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5 December 2023

INTEREST RATE UPDATE

Interest Rates: Nearing the peak of Table Mountain

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Key Points

- **The RBA kept the cash rate unchanged at 4.35% following its December meeting;**
- **This decision was widely expected;**
- **The RBA retains a bias towards higher interest rates;**
- **Developments in inflation, the jobs market and global interest rates will play an important role in the outlook for our cash rate.**

RBA announcement

The RBA kept the cash rate at 4.35% followings its December meeting. The decision was widely expected. The data on economic activity has been mixed over the past month while the inflation news has been good (i.e., it is heading lower). Given that backdrop and the knowledge that the full impact of past rate hikes has yet to hit the economy, the decision to keep the cash rate unchanged was straight forward.

The outlook part of the statement released following the decision was unchanged. If there is to be any move in interest rates for at least the next 3-6 months, it will be up. That is in line with current financial market pricing. Financial markets have rate cuts in Australia priced to occur later than in peer economies. That also makes sense given that the cash rate is currently lower in Australia.

Drivers of the interest rate outlook

In my view there will be three main drivers of the interest rate outlook for the next year: the path of inflation, what is happening in the jobs market and movements in the global cash rate.

Inflation is moderating. While the most recent update had the annual inflation rate at a tick under 5%, my read is that the inflation run rate is currently somewhere between 3-4%. Business surveys are consistent with moderating price growth. Alternative measures of inflation (such as the Melbourne Institute monthly index) suggests that inflation is already near the RBA's target band. Consumer inflation expectations though are still a bit high.

The key issue is that RBA forecasts only have inflation returning to the 2-3% target band by the end of 2025, and that we will only just be scraping into the band by that time. It is my belief that it has been the extended period outside the inflation target band that has been the major factor influencing financial market medium-term inflation expectations. That is why the RBA is so focused on ensuring that inflation is still not above 3% by end-2025.

The good news is that inflation has tended to surprise on the low side of expectations both in Australia and globally since April. True, the CPI was higher than anticipated in Australia in Q3, although the increase in the Minimum Wage had an outsized impact. There have been common economic shocks that have driven inflation in most developed economies post COVID. The strong progress on reducing inflation in other countries should give the RBA some comfort that inflation won't exceed its current forecast profile.

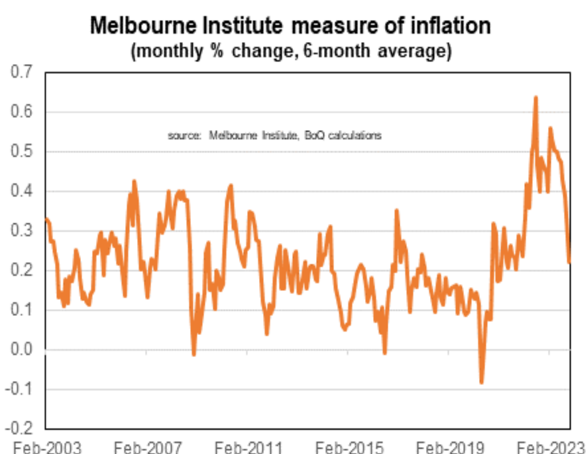
Recent RBA statements expressing concern about the potential risks to the inflation outlook have seen financial markets price a probability of another rate hike in the first half of next year. As noted, with the current inflation rate close to 5% the RBA cannot tolerate any further upward inflation surprises. It is understandable that investors are pricing in a reasonable probability of another rate rise over the next couple of quarters.

By the end of next year financial markets have priced the probability of a rate cut. I think that pricing largely reflects movements in global interest rates (see below). But in the second half of next year household real

disposable income growth will turn positive as inflation declines and income tax cuts are (most likely) delivered. Governments' may also provide further 'cost of living relief'. This means that households are likely to have more spending power in the second half of next year. And this matters for the interest rate outlook. One of the main reasons that the cash rate in Australia is lower than other countries is that we have had weaker real disposable income growth.

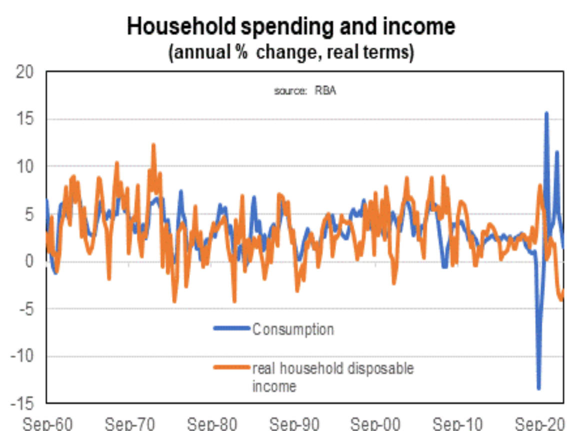
One possibility is that households might increase their rate of saving from this additional disposable income to replace the funds they have had to spend this year to offset the impact of higher inflation. But an alternative scenario is that households decide to spend the extra funding as a catch-up to all the goods and services they have not been able to buy. In the second scenario, economic growth could be stronger than currently projected and therefore the inflation risks higher. It would also mean that interest rates could be higher than what is currently suggested by financial market pricing.

Some inflation indicators already suggest that inflation is consistent with the RBA's target.

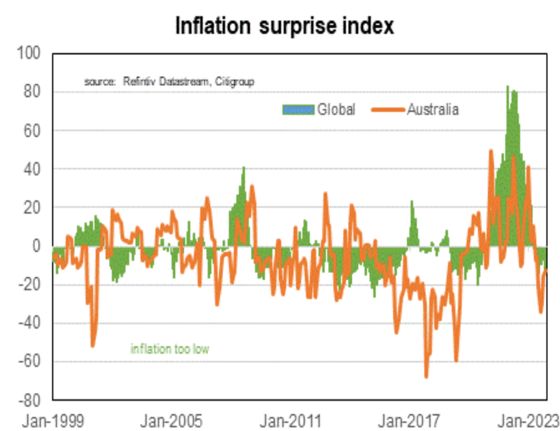


Consumer inflation expectations though remain too high.

Real household disposable income growth will improve next year. But will it boost spending?



Inflation has surprised on the low side of expectations since Q2.



Jobs market

The second key factor that will determine the rates outlook is how the jobs market evolves. Movements in indicators such as job ads, job vacancies and employer hiring intentions all suggest that the demand for workers

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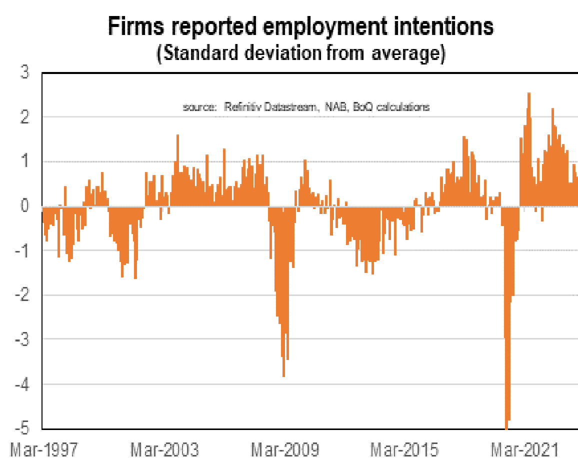
remains strong albeit clearly slowing. The (modest) rise in both the unemployment and underemployment rates so far has been more a reflection of the very strong rise in the supply of workers, due to the big increase of immigration.

Most forecasters (including the RBA) have a modest rise in the unemployment rate next year (RBA forecast is 4.3% at end 2024). If the unemployment rate ends up lower than that I don't think that would have a major influence on the interest rate outlook. The unemployment rate is currently near fifty-year lows at a time of the highest inflation rate in around thirty years. Yet wages growth is only around 4%. Even if the jobs market is a little bit stronger than expected in 2024, it is likely to be weaker than where it is today. It is hard to see how the wages outlook will become a bigger impediment to lower inflation.

Weakness in the jobs market is often a catalyst for lower interest rates. But how much weakness is required before the RBA begins to think about the need for lower interest rates is less clear. Obviously progress on the inflation front plays an important part in that decision. I think that the unemployment rate would need to rise to at least above 4% (and potentially 4.25%) before the RBA would start thinking the economy may need the assistance of higher rates. The RBA does not have the unemployment rate going over 4% until the second half of next year.

Business employment intentions remain strong.



There has been no notable acceleration of wages growth this year.

Global cash rate movements

Some signs of slowing in the US economy and some lower global inflation numbers has led to financial markets recently pricing significant rate cuts in the US and Europe for next year.

It is very unlikely that the RBA would be hiking rates as the rest of the world is cutting. True, the RBA did reduce the cash rate as the Federal Reserve was raising rates in the pre-COVID years. But the US economy was receiving very strong fiscal support at a time that fiscal policy was being tightened in Australia. Further, Australia was feeling the after-effects of the end of the mining boom while the US had fully recovered from the impact of the GFC.

Australia was also hiking rates in the early 2000s when the Federal Reserve was reducing them. But the US economy had not fully recovered from the impact of the 2000 stock market crash while the Australian economy was in the early stages of a large mining boom.

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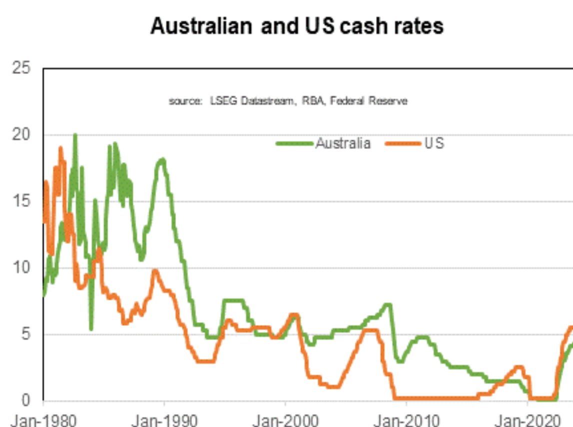
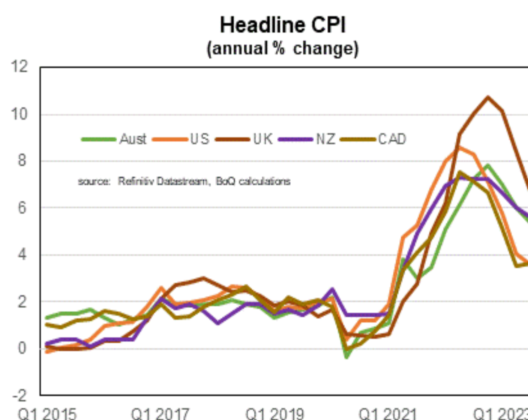
On this occasion, the economic shock has been similar for most developed countries (pandemic shutdowns, Russia-Ukraine War, very strong fiscal and monetary policy support) although there have been some country-specific differences (e.g., the extra degree of fiscal support in the US compared with Australia). The cash rate cycles are more likely to be more strongly correlated in this cycle than the ones mentioned above.

To my mind the bigger question globally is whether global central banks will be as aggressive in delivering rate cuts as currently priced by financial markets. Similar to Australia, global central banks inflation forecasts are more consistent with rate cuts not taking place until 2025 (although some US officials are openly speculating about reducing rates next year). Of course, central banks might be underestimating how much global economic growth may slow or the speed of the moderation of inflation.

The Australian and US cash rates are typically highly correlated.



The performance of inflation has been similar across most countries through COVID.



Finally, there is the question of how much interest rates may fall when the rate cutting cycle does eventually start. In a recent survey economists' expectation for the cash rate at the end of 2025 ranged between 2.6% and 3.85%.

Financial market views on the medium-term cash rate outlook have evolved over the course of this year. One measure used to gauge financial market medium-term views is the 5-year interest rates (essentially where financial markets think the average cash rate over 5 years will be in 5 years' time). In the US, Canada and the UK that number is between 3.5-4%. In Australia and New Zealand that number is currently over 4.5%. At face value that number looks far too high. The rise in house prices this year though suggests that the current cash rate level is not impacting the economy as much as was expected (the population boom is playing a large role here).

Even if we take the US/UK/Canada estimate for Australia it implies that the rate cutting cycle could be muted (which is the current financial market pricing). Of course, financial market views could change once the global rate cut cycle begins.

History provides a rough guide. The cash rate is very unlikely to return to the levels seen in the 1980s and 1990s given that inflation this decade will almost certainly be well below the rate recorded in those two decades. In the previous decade the cash rate averaged 2.6%. But that was a decade when the GFC fallout was impacting many major global economies (notably Europe). And Australia was facing the impact of the end of one of the biggest mining booms in Australia's history (and at a time of tightening fiscal policy). In the 2000s the cash rate averaged 5.3%, but that's when there was a dramatic increase in borrowing in parts of the global

economy (that led to the GFC). Domestically, the benefits of the massive mining boom was pushing up domestic household disposable incomes and creating a big capex boom.

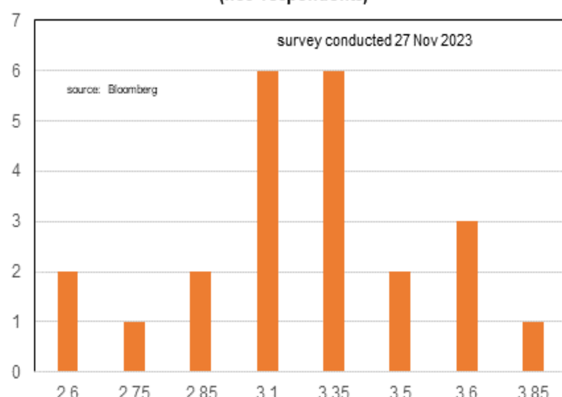
Average cash rate outcomes by decade (%)

Decade	Nominal cash rate	Real cash rate
1980s	13.6	3.9
1990s	7.2	1.7
2000s	5.3	2.7
2010s	2.6	-0.1
2020s	1.3	-0.1

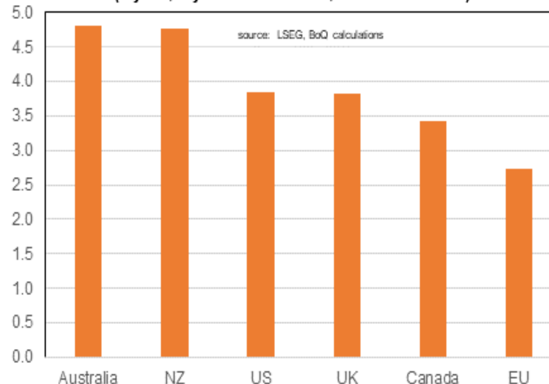
Source: LSEG Datastream, RBA, BoQ calculations. Real cash rate is nominal cash rate minus 10-year average of annual CPI % change

The current decade is likely to be one characterised by significant investment spending (housing, green energy, defence, infrastructure). Fiscal policy is unlikely to be as tight as it was the previous decade but (at least in Australia) I wouldn't expect it to be significantly looser. The economy though is unlikely to get a further significant boost from a bigger rise in commodity prices (but they also may not fall significantly). This suggests that the average cash rate this decade is likely to be above the 2010s, but lower than in the 2000s.

There is a wide range of views amongst economists as to where the cash rate will be at the end of 2025.



Markets expected the cash rate in the medium term to average 3.5-4% in US, UK and Canada.



Bottom line

The bottom line is that I think the cash rate has hit its peak. I expect the decline of inflation to be a little faster than currently projected by the RBA and the rise in the unemployment rate to be a bit higher. Financial market pricing for rate cuts to begin in the US, Europe and Canada from the second half of next year look about right to me. I think the first rate cut won't take place in Australia until early 2025, as I think it will take until then for inflation to have entered the top of the 2-3% target band. We shall see.

Earlier this year the Chief Economist of the Bank of England (Huw Pill) said he preferred that the profile of interest rates in the UK followed the outline of Table Mountain: they reach a decent height and then stay there for an extended period. Personally, I think that is what will happen with the cash rate in Australia. It is now at its

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peak, and that peak is below the heights reached in other countries. But the cash rate is likely to stay at this level for at least a year, and probably stay unchanged for longer than in other countries, partly because it settled at a lower peak.

We really do live in interesting times.

Regards

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