Outlook for Bond and Swap Yields

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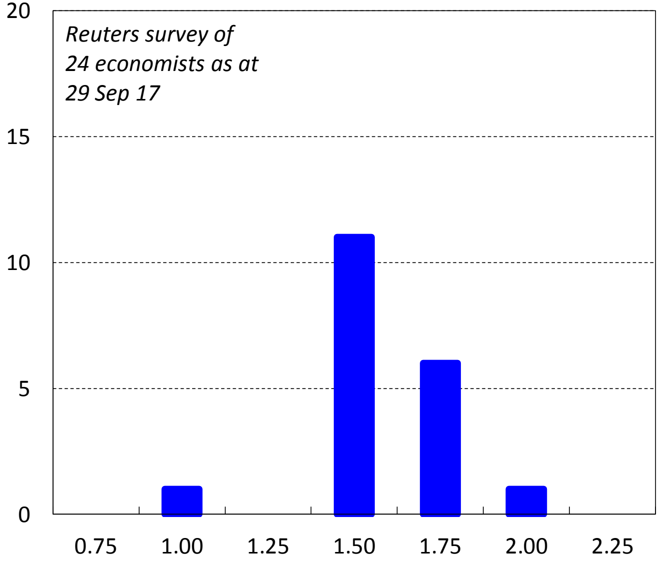
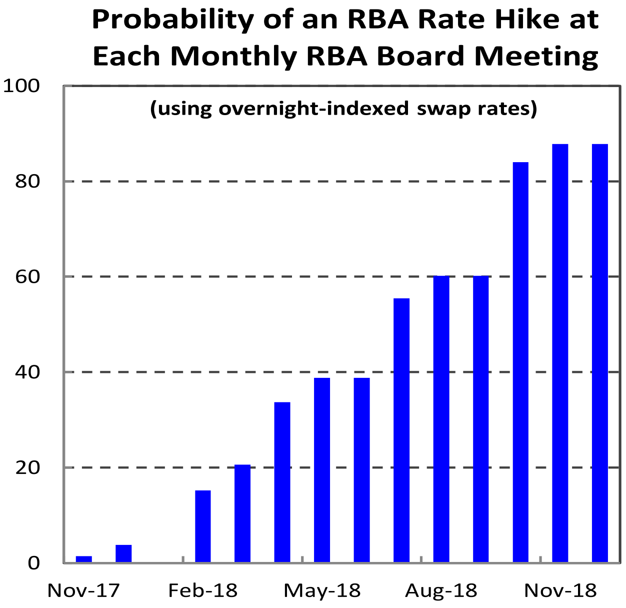
Australian Cash Rate Outlook

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



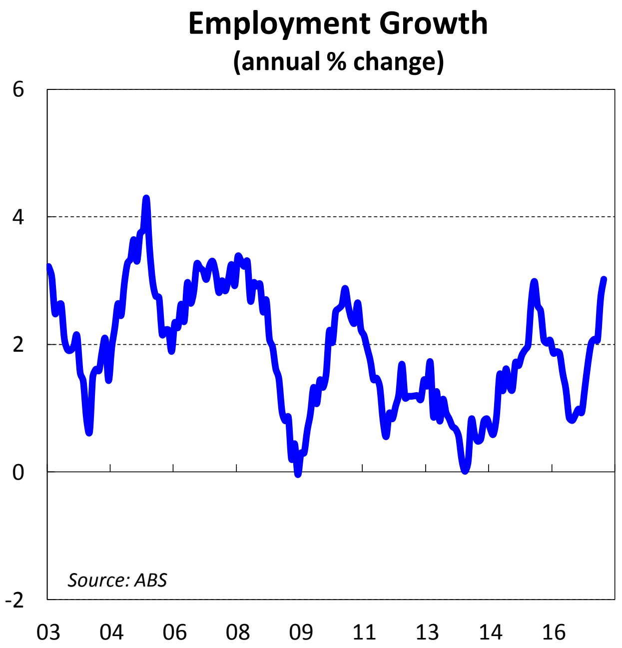
- The Reserve Bank cash rate remains at a record low of 1.50%.
- The median consensus among economists is for the cash rate to stay at 1.50% by the end of June next year.
- While 11 economists expect the cash rate to be on hold by end June 2018, 7 expect the RBA will have started a rate-hike cycle.

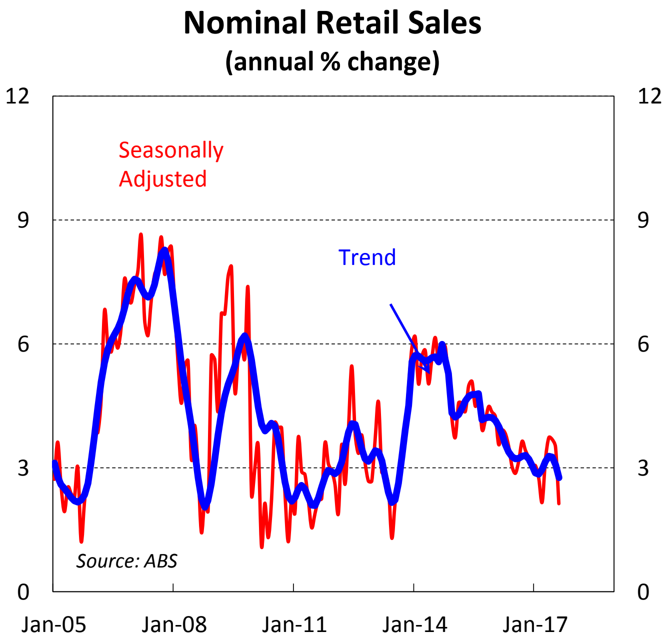
Australian Cash Rate – Market Pricing



- 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.

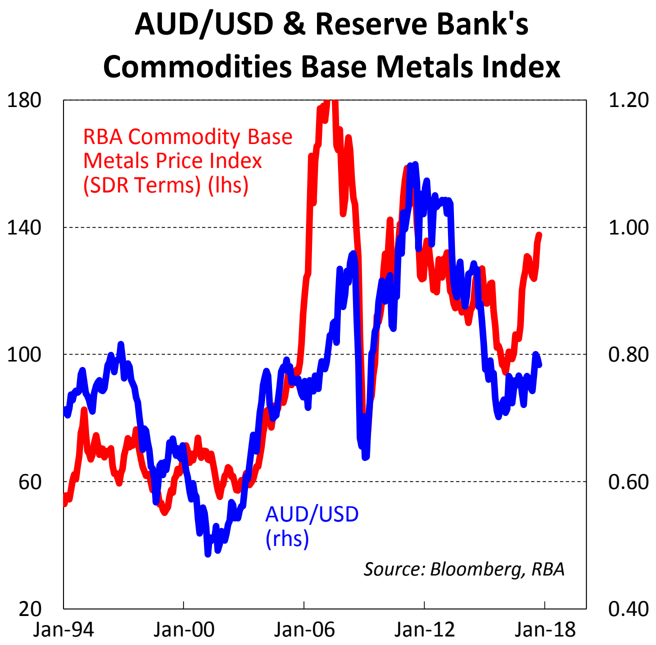
Employment & Consumption are on the Radar





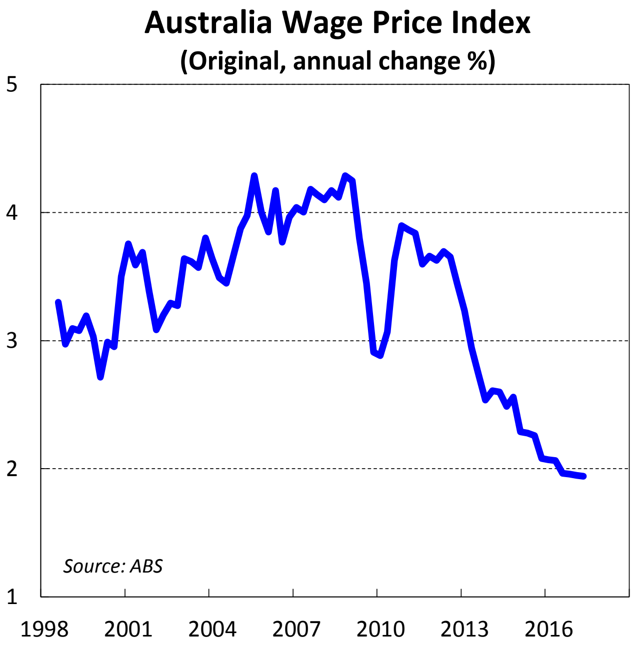
- The next update on inflation is 25 October.

Australian Cash Rate Projections



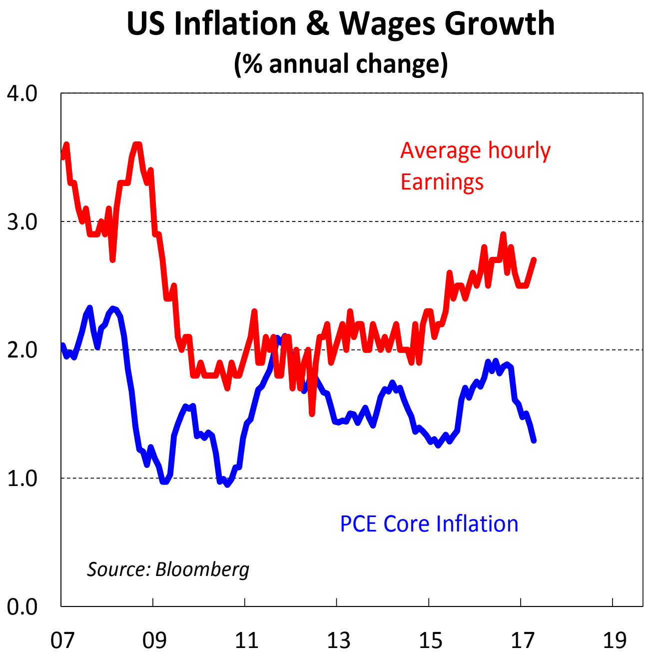
- We expect the RBA to keep the cash rate steady in 2017 and 2018 due to:
    - The appreciation of the Australian dollar this year, which is weighing on output and inflation. The AUD is up over 2.5% in trade-weighted terms since end 2017.
    - High household debt and weak wages growth constraining 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



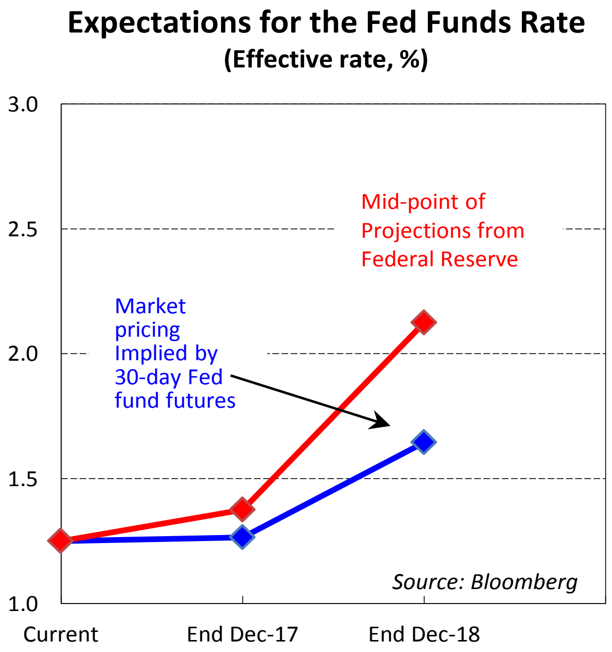
- Wages growth remains subdued in Australia.
- The RBA suggests the Phillips curve might be flatter. That is, there is a weaker inverse relationship between the unemployment rate and wages.
- One of the reasons might lie with digital innovation and globalisation. The labour force is now more global and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

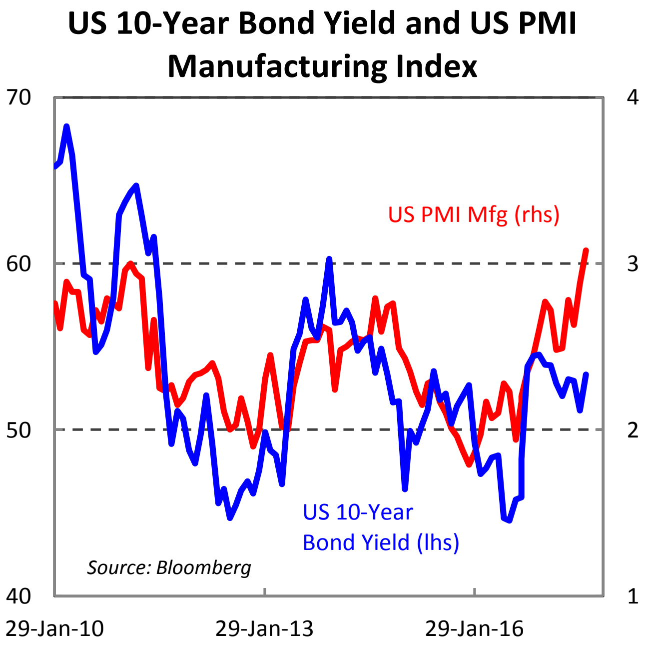


- The median projections of Fed officials (i.e. the dot plot) is for the Federal Open Market Committee (FOMC) indicate the Fed expects to hike a further 4 times between now and the end of 2018.
- The last FOMC meeting minutes (published overnight) indicated that the FOMC still expect to raise rates again 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

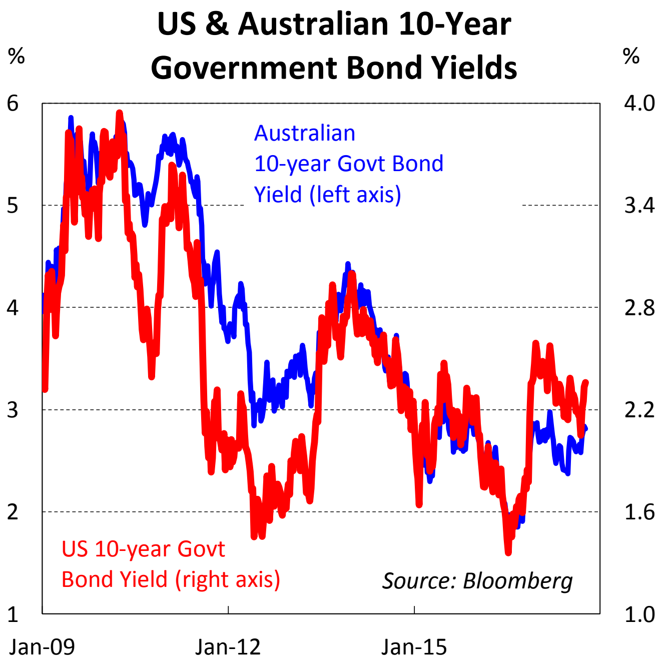
- Financial markets do not expect the US FOMC to hike 4 times by end 2018. We expect it will be 3 times. Financial markets are fully priced for only 1 more. Who is right will play out in bond and swap markets.
- Market pricing is less than the Fed due to expectations for US inflation. Markets are unconvinced 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



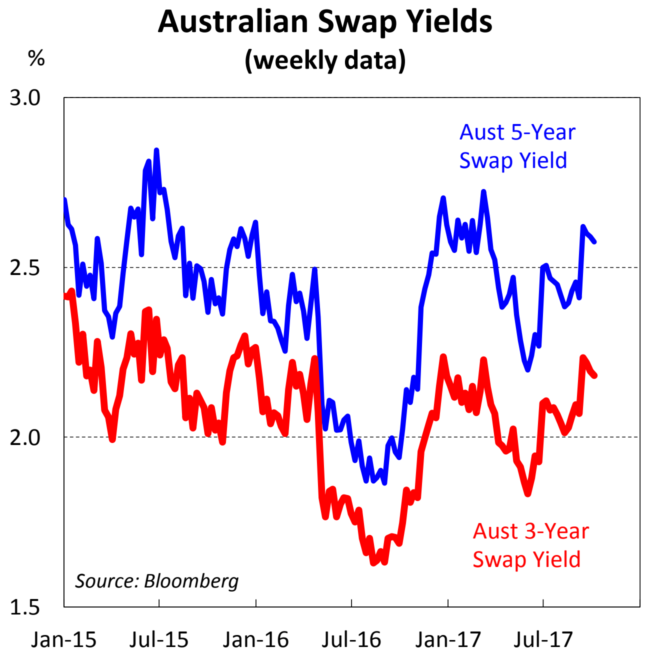
- The risks to US bond and swap yields are to the upside.
- We continue to expect higher US yields, but yields should grind rather than gallop higher.
- These upside risks come from:
  - Possible risks to inflation if US Fed Chair Yellen is correct and low inflation is only temporary.
  - US fiscal policy, 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



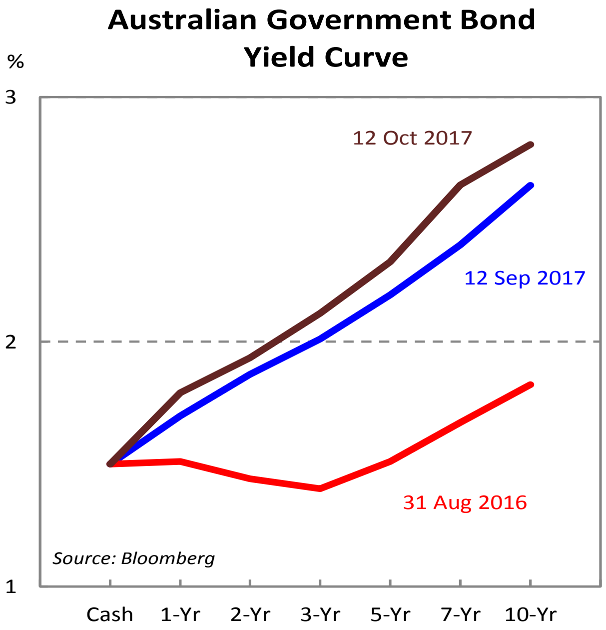
- US bond yields remain the key driver of Australian bond yields, especially for maturities of 2 years and longer.
- The greater the maturity of the bond, the stronger the relationship.
- We expect this correlation to continue.

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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