23 April 2015

All hurdles now negotiated –RBA still on course for a rate cut in May

We have now passed the last three significant milestones for insights into the Reserve Bank Board decision on May 5. These are the Board minutes for the April meeting; the Governor's important speech in New York; and the March quarter inflation report. From our perspective the case for a cut in May remains strong and we continue to expect the Bank to finally deliver on the second leg of the 50bp's of cuts in "early 2015" we forecast back on December 4 last year.

In the minutes, the decision not to cut rates at the April meeting despite "financial markets assign[ing] a high probability to a reduction in the cash rate at the current meeting" seemed to be explained by a need for more time and more data to "assess whether or not the economy was on the previously forecast path". It seems that even the "previously forecast path" would be sufficient to justify another rate cut. In that regard, it appears to us that the Bank is actually preparing to lower the growth forecasts which printed at the February Statement on Monetary Policy (SoMP).

This decision would be specifically around business investment and exports. In the minutes the Board significantly lowered its expectations for both mining and non-mining investment. On non-mining investment, it refered to "forward looking indicators as well as liaison" suggesting that it was likely to remain subdued, AND COULD EVEN DECLINE over the next year or so" (our emphasis). On mining investment, it noted that "the recent declines in bulk commodity prices could, at the margin, lead to a larger than expected fall in mining investment and some decline in the production of iron ore and coal", implying a more subdued outlook for exports.

Forecasts are revised in the Statement on Monetary Policy which will print on May 8, 3 days after the board meeting.

If we are right and the Board has decided to cut its growth forecast in 2015 and 2016, probably from 2.75% and 3.50% to 2.50% and 3.25% respectively, then a decision not to cut would seem particularly bizarre. That is because the 2.75% and 3.50% forecasts were predicated on another cut after February. In formulating the forecasts for the February Statement, the Bank assumed "market pricing" which implied a follow up cut by May.

Not delivering the assumed cut and lowering the growth forecast would be internally consistent but hardly a likely policy option for a Bank that appears comfortable about the inflation outlook but concerned about below trend growth. Better to deliver the cut and revise down the growth forecast, not because an assumed rate cut has not been delivered but because the overall outlook has deteriorated further, particularly around both mining and non-mining investment and exports.

While the minutes do note that consumption and dwelling investment have picked up, there was no strong implication of an upgrading in the outlook for the household sector, with retail trade in the early months of 2015 being described as "about average". Indeed, it would be difficult to raise the outlook for the consumer in the face of the recent fall in the terms of trade associated with the 21% fall in the iron ore price and a resilient AUD. We have revised down our forecast for nominal GDP growth in 2015 to 2.4%, implying ongoing soft household income growth.

There appears to be more specific signs that the Board is increasingly more comfortable with the risks around the housing market: "there had been little change to housing market conditions overall or in the growth of housing credit in early 2015". In his speech, the Governor pointed out that "popular commentary is, in my opinion, too focussed on Sydney prices and pays too little attention to the more disparate trends among the other 80% of Australia". It is important to highlight the Board continues to note "the Bank was working with other regulators to assess and contain risks arising from the housing market". That, of course, refers to the guideline around restricting the growth in banks' portfolios of residential loans to investors to 10%yr. Growth has already reached that level. In previous investor driven "booms", growth in loans to investors reached 30%yr. Certainly that growth was off lower bases, but given the attractive fundamentals in terms of the historically narrow gap between rental yields and mortgage rates and the low returns available in alternative forms of saving such as bank deposits, it seems fairly clear that these "guidelines" can be reasonably expected to "bite" at some stage in the cycle.

Fiscal policy at the state level is also seen to be unhelpful in supporting growth with only NSW and Victoria getting any boost from public demand.

A key explanation for the decision to hold rates steady was around "receiving more data including on inflation". In that regard the March quarter inflation report does not represent a "hurdle" to cutting. Headline inflation printed 0.2% (1.3% annual) and core inflation printed 0.6% (2.4% annual). There may have been some nagging concern around the sharp jump in core inflation between September (0.45%) and December (0.65%), but the March print of 0.6% allayed any concerns around a sustained lift in core inflation. It is true that the detail in the report highlighted some likely pressures coming through from the weaker AUD (cars; leisure (holidays); and household goods). However, there were equally encouraging signs around the key housing inflation numbers with rents (0.4%) and house purchase (0.9%) both showing marked slowdowns compared to 2014.

One issue that markets will clearly be pondering is whether the surprisingly strong employment report for March, which printed after the Board meeting, will be sufficient for the RBA to revise its "previously forecast path" for the labour market. There is no evidence to suggest that the Board has significantly changed its view on the labour market: "labour market conditions were likely to remain subdued"; "the various forward looking indicators were stronger than a year earlier but remained at levels consistent with only modest employment growth in the months ahead". It is unlikely that one monthly report, given the recent volatility in these reports, would change this fairly entrenched view.

The Board introduced a new concept in the minutes, questioning the effectiveness of monetary policy by pointing out that "the responsiveness of borrowers and savers to changes in interest rates and asset prices was unusually uncertain". This may imply that resistance to ever lower rates is apparent although it appears to say more about what might happen after the May meeting rather than over the next few weeks. It is also true that an immediate response to the "cash flow" boost from a rate cut has been more muted than was previously the case, particularly pre GFC. However, it does not dispute the fact that the household sector is a net borrower and that the cash flow boost is being used by households to boost the strength of their balance sheets. In due course, these stronger balance sheets can be used to boost spending in an environment of ongoing constraint in incomes growth.

The ever present plea for a lower AUD is emphasised in the minutes: "further depreciation of the Australian dollar was likely given the recent declines in key commodity prices". At the time of the April meeting, the AUD was trading around USD0.76. Now we see it in the 0.77-0.78 range. This should be a clear signal that jawboning the AUD is unsuccessful if interest rates are not adjusted accordingly. It is clear in these minutes and in the Governor's speech that a lower AUD is necessary to achieve the adjustment in the economy that will be required to provide some buffer to the huge fall in Australia's export prices and the sharp decline in mining investment.

While I appear to be making a fairly convincing case for a cut in May, markets are still nervous. We can make a strong economic case for lower rates but we cannot, as we have seen in recent months, anticipate the tactics of the Reserve Bank. Tactics are not about recognition of the case for a cut but around how a cut might be best used when the board feels that it is near the bottom of the cycle. One journalist who writes regularly on the RBA and, to date, appears to be favouring an extension of the pause, argues that if the Bank delivers in May, markets will assume that the Bank is at the end of the cycle and have little effectiveness in "jaw boning" the AUD – better to delay the cut and maintain the very strong easing bias. That is a reasonable alternative tactic but, as the journalist points out, risks the Bank losing a degree of credibility. Note that in the previous eight instances the Bank has used the term "for the time being" it has acted within two months. "For the time being" was first introduced in the March statement by the Governor.

For our part, we do not see that, in a developed world of negative to zero rates, 2% should be seen as a rate floor. However, we do expect that, following the cut in May, the Board will be quite "patient" before it decides whether even more cuts are necessary. That decision will hinge on whether it feels that it can maintain a forecast of 3.00-3.25% growth for 2016. That will not be clear until the fourth quarter of this year.

For now, we are comfortable to stick with our own forecast of 3.00% growth in 2016 and a flat rate profile after May. However, this view will be well tested over the course of the second half of 2015.

Bill Evans, Chief Economist.

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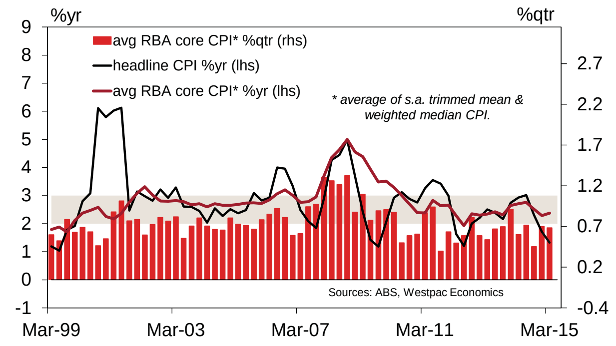
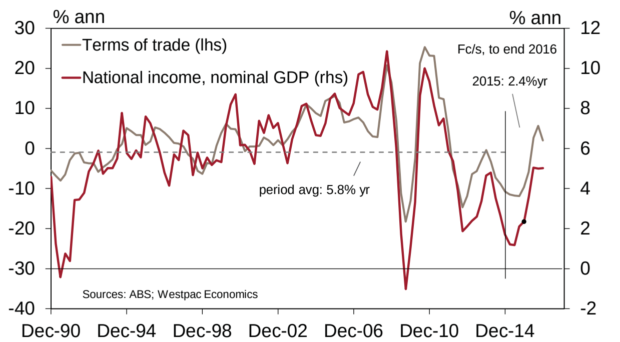
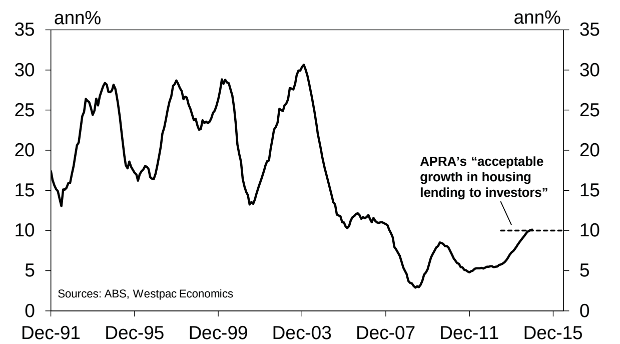


National income dented by terms of trade slump



Investors: total outstanding debt



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