Interest Rate Outlook

Tuesday, 6 March 2017

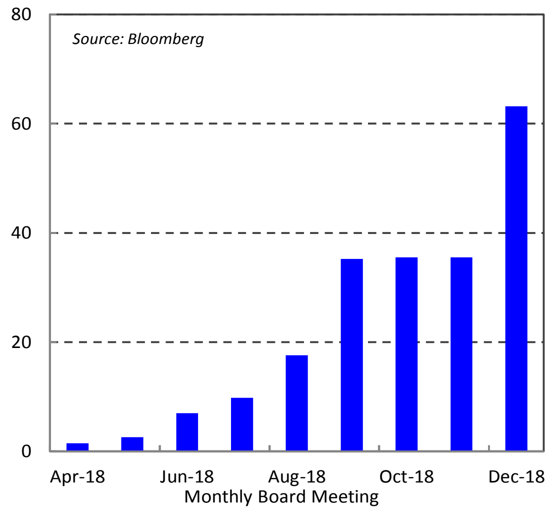
Reserve Bank Shows Subtle Shifts in Optimism

The second Reserve Bank (RBA) meeting for this year was held today. As widely anticipated, the RBA Board kept the cash rate steady at 1.50% where it has remained for nineteen months now.

There was little shift in the message of today's statement compared with February's statement There was slightly more optimism in the economy. This greater optimism was subtle. First, the RBA notes that non-mining business investment is "increasing" compared with "improved" last time. And second, the RBA notes that "the rate of wage growth appears to have troughed". The outlook for wages growth will be a key determinant to the outlook for inflation and ultimately the outlook for the cash rate. Wages growth has picked up and firms are reporting greater labour shortages. The RBA has said in other commentary that firms are choosing to address these labour shortages by means other than raising wages, for example paying hiring bonuses and giving existing workers more hours. As the unemployment rate continues to drift lower, there will be a point where wages should rise more noticeably.

The RBA has reiterated that "one continuing source of uncertainty is the outlook for household consumption". There was further evidence of the cautious consumer in today's retail sales data. 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 today noted its "central forecast is for the Australian economy to grow faster in 2018 than it did in 2017".

Probability of an RBA Rate Hike
(overnight-indexed swaps pricing, 6 Mar18)



On the global economy, the RBA now describes the pick-up in the global economy in 2017 as having "strengthened" and that growth has "picked up in the Asian economies".

On the ructions in financial markets, the RBA only notes that "market volatility has increased from the very low levels of last year". One measure of volatility is the VIX index. The higher this index, the more volatile are financial markets and the more risk averse investors are. This index now stands at nearly 19 and close to the long-run average, up from a 2017 low of 9.1.

We remain comfortable with our long-held view that the RBA will take its time in starting a rate-hike cycle. Financial markets appear to be coming round to this view too. The overnight-indexed swap market is attaching a probability of 63% that the RBA will hike by the end of this year. This is a marked shift down when compared with three months ago.

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