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RBA Delivers First Rate Cut in Nearly 3 Years

Reducing Unemployment a Key Driver

- **The RBA delivered its first rate cut since August 2016 in a widely-expected decision. The 25 basis point rate cut took the cash rate to an all-time low of 1.25%.**
- **The decision to cut the cash rate was all about the labour market. The RBA wants to ensure there is faster progress in reducing the unemployment rate, so as to ensure inflation reaches the target band over the medium term. A sub 5% unemployment rate is on the RBA's radar.**
- **There has been a loss of economic momentum since the second half of last year. It will likely be necessary for the RBA to do more cutting to push the unemployment rate lower.**
- **We continue to expect another two rate cuts from the RBA this year, taking the cash rate to 0.75% before the end of this year. Our preferred timing is August and November, but a rate cut as soon as July cannot be ruled out. The timing will depend significantly on jobs data.**
- **We are wary of becoming too pessimistic on the economic outlook and throwing the baby out with the bathwater. There remain important pillars of support to economic activity, including infrastructure spending, population growth and net exports.**
- **The RBA takes to the podium tonight to deliver a speech at a Board dinner. This speech will be gleaned for more clues as to how far the cash rate might fall in this rate-cutting cycle.**

The Reserve Bank (RBA) delivered the first rate cut since August 2016 in a widely-expected decision. It cut the cash rate by 25 basis points, taking it to a record low of 1.25%.

The decision to cut the cash rate was all about the labour market. The RBA wanted to ensure there is faster progress in reducing the unemployment rate, which will help the inflation rate reach the RBA's target band over the medium term.

Recall that back in April, minutes from the Board meeting outlined the preconditions necessary for a rate cut. These preconditons were a move higher in the unemployment rate and a move lower in the inflation rate. Both conditions were met by mid May, cementing expectations for today's rate cut. 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, the RBA needed to inject stimulus.

The RBA in their final statement stressed that "the Board will continue to monitor developments in the labour market closely and adjust monetary policy to support sustainable growth in the economy". This sentence underscores the fact that an easing bias remains in place. Indeed, with unemployment at 5.2% and job ads falling sharply in May, it will most likely be necessary for the RBA to do more rate cutting to push the unemployment rate lower and under 5%.

RBA Governor Lowe has recently said the economy can support an unemployment rate under 5%

without raising inflation concerns. Indeed, Lowe also said monetary policy can help the unemployment move lower and we should want it go lower.

We are sticking to our view then that two more rate cuts are in store this year, taking the cash rate to 0.75% before the end of this year. Our preferred timing for these rate cuts are August and November, but there is a real risk the RBA delivers a follow-up rate cut as soon as July. Evidence of more softening in the labour market and greater risks in the global economic outlook are likely to be needed to deliver a follow-up rate cut as soon as next month.

Some market participants expect the RBA to take the cash rate to 0.50% in this easing cycle, but we are wary of becoming too pessimistic at this point in time. Economic growth remains supported by strong public infrastructure spending, firm contributions from the export sector amid elevated bulk commodity prices and a robust pace of population growth. However, consumer spending growth remains subdued. The downturn in housing is hurting consumption. High household debt and weak wages growth are also headwinds for the consumer. But election uncertainty has now passed, stimulus from the government is possible and stimulus from the RBA should lead to some improvement in the domestic economy.

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

Tomorrow GDP data is likely to show that the economy expanded by 0.6% in the March quarter. This is a reasonable rate of growth. However, the annual rate of growth will fall from 2.3% in Q4 2018 to 1.9% in Q1 2019 if our forecast is correct.

There has been some discussion around quantitative easing (or bond-purchasing by the central bank, also known as QE) in economist circles. But we feel it is too early for the RBA to be embracing QE. Central banks favour interest-rate policy over QE and only move to QE once interest-rate policy loses its effectiveness. We believe it would not be until the cash rate reached 0.50% or possibly below 0.50% that QE would need to be entertained.

There has also been some discussion around changing the inflation target band, which is 2-3% per annum over time. In our view, moving the inflation target would not be the solution and it would be damaging to future inflation expectations, which are used in setting wages and prices. Moving the inflation target band every time inflation undershoots or overshoots the target would also create considerable uncertainty around how the RBA conducts monetary policy. This discussion might go some way to explaining why Lowe was keen to point out in one of his recent speeches that the inflation target band remains the RBA's "north star".

Tonight, the RBA Governor takes to the podium this evening at 7:30pm AEST to deliver a speech titled "Today's Reduction in the Cash Rate". The Governor will also take questions from the media after his speech. We might get a clearer indication of future RBA policy action from this speech.

The market reaction from today's decision has been limited. The Australian dollar initially rose around 15 pips against the US dollar on the decision, but has since given up these gains, and short-term Australian bond yields were little changed.

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