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NOVEMBER 2019 INSIGHTS

Wage growth hope evaporates

HIGHLIGHTS

- The RBA left the cash rate on hold at 0.75% in November as was widely expected.
- Market pricing for further action from the RBA has eased, in line with lower expectations of further monetary policy easing globally.
- Despite their best efforts to be optimistic about the outlook, the RBA contained a blunt message around wage growth and its implications for inflation and the broader outlook.
- As a result, risks remain skewed to the downside.

RATES RECAP

- After three rate cuts in 5 months, the RBA left the cash rate unchanged, as was widely expected, at their November meeting.
- The RBA continues to hold an easing bias as risks, both locally and globally, remain skewed to the downside.
- The RBA is apparantly seeing things slowly turning, with another mention of a "gentle turning point" showing up in their statements.
- A thawing of geopolitical tensions when it comes to the trade negotiations and brexit has seen a more ebullient mood permeate through global markets.

Key Market Moves

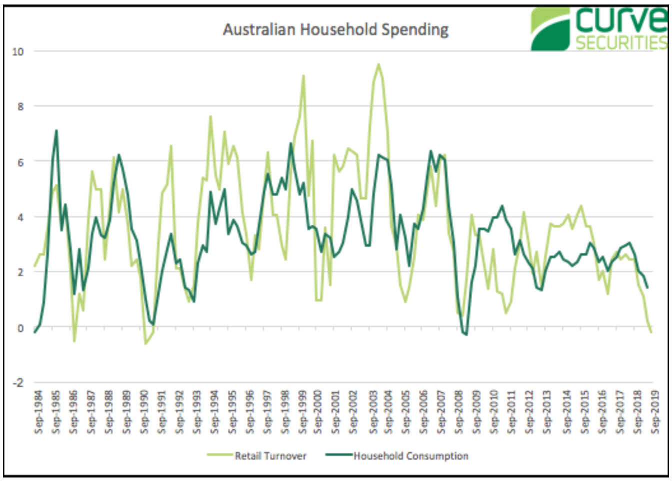
	Latest	1 Month Ago	Change
Cash Rate	0.75	0.75	0.00
3M BBSW	0.93	0.84	0.10
6M BBSW	1.05	0.95	0.10
1 Year Swap	0.88	0.67	0.20
3 Year Swap	0.94	0.63	0.32
5 Year Swap	1.15	0.76	0.39
3 Year Futures	0.89	0.58	0.32
10 Year Futures	1.30	0.89	0.41
AUD	0.69	0.67	0.02
ASX 200	6727	6593	133
US 2 year	1.67	1.46	0.21
US 10 year	1.92	1.56	0.36
US 30 year	2.40	2.05	0.35
USD Index	98.13	98.97	-0.84
Dow Jones	27675	26478	1197

- As a result we have yield curves start to steepen as expectation of further monetary policy easing over the months head start to fade.
- While the cash rate remained unchanged over the past month, the three year swap rate has risen 32bp while the 5 year has jumped 39bp.
- We have seen similar moves overseas with the US 2 year yield rising 21bp while the 10 year has jumped 36bp.
- For these moves to be sustained, we will need to see follow through on the progress made on the geopolitical issues followed by positive data.

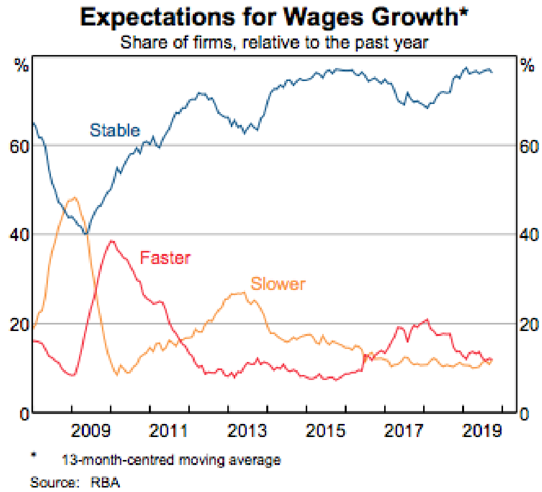
Wage growth hopes evaporate

The RBA elected to leave the cash rate on hold in November after cutting it three times in the previous five months. The RBA affirmed in the November Quarterly Statement on Monetary Policy, that the pause was on the basis that it *"allows time to assess the effect of the recent easing of monetary policy as well as global developments."*

November's Statement suggested that the RBA is doing its best to look on the bright side. There were comments such as *"The Australian economy is gradually coming out of a soft patch"* and *"the Board also recognised that global financial markets appear to have passed a trough of pessimism".*



There were the usual highlights around the positives for the outlook centred around the export sector, infrastructure and the rebound in the housing market. The RBA continues to anticipate a pick up in consumption thanks to a pick up in disposable income, something that shouldn't be confused with a pick up in wage growth.



According to the Statement, *"consumption is expected to increase"* and it *"will be supported by an expected pick-up in growth in household disposable income."*

To allay any confusion between wage growth and disposable income, the Statement said that:

"The forecast pick-up in growth in household disposable income arises from growth in labour demand, the recent monetary policy easing lowering household interest payments and the low- and middle-income tax offset lowering tax payments."

So the RBA is expecting the benefit of tax cuts for homeowners with mortgages, which is only around one third of households, and income tax cuts will flow through to an increase in consumption. To date, there has been little sign of any flow through from interest rate or tax cuts with retail volumes actually falling further.

The Statement also contained a solid dose of reality. In the Economic Outlook, the RBA put it bluntly, saying that *"wage growth is no longer expected to pick up".*

What is of greater concern, is that the preconditions for a sustained uplift in wages is still some way off. According to RBA forecasts the unemployment rate:

"is expected to decline only gradually over the next couple of years, to a little below 5 per cent. At this level, the unemployment rate will still be somewhat short of the central estimate of the rate consistent with full employment, of around 4½ per cent."

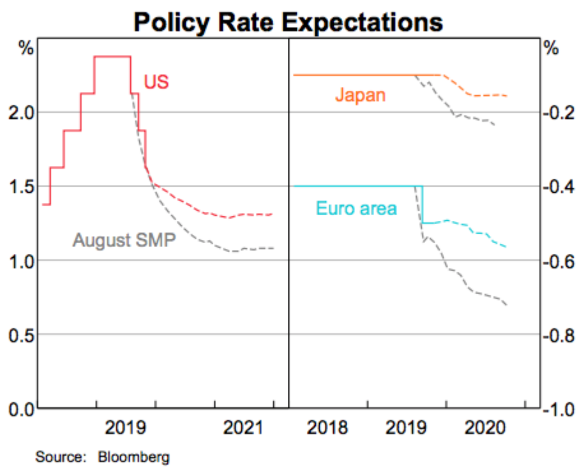
The lack of progress reducing the unemployment rate means *"spare capacity is expected to remain in the labour market over the next couple of years."* This means that *"consistent with this outlook, wages growth is low and shows little sign of picking up."*

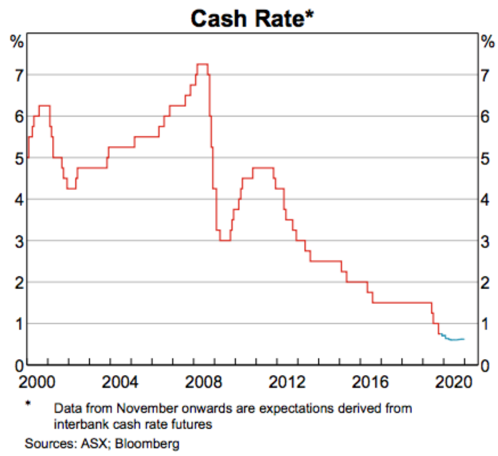
That is going to make things interesting for monetary policy over the coming months. The reliance on increases in disposable income rather than wages to boost consumption will make it difficult for the RBA to have much more of an impact. With the cash rate already at 0.75%, their ability to boost disposable income through rate cuts is now quite limited.

OUTLOOK FOR INTEREST RATES

While the RBA decided to leave the cash rate on hold in November, it should not be taken as a sign that the easing cycle is over. Despite the signs of optimism in the RBA's rhetoric, the risk are still skewed to the downside.

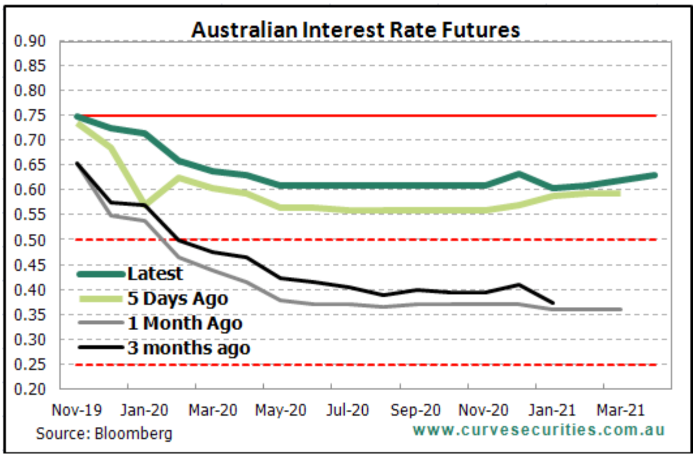
Based on the RBA's current outlook, it is still more likely that





the next move in the cash rate will be down not up. Inflation outcomes still hold the key to the outlook for monetary policy and inflation is hinging on wage growth. The Statement made that fact pretty clear, saying:

"Wages growth is also low, and it is increasingly clear that lower unemployment is needed to generate wages growth that is consistent with sustainably achieving the inflation target."

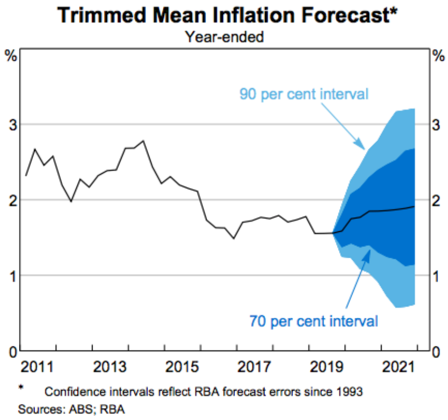


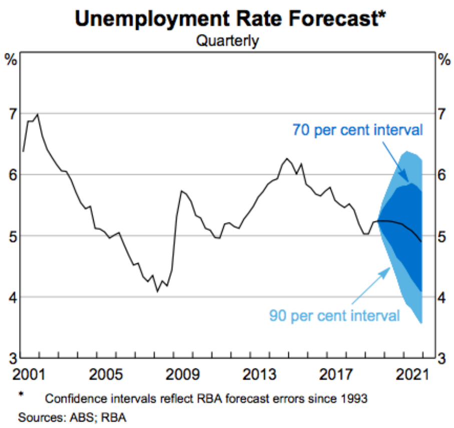
So with little risk of inflation surging back into the RBA's target band anytime soon, the risk of a higher cash rate is off the table for the time being.

With that said, the market is less convinced that the RBA will be cutting rates more so now than anytime in the past three months. As sentiment global has picked up thanks to a thawing in geopolitical risks, so has expectations for the path of the cash rate.

Up until recently, the market has been expecting the cash rate to be cut to 0.5%. However, over the past couple of weeks those expectations have eased. It is likely to be as much about easing expectations globally as it has been about the domestic market outlook. The markets expectations for future policy action from RBA, US Federal Reserve, ECB and BoJ have all pulled back in recent weeks.

That suggests that unless we see a substantial turnaround in the global back drop over the next few weeks, the RBA's pause is likely to be extended into the New Year given there is no scheduled meeting for January.





An extended pause will also give the RBA time to see if the pick up in disposable outcome as outlined above shows signs of working its way through the economy. However beyond that, the risk remains that the RBA will need to act again in order to reduce spare capacity in the labour force, to generate the necessary wage growth and to get inflation sustainably back into their target band.

AUSTRALIAN ECONOMIC HIGHLIGHTS

- Growth was in line with estimates 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 pressures remains weak in Q3, with both headline and core inflation printing in line with expectations. The headline index was up 0.5% which saw the annual rate edge up to 1.7%, while the trimmed mean was up 0.4%, leaving the annual rate unchanged at 1.6%. Both were in line with the RBA's forecasts.
- The employment data was in line with estimates in September, with 14,700 new jobs created over the month. The unemployment rate fell slightly to 5.2% after the participation rate eased back 0.1% to 66.1%.
- After stabilising last month, the ANZ job ads resumed its slide in October, posting a 1% fall. It continues the recent trend of softening job ads.
- Business confidence posted a 2 point gain in October with the index back above zero. Business conditions remain below their long run average but gained 1pt to print at 3 for the month. The crucial Employment index continued its uptrend.
- Consumer confidence continues to slide in October despite recent tax cuts and a third interest rate cut. It appears that the message that record low interest rates is sending is outweighing the lower rates. The index slumped 5.5% to 92.8.

- Retail sales had another poor quarter in Q3, with total retail volumes falling for the third time in the past 4 quarter to be down over the past 12 months. It is the first time retail sales volumes have gone backwards since the 1990s recession.
- After some big increases in July and August, Housing finance was mixed in September. The value of new credit to owner occupier's continue to rise strongly while new investor pulled back. Despite the strong run of new credit, growth in outstanding credit continues to slow as mortgagees continue to repay their loans quicker thanks to interest rate cuts.
- Australia continues to post robust trade surplus's, chalking up another $7.1bln in September. The positive this month was it was on the back of a rise in both imports and exports with both rising 3% for the month.

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