Monday, 1 May 2023

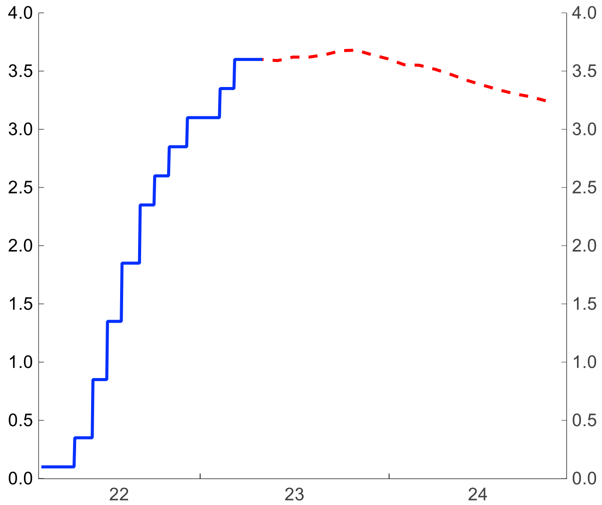
RBA Expected to Extend Pause In May

Central banks will take the limelight this week in what is a busy week for key central bank meetings, with plenty of economic data thrown in for good measure.

In Australia, all eyes will be on the RBA tomorrow, with the question on everyone’s lips being “will they or won’t they” after the RBA paused hiking interest rates at its April meeting.

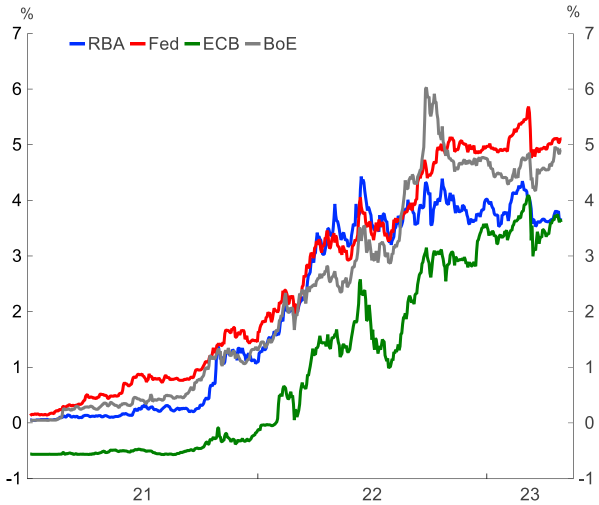
Financial markets are convinced that the hiking cycle is all but over, and that the RBA will pause at the upcoming meeting. Looking further into the future, markets are attaching a small chance of a hike later down the line, with a little under 10 basis point of hikes priced to August. However, the key point is that markets expect that interest rates will remain broadly unchanged for a while from here, with a full 25-basis-point cut not being priced until 2024.

Cash Rate Market Pricing
30-Day Interbank Cash Rate Futures



Sources: Bloomberg; RBA; Macrobond

Central Bank Terminal Rates
The market expected peak of policy rate



Sources: ICE, CME Group; Macrobond

Recent economic data and communication from the RBA suggests the needle has swung in the direction of a pause next week.

Economists tend to agree, with 70% of economists surveyed by Bloomberg ahead of the meeting expecting a pause. The other 30% expect a 25-basis-point hike.

Key to this view is communication from the RBA about how they see the inflation and economic outlook playing out and what may be their response under various scenarios.

In the April Board meeting minutes, the RBA laid out the arguments for further hikes versus a pause at the April meeting. These arguments, combined with recent speeches from the RBA Governor, provide key insights into the approach the Board is taking to setting monetary policy.

The RBA’s most recent set of forecasts from its February Statement on Monetary Policy (SoMP) forecast a return to the top of the 2-3% target band by mid 2025. Importantly, the April meeting minutes mentioned these forecasts and showed an unwillingness by the Board to tolerate a later return to the top of the band. The minutes noted that "it would be inconsistent with the Board's mandate for it to tolerate a slower return to target".

So, on that side of the ledger the RBA is suggesting that it will hike further if data suggests that inflation would not return to the top of the 2-3% band until later than mid-2025.

On the other side of the ledger, the RBA Governor has made many comments about his desire to achieve a "soft landing" and maintain as many of the job gains to date as possible. To do this, the RBA is more willing to tolerate a slower return to target than other global central banks, as the Governor noted in his Press Club address.

During the Q&A, the Governor also reiterated some points previously made during Parliamentary appearances. In particular, he noted that (emphasis added) "we've discussed that at our Board meetings: whether it would be beneficial to get inflation back down to 3% a year earlier. There's an argument for that, but it would mean job losses – more job losses – and our judgement at the moment is that, if we can get inflation back to 3% by mid-2025 and preserve many of those job gains that have been delivered in the last few years, **that's a better outcome than getting inflation back to 3% one year earlier and having more job losses.**"

These statements taken together provide an indication that the RBA will likely keep interest rates on hold unless the economic data suggest that their "mid 2025" goal will be jeopardised.

So, how are they tracking towards that goal? Key to understanding this was the March quarter consumer price index (CPI), released last week. This showed that inflation peaked in the December quarter of 2022 but remained elevated in the March quarter of 2023. Annual headline inflation slowed to 7.0%, from 7.8% in the December quarter. The annual trimmed mean, which provides a better measure of underlying inflation, slowed to 6.6%, from 6.9%.

Importantly, for the RBA, the release showed that inflation was on its way down and that the near-term path laid out in the February SoMP forecasts (namely, 6.7% headline inflation and 6.2% trimmed mean inflation over the year to the June quarter of 2023) was within reason of being achieved without needing additional hikes.

For the May meeting, the Board will have the benefit of receiving updated economic forecasts. These will consider stronger-than-expected population growth, in addition to updates on other key variables, such as the labour market and inflation. Stronger population growth is likely to place upward pressure on inflation, all else equal. However, after taking everything into account, the inflation path is unlikely to be materially different from that laid out in the February SoMP.

The RBA's approach differs from that taken by many other major central banks, including the US Federal Reserve. The Fed has placed more emphasis on getting inflation back to target quicker, to reduce the chance of inflation expectations rising. They are also willing to tolerate a higher degree of job losses to achieve these goals.

Domestic circumstances also play a role. The RBA Governor has noted three differences between Australia and other countries. These include weaker domestic wages growth, a faster pass-through of rates to mortgage holders, and the RBA being "prepared to have a slightly slower return of inflation to target than some other central banks".

Time will tell whether the RBA succeeds in walking the narrow path and achieving a soft landing.

Other domestic data

Dwelling prices

This morning, we received an update on growth in dwelling prices for April. The result showed that dwelling prices rose 0.5% in April. This follows a 0.6% increase in March and marks the second consecutive monthly increase in prices. The result suggests that the rapid pace of falls in dwelling prices seen since the RBA began its hiking cycle in May 2022 is likely over.

Indeed, we now expect prices to stabilise over 2023, with a broadly flat outcome nationally over the year. In 2024, we expect prices to rise by around 5% nationally, supported by expected interest rate cuts from the RBA over the year.

The stabilisation over the past few months means that the national peak-to-trough decline appears to have bottomed at 9.1% from April 2022 to February 2023. This follows an incredible run up of 29.5% from the pre-pandemic period (December 2019) to the peak in April 2022. Accounting for the surge, the subsequent drop, and the current stabilisation, national dwelling prices were 19.2% above pre-pandemic levels in April.

There are a range of factors that have contributed to a stabilisation over recent months. These include low levels of supply combining with still robust levels of demand. On the supply side, stock levels remain very low and well-down on historical averages. This includes the stock of existing listing on the market, in addition to the flow of new listings.

On the demand side, a record surge in overseas migration has added to demand for housing, both rentals and purchases. This is having flow on implications to the broader market. For example, surging rents and increased rental competition are likely leading would-be buyers to accelerate buying plans to avoid having to compete for rentals. The surge in new migrants is also likely having a direct impact on the market. Typically, new migrants tend to rent on arrival and take several years before they transition to being a homeowner. However, those that are in a position to do so are also likely accelerating their home purchase plans to skip the rental queue.

Across the capital cities, April price increases were driven by Sydney (1.3%), Perth (0.6%), and Brisbane (0.3%). Darwin was the only capital to record a fall in April (-1.2%).

Retail trade

Consumer spending remains a key area the RBA is monitoring as it seeks to achieve its goal of a soft landing. On Wednesday, the Australian Bureau of Statistics (ABS) will release the latest March retail trade data. This provides key information on consumer retail spending, which accounts for around a third of the entire consumer spending basket. In February, retail spending rose 0.2%. This followed volatility over the holiday period. Looking through some of this volatility, an underlying trend of weakness is evident, as spending over the three months to February 2023 was 1.5% lower than spending over the three months to November 2022.

In March, we expect that nominal retail spending continued to rise, but only modestly. We expect a gain of 0.2% over the month. Analysts have reported a wide range of estimates, ranging from a fall of 0.7% to a gain of 0.6%. Importantly, the monthly retail spending data is in nominal terms and inflation is still running at a rapid pace. This suggests that the volume of retail spending, once accounting for price increases, has likely been falling over recent months.

Additionally, the population continues to grow at a record pace following the surge in net overseas migration. This is also contributed to the retail spending data holding up. This suggests that spending on a per capita basis has also likely been negative.

Housing finance

On Friday, the ABS will release the March lending indicators data, which provide an update on housing finance commitments. New loan commitments have been steadily declining for over 12 months in line with slowing housing market activity and falling dwelling prices. Indeed, new loan commitments are down 33% from their January 2022 peak. However, the pace of declines has been slowing in recent months, in line with dwelling prices stabilising. In fact, the monthly pace of falls has slowed from the July 2022 low of -6.7% to the recent February outcome of -0.9%.

March is expected to show further signs of stabilisation, although we still expect some continued weakness in the month. We expect approvals to fall 0.3% in the month, with approvals for owner-occupiers (-0.5%) leading the fall, while approvals for investors are expected to be flat (0.0%).

Trade balance

The March trade balance data will be released on Thursday. Australia continued to record a strong trade surplus in February of $13.9 billion. This followed a $11.3 billion surplus in January. For March, we expect another strong result, with a surplus of $13.6 billion expected in the month. This reflects a broadly unchanged result for exports, partly offset by an expected 0.7% rise in imports.

International

On the international front, the key events to watch will be the meetings of the Federal Reserve (early Wednesday morning AEST) and the European Central Bank (ECB) (late Thursday night AEST).

Financial markets are pricing in an 88% probability of a 25-basis-point hike from the Fed. This follows data last week showing that wages pressures remain elevated and above expectations. Additionally, inflationary pressures remain elevated, despite continuing to recede in absolute terms. Federal Reserve members have consistently expressed concerns over the ‘stickier’ components of inflation, particularly in relation to services. Additionally, members have also noted the continued strength of the labour market and limited signs that a material slowing is underway. The Fed is expected to hike again in May to guard against the risk of these pressures becoming more embedded, taking the fed funds rates to a range of 5.00% - 5.25%.

However, a material slowing in the economy is expected to lead to cuts in interest rates beginning by the end 2023. Indeed, financial markets already have an aggressive cutting cycle priced in by the second half of 2023, with over 50 basis points of cuts currently priced to the end of 2023.

Markets are also expecting a hike from the ECB, continuing the aggressive hikes the bank has been on since kicking off its hiking cycle in July 2022. In fact, interest-rate markets are currently pricing a 112% chance of a hike at the upcoming meeting. This implies that a 25-basis-point hike is a done deal, and that there is a smaller probability of a more aggressive 50-basis-point move. The most recent move was a 50-basis-point hike in March.

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Group Forecasts

		2023			2024		
End Period:	**Close (28 Apr)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	3.60	3.60	3.60	3.60	3.35	3.10	2.85
90 Day BBSW, %	3.68	3.70	3.70	3.72	3.47	3.22	2.97
3 Year Swap, %	3.45	3.50	3.50	3.40	3.30	3.10	2.90
10 Year Bond, %	3.39	3.40	3.30	3.20	3.00	2.80	2.70
US Interest Rates:							
Fed Funds Rate, %	4.875	5.125	5.125	4.875	4.375	3.875	3.375
US 10 Year Bond, %	3.51	3.50	3.40	3.30	3.10	2.90	2.80
USD Exchange Rates:							
AUD-USD	0.6615	0.69	0.72	0.74	0.75	0.76	0.76
USD-JPY	136.30	130	129	128	127	126	125
EUR-USD	1.1019	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.2567	1.23	1.24	1.25	1.26	1.27	1.28
NZD-USD	0.6182	0.64	0.66	0.67	0.68	0.68	0.68
AUD Exchange Rates:							
AUD-USD	0.6615	0.69	0.72	0.74	0.75	0.76	0.76
AUD-EUR	0.6005	0.63	0.65	0.66	0.67	0.67	0.66
AUD-JPY	90.174	89.7	92.9	94.7	95.3	95.8	95.0
AUD-GBP	0.5266	0.56	0.58	0.59	0.60	0.60	0.59
AUD-NZD	1.0696	1.08	1.09	1.10	1.11	1.13	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.0	1.5
CPI (Headline), %	3.5	7.8	4.0	3.1
CPI (Trimmed mean), %	2.7	6.9	3.7	3.1
Unemployment Rate, %	4.7	3.5	4.5	5.0
Wages Growth, %	2.4	3.3	4.0	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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