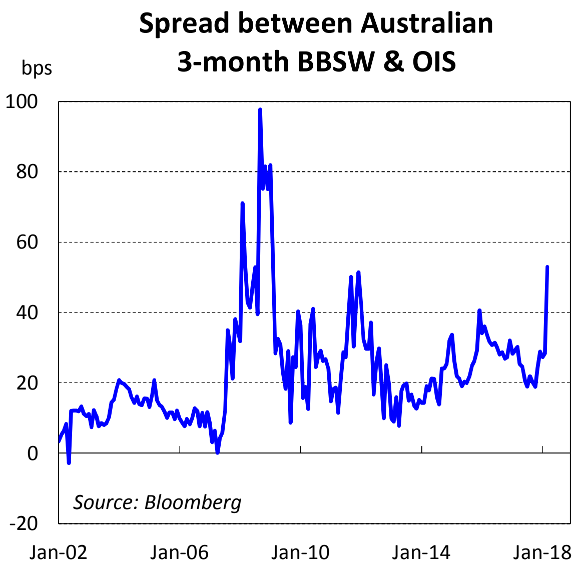
Interest Rate Outlook

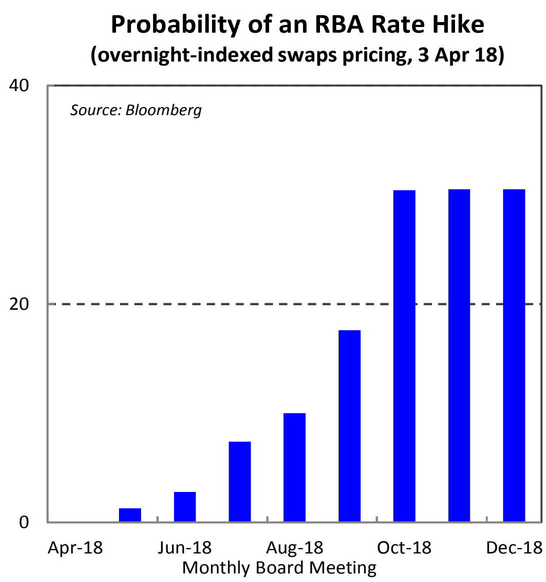
bankSA

Tuesday, 3 April 2017

Funding Risks Eyed by the RBA

- **The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today. This decision was widely expected by financial markets.**
- **The accompanying statement remains cautiously optimistic about the economic outlook. However, the RBA suggests some risks are creeping in, especially in global financial markets. These risks relate to volatility and pressures on funding costs.**
- **Funding costs have risen in the US and this has flowed on to Australia, but the RBA still highlights that financial conditions remain expansionary. The RBA highlights that short-term interest rates have increased as well as long-term bond yields.**
- **On the domestic front, the text was very little changed from the last statement. There were three minor tweaks to the rhetoric on the domestic economy. These tweaks related to prices for Australian commodity exports, household consumption and the labour market.**
- **We continue to expect the RBA to leave the cash rate on hold this year. Financial-market pricing has continued to move towards this view.**





The third Reserve Bank (RBA) meeting for this year was held today. In a widely-anticipated move, the RBA Board kept the cash rate steady at 1.50% where it has remained for twenty months now.

The accompanying statement today remains cautiously optimistic about the economic outlook, however, the RBA suggests some risks are creeping in, especially in global financial markets. These risks relate to volatility and pressures on funding costs. The main changes between today's statement and February's RBA statement relate primarily to volatility and funding costs.

One of the key drivers of financial markets more recently has been the rise in trade protectionism, which has given rise to fears over trade wars. These fears have caused both risk aversion and volatility to rise. Indeed, the RBA notes that "equity market volatility has increased from the very low levels of last year". A measure of equity market volatility is the Chicago Board Options Exchange SPX Volatility index. This index closed near 24 points overnight, from under 10 points around the start of this year.

The RBA further goes on to note that credit speads have also "widened a little, but remain low". The RBA repeats (from last month) that "financial conditions remain expansionary", but highlights that there has been :"some tightening of conditions in US dollar short-term money markets". This tightening has flowed through to higher short-term interest rates in Australia and a few other countries. For example, in Australia, the 90-day bank bill rate has risen from its low point this year of 1.76% (on February 9) to 2.04% at today's close. It represents an increase of 28 basis points in just under one month. The spread between bank-bill swap rates and the overnight-ondexed swpa rates for 90 days has blown out by 27bp to sit at 53bp today.

The RBA notes that short-term interest rates have been increasing for reasons other than the tightening in US monetary policy. However, the RBA does not offer the reasons for the rise in short-term interest rates. Market expectations that the US central bank will continue to raise its key benchmark rate further this year is likely contributing to the rise. Heavy T-bill issuance in the US related to prior government funding and debt-ceiling constraints might also be playing a role, although the correlation between spreads and issuance is not overly tight. The lift in funding costs might also be due to a knock-on impact of recent US corporate tax cuts; these tax cuts might be causing large US technology companies to shift investments out of overseas corporate bonds, including those issued by banks.

Bank-funding markets are still operating well, but if this trend on short-term money market rates continues, then there will be further upward pressure on the funding costs for banks. The RBA offers no insights on if these pressures will persist.

On the global economic front, the RBA reaffirms that the "global economy has strengthened over the past year". The RBA also reaffirms that globally inflation remains low, although it has increased in some economies. The RBA expects that a number of central banks will continue to withdraw some monetary stimulus.

On the domestic front, the text was very little changed from the last statement. There were three tweaks to the rhetoric on the domestic economy. These tweaks relate to the prices for Australian commodity exports, household consumption and the labour market.

Firstly, the RBA notes that prices of a number of Australia's commodity exports have fallen recently, but remain within the ranges of the past year or so.

Together with greater volatility in financial markets, there are downside risks to the Australian dollar in the short term. However, the RBA's commentary on the Australian dollar stayed the same from the previous month.

Secondly, the RBA repeated that "one continuing source of uncertainty is the outlook for household comnsumption" but added that "consumption growth picked up in late 2017".

The growth drivers are changing in Australia. They are moving away from the consumer and housing towards business and infrastructure. The nature of this shift will determine how fast the economy grows in the year ahead. The RBA's central forecast remains "for faster growth in 2018".

Finally, the language around employment was tweaked, but only slightly. The RBA notes that employment growth and labour-force participation has recorded strong growth over the past year.

The RBA added this month that the lift in the participation rate has been particularly noticeable with "women and older Australians". The RBA also adds that the unemployment rate has been "steady at around 5½ per cent over the past six months".

We continue to expect the RBA to leave the cash rate on hold this year. Financial-market pricing has continued to move towards this view. The overnight-indexed swap market has a probability of 31% attached to an RBA rate hike of 25bp before the end of this year. This probability compares to 71% just three months ago.

Besa Deda, Chief Economist
Ph: 02-8254-3251

Contact Listing

Chief Economist	Senior Economist	Senior Economist
Besa Deda	Josephine Horton	Janu Chan
dedab@stgeorge.com.au	hortonj@stgeorge.com.au	chanj@stgeorge.com.au
(02) 8254 3251	(02) 8253 6696	(02) 8253 0898