– APRIL 2017 INSIGHTS BY THE CURVE TEAM –

HIGHLIGHTS

- The RBA once again elected to leave the cash rate on hold at 1.50% following their April Board meeting.
- The accompanying statement to the decision saw a less optimistic and more cautious outlook.
- New macro prudential lending oversights reduce upside risk to interest rates.
- While downside risks prevail, they could be offset by monetary policy divergence between the FOMC and the RBA.

RATES RECAP

- The RBA left the cash rate on hold yet again in April with the cash rate remaining at 1.50%.
- Governor Lowe and the RBA Board continue to expect growth to pick up and inflation to return to the target band over time.
- However the tone of the accompanying statement has started to soften and was far more cautious and less optimistic.
- The change of tone when combined with increase regulatory oversight on bank lending activity from the regulators has seen the market recalibrate its expectations for the cash rate.
- The FOMC hiked rates as expected and has flagged that there is more to come. They have also raised the possibility of balance sheet normalisation by the end of the year.
- Despite increased normalisation of monetary policy on the horizon in the US, the yield curve has flattened as concerns over the Trump administration's ability to get things done has grown following the failed attempt to get the healthcare bill through congress.

Key Market Moves

	Latest	1 Month Ago	Change
Cash Rate	1.50	1.50	0.00
3M BBSW	1.79	1.79	0.00
6M BBSW	1.99	2.00	-0.01
1 Year Swap	1.75	1.85	-0.09
3 Year Swap	1.92	2.19	-0.27
5 Year Swap	2.37	2.67	-0.31
3 Year Futures	1.82	2.07	-0.25
10 Year Futures	2.59	2.85	-0.26
AUD	0.75	0.76	-0.01
ASX 200	5853	5761	91
US 2 year	1.23	1.33	-0.10
US 10 year	2.31	2.52	-0.21
US 30 year	2.96	3.12	-0.16
USD Index	100.73	101.81	-1.08
Dow Jones	20663	20925	-262

MONETARY POLICY WORLDS APART

Developments over the past months have seen a further widening in the divergence of monetary policy outlooks between Australia and the US. The outlook for monetary policy in the US continues to evolve and it is likely to have a growing impact on Australia's setting of monetary policy.

As expected, the US FOMC followed through on the strong rhetoric in the lead up to their March meeting and lifted the Fed Funds Rate for the second time in four months. The economic situation continues to evolve in line with the FOMC members expectations and as such, warranted another adjustment to the calibration of monetary policy. The minutes stated that:

> *"Participants continued to anticipate that, with gradual adjustments in the stance of monetary policy, economic activity would expand at a moderate pace, labor market conditions would strengthen somewhat further, and inflation would stabilize around 2 percent over the medium term."*

It is clear that the FOMC is now far more comfortable with the trajectory of the US economy. This is even before any potential fiscal impact is announced or in train. As a result, we are likely to see further hikes over the months ahead as *"the Committee expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate."*

Further evidence of the FOMC's conviction to normalise monetary policy was the fact that the Federal Reserve's balance sheet was discussed at the latest meeting. The Fed's balance sheet ballooned from around $1 trillion prior to the GFC to around $4.5 trillion at present thanks to Quantitative Easing. According to the minutes, *"many participants emphasised that reducing the size of the balance sheet should be conducted in a passive and predictable manner."*

Since the meeting, a number of Fed members have been back on the speaking circuit. The consensus from those speeches so far is that if things evolve as expected, the FOMC revise its current maturity reinvestment strategy by year end. This would be the second stage of the normalisation process, which would see excess liquidity be slowly drained from the global financial system.

At the same time, it is becoming apparent the RBA is heading in the opposite direction. Ahead of the RBA's April meeting there was an evenly weighted debate on the future direction of interest rates in Australia. There were suggestions that the RBA should be lifting rates to reign in excesses accumulating in the housing market, threatening financial stability and the long term health of the economy.

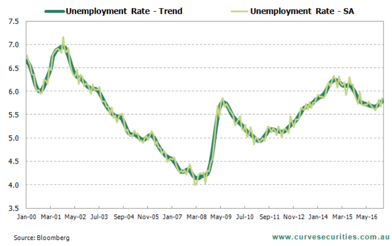
Ahead of the meeting APRA, at the direction of the Council of Financial Regulators, headed by RBA Governor Philip Lowe, announced another round of macro-prudential oversight for the banks around lending practices and standards. The latest round, while once again focusing on investor activity, also zeros in on interest only lending, a segment that is booming.

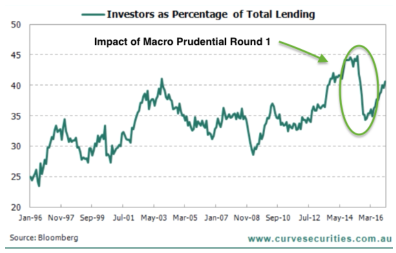
The first round of macro prudential regulatory intervention was largely negated by two further rate cuts from the RBA. This time around, the measures should have a more profound impact on activity. If not, expect more stringent measures to be announced in due course.

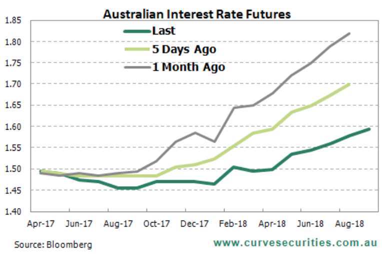
The announcement effectively nullifies the rationale for imminent rate hikes by the RBA, something that was reflected in the statement following the April RBA Board meeting. While concerns around the housing market had eased following the new regulatory announcement, concerns over the outlook for the economy, most noticeably the employment market were more acute.

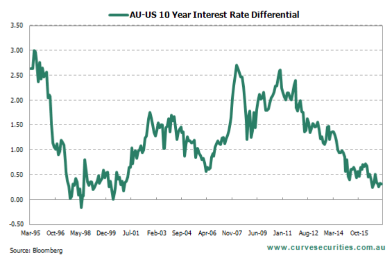
What we are left with is one central bank lifting interest rates and looking to normalise its balance sheet while another is facing growing downside risks to its outlook for monetary policy.

OUTLOOK FOR INTEREST RATES









Last Tuesday saw a subtle shift in the RBA's outlook. The shift wasn't just evident in the accompanying statement but also in the Governor's speech that followed Tuesday evening.

With the announcement of new macro prudential rules ahead of the meeting, the RBA appeared more comfortable with the concerns around financial stability that had been intensifying in recent months.

With less emphasis devoted to the risks around the housing market, the RBA's concerns around the downside risks were far more evident. The language around the employment market was the most noticeable shift with the statement saying:

> *"some indicators of conditions in the labour market have softened recently. In particular, the unemployment rate has moved a little higher and employment growth is modest."*

The enduring weakness in the employment market is directly impacting wage outcomes with wage growth languishing at multi-decade lows. This is having a continued flow on effect to wages with the RBA noting that *"the rise in underlying inflation is expected to be a bit more gradual with growth in labour costs remaining subdued."*

With the macro prudential measures designed to reduce risk around housing, these growing downside risks have seen the market reprice their expectations of a rate hike from the RBA. Only a month ago, the market had a hike priced in for early next year. The market now expected very little movement in the cash rate for the foreseeable future. The balance of the interest rate debate may have even swung to those calling for cuts.

This is where the divergence amongst US and Australian monetary policy outlooks could have a significant bearing on the outlook for interest rates. If the FOMC continues to lift rates throughout 2017 and into 2018 we will see the Australian-US interest rate differential turn negative.

The FOMC is only three rate hikes away from the lower bound of their target rate drawing level with our own cash rate. This could occur as soon as the last quarter of this year. The interest rate differential is even less at the 10 year part of the curve.

If this does occur, then all other things being equal, we should see the AUD come under significant pressure, easing the overall setting of monetary policy in the process. This would help to offset some of the downside risks mentioned above.

This gives the RBA the luxury of time. Time to see how the risks to financial stability emanating from the housing market, time to assess how the downside risks to the employment market and inflation evolve over the months ahead. All of which mean the cash rate is likely to remain unchanged for some time yet.

AUSTRALIAN ECONOMIC HIGHLIGHTS

- **Growth** bounced back in Q4 with **GDP** rising by 1.1% for the quarter. The pick up in growth saw the annual rate of growth rise to 2.4%, ahead of the RBA's forecasts. The improvement in some sectors could prove unsustainable, casting a cloud over the outlook for growth.
- **CPI** was soft again in Q4. Headline inflation was up 0.5%, short of the 0.7% rise that was expected. The quarterly increase was still enough to lift the annual rate from 1.3% to 1.5%. The RBA's preferred measure, core inflation, just missed expectations, rising by 0.4% which saw the annual remain largely unchanged at 1.5%.
- The **employment data** remained soft in February with total employment falling 6,400 after a modest gain was expected. The swing between full and part time went against with trend while the unemployment rate edged up a further 0.2% to 5.9%. The recent weakness in the data has seen the trend unemployment rates start to turn higher which is a worrying sign.
- **ANZ job ads** were soft again in March, posting a moderate gain of 0.3% after last months decline of 0.7%.
- The NAB survey gave back the previous months bounce in February. The **NAB business conditions** bounced back after last month's sharp decline with the index lifting 5 points to 14, largely due to a rebound in trading conditions. **Business confidence** on the other hand remains subdued in comparison, slipping 1 point to 6.
- **Consumer confidence** printed below the key 100 level for the fourth straight month in March as consumers remain cautious on their own finances, especially compared to a year ago even after two rate cuts last year.
- **Retail sales** are starting to suffer as a result of consumers lack of confidence in their own finances. Retail sales were down 0.1% in February while the trend monthly change has slowed from 0.4% to just 0.1% over the past six months.
- **Housing finance** collapsed in February driven by investors. The number of owner-occupier loans and the value of occupier loans were both down 0.5%. The value of investor lending was down 5.9%, more than offsetting the 4.6% increase the previous month.

- Australia's **trade surplus** bounced back as expected in February after January's unexpected decline. The drivers were disappointing with the bounce due to a sharp fall in imports (-5%) rather than exports picking back up. Driving the fall was a 10% decline consumption goods imports, another sign consumption is waning.
- **Building approvals** posted an unexpected rise in February with both private housing and medium density approvals up over the month. The trend still points to lower approvals ahead with the annual rate still negative.
- In yet another sign consumption is struggling, **Motor vehicle sales** fell sharply in February. The 2.7% decline was broad base with all categories seeing sales fall over the month with total sales now down 4.1% on a year ago.

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