Commonwealth Research

ECONOMICS

7 Jan. 08

Economic & Financial Market Outlook

- **We expect the US to avoid recession and Asia to successfully "decouple" from the US.**
- **The Australian economy should stay strong - we are holding to our February rate rise call.**
- **We see some eventual modest upward pressure on Australian bond yields and spreads.**
- **The AUD should retest USD0.90 towards mid year.**

Summary

Financial market pressures are set to persist. Uncertainty over the magnitude and distribution of sub-prime-related losses mean that a slow drip-feed of "bad news" will continue. Higher funding costs and a tightening in lending standards raise the possibility of the problems on Wall St crossing over to Main St. The US housing downturn has further to run and may ultimately drag the US consumer down as well. The focus is increasingly on the possibility of a US recession and what that might mean for the rest of the world.

Our view is that while the US is in for a period of sub-trend growth, it will avoid recession. And, despite the risks, we remain cautiously optimistic about the global economic environment in 2008. This optimism is based on the idea that the rest of the world, or at least that part most relevant to Australia, is decoupling from the US economy. Following from these conclusions, the positive commodity price story should hold as well.

The rise in funding costs is now flowing through to Australian lending rates. The downside risks posed by this contagion, however, look modest at this stage. The contagion channel of most concern would be if a US slowdown turned the commodity price cycle around. But the correlation between US growth and commodity prices has weakened considerably in recent years, suggesting the US exerts a smaller influence on commodity markets. And the Asian economies that are now more important for the Australian commodity story look set to continue to grow strongly.

The general economic theme underlying our Australian forecasts for much of 2007 was "convergence". The strong parts of the economy were expected to remain strong (capex, public spending, labour market). The weak parts were set to move to the strong side of the ledger (housing construction, rural sector, exports). So we expected this convergence to occur towards the high side. The housing component of this convergence theme is yet to appear in any convincing fashion. And any rural pick up will be more muted than earlier expected. But the broad convergence theme remains intact.

We believe that a fundamental case exists for a better inflation performance than policy makers currently expect. That case is based on the expansion of the supply side of the Australian economy (capital and labour). Nevertheless, the near term risks are to the high side. The momentum behind economic activity and an early look at the Q4 CPI suggest that the current 6¾% cash rate will not be enough. The acceleration in ongoing inflation evident during 2007 looks to be a relatively robust result in the sense that it would require a "low" Q4 number (<0.7%) to kill the uptrend. An outcome similar to that in Q3 (>0.9%) would mean a further lift. Our preliminary figuring puts Q4 underlying CPI growth at 0.8%. That outcome would leave the inflation rate uncomfortably high. Continued economic strength, domestically and offshore (exc US), would add to the case for another move. We are holding to our call for a 7% cash rate in February.

Further Fed rate cuts are likely early in 2008 now seems likely. The situation where the RBA is raising rates at a time when the Fed is cutting is another example of the decoupling theme. Consistent with this view, we expect US 2-year and 10-year bond yields to hover around 3% and 4% respectively over the next six months. Further out, our broader economic views and some lingering inflation risks should exert some modest upward pressure on Australian bond yields and spreads to the US.

The AUD tends to trade as a bellwether of financial market sentiment. Against that backdrop, the near-term risk is that the AUD declines to a low of USD0.82. We would then expect a recovery in the AUD towards the low 'nineties around mid year, assuming the worst of the global economic slowdown and volatility in financial markets has passed. Further out, a strengthening USD led by an improving US economy during H2 2008, will cap the AUD upside.

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The International Economy

The global economy maintained a significant momentum in the first half of 2007 and appeared on track for continued above-average growth. Emerging problems in the US sub-prime housing market, however, triggered a significant re-pricing of risk and financial market turbulence in QIII. This turbulence has proved persistent. Activity in a number of important financial markets has dried up. Liquidity has been constrained. Spreads and funding costs have increased. The Fed has cut US interest rates and other central banks have followed.

Financial market pressures seem set to persist. Uncertainty over the magnitude and distribution of sub-prime-related losses mean that a slow drip-feed of "bad news" will continue. Higher funding costs and a tightening in lending standards raise the possibility of the problems on Wall St crossing over to Main St. The US housing downturn has further to run and may ultimately drag the US consumer down as well.

So the downside risks to global economic growth are greater than seem for some considerable time. History shows that financial shocks can have a large negative impact if they are transmitted to the real economy. The negative impact typically persists until decisive action is taken to fix the problem. The fix can be expensive – the fiscal cost of the US S&L crisis of the late 1980s, for example, was 4% of GDP.

The focus is now increasingly on the possibility of a US recession and what that might mean for the rest of the world.

Our view is that while the US is in for a period of sub-trend growth, it will avoid recession. And we believe that the rest of the world, or at least the bit that is most important for Australia, is "decoupling" from the US. Following from these conclusions, the positive commodity story that has provided an enormous income injection into the Australian economy over the past few years remains intact.

Many of the fundamental factors that have driven financial markets in recent years also remain in place. In particular, global savings continues to run ahead of global investment in physical assets at a time when interest rates are still relatively low. By definition, the "excess" finds its way into financial assets. The structural improvements in the way the global economy operates and the returns those improvements generate are still there. So the demand for financial assets will return (at a different price) and markets should eventually settle.

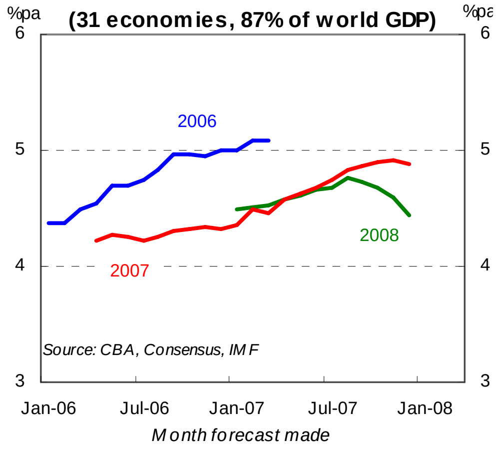
The depth and length of the US slowdown remains uncertain. US housing market activity is still declining. While consumers have been surprisingly resilient, the various "headwinds" have worsened in the past few months: tighter credit and higher oil prices in particular.

The broader US economy, however, retains respectable momentum. Falling housing activity has been a drag on the US economy for six consecutive quarters. But the *non-housing* part of the US economy has been running at an annual rate of 3% or better through this period.

US policy makers are also on the job. The Fed has cut its benchmark interest rate by 100bpts. Our preferred indicators of Fed policy action, such as trends in non-farm payrolls, suggest that 2 more 25bpt cuts are likely in the near term.

The fallout will at least partly depend on the longevity of the shock. For example, assuming a 10% fall in house and equity prices and a 50bpt widening in the term premium, IMF simulations show that a temporary shock (in which the reversal starts after two quarters) would have only a small economic impact, largely confined to the US. In a sustained shock, however, a negative wealth effect depresses consumption and the spillover effects to the rest of world are notably larger.

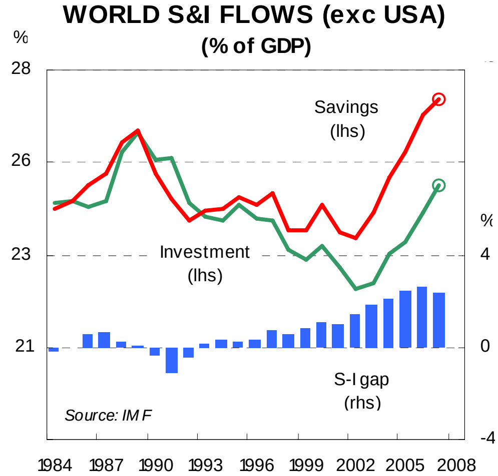
WORLD GDP FORECAST EVOLUTION



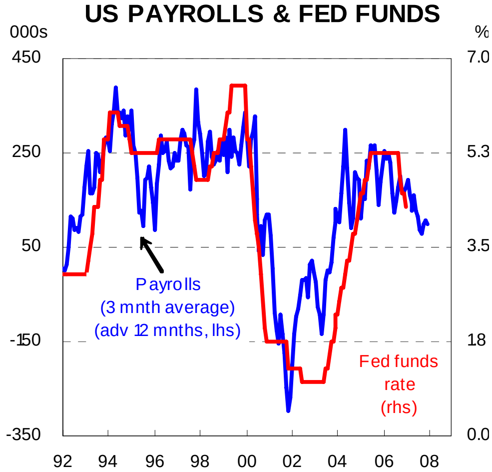
	GDP (%ch)		CPI (%ch)	
	2007	2008	2007	2008
US	2.2	2.1	2.8	2.6
Japan	1.8	1.5	0.0	0.4
EUR	2.6	1.9	2.1	2.3
UK	3.1	1.9	2.3	2.1
Canada	2.6	2.2	2.2	1.6
China	11.4	10.5	4.6	4.1

Source: Consensus Economics

WORLD S&I FLOWS (exc USA)



US PAYROLLS & FED FUNDS

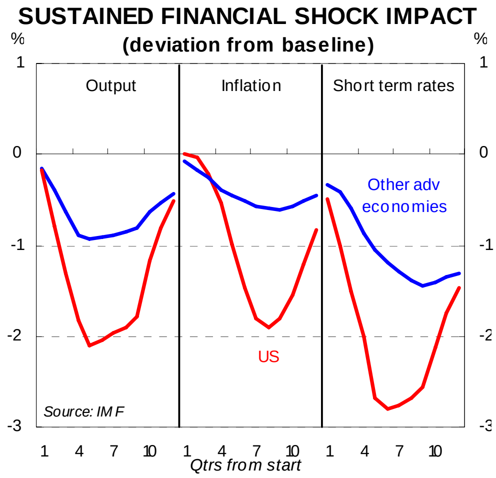


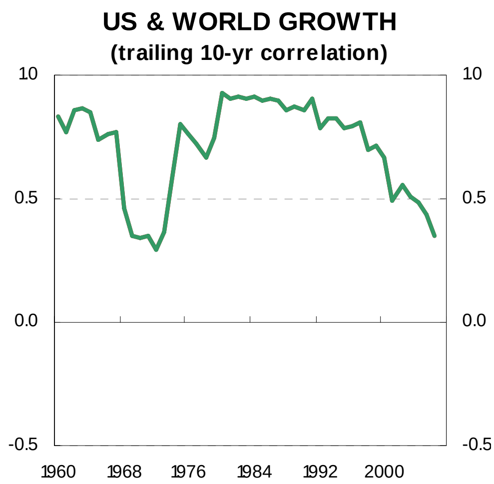
Beyond the US, recent activity indicators for Japan and Europe have been a little disappointing. But growth elsewhere remains strong.

In spite of the risks we remain cautiously optimistic about the global economic environment in 2008. This optimism is based on the idea that key parts of the world economy are decoupling from the US.

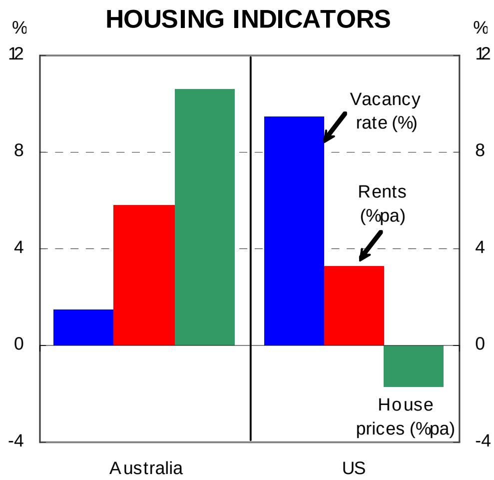
There are a number of arguments to support our decoupling view:

- The global economy entered the current episode with considerable growth momentum. Forecasts are in the process of being revised down. But the global economy is still expected to grow by better than 4% in 2008.
- The correlation between US and global growth has halved over the past decade. So while the US is still important, global growth direction is no longer dominated by the US.
- Direct and indirect trade exposures among the major economic groupings to the US economy have fallen.
- An IMF study looking at the sources of Asian output fluctuations concluded that the importance of global and country-specific factors has fallen. The importance of regional influences has increased – trade and financial linkages are increasing the interdependence of Asian growth.
- Similarly, research by Warwick McKibbin (RBA Board member and academic) highlights the importance of global capital flows in determining growth outcomes. His modelling work shows that perceptions about returns from investing in the US economy are being revised lower. Global investors will allocate less capital to the US and more elsewhere. This shift accentuates the negatives in the US outlook and pushes the USD lower. But activity in other economies, especially in Asia, benefits from greater capital inflows.

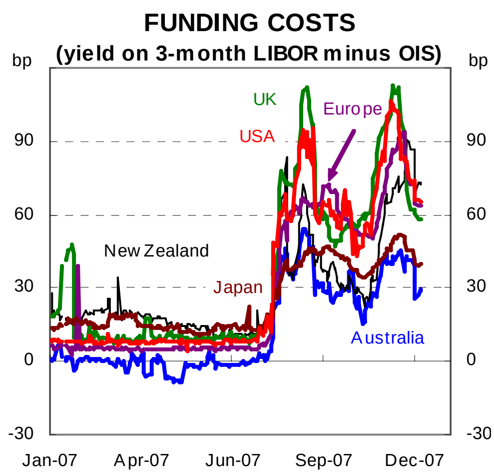




While growth risks are to the downside, inflation risks are still skewed to the high side. Oil prices have recently touched USD100bl. Broad-based gains in other industrial commodity prices and food prices are also evident. Upward pressures on headline inflation across the globe will persist in the short-term. The structural nature of many of these price trends would typically be accommodated by central banks – allowing the price *level* to adjust but guarding against this levels adjustment getting built into the ongoing inflation *rate*. The risk of these second round effects is greater given widespread capacity constraints, with labour markets across the globe generally very tight.



The very uncomfortable clash of risks has complicated the task for policy makers. As noted, the Fed's focus is on the downside risks to growth and we expect further rate cuts. The BoE and BoC have followed with rate cuts. Consumer vulnerability in the UK and the heavy export exposure to the US and the high CAD are the key issues. The ECB, in contrast, is still concerned about inflation. HICP inflation has risen to 2.6% and with capacity tight the scope for rate cuts is limited. Rapid growth and inflation pressures in China will ensure continued gradual tightening measures implemented by the PBoC through 2008.



Contagion & Australia

The Australian and US housing cycles and markets are in fundamentally different positions:

- Housing demand in Australia is running ahead of supply. So vacancy rates have fallen to record lows, rents are rising at the fastest rate since the late 1980s and house prices are lifting.
- Australia does not have a sub-prime component in its housing market. The closest equivalent, the non-conforming segment,

accounts for 1% of the overall market (vs 15% for the sub-prime component of the US market).

- Bank funding costs have risen. But by less than in other economies. Australian bank CDS premia increased by more than for corporates. But Australian bank CDS premia remain below US and European banks.

So any *direct* contagion from the US housing shakeout appears unlikely.

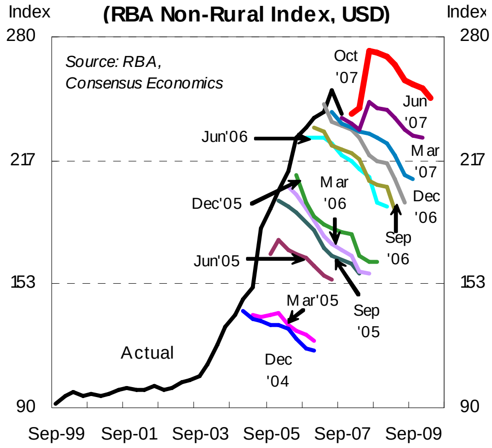
Indirect channels are allowing some contagion. The rise in funding costs is flowing through to Australian lending rates. And business surveys provide some tentative evidence that finance is harder to obtain. The downside risks posed by this contagion to the Australian economic outlook, however, look modest at this stage.

The contagion channel of most concern would be if a US slowdown turned the commodity price cycle around. Falling commodity prices would eventually become a large drag on the Australian economy. Concerns about global growth have only freshened up fears about the price bust that commodity strategists have wanted to put into their forecasts for the past few years.

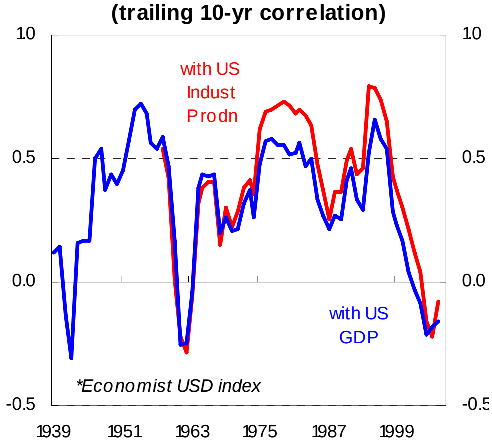
But the correlation between US growth and commodity prices has weakened considerably in recent years, suggesting the US exerts a smaller influence on commodity markets. And the Asian economies that are now more important for the Australian commodity story looks set to continue growing at a respectable rate. These trends give us some confidence that the commodity price story has further to run.

Australian policy makers also have considerable firepower available to offset any negative fallout from financial market turmoil. Interest rates can be cut a long way. And there is sizeable scope for fiscal stimulus.

COMMODITY PRICE FORECASTS
(RBA Non-Rural Index, USD)



US & REAL COMMODITY PRICES*
(trailing 10-yr correlation)



The Domestic Economy.

The general economic theme underlying our Australian forecasts for much of 2007 was "convergence". The strong parts of the economy were expected to remain strong (capex, public spending, labour market). The weak parts were set to move to the strong side of the ledger (housing construction, rural sector, exports). So we expected this convergence to occur towards the high side.

The housing component of this convergence theme is yet to appear in any convincing fashion. And any rural pick up will be more muted than earlier expected. But the broad convergence theme remains intact.

Australia: Key Forecasts

	2006/07	2007/08	2008/09
GDP (%ch)	3.2	3.8	3.8
Unemp. (%)	4.5	4.5	4.8
Core CPI (%ch)	2.9	2.8	2.7
WPI (%ch)	4.0	4.2	3.8
CAD ($bn)	59.0	63.4	60.9

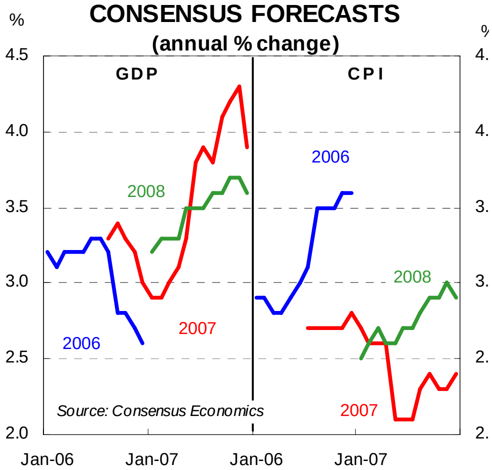
A strong domestic economy is now very much the consensus view. The latest surveys of views on Australian economic prospects remain upbeat. Most forecasting houses went through a process of revising *up* their forecasts for growth in 2007 and, to a lesser extent, 2008. Inflation projections for 2008 have also been revised higher.

Where we differ from the consensus is that we can see some greater downside risks to the consumer part of the growth equation. And we believe that inflation will return to within the 2-3% target band more quickly than currently expected.

There are some (admittedly tentative) signs of consumer caution that are central to our views about the consumer. This caution may reflect some of the uncertainties in play at present – global issues, new government, RBA intentions and so on.

Consumer caution may also be an indication that the *level* of interest rates is close to the point where household spending decisions are affected. The negative correlation between trends in household debt servicing and consumer spending certainly suggests that the risks lie

CONSENSUS FORECASTS
(annual % change)



Forecast made in...

to the low side.

Other indications consistent with consumer caution include:

- surveys showing an increased preference for repaying debt;
- a preference for using housing equity withdrawal for investment purposes rather than funding spending on consumer durables;
- the pick up in growth of M3 and Broad Money (measures of cash savings).

These indications suggest a need for caution by the monetary authorities in how far and fast they move on the interest rate front.

The consumer caution angle also illustrates the importance of trends in petrol prices. The close correlation between petrol prices and credit card cash advances – potentially an indicator of financial strain – suggest that some households are operating close to the edge.

Our estimate of the critical level of petrol prices – beyond which history suggests consumer spending will suffer – currently stands at $1.33/litre. The current national average price of $1.39 is well beyond that stress level.

So there is a risk that households are close to some sort of tipping point. And the strong domestic picture could soften.

Some consumer restraint would be one factor contributing to an easing in inflation pressures. But developments on the *supply* side of the economy are likely to prove more important.

Investment spending is a clear area of economic strength. Private investment spending has run in a 6-17%pa band over the last four years. Public investment spending has grown at a 7-9%pa pace over the same period. Business spending plans, the round of State Budgets and the recent election campaign indicate that there is plenty more capital spending to come. The bottom line is that our capital stock will grow at the fastest rate seen since the early 1980s.

Immigration rates are around fifty-year highs at present. And an increasing proportion of that intake is in the skilled category. The labour force participation rate is at record highs and the birth rate is lifting (modestly). The bottom line is that the supply of labour is growing at the fastest rate since the mid 1980s.

The potential growth rate of an economy is largely a function of the supply of capital and labour. So faster growth in both those inputs should translate into a rise in potential growth rates. A simple production function suggests that prospective trends should be sufficient to lift potential growth rates to 4-4½%pa over the next couple of years.

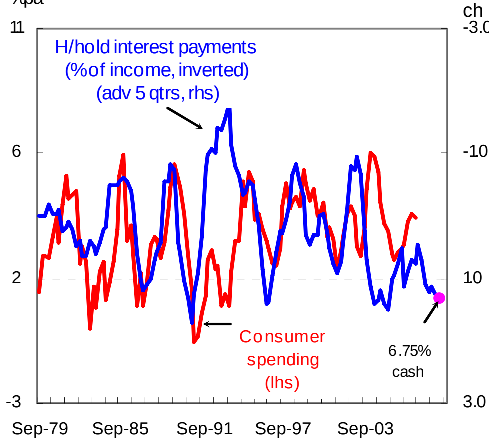
The capital/labour story suggests that the supply-side of the economy will be growing at the fastest pace seen since the late 1980s. This step up has some implications for the inflation outlook. A strengthening in the *demand* side of the growth equation is likely to be less inflation threatening if the *supply* side expands as well.

Our demand-supply projections imply that a negative output gap will emerge over the next few years. And negative output gaps typically go hand in hand with low or slowing inflation.

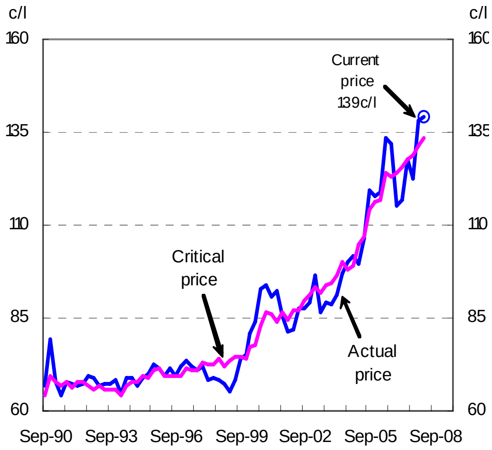
The same projections imply that the capital:labour ratio is now rising sharply. This capital deepening means that productivity growth should lift. Rising productivity growth is another inflation-friendly result.

Additional labour supply – especially in the skilled categories – is a factor that helps limit tight labour markets flowing through to wages growth. There is a limit to how far this labour supply response can run. But we don't appear to be there yet. Immigration targets were revised

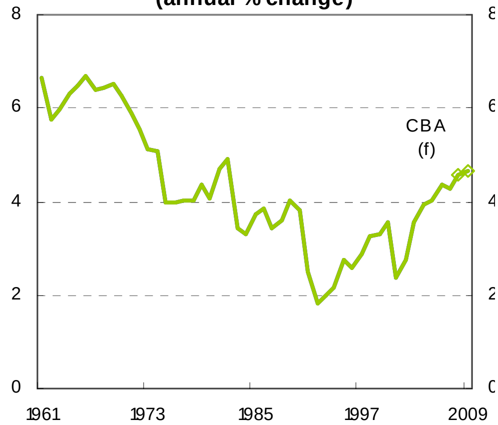
DEBT & CONSUMER SPENDING



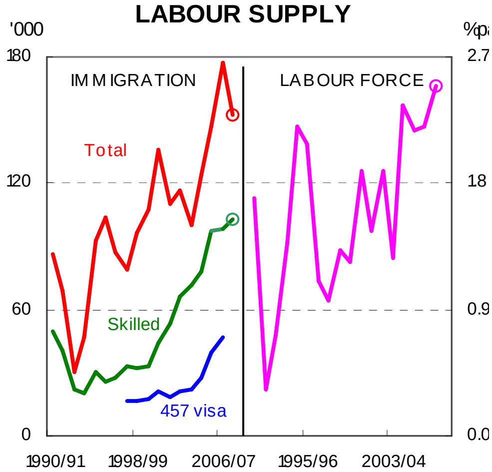
PETROL STRESS LEVELS



THE CAPITAL STOCK
(annual % change)



LABOUR SUPPLY



higher in the May Budget. The impact of earlier welfare-to-work reforms are still filtering through. Prospective tax cuts are skewed towards the low end of the income range and should improve the welfare/work tradeoff. Increased longevity and changes to superannuation arrangements are encouraging older workers to remain in the labour force. Pressures on household finances are forcing some people back into the labour force through the need to generate extra income

On top of these supply issues, the lift in the AUD over the past year means that import prices are now falling. This fall should also assist in restraining inflation.

There are some exceptions to this supply-demand story. Imbalances in the markets for housing and food pose upside inflation risks.

Demand for new housing has been running ahead of supply for a while now. This pressure plays out either via rising residential construction, rising house prices or rising rents. We believe that construction activity will lift. But a lift is yet to eventuate. Low affordability limits the scope for dwelling price rises. So the escape valve is likely to be rising dwelling rents.

Food prices have risen quite significantly over the last couple of years. This trend is not limited to Australia. It is a global phenomenon.

Rising food prices may be an indication that an upward rating of food commodity prices is underway, much as we have already seen for industrial commodities. And for much the same reasons.

Incomes in China and India are growing rapidly, albeit from low levels. History shows that the biggest increase in food consumption comes at relatively low income levels. The incremental protein intake, for example, is far greater as incomes move from USD2,000 to USD5,000 than at any other stage. As incomes rise, most of the addition goes to food – either more of it or better quality. Coupled with large populations, the boost to demand is potentially very large. This structural adjustment brings with it upside risks to Australian and global inflation.

Resource exports are the key variable to monitor when assessing how the supply-side story is playing out. We are now at the point where resource *production* is lifting in response to the mining investment boom of the last five years. Most of this production lift will be in the form of *exports*. And there seems to be enough in this story to shift resource export growth up from the flat outcomes of the past five years to something like 6-7%pa. That turnaround is enough to add 0.5ppts to potential GDP growth.

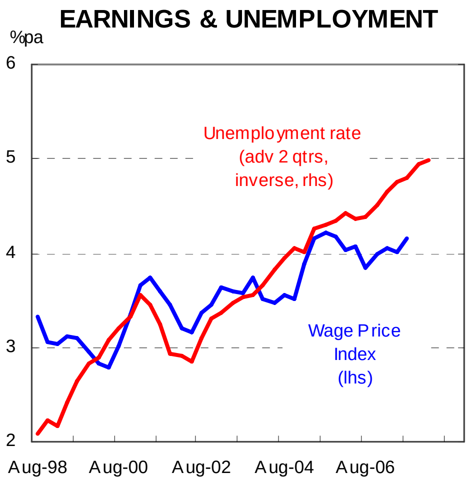
Monetary Policy & Bond Markets

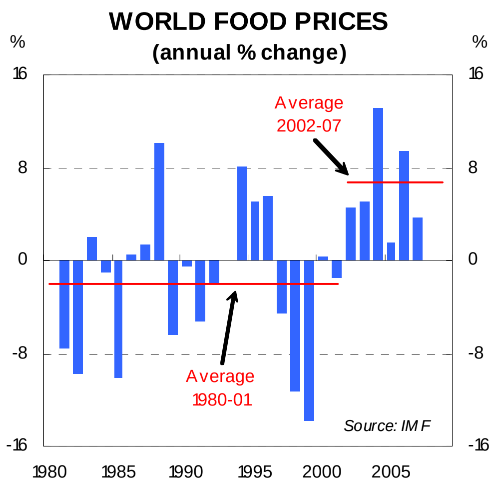
While a fundamental case exists for a better inflation performance than policy makers currently expect, the near term risks are skewed to the high side. The momentum behind economic activity and an early look at the QIV CPI suggest that the current 6¾% cash rate will not be enough. We have pencilled in a follow-up rise to 7% in February 2008.

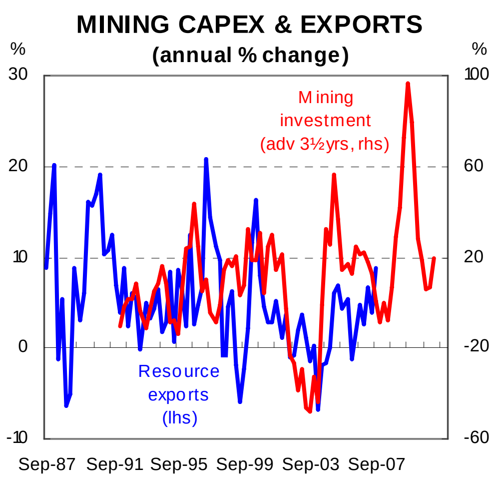
The acceleration in ongoing inflation evident during 2007 looks to be a relatively robust result in the sense that it would require quite a “low” QIV number (<0.7%) to kill the uptrend. An outcome similar to that in QIII (>0.9%) would mean a further lift.

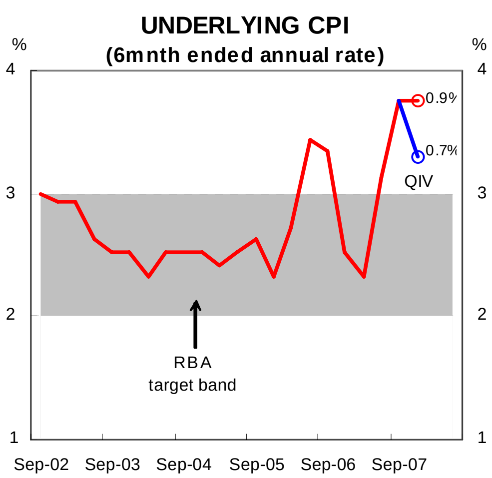
Our preliminary figuring puts QIV underlying CPI growth at 0.8%. That sort of outcome would leave the inflation rate uncomfortably high. Continued economic strength, domestically and offshore (exc US), would complete the case for a February move. The QIV CPI will be released on 23 January.

The situation where the RBA is raising rates at a time when the Fed is









cutting is another example of the decoupling theme.

A clear risk to our RBA tightening view is that the global credit crunch pushes the US into recession and drags world growth sharply lower (ie that the rest of the world does not manage to "decouple"). Such a deepening of the credit crisis would continue underpinning the flight to the relative safety of government bonds. Market expectations of further RBA tightening would be removed and speculation about rate *cuts* would commence.

The unemployment rate remains our preferred indicator on how the interest-rate story is playing out. It may be too simplistic a characterisation of the monetary policy process. But the close correlation between short-run swings in unemployment and the cash rate provide a compelling justification for keeping a close eye on the labour market. A "no change" outcome from the February RBA Board meeting would be consistent with that metric.

Market pricing has waxed and waned since the last rate hike in November. Pricing for a rate hike in the next three months has gone from a certainty to about a one-in-three chance at present.

The risk of an RBA tightening and illiquidity in global money markets has had a substantial influence on short-term interest rates. Bank-bill swap rates reached 11-year highs and were well above the current RBA cash rate in December. Short term interest rates have since fallen back. However, the on-going call on global banks liquidity and uncertainty over the scale and location of sub-prime related losses yet to be announced suggests that interest rate settings will remain volatile.

Risks to US growth have intensified over recent months. The US housing recession continues, credit conditions have tightened further and jobs growth has slowed. A number of large investment and commercial banks announced sizeable sub-prime related write-downs and losses.

So further Fed rate cuts early in 2008 now seem likely. Market pricing shows an expectation that the Fed could take rates to as low as 3% in 2008.

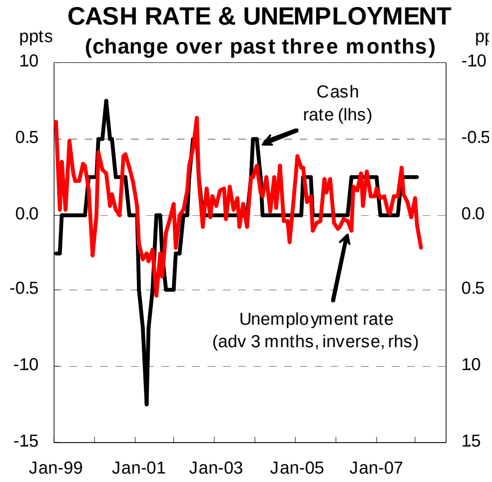
Our view is that, short of a consumer recession, the Fed will not move monetary policy settings to a very accommodative stance. Consistent with this view, we expect US 2-year and 10-year bond yields to hover around 3% and 4% respectively over the next six months.

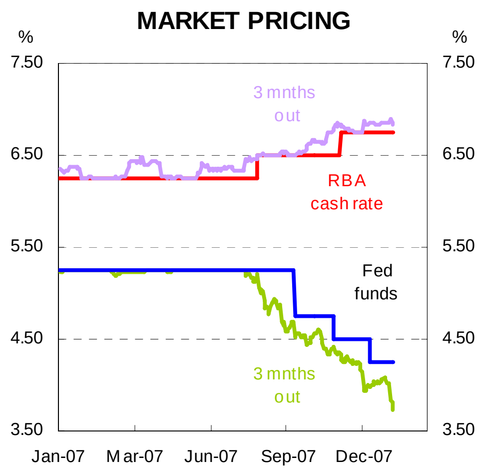
Further out, our broader economic views and some lingering inflation risks should exert some modest upward pressure on Australian bond yields and spreads to the US.

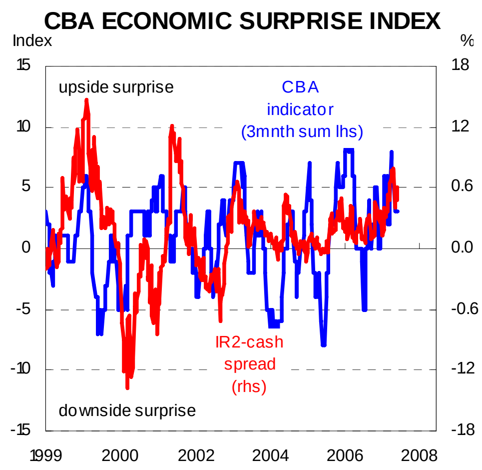
We see the risks to our forecasts as predominantly on the downside as the full impact of the US housing recession and credit-crunch become apparent.

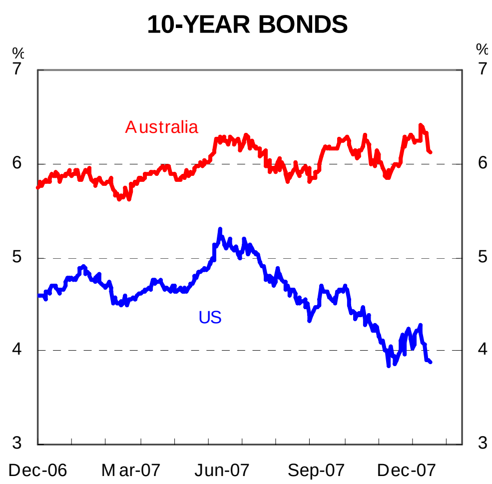
Our base forecasts imply that the Australian curve should be under slight inversion pressure in the first half of the year as the RBA tightens further but concerns about US and global growth cap long-end yields. This mix could give way to steepening pressure in the second half as the global outlook stabilises, though we see potential for the front end of the curve to largely match any rise in longer-term yields. A significant steepening of the yield curve is unlikely until it becomes clear that the interest rate cycle has turned.

The risks to our central case are two-sided; Australia could remain subject to on-going inflation and interest rate risks due to solid world growth. Or these risks could be alleviated by a sharper than expected US slowdown. Either scenario would likely result in greater inversion pressure on the domestic yield curve and a wider interest rate gap to the US than we are currently forecasting. The former would exacerbate pressure on domestically-sensitive short-term rates. The









trend toward a flatter (inverse) yield curve and wider interest rate differential evident over recent years would continue. The alternative of a sharp US slowdown could well stop the RBA tightening further. But the relative strength of the domestic economy and inflation would prevent the front end of the curve matching any rally in US bonds.

Ultimately, weaker global growth and a consequent fall in commodity prices could threaten the health of the Australian economy, delivering the turn in the rate cycle needed to generate a significant steepening of the yield curve. Australia's high debt, interest rates and leverage to booming commodity prices mean the economy could be exposed to a change of fortune should risks of US recession materialise and spill over to the global economy (exposing the 'de-coupling' theory).

The Bank of Japan (BoJ) last raised its target for the overnight call rate by 25bp to 0.5% on 21 February 2007. Japanese economic indicators are indicating that the economic recovery has matured and domestic demand is likely to slow. In particular, residential construction is likely to be a drag on the economy in the short term from recent changes to regulation. Japanese consumer prices have stagnated. The annual rate for core inflation (CPI ex food) has contracted for eight of the last nine months. And Japan remains vulnerable to any US hard landing.

So we see short-term rates remaining steady for at least the next six months. Japanese long-end rates are likely to remain under some modest downward pressure from the downward forces working on US long end yields.

The Eurozone is facing downside risks to economic growth but inflation risks remain persistent. We expect that on balance the ECB will be forced to keep rates at 4% in coming months, despite some signs of slowing economic growth. But the credit crunch and illiquidity will keep euribor rates above cash. Falling US bond yields (from the flight to quality bid) and the threat to global economic growth will cap the rise in Eurozone long-end yields.

Foreign Exchange Markets

Volatility in foreign exchange markets also increased appreciably in the second half of 2007. Bouts of risk aversion were sparked by downgrades to prospects for US financial companies. Declines in share markets and concerns over global economic growth further added to market volatility.

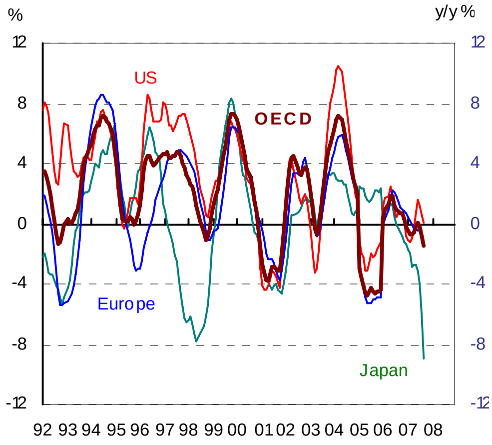
The AUD tends to trade as a bellwether of financial market sentiment. The AUD will depreciate when there is uncertainty and volatility in financial markets

Against that backdrop, the near-term risk is that the AUD declines to a low of USD0.82. We would then expect a recovery in the AUD towards the low 'nineties around mid year, assuming the worst of the global economic slowdown and volatility in financial markets has passed. Further out, a strengthening USD led by an improving US economy during H2 2008, will cap the AUD upside. That said, we expect the AUD to outperform the major currencies during any period of USD appreciation.

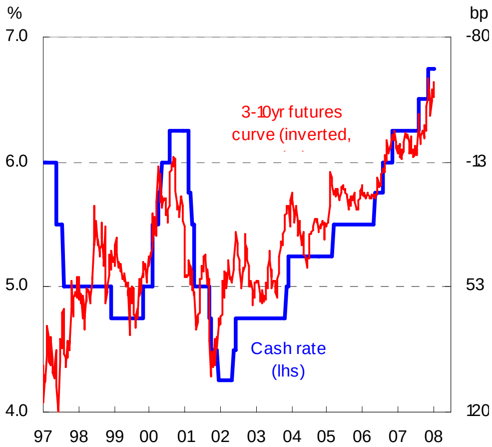
The world economy is less dependent on the US growth cycle than at any time in the last three decades. But the world economy is more heavily influenced (correlated) with US financial markets than at any time in the last three decades. This correlation reflects the exponential growth in global offshore investment over the last thee decades. The bulk of that investment still flows to the US economy because of the weight of the US market in international benchmarks. Hiccups in US financial markets quickly translate into hiccups in markets elsewhere.

Slowing US economic growth and the Fed's easing cycle will continue to weigh on the USD over coming months. But upward corrections in the USD should be expected. Concerns over stagflation are likely to generate a bear steepening in the US yield curve and initially be USD

OECD LEADING INDEX



AUS CASH RATE & THE YIELD CURVE



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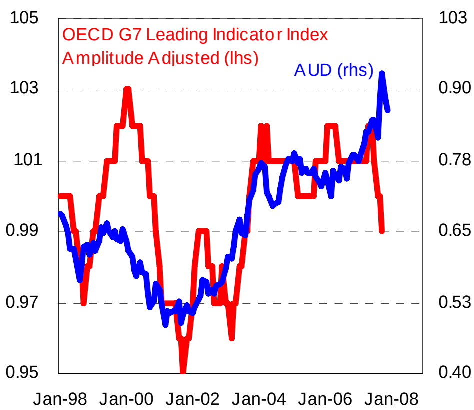
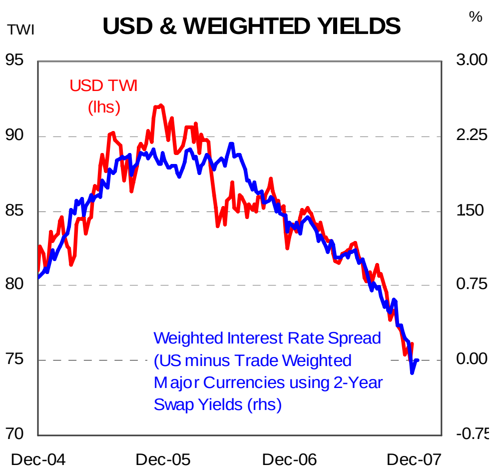


USD & WEIGHTED YIELDS



positive. But over the medium-term, a slower US economy will weigh on the USD. The risk is that stagflation concerns spread to the Eurozone and the UK. In that environment, the EUR and GBP are likely to come off worse than the USD.

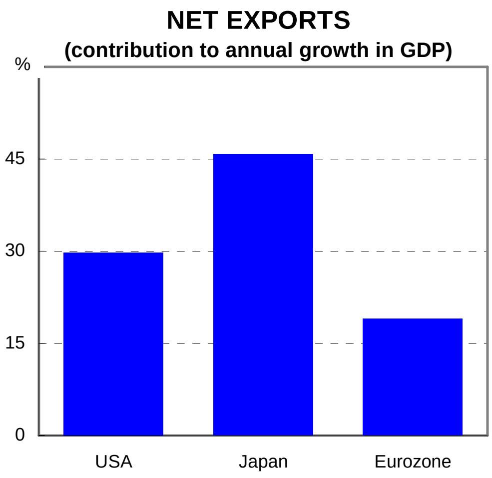
The downward trend in the USD is likely to remain in place as long as interest rate markets price the risk of further Fed rate cuts. The US interest rate market is likely to continue to price the risk of rate cuts while the housing sector contracts.

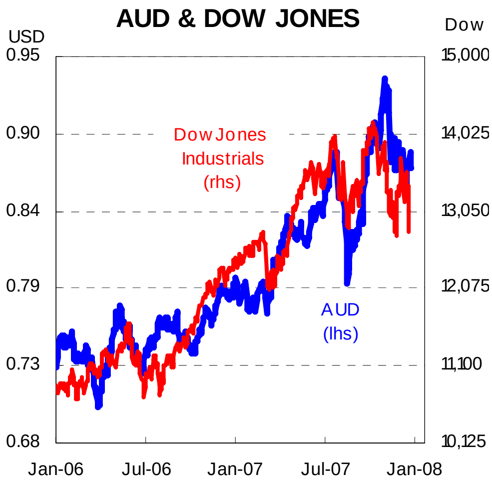
There has been talk of co-ordinated intervention by the G-7 industrial economies to halt the slide of the USD. In our view, intervention is unlikely to occur while the US remains in an easing cycle and each of the G3 economies receive the benefit of rising net exports. Over the last twelve months, net exports have contributed 30% of US GDP growth, 20% of Eurozone growth and 46% of Japanese GDP growth.

The Euro will continue to be seen as being a major alternative to the USD. With Eurozone inflation at 3.1% p.a. in December, the European Central Bank (ECB) is unlikely to entertain lowering interest rates. The Euro will find support between 1.42 and 1.43 on any dips.

The JPY is influenced by a combination of Japan's current account surplus, risk appetite and global investment opportunities. Japan's current account surplus is large at 4.7% of GDP. So the JPY will strengthen if there isn't significant offshore investment by Japanese investors to offset the inflow generated by that large surplus. When the environment for offshore investing turns less favourable as is currently the case, the JPY strengthens led by the current account surplus as; (1) less capital is put offshore by the Japanese and/or; (2) some capital is repatriated. When uncertainty spikes, there is also a "flight to the safety" of current account surplus countries. A declining US TWI is also providing support for the JPY. As we expect the global economic expansion to remain broadly on track, we do not expect the JPY to significantly appreciate beyond 105 against the USD unless a bear market develops in global equity markets during early 2008. In such a case, the JPY will strengthen towards 102 to the USD.

Our forecasts are shown in the table on the following page.





Key Financial Forecasts:

Australia		Current	3 mnths	6 mnths	9 mnths	12 mnths
	Official cash	6.75	7.00	7.00	7.00	7.00
	90-day bank bills	7.12	7.10	7.20	7.15	7.15
	3-year bonds	6.67	6.60	6.80	6.90	6.90
	10-year bonds	6.06	6.20	6.30	6.40	6.50
	3-10's curve	-61	-40	-50	-50	-40
	Aus-US 10 yr spread	217	220	220	230	220
USA	*Fed funds*	4.25	3.75	3.75	3.75	3.75
	10-year bonds	3.89	4.00	4.10	4.10	4.30
Currencies	*EUR/USD*	1.47	1.45	1.46	1.38	1.32
	USD/YEN	109	110	115	118	118
	AUD/USD	0.8725	0.88	0.92	0.88	0.85
	TWI	68.3	69.3	73.2	70.8	68.8

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