Friday, 18 June 2021

Outlook for the RBA, Fed and AUD

RBA to Start Hiking Rates in Early 2023

- **For some time, we have been flagging the growing risk of a cash rate hike before 2024. Yesterday's jobs data, which was nothing short of amazing, has led us to formally alter our forecast. We now expect the Reserve Bank (RBA) to move before 2024.**
- **The unemployment rate is likely to have a '4' in front this year and hit full employment in the middle of next year, which will generate wage and inflation pressures. Reports of labour shortages by businesses are only likely to get louder.**
- **We expect the RBA to deliver its first rate hike in early 2023, followed by two more rate hikes over 2023. We expect the first rate hike will be 15 basis points in size and the other two rate hikes will be 25 basis points each, taking the cash rate to 0.75% by the end of 2023. This is the same cash rate that prevailed before the pandemic.**
- **Our views around the RBA's yield curve control (YCC) and quantitative easing (QE) programs remain unchanged. The RBA will decide the future of these programs at its July 6 board meeting. We expect the RBA will keep its YCC target of 0.10% pegged to the April 24 bond rather than move to the November 24 bond. We also anticipate QE will be extended in the form of an open and flexible program with $5 billion in purchases per week.**
- **Australian bond and swap yields troughed last year, as investors reassessed the economic outlook. We anticipate the upward pressure on yields to continue, as markets reprice expectations around the RBA. The YCC and QE programs will cap some of these upward pressures but not enough to cease the move higher. The upwards pressure on swap yields has implications for fixed borrowing rates, including fixed home loan rates.**
- **We anticipate the US Federal Reserve will begin tapering its QE program in January 2022, although acknowledge that it could start tapering as soon as the December quarter of this year.**
- **The Fed should start raising the federal funds rate in December 2022 and follow with at least two rate hikes in 2023. This suggests the Fed will move earlier than the RBA and will be moving by slightly more than the RBA over 2023, which has implications for the AUD.**
- **The AUD/USD struggled to regain its 2021 high of 0.8007 in May when iron ore prices pierced US$230 a tonne. Market expectations that the Fed could begin pulling back policy by early next year is contributing to a rise in the USD and selling in the AUD/USD.**
- **A short time ago, AUD/USD fell to a 17-month low of 0.7511. It is likely to continue to face more downward pressure and could fall to 70 US cents before demand returns. Our forecasts for AUD/USD have been pared back to 0.8000 for the end of 2021 and 0.8400 for the end of 2022. The risks attached to these forecasts lie to the downside.**

Cash rate

We have been flagging for several months that the run of strong economic data suggests the Reserve Bank may not wait until 2024 to start a rate-hike cycle. Yesterday's jobs data, which was nothing short of amazing has now cemented our view that the RBA will indeed move before 2024.

We now think the first cash rate hike of 15 basis points will arrive in early 2023, followed by two further rate hikes in 2023 of 25 basis points each in the June quarter and December quarter. That would take the cash rate from the current record low of 0.10% to 0.75% by the end of 2023. So, at the end of 2023, the cash rate would be at the same level it was before the pandemic.

The RBA has had a mantra since the pandemic started that it does not think conditions in the economy will justify an increase in the cash rate before 2024. But we think the conditions are likely to be met much sooner than what they are anticipating. Australia's economic performance has consistently surprised to the upside since the pandemic hit our shores.

A key focus for the RBA is the labour market. The unemployment rate in May fell to 5.1%, returning unemployment to where it was prior to the pandemic. The Reserve Bank last month published fresh forecasts and outlined an unemployment rate forecast for 5.0% for December 2021 and 4.5% for December 2022. However, the strength of the jobs market recovery means these forecasts will be met much sooner. Indeed, we expect the unemployment rate will reach 4.5% by the end of this year. We also expect the unemployment rate to be under 4% before the end of next year, which should put upward pressure on wages and inflation.

Full employment has been defined by the RBA to be in the high 3s to low 4s. Full employment is a level where wage pressures and, therefore, inflation pressures are expected to build more materially. While we expect we will hit full employment around the middle of next year, we anticipate that the RBA will be cautious in withdrawing policy support because of the ongoing risks posed by the pandemic. These risks include a slow vaccine rollout, variants of the virus and uncertainty around the reopening of international borders.

The RBA has also stated it will need to see inflation sustainably within its 2–3% target band before lifting rates. In other words, it is not enough for inflation to just hit 2%. It needs to hit 2% or higher and stay there for some time. We expect annual underlying (or trimmed mean) inflation will reach 2.2% in the December quarter of 2022 and be at 2.0% in the final quarter of 2023.

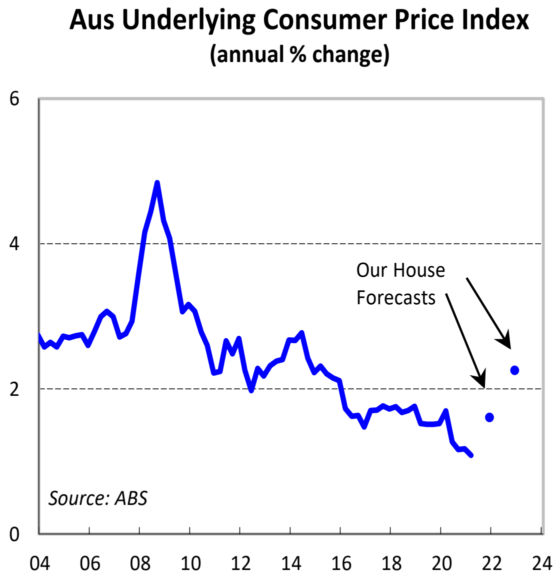
As a result, we favour the first rate hike to be delivered by the RBA occurring in early 2023. However, the chance of this rate hike occurring sooner, in late 2022, isn't zero.

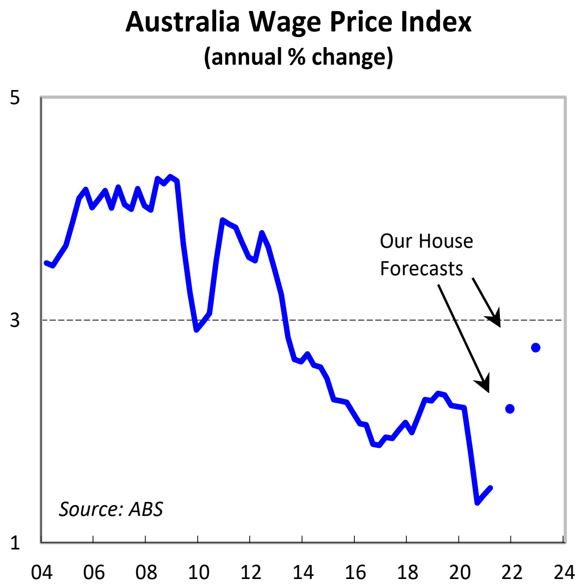
Our cash rate view is predicated on the continued recovery in the labour market, which will be supported by ongoing economic growth. Businesses have been reporting labour shortages since late last year. These reports have become more prominent as the labour market has tightened and the economic recovery has deepened and broadened. The rapid pace of jobs growth means these reports are likely to get even louder.

In a speech yesterday, the RBA Governor spoke about these labour shortages. He said that firms can take two approaches. One is to lift wages and the other is to use non-wage strategies to retain and attract staff. Governor Lowe suggested the latter was the approach being used by many businesses. But as the labour market continues to tighten, businesses will likely need to turn more towards lifting wages to attract staff and the right type of staff.

The RBA has repeatedly stated that higher wages growth will be needed to drive inflation back into the 2-3% target band. Specifically, the RBA has noted that it is likely that wages growth would need to be "sustainably above 3%" per annum to achieve this target. However, so far, there has been limited response in the wages data to the rapid recovery in the labour market, despite widespread reports of labour shortages.

It is plausible that the Reserve Bank will reach its inflation and employment goals without hitting the wages growth target. In this scenario, we expect the Reserve Bank would not wait to hike interest rates. In a nod to this possibility, in a speech earlier this week, RBA Governor Lowe acknowledged that to achieve the inflation target "wage increases will need to be materially higher" notably stopping short of calling out the "above 3%" threshold.





Yield-curve control and quantitative easing

The RBA also has two other key policies in place that have been deployed to support low borrowing rates in the economy and a lower Australian dollar than otherwise would be the case.

YCC involves the RBA buying and selling bonds to keep the 3-year government bond yield at around 0.10%. It is tied to the April 2024 bond and the RBA needs to decide as to whether to leave it pegged at April 2024 or extend it to the next bond maturity of November 2024.

The QE program involves the RBA buying $5 billion of government bonds with maturities of 5 to 10 years over a period of about six months with the total volume of purchases totalling $100 billion. The RBA needs to decide whether to extend this program and if there is an extension, what form this extension might take.

The RBA will decide the future of these policies at next month's Board meeting on July 6.

Our view on these policies remains unchanged. We anticipate the RBA will maintain its YCC target of 0.10% pegged to the April 24 bond. If the RBA were to extend the peg to the November 2024 bond, it implies the first rate hike from the RBA will not happen until 2025, which is too late given the economic conditions. And we continue to expect the QE program will be extended but take the form of an open and flexible program involving purchases of $5 billion per week. The RBA is likely to review this program again in December. We still expect the RBA to continue the program to the middle of 2022, but the pace of purchases in 2022 is likely to be lower than in 2021.

Implications for lending rates

The strong recovery in Australia and in major economies offshore has led to a reassessment by investors of the outlook for economic activity and inflation. This reassessment began in November of last year. Since then, Australian government bond yields and swap yields have noticeably lifted. For example, the Australian 3-year swap yield troughed at 0.07% on 11 November 2020 and has lifted 41 basis points to close trade at 0.48% today. The lift in the Australian 3-year swap rate has been more muted than the rise in the 4-year and 5-year swap yields because of the YCC program. The Australian 5-year swap yield, for example, has increased 78 basis points from a low of 0.16% in September 2020 to today's close of 0.94%. The lift in swap and bond yields has been restrained by the YCC and QE programs of the RBA, but the upward pressure on these yields is likely to continue.

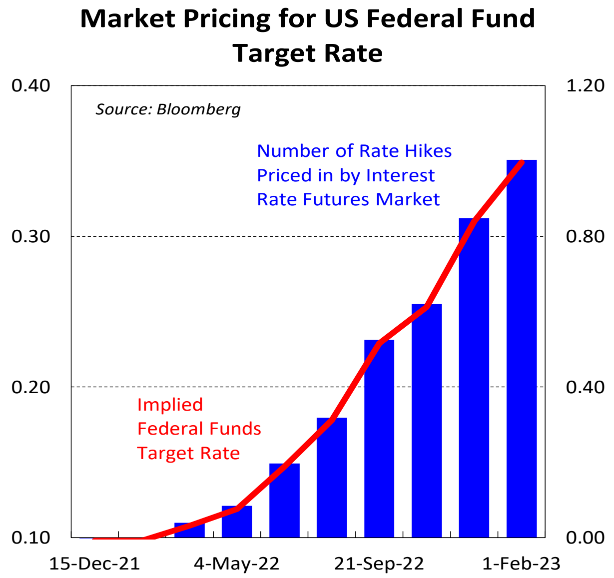
The variable mortgage rate typically changes when the RBA changes the cash rate. However, fixed borrowing rates, including fixed home loan rates, are influenced by swap rates, which are benchmarked to government bond yields. The lift in swap yields over recent months has already led to some lenders lifting their fixed home loan rates.

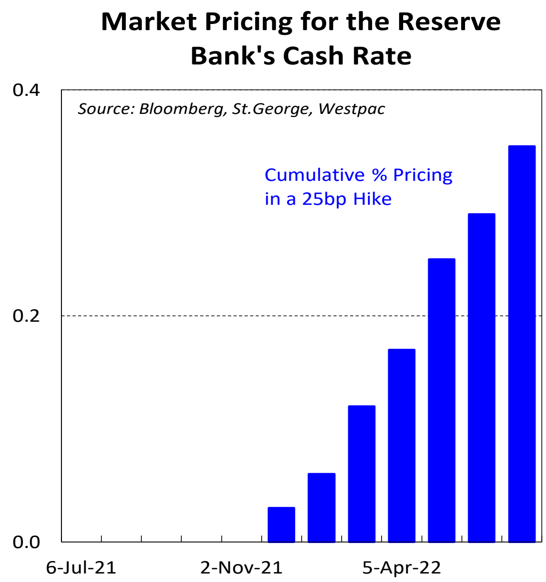
US Federal Reserve policy outlook

Another key development this week, which has a bearing on our forecasts, was the Federal Reserve Open Market Committee (FOMC) meeting. After this meeting, the dot plot of the forecasts for the federal funds target rate of the FOMC members was published. This plot suggested that FOMC members expected two rate hikes in 2023. The latest pricing of fed fund futures contracts shows financial markets are fully priced for a rate hike cycle to begin in January 2023.

We think the V-shaped nature of the recovery in the US this year amid an accelerated vaccination program means the Fed will start raising rates in late 2022. We also anticipate the Fed will begin tapering its QE program in January 2022, although acknowledge it could start tapering as soon as the December quarter of this year.

The Fed should follow with at least two more rate hikes in 2023, after starting with a 25 basis point hike in late 2022. So, we expect the Fed to move earlier than the RBA and by more, which has implications for the outlook for the Australian dollar.





Australian dollar

Our long-held view for the Australian dollar has been that it will reach 82 US cents by the end of this year and 85 US cents by the end of next year. The AUD/USD hit its highest level this year of 0.8007 on February 25, rising from its pandemic-driven low of 0.5510 on 19 March 2020. That represents a gain for the AUD over that time of 25 US cents.

Since hitting that high this year, the AUD/USD has trended lower, although it managed to rally up to 0.7891 on May 10. On this same day, iron ore prices pierced through US$230 a tonne to be 212.2% higher than a year earlier, yet the AUD could not muster up enough of a rally to break above 80 US cents. The highest AUD/USD stretched to was 0.7891, before it succumbed to selling pressures.

That difficulty the AUD incurred to regain 80 US cents amid extremely elevated iron ore prices tells us that there is some underlying weakness in the AUD. This weakness might make it harder for the AUD to break and hold above 80 US cents this year with the shift in policy expectations for the Fed.

The Australian dollar is currently trading at around 0.7540. The sell off in the AUD/USD has been accelerated by market expectations the US Federal Reserve could start tapering its QE program as soon as later this year and that rate hikes in the US will commence no later than 2023. The spectacular jobs data yesterday could only lift the AUD/USD by 30 pips and this lift was very brief.

The AUD/USD a short time ago fell to a 2021 low of 0.7511, breaking out of the trading range it has held from 1 January to earlier today of 0.7532 to 0.8007. The AUD/USD is likely to continue to face more downward pressure and could trend down towards 70 US cents before demand returns.

Due to our shifts in our views for the RBA and Fed, we are winding back our forecasts for the AUD/USD over the next two years. For the end of this year, we expect the AUD to now be at 80 US cents with a growing risk it might end in the high 70s. And for the end of next year, we anticipate the AUD will be at 84 US cents with a growing risk it might be closer to the 80 US cent mark.

The interest rate moves from the Fed and RBA are not dramatically different over 2023. However, the Fed is likely to move earlier both on monetary policy and tapering of QE and that suggests some early strength for the USD.

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