AUGUST 2019 INSIGHTS

How low can the RBA go?

HIGHLIGHTS

- The RBA left the cash rate on hold at 1.00% in August as was widely expected after lowering it by 25bp in June and July.
- Rates globally have continued to fall with a number of other central banks cutting rates the past months, which has seen yield curves flatten significantly.
- We got a number of updates from the RBA the past week that both provided clarity over the near term outlook but posed more questions over the long term outlook.
- It is clear more monetary policy easing is coming but what form it takes is open to debate.

RATES RECAP

- After lowering the cash rate 25bp in June and July, the RBA left the cash rate on hold at a new low of 1.00%.
- Risk remain to the downside as the global outlook deteriorates and domestic demand remains weak. This has seen the RBA retain an easing bias .
- However Governor Lowe in his testimony to parliament last week did suggest that the economy could be in the midst of a "gentle turning point".
- That hasn't stopped them assessing potential unconventional monetary policy tools should a scenario arise that would require such action.

Key Market Moves

	Latest	1 Month Ago	Change
Cash Rate	1.00	1.00	0.00
3M BBSW	0.97	1.13	-0.16
6M BBSW	0.96	1.17	-0.21
1 Year Swap	0.76	1.03	-0.26
3 Year Swap	0.68	1.03	-0.35
5 Year Swap	0.81	1.24	-0.43
3 Year Futures	0.63	0.96	-0.33
10 Year Futures	0.91	1.44	-0.53
AUD	0.68	0.70	-0.03
ASX 200	6590	6697	-106
US 2 year	1.58	1.85	-0.26
US 10 year	1.65	2.12	-0.48
US 30 year	2.13	2.65	-0.51
USD Index	97.38	96.81	0.57
Dow Jones	25898	27332	-1434

- While the cash rate remained on hold, the past month has seen yield curves both here and abroad flatten dramatically as central banks cut rates or indicated looser monetary policy was likely over the months ahead.
- Much of the outlook, especially from a global perspective hinges on the outcome of the trade war which is becoming increasingly intractable and likely to drag out for some time.

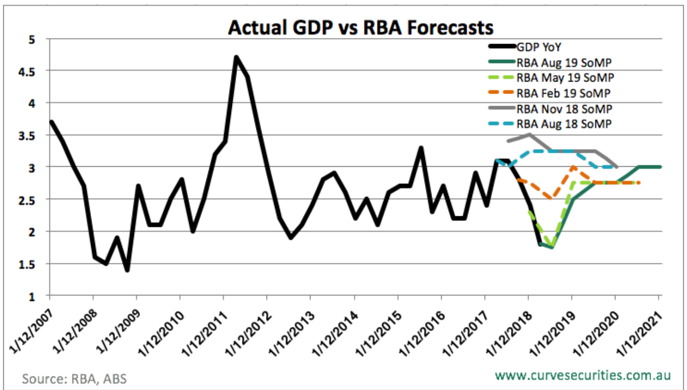
HOW LOW CAN THE RBA GO?

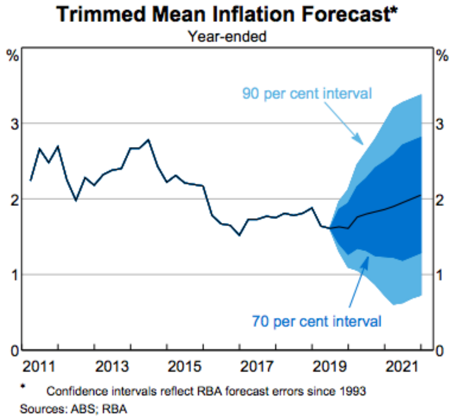
The RBA's recent about face on their assessment of the employment market and subsequent two rate cuts has fuelled a great deal of uncertainty over what the outlook may hold. Further complicating the outlook for monetary policy is the deteriorating global outlook, primarily driven by geopolitical uncertainty, which is in turn undermining economic activity.

Last week provided the RBA with the perfect platform in which to address the growing uncertainty over the outlook and provide some clarity on what the future for monetary policy may look like.

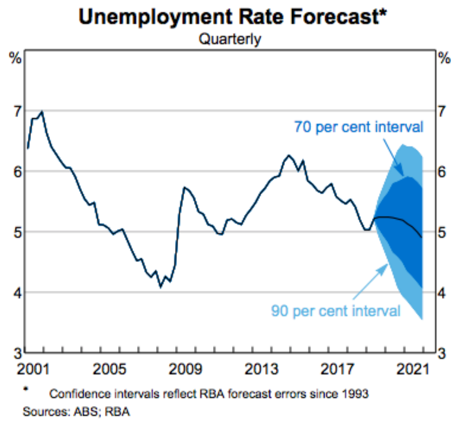
On Tuesday the RBA Board met and left the cash rate on hold as was widely expected following successive rate cuts the prior two months. The accompanying statement highlighted the risks to the outlook, both stemming from domestic and international factors. It also gave some insight to the revised forecasts to be released by the RBA a few days later; however, the RBA closed the statement by saying:

"It is reasonable to expect that an extended period of low interest rates will be required in Australia to make progress in reducing unemployment and achieve more assured progress towards the inflation target. The Board will continue to monitor developments in the labour market closely and ease monetary policy further if needed to support sustainable growth in the economy and the achievement of the inflation target over time."





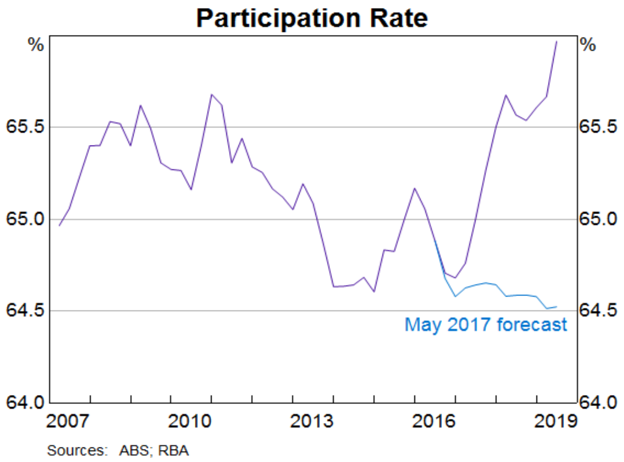
Prior to the release of the Quarterly Statement on Monetary Policy, Governor Lowe and other members of the RBA Board headed to Canberra for their semi-annual testimony to the House of Representatives Standing Committee on Economics. There was plenty for the RBA Governor to cover in his opening statement given the substantial shift in the outlook and adjustments to policy in the intervening six months since his last testimony.



In walking the committee through the RBA's updated central scenario, Governor Lowe said that *"looking ahead, there are signs the economy may have reached a gentle turning point."* He then added more detail to what he meant by turning point, adding that:

"This outlook is supported by a number of developments including: lower interest rates, the recent tax cuts, a

depreciation of the Australian dollar, a brighter outlook for investment in the resources sector, some stabilisation of the housing market and ongoing high levels of investment in infrastructure. It is reasonable to expect that, together, these factors will see growth in the Australian economy return to around its trend rate next year."

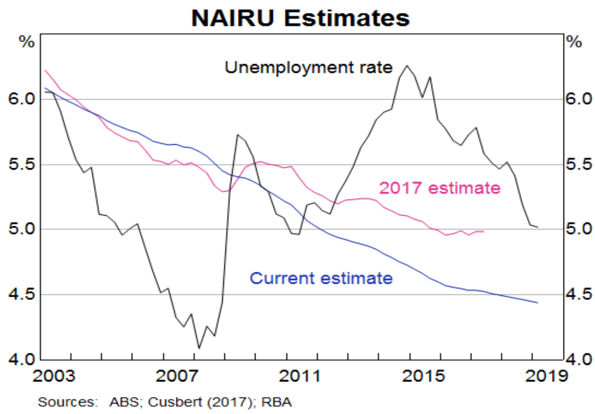


Following his opening remarks and while the Q&A session continued, the RBA released their Quarterly Statement on Monetary Policy. The Statement contained the RBA's revised forecasts all the way out to the end of 2021.

As the RBA had eluded to in the lead up to the Statement being released, the RBA actually lifted their expectations for growth over the medium term, despite the expectations that growth will remain a little softer over the near term. According to their forecasts, growth will improve to be above trend and hit an annual rate of 3% by June 2021.

However weakness over the near term has had ramifications for other components of the forecasts. After a recent increase in the unemployment rate, it is now expected to plateau at around 5.25% over the next couple of years before drifting down to 5% as growth increases above trend. Given the RBA's revised assessment of full employment, spare capacity in the labour force is going to remain higher for longer.

This in turn means that expectations around the path of inflation have been revised down. With spare capacity in the labour force remaining prevalent for longer than expected due to the labour market supply side response, the conditions required to lift wages are going to take longer to materialise.



As has been the case for some time, these forecasts are made on a number of assumptions. The RBA stated that the "technical assumptions set on August 7 include the cash rate moving in line with market pricing". The RBA also outlined just what market pricing was suggesting with the Statement saying:

"Current market pricing implies one 25 basis point cut in the cash rate by the end of this year, to 0.75 per cent, and a further 25 basis point cut in the first half of 2020."

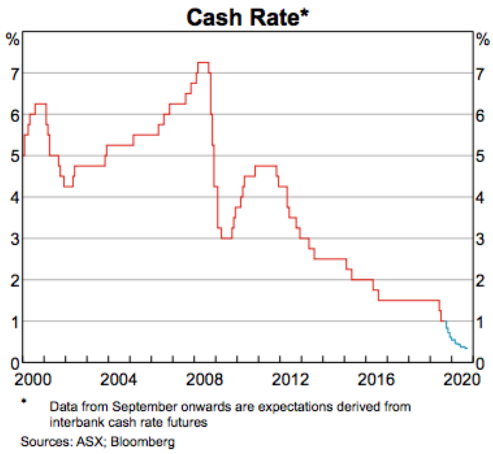
The assumption of two further rate cuts goes some way to rationalising the uplift in the growth profile in the RBA's forecasts.

However, even with two further rate cuts, the unemployment rate is still expected to be 0.5% above the updated assessment of full employment, or NAIRU, and both headline and core inflation are only expected to get back to 2% over the forecast period. That leaves the RBA with very little margin of error.

It also suggests that there is a distinct possibly that further monetary policy that is currently included in the RBA's assumptions will be required. It is at that point, that we enter the realm of uncertainty once again as the RBA lurches towards the zero lower bound.

OUTLOOK FOR INTEREST RATES

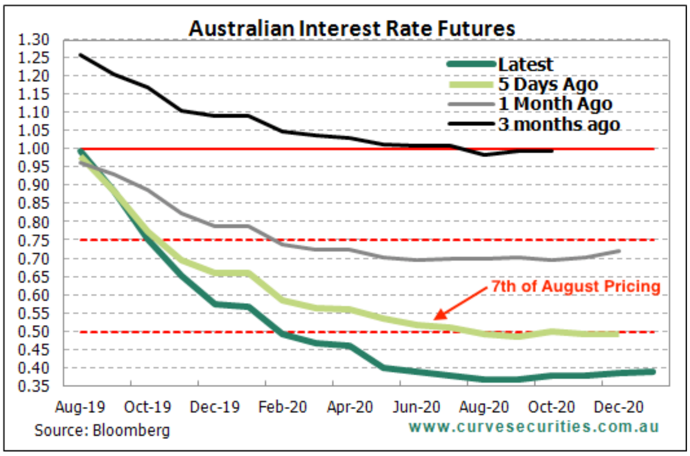
The latest series of updates gave some clarity on the outlook for monetary policy over the near term; however, it also created greater uncertainty over the long run outlook for monetary policy.



Over the near term, the RBA's forecasts make it pretty clear that we are going to see a more accommodative monetary policy setting. While the assumptions underpinning their forecasts suggests two more cuts to the cash rate, the timing of further moves are still a little uncertain. Market pricing at the time the assumptions were made suggested one cut by year end and a follow up in the first half of next year.

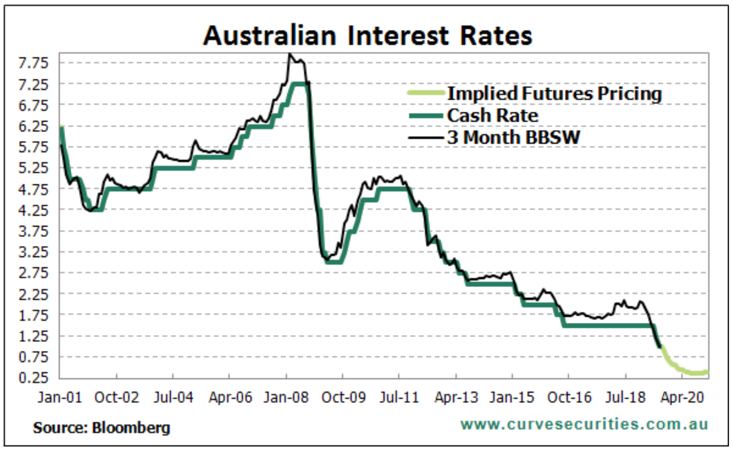
With the RBA making a swift adjustment to policy based on their reassessment around what constituted full employment, they may elect to move more slowly as they get closer to the zero lower bound. That means we could see them revert back to quarterly moves coinciding with the release of their Quarterly Statement on Monetary Policy.

This gives them the platform to outline the decision in more detail and greater transparency. However, Governor Lowe in his near 3 years at the helm of the RBA has time and time again proved that he does things a little differently.

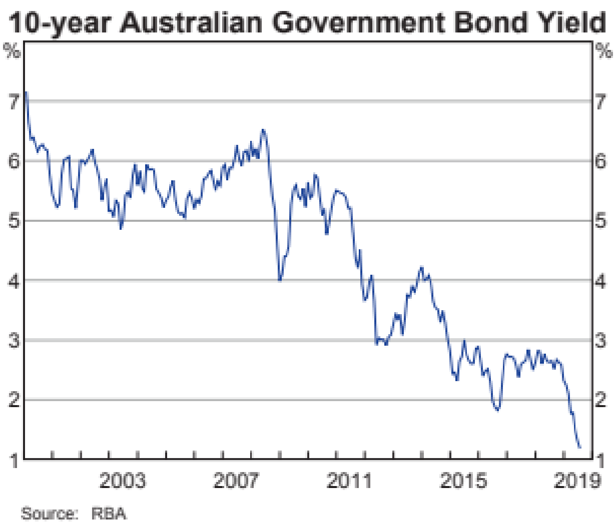


As has been highlighted by the RBA repeatedly, employment outcomes are the key barometer, by which they are currently assessing the effectiveness of monetary policy. So I expect that timing of any subsequent moves will be driven by labour market developments and the unemployment rate.

Beyond two further rate cuts, which would take the cash rate to 0.5%, the outlook for monetary policy is a little more uncertain.



The RBA continue to emphasise in detail, that risks to the outlook remain tilted to the downside. Given the small margin of error in the RBA's forecasts, it begs the question of what would be the RBA's next move if two more rate cuts weren't enough.



In the Q&A session following his opening statement to parliament, Governor Lowe went into considerable detail on what could be done in the event that the RBA is required to go beyond current market expectations.

When questioned by the Committee, Lowe said "We are prepared to do unconventional things if the circumstances warranted it." However he stressed, that in a situation that would warrant such action, he would hope to receive support in the form of fiscal support and policy reform in order to support the economy.

The committee then pushed him further on the concept of unconventional policy and at what point in time would this be likely to be called upon. His response was:

" *If we're talking about QE as being the central bank purchasing government securities— which I think in the Australian context is the most likely form it would take—in principle, we could do that at any level of interest rate and principal."*

Importantly, he then said:

"I think it's reasonable to expect that we wouldn't do it at the current level of interest rate, or even a bit below the current level of interest rate. We'd need to be very close to zero to do that."

So it isn't out of the realm of possibility that the RBA is forced to take the cash rate to the lower bound and then turn to *"unconventional policy"* to support the economy. Let's hope that the RBA is right and we have reached a *"gentle turning point"* for the economy as the alternative is not a scenario we want to face.

AUSTRALIAN ECONOMIC HIGHLIGHTS

- Growth fell short of estimates again in Q1 with the economy only growing by 0.4% as the weakness from the second half of 2018 spilled into the start of 2019. The annual pace of growth slowed further from 2.4% to 1.8% and is likely to undershoot the RBA's estimate this quarter.
- Inflation came in slightly above expectations in Q2 with headline CPI printing at 0.6% for the quarter which saw the annual rate lift from 1.3% to 1.5%. The RBA has moved to using the trimmed mean as their preferred measure of core inflation and it increased by 0.4% for the quarter with the annual rate steady at 1.6%
- The employment data was well below estimates in July with a margin 500 jobs added. Despite the low number of jobs created, a positive revision on the 42.3k to 45.3k in June, saw the unemployment rate remained unchanged at 5.2% thanks to yet another record high reading in the participation rate.
- The ANZ job ads continued is recent volatility with a modest 0.8% increase in August, a significant slowdown from a revised 4.9% print in July.
- Business confidence posted a small 2 point gain in July with the index climbing to 4 but remains below its long run average. Business conditions also remains below its long run average, losing 2 points to 4. The crucial employment index, which had been the main positive the past few months, fell sharply from 5 to 0 which doesn't bode well for the employment outlook.
- Consumer confidence dipped below the crucial 100 level, registering at 96.5. Large falls in expectations for the economy 1 and 5 years ahead, down 17.4% and 12.2% respectively, were key contributors. This months will prove more interesting after another rate cut from the RBA.
- After lacklustre first quarter, Retail sales have remained soft through the second quarter. After rising only 0.1% in May, June data provided a modest again of 0.4% . Ex-inflation sales for Q2 were only 0.2% meaning ex-inflation sales are only up 0.1% over the first half of the year.

- Housing finance showed some signs of life in June with small gains across the board. The value of owner occupier and investor lending were up over the month, rising 2.4% and 0.5% respectively. Headwinds to new lending still remain despite recent rate cuts.
- Australia's trade surplus continued to hit new record highs. The surplus came in at $8bln in June as solid revenues from exports, particularly iron ore and LNG.
- After a volatile few months, Building approvals continued their downtrend. Approvals are still down around 25% over the past 12 months and down almost 45% from their late 2017 peak.