

CASH RATE OUTLOOK

The RBA Gains Some Breathing Room

Tuesday, 18 October 2011

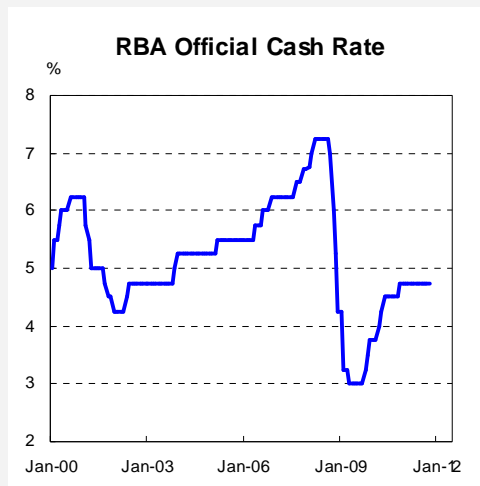
- The Minutes of the October meeting confirmed that Reserve Bank of Australia (RBA) had softened its tone to a more dovish stance.
- A notable development was the RBA's outlook on inflation. As a result of revisions to seasonality and the expenditure weights it appears that there will be a lower starting point for underlying inflation.
- The lower starting point for inflation and also growth now predicted to be slower has allowed the RBA to gain some breathing room and opened the possibility of cutting rates, provided Q3 underlying inflation is benign and if it "proves necessary."
- Although we expect Q3 underlying inflation to be within the RBA's comfort zone, financial market sentiment has improved since the October meeting. In addition, recent domestic demand partial indicators have improved – including retail sales, building approvals and employment data and suggest that domestic economic activity is holding up relatively well.
- Our long-held view for rates on hold remains intact and we expect the RBA to sit pat at its meeting in November and December. However, weak global growth prospects and ongoing sovereign debt issues in Europe mean that we could not completely rule out a rate cut before the end of this year.

The minutes of the October meeting confirmed that Reserve Bank of Australia (RBA) had softened its tone to a more dovish stance.

The extreme volatility in financial markets as a result of sovereign debt woes in Europe and heightened downside risks to global growth remained at the fore of the RBA's concerns. However, it maintained its upbeat assessment on Asia, noting that growth in emerging Asia "remained solid, although slower than in 2010". It was noted that investment and consumption in China had softened a little and that availability of finance to certain industries was quite tight, but that the broader economy was still growing at a robust pace and that exports were still growing to advanced economies.

Domestically, the RBA continues to expect the terms of trade to have risen further in the September quarter to another record high. Although the prices of exchange-traded commodities (base metals) have fallen significantly, bulk commodity prices (iron ore and coal) had remained at high levels. More recently, however, spot iron ore prices have fallen quite sharply over the past two weeks on slower demand. Meanwhile, economic conditions remained mixed across different sectors of the economy with weakness in housing, retailing, manufacturing, construction and wholesale sectors but strength in mining, transport and recreation and personal services sectors.

A notable development was the RBA's outlook on inflation. As a result of revisions to the seasonality and weightings in the CPI by the Australian Bureau of Statistics (ABS), it appears there will be a lower starting point for inflation. Q3 inflation data will use the revised weights



and seasonal factors. If the new seasonal effects and weights were applied to historical data, underlying inflation over the year to the June quarter would have been in the lower half of the RBA's 2-3% pa target band rather than the top half (2.25-2.50% rather than 2.50-2.75%).

The lower starting point for inflation and also growth slower than previously forecasted by the RBA has allowed it to gain some breathing room and opened the possibility of cutting rates, provided Q3 underlying inflation is benign and if it "proves necessary."

We expect quarterly underlying inflation in Q3 (released 26 November) to print 0.6%, which would take the annual rate to 2.6% (provided no back revisions) and likely to remain within the RBA's comfort zone. However, financial market sentiment has improved since the October meeting amid hopes that European leaders are to unveil a comprehensive strategy to address the crisis. In addition, recent domestic demand partial indicators have improved – including retail sales, building approvals and employment data and suggest that domestic economic activity is holding up relatively well. Further, consumer and business confidence have partially recovered after sustaining heavy falls in August.

Given these recent developments, our long-held view for rates on hold remains intact and we expect the RBA to sit pat at its meeting in November and December. However, weak global growth prospects and ongoing sovereign debt issues in Europe mean that we could not completely rule out a rate cut before the end of this year, especially if these downside risks weigh on local demand.

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