Global Research

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Australian Economic Perspectives
A lower medium-term AUD & neutral RBA rate

Economics

Australia

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Overview

The neutral cash rate is a fluid concept, and subject to much uncertainty. As generally defined, it's the cash rate for an economy that neither leads to higher nor lower future inflation, if the economy was running near full employment. While opinions can differ widely on an economy's neutral cash rate, it remains a critical variable, suggesting what the 'average' level of the cash rate will be over the coming years, key for many assets.

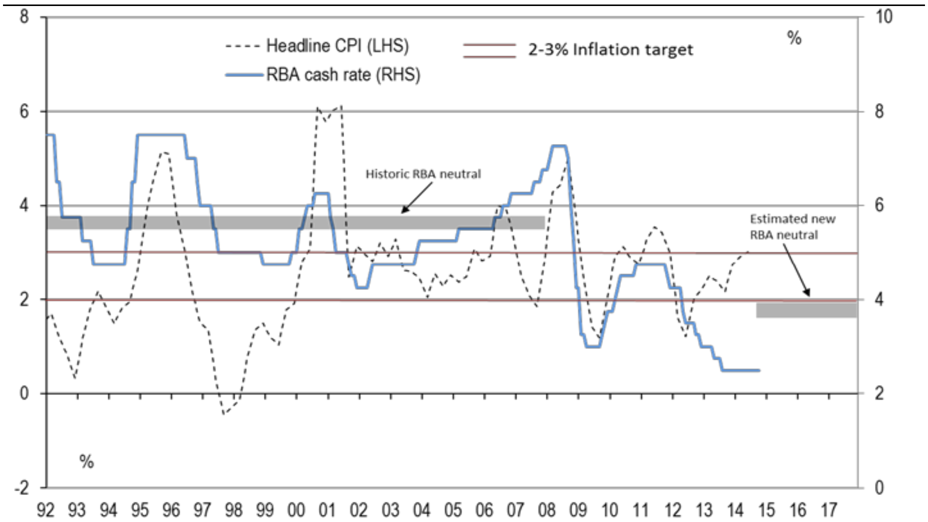
This week we consider a few reasons to argue the RBA's neutral cash rate – moving forward from today's 2.5% – may be much lower than its historic average of 5½-5¾%, in the order of 3¾%-4%. Overall, a combination of wider domestic lending margins relative to the RBA cash rate, the likelihood of slower trend domestic GDP growth, and the likelihood the AUD is going to remain above its post float trade-weighted exchange rate average, all point to a lower RBA neutral cash rate over the next few years.

We also consider our long-term AUD forecast. Notwithstanding the difficulties associated with forecasting exchange rates, invariably, some combination of commodity prices and relative yields have always shown the most significant statistical significance as far as correlating with the AUD.

In light of a lower neutral RBA cash rate, as well as lower commodity price outlook (with our global commodities team having this week cut their long term iron ore price to US$75/t cfr (from US$89/t cfr), we lower our long-term AUD forecast from USD0.85 to USD0.80. In the near-term, we continue to target USD0.85 for end 2014 & 2015

Week ahead: *Q3 underlying CPI should print 0.5% q/q, with headline 0.6%, seeing y/y rates slow after Q2's lift. Q3's NAB business survey provides insight on capex intentions. Markets will watch RBA minutes & speeches by Kent, Lowe & Stevens. Offshore, some pick-up of m/m US core CPI & home prices is seen, as new home sales retrace. We expect China's Q3 GDP to moderate. Oct PMIs are due in the US, CH & EU.*

Figure 1: RBA's neutral cash rate could be 1¾%pts lower at 3¾%-4%



Source: ABS, RBA, UBS forecasts

Data week: 20th – 24th October

Monday
RBA Kent speech

Tuesday
RBA meeting minutes (Oct)
Goods imports (Sep)
RBA Lowe speech

Wednesday
Skilled vacancies (Sep)
CPI (Q3)

Friday
NAB business survey (Q3)
RBA Stevens speech

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A lower medium-term AUD & neutral RBA rate

Why the RBA's neutral rate is lower

The neutral cash rate is a fluid concept, and subject to much uncertainty. As generally defined, it's the central bank cash rate for an economy that neither leads to an increase nor a decrease in future inflation, if the economy was running near full employment. But of course, the 'structural' drivers that are the input to ascertaining these factors can change over time, including productivity growth, population growth, demographic factors, as well as numerous international forces being faced by an economy.

While opinions can differ widely on an economy's neutral cash rate, it nonetheless remains a critical variable. By definition, it suggests what the 'average' level of the cash rate will be over the coming years, thereby significantly influencing other market variables, such as long term yields, curves, relative interest rates and exchange rates.

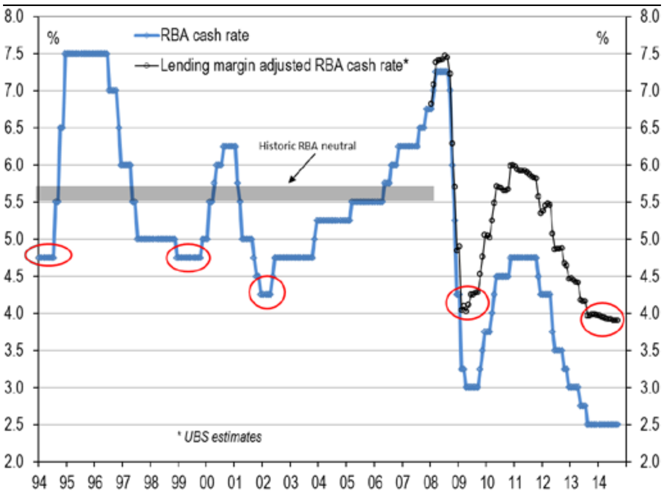
Some insight to the neutral cash rate can be ascertained from history. For Australia, this is made somewhat easier by the fact that much of the 1990s and 2000s, inflation averaged in the centre of the RBA's 2-3% target (Figure 1) and market lending rates largely moved in lock-step with the RBA cash rate. From 1993-2007 (from when the RBA adopted its inflation target, through to the global financial crisis), the CPI averaged 2.6%, the middle of the target band. Over this 15 year period, the cash rate averaged 5.6%, suggesting the RBA's neutral rate during this period was roughly 5½%-5¾%.

Without embarking on an exhaustive analysis, we consider a few reasons to argue the RBA's neutral cash rate – moving forward from today's 2.5% rate – may be much lower than this, in the order of 3¾%-4%. This would suggest, as we wrote a few weeks ago, that the US Fed is likely to 'out hike' the RBA over the next few years, broadly consistent with our outlook for yield compression and a lower AUD.

Figure 2: From end-2007, the economy-wide lending rate spread to RBA cash has jumped 141bp…

Source: RBA, UBS estimates

Figure 3: …adjusting for this suggests the RBA's new neutral could be about 4¼%…



Source: RBA, UBS estimates

1) <u>The margin on market lending rates has widened to the RBA cash rate</u>: relative to the past, the average economy-wide lending rate (Figure 2, based on our analysis of the weighted average borrowing rate across the economy, both households & businesses) is still 141bp wider than at the end of 2007 (having

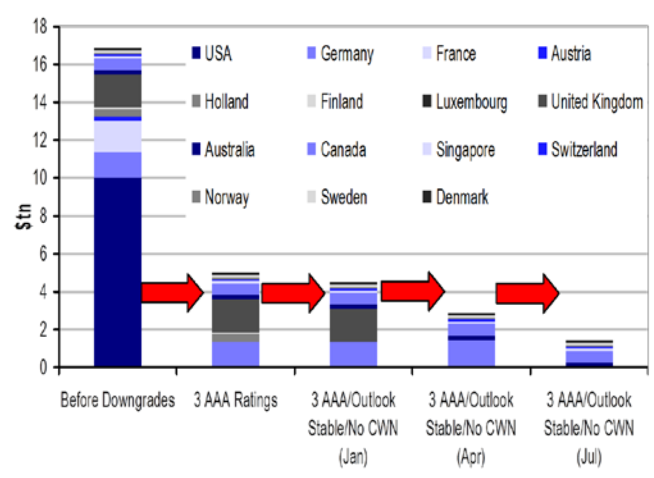
peaked at 148bp & narrowed recently). So if 5.6% was the RBA's average cash rate between 1993-2007, a simple 'new' neutral could be closer to 4¼% (ie, 5.57% – 1.41% = 4.16%). The result is little different if we compare the current spread to the average through 1993-2007, rather than the end point. As Figure 3 shows, today's 2.5% rate is broadly equivalent to a 4% rate when adjusted for this margin widening, putting rates about 150bp below 'historic' neutral on this basis.

2) <u>Trend 'domestic' GDP growth is likely lower:</u> While some argue Australia's overall potential GDP growth has slowed below 3% (from an historic 3¼%), we'd argue trend growth has potentially gone higher on the back of the economy's capacity expansion in exports (see *AEP – "Can exports fill the mining capex hole"*, 13/09/13). Indeed, we'd argue potential growth could have lifted to 3½%-3¾%. However, it is nonetheless likely that trend for the domestic economy – the part that can more significantly drive domestic inflation pressures and the CPI (& ergo, RBA cash rate policy) – has gone down significantly.

In the 10 years to 2007, GDP growth averaged 3½% y/y, comprising 4¾% domestic demand but –½%pt net export drag. While we believe overall trend growth may now be a higher 3½%-3¾%, this reflects the dramatic uplift in Australia's resource export volume capacity that should deliver a sustained net export 'add' of ¾%pt. In contrast, slower credit growth, sustained high leverage, mild demographic headwinds, lower prices for those resource export volumes and ongoing fiscal consolidation argue for a slower domestic economy nearer 3% (not 4¾%). If the RBA's neutral was to continue to average less than 90bp above domestic growth, this would imply a neutral cash rate a little under 4% from here.

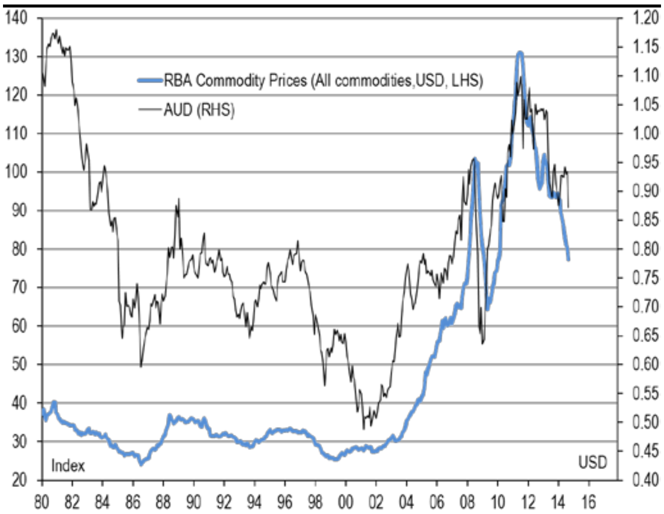
3) <u>Lower cash rate starting point, but higher economy-wide leverage</u>: Excluding 2006/07, when the RBA may have missed the extent of the fiscal easing, they managed to control the economy by moving the cash rate from an average peak of 6¾% to an average trough of 4½%. In other words, the RBA's peak to mid-point (or mid-point to trough) moves were only about 120bp. So, if the RBA's current 2.50% is the 'new trough'…3¾% starts to look like the new neutral RBA cash rate. This approach recognises ongoing (& now higher) sensitivity of the economy, and particularly the household sector, to leverage (see Macro Keys: *"Dollar bloc – from de-leverage to leverage"*, 21/01/14).

Figure 4: The supply of AAA stable-rated debt shrunk in 2012 to less than USD2trn, from USD17trn prior to the GFC. Australia is one of only 7 super-AAA debt providers



Source: UBS FX Strategy

Figure 5: While commodity prices have corrected lower – & may correct further – they seem likely to persist above their level during much of the AUD's post float history



Source: Datastream, RBA, UBS

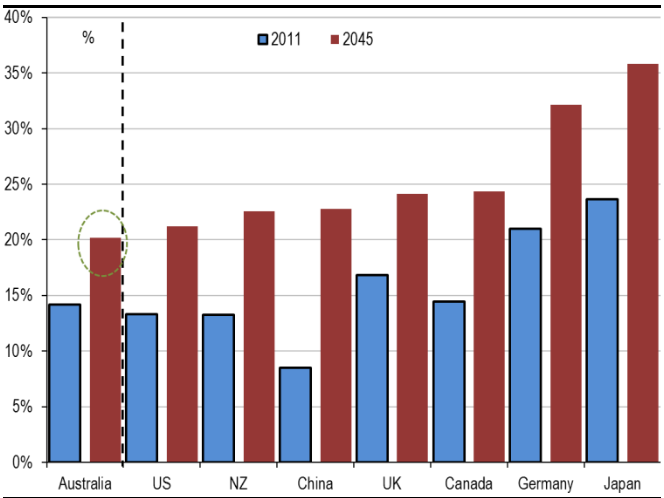
4) A higher AUD than in the past: An economy's monetary or financial conditions is best viewed as some combination of domestic policy (our domestic interest rates set by the RBA) and 'external' policy (our exchange rate, or how the world 'relatively' impacts the economy). This is the essence of the monetary conditions indexes (or MCIs), constructed by weighting these two variables, that central banks like the RBNZ and Bank of Canada used extensively during the late 1990s and early 2000s to guide their interest rate policy.

The average AUD trade-weighted index (TWI) since the AUD's 1983 float – but prior to the 2007/08 global financial crisis – was 58.6 (or 61.4 through to now). If the AUD was to be circa 65 on the TWI (circa USD80-85), it's roughly 10% above average. To the extent external forces – be that offshore demand for our super-AAA rated debt (Figure 4), or higher yield in a persistent lower yield global economy – leads to a higher than historic AUD, the case could be made for a lower on average domestic interest rate to balance this headwind.

Overall, a combination of wider domestic lending margins relative to the RBA cash rate, the likelihood of slower trend domestic GDP growth, and the likelihood the AUD is going to remain above its post float trade-weighted exchange rate average, all point to a lower RBA neutral cash rate over the next few years. Our analysis suggests it could be 3¾%-4%, around 1¾% lower than the traditional neutral cash rate of 5½%-5¾%.

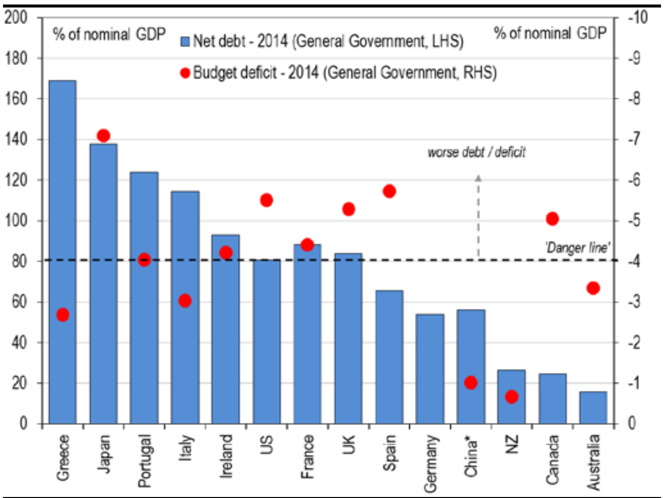
Of course, this has little impact on our view that the RBA will be keen to starting moving (cautiously) away from the current record low cash rate sometime around mid-2015. However, it does suggest the extent of the upward rate cycle may be less than in the past, consistent with our long-held view that the US Fed will likely 'out-tighten' the RBA through 2015 & 2016, narrowing Aussie yield spreads to offshore and encouraging the AUD to continue its move lower (AEP – "*Trimming long bond yields – still a flatter curve & narrower spreads ahead*", 26/09/14).

Figure 6: Dependency ratio - Australia faces a less challenging demographic outlook than most, helped by relatively fast population growth…



Source: United Nations

Figure 7: …while the fiscal challenge is important, it is also a less significant headwind to growth than is the case for most other economies



Source: IMF

Could the RBA's neutral be even lower? We are cautious about getting too bearish on Australia's absolute and relative growth outlook (which would imply the neutral cash rate is lower than our 3¾%-4% estimate). While commodity prices are moving lower in an environment where China's growth is slowing, they are still likely to remain well above their average prior to 2003 (see again Figure 5).

Australia also benefits from strong population growth, forecast to still be around 1½% per year, compared with sub-1% growth across the US, Europe & Japan. Similarly, Australia's demographic outlook, while still a headwind, compares very favourably to other advanced economies (Figure 6). Finally, while fiscal consolidation is also a headwind, it is arguably less of a headwind to future growth than for most other economies (Figure 7).

Lowering our long-term AUD to USD0.80

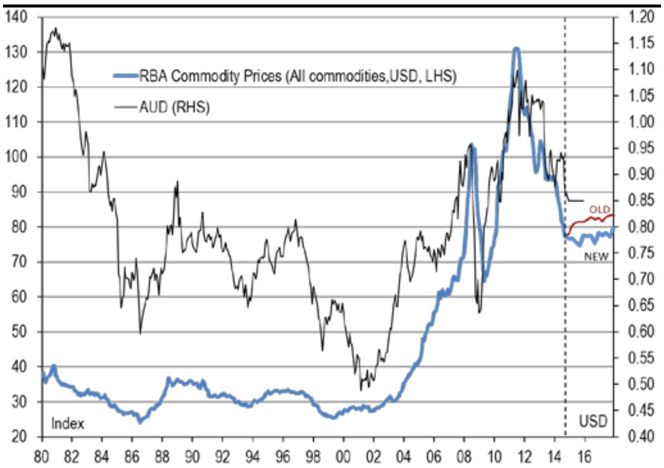
The difficulties associated with forecasting exchange rates are well known. But this doesn't change the reality that currency effects can be significant. Moreover, having a medium-term benchmark is key to forecasting longer-term interest rates and economy-wide income, as well as company earnings (especially for those with offshore assets).

Invariably, some combination of commodity prices and relative yields have always shown the most significant statistical significance as far as correlating with the AUD. This week our commodities team have lowered their long-term iron ore price, while we have lowered our assessment of the RBA's neutral rate (see above). Given this, we re-examine our long-term forecast for the AUD, also lowering it from USD0.85 to USD0.80.

- Our global commodities research team have cut their long term iron ore price to US$75/t cfr (from US$89/t cfr) based on their incentive pricing methodology, and reflecting both rising global iron supply and a lower global demand environment (see "*Iron Ore: Game changer*", 15/10/14). With iron ore almost 30% of Australia's exports, this 15% downgrade to the long-term iron ore outlook lowers our commodity price outlook sufficiently to be more consistent with USD0.80 than USD0.85 (see Figure 8).

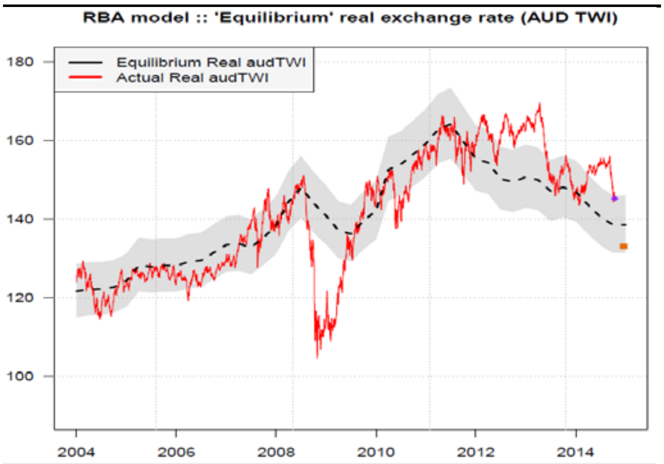
- As discussed above, we now believe the RBA's neutral cash rate is as much as 175bp lower than in the prior cycle. Like lower iron ore prices, lower relative long-term cash rates should contribute to a lower medium term exchange rate. Using the UBS Rates Strategy version of the RBA's AUD fair value model, and inputting a lower long-term iron ore price and lower AUD cash rate, the model also points to 'fair value' for the AUD being around 7½% lower than currently, close to USD0.80 (Figure 9). In the nearer-term, we continue to target USD0.85 for the AUD end 2014 & end 2015.

Figure 8: An USD75/t long-term iron ore price suggests a lower long-term AUD valuation…



Source: RBA, Datastream, UBS

Figure 9: Lower iron ore & tighter yields suggests fair is 7½% from here…see orange dot, using RBA's model



Source: RBA, UBS Rates Strategy

Australian Economic Outlook

	Calendar Year (average % y/y change)				Fiscal Year (average % y/y change)			
	2012	2013	2014 (f)	2015 (f)	2011/12	2012/13	2013/14	2014/15 (f)
REAL:								
GDP	3.6	2.3	3.1	3.2	3.6	2.6	2.8	3.0
Non-farm GDP	3.7	2.3	3.1	3.1	3.7	2.7	2.9	2.8
Private Consumption	2.6	2.0	2.5	3.0	2.5	2.1	2.5	2.6
Dwelling Investment	-3.3	1.8	10.0	4.5	-2.2	-0.2	5.0	9.1
Business Investment *	17.3	-2.3	-5.2	-2.0	23.1	6.8	-4.9	-4.8
- Machinery & equipment *	1.7	-9.7	-8.1	2.0	12.6	-3.3	-12.4	-2.4
- Non-residential construction *	34.1	1.3	-6.6	-6.9	37.4	14.9	-2.2	-9.7
Domestic Final Demand	4.3	1.0	1.5	2.0	5.1	2.0	1.2	1.6
- Private Final Demand *	5.1	1.2	1.4	2.1	6.0	3.0	1.2	1.5
- Public Final Demand *	1.3	-0.2	1.4	2.0	2.1	-1.3	1.5	1.8
Stocks (%pts contribution)	0.0	-0.5	0.2	0.5	0.1	-0.3	-0.4	0.6
GNE	4.1	0.4	1.6	2.5	5.0	1.8	0.8	2.2
Exports	5.7	6.6	7.3	7.3	4.7	6.0	6.8	7.2
Imports	6.4	-2.0	1.0	5.0	11.4	1.0	-2.3	4.6
Net Exports (%pts contribution)	-0.1	1.8	1.4	0.7	-1.3	1.1	2.0	0.7
Nominal GDP	3.4	3.6	3.4	4.5	5.6	2.6	4.1	3.2
OTHER KEY INDICATORS								
Headline CPI	1.8	2.4	2.7	2.6	2.3	2.3	2.7	2.5
RBA 'underlying' CPI **	1.8	2.4	2.7	2.6	2.4	2.4	2.7	2.5
Wage Price Index	3.6	2.8	2.7	3.1	3.6	3.3	2.6	2.9
Employment	1.2	1.0	1.0	1.6	1.2	1.2	0.8	1.3
Unemployment Rate (quarterly, % at year-end)	5.3	5.8	6.1	5.8	5.1	5.6	5.9	5.9
Dwelling Commencements (000s)	151	168	190	175	145	162	181	186
Current Account Balance (% of GDP)	-4.4	-3.3	-3.3	-3.3	-3.5	-4.0	-2.9	-3.6

QUARTERLY		Mar-14	Jun-14	Sep-14 (f)	Dec-14 (f)	Mar-15 (f)	Jun-15 (f)	Sep-15 (f)	Dec-15 (f)
GDP	(% q/q)	1.1	0.5	0.6	0.8	0.9	0.9	0.7	0.7
	(% y/y)	3.4	3.1	3.0	3.0	2.8	3.2	3.4	3.3
		Mar-14	Jun-14	Sep-14 (f)	Dec-14 (f)	Mar-15 (f)	Jun -15 (f)	Sep-15 (f)	Dec-15 (f)
Headline CPI	(% q/q, nsa)	0.6	0.5	0.6					
	(% y/y, nsa)	2.9	3.0	2.4					
RBA 'underlying' CPI *	(% q/q, sa)	0.5	0.7	0.5					
	(% y/y, sa)	2.7	2.8	2.6					
FINANCIAL MARKETS (at end qtr)		Mar-14	Jun-14	Sep-14	Dec-14 (f)	Mar-15 (f)	Jun -15 (f)	Sep-15 (f)	Dec-15 (f)
- Cash (%)		2.50	2.50	2.50	2.50	2.50	3.00	3.00	3.00
- 90 Day Bills (%)		2.67	2.69	2.71	2.70	2.80	3.10	3.10	3.10
- 3-year Commonwealth Bonds (%)		2.81	2.70	2.73	3.10	3.40	3.70	3.80	3.80
- 10-year Commonwealth Bonds (%)		4.07	3.56	3.51	3.80	4.00	4.10	4.20	4.30
- S&P/ASX 200 (Index)		5395	5396	5293	5625	5700	5800	5875	5950
Exchange Rates (end qtr):	AUD/USD	0.928	0.942	0.873	0.850	0.850	0.850	0.850	0.850
	AUD/EUR	0.673	0.688	0.691	0.669	0.679	0.688	0.698	0.708
	AUD/JPY	95.6	95.4	95.8	91.8	93.3	94.8	96.3	97.8
	TWI	71.0	72.0	68.9	68.6	67.7	65.9	66.5	66.9

Source: ABS, Datastream, RBA, UBS estimates * adjusted for private & public transfers ** 3-core average, sa

UBS Australian Forecasts: What & Why?

Forecasts versus consensus

- Our 2014 real GDP forecast for 3.1% y/y is a tick above Consensus of 3.0%. Our forecast for the RBA to start hiking in Q215 is earlier than Consensus (for Q315).

Recent forecast changes

- On October 10, we reverted back to end-2014 on the timing of our long-held forecast depreciation of the AUDUSD to 0.85 (was most recently by mid-2015).
- On September 25, following our US team lowering their end-2015 forecast of 10-year bond yields to 3.7% (was 4.0%), we also cut Australia to 4.3% (was 4.5%).
- On September 6, after Q2 GDP, we downgraded our 2014 real GDP forecast to 3.1% y/y (was 3.3% y/y); but raised 2015 to 3.2% y/y (was 3.0% y/y).

Key growth drivers

- We see 3% y/y GDP growth holding ahead. Better wealth, confidence & low rates should combine with a better global backdrop to see consumption & housing pick-up moderately, plus strong exports post the mining capex boom. A lower AUD (USD0.85 in 2015) should drive a lift in non-mining capex growth into 14/15.
- However, the downdraft from falling mining activity, a slower China and falling commodity prices, will constrain the pick-up in growth. Weaker nominal income growth will impact wages, spending and hiring, as well as the Government's Budget, and see a less buoyant economy than normally is the case when the world recovers.
- Better affordability, low rates and rising income, are underpinning a strong uplift in housing activity. We forecast 190k dwelling commencements in 2014 (after 168k in 2013), adding up to ½%pt to GDP growth.
- Better wealth & a stabilising jobs market should see a lift in consumption growth from 2%, towards 3% in 2014 (+½%pt to growth), still below historic averages. With income modest, we see a lower saving rate as key.
- Exports should rise strongly in 2014 & 2015, due to expanded capacity in resources, post the capex boom. But, weaker mining capex will sharply drag on growth.

Key inflation drivers

- We see underlying inflation easing from 2¾% y/y in mid-14, to 2½% by end-14, but up again to 2¾% y/y by end-15.
- For 2H14, a recently stronger AUD sees renewed imported disinflation, while the carbon tax repeal reduces domestic prices. Thereafter, a falling AUD will lift imported prices. But only modestly rising demand & elevated unemployment, driving ongoing subdued wages growth and weak pricing power, should see low domestic/non-traded inflation pressures.

Monetary & fiscal policy outlook

- RBA – while growth is likely to stabilise & lift in 2014 so the RBA does not cut, sub-trend growth & elevated unemployment should see the RBA hold until early-15.
- Government – we see fiscal policy as a mild drag on growth in the period ahead, as the new Coalition attempts to return the budget to structural balance.

Key forecast risks

- Downside: Our forecast US & global recovery losses steam, or China slows more rapidly than expected. AUD above parity would likely undermine the recent lift in business confidence & improved domestic growth outlook. Consumers again become cautious, keeping saving elevated. A weaker nominal environment drags on growth, & non-mining activity more than expected.
- Upside: An AUD toward USD0.80 or lower would provide more stimulus to the domestic economy, as could more rate cuts from RBA. Consumer appetite for credit could strengthen more than expected, driving stronger domestic spending and non-mining capex.

Key growth signposts

- The AUD moving towards our long-held USD0.85 target, which would support the rebalancing of growth.
- Improved business survey conditions and confidence.
- A peak in the unemployment rate.

Positions on key controversies

- Mining capex unwind – this is likely to be concentrated from 2014, and we expect some offset from non-mining capex into 2015. A sharper than expected correction carries key risks for our outlook.
- Consumer caution – we do not expect the consumer to return to the leverage-keen environment of the 2000s. However, we do expect some modest further retracement from the still high household savings rate.

  Terms of trade – a much weaker trend for commodity prices will mean the pick-up in Australia's growth will be more export volume led, with a more sluggish domestic recovery. However, that does not ensure a recession or the need for further cash rate cuts.

Market trends

Monetary policy: The RBA – no cuts, no hikes for 2014

- **Cash:** We've drifted our start to the RBA's rate hike cycle from Q115 to Q215, to reflect a likely higher AUD path. It remains true that if the AUD is below USD85 in early 2015, the RBA could begin in Q1, while an AUD still near USD0.90 could delay it into 2H15. We expect moderating 2H14 inflation, and a desire to remove upside AUD risks by getting closer to a likely Q2 Fed tightening, will provide the RBA enough incentive to wait until Q2, before stepping away from record low rates. We look for a 25bp hike in both May & June. Our end-15 cash rate target is 3.00%.

Aussie 10-years – target 4.3% in 2015

- **US 10-years:** Post the Fed's start to tapering, US 10-year yields backed up to 3.0%, removing much of the distortion from QE, and returning yields to our 'fair value' range (Figure A). However, despite recently better US data, and rising inflation pressures, US treasuries have rallied again toward 2½%. Improving growth and expectations of Fed rate hikes mid 2015 should still see yields rise into end-14. We target 2.8% end 2014 and 3.7% end 2015.

- **Australian 10-years:** Having initially under-performed in the sell-off (helped by strong domestic data), Aussie 10-years have rallied by more than their offshore peers recently. We look for yields to move higher, in line with our forecast for global yields. We see some out-performance, due to a less aggressive RBA and a more moderate growth outlook, weighed on by weak capex, a slower China and falling commodity prices. We target 3.8% end 2014 and 4.3% end 2015.

Australian 3-years – targeting a rise back to over 3%

- **Australian 3-years:** The recent rally in yields returned Aussie 3-years back close to cash, before jumping back to 2¾%. Even if the RBA trims again, unless the economy slows sharply, the proximity to the end of the cutting cycle suggests 3-year yields should rise sharply before the first hike. We target 3.1% end 2014, rising to 3.8% end 2015.

Yield Curve – a bias to flatten

- **Yield curve:** The curve has flattened to our expected 75-80bp in 1H14, though mostly driven by the long, rather than short-end. From here, we see the curve staying flat, as the entire curve moves higher into 2015, with a bias toward 50bp by end 2015.

Aussie – US 10-yr spread – can it tighten to 50bp?

- **Australian-US spread:** A less buoyant Australian outlook – & less easy policy – argues for ongoing long-end compression. In the near term, an on-hold Fed, versus a re-active RBA suggests the spread should stay around 100bp. But we look for a tightening to 60bp by end 2015 as the US Fed begins its rate hike cycle mid-2015.

Source for text and charts: Bloomberg, DataStream, UBS
** UBS forecasts for end 2014 & end 2015*

Figure A: US 10-year bond yield

Figure B: Australian 10-year bond yield

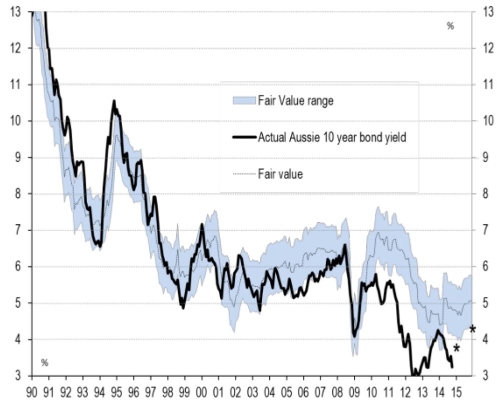


Figure C: Australian 3-year bond yield

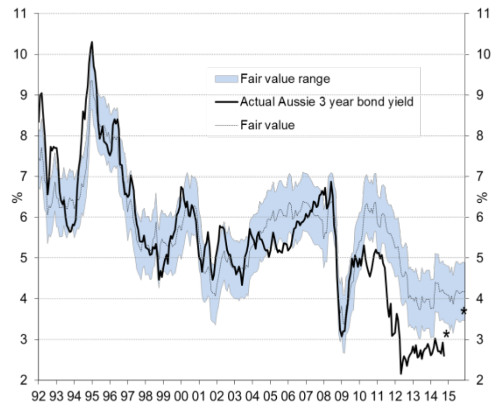
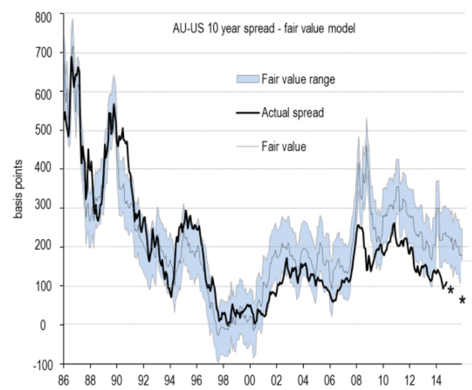


Figure D: AU-US 10-year bond yield spread



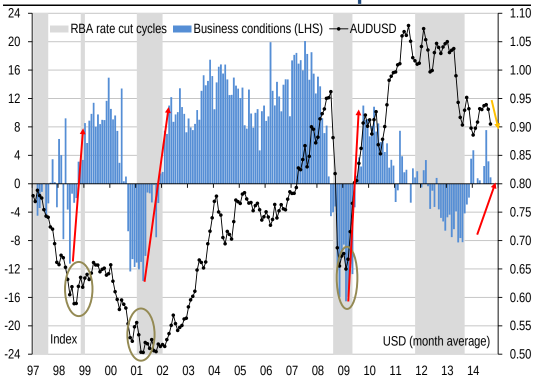
Week in Review: 13th – 17th October

Data was relatively soft. Business conditions fell further in September to below average, and business confidence also eased back, despite a lower AUD. Consumer sentiment edged up in October, but only partly retracing September's drop. Car sales rebounded in September, albeit after dropping to a 2-year low. Q2 dwelling & non-residential building commencements both retraced sharply in Q2. RBA Debelle's flagged the prospect of higher volatility in markets ahead.

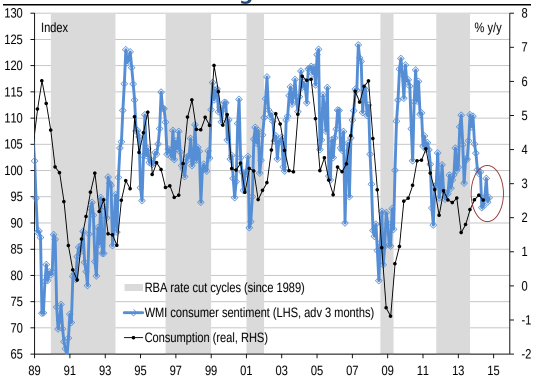
Offshore (ahead of Yellen's speech tonight), global data was mixed, in a volatile week for markets. US Sep retail sales fell back at the core level, but US IP rose solidly and jobless claims fell further. Eurozone data was weak, with a slump in the German October ZEW, and UK September CPI fell to a 5yr low; EU inflation was unchanged at 0.3% y/y, but core edged up to 0.8% y/y. China's September exports & imports both beat, as did loans data, but CPI fell more than expected to 1.6%.

In the week to noon, the AUD was little changed, rising 0.1% to USD0.877, 10-year bond yields dropped a further 7bp to 3.25%, while the ASX200 partly recovered, rising 1.3% to 5208.

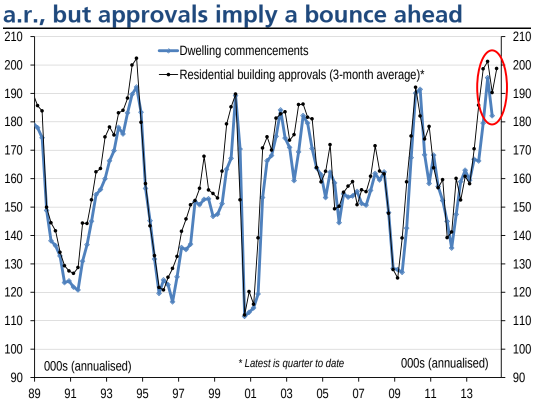
Business conditions eased in September



Consumer sentiment edged up in October, but remains below average



Q2 dwelling commencements retraced to 182k a.r., but approvals imply a bounce ahead



Source: ABS, RBA, NAB, Westpac, Melbourne Institute, UBS

- Westpac/Melbourne Institute **consumer sentiment** bounced a modest 0.9% m/m in October to 94.8 (UBS: up, mkt: nf), but only partly offsetting a 4.6% m/m drop to 94.0 in September, and still fell 12.5% y/y – to stay below its average (of 101.5 since 1974). 'Time to buy a dwelling' bounced 2.3% m/m to 113.9, but after dropping 8.8% m/m, it was still -12.4% y/y – and below its average (125.7) – albeit actual approvals have been holding a near record high level. On the positive side, unemployment expectations improved further to the best (i.e. lowest) level in almost a year, albeit after March spiked to the highest level since the GFC.

- **Dwelling commencements** (number) retraced a sharp 6.9% q/q in Q2 to 182k a.r. (UBS: -5%, mkt: nf), but only partly offset Q1's 8.9% q/q surge to a record high level of 196k a.r. The y/y moderated to 9.2%, after Q1's +22.7% was the fastest since Q210.

- Real (public & private) **non-residential building commencements** retraced sharply in Q2 (-11.5% q/q, after +16.7%), trending at a weak level (-7% y/y).

- **Car sales** rebounded 2.9% m/m in September (UBS: 'up', mkt: nf) – after August fell 1.6% to the lowest level since July 2012 – to be up 0.8% y/y (best since July 2013).

- NAB's **business conditions** fell further to +0.9 in September, the lowest since May, down from +3.1 in August (was +3.5), & +7.6 in July (which was highest since 2010). Conditions are now below their average (since 1997) of +4.4. **Business confidence** also dropped back to +4.9, the lowest since the change of Government a year ago, after +7.5 in August (and +9.3 in July). That said, confidence is still only modestly below its average (since 1997) of +5.9.

- **RBA's Debelle** flagged the prospect of illiquidity and higher volatility in markets ahead, saying "there are a number of anomalies present in financial markets in terms of pricing and volatility. There are also some misplaced perceptions amongst market participants about the degree of liquidity present in some market segments".

Week Ahead: 20th – 24th October

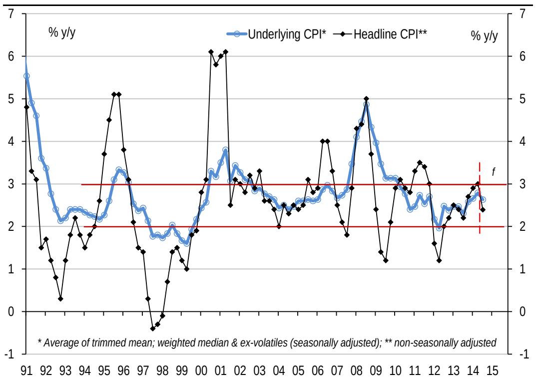
Key Q3 CPI (Wed) should show welcome dis-inflation y/y – with 'underlying' moderating to 0.5% q/q, while headline rises 0.6%, a below average Q3 result. Elsewhere, RBA watchers will scrutinise the October meeting minutes (Tue) – and speeches by Kent (Mon), Lowe (Tue) and Stevens (Thu) – with a focus on housing risks, as well as recent AUD depreciation. NAB's Q3 business survey updates capex intentions, while September goods imports (Tue) & skilled vacancies (Wed) are due.

Offshore (post Yellen's speech tonight), consensus expects Aug existing home sales (Tue) to bounce, with a pick-up of Sep core CPI (Wed) and Aug home prices (Thu), but new home sales (Fri) to retrace after a sharp bounce. Elsewhere, we expect China Q3 GDP (Tue) to moderate, but Sep IP (Tue) to bounce. Flash Oct PMIs are due (Thu) in the US, China & Europe. The BoC (Wed) is seen on hold, the BoE releases its meeting minutes (Wed), while UK Q3 GDP (Fri) is due.

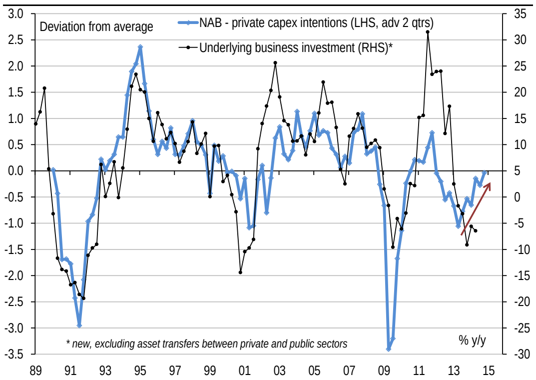
Date	Time (AEDT)	Data/Event	UBS	Market*	Previous
20 Oct	10:30	RBA Kent speech at Leading Age Services Congress	-	-	-
21 Oct	11:30	RBA meeting minutes (Oct)	-	-	-
21 Oct	11:30	Goods imports (Sep)	nf	nf	-3.1%
21 Oct	19:55	RBA Lowe speech at Australasian Fixed Income Conference	-	-	-
22 Oct	11:00	Skilled vacancies (Sep)	nf	nf	+3.8%
22 Oct	11:30	CPI – headline, non-seasonally adjusted (Q3)	+0.6%	+0.4%	+0.5%
22 Oct	11:30	Core CPI – trimmed mean (Q3)	+0.4%	+0.5%	+0.8%
22 Oct	11:30	Core CPI – weighted median (Q3)	+0.6%	+0.5%	+0.6%
23 Oct	11:30	NAB business conditions (Q3)	'steady'	nf	1.3
23 Oct	11:30	NAB business confidence (Q3)	'steady'	nf	5.9
23 Oct	20:00	RBA Stevens speech to Payments Clearing Association	-	-	-

Source: ABS, Bloomberg, RBA, Reuters, Dow Jones * Market may not be final

Q3 CPI (headline & underlying both) should moderate y/y…



Will capex intentions hold onto their recovery to average?



Source: ABS, NAB, RBA, UBS

CPI (Q3)

For Q3 CPI, we forecast the y/y pace of both headline and underlying CPI should show some welcome easing. For headline, we find a relatively low rise of 0.6% q/q, albeit ticking up from 0.5% q/q in Q2, seeing the y/y pace moderate to 2.4%, just below the midpoint of the RBA's 2-3% target (after Q2 spiked to 3.0% y/y). Meanwhile, the 3 key core measures are seen averaging a relatively low increase of 0.5% q/q in Q3, below Q2's 0.7% q/q, which eases the y/y pace to 2.6% (after 2.8%). For details, see our 10/4/14 AEP "Q3 CPI survey – points to y/y disinflation".

NAB business survey (Q3)

NAB's monthly survey of business conditions and confidence both weakened between July and September, but their trends are broadly consistent with the quarterly survey showing a broadly steady result for Q3 conditions (after 1.3 in Q2) and confidence (after 5.9 in Q2). Of more interest will be if capex intentions can hold onto their improving trend since last year, after Q2 reached around its average level.

Economic Calendar

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
------- 13 Oct -------	------- 14 Oct -------	------- 15 Oct -------	------- 16 Oct -------	------- 17 Oct -------
AU TOTAL LOANS (Aug) Act: -9.5%, Pre: +2.5% r NZ FOOD PRICES (Sep) Act: -0.8%, Pre: +0.3% CH TRADE BALANCE (Sep, USD) Act: $30.9bn, Pre: $49.8bn NZ REINZ HOUSE PRICE (Sep) Act: +0.2%, Pre: +1.1% US HOLIDAY Bond mkt open, stock mkt closed	RBA DEBELLE SPEECH AU BUSINESS CONDITIONS (Sep) Act: 0.9, Pre: 3.1 r AU BUSINESS CONFIDENCE (Sep) Act: 4.9, Pre: 7.5 r EU IP (Aug) Act: -1.8%, Pre: +0.9% r UK CPI (Aug) Act: 0.0%, Pre: +0.4% GE ZEW (Oct) Act: 3.2, Pre: 25.4	AU WMI CONS SENTIMENT (Oct) Act: +0.9%, Pre: -4.6% AU CAR SALES (Aug) Act: +2.9%, Pre: -1.6% r AU DWELLING COMMENCE (Q2) Act: -6.9%, Pre: +8.9% r CH CPI (Sep y/y) Act: +1.6%, Pre: +2.0% US RETAIL SALES (Sep) Act: -0.3%, Pre: +0.6% US PPI (Sep) Act: -0.2%, Pre: 0.0% FED BEIGE BOOK (Oct) ECB DRAGHI SPEECH JN IP (Aug f) Act: -1.9%, Pre: -1.5% (Aug p) UK UNEMPLOYMENT RATE (Aug) Act: 6.0%, Pre: 6.2%	RBA DEBELLE SPEECH NZ MANUFACTURING PMI (Sep) Act: 58.1, Pre: 56.5 US IP (Sep) Act: +1.0%, Pre: -0.2% r US HOUSING MARKET INDEX (Oct) Act: 54, Pre: 59 EU CPI (Sep f, y/y) Act: +0.3%, Pre: +0.3% (Sep p) CH TSF LOANS (Sep, RMB) Act: 1005bn, Pre: 957bn	US HOUSING STARTS (Sep) UBS: 1000k, Pre: 956k US UM CONS CONF (Oct p) UBS: 84.0, Pre: 84.6 (Sep p) FED YELLEN SPEECH CA CPI (Sep) Mkt: +0.1%, Pre: 0.0%
------- 20 Oct -------	------- 21 Oct -------	------- 22 Oct -------	------- 23 Oct -------	------- 24 Oct -------
RBA KENT SPEECH NZ SERVICES PSI (Sep) UBS: nf, Pre: 57.9	RBA MINUTES (Oct) RBA LOWE SPEECH AU GOODS IMPORTS (Sep) UBS: nf, Pre: -3.1% NZ TOURIST ARRIVALS (Sep) UBS: nf, Pre: -3.0% NZ CREDIT CARD BILLINGS (Sep) UBS: nf, Pre: +0.7% US EXISTING HOME SALES (Sep) Mkt: +0.8%, Pre: -1.8% CH GDP (Q3, y/y) UBS: +7.1%, Pre: +7.5% CH IP (Sep) UBS: +7.9%, Pre: +6.9%	AU CPI (Q3) UBS: +0.6%, Pre: +0.5% AU TRIMMED MEAN (Q3) UBS: +0.4%, Pre: +0.8% AU WEIGHTED MEDIAN (Q3) UBS: +0.6%, Pre: +0.6% AU SKILLED VACANCIES (Sep) UBS: nf, Pre: +3.8% US CORE CPI (Sep) Mkt: +0.2%, Pre: 0.0% BOE MINUTES (Oct) BOC DECISION (Oct) Mkt: nf, Pre: 1.00%	RBA STEVENS SPEECH AU NAB BUS CONDITIONS (Q3) UBS: 'steady', Pre: 1.3 AU NAB BUS CONDFIDENCE (Q3) UBS: 'steady', Pre: 5.9 NZ CPI (Q3) UBS: +0.6%, Pre: +0.3% US MFG PMI (Oct p) Mkt: nf, Pre: 57.5 US FHFA HOME PRICE (Aug) Mkt: +0.4%, Pre: +0.1% EU COMPOSITE PMI (Oct p) Mkt: nf, Pre: 52.4 CH HSBC MFG PMI (Oct p) Mkt: nf, Pre: 50.2	NZ TRADE BALANCE (Sep) UBS: -$750mn, Pre: -$472mn US NEW HOME SALES (Sep) Mkt: -6.3%, Pre: +18.0% UK GDP (Q3 a) Mkt: nf, Pre: +0.9% (Q2)
------- 27 Oct -------	------- 28 Oct -------	------- 29 Oct -------	------- 30 Oct -------	------- 31 Oct -------
RBA ELLIS SPEECH US PENDING HOME SALES (Sep) Pre: -1.0% US COMPOSITE PMI (Oct p) Pre: 59.0 GE IFO (Oct) Pre: 104.7	US DURABLES (Sep) Pre: -18.2% US S&P/CS HOME PRICES (Aug) Pre: -0.5% US CB CONSUMER CONF (Oct) Pre: 86.0	FED DECISION (Oct) QE pace pre: $15bn JN IP (Sep p) Pre: -1.5% (Aug p)	AU HIA NEW HOME SALES (Sep) Pre: +3.3% AU EXPORT PRICES (Q3) Pre: -7.9% AU IMPORT PRICES (Q3) Pre: -3.0% RBNZ DECISION (Oct) Pre: 3.50% US GDP (Q3 a) Pre: +4.6% (Q2)	AU PPI (Q3) Pre: -0.1% AU CREDIT (Sep) Pre: +0.4% NZ DWELLING CONSENTS (Sep) Pre: 0.0% NZ ANZ OWN ACTIVITY (Oct) Pre: 37.0% NZ HOUSEHOLD CLAIMS (Sep) Pre: +0.3% US CORE PCE (Sep) Pre: +0.1% EU CPI (Oct) Pre: +0.3% BOJ DECISION (Oct)
------- 3 Nov -------	------- 4 Nov -------	------- 5 Nov -------	------- 6 Nov -------	------- 7 Nov -------
AU MANUFACTURING PMI (Oct) Pre: 46.5 AU RPDATA DWELLING PRICE (Oct) Pre: +0.1% AU RESI BUILD APPROVALS (Sep) Pre: +3.0% AU ANZ JOB ADS (Oct) Pre: +0.9% AU RBA $A COMMOD PRICE (Oct) Pre: -1.4%	RBA DECISION (Nov) Pre: 2.50% AU TRADE BALANCE (Sep) Pre: -$787mn AU RETAIL SALES (Sep) Pre: +0.1% AU RETAIL VOLUMES (Q3) Pre: -0.2% NZ COMMODITY PRICE (Oct) Pre: -1.3%	AU SERVICES PSI (Oct) Pre: 45.4 NZ EMPLOYMENT (Q3) UBS: +0.8%, Pre: +0.4% NZ UNEMPLOYMENT RATE (Q3) UBS: 5.4%, Pre: 5.6% NZ LABOUR COST INDEX (Q3) UBS: +0.6%, Pre: +0.6% NZ QES – EARNINGS (Q3) Pre: +0.5%	AU EMPLOYMENT (Oct) Pre: -29.7k AU UNEMPLOYMENT RATE (Oct) Pre: 6.1% UK IP (Sep) Pre: 0.0% BOE/BOJ DECISION (Nov) Pre: 0.50% / Pre: 0.05%	RBA SOMP (Nov) AU CONSTRUCTION PCI (Oct) Pre: 59.1 US PAYROLLS (Sep) Pre: +248k US UNEMPLOYMENT RATE (Sep) Pre: 5.9% GE IP (Sep) Pre: -4.0%

UBS: UBS Forecast **Pre**: Previous Release **Act**: Actual **Mkt**: Market **a**: advanced **r**: revised **p**: preliminary **f**: final **nf**: no forecast **Note**: Dates subject to change

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