Monday, 6 March 2023

Will the RBA Wonder Off The Narrow Path?

Reserve Bank March Meeting

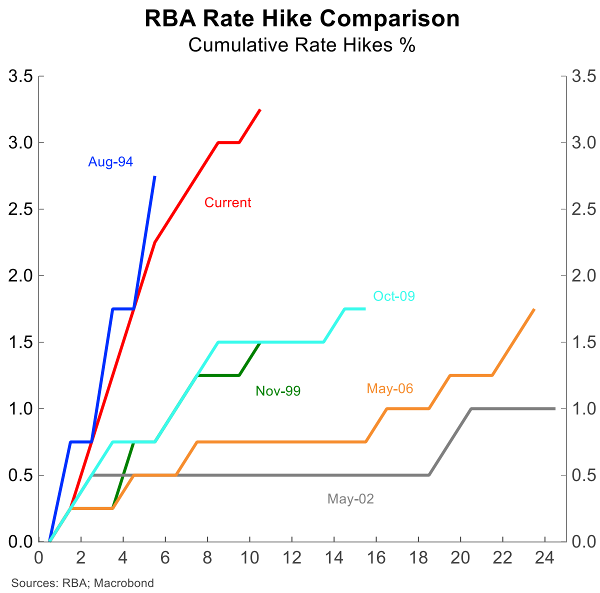
All eyes this week will be on the outcome of the Reserve Bank (RBA) Board meeting.

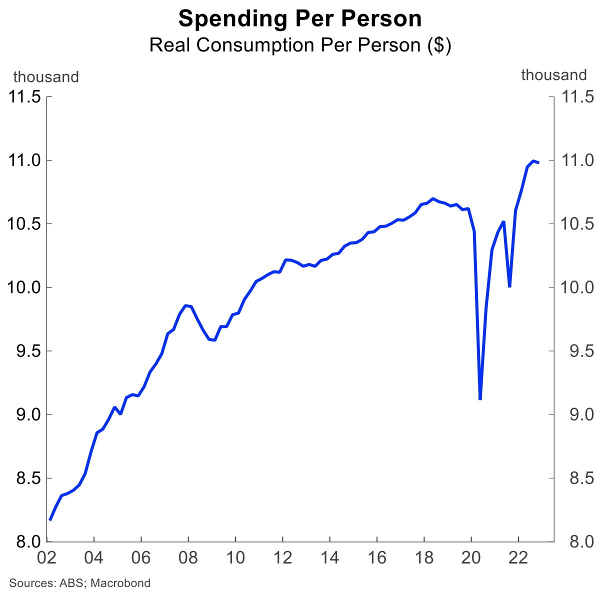
The RBA Board is widely tipped to deliver another 25-basis point interest rate hike at its meeting tomorrow. This would be the tenth hike in a row, taking the cash rate to 3.6% – the highest level since May 2012.

The guidance provided in tomorrow's policy statement will be key. February's policy statement made it clear that "further increases in interest rates will be needed" to ensure inflation returns to the RBA's target band within an appropriate timeframe. This led to an increase in market pricing for the cash rate peak, which today sits at around 4.2%. If the cash rate does indeed reach this level, it would be the highest rate since April 2012.

Investors and economists will be looking for any shifts in the RBA's rhetoric, including whether the Board is still hopeful of "keeping the economy on an even keel".

Since the RBA Board met in February, we have had a run of underwhelming economic data. The National Accounts released last week confirmed that the economy had reached a turning point, and that this point materialised earlier than in other advanced economies, including the US. The National Accounts showed that domestic demand from households, businesses and governments stalled over the December quarter. Indeed, after adjusting for inflation, consumption per person declined. This means that without strong migration, household consumption would have fallen over the December quarter.





We also received residential construction data which showed that indicators of future activity continued to slump. Private sector approvals have fallen to their lowest level since July 2012. Compared to their peak in March 2021, private sector approvals are down by almost 50%. New housing finance also continued its slide. Particularly concerning was the fall in new lending for the construction of dwellings, which is now more than 60% below its February 2021 peak. This points to weakness in activity, not necessarily today, but down the track as the pipeline of residential construction projects come to completion and there are limited new projects to sustain activity.

In a separate release, the Australian Bureau of Statistics (ABS) showed that inflationary pressures remained elevated; the monthly consumer price index indicator increasing by 7.4% over the year to January 2023. While this was a step down from the 8.4% recorded in December, the read showed that inflation remains too high. This was confirmed by today's release of the Melbourne Institute's inflation gauge which showed that headline inflation remained uncomfortably high, increasing by 6.3% in annual terms to February 2023. This was slightly lower than the 6.4% read recorded in January.

The choice for the RBA is difficult. On the one hand the economy is slowing and slowing quickly. On the other hand, inflation remains too high, and the longer it remains high the greater the risk that it will become embedded in the economy's price setting process. The higher interest rates must go to get inflation down, and the longer they need to remain contractionary, the higher the chance of a hard landing.

It is quite possible that the persistence of high inflation knocks the RBA off that narrow pathway.

We will be looking for any hints on the RBA's perceived progress towards achieving a soft landing in tomorrow's statement.

Our central case remains for a significant slowdown which will see the unemployment rate continue to increase. But if the RBA does have to go beyond 4.1% to get inflation out of the system, it is very likely that a recession will be hard to avoid.

International Data

Domestic economic indicators are showing clear signs that higher interest rates are biting. The labour market has started to turn, wage growth is losing some steam, and demand has slowed. In other countries, we are only seeing subtle signs that their economies are slowing.

In the US, labour market outcomes surprised on the upside in January with the unemployment rate ticking lower and the number of nonfarm jobs increasing by more than 500k. On Friday, we will get the US labour market report for February – a stronger than expected read may point to higher rates for longer in the US.

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Forecasts

End Period:	Close (3 Mar)	2023 Q2 (f)	2023 Q3 (f)	2023 Q4 (f)	2024 Q1 (f)	2024 Q2 (f)	2024 Q3 (f)
Aust. Interest Rates:							
RBA Cash Rate, %	3.35	4.10	4.10	4.10	3.85	3.60	3.35
90 Day BBSW, %	3.63	4.30	4.30	4.22	3.97	3.72	3.47
3 Year Swap, %	4.07	3.95	3.90	3.80	3.65	3.50	3.35
10 Year Bond, %	3.90	3.75	3.45	3.25	3.00	2.80	2.70
US Interest Rates:							
Fed Funds Rate, %	4.625	5.375	5.375	5.375	4.875	4.375	3.875
US 10 Year Bond, %	3.95	3.80	3.50	3.30	3.10	2.90	2.80
USD Exchange Rates:							
AUD-USD	0.6770	0.71	0.72	0.74	0.75	0.76	0.76
USD-JPY	135.87	131	130	129	128	127	126
EUR-USD	1.0635	1.09	1.10	1.11	1.12	1.13	1.14
GBP-USD	1.2036	1.22	1.23	1.24	1.25	1.26	1.27
NZD-USD	0.6220	0.65	0.66	0.67	0.68	0.68	0.68
AUD Exchange Rates:							
AUD-USD	0.6770	0.71	0.72	0.74	0.75	0.76	0.76
AUD-EUR	0.6365	0.65	0.65	0.67	0.67	0.68	0.67
AUD-JPY	91.95	93.0	93.6	95.5	96.0	96.5	95.8
AUD-GBP	0.5622	0.58	0.59	0.60	0.60	0.60	0.60
AUD-NZD	1.0879	1.09	1.09	1.10	1.11	1.13	1.13

	2021	2022	2023 (f)	2024 (f)
GDP, %	4.6	2.7	1.0	1.5
CPI (Headline), %	3.5	7.8	4.0	3.0
CPI (Trimmed mean), %	2.6	6.9	3.6	3.1
Unemployment Rate, %	4.7	3.5	4.6	5.1
Wages Growth, %	2.4	3.3	4.0	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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