Flashnote

HSBC
Global Research

Macro
Australian Economics

The RBA Observer

On hold, as rebalancing continues

- **Low interest rates are supporting a housing price boom and an upswing in residential construction**
- **Timely indicators suggest some recent improvement in conditions in the services and manufacturing sectors and the recent decline in the AUD should support further rebalancing**
- **We see the RBA as unlikely to cut further in this easing phase and expect that rates may need to rise in H2 2014**

On hold next week: but what about 2014?

Growth is showing further signs of rebalancing – from being mining investment-led to being driven by the non-mining sectors. Low interest rates are lifting the established housing market and this month brought more evidence that the upswing in residential construction is picking up pace. There are also signs that the rebalancing is broadening, with the purchasing manager's indexes for construction, manufacturing and services all rising. Helpfully, despite slowing down, mining investment has not yet fallen away sharply – it has levelled out – which is allowing more time for growth to rebalance.

The RBA will be heartened that its low cash rate setting is supporting Australia's great rebalancing act. However, as noted in speeches by the Governor and Deputy Governor this month, it would still like financial conditions to be looser – to allow a faster rebalancing. The challenge is that it is unlikely to want to cut interest rates further to achieve this, for fear of over-heating the housing market. It would prefer a lower AUD: the recent modest decline in the currency would, no doubt, be welcome.

We expect the cash rate to be left on hold next week, at its historic low of 2.50%.

What about 2014? Our central case is that the rebalancing of Australia's growth will continue into 2014, supported by low interest rates and a modest decline in the AUD (we forecast it to be US86 cents by end-2014). The lower AUD is expected to be partly driven by tapering by the Federal Reserve, which we expect to begin by early 2014. In this central case, we expect that the RBA might have to start lifting rates in H2 2014, as the housing market boom continues, and we expect that a pick-up in growth and lower AUD will start to lift underlying inflation into the upper half of the RBA's target band by then.

There are clearly risks to this view: weaker global growth, lower commodity prices, the lack of a Federal Reserve taper and AUD strength are key risks. Locally, tighter fiscal policy is a key risk, with next month's mid-year budget update worth watching carefully.

29 November 2013

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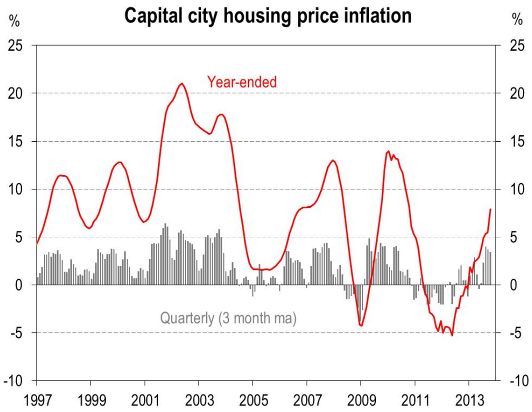
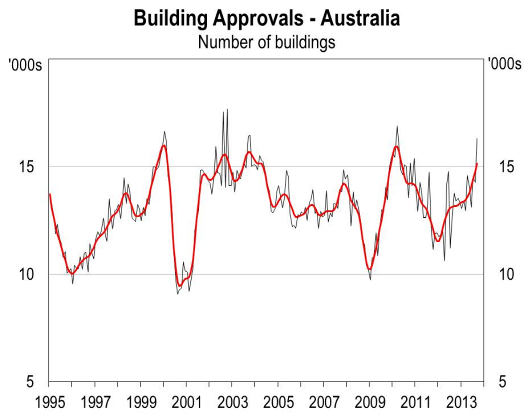
1. Australia's housing market is booming



Source: RP Data/Rismark

2. Housing construction also looks set to accelerate



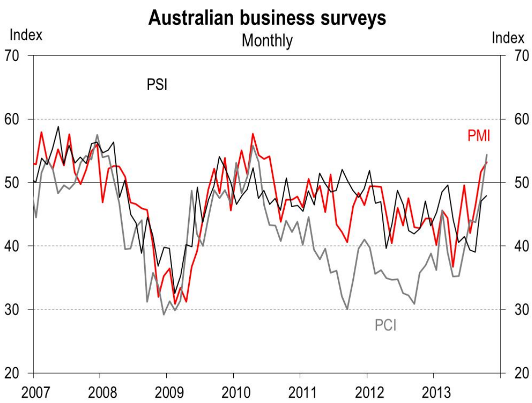
Source: ABS

Housing market booming and more signs of life elsewhere

House prices are rising strongly (+7.6% y-o-y) supported by low interest rates (Chart 1). There are also further signs that the housing construction upswing is picking up pace (Chart 2). The lift in the housing market is largely as expected, given the level of rates. As noted in a recent speech, the RBA Deputy Governor, Phil Lowe, suggested that while we could end up in 'a situation where house prices grow too strongly for too long … we're not in that situation at the moment'. We agree. Australia does not have a housing bubble (see *Downunder digest: Australia's household debt: Why we are not worried*, 21 November 2013). But we do think the housing boom could constrain the RBA from cutting rates further.

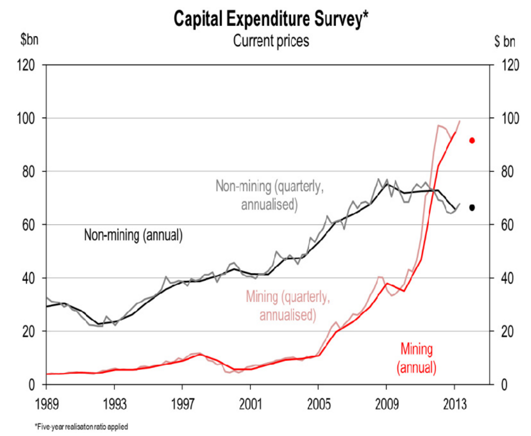
Evidence is also building that the pick-up is spreading beyond the housing sector. Business and consumer sentiment have improved in recent months, supported by low interest rates, rising household wealth and increased political certainty, following a change of government in early September. The purchasing manager's indexes for manufacturing, construction and services have all risen in recent months (Chart 3). The forward-looking capital expenditure survey also suggests that expectations for investment outside the mining sector have improved a little, while mining investment is plateauing, not plummeting (Chart 4).

3. There are early signs that rebalancing is broadening



Source: Thomson Reuters Datastream

4. Forward-looking surveys have investment plateauing



Source: ABS

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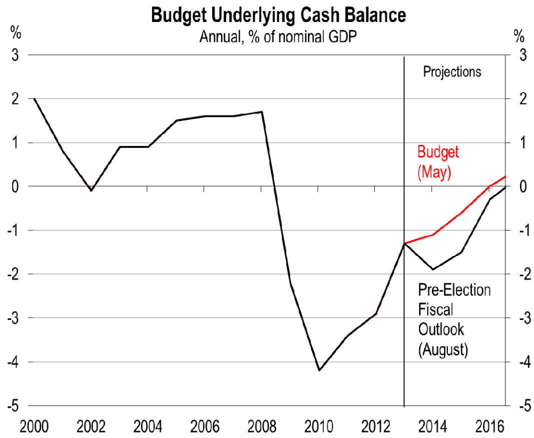
5. AUD still high for RBA, but not too far out of line

Source: RBA

6. Government set to provide fiscal update in coming weeks



Source: Australian Treasury

High AUD still in focus and fiscal tightening another threat

Despite the apparent rebalancing of growth that is already in progress, the RBA would like to see looser financial conditions to support an even more rapid rebalancing. After all, growth is still below trend and the unemployment rate continues gradually to drift upwards.

Indeed, in the RBA's quarterly official statement, published on 8 November, it noted that a lower AUD is 'likely to be needed to achieve balanced growth'. This continues the RBA's rhetorical position that the currency is 'uncomfortably high'. In a speech given last week, the RBA Governor, Glenn Stevens, suggested that it is his 'judgement' that 'the Australian dollar is currently above levels that we would expect to see in the medium term'.

In his speech, the Governor presented the RBA's modelling for the AUD (the RBA's own modelling puts a very large weight on the terms of trade and thus commodity prices). Interestingly, on the basis of the RBA's model, the current level of the inflation-adjusted (real) trade-weighted index is currently not far from fair value (Chart 5). As we have been writing in recent months, we think the RBA would be comfortable with the AUD somewhere between US85 and US90 cents. The RBA Governor also mentioned the possibility of intervening in the currency market, though we think the bar for considering this is very high, with a currency of well over US95 cents needed for this to be contemplated, in our view.

Since the Governor's speech the AUD has come down a bit, and is now trading around US91 cents: this would be welcomed by the RBA. Our own view is still that the AUD will be around US90 cents at year-end and will fall modestly through 2014 to US86 cents.

Another challenge for the economy is the fiscal outlook. The last set of fiscal estimates, published by the previous government in August, projected a larger fiscal deficit for 2013/14 than in the May budget (Chart 6). The current government is expected to provide its mid-year fiscal update next month. It seems likely that its fiscal deficit will be larger in the short run, but the key question is: how quickly is it planning to get back to surplus? Tighter short-term fiscal policy is a downside risk to the economy.

Where are rates headed in 2014?

Growth in Australia's economy is showing more signs of rebalancing and we expect these trends to continue into 2014. As mining investment edges downwards in 2014 we expect growth to be supported by a ramp-up in resource exports and growth in the non-mining sectors of the economy. We expect the housing boom to continue as low interest rates continue to provide support. The recent pick-up in consumer confidence is expected to translate into a modest pick-up in household consumption. Recent improvements in business confidence are expected to see a rise in investment outside the mining sector. Given our expectation that growth will be heading back towards trend by mid-2014, we also expect employment growth to start picking up in coming quarters and for the labour market to start to tighten.

With a housing boom expected to be well underway by mid-2014, growth having largely rebalanced and the AUD having declined a bit further, we expect that inflation will start to rise. With this in mind, our central case is that the RBA will start to lift rates in H2 2014.

Clearly there are risks to this view. Globally, there is the ongoing risk that the Federal Reserve does not taper anytime soon. The main implication for Australia would be a stronger AUD, which would limit the speed of Australia's growth rebalancing. As always, China also presents risks. If China's growth was to slow more than expected – particularly if there was a slowdown in infrastructure investment – this could mean lower commodity prices, which would be a drag on Australian income growth.

Locally, fiscal consolidation presents a risk to the growth outlook. Australia's new government is set to publish its first fiscal outlook in coming weeks. Aggressive fiscal consolidation over the next year is a downside risk to the growth outlook and could present a risk to our rates view. However, our central case is that the mid-year update shows short-term fiscal support, with consolidation projected for the out-years.

All in all, we see the risks to our rates outlook as fairly balanced. Locally, the debate amongst economists remains whether there is another rate cut yet to come in early 2014 – while possible, we think this is unlikely.

Bottom line

As local growth continues to rebalance and the housing market is booming we see the RBA remaining on hold next week.

We continue to expect that the RBA's easing phase is done and our central case is that it may need to lift rates in H2 2014, though clearly there are risks around this medium-term view.

1. HSBC's main forecasts for Australia

	Year-average (%)				Year-ended (%)						
	2012	2013f	2014f	2015f	Q213	Q313f	Q413f	Q114f	Q214f	Q314f	Q414f
GDP	3.7	2.5	2.8	3.4	2.6	2.4	2.5	2.7	2.9	2.9	2.9
CPI*	1.8	2.3	2.7	2.8	2.4	2.2	2.2	2.4	2.8	2.9	2.8
Trimmed mean*	2.3	2.3	2.7	2.7	2.3	2.3	2.3	2.5	2.7	2.8	2.8
Unemployment rate	5.2	5.7	5.6	5.1	5.6	5.7	5.8	5.8	5.7	5.5	5.3
AUD/USD** ^	1.04	0.90	0.86	--	0.92	0.92	0.90	0.89	0.88	0.87	0.86
Cash rate^	3.00	2.50	3.00	4.00	2.75	2.50	2.50	2.50	2.50	2.75	3.00

Source: HSBC estimates; *Includes effect of carbon tax from Q312; **AUD forecasts detailed in 'Currency Outlook: November 2013' ^end-period

Disclosure appendix

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