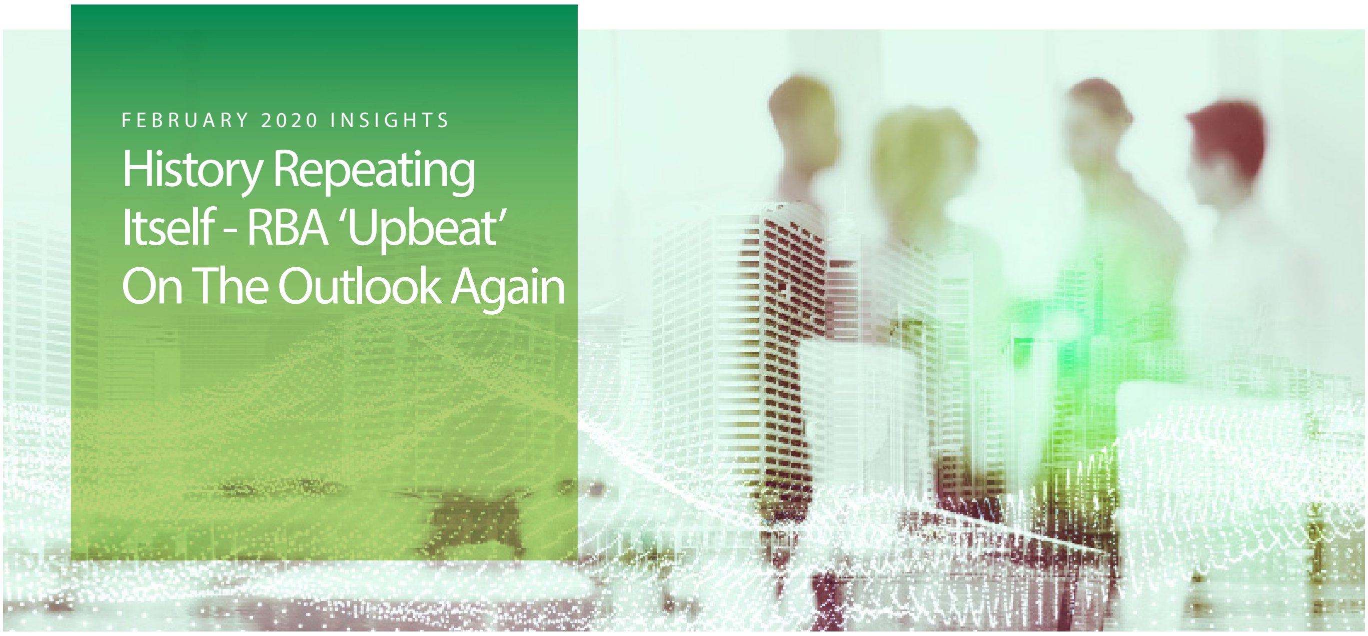
FEBRUARY 2020 INSIGHTS

# History Repeating Itself - RBA 'Upbeat' On The Outlook Again



## HIGHLIGHTS

- The RBA left the cash rate on hold at 0.75% in February, as was widely expected.
- Recent employment and inflation data was enough to support the RBA's 'gentle turning point' narrative.
- In their recent commentary the RBA outlined what would be seen as a trigger for further rate cuts.
- Despite the RBA's panglossian view on the outlook, risks remain skewed to the downside.

## RATES RECAP

- The cash rate has been on hold for four straight months.
- BBSW has ended the last month roughly where it started, despite a brief fall through the middle of the month.
- The long end of the curve hasn't completely bounced back with rates further out remaining lower than a month ago.
- The AUD has drifted lower contributing to an easing in overall monetary conditions over the month.
- There has been a similar shift in yield curves global curves with most ending the month flatter.
- US 10 year yields are off their lows but are still down 23bp.
- Both bond and equity markets have been gyrating throughout the month as headlines emerge on the Coronavirus and its expected impact on the outlook.

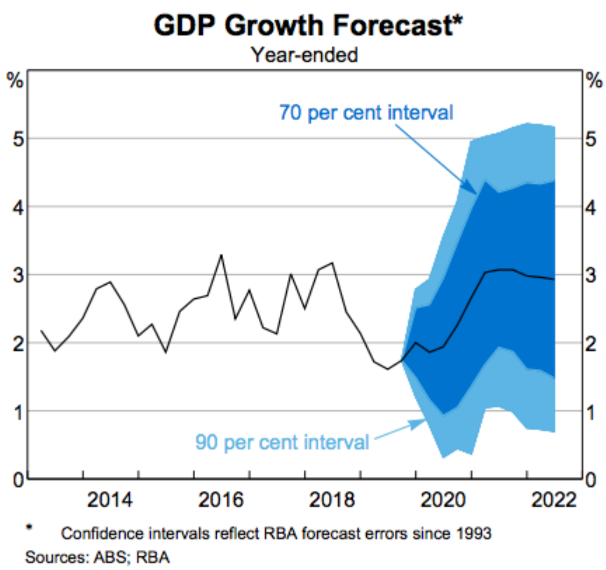
**Key Market Moves**

| | Latest | 1 Month Ago | Change |
|---|---|---|---|
| Cash Rate | 0.75 | 0.75 | 0.00 |
| 3M BBSW | 0.91 | 0.91 | 0.01 |
| 6M BBSW | 0.96 | 1.00 | -0.04 |
| 1 Year Swap | 0.76 | 0.75 | 0.01 |
| 3 Year Swap | 0.72 | 0.81 | -0.09 |
| 5 Year Swap | 0.89 | 1.02 | -0.13 |
| 3 Year Futures | 0.70 | 0.81 | -0.10 |
| 10 Year Futures | 1.03 | 1.27 | -0.24 |
| AUD | 0.67 | 0.69 | -0.02 |
| ASX 200 | 7013 | 6929 | 84 |
| US 2 year | 1.41 | 1.57 | -0.16 |
| US 10 year | 1.59 | 1.82 | -0.23 |
| US 30 year | 2.05 | 2.28 | -0.23 |
| USD Index | 98.65 | 97.36 | 1.29 |
| Dow Jones | 29103 | 28824 | 279 |

## History Repeating Itself - RBA 'Upbeat' On The Outlook Again

It is hard not to get a sense of déjà vu when it comes to the RBA's current outlook for monetary policy.

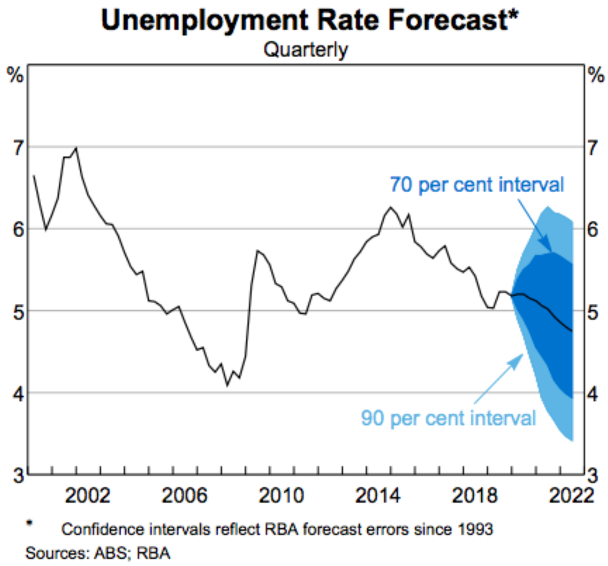
When we last received a series of rate cuts in 2016, the RBA repeatedly trotted out a panglossian outlook for the domestic economy. Growth was expected to pick up, taking inflation with it. The RBA even went as far as saying the balance of risks saw a greater probability that the next move in the cash rate would be up, not down on numerous occasions.




On they went, forecasting inflation hitting the target band over the medium term and unemployment heading towards a level considered to be full employment. This optimism continued through 2017 and 2018 before it suddenly shifted in early 2019.

It abruptly became apparent that there was more slack in the labour force than was previously thought. The assumption that full employment would be reached when unemployment hit 5% suddenly shifted. Now it is expected that full employment is somewhere around 4.5% or a little lower.

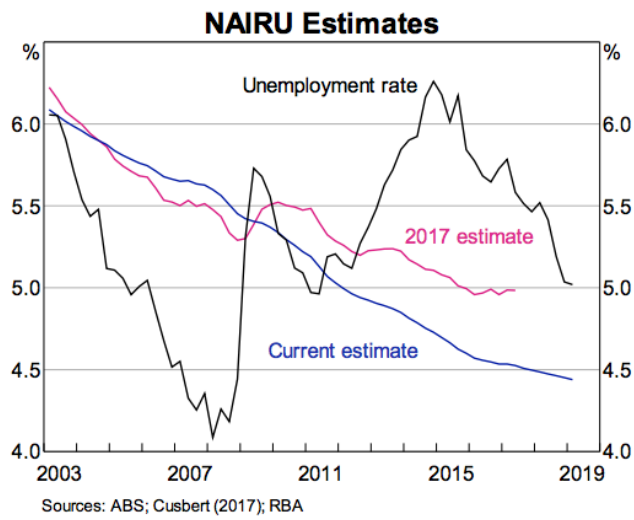
After cutting the cash rate three times in 2019, the market had been expecting to see further easings, at least one,




maybe two, this year. That would have taken the cash rate down to the lower bound of 0.25%. The level which the RBA has indicated would be its low point. A point at which other monetary policy tools would be called upon.

Instead, the RBA this week through multiple statements and appearances has made it clear that the extend and pretend narrative is back in place for the foreseeable future. Until of course it isn't.

We heard from the RBA four times last week. We had the post meeting statement and quarterly Statement on Monetary Policy released, while Lowe spoke at the National Press Club luncheon and made his Semi Annual testimony to parliament.



The message was pretty clear. In his opening statement to the House of Representatives Standing Committee on Economics, Governor Lowe said that:

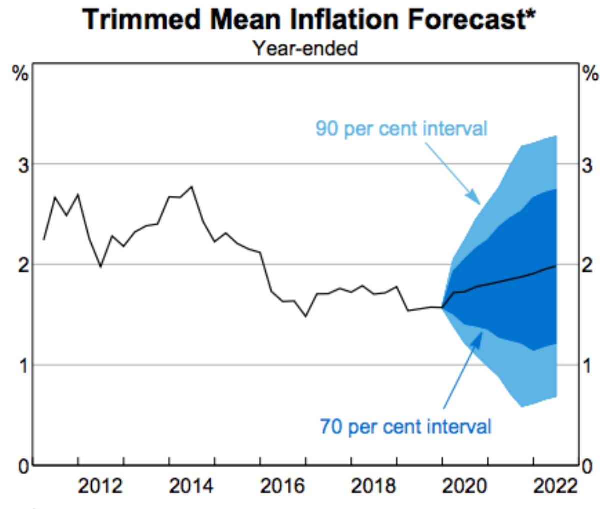
*"If the unemployment rate were to be moving materially in the wrong direction and there was no further progress being made towards the inflation target, the balance of arguments would tilt towards a further easing of monetary policy."*

Unless either of those developments become an issue, the RBA is clearly in no rush to ease monetary policy any further. So we find ourselves back in a similar position to where we were during the late 2016 to early 2019 period. The RBA could be expected to be on hold until or unless the data deteriorates.

That doesn't exactly reconcile with their forecasts. According to their forecasts, growth is expected to pick up to 3% over the forecast period. Unemployment is expected to drift below 5% and inflation is expected to creep up and nudge the bottom of the target band at 2%.

The problem with the RBA's narrative are the assumptions which their forecasts are based on. According to the latest quarterly Statement on Monetary Policy:

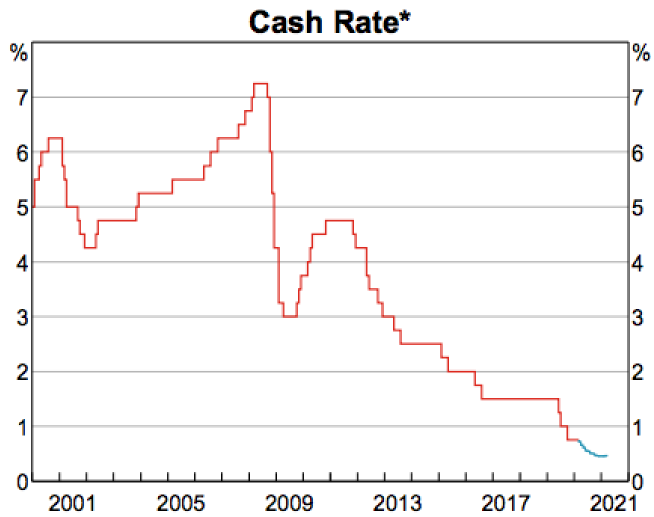
*"The domestic forecasts are conditioned on the technical assumption that the cash rate moves in line with market pricing, which implies one 25 basis point cut in the cash rate around the middle of 2020."*




* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

So we have the RBA saying that they will only look to ease policy further if the data deteriorates but has a rate cut assumed in their forecasts. Does that mean that without the rate cut, inflation will fall short of the target band, growth be weaker than forecasts and unemployment not fall as far as expected? Does that then lead to them cutting anyway?

Time will tell, but despite the RBA's panglossian view on the outlook, the risk that we see further rate cuts remains.




* Data from March onwards are expectations derived from interbank cash rate futures
Sources: ASX; Bloomberg

## Outlook for interest rates

With the RBA signalling that they are done cutting rates for now, the market's expectations for imminent rate cuts has adjusted accordingly. Up until we got the slightly stronger than expected employment data in January, the market was still leaning towards a February rate cut.

While the RBA has retained panglossian view on the outlook, markets are still expecting that the cash rate will be cut at least one more time this year. This is despite the RBA has telling us it will need to see a material deterioration in the employment data or lack of progress on the inflation target to trigger another rate cut.

A rate cut is now expected at the August Board meeting based on current market pricing. Most economist and market commentators also don't think that the easing cycle is done just yet.

It is hard to argue that the easing cycle is over given the RBA's own forecasts, which only just see inflation getting back to the target band and employment remaining above the new expected NAIRU level, are based on the assumption of a rate cut.

The big question for the outlook is how the RBA views the incoming data. They have already acknowledged that there will be temporary impacts from natural disasters in Australia and the Coronavirus. These events will impact growth figures and could also have an impact on the employment data.

That means we might need to see a more sustained impact on the data than would usually be the case to see the RBA act. Exactly where their trigger point is also remains unclear. How far does the unemployment rate need to rise to be considered material? How much longer does inflation need to stay below the band, give it has been below for four years already, to be considered making little progress?

Aside from Governor Lowe appearing on a panel at the Australia-Canada Economic Leadership Forum later this week, we will hear very little from the RBA between now and next month's board meeting.

Between now and they we will get a full refresh of monthly data which will be unlikely to be enough to materially shift the outlook. The one risk to keep an eye on is the Coronavirus.

Australia is heavily reliant on China and not only for resource export. While a dip in demand could hit resource exports, it is other areas which could suffer much worse.

Our tourism and tertiary education sectors are heavily reliant on China. The worse the spread of the virus becomes, the greater the impact of the containment measures will become. How the situation evolves will have a significant impact on the outlook for monetary policy.

For now we wait and watch the updates from the authorities. It is likely the RBA is out of play for now but I expect we haven't seen the last of rate cuts in this cycle.

## Australian Economic Highlights

- Growth was below estimates in Q3, with the economy only growing by 0.4% as the weakness from the second quarter continued. The annual pace of growth remained low at 1.7% and is likely to undershoot the RBA's estimate this quarter.
- Inflation pressures rose slightly in Q4, with both headline and core inflation printing in line with expectations. The headline index was up 0.7% which saw the annual rate edge up to 1.8%, 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.
- Employment data was above estimates in December, with a gain of 29,000 jobs over the month. The unemployment rate edged lower to 5.1% with the participation rate steady 66.0%.
- ANZ Job ads gained back some of the lost December ground in January, up 3.8% after falling 5.7% in December. Despite the volatility the series trend still appears to be in decline.
- Business confidence remained in negative territory in January, despite gaining 1 points to post at -1 for the month. Business conditions also held steady at 3 points for December. The crucial Employment index also lost 3 points to post at 1 points for the month.
- Consumer confidence fell in January and resumed recent run of soft prints. The index posted a 93.4 reading, which was a 1.8% fall over the December reading.
- Retail sales had positive quarter in Q4 despite a negative print for the month of December. Despite the quarter printing 0.5% above the zero expectations it is too early to tell if this result is mere noise of reversal of the downward trend.
- After a mixed run of data, housing finance was slightly up in December. The value of new credit to owner occupier's continue to rise but by a reduced rate, printing at 2% for the month. Growth in outstanding credit continues to slow as mortgage holders continue to repay their loans quicker thanks to interest rate cuts.
- Australia continues to post robust trade surplus's, chalking up another $5.2bn in December, down slightly on November's $5.8bln. The decline was largely centred on reductions of commodity exports, which are rescinding from recent highs.
- Building approvals were largely unchanged in December with a decline of 0.2%, after the strong recent downtrend the market looked favourably upon the recent stability.