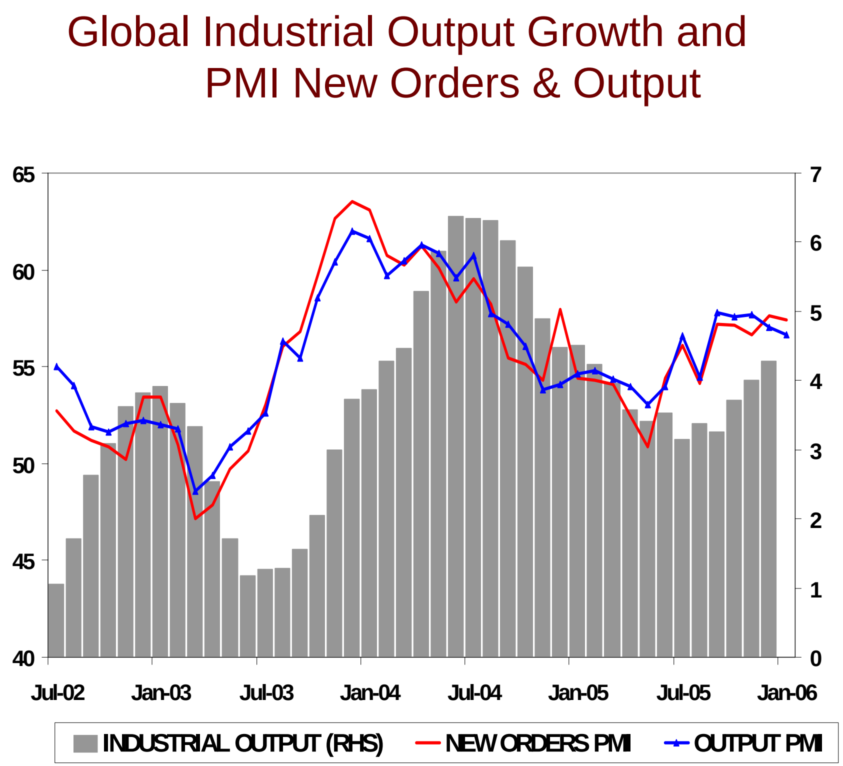
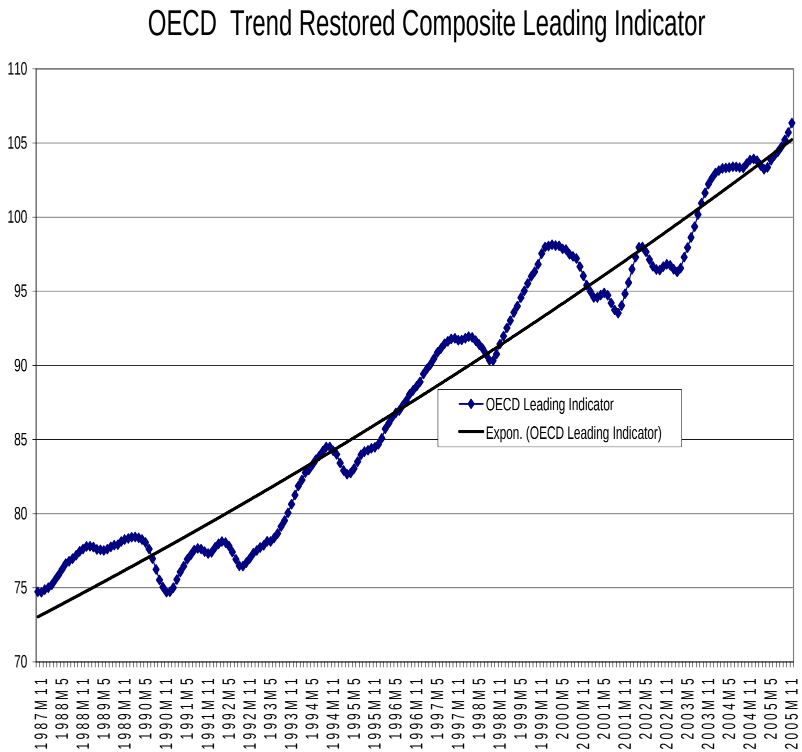
GLOBAL OVERVIEW

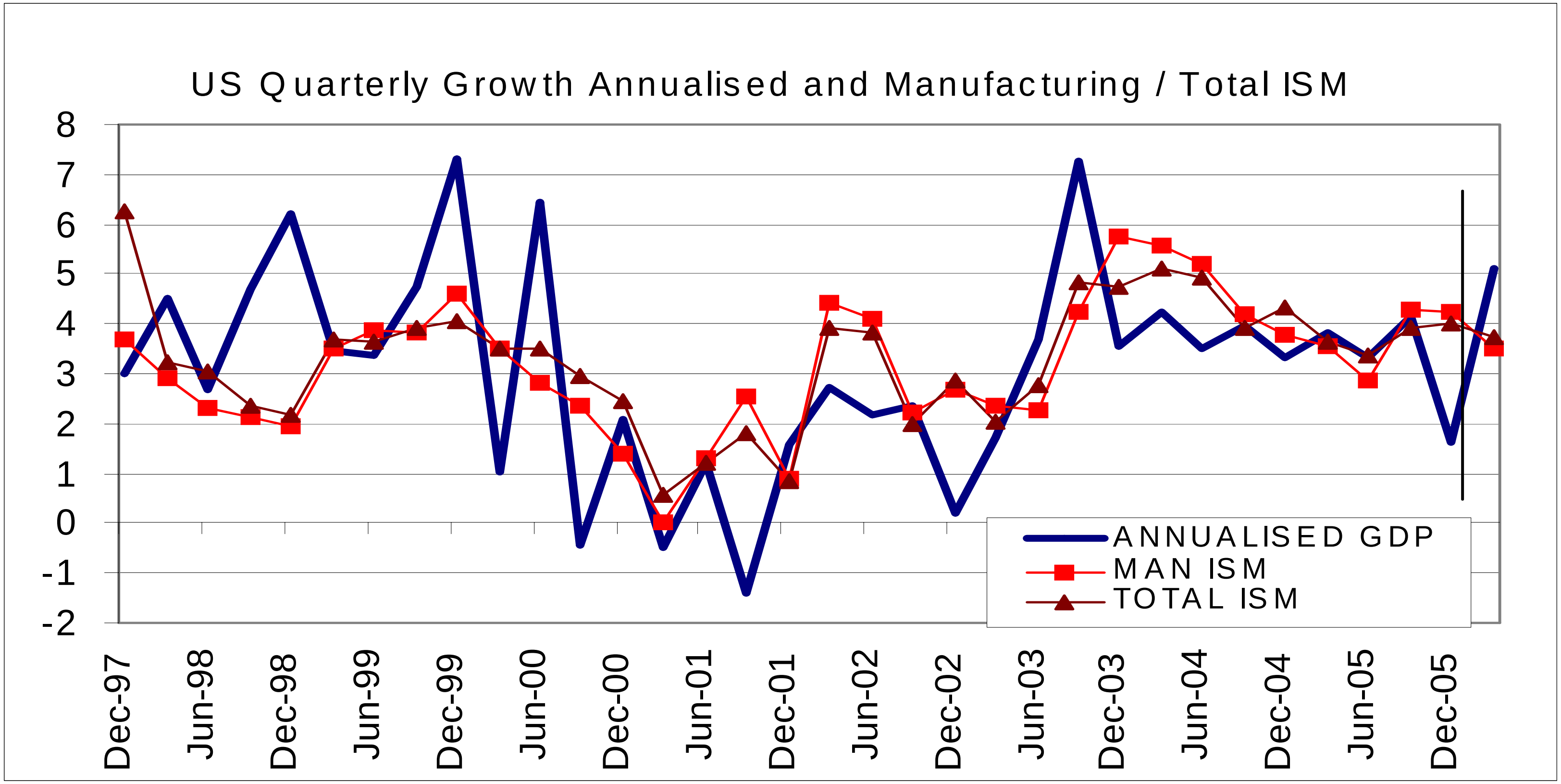
Internationally the Global Context is Important; Recent Data Suggests Some Strengthening….





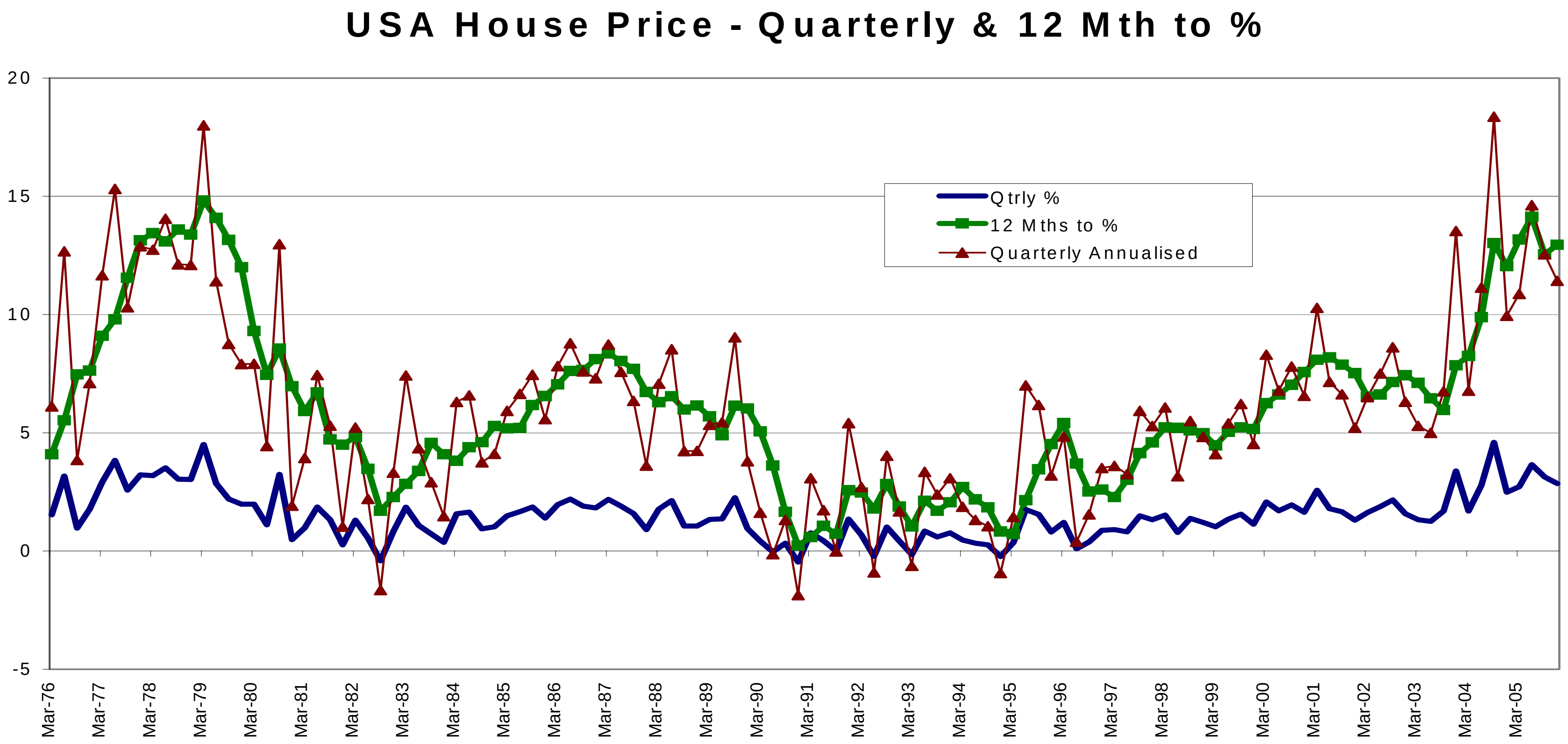
National Australia Bank

Surprisingly Weak GDP in December. Most other measures strong and continuing into March



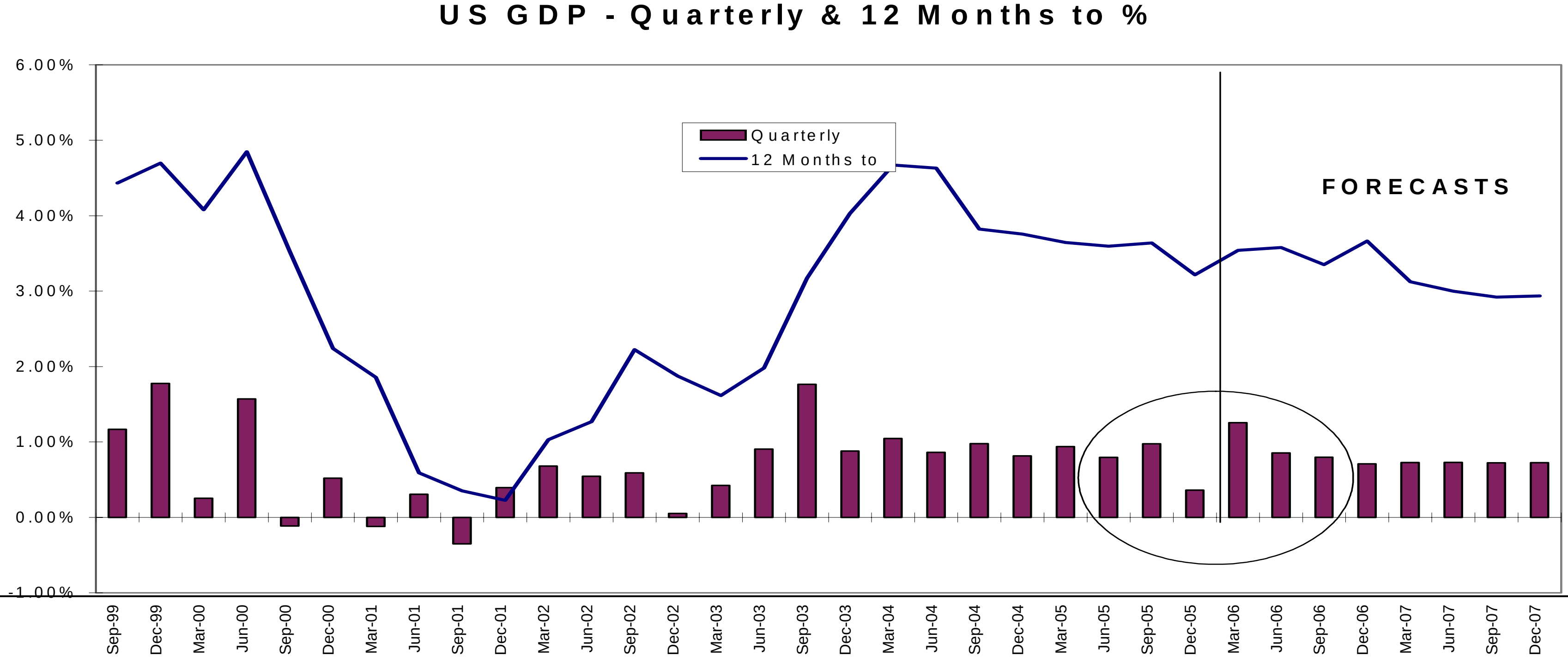
National Australia Bank

Best data on US House Prices – OFHEO
Only up to Dec Qtr – but still strong.
A medium term risk……. but not yet



In the US….Growth to continue around 3 1/2 % in 2006 before slowing in 2007.

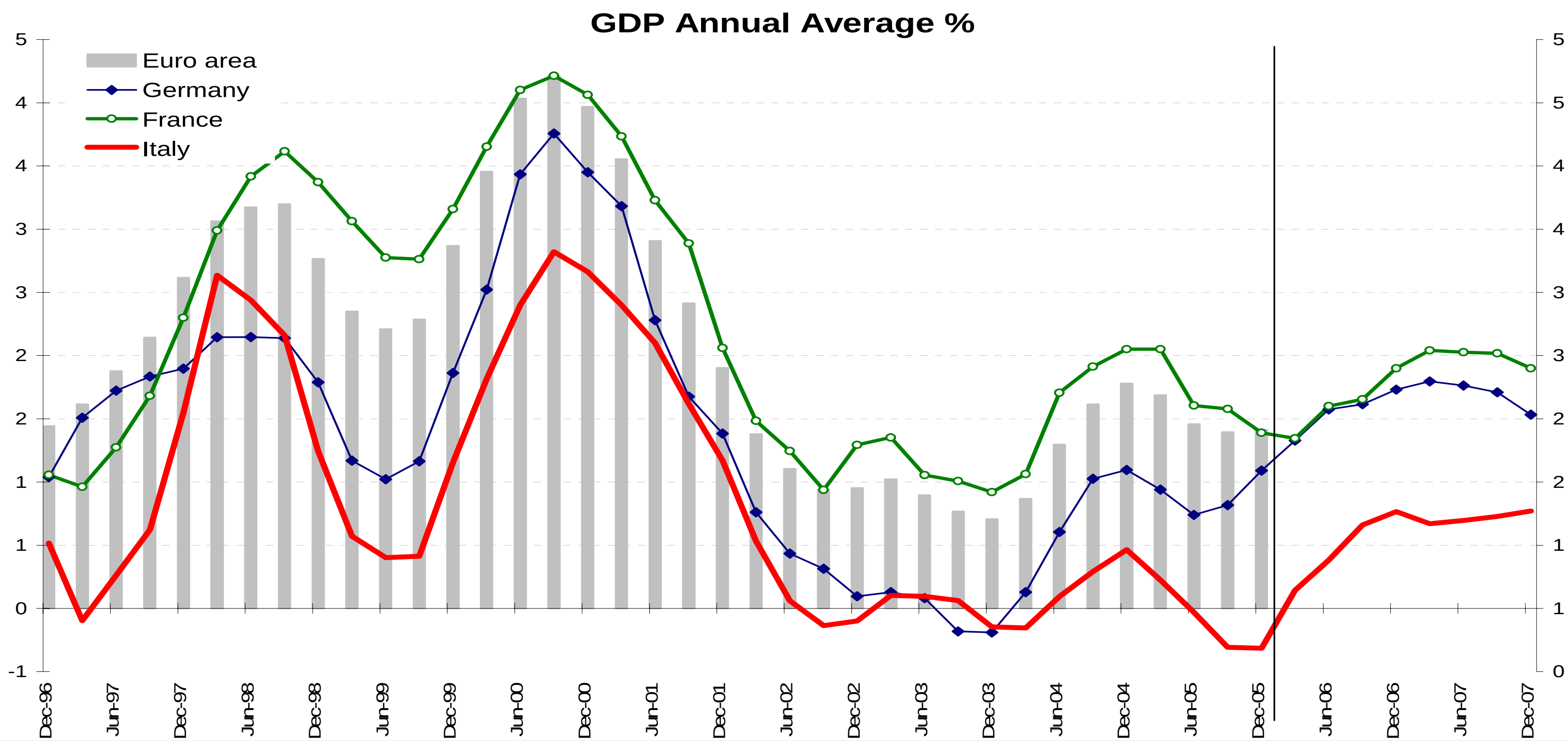
•Q4 looks too low. Could be revised up or at least next few quarters will be artificially high – base effects and rebuilding effects kicks in. GDP around 3 ½ % in 2006. Slower 07 as house price slows



National Australia Bank

Elsewhere around the globe…Europe

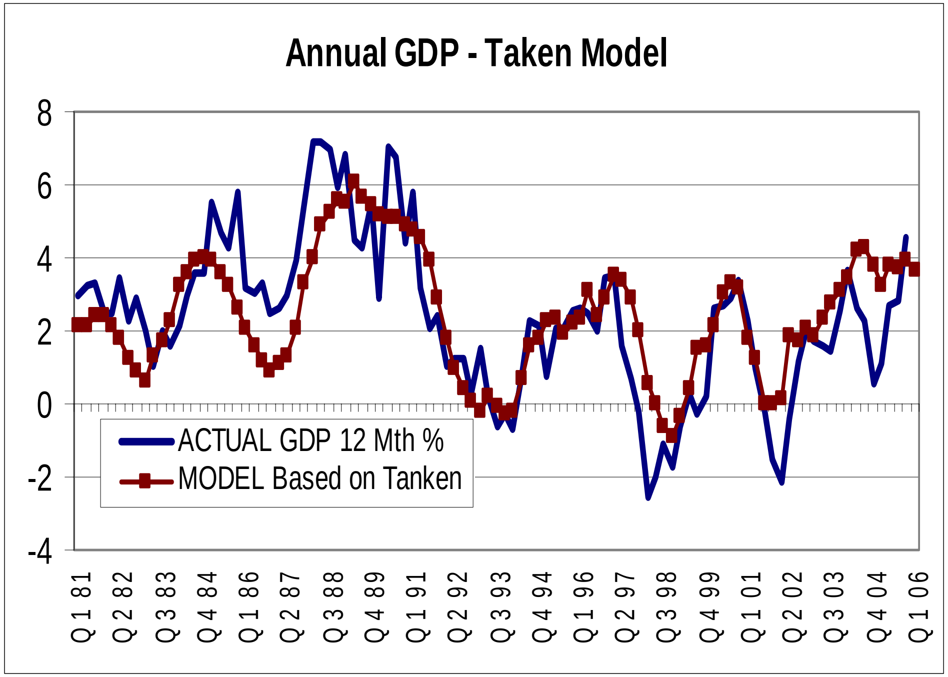
- But activity still not great 2006 and into 2007



National Australia Bank

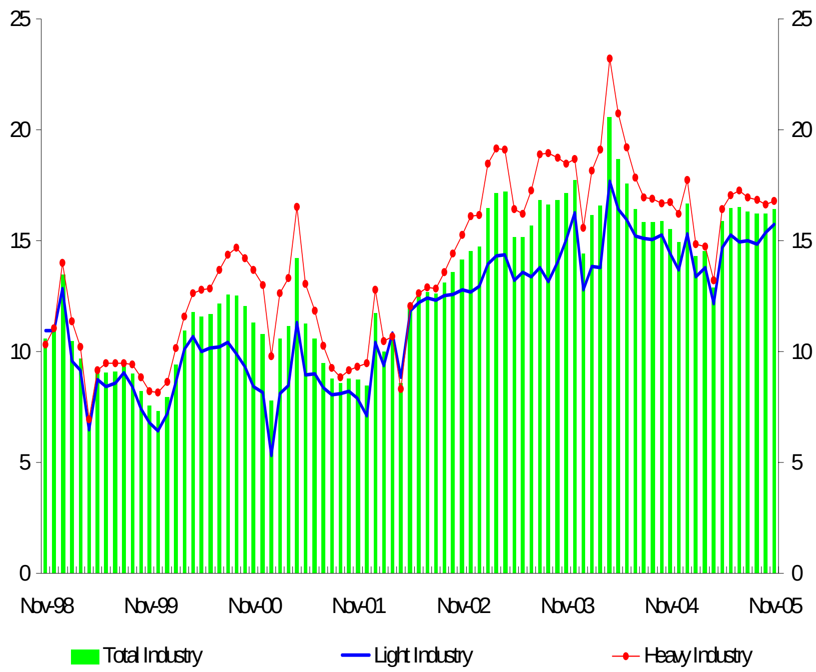
Japan showing strength .....

- Taken (key survey in Japan) has been strong for most of 2005
- Was much stronger than accounts (re basing issues) but now catching up
- Both point to growth thru 2005 of around 4%. March Expectations still strong

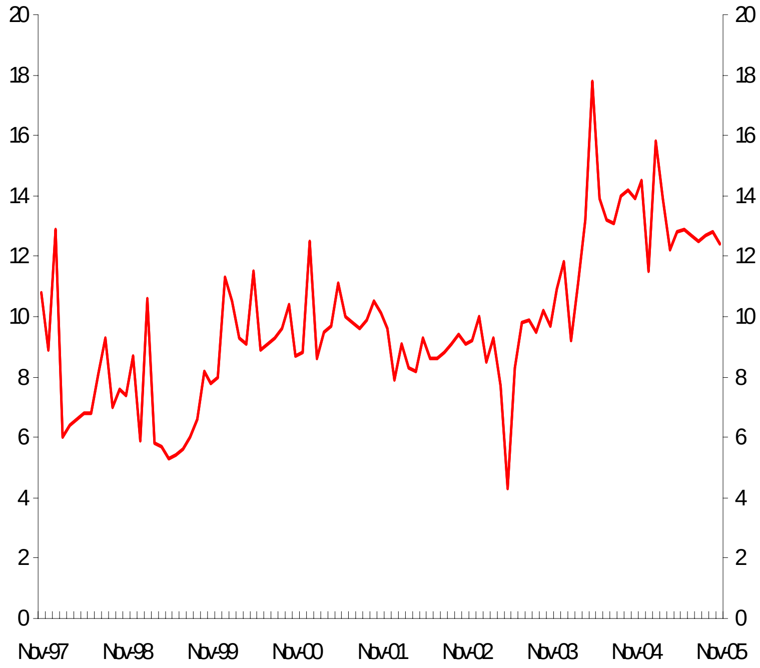


Chinese growth still strong…
Industrial Production around 16 – 16 ½%
Real Retail Sales around 12 – 12 ½ %

Industrial Output (3mma, % yoy)

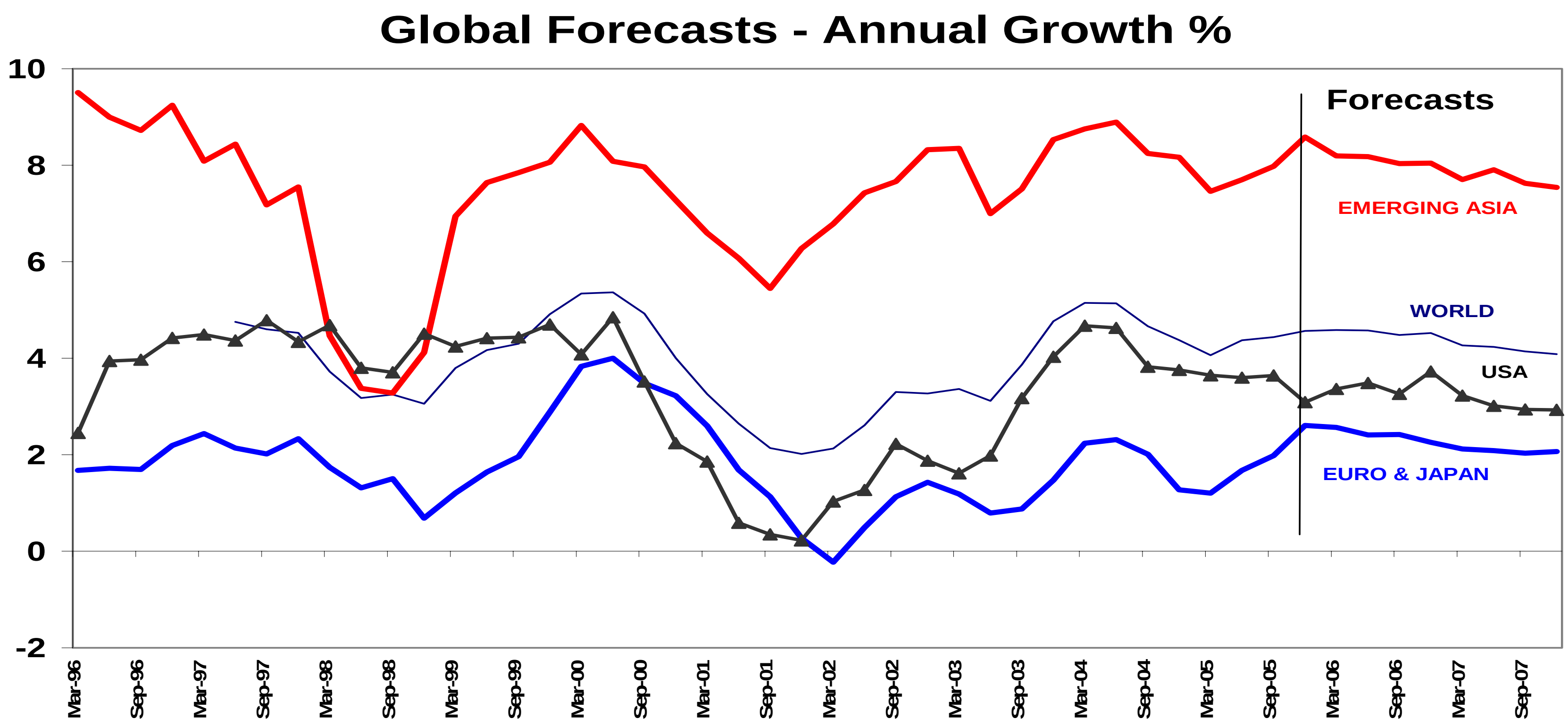


Retail Sales (% yoy)



National Australia Bank

Looking Forward We See Only Moderate Slowing – Global Growth 4 1/2 + in 2006 slowing moderately to 4 ¼ % in 2007. And no crash in China

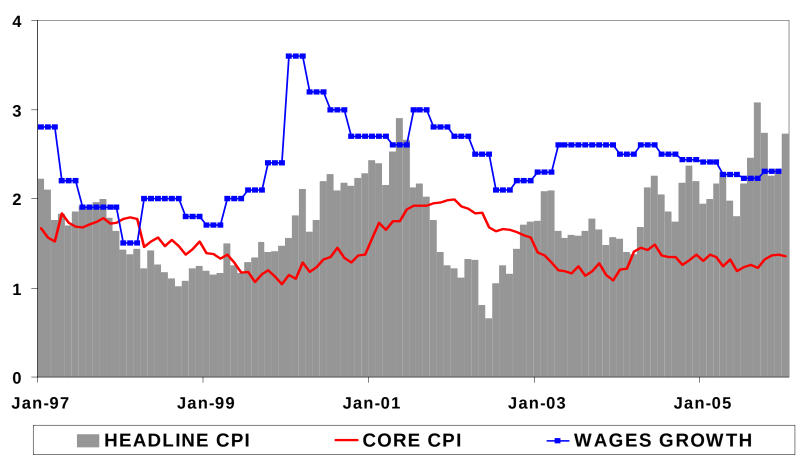


National Australia Bank

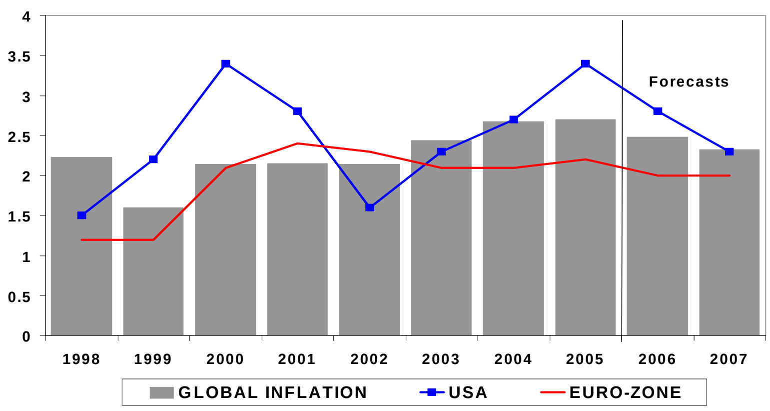
Globally the challenge for Central banks was to prevent oil price spike in price levels feeding into inflationary process…
Data suggests that has been achieved. Forecasts embody that.

- Their response depends where they are re neutral rates
- To date see oil in headline CPI but not core
- Not yet in Core PPI and not in wages

G7 Consumer Prices and Wages % yoy



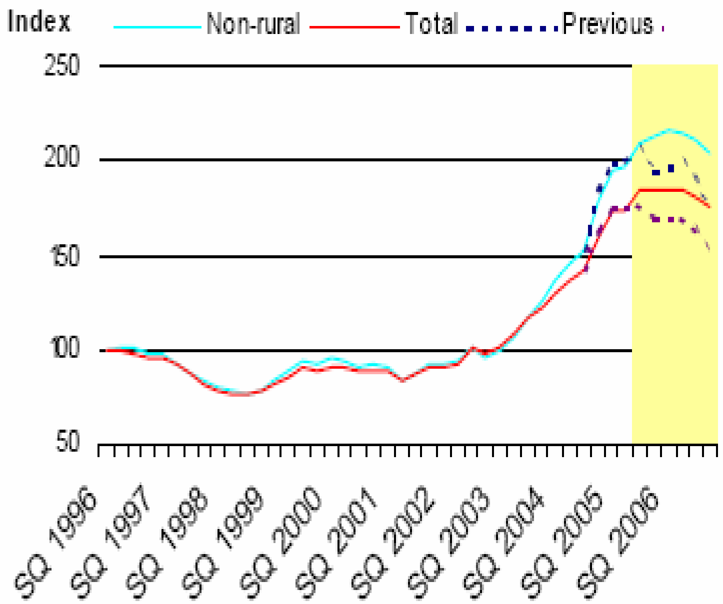
Global Consumer Prices % yoy

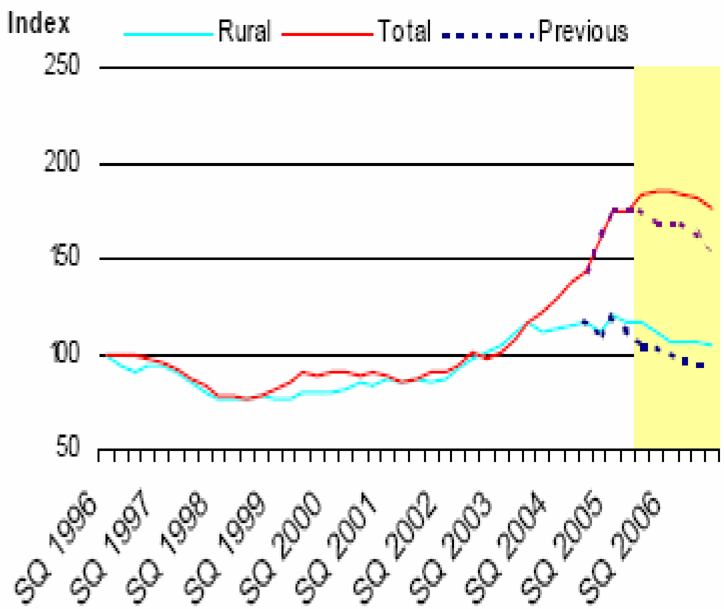


National Australia Bank

Global Outlook Relatively Supportive for Demand. We See Commodity Prices Staying Stronger for longer relative to our forecasts earlier this year…

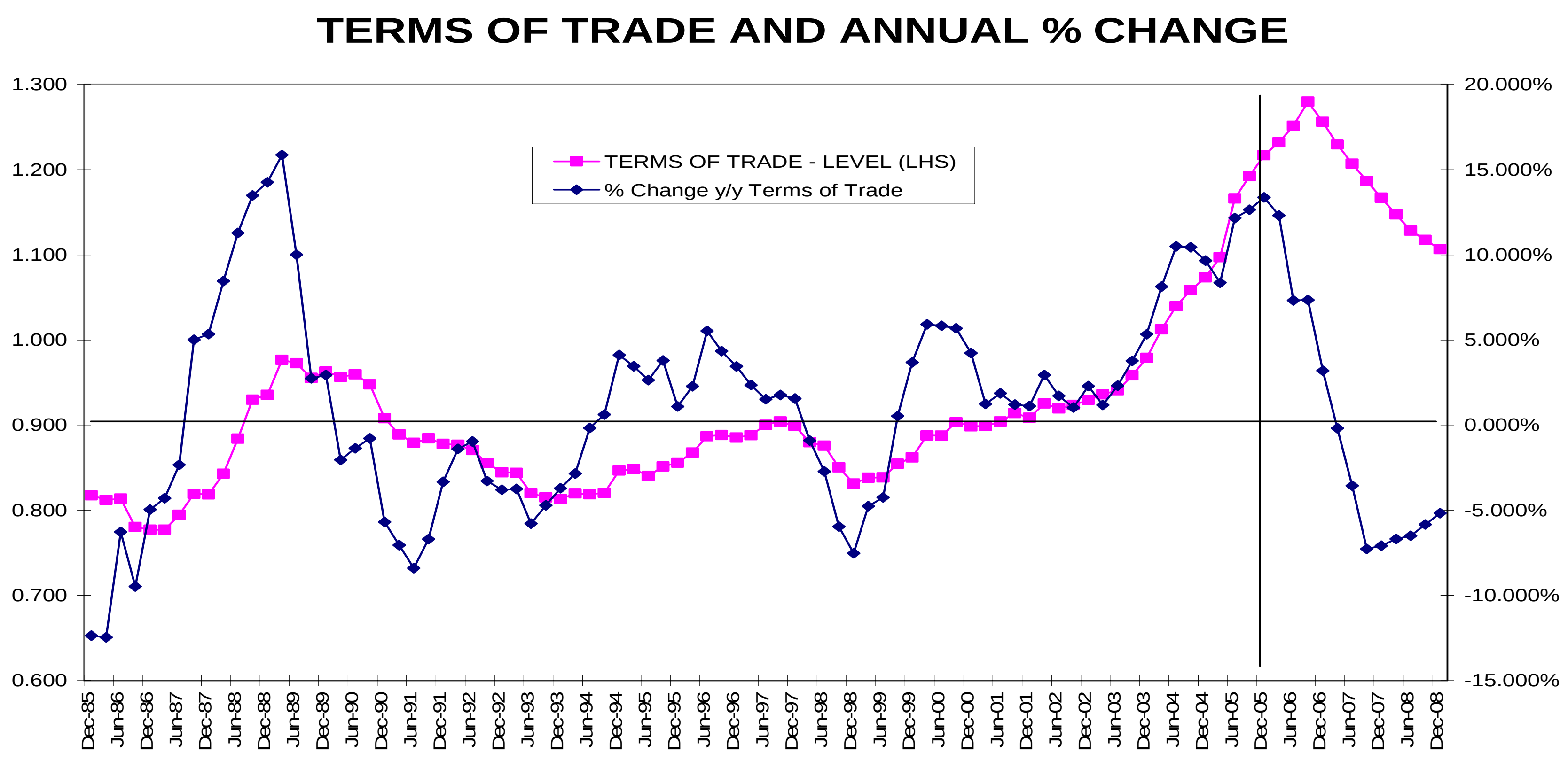
- **Minerals & Energy commodity prices have been significantly revised upwards – particularly for oil and base metals – reflecting the continued strength of global demand, an increase in global industrial production and the slow response of supply;**
- **Rural commodity prices have also been revised upwards – in line with the short term outlook for sugar, wheat and cotton**





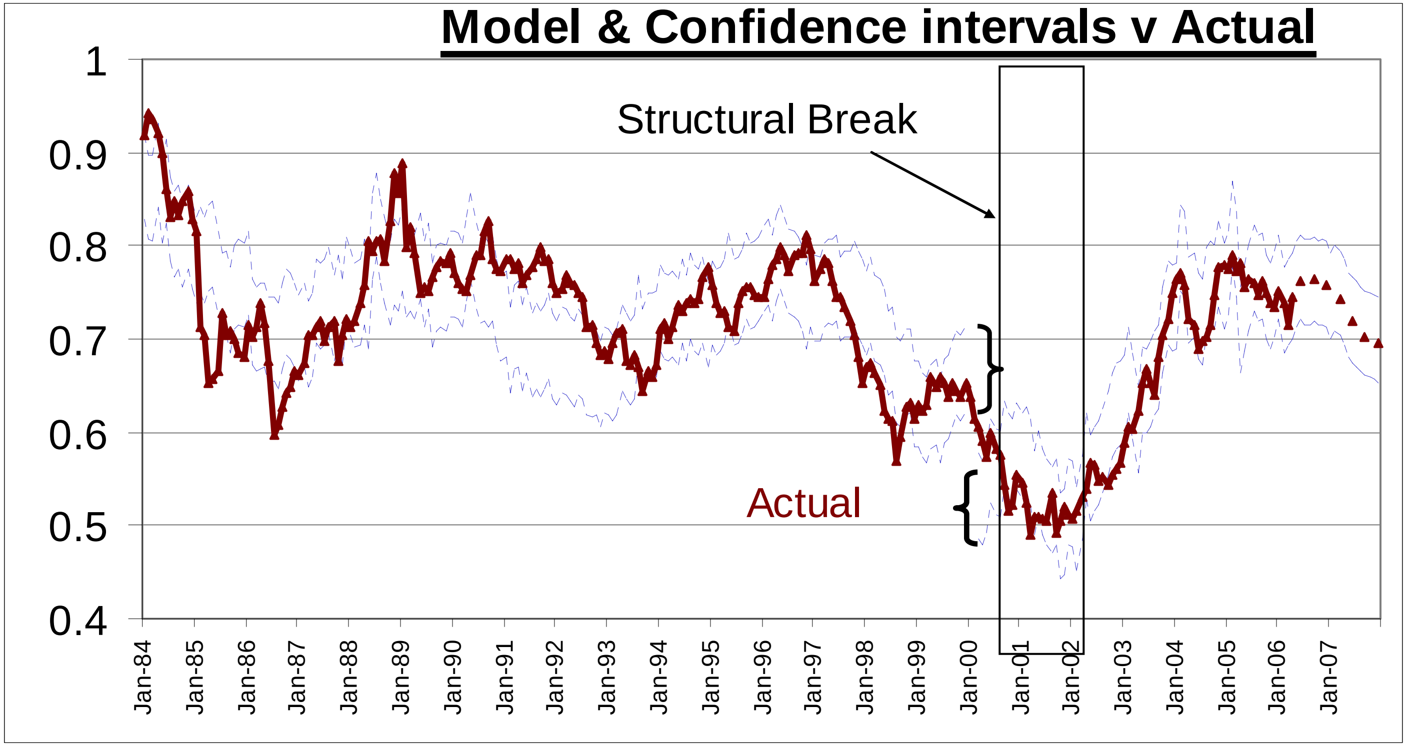
National Australia Bank

That has meant that the terms of trade are expected to continue to rise moderately over the next 6 months before moving moderately lower (albeit at still high levels)



National Australia Bank

Exchange Rate Models – limited abilities but still useful. Put in higher commodity forecasts, better domestic economy and higher rates points to moderate upside in next 6 months before easing back through 2007.



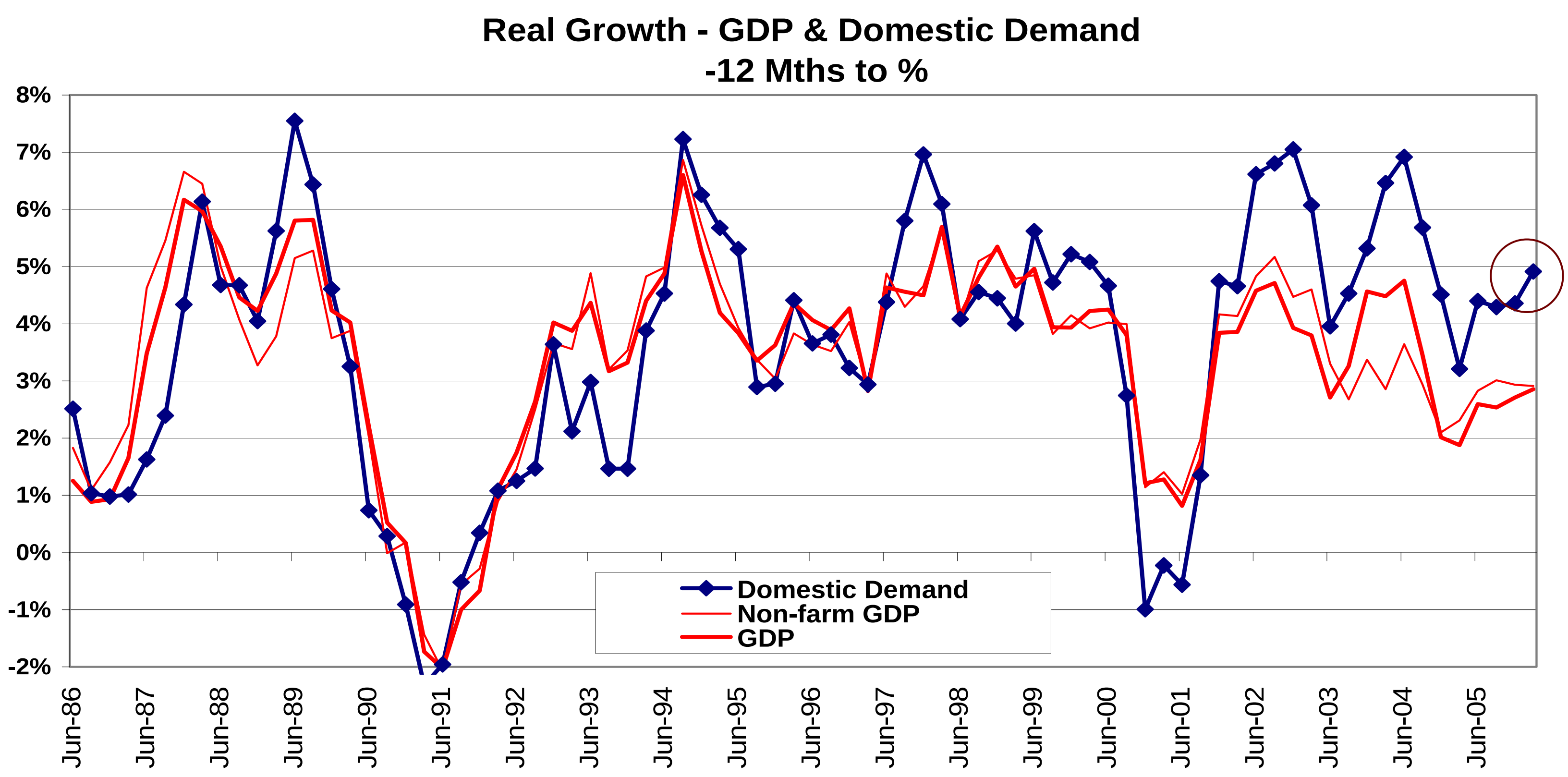
Models Driven by - commodity prices (global growth)

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

National Australia Bank

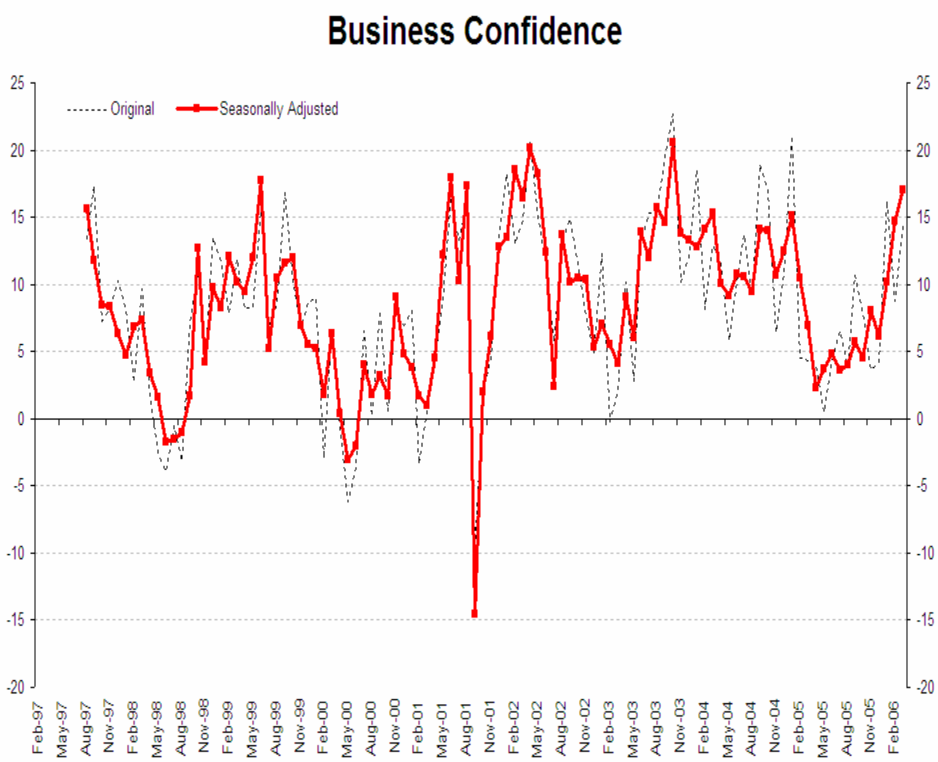
AUSTRALIA

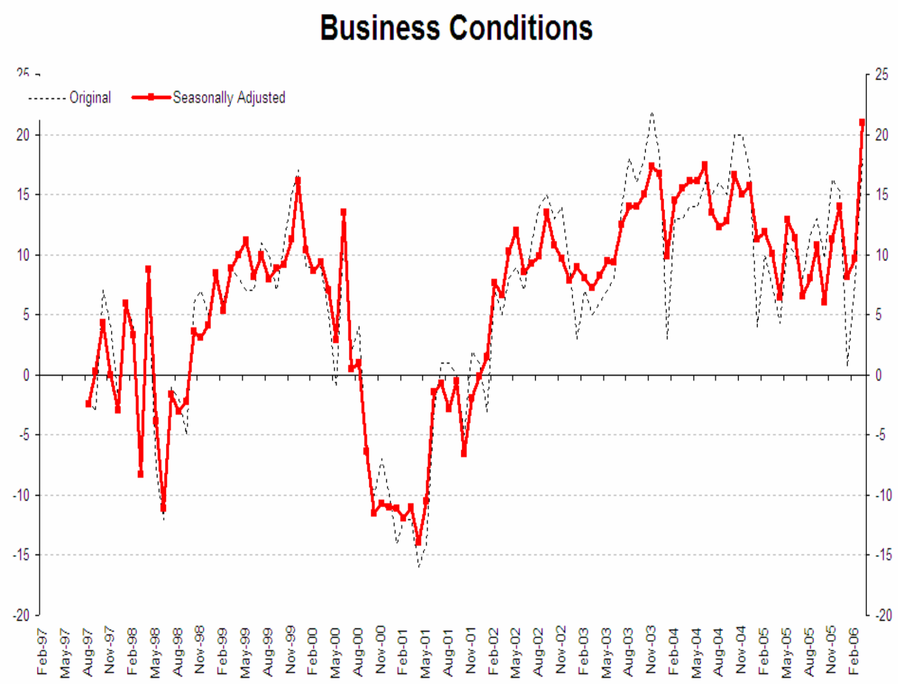
Latest Accounts Suggest After Slowing Growth over last 12-18 Months. Stabilised Around 2 3/4 %. Demand Also Slowed to around 4%. But we think in early 2006 has accelerated to near 5%



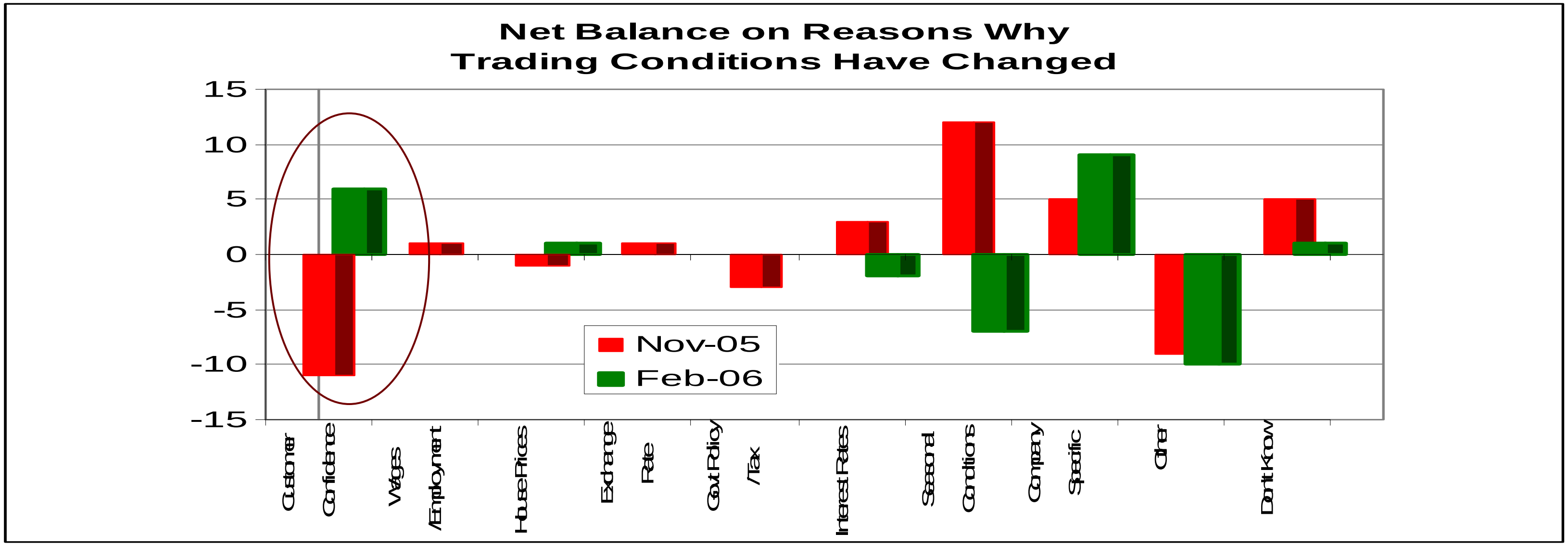
National Australia Bank

March Monthly Survey has very very strong results. Confidence has been stronger for some time (after fears of hard landing in mid 2005) But now conditions!!





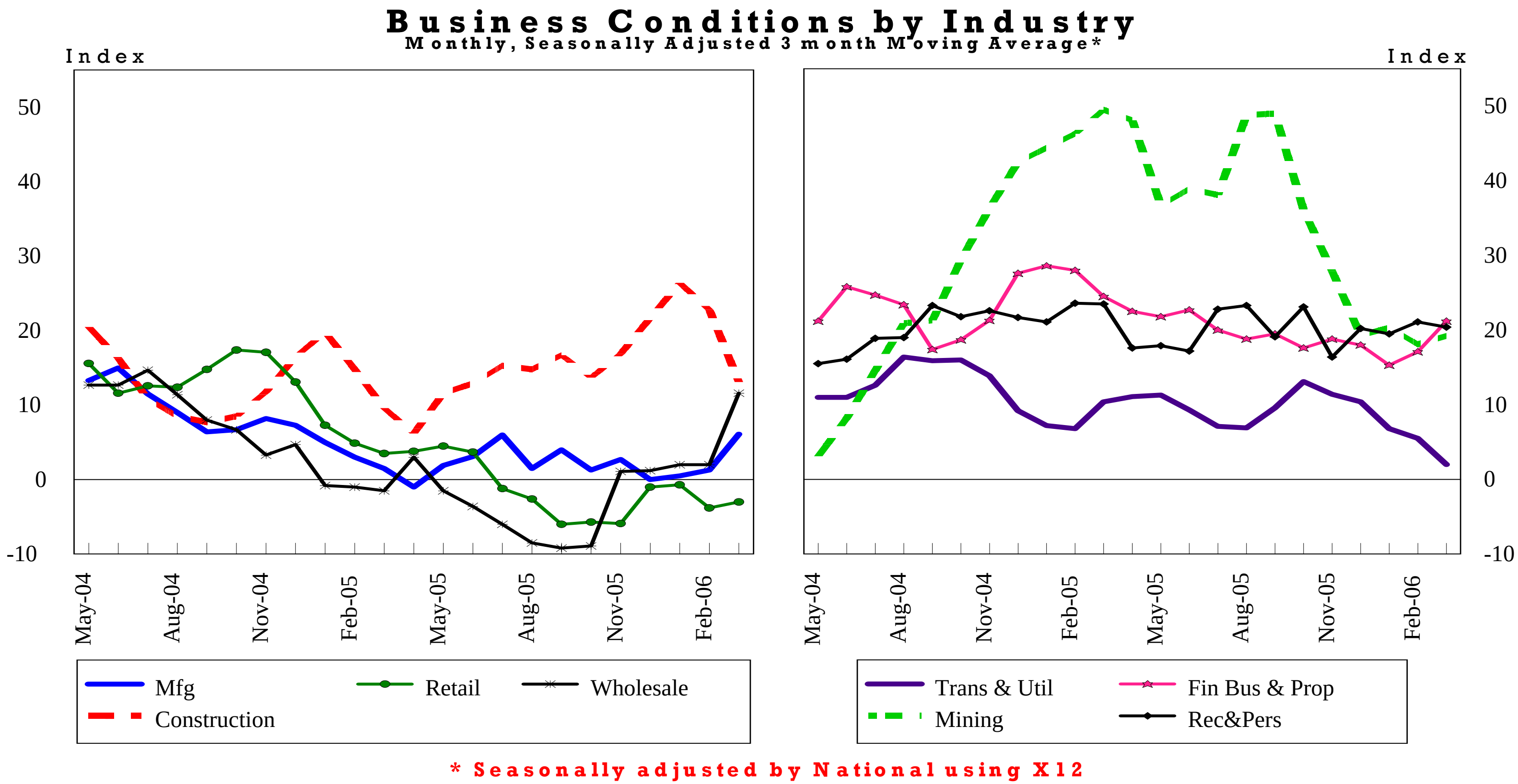
When asked why things have improved business point to improved customer sentiment…



We are not taking the survey results fully on board in our forecasts but would be silly to ignore it completely.

National Australia Bank

Differences across sectors are still marked. Mining slowing but still strong. Services also good . Construction (driven by infrastructure) slower but OK. Cyclicals weak but improving (esp wholesale). Transport eroding further in the face of oil prices.



National Australia Bank

What drives consumption…

In the long run:

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

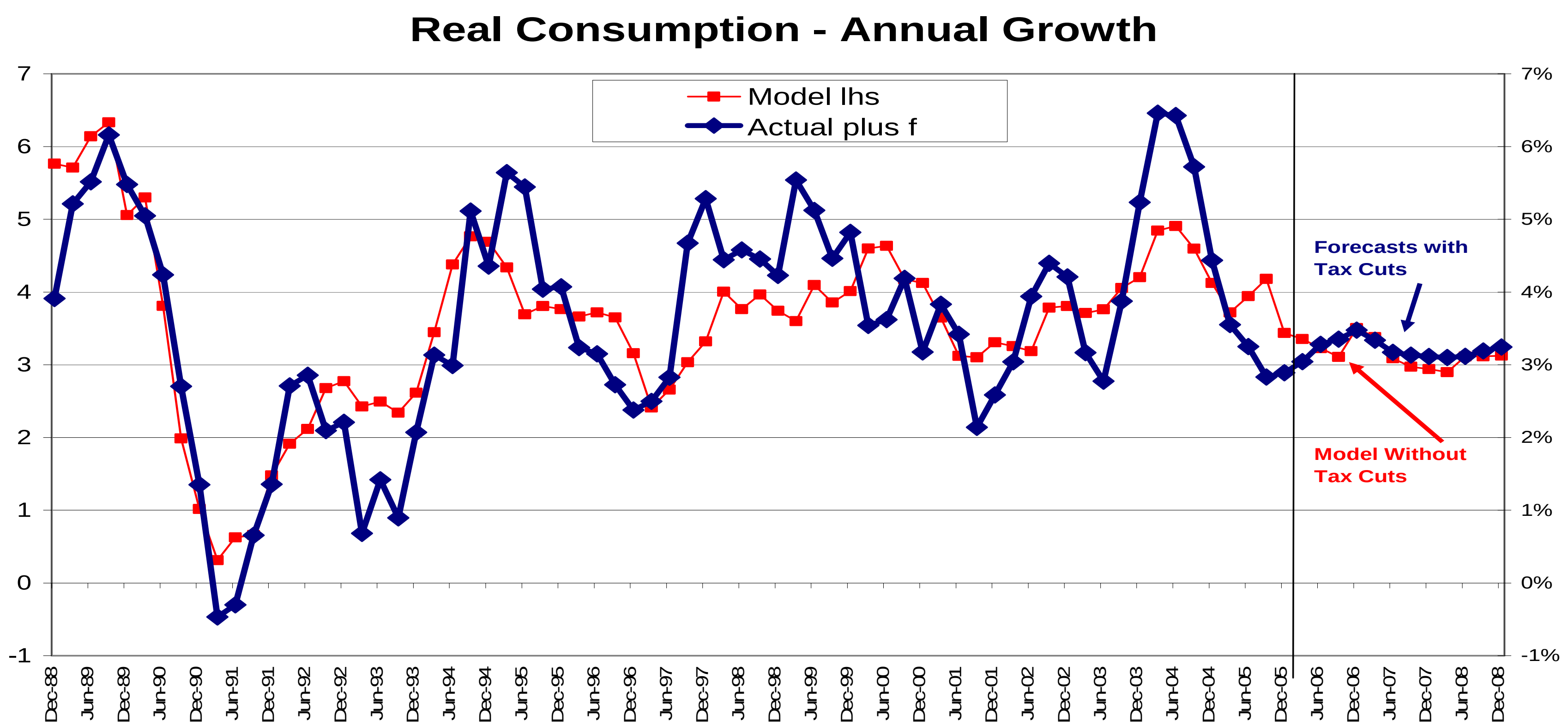
Implies : Households don't have negative savings. But are inclined to more cash poor when house prices rising. Note very large elasticity on house prices – i.e. 10% change in growth rate of HP reduced consumption by 1% (we have seen 20% over past few years). Helps explain dynamics across states.

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)

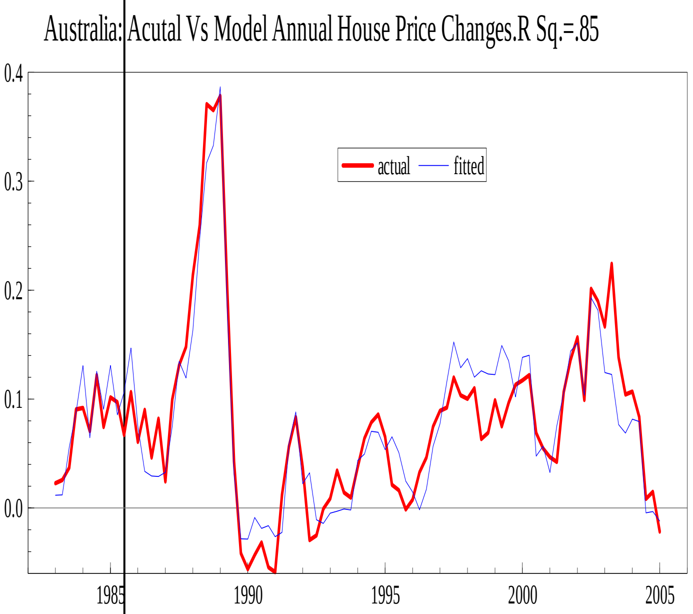
Consumption Model has been stronger than Statistician in part due to equity markets & more recently housing bottoming/picking up. Model without tax cuts wants to weaken a touch but we assume tax cuts

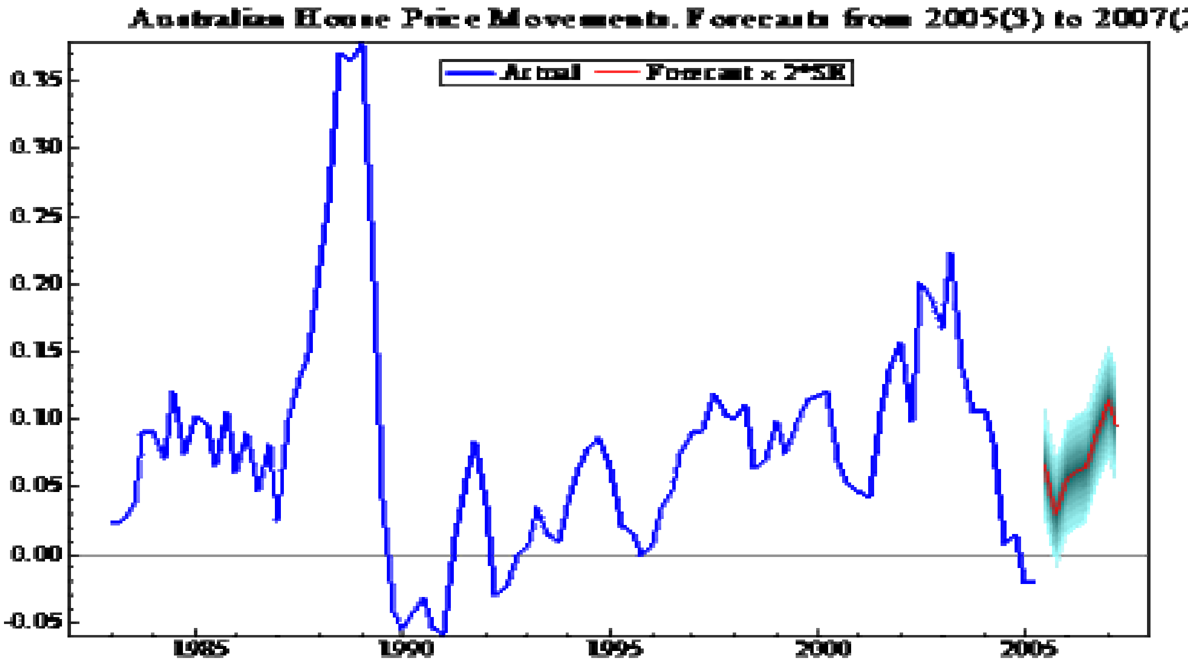


National Australia Bank

Housing Price Model.
Longer run driven by population, incomes and real rates.
Overall expect house prices to go up around 5-7% this year...

Short run driven by : incomes, construction cycle, unemployment and to a lesser extent share prices. And not far from equilibrium

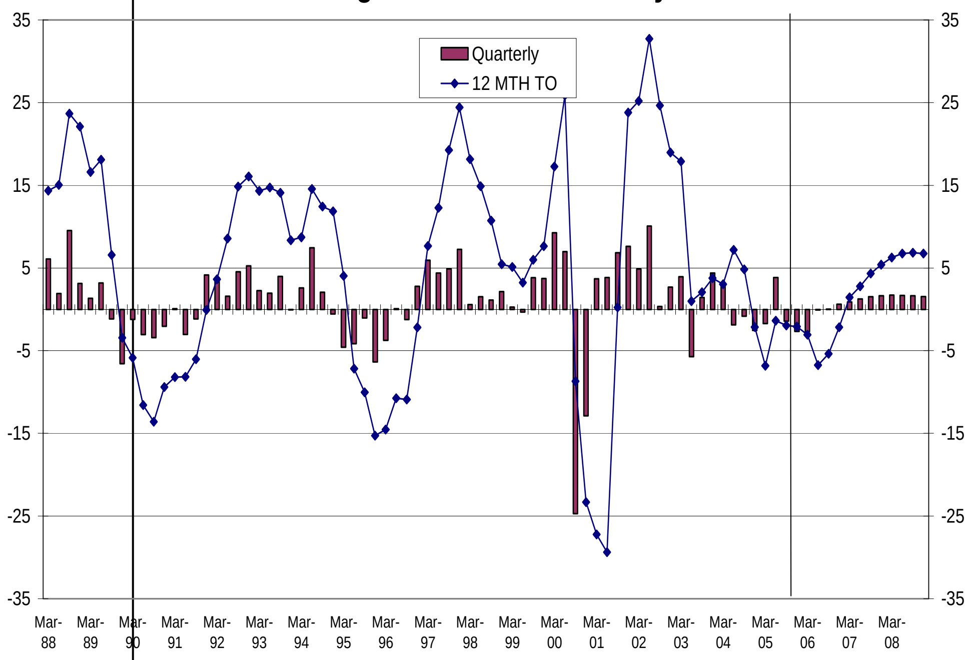




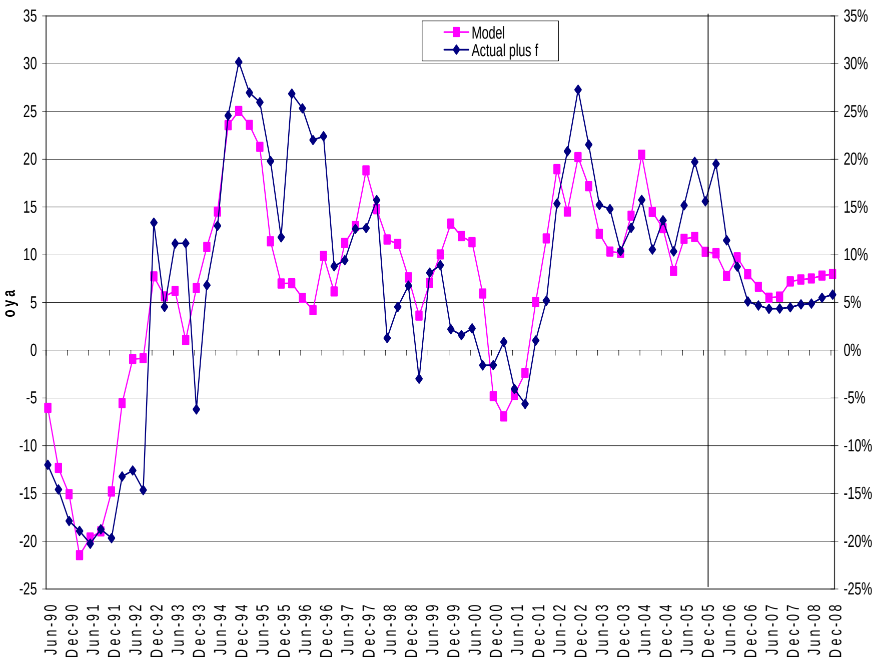
National Australia Bank

Dwelling cycle flattening out but mild by past standards
Business investment very strong but to moderate

Dwelling Activity Cycle Mild

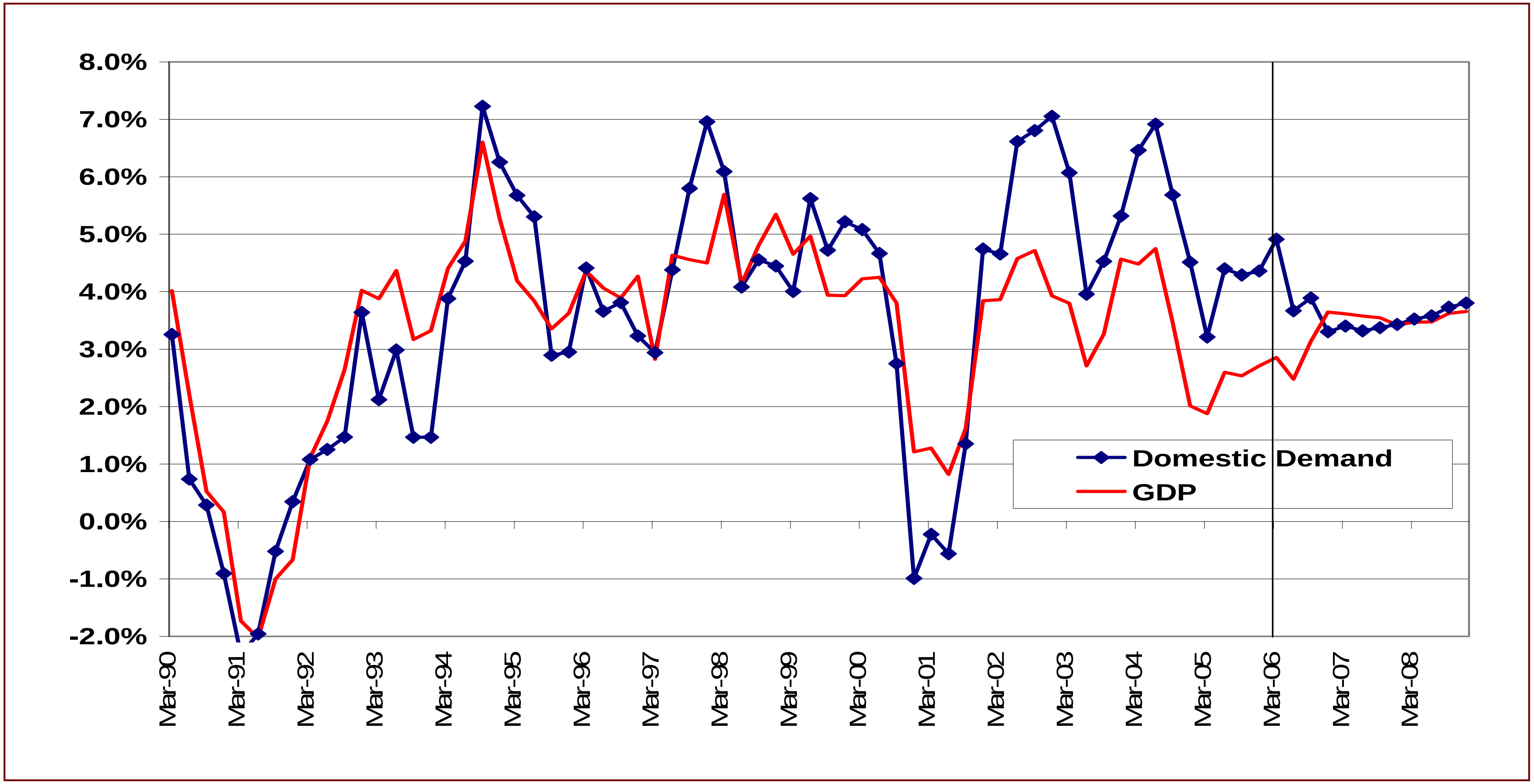


Business Strong Fuelled by Mining and General Capex



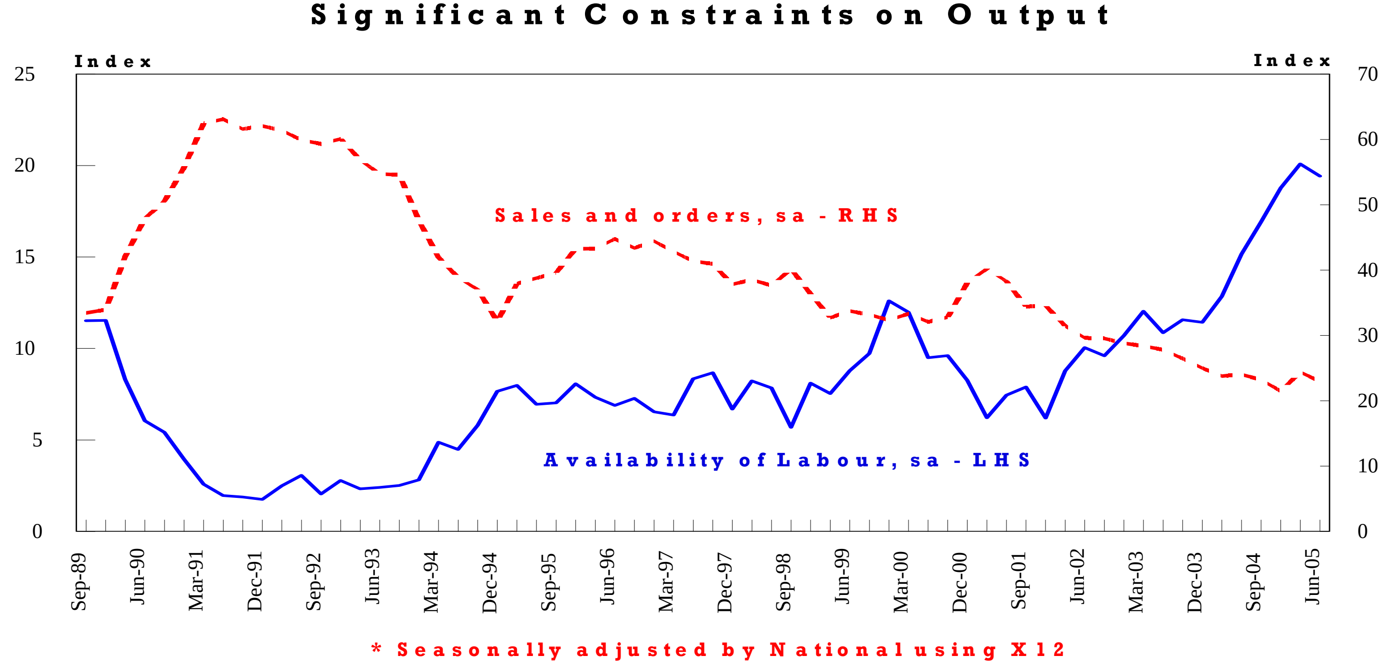
National Australia Bank

For 2006 we now expect GDP to be around 3% rising to 3 ½ % in 2007. We had not expected to see such a strong start to 2006. After near term strength in demand, we expect it to ease back. If not, look out for RBA!!



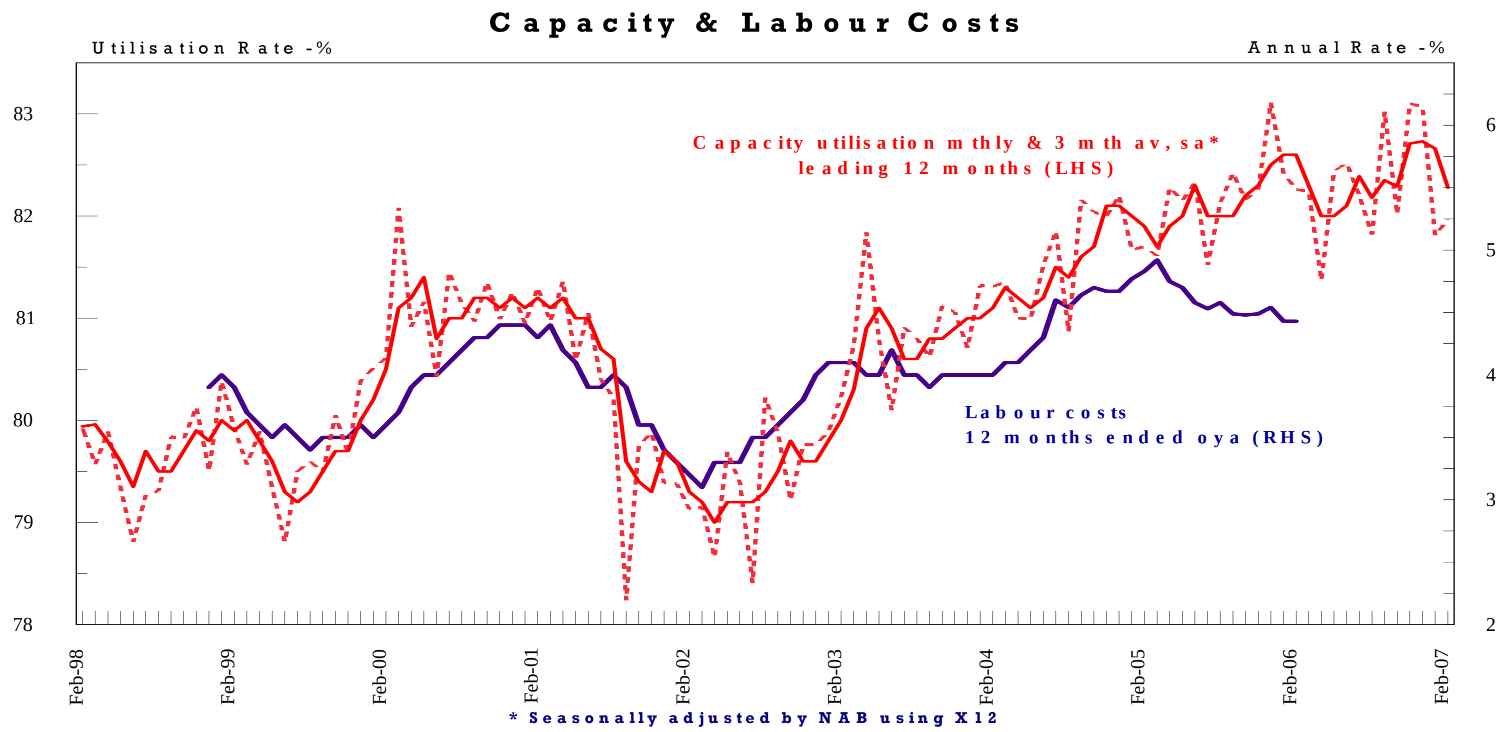
As well as a stronger outlook than previously expected RBA is concerned about inflation outlook given capacity pressures.

Ability to Hire Suitable Labour at all time high….
While Concerns about Insufficient Demand low but…



National Australia Bank

Wages seems to have peaked. But RBA still concerned about high levels of capacity (albeit are signs that it too has peaked).



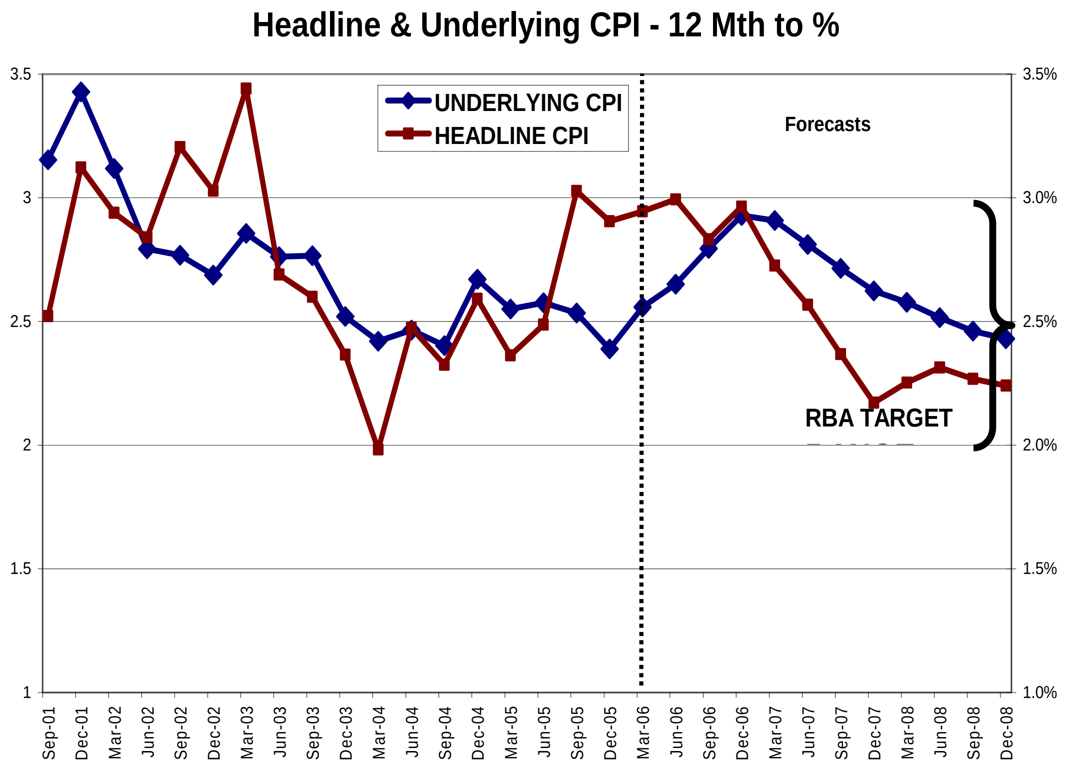
National Australia Bank

While recent data on inflation is encouraging (and will again be so in the March quarter) it's the outlook for core inflation that is the main issue. By end 2006 at top of target!!

- Near Term Underlying CPI around 2 1/4 %. (expect 2 ½ % in March)

- Headline around 2 ¾ % - and very dependent on oil prices. (expect 3% in March)

- Underlying inflation to approach 3%in 2006 as indirect effects of higher oil prices & the lower productivity come through. Lower AUD forecasts also doesn't help



National Australia Bank

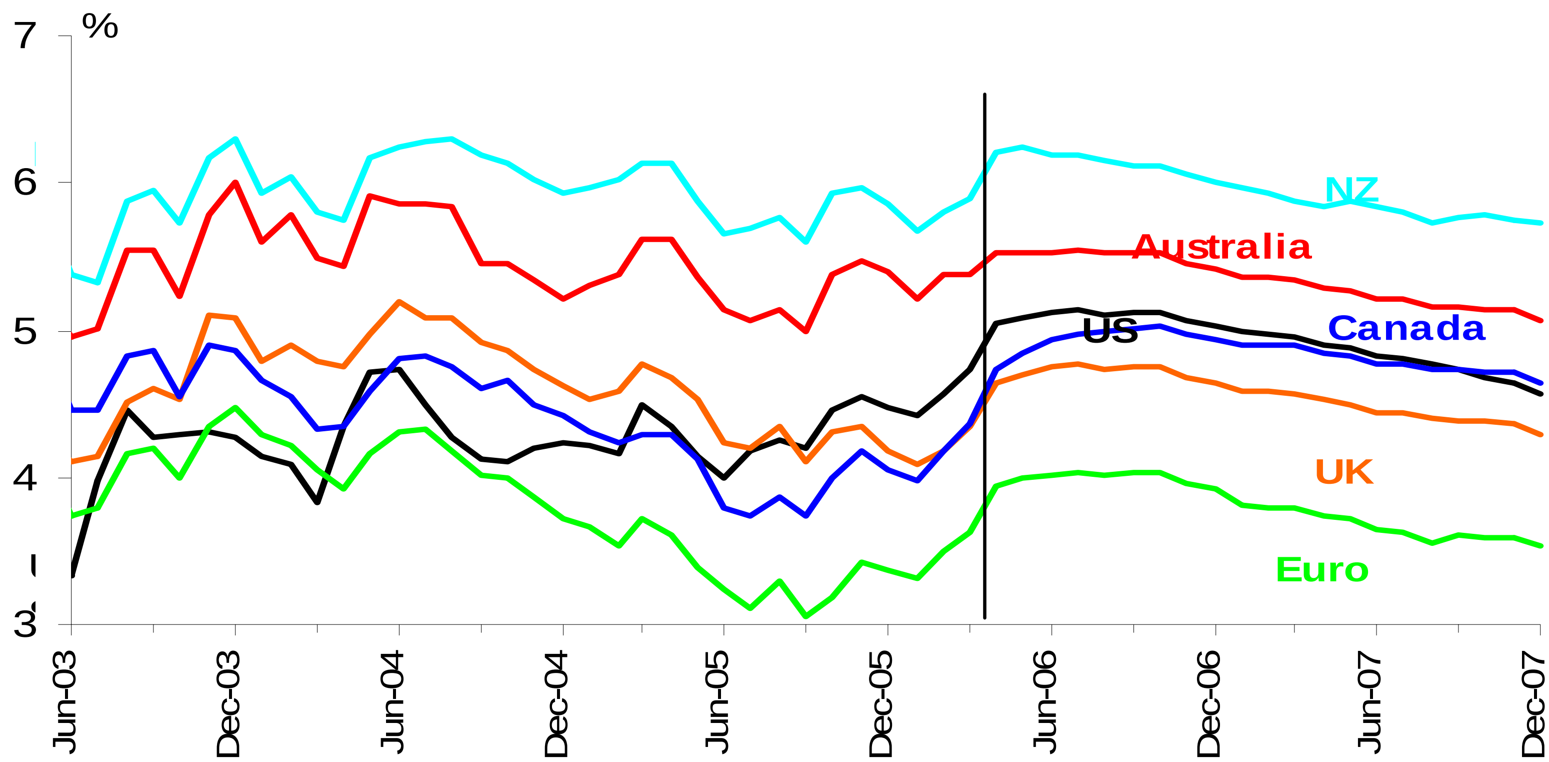
Rates ….our view

- We had previously been in the "unchanged" camp
- But faster start to 2006 and implied higher growth in domestic demand and inflation outcomes change this.
- Housing also showing new signs of life and credit strong
- Labour market outcomes and forecasts critical (employment & wages)
- Tax cuts – could also add to the mix
- Really need excellent inflation data to stop them going - together with no signs of accelerating wages

Rates ….our view

- If get good CPI data then probably 25 points in the next few months (say August)
- But if wages and/or CPI disappoints sooner (May not the base case but…..)
- We are not fully taking the strength of the Survey on board (assume some noise as well as signal) in our forecasts of domestic demand. If strength of the Survey was maintained (and domestic demand stayed at current levels) we would be looking at 25 points X 2.
- But that some time off yet and very data dependent.

At the longer end very much set by global factors.. US rates near their peak Aust also. Both ease back a touch as us economy slows and inflation goes lower. But our differentials to narrow



National Australia Bank