– JULY 2018 INSIGHTS BY THE CURVE TEAM –

HIGHLIGHTS

- The RBA left the cash rate on hold again in July and continues to see a gradual move towards achieving its forecasts over the medium term.
- Short term rates have remained elevated with the slowdown in broad money putting pressure on funding markets.
- Financial institutions are starting to pass the increase in funding costs onto borrowers by lifting mortgage rates.
- The increase in funding costs and high mortgage rates are impacting the outlook for monetary policy.

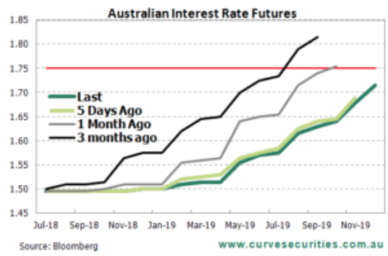
RATES RECAP

- The RBA left the cash rate on hold again in July with the cash rate remaining at 1.50% since August 2016.
- The RBA continues to suggest the next move in the cash rate will be up. However market pricing for a hike continues to fall and a hike isn't fully priced for 2018 or 2019.
- There is more than just the RBA's economic outlook impacting the expectations for the timing of a change in the cash rate
- Short end pressure on rates has continued, even as we move into the new financial year. While BBSW rates have eased back a few basis points pressure on funding costs remain elevated.
- Broad money growth has flatlined over the past 7 months which is contributing the tightness in funding markets.
- The Australian Dollar continue to trade within a relatively tight range and such is having minimal impact on the monetary policy outlook.
- The Fed lifted the Fed Funds rate in June as expected with the market still leaning towards two more this year.

Key Market Moves

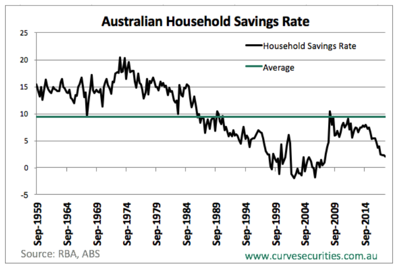
	Latest	1 Month Ago	Change
Cash Rate	1.50	1.50	0.00
3M BBSW	2.06	2.06	0.01
6M BBSW	2.19	2.16	0.03
1 Year Swap	2.04	2.01	0.04
3 Year Swap	2.17	2.24	-0.08
5 Year Swap	2.49	2.61	-0.12
3 Year Futures	2.07	2.22	-0.15
10 Year Futures	2.61	2.78	-0.17
AUD	0.75	0.76	-0.01
ASX 200	6284	6045	239
US 2 year	2.55	2.50	0.05
US 10 year	2.84	2.95	-0.11
US 30 year	2.94	3.09	-0.15
USD Index	93.89	93.54	0.35
Dow Jones	24456	25317	-860

FUNDING MARKETS ARE IMPACTING THE OUTLOOK MONETARY POLICY



The RBA elected to leave the cash rate on hold in July, extending the record longest run of a stable cash rate. One things that has also remained quite stable in recent months has been the RBA's outlook, which it articulates in the accompanying statement to their interest rate decisions and their quarterly Statement's on Monetary policy.

Despite the RBA's desire to be seen as a source of stability and confidence, the markets expectations for the next move up in the cash rate have been slowly slipping over the past month. The market now has no move up in the cash rate fully priced in as far as the futures pricing goes, which is currently out to the end of 2019.

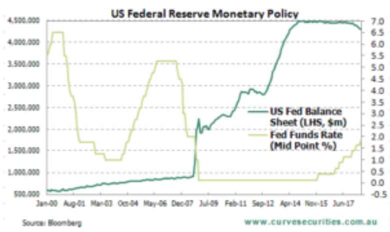


If the RBA's outlook hasn't changed, why has market pricing continued to fall over the past few months? Developments in funding markets just might have something to do with it.

Funding markets in Australia have been getting tighter throughout the course of 2018. There are a number of reasons for this tightening in funding markets but no one single development can be pointed to as the root cause.

Three of the key developments that sit at the centre of many of the theories revolve around:

- The US tax plan and the subsequent repatriation of funds back to the US.
- Normalisation of US monetary policy by lifting interest rates and quantitative tightening through the reduction of the Fed's balance sheet.
- The falling saving rate in Australia.

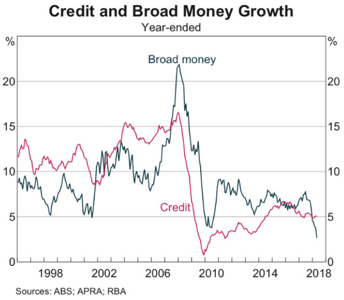


The combination of these and other factors has pushed up BBSW and deposit pricing as financial institutions in Australia fight for a bigger slice of the funding pie. That pie of available funding essentially stopped growing back in October according the RBA's measure of broad money.

This shift in funding markets give financial institutions in Australia two choices.

If they want to continue to lend they will have to fight for funding by lifting the rates they are willing to offer to attract funds. To be able to continue to lend at a profit, they will eventually have to pass that increase in funding costs on in the form of higher mortgage rates.

If they aren't willing to increase the rates, they are willing to offer to attract funding then they will have slow or stop lending. This will still require an increase in mortgage rates to discourage borrowing as well as passing on the increase cost of maintaining current funding.



We have already seen some institutions increase their mortgage rate due to increases in funding cost. So far we have seen the second tier banks along with some regionals and mutuals lift rates. The major banks have continued absorb the increase cost of funding but the can only last so long. The bad press from the Royal Commission would also be impacting their ability to lift mortgage rates out of cycle.

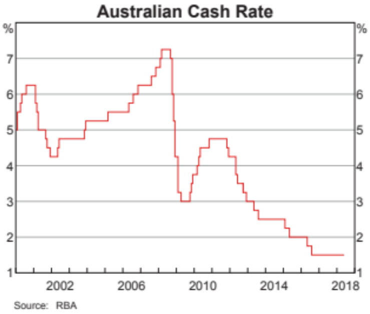
As a result, the increase in funding costs is impacting the outlook for interest rates in two ways.

One obvious implication is that if financial institutions are lifting mortgage rates out of cycle, there is less need for the RBA to increase interest rates should their central forecasts materialise as expected.

The other is that credit growth and economic growth usually go hand in hand. So falling credit growth will impact economic growth over time.

OUTLOOK FOR INTEREST RATES

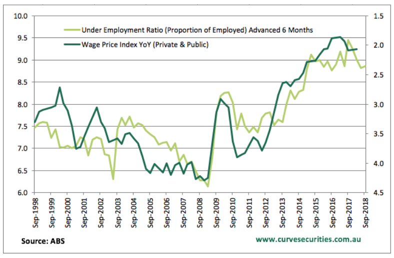
As far as the RBA is concerned, the outlook for monetary policy has not changed from a month ago. They still expect growth to pick up over the forecasts period. The pick up in growth is expected to underpin employment growth and eat into the slack in the labour force. The reduced slack in the labour force is then expected to drive up wages which in turn will lift inflation back to the target band.



Of course there are risk to their outlook and the RBA is open about those risks. According to their latest statement, the growing trade war represents the biggest risk to the global economy. Locally it is the consumer who poses the biggest risk due to record high debt levels and low wage growth.

It is the risk to the consumer that is still the biggest overall risk to the RBA's outlook. The combination of the record high debt levels and low wages poses the biggest threat to the outlook. As it stands, little progress is being made on one front and things look to be getting worse on the other.

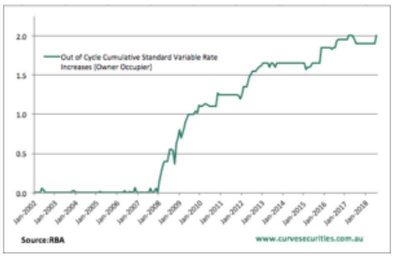
The RBA desperately want to see wage growth as it will negate many of the risks that the Australian economy currently faces. Increased wage growth will help underpin



consumption, which remains the biggest components of the economy, as well as help consumers reduce their elevated debt levels.

The problem is that wage growth seems a long way off at the moment. The unemployment rate remains stuck in the mid 5% region. More importantly, underemployment has been elevated to around 9% and showing little signs of falling.

Employment growth so far in 2018 has been underwhelming compared to the lofty levels of 2017. Forward indicators of employment, such as the NAB employment index and ANZ job ads series have both eased in recent times. Both suggest slower rates of employment growth over the months ahead and as such, a material fall in unemployment could take longer than the RBA expects.



The issue of excessive debt could start to become a real problem. While the RBA has been on hold for the best part of two years and is not expected to increases the cash rate anytime soon, a number of financial institutions are lifting rates out of cycle. Increased funding costs as outlined above are forcing these financial institutions to increase mortgage rates.

So far the increases have only been small but if funding costs remain elevated then we are likely to see more out of cycle increases. Add that to the large pipeline of loans that are set to switch form interest only to principle and interest over the coming years and households propensity to consumer is going to fall.

The RBA has openly stated that the risks associated with further cuts to the cash rate outweigh the prospective benefits so it is unlikely that the RBA to come to rescue. The question will be how long does it take for growing concerns over the household sector to filter through to their outlook.

AUSTRALIAN ECONOMIC HIGHLIGHTS

- **Growth** accelerated in the Q1 with the economy growing 1% while the previous quarter was revised up to 0.5%. Net exports did the bulk of the heavy lifting while investment and government spending also helped.
- **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.
- The pick up in April was short lived as The **Employment data** for was a little softer, in line with what we have seen so far in 2018 Total growth of 12,000 fell short of estimates. Despite the weak growth the unemployment rate fell 0.2%, drives by a fall in the participation rate. Underemployment remains elevated.
- After a bounce in May **ANZ job ads** report resumed its decline in June. Jobs ads were down 1.7%, more than offsetting last months revised 1.4% increase.

- The **NAB business conditions** and **Business confidence** indexes remained largely unchanged in June at 15 and 6 respectively. The unchanged headline conditions masks the changes in the sub components with profitability and trading conditions rising but the important employment index falling.
- **Consumer confidence** was largely unchanged in June with the index still hovering just above the key 100 level. Despite the 0.3% rise, the current level of the consumer confidence index continues to point to subdued consumer activity.
- After a welcomed bounce in April, **Retail sales** were up again in May, rising 0.4%. Food continues to be the main contributor to growth however a late arrival for winter helped clothing and department store sales. The discretionary spending bellwether, cafe and restaurant spending, was down 1%.
- **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 remained in surplus for the first two months of the second quarter with prints of $472m in April and $827 in May. Ironically, despite both Australia's imports and exports being at record highs, the smaller decline in the level of trade surplus so far this quarter means next exports will contribute far less to growth.
- **Building approvals** slipped for the second straight month with May's 3.2% decline adding to the revised 5.6% fall the previous month. Interestingly it was a sharp fall in private housing approvals which drove the decline this month.

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