BOQ GROUP

6 June 2023

ECONOMIC UPDATE

RBA Update: The interest rate peak is getting peakier

Key Points

- The RBA hiked rates by one quarter percentage point at its June meeting, taking the cash rate to 4.1%;
- Concerns about inflation staying too high is the key concern;
- While I have been thinking rates had peaked, the risk very much is that there are more rate hikes to come;
- I now think the peak cash rate in this cycle will be 4.35%.

The RBA hiked rates by a quarter percentage point at its June meeting, taking the cash rate to 4.1%. Concerns about inflation staying too high for too long was the key factor driving the rate rise. The higher-than-expected April CPI data was probably the most single important single piece of data. But a backdrop of stubbornly high global inflation has not helped. At the start of the year the thoughts were that the cash rate might rise by between one quarter to one half percentage points in 2023. The cash rate has already risen by one percentage point this year, and the RBA may not have finished yet.

There have been good arguments as to why the cash rate should peak at 3.5-4%

For some time I had been thinking that the peak in the cash rate would be 3.6% in this cycle (subsequently revised up to 3.85%). My key argument was that size of the rate hikes (and the speed of the change) matters as much as the level of interest rates. The failure of several US banks and the problems in the UK bond market last year were two examples where the financial system was unable to painlessly absorb the rapid pace of interest rate hikes.

RBA analysis indicates that the full impact of higher interest rates does not hit the economy until 12-18 months following the rate change. And there are obvious reasons in this economic cycle as to why there are delays in higher rates impacting the economy. These include the higher-than-normal proportion of fixed rate home loans, as well as the supply-chain problems and worker shortages resulting in longer-than-usual delays to meet customer demand (notably in residential construction).

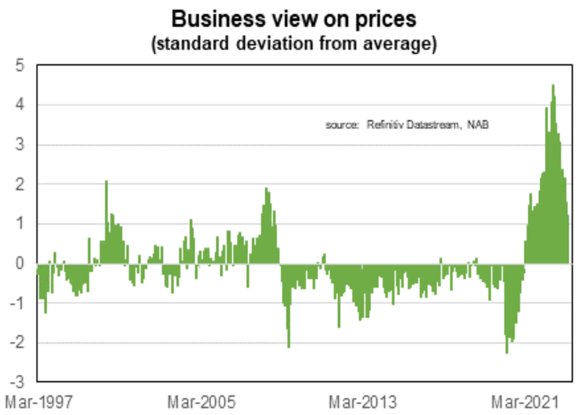
Over the next 6-12 months a sizeable proportion of borrowers will have rolled over from fixed home loans to variable rates. While the focus has been on the ‘fixed-rate cliff’ the majority of borrowers are already paying higher mortgage rates. The rise in mortgage rates has not been as steep as the increase in cash rate reflecting tough competition in the mortgage lending market although anecdotally this is changing.

Supply-chain problems are less of an issue, with a fair chunk of the residential construction backlog to be completed over the next 6-12 months. Concerns about worker shortages will continue to decline although may remain a worry for many firms for another 1-2 years.

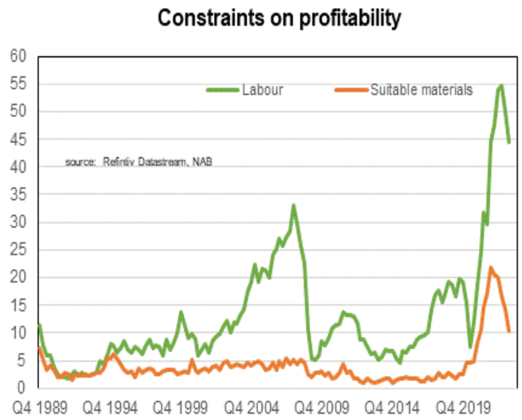
There are clear signs the economy is slowing. The leading economic indicator series for the economy is declining. Forward orders are growing at around their long-term average although that is well down from the pace seen this time last year. Building approvals point to a sharp slowing in residential construction next year. Household spending on discretionary items is weakening (such as spending at restaurants and cafes). Business and consumer inflation expectations data point to easing pricing pressures, albeit at a level above what is consistent with 2-3% inflation.

The huge amount of saving built up over COVID has allowed some households to keep spending despite the rising cost of living and increasing interest rates. The excess saving is likely to be able to fund spending by a segment of households for some time.

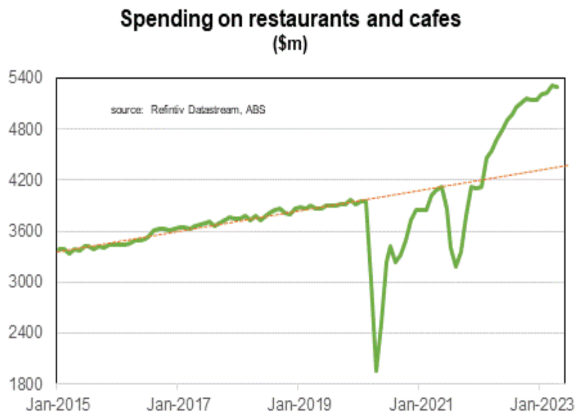
Business views on prices are well above average but substantially down from where they were last year.



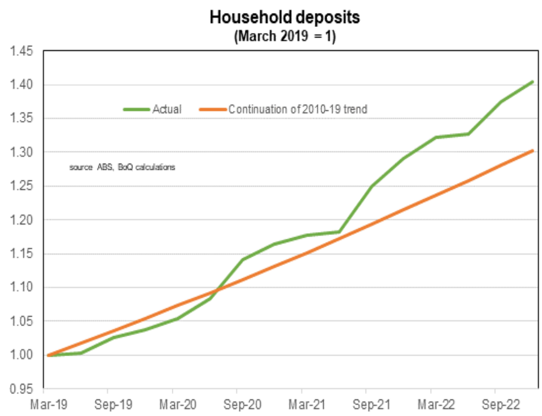
Supply-chain and worker shortages worries are reducing.



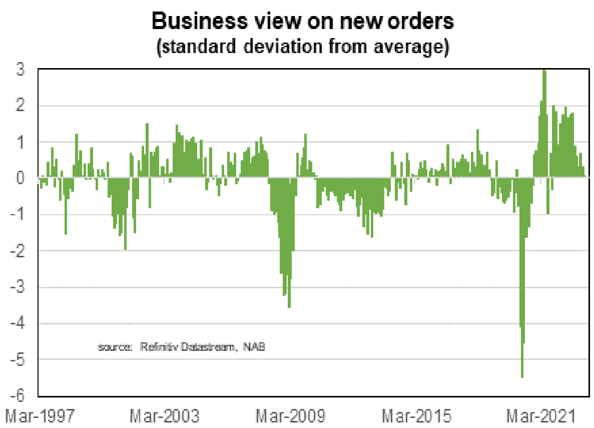
Spending at restaurants has been strong but looks to be slowing.



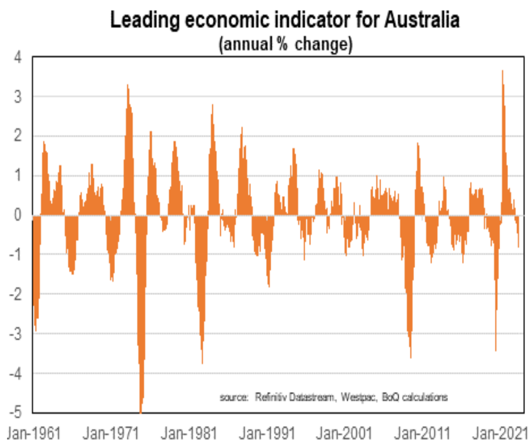
Household deposit growth has increased significantly over the past year.



There has been a substantial slowing of growth in order books over the past year.



The leading economic indicators point to sub-par growth in coming months.



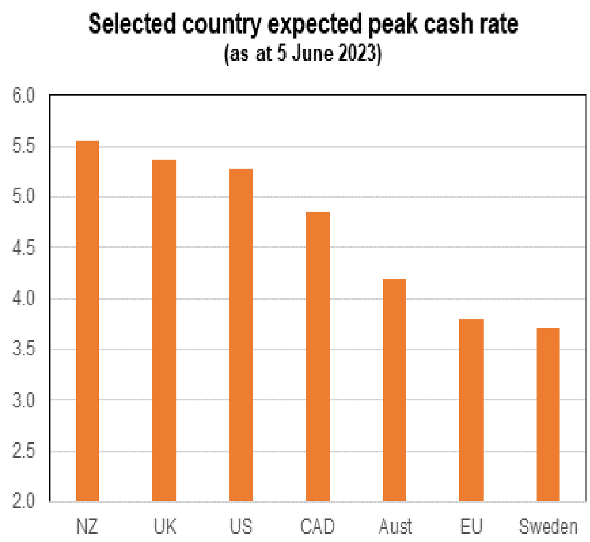
But the cash rate is going to peak above 4%

But the cash rate will peak higher than what I had expected. Despite the increase in rates, house prices are on the rise again. This would concern the RBA as declining asset prices (including house prices) is one way that monetary policy impacts the economy. In some respects, the combination of factors that have created the rise in house prices is unique to the housing market. There has been a rebound in demand due to the pickup of population growth. When combined with the structural undersupply of housing that has led to a jump in rents, making owning a home more attractive option for some. The large build-up of saving over COVID and the reduction in house prices may have made it easier for some households to afford a house deposit.

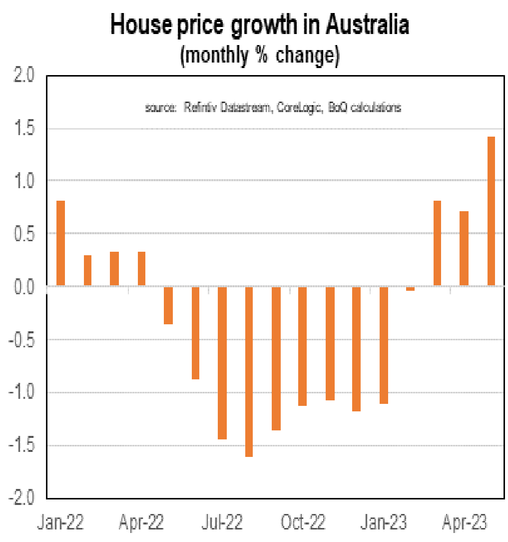
International comparisons suggest that the Australian cash rate looks low. Financial Market expectations about the cash rate in the countries typically compared with Australia (the US, UK, Canada and New Zealand) suggests a peak between 4.75-5.5%. The shape of the Australian yield curve suggests that financial markets don't think that monetary policy is as tight as in other economies. Interest rate differentials have played a big role in the relative weakness of the $A this year (or more particularly, the strength of the $US).

Finally, there has been debate as to how much the Federal Budget and the recent Minimum Wage Case will add to inflationary pressures in the economy. There was no significant financial market reaction post the release of the Budget. And both the Treasury and the RBA have stated they think that the Budget will if anything reduce recorded inflation. My view though is that the forecast move from a (slim) budget surplus to a (slim) deficit typically would be expected to modestly add to economic growth. Interest rates did rise post the Minimum Wage case announcement suggesting investors saw the decision as increasing the odds of additional rate hikes.

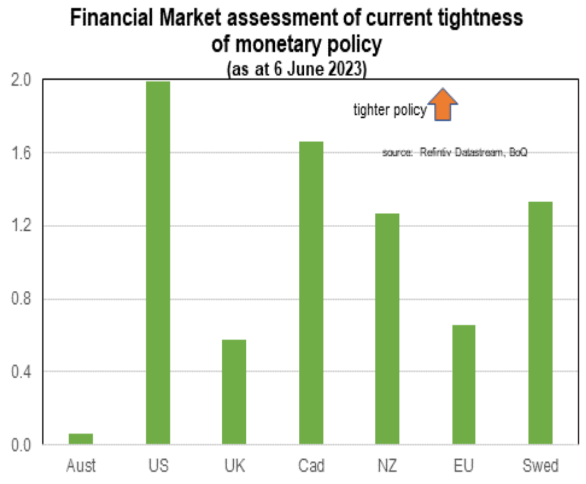
The projected peak in the cash in Australia is not high by peer country standards.



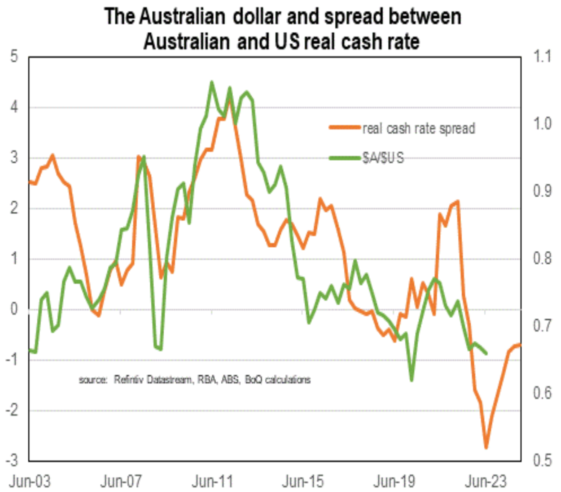
House prices are on the rise despite increasing interest rates.



Financial markets don't think that the current cash rate in Australia is very restrictive.



Low interest rates have contributed to the weaker currency that has added to inflationary pressures.



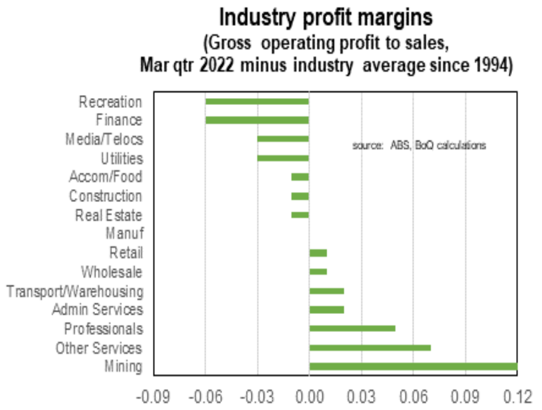
In recent times the RBA has highlighted that rising unit labour costs (growth in labour costs minus productivity growth) could lead to inflation being sustainably higher than the 2-3% target band. The short-term link between changes in unit labour costs and inflation though is mixed. Mostly that is because there can be plenty of noise in the short-term measurement of productivity growth (and therefore unit labour costs), something that has happened over the past couple of years.

It is also because a rise in unit labour costs does not always lead to a commensurate rise in prices. Firms have the choice to either absorb the rise in costs within profit margins, reduce other costs (including by cutting the number of workers) or improving productivity growth. Which choice it makes will depend upon a variety of factors, including the state of the economy, the size of profit margins, the competitive structure of the industry, how long the firm expects unit labour cost growth to remain elevated and a firms' ability to improve productivity.

I am not persuaded by the argument that movements of unit labour costs is an important reason to change the cash rate this year. It is fair to say that the RBA appears to have a different view. Most economists would agree that having wages growth sustainably above productivity growth (plus 2-3% for inflation compensation) would be a concern.

The link between short-term movements in unit labour costs and inflation have been mixed. They are more important in the longer term.

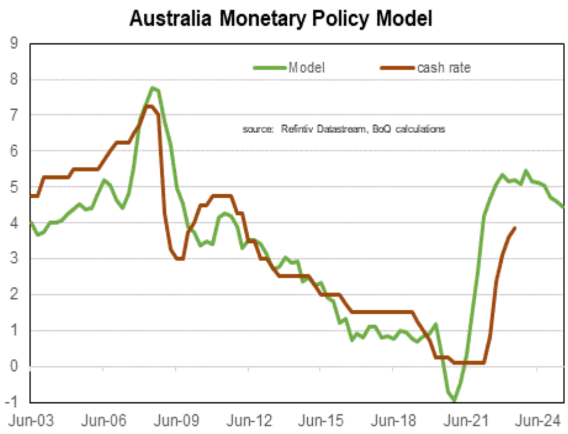
Profit margin performance is mixed between industries.



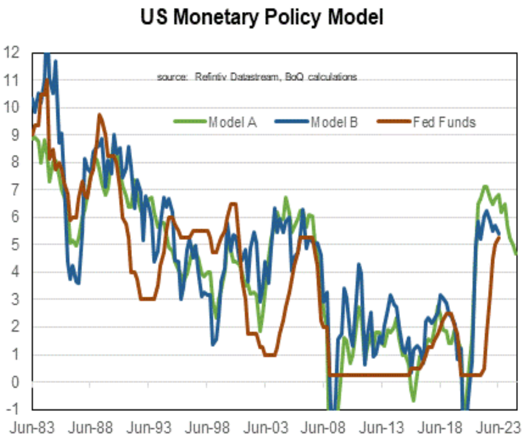
A basic monetary policy model suggests that the risks are that the cash rate in Australia may need to head higher over the next 6-12 months. And that there may be no reduction in the cash rate before at least mid-2025. The model has done a decent job of picking the level and changes in the Australian cash rate over the past fifteen years (the model suggested that the cash rate should have started to rise in the second half of 2021 well before the first RBA move). The model assumes that inflation declines over the next couple of years in line with RBA forecasts. A lower cash rate would require weaker inflation (and higher unemployment rate) than the current RBA view.

By contrast a model for the US cash rate suggests that it is currently at the lower end of its expected range (albeit with some potential for a further modest move higher in coming months). Forecasts for the US economy are currently consistent with rate cuts in the second half of next year.

The risks are that the Australian cash rate will need to head higher.



The cash rate in the US is close to its peak and could be declining by H2 2024.



For much of the past year financial markets have projected that the peak in the Australian cash rate would be somewhere between 3.5-4.5%. We are now near the middle of that range. With inflation above 6% and the unemployment rate still near its lowest level in fifty years suggests the risks are that the cash rate may need to head higher.

I think that economic growth next year might be weaker than the RBA or consensus think. This means that the inflation rate could be lower and the unemployment rate higher than what the RBA expect. But the level of the cash rates globally and the evident RBA concerns about the inflation risks means that I have revised up (again) my end point forecast for the cash rate. I now expect the peak to be 4.35%, with the risk that it may go higher still.

I am not unduly pessimistic about the economic outlook. Strong population growth means there is plenty of residential and infrastructure work that needs to be done. Defence and climate-change spending will likely have to rise by more than currently anticipated. But a cash rate peak of 4%-plus does raise the odds of a sharper economic slowdown for next year than what most are currently predicting.

We really do live in interesting times.

Regards

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