

WEEKLY ECONOMIC COMMENTARY



Week beginning 2nd February 2015
ECONOMIC DATA ROUNDUP

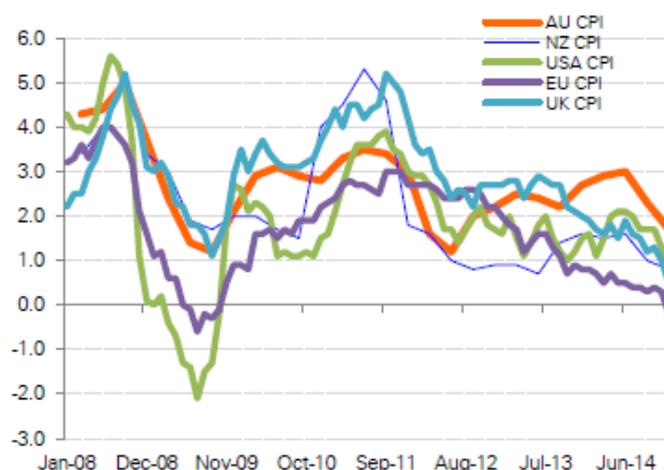
DATA RELEASED LAST WEEK

Economic Data	Period	Actual	Previous
NAB Business Conditions	December	+4	+5
NAB Business Confidence	December	+2	+1
Headline CPI - Quarterly	December quarter	+0.2%	+0.5%
Headline CPI - Annual	December quarter	+1.7%	+2.3%
Underlying CPI - Quarterly	December quarter	+0.7%	+0.5%
Underlying CPI - Annual	December quarter	+2.25%	+2.6%
Private Sector Credit	December	+0.5%	+0.5%

The **NAB Business Conditions Index** declined by 1 point to +4 in December, while the **Business Confidence Index** increased by 1 point to +2, both down considerably from the spike recorded last October when conditions were at +12 and confidence was at +5. The decline in business conditions this month was evident across all three components: trading conditions down 1 point to +9.5; profits down 1 point to +4; and employment was down 1 point to -1 (the lowest level since September 2014). The Conditions Index strengthened during the second half of 2013, from around -6, as the economy responded to RBA rate cuts, but has trended sideways through 2014 (from +3 in January to +4 in December). While lower oil prices boosted business confidence in the transport sector, there was little change in confidence in most other industries.

Headline inflation printed at 0.2% in the December quarter for an annual print of 1.7% and compares with +0.5% and +2.3% in the previous quarter. This is the weakest annual rate since June 2012 although the abolishment of the carbon tax is contributing approximately 0.4% to the reduction, with some small impact this quarter. The Reserve Bank's preferred measure of **underlying inflation** was well above forecast at 0.7% in the quarter, with the annual rate of underlying CPI at 2.25% (the lower end of the RBA's target range). At the component level, the largest fall was in transport and was attributed to the fall in petrol prices this quarter. The largest downside surprises were for fruit and vegetables, as well as retailing components such as clothing and footwear and household furnishings and audio, visual and computing equipment. Upside surprises were for insurance and "other financial services", as well as for international travel and meat.

Inflation is on the decline globally



Source: Deutsche Bank, Bloomberg Financial LP

Private sector credit rose 0.5 in December to be up 5.9% annually – the fastest annual growth rate since January 2009. Housing credit was up 0.6% (+7.1% annually), personal credit was flat (+0.9%) annually and business credit was up 0.5% (+4.8% annually)

In other releases, the **Westpac/Melbourne Institute Leading Index**, which indicates the likely pace of economic activity three to nine months into the future, fell by 0.12 points in December and has now registered below trend growth in eleven of the last twelve months. The Department of Employment's vacancy report showed **Internet job vacancies** fell 1% in December, with the latest decline the result of a 2.9% drop in ads in Western Australia. **Export prices** were flat in the December quarter as a fall in crude material prices was offset by gains elsewhere. Prices are down 9.1% annually, with the crude material category down 26.2%. **Import prices** rose 0.9% in the quarter to be up just 0.3% annually.

Data over the next week

Economic Data	Date	Period	Forecast	Previous
Trade Balance	3 Feb	December	-\$1,100m	-\$925m
Building Approvals	3 Feb	December	-5.0%	+7.5%
RBA Board Meeting – Rate Decision	3 Feb	February	2.50%	2.50%
Retail Trade	5 Feb	December	+0.3%	+0.1%

ECONOMIC COMMENTARY

LAST WEEK

After the Australia Day long weekend, markets returned to see the Australian dollar trading almost two cents lower on some weaker offshore sentiment which boosted the US dollar as well as heightened expectations of an imminent rate cut by the Reserve Bank. This sentiment also pushed yields lower early last week.

The release of December quarter inflation data, that showed that underlying inflation was higher than expected in the December quarter, caused markets to wind back expectations of an imminent RBA rate cut and yields drifted higher.

Offshore, there was no market reaction following the US Federal Reserve's two-day policy meeting where (as expected) they are still taking a "patient" attitude over the possibility of raising interest rates but on track to begin "normalising" monetary policy in mid-2015. Market expectations of lower cash rates won the day however and yields rallied (fell) by up to 20 basis points last week.

By the close of trading on Friday, the 90-day bank bill was trading at 2.56% compared to 2.65% a week earlier. In the long term maturities, 3 and 10 year bond yields closed at 1.95% and 2.45% respectively, from 2.11% and 2.64% a week earlier.

CURRENCY

After opening the week lower and trading down to USD0.7855 over the weekend, the Australian Dollar managed to recover some of the sell-off and spiked higher after the release of the CPI data last Wednesday. After posting a high of USD0.8025 the currency fell following an article last Thursday by RBA watcher, Terry McCrann, which postulated that the RBA "will almost certainly" lower the cash rate this week (and revise its growth outlook lower in next Friday's Statement). A stronger US Dollar late in the week on speculation the US Fed will be the only developed-nation to raise rates this year and further talk of imminent rate cuts by the RBA pushed our currency to a new five-year low of USD0.7720 last Friday.

By the close on Friday the Australian dollar was trading at USD0.7787 compared to USD0.8001 a week earlier.

EQUITIES

Despite concerns about the fallout from the Greek elections a week ago, global equity markets posted solid gains last week. Oil was once again in the spotlight late in the week falling to near a six-year low after the US government reported record-high inventories which hurt energy stocks, but Wall Street managed to recover. Our market posted gains every day last week on the belief that interest rates will fall causing investors to continue to move to holding companies that provide strong, sustainable dividends.

By the close on Friday the S&P/ASX200 Index was trading at 5,588.3 compared to 5,501.8 a week earlier.

THIS WEEK

The focus this week will be squarely on the first RBA Board meeting of the year. Refer comments below for a preview on what is expected and the possible repercussions. The RBA also releases its latest Quarterly Statement on Monetary Policy on Friday which should provide an update on their economic forecasts and thinking on policy.

On the economic data front we have the Trade Balance, building approvals and retail sales for December out this week.

INTEREST RATE VIEW

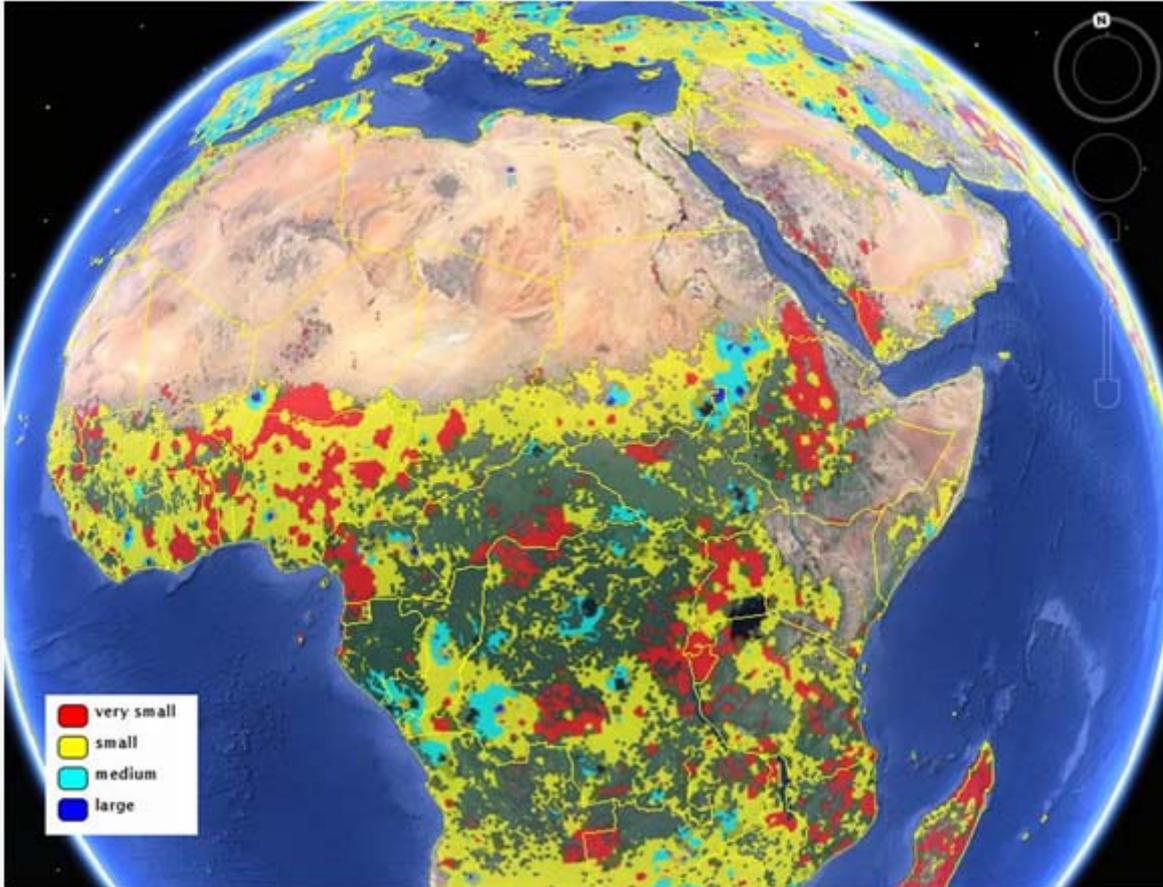
There is a growing expectation that if the RBA does not cut the official cash rate this week, then it will at least indicate that it is open to a reduction sometime this year. Despite the higher CPI data last week the market now sees a 60% chance of a rate cut tomorrow, up from 50% just before the CPI data was released last Wednesday. Market pricing for the cash rate 12 months ahead has moved below 2% for the first time. With this expectation increasing as I write, a large correction may occur should the RBA fail to deliver a cut and not adjust its language toward an easing bias. That said, the meeting is of course, "live" and the RBA could well cut or at least tweak the language in the accompanying commentary to open up the prospect of a cut in the future, should February not eventuate.

Economic Data	12 months ago	6 months ago	3 months ago	1 month ago	Now
Official Cash Rate	2.50	2.50	2.50	2.50	2.50
90 day Bank Bill	2.63	2.65	2.74	2.78	2.56
180 day Bank Bill	2.65	2.67	2.76	2.83	2.57
1 year swap	2.61	2.63	2.69	2.53	2.31
3 year swap	3.08	2.87	2.83	2.45	2.23
5 year swap	3.63	3.25	3.19	2.72	2.43
10 year swap	4.39	3.82	3.69	3.18	2.76
AUD/USD	0.8724	0.9374	0.8866	0.8131	0.7787
S&P/ASX200 Index	5,188.1	5,622.9	5,447.7	5,416.6	5,588.3

CHARTS OF THE WEEK

African Farms are increasing in size

The map below is a snapshot of central Africa, showing the size of fields being used for agriculture. A recent trend is emerging whereby larger corporate agribusinesses are integrating with family farmers. As a result, it is expected that the number of small scale farmers will decline.



Source: <http://goo.gl/OlsjRR>

Dairy trade prices rise

Fonterra's Global Dairy Trade index gained by 3.6% in the first auction of 2015 and 1% in the second, pointing to a recovery in dairy prices. Whole milk powder prices increased by 1.6% to USD 2,307 in the first auction, skim milk powder increased by 2.8% , anhydrous milk fat prices increased 6.8%, butter increased 13.2%, butter milk powder increased by 10.5%, cheddar increased by 3.2% and rennet casein increased by 4.2%.

The increase in this year's second auction was led by whole milk powder at 3.8%. Bank economists maintain a positive outlook on dairy prospects.

Global Dairy Trade Price Index over 10 years



Source: <http://goo.gl/OlsjRR>



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