– NOVEMBER 2016 INSIGHTS BY THE CURVE TEAM –

HIGHLIGHTS

- The RBA left the cash rate on hold again in November at 1.50% after cutting by 0.25% in May and August.
- November's quarterly Statement on Monetary Policy saw the RBA's forecasts remain largely unchanged.
- Post US Presidential Election volatility or uncertainty appears to be the last hurdle for an FOMC December rate hike.
- There are growing signs that we have hit the bottom of the easing cycle, notwithstanding a major economic shock here or abroad.

RATES RECAP

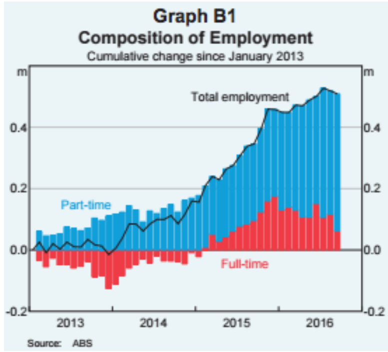
- The RBA left the cash rate on hold in November after lowering it at both the May and August meetings.
- This suggested there would be little change to the RBA's forecasts in the upcoming November quarterly Statement on Monetary Policy.
- The statement also suggested that if the economy evolved as the RBA expected there would be little case to lower the cash rate further.
- While most cash rates globally have remained steady, longer term rates are starting to rise.
- US Treasuries have led the way higher and have taken the Australian market with it.
- The only hurdle that remains for the FOMC to hike rates in December is excessive market volatility following the US Presidential election.

Key Market Moves

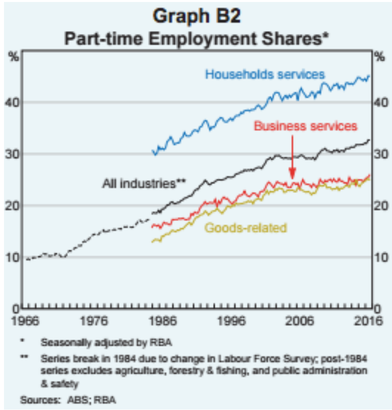
	Latest	1 Month Ago	Change
Cash Rate	1.50	1.50	0.00
3M BBSW	1.74	1.73	0.01
6M BBSW	1.97	1.94	0.03
1 Year Swap	1.73	1.69	0.04
3 Year Swap	1.76	1.69	0.07
5 Year Swap	2.04	1.97	0.07
3 Year Futures	1.62	1.53	0.09
10 Year Futures	2.16	1.98	0.17
AUD	0.76	0.76	0.00
ASX 200	5472	5339	132
US 2 year	0.83	0.78	0.05
US 10 year	1.72	1.67	0.04
US 30 year	2.45	2.39	0.06
Dow Jones	18240	18085	155

RBA ADDRESSES EMPLOYMENT TRENDS

The cyclical and structural shift in Australia's economy has been widely documented over the course of 2016. The softness in month-to-month employment outcomes against the downtrend in the unemployment rate has been difficult to reconcile for the casual observer and economists alike.

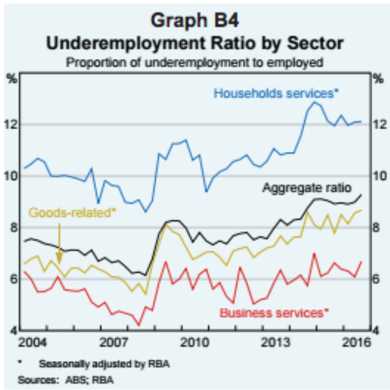


In their quarterly Statement on Monetary Policy the RBA addressed this very issue. The main reason for this extra level of detail is the direct linkage that employment conditions have with inflation and in turn, the setting of monetary policy. The RBA openly stated in the document that a *"degree of spare capacity remains in the labour market."*



The development in the employment market was significant enough for the RBA to devote additional airtime to it, including it as one of three deeper analysis pieces it included this quarter. One of the biggest developments in the employment market has been the predominance of part time employment growth to which the RBA said:

> *Part-time work has accounted for all of the increase in employment since the beginning of the year and more than two-thirds of the increase since 2013 (Graph B1). Over the longer run, the share of part-time employment has increased steadily to be around one-third of total employment, compared with 10 per cent in the mid 1960s (Graph B2).*



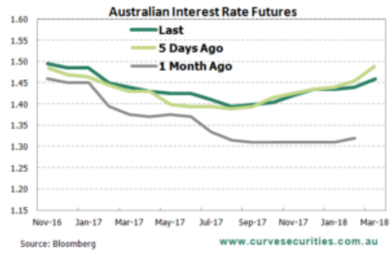
The RBA was quick to point out that this development has both supply and demand contributors. That is, there is greater demand for part time work thanks to the rise of dual income households. This trend has been underway for some time and hasn't accelerated all of a sudden. Rather the RBA points towards the demand side of the equation:

> *"While the unemployment rate has declined over the past year, the underemployment rate – which captures the share of employed people who want and are available to work additional hours – has remained elevated (Graph B4). This suggests that the recent strength in part-time employment is more likely to have been driven by weakness in labour demand than changes in employee preferences."*

The weakness in labour demand has been one of the big contributing factors in the lack of wage pressures in the economy for some time. Wage growth is currently at its lowest point since data collection on wages begun over 20 years ago.

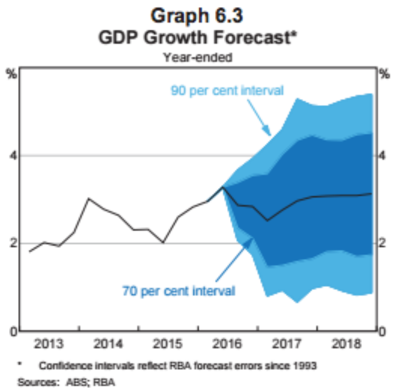
How the employment situation continues to evolve will be of great concern for the RBA given the linkage between wage pressures and inflation.

OUTLOOK FOR INTEREST RATES



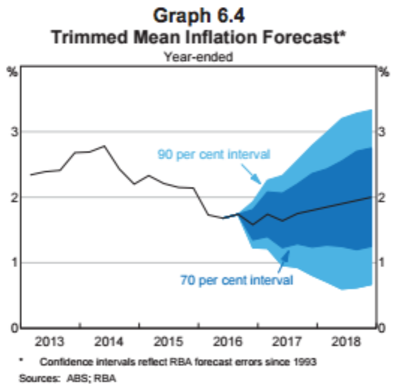
Going by the accompanying statement from the RBA's November Board meeting, the outlook for monetary policy and interest rates should be quite straightforward. Towards the end of the accompanying statement, Governor Lowe, in reference to the upcoming Statement on Monetary Policy said that:

> "The Bank's forecasts for output growth and inflation are little changed from those of three months ago. Over the next year, the economy is forecast to grow at close to its potential rate, before gradually strengthening. Inflation is expected to pick up gradually over the next two years".



One of the assumptions is that the cash rate moves broadly inline with market expectations. As always though, that is not a commitment of the RBA to follow that path. At the time that the forecasts were put together the market has less that a 50/50 chance priced in that the RBA would lower the cash rate any time before early 2018. From that, the conclusion could be drawn that the easing cycle is done and dusted.

Absent any significant economic shock, either here or abroad, then that scenario is easily plausible. The problem is that there is considerable uncertainty around those forecasts. Looking at the RBA's own confidence intervals around their forecasts and its is easy to see how large the range of possible outcomes are.



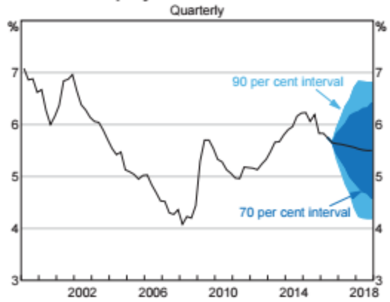
The key to the outlook still revolves around inflation. Parts of the inflation equation we cannot control. Things like the price of oil, which has such a large impact on headline inflation, is something that is hard to predict, let alone come up with an accurate forecast.

Other factors can have a more predictable impact on inflation. That is why it was very timely for the RBA to take a deeper look at the underlying trends in the employment market. More importantly, it was the discussion around the slack in the workforce that the trend towards part time employment is creating.

The larger degree of slack than the unemployment rate suggests there is, will result in a lag between a pick up in employment demand and a substantial increase in wage pressure. With wage pressures expected to remain low, there is reduced risk that underlying inflation with pick up noticeably over the RBA's forecast horizon. This in turn means that the RBA will be able to allow the Australian economy to run a little hotter than it otherwise would before having to worry too much about inflation. So while the bottom of the cycle could be now behind us, any potential move higher in the

cash rate could still be some way off yet.

Graph 6.5
Unemployment Rate Forecast*
Quarterly



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

AUSTRALIAN ECONOMIC HIGHLIGHTS

- **Growth** just missed expectations in Q2 with **GDP** rising by 0.5%, down from 1.0% in Q1. Despite the slowing on a quarterly basis, the annual rate still improved from a revised 3.0% to 3.3%.
- **CPI** was a little mixed in Q3. Headline inflation was up 0.7% ahead of expectation of 0.5% which saw the annual rate lift from 1.0% to 1.3%. The RBA's preferred measure, core inflation, just missed expectations, rising by 0.35% which saw the annual rate edge lower by 0.1% to 1.5%.
- The **employment data** disappointed again in September as the softer run throughout 2016 continued. Full time employment fell by 53k whilst part time employment rose by 43.2k. The unemployment rate actually fell to 5.6% after a slip in the participation rate to 64.5% from 64.7% recorded in August.
- **ANZ job ads** returned to a positive reading of 1.0% in October whilst the negative September reading was also revised up to a flat reading after initially recording a negative 0.3% print.
- **NAB business conditions** index slipped in October with the index dropping 2 points from 8 to 6 while **Business confidence** was also 2 points weaker at 4. In a worrying sign the employment index fell again to 0 as did forward orders.
- **Consumer confidence** continued to print above the key 100 level in October. The index posted a solid increase of 1.1%, taking it to 102.4 with optimists continuing to marginally outweigh pessimists.
- **Retail sales** continued to bounce back to life in September with total sales growing by 0.6% for the month following the solid reading in August which was revised up to 0.5% from 0.4%. Both of these prints are the largest increases in retail sales since January this year and comes on the back of almost no growth in the preceding three months. However inflation adjusted retail sales actually fell for the third quarter, down 0.1%.
- **Housing finance** was softer in August. The number of owner-occupier loans were down 3.0% with the value of occupier loans falling 1.6% while investor lending was largely

flat, up 0.1%.

- Australia's **trade deficit** continued to improve substantially for the third straight month in September. The deficit printed at $1.227 billion which was far smaller than the expected $1.7 billion deficit. Improving primary export prices including iron ore and coking coal did most of the heavy lifting as demand from our primary export partners continued to recover.
- **Building approvals** disappointed in September recording a fall of 8.7% against an expected fall of 3.0%. The September reading puts the annual rate of building approvals at negative 6.4% suggesting that the upswing in construction activity may be slowing.
- **Motor vehicle sales** were up in September, growing by 2.5%. The solid reading was not enough to have a significant effect on the annual increase, which is only up 0.8% from twelve months ago.

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