Thursday, 21 February 2019

Cash Rate Outlook: Cuts Expected

- **We now expect the Reserve Bank to cut the cash rate this year, in August and November, by 25 basis points each.**
- **We are concerned about the housing outlook and the impact of the housing downturn on consumer-spending growth.**
- **There is a risk that conditions in the housing market are deteriorating faster than the data is showing.**
- **Businesses are also more fragile about the outlook, throwing some doubt on business-spending plans this year.**

We have had a very long held view that the RBA would remain on hold this year and next. But the profusion of downside risks in the global and domestic economy now means we are shifting this view. We have highlighted in recent weeks that the odds of a rate cut from the RBA have shortened considerably; we now think the RBA will need to cut the cash rate.

Around the end of last year, the global economic risks shifted to the downside. Those risks grew as we moved into 2019. These risks included a US government shutdown (longest in history), an unresolved Brexit (with an impending date to leave the EU), Italy entering recession in Q4, the German economy also stalling in Q4, ongoing US-China trade tensions and slower growth likely in China in the year ahead.

While these global risks suggest some downside risk to the Australian economic outlook, we became uncomfortable with our on-hold view as the run of local data this year suggested a weaker domestic outlook.

Indeed, since the start of this year, almost every single economic data release has been weak or weaker-than-expected with the exception of employment. Employment remains robust but it also lags economic activity. Perhaps the greatest concerns have been the acceleration in the housing downturn in Sydney and Melbourne and a sharp fall in business conditions which suggest businesses might be feeling more fragile about the outlook.

In recent weeks, I have travelled around Australia and spoken to our very diverse customer base. These customers have kindly shared their anecdotes about what is happening in their business and industry. While there was some optimism over longer-term prospects, customers linked to the housing industry were particularly downbeat. Reports of weak sales volumes and pre-sales activity suggest that there is more weakness to come. The downturn in housing is also spreading. While some cities like Canberra, Adelaide and Hobart are arguably still recording growth in dwelling prices, there are signs of a slowing in these markets too.

The close linkages between dwelling prices and consumer spending means we expect consumer spending to grow only modestly this year. The weakness in retail sales towards the end of last year suggests that the weakness in housing may already be impacting adversely on consumer spending. Further, the recent devaluation by Vicinity of its shopping centres, the first since around the GFC

and is a product of the tough times facing retailers in this environment.

At a time when housing construction activity is softening, it was important for business spending to step in and do some of the heavy lifting. Infrastructure spending, exports (especially LNG) and government spending are certainly helping to support economic activity, as is ongoing population growth. But the slowdown in housing and consumer spending growth means more is needed to support economic activity.

The latest ABS data shows non-mining business-spending plans have been upgraded for 2018/19 and if these plans come to fruition would give an underpinning to growth. However, a moderation in business confidence and conditions since early last year casts some doubt over these plans. In a year when the country is also heading to the polls and elections by their very nature bring uncertainty, some more fragility for businesses might be in store.

Domestic economic activity remains in gear 3 – not too fast and not too weak. However, there's a risk that we move to gear 2 if business spending falters and if the housing downturn really starts to bite on the consumer. The psychology of the consumer remains the difficult variable to pick in this equation.

The Reserve Bank is betting on a lift in wages growth to come through, which will support consumer spending. Lowe made the point recently that household income growth is the single important driver of consumer spending. Lowe also said the RBA thinks wages growth is at a turning point. While we think wages growth is improving, it's a slow grind. This week's wages data underscores our view. Annual wages growth was steady and low at 2.3%. In an environment where dwelling prices have much further to fall, wages growth is running at around 2.3% annually, the risk is that consumers will tighten their purses and wallets further.

Wages growth picking up will be the key to lifting inflation into the RBA's 2-3% per annum target band. Underlying inflation (inflation stripping out volatile price items) has been running under this band for three years and the RBA's latest forecasts it now expects underlying inflation to take a lot longer to get back into the band.

However, given the softer conditions and the risks to the outlook, the RBA will likely need to cut the cash rate to provide some support to economic activity and encourage inflationary pressures (in order to ensure underlying inflation does return in the band over time).

For these reasons, we are shifting our view to now expect the RBA to cut the cash rate. The risks have grown too much to the downside that it seems appropriate for us to change our view.

Financial markets moved to this view earlier, pricing in fully the chance of a rate cut a few weeks ago. The consensus among economists is still for no change from the RBA, but this consensus may shift as well if the run of data continues in the way it began this year.

RBA rhetoric remains hopeful despite acknowledging that the risks around a cash rate move are now "evenly balanced" whereas previously they indicated it was more likely that the next move would be up.

Given this optimistic stance and as the RBA has put employment in the spotlight, which is a lagging indicator, it might take some time for the RBA to start cutting rates, in our opinion. We expect the first rate cut in August, followed by another later this year.

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