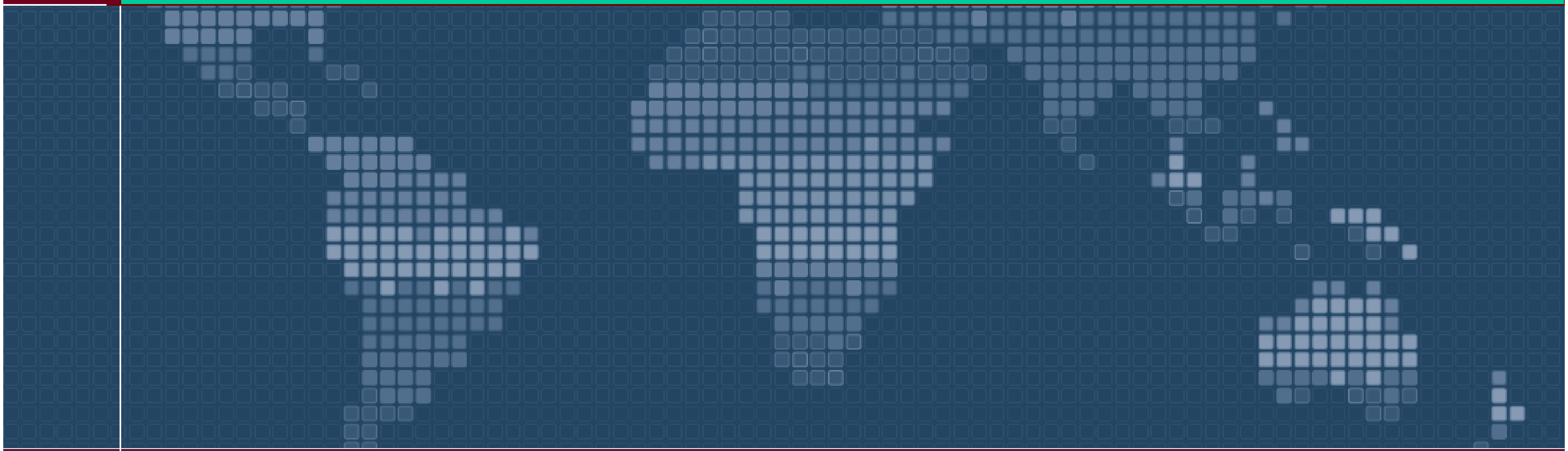
Economic Overview:

Alan Oster - Group Chief Economist

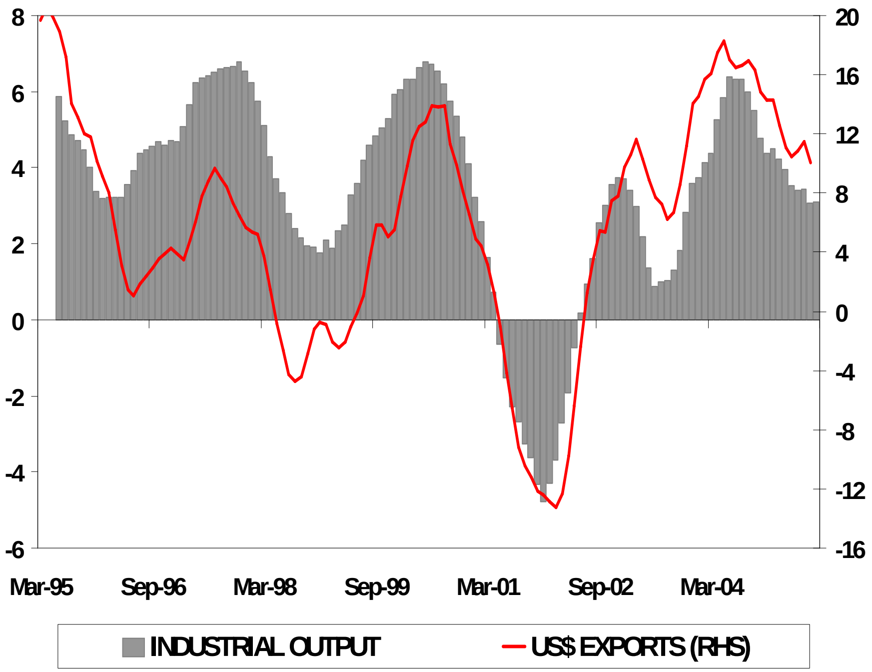


Global Outlook

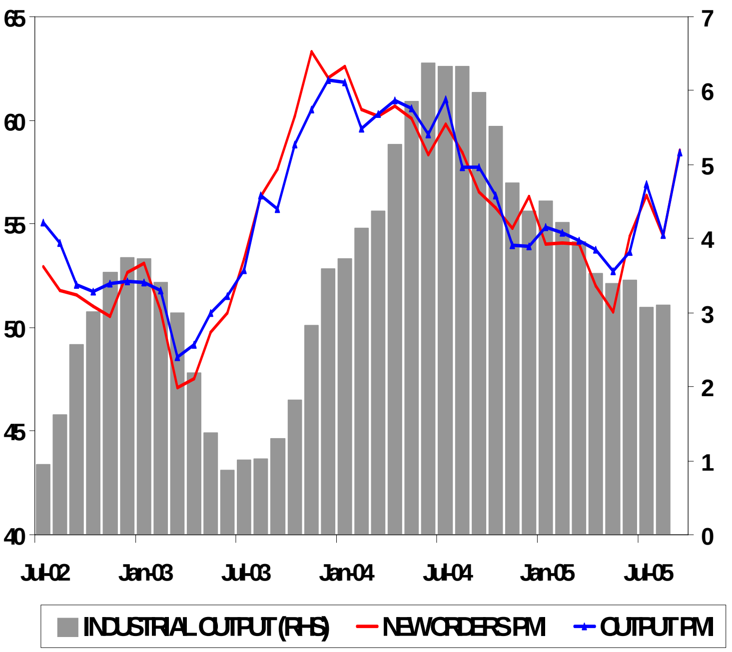
- In a few Words

Global industrial production and exports slowed from peak in mid 2004. But still reasonable. Indeed recently signs up kick- especially new orders

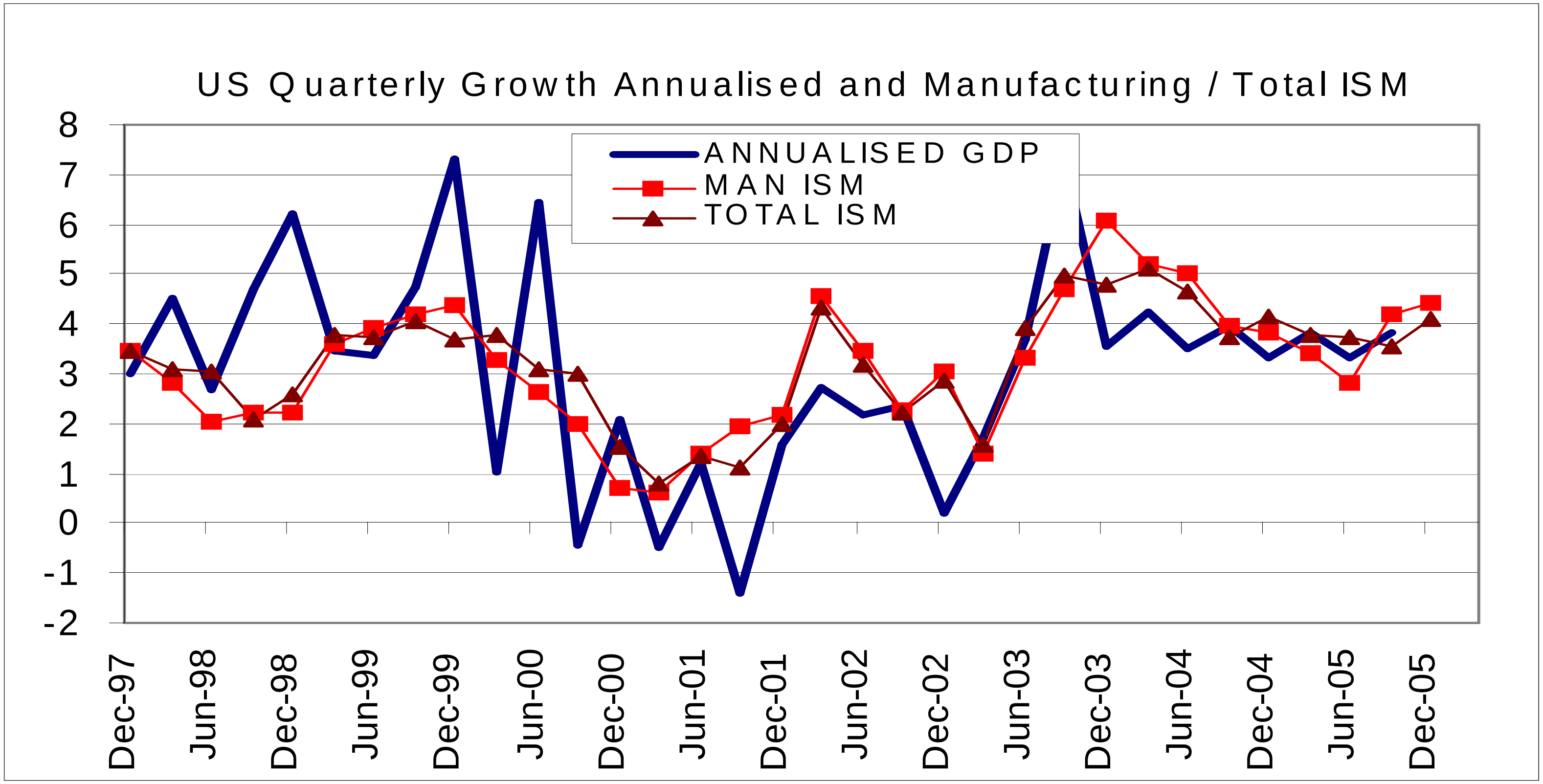
Global industrial output and exports % yoy



Industrial output growth and new orders %



Survey data post Katrina good.   GDP estimated at 3 ¾ % in Sept. Early signs are that October was also reasonable to good. Services a touch weaker.



What drives US Consumer…Not just oil House Prices were largely offsetting oil!!

12 month growth in US Consumption

- **Δ Real Household Incomes = 0.32 (spend 32% of change in income) Wages & employment still the key.**
- Δ Shares = 0.009 (spend 1% of change in share value)
- **Δ House Prices = 0.121 (spend 12% of added value of house)**
- Δ Confidence = 0.02 (spending +/- 2% of change in confidence)
- **Δ Oil = - 0.002 ($10 to oil takes off ½ % from spending)**

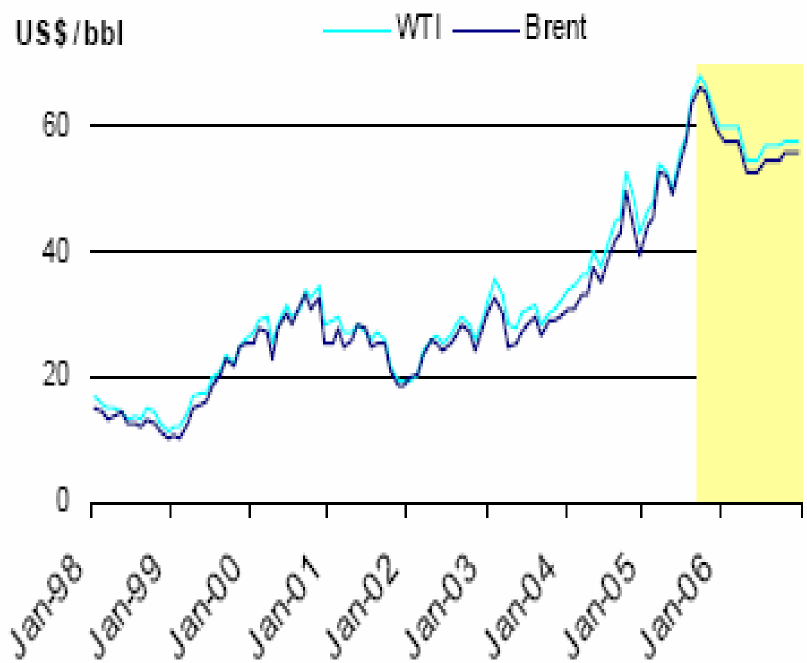
So globally we see a slowing still reasonable growth. Albeit very USA /China / India reliant.

Global GDP Forecasts

December year annual average % change	2000	2001	2002	2003	2004	2005 (f)	2006 (f)
US	3.7	0.8	1.6	2.7	4.2	3½	3½
Japan	2.4	0.2	-0.3	1.4	2.7	2½	2¼
UK	4.0	2.2	2.0	2.5	3.2	1½	2¼
Euro-zone	3.8	1.8	0.9	0.7	1.7	1¼	1½
Canada	5.2	1.8	3.4	2.0	2.8	2¾	3
Australia	3.1	2.2	4.1	3.6	2.7	2½	3
New Zealand	3.3	2.9	4.8	3.4	4.4	2½	2½
China	8.0	7.5	8.1	9.3	9.5	9¼	8½
India	5.5	4.5	4.8	7.3	7.3	7½	6½
World	4.8	2.3	2.7	3.6	4.8	4¼	4
Non-Japan Asia	7.7	4.2	6.1	6.3	7.5	6½	6½
Latin America	4.0	-0.3	-1.0	2.4	5.7	5	3¾

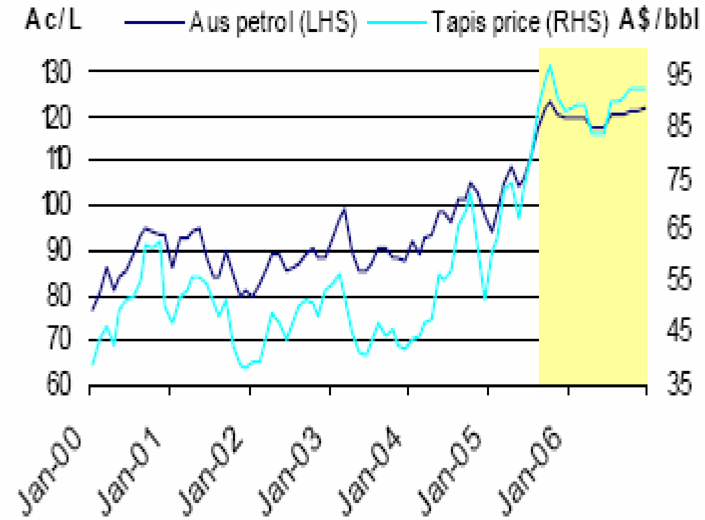
Oil Price to remain high… around USD 57 per barrel
With local petrol price implications... Expect 120c a litre for a while..

Figure 1: Average oil prices to plateau, not peak



Source: Datastream, Group Economics

Figure 7: Further pressure for Australian petrol prices



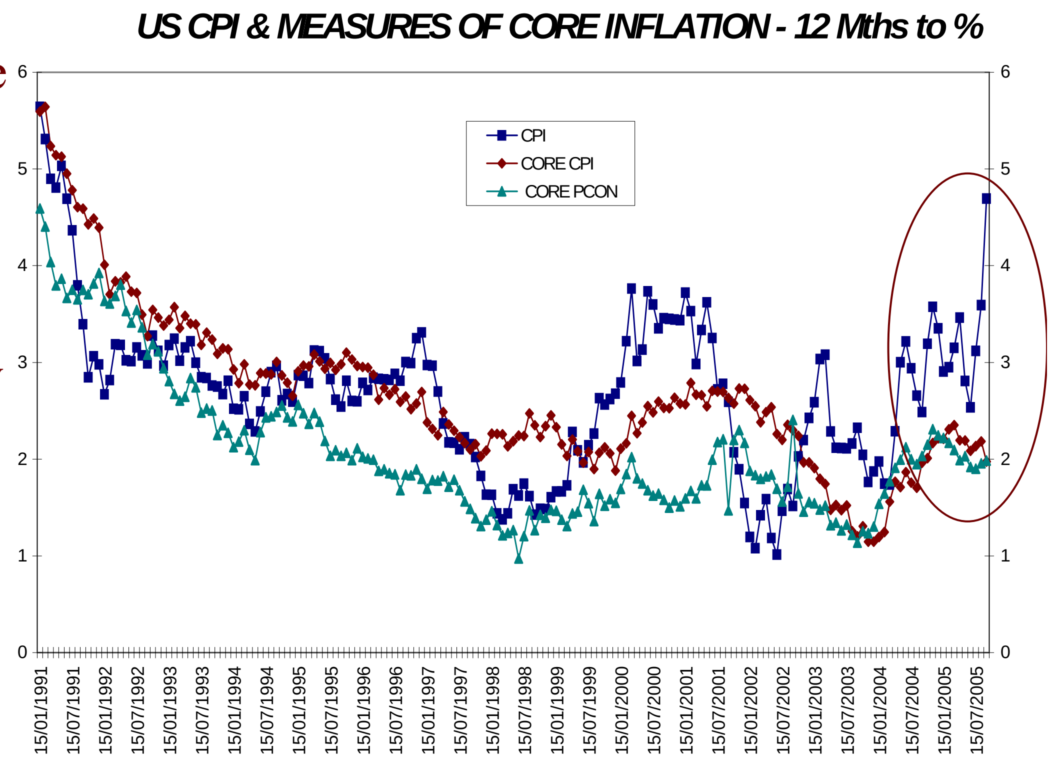
Source: Datastream, FuelTrac, Group Economics

US Rates......

➢ Fed still worried more by inflation than growth. Trying to stop CPI oil spike feeding into core inflation

➢We expect they will continue with further 25 points in the next meeting (ie Fed Funds to 4 ¼ % by Xmas). Question is will they go beyond 4 ¼%. **Yes we think 4 ½ - 4 ¾ % early next year**

➢ Also still expect US bonds to rise and $US to stay firm



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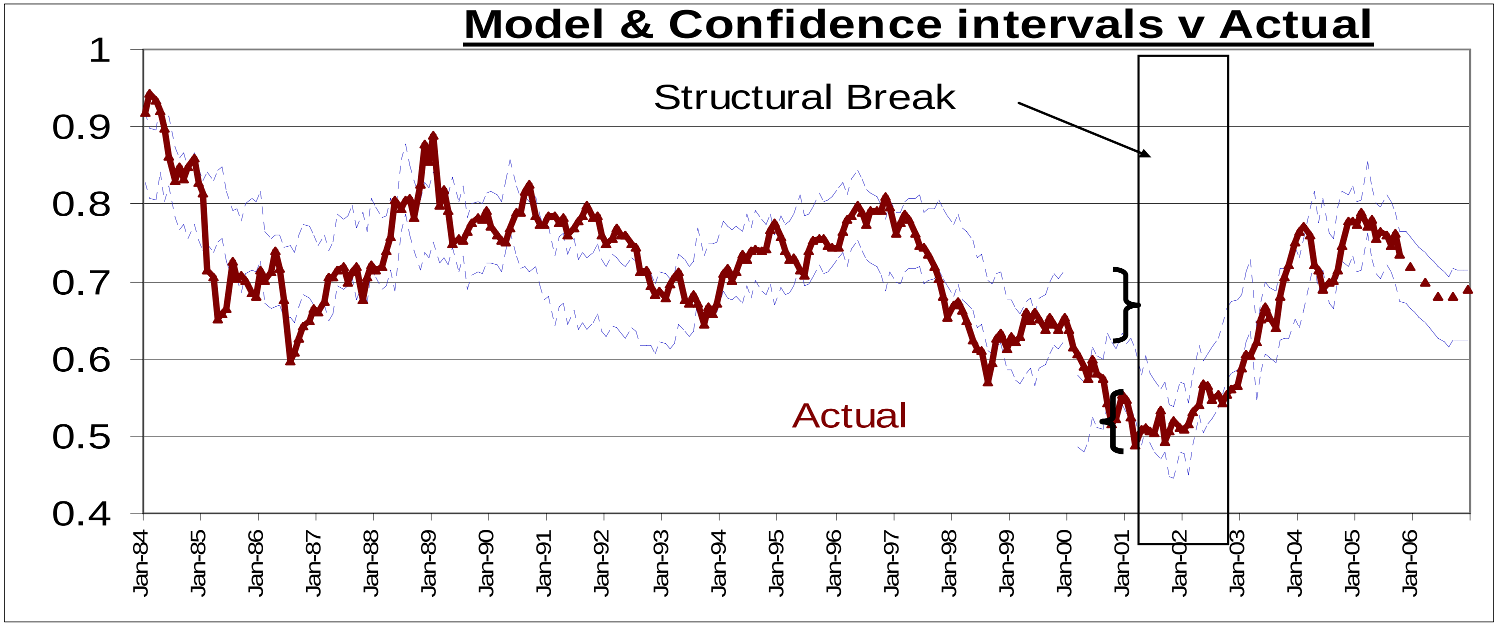
Exchange Rate Models used to do well.
But unable to cope in 2000-2002 (very much a $US story).
Now working reasonably well – or at least as per pre 2000.



Models Driven by - commodity prices (global growth)

- growth differentials (UN and I differentials)
- sustainability (policy/CAD & capital flows)

Role Of Construction in Economy

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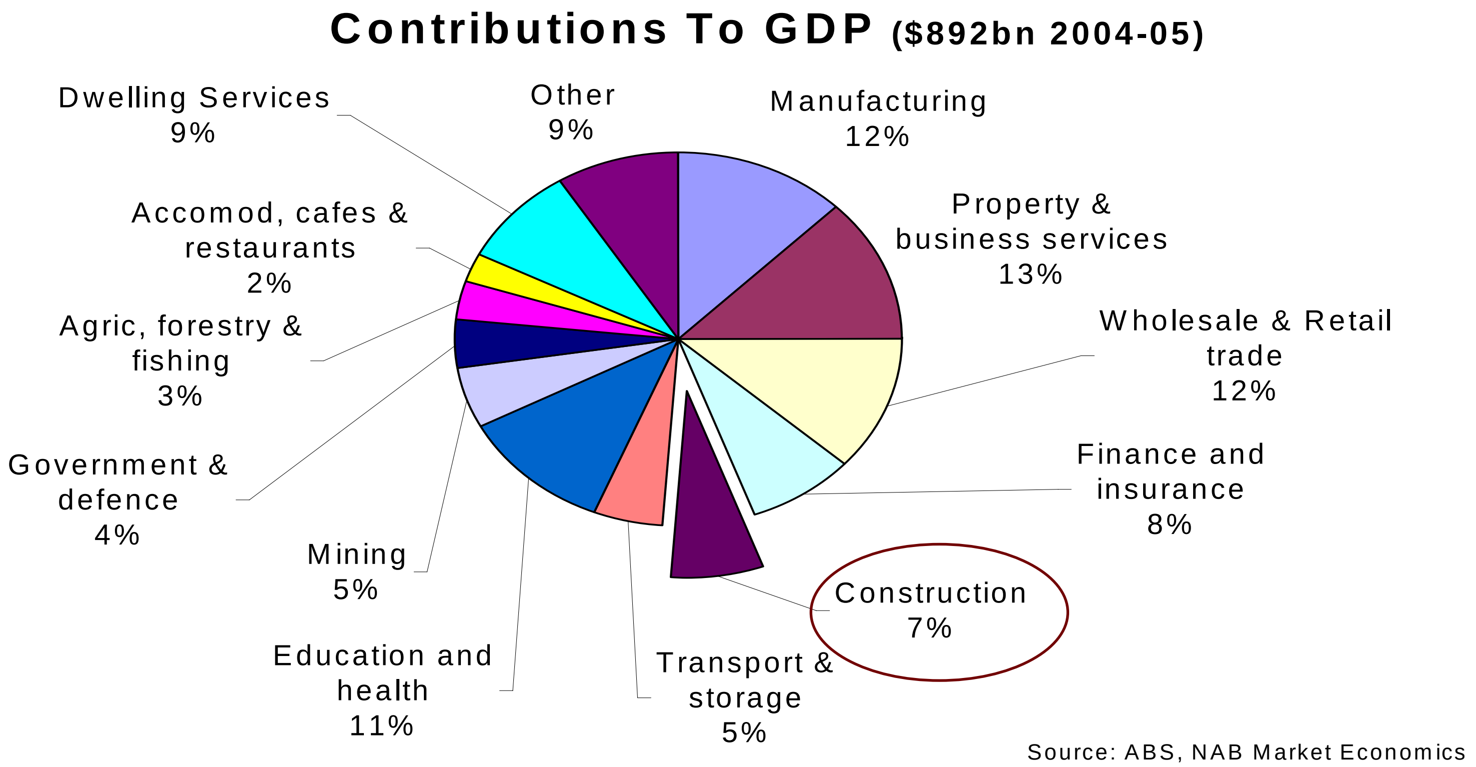
Construction around 7% of GDP



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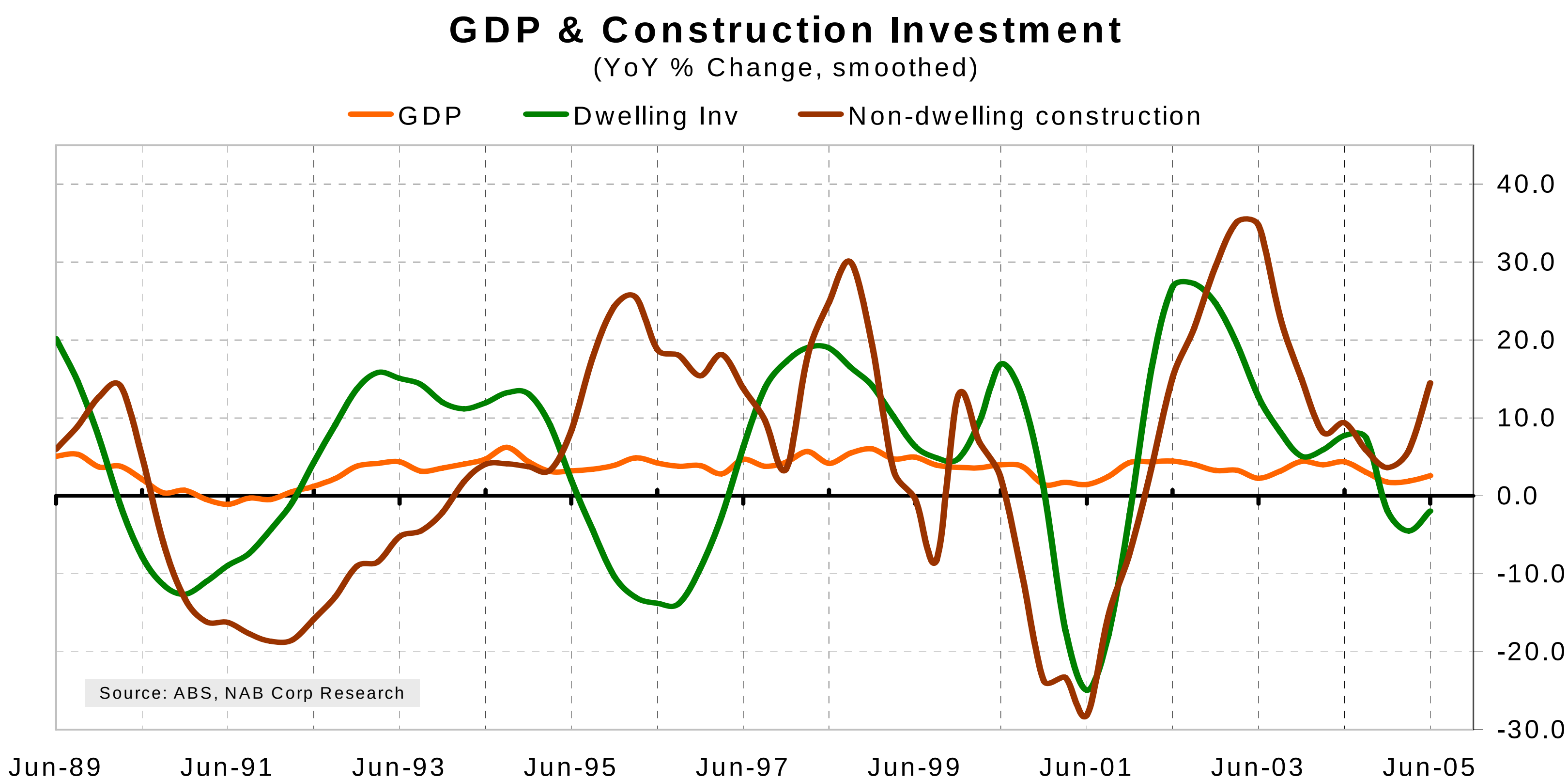
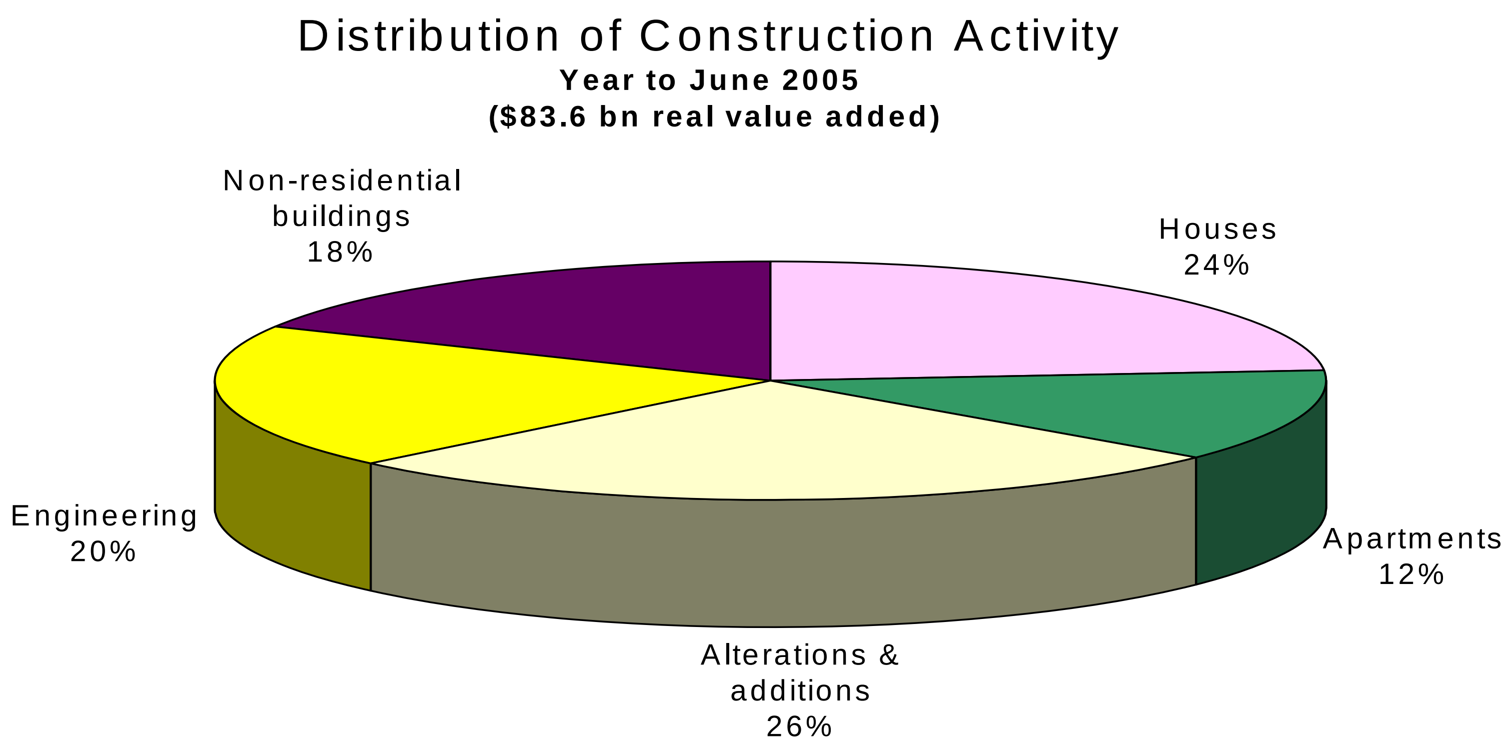
But typically a lot more volatile than other segments of the economy



And Construction not just dwellings……

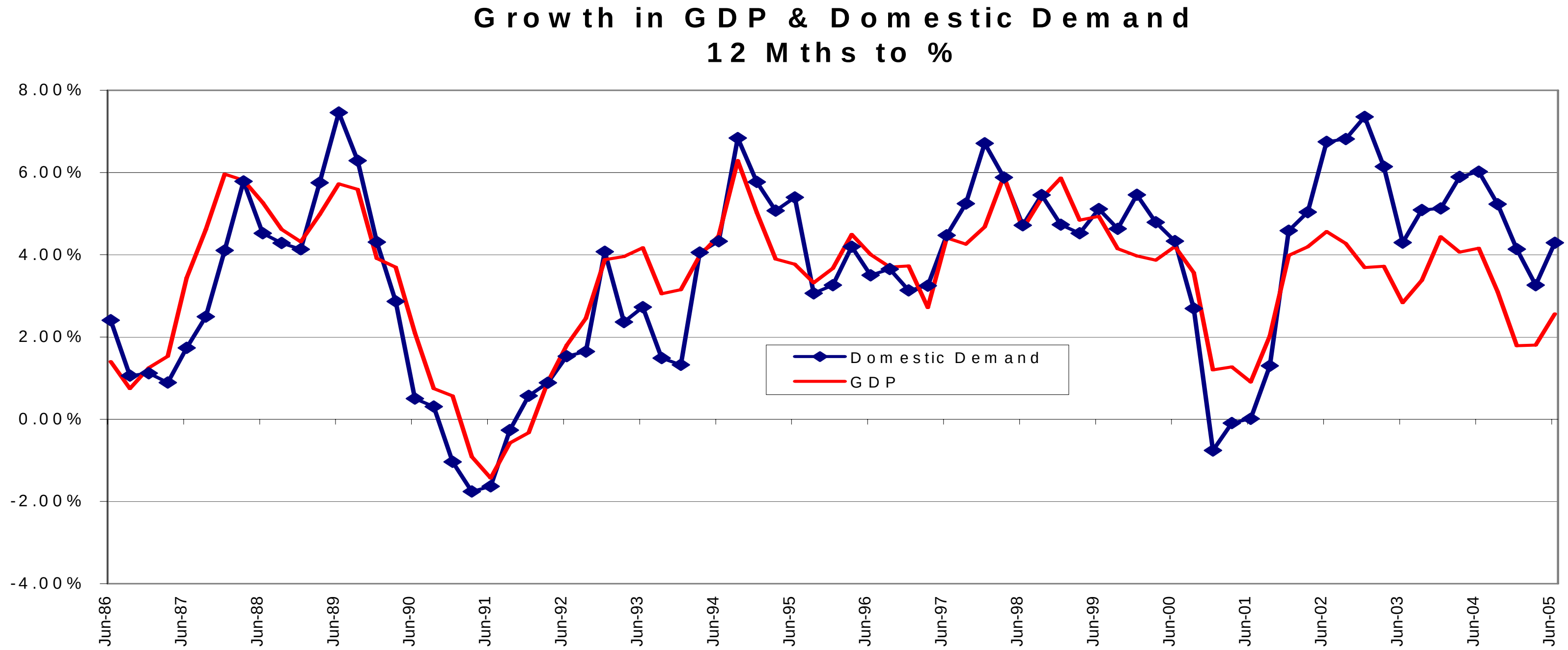


Source: ABS National Accounts, NAB Market Economics

Australian Outlook

Economy & Construction

Where are we on the local economy. Accounts show a sharp slowing last year and stabilising / up kick now.



Took a long time before RBA believed it (labour market, business surveys, skill shortages)…

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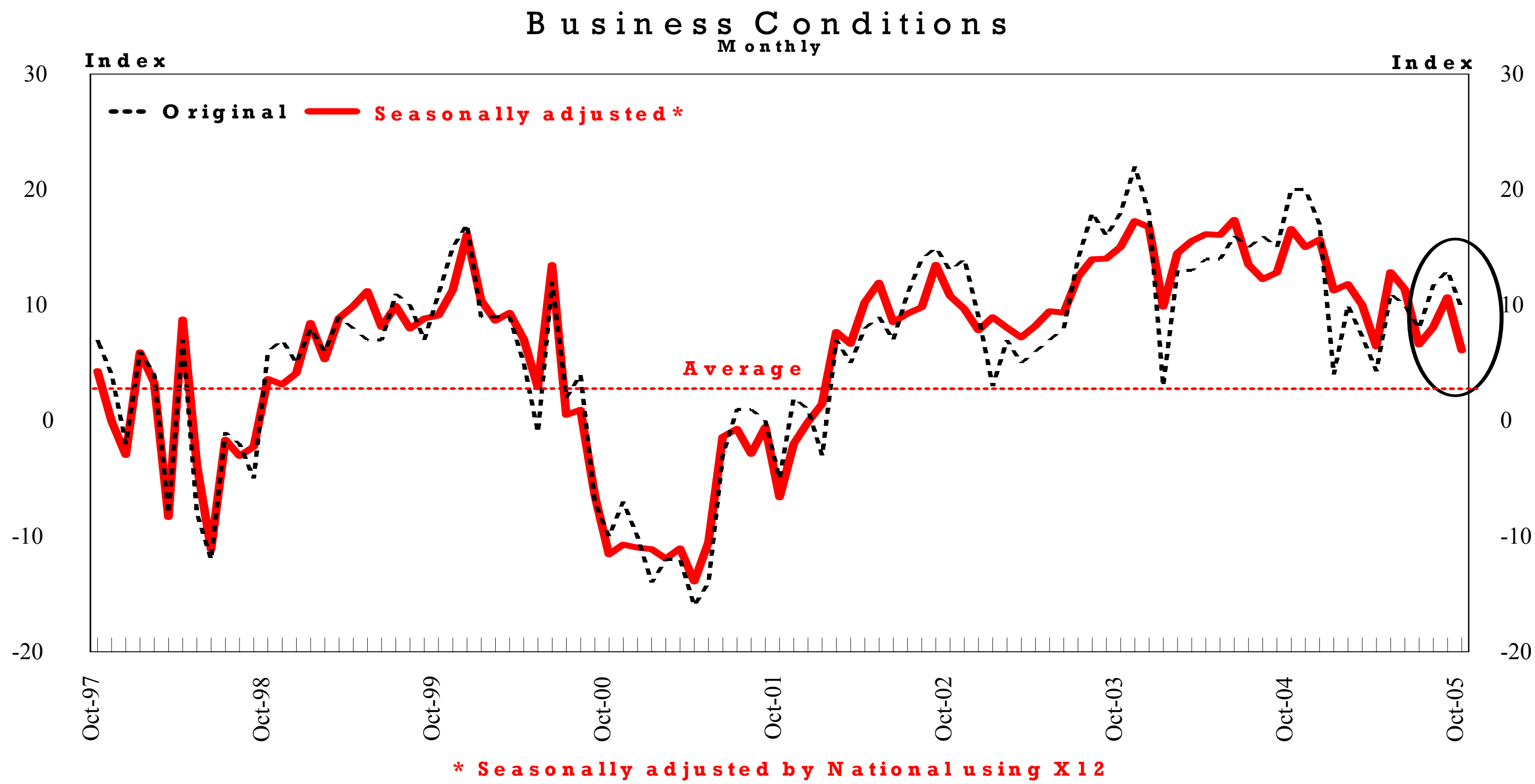
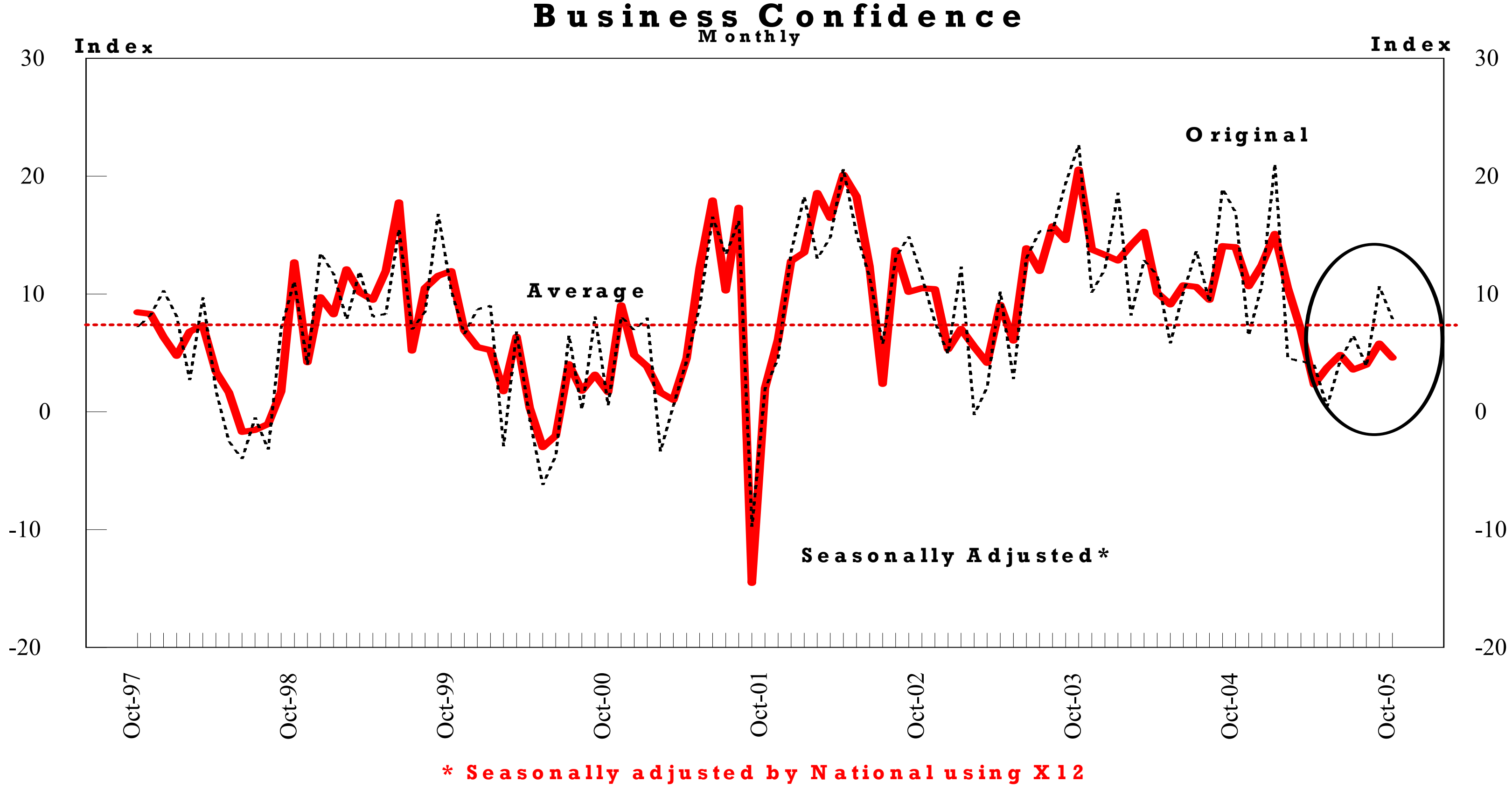
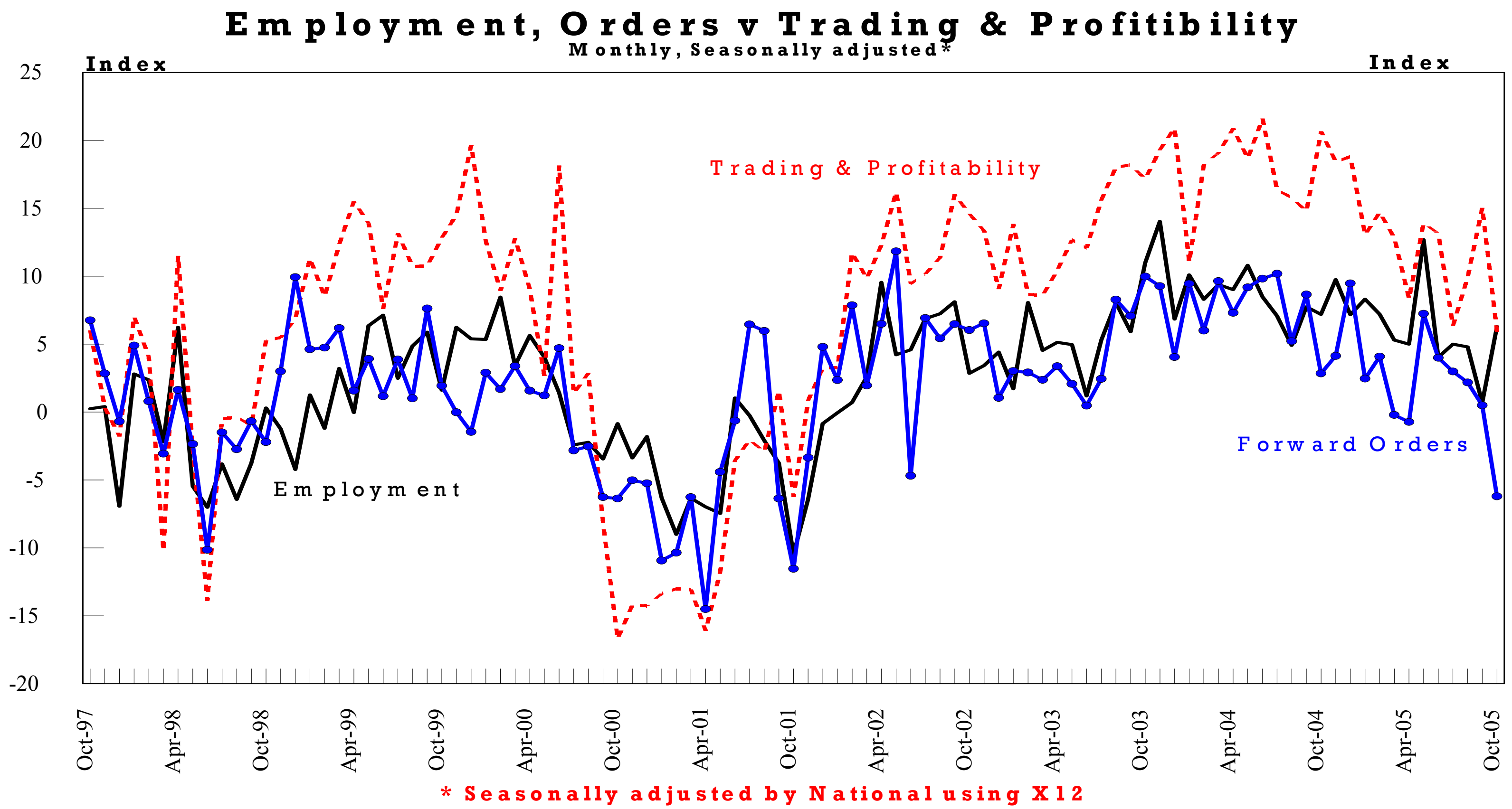
Actual business conditions volatile – in recent months. October renewing down trend.   But economy not crashing!!



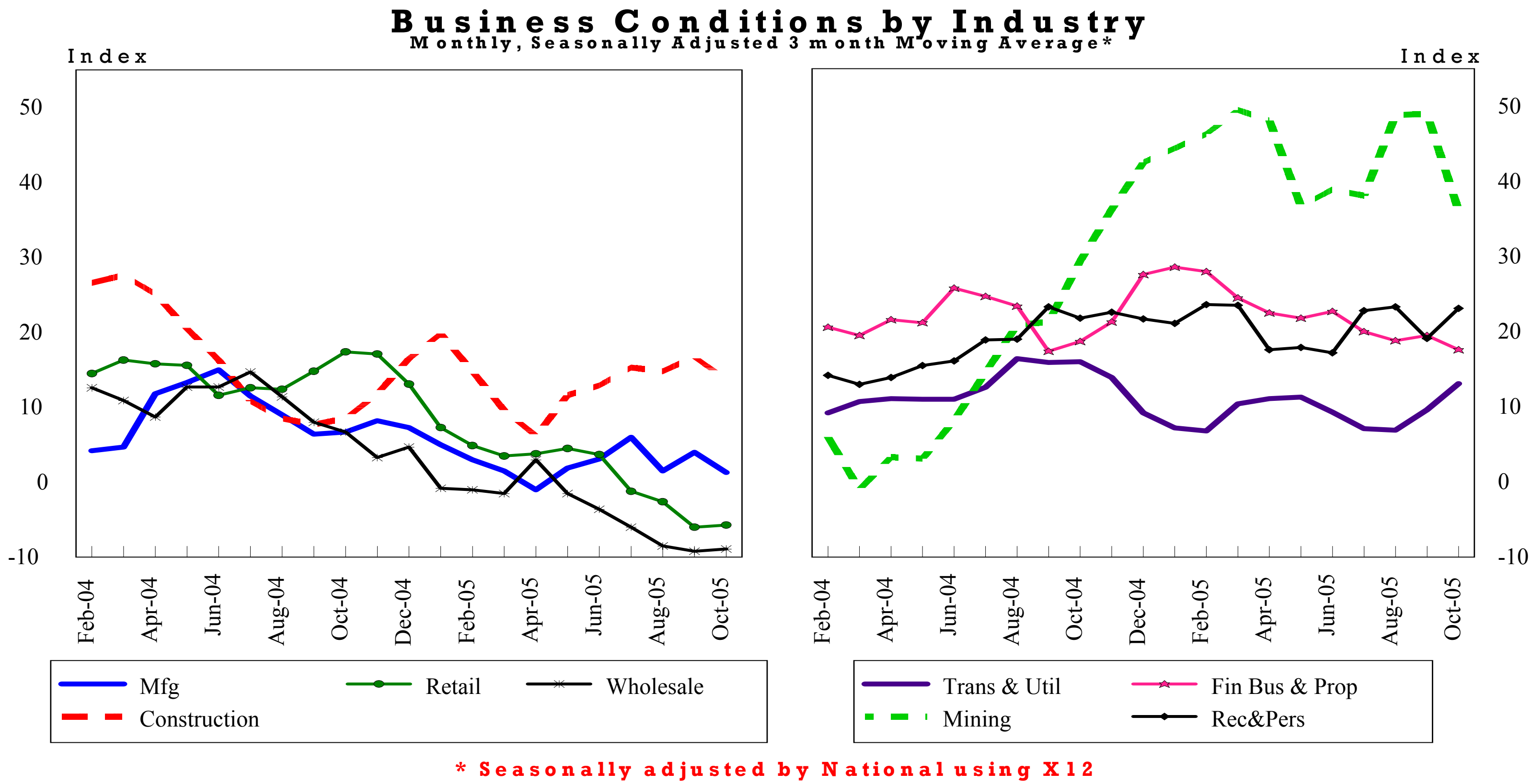
Certainly Confidence still weakish….
Doubts on sustainability of current levels……



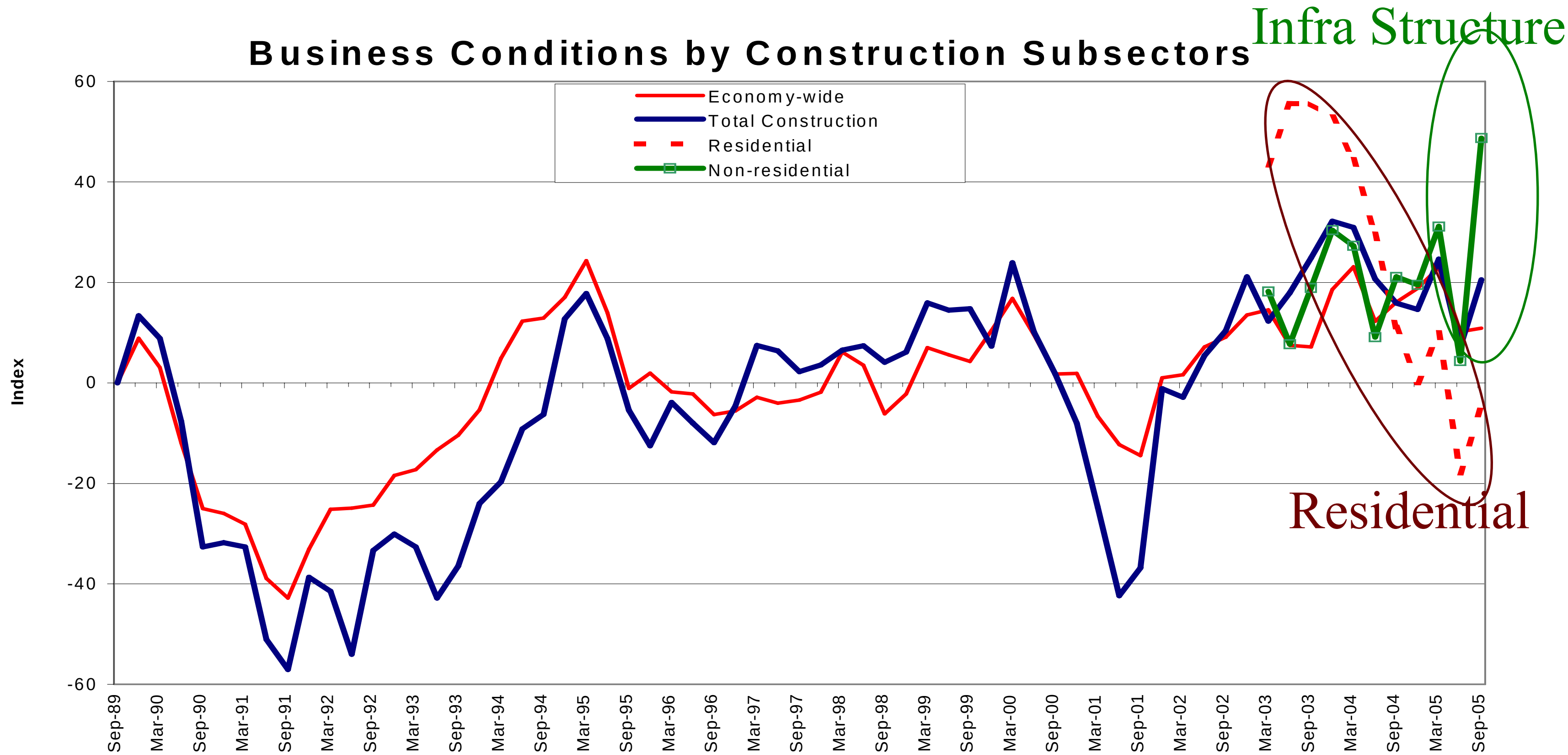
Can see lower forward orders and confidence affecting employment and trading/ profits. Again volatile but trend clear….



Differences across sectors marked. Mining and non residential construction up. Services sideways. Transport a surprise. Cyclicals and oil sensitive going down.



Within Construction have very different things happening re residential and the rest…



What drives consumption…

In the long run:

- Income Elasticity 0.87
- House prices Elasticity 0.11
- Equity markets Elasticity 0.01

Implies : Households don't have negative savings. But are inclined to more cash poor when house prices rising. Note very large elasticity on house prices – i.e. 10% change in growth rate of HP reduced consumption by 1% (we have seen 20% over past few years). Helps explain dynamics across states.

In the short run

Same drivers as long run + change in petrol prices + how far from long run equilibrium

Petrol prices = 10c a litre lowers consumption by 0.2 (we have had 25c or so)

Another approach is to look at borrowing ability

- Basically what I've done is to work out a formulae for maximum lending ability using average data in ***each state***.
- HBA = AWE (annual) X Income test (assume 25% of AWE)

  X 1/(interest rate on standard home loan)

  X Loan to Valuation ratio (assume 80%).
- Then can compare this to change in house prices in each state
- Hypothesis is that added borrowing ability used to bid up the house price through time
- So what does it look like…….

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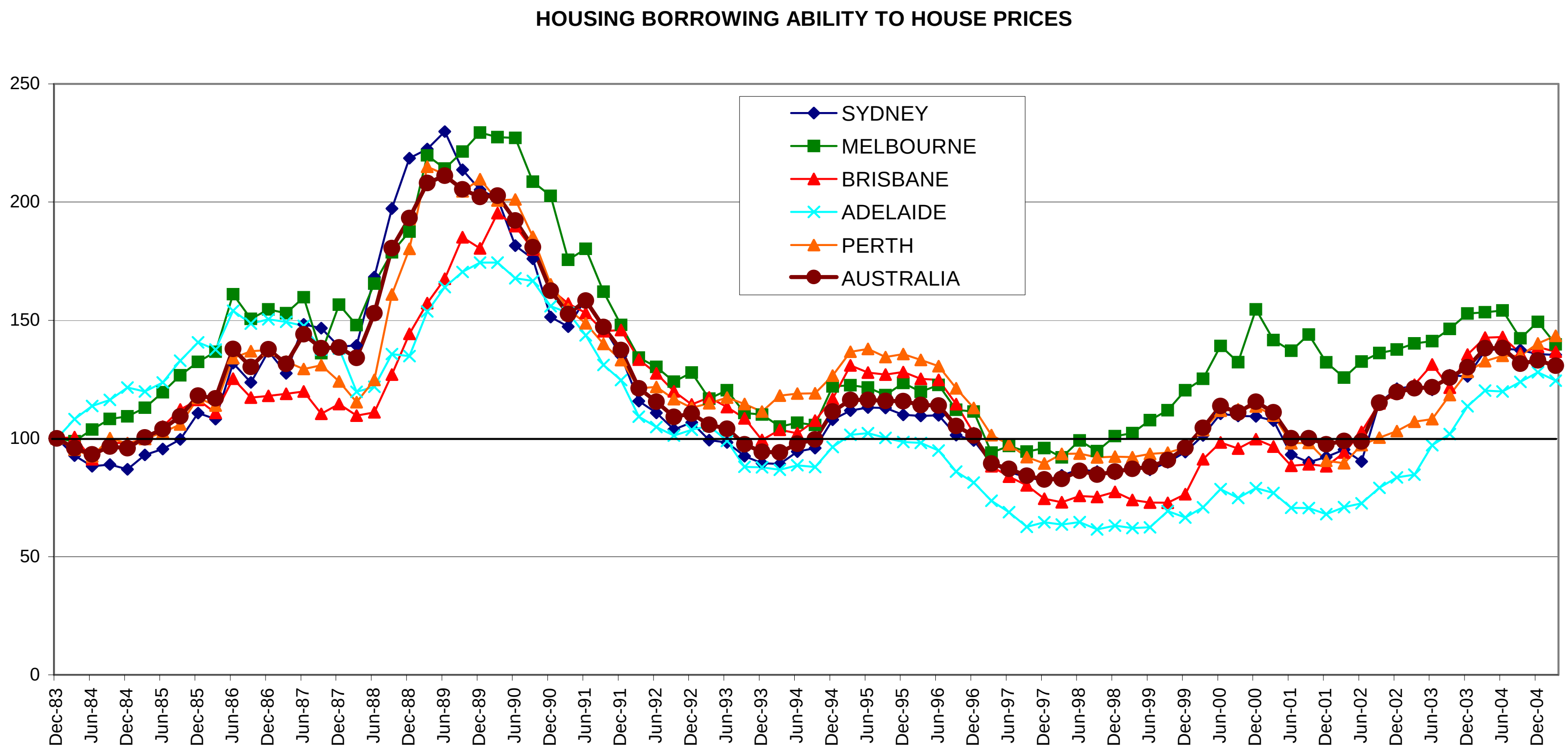
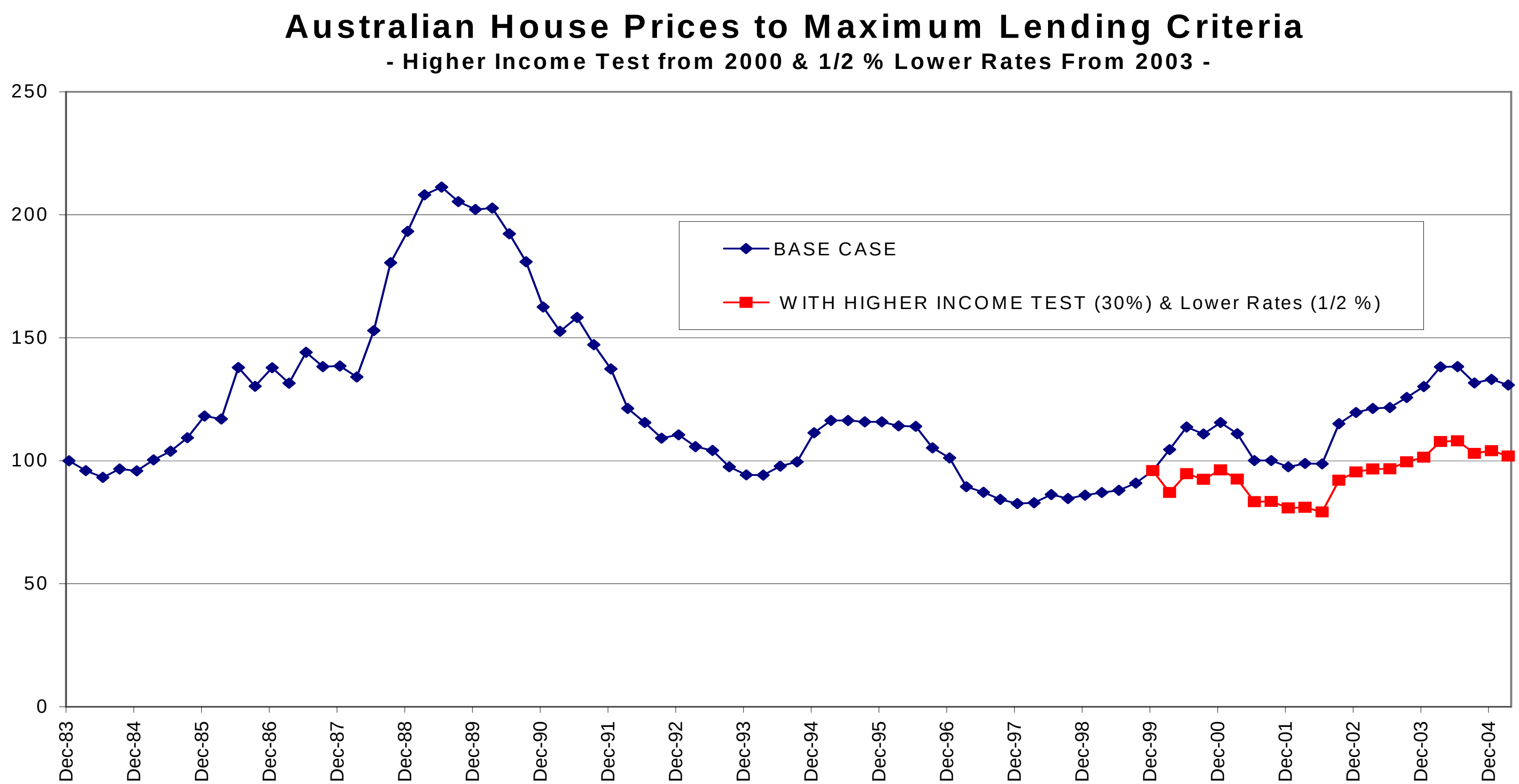
Basically says house prices not that out of line with what you expect…. Not like late 1980s



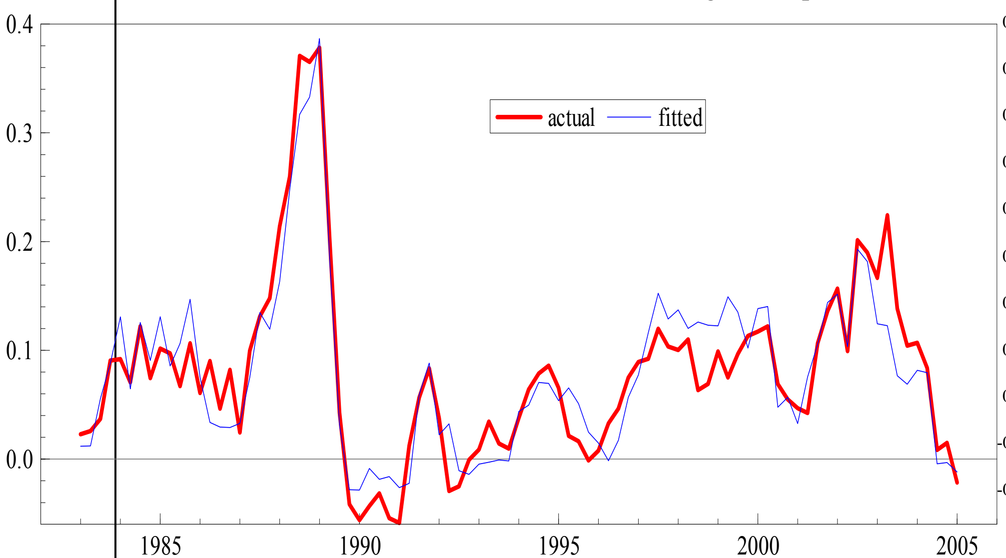
And while don't have system data do have some NAB data re average home loan and income test data….



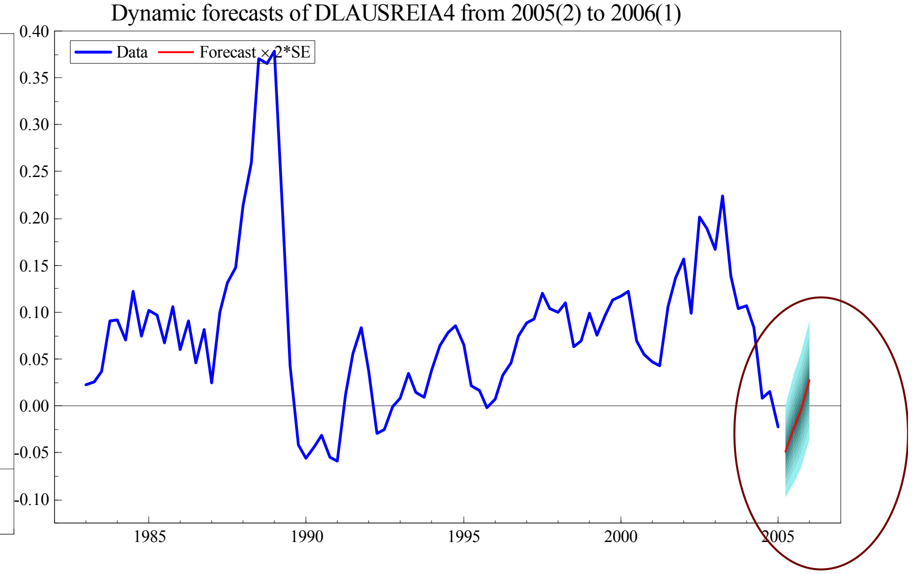
Housing Price Model.
Longer run driven by population, incomes and real rates.
Overall expect house prices to go sideways for a while yet..

Short run driven by : incomes, construction cycle, unemployment and to a lesser extent share prices. And how far from equilibrium

Australia: Acutal Vs Model Annual House Price Changes.R Sq.=.85

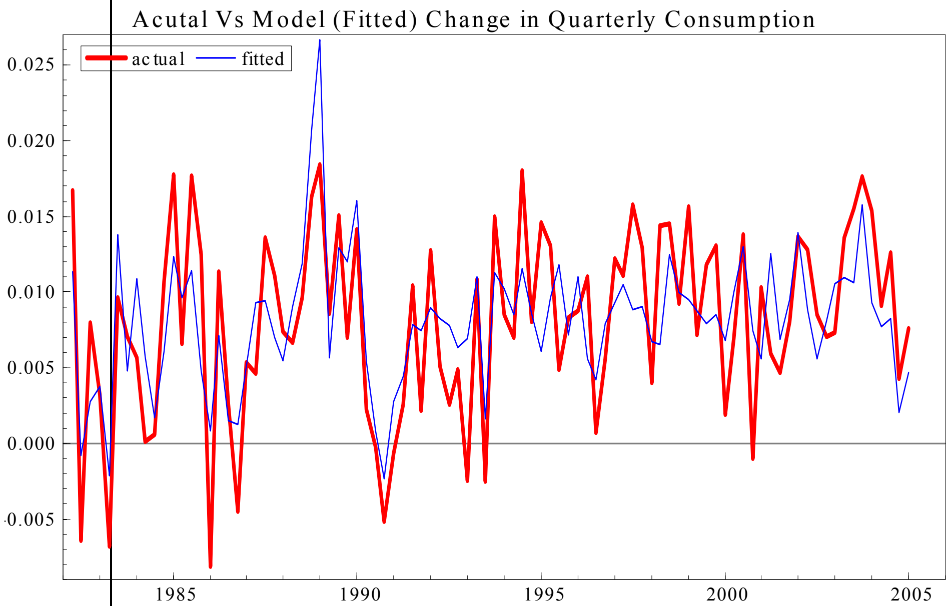


Dynamic forecasts of DLAUSREIA4 from 2005(2) to 2006(1)

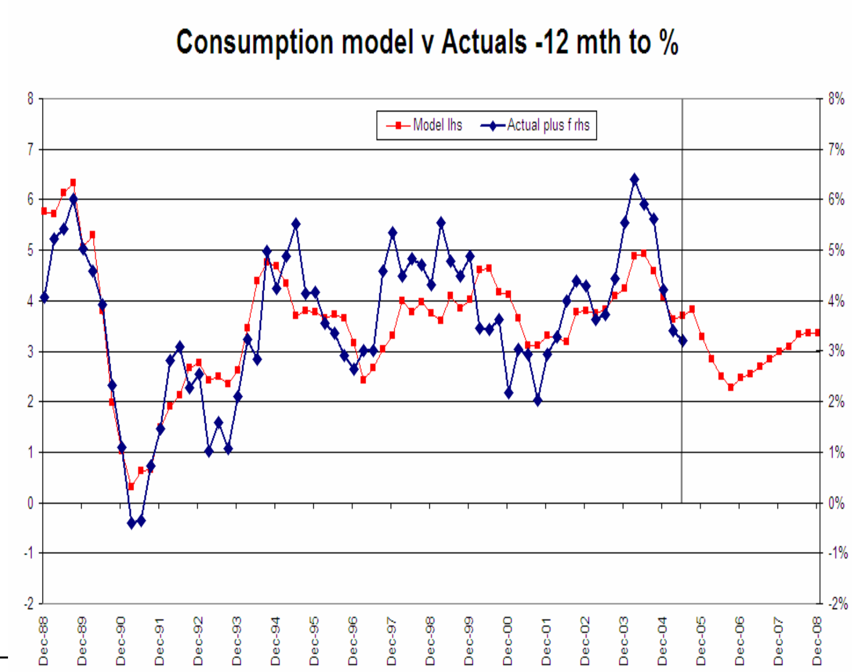


What drives consumption…

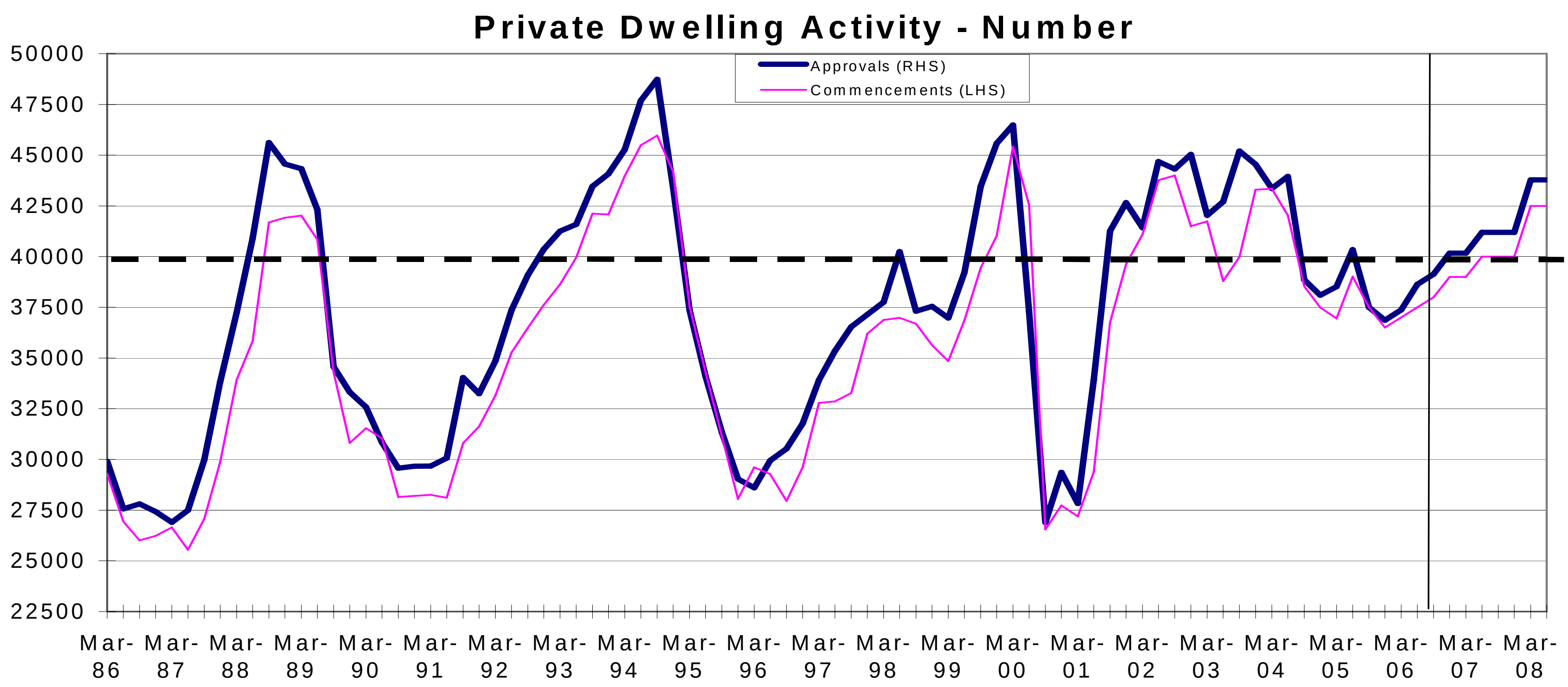
Model does reasonably well on Qtrly basis



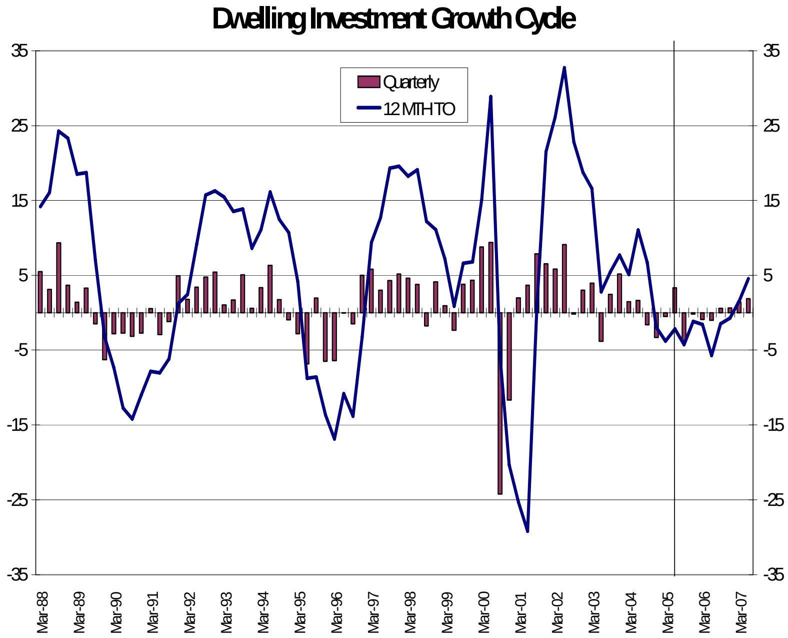
And implications are for further slowing in annual consumption

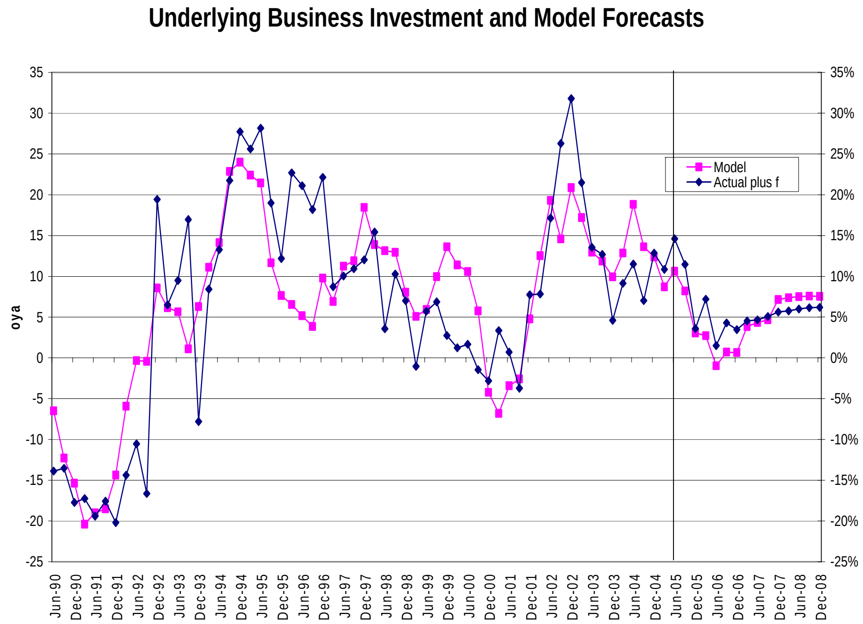


Residential Activity Cycle
Limited excess supply….led by owner–occupier…..
waiting for return of patient investor

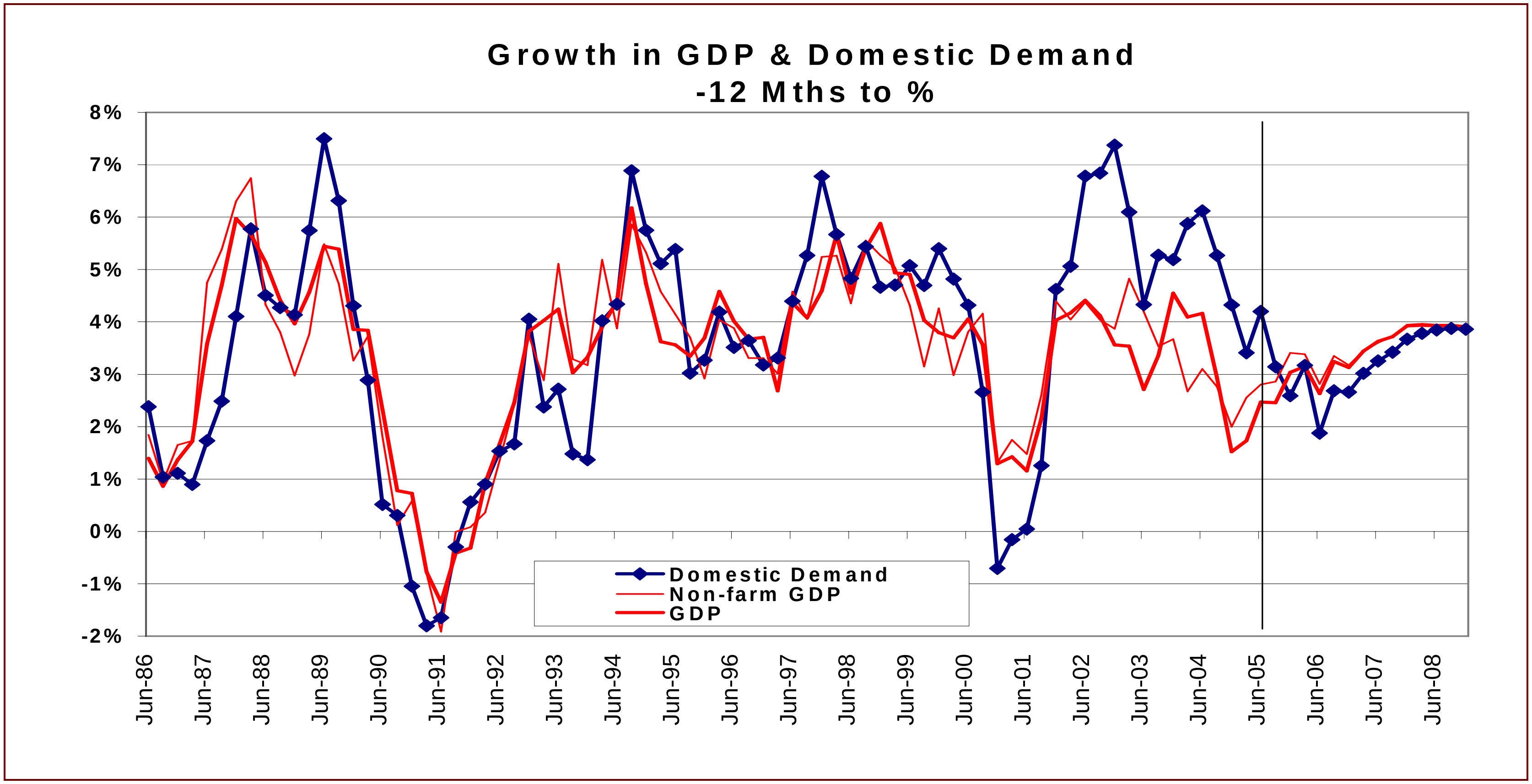


Dwelling Cycle Mild.
Business Investment to slow but still OK....

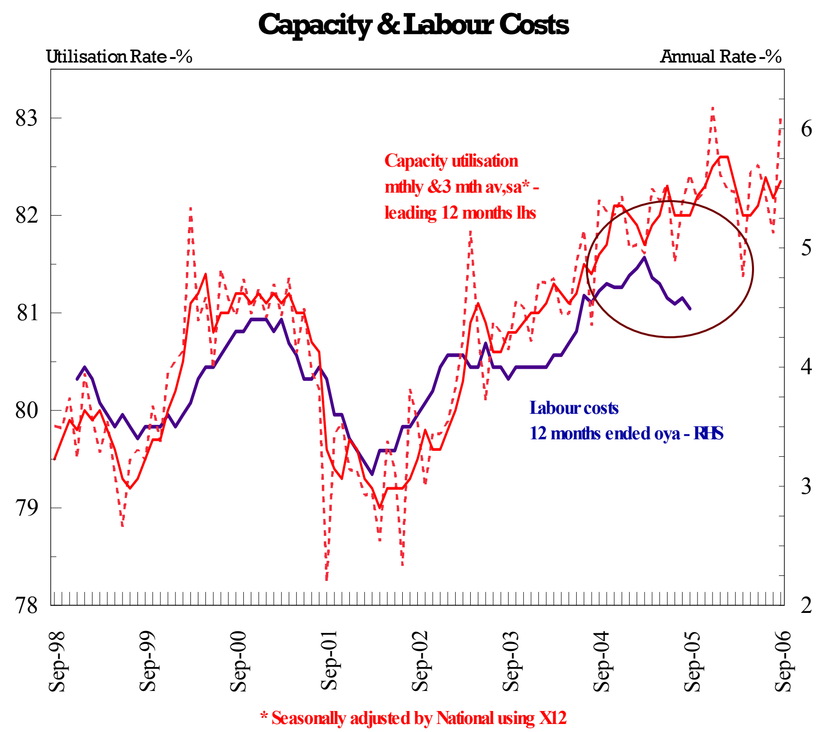


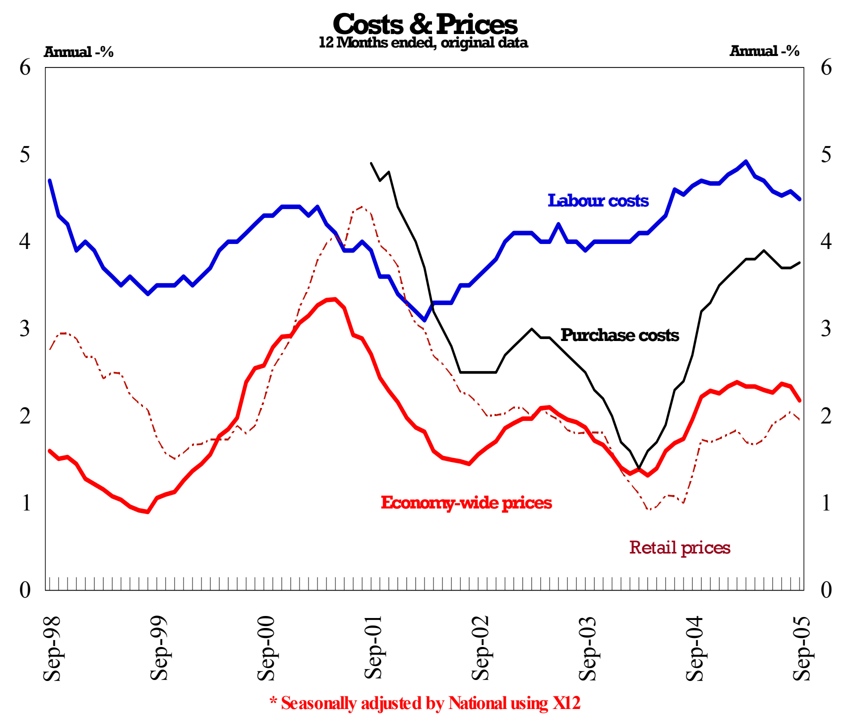


Given June accounts and higher start point we now see 2005 at a around 2 1/2%. For 2005/06 around 2 ¾ % and 3 % in 2006



Wages are topping out but are risks if capacity doesn't renew downward direction. Prices are past their bottom. Fuel prices adding to near term inflation upside as is lower productivity

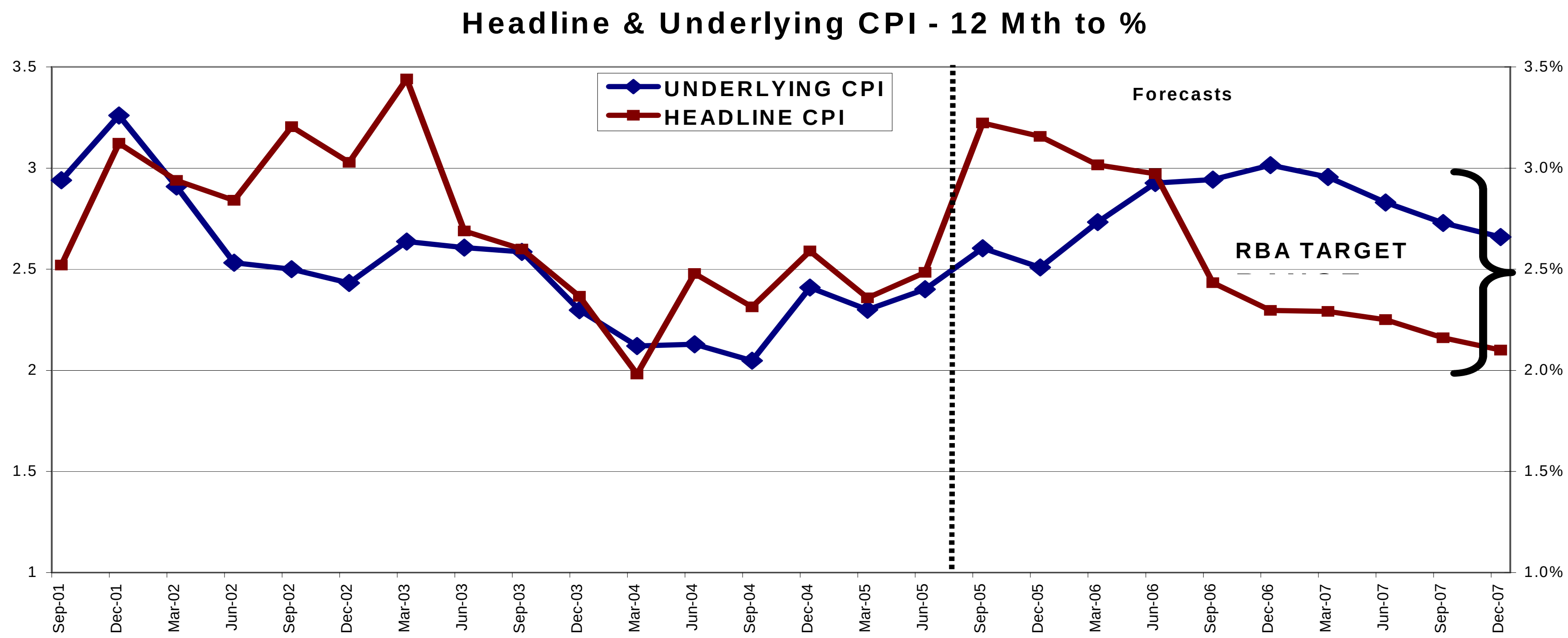




- This slide neatly summarises RBA's concern…..

Near Term Underlying CPI around 2 1/2 %. Headline going north on oil prices. Underlying going higher in 2006 from indirect effects of oil & lower productivity

- Underlying up reflecting: lower currency, productivity & indirect effects of oil.



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Rates ….our view

<u>For 2006 are risks on both directions</u>

- Inflation rising as indirect effects of oil flow through and productivity slows. Headline looks worse in the near term
- Terms of trade could see further tax cuts
- Labour market still tight and difficult to find skilled labour

<u>But on the other hand</u>

- House price effects still feeding through
- Domestic demand still slowing – inflation slowing in longer run
- Globally confidence and oil price outlook uncertain after Katrina. Unemployment up a touch regardless.

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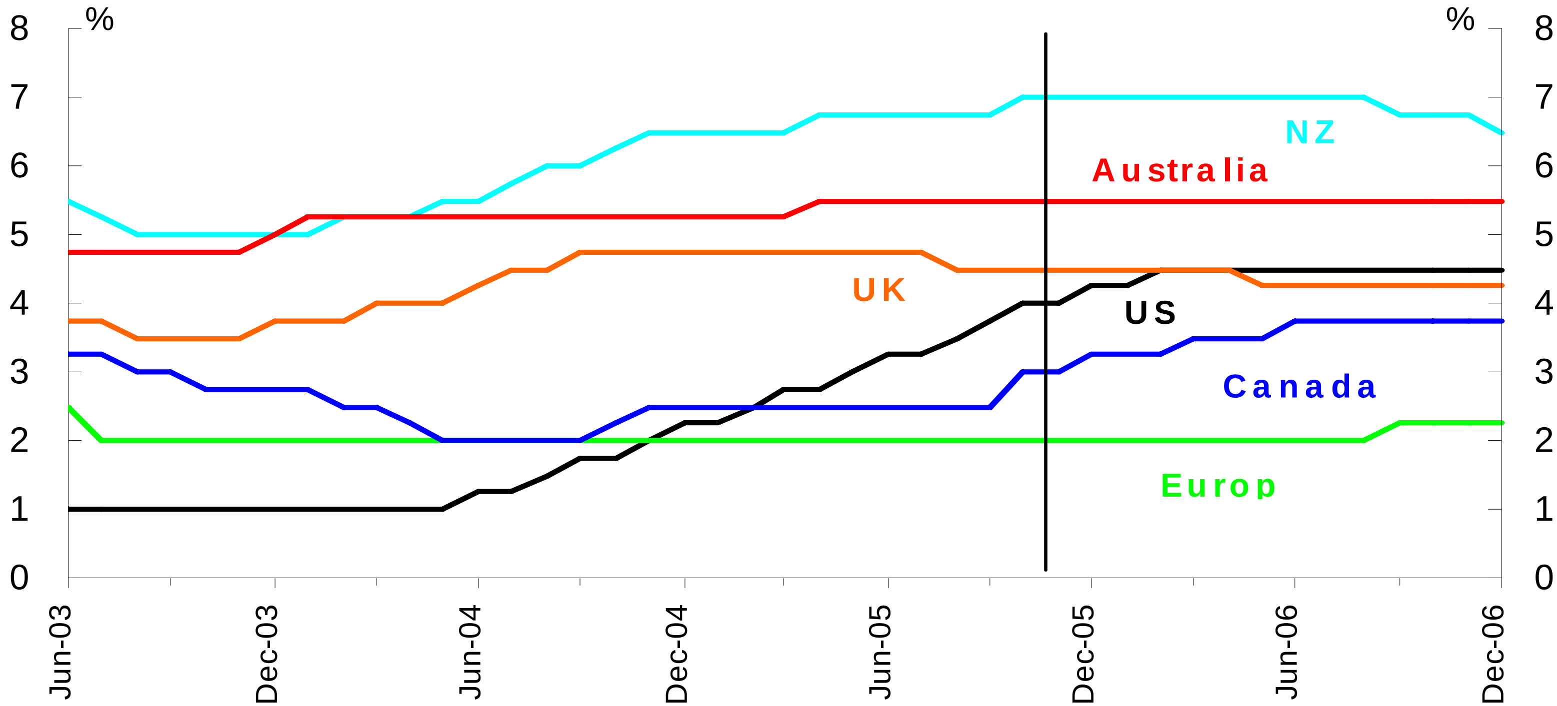
Rates.........on balance sit and watch

➢Expect RBA to sit and watch. Risks both ways. Expects lots of Maradona type statements but not much action



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At the long end .....

➢ Long end still dominated by US which still looks too low..

We expect moderate US sell off. Will have some impact on Aust long rates