Friday, 24 May 2019

st.george

RBA Set to Take the Cash Rate Sub 1%

Our View Shifts to 3 Rate Cuts This Year

- **We have been forecasting two rate cuts for this year since February 21. At the time, these forecasts were non-consensus. Earlier this week, we brought forward the timing of our rate cuts to June and August, from August and November previously.**
- **We are also expecting the RBA to cut the cash rate in November, taking the number of times the RBA cuts this year to three and the cash rate to 0.75%.**
- **In a speech earlier this week, RBA Governor Lowe highlighted that we can have a lower unemployment rate that is consistent with the inflation target and, indeed, should have an unemployment rate that is lower. Lowe added monetary policy would help achieve these outcomes.**
- **Further, Lowe does not expect jobs data to continue to surprise on the upside and thinks it is possible to have an unemployment rate below 5% without raising inflation concerns.**
- **The RBA's current forecasts have the unemployment rate averaging 5% this year and next year. These forecasts were based on the assumption that the cash rate would follow market pricing, which had two rate cuts almost fully priced in by year's end. Therefore, more than two rate cuts are necessary for the RBA to achieve an unemployment rate below 5% this year and next year.**
- **The Governor also expects inflation to take a long time to return to the RBA's target band and described the band as the RBA's "north star".**
- **Lowe's description that inflation will take a "long time" to get back to the band sniffed of a central bank losing its patience with inflation disappointing under the band for so long. His remarks suggest the RBA is preparing to help inflation get back to the band sooner.**
- **Given we are forecasting three rate cuts from the RBA this year, we are also revising down our Australian dollar forecast. We are now expecting the AUD/USD exchange rate to end this year at 0.66, from 0.68 previously. Global-growth concerns are also persisting and likely to hurt the Australian dollar, although commodity prices continue to provide some underlying support.**

Since early this year, we have been forecasting rate cuts from the RBA. When we made our projections in February, this view was a non-consensus view. The domestic data in recent months has continued to paint an economy that is losing momentum, despite a jobs market that remains relatively firm. On Tuesday, we brought forward the timing of our rate cuts from August and November to June and August.

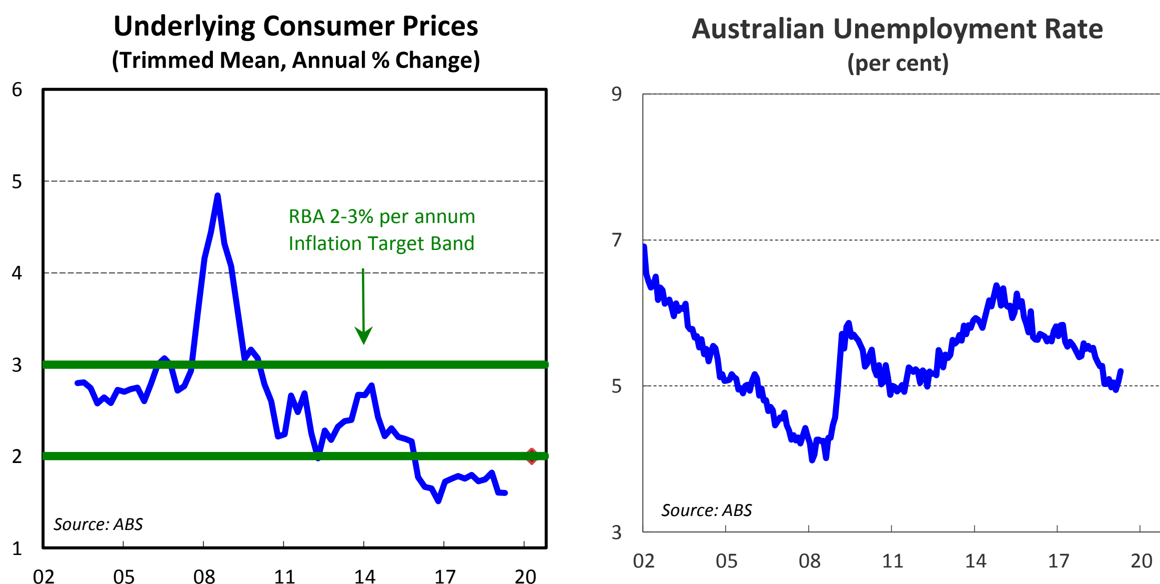
June is almost certainly a done deal with the preconditions for a rate cut, as set out by the RBA in the minutes of its April board meeting, being met with the tick up in the unemployment rate last week.

To recap, these preconditons outlined that a move higher in the unemployment rate and a move lower in the inflation rate would warrant an easing in monetary policy. In late April, the inflation rate moved down and last week the unemployment rate moved higher. Amid that backdrop, wages growth stalled in Q1 for the third straight quarter.

The Reserve Bank Governor Philip Lowe delivered a speech on Tuesday titled "the economic outlook and monetary policy". This speech gave important clues about the outlook for the cash rate and the RBA's thoughts on the outlook for the labour market and inflation.

For some time, Australian economic growth had slowed while jobs growth had remained firm. The rhetoric for much of this year suggested the RBA viewed this as a conundrum that needed to be solved, despite employment typically lagging economic activity. However, Lowe this week said that he is not expecting the labour market to continue to surprise on the upside. While Lowe wouldn't rule out an improvement in the unemployment rate as a possibility, he said "the recent flow of data makes it less likely". These remarks suggest the RBA believes the slowing in GDP growth is giving the better signal to the outlook for the economy and more needs to be done in lowering the unemployment rate.

Lowe further said that "the Australian economy can support an unemployment rate below 5% without raising inflation concerns". In Tuesday's question-and-answers session, Lowe highlighted that monetary policy can help the unemployment move lower and we should want it go lower. Lowe also said the RBA has been gradually reassessing this year what unemployment rate is compatible with the [2-3% per annum] inflation target and that it seems more likely to be lower than 5%. Lowe explained that the "evidence keeps accumulating" that we can sustain a lower unemployment rate of under 5%. Clearly, the unemployment rate is in the limelight.



The RBA's current forecasts have the unemployment rate averaging 5% this year and next year, before falling to 4¾% in 2021. These forecasts were based on the assumption that the cash rate would follow market pricing, which had two rate cuts almost fully priced in by year's end. Therefore, more than two rate cuts are necessary for the RBA to achieve an unemployment rate below 5% this year and next year.

Lowe's strong language around monetary policy helping push the unemployment rate lower amid subdued wages growth suggests to us that the RBA will need to take the cash rate sub 1% this year.

Lowe confirmed the inflation target band remains important, describing it as the central bank's "north star". With underlying inflation registering under the target band for more than three years and not projected to reach the band until the June quarter of 2020, more rate action is required from the RBA.

Lowe's description that inflation will take a "long time" to get back to the band sniffed of a central bank losing its patience with inflation disappointing under the band for so long. Lowe said on Tuesday a lower cash rate would support employment growth and bring forward the time when inflation is consistent with the target".

The weight of evidence means we are taking the number of 25 basis-point rate cuts to three this year. These three rate cuts take the cash rate to 0.75% by November this year.

It is possible the RBA might need to take the cash rate to 0.50% in this easing cycle, but we are also wary of becoming too pessimistic at this point in time. Economic growth remains supported by public infrastructure spending, net exports and population growth, but consumer spending growth remains subdued. The downturn in housing is hurting consumption. High household debt and weak wages growth are also challenges for the consumer. But election uncertainty has now passed, stimulus from the government is possible and forthcoming RBA rate cuts should lead to some improvement in the domestic economy.

Moreover, there is some evidence gathering that we might be nearing a bottom in the Sydney and Melbourne housing downturn, although prices might dwell around the bottom for some time. The improvement in auction rates in these cities and a reduction in the monthly price declines give us some encouragement around this view.

Our insertion of an extra rate cut this year means we also expect the Australian dollar to finish the year at a weaker rate. Global-growth concerns are also persisting with US-China trade tensions deteriorating. Iron ore prices are holding up, supported by supply constraints, but the weight of rate cuts at home and more fragile global growth suggests the AUD will move lower. We are revising down our end-year forecast from US 68 cents to US 66 cents.

Besa Deda, Chief Economist
Ph: 02-8254-3251

Contact Listing

Chief Economist

Besa Deda
dedab@stgeorge.com.au
(02) 8254 3251

Senior Economist

Janu Chan
chanj@stgeorge.com.au
(02) 8253 0898

The information contained in this report ("the Information") is provided for, and is only to be used by, persons in Australia. The information may not comply with the laws of another jurisdiction. The Information is general in nature and does not take into account the particular investment objectives or financial situation of any potential reader. It does not constitute, and should not be relied on as, financial or investment advice or recommendations (expressed or implied) and is not an invitation to take up securities or other financial products or services. No decision should be made on the basis of the Information without first seeking expert financial advice. For persons with whom St.George has a contract to supply Information, the supply of the Information is made under that contract and St.George's agreed terms of supply apply. St.George does not represent or guarantee that the Information is accurate or free from errors or omissions and St.George disclaims any duty of care in relation to the Information and liability for any reliance on investment decisions made using the Information. The Information is subject to change. Terms, conditions and any fees apply to St.George products and details are available. St.George or its officers, agents or employees (including persons involved in preparation of the Information) may have financial interests in the markets discussed in the Information. St.George owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of St.George.

Any unauthorised use or dissemination is prohibited. Neither St.George Bank - A Division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ACL 233714, nor any of Westpac's subsidiaries or affiliates shall be liable for the message if altered, changed or falsified.