Weekly Economic Outlook

Bank of Melbourne

Monday, 1 November 2021

Heat on RBA as Inflation Pressures Build

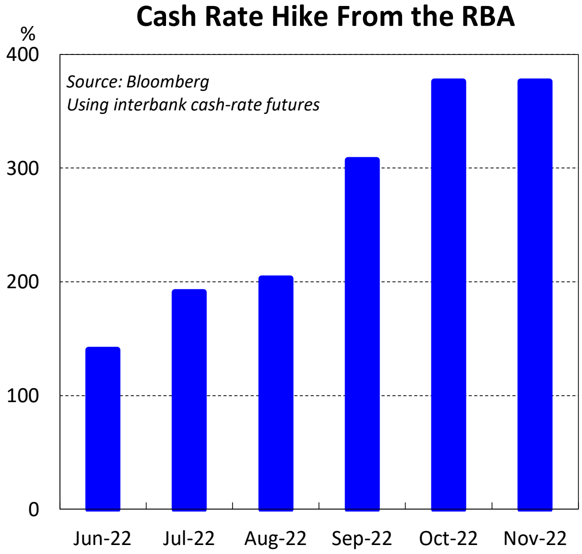
Last week's significant data outcomes and events mean the Reserve Bank (RBA) meeting tomorrow could be shaping up to be very important. It will certainly be closely watched – even more so than usual.

First, last week's data showed the underlying inflation rate moved into the Reserve Bank's inflation target band for the first time in nearly six years. At 2.1% per annum, it was also above the RBA's forecast of 1.75% for the December quarter this year.

Second, the RBA did not buy bonds to defend its three-year government bond yield target of 0.10%. Indeed, last Friday the three-year government bond yield shot up to a high of 0.78% and remains near that level today.

Third, last week interest rate markets moved to fully price in a 25 basis point rate hike in June next year and almost three more rate hikes to follow over the remainder of the year. Financial markets have moved a long way in a short space of time. The move seems well overcooked.

Market Pricing for a 25 Basis Point Cash Rate Hike From the RBA



The RBA Board meets tomorrow. The RBA will be feeling the heat from this backdrop. Throughout the pandemic, the RBA has maintained that it does not expect to lift the cash rate until 2024. But the economy has bounced back faster than expected and inflation is running hotter than the central bank has forecast. Our long-held view has been that the RBA will need to hike before 2024, most likely in early 2023.

Therefore, there is a possibility that the RBA waters down its guidance around the timing of the first rate hike, flagging the prospect of a move before 2024. Inflationary pressures combined with the prospect that the labour market may hit full employment sooner than previously expected suggests a shift in guidance cannot be ruled out.

The RBA's decision to not defend the three-year government bond yield target also throws up questions. In particular, whether the RBA is preparing to weaken its commitment to yield curve control or abandon it altogether. Yield curve control plays an important role in reinforcing the RBA's guidance that the cash rate will not increase until 2024.

Tomorrow's RBA statement is also likely to refer to revisions to its growth and inflation forecasts with the full set of projections to be provided in Friday's quarterly Statement on Monetary Policy. These forecasts are likely to be upgraded for both 2021 and 2022.

Central banks are the flavour during the week. The US Federal Open Markets Committee is meeting over Tuesday and Wednesday. The US central bank is widely expected to formally announce a tapering in its quantitative easing program to start in November or December, reflecting the strength of the recovery as well as growing inflation and financial stability concerns. We expect the bond buying program will conclude in the middle of next year before rate hikes commence at the end of 2022.

And there will be plenty of eyes on the Bank of England (BoE) meeting on Thursday. There is considerable uncertainty over the outcome of the meeting, although investors are expecting the central bank to kick off the interest rate tightening cycle to curb inflationary pressures. Supply chain disruptions, higher energy prices and rising wages in some industries have undermined the central bank's previous view that much of the jump in prices will be transitory. Last month the BoE said it expects inflation to exceed 4% in the December quarter, more than double the 2% target.

Turning to the local data calendar, dwelling prices earlier today kicked off the jam-packed week. Dwelling price growth has moderated since earlier this year. However, it has not run out of puff yet. Data released this morning showed dwelling prices rose 1.5% in October, a similar result to August and September. The monthly growth rate peaked in March at 2.8%.

Over the year, dwelling prices are up 21.6%, the highest annual growth rate since 1989. The exceptionally strong growth reflects the record low cash rate, constrained housing supply, the rapid recovery in the labour market from lockdowns in 2020 and housing-focused stimulus measures like HomeBuilder.

So where to from here?

We expect momentum to slow and for prices to grow by 8% in 2022 after blistering growth of over 20% this year. The softer forecast reflects stretched affordability and a possible further tightening in macroprudential policy. Fixed home loan rates are also being pushed higher.

Affordability constraints are biting, after dwelling prices have grown more than 12 times faster than wages in the past year. Affordability is particularly stretched in Sydney and Melbourne, where median dwelling prices are now nearly $1.1 million and $800k, respectively.

Rising affordability pressures are reflected in the decline in new lending to first-home buyers since January. First-home buyers typically have lower incomes than other buyers and tend to be more price sensitive. Saving for a deposit is becoming an increasingly challenging hurdle for first home buyers. Existing homeowners who are looking to move are likely to be less impacted because they have the benefit of equity that has accumulated as housing values have skyrocketed.

The Australian Prudential Regulatory Authority (APRA) has signalled that it may take further steps to temper housing risks, and this would take more steam out of dwelling price growth. APRA has so far taken a 'light' touch by modestly raising the mortgage serviceability buffer from 2.5 to 3 percentage points last month. This is expected to have a modest impact. Auction clearance rates since the decision reveal that the housing market has largely brushed off the move. We expect regulators could tighten the screws more significantly in the coming year, with limits on borrowers with high debt-to-income ratios a likely target.

We anticipate the housing market will move into the correction phase in 2023, with a 5% contraction in prices. This is consistent with our expectation that the Reserve Bank will begin hiking the cash rate in 2023. The increase in interest rates will trim borrowing capacity, and sentiment will turn. However, it is worth underscoring that a 5% decline in prices is mild given, by this stage, prices would have run up over 40% since the start of 2019.

This morning, data on housing finance was released for September. Approvals declined 1.4% in the month as the HomeBuilder pull-forward continued to unwind and Delta lockdowns crimped transaction volumes. The fall in lending was driven by a 2.7% decline in approvals for owner-occupiers, while lending to investors increased 1.4%.

On Wednesday, building approvals data for September will be published. We expect an 8% decline in the month alongside the disruptions from the Delta outbreak, the ongoing unwind of the HomeBuilder effect and a reversal of some of the recent jump in apartment approvals.

Elsewhere on the domestic front, retail sales volumes for the September quarter will be released on Thursday. We expect a 4.5% decline in volumes, after sales were smashed by lockdowns in NSW, Victoria and the ACT.

Also on Thursday, the trade balance for September will be published. We have forecast a surplus of $12.4 billion, following a record high of $15.1 billion in August. The main driver of the pullback in September is the sharp drop in iron ore prices, down around 25% to about US$120 per tonne for the quarter.

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Forecasts

End Period:	Close (29 Oct)	2021 Q4 (f)	2022 Q1 (f)	Q2 (f)	Q3 (f)	Q4 (f)	2023 Q1 (f)
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.10	0.10	0.10	0.25
90 Day BBSW, %	0.07	0.07	0.10	0.15	0.20	0.40	0.65
3 Year Swap, %	1.34	1.30	1.30	1.25	1.20	1.20	1.30
10 Year Bond, %	1.90	1.95	2.05	2.15	2.25	2.30	2.30
US Interest Rates:							
Fed Funds Rate, %	0.125	0.125	0.125	0.125	0.125	0.375	0.625
US 10 Year Bond, %	1.57	1.75	1.90	2.00	2.10	2.20	2.25
USD Exchange Rates:							
AUD-USD	0.7543	0.75	0.76	0.77	0.78	0.78	0.79
USD-JPY	113.58	112	112	113	113	114	114
EUR-USD	1.1682	1.19	1.20	1.19	1.18	1.18	1.17
GBP-USD	1.3795	1.38	1.39	1.40	1.41	1.41	1.40
NZD-USD	0.7203	0.71	0.72	0.73	0.74	0.74	0.74
AUD Exchange Rates:							
AUD-USD	0.7543	0.75	0.76	0.77	0.78	0.78	0.79
AUD-EUR	0.6457	0.63	0.63	0.65	0.66	0.66	0.68
AUD-JPY	85.673	84.0	85.1	87.0	88.1	88.9	90.1
AUD-GBP	0.5468	0.54	0.55	0.55	0.55	0.55	0.56
AUD-NZD	1.0471	1.06	1.06	1.05	1.05	1.05	1.07

	2019	2020	2021 (f)	2022 (f)
GDP, %	2.1	-0.9	0.0	7.4
CPI (Headline), %	1.8	0.9	3.1	2.4
CPI (Trimmed mean), %	1.5	1.1	2.3	2.8
Unemployment Rate, %	5.2	6.8	4.9	3.7
Wages Growth, %	2.2	1.4	2.0	2.8

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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