ECONOMICS

31 Oct. 07

CBA London
Daily Alert

- **We expect the Fed to cut by 25bps and leave its options open with regard to further easing.**
- **A Fed rate cut would support AUD and NZD.**

Indicative Market Rate *Information current as at 7.00am UK time Source: Bloomberg*

BONDS					US$ SPREAD			A$ FUTURES		CURRENCIES	
	US	CAD	AUS	NZ	CAD	AUS	NZ	Bill IR1	92.86	EUR	1.4459
2yr	3.81	4.09	6.74	7.22	28	293	341	3yr YM1	93.34	AUD	0.9235
5yr	4.05	4.18	6.57	6.97	12	251	291	10yr XM1	93.82	NZD	0.7679
10yr	4.38	4.27	6.14	6.46	-12	175	208			CAD	0.9531
SWAPS	AU$	%ch	NZ$	%ch	OIS	AU$	NZ$	EQUITIES			%ch
2yr	7.29	*0.04*	8.65	*-0.03*	3	6.79	8.35	Dow		13,792	*-0.56*
3yr	7.29	*0.04*	8.46	*-0.02*	6	6.93	8.47	Nikkei		16,738	*0.52*
5yr	7.17	*0.04*	8.17	*-0.03*	12	7.15	8.72	HangSeng		31,409	*-0.72*
7yr	7.01	*0.04*	7.98	*-0.02*				ASX200		6,754	*0.06*
10yr	6.92	*0.03*	7.78	*-0.03*				NZSE50		4,209	*-0.25*

Looking ahead: Markets are firmly focussed on the FOMC rate decision and statement later today (18:15GMT). A 25bp cut is virtually a done deal in our view, particularly given that such a move is almost fully priced by the market. The Fed is unlikely to disappoint in the current environment of market fragility. The statement will therefore garner most attention. While the Fed is likely to highlight the downside risks to the growth outlook to justify its decision to cut rates, we think it will stop short of explicitly flagging that further easing is in the wings. Importantly we think the Fed is still easing as "insurance" over the risks, not due to a belief that the central scenario has deteriorated markedly. On that front, the Fed will be most comfortable leaving its options open to assess the data and anecdotes in the coming weeks, particularly given a number of FOMC members still harbour lingering inflation concerns. In the absence of a rate cut tonight, the Fed would likely reassure markets that it will "act as necessary" going forward, leaving the door open for a December rate cut. Ahead of the Fed's meeting we receive the US Oct ADP employment report, Q3 GDP and the Q3 employment cost index.

Bonds: The Australian 3s10ys yield curve inverted further today to -47 as the stronger than consensus credit and building data reinforced expectations for a near-term RBA rate hike. We believe the RBA will increase the cash rate by 25bps to 6.75% when it meets next week. Participants' stopping out of 3s/10s steepening trades has been a theme as the curve continues to invert to record levels. RBA board member McKibbin said today that a US recession would have "minor" implications for the world, clearing way for further RBA tightening in the face of the Fed's easing cycle.

FX: Markets were relatively quiet in Asian trade today, awaiting the FOMC meeting tonight. Our forecast for a 25 basis point cut by the Fed tonight would give the carry trade currencies support. A no-change decision would likely weigh heavily on these currencies. The surprisingly strong Australian September building approvals and private sector credit data guided the AUD higher to US$0.9233 this morning. AUD's gains were capped as markets hedge their bets before the Fed's interest-rate decision. An increase in New Zealand October business confidence to -12.0 from -26.5 has given the NZD some support this afternoon, though the NZD's appreciation also remained contained. Both AUD and NZD are in demand in early London, though remain off their recent highs of US$0.9272 and US$0.7739 respectively. Though it was a quiet day, the EUR reached a fresh record high of US$1.4448 in Asian trade, reaching further yet to touch US$1.4467 in early London. Cable continues to push to new multi-decade highs, holding just above 2.0700 currently. The Bank of Japan this afternoon announced that interest rates will remain at 0.50%. Once again, and for the fifth consecutive meeting, Mizuno was the only board member to argue for a rate rise. Both Japanese housing starts and construction spending fell by more than expected in September, weighing on the JPY in late afternoon trade. The JPY was, however, range bound for most of the session ahead of the FOMC meeting, which will be the major driver of currencies later today. The USD looks set to remain under pressure in the lead up to the Fed's announcement.

Commodities: Crude oil prices slumped by more than US$3 a barrel as investors cashed in profits ahead of the Federal Reserve meeting. In addition, data out on Wednesday is expected to show crude stocks rising in the past week. And Mexican output is expected to quickly recover after poor weather shuttered production early in the week. Base metal prices were again softer on the London Metal Exchange on Tuesday. Investors squared positions ahead of the US interest rate decision while a rise in inventories dragged the copper price down 1.3%. The price of gold also eased from 28-year highs on Tuesday in thin trade, weighed down by a weaker oil price and directionless greenback.

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Stocks: US blue chip shares fell on Tuesday, especially softening in the last hour of trade as investors stayed on the sidelines ahead of the Federal Reserve interest rate decision. Shares in Exxon Mobil fell by 2.8%, tracking a 3.4% decline in the oil price. Shares in Merrill Lynch fell by 2.6% after the bank failed to make a formal appointment to fill the vacancy left by the retiring chief executive Stanley O'Neal. The Dow Jones fell by 77pts or 0.6% while the Nasdaq eased by less than a point. The ASX 200 was little changed on Wednesday.

Economic Developments

$-Bloc (US, Canada, Australia and New Zealand)

US

- No major releases.

We expect further easing from the Fed in the near-term in the form of two 25bp rate cuts at the next two meetings.

Canada

- No major releases.

We think rate hikes from the current rate of 4.50% are off the agenda in the foreseeable future given the risks to the US outlook.

Australia

- The RBA private sector credit figures released today revealed that credit continued to grow at a very solid pace in September bolstering the view that the underlying growth pulse of the non-farm economy remained very resilient in QIII 2007. The non-farm economy grew by 5.2%pa in QII. Total credit expanded by 1.2% (after August's 1.4% lift). Annual total credit growth picked up to 15.9%, down a touch from 16% in August, but well up on the 14.3% recorded at the end of 2006. Market expectations centred on a 1.0% increase in total credit in September.

- From a ***monetary policy perspective***, today's stronger than expected jump in the credit data bolsters our view that the ***RBA will lift official rates by 0.25% to 6.75% on 7 November.*** And it reinforces our view that the central bank will be steadfastly sticking to a ***strong tightening bias*** after the likely November policy move, given that price pressures in the economy remain firmly skewed to the upside due to capacity constraints and tightening labour market conditions - in the context of a deteriorating underlying CPI outlook. The QIII CPI showed underling inflation right at the top of the RBA's 2-3% target zone.

- **Dwelling approvals registered a 6.8% rise to 13710 in September. But they were distorted by an exceptional, 13.8%, rise in the multi-unit segment, while the detached houses area rose by a more modest 2.5%.** National dwelling approvals continue to display divergent trends. Approvals to build new private dwellings in the large NSW market remain weak, dragging the national figures lower. By contrast, the rest of Australia is in solid shape. The net effect is that 2007's approvals are likely to be near 154k, well below CBA's estimate of national underlying demand of around 175k.

- The fundamental drivers of demand for housing remain sound. Thanks to high levels of net migration, annual population growth is relatively strong at 300k, or 1.43%pa. Investors should be encouraged by low vacancy rates, accelerating rents and rising dwelling prices. While affordability is low, judging by this year's approvals, prospective home builders do not seem to be discouraged, except in NSW.

- Approvals for commercial, industrial and other non-dwellings buildings is holding up at high levels. Approvals to build new warehouses and offices have been particularly strong this year. With office vacancy rates at low levels, particularly in Brisbane and Perth, it is easy to understand why.

On the back of the recent upside surprise in the core Q3 CPI, we believe the RBA will hike the cash rate by 25bps to 6.75% at its November meeting.

New Zealand

- **Headline business confidence increased in October with a net 12.9 % of respondents expecting business conditions to deteriorate over the coming year compared with 26.5% of respondents in September.** US credit-related global growth uncertainties at this stage have not significantly impacted the New Zealand growth outlook, perhaps helping to shore up business confidence. Firms' overall own activity expectations remain in modest positive territory, and remain consistent with GDP growth in the vicinity of 2%-3% p.a. Export activity expectations have been tempered by the NZD rebound of late. In contrast, the construction sector is more upbeat as infrastructure projects come on stream. Inflation indicators remain well above average - and are increasing once more under all measures. Despite early signs on consumer spending slowing, the RBNZ has some way to go before it has tamed upside medium term inflation risks. We remain comfortable that the RBNZ will not cut the OCR until late 2008 as it awaits concrete evidence of a sustained slowing in domestic spending-related inflation pressures.

We think the RBNZ will leave the OCR unchanged at 8.25% until late 2008, when we expect easing to begin.

Europe

- No major releases.

We expect the ECB to leave its key policy rate unchanged at 4.0% in the foreseeable future amid the current market turbulence.

UK

- No major releases.

Given recent money market developments, we believe the Bank of England will leave the key policy rate unchanged at 5.75% in the foreseeable future.

Japan

- **The Bank of Japan announced that interest rates will remain at 0.50%.** Once again, and for the fifth consecutive meeting, Mizuno was the only board member to argue for a rate rise. A raft of Japanese data came in on the weak side overnight, supporting the BoJ’s cautious approach towards undertaking further monetary policy tightening. Labour cash earnings fell 0.5% on an annual basis in September, while housing starts and construction orders were also below expectation.

We expect the BoJ to leave rates unchanged until mid 2008.

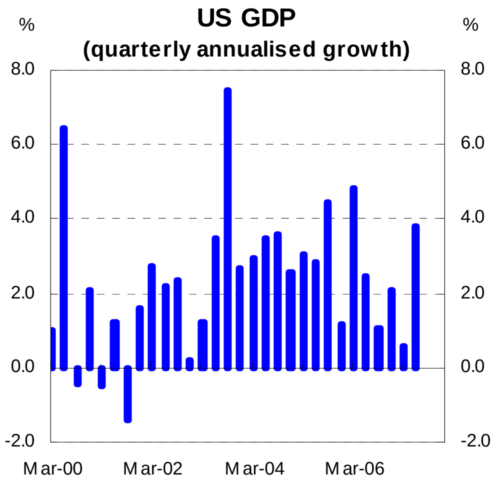
Economic Preview

US

Wednesday 31 October, 12:30

US GDP annualised, 1st estimate, Q3 (f) +3.1%

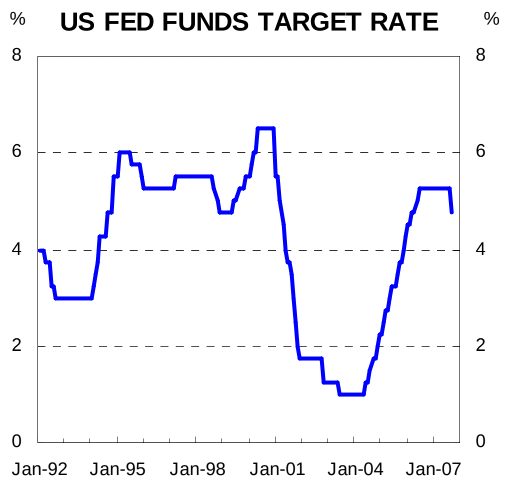
The US economy grew by 3.8% on a quarterly annualised basis in Q2. In Q3, consumer spending is expected to rebound after a relatively weak print in Q2 when gasoline prices weighed on consumers. Business investment growth should be positive, albeit moderate and slower than in Q2. Housing continues to be the weak link - another large fall is expected in Q3 expected; while net exports should be moderately positive. Looking into Q4, the key risk is that consumer spending will slow, weighed upon by the various negative factors in play including tighter lending conditions, higher mortgage rates, softer house prices, higher petrol prices and slower employment growth.



Wednesday 31 October, 18:15

FOMC meeting, (f) 25bp cut to 4.50%

We expect a 25bp rate cut from the Fed at its October 31 meeting. The Fed's central scenario when it delivered the 50bp cut in September was still for moderate growth. The cut was delivered because the downside risks to economic growth had increased on the back of the sub-prime and credit fallout and the associated tightening in lending conditions. The ongoing deterioration in the housing market since September means the risks to consumers have increased further. This is why we believe the Fed will opt for another "insurance" rate cut.



Canada

Wednesday 31 October, 12:30

CA GDP, Aug (f) +0.1%

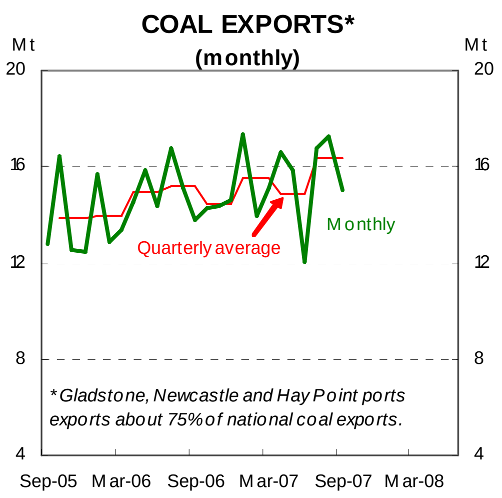
Canadian GDP growth is expected to slow to a monthly rate of 0.1% in August, after two consecutive months of 0.2% growth. Domestic demand is generally expected to continue at its recent heady pace. However, the external sector is expected to weigh in on growth as exports are hit by slower US demand and a loss of competitiveness via the stronger Canadian dollar.

Australia

Thursday 1 November, 0:30

AU Trade balance, Sep (f) –$0.8 billion

Already released data shows that the *value* of goods imports decreased by 4% in September. The trade-weighted exchange rate lifted by 1% in September. These trends imply that import *prices* were steady-to-down in September and that import *volumes* decreased significantly. Our CBA Commodity Price Index increased by 2% in September. So higher export *prices* will support export receipts. However, our coal export indicator suggests that mining export volumes probably declined in September. We have pencilled in a modest increase in total exports for September. We estimate the trade deficit will narrow significantly from $1.6 billion in August to $0.8 billion in September.



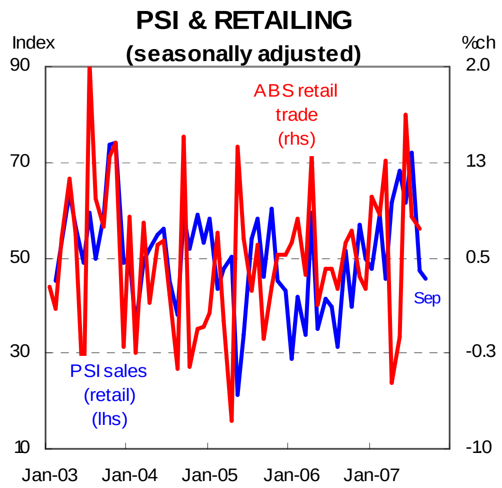
Thursday 1 November, 0:30

AU Retail sales

values, Sep (f) 0.5%

volumes, QIII (f) 1.7%

After several months of strong increases in retail spending, we expect a solid increase of 0.5% in the September month. This view is reinforced by the retail component of the Performance of Services index. Taking out changes in prices, we expect retail volumes to increase very strongly by 1.7% in the September quarter. We estimate that retail spending will contribute 0.4ppts to GDP growth.



New Zealand

No major releases.

Economic Calendar

Date	Time UK	Econ	Event	Period	Unit	Last	Forecast Market	Forecast CBA
Wed 31 Oct	~	AU	HIA new home sales	Sep	m%ch	-8.6	~	~
	~	JP	BoJ target rate	Oct	%	0.5	0.5	0.5
	0.30	AU	Private sector credit	Sep	m%ch	1.5	~	1.2
	0.30	AU	Building approvals	Sep	m%ch	-1.7	~	2.0
	2.00	NZ	NBNZ Business confidence	Oct	~	-26.5	~	~
	5.00	JP	Housing starts	Sep	y%ch	-43.3	-33	~
	5.00	JP	Construction orders	Sep	y%ch	-14.2	~	~
	9.00	EZ	Consumer confidence	Oct	~	-5.0	-5	~
	9.00	EZ	Industrial confidence	Oct	~	3.0	2	~
	10.00	EZ	Unemployment rate	Sep	%	6.9	6.9	~
	10.00	EZ	Economic confidence	Oct	~	107.1	106.7	~
	10.00	EZ	Services confidence	Oct	~	18.0	19	~
	12.30	CA	GDP	Aug	m%ch	0.2	0.1	~
	12.30	US	GDP annualised	QIII	%	3.8	3.1	~
	12.30	US	Core PCE	QIII	q%ch	1.4	1.6	~
	12.30	US	Employment costs	QIII	%	0.9	0.9	~
	13.00	US	Fed’s open market committee meets on interest rates					
	13.45	US	Chicago purchasing manager	Oct	~	54.2	53.0	~
	14.00	US	Construction spending	Sep	m%ch	0.2	-0.4	~
	18.15	US	FOMC rate decision	Oct	%	4.75	4.50	4.50
	21.30	AU	AiGroup PMI	Sep	~	50.7	~	~
Thu 1 Nov	0.30	AU	Trade balance	Sep	$m	-1,614	~	–800
	0.30	AU	Retail trade	Sep	%	0.7	~	0.5
	0.30	AU	Retail trade volumes	QIII	q%ch	-0.2	~	1.7
	5.00	JP	Vehicle sales	Oct	y%ch	-9.5	~	~
	~	US	Total vehicle sales	Oct	$mn	16.2	16.0	~
	11.30	US	Challenger job cuts	Oct	y%ch	-28.5	33.8	~
	12.30	US	Personal income	Sep	%	0.3	0.4	~
	12.30	US	Personal spending	Sep	%	0.6	0.4	~
	12.30	US	PCE Core	Sep	m%ch	0.1	0.2	~
					y%ch	1.8	1.8	~
	14.00	US	ISM Manufacturing	Oct	~	52.0	51.6	~
	14.00	US	ISM Prices paid	Oct	~	59.0	63	~
	16:00	GE	ECB’s Weber speaks in Berlin					
Fri 2 Nov	11.00	CA	Unemployment rate	Oct	%	5.9	5.9	~
	12.30	US	Change in non-farm payrolls	Oct	‘000	110.0	88	~
	12.30	US	Unemployment rate	Oct	%	4.7	4.7	~
	14.00	US	Factory orders	Sep	%	-3.3	1.0	~

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