RBA Recap

- The RBA ended the yield curve target on the April 2024 government bond following a market sell off.
- Despite upgraded economic forecasts, including core inflation being in the 2-3% target range for the next two years, the RBA maintains that a cash rate increase is unlikely until late 2023 or 2024.

Markets Recap

- Like last month, yields again rose sharply with New Zealand CPI, BOQ's primary bond issue and Australia's CPI driving market rates higher.
- Working against markets were central banks, who remain dovish despite strong economic data.

Investing Considerations

- Higher yields have arrived, as markets price in cash rate hikes as soon as mid next year.
- Investors should consider market expectations, reference rates and the different yields across products before investing.

Economic Summary

- Backward looking data show the impact of lockdowns, but forward indicators such as the business survey show a recovery is underway.
- Employment and wages remain pivotal to monetary policy.

RBA Recap

Policy Decision:

The RBA ended the 0.10% yield curve target on the April 2024 Australian government bond. It followed a massive market sell off, where the bond was trading above 0.50%. The RBA said *“the decision to discontinue the yield target reflects the improvement in the economy and the earlier-than-expected progress towards the inflation target.”*

Markets are pricing in cash rate rises as soon as mid next year, which was counter to the RBA’s central scenario of 2024 being the first cash rate increases. To defend the 0.10% target, the RBA would have “*ended up holding all the freely tradable bonds in the bond line, so that trading in that bond would cease”.*

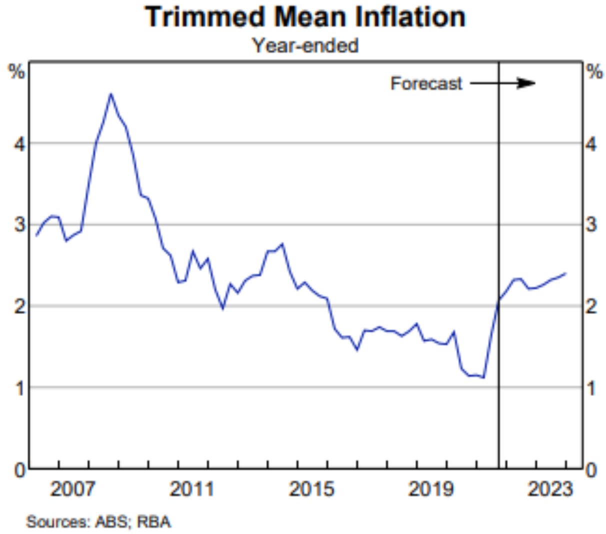
Alongside the removal of the yield curve target, the RBA revised their central expectation for rate hikes. They no longer believe *“the central scenario for the economy is that this condition [cash rate rises] will not be met before 2024”.* Instead, they view a rate hike in 2023 as “*plausible”.* They maintain that 2022 will likely be too early.

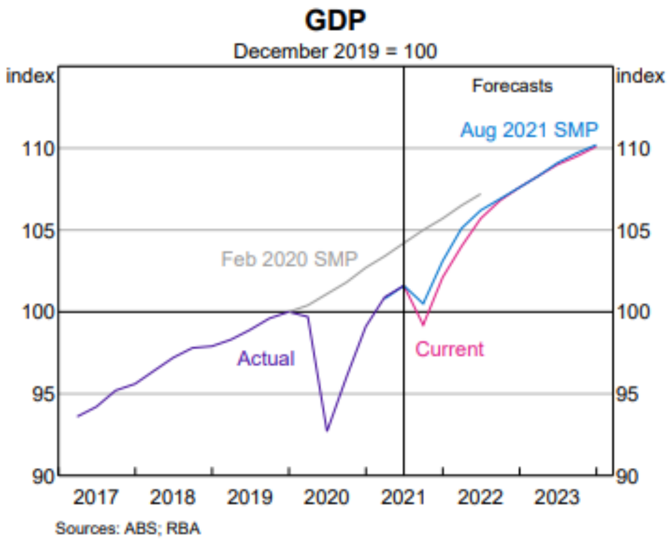
Statement on Monetary Policy:

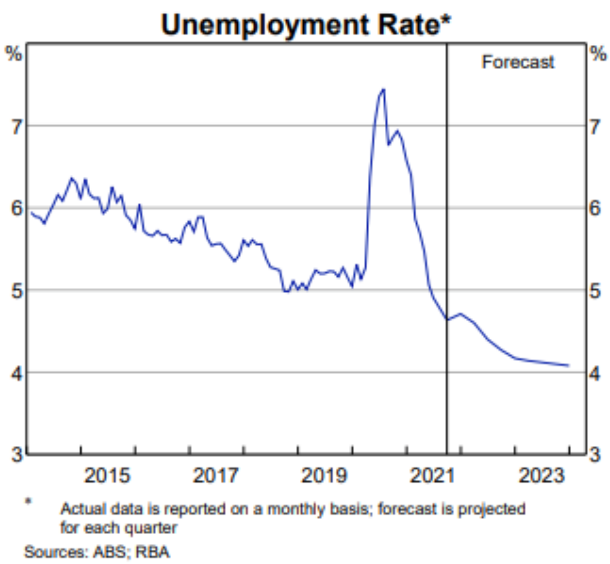
The RBA’s adjusted outlook for cash rate rises was in line with their upgraded forecasts for the economy.

In August, the RBA did not expect core inflation to be in the 2-3% target band until the end of 2023. Given the latest core inflation data for Q3 was 2.1%, they now expect it to remain at the lower end of the band until mid 2023 before reaching 2.5% in late 2023.

GDP forecasts were upgraded, but when accounting for the drop in GDP in Q3 due to covid, projected GDP is the same as the August forecasts. It is







expected to be as high as 5.5% by the end of 2022 before falling to 2.5% at the end of 2023.

Despite lockdowns in Q3, unemployment forecasts were upgraded compared to August. It is expected to be below 5% by the end of the year and over the course of 2022. An unemployment rate of 4% is expected by mid 2023.

Markets Recap

Yields Increase Sharply Again

Last month there was a noticeable jump in yields. This month the rise has been unprecedented. Using swap rates as an example, the one year, three year and five-year swap went as high as 0.58%, 1.48% and 1.78% respectively. They have since fallen and are trading at 0.28%, 1.16% and 1.57% respectively.

It amounted to several investment opportunities. Highlights included:

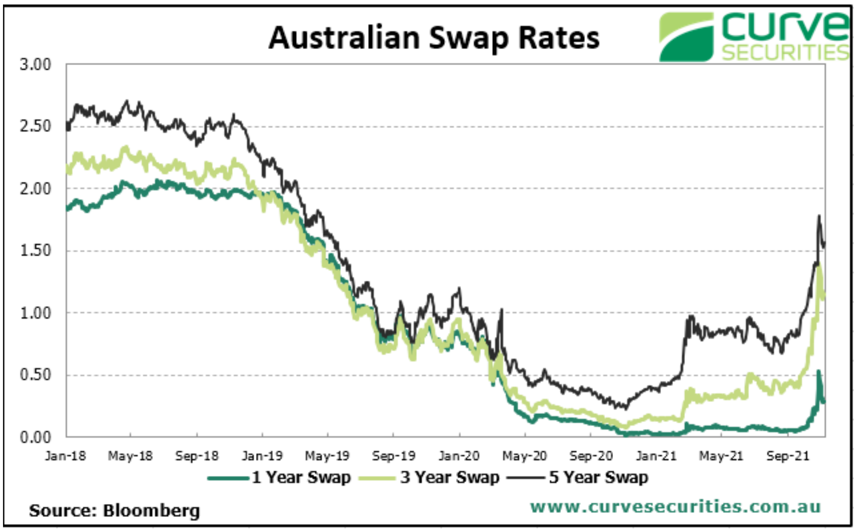
- Treasury Corp Victoria November 2023 bond trading at over 1%.
- Westpac fixed covered November 2023 trading at over 1%.
- 12-month term deposits over 1%.
- 5-year investments well above 2%.

It is worth noting two features of the yield increases:

- It is most pronounced in fixed rate bonds. Term deposits and FRNs increased but have been slower to adjust because they are affected by supply and demand factors more so than fixed bonds.
- It has been a steepening of the curve. Meaning short term rates have risen, but not to the same extent as longer rates, i.e., three years and longer.

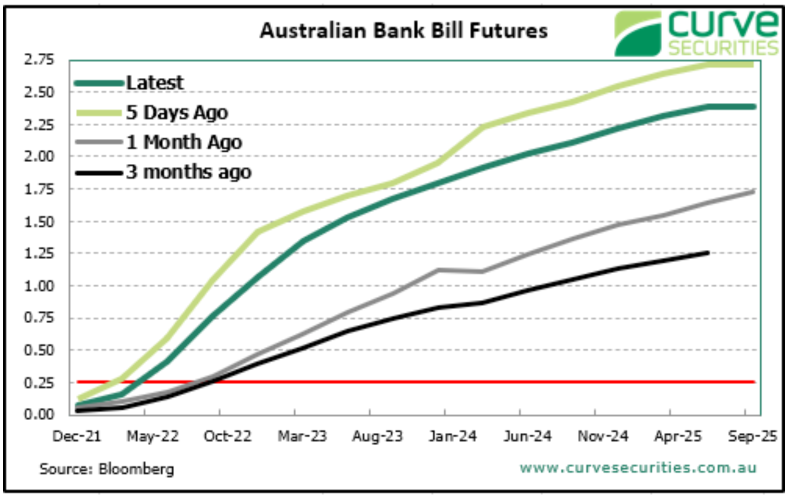
Key Market Moves

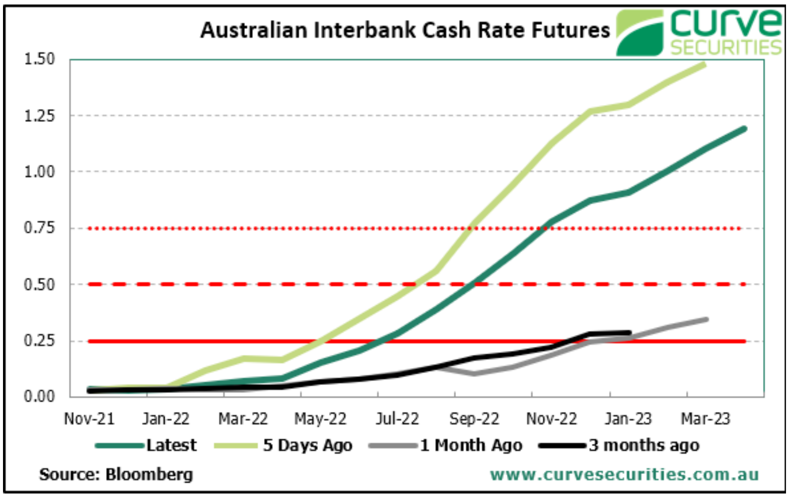
	Latest	1 Month Ago	Change
Cash Rate Target	0.10	0.10	0.00
Cash Rate (Actual)	0.03	0.03	0.00
3M BBSW	0.05	0.02	0.02
6M BBSW	0.14	0.06	0.07
1 Year Swap	0.28	0.12	0.16
3 Year Swap	1.16	0.65	0.51
5 Year Swap	1.57	1.13	0.44
3 Year Futures	1.05	0.65	0.39
10 Year Futures	1.78	1.67	0.11
AUD	0.74	0.73	0.01
ASX 200	7445	7320	125
US 2 year	0.41	0.32	0.10
US 10 year	1.46	1.61	-0.15
US 30 year	1.89	2.16	-0.27
USD Index	94.28	94.07	0.21
Dow Jones	36328	34746	1582



Three key events drove yields higher over the month:

- New Zealand inflation. Core inflation was 2.2% annually, which was higher than expected. Headline inflation is 4.9%, with supply chain disruptions especially in energy markets driving higher prices.
- Bank of Queensland's 5-year bond issue. This priced higher than many expected, with the FRN at +80 and the fixed 5-year yield to maturity 2.13%. Similar bonds such as BOQ's May 2026 FRN and Suncorp 2026 FRNs were up as much as 10 basis points following the issue.
- Australian inflation. Like New Zealand, core inflation was higher than anticipated at 2.1% annually, which is within the RBA's target band. Headline inflation was 3%, which was driven by increases in fuel and housing related prices.





These factors made it easier to envisage higher yields sooner than what was being priced in. Markets are now pricing in cash rate rises as soon as mid next year and expect by mid 2023 the cash rate will be at least 1.25%.

Central Banks Dovish

By contrast, central banks have a dovish stance. Following Australia's inflation number, the RBA ended the yield curve target but maintained that it *"is likely to take time*" before prices are sustainably within the target band. Their stance pushed yields back down, with three to five year swap rates falling as much as 20 basis points after the meeting.

In the US, core inflation is 4% and wages are up 4.2% for the year. However, the Fed decided to taper their $120 billion a month purchases by $15 billion a month, meaning they plan to continue QE until July next year.

The Bank of England decided to maintain their cash rate at 0.10% despite many expecting it to rise to 0.25%. Core inflation is 2.9% and unemployment 4.6%.

These dovish positions seem to be keeping yields from rising too high. If the RBA were to suddenly shift to a more hawkish stance, it would likely send yields higher still.

Investing Considerations

For most of this year, the challenge for investors was knowing rates will rise at some point. There was a trade-off whereby sitting on the sidelines meant forgoing yield, but by investing there was the potential that a higher rate could be achieved later.

Higher rates have arrived. In terms of relative value, the 5-year swap is close to 1.40% higher than the cash rate. Over the past 25 years, this has averaged around 0.75%. This shows that cash rate hikes are being priced in, so higher rates are available right now for investors, not just when the RBA actually increases the cash rate.

The caveats to this are term deposits tend to be slower moving. Especially in the current market where ES balances are enormous, so ADIs appetite for funds remains low. Similarly, FRN margins remain suppressed as the TFF reduced new issuance over the past 18 months.

We believe the beginning of the TFF maturities will mark another uptick in yields, especially for FRNs and TDs as ADIs need to raise funds. This is unlikely to occur until the back end of 2022. This will coincide with the phasing out of the CLF, which will be another impetus for higher yields.

Nonetheless, current rates are very attractive, especially if one of the two scenarios occurs:

- The RBA’s expectation for the economy is correct. It would mean the cash rate remains at 0.10% until at least the end of 2023 whereas current market rates are priced in for a cash rate rise as soon as mid next year. Another covid outbreak in winter as vaccine effectiveness wears off could be a scenario where this plays out. Investing now at high rates would lock in that interest rate for at least two years.
- Early hikes dampen the economy to the extent that the RBA stops hiking. Many new loans have been written over the past 18 months at record low interest rates. If the RBA increases the cash rate, it is plausible that indebted borrowers come under more pressure and the economy slows so the RBA stops hiking rates. Currently, markets expect the cash rate to rise indefinitely from mid next year until 2024. If the RBA for example stop hiking rates at a cash rate of 0.75%, and the margin of the 5-year swap over the cash rate goes back to its historical average, then the 5-year swap would trade near its current level.

When investing, consider:

- Comparing the rate on an equivalent fixed bond vs a TD. A higher yield on the fixed bond would show you should either buy the fixed bond or wait until the TD rate increases towards or higher than the fixed bond.

- Compare rates to benchmark yields, such as government bonds and swaps (acts like a benchmark credit curve). If you are receiving a rate that is only slightly above these reference rates, you are better off waiting for a higher margin over these.
- Market data could swing the market up or down. For example, on 17 November the latest wages data for Australia is released. A stronger than expected rise could bump yields up, as this would re affirm the markets stance that cash rates will rise as soon as next year. A soft number could see yields decline, as it would indicate markets are overestimating the ability of the RBA to raise the cash rate so soon.

Australian Economy

Data releases over the month show the impact that lockdowns across the Southeast of the country have had on economic activity. We have seen building approvals fall away as the impact of the Home Builder program fades. Retail sales volumes over the third quarter were down 4.4%. New housing finance approvals have also wilted. The trade balance has also receded from its record high as the fall in exports has outpaced the fall in imports.

If not for the pandemic induced lockdowns, it would be panic stations for both fiscal and monetary policy to step in. Much of those lockdown induced headwinds are already fading as lockdowns are unwound and economies are re-opening. This should start to show up in the data in the next few months.

Quarterly Data

	Period	Value/Index	QoQ	YoY
GDP ($m)	Q2	$505,134	0.7	9.6
CPI	Q3	118.8	0.8	3.0
CPI - Trimmed Mean	Q3	118.9	0.7	2.1
House Prices	Q2	176.3	7.7	19.8

Monthly Data

	Period	Value/Index	MoM	YoY
TD-MI Inflation	October	120.77	0.2	3.1
TD-MI Trimmed Mean	October		0.2	2.8
Unemployment Rate (%)	September	4.6	0.1	-2.3
Total Employment ('000)	September	12,885	-138.0	303.5
Full Time Employment ('000)	September	8,983	26.7	442.9
Part Time Employment ('000)	September	3,901	-164.7	-139.1
ANZ Job Advertisements	October	203,428	6.2	56.0
NAB Business Confidence	October	20.8	11.2	23.4
NAB Business Conditions	October	10.8	6.0	6.9
NAB Employment Index	October	5.6	4.2	9.3
Consumer Confidence	October	104.64	-1.6	10.8
Retail Sales	September	$29,669	1.3	1.7
Trade Balance ($m)	September	$12,243	-$2,496	$6,635
Exports ($m)	September	$44,969	-6.4	33.3
Imports ($m)	September	$32,725	-1.8	16.3
Housing Finance Ex-Refi ($m)	September	$30,310	-1.4	35.5
Housing Finance O/O Ex -Refi ($m)	September	$20,689	-2.7	20.8
Housing Finance Inv Ex-Refi ($m)	September	$9,621	1.4	83.2
Building Approvals Total	September	$18,090	-4.3	12.8

Data that is more real time, such as the NAB business survey, paint a different picture of the underlying momentum in the economy. Business conditions have improved markedly in the past month with the October read seeing the index up 6 points to 11. The improvement was broad based with Trading, Profitability and the Employment index all up between 5 and 7 points. Forward orders also surged from -1 to 15 in a sign there will be a noticeable pickup in activity as the economy re-opens. Most importantly business conditions have staged a massive turnaround over the past two months, jumping from -8 in August to 21 in October.

The crucial element from all those is what happens to the employment market, which will determine the outlook for monetary policy. While inflation has firmed recently and could prove sticky, the RBA will be reluctant to act until they see wage growth underpinning inflation.

There is widespread anecdotal evidence and stories of acute wage pressures impacting the economy. We are also seeing headlines on labour shortages and how many low skilled and low paying jobs are struggling to be filled. Yet we haven't seen these wage pressures show up in the official wage data with the next update due on the 17th of November.

What we know is that hundreds of thousands of workers have left the labour force since the start of the pandemic. Many of these were temporary visa holders from overseas who opted to move home as work opportunities dried up and the ability to move freely between Australia and their home country to see family was restricted. With immigration still limited, filling these types of positions is proving difficult. Firms are also having to compete for experienced workers or those with specific skills for a similar reason.

How this situation resolves itself as the economy reopens will have a significant impact on monetary policy. If labour supply improves then wage pressure will remain muted. Should employers resort to increasing wages to attract staff during a period of limited supply, then the RBA should finally get the wage growth they have been yearning for. We are unlikely to see enough in the wage data this quarter to change the narrative. It could be a different story come February.

This document is intended to provide you with general information only. It does not take into account your investment objectives, financial situation or particular needs. Before acting on this information, you need to consider the appropriateness of the information in lieu of your investment objectives, financial situation or needs.