FINANCIAL MARKET UPDATE

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Summary:

- **The RBA is highly likely to cut rates again in November;**
- **The new policy announced will be QE (RBA buying Government bonds to reduce rates);**
- **Over the next few months there is a risk that the $A might fall under 70c;**
- **But over the next 6-12 months I still look for the AUD to head towards 75c.**

The good news is that there has been good news. The news flow on potential vaccines has been good. It looks likely that Australian GDP growth will be strong in both the September and December quarters as a result of the re-opening of state economies. After a slow few months the Chinese consumer has got regain enough confidence to get out there and start spending again.

But momentum in the economy (outside of Victoria) appears to be slowing. This apparent loss of momentum is troubling given the amount of spare capacity in the economy. One result is that the RBA will provide further assistance. This is likely to be a (small) reduction of interest rates. And also include a QE program (buying Federal and State Government 5-10 year bonds).

The AUD has been one of the weaker currencies over the past month. A key reason has been the change in tone by the RBA over the past few weeks. But also the $US has held up. There is thinking that bigger budget deficits could see a weaker $US. But there has been relatively little movement in the current account deficit. This means the aggregate amount of overseas financing needed for the US economy has not significantly changed.

In the short term there are reasons to think that the Euro may weaken. And given the size of the Euro currency market, if the Euro weakens it often means the $US strengthens. And if that happens there is the clear risk that the $A could head lower, and potentially break 70c. But the bigger picture is that the $US looks overvalued. Over the next 6-12 months I still look for the $A to head higher towards 75c.

Interest Rates

The good news is that there has been good news. The number of new cases is now low enough in Victoria to convince the Government to ease restrictions. The news flow on potential vaccines has been good, with growing confidence that there will be at least one positive announcement before year-end. It looks likely that Australian GDP growth will be strong in both the September and December quarters as a result of the re-opening of state economies. After a slow few months the Chinese consumer has got regain enough confidence to get out there and start spending again. And the US economy is holding up Ok despite a renewed rise in virus numbers.

But it has not been all good news. While Australia is getting on top of COVID, the situation is worsening in Europe resulting in renewed lockdowns. Even before any announced Government action European service sector activity had been weakening as consumers turned cautious about going out to restaurants and bars. Domestically, momentum appears to be slowing outside of

Victoria, evidenced by the softening in the growth of retail spending and payrolls over the past couple of months.

This apparent loss of momentum is troubling. The underutilisation rate is currently higher than it was at any time during the 1990s recession. Capacity utilisation is well below average. 'Underlying' inflation is running at around 1.25-1.5%, comfortably below the bottom end of the RBA's 2-3% target. And it will not be easy to get inflation back there. Wages growth is less than 2%, well below the 3%-plus mark more typical of a 'normal' economy. The high level of unemployment means stronger wages growth is unlikely any time soon. And household, business and financial market inflation expectations are all well below average (although they have ticked up a little over the past month).

All of this means the economy needs more help. The recent Federal Government Budget will succeed in putting plenty of cash in household and business bank accounts. But the big unknown is how much of that money will be spent. Sentiment surveys suggest that households are getting more comfortable about the state of their family budget. But the same surveys also suggest consumers are in no rush to go on a spending splurge.

The RBA will provide the economy with more help. It is highly likely that at their November meeting the RBA will cut the cash rate to 0.1% (from its current rate of 0.25%). The 3-year target for Australian Government bonds will also be reduced to 0.1%. As will the rate they charge on lending funds to banks.

The movement to 0.1% will take the Australian cash rate down to around the average of global peer central banks. The Australian overnight lending rate will still be above those in Continental Europe and Japan (where they are negative). But it will be below the US (and Canada), and about the same as the UK (there is a good chance that New Zealand will look to take their cash rate negative next year).

But the existing level of interest rates means the any rate change will at best have a minimal impact. This is the reason why the RBA has said that it is movements in the size of their balance sheet that will be a better way to judge how much help the economy is getting from monetary policy (the bigger the balance sheet the more money that is poured into the economy).

The growth in the RBA balance sheet so far this year has reflected either buying bonds to reduce financial market volatility or to support the policy of keeping Government bond yields at 0.25%, or lending to banks. But the RBA's balance sheet is currently not as large (relative to the size of the economy) as that of peer central banks. One of the main reasons is that prior to COVID the size of the RBA balance sheet was relatively steady. By contrast, other central banks have been buying a large amount of financial assets (mainly government and corporate bonds, but also equities) for some years reflecting the historically weaker state of their economy, lower inflation outcomes or the already low level of their interest rates.

Quantitative Easing

The RBA is also likely to announce a new program in November (Quantitative Easing, or QE). This is when the RBA buys financial assets with an aim to reduce interest rates. The assets to be purchased are likely to be 5-10 year Federal and State Government bonds.

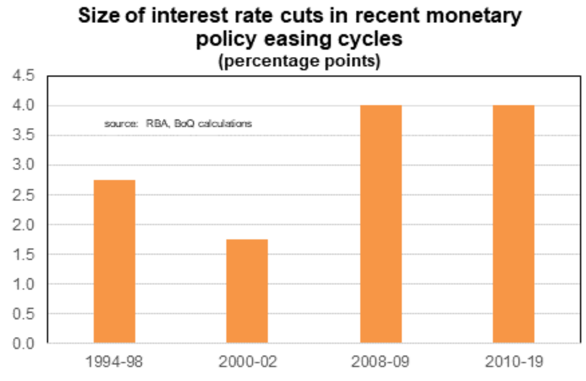
The RBA currently explicitly sets an interest rate target for shorter-dated Federal Government debt. Some analysts are suggesting that the RBA could do something similar for longer-dated Government rates (such as for 10-year yields). But short-term interest rates are heavily influenced by the outlook for the cash rate. This is something that is easier for the RBA to influence. Not only can they buy (or sell) bonds to help set the target but they can provide 'forward guidance' (telling investors where the RBA thinks the cash rate will be heading into the future). By contrast, longer-term interest rates are more heavily influenced by global factors. The Bank of Japan has set a target for 10-year rates. But one of the reasons they can influence that rate is they already own a significant chunk of the Japanese Government bond market.

There is a debate in the financial markets about the size of the RBA's QE program. According to a recent Reuters survey analysts think the program size will be somewhere between $75-200b (with the consensus around $100b). It is useful for investors' to know how much the RBA is buying as it will influence views about the demand and supply outlook for the government bond market (and therefore how much it will influence the level of interest rates). Similarly it is useful for investors to understand the time period of the QE program (and so how much the RBA intends to purchase each month) as this will influence views on how quickly the demand and supply of government bonds may change (and therefore interest rates). The consensus from the Reuters survey is for the QE program to finish by the end of next year.

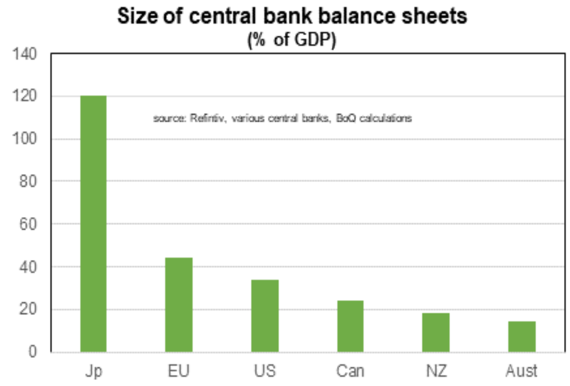
The RBA could also likely include some flexibility in its QE program. For example they may state that the size and speed of the QE program could be altered depending on the progress in reducing the unemployment rate and increasing inflation.

The assets that the RBA will likely purchase is Federal and State Government 5-10 year bonds. By doing so they will reduce longer-term financing costs in the economy (most immediately for the Federal and State Governments). The proportion of the state government bond market currently owned by the RBA is approaching the peak last reached about twenty years ago. Banks though are the biggest buyers of state government bonds reflecting a change in (liquidity) regulations post the GFC.

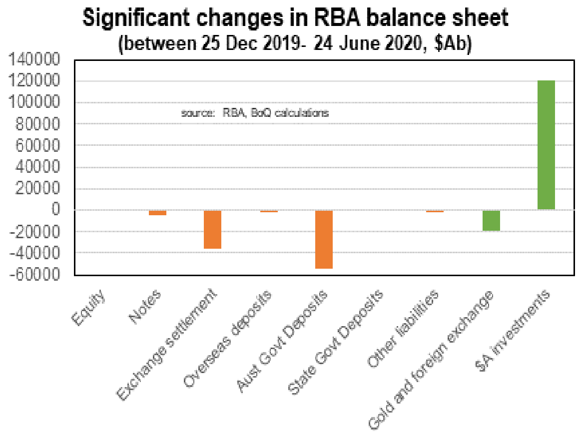
Interest rates can't do the same work now as they have done in previous cycles.



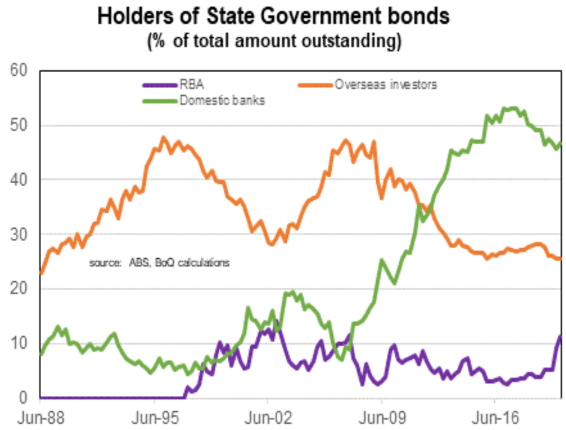
To gauge the amount of support coming from monetary policy look at the RBA balance sheet.



The big change in H1 was RBA buying bonds that created more Government and bank deposits.



A change in regulations has seen banks become the biggest buyers of state government debt.



Exchange Rate

The AUD has been one of the weaker currencies over the past month. A number of emerging market currencies (such as the Russian Rouble and Turkish Lira) have also been weak. This could be put down to concerns about the economic outlook as a result of the rise of COVID cases in Europe and the US. But neither the New Zealand or Canadian dollars (currencies that are often influenced by the same factors as the $A) has fallen by as much. And other emerging market currencies (such as the Thai Baht and Indonesian Rupiah) had a stronger month.

A more compelling reason for the underperformance of the $A has been the change in tone by the RBA over the past few weeks. In a number of speeches the RBA has made it clear that that are likely to both reduce interest rates and expand the size of its balance sheet (putting more money into the economy) at their November meeting. With no other obvious changes in policy by other central banks (with the exception of the European Central Bank, or ECB), this led to a fall in the $A.

At the same time (and contrary to many expectations) the $US has held up. Partly that is because the US economy is still doing quite well despite rising COVID cases. In recent weeks financial markets have been focusing on the likelihood of a further large US fiscal boost. With inflation very low more fiscal stimulus is widely considered necessary for the economy.

Historically large budget deficits have at times coincided with a weaker $US. This may have reflected the need for a weaker currency to attract overseas investors to buy the extra debt. Over recent weeks many investors' have started to position themselves for a lower $US (and a move higher in the Euro).

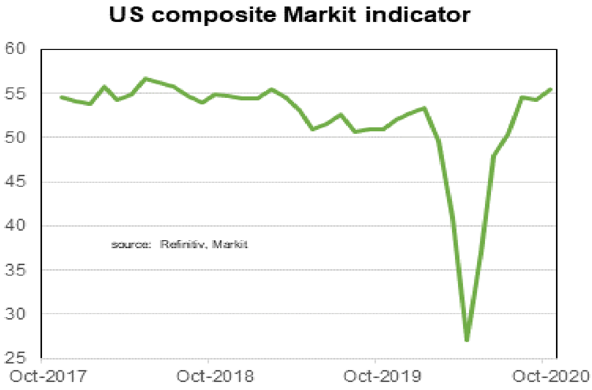
On this occasion the massive increase in the US budget deficit has not coincided with any big change in the current account deficit. This means the aggregate amount of overseas financing needed for the US economy has not significantly changed. So while the US Government is now borrowing lot more, other sectors of the economy (such as households) are borrowing less.

I think the near term risk is that the $US could head higher. US interest rates are currently higher than for most other developed countries (Australia is an exception). The rise in new cases is leading to a weaker European economy. With inflation too low it is likely that the ECB will need to provide further monetary policy help to its economy in coming months (this was the indication from the October ECB meeting). This suggests that the Euro is likely to weaken. And given the size of the Euro currency market, if the Euro weakens it often means the $US strengthens. And if that happens there is the clear risk that the $A could head lower, and potentially break 70c. If that key level does break it means the $A could head down towards 6750-6850.

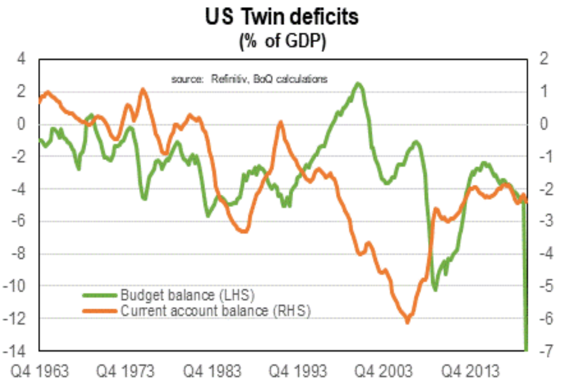
But the bigger picture is that the $US looks overvalued. After a very good run the US equity market is increasingly expensive relative to other sharemarkets. The relatively greater impact of COVID cases on the European economy is a temporary factor. And while the US economy is performing well, the Chinese economy is performing better.

My 'simple' model says that the $A should be currently trading at around 74c. Commodity prices are still high (notably iron ore), while Australia is running a current account surplus. There is a near term risk that global factors (such as a weaker Euro) could lead to the $A heading back under 70c. But over the next 6-12 months I still look for the $A to head higher towards 75c. But it will likely be a case of two-steps-forward-one-step-back.

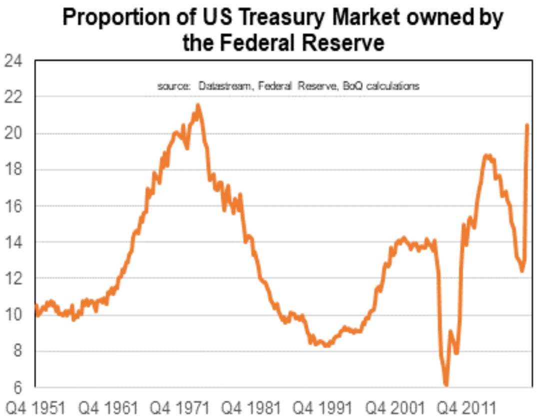
Despite the rise in COVID cases the US economy is still doing Ok.



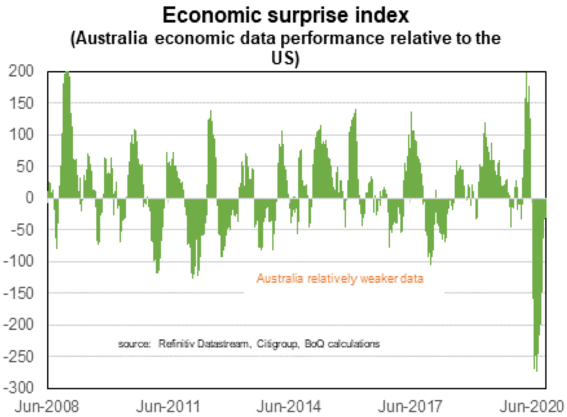
The budget deficit can influence the $US. But how the deficit is funded is what matters.



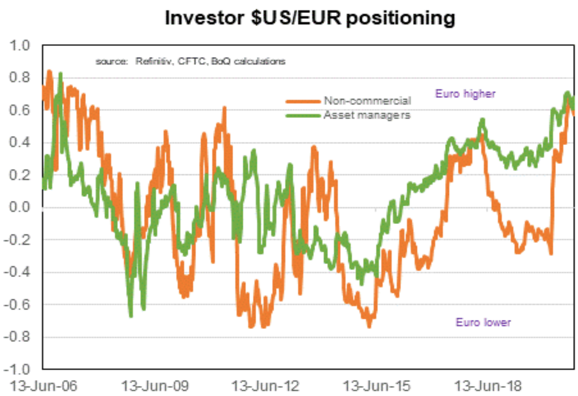
The Federal Reserve is increasing its ownership of the US Government bond market.



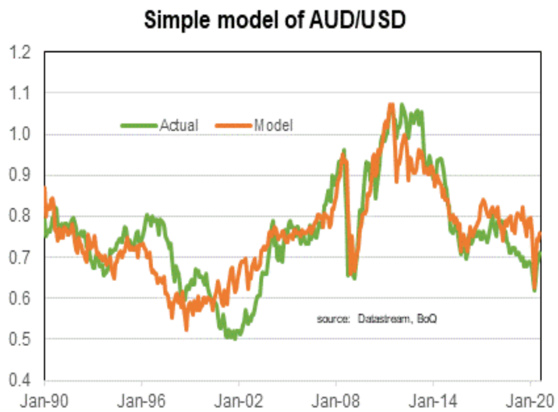
Over the past couple of months there has been a slowing in the US economy outperformance.

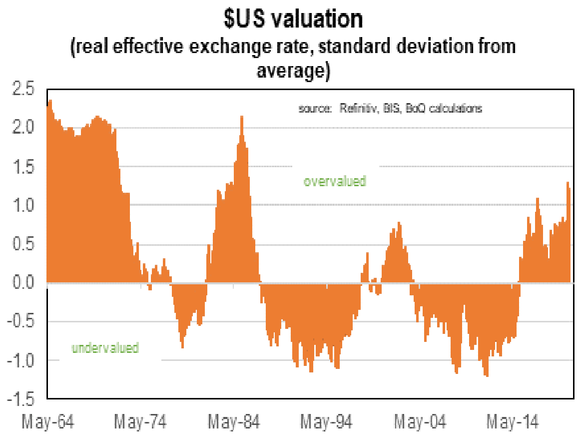
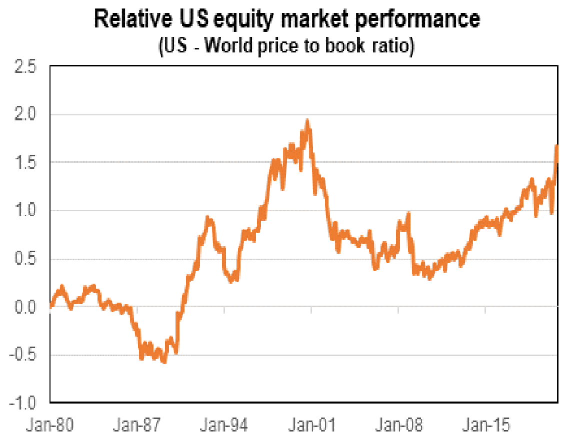


Both short-term and long-term money managers are invested for a lower USD.



My 'simple' AUD model says 'fair value' is currently around 74c.



On some measures the USD has not been this 'over-valued' for 35 years.	The last time US equity market valuations were this rich was in the 1990s tech boom.
	

We live in interesting times.

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