Monday, 3 July 2023

Tough Decisions As Terminal Rate Nears

To hike, or not to hike? That is the question the Reserve Bank (RBA) Board will be considering tomorrow as the July monetary policy decision takes centre stage this week.

After 400 basis points of hikes since May 2022, the light at the end of the tunnel is near and becoming more visible. However, this doesn't necessarily mean the RBA is finished hiking. As we near the end of the tightening cycle, it becomes more difficult to know whether the RBA will hike again at each meeting.

Indeed, there is a lot of uncertainty around the RBA's next move this Tuesday. Interest-rate markets think the RBA has more work to do, but not necessarily this week. Financial market pricing implies that there is a good chance of two more hikes (i.e. to 4.60%) before we reach the terminal rate, with a peak rate of 4.53% priced by the end of 2023. However, markets are uncertain around when these hikes are likely to be delivered. For July, there is currently a 22% implied probability of a 25-basis-point hike.

Economists are similarly divided on the next move. A Bloomberg survey of 27 economists found that they are almost exactly split down the middle regarding the next move. 14 of 27 economists expect the RBA to pause in July, while 13 expect a 25-basis-point hike.

We are one of the 13. While we acknowledge that it is likely to be another 'finely balanced' decision, we think the scales are tilted towards another 25-basis-point hike this month.

There are several reasons for this. As the RBA re-stated in the June monetary policy statement: "The Board will continue to pay close attention to developments in the global economy, trends in household spending, and the outlook for inflation and the labour market." Let's examine these points in turn.

On developments in the global economy, data from the US and other major nations paints a picture of economies that are still relatively robust, and with inflationary pressures that are stickier than first expected. This suggests that rates may need to move higher and/or stay at elevated levels for longer to contain inflation. We have seen this reflected in financial market pricing, as markets are shifting to pricing a 'higher for longer' scenario across many key economies.

On trends in household spending, retail sales data for May surprised to the upside. Sales rose 0.7% in the month, following a flat result in April. Temporary factors did impact the month, including consumers taking advantage of discounting amid earlier-than-usual end-of-financial-year sales. We expect sales to resume their slowdown in coming months. However, the result did still surprise markets. Importantly, spending on cafes, restaurants & takeaway was strong and rose to its highest level in history. This suggests spending on services may be holding up, which will likely be a concern for the RBA.

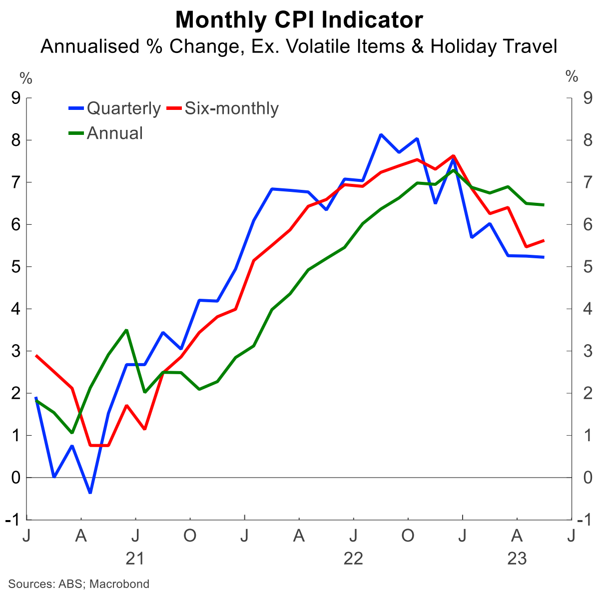
Looking at the outlook for inflation, the May monthly inflation indicator showed that inflation is on its way down. However, there are signs of stickiness, as we have seen overseas, once we strip away volatile items.

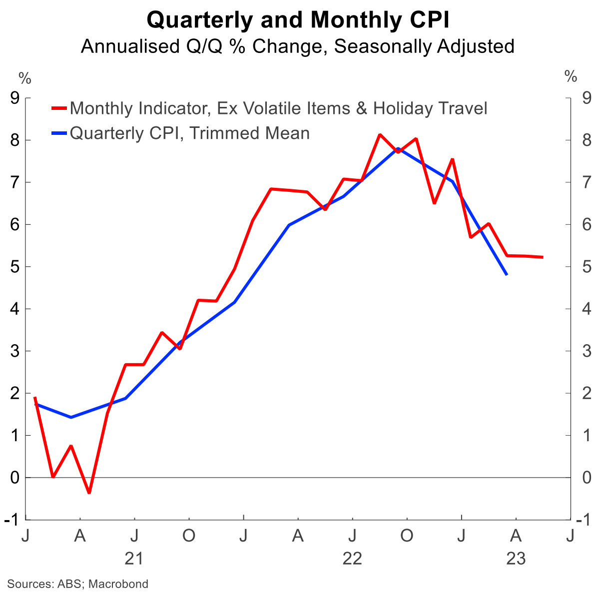
The result provided positive signs that headline inflation is slowing and that the disinflationary process continues. Headline inflation fell to 5.6% over the year to May. This followed a 6.8% outcome in April and was lower than expected by economists.

Much of this was driven by large falls in a few items, such as fuel, and holiday travel. Fuel prices have been volatile in recent months as the changes to the fuel excise rate last year impact the numbers. Additionally, holiday travel & accommodation is a category that can be quite volatile from month to month. It has also been impacted by large demand fluctuations as people have been getting back to their normal rhythm following prolonged travel restrictions of some form.

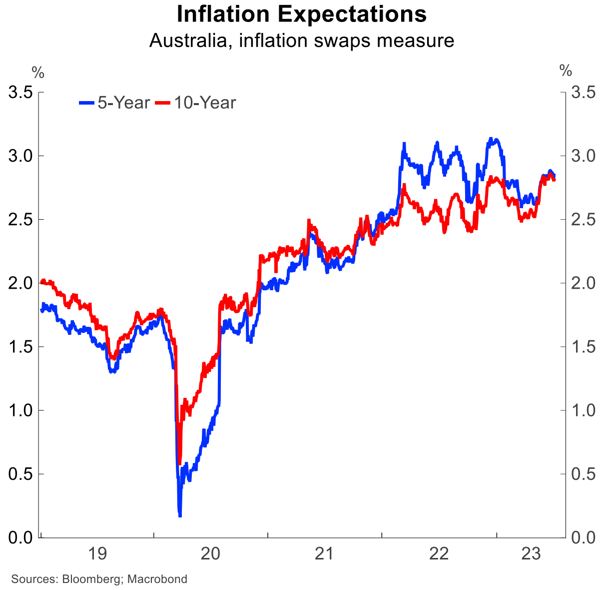
However, the details got a little murkier when we looked under the surface. The seasonally adjusted monthly inflation measure, excluding volatile items and holiday travel, accelerated on a monthly basis in May (0.5% vs 0.2% in April). The annual reading was unchanged at 6.5%.

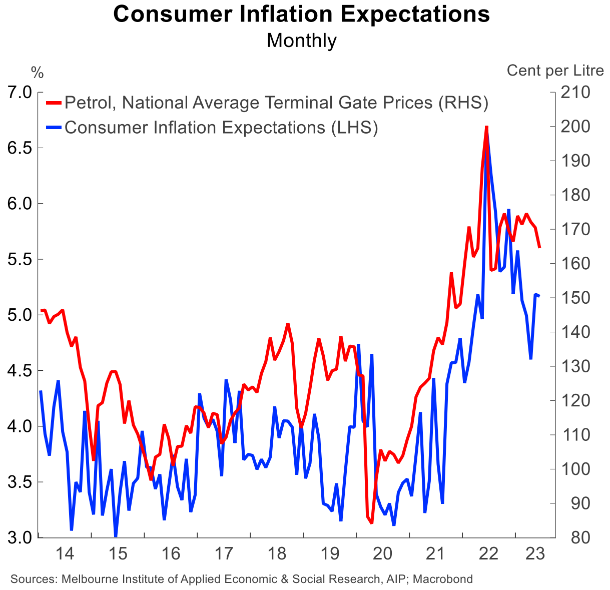
This suggests that there is some risk that underlying inflationary pressures may be stickier than the RBA would like to see. This has been a theme overseas, particularly around services inflation. Services inflation is more impacted by domestic supply and demand factors, including domestic labour market developments, and tends to be stickier. The RBA has flagged this risk as one of its key concerns.



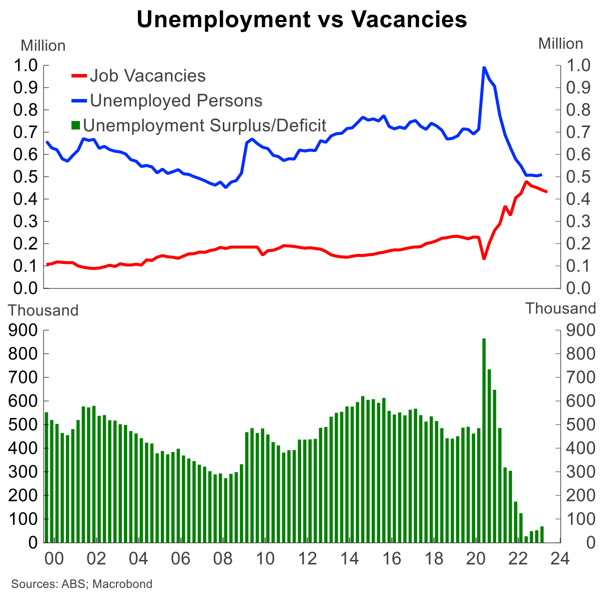


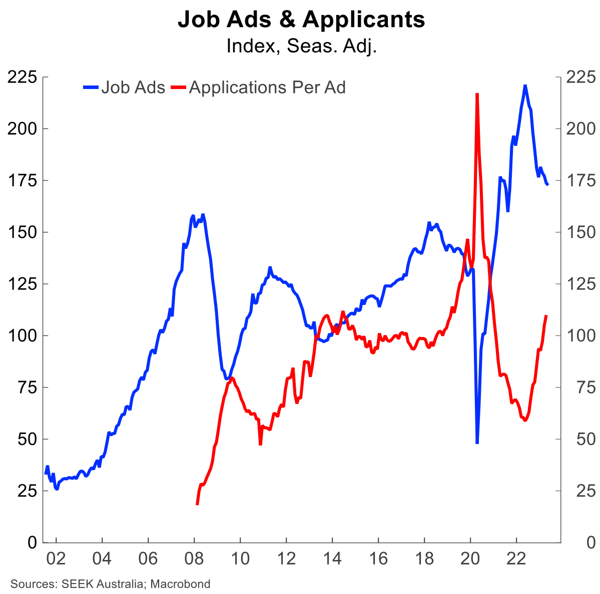
Inflationary expectations are also vital to the RBA succeeding in getting inflation back to the 2-3% target band in a reasonable timeframe. The longer inflation remains elevated, the greater the risk that economic participants come to expect inflation to remain high in the future and build those expectations into their decision-making processes. So far, the RBA thinks inflation expectations have remained reasonably well anchored. However, financial market measures of expectations have moved higher over the last month or so and are currently hovering near the top of the 2-3% band. Additionally, consumer inflation expectations rose in May and remained elevated in June. These are volatile and are typically impacted by items which consumers interact with regularly and where prices can change frequently (e.g. fuel). As a result, these need to be interpreted with caution. However, the recent results are still moving in the wrong direction.





Finally, the outlook for the labour market remains robust, despite the emergence of a gradual slowing. Almost 76,000 jobs were added in May and the unemployment rate remained around its lowest level in almost 50 years. Job vacancies confirmed the gradual slowdown we have been noting for several months as the demand for labour comes into better balance with supply. Job vacancies fell 2.0% over the three months to May, following a 2.4% drop over the three months to February. Other measures of labour market slack are also easing from very tight levels. However, this process is taking longer than expected, indicating the continued strength in the labour market.





Taking these factors together, we think the evidence suggests that further tightening of monetary policy is required to sustainably return inflation back to the 2-3% target band.

Economic Data

This morning, we received a range of housing data. Dwelling prices continued to rise in June, extending the stabilisation and recovery in prices that has been seen through much of 2023. This was despite a surprise rate hike from the RBA earlier in the month. National dwelling prices were 1.1% higher in the month. This follows growth of 1.2% in May. This continues the run of strong growth over recent months and means that dwelling prices are 3.4% higher since their February

2023 trough.

Sydney led the growth, as has been the case so far during this upturn. Prices in Sydney were 1.7% higher over the month and up 4.9% over the quarter. The strong growth means that prices in Sydney are now 6.7% above the January 2023 trough. Most other regions also recorded growth. All capital cities, except Hobart, were higher in the month and most regional areas, except regional Victoria and regional Tasmania, were also higher.

Building approvals surprised to the upside in May and jumped 20.6% in the month. This followed a 6.8% decline in April. The sharp move reflected a surge in apartment and multi-density dwelling approvals, which rocketed 59.4% in the month. This is a volatile category as the approval of large apartment blocks can drive outsized swings in the numbers. Approvals for private sector houses rose 0.9% in the month, to be down 15.3% from a year ago.

Dwelling approvals have been trending lower as a confluence of factors impacts the sector. This includes elevated building costs due to high material and labour costs, challenges facing building companies, which have contributed to rising insolvencies in the sector, consumer demand being negatively impacted by higher interest rates and high building costs, and the unwind of the HomeBuilder stimulus measures.

Housing finance rose 4.8% in May, reflecting a 4.0% increase in owner-occupier loan commitments and a 6.2% gain in investor loan commitments. The gain followed a 1.0% decline in new loan commitments in April. Housing finance is picking up in line with a stabilisation in the housing market, including prices and volumes.

The RBA is likely to take note of the continued gains in dwelling prices and increases in housing finance. Stronger asset prices contribute to a wealth effect, which may support consumer spending more than would otherwise be the case. Additionally, the housing sector is one of the most interest-rate sensitive sectors in the economy. A recovery in dwelling prices and a pick-up in lending, while being driven by a range of factors and not just interest rates, could be a sign that interest rate settings are not quite as restrictive as previously thought.

Turning to other data this week, the latest trade balance figures for May will be released on Thursday. The trade surplus is expected to remain very robust in May, and broadly unchanged from the April result. We expect an $11.0 billion surplus to be recorded in the month. This would be on the back of an $11.2 billion surplus in April. Exports are expected to fall slightly but remain robust and broadly unchanged from the previous month. Similarly, imports are expected to be broadly unchanged from April.

Jarek Kowcza, Senior Economist
Ph: +61 481 476 436

Group Forecasts

		2023		2024			
End Period:	**Close (30 Jun)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.60	4.60	4.60	4.35	4.10	3.85
90 Day BBSW, %	4.35	4.80	4.80	4.63	4.38	4.13	3.88
3 Year Swap, %	4.30	4.30	4.15	4.00	3.80	3.60	3.50
10 Year Bond, %	4.02	3.80	3.70	3.50	3.30	3.20	3.10
US Interest Rates:							
Fed Funds Rate, %	5.125	5.375	5.375	4.875	4.375	3.875	3.375
US 10 Year Bond, %	3.84	3.60	3.50	3.30	3.10	3.00	2.90
USD Exchange Rates:							
AUD-USD	0.6664	0.69	0.69	0.71	0.72	0.73	0.74
USD-JPY	144.31	138	136	134	132	130	128
EUR-USD	1.0909	1.11	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.2703	1.27	1.27	1.28	1.28	1.29	1.29
NZD-USD	0.6125	0.62	0.62	0.63	0.64	0.65	0.66
AUD Exchange Rates:							
AUD-USD	0.6664	0.69	0.69	0.71	0.72	0.73	0.74
AUD-EUR	0.6109	0.62	0.62	0.63	0.64	0.64	0.64
AUD-JPY	96.2	95.2	93.8	95.1	95.0	94.9	94.7
AUD-GBP	0.52	0.54	0.54	0.55	0.56	0.57	0.57
AUD-NZD	1.09	1.11	1.11	1.13	1.13	1.12	1.12

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.6	0.6	1.0
CPI (Headline), %	3.5	7.8	4.2	3.2
CPI (Trimmed mean), %	2.7	6.9	4.1	3.2
Unemployment Rate, %	4.7	3.5	4.2	5.3
Wages Growth, %	2.3	3.4	4.1	3.3

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

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

Contact Listing

Chief Economist
Besa Deda
dedab@stgeorge.com.au
+61 404 844 817

Senior Economist
Pat Bustamante
pat.bustamante@stgeorge.com.au
+61 468 571 786

Senior Economist
Jarek Kowcza
jarek.kowcza@stgeorge.com.au
+61 481 476 436

Economist
Jameson Coombs
jameson.cooombs@stgeorge.com.au
+61 401 102 789