Market Bulletin

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Rushing towards easy

In brief

- The outlook for rate cuts was always ‘when, not if’. The explicit easing bias introduced by the Reserve Bank of Australia (RBA) this week means the ‘when’ is now June, with a further cut likely to come in August.
- Proposed revisions to banks serviceability regulations should aid in transmitting lower rates to households, mitigating some of the downward pressure on the housing market but this is not certain.

The release of the minutes of the RBA’s May meeting, followed very quickly by a speech from RBA Governor Philip Lowe, have cemented the market view for a rate cut at the June meeting.

The minutes were dovish, as was the Governor’s speech, and both highlighted the need for a falling unemployment rate to meet the RBA’s inflation target. The rise in the unemployment rate in April to 5.2% created the impetus for a rate move, however, the noisy nature of the labour market data meant that it wasn’t clear the RBA would react to one poor reading. Furthermore, significant policy changes are often timed around the quarterly release of the RBA’s economic forecasts (February, May, August and November). This was not to be the case.

The speech by Lowe reinforced the dovish message and forward guidance clearly points to a cut in June.

> *“A lower cash rate would support employment growth and bring forward the time when inflation is consistent with the target. Given this assessment, at our meeting in two weeks' time, we will consider the case for lower interest rates”, Governor Lowe, RBA.*

Kerry Craig
Global Market Strategist

The case for cuts

The RBA typically keeps its cards close to its chest when signaling changes to policy. Last year the narrative was that the next rate move was more likely to be up than down. Earlier this year the view was more neutral, but has quickly become one of easing. The rapid change in view of the RBA towards a rate cut means that it will not wish to set the market up for a swing and miss by delaying the policy change until the August meeting.

Comments around the RBA's last set of economic forecasts and the assumptions that underpin the return to the inflation target were a clear signal to the market to adjust expectations for an earlier rate move. The projections included in the May Statement of Monetary Policy showed the underlying level of inflation returning to the bottom of the 2-3% target band by the middle of 2020, six months later than previously assumed. This is contingent on the cash rate being 50 basis points lower than the current 1.5%. The implication is that these forecasts are only achievable if the official cash rate is lower.

> *"It is worth pointing out that when preparing these forecasts, we used our normal technical assumption that interest rates would move broadly in line with market pricing. At the time the forecasts were prepared, market pricing implied that the cash rate was expected to decline to 1 per cent over the next year", Governor Lowe, RBA.*

The focus on the labour market and need for a decline in the unemployment rate has become pivotal to the RBA's outlook for the economy. Even with the most recent rise in the unemployment rate, the RBA still has a balanced view. Governor Lowe even went as far as noting some aspects of resilience.

More slack in the labour market

The Australian labour market is producing many of the same puzzles experienced in other developed economies—falling unemployment rates but little wage growth, meaning lower overall rates of inflation. Estimates of the point at which the decline in the unemployment rate creates inflation in the economy are fuzzy at best, and estimates are frequently revised based on structural changes in the economy and labour market. The very exciting technical term is the non-accelerating inflation rate of unemployment (NAIRU).

NAIRU was thought to be around 5% and any unemployment rate below this should start to generate inflation pressures (via wages) in the economy. However, given the absence of inflation despite the robust pace of job growth in Australia over the last two years, the NAIRU must be lower, or as Governor Lowe put it "we can do better".

A lower NAIRU means that there is more economic slack that can be used up to generate growth and inflation. While the labour market has been resilient, forwarding indicators such as vacancy rates and employment intentions in business surveys have weakened. Employment growth has also slowed, meaning that further policy support is needed. The way to unlock that potential is not just through lower interest rates. Fiscal stimulus and tweaking of regulations that were implemented to promote financial stability and take the heat out of the housing market are also required.

This explains the timing of the Australian Prudential Regulation Authority announcement to change the 7% serviceability rate applied to new home loans. Cutting interest rates while regulation is still tight would impede the flow from lower interest rates to increased credit growth. The proposed change should aid this transmission mechanism and ease pressure on lenders.

While this is a positive for the housing market outlook and may lead to a rise in housing credit growth, the bias in bank lending is still to increase the quality of lending and high street banks may still be feeling the burn from the Royal Commission into Banking as well as working on their own internal risk measures. As such, this move in itself will probably not have a huge impact but does suggest that we could expect further tweaks to regulation to increase banks' willingness to lend and that the downside to the housing market from here could be limited.

Investment implication

Investors should expect lower cash rates in Australia this year and if history is a guide, the RBA is likely to cut rates twice in quick succession. The combination of stimulative fiscal and monetary policy may ease some of the concerns around the housing market and fragility of the consumer. However, the high level of household leverage and low savings rate suggest that the impact of rate cuts is weakened compared to history as households opt to pay down existing debt. The expectation for lower cash rates means that bond yields and the Australian dollar are also likely to be lower. Income seekers should look offshore where opportunities in global credit markets offer higher rates of income and a weaker Australian dollar can add to returns.

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