BOQ GROUP

1 August 2023

INTEREST RATE UPDATE

First, reach the peak

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Key Points

- **The RBA kept the cash rate at 4.1% following its August meeting;**
- **The lower-than-expected June quarter CPI data would have been a key factor behind that decision;**
- **The pace of the decline of inflation will be the key question behind any further rate hikes, particularly the behaviour of service-sector prices;**
- **I think the risks are that inflation may again surprise on the high side some time over the next 3-6 months and that will be the catalyst for another rate rise.**

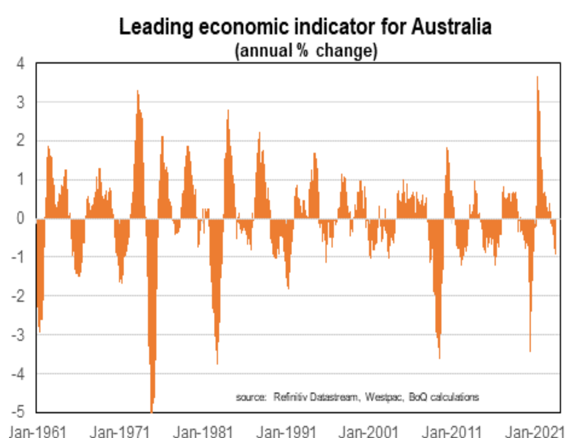
RBA interest rate decision

The RBA decided to keep the cash rate unchanged at its August meeting at 4.1%. The economy is slowing pretty much in line with RBA expectations from May, and so is inflation (despite the lower-than-expected CPI outcome in June). Given that we have yet to see the full impact of the past rate hikes an unchanged rate decision this meeting was sensible.

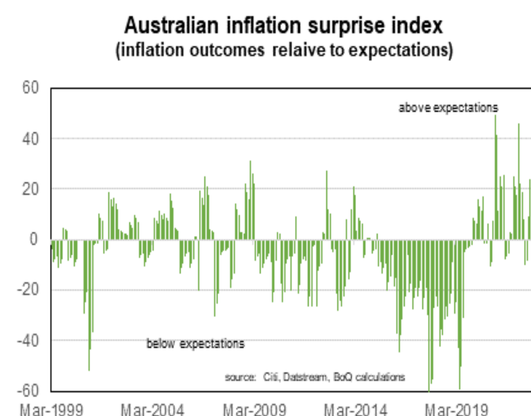
The RBA is projecting that the inflation rate will return to within the 2-3% target band by the end 2025, with an unemployment rate of around 4.5% by the end of next year. If those forecasts remain unchanged, and the certainty around those forecasts don't change, the RBA may not increase rates again. On the RBA's forecasts, rate cuts would have to wait until 2025 (later than current financial market pricing).

The key question though is how certain can the RBA be that inflation returns back to 2-3% within the foreseeable future. The RBA noted the risks around service-sector inflation, and that the current annual rate of the CPI at around 6% is too high. This means if there is to be a rate change any time over the next 6 months it will be a rate hike.

The economy is slowing.



Inflation has started to come in lower than expected.



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Short-term outlook for interest rates

The economy is slowing. Growth of firms' order books is moderating. Firms are no longer looking to build up their inventories and will almost certainly be winding back their capex spending in coming months. Consumers are aggressively pulling back on discretionary spending and running down their saving to meet their needs.

Inflation is declining. Annualising the past two quarters, both the headline and the RBA's preferred measure of underlying inflation was running at around 4.5% in the June quarter. All the indications are that further declines are to come, with producer price growth slowing and import price growth around flat in the year to June 2023. We have yet to see the full impact of the most aggressive rate hike cycle in thirty years on the economy, not the least as a substantial number of fixed rate mortgages roll off over the next 9 months.

So, a good argument could be mounted (and one that I do make) that interest rates have already gone high enough. This is particularly the case given that the RBA has estimated that over one-half of the rise of inflation could be attributed to supply-chain problems, something that can't be influenced by interest rate movements. And those supply-chain problems are now diminishing.

But the risks are that the cash rate may need to head higher. Despite the slowing economy the unemployment rate is still near thirty-year lows. Demand for workers is declining and stronger immigration growth is boosting the supply of workers. Worker shortages remain the biggest issue for many firms' and that is likely to remain the case for at least the next 6-12 months. The rise in house prices over recent months will help support household spending, although I don't expect the recent strength of house prices to be sustained.

While further declines in inflation is virtually certain, the big question over the next year is whether inflation will come down enough. There will be a decent jump in rents and electricity prices. Wages growth is likely to be a little higher, partly reflecting the recent National Wage Case decision (where the minimum wage rose by 5.75%). Globally, service-sector inflation has proven sticky driven by higher costs and strong demand. Oil prices have headed higher over the past month. The Russia decision to stop Ukrainian wheat exports and the probability of an El Nino event this year suggest that the reduction in food prices could be limited. So, while the most probable outcome is that inflation will come down to the RBA's target, that outcome is not certain.

This is particularly the case given that the cash rate in Australia is well below that of peer countries. There is a good reason for that given the high level of household debt relative to incomes in Australia. But household debt relative to incomes is also relatively high in Canada and New Zealand. Of course, it is possible that all the other central banks have increased interest rates by too much.

The bottom line is that while I think interest rates have gone up enough, borrowers should prepare themselves for the possibility of a higher cash rate. I think the peak in the cash rate in this cycle will be 4.35%, with the RBA moving the next time inflation surprises on the high side of expectations.

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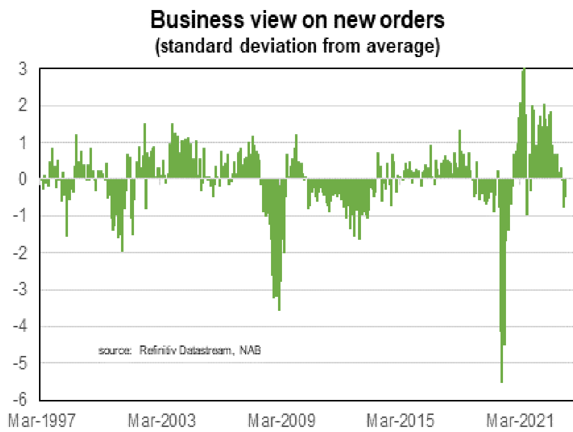
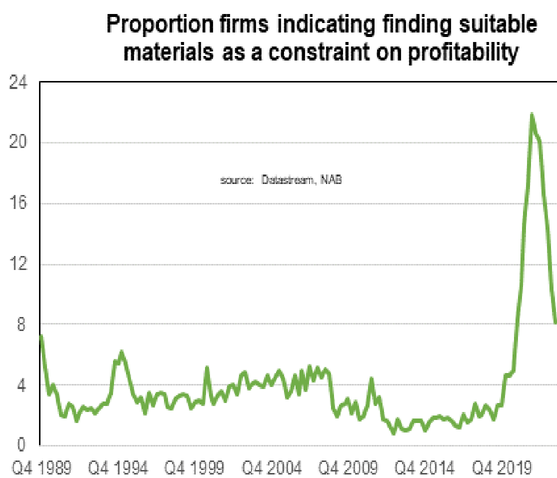
New orders are now growing at below-par pace.

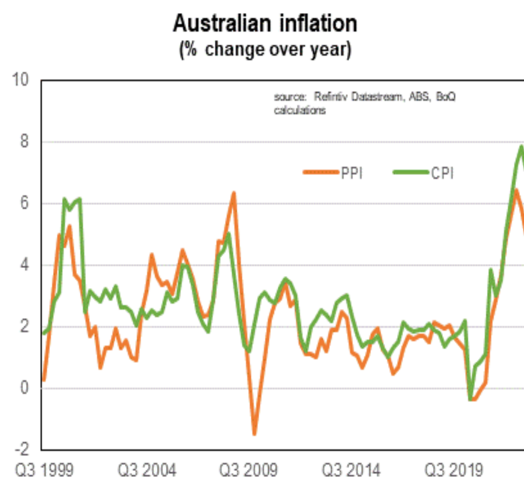


And inflation is clearly declining.

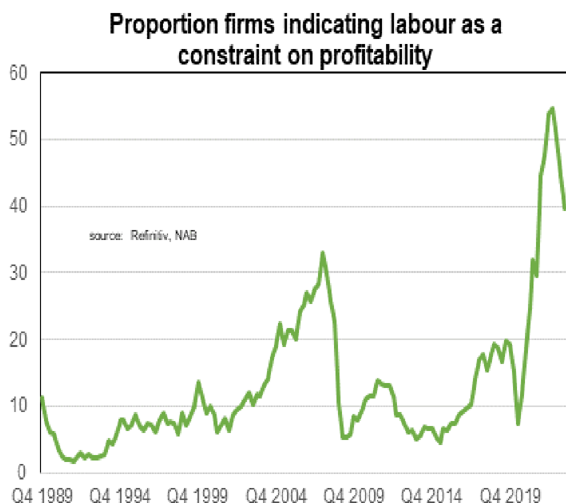
Supply-chain problems have been substantially reduced, although they have not yet disappeared.



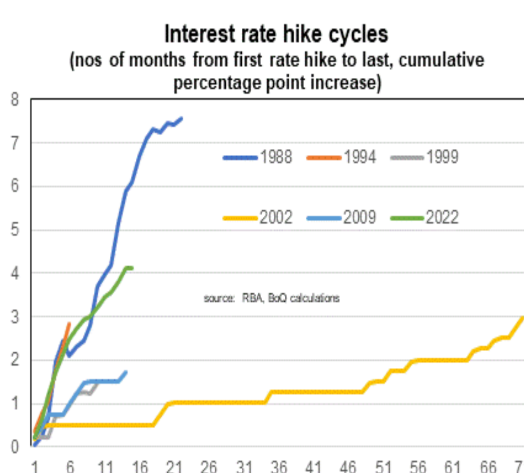
The slower growth in producer inflation augers well for further declines in the CPI.



Worker shortages is becoming less of an issue, but it remains firms' biggest problem.



This has been the most aggressive rate hike cycle in thirty years.



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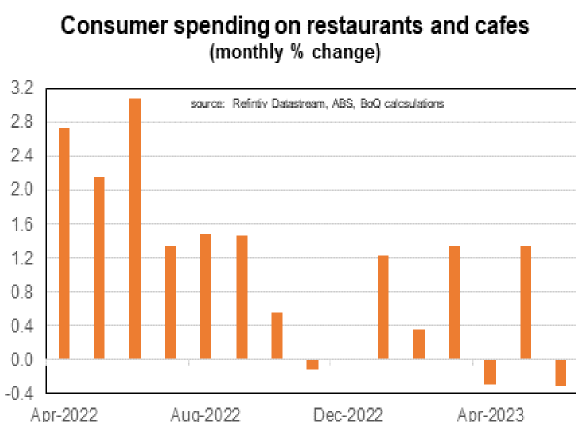
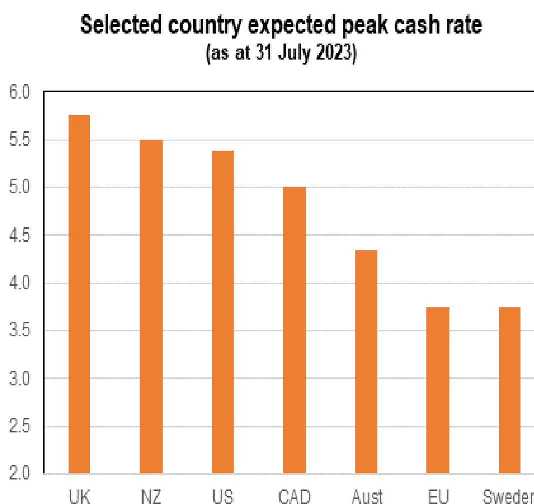
Consumer discretionary spending is slowing.



Labour cost growth remains high.

Goods inflation is declining. But that is not the case with service prices.

The cash rate in Australia is low by peer country standards.



How serious will be the economic downturn

At the start of the year a popular view was that if interest rates rose too high it could cause a serious economic downturn, not the least reflecting the fixed-rate mortgage 'cliff'. At that time, I thought that the economy could handle a cash rate of 3-3.5% but might struggle if the cash rate went too much higher (which it obviously has).

Using the benchmark of two consecutive quarters of negative GDP growth as a recession that view could still prove to be correct. Quarterly economic growth in the March quarter was only 0.2%. While I think some of that weakness can be put down to supply constraints, there is no doubt demand in the economy was slowing. And as we have yet to see the full impact of the rate rises to date further slowing in economic growth is likely. While I am not forecasting one quarter of negative economic growth over the next year let alone two consecutive declines, clearly not a lot needs to go wrong for that to occur.

I don't think two consecutive quarters of negative GDP growth is a very good gauge of a recession. How can a pattern of GDP growth of (-0.1%, -0.1%) be a worse outcome than a pattern of (-2%, +0.1%, -1%). A better way

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to think of a recession is changes to the unemployment rate. My rule of thumb is that if the unemployment rate rises by less than two percentage points it is an economic slowdown. Anything above 2-3 percentage points is a recession (others may have a different categorisation, particularly those that have become unemployed!).

At the time of writing, the median financial market economist forecast (from the July Bloomberg survey) for the unemployment rate by the end of 2024 was 4.75% (the RBA is expecting the unemployment rate to be 4.5%). The highest financial market economist forecast is for a peak of 5.5% by the end of next year. So even the most pessimistic forecaster is not expecting the unemployment rate to rise by more than two percentage points.

Those forecasts of course could always be wrong (an unfortunate occupational hazard for economists). But the still high level of demand for workers means there is at least some chance that the rise in the unemployment rate may be modest in this cycle.

So, assuming the unemployment rate forecasts are correct, why is it that the economy may perform better in this economic cycle than many had feared given the rise of interest rates. The first is that the economy started from a point of extreme jobs market strength. The unemployment rate was at fifty-year lows and over 50% of firms indicated that they struggled to find workers. Another supporting factor is that households were able to build up a saving mountain through COVID, something that has helped support consumer spending in recent months.

Another positive is that when the negative shock of higher unemployment hits consumer spending next year, it will be at the same time as the cost of living might become less of a problem (wages growth may be above inflation by then). Household disposable income are also likely to get a boost in the second half of next year from income tax cuts (although I suspect a fair percentage of the tax cuts might be saved as households look to rebuild their saving or to pay down debt).

An additional positive is that population growth is currently at its fastest pace in over a decade. More people buy more things and that can partly compensate for the slowing of per capita spending (or how much each person spends). By contrast population growth was slowing during the last major recession in the early 1990s.

More people also mean there is greater demand for housing, as well as infrastructure. While the building approvals numbers point to a slowing in residential construction in coming quarters, there is still plenty of work for builders in the pipeline (the problem is how profitable is that work). And the strong population growth should underpin a pickup in dwelling construction once building costs and interest rates decline. There is so much infrastructure work (at a time of high inflation) that state governments are having to postpone projects.

Climate change and changing geo-politics is also requiring substantial additional investment. And all the signs are that the ‘care economy’ (child care, aged care, NDIS, health) will become a bigger part of our economy over the next decade.

Finally, the global economic backdrop has not been as bleak as expected with the IMF recently revising up its forecast for the world economy for this year (although they kept forecasts for next year unchanged). With interest rates still high in many OECD countries and Chinese economy sluggish, there remains a great deal of uncertainty about the global outlook.

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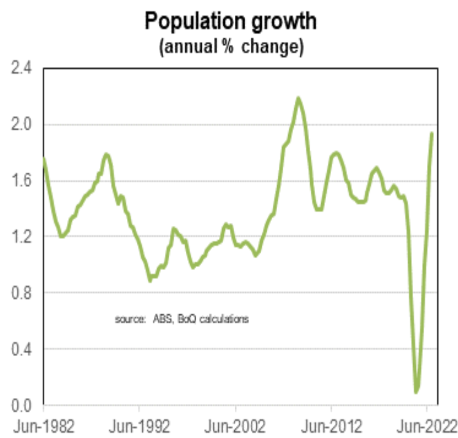
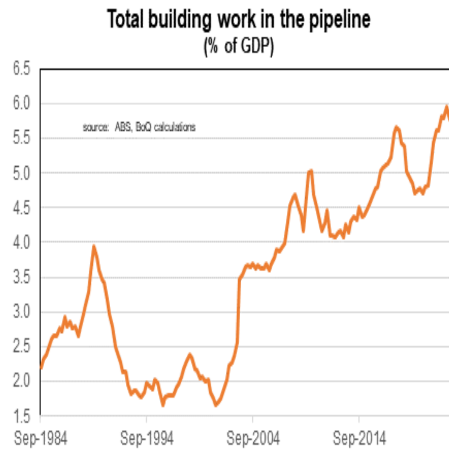
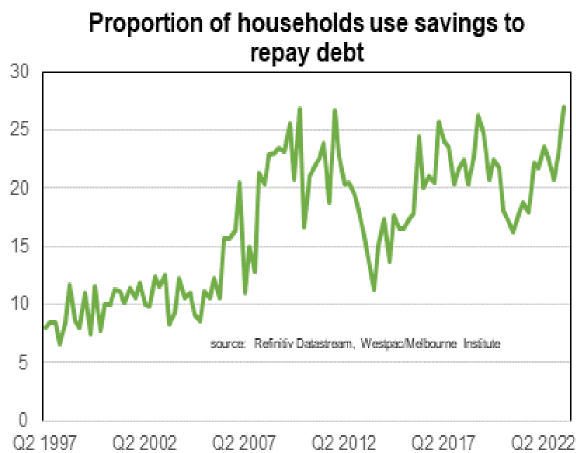
Strong population growth at a time of strong jobs growth is supporting the economy.



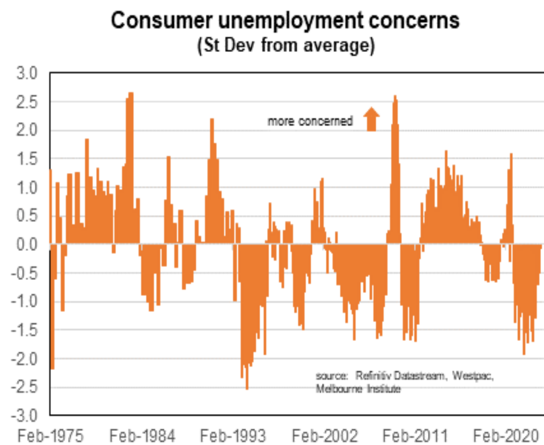
There is plenty of building work still to be done.



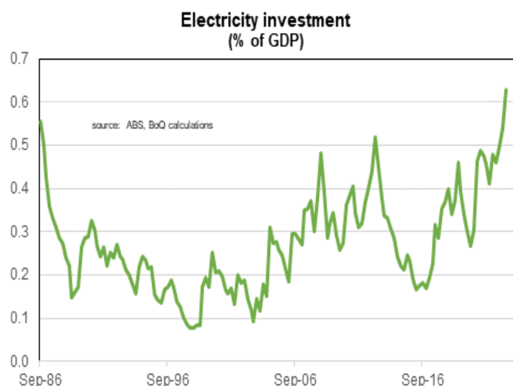
Households are keen to repay debt.



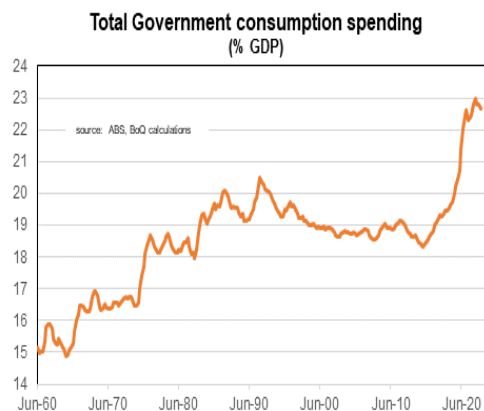
And they are becoming more concerned about unemployment.



Investment into electricity is at a record high (relative to the size of the economy).



As is government consumption spending.



When will there be the first rate cut

One of the questions that I have been asked over the past few months is around the timing of the first rate cut. It is a fair enough question, particularly for those with a mortgage. By any benchmark the cash rate is now above 'neutral' (the long-term expected cash rate) so once inflation returns back to 2-3% that should lead to a reduction in the cash rate.

Three things need to happen before we will get interest rate cuts. First, inflation must be in the '2's'. That does not mean we will have to wait for annual (underlying) inflation rate to hit that mark. But it will require quarterly CPI to average 0.7% for at least two quarters (I think the quarterly CPI measure is still more important as the monthly CPI provides coverage of only two-thirds of the measured goods and services). On my forecasts we won't have two CPI quarterly growth rates of that magnitude until at least the second half of next year.

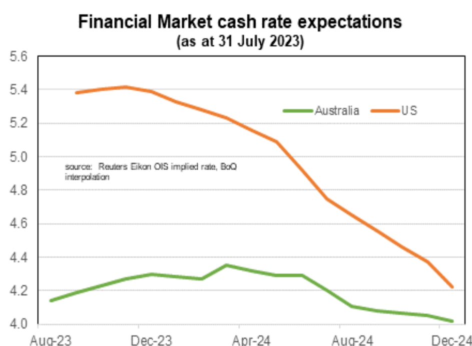
Second, a rate cut is likely to require a notable rise in the unemployment rate which I will define as at least a 0.5% percentage point increase. If inflation declines but the unemployment rate stays around current levels it is not clear to me that the economy is in need of monetary policy assistance. Given the current level of demand for labour again I don't think we'll see much rise in the unemployment rate until at least the middle of next year.

Third, a decline in domestic interest rates is more likely if we see a fall in the global level of interest rates. Interest rates are declining in China reflecting weak economic growth and low inflation. In some emerging markets (such as Chile and Brazil), interest rates are also beginning to fall although inflation has declined a lot in those countries and their central banks hiked rates more aggressively.

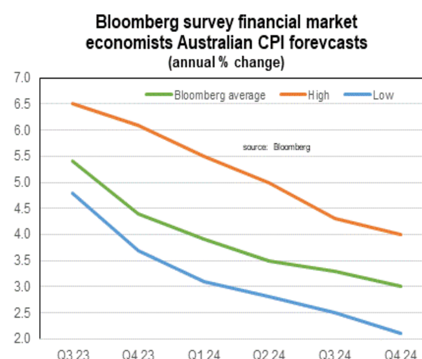
In peer countries the talk is still about rates going up. At the time of writing financial markets are not expecting rate cuts in any of the US, EU, UK, Canada or New Zealand until the second quarter of next year at the earliest. And given that the peak in the Australian cash rate is likely to be below that of peer countries it is likely that rate cuts in Australia will lag that of peer countries.

The experience of the past year is that before we can think about rate cuts, we need to make sure we have seen the last of the rate hikes. At the time of writing financial markets are largely priced for one more rate hike in Australia by end of this year (for a peak in the cash rate of 4.35%). The first rate cut is not priced until well into the second half of 2024. Given the domestic and global economic and inflation outlook, that pricing appears reasonable to me.

Financial markets are expecting US interest rates to decline earlier than in Australia.



Financial market economists' central-case forecast is for inflation to be 3% at end 2024.



So, we may not have seen the last of the rate hikes. And the potential for rate cuts may be at least a year away. That is not good news for the 37% of households that own a mortgage (higher interest rates though are good news for savers). But those higher interest rates and the reduction of supply-chain and worker-shortage worries should see inflation concerns diminish over the next 1-2 years. And providing inflation does decline as forecast that should set the scene for a decent rebound in economic growth.

We really do live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland

BOQ | 255 George Street Sydney NSW 2000

Twitter: @petermunckton

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