Tuesday, 7 October 2014

RBA and Economy in Holding Pattern

- **The cash rate is on hold – again. The RBA is in no hurry to lift it given the mixed signals in the economy. Spare capacity in the labour market; reticence to invest among the business community and a high Australian dollar (AUD) require ongoing low rates. A boom in housing construction and prices lean in the opposite direction.**
- **China is showing signs of slower growth – but at a pace that is twice as fast as most other economies. Be alert, not alarmed.**
- **The RBA wonders if financial markets are asleep. Are world financial markets really as 'riskless' as market pricing suggests. Be alert. If rates rise in the US, markets could react badly.**
- **The RBA has recognised the recent fall in the AUD. However, the RBA still appears unsatisfied with current levels, suggesting it would prefer the AUD to be even lower. This likely reflects the long-run relationship between commodity prices and the AUD.**
- **The lower AUD should provide the needed support for the Australian economy, and help offset the significant drag on growth from mining investment. We continue to expect the RBA will lift the official cash rate in 2015, but the patchy recovery in the domestic economy suggests that this could now be delayed till June.**

RBA Statement: At its meeting today, the Board decided to leave the cash rate unchanged at 2.5 per cent.

Growth in the global economy is continuing at a moderate pace. China's growth has generally been in line with policymakers' objectives, though some data suggest a slowing in recent months. Weakening property markets there present a challenge in the near term. Commodity prices in historical terms remain high, but some of those important to Australia have declined further in recent months.

Our view: *The RBA has now acknowledged further signs of slowdown in the Chinese economy. It remains a "bull' on China over the long term but is aware that cycles will occur in the short term. Solid demand from China is expected to underpin growth in Australia over the next decade. The RBA does not mention Europe's troubles and concludes that global growth is still 'chugging along'.*

RBA Statement: Volatility in some financial markets has picked up in recent weeks. Overall, however, financial conditions remain very accommodative. Long-term interest rates and risk spreads remain very low. Markets still appear to be attaching a low probability to any rise in global interest rates or other adverse event over the period ahead.

Our view: *The RBA is sending a subtle hint that financial markets might be too relaxed about the* *possibility of higher interest rates or other adverse events in the future (i.e. weaker share markets, falling house prices, global slowdown, European recession). If the glass is half full, it can become more than half empty.*

RBA Statement: In Australia, most data are consistent with moderate growth in the economy. Resources sector investment spending is starting to decline significantly, while some other areas of private demand are seeing expansion, at varying rates. Public spending is scheduled to be subdued. Overall, the Bank still expects growth to be a little below trend for the next several quarters.

Our view: *The battle to fill the gap left by declining resources sector investment continues. A housing boom is helping fill the gap. Export volumes are growing and ongoing (but unplanned) government spending will create demand. We continue to expect that Australia's GDP growth will be a touch above 3% for 2014, in comparison to the RBA's 3% forecast.*

RBA Statement: Labour market data have been unusually volatile of late. The Bank's assessment remains that although some forward indicators of employment have been firming this year, the labour market has a degree of spare capacity and it will probably be some time yet before unemployment declines consistently. Growth in wages has declined noticeably and is expected to remain relatively modest over the period ahead, which should keep inflation consistent with the target even with lower levels of the exchange rate.

Our view*: Does the RBA believe the most recent numbers? We doubt it. On the plus side is the rise in job ads. On the negative side is an economy that is treading water in terms of new private sector investment (outside of housing). One wonders if the very modest growth in wages might be holding back domestic demand and in particular, retail spending. We agree that inflation remains broadly under control.*

RBA Statement: Monetary policy remains accommodative. Interest rates are very low and have continued to edge lower over recent months as competition to lend has increased. Investors continue to look for higher returns in response to low rates on safe instruments. Credit growth is moderate overall, but with a further pick-up in recent months in lending to investors in housing assets. Dwelling prices have continued to rise over recent months.

Our view: *The RBA's growing concern about speculative investment in the property market is expressed in this paragraph. After various warnings in recent weeks directed at property investors, we are not surprised that they would get a mention in today's statement. It continues to suggest that there is a very high bar for further rate cuts, and that low interest rates are doing what they can to support the economy.*

RBA Statement: The exchange rate has declined recently, in large part reflecting the strengthening US dollar, but remains high by historical standards, particularly given the further declines in key commodity prices in recent months. It is offering less assistance than would normally be expected in achieving balanced growth in the economy.

Our view: *The RBA has recognised the recent fall in the AUD, which has depreciated both against the USD and in trade-weighted terms over the past month. However, the RBA still appears unsatisfied with current levels, suggesting it would prefer the AUD to be even lower. This likely reflects the long-run relationship between commodity prices and the AUD. The lower profile for* *commodity prices is now pointing to a currency towards 80 US cents.*

While we continue to see a risk that the AUD will resume its trend downwards due to the growing prospect of the Federal Reserve tightening monetary policy, a triple-A rating and relatively high yields could keep the AUD out of line with its traditional fundamentals. An Australian dollar around current levels would provide support to the domestic economy.

RBA Statement: Looking ahead, continued accommodative monetary policy should provide support to demand and help growth to strengthen over time. Inflation is expected to be consistent with the 2–3 per cent target over the next two years.

Our view: *The RBA remains relaxed about the outlook for inflation, maybe a bit too relaxed in our view.*

RBA Statement: In the Board's judgement, monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target. On present indications, the most prudent course is likely to be a period of stability in interest rates.

Our view: *There is again little change to the RBA's stance. The RBA has maintained that "the most prudent course is likely to be a period of stability in interest rates". An unwillingness to boost housing demand any further will rule out any further rate cuts, but the below trend growth outlook and soft labour market remains concerns for the RBA. The lower Australian dollar should provide the needed support for the Australian economy, and help offset the significant drag on growth from mining investment. We continue to expect the RBA will lift the official cash rate in 2015, but the patchy recovery in the domestic economy suggests that this could now be delayed till June.*

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The Detail

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