Interest Rate Outlook

Bank of Melbourne

Tuesday, 3 March 2015

RBA Leaves Cash Rate On Hold at 2.25%

- The RBA has paused for breath and left its cash rate on hold at 2.25%. It has left the door wide open for a further cut but will wait for further data to come in. We expect a rate cut to be announced in May.
- The global economy is still growing although at a modest pace. The global environment is broadly supportive of economic activity in Australia.
- There appeared to be little change in the RBA's assessment to the domestic economy, despite some worrying data on employment and business investment over the past month. Nonetheless, the question marks over the recovery in non-mining investment, the soft labour market and below trend pace of growth continue to suggest that another rate cut is likely.
- Imbalances in the housing market must continuing to weigh on the minds of the RBA board members. The RBA has also noted rising prices of other assets including shares and commercial property.
- Other than adopting an easing bias, there was little change in today's RBA's statement in comparison to the statement in February. We will need to await the minutes for further insight into their decision today. The Financial Stability Review towards the end of this month will also be a key focus and will likely provide discussion on the housing market.

RBA Statement: At its meeting today, the Board decided to leave the cash rate unchanged at 2.25 per cent.

Growth in the global economy continued at a moderate pace in 2014. A similar performance is expected by most observers in 2015, with the US economy continuing to strengthen, even as China's growth slows a little from last year's outcome.

Our view: Global growth is modest but positive. No mention was made of Europe and concerns regarding Greece's debt situation. The European Central Bank begins its extended quantitative easing this month as it endeavours to ramp up growth in the Eurozone.

RBA Statement: Commodity prices have declined over the past year, in some cases sharply. The price of oil in particular has fallen significantly. These trends appear to reflect a combination of lower growth in demand and, more importantly, significant increases in supply. The much lower levels of energy prices will act to strengthen global output and temporarily to lower CPI inflation rates.

Our view: The solid supply of oil from the United States, Saudi Arabia and Russia has pushed prices lower. Saudi Arabia has the lowest costs of production and seems most likely to win the battle for *market share. In the meantime, producers in the United States and Russia will fell the pain while consumers and business enjoy lower energy costs.*

RBA Statement: Financial conditions are very accommodative globally, with long-term borrowing rates for several major sovereigns at all-time lows over recent months. Some risk spreads have widened a little but overall financing costs for creditworthy borrowers remain remarkably low.

Our view: Global interest rates in the major economies are at or close to all time lows. German ten-year government bonds yield just 0.36% while in the US they sit at 2.09%. Our ten-year government bond yield, at just 2.50%, would have been unthinkable five or ten years ago. Are these rates the 'new normal' or will yields rise when the US finally begins to lift its Fed Funds rate?

RBA Statement: In Australia the available information suggests that growth is continuing at a below-trend pace, with domestic demand growth overall quite weak. As a result, the unemployment rate has gradually moved higher over the past year. The economy is likely to be operating with a degree of spare capacity for some time yet. With growth in labour costs subdued, it appears likely that inflation will remain consistent with the target over the next one to two years, even with a lower exchange rate.

Our view: From these comments, it appears that the RBA's assessment on the economy remains little changed from last month. The RBA has chosen not to focus on the spike in the unemployment rate to a 12-year high of 6.4% in January. As hinted in past commentary, it is focusing on the trend in the labour market. Interestingly, there is no mention of the disappointing ABS capex data that was released last week, which suggested that the recovery in non-mining investment will stall. Its omission comes despite the RBA's need for a further pick up non-mining investment. We will watch out for further insights in the minutes of today's board meeting.

RBA Statement: Credit is recording moderate growth overall, with stronger growth in lending to investors in housing assets. Dwelling prices continue to rise strongly in Sydney, though trends have been more varied in a number of other cities over recent months. The Bank is working with other regulators to assess and contain risks that may arise from the housing market. In other asset markets, prices for equities and commercial property have risen, in part as a result of declining long-term interest rates.

Our view: *Recent data would have heighten the RBA's concerns about imbalances within the housing market. Further measures by APRA to cool investor housing activity are now more than likely to be adopted. We are likely to gain further insight into the RBA's thoughts in regards to the housing market when it publishes its Financial Stability Review later this month.*

The RBA has also noted the rising share market and prices of commercial property, highlighting that risk-taking as a result of low interest rates is becoming widespread across asset classes.

RBA Statement: The Australian dollar has declined noticeably against a rising US dollar, though less so against a basket of currencies. It remains above most estimates of its fundamental value, particularly given the significant declines in key commodity prices. A lower exchange rate is likely to be needed to achieve balanced growth in the economy.

Our view: *The frustrations with the level of the Australian dollar remains. The RBA maintains that "a lower exchange rate is likely to be needed to achieve balanced growth in the economy." The*

Australian dollar has stabilised around 0.77-0.79 against the US dollar over the past month and has actually edged a little higher in trade weighted terms.

RBA Statement: At today's meeting the Board judged that, having eased monetary policy at the previous meeting, it was appropriate to hold interest rates steady for the time being. Further easing of policy may be appropriate over the period ahead, in order to foster sustainable growth in demand and inflation consistent with the target. The Board will further assess the case for such action at forthcoming meetings.

Our view: *The RBA has left the door well and truly open for a further rate cut. We expect the RBA will cut the cash rate in May. Beyond that rate movements will depend on how the data pans out.*

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