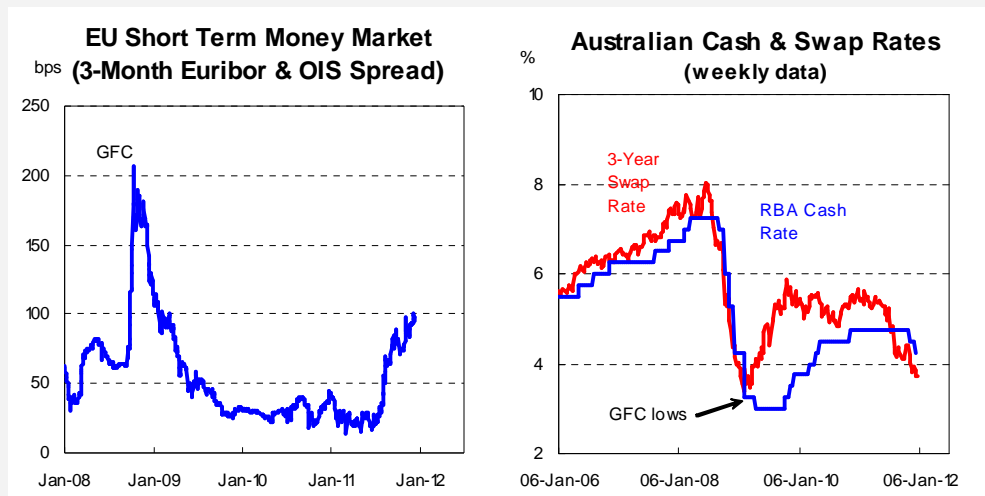


RBA MINUTES AND CASH-RATE OUTLOOK

RBA Will Play it By Ear

Tuesday 20 December 2011

- The RBA suggested in its minutes that on domestic considerations alone, there was no “strong need to cut interest rates” in December. But the developments in Europe pushed the RBA to cut rates for a second time this year.
- The RBA sees it as very difficult in judging how events will ultimately play out in Europe. The RBA therefore is likely to play it by ear, assessing and weighing up each development in Europe carefully in order to decide on the next interest rate move.
- We are increasingly pessimistic on Europe and so have recently added in another rate cut to our forecast profile. We now expect a 25bp rate cut in February and another in March. European policymakers in our view are falling further behind the curve.
- Swap rates have fallen a long way in recent months and are not far off the GFC lows. These falls have also flowed on to declines in fixed mortgage rates. While a scenario as nasty as the GFC cannot be fully ruled out, we believe that swap rates at these levels are relatively attractive. So we believe these levels might provide a good opportunity for borrowers to consider hedging some of their interest-rate exposures.



Board Minutes – Summary Key Points

The Reserve Bank (RBA) decided to cut the cash rate on December 6 for the second time this year to 4.25%.

The RBA Board minutes revealed that the RBA considered the question of whether a further reduction in the cash rate would be appropriate after a reduction in November. The RBA considered both sides of the debate.

Firstly, on the one hand, the RBA had “further evidence that a major investment boom was in progress” (indeed, business investment is expected to grow by more than 30% this financial year) and “the overall economy was expanding at a pace broadly in line with trend”. Furthermore, the RBA considered that “Australia’s main trading partners were still recording solid growth”. The RBA noted that “this did not suggest any strong need to cut interest rates”.

However, the RBA weighed up these factors against developments in Europe, which “continued to pose downside risks to the global economy and, consequently, also to Australia”. The RBA judged that “these risks had, if anything, increased through the timing and magnitude of any effects that might flow from them remained very difficult to predict”.

These minutes from the RBA suggest then that on domestic considerations alone, the RBA would have left rates alone but the European equation pushed them into cutting again.

Indeed, we have argued for a while now that the deeper the European crisis, the more cutting the RBA will need to do. The RBA will play it by ear, assessing and weighing up each development in Europe carefully.

As the RBA noted in its minutes today it remains "very difficult to judge how events would ultimately play out in Europe". On the one hand, the RBA considers that if recent efforts in Europe are successful in moving towards a solution, confidence should improve. But on the other hand, the RBA considers the possibility of a much worse outcome, involving a severe contraction in the European economy, which would have global effects. Later in the minutes, the RBA notes that "it seemed highly likely that the sovereign credit and banking problems would weigh heavily on economy activity there over the period ahead, and there was a non-trivial possibility of a very sharp contraction."

Cash Rate Outlook

European leaders and policymakers are yet to come up with an effective solution. The longer they take to come up with an effective solution, the further behind the curve they fall and the deeper the economic shock to Europe and the rest of the world. We are increasingly pessimistic on Europe.

Strains in European inter-bank markets are intensifying (refer to the LHS chart on the front page as an example), with an increasing number of banks effectively shut off from new funding and having to rely on the European Central Bank. Some banks also appear to be running short of collateral to obtain funding from the ECB. Global markets subsequently are experiencing considerable turbulence, especially in Europe.

We recently added another rate cut to our forecast profile for the cash rate (on December 15). We now expect the RBA to cut rates again in February and also in March (by 25bp each), taking the cash rate to 3.75%.

The most recent poll of economists taken on December 9 revealed that the median expectation is for the cash rate to be cut one more time next year to take the cash rate to 4.00%.

Opportunity for Borrowers

Swap rates have fallen a long way in recent months and are not far off the GFC lows. It has also flowed on to declines in fixed mortgage rates, which price off swap rates. The uncertainty over Europe means that while swap rates could revisit the 2009 lows, there is also some possibility that they will not breach below these lows. Swap rates are pricing in a GFC-type scenario that includes the RBA cash rate falling to 3% by the middle of next year. While a scenario as nasty as the GFC cannot be fully ruled out, we believe that swap rates at these levels are still relatively attractive. So we believe now is a good opportunity for borrowers to consider hedging some of their interest-rate exposures. Please refer to our Interest Rate Update Note titled "An Opportunity for Borrowers" published on November 24 for more detailed information.

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