

Monday, 24 June 2019

An RBA Rate Cut in July Draws Near

This week there is little data except for private-sector credit on Friday, which is likely to show the subdued trend in credit growth remains intact. Our expectation is that credit to the private sector only expanded by 0.2% in May, leaving annual growth steady and sluggish at 3.7% and well below the long-run average.

This weak credit growth story is a reflection of weaker activity in the economy more broadly. The loss of momentum in the domestic economy since the second half of this year has persisted through this year and prompted the Reserve Bank (RBA) last month to cut the cash rate to a new record low of 1.25%.

More easing from the RBA is likely. Late last week RBA Governor Lowe delivered a speech in Adelaide and reaffirmed market expectations that more taps on the accelerator are on the way. Indeed, Lowe's message was loud and clear that more rate cuts would be necessary and sooner rather than later.

We have flagged for some time that July was a live date for the RBA. Lowe's comments suggested next week's decision is now a lay-down miseré; the cash rate is likely to drop to 1.00% on Tuesday after the board meets. Interest-rate futures are attaching a probability of nearly 80% to such an outcome.

In his speech Lowe said that it is "unrealistic to expect that lowering interest rates by a $\frac{1}{4}$ of a percentage point will materially shift the path we look to be on", which suggests more rate cuts are needed and sooner to stimulate economic activity. Lowe went even further and added that "it is not unrealistic to expect a further reduction in the cash rate".

Lowe last month highlighted the natural rate of unemployment is lower than previously thought and at 4.5%. With a current unemployment rate of 5.2%, the RBA clearly needs to do more rate cutting to actively reduce the jobless rate to as low as 4.5%. Rate cuts will help foster stronger economic growth and job creation. If the RBA knows it needs to do more easing, then waiting beyond July makes little sense.

Since February, we have slated three rate cuts are likely from the RBA this year. The third rate cut this year might also come sooner rather than later. Our forecast for the cash rate by the end of this year remains at 0.75%, but there remains some risk the RBA will need to do more than three, especially to achieve a sharply lower unemployment rate towards 4.5%. Incoming data over the next few months will help determine the terminal rate, especially data on the labour market.

Australian swap rates have declined over this year; the Australian 3-year swap rate since hitting a 2019 high of 1.97% on January 18, has fallen to a low of 0.96% last week, and remains near these lows. The 5-year swap rate has experienced similar pressures, falling from a high of 2.25% to a low of 1.13%. Australian swap rates have also been under downward pressure because of the compression in US bond rates, as US markets anticipate a Fed rate-cut cycle to commence later this year.

Rate cuts domestically are keeping the Australian dollar capped. The AUD/USD exchange rate hit a high of 0.7048 in the wake of the RBA rate cut on May 7 and hit a low of 0.6832 on June 18. It is the trade-weighted exchange rate that matters the most for economic activity and on this measure, the AUD has declined from 60.5 on May 7 to as low as 59.2 on June 18.

The RBA would prefer a weaker AUD, as it would provide greater stimulus to the economy by promoting Australian export competitiveness and making domestically-produced goods more attractive compared with imported goods.

The AUD will also take direction later this week from a Group of 7 meeting to be held in Canada, commencing on Friday and lasting two days.

Forecasts

End Period:	2019			2020			
	Close (Jun 21)	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)	Q3 (f)	Q4 (f)
Aust. Interest Rates:							
RBA Cash Rate, %	1.25	1.00	0.75	0.75	0.75	0.75	0.75
90 Day BBSW, %	1.22	1.15	1.00	1.00	1.00	1.00	1.00
3 Year Swap, %	0.96	1.00	1.05	1.15	1.20	1.25	1.30
10 Year Bond, %	1.28	1.30	1.40	1.45	1.60	1.70	1.75
US Interest Rates:							
Fed Funds Rate, %	2.375	2.125	1.875	1.875	1.875	1.875	1.875
US 10 Year Bond, %	2.05	2.10	2.05	2.10	2.20	2.25	2.30
USD Exchange Rates:							
AUD-USD	0.6926	0.6800	0.6600	0.6600	0.6700	0.6700	0.6800
USD-JPY	107.32	111.00	112.00	112.00	112.00	111.00	110.00
EUR-USD	1.1369	1.1000	1.1000	1.1100	1.1200	1.1300	1.1400
GBP-USD	1.2737	1.2800	1.2800	1.2800	1.2900	1.2900	1.3000
NZD-USD	0.6589	0.6400	0.6500	0.6500	0.6600	0.6600	0.6700
AUD Exchange Rates:							
AUD-USD	0.6926	0.6800	0.6600	0.6600	0.6700	0.6700	0.6800
AUD-EUR	0.6093	0.6180	0.6000	0.5950	0.5980	0.5930	0.5960
AUD-JPY	74.35	75.50	73.90	73.90	75.00	74.40	74.80
AUD-GBP	0.5434	0.5310	0.5160	0.5160	0.5190	0.5190	0.5230
AUD-NZD	1.0513	1.0200	1.0200	1.0400	1.0200	1.0200	1.0100

	2018	2019 (f)	2020 (f)
GDP, %	2.3	2.2	2.5
CPI (Headline), %	1.8	1.8	1.6
CPI (Underlying), %	1.7	1.3	1.7
Unemployment Rate, %	5.0	5.4	5.6
Wages Growth, %	2.3	2.6	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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