Interest Rate Outlook

Tuesday, 4 July 2017

Bank of Melbourne

The Unwavering Hand of the RBA

- **The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today. The decision was widely expected by markets, although a sharp fall in the AUD after the announcement indicates that financial markets were prepared for a more hawkish stance.**
- **The surprise today for markets was that there was very little change in the RBA's commentary. It follows more hawkish comments from other central banks around the world other than the US Federal Reserve. These include the European Central Bank (ECB), the Bank of England (BoE) and the Bank of Canada (BoC), raising the prospects of higher official interest rates globally.**
- **Despite a pick up in job growth in recent months, there was only a subtle change to the RBA's comments on the labour market. The RBA does not yet appear convinced that the improvement in the labour market is sufficient to begin thinking about tightening rates. We would agree. The unemployment rate currently sits at 5.5%, lower than its mid-2015 peak of 6.3%, but still at a level where spare capacity remains. Slow wage growth further underscores the degree of spare capacity in the economy.**
- **There also remains some concerns about the weakness in household spending. Indeed, as a large component of the economy, there remain question marks over whether the upbeat mood in the business sector can continue while consumers remain in the doldrums. Today's retail spending data, however, which point to a pickup in household spending over the June quarter, would be encouraging news for the RBA.**
- **An unemployment rate pointing to ongoing spare capacity in Australia, and a higher starting point for interest rates suggests that the RBA is further behind other central banks in considering tighter policy. Rate hikes remain a fair way off, but the uptick in retail spending and stronger labour market of late suggests that the possibility of another rate cut in this cycle is certainly becoming more remote.**

The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today. The decision was widely expected by markets, although a sharp fall in the AUD after the announcement indicates that financial markets were prepared for a more hawkish stance.

In this regard, the RBA fell short of expectations. There was little shift in the RBA's commentary. Despite a pick up in job growth in recent months, there was only a subtle change to the RBA's comments on the labour market – continuing to state that "indicators of the labour market remain mixed". The RBA further continued to point to wage growth remaining low and that it was "likely to continue for a while yet". The positive change was a removal of the statement that total hours worked remaining weak.

There were a few more notes of caution in the RBA's accompanying statement. There was recognition that consumption growth remained "subdued".

The RBA also pointed to the decline in global inflation reflecting lower oil prices. Core inflation and wage growth was also "subdued" in most countries.

The concerns regarding high household debt and risks coming from the housing market remains.

That being said, the RBA remains mostly upbeat with the outlook for domestic growth , noting that the slowdown in GDP growth in the March quarter was partly due to "temporary factors". There continued to be a positive tone in regards to business conditions and capacity utilisation. The RBA also reiterated that business investment not directy affected by mining investment had "picked up".

On the global economy, there was also little change, noting that "the broad-based pick up in the global economy is continuing".

Summary

The RBA does not yet appear convinced that the improvement in the labour market is sufficient to begin thinking about tightening rates. We would agree. The unemployment rate currently sits at 5.5%, lower than its mid-2015 peak of 6.3%, but still at a level where spare capacity remains. Slow wage growth further underscores the degree of spare capacity in the economy.

There also remains some concerns about the weakness in household spending. Indeed, as a large component of the economy, there remain question marks over whether the upbeat mood in the business sector can continue while consumers remain in the doldrums. Today's retail spending data, however, which point to a pickup in household spending over the June quarter, would be encouraging news for the RBA.

Today's decision precedes a number of central banks globally that have become less dovish. Markets have faced more hawkish commentary, leading to speculation of rate hikes other than the US Federal Reserve. These include the European Central Bank (ECB), the Bank of England (BoE) and the Bank of Canada (BoC).

An unemployment rate pointing to ongoing spare capacity in Australia, and a relatively higher starting point for official interest rates suggests that the RBA is further behind other central banks in considering tighter policy. Rate hikes remain a fair way off, but the uptick in retail spending and labour market of late suggests that the possibility of another rate cut in this cycle is certainly becoming more remote.

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