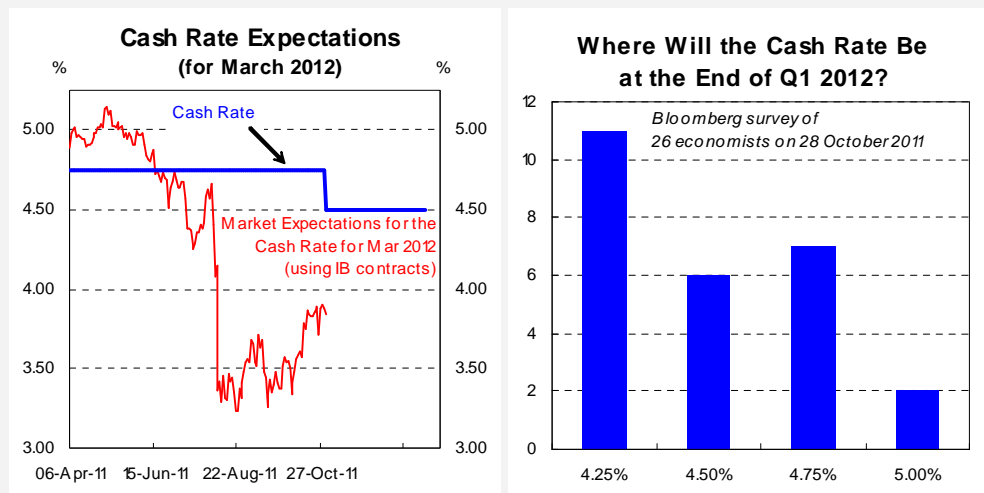


CASH RATE OUTLOOK

RBA Makes it Six Cups in a Row

Tuesday, 1 November 2011

- The Reserve Bank (RBA) cuts the cash rate by 25bp, making it the sixth consecutive change in rates on Melbourne Cup day. It takes the cash rate to 4.50% and towards a more neutral stance – one that is not applying as much restraint on the economy.
- Last week's low underlying inflation outcome – the lowest quarterly rise in fourteen years that took the annual inflation rate to the middle of the RBA's target band – cleared the way for a rate cut today.
- The high exchange rate, caution by households and tighter than normal financial conditions appear to be among the overwhelming domestic factors in the rate cut decision today. The global economic outlook must have also forced the RBA's hands with the RBA hinting that the significant slowing in Europe is hurting trade in Asia.
- We do not think this is the start of a deep easing cycle but we do expect a follow up rate cut in February next year.



The Reserve Bank prepared us for the increased possibility of a rate cut last month when they warned that an improved inflation outlook would increase the scope for monetary policy to provide some support for demand. The low inflation outcome published last week for the September quarter cleared the way for the RBA to cut rates to support demand. Underlying inflation was the lowest quarterly outcome for fourteen years and saw the annual rate step down from 2.7% to 2.5%. Indeed, after last week's inflation data that included new seasonal adjustments and weights, we became convinced that a rate cut was more likely to occur.

The RBA in their statement today indicate they now expect inflation to be more consistent with their 2-3 per cent target in 2012 and 2013. It means their existing forecasts for inflation (published in August 2011) to breach the target band over this horizon will be downgraded on publication of their Statement on Monetary Policy this Friday. This forthcoming Statement will also give more detail behind today's decision.

The high exchange rate, caution by households combined with tighter than normal financial conditions appear to be among the overwhelming domestic factors in the rate cut decision today. The Aussie economy remains multi-speed or patchwork in nature, but the soft patches are now at the forefront of the RBA's thinking.

The global economic outlook must have also forced the RBA's hands. While the RBA note today that domestic demand in the Asian region is generally expanding, they also note that the "trade performance...is starting to see some effects of a significant slowing in economic

activity in Europe". Further, China's growth rate is noted as having "slowed", as Chinese policymakers intended. And while the RBA highlights that "fears of a major global downturn have not been borne out so far", there is clearly ongoing uncertainty.

The RBA has said a "*more neutral* stance of monetary policy would now be consistent with achieving sustainable growth and 2-3 per cent inflation over time". These words could imply that rates are still applying some restraint on the economy, even after today's easing, and that more easing therefore is still required.

The big question on everyone's lips now is whether this a one off rate cut or the start of a series of rate cuts. It would be unusual for the RBA to cut rates just the once. We believe there is room for a follow up rate cut in February next year, but we do not believe that there will be a deep easing cycle or a long series of rate cuts to come.

We expect the RBA to cut rates by another 25bp in February and then leave rates steady, unless there are unforeseen adverse events that unfold over the next few months.

The RBA last cut rates in April 2009 when it was easing aggressively in response to the global financial crisis. Today's rate cut makes it the sixth consecutive rate change (i.e. cut or hike) on Melbourne Cup day.

Financial markets are fully priced for another 25bp easing by March next year while economists are more evenly divided (refer to the charts on the front page).

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