Interest Rate Outlook

Tuesday, 1 April 2014

BankSA

RBA Cash Rate held at 2.50%

- The RBA continued to signal a "period of stability in interest rates", suggesting that it intends to keep the cash rate on hold for some time.
- There was however, a touch less optimism in today's Statement, reflecting slower growth in China and the rise in the Australian dollar over the past few months. Nonetheless, the commentary still hints that the RBA is expecting growth China's growth to be in line with the government's target of 7.5% this year.
- The RBA pointed out that the recent appreciation in the Australian dollar would reduce the impact of the exchange rate in helping to achieve "balanced growth". The central bank also reiterated that "the exchange rate remains high by historical standards".
- Despite the slightly less positive nuances this month, the RBA still seems confident that domestic growth will pick up and that the transition in growth drivers from mining investment to other sectors of the economy will occur. Additionally, a lower terms of trade and Federal Reserve tapering continue to point to a weaker Australian dollar, which would provide support to the domestic economy.
- We remain comfortable with our long-held view that the RBA will be on hold for most of 2014, before beginning to raise the cash rate towards the end of the year.

RBA Statement: At its meeting today, the Board decided to leave the cash rate unchanged at 2.5 per cent.

Growth in the global economy was a bit below trend in 2013, but there are reasonable prospects of a pick-up this year. The United States economy, while affected by adverse weather, continues its expansion and the euro area has begun a recovery from recession, albeit a fragile one. Japan has recorded a significant pick-up in growth. China's growth remains generally in line with policymakers' objectives, though it may have slowed a little in early 2014. Commodity prices have declined from their peaks but in historical terms remain high.

Our view: The RBA continues to see the outlook for the global economy as one of improvement. Its view on the US, Europe and Japan is very much unchanged from March. However, the RBA is recognising the risks emerging from China. Despite the concerns over China's shadow banking system, and emerging defaults in recent times, the RBA still sees the outlook for Chinese growth as positive and "in line with policy objectives". This could imply that the RBA still expects China's growth to meet its government's 7.5% growth target this year.

RBA Statement: Financial conditions overall remain very accommodative. Long-term interest rates and most risk spreads remain low. Equity and credit markets are well placed to provide adequate funding, though for some emerging market countries conditions are considerably more challenging than they were a year ago.

Our view: This paragraph was a carbon copy of comments from a month ago. While global bonds have been supported by safe-haven demand as a result of political instability between Russia and the West, tapering of the Fed's asset purchase program and a gradual improvement in the US economy suggest to us that bond yields will again edge higher.

RBA Statement: In Australia, the economy grew at a below trend pace in 2013. Recent information suggests slightly firmer consumer demand over the summer and foreshadows a solid expansion in housing construction. Some indicators of business conditions and confidence have improved from a year ago and exports are rising. But at the same time, resources sector investment spending is set to decline significantly and, at this stage, signs of improvement in investment intentions in other sectors are only tentative, as firms wait for more evidence of improved conditions before committing to expansion plans. Public spending is scheduled to be subdued.

Our view: There remains some caution about the transition in growth drivers of the Australian economy from mining investment to other sectors. The comments seem to suggest that the RBA is still expecting non-mining investment to improve despite "only tentative" investment intentions as firms are waiting for more evidence of improved conditions. The decline in resource project construction remains a downside risk to the outlook. On balance, we expect that low interest rates and a stronger global economy will support a pickup in growth this year.

RBA Statement: The demand for labour has remained weak and, as a result, the rate of unemployment has continued to edge higher. It will probably rise a little further in the near term. Growth in wages has declined noticeably. If domestic costs remain contained, some moderation in the growth of prices for non-traded goods could be expected over time, which should keep inflation consistent with the target, even with lower levels of the exchange rate.

Our view*: We also expect the unemployment rate to edge higher, and to peak sometime mid this year. However, leading indicators are providing a promising sign that the labour market will stabilise. Improvements in the labour market also tend to lag behind economic activity.*

The RBA is continuing to rely on domestic price pressures easing in order for inflation to be consistent with its 2 to 3 per cent per annum target band over the medium-term.

RBA Statement: Monetary policy remains accommodative. Interest rates are very low and savers continue to look for higher returns in response to low rates on safe instruments. Credit growth is slowly picking up. Dwelling prices have increased significantly over the past year. The decline in the exchange rate from its highs a year ago will assist in achieving balanced growth in the economy, but less so than previously as a result of the rise over the past few months. The exchange rate remains high by historical standards.

Our view: *Low interest rates are doing what they can to support the economy. There is growing evidence of risk-taking by investors, rising asset prices and a pickup, albeit gradual, in credit growth.*

The RBA has however, toned down some of its earlier optimism as a result of the Australian dollar strengthening in recent months. The RBA has reiterated that the "exchange rate remains high by *historical standards".*

RBA Statement: Looking ahead, continued accommodative monetary policy should provide support to demand, and help growth to strengthen over time. Inflation is expected to be consistent with the 2–3 per cent target over the next two years.

Our view: *Despite below trend growth over 2013, and a further lift in the unemployment rate, the RBA remains relatively confident that low interest rates and the lower Australian dollar will result in stronger growth. We tend to agree.*

RBA Statement: In the Board's judgement, monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target. On present indications, the most prudent course is likely to be a period of stability in interest rates.

Our view: *There is no change to the RBA's outlook for interest rates and it continues to signal a "period of stability in interest rates". We continue to expect the RBA will leave rates on hold for most of this year before looking to raise them before year's end.*

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