JUNE 2020 INSIGHTS

RBA Remains Concerned About the Outlook Without Further Policy Initiatives

HIGHLIGHTS

- Containment measures continue to be rolled back and the data suggests that the worst is now behind us.
- Monetary policy once again remained unchanged over the month with the RBA remaining *"committed to do what it can to support jobs, incomes and businesses."*
- In his appearance before the Covid-19 Parliamentary Committee, Governor Lowe spoke candidly about how much more room monetary policy has left and what else the RBA could do if required.
- He also voiced concerns over the long run prospects for the economy if unemployment remains high for too long and if structural issues facing the economy weren't addressed.

RATES RECAP

- The RBA left the cash rate and its yield curve target unchanged again in June and reiterated that *"the Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band."*
- While the cash rate target is 0.25%, the actual cash rate remained unchanged at 0.14% driven by the ongoing excess of liquidity currently in the system.
- BBSW remained largely unchanged over the month with the 3 months rate sitting at 0.10% while the 6 month was 0.17%.
- The curve has finished the month a little steeper once again with the three year rate continuing to hover around the RBA's target of 0.25% while the 10 year rate drifted a little wider.

Key Market Moves

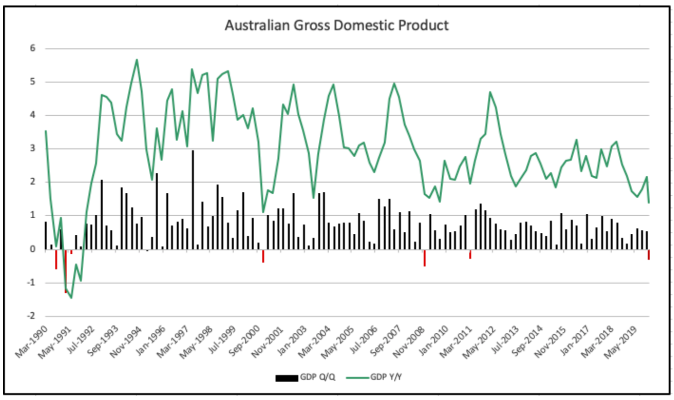
	Latest	1 Month Ago	Change
Cash Rate Target	0.25	0.25	0.00
Cash Rate	0.14	0.14	0.00
3M BBSW	0.10	0.10	0.01
6M BBSW	0.17	0.17	0.00
1 Year Swap	0.18	0.13	0.05
3 Year Swap	0.29	0.23	0.06
5 Year Swap	0.51	0.44	0.07
3 Year Futures	0.29	0.23	0.06
10 Year Futures	1.01	0.89	0.13
AUD	0.69	0.65	0.05
ASX 200	6115	5391	724
US 2 year	0.20	0.16	0.05
US 10 year	0.82	0.68	0.14
US 30 year	1.57	1.38	0.19
USD Index	96.40	99.73	-3.34
Dow Jones	27272	24331	2941

- Credit spreads continue to drift lower as investors chase yield further out the curve. With issuers reluctant to issue significant volumes in the short end, long end spreads are expected to continue to decline as excess liquidity is absorbed.
- The AUD has remained very volatile again in May. After the sharp sell off in March and subsequent rebound it has continued to rise along with other risk assets through April and May and is now hovering around 0.70. This could become a concern for the RBA should it continue to rise.

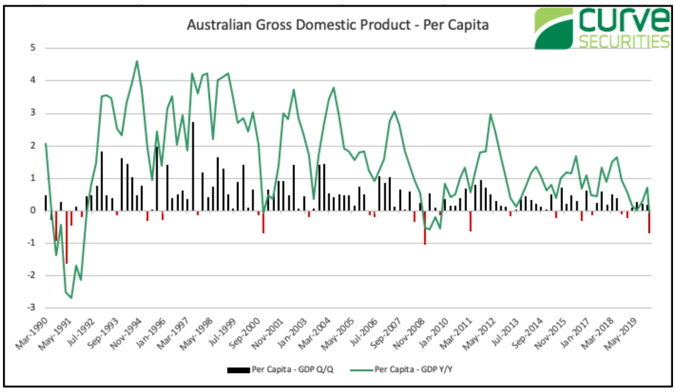
RBA Remains Concerned About the Outlook Without Further Policy Initiatives

A few years ago, Australia took the record off the Netherlands for the longest uninterrupted economic expansion. That is a period absent two consecutive quarters of negative growth. It took the Global Financial Crisis to bring to an end the Netherlands run of 103 quarters of uninterrupted growth. The latest data suggests Australia's run will come to an end after pushing the record out to 114 quarters, a mark that may never be bettered.

The latest data showed that panic buying ahead of the Covid-19 driven lockdowns wasn't enough to keep the Australian economy from going backwards in the first quarter. Despite only the last few weeks being directly impacted, the economy slowed enough over the quarter for growth to come in 0.3% below the December 2019 level. With the second quarter forecast to post the biggest quarterly contraction since the Great Depression, it has now been assumed Australia is already in the midst of its first recession in almost 30 years.

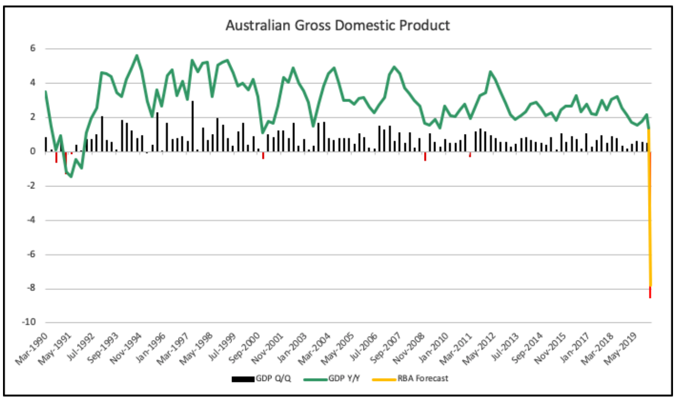


Slowly, with the virus now largely under control within our national boarders, the containment measures are being unwound. Activity trackers are showing the worst in terms of the pull back in overall activity is now behind us; however, we remain a long way from levels of activity experienced before the onset of the virus and the associated containment measures.



According to the latest from the RBA, with the health crisis turning out to be not as severe as was first anticipated, the economy is tracking somewhere between their baseline scenario and their upside scenario. However at his appearance before the Covid-19 Parliamentary Committee, the governor provided a bit of a reality check for anyone anticipating a V-Shaped recovery, saying:

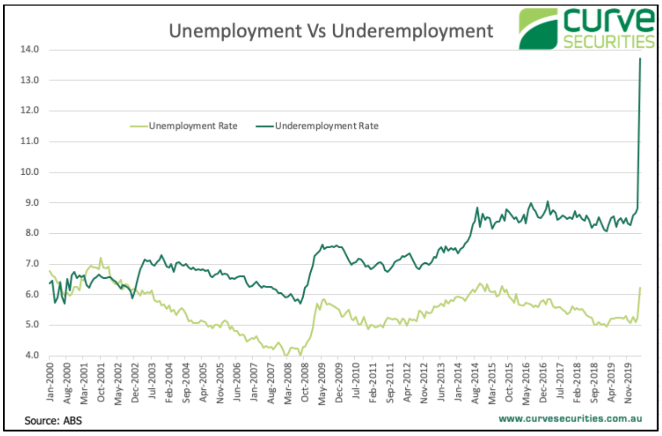
"Even in the upside scenario, we are going to have high unemployment for quite a few years and inflation is going to be lower than two per cent for quite a few years. We talk about it being upside, but it's actually still a pretty depressing scenario"



In the very next answer in the same line of questioning, he went on to say *"we call it 'upside', but, in many ways, it's a very downside, depressing scenario, with weak employment, high unemployment and low inflation."*

It is the employment element of that scenario that is the biggest point of concern for the RBA. In discussing the outlook the Governor was questioned on his thoughts around where the current level of full employment was, given it is an important yardstick for the setting of monetary policy. He gave quite a long answer, one which I think needs to be digested in full to get context on why avoiding a sustained increase in the level of unemployment should be avoided at all costs:

"We know from previous sharp economic downturns there is scarring in the labour market. People fall out of jobs and then have trouble getting back in, and then we have more long-term unemployment. So I think it's quite possible that the estimate of full employment starts rising again, back towards five per cent—there's a lot of uncertainty, again, around that. And, because that entails a very significant social cost of higher unemployment growth, this is one of the reasons I was so supportive of what the government had done with the job program to keep those connections between businesses and firms so that we don't see the scarring in the labour market. If we don't get a decent recovery fairly soon we will see more scarring, which will mean the estimate of full employment starts to rise, which is a terrible social loss. We want to reduce the amount of scarring so that the estimates of full employment and the unemployment rate don't start rising."



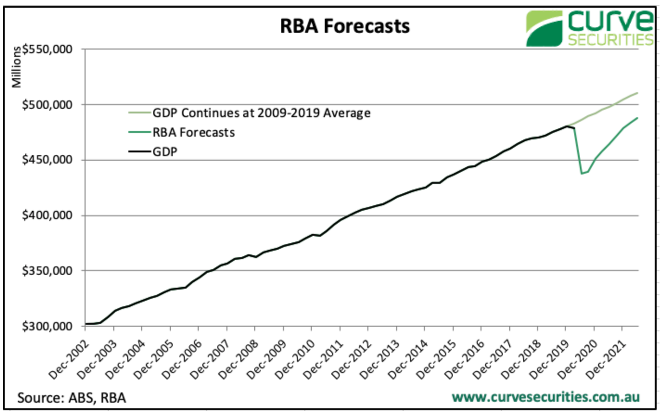
The rise in the unemployment rate so far has been a lot less than was first estimated. The April data showed unemployment increased from 5.2% in March before the containment measures intensified to 6.2% in April. One reason for the smaller than expected increase was the JobKeeper program meant many people were still counted as employed. The other main reason was many who lost their jobs left the workforce.

You are recorded as leaving the workforce if you haven't worked or looked for work. Given the lockdown was in full swing in April, there might not have been much point of looking for work. Job ads fell more than 50% across the economy so there wasn't a lot of new jobs going anyway. It means the participation rate fell sharply from 66% to 63.5%. If all those people remained in the workforce, the unemployment rate would have jumped to almost 10%. Even higher were it not for JobKeeper.

So it is going to be essential that people can get back to work and into new jobs as quickly as possible. That is going to not only take a recovery back to levels of activity experienced before the crisis but a sustained increase in activity is going to be required.

However, with consumer and business confidence still low, a robust recovery may be protracted. It means it will be up to policy responses and stimulus measures to help boost activity. Based on comments from Governor Lowe, the RBA is running out of room to provide much more support:

"Fiscal policy will have to play a more significant role in managing the economic cycle than it has in the past. For the last 20 years monetary policy has been the mainstream instrument; we've moved interest rates up and down to manage the business cycle and keep inflation under control. In the next little while there's not going to be very much scope at all to use monetary policy in that way. So I think fiscal policy will have to be used, and that's going to require a change in mindset."



So while the RBA does have some scope to provide support, it is going to be up to the Government to do the heavy lifting. It is not just spending that is required either. The Government is going to need to tackle long overdue policy reform to deal with structural issues the economy is facing. They are going to have to provide the economy with a platform to grow. If they don't, then the alternative is quite bleak with Governor Lowe saying:

"My fear has been that, if we don't tackle some of these issues, we'll just kind of meander along. The economy will be okay, but we will not return to the type of growth in living standards that we have seen overover the past 20 years."

So with our record run of uninterrupted growth coming to an end and with little scope for monetary policy to provide further support to re-start the business cycle, it is up to the Government to shape the new normal that will face us over the months and years ahead.

Outlook for interest rates

Little has changed over the past month as far as the RBA current stance on monetary policy goes. They reiterated their outlook for the setting of monetary policy in the accompanying statement to the June Board meeting with the last sentence once again stating:

"The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band."

On the outlook for inflation, little has changed over the past month with the underlying rate of inflation still expected to undershoot the target for a number of years. As discussed above, the Governor did have something to say about how the concept of full employment my evolve over the months ahead. As he highlighted, while it may increase, meaning we are closer to full employment than might have previously been the case, that is not exactly a good thing social cost and scarring that would be accompanied by a higher assumed level of full employment.

That means that any removal of the yield curve target or an increase in the cash rate still remains a long way off. However there is still some downside risks facing the economy and the Governor was questioned by the Parliamentary Committee if the RBA could or would do more if required. The Governor was specifically asked that question in the context of the possibility of negative rates and broadening the Quantitative Easing program, to which he said:

"So I just don't think negative interest rates work. My appetite for buying private sector assets is very limited—that comes with a whole bunch of government issues. The package we've got so far is working. If we had to do more, we could purchase more government bonds, but at the moment our yield curve target is working well, and the Australian government bond market is working as well as it was before the crisis. So, as things stand at the moment, I don't see the need to do any more."

At the time of his appearance before the Parliamentary committee, the 3 year government bond yield was sitting almost bang on the 0.25% target. Since then, the yield has drifted a little higher and current sits at 0.28%. There is nothing in that move that would be enough to alarm the RBA or suggest that they need to buy more bonds. There has also been no material dysfunction across bond markets in the intervening period.

While the three year yield has been rather stable, there has been a little more volatility further out the curve. The 10 year yield spent most of the month hovering around 0.90% for before spiking higher in line with US and other major benchmark rates. It did get as high as 1.09% before drifting back to 1.01%. Were the long end of the curve continue to risk materially, that might be something that the RBA could have some concern over.

The more pressing issue for the RBA is likely to be the rising AUD. Since plunging to 0.55% as the height of the market panic around the spread of COvid-19, the AUD has since recovered all of its losses and is now hovering around just under 0.70. It briefly breach that level earlier in the week. A rising AUD works against the RBA and results in a tighter overall setting of monetary policy.

Australia's currency has been the beneficiary of risking markets globally and has been tracking equities higher since the lows in March. There are also large flows working against the RBA when it comes to the AUD. The lack of tourism in both directions hurst as Australians used to spend more money overseas that tourists to Australia used to spend. That means less people selling AUD to travel than those requiring it when they hit our shores.

According to Governor Lowe, further bond purchases are the only tool left in their tool kit. They could obviously adjust their target through these purchases. They could try to push down rates further out the curve, making the interest rate differential less appealing in an attempt to drive the currency down. How effective this would be is unclear. Time will tell if the RBA feels the need to go down this path but at the moment they seem content to wait and watch.

So for now the RBA is likely to sit pat and assess the incoming data and hope the the Government continue to work on fiscal measures and policy changes to help shape an economic environment conducive to a sustain increase in growth over the months ahead.

Australian Economic Highlights

- Growth for the first quarter dipping into negative territory, falling by 0.3% with the economy slowing as Covid-19 containment measures ramped up. It means with the second quarter expected to be deeply negative, the Australian economy is in the midst of its first technical recession in almost 30 years.
- Inflation was largely in line with expectations in Q1. Headline inflation rose 0.3% taking the annual rate to 2.2% while the trimmed mean was up 0.5% with the annual rate edging up to 1.8%. Prices are expected to fall in Q2; however, core inflation is expected to remain positive.
- The April Employment data saw almost 600,000 jobs lost as was widely expected. However the unemployment rate didn't rise anywhere near as much as expected thanks to a fall in the participation rate. The unemployment rate rose to 6.2% while the participation rate fell heavily from 66% to 63.5%. As the economy re-opens and people start looking for work again the participation rate could rise, taking the unemployment rate with it.
- After falling by a record 53.1% in April, the ANZ Job ads report marked time by comparison in May, rising by 0.5%. Weekly data suggests that new jobs ads are slowly returning as the economy re-opens. However the level of job ads still remains well below pre-crisis levels.
- Business confidence continue to improve from the record lows recorded in March with the index now up to -20. Despite the recovery, confidence across all industries still remains very low. Business conditions improved with the index up from -34 to -24. The big concern from the survey was that the employment index which continue to hover around its record low, only up 3 points from the previous month.
- As was flagged by the weekly consumer sentiment reports, Consumer confidence fell sharply in April with the index falling by 17.7% to 75.6. What was surprising was the sharp move around expectations pertaining to the housing market. This poses a big risk to the outlook given how critical housing is to the performance of the broader economy.
- After benefiting from the pre-lockdown tailwind of panic buying, Retail sales fell heavily in April, more that offsetting the March surge. Total sales were down 17.7% for the month. More recent data suggests that sales are slowly recovering as the containment measures are rolled back but remain below pre-crisis levels.
- Housing finance was mixed in March as the virus containment measures ramped up. Owner occupier finance continues to increase while investor credit continues to decline. Falling housing turnover could see new housing finance slow sharply in the months ahead.
- Australia's trade surplus remained elevated in April as the fall in both exports and imports kept pace with each other. The trade balance sat at $8.8bln in April, down from, $10.6bln as imports fell 10% and exports fell 11%.
- Building approvals continue to drift lower rather than collapse as many had anticipated. Total approvals were down 1.8% with private housing approvals actually rising 2.7%. Approvals had already fallen heavily ahead of the economy slowing but fears are there will be no new projects coming on line to replace completing ones as the months roll on.