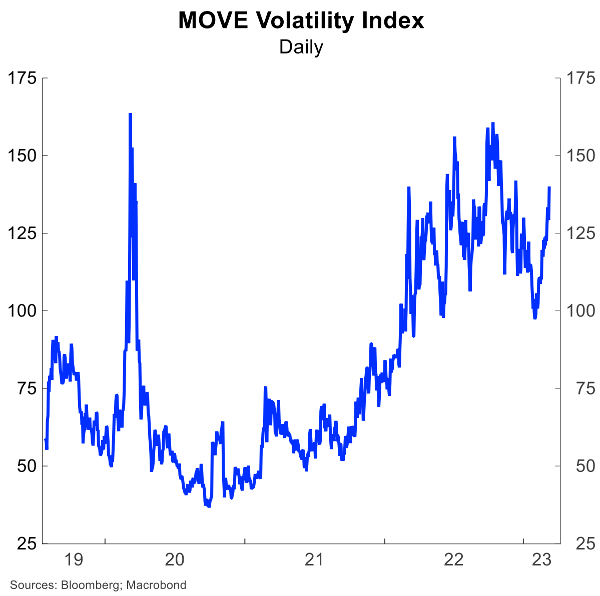
# RBA – Pause, Peak or False Summit?

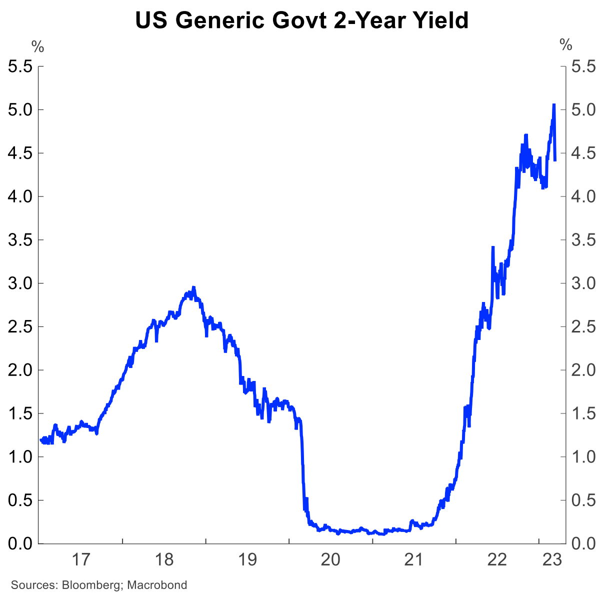
Recent developments in global markets increase the likelihood that the Reserve Bank (RBA) will indeed pause at next month's meeting. There is also a rising probability that we are near the end of the tightening cycle given evidence that inflationary pressures have peaked, the unemployment rate has turned and household spending is contracting in per capita terms. Furthermore, tightening delivered since May last year is likely to continue to bite more as we move through 2023, given the full effects haven't yet flown through. Interest-rate markets now have a probability of just 13% attached to a rate hike next month and have a peak in the cash rate of 3.85% for September.

And one cannot fully rule out the end of the tightening cycle altogether. What is completely clear – is that the economy reached a turning point late last year when signs of slowing emerged more notably. It is now up to policymakers to decide if that slowing is sufficient to bring down inflation quick enough for their liking. The data will be the key. The RBA has been knocked off any pre-determined path by the recent economic indicators and market ructions.

## Silicon Valley Bank Collapse

Financial markets were rocked on Friday by the collapse of Silicon Valley Bank (SVB) – the 16th largest bank in the US (with $209 billion in assets). It marked the biggest US bank failure since Washington Mutual was seized in September 2008. The moves in short-dated US bond yields were sizeable and of the kind not seen since the Global Financial Crisis (GFC) in 2008, as investors flocked to the relative safety of government bonds. Risk aversion lifted considerably – the MOVE volatility index for bond markets jumped 11 points to a 4-month high. Not surprisingly, bank shares were sold off heavily and share markets across the US and Europe were a sea of red.



The effects have rippled across Europe and Asia, including the Australian market, today, although the moves were more muted in Australia.

## Response by Federal Authorities – including the set up of BTFP

The Federal authorities in the US - the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), in consultation with the US Federal Treasury – announced earlier today (AEDT) that depositors of SVB will have access to all of their money effective 13 March.

The FDIC already provides insurance for bank deposits of up to $250k. However, SVB was unusual in that a large amount of its deposits were uninsured (i.e. above $250k). This reflects the fact that the client base of SVB was largely made up of firms across the technology sector, startups, founders, venture capitalists, and workers in the technology industry, among others. This contrasts with the traditional client base of regular households across many larger retail banks. As a result, to support depositors and limit the risk of contagion to other institutions, the FDIC will ensure that all depositors (even those with deposits over $250k) will be made whole.

They also announced a similar systemic risk exception for Signature Bank, which was closed today by its state chartering authority. Insured and uninsured deposits will also be made whole at Signature Bank.

If the proceeds from the resolution of each bank are not enough to cover the cost of insuring all deposits, a special levy will be applied to remaining banks to recover the costs to the taxpayer.

The Federal Reserve Board had also announced it will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors. A new facility, the Bank Term Funding Program (BTFP), will offer loans of up to one year to lenders who pledge as collateral US Treasuries, agency debt, mortgage-backed securities, and other qualifying assets. The assets, valued at par (rather than their current market value), should eliminate an institution's need to do a fire-sell of its assets to meet withdrawal requests from depositors, hence mitigating systemic stress.

These announcements are designed to ensure liquidity in the financial system and limit contagion to other financial institutions. The authorities are trying to shore up confidence in the US banking system to prevent a possible run on deposits and illiquidity emerging.

## SVB Background

The closure of the SVB came two days after the company raised capital and sold assets at below cost. Soon before the FDIC stepped in, SVB was forced to sell most of its available-for-sale securities at a loss to offset a drop in customer deposits. It announced a $2.25 billion capital raising but it was a case of too little too late.

SVB was a lender to some of the tech sector's largest companies and had been in business for four decades. Customer deposits tripled from 2018 to 2021 when interest rates were low and tech start-ups were cash rich. In fact, deposits rose so quickly that they outpaced growth in lending. As at the end of 2021, SVB held $189 billion of deposits, versus only $66 billion of loans. This mismatch is the opposite of what most banks experience, where loans are typically larger than deposits.

With loan demand not matching the inflows of deposits and with SVB being flush with cash, the bank invested its excess funds in government bonds, mortgage-backed securities (MBS), corporate bonds, and other securities when interest rates were at record lows.

But when rates rose sharply over 2022, tech firms and the venture capital market slowed significantly, and with it deposit activity at SVB, which turned from inflows to outflows.

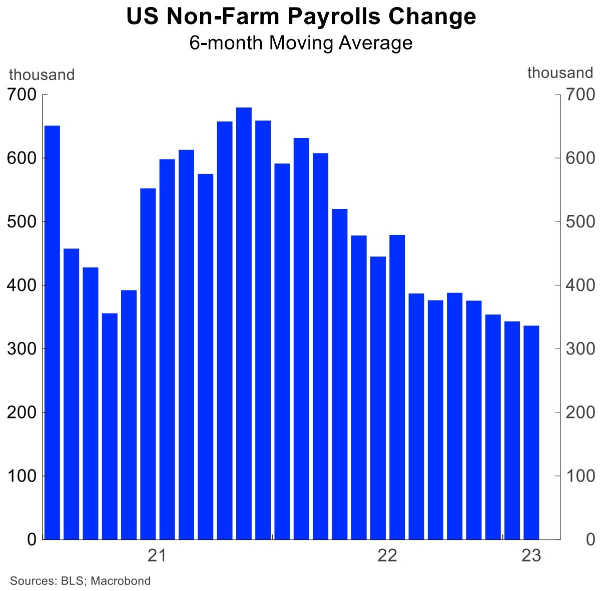
SVB's investments also hurt the company, as these assets quickly deteriorated in value as rates rose. As SVB suffered a liquidity mismatch, it needed to sell assets to fund customer withdrawals. A tipping point was reached when SVB suffered a near $2 billion loss from selling securities and turned to the capital markets for help. Venture capital funds advised companies to pull their SVB deposits and other informed investors headed for the exits, this caused a classic bank run and led to the sharp sell-off in the SVB stock price and regulatory intervention late last week.

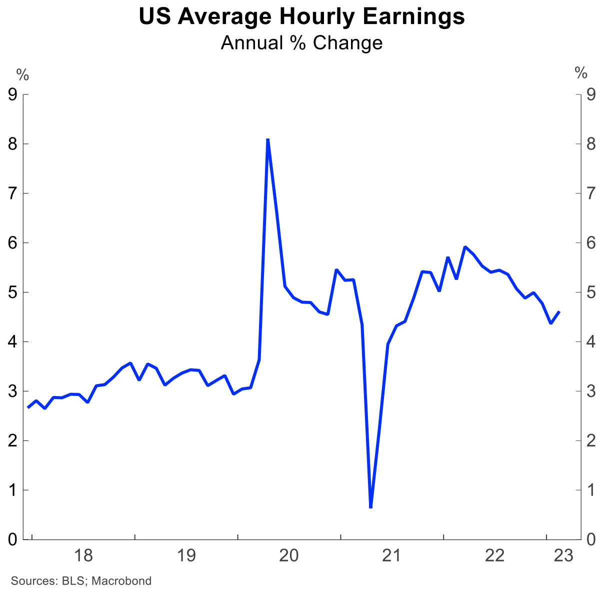
## US Rates and Employment Outlook and Payrolls Report

The SVB episode has led markets to lurch from a possible Fed rate hike on March 22 of 50 basis points in size to only 25 basis points, despite the strength of Friday's jobs report. Indeed, developments with SVB overwhelmed the payrolls release as the collapse of SVB highlighted the danger of duration risk in portfolios. It also illustrates that pockets of stress are emerging.

The Chair of the Federal Reserve, Jerome Powell, has explicitly referred to Friday's jobs data as a key driver of the Fed's policy decision.

Non-farm payrolls beat consensus expectations – rising by 311,000 versus expectations of 225,000. But January's outcome was revised lower, albeit modestly. Month-to-month fluctuations perhaps are less of a guide, given the volatility. The 3-month moving average, which smooths out the data, has stepped up in the past two months and the 4-week moving average of initial jobless claims remains under the 200,000 mark – suggesting that the jobs market remains tight. The 6-month moving average for payrolls has slowed since October and the unemployment rate lifted from a record low of 3.4% in January to 3.6% in February, as the participation rate rose. Annual growth in average weekly earnings stepped up to 4.6% last month, which is up from 4.4% in January, but well off the peak of 5.9% in March last year.



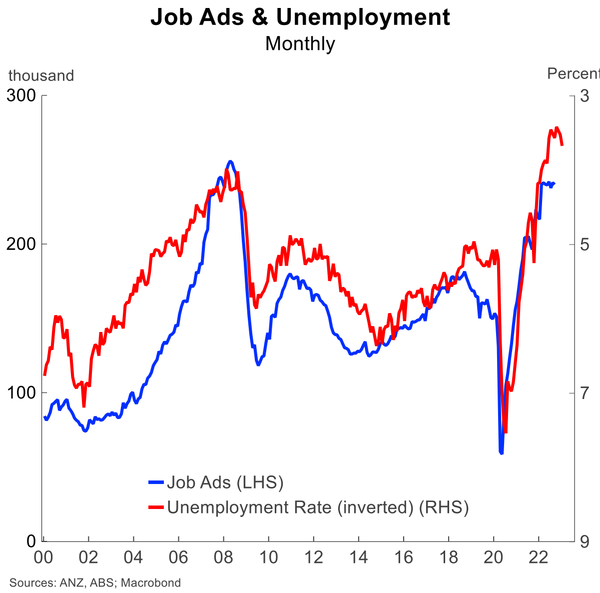

The upshot is that there are some signs of slowing in the labour market, but signs are mixed at best and the slowing would likely not be fast enough for the Fed's liking. However, stepping up rate hikes to 50 basis points is unlikely in the wake of the SVB developments. As yet, the full fallout of SVB is not completely clear. More information is likely to flow over coming days and weeks. It sends an important message though to policymakers that pain is emerging in areas of the economy from higher rates.

Interest-rate markets have stepped away from the possibility of a 50-basis point hike from the Fed. Markets now see the Fed moving by 25 basis points, but there is even some uncertainty brewing around a move of that size. Additionally, the peak in the federal funds rate is now at 5.1% versus 5.7% just last week. We would not be surprised if the Fed pauses – it is in the realm of possibility. Developments with SVB are fluid.

## Implications for Australia and the Reserve Bank

In a speech after the Board decision last week, the RBA Governor suggested that a rate hike and a pause would be on the table at the next meeting and that between now and then they would have "important data" on employment, monthly inflation, retail spending, and the business survey. The Governor also stated that the Board have "got a completely open mind about what happens at the next Board meeting."

However, our sense is that the RBA would prefer to pause but is nervous that the data will not be soft enough to allow it to pause and so this data will be crucial to determining the decision. We think the data is showing a slowdown underway in the economy and the developments in the US will make it more likely that the RBA will need to pause. In fact, depending on developments in the US and the results from these partial economic indicators, one cannot even fully rule out that the RBA is at the end of the cycle.


## Labour Force Survey (Thursday)

The labour market is the indicator to focus on out of the four the RBA Governor has singled out. The labour force survey is out this Thursday. Customer liaison suggests that the jobs market has turned a corner – there are rising reports of redundancies, shedding labour that was hired last year that was not the right fit and outsourcing increasing to India and the Philippines. Furthermore, the ramp up in net overseas migration is injecting labour supply to the economy.

The trend series on job ads and vacancies have started to turn lower but with an unemployment rate at 3.7%, it will take time for the labour market to feel a lot looser. The RBA estimates full employment to be in the low 4s.

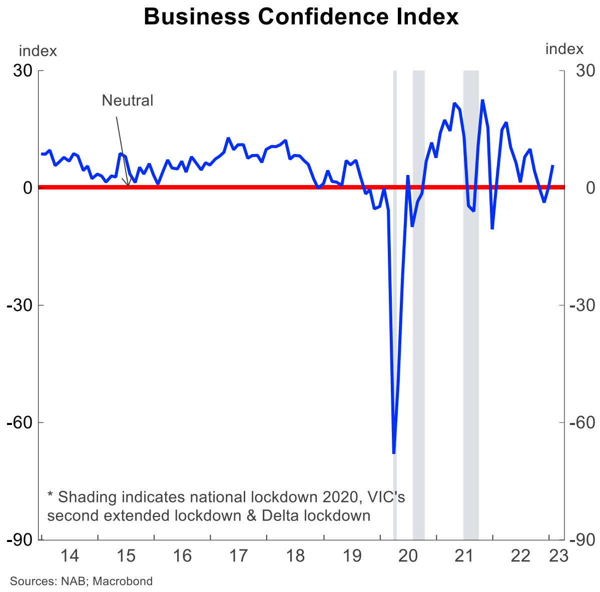
We expect employment to rise by 50k in February – bang in line with consensus expectations. The range of forecasts is very wide, sitting between a rise of 4,000 to as high as an increase as 100,000. We expect the unemployment rate to dip to 3.6%, from 3.7% previously. However, the low in the unemployment rate of 3.4% is behind us – it is unlikely we will revisit this low or break under it.

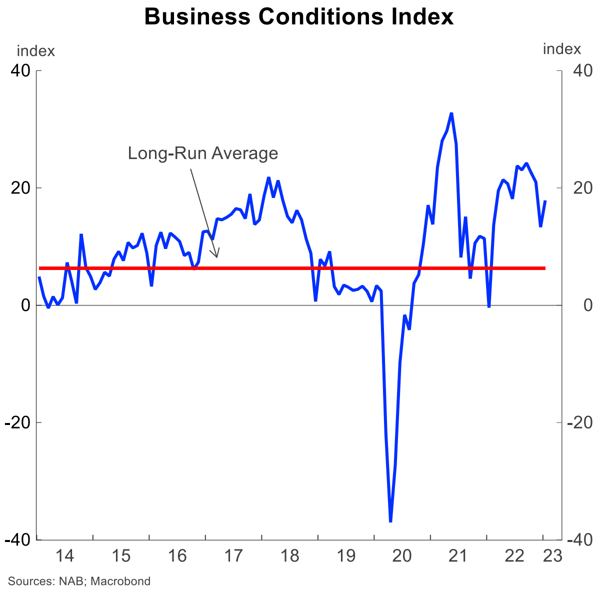
A result in line with our expectations should be enough for the RBA to pause, but an employment outcome above 50k could make it a more finely balanced decision.

## Confidence Surveys (Tomorrow)

The RBA is also closely eyeing the business survey out tomorrow for February, along with consumer confidence for March. Consumer confidence deteriorated last month to 78.5 – well below the 100 mark that divides the pessimists from the optimists.

Business confidence, however, has remained relatively resilient. The RBA will be looking to see if the signs of weakening in economic activity and is starting to show up more materially in business confidence. Business confidence in January was +6 – around the long-run average. Business conditions also remained upbeat, but we would expect this to show a slide in the new reading tomorrow.

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# Group Forecasts

| | | 2023 | | | 2024 | | |
|---|---|---|---|---|---|---|---|
| **End Period:** | **Close (13 Mar)** | **Q2 (f)** | **Q3 (f)** | **Q4 (f)** | **Q1 (f)** | **Q2 (f)** | **Q3 (f)** |
| **Aust. Interest Rates:** | | | | | | | |
| RBA Cash Rate, % | 3.60 | 4.10 | 4.10 | 4.10 | 3.85 | 3.60 | 3.35 |
| 90 Day BBSW, % | 3.64 | 4.30 | 4.30 | 4.22 | 3.97 | 3.72 | 3.47 |
| 3 Year Swap, % | 3.71 | 3.95 | 3.90 | 3.80 | 3.65 | 3.50 | 3.35 |
| 10 Year Bond, % | 3.58 | 3.75 | 3.45 | 3.25 | 3.00 | 2.80 | 2.70 |
| **US Interest Rates:** | | | | | | | |
| Fed Funds Rate, % | 4.625 | 5.375 | 5.375 | 5.375 | 4.875 | 4.375 | 3.875 |
| US 10 Year Bond, % | 3.70 | 3.80 | 3.50 | 3.30 | 3.10 | 2.90 | 2.80 |
| **USD Exchange Rates:** | | | | | | | |
| AUD-USD | 0.6580 | 0.71 | 0.72 | 0.74 | 0.75 | 0.76 | 0.76 |
| USD-JPY | 135.03 | 131 | 130 | 129 | 128 | 127 | 126 |
| EUR-USD | 1.0643 | 1.09 | 1.10 | 1.11 | 1.12 | 1.13 | 1.14 |
| GBP-USD | 1.2030 | 1.22 | 1.23 | 1.24 | 1.25 | 1.26 | 1.27 |
| NZD-USD | 0.6130 | 0.65 | 0.66 | 0.67 | 0.68 | 0.68 | 0.68 |
| **AUD Exchange Rates:** | | | | | | | |
| AUD-USD | 0.6580 | 0.71 | 0.72 | 0.74 | 0.75 | 0.76 | 0.76 |
| AUD-EUR | 0.6186 | 0.65 | 0.65 | 0.67 | 0.67 | 0.68 | 0.67 |
| AUD-JPY | 88.82 | 93.0 | 93.6 | 95.5 | 96.0 | 96.5 | 95.8 |
| AUD-GBP | 0.5470 | 0.58 | 0.59 | 0.60 | 0.60 | 0.60 | 0.60 |
| AUD-NZD | 1.0733 | 1.09 | 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 | 3.0 |
| CPI (Trimmed mean), % | 2.6 | 6.9 | 3.6 | 3.1 |
| Unemployment Rate, % | 4.7 | 3.5 | 4.6 | 5.1 |
| 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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