Interest Rate Outlook

bankSA

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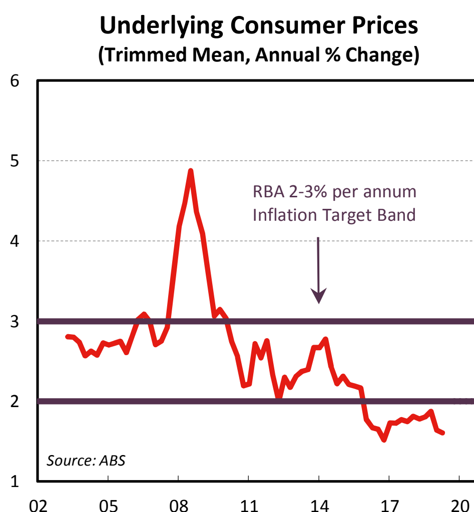
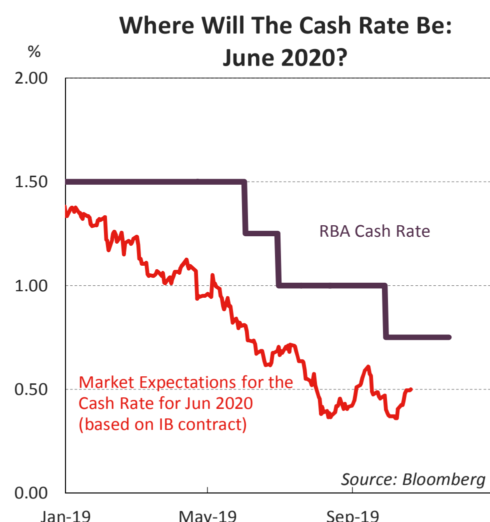
RBA Cash Rate Outlook

Vows and Declarations

- **Unlike the winner of the Melbourne Cup – Vow and Declare – the Reserve Bank (RBA) did not surprise financial markets today. The RBA left the cash rate unchanged at 0.75%.**
- **Today's on-hold decision follows rate cuts of 25 basis points each at the June, July and October meetings. We continue to expect another rate cut in Febraury 2020.**
- **The RBA has maintained an easing bias, declaring in the final paragraph of its accompanying statement that it is prepared to ease monetary policy further if needed.**
- **The statement also suggests the RBA has cut the growth forecast for 2019 to 2¼%, from 2½% previously. The RBA expects growth to swing to 3.0% in 2021. We do not anticipate growth to strengthen as much.**
- **The RBA also hints at slightly softer inflation forecasts; in the statement it refers to expected inflation "to be close to 2 per cent in 2020 and 2021".**
- **The statement has only sprinkles of optimism, namely around housing prices and the global economy. However, caution has also stepped up with uncertainty around the drought and downturn in the housing construction cycle adding to their ongoing concerns. Uncertainty about the consumer-spending outlook continues to be singled out.**
- **The RBA now expects wages growth to remain at around its current (subdued) rate for some time yet. It has also explicitly tied the inflation outlook to an improvement in wages growth.**
- **We are left with a sense of an RBA waiting for now, but not for long. Another rate cut is likely by early next year. While the RBA did not mention unconventional policies in today's statement, the spectre of these policies is looming larger.**





Unlike the winner of the race that stops the nation, the Reserve Bank (RBA) did not surprise financial markets today. The RBA left the cash rate unchanged at 0.75%. This decision is in line with widely-held expectations. Interest-rate markets had only attached a 5% chance of a move.

Today's on-hold decision follows rate cuts of 25 basis points each at the June, July and October meetings. We expect another rate cut in Febraury 2020 with some risk the cut comes sooner in December. The RBA has maintained an easing bias, declaring in the final paragraph of its accompanying statement that it is prepared to ease monetary policy further if needed.

The statement suggests the RBA has cut the growth forecast for 2019 to 2¼%, from 2½% previously expected in the August Statement on Monetary Policy (SoMP). The RBA then expects growth to swing to 3.0% in 2021. Our forecasts are softer than that of the RBA's. The RBA's current growth forecast of 2.8% in 2020, which was adopted in August, is likely to be retained in Friday's SoMP.

The RBA again described the Australian economy as being at a "gentle turning point". We also think the worst is behind us, but we are not anticipating activity to strengthen as much as the RBA suggests. We expect growth to be at 2.7% in 2021, from 2.3% expected this year.

The RBA also hints at slightly softer inflation forecasts; in the statement it refers to expected inflation "to be close to 2 per cent in 2020 and 2021". The August SoMP slated underlying and headline inflation at 1.9% for 2020 and 2.1% for 2021.

The RBA expects growth to be supported by:

- The low level of interest rates
- Recent tax cuts
- Ongoing spending for infrastructure
- The upswing in housing prices in some markets
- A brighter outlook for the resources sector

However, the RBA remains cautious about the outlook for consumer spending. It again has repeated its mantra that the main domestic uncertainty continues to be the outlook for consumption. After yesterday's soggy retail-spending figures, few economists would disagree. The RBA statement added two more uncertainties – the effects of the drought and the evolution of the housing construction cycle.

There were some sprinkles of optimism and they came from the RBA characterising the cycle in housing prices as an "upswing", which is new. On the global economy, the RBA also inserted a new sentence to note that expectations of further easing around the world have generally "been scaled back over the past month and financial market sentiment has improved a little". However, the RBA has continued to characterise the risks to the outlook for the global economy as "tilted to the downside".

While inflation continues to be the RBA's guiding north star, wages inflation and the labour market continue to be very important. The RBA underscores this importance in today's statement by tying the inflation outlook explicitly to the wages outlook.

The RBA seems less assured that wages growth will gradually rise and improve as it did earlier this year (as recently as August). The RBA highlights that "wages growth remains subdued and is expected to remain at around its current rate for some time". The RBA adds that "a further gradual lift in wages growth…is needed for inflation to be sustainably within the 2-3 per cent

target range".

The RBA in its final paragraph refers to "global developments" and the "evidence of spare capacity in the Australian economy" as reasonable reasons to expect an extended period of low interest rates in order to reach full employment and achieve the inflation target. The statement concluded with the final sentence identical to the last statement in October; one in which the RBA will continue to monitor developments, including in the labour market, and stands "prepared to ease policy further if needed".

In our opinion, the RBA's reference to monitoring developments is a signal that there is no rush to cut the cash rate again as soon as December.

There was no mention of the possible use of QE or other unconventional policy tools. The RBA appears comfortable to sit and wait for now. Interest-rate markets are attaching a probability of 17% to a rate cut next month (down from a high of 90% on October 10) and a 47% chance of a rate cut by February 2020 (down from a high of 127% over October 7-10). The improved trade relations between the US and China and the strengthening recovery in dwelling prices has likely assisted in shaving the odds of another rate cut at these meetings in December 2019 and February 2020.

Implications and the Outlook

The RBA is clearly hoping for an improvement in economic activity, which will lead to a falling unemployment rate. These outcomes will assist the RBA in achieving the broader goal of bringing inflation back towards its 2 to 3% target.

Both domestic and international developments are frustrating the progress towards the RBA's aims.

Domestically, the key risk is the ongoing restraint in spending by the consumer, under the weight of slow wage growth and high household debt. There are few signs of a meaningful pick up in consumer spending to date, despite a boost to incomes from tax rebates and rate cuts from the middle of this year. Households appear to be choosing to repair their balance sheets. However, the ongoing recovery in dwelling prices, lower mortgage rates and the tax boost should eventually bring about a modest improvement.

Internationally, uncertainty is lingering amid the ongoing trade conflict and other geopolitical risks, despite some improvement in recent weeks from a likely phase 1 deal between the US and China.

Moreover, the current below trend rate of growth suggests that the unemployment rate continues to be at risk of moving higher and further away from the RBA's estimate of full employment.

Without further tangible signs of improvement it would seem likely that the RBA would provide further monetary policy support. We are expecting another rate cut early next year, in February, to 0.50%.

At this point, there will be increasing talk of other ways the RBA can support the economy, such as unconventional monetary policy measures. These are likely to include quantitative easing in the form of government bond purchases to bring down long-term interest rates. QE can also help weaken the currency, which is another important way easing policy effects economic activity.

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

Contact Listing

Chief Economist

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

Senior Economist

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

Economist

Nelson Aston
nelson.aston@banksa.com.au
(02) 8254 1316

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