Tuesday, 6 December 2016

Bank of Melbourne

RBA Leaves Cash Rate At 1.50%

- **The RBA left its cash rate at 1.50% following its December meeting as widely expected by financial markets. The Statement was broadly similar to the previous month but appeared to be leaning towards the 'good news' rather than some of the weaknesses witnessed in the economy recently.**
- **The Governor was quick to point out that, while inflation remains below most central banks' targets, headline inflation rates have increased recently. We agree, but there is still some way to go before inflation picks up to those forecast levels.**
- **The RBA's view on inflation is crucial to its interest rate settings. It expects inflation to remain low for 'some time' before returning to more normal levels. 'Some time' is not defined and we wonder if the RBA might need to reduce the cash rate a touch further to help the process along.**
- **With the US Federal Reserve likely to lift its Fed funds rate next week and the possibility of some retracement of recent commodity price gains, the AUD seems unlikely to make much headway against the USD. Indeed, if GDP for the September quarter is a larger contraction than forecast, the AUD could see some downward pressure. This matters for monetary policy.**
- **We are concerned that economic growth will not reach trend or potential growth during 2017 and as such we do not believe that the RBA is done cutting rates in this cycle.**

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China remains a key economy for Australia's ongoing prosperity. Stimulus measures in China have steadied growth and prompted a pick-up in commodity prices. This is good for Australia but question marks remain over its sustainability. The Statement noted that demand for commodities had risen. There have also been cut-backs in supply – including reduced iron ore production in China. Higher prices for commodities have lifted income in Australia, but again, is this sustainable? We hope so but fear that it may fade as we move into 2017.

Bond yields have risen both domestically and offshore. This has seen fixed rates rise in Australia. The RBA points out while bond yields have risen it has been an orderly process and that globally, monetary policy remains remarkably accommodative.

The mixed fortunes of the labour market were noted, particularly the variation in labour markets across the States and Territories as well as the ongoing high level of labour underutilisation. Australians would like to do more work. Part-time employment, while a choice for some, is a restraint for others. Forward looking indicators continue to point to labour market expansion.

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Given its overall assessment of the global and domestic economies, the RBA's call to leave rates on hold was reasonable and expected. What matters from here on in is the pace of economic activity and the RBA's outlook for inflation. Today's data on exports and imports combined with other data on retail spending and business investment points to a soft patch in economic growth. We are looking down the barrel of sub-2.0% growth this time next year – a view a touch weaker than that forecast by the RBA. The RBA did highlight 'some slowing in year-ended growth' but it also looks through this weakness.

Outlook for Monetary Policy

With the US Federal Reserve likely to raise its Fed funds rate next week and the possibility of some retracement of recent commodity price gains, the AUD seems unlikely to make much headway against the USD. Indeed, if GDP for the September quarter is a deeper contraction than forecast, the AUD could see some downward pressure. This matters for monetary policy. As the RBA continues to point out, low interest rates and the overall weaker AUD is assisting in our economic transition away from the mining invest boom and towards services and other non-mining industries.

We are concerned that economic growth will not reach trend or potential growth during 2017 and as such we do not believe that the RBA is done cutting rates in this cycle.

The <u>one page</u> text of the Governor's Statement can be found at http://www.rba.gov.au/

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