WEEKLY ECONOMIC COMMENTARY

Week beginning 28th October 2013

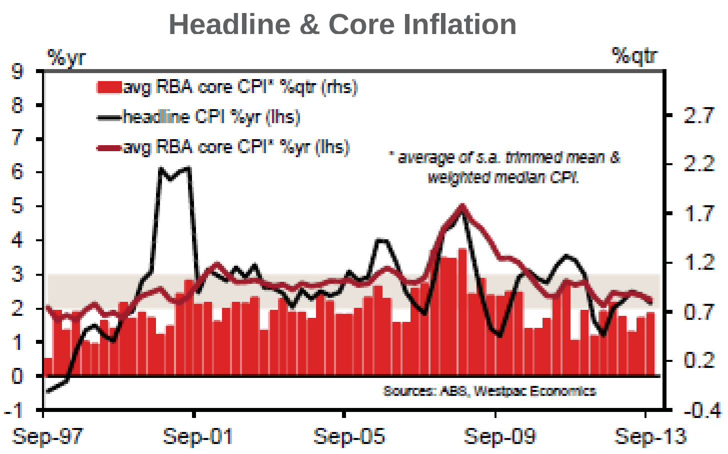
ECONOMIC DATA ROUNDUP

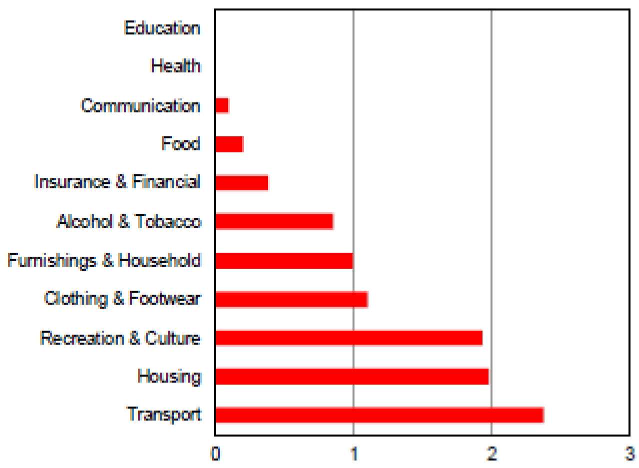
DATA RELEASED LAST WEEK

Economic Data	Period	Actual	Previous
Inflation - Headline CPI (Quarterly)	Sept quarter	+1.2%	+0.4%
Inflation - Headline CPI (Annually)	Sept quarter	+2.2%	+2.4%
Inflation - Underlying CPI (Quarterly)	Sept quarter	+0.7%	+0.6%
Inflation - Underlying CPI (Annually)	Sept quarter	+2.3%	+2.4%
DEWR Internet Vacancies Index	September	+0.5%	+0.3%

Headline CPI increased by a larger than expected 1.2% in the September quarter, the largest quarterly rise in almost five years, pushing the annual headline inflation rate to 2.2% (from 2.4% in the June quarter and 2.5% in the March quarter). The RBA's preferred measure of **underlying or core inflation** was up 0.7% in the quarter for a rise of 2.3% annually. Both CPI measures are still in the lower end of the RBA's target range for inflation of between 2% and 3%.

There was a mix of seasonal price rises in utilities (+5.7%, with electricity prices +4.4% and sewerage prices +9.9%), holiday travel and accommodation (+4.7%), childcare (+3.4%), alcohol and tobacco prices (+0.9%) and non-seasonal rises in petrol (+7.6%), clothing and footware (+1.1%) and property rates and charges (+7.9%) that contributed to the large rise. These were partially offset by price falls in fruit and vegetables (-1.2%), pharmaceuticals (-1.1%), motor vehicles (-0.8%) and audio visual and computing (-0.8%).





Source: ABS & Citi Research

The **DEWR Internet Vacancies Index** rose by 0.5% in September, after rising an upwardly revised 0.6% in August (previously reported as 0.3%). It was the fourth consecutive monthly increase in skilled vacancies, however they remain down 12.0% over the last year.

Last week, Reserve Bank of Australia (RBA) Deputy Governor, Philip Lowe, spoke on 'Investment and the Australian Economy', and provided a cautiously optimistic outlook for non-mining investment. While the RBA still expects mining investment to decline by more than 3% of GDP over coming years, it now expects non-mining investment "to pick up to at least high single-digit rates within the next couple of years".

Data over the next week

Economic Data	Date	Period	Forecast	Previous
Private Sector Credit	31 Oct	September	+0.4%	+0.3%
Building Approvals	31 Oct	September	+2.5%	-4.7%
International Trade – Import prices	31 Oct	Sept quarter	n/a	-0.3%
International Trade – Export prices	31 Oct	Sept quarter	n/a	-0.3%

ECONOMIC COMMENTARY

LAST WEEK

The key event for markets last week was the higher than expected September quarter CPI data which initially spooked markets into thinking there would be no further rate cuts from the Reserve Bank. Along with weaker than expected US employment data and diminishing expectations of a near-term tapering of the US bond-buying program by the Federal Reserve, bond yields fell, while equities and the Australian Dollar rallied.

There were reports last week that the amount of bad loans written off by China's five biggest banks had tripled in the first half of 2013 (to US$3.65bn), raising market fears that banks may be cleaning up their books ahead a fresh wave of defaults. Reports that the People's Bank of China could tighten cash in its financial system to address the associated inflation risk caused interest rates to rise.

Further analysis of the CPI data saw economists come to their senses declaring that, although the quarterly data printed the largest quarterly rise in almost five years, the annual read of both headline and underlying inflation were still in the lower end of the RBA's target band of between 2% and 3% and "relatively well contained".

By the close of trading on Friday, the 90-day bank bill was trading at 2.60% compared to 2.58% last week. At the long end, 3 and 10 year bond yields closed lower at 3.01% and 3.97% from 3.07% and 4.12% a week earlier.

CURRENCY

The Australian Dollar (AUD) pushed higher against a much weaker US Dollar early last week after the release of disappointing US employment data. The data increased expectations that the US Federal Reserve won't wind back its economic stimulus program until next year which sent the US Dollar lower against most cross rates and gave the AUD a boost. The higher than expected CPI data caused markets to unwind expectations of further rate cuts which also caused the local currency to rally, touching a four month high of USD0.9758 last Thursday. The news out of China (refer comment above) however spurred a sell-off late in the week.

By the close on Friday, the AUD was still trading up at USD0.9601 compared to USD0.9635 a week earlier.

EQUITIES

Our share market closed at a fresh five-year high last Friday as investors responded to the expectation that the United States will keep its monetary stimulus in place until March or even longer. Traders have pushed expectations for an end to the US Federal Reserve's $85 billion per month bond-buying program from December back to March with some investors betting on June and others even suggesting the US Fed could possibly increase purchasing bonds in the short term. These expectations are fueling the purchase of equities offshore which has flowed through to our market.

By the close on Friday the S&P/ASX200 Index was trading at 5,386.3 compared to 5,321.5 a week earlier.

THIS WEEK

This week is a little quiet with respect to economic releases with only September Private Credit and Building Approvals data as well as the October RPData House Price Index due. Offshore the US Federal Reserve has its two day meeting which will gain some attention given the events over the last month – the focus will be on gaining any indication as to the timing of any proposed tapering.

INTEREST RATE VIEW

Expectations of a delay until next year in the US Federal Reserve's proposed tapering has seen financial markets reprice expectations of RBA moves over the next year. Following the higher than expected inflation numbers last Wednesday, financial futures are pricing in a 30% (previously around 50%) probability of another rate cut in early 2014.

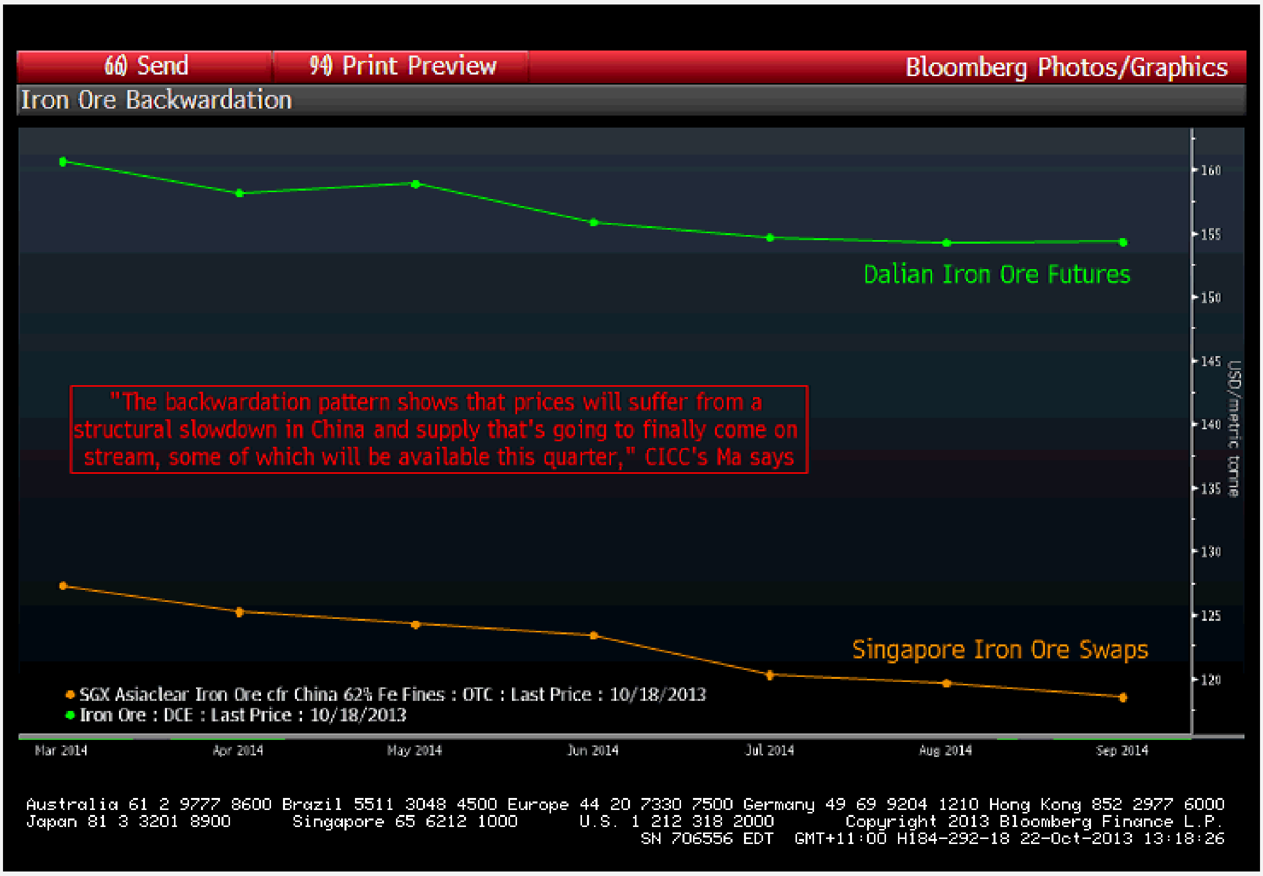
Similarly, futures have scaled back their estimates of a rate increase at the back end of next year from over 100%; currently estimating this probability at around 80%.

Economic Data	12 months ago	6 months ago	3 months ago	1 month ago	Now
Official Cash Rate	3.25	3.00	2.75	2.50	2.50
90 day Bank Bill	3.19	2.94	2.74	2.59	2.60
180 day Bank Bill	3.13	2.93	2.68	2.59	2.63
1 year swap	3.11	2.89	2.71	2.67	2.75
3 year swap	3.22	3.10	3.15	3.21	3.31
5 year swap	3.51	3.44	3.66	3.75	3.83
10 year swap	3.96	3.97	4.41	4.49	4.52
AUD/USD	1.0317	1.0300	0.9259	0.9327	0.9601
S&P/ASX200 Index	4,472.4	5,097.5	5,042.0	5,307.1	5,386.3

CHART OF THE WEEK

Source: Bloomberg, 22nd October 2013, article by Bloomberg News -- Iron ore supply will outpace demand in 2014, ending three years of shortfalls, as new mine capacity puts the steelmaking ingredient on course for a 22% price plunge, according to China International Capital Corp.

The chart below shows iron ore futures in their Dalian Commodity Exchange trading debut on October 18 were in backwardation, where near-term material is more expensive than longer-dated contracts. The expectations of more supplies mirror what is happening in the paper market, as swaps traded on the Singapore Exchange show the same pattern.



BHP Billiton Ltd. and Fortescue Metals Group Ltd. are among the mining companies that spent billions of dollars on new projects to boost output. With global supply growth expected to outpace that of demand, Ric Deverell, head of commodities at Credit Suisse Group AG, recommended shorting iron ore, or making bets on lower prices, at a conference in London on 8th October.

“The backwardation pattern shows that prices will suffer from a structural slowdown in China and supply that’s going to finally come on stream, some of which will be available this quarter,” said Kai Ma, a Beijing-based analyst at CICC. Australia will add another 78 million dry metric tons by the end of this year, or 6.6% of the global seaborne market in 2012, Ma said.

Spot prices will drop to an average of $124 a ton this quarter, and decline further to an average $105 in 2014, according to CICC. Iron ore with 62% content delivered to the Chinese port of Tianjin traded at $134.40 a ton on October 18, according to The Steel Index Ltd.

Iron ore is still in what’s considered a bull market, as prices remain more than 20% higher than this year’s low on 31 May 2013. The rally was spurred by delays to the supply expansions, mostly in Australia, and coinciding with China’s replenishment of stockpiles that shrank in March this year to the lowest level since 2009.

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