Wednesday, 18 June 2014

Cash Rate Outlook

On Hold For Longer

- The next move from the Reserve Bank is still likely to be a rate hike, but the "period of stability in interest rates" should last for a while longer. We now expect the RBA to start raising rates in the first quarter of next year.
- The economic recovery in Australia remains intact, but some uncertainties have risen over the past month or so. Risks to the outlook include the pessimism among consumers, especially after the Federal Budget, the paring back of housing activity, the still relatively high AUD and slower global growth.
- The downside risks to the economy suggest it will take longer for the recovery to build momentum and that a rate hike then is still some way off.

Our long-held view (in place since October 2013) has been that rates would remain low at 2.50% for some time and the next move in the cash rate would be up near the end of this year. The Reserve Bank last changed the cash rate on the 6th of August 2013, with a cut of 25bp to take the cash rate to a record low of 2.50%.

We remain convinced the next move from the Reserve Bank will be a rate hike because the threshold for further easing is still high. Inflation has moved in the upper part of the Reserve Bank's target band and economic growth has improved since turning a corner around September of last year.

However, we now expect the tightening cycle to start in the early part of next year, rather than later this year.

While the economy remains in recovery, there are risks and the recovery may take longer to build momentum. The Australian economy continues to adjust to the decline in mining investment and the outlook depends on the successful transition from mining investment growth to growth in non-mining. Mining investment is set to fall sharply in 2014-15 and surveys suggest a pick-up in non-mining investment will occur and we have started to see evidence of this. But this pick-up is still modest in nature and uncertainty about the outlook for non-mining investment remains.

The latest available data reveals businesses are optimistic about the economic outlook and the recent Federal Budget contained some favourable measures for businesses. However, businesses capacity to invest and expand still relies on consumer demand and the downside risks to consumer demand in the wake of the Budget have risen.

The key gauge of consumer sentiment revealed that consumers were feeling pessimistic about the outlook heading into the Federal Budget. In the wake of the Budget, consumer sentiment fell 6.8% and very little of this drop was recovered in the subsequent survey taken in June.

The Federal Budget contained tightening measures to get the Budget back into the black by the end of the decade. These tightening measures have an impact on households. While we do not expect the Budget measures to derail the economic recovery, the adverse impact on consumer sentiment could cut the pace of growth in consumer spending and slow the pace of improvement in the broader economy.

The Reserve Bank Board minutes, published yesterday, pointed out that "high-frequency" (i.e. large) movements carried little predictive content for trends in consumption spending. So the outsized drop in the in consumer sentiment in May might not be a reliable guide to the outlook for consumer spending.

However, consumer sentiment has been in the "pessimistic" territory for four consecutive months and only in one of these months has the outcome been in the high-frequency category. So the risk remains that the longer consumers remain more downbeat about the outlook, the more likely there will be a more sustained impact on household spending.

The economy grew at its fastest clip in two years in the first three months of this year. Recent data suggests this pace of growth won't be matched or bettered in the next few quarters. There's been some paring back in domestic demand, particularly in housing. The rates of growth in housing lending and building approvals witnessed earlier this year were unsustainable and some moderation was to be expected. However, earlier strength in building approvals suggests dwelling investment will provide welcome strength for economic growth.

Low interest rates continue to be a fundamental pillar of support to the economy. Low interest rates are keeping financial conditions easy and supporting an ongoing recovery in the economy. The level of the Australian dollar can also provide stimulus to the economy. While the Australian dollar is off its heights struck in April last year, it remains high by historical standards, particularly given the recent decline in commodity prices. So the Australian economy recovery will struggle to produce enough momentum to warrant a rate hike as soon as later this year, with the AUD at current levels.

Furthermore, recently the World Bank downgraded its growth forecasts for the world economy, suggesting the external environment for Australia is not as favourable as it was around the turn of this year. China's economic data also continues to remain mixed in nature.

In sum, a recovery is underway in the Australian economy, supported by dwelling investment, strong export growth and household consumption. This recovery continues to suggest that low interest rates are providing support to the economy and that the next move from the RBA will be an increase in rates. However, the concerns about the outlook suggest the start of the rate-hike cycle is still some time away.

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