

Interest Rate Outlook

Tuesday, 5 November 2013



RBA Cash Rate held at 2.50%

- The Governor's Statement was very similar to the previous month's Statement. It leaves the door open for a further cut but we believe that would only occur if there was a significant deterioration in economic activity.
- The RBA noted the rise in both housing and equity prices but sees this as natural response to the low interest rate environment.
- There was, once again, mention on the improvements in business and consumer sentiment, but the RBA was cautious about this pickup being sustained.
- The RBA is uncomfortable with the strength of the Australian dollar. A lower AUD would help the Australian economy adjust to the decline in resource related construction activity.
- We believe the RBA will be on hold in December and remain on hold for the bulk of 2014. After that it could be time for rates to rise from their historically low level.

Below is the Governor's statement interspersed with our views.

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

Recent information is consistent with global growth running a bit below average this year, with reasonable prospects of a pick-up next year. Commodity prices have declined from their peaks, but generally remain at high levels by historical standards. Inflation in most countries is well contained.

Our view: This paragraph is identical to last month's Statement. Global growth is positive but still below trend. Inflation is not a global concern despite huge injections of liquidity and problems in some countries driven by exchange rate changes. The globe appears to heading for a slow synchronized upswing in 2014.

RBA Statement: Overall, global financial conditions remain very accommodative. Volatility in financial markets has abated recently. Long-term interest rates remain very low and there is ample funding available for creditworthy borrowers.

Our view: While volatility has abated, it could re-emerge in early 2014 as the US debt negotiations hit the headlines and as markets contemplate a reduction or tapering in the US bond purchasing program.

RBA Statement: In Australia, the economy has been growing a bit below trend over the past year and the unemployment rate has edged higher. This is likely to persist in the near term, as the economy adjusts to lower levels of mining investment. Further ahead, private demand outside the

mining sector is expected to increase at a faster pace, though considerable uncertainty surrounds this outlook. There has been an improvement in indicators of household and business sentiment recently, but it is still too soon to judge how persistent this will be. Public spending is forecast to be quite weak.

Our view: The unemployment rate could well exceed 6.0% in the near term. Changes to the participation rate can lead to significant changes to the monthly figures. The slowdown in resource related construction investment is expected to see some jobs come to an end in 2014 and this would have negative flow-on effects throughout the wider economy. Public spending is singled out as a possible area of weakness. This comes despite a strong credit rating and a widely accepted need for productivity enhancing infrastructure investment.

RBA Statement: Recent data on prices show inflation consistent with the medium-term target. The Bank's assessment is that this is likely to remain the case over the next one to two years.

Our view: We agree. However, if the AUD falls in 2014 there could be upward pressure on the prices of imported goods.

RBA Statement: The easing in monetary policy that has already occurred since late 2011 has supported interest-sensitive spending and asset values. The full effects of these decisions are still coming through, and will be for a while yet. The pace of borrowing has remained relatively subdued overall to date, though recently there have been signs of increased demand for finance by households. There is also continuing evidence of a shift in savers' behaviour in response to declining returns on low-risk assets. Housing and equity markets have strengthened further, trends which should in time be supportive of investment.

Our view: Like the RBA, we expect that the full impact of earlier rate cuts is yet to be felt. The appetite for risk is growing with its effects being seen in the housing and equity markets. The RBA is aware of the rise in housing prices but is comfortable with developments to-date. With credit growth still low, talk of a bubble is premature. The issue will be watched as 2014 unfolds.

RBA Statement: The Australian dollar, while below its level earlier in the year, is still uncomfortably high. A lower level of the exchange rate is likely to be needed to achieve balanced growth in the economy.

Our view: We believe the AUD is headed lower over time. When the US tapers its bond buying program the USD is likely to strengthen and the AUD decline as it did a few months ago. A lower AUD would be helpful for the Australian economy.

RBA Statement: At today's meeting, the Board judged that the setting of monetary policy remained appropriate. The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the target.

Our view: While the economy is not recovering in a robust fashion, it is seeing growth. Sentiment has picked up a attitudes towards risk taking are changing. We expect the RBA will remain on hold in December and for a substantial portion of 2014.

Hans Kunnen, Senior Economist Ph:02-8254-8322

Contact Listing

Chief Economist

Besa Deda

dedab@stgeorge.com.au

(02) 8254 8322

Senior Economist

Josephine Horton

hortonj@stgeorge.com.au

(02) 8253 6696

Economist

Janu Chan

chanj@stgeorge.com.au

(02) 8253 0898

State Manager

Hans Kunnen

kunnenh@stgeorge.com.au

(02) 8254 8322

State Manager

Mark Goldsmith

goldsmithm@banksa.com.au

(08) 8424 5597

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