SEPTEMBER 2019 INSIGHTS

Global headwinds pose risks to the outlook

HIGHLIGHTS

- The RBA left the cash rate on hold at 1.00% in September, as was widely expected after lowering it by 25bp in June and July.
- Rates globally have remained at or near record lows with a number of other central banks cutting rates the past month.
- The RBA made a number of announcements the past month that both provided clarity over the near term outlook but also posed more questions over the long term outlook.
- Given many keys risks to the outlook lie in foreign political dealing, we will likely need to see resolutions in multiple domains before significant and sustainable growth can develop around the globe.

RATES RECAP

- After lowering the cash rate 25bp in June and July, the RBA left the cash rate on hold at 1.00% again in September.
- Risks remain to the downside as the global outlook deteriorates and domestic demand remains weak. This has seen the RBA retain an easing bias.
- Governor Lowe outlined in his recent speech at the Fed's Jackson Hole Symposium that there are limits to what can be expected from monetary policy alone in terms of maintaining prosperity of the Australian people.
- That hasn't stop 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	1.01	0.97	0.04
6M BBSW	1.06	0.97	0.09
1 Year Swap	0.88	0.82	0.06
3 Year Swap	0.82	0.74	0.09
5 Year Swap	0.94	0.86	0.07
3 Year Futures	0.82	0.65	0.17
10 Year Futures	1.04	0.96	0.08
AUD	0.69	0.68	0.01
ASX 200	6656	6584	72
US 2 year	1.53	1.65	-0.11
US 10 year	1.56	1.74	-0.18
US 30 year	2.04	2.26	-0.22
USD Index	98.44	97.49	0.95
Dow Jones	26797	26287	510

- 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 is likely over the months ahead.
- Much of the outlook, especially from a global perspective, remains hinged on the outcome of the trade war, which is becoming increasingly intractable and likely to drag out for some time.

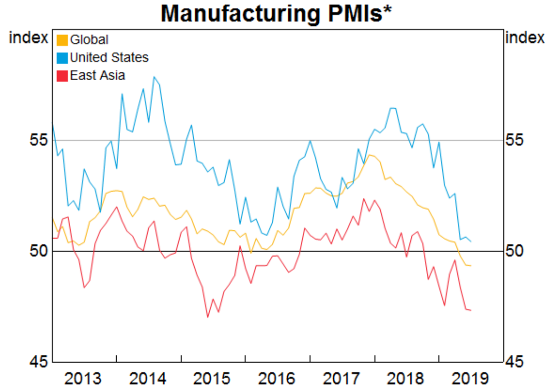
Global Headwinds Pose Risks to the Outlook

With recent data now showing a clear trend, that local consumption and expenditure is slowing, the small open economy that is Australia is becoming increasingly reliant on international trade. For the last 2 years we have seen a steady monthly increase in the balance of trade. From a -$1.7bln deficit in December 2017, the Trade balance peaked in June at $8bln before dropping slightly in July to its second highest level of $7.2bln.

It is positive to see strong export growth and steady import levels, however the concern for the outlook is that with current headwinds to trade persisting in many parts of the globe, should these exports volumes fall away there would be broad implications for the economy.

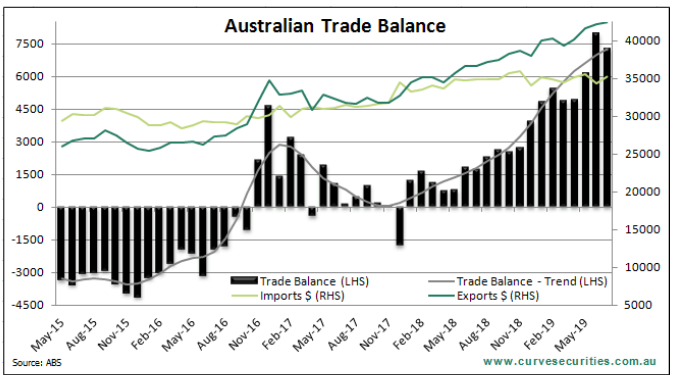
The most obvious and certainly largest risk to Australian trade is the ongoing effects of US-China Trade War. In what has become a stalemate, both sides have imposed tariffs on politically important goods. The US have imposed tariffs on Chinese made consumer goods, a large employment industry in China, whilst the Chinese have gone after US agricultural products, with costs falling on President Trumps key supporter base in Rural USA.

Manufacturing PMIs*



* Number above (below) 50 indicates an increase (decrease) in overall activity compared to the previous month

Source: Markit RBA



Whilst the direct effects of these specific tariffs could have a positive effect on Australia through increase in exports of agricultural products to China, the net effect on global growth is the concern for the domestic outlook. The effect of these ongoing tensions for the US and China will be lower growth and increased volatility on both sides until a resolution is reached. We have already seen this effect materialise as the second link in the global supply chain, Germany contracting in Q2, while manufacturing PMI's around the globe are also in a steep recent downtrend.

There are broad fiscal implications of a decline in export volumes brought about through a softening of Chinese demand for mineral ores and fuels. Current volumes remain strong but there is a clear downtrend in Chinese Industrial productions levels. Governor Lowe has been rather direct, calling on the government to increase expenditure on infrastructure. Should export volumes decrease, the proportion of decrease in tax receipts would potentially jeopardise the capacity of government spend whilst still maintaining a budget surplus. At his speech at the US Fed Symposium, Governor Lowe stated:

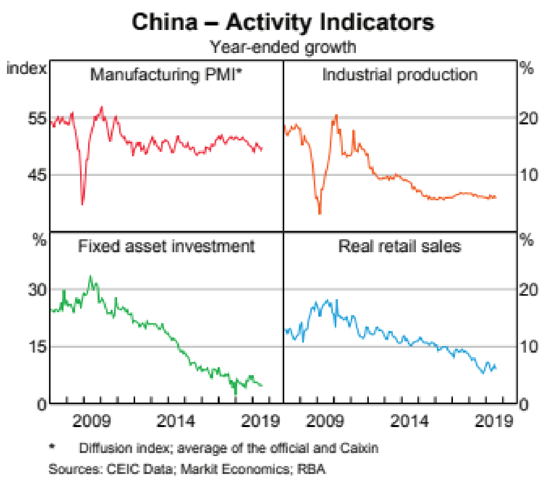
"A second lever is fiscal policy, including through extra spending on quality infrastructure. If this lever could be used, it could boost aggregate demand and support future

productivity. It is worth recalling that very low interest rates increase the value of projects with very long-lived payoffs. Some well-chosen infrastructure projects would fall into this category."

Other global concerns for the RBA lie in the ongoing Brexit negotiations in England, tensions in Hong Kong and fiscal crises in South America. Whilst none of these individually provide a great risk to the domestic outlook, it is the accumulation of these factors and their combined effect on global trade that the RBA is concerned with.

There is also a key element that must be considered here. While, the global tensions pose serious potential risk factors to the outlook, if they are resolved in a positive manner there are significant upsides. It is widely expected that the US-China tension is to remain a stalemate. However, it is possible that scheduled talks could result in a signed trade deal. Should that eventuate, it would have positive growth effects on both sides and by default here in Australia.

Similarly, with the current Brexit deadline, October 31st, fast approaching, there is a chance a productive resolution could eventuate in the next few months that would boost growth in the UK, the worlds fifth largest economy. These current geopolitical events are simply risk factors that need to be assessed and prepared for. The comforting factor for the outlook is that the RBA is aware of these headwinds.

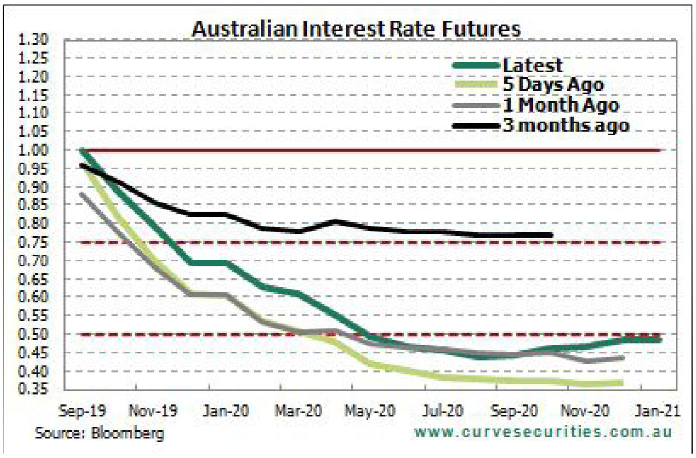


OUTLOOK FOR INTEREST RATES

With risks to the outlook lying mainly outside our borders, the outlook for interest rates is near unchanged from last month.

The RBA left rates on hold once again this month and the continual decline in the BBSW curve has steadied. August was the first month since March where 3 month BBSW has increased in the period.

There has also been some retracement in the bank bill futures with the market no longer pricing in a cut the cash rate for November. The market now has an 80% chance of 25bps cut priced in for November with a second cut not fully priced until May 2020.



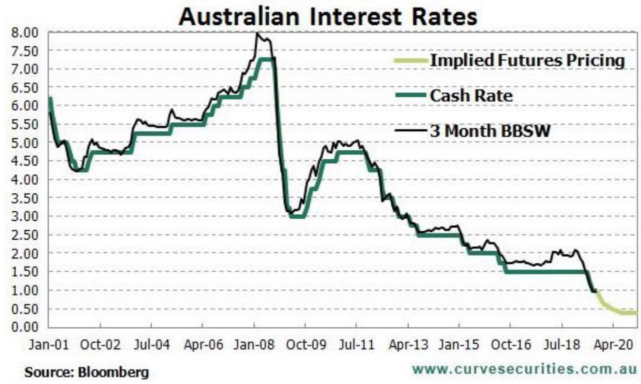
It was clear this month from comments made by Governor Lowe that the RBA is fully aware in order to achieve all 3 goals outlined in there mandate; of full employment, a stable currency and the economic prosperity of the Australian people, they will need assistance from the Government.

"Another element of the reality we face is that monetary policy is just one of the levers that are potentially available for managing the economy. And, arguably, given the challenges we face at the moment, it is not the best lever."

Governor Lowe has proven time and time again that he holds in the highest of concerns the role of the RBA in articulating their course of action. That explaining not only the data and logic that brought them to their conclusion, but what alternative viewpoints and courses could have been taken.

To that end, it is likely that whilst the RBA continues under their technical assumption of the cash rate following market pricing, the market can expect that to eventuate. Should the RBA choose to do otherwise we would likely see a strong indication from the board prior to that occurring.

It remains the case that after adjustment to NAIRU recently, employment data will be the key factor in determining the settings of monetary policy. With unemployment still at 5.2% there is a large reduction in unemployment required to achieve a rate equal to the NAIRU. To that end, should there be any upward trend in the unemployment rate the RBA would likely look to move preemptively in order to prevent any increase in the spare capacity already present in the economy.



With the retracement in futures pricing of cuts to the cash rate, it also extended the timeline for any potential shift toward unconventional monetary policy measures. Since Governor Lowe has indicated those measures wouldn't take place until after the cash rate reached 0.5% we appear to be further from those than we were this time last month.

AUSTRALIAN ECONOMIC HIGHLIGHTS

- Growth printed in line with estimates again in Q2 with the economy only growing by 0.5% as the weakness from the first quarter continued. The annual pace of growth slowed further from 1.8% to 1.4% 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 above estimates in August with 41.1k jobs added. Despite the high number of jobs created, a negative revision on the 0.5k to -2.3k in July, saw the unemployment rate remain 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 July, a significant slowdown from a revised 4.9% print in July.
- Business confidence posted a 2 point loss in August with the index falling to 1 after July was revised upward to 3. Business conditions also remains below its long run average, losing a further 3 points to 1. The crucial Employment index, which fell to zero last month, bounced back slightly to 2pts, other business condition elements all fell heavily.
- Consumer confidence bounced back to the crucial 100 level, registering at a gain of 3.6%. The largest gains were in expectations of family finance for the forward 12 months and 5yrs with 9.6% and 4.5% gains respectively. A notable decline was seen in the unemployment expectations index which fell -0.8% to 133.3.
- After lacklustre first quarter, Retail sales have remained soft through the second quarter. After rising only 0.4% in June, July data provided a negative reading -0.1% .

- Housing finance showed signs of life in July with gains across the board. The value of owner occupier and investor lending were up over the month, rising 5.3% and 4.7% respectively. It appears recent headwinds to home lending to are dissipating.
- Australia's trade surplus continued but fell back from recent records. The surplus came in at $7.2bln in July as solid revenues from exports, particularly iron ore and LNG continued.
- After a volatile few months, Building approvals continued their downtrend. Approvals are still down around 28.5% over the past 12 months and down almost 50% from their late 2017 peak.