BOQ GROUP

5 September 2023

INTEREST RATE UPDATE

Choosing the Cash Rate path

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Key Points

- **The RBA cash rate was kept unchanged at 4.1%;**
- **This was expected given the weaker economic and lower inflation data that has printed in the past month;**
- **The domestic and global economic inflation outlook remains uncertain;**
- **I still think that some inflation data will surprise with strength in coming months and this will lead to one more quarter percentage point rate hike before year-end.**

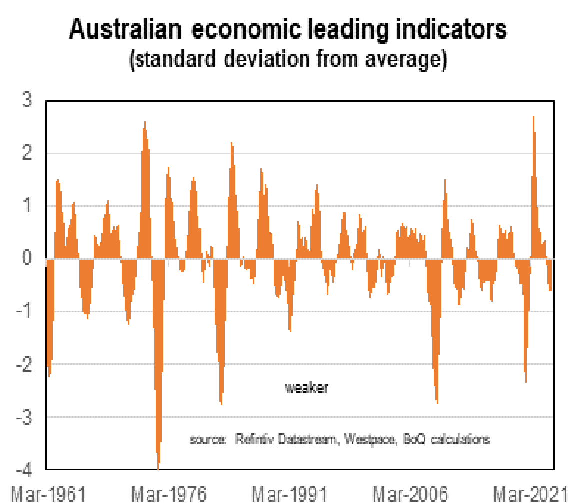
The RBA kept the cash rate unchanged

The RBA kept the cash rate at 4.1% following its September meeting. That was widely expected amongst economists and the financial markets. The economic data has been weaker than expected and inflation lower over the past month.

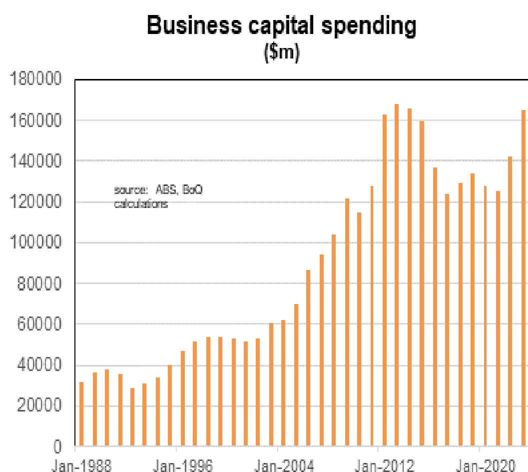
The RBA appears broadly comfortable with economic and inflation developments, still forecasting that inflation returns back towards the 2-3% target by the end of 2025. The current level of inflation means they clearly retain a bias to increase the cash rate although recent developments on the inflation front would mean they are more relaxed than they would have been three months ago. The RBA is aware that interest rates have risen very quickly over the past year, and that the full impact of higher rates has yet to hit the economy.

The RBA nominated four risks to the outlook. One is that service-price inflation has remained too high in a number of countries and that could be the case in Australia. Another is that it's difficult to know what firms will decide with their price and wage decisions given the combination of a slowing economy, a very low unemployment rate and above-target inflation. The outlook for consumer spending remains uncertain given that some households are feeling the squeeze from the high cost of living while others have the income and saving buffers to keep spending. Finally, the outlook for the Chinese economy is uncertain.

The leading indicators suggest that the Australian economy is in for a period of sub-par growth.



Firms expect to be spending more on capex although have revised down the size of budgets.



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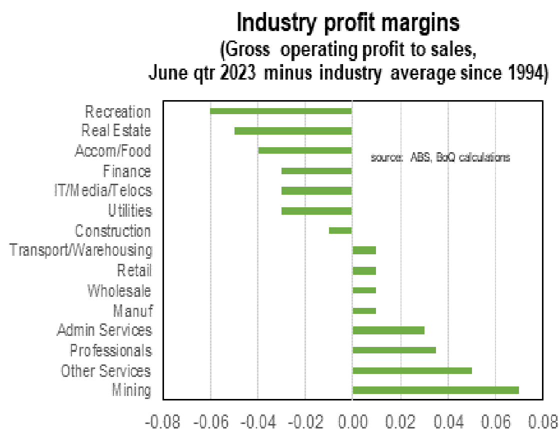
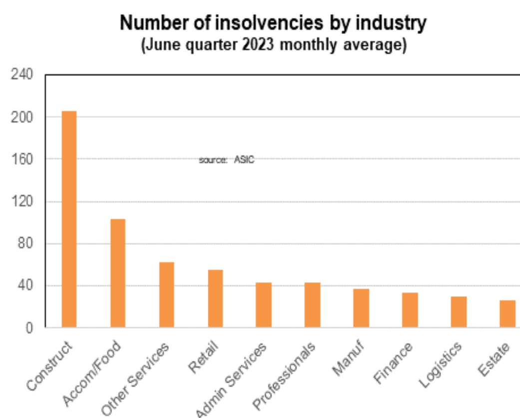
Margin performance has been mixed across the economy.



Construction firms have struggled with the large rise in costs.



Inflation is declining…but will it be enough

The most important factor that will drive the cash rate outlook is inflation. The good news is that inflation is declining and will almost certainly fall further. Partly that reflects the 'base' effects (there is no new Russia-Ukraine war to drive prices higher). The growth rate of both Import Prices and the Producer Prices are consistent with further moderation in the CPI. Supply-chain problems are diminishing, as are worker shortages (albeit more slowly). A further fall in CPI growth rate would be consistent with inflation developments globally. While the monthly headline CPI rose by a little under 5% in the year to July (with the Trimmed Mean measure a bit over 5.5%) the monthly/quarterly inflation percentage changes suggest that the inflation momentum is currently around 3.5-4.5%. But it is not all good news.

Labour costs are likely to rise further, and this could lead to higher prices (notably in the services sector). This is consistent with the evidence from a recent NAB business survey where firms indicated they were raising prices and they faced higher labour costs. Governments have done a decent job of mitigating the direct cost of rising electricity prices on the CPI. But the impact of the indirect cost (higher electricity prices increasing business costs which are passed onto the consumer via higher prices) is still to be felt.

The low value of the $A could lead to a rise of import prices, particularly if oil prices continue to head higher. We have been paying more at the petrol pump in recent weeks. A looming El Nino and reduced Ukrainian shipments of wheat could result in a renewed increase in food prices. Consumer inflation expectations have stopped declining and remain above the levels historically consistent with 2-3% inflation.

Providing inflation declines in line with (or below) the RBA's forecast, we have most likely seen the last rate hike in this cycle. But it is not yet clear that the CPI will return to 2-3% over the next couple of years. This uncertainty is the reason why I think that inflation readings that come in above the RBA's forecast would most likely lead to a rise in the cash rate.

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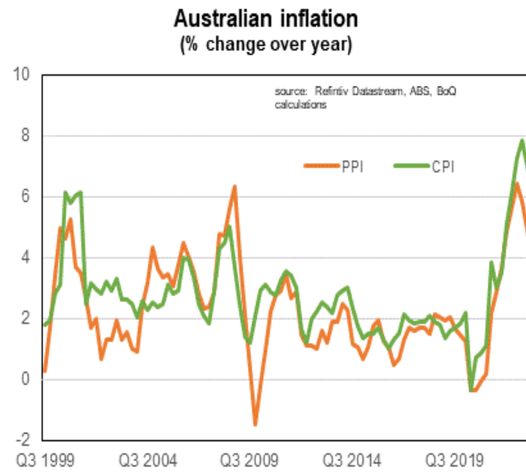
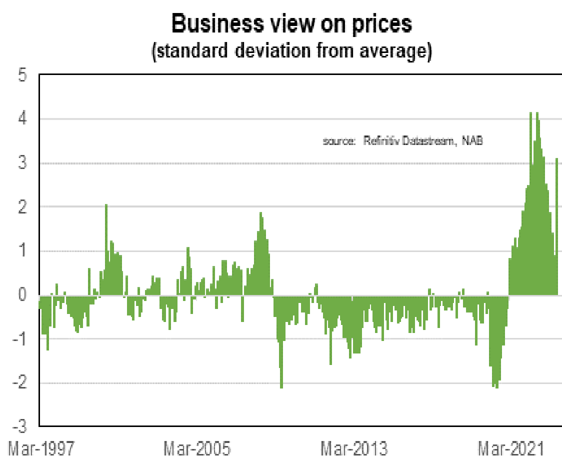
Inflation has declined significantly although remains above target.

Inflation for most goods has further to slow.

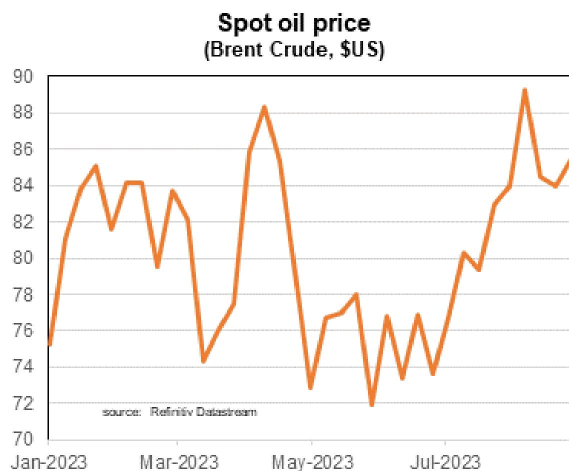


Firms indicated a big rise of inflation pressure in July.



Higher labour costs likely played a role.

Oil prices have risen over the past few weeks.



Food prices have declined over the past year. But that could change in an El Nino year.

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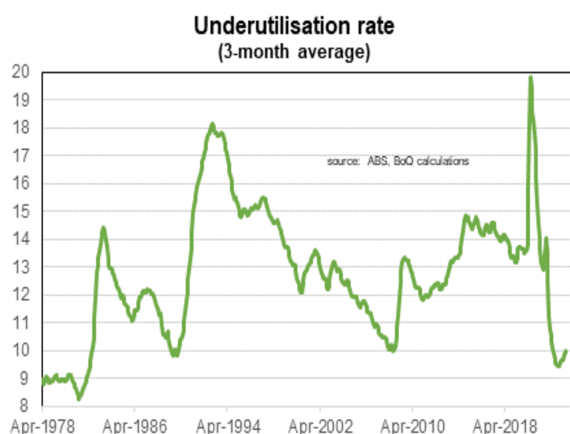
Jobs market – weaker but still too strong for any imminent rate reduction

While inflation remains above 3% the risk will be that the cash rate could head higher. In my view a rate cut though will require not only inflation returning back under 3% but a weaker jobs market. Even putting aside the fall in jobs in July, there has been some weakening in the labour market. Firms have reduced their employment intentions (although they remain above their historical average) and there has been an increase in the underutilisation rate. There are now more applicants per job than there were last year (although that may also reflect the need for some households to find another job to help meet the high cost of living).

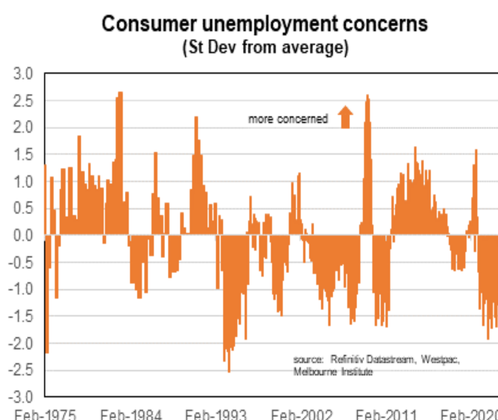
Firms say that finding skilled staff remains their number one problem. Job ads have declined from their peak but remain high by historical standards. Despite the tick-up in July the unemployment rate remains near fifty-year lows.

I think it will be necessary to see the unemployment rate move above 4% before the RBA would look to rate cuts (assuming that inflation is sub-3%). On the RBA's forecasts that won't happen until the first half of next year (the consensus amongst financial market economists is the first quarter of 2024).

The underutilisation rate has risen from its lows.

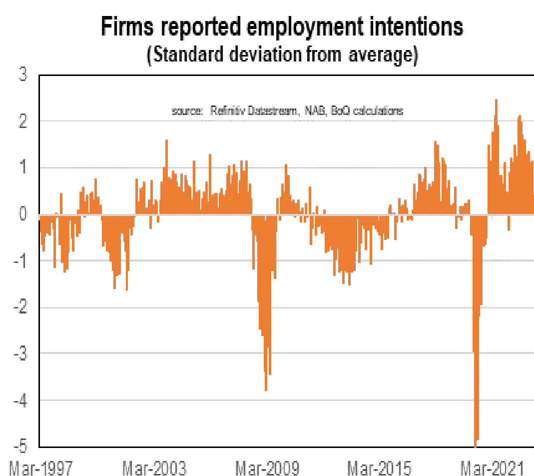


This is consistent with a decline in consumer confidence about the jobs market.



And the increase in the number of applications per vacancy.

Firms' are still reporting above-average employment intentions.



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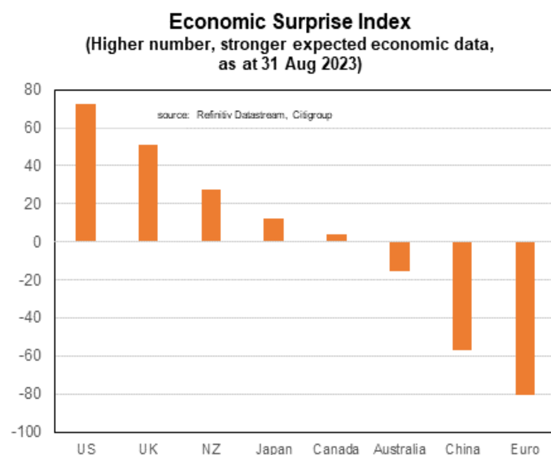
Global interest rates

It is not only domestic events that the RBA needs to take into account when setting monetary policy. If interest rates rise in the rest of the world but remain unchanged in Australia that would likely lead to a weaker $A. That is currently what is happening, with the relatively stronger US economic data a key factor as to why the $A is trading below 65c.

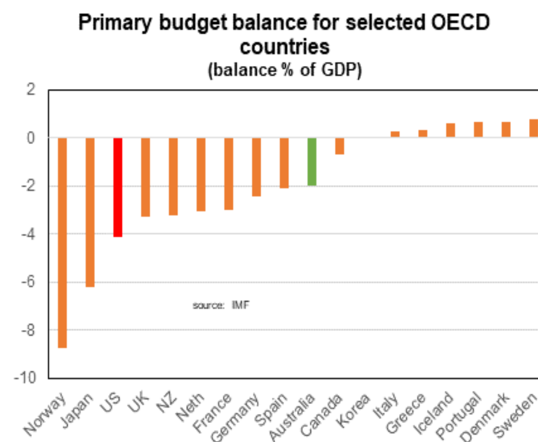
I think that US economic growth will slow in coming months. The existence of 30-year mortgages means that monetary policy can take longer to impact the economy in the US. The recent August employment report underlined that US economic growth is slowing. Inflation in the US is already back at target if we use the same underlying inflation measure as we do in Australia. The leading US economic indicators have declined sharply over the past year albeit not (yet) as much as in previous recessions. Calculations by the New York Federal Reserve (based on the shape of the yield curve) suggest a high chance of a recession in the first half of next year.

Financial markets are pricing lower inflation in the US (although they also think there is a good chance that inflation will still be above target next year), some slowing in economic growth and a lower cash rate from the second quarter of next year. The recent strength of the US economic data (helped by rising real household disposable income growth) means that if there is any change in 2023 it will be a rate hike.

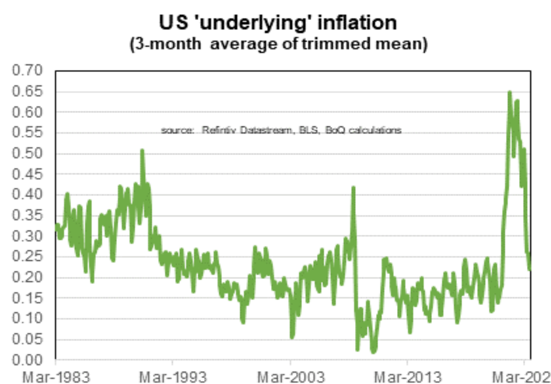
The US economy has been stronger than other major countries and compared with analyst expectations.



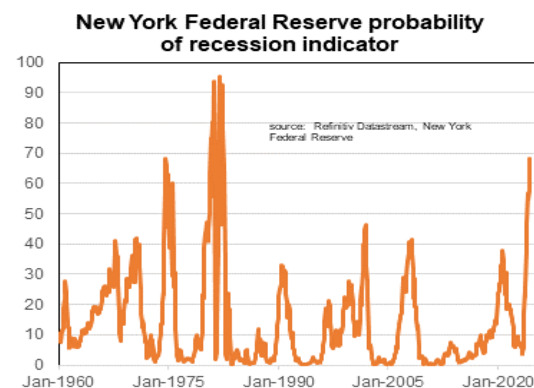
One reason is that the US economy has received greater fiscal support.



US inflation has returned back to its pre-pandemic level.



Forward indicators suggest that the US economy could slow sharply by the middle of next year.



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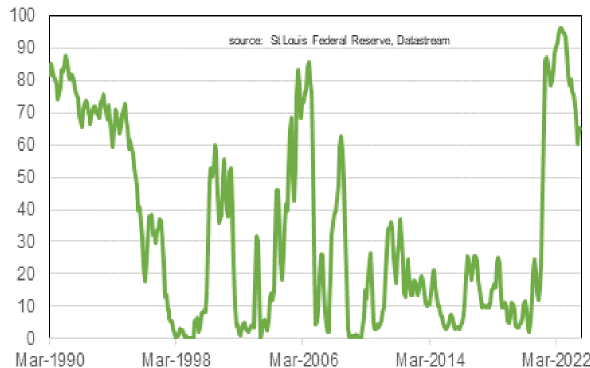
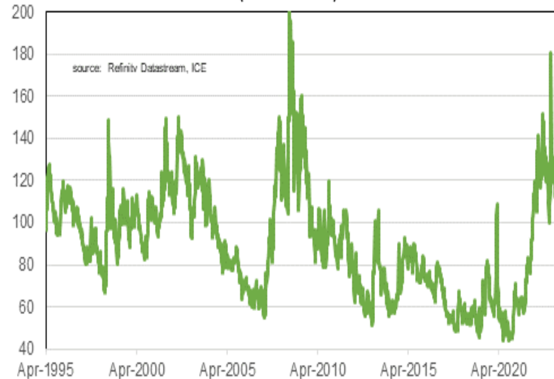
Concerns about above target inflation have reduced but remain high.



This is a key reason why uncertainty about the interest rate outlook in the US remains elevated.



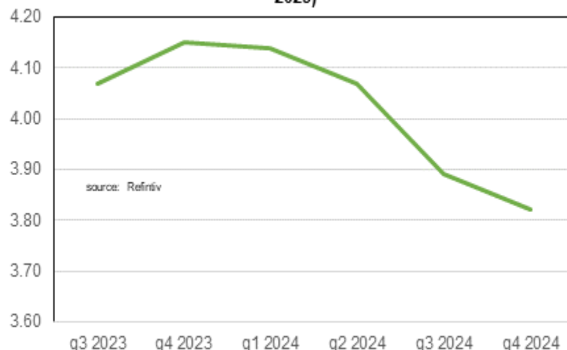
Financial market pricing and models

At the time of writing investors think there is a reasonable chance of one more rate hike in Australia at some stage over the next 6-9 months. Financial markets have a one quarter percentage point rate cut priced by the end of 2024. Financial market economists broadly agree with that path although the median expectation is for an earlier rate reduction (Q2 2024) and the cash rate to be a little lower by the end of next year.

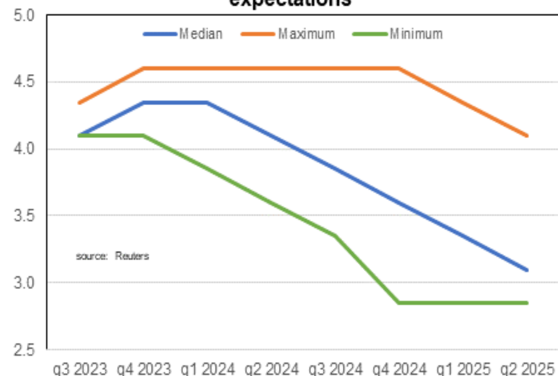
I have developed a monetary policy model based on the key variables that have historically driven cash rate movements. That model suggests that the cash rate is currently around its right level. Using RBA forecasts for variables such as inflation and wages (as well as my own view on other variables used in the model) suggests that the cash rate could rise by 0.25-0.5% over the next 6 months. The model suggests that the cash rate will not be below its current level at end-2024.

That does not mean a rate hike is a certainty. It is possible that the factors that have driven cash rate decisions in the past might change in the future. The forecasts that drive the cash rate outlook could also be wrong (inflation numbers have been lower than expected in recent times).

Financial markets are pricing in a chance of a rate hike this year with one quarter percentage point cut priced by the end of next year.



Financial market economists broadly agree although think the cash rate will be higher this year and lower by the end of 2024.



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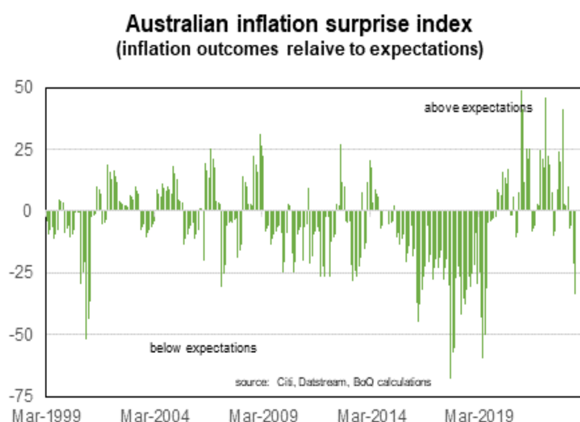
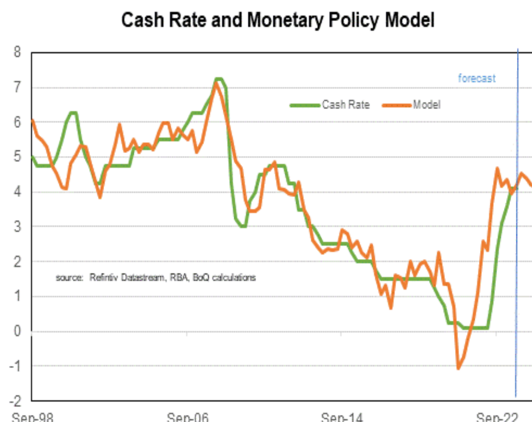
Inflation has been typically coming in below analyst expectations in recent months.



My monetary policy model suggests that the cash rate is currently around its 'right' level.



Alternative scenarios

The most probable cash rate path is that there is a decent chance of another quarter percentage point rate hike this year. Next year slowing economic growth and declining inflation could allow some reduction in the cash rate before year-end. My forecast is for one more quarter percentage point rate hike in Q4 2023, before a rate cut in Q4 2024.

That however is not the only path that the cash rate may follow over the next 18 months. One possibility is that inflation doesn't decrease as much as expected because of a rebound in global economic growth and an increase in commodity prices. High labour costs means that service-sector inflation remains elevated. The bounce-back in house prices in most Australian cities and the resilience of business confidence means domestic economic growth may not slow as much as currently projected. In this scenario inflation may still decline but remain in the '3's'. This would result in modest further rate rises (0.5-1%). Rate cuts would be likely delayed until at least 2025. The higher the cash rate goes the greater the chance of an eventual sharp economic slowing.

An alternative scenario is that the lagged impact of higher rates hits the domestic and global economy a lot harder than currently anticipated. The combination of slowing demand and a rising unemployment rate leads to inflation declining a lot quicker than forecast. There would be no more rate hikes. Cash rate declines in this scenario would likely begin before the end of the first half of next year, with the cash rate level at the end of 2024 likely to be below current financial market and economist forecasts.

Of course, there are many other possible scenarios. But the two scenarios highlighted I think are the most likely alternatives. And that suggest that there is more room for the cash rate to decline over the next 12-18 months than for it to rise (as the range of economist forecasts in an earlier chart highlights). This makes sense given the current level of interest rates and the slowing that is already taking place in economic growth. But the recent history of pandemics, wars and extreme weather events means the economic outlook can change quickly. That is why financial markets are relatively uncertain about the outlook for interest rates (as illustrated by the relatively high level of expected volatility of US interest rates).

We really do live in interesting times.

Regards

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