Bulletin

4 December 2014

RBA expected to do two 'insurance cuts' in February and March next year; rate hikes in 2016

- **Westpac has revised its profile for the RBA cash rate. While we still expect rates to be on the rise in 2016 as the world economy gathers considerable momentum, we now expect the RBA to cut rates further in the early months of 2015 in an effort to bolster domestic demand and lower the AUD before evidence on the world economy becomes clearer around the middle of the year. Accordingly we now expect the RBA to cut rates by 25bps in February and again in March prior to another period of stability.**

We have revised our interest rate outlook. We still expect rates to be on the rise in 2016 as the world economy gathers considerable momentum but we now expect the RBA to cut rates further in the early months of 2015 in an effort to bolster domestic demand and lower the AUD before evidence around the world economy becomes clearer around the middle of the year.

We expect a 25bp rate cut at the February Board meeting and another one to follow in March.

Our initial response to the September quarter national accounts was that the Reserve Bank would accept that the dismal growth profile was due to a lumpy fall in government spending; a temporary pause in the dwelling investment upswing; a sharper than expected drop in mining investment; and the fall in the terms of trade, which was already known to the policy makers.

However on reflection we think that the weakness in the accounts – including falling inflation; contracting national incomes; and a loss in growth momentum – coupled with further sharp falls in commodity prices, continued weakness in consumer sentiment – which has failed to recover from its post-Budget fall – and the prospect of a further significant negative shock to confidence will be enough to prompt the RBA to use some of their remaining policy 'scope' and lower rates further.

At a dinner for the Australian Business Economists on November 25 Deputy Governor Lowe emphasised that he expected that monetary policy still worked, even with rates at record low levels, and that if the outlook were to deteriorate sufficiently, policy could be eased further. The risks embodied in the national accounts – where all states but NSW contracted, national income contracted for a second consecutive quarter (widely reported as an 'income recession') and inflationary pressures eased markedly – would be sufficient for the Bank to revise down its already downbeat outlook for 2015.

We have lowered our GDP forecast for 2015 from 3.2% to 2.7% (below trend) and we expect that the RBA will make a similar adjustment.

Other risks around the impact of the national accounts on both business and consumer confidence are real. The Bank will receive more evidence on these issues from two more reports on consumer and business confidence and two employment reports before the February meeting. It is our expectation that the risks to these numbers are to the downside. Meanwhile unemployment looks set to rise further near term.

Until recently it appeared that the pursuit of a lower AUD and providing improved cash flow for companies and households with a mortgage which would result from lower rates, was taking a 'back seat' to expectations that low rates would eventually see the non-mining upturn strengthen and concerns around overstimulating the housing market. However, the RBA has made a clear shift in rhetoric in recent months, returning to the more strident language on the currency used late last year and softening concerns around housing. The pronounced and sustained weakness in the terms of trade over the second half of this year obviously lowers the fair value of the Australian dollar, and the RBA's recent commentaries clearly imply that in their minds the currency is far from reflecting this in full, despite recent losses. In addition, ongoing QE in Japan and Europe is indicative of both global disinflation pressures and a valuation 'premium' for exchange rates with conventional policies.

On housing, the RBA has noted a clear moderation in price appreciation in recent months. The Bank also has some scope to use macro prudential tools to contain any further sharp upswing in investor housing activity, if it were to occur.

Of course the next Board meeting is not until February 3 and much could change over that period. In particular, commodity prices – which have shown sharp swings in the past – could post a strong recovery from recent sharp falls. However, while we expect commodity prices to be lifting over the course of 2015, the picture on prices is likely to still be unclear in the March quarter. In fact we expect commodity prices to fall further in the March quarter prior to lifting through the second half of 2015. The Lunar New Year which begins on February 19th in 2015, adds another layer of complexity with the relative strength of the seasonal bounce back in Chinese economic activity not likely to be known to the RBA by the February meeting. That will leave them to peruse the iron ore price, Q4 Chinese GDP and the November/December partial data to aid their decision-making. We do not expect a short term positive impulse that would alter their present mindset, even though we do expect that Chinese growth will firm as the 2015 year unfolds.

It is also important to note the following points :

1. The minutes to the December RBA decision – to be released on December 16 – could provide some guidance to the Bank's thinking. This will give a more detailed account of the Board's assessment of risks and 'colour' around their thinking.

2. The February Board meeting is likely to be the preferred timing for the Bank. It comes after the release of what we expect to be a soft December quarter inflation report and it

allows the Bank to use the 70 page quarterly Statement on Monetary Policy, released 3 days later, to explain its decision.

3. We do not think that the Bank would make such a reversal in policy for just one move. We expect the cut would be followed by a second cut in the following month (March) prior to another period of stability.

4. Fiscal policy will remain a headwind for the economy. Although the Treasurer has committed to not introducing any harsh new cuts in the Mid–Year Economic and Fiscal Outlook, which is likely to be released in the week beginning December 14, the evidence and the rhetoric around a sharply deteriorating fiscal position will continue to unnerve consumers and businesses.

5. The Reserve Bank will have little or no new information on housing between now and its February meeting with the market essentially closed through Dec-Jan meaning mid-Feb will be earliest next reading on conditions.

6. It is our view that the Bank will be 'surprised' by the pace of recovery in the world economy in the second half of 2015. That will preclude any further moves. Australia's terms of trade will improve for a period and the key issues which the Bank has been concerned about will begin to dissipate as the terms of trade lift. By mid-2016 rates will be on the rise , taking the lead from the US Federal Reserve which will begin its tightening cycle by September 2015.

Implications for the Markets

Fixed Rates
Markets are already pricing in a full cut of 25bps by mid-2015. Certainly any move to bring the cut forward by the RBA will lead to markets pricing in another cut.

However swap rates are unlikely to fall too much further (the 3 year swap rate is currently around 2.6%) since the markets will be focussing on the expected first hike by the US Fed, which we anticipate is timed for September. Anticipation of that event is almost certain to trigger a rise in fixed rates in the US. That is likely to contain any further falls in fixed rates when the RBA moves.

We are also at odds with the market in anticipating rate hikes from the June quarter in 2016 as the Australian economy derives a considerable boost from a strengthening world economy.

The Australian Dollar
We had been expecting to see a lift in commodity prices by year's end but are now delaying the timing of that recovery until mid-2015. This means that the low point in the AUD is likely to be around the June quarter, in the aftermath of the rate cuts and amid both a strengthening USD as markets focus on the first Fed tightening; and ongoing weakness in the Euro and the Yen as the ECB and BoJ embrace aggressive QE.

As indicated above, the RBA views the currency as overvalued and would like to see it fall further. At a minimum, it would like to hold on to the losses already recorded. Westpac puts current AUD/USD fair value in the 79-81¢ range – an estimate that incorporates both the cuts introduced into our forecasts today and a lower trajectory for commodity prices out to mid-2015.

In that scenario we see the low point of the AUD as around USD 0.80 by June 2015. Our previous forecasts were predicated on stable interest rates, higher commodity prices and a premium to fair value. We have altered each assumption in an 'AUD negative' direction, with the fair value premium removed from our expectations for the first time in the QE era.

A strengthening world economy; rising commodity prices; RBA on hold with the next move up; and Australian interest rates still comfortably above US rates are likely to see AUD strengthen through the second half of 2015 and into 2016.

As we have seen in previous episodes of Fed hikes the highly preemptive foreign exchange markets are likely to have moved largely before the first 'well-signalled' move.

In those circumstances we expect the AUD will finish 2015 at around USD 0.85 and continue to benefit from strong world growth; rising commodity prices; and, rising AUD rates from the June quarter.

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Financial forecasts

	Latest (4 Dec)	Mar 15	Jun 15	Sep 15	Dec 15	Mar 16	Jun 16
Cash	2.50	2.00	2.00	2.00	2.00	2.00	2.25
90 Day Bill	2.73	2.20	2.20	2.20	2.22	2.25	2.55
3 Year Swap	2.61	2.55	2.70	2.75	2.75	3.00	3.50
10 Year Bond	3.07	3.10	3.30	3.35	3.35	3.60	4.00
10 Year Spread to US (bps)	79	70	70	65	60	70	80
AUD/USD	0.838	0.82	0.80	0.83	0.85	0.87	0.89

Source: Bloomberg, Westpac

More detailed forecast updates will be provided in our Weekly, out tomorrow, and in the December-January edition of Westpac Market Outlook, scheduled for Tuesday of next week.

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