

# MONTHLY ECONOMIC OUTLOOK

March 2009

Thursday, 12 March 2009

- The Reserve Bank of Australia (RBA) left the cash rate unchanged this month at 3.25% after slashing the cash rate by 400bp in total since the easing cycle began. We think the RBA may resume cutting rates as soon as next month with a cut as big as 50bp in size not to be dismissed. The deterioration in the global economy and ongoing credit market issues suggest that the RBA may need to take out further rate insurance. We expect the RBA to take the cash rate to an end point of 2.25% before the year is ended.
- In March, we learned that the economy contracted in the December quarter by 0.5%. It was the first contraction in eight years. We predict that the economy will enter a technical recession when the March quarter GDP figures are published on June 3. Stripping out the farm sector, the Australian economy is already experiencing a recession with contractions recorded in the non-farm economy in both the September and December quarters.
- Globally, risk aversion remains elevated but well off its peak struck in October 2008. But with central banks around the globe in the midst of a rate-cutting cycle and with some central banks resorting to quantitative easing, bond yields are generally being pressured lower. In Australia, the yield curve continues to face steepening pressures with the prospect of an RBA with still more rate-cutting to do.
- The Aussie dollar has stuck to a relatively narrow trading range over February and March of around US\$0.6300-0.6500. We expect that the AUD will stay tied to US\$0.6000-0.6500 in the next few months before grinding higher thereafter. Weak near-term prospects for world growth and heightened risk aversion are factors hampering the AUD but Australia's outperforming economy is giving some underlying support.
- Domestic economic data was mixed over the past month. There are signs that rate cuts and the government grants are helping cushion the downturn in the Australian economy with retail sales higher in December and January and housing finance lifting for four straight months. However, the unemployment rate continues to move higher (now at a near 4-year high of 5.2%). Businesses and consumers also remains downbeat.

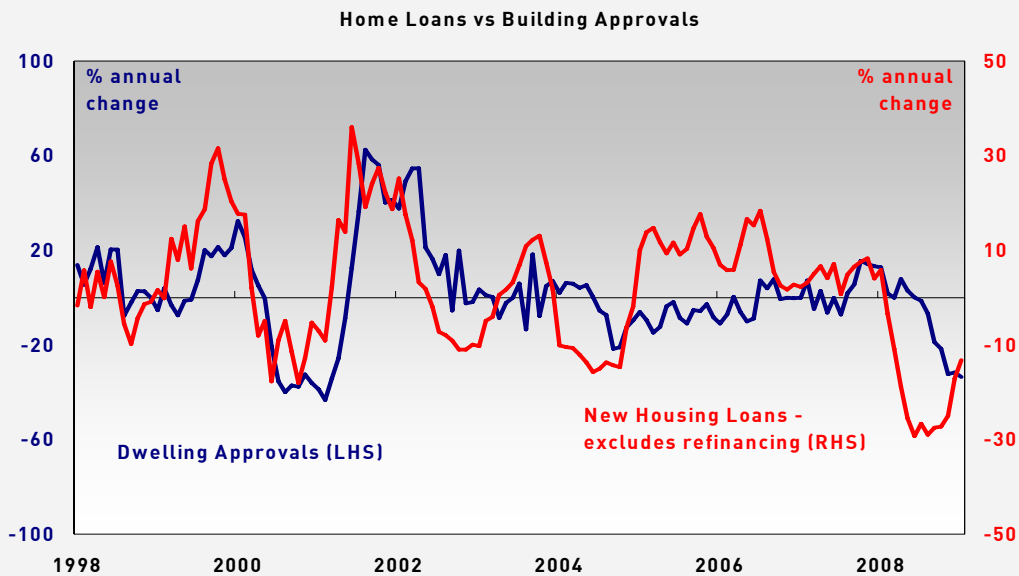
## Table of Contents

<b>Economic Developments</b>	<b>Page 2 – 4</b>	<b>Commodity Markets</b>	<b>Page 9</b>
<b>Australian Economic Data</b>	<b>Page 5 – 6</b>	- Oil	
- Company Profits & Inventories		- Gold & Base Metals	
- Private Capital Expenditure		<b>Share Markets</b>	<b>Page 9</b>
- Wage Cost Index		- Australia	
- Employment		- International	
- Private Sector Credit		<b>Recent Australian Data</b>	<b>Page 10</b>
- Housing Finance		<b>Upcoming Data &amp; Events</b>	<b>Page 10</b>
- Consumer Confidence		<b>Forecasts</b>	<b>Page 11</b>
- Construction Work Done		<b>St George Contacts Listing</b>	<b>Page 12</b>
<b>Interest Rates</b>	<b>Page 7</b>		
- Central Bank Outlook			
- Bond Yields			
<b>Currency Markets</b>	<b>Page 8</b>		
- Australian Dollar			
- Global Currencies			

## RESIDENTIAL PROPERTY OUTLOOK

### Summary:

- Housing finance is experiencing a recovery; housing finance has risen in the last few months from cyclical lows. The recovery is being led by first-home buyer demand. The lift in first-home buyer should filter through to the rest of the housing market later in the year.
- The strong fundamentals of high population growth, a national undersupply of housing stock and low rental vacancies are helping to support the housing sector. These fundamentals together with low mortgage rates mean we are (cautiously) optimistic on the outlook for housing over the medium term. In the shorter term, housing may remain sluggish.
- A key risk factor for the near term outlook of housing is rising unemployment and difficulties in accessing finance (due to the ramifications of the global credit crisis).



### ECONOMIC CONDITIONS

The local economy has slowed considerably as a result of tighter financial conditions since the onset of the sub-prime credit crisis. Domestic demand has eased as the share market records hefty losses and the uncertainty weighs on consumer and business sentiment. The easing in domestic demand has also been felt in the property market.

### HOUSING FINANCE

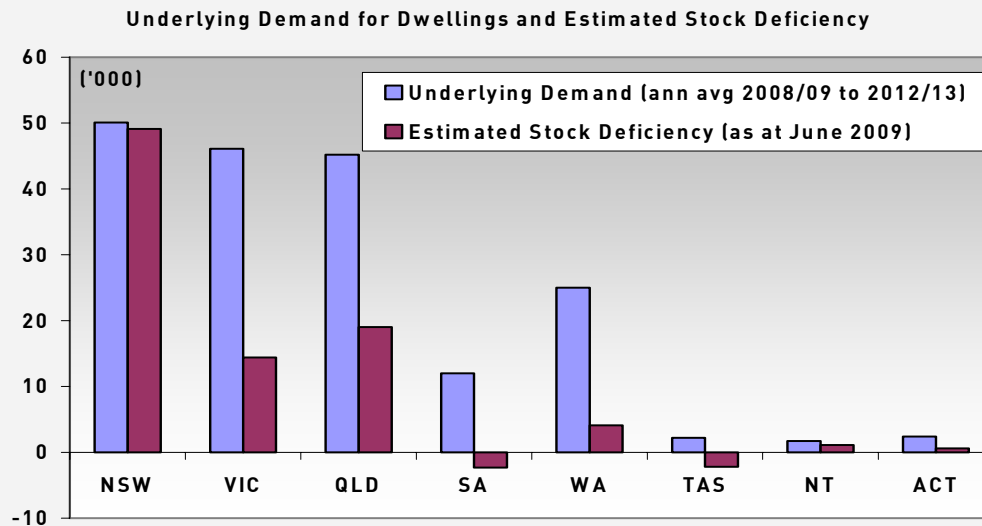
In recent months, demand for housing finance has lifted, after a sharp cutback for much of 2008. But late last year, housing finance started to pick up. The number of housing loans made to owner-occupiers has lifted for four consecutive months to January 2009. The value of all loans has lifted for the last two straight months. It highlights that the efforts by both the government and the RBA to boost housing activity are having an effect. With our expectations that rates could be cut further in coming months by the RBA, demand for housing loans should continue to recover, albeit from a low level. On a year ago, the number of loans to owner-occupier is down 15.8% & the value of all loans is down 31.1%.

First-home buyer demand helped push the demand for housing loans higher. The proportion of first-home buyers among all those seeking housing finance rose to 26.5% in January. It is the highest reading in records going back 17½ years and also a solid improvement compared to the average of 16.9% for the last 5 years.

The demographics are supportive of the housing market. But rising unemployment may keep housing activity sluggish and the recovery a modest one until the medium term.

## POPULATION GROWTH

The softness in dwelling approvals is occurring at the same time as a lift is underway in Australia's population. A high overseas migration intake and a rise in the natural increase has led to a solid rate of growth at 1.7% pa in the June quarter 2008 - the highest rate since 1989.



Source: BIS Shrapnel

## HOUSING STOCK

The combination of high population growth and a low level of building have resulted in a nationwide shortage of dwellings. An undersupply of housing stock is essentially a major issue in the Australian property market – quite the opposite to the situation in the United States where there is an oversupply of houses. The chart above shows the annual underlying demand for dwellings (the annual average over 2008/09-2012/13) and the estimated stock deficiency as at June 2008. The total number of deficiencies in Australia is estimated to be over 80,000 in 2009 and grow to over 100,000 in 2010. The States expected to record the largest deficiencies of housing stock this year are New South Wales, Queensland and Victoria. Some of the major obstacles to new housing are increased development land costs, higher construction costs and high taxes.

## THE RENTAL MARKET

The shortage in dwellings has pulled down the rental vacancy rates across all of the States and was as low as 1.2% in Sydney and 1.1% in Melbourne during the September 2008 quarter. It has contributed to large increases in rents; the median weekly rent in Sydney grew by 17.8% for a 3-bedroom home and by 14.7% for a 2-bedroom apartment over the year to September 2008. There should be a continued upward pressure on rent for dwellings over the next 1-3 years as it is hard for supply to adjust quickly, particularly against the current economic backdrop.

## HOUSING AFFORDABILITY

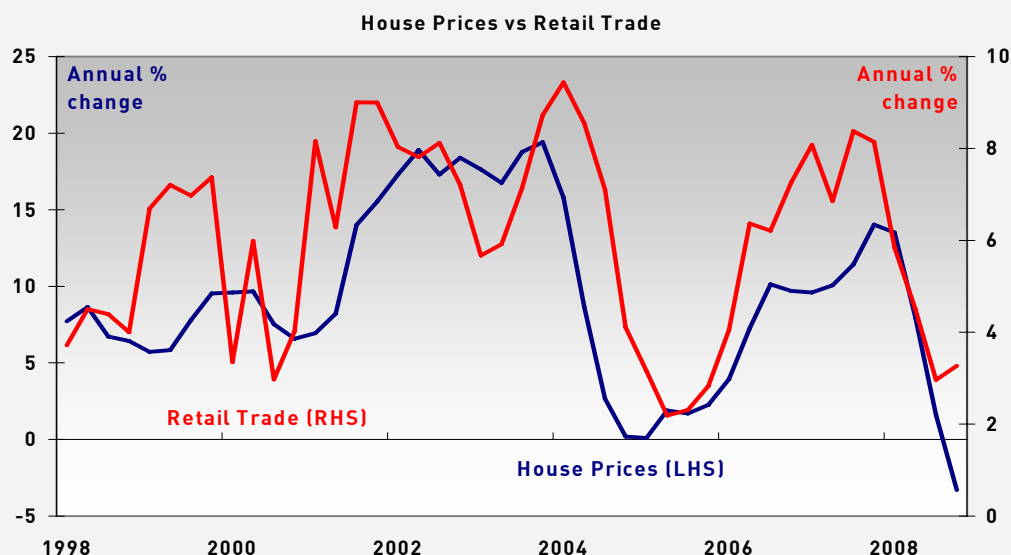
The lack of supply in housing is a factor that is keeping house prices afloat and raising the issue of housing affordability. In order to combat affordability, the Federal Government announced a boost to encourage first-home buyers to enter the property market. One such measure is the additional boost of \$7,000 for existing dwellings and an additional \$14,000 for new dwellings until June 30, 2009. The first homeowner's grant now totals \$14,000 for buyers of existing dwellings and \$21,000 for buyers of new dwellings. These incentives are spurring more buyers at the lower end of the market but there are arguments though that these government handouts create excess demand and therefore support prices. Nonetheless, there is the risk the end of the boost may be accompanied by a slump in prices. We suspect that the Government may look at extending the grant beyond June.

In terms, of rental affordability, the Federal Government has introduced the National Rental Affordability Scheme, which is designed to stimulate the supply of up to 50,000 new affordable rental dwellings.

#### RESIDENTIAL PROPERTY PRICES

National house prices have begun to flatten out with the latest figures from the Australian Bureau of Statistics showing that the weighted average house price for established houses fell by 0.8% in the December quarter. Over the year, the average house price is 3.3% lower. Within the overall total, house prices at the higher end of the price scale have recorded among the largest falls while house prices at the lower end have experienced greater stability.

We expect overall house prices to be sluggish for much of this year as households repair their balance sheets. Further, the economic slowdown and global credit crisis will make households cautious in making discretionary and/or large spending outlays. However, high population growth, high immigration, limited housing stock and large increases in rental returns should see a moderate recovery in the medium to long term. As such, with these strong fundamentals we remain cautiously optimistic on the housing market over the medium term.



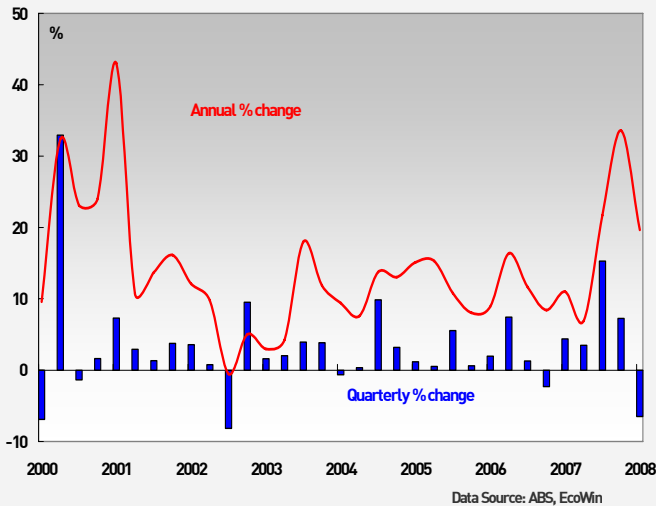
#### INTEREST RATES

The Reserve Bank has acted swiftly to signs of an easing economy and has cut interest rates by 400bp (to 3.25%) since September last year. The RBA left the cash rate unchanged this month at 3.25% after slashing the cash rate by 400bp in total since the easing cycle began. We think the RBA may resume cutting rates as soon as next month with a cut of 50bp in size.

The deterioration in the global economy and ongoing credit market issues suggest that the RBA may need to take out further rate insurance. We expect the RBA to take the cash rate to an end point of 2.25% before the year is ended. Consensus forecasts range from 2% to 3.25%.

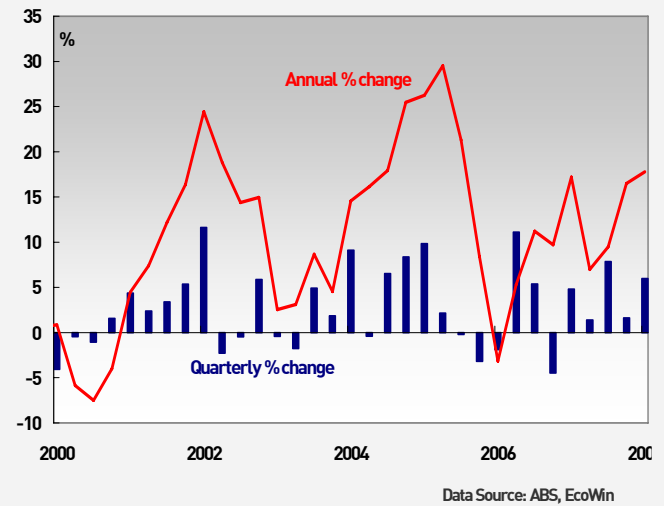
# Australian Economic Data

## Company Profits & Inventories



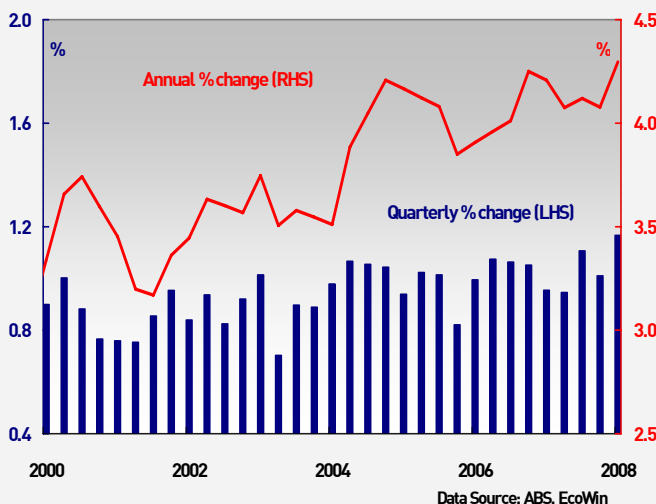
Company gross operating profits dropped by 6.5% in the December quarter. This caused the annual rate to ease to 19.7%, from 33.6% in the previous quarter. All industry sectors except mining experienced a decline in company profits in the quarter. Meanwhile, business inventories fell by 1.9% in the December quarter, which was the largest decline in 22 years. The major contributor to the fall in inventories was manufacturing.

## Private Capital Expenditure



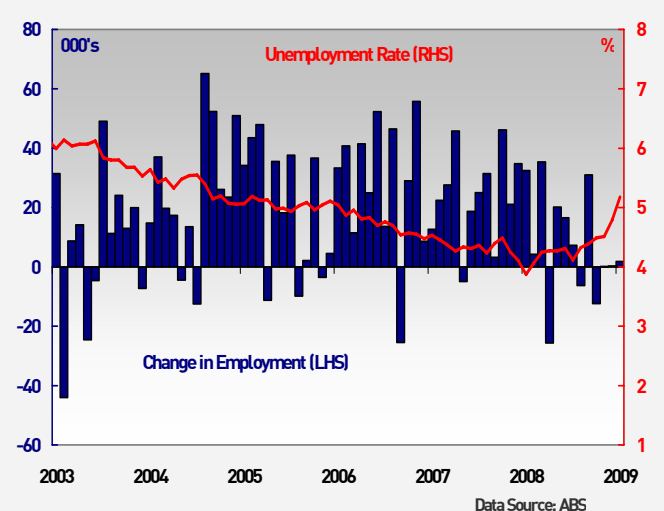
Private new capital expenditure in volume terms rose by 6.0% in Q4, which lifted the annual rate to 17.8%. Investment in 'buildings and structures' rose by 11.5%, while investment in 'equipment, plant and machinery' was up by 1.0% in the quarter. The fifth estimate for 2008-09 investment intentions is 14.3% higher than the same estimate for 2007-08. The first estimate for 2009-10 is also higher than the estimate of a year ago.

## Wage Cost Index



Wages rose by 1.2% in the December quarter, pushing up the annual rate to 4.3%. However, it remains below the RBA's 'perceived' line in the sand of 4.5%pa. Industries that recorded the largest quarterly increases in wages were electricity, gas & water supply (+1.9%), retail trade (+1.7%), government administration & defence (+1.7%), accommodation, cafes & restaurants (+1.5%) and health & community services (+1.6%). Wages grew the most in the quarter in WA (+1.8%), SA (+1.4%) and NT (+1.5%).

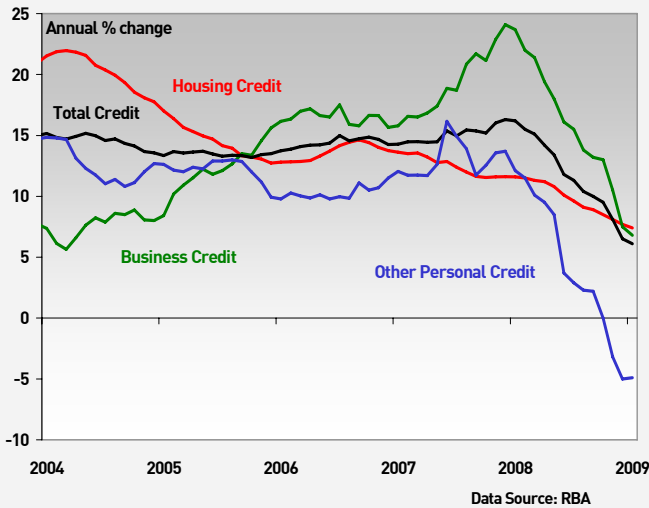
## Employment



The number of people employed rose by 1,800 in February. It is the third consecutive month jobs have been created. Nevertheless, the gains are significantly lower than the average increase of 11,500 per month in 2008. There was a large fall in the number of full-time positions, which fell by 53,800. The unemployment rate edged higher by 0.4pts to 4.2% - this is the highest rate in 4 years.

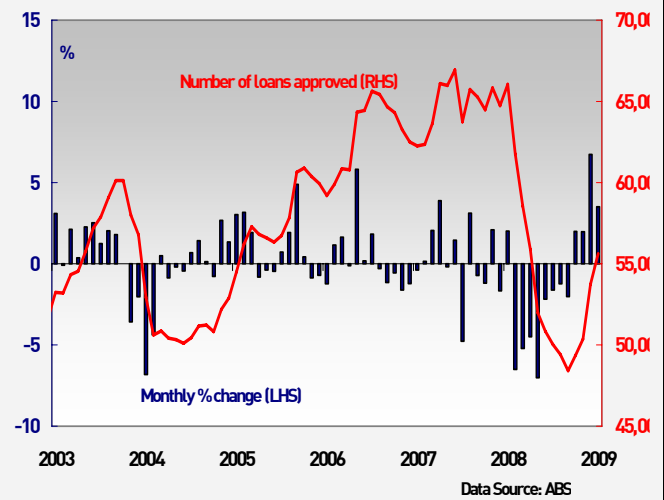
# Australian Economic Data

## Private Sector Credit



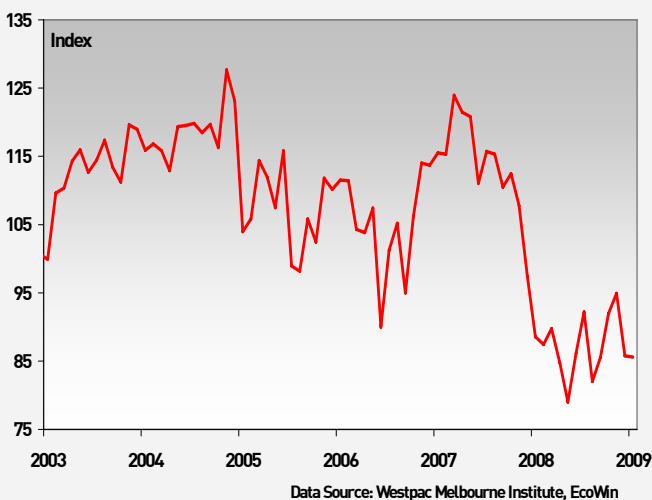
Private sector credit rose by 0.6% in January. However, the annual rate slowed further to 6.1%. Indeed, credit growth has slowed markedly since the peak of 16.4% in December 2007. Housing credit rose by 0.5% in January. This component showed that owner-occupiers fared much better than investment housing. Meanwhile, business credit (+0.7% m/m) rebounded from the previous month, while 'other personal' credit (-0.2% m/m) was dismal.

## Housing Finance



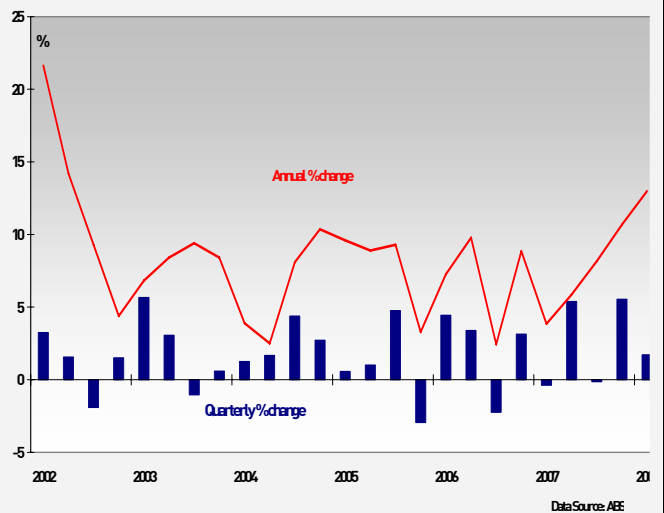
The number of loans to owner-occupiers rose by 3.5% in January. This was the fourth consecutive monthly increase with home loans gaining 14.9% throughout this period. However, housing finance is still lower by 15.8% over the year. Housing finance has improved in recent months due to lower mortgage rates and the increase in the first-home buyers grant.

## Consumer Confidence



The Westpac - Melbourne Institute's index of consumer sentiment fell by 0.2% in March. This brings the index down to 85.6, which is 3.4% lower from a year ago. Confidence slipped as Australia moved closer to recessionary levels and the deterioration in the global economy continued.

## Construction Work Done

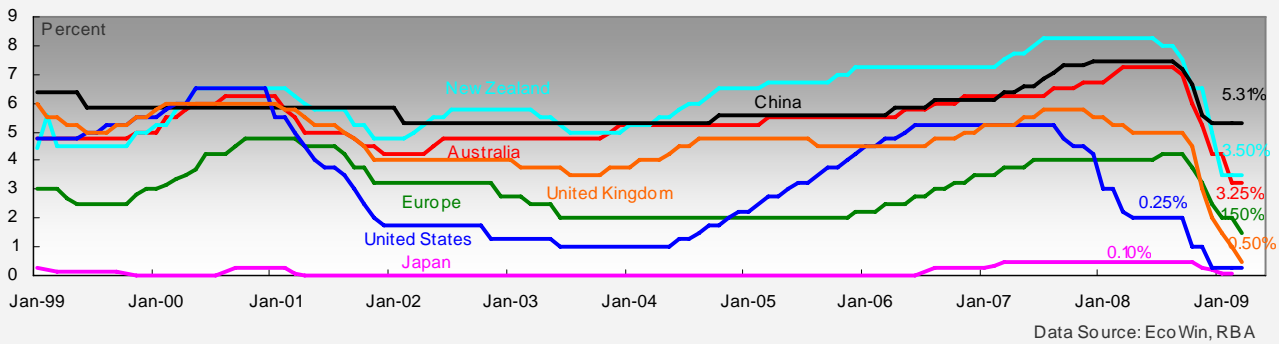


Construction work done jumped by 1.7% in the December quarter. The annual pace of growth moved up to 13.0%, from 10.7% previously. The increase in the quarter and the past year has been driven by engineering construction (+3.6% q/q, +24.3% y/y) and non-residential construction (+1.3% q/q, +5.3% y/y). Meanwhile, residential construction fell by 1.0% in the quarter (+2.9% y/y).

# Interest Rate Markets

## Central Bank Outlook

Central Bank's Official Interest Rates

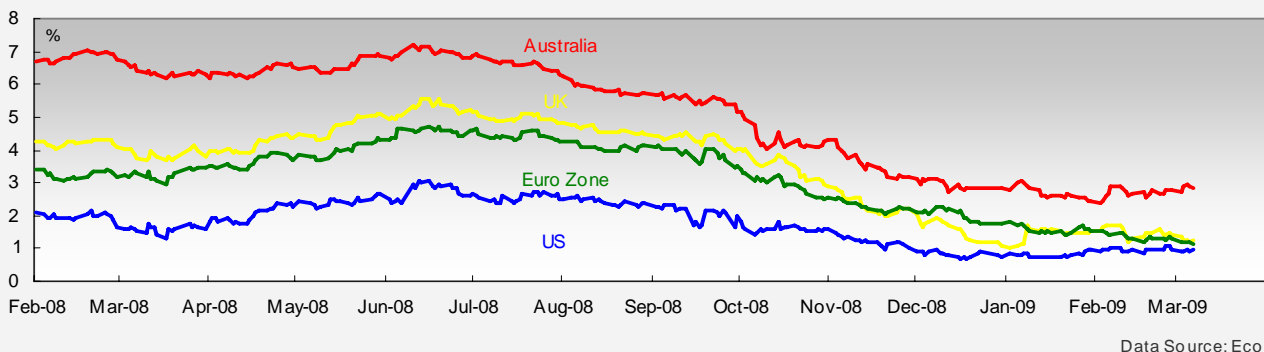


The RBA left its cash rate unchanged at 3.25% this month. It marks the first pause in the current easing cycle since the RBA started lowering rates in September 2008. Since then rates have been cut by a hefty 4%. Much of these interest rate cuts have also been passed on to mortgage rates given Australia's greater focus on variable rate mortgages (compared to say the US where a very large share of loans are based on fixed rates). In this month's decision, the RBA noted that the fiscal stimulus and the interest rate reductions are providing "significant" stimulus to the domestic economy. The RBA also noted that in Australia, conditions have not weakened as much as in other countries. Indeed, while Australia posted its first contraction in GDP in eight years in Q4, the fall was much less than that seen in the major economies. Nonetheless, Australia is moving closer to recessionary territory (with two consecutive quarters or more of contractions defined as a recession), which means that the RBA should be more inclined to cut rates further.

The expected low point in Australian interest rates, however, is well above that of the other major economies. In the US, UK, Euro Zone and Japan interest rates are heading to or are very close to zero. Some of the central banks of these countries have now had to turn to or consider other non-standard measures of monetary policy to help stimulate economic conditions (eg quantitative easing measures). The large gap between the expected low point in Australia and the major economies can be explained by many factors. Interest rates in Australia started being lowered from a much higher level than these countries, allowing the RBA more scope to lower rates and prop up economic conditions. The transmission mechanism has also been comparatively more effective in Australia compared to in the US, the UK and in New Zealand for example. Australia has a more stable banking system, a rising terms of trade and faces an undersupply of housing. This along with the fact that the Australian economy is much better placed than the major economies, means that it is likely not necessary for the RBA to move rates to near zero.

## Bond Yields

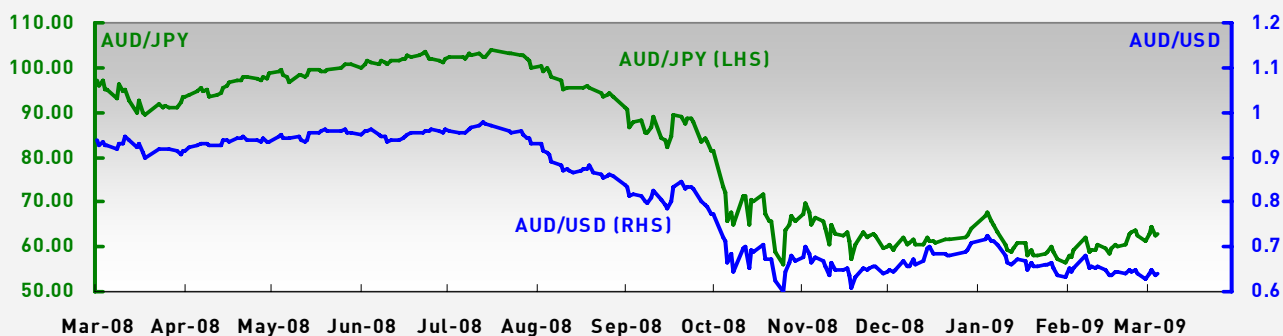
Global 2-Year Bond Yields



Risk aversion, although still at a historically high level, is much lower than the peak reached in October last year. So the demand for safe-haven government debt has eased from that seen at the height of the financial crisis over September and October 2008. Supply fears in the US government debt market have more than offset the demand for safe haven. It is expected that the US government will sell record amounts of debt in response to the deepening recession. Since the end of January 2009, US generic treasury debt yields rose by around 5bp. Elsewhere, UK 2-year yields fell 11bp, while Euro Zone 2-year yields dropped 16bp as the central banks in these countries continued to lower rates (the Fed in contrast has run out of scope to lower rates). In Australia, 2-year yields fell 32bp as markets moved to price in a lower endpoint for the RBA cash rate.

# Currency Markets

## Australian Dollar

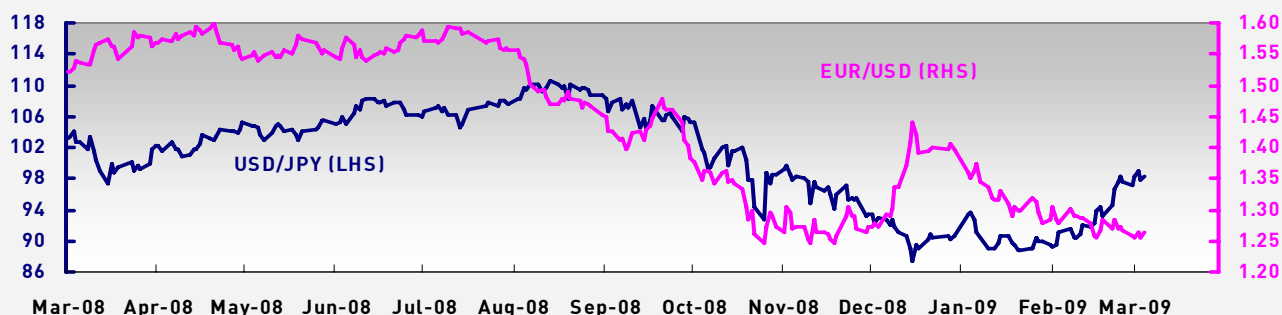


Data Source: EcoWin

The Australian dollar stuck to a trading range over February and so far in March of around USD0.6249-0.6850. This is in line with our expectations. We expect the AUD to end March near US 64 cents. Thereafter, however, we could see a very gradual improvement to around 65 US cents by June and the long-term average of around 71 US cents by year-end. Two key reasons behind why we expect a gradual appreciation in the AUD is USD vulnerability later this year and the fact that the bulk of the RBA's rate cuts have already been carried out. On the latter, although more rate cuts are expected from the RBA they are more likely to be in much smaller increments (of 50bp or 25bp) compared to the 75bp-100bp delivered through October to December last year. As in this month, pauses in between rate cuts are also expected. We are not favourable on the USD in the medium term mainly because interest rates are at very low levels (of 0% - 0.25%) and there is a growing twin deficits problem. The USD may also struggle later in the year on growing concerns that China and Japan will not continue to invest enough capital in the US economy.

Another reason why we expect the AUD to appreciate gradually is the fact that Australia is still much better placed compared to the other major economies. The contraction in domestic GDP in Q4 of 0.5% was much smaller than the falls of around 1.5% seen in the US, the UK and the Euro Zone in that quarter. Meanwhile, Japan fared even worse, with its GDP falling by a hefty 3.2% in that period. Current indicators suggest that that the recessions in these major economies are getting worse. Although our core view is that Australia will not avoid a recession, we believe that Australia will not experience a prolonged period of contraction like that in the major economies. We expect the GDP data for the first half of 2009 to remain weak, but improve gradually thereafter. This would be in line with a recovery (even if modestly) in global growth in the second half of this year. As world economic activity recovers somewhat, risk aversion and currency volatility should recede, lessening downward pressure on the domestic currency.

## Global Currencies

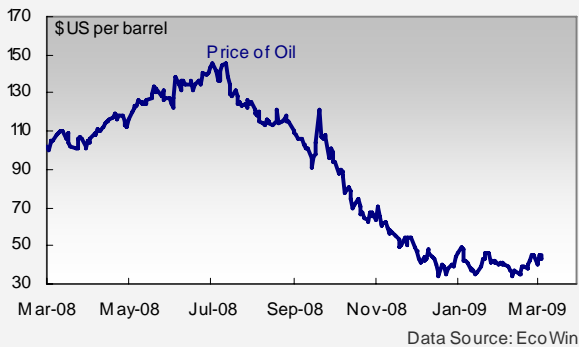


Data Source: EcoWin

With the current crisis yet to have reached its end, the USD continues to gain on repatriation flows. The US central bank has also generally been more pro-active in fighting the credit crisis than some of its counterparts in Europe and elsewhere (notably the ECB). Among the biggest movers for the month were the GBP as the UK economy deteriorated sharply and the Bank of England resorted to quantitative easing. The JPY was also a big mover. Against the currencies of the G6 countries, the USD appreciated 1.9% since the start of February. Against the majors, the USD was 4.5% higher against Sterling and 0.2% higher versus the Euro. The USD managed to gain 7.2% versus the Yen.

# Commodity Markets

## Oil



In the last month, the price of oil has been supported by expectations for another cut in OPEC oil production on March 15 and contained risk aversion. Earlier this month, oil prices also benefited from reasons to be optimistic about the Chinese economy. Data had shown the third consecutive improvement in Chinese manufacturing activity. The current index level measuring this is also only a short distance away from indicating an expansion in activity. The manufacturing data is a good guide to Chinese industrial production, which in turn is a good guide to where the overall Chinese economy is heading. Oil is currently trading near \$US42 per barrel, which is little changed from the end of January. The increase in the price, however, is quite subdued with global growth concerns a major factor hampering gains.

## Gold & Base Metals



Although investor sentiment has improved from the lows seen at the peak of the global financial crisis over September/October 2008, it still remains in a fragile state. Accordingly, the demand for 'safe haven' gold continued over the last month. The price of gold has averaged US\$934.46/oz since the start of February compared to US\$934.46/oz over January (up 8.3%). The current level is up 0.7% from the same time last year but below the peak of above \$US1,000 reached early last year.

As in that seen in the oil market, base metals have also benefited from contained risk aversion. The LME index (a basket of six base-metal prices) rose 6.3% from the end of January. From a year ago, however, this index is down 57.5%.

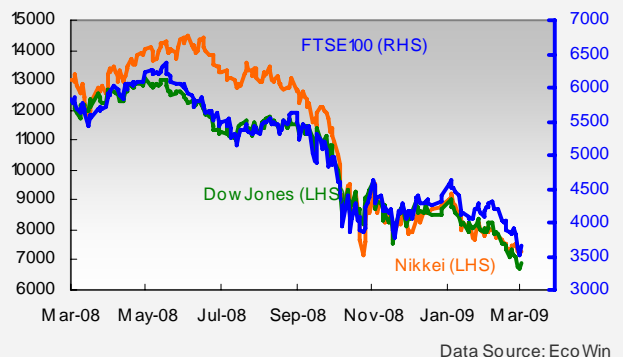
# Share Markets

## Australia



The ASX200 is down 8.6% from the end of January. Financials took their lead from the US and were hard hit. Other sectors that posted large falls were industrials, telecommunications, utilities, and consumer discretionary stocks. The sectors that held up somewhat better were health stocks and consumer staples. But the energy sector was one of the few sectors to record gains.

## International Markets



The VIX Index (a measure of risk aversion), at 43.6 points, remains below the all-time peak of 89.53 points reached in October 2008. But it is still well above the 5-year average of around 17 points. So global equity markets continued to be pressured lower by adverse financial/economic headlines. Since the end of January: Dow Jones -13.4%, FTSE -11%, Nikkei -9.4%.

## Recent Australian Data

**Red** – Indicates the result was **weaker** than consensus expectations

**Blue** – Indicates the result was **stronger** than consensus expectations

**Black** – Indicates the result was **in line** with consensus expectations

<p><b>March 2009</b> WMI Consumer Confidence -0.2% m/m, Previous -4.6% 11/3</p> <p><b>February 2009</b> Employment Change 1.8k, Consensus -20k 12/3 NAB Business Confidence -22 pts, Previous -32 10/3 TDMI Inflation Gauge 0.7% m/m, Previous 0.8% 2/3 WMI Consumer Confidence -4.6% m/m, Previous 2.2% 11/2</p> <p><b>January 2009</b> Housing Finance 3.5% m/m Consensus 4.0% 11/3 Building Approvals -3.7% m/m, Consensus 1.0% 5/3 Trade Balance \$1.0b, Consensus \$1.1bn 5/3 Retail Sales (sa) 0.2% m/m, Consensus -0.5% 3/3 Private Sector Credit 0.6% m/m, Consensus 0.3% 27/2 Employment Change 1.2k, Consensus -10k 12/2 NAB Business Confidence -32 pts, Previous -20 pts 10/2 TD-MI Inflation Gauge 0.8% m/m, Previous -0.2% 2/2 WMI Consumer Confidence -2.2% m/m, Previous 7.5% 21/1</p> <p><b>December 2008</b> Gross Domestic Product -0.5% q/q, Consensus 0.2% 4/3 Current Account -\$6.5b, Consensus -\$7.4b 3/3 Company Operating Profit -6.5% q/q, Consensus -2.0% 2/3 Private Capital Expenditure 6.0% q/q, Consensus -3.0% 26/2 Wage Cost Index 1.2% q/q, Consensus 0.9% 25/2</p>	<p>Housing Finance 6.4% m/m, Consensus 3.5% 11/2 Building Approvals -2.9% m/m, Consensus 2.0% 4/2 Retail Sales (sa) 3.8% m/m, Consensus 1.4% 4/2 Trade Balance \$0.6bn, Consensus \$1.1bn 3/2 House Price Index -0.8% q/q, Consensus -1.0% 2/2 Private Sector Credit -0.3% m/m, Consensus 0.5% 30/1 Consumer Price Index -0.3% q/q, Consensus -0.4% 28/1 Producer Price Index 1.3% q/q, Consensus 0.4% 27/1 NAB Business Confidence -20 pts, Previous -30 pts 27/1 TD-MI Inflation Gauge -0.2% m/m, Previous -0.6% 19/1 Employment Change -1.2k, Consensus -20k 15/1 WMI Consumer Confidence 7.5% m/m, Previous 4.3% 10/12</p> <p><b>November 2008</b> Housing Finance 1.3% m/m, Consensus 1.0% 14/1 Building Approvals -12.8% m/m, Consensus -1.5% 8/1 Trade Balance \$1.4bn, Consensus \$2.1bn 8/1 Retail Sales (trend) 0.1% m/m, Consensus 0.1% 7/1 Private Sector Credit 0.4% m/m, Consensus 0.5% 31/12 Employment Change -15.6k, Consensus -15.0k 11/12 NAB Business Confidence -30 pts, Previous -29 pts 9/12 TD-MI Inflation Gauge -0.6% m/m, Previous -0.2% 1/12 WMI Consumer Confidence 4.3% m/m, Previous -11% 12/11</p>
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## Upcoming Data and Events – Australia & US

### Australian Data / Events Underlined

<p><b>March 12</b> US Retail Sales, Feb US Business Inventories, Jan US Initial Jobless Claims, Mar 7</p> <p><b>March 13</b> US Trade Balance, Jan US UoM Consumer Confidence, Mar</p> <p><b>March 16</b> US Empire Manufacturing, Mar US Long Term TIC Flows, Jan US Industrial Production, Feb NAHB Housing Market Index, Mar</p> <p><b>March 17</b> <u>AU RBA Board Meeting Minutes</u> US PPI, Feb</p>	<p>US Housing Starts, Feb</p> <p><b>March 18</b> <u>AU WMI Leading Index, Jan</u> US Current Account, Q4 US CPI Core, Feb US FOMC Rate Decision</p> <p><b>March 19</b> <u>AU New Motor Vehicle Sales, Feb</u> <u>AU Dwelling Starts, Q4</u> <u>AU Preliminary BoP Imports, Feb</u> US Leading Indicators, Feb US Philadelphia Fed, Mar</p> <p><b>March 23</b> <u>AU Treasurer Wayne Swan Address</u> US Existing Home Sales, Feb</p>	<p><b>March 24</b> US House Price Index, Jan US New Home Sales, Feb</p> <p><b>March 25</b> US Durable Goods, Feb US New Home Sales, Feb</p> <p><b>March 26</b> US Core PCE, Q4</p> <p><b>March 27</b> US PCE Core, Feb</p> <p><b>March 30</b> <u>AU HIA New Home Sales, Feb</u></p> <p><b>March 31</b> <u>AU RBA Credit, Feb</u> US Consumer Confidence, Mar</p>
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## Forecasts

End Period:	2008		2009				2010	
	Q3	Q4	Q1 (f)	Q2 (f)	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)
RBA Cash, %	7.00	4.25	3.25	2.50	2.25	2.25	2.25	3.00
3 Year Bond, %	5.09	3.90	2.90	2.40	2.70	2.90	3.20	3.50
10 Year Bond, %	5.40	3.99	4.10	3.60	3.50	3.70	3.90	4.20
AUD/USD	0.7924	0.7073	0.6400	0.6500	0.6800	0.7100	0.7300	0.7500
USD/JPY	106.11	90.60	95.00	97.00	98.00	100.00	101.00	102.00
EUR/USD	1.4092	1.3978	1.2850	1.2900	1.3100	1.3300	1.3400	1.3500
GBP/USD	1.7805	1.4626	1.4200	1.4300	1.4600	1.4800	1.5200	1.5400
USD/CHF	1.0644	1.0669	1.1700	1.1600	1.1500	1.1700	1.1800	1.1800
USD/CAD	1.1221	1.2165	1.2600	1.2500	1.2400	1.2200	1.2100	1.2000
NZD/USD	0.6698	0.5835	0.4950	0.4900	0.5100	0.5300	0.5500	0.5600
USD/CNY	6.8460	6.8225	6.8400	6.8200	6.8000	6.7800	6.7600	6.7500
USD/SGD	1.4354	1.4303	1.5230	1.5460	1.5360	1.5290	1.5180	1.5030
AUD/EUR	0.5623	0.5055	0.4980	0.5040	0.5190	0.5340	0.5450	0.5560
AUD/JPY	84.08	64.03	60.80	63.10	66.60	71.00	73.70	76.50
AUD/GBP	0.4451	0.4835	0.4510	0.4550	0.4660	0.4800	0.4800	0.4870
AUD/CHF	0.8892	0.7549	0.7490	0.7540	0.7820	0.8310	0.8610	0.8850
AUD/CAD	0.8435	0.8604	0.8060	0.8130	0.8430	0.8660	0.8830	0.9000
AUD/NZD	1.1830	1.2109	1.2930	1.3270	1.3330	1.3400	1.3270	1.3390
AUD/CNY	5.4248	4.8256	4.3780	4.4330	4.6240	4.8140	4.9350	5.0630
AUD/SGD	1.1374	1.0117	0.9750	1.0050	1.0450	1.0860	1.1080	1.1270

Source: historical data from Bloomberg

# St George Contact Listing

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## Economics & Strategy:

Chief Economist	Besa Deda	<a href="mailto:dedab@stgeorge.com.au">dedab@stgeorge.com.au</a>	(02) 9320 5854
Senior Economist	Jo Heffernan	<a href="mailto:heffernanj@stgeorge.com.au">heffernanj@stgeorge.com.au</a>	(02) 9320 5751
Treasury Economist	Amanda Tan	<a href="mailto:tanam@stgeorge.com.au">tanam@stgeorge.com.au</a>	(02) 9320 5816
Economist	Marie Tasevski	<a href="mailto:tasevskim@stgeorge.com.au">tasevskim@stgeorge.com.au</a>	(02) 9320 5679

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