Interest Rate Outlook

bankSA

Tuesday, 5 March 2019

A Hopeful RBA, Despite Recent Weak Data

- **The start of the new year has heralded a string of weak economic data. Today's retailing data kept to this script. Grey clouds have also hovered over the global growth outlook with a recent US government shutdown, ongoing US-China trade tensions, an unresolved Brexit deal and Italy entering recession.**
- **Financial-market pricing for central banks has shifted remarkably since early December as a result. In the US, markets no longer expect the US Federal Reserve to hike further. At home, markets have shifted to price in a the possibility of an RBA rate cut this year, away from a chance of a rate hike previously.**
- **The RBA left the cash rate on hold at 1.50%, as widely anticipated.**
- **The accompanying statement was what we waited for with bated breath. We expected a more prudent tone to prevail from the RBA. While we could argue that occurred, it certainly was not as cautious as the RBA could have been. We are left with an impression of a central bank that is hopeful about the economic outlook.**
- **The RBA indicated that it downgraded its GDP growth forecasts for 2019 from 3.25% previously to around 3%. However, these forecasts seem optimistic given the downturn in housing and weakness of recent economic data. Moreover, there continue to be downside risks to the outlook. The RBA's forecasts are important in that they remain above the trend rate of growth 2.75%, which makes it less likely the RBA is about to adopt an easing bias.**
- **The RBA still expects underlying inflation to pick up over the next few years, but it does now expect it will "take longer than earlier expected".**
- **Policymakers also repeated that the main domestic uncertainty remains around the outlook for household spending, but this time linked it explicitly to the effect of falling house prices in some cities. The downturn in dwelling prices and the negative wealth impact on consumer spending is our biggest concern for the growth outlook.**
- **The RBA appears to be betting on a pick up in household income to support spending, but we are sceptical that the likely improvement in household income will be enough.**
- **The labour market has been the one piece of economic data that has bucked the trend this year and remained firm. The RBA describes the labour market today as "strong" and expects the unemployment rate to decline to 4.75% over the next couple of years. The labour market is an important story for the economic outlook and one that the RBA is relying on to generate wages growth that will help support consumer spending. But it is also a lagging indicator.**
- **We continue to expect the RBA to remain on hold for an extended time, but we acknowledge the risks of the next move being a rate cut have grown considerably. Much could depend on developments in the labour and housing markets.**

The start of the new year has heralded a string of weak economic data. This data has included an acceleration of the downturn in dwelling prices, a massive decline in building approvals (nearly 19% over the two months to November), a big fall in business conditions and falls in both consumer and business confidence. Private-sector credit also painted a soft picture.

Today, the retailing data kept to the script of weaker economic activity around the turn of the year; retail sales fell in December and retail sales volumes barely grew. Further, the recent fall in the shopping centre values by shopping-mall giant Vicinity points to the widening of retailing woes.

A more fragile global economy adds to this weaker domestic data story. In the past two months, the US has recorded its longest ever government shutdown, a Brexit deal remains unresolved with the European Union, China-US trade tensions are continuing and Europe's third-largest economy has entered recession.

Financial-market pricing for monetary tightening by central banks has shifted remarkably since early December. In the US, financial markets no longer expect the US Federal Reserve to hike further. And at home, financial-markets are pricing in a small chance of a rate cut from the RBA this year, away from a chance of a rate hike previously.

So the first meeting of the year by the RBA Board was keenly awaited (with bated breath!) The RBA left the cash rate on hold at 1.50%, as widely anticipated. The accompanying statement was what we were waiting for! We expected a more prudent tone to prevail from the RBA. While we could argue that occurred, it certainly was not as cautious as it could be. We are left with an impression of a central bank that is hopeful about the economic outlook.

The RBA did downgrade its GDP growth forecasts for this year from 3.25% previously to around 3% for 2019, but this downgrade is not deep enough. We think the RBA is being too optimistic about the outlook. For 2020, the RBA implied it cut the growth forecast from 3% previously to "a little less" due to slower growth in resources exports. The RBA's forecasts are important in that they remain above or at the RBA's assessed trend rate of growth 2.75%. If a central bank is forecasting above trend growth, then it is highly unlikely to adopt an easing bias.

The inflation forecasts were also revised with the underlying inflation forecast for 2019 reduced from 2.25% to 2%. The 2020 forecast remains at 2.25%.

So the RBA still expects underlying inflation to pick up over the next few years, but it now thinks it will "take longer than earlier expected". Underlying inflation has stayed under the RBA's 2-3% per annum band for nearly three years already.

In the strongest indication in the statement that the RBA recognises that data has been weak recently, the RBA noted that "some downside risks [in the domestic economy] have increased". The RBA also noted that "downside risks have increased" for the world growth outlook.

The main domestic uncertainty was highlighted again as being around the outlook for household spending, but this time linked it explicitly to the effect of falling house prices in some cities. The downturn in dwelling prices and the negative wealth impact on consumer spending is our biggest concern for the growth outlook, especially as in recent months the downturn has accelerated in Sydney and Melbourne. Furthermore, leading indicators suggest the housing downturn has much further to run.

The RBA appears to be betting on a pick up in household income to support spending, but we are sceptical that the likely improvement in household income will be enough. Wages growth has remained subdued and there does not seem to be any indications that the pace of improvement is about to accelerate by enough. The RBA also seem to be hoping that the recent trends in

consumer spending are not entrenched because it highlights that consumer spending is volatile and subject to revisions. We are less hopeful.

The labour market has been the one bit of partial economic data that has bucked the negative flow of data this year and remained firm. The RBA describes the labour market today as "strong" and expects the unemployment rate to decline to 4.75% over the next couple of years. The labour market is an important story for the economic outlook and one that the RBA is relying on to generate wages growth that will help support consumer spending. But it is also a lagging economic indicator.

This time two months ago, financial markets attached a 53% probability the RBA would deliver a rate hike by the end of 2019. Today, the probability has shifted to a rate cut with a probability of 34%. We remain of the view that the cash rate will be on hold this year, but acknowledge the risk of a rate cut has grown and greyer clouds have moved in.

Finally, the RBA Governor chose to repeat the concluding paragraph which explains the policy decision with the same words that he used in December last year, despite lower forecasts and recognition of downside risks. Notably, it includes the sentence "further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual."

Tomorrow's speech by the RBA Governor Lowe and Friday's quarterly Statement on Monetary Policy will be important in gaining further insights into RBA thinking.

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

Contact Listing

Chief Economist

Besa Deda
dedab@banksa.com.au
(02) 8254 3251

Senior Economist

Josephine Horton
hortonj@banksa.com.au
(02) 8253 6696

Senior Economist

Janu Chan
chanj@banksa.com.au
(02) 8253 0898

BankSA Financial Markets

(08) 8424 4305

The information contained in this report (.the Information.) is provided for, and is only to be used by, persons in Australia. The information may not comply with the laws of another jurisdiction. The Information is general in nature and does not take into account the particular investment objectives or financial situation of any potential reader. It does not constitute, and should not be relied on as, financial or investment advice or recommendations (expressed or implied) and is not an invitation to take up securities or other financial products or services. No decision should be made on the basis of the Information without first seeking expert financial advice. For persons with whom BankSA has a contract to supply Information, the supply of the Information is made under that contract and BankSA's agreed terms of supply apply. BankSA does not represent or guarantee that the Information is accurate or free from errors or omissions and BankSA disclaims any duty of care in relation to the Information and liability for any reliance on investment decisions made using the Information. The Information is subject to change. Terms, conditions and any fees apply to BankSA products and details are available. BankSA or its officers, agents or employees (including persons involved in preparation of the Information) may have financial interests in the markets discussed in the Information. BankSA owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of BankSA.

Any unauthorized use or dissemination is prohibited. Neither BankSA- A Division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ACL 233714, nor any of Westpac's subsidiaries or affiliates shall be liable for the message if altered, changed or falsified.