

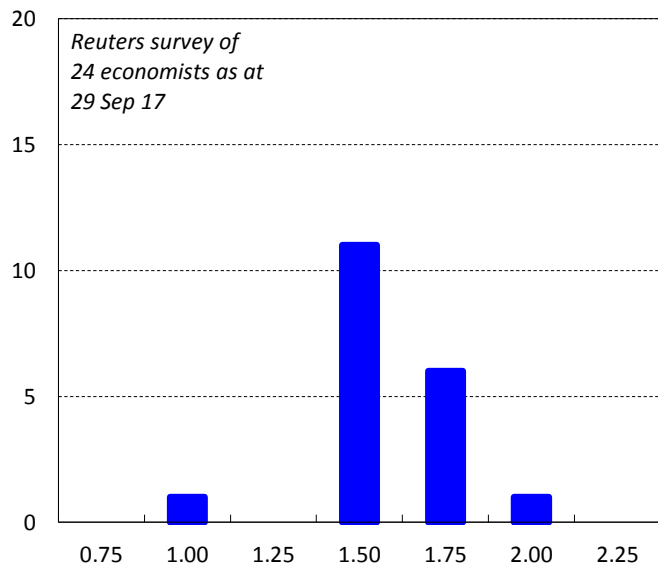
# Outlook for Bond and Swap Yields

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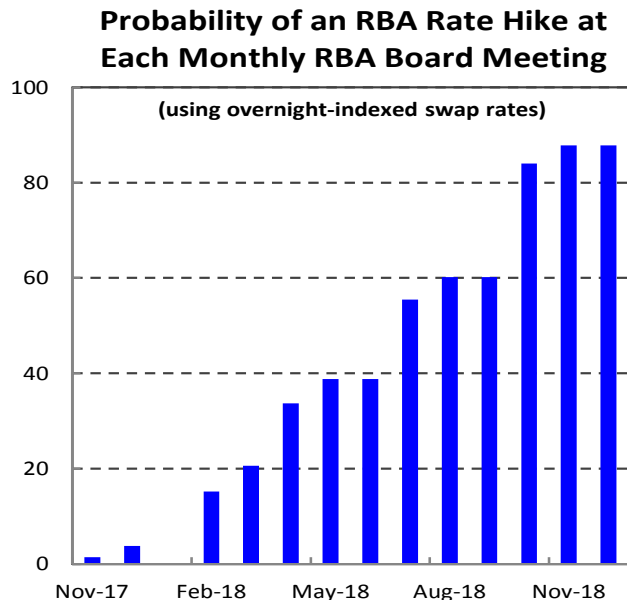
# Australian Cash Rate Outlook

## Where Will the Cash Rate Be at the End of Jun 2018?



- The Reserve Bank cash rate remains at a record low of 1.50%.
- The median consensus among economists is for the cash rate to stay at 1.50% by the end of June next year.
- While 11 economists expect the cash rate to be on hold by end June 2018, 7 expect the RBA will have started a rate-hike cycle.

# Australian Cash Rate – Market Pricing

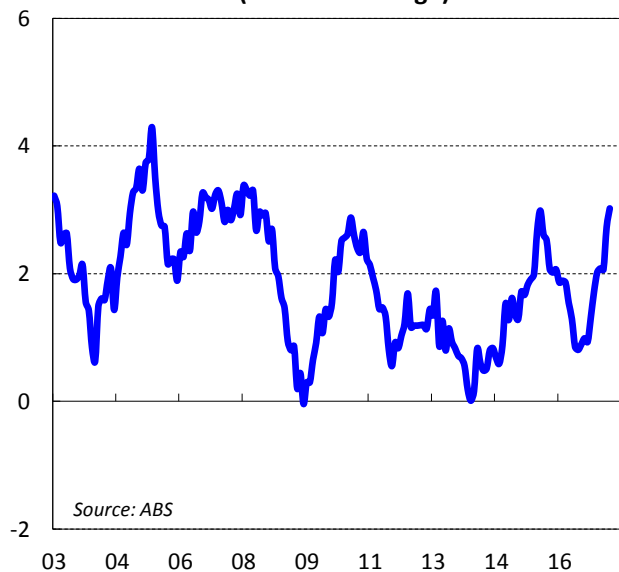


- Markets are attaching a 39% probability of a rate hike by end June 2018 (using overnight-indexed swaps pricing).
- This probability is 88% for the end of 2018.
- The unexpected drop in retail sales for August (published last week) highlighted the risk to economic growth from weak household income growth and high housing debt.
- However, market pricing only lengthened slightly after the data.
- Employment growth has stayed robust, adding to market expectations for a hike next year.

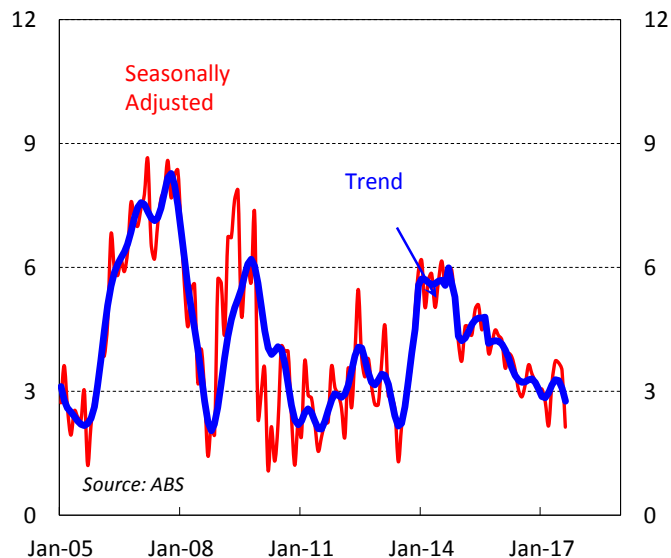


# Employment & Consumption are on the Radar

**Employment Growth**  
(annual % change)

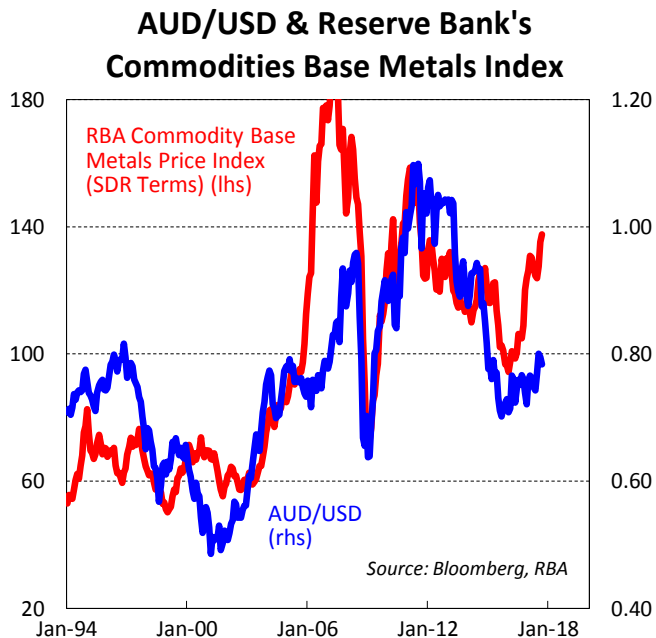


**Nominal Retail Sales**  
(annual % change)



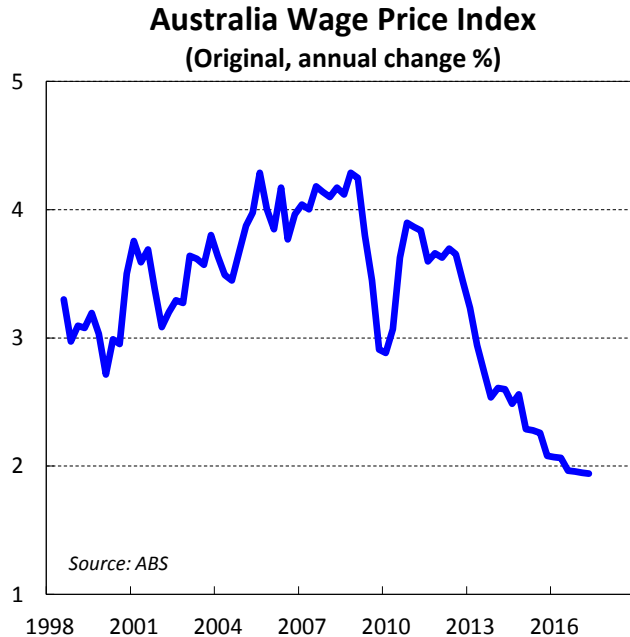
- The next update on inflation is 25 October.

# Australian Cash Rate Projections



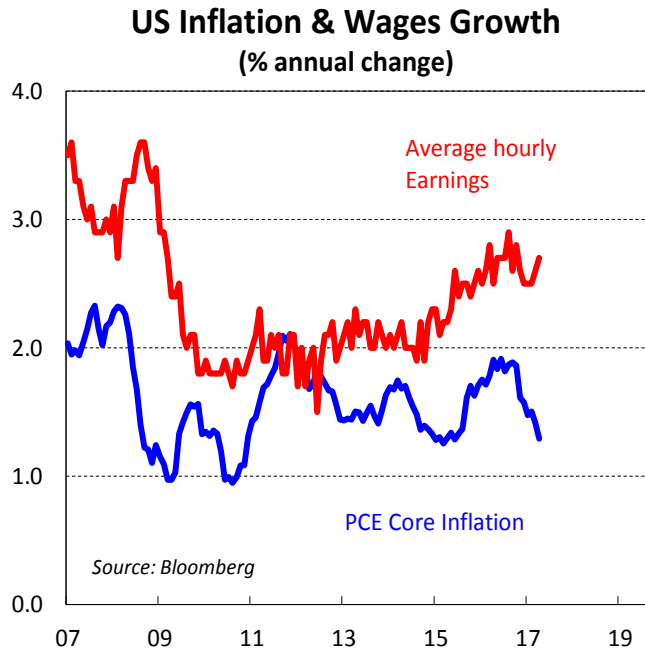
- We expect the RBA to keep the cash rate steady in 2017 and 2018 due to:
  - The appreciation of the Australian dollar this year, which is weighing on output and inflation. The AUD is up over 2.5% in trade-weighted terms since end 2017.
  - High household debt and weak wages growth constraining inflation and consumption.
- However, the outlook for business spending appears to be showing nascent signs of improvement and the labour market also continues to strengthen.

# Trends in Wages



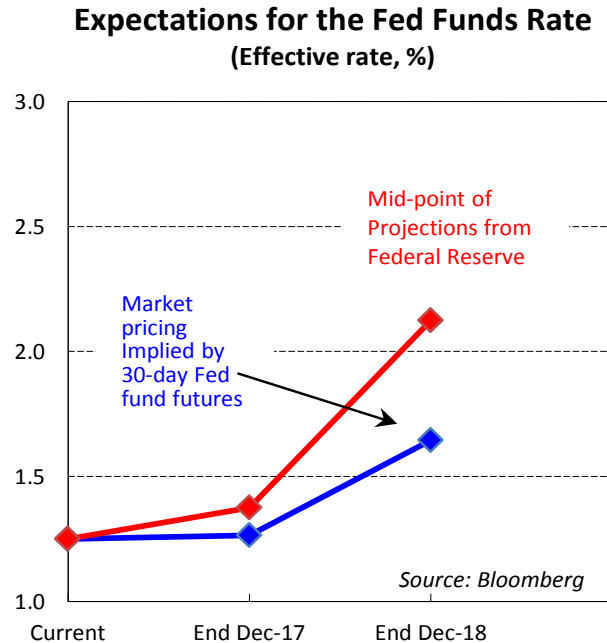
- Wages growth remains subdued in Australia.
- The RBA suggests the Phillips curve might be flatter. That is, there is a weaker inverse relationship between the unemployment rate and wages.
- One of the reasons might lie with digital innovation and globalisation. The labour force is now more global and competitive, so workers are reluctant to bargain for higher wages.

# Weak Wages Growth Not Unique to Australia



- Wages growth is weak in all key advanced economies.
- The RBA is looking closely at how things play out in the US with wages.
- The US unemployment rate is below the natural rate of unemployment, yet wage pressures have not escalated.
- Many US Fed officials believe low wage and price inflation in the US is only temporary, however, some members are worried it could be persistent.

# Financial Markets Less Hawkish Than The Fed



- The median projections of Fed officials (i.e. the dot plot) is for the Federal Open Market Committee (FOMC) indicate the Fed expects to hike a further 4 times between now and the end of 2018.
- The last FOMC meeting minutes (published overnight) indicated that the FOMC still expect to raise rates again in December 2017.
- Financial markets are attaching a 77% chance to this occurring. These odds have shortened over the past month.
- The reduction in the Fed's bond-buying program is starting this month.

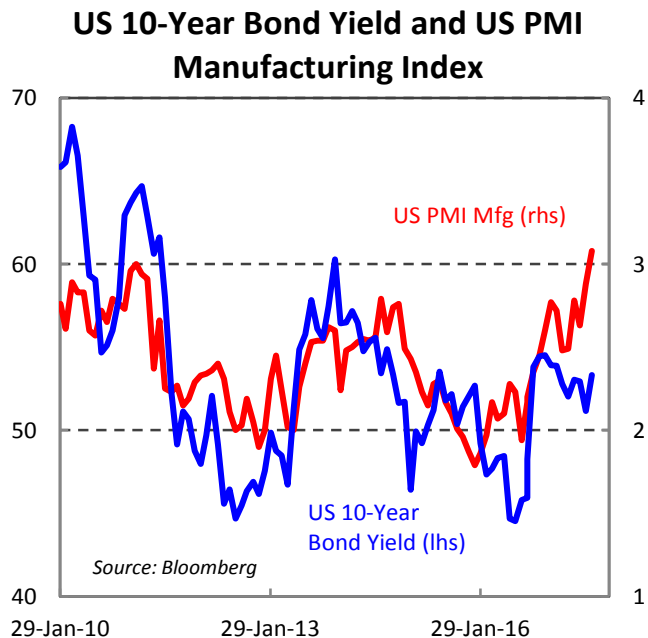


# US Inflation Expectations



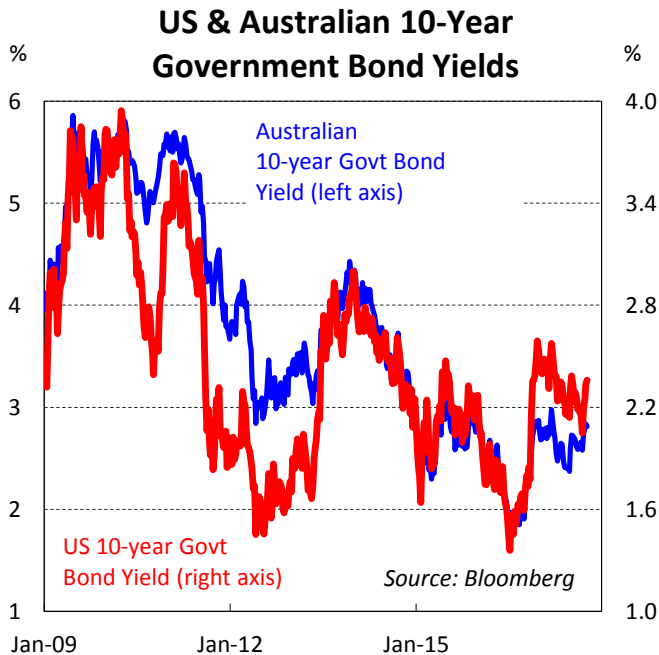
- Financial markets do not expect the US FOMC to hike 4 times by end 2018. We expect it will be 3 times. Financial markets are fully priced for only 1 more. Who is right will play out in bond and swap markets.
- Market pricing is less than the Fed due to expectations for US inflation. Markets are unconvinced that US inflation will push sharply higher over next few quarters.
- These views are reflected in the 5-year, 5-year forward inflation expectations rate - a measure of expected inflation (on average) over the next 5 years.

# Upside Risk to US 10-Year Bond Yields



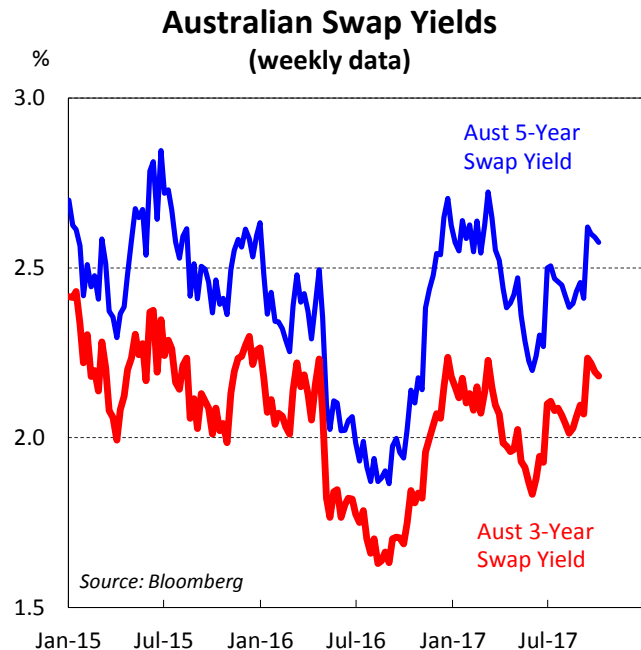
- The risks to US bond and swap yields are to the upside.
- We continue to expect higher US yields, but yields should grind rather than gallop higher.
- These upside risks come from:
  - Possible risks to inflation if US Fed Chair Yellen is correct and low inflation is only temporary.
  - US fiscal policy, although it might take time for a tax plan to happen.
- Choice of Fed Chair might matter too. Candidates in contention are Yellen, Powell, Warsh & Cohn.

# US Bond Yields Still Key Driver of Aust. Yields



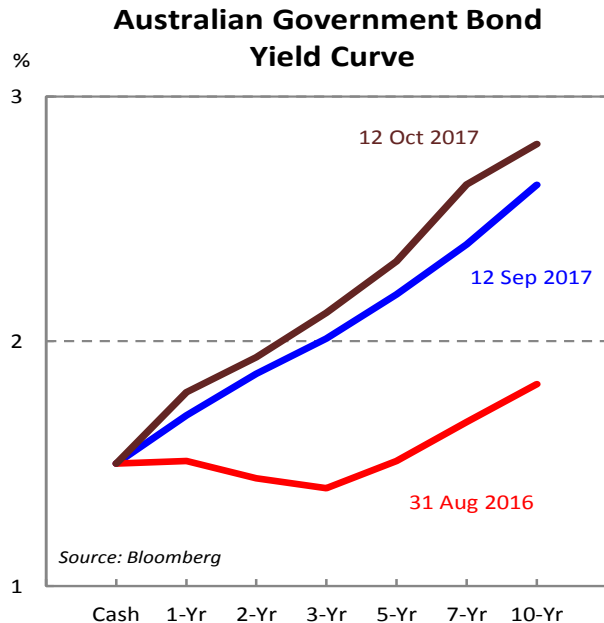
- US bond yields remain the key driver of Australian bond yields, especially for maturities of 2 years and longer.
- The greater the maturity of the bond, the stronger the relationship.
- We expect this correlation to continue.

# Australian Swap Rates Outlook



- Australian swap rates bottomed in August 2016. We do not expect swap rates to revisit these lows.
- Australian 3-year swap yields are up 57 basis points and Australian 10-year swap yields are up 74 basis points from their lows.
- Earlier this year, 3-year swap and 10-year swap rates had been up as much as 69 and 90 basis points, respectively, from their lows.

# Australian Government Bond Yield Curve



- The Australian 2-10 year part of the bond curve has steepened compared with one month ago. It has steepened from 77 basis points to 87 basis points.
- Both short-end rates and long-end rates have lifted over the past month, but the long-end by more. The long end shifted by more, fuelled by Fed Chair Yellen reiterating at the last Fed meeting that a rate hike is likely later this year.
- We expect that further steepening is likely with the RBA on hold and US yields likely to grind higher.

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