Flashnote

HSBC Global Research

Macro
Australia Economics

The RBA Observer

On hold for some time yet

- **Lower commodity prices and a persistently high AUD are squeezing local income**
- **The rebalancing of growth in the local economy has also lost some momentum recently**
- **We still expect the cash rate's low point to be 2.50%, but now expect the next hike to be in Q1 2015 not in Q4 2014; the cash rate is still expected to be 3.50% by end-2015**

Some loss of momentum

Growth in Australia showed strong momentum around the turn of the year. Q1 GDP increased 1.1% q-o-q and 3.5% y-o-y, which is above trend for Australia. GDP was supported by strong growth in resources exports to China, as new mining and export capacity came on line. At the same time, there was a modest lift in household spending and residential investment rose sharply. The numbers provided evidence that growth is rebalancing away from being mining investment-led. GDP growth was strong despite the drag from falling mining investment.

But there has been some loss of momentum since the first quarter. New building approvals have fallen, and growth in retail sales and housing price growth has slowed. Consumer sentiment has deteriorated, reflecting the impact of the Federal budget cuts on confidence. Trade data also suggest that the strong growth in resources exports in Q1 is unlikely to be repeated in Q2. In addition, growth in incomes is being squeezed, as commodity prices fall without a matching decline in the AUD (the currency has actually appreciated). As a result, we expect GDP growth has slowed into the second quarter.

Nonetheless, the underlying trend of improvement in the Australian economy is expected to continue in 2H, given monetary policy is still loose. Despite slower growth in housing prices, they are still rising, reflecting the impact of low interest rates. Also, the slowdown into Q2 has not yet impacted business confidence, with firms continuing to report plans to take on new employees. Forward-looking business surveys suggest hiring intentions are still at higher levels than last year. We still expect the unemployment rate to edge lower through 2014.

With an improvement in the labour market still underway and housing prices still rising, the RBA is unlikely to deliver any further rate cuts, in our view. However, we now see them on hold for longer than we previously expected. We expect the cash rate to remain on hold for the rest of this year, before rising in Q1 2015.

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Paul Bloxham
Chief Economist, Australia and New Zealand
HSBC Bank Australia Limited
+61 2 9255 2635
paulbloxham@hsbc.com.au

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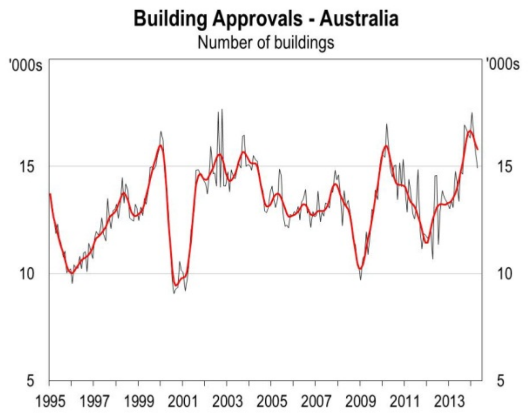
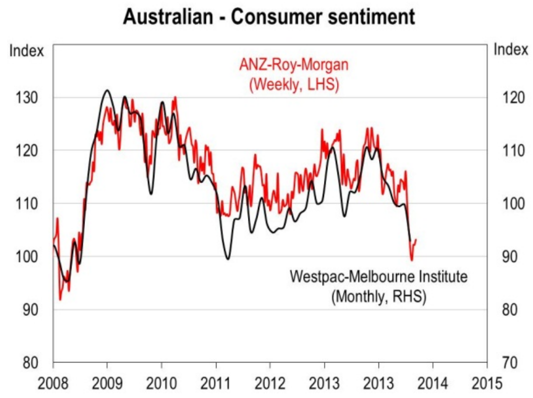
1. Building approvals have fallen recently



Source: ABS

2. Consumer sentiment declined due to budget cuts



Source: Thomson Reuters Datastream

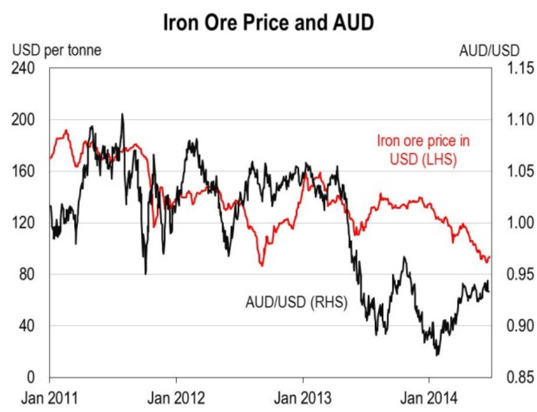
Timely indicators suggest a slowdown into Q2

Following a strong Q1 GDP print, timely indicators suggest that growth is likely to have slowed into the second quarter. Building approvals fell, housing prices and retail sales growth also slowed (Chart 1). Part of the loss of momentum may just reflect some retracement after a strong lift in these indicators around the turn of the year. It may also reflect the impact of Federal budget cuts announced in May. The negative impact of the Federal budget on consumer sentiment has persisted into June, although there are some signs of stabilisation (Chart 2). After strong growth in resources exports in Q1 the more timely trade data also suggest that exports are not likely to contribute as much to growth in Q2.

High AUD is squeezing local incomes

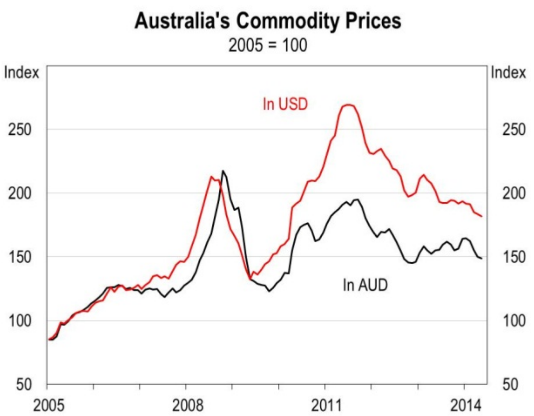
The slowdown in China in the first half has also put downward pressure on commodity prices, with iron ore prices 30% lower than at the beginning of the year (Chart 3). At the same time, the AUD has appreciated by 4% since the beginning of the year, supported by the positive carry available from investing in Australia. The combination of falling commodity prices and a rising AUD means the AUD value of commodity exports has fallen, which is squeezing local income growth (Chart 4). The AUD is

3. Iron ore prices falling but AUD rising, squeezing incomes



Source: ABS, Thomson Reuters Datastream

4. Commodity prices are falling in AUD terms too



Source: RBA

not working as an international shock absorber as it has done in the past to protect Australia's economy. In recent months, the RBA's commentary has been stating that the 'exchange rate remained high by historical standards, particularly given the further decline in commodity prices'. While the RBA has not yet returned to the full-blown jawboning of last year, when it repetitively stated that the AUD was 'uncomfortably high', it is clear that the RBA would like a lower currency.

Still see gradual rebalancing: RBA unlikely to cut again

We remain of the view that Australia's great 'rebalancing act' is underway, albeit happening only gradually. There are still clear signs that monetary policy is working. Although housing price growth has slowed, timely indicators of conditions, such as auction clearance rates, still suggest that there are elevated levels of activity in the housing market. Business surveys are also still reporting that conditions are better and confidence is higher than it was last year, despite the impact of the budget cuts announced in May (Chart 5). Business surveys are also continuing to report stronger hiring intentions than they were last year and the unemployment rate remains below its 6.0% peak level from earlier in the year (Chart 6).

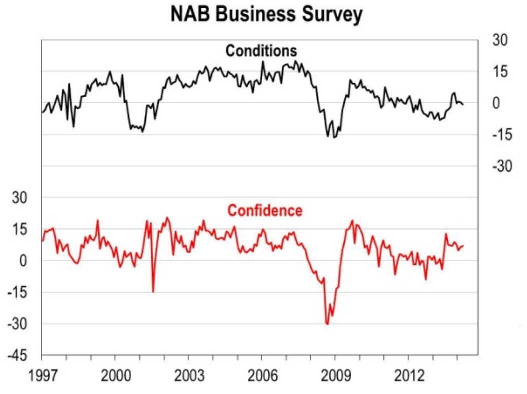
Our central case also assumes a pick-up in China's growth in the second half and that this should provide some support for commodity prices. We expect iron ore prices to rise through the second half, supported by Chinese demand. At the same time, an improving US economy and signs that US rates will need to rise at some point next year are expected to put some downward pressure on the AUD through the second half.

RBA tactics and commentary: it likes a lower currency

We still see the hurdle for the RBA to consider further rate cuts from here as high. We expect the RBA to repeat in its commentary that the 'most prudent course is likely to be a period of stability in interest rates'. We doubt it will be adopting an easing bias, although the risk is that the commentary is more dovish than last month.

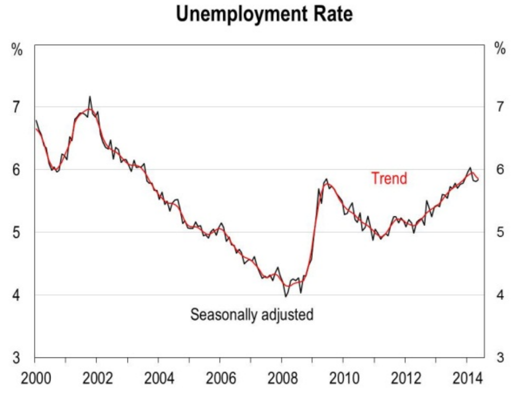
The RBA is likely to be becoming increasingly frustrated with the level of the AUD. We expect it to once again note that the AUD is 'historically high' and that this is especially the case, given the further declines in commodity prices.

5. Business conditions held up despite the budget cuts



Source: Thomson Reuters Datastream

6. The unemployment rate is still below its peak



Source: ABS

HSBC

1. HSBC's main forecasts for Australia

	Year-average (%)			Year-ended (%)							
	2013	2014f	2015f	Q114	Q214f	Q314f	Q414f	Q115f	Q215f	Q315f	Q415f
GDP	2.4	2.8	3.2	3.5	2.7	2.6	2.5	2.4	3.1	3.5	3.7
CPI*	2.4	2.8	2.9	2.9	3.0	2.7	2.7	2.8	3.0	2.9	2.8
Trimmed mean*	2.4	2.7	2.9	2.7	2.7	2.7	2.6	2.9	2.9	2.9	2.7
Unemployment rate	5.7	5.8	5.6	5.9	5.9	5.8	5.7	5.6	5.6	5.5	5.5
AUD/USD** ^	0.89	0.86	0.86	0.93	0.93	0.87	0.86	0.86	0.86	0.86	0.86
Cash rate (previous)^	2.50	2.75	3.50	2.50	2.50	2.50	2.75	2.75	3.00	3.25	3.50
Cash rate (current)^	2.50	2.50	3.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.50

Source: HSBC estimates; *Includes effect of carbon tax from Q312; **AUD forecasts detailed in 'Currency Outlook: June 2014' ^end-period

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Issuer of report
HSBC Bank Australia Limited
Level 32
HSBC Centre
580 George Street
Sydney, NSW 2000, Australia
Telephone: +61 2 9006 5888
Fax: +61 2 9255 2205
Website: www.research.hsbc.com

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