Interest Rate Outlook

bankSA

Tuesday, 1 November 2016

RBA Leaves Cash Rate At 1.50%

- **The RBA left its cash rate at 1.50% following its November meeting as widely expected by financial markets. We argued that a case could be made for reducing rates and we still expect the cash rate will decline before the middle of next year. At present the RBA is being patient.**
- **While the Governor's Statement was very similar to last month there were some significant additions. The RBA acknowledged that the September quarter read on underlying inflation was below its target band but that its latest forecasts are for inflation to pick up gradually over the next two years. We will have to wait for Friday's quarterly Statement on Monetary Policy for the reasoning behind their optimism.**
- **The RBA appears to emphasise flexibility and patience. It is also placing faith in its forecasts of gradually rising inflation. For inflation to achieve the RBA's target we will need to see a stronger labour market, above trend economic growth, a weaker currency and firmer wage growth. None of these should be taken for granted - and assistance from expansionary fiscal policy seems unlikely.**
- **The final paragraph of today's Statement gave no hint of an easing bias. As such it will require economic data outcomes outside of the RBA's expectation for further rate cuts to occur. Labour market date due on the 17th November will be important as will Friday's retail trade numbers – but these are unlikely to sway the RBA into cutting this year.**
- **We expect the RBA's cash rate will move down to 1.0% before the end of 2017.**

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With modest wage growth, a soft labour market, strong competition among retailers and a stronger currency over the past year, it is difficult to see where inflationary pressures will come from.

The RBA has highlighted its medium-term concerns regarding the Chinese economy. While activity in China has picked up of late, it is being stoked by rapid growth in corporate debt. At the same time the RBA has acknowledged that elements of the financial system in China are opaque. This is not a comforting situation. We acknowledge that China has sufficient reserves to deal with weaknesses in its financial system; however, its attempts at intervention in the sharemarket earlier this year demonstrate that policy execution is not always smooth.

On the domestic front, the RBA noted that lending for housing has slowed as has turnover in the housing market. Despite this, prices in some markets have been rising briskly over the past few months.

Given its overall assessment of the global and domestic economies, the RBA's call to leave rates on hold was reasonable. We look forward to further details regarding its thinking on Friday – but these are unlikely to sway the RBA into cutting this year.

Outlook for Monetary Policy

The RBA appears to emphasise flexibility and patience. It is also placing faith in its forecasts of gradually rising inflation. For inflation to achieve the RBA's target we will need to see a stronger labour market, above trend economic growth, a weaker currency and firmer wage growth. None of these should be taken for granted - and assistance from expansionary fiscal policy seems unlikely.

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While we are not expecting the US Federal Reserve to lift rates in November, a December hike is looking highly likely. While a December Fed hike has likely been priced into foreign exchange markets, it could still exert some residual downward pressure on the AUD thus assisting in economic growth and potentially lifting import prices.

We expect the RBA's cash rate will move down to 1.0% before the end of 2017.

The <u>one page</u> text of the Governor's Statement can be found at http://www.rba.gov.au/

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