Interest Rate Outlook

bankSA

Tuesday, 29 November 2016

Australian Outlook for Interest Rates

Fixed Rates on the Way Up

- **Swap rates hit a turning point back in August. Yields have risen hard and fast since bottoming in late August. There has been some pullback, and there is a risk of a further pull back from current levels, but the lows are unlikely to be revisited.**

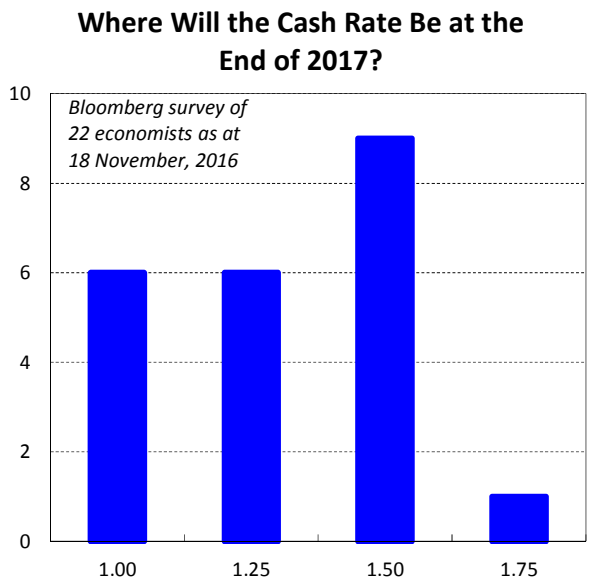
- **The Reserve Bank could be forced to cut the cash rate again next year should the labour market continue to stay soft. However, we are nearing the end of the rate-cutting cycle.**

- **US yields are likely to press higher over the next twelve months, pushing Australian 3-year and 5-year swap yields higher. Australian swap yields have been driven more by US developments than domestic influences.**

- **In this global-bonds backdrop, it could be prudent for clients with interest-rate exposure to take some risk off the table by hedging.**

The Reserve Bank (RBA) has left the cash rate unchanged at 1.50% since August. A new Governor, Philip Lowe, took office in September 2016. Over the last few months, there has been considerable debate about what the next move will be and when.

The latest survey of economists shows a division between those expecting rate cuts and those expecting an RBA on hold for longer. Such divergent views among economists suggest we could be close to or at the end of the RBA rate-cutting cycle.



We believe there is still a risk of at least one more rate cut from the Reserve Bank next year should

employment and wages growth continue to remain soft. Wages growth is running at the weakest annual pace in nineteen years and employment growth is weakening. The run up in commodity prices has given a boost to Australia's terms of trade, which the RBA has indicated as providing a "slight tailwind" to economic activity. We are less convinced of the longer term sustainability of this terms-of-trade improvement. With the construction cycle also starting to reverse as we near 2018, it leaves the Australian economy vulnerable on the growth front.

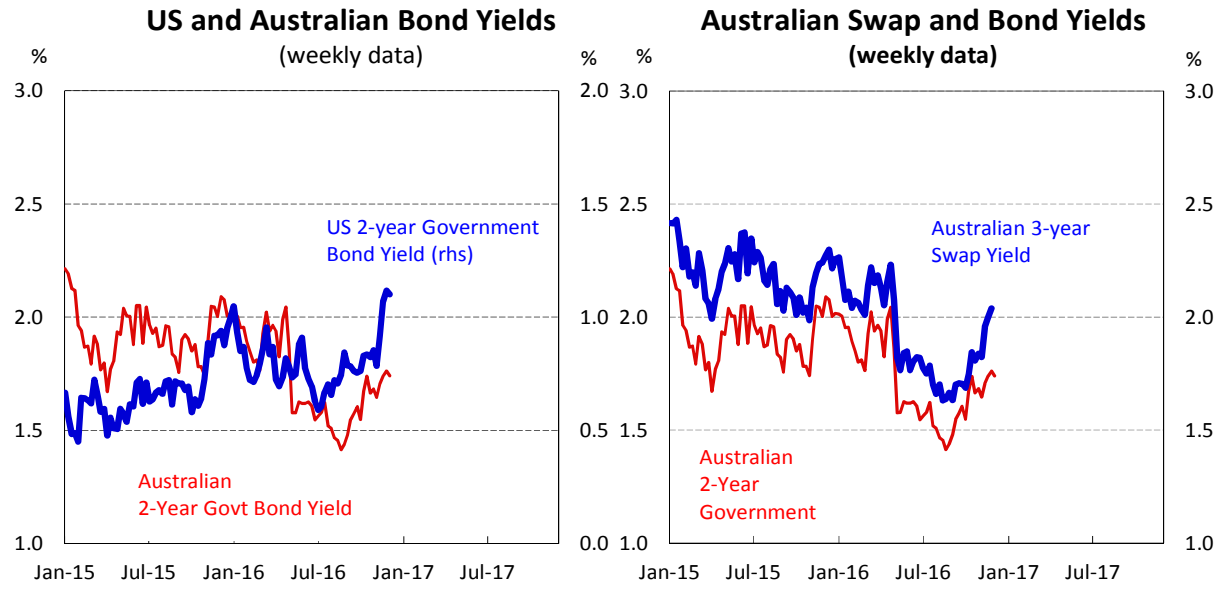
We do not expect the RBA cut the cash rate until Q2 of next year, or possibly as late as Q3. We also expect we are near the end of the easing cycle. In previous commentary, the RBA seemingly drew a line in the sand at a 1.00% cash rate.

Recent Reserve Bank rhetoric stresses that the hurdle for another rate cut is high. It means the RBA will not want to cut the cash rate again unless it has to. Domestic data will need to stay weak, namely household spending and employment data, for the RBA to visit cutting the cash rate again.

Market pricing has diverged with economists. Interbank-cash-rate futures are attaching a 19% probability of a rate hike by the end of next year. This probability is too high at a time when inflation is running below the Reserve Bank's target band; headline inflation grew by 1.3% per in the year to the September quarter. Inflation is likely to rise only slightly in the near term and remain below the 2% threshold through 2017. It leaves a tightening as unlikely in 2017.

This market pricing is reflected in swap yields. Fixed rates are priced off the swap yield curve. However, swap yields have been more influenced by US developments than domestic monetary tightening. In particular, expectations that US inflation will rise are a key factor behind the lift in bond and swap yields internationally. Australian swap yields have moved a long way from the low on 31 August. Australian 3-year swap yields are up 44bp and 5-year swap yields have jumped 62bp since the end of August. They were up by more last week, but have retreated modestly.

The push higher in US bond and swap yields has also been driven by robust US economic data that suggests the US Federal Reserve will raise the Fed funds target rate next month. US policymakers seem more confident that US inflation is heading toward their 2% longer-term target. The tightness of the US labour market is considered influential in this regard. The US unemployment rate sits at 4.9%, a level considered close to full employment. Business fixed investment remains sluggish, but the Fed is betting on an improvement amid faster overall economic activity.



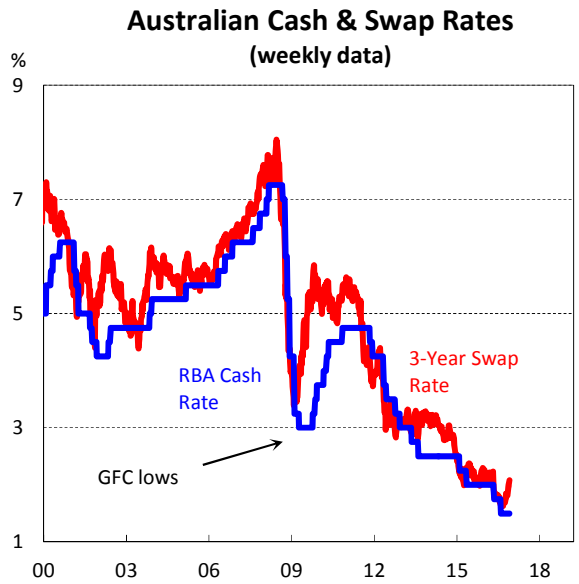
The Trump victory at the Presidential election pushed US Treasury yields even higher, as markets

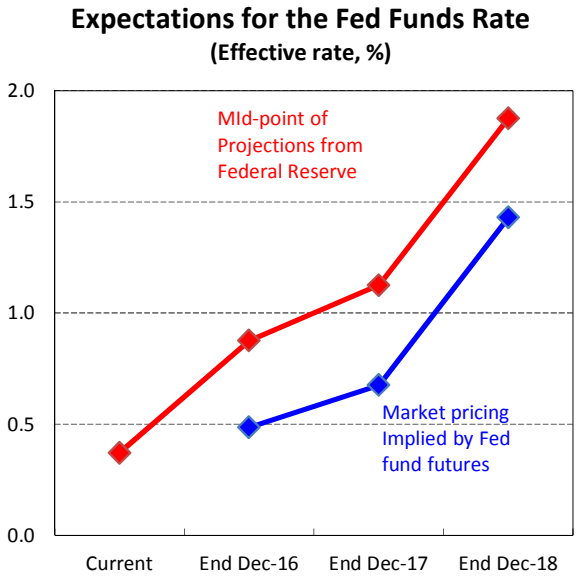
interpreted a Trump presidency to mean greater fiscal stimulus. There was a re-evaluation of US real and nominal yields across the US yield curve. Indeed, this re-evaluation set the Australian and US yield curves on a bear-steepening path. Late last week, the Australian 3-10 year swap yield curve steepened to be at its widest since July 2015; it remains near these levels today.

Trump has indicated there will be tax cuts and infrastructure spending. These plans are expected by the markets to stoke inflation and lead the Federal Reserve to hike rates by more over the tightening cycle. While the Trump Presidency is likely to result in more fiscal stimulus, the size of it and its impact is difficult to ascertain at this stage. Uncertainties are high around the detail of these policies and the likelihood of implementation and success. Markets are adopting the most optimistic scenario; the reality might be not as optimistic. It means the proposals when they meet with the political realities could see some pullback in yields.

The run up in US Treasury yields has been hard and fast. The Federal Reserve meets on 13-14 December to decide on interest-rate settings. It is also possible that the market will take the decision as a time to take more of a breather, rather than run yields much higher. Much will depend on the Fed's accompanying statement and its forward guidance. Financial markets expect the Fed to hike once more in 2017. Rhetoric to suggest there might be more than one rate hike next year could cause the market to forget the breather and take yields higher. That in turn could drag domestic swap and bond yields higher, especially 3 years and longer.

With markets pricing in a tightening domestically next year, we see a risk of a further pullback in Australian 3-year and 5-year swap yields. The spread or differential between Australian 3-year swap yields and cash is near its widest since April 2014.





However, we expect that we have seen the lows in swap yields and the lows will not be revisited. Even if the Reserve Bank cuts the cash rate again, the Reserve Bank is near the end of its easing cycle. In an environment where US yields are being pressured higher, Australian swap yields (and fixed rates that are priced off swap yields) are unlikely to revisit their lows.

It means any reasonable pullback in swap yields should be viewed as a possible opportunity for clients with interest-rate exposure to take some risk off the table by hedging.

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