Interest Rate Outlook

Tuesday, 1 August 2017

Bank of Melbourne

A$ Back in the Limelight

- **The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today as widely expected.**
- **Of interest for financial markets was the RBA's reaction to the recent appreciation of the Australian dollar. Given that RBA Governor Lowe recently expressed his preference for a lower currency, it wasn't too surprising that the RBA made mention of the AUD's recent rise. Financial markets were unsurprised either – the broader impact on the AUD was minimal only dipping briefly before rebounding upon the release of the statement.**
- **The comments on the AUD in today's statement differs slightly in nature to some jawboning efforts by the RBA in the past. The difference being that the RBA does not hint at the AUD being overvalued, only that its appreciation would negatively impact the growth and inflation outlook.**
- **The other point of focus in today's statement was insight into the RBA's updated growth and inflation forecasts which are scheduled to be published on Friday in its quarterly Statement on Monetary Policy. The RBA indicates that economic growth forecasts are "largely unchanged". Friday's Statement on Monetary Policy will also give us some further insight into the RBA's thinking.**
- **There are some key reasons for the RBA to be more positive about the domestic outlook, including ongoing optimism in the business sector and further improvement in the labour market. Moreover, a global upswing is continuing. However, some notes of caution remain in the RBA's commentary, particularly with respect to the outlook for household consumption and ongoing spare capacity in the labour market. The appreciation of the Australian dollar further adds to the RBA's list of concerns.**
- **It continues to appear that the RBA is quite comfortable leaving rate settings on hold for some time. The risks to the outlook suggests that rate hikes remain a way off, particularly if the AUD holds at current levels or appreciates further.**

The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today as widely expected.

Of interest for financial markets was the RBA's reaction to the recent appreciation of the Australian dollar. The AUD has appreciated 4.8% against the US dollar and 3.4% in trade-weighted terms since the RBA's last board meeting in July. Given that RBA Governor Lowe recently expressed his preference for a lower currency, it wasn't too surprising that the RBA made mention of the AUD's recent rise. Financial markets were unsurprised either – the broader impact on the AUD was minimal only dipping briefly before rebounding upon the release of the statement.

The RBA today said that the higher exchange rate would "contribute to subdued price pressures in the economy" and was "weighing on the outlook for output and employment". In addition, an appreciating exchange rate was "expected to result in a slower pick-up in economic activity and inflation that currently forecast".

The comments on the AUD in today's statement differs slightly in nature to some jawboning efforts by the RBA in the past. The difference being that the RBA does not hint at the AUD being overvalued, only that its appreciation would negatively impact the growth and inflation outlook. We think that the current rally is a little overdone, but we have recently upgraded our end of year AUD forecast to 78 US cents.

The other point of focus in today's statement was insight into the RBA's updated growth and inflation forecasts which are scheduled to be published on Friday in its quarterly Statement on Monetary Policy.

On this front, the RBA has stated that economic growth forecasts are "largely unchanged" and annual growth is expected to be close to 3 per cent. Caution remained in regards to the outlook for household consumption, which was "one source of uncertainty" given slow wage growth and high household debt. The RBA for the first time in its monthly accompanying statements alluded to the impending downturn in residential construction, but remained optimistic that level of construction will remain high. However, there was greater optimism regarding the business sector, which is in light of the persistently elevated levels of business confidence and conditions. Specifically, the RBA was more upbeat on non-mining business investment and that "some pickup" was "expected".

The other note of optimism was surrounding the labour market, where employment growth had been "stronger over recent months". Today, the RBA makes note of its forecast for the unemployment rate to "decline a little" over the next couple of years, although this view has been expressed previously in the RBA's previous Statement on Monetary Policy in May.

In regards to inflation, there were no surprises for the RBA following the June quarter inflation release last week. The RBA signals that higher electricity (as well as tobacco) prices would boost CPI inflation.

Summary

There are some key reasons for the RBA to be more positive about the domestic outlook, including ongoing optimism in the business sector and further improvement in the labour market. Moreover, a global upswing is continuing. However, some notes of caution remain in the RBA's commentary, particularly with respect to the outlook for household consumption and ongoing spare capacity in the labour market. The appreciation of the Australian dollar further adds to the RBA's list of concerns.

We will gain some more insight into the RBA's thinking and when it releases its quarterly Statement on Monetary Policy on Friday.

It however, continues to appear that the RBA is quite comfortable leaving rate settings on hold for some time. The risks to the outlook suggests that rate hikes remain a way off, particularly if the AUD holds at current levels or appreciates further.

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