– JUNE 2018 INSIGHTS BY THE CURVE TEAM –

HIGHLIGHTS

- The RBA left the cash rate on hold again in June and continues to see a gradual move towards achieving its forecasts over the medium term.
- Short term rates have started to pick up again with the slowdown in broad money putting pressure on funding markets.
- The Australian economy continues to keep on keeping on as exports underpin a solid pick up in growth in Q1.
- Risks to the domestic outlook remain centred on the consumer with wages still the key metric to watch in the context of the outlook for interest rates.

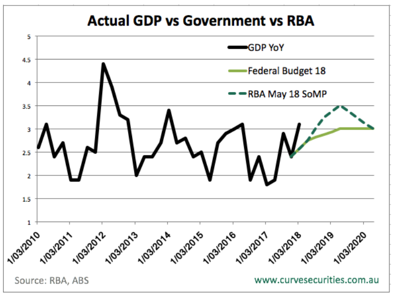
RATES RECAP

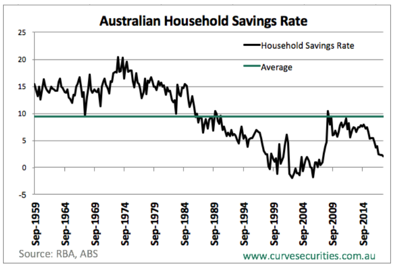
- The RBA left the cash rate on hold again in June with the cash rate remaining at 1.50% since August 2016.
- Market pricing continues to suggest the next move in the cash rate will be up. However expectations have been pushed out yet again and the hike is now not expected until to November 2019.
- Short end pressure on rates has picked up again with BBSW on the rise again under the new BBSW calculation methodology.
- Broad money growth has flatlined over the past 6 months which is contributing the tightness in funding markets.
- The long end of the curve has drifted higher again while the US curve is a little lower as uncertainty emanating from a number of areas around the globe grows.
- The Australian Dollar continue to trade within a relatively tight range and such is having minimal impact on the monetary policy outlook.
- The Fed remains the only central bank looking to lift rates in the near term and is expected to hike rates again this week.

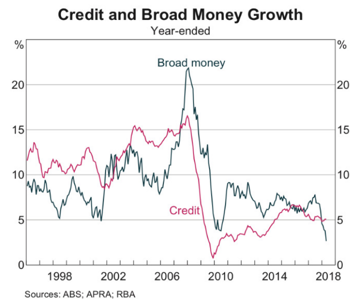
Key Market Moves

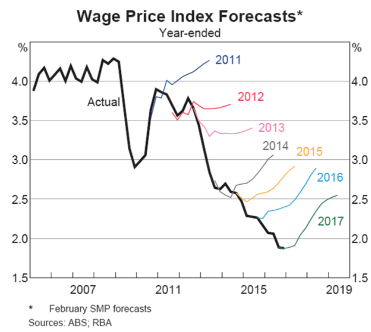
	Latest	1 Month Ago	Change
Cash Rate	1.50	1.50	0.00
3M BBSW	2.06	1.93	0.13
6M BBSW	2.17	2.04	0.13
1 Year Swap	2.01	1.93	0.08
3 Year Swap	2.25	2.24	0.01
5 Year Swap	2.62	2.62	0.01
3 Year Futures	2.24	2.20	0.03
10 Year Futures	2.80	2.80	0.01
AUD	0.76	0.75	0.01
ASX 200	6061	6116	-55
US 2 year	2.52	2.53	-0.01
US 10 year	2.95	2.97	-0.02
US 30 year	3.09	3.10	-0.01
USD Index	93.69	92.54	1.16
Dow Jones	25322	24831	491

CONSUMERS STILL POSE THREAT TO OUTLOOK









The Australian economy just keeps on keeping on. While the core engine of growth has evolved over time, the Australian economy has continued to grow. It has now extended its world record, which it took from the Netherlands last year. Our run without a technical recession is now into its 26th year.

Australia's growth rate accelerated in the first quarter as exports bounced back from the weaknesses seen late last year. The pick up in exports helped propel the growth for the first quarter to a gain of 1% which was ahead of estimates. It also helped lift the annual rate above 3%, slightly ahead of expectations and forecasts from the RBA and Treasury.

Exports accounted half of the 1% increase in the economy with public spending and a build in inventories also helping to boost the final number.

The one blight on the growth report care centred around what remains the biggest risk to the economy: the Consumer. The data continued to paint a picture of a consumer that is under pressure. Retail sales didn't add to GDP over the quarter with spending on services predominately responsible for the 0.2% increase in overall consumer activity.

The consumer remains the biggest component of the Australia economy and is still responsible for almost 60% of all activity. Currently the Australian economy is fortunate that other drivers of growth, such as exports and government spending, are making up for the lack of consumer activity. However over the long run, the economy needs a healthy consumer to underpin sustainable growth.

The problem in the headwinds for consumer are showing no signs of easing.

Even though consumption in the first quarter was quite soft, the savings rate still fell. A fall in savings at a time of weak consumption is a worrying sign. It also suggests that even if consumers wanted to lift spending, they don't have the capacity to do so.

If the consumer wants to increase their activity, they could always run down savings further to boost consumption. During the 2000's we even saw the savings rate turn negative briefly as consumers had the availability of credit and propensity to borrow. Both of those preconditions don't really exist in the current environment.

Borrowing is likely to become harder over the coming months. The impact of regulatory changes put in place to curtail lending to some areas of the economy and the impact of the royal commission have been widely publicised. What isn't as apparent is the fact that funding is becoming harder to come by.

You only need to take a look at the growth rate of broad money to understand one of the reasons why bank funding has become harder to source. The RBA defines broad money as *"currency plus ADI deposits from the non-AFI private sector, plus other short-term liquid AFI liabilities held by the non-AFI private sector."*

Broad money hasn't grown in the past 6 months and the annual rate of growth has plummeted. If growth within the system is not there then banks could source funds offshore. The problem there is that the US Treasury is currently crowding out one of the key markets for offshore funding. Interest rate spreads with the US have also made it less attractive to allocate funds to Australia for offshore investors.

The other way in which consumers can lift consumption is though higher wage growth. Both the RBA and Treasury expect wages to grow strongly over their respective forecast periods. This in turn is expected to lift consumption and underpin sustainable growth. The problem is neither have a good track record of forecasting wage growth. The chart showing the RBA's previous forecasts shows how good their track record is. The Treasury's track record is very similar.

What all this suggests is that consumer is likely be the biggest headwind to Australia's long term growth profile and continue to pose the biggest risk to the RBA's forecasts. That is also before any negative impacts from a pull back in the housing and subsequent wealth effects are considered.

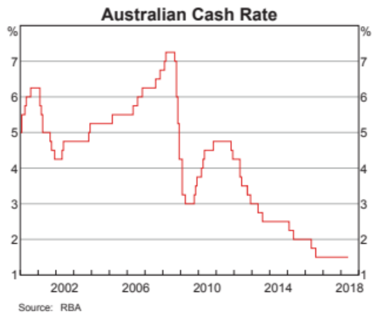
This is why the RBA continues to highlight this risk to the outlook in their communiques.

OUTLOOK FOR INTEREST RATES

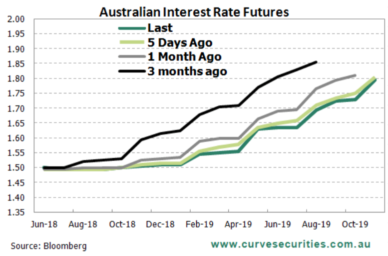
The RBA continues to makes its stance on the outlook for monetary policy crystal clear. After leaving their forecasts largely unchanged on the May Quarterly Statement on Monetary Policy, they also held rates steady at their June Board meeting. The standard conclusion to their accompanying statement, that we have become accustomed to continue to, read:

> *"The low level of interest rates is continuing to support the Australian economy. Further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual. Taking account of the*

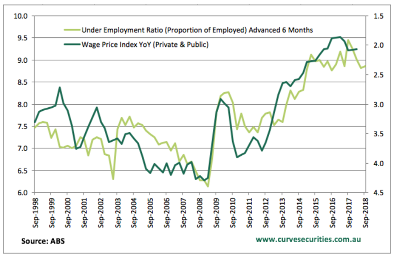
> *available information, the Board judged that holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time."*



In a time of growing uncertainty, mostly stemming from offshore developments, the RBA wants to be seen as a source of stability and confidence. The message here, when seen through the context of their forecasts, is that rates are expected to remain on hold for some time. However they do repeatedly tell us that the next move is likely to be up.



The current market pricing reflects what the RBA has been telling us. While the market has remained circumspect about the prospects of when we will actually see that move higher, many major economists over the past month or two have revised their expectations and generally pushed back calls for a rate hike into 2019 and beyond.



Markets expectations for the a move higher in the cash rate has gone from May 2019 three months ago, then August 2019 last month, to now be fully priced for November 2019. A number of economists actually now expect no move up in the cash rate until 2010 at the earliest. Depending on how much weight you place on the risks to the outlook from the cosnumer, you could argue that the outlook for the next move being up or down is evenly balanced.

With other drivers of the economy, such as exports and government spending, expected to prop up growth over the months ahead, it is unlikely that the RBA will make any changes to their rhetoric anytime soon. The key is how the risks, most notably the consumer, evolve as fresh data is released.

The key metric to watch remains wage growth. Without a pick up in wage growth, the RBA is unlikely to shift their current stance on the outlook. However, if we see growing weakness from the consumer sector then we could see the outlook become more balanced.

AUSTRALIAN ECONOMIC HIGHLIGHTS

- **Growth** for Q4 came in at 0.4%, short of both the market and RBA's expectations. The economy grew just 0.4% in Q4 which saw the annual rate slow to 2.4% from an upwardly revised 2.9% last quarter.
- **CPI** was largely in line with estimates in the first quarter. While the annual rate of headline inflation was unchanged, the core rate edged higher thanks to revisions to previous quarters. It has the RBA suggesting core inflation has bottomed for this cycle.
- After a weak run over the past few months employment growth return in April. The **Employment data** showed total growth of 22,600 which was nearly spot on estimates. However the number of new jobs wasn't enough to offset the

growth in the labour force which saw the unemployment rate rise to 5.6%.

- After falling for three straight months the **ANZ job ads** report posted a solid bounce in May. Jobs ads were 1.5% higher over the months.
- The **NAB business conditions** index pulled back from its all time high of 21 in May with the index falling back to 15. Profitability, trading conditions and the employment index were all down. The **Business confidence** also eased back with the index back at its long run average of 6 from 11 the previous month.
- **Consumer confidence** slipped a little again in May but managed to hold above the key 100 level. The survey period straddled the release of the budget. Confidence was set to fall a little further but the budget was positively received, largely due to the announcement of tax cuts.
- After a soft first quarter, **Retail sales** improved a little in April. Total sales rose 0.4%, just ahead of estimates but the volatility amongst the components means it is too early to tell if discretionary spending set to pick up.
- **Housing finance** was generally softer again in April following the collapse in investor finance in March. Investor finance was down again in April with a small fall in value of loans. The number of loans to owner occupiers was also down while the volume of owner occupier loans was slightly higher.
- Australia's **trade** balance has gone from strength to strength throughout the first quarter. After solid results in January and February, the trade surplus rose to $1.5bln in March. Net exports are expected to boost growth in the first quarter.
- **Building approvals** continued with their run of more stable month to month changes in April. While total approvals were down 5%, private house approvals continue to trend higher with the recent fall in house prices not yet impacting on approval levels.

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