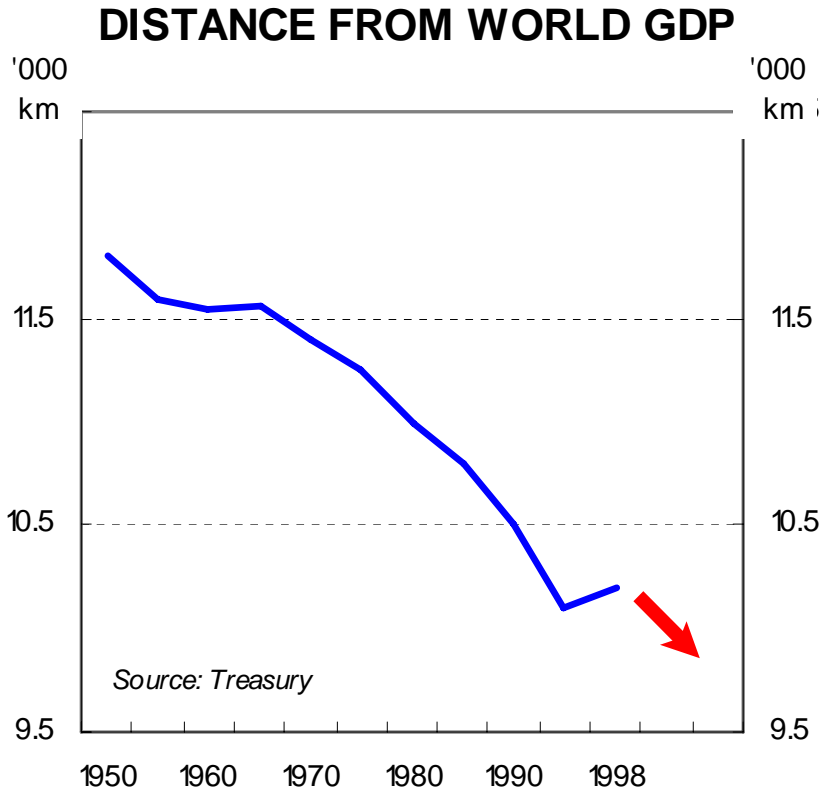


The Terms-of-Trade Supercharger



The Terms-of-Trade Supercharger

The China boost



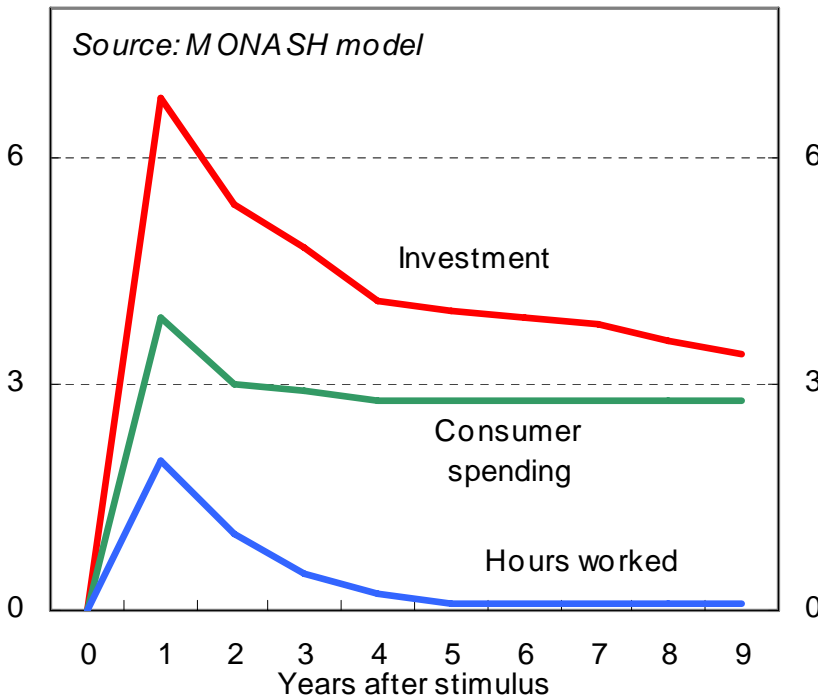
- Centre of world economic gravity shifting toward Asia.



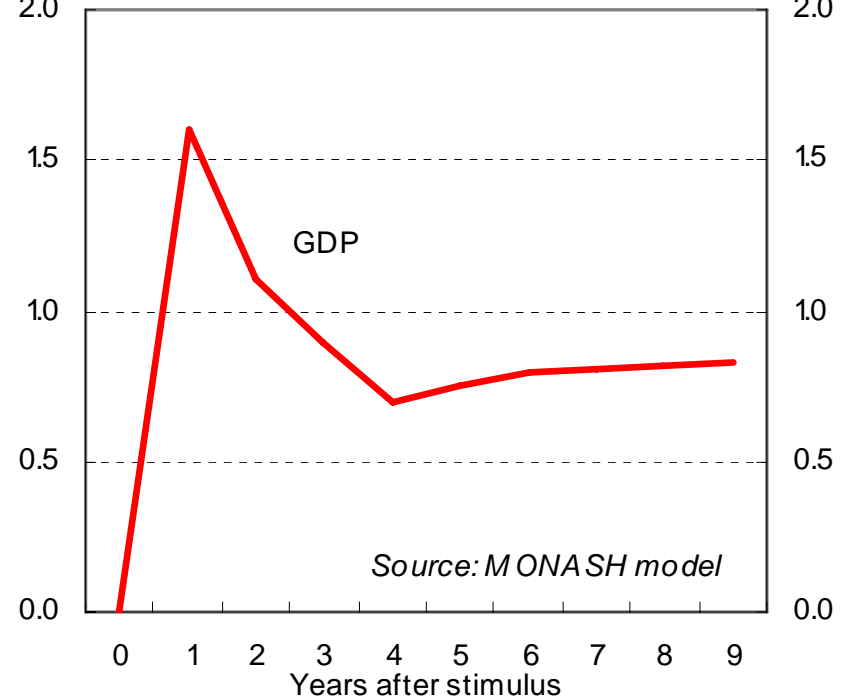
The Terms-of-Trade Supercharger

Australia: more income = more spending = inflation risks?

IMPACT OF A 10% RISE IN THE TOT
(% deviation)



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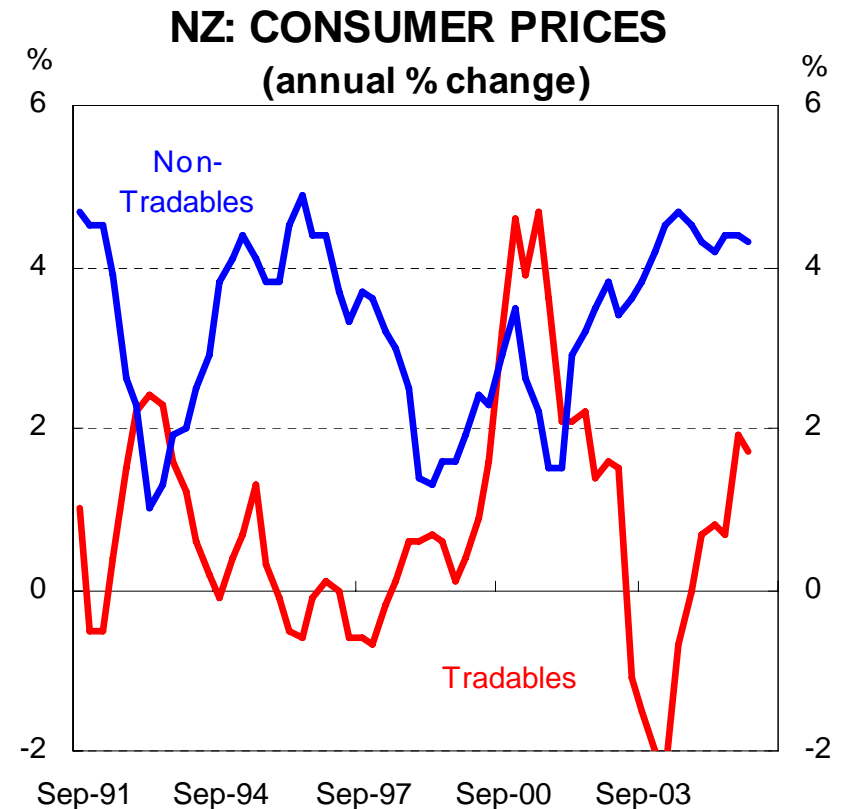
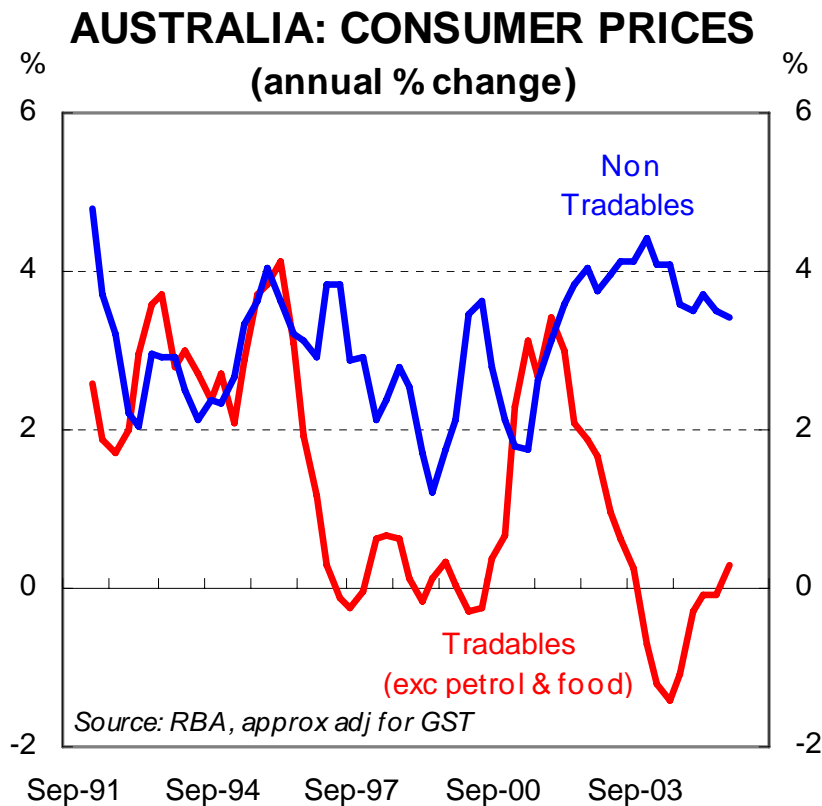


- Rising terms-of-trade boosts incomes, spending and employment.
- If capacity constraints prevent GDP response, then inflation risks rise.



Inflation Risks

Mind the gap

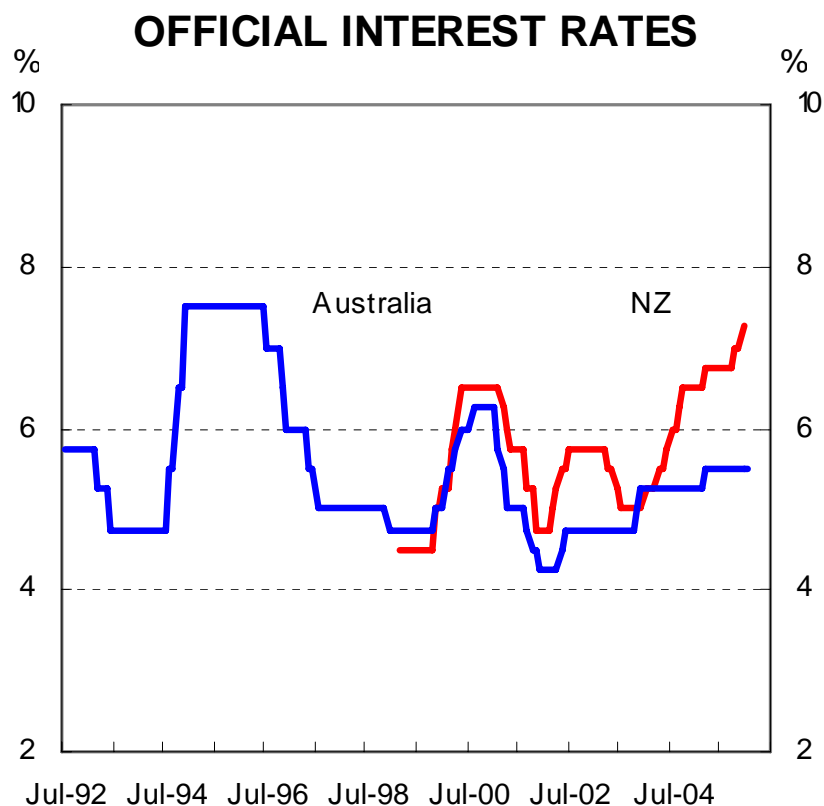


- Capacity issues are contributing to domestic price pressures.
- The benefits from a rising currency are used up.



Monetary Policy

Game over?

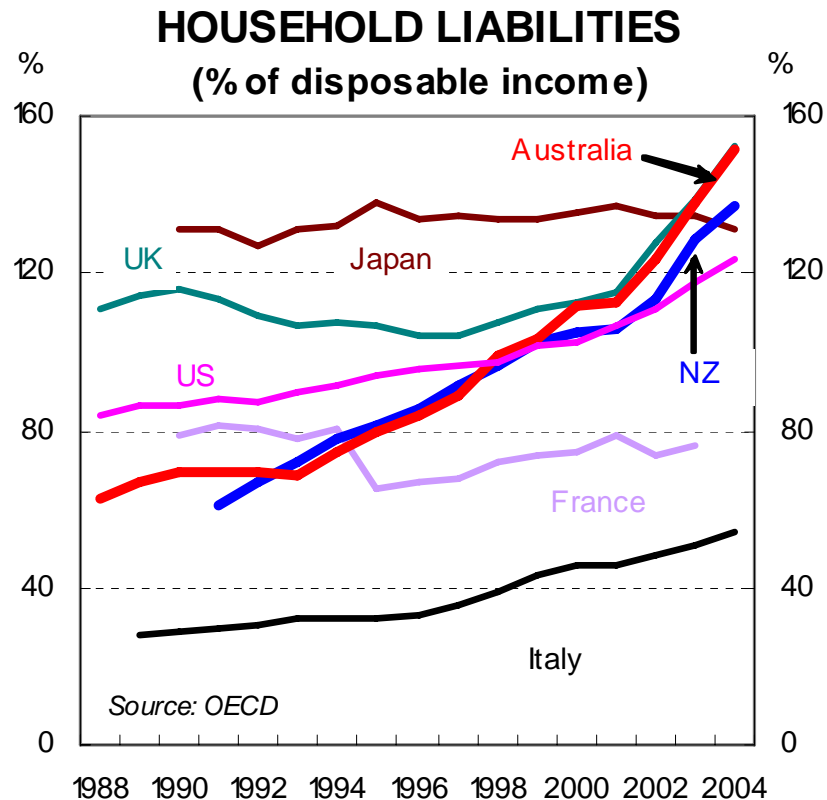


- **RBA: background conditions/macro stability requirements/inflation risks will probably require a rate rise at some point.**
 - toleration of inflation risks lower if inflation is already at 3%pa.
- **RBNZ: odds on further rate rises have fallen after Q4 CPI.**
 - rate cuts in 2007?
- **The long end: the economic fundamentals also favour a rise in longer-term interest rates.**



Housing Issues

The dark side

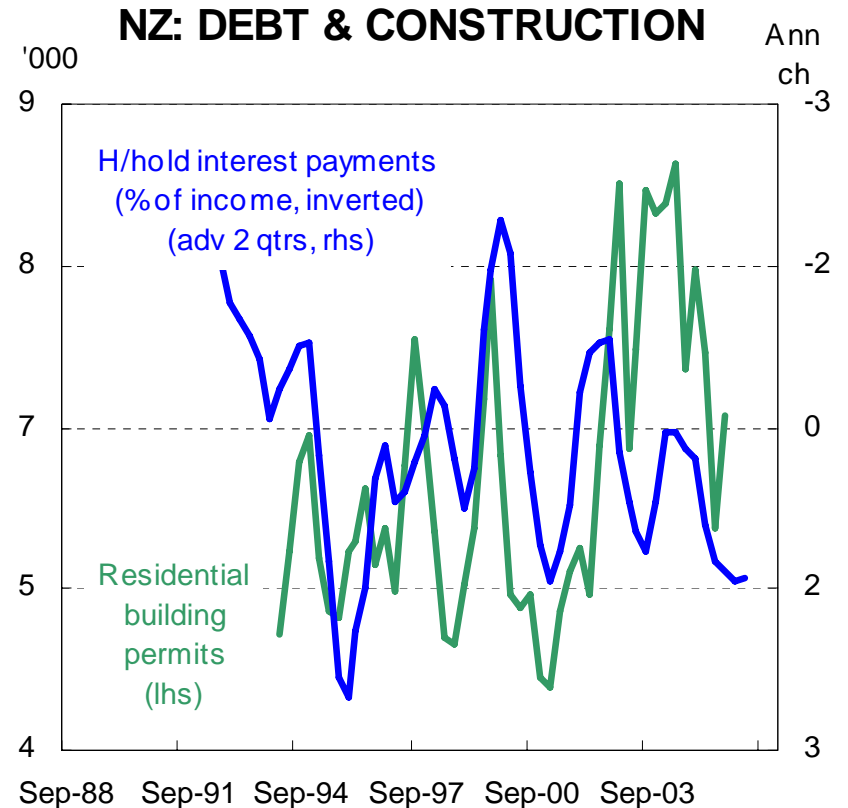
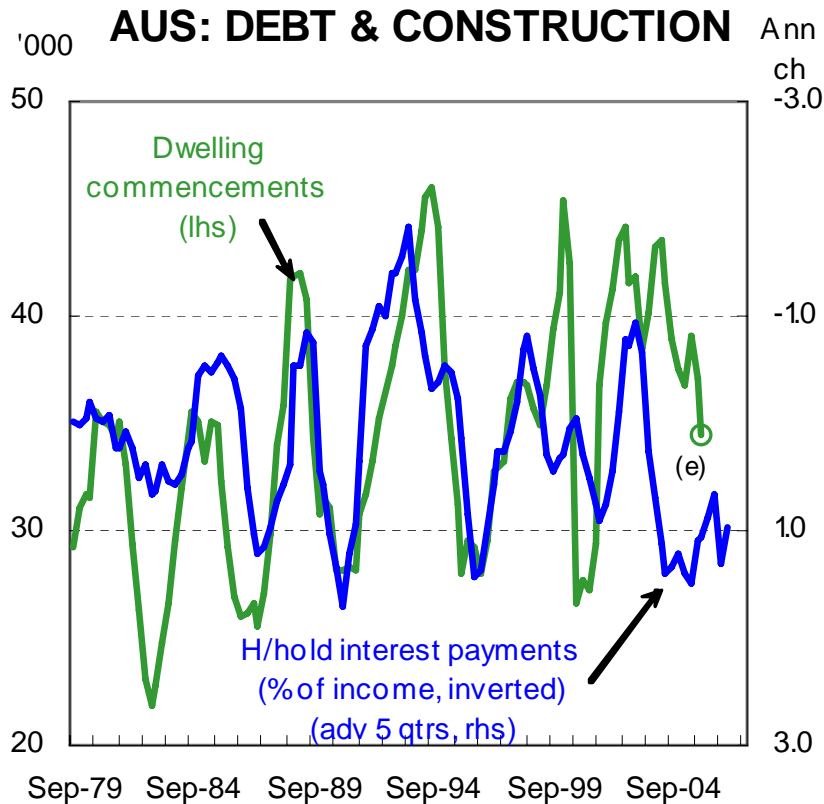


- Consumers reacted rationally to falling unemployment and low interest rates by gearing up.
- Housing booms were one outcome. Stretched household balance sheets are another.
- Household sensitivity to interest rate changes has increased.



Housing Issues

Will debt bite?

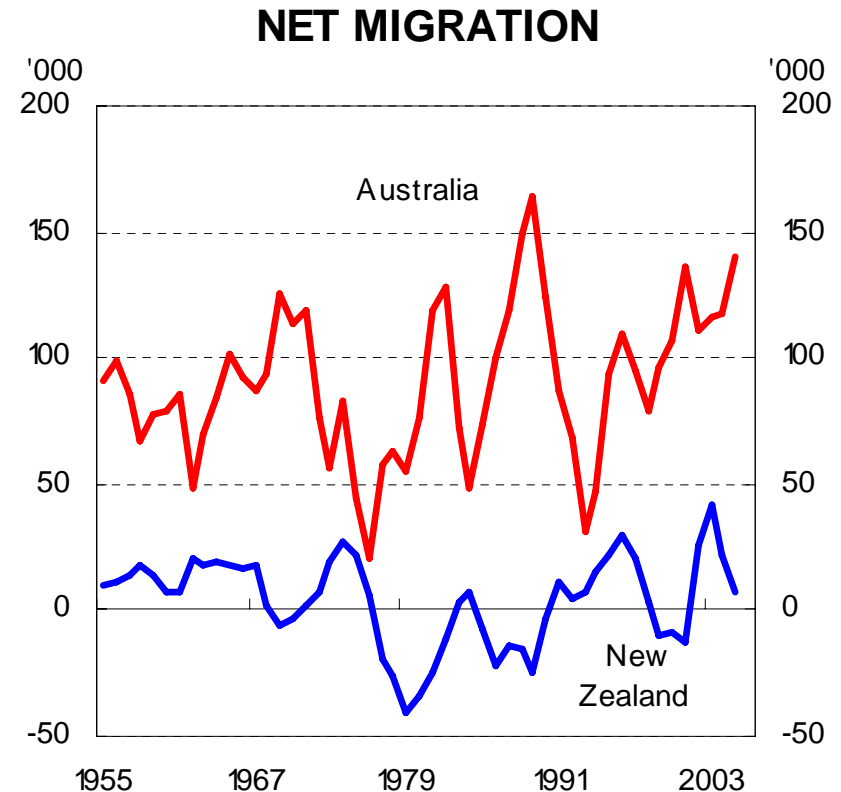
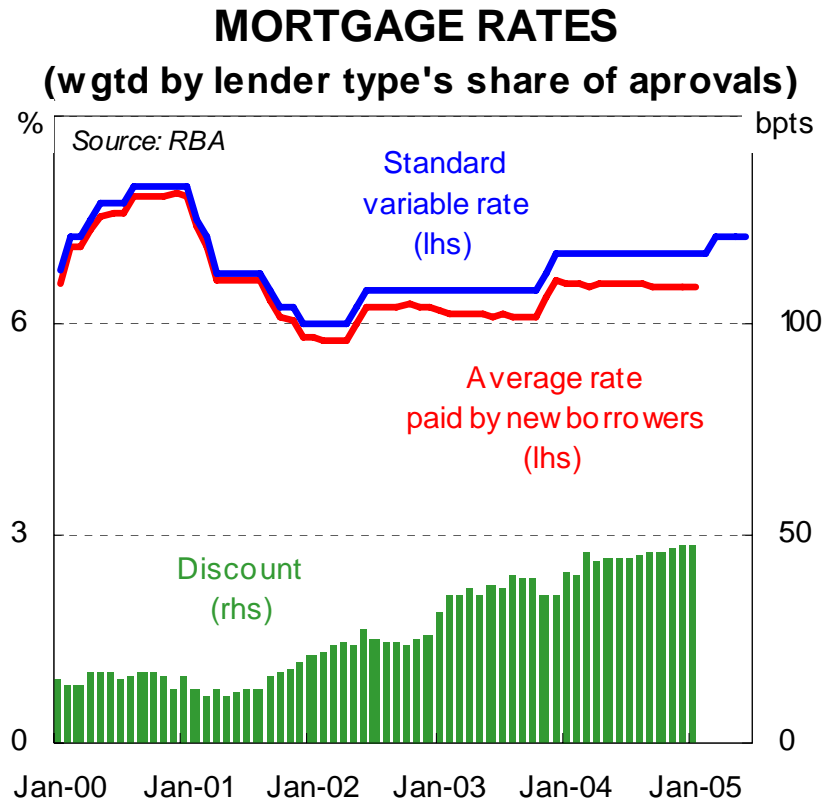


- Debt servicing ratios consistent with further slowing in housing activity.



Housing Issues

Dragging the anchor

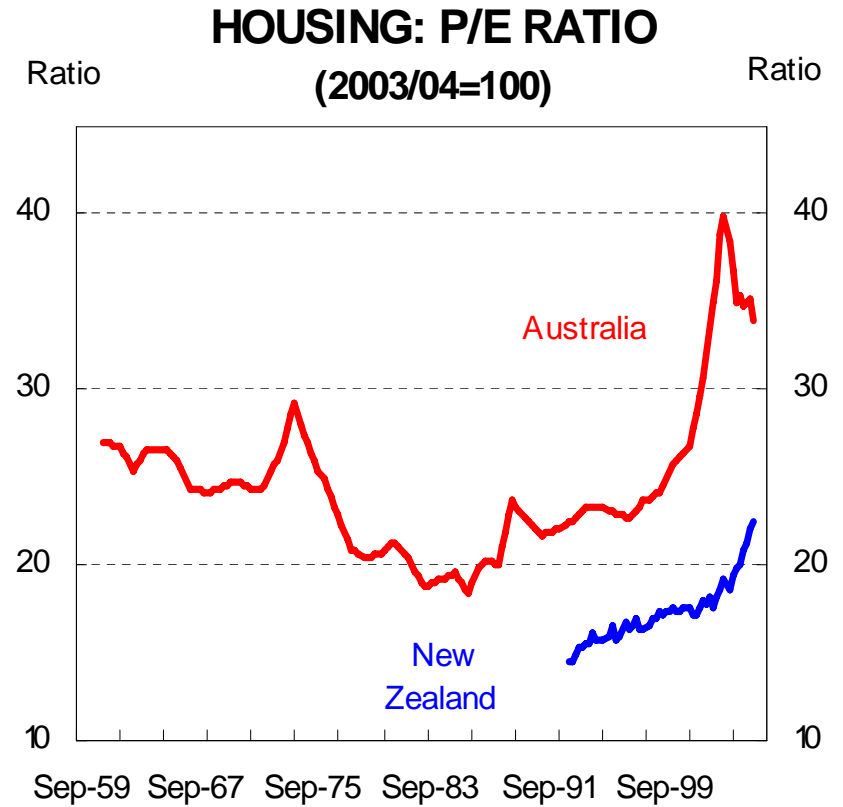
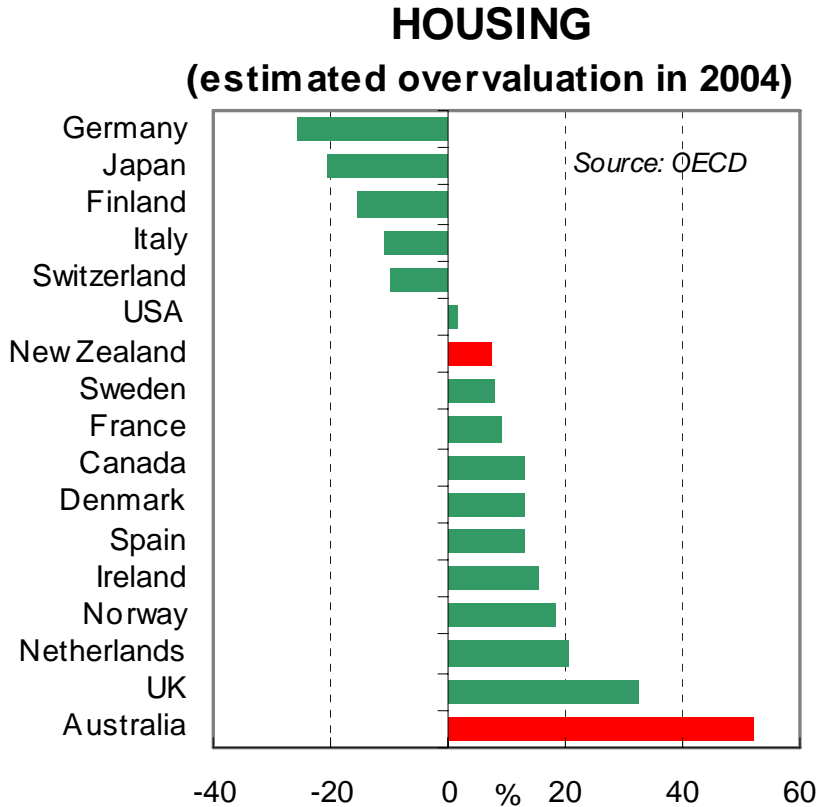


- Competition keeping a lid on mortgage rates.
- Migration trends moderating Aust housing cycle, accentuating NZ cycle.



Housing Issues

Rushing for the door?

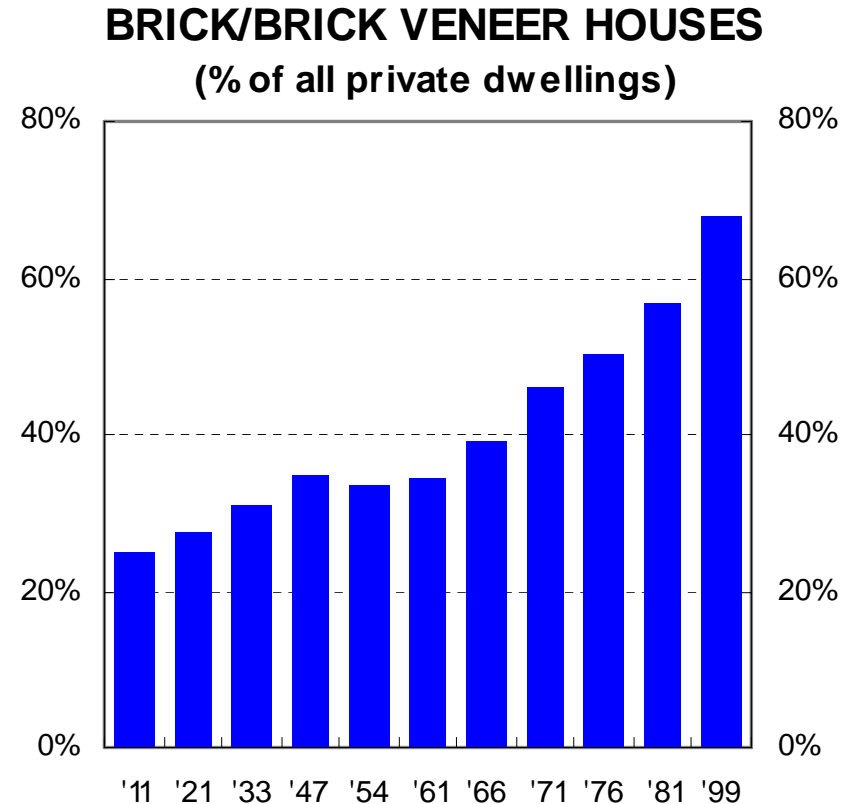
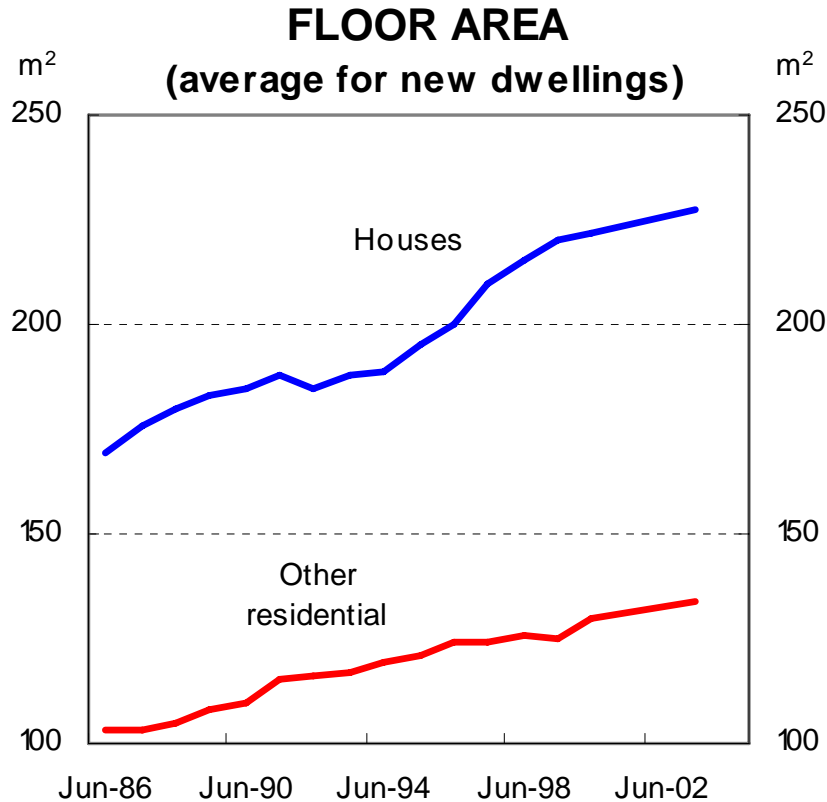


- Housing “overvalued” on some criteria.
- Applying investment valuation criteria to housing may be misleading.



Housing Issues

Bigger is better

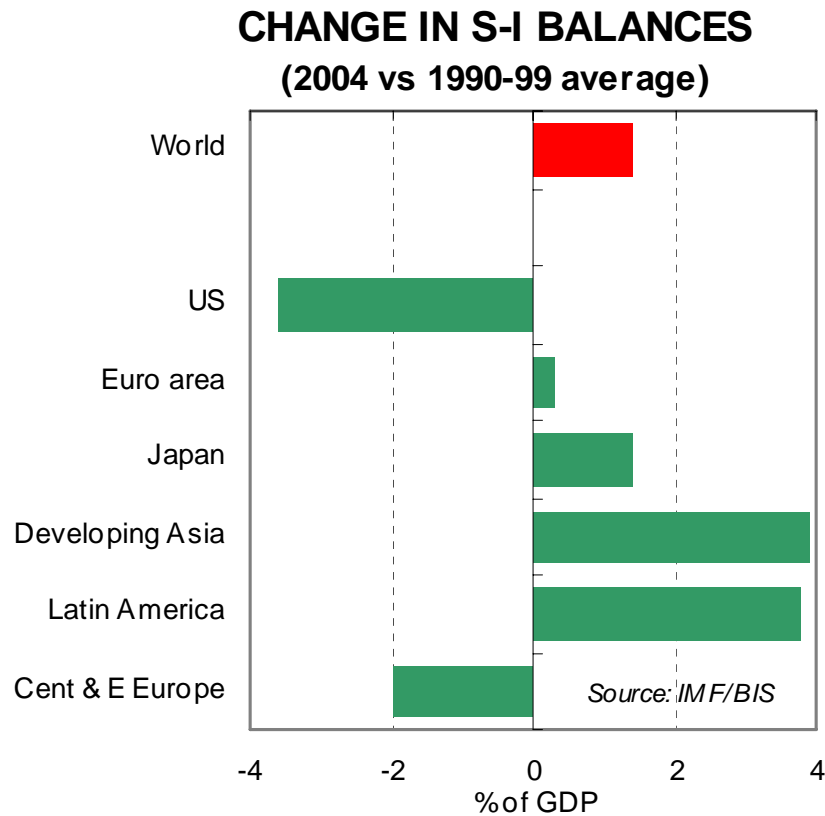


- Spending on “essentials” has fallen - more to spend on housing.
- Rising trend in new dwelling size. Preference for more expensive materials.



Housing Issues

The global risk

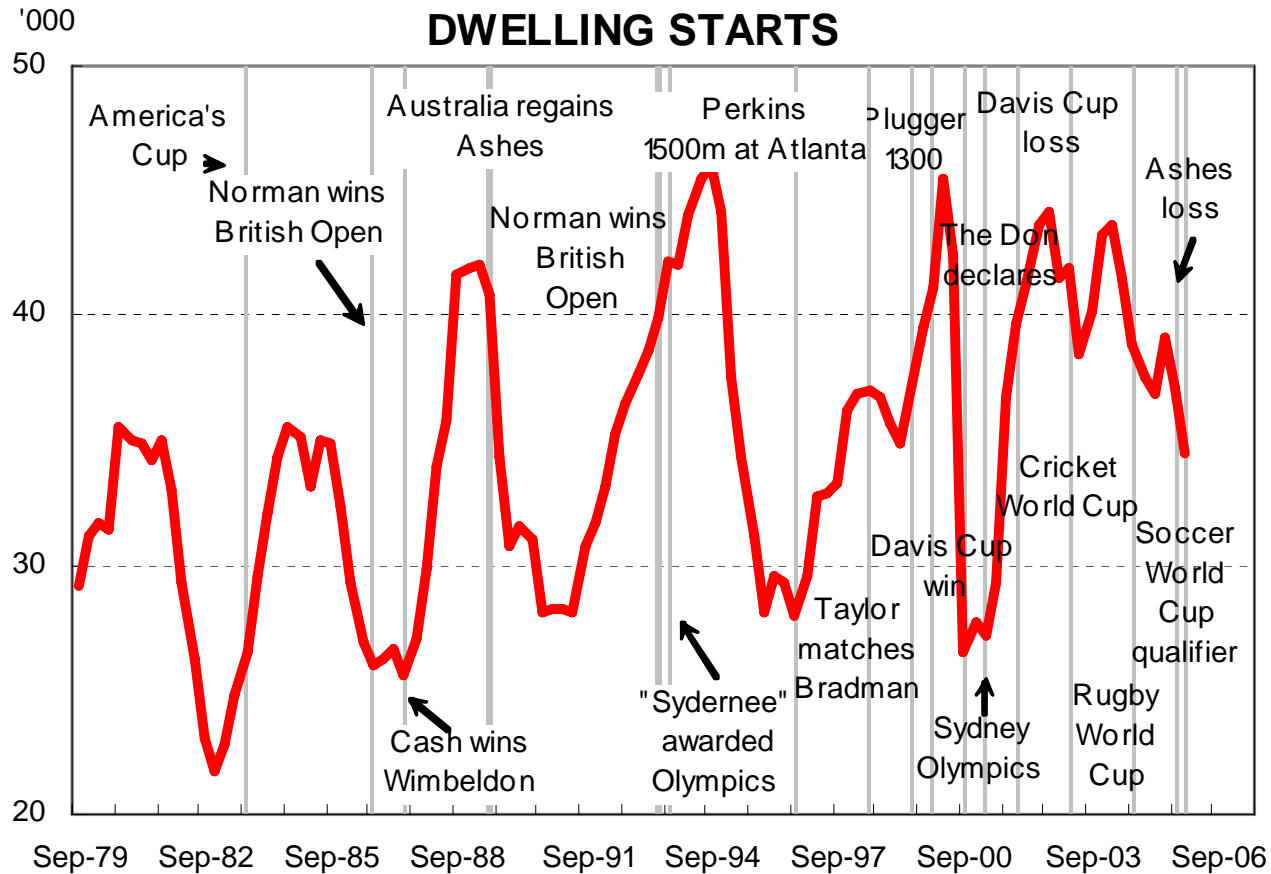


- Global saving has outpaced global investment.
- Excess savings flowing into asset markets.
- Pursuit of capital gain / yield pick-up has essentially pushed down the allowance for risk.
- Markets and real economy exposed to any re-pricing of risk.



Factor X

Sport and housing



- **Greg Norman wins and cricket losses seem to do the most to get the Australian housing market going.**



Our View



Global growth risks

- respectable growth momentum for now - low interest rates and ample global liquidity fuelling imbalances;
- “normalisation” in Japan a potential trigger?

Australia retains momentum but inflation risks lifting

- signs of consumer caution – but economic fundamentals still favourable;
- business capex and export lift are rebalancing growth;
- risks of second-round flow through into inflation.

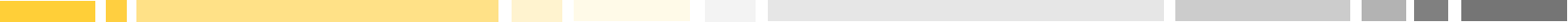
New Zealand inflation risks remain as growth slows

- sub trend growth likely but upside risks in the near term;
- tight product and labour markets generating inflation pressures.

Economic policy and markets

- RBA edging back to a tightening bias;
- RBNZ inflation concerns should see rates hold at high levels.





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