The RBA, The Fed and the Outlook for Interest Rates

Our weekly view on asset allocation.

08 November 2021

RBA Concedes Some Ground but Continues to Emphasise Patience

The Reserve Bank of Australia (RBA) maintained its cash rate at 0.1% and left the $4bn per month pace of asset purchases (QE) unchanged (until February) following its monthly monetary policy meeting last Tuesday.

The RBA did announce that it is abandoning the 0.1% yield target for short-duration bonds (to April 2024). The decision to drop its yield curve control policy comes after it did not intervene to defend the target the previous week when 2-3-year bond yields surged following the recent stronger than expected Australian CPI release. A faster "improvement" in inflation and volatility in market pricing were cited as key factors behind the decision. The RBA Governor also flagged it was unlikely the yield target would be used in the future.

The RBA also dropped its guidance for no increase in the cash rate until 2024. Cash rate guidance was shifted to be more "data-based", with an emphasis on core inflation "sustainably" reaching the mid-point of the target band (2.5%) alongside wage growth picking up to 3%. In this respect, the RBA remains resolutely dovish, expecting these conditions will not be met until the end of 2023.

At the RBA Governor's post-meeting press conference he continued to push back against current market pricing, which has moderated a little but still implies (just over) three rate hikes in 2022, beginning mid-2022.

So, while the RBA has conceded some ground, it continues to emphasise patience. The RBA is monitoring inflation, wage growth and the unemployment rate to determine the date to begin lifting the cash rate.

Exhibit 1: Shorter-term bond yields have spiked recently as the RBA failed to defend its yield target

Source: Refinitiv, Wilsons.

Exhibit 2: The market continues to price multiple (3) rate hikes by end of 2022

Source: Refinitiv, Wilsons.

RBA Inflation Forecasts Upgrade Marginally

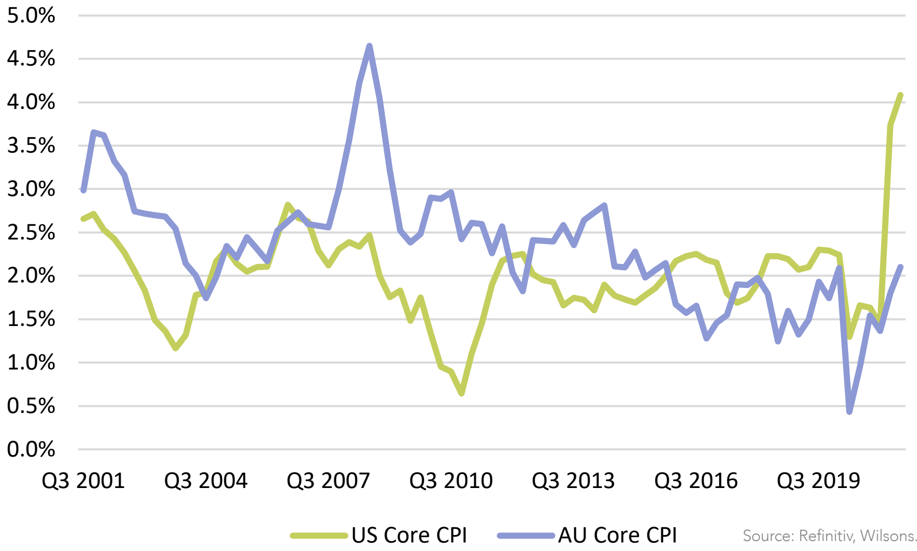
The RBA acknowledged recent higher than expected inflation data by raising its inflation forecasts. The central inflation forecast for underlying inflation is now 2.25% over 2021 and 2022 (was 1.75%) and 2.5% over 2023 (was 2.25%). Wages growth is expected to pick up gradually as the labour market tightens, with the wage price index forecast to increase by 2.5% over 2022 (unchanged) and 3% over 2023 (was 2.75%).

While keeping a relatively benign inflation profile, the RBA acknowledged inflation uncertainties relating to the persistence of the current disruptions to global supply chains and the behaviour of wages as we move toward the lowest (forecast) unemployment rate in decades.

On the growth front, the RBA downgraded (lockdown impacted) GDP growth to 3% for 2021 (was 4%). Growth was upgraded to 5.25% (was 4.25%) for 2022 and held steady at 2.5% in 2023.

The unemployment rate is forecast to be 4.25% at the end of 2022 and 4% at the end of 2023 (both unchanged). The lowest since late 2007.

Exhibit 3: Australian inflation has picked up but less dramatically than in the US

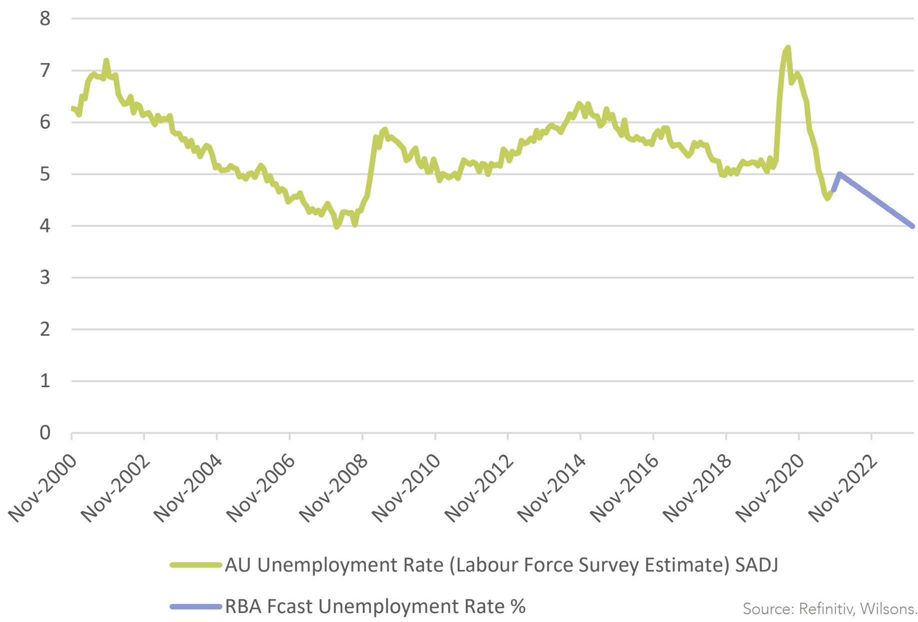


Source: Refinitiv, Wilsons.

Exhibit 4: Wage growth was stubbornly low in the last cycle

Source: Refinitiv, Wilsons.

Exhibit 5: The RBA is forecasting a return to very low unemployment but limited wages pressure



Source: Refinitiv, Wilsons.

RBA Relatively Dovish in a Global Context

The RBA appears more relaxed about inflation than many of its central bank counterparts. The Norges Bank (Norway) and the Reserve Bank of New Zealand have already hiked interest rates, while the Bank of England and Bank of China are likely to follow. The RBA's views around the extent of transitory inflation likely align more closely with the Fed. While the RBA appears to be a degree more dovish than the Fed, we expect the local economy to produce sufficient momentum over the coming year to encourage the RBA to follow the Fed reasonably promptly in raising rates.

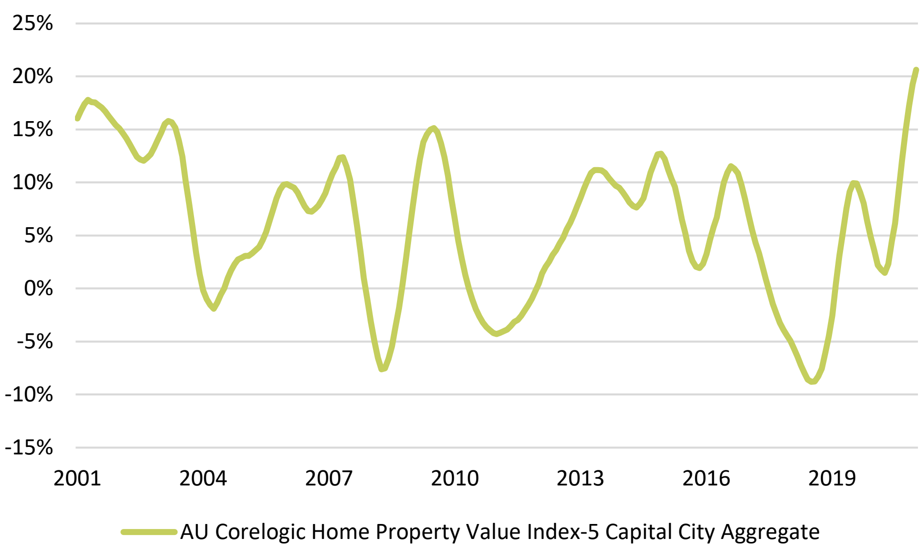
We would put a Fed rate lift-off somewhere around September to December 2022. This would likely see the RBA start the hiking cycle in late 2022 or early 2023, in our view.

Hence, we feel current market pricing for the RBA's cash rate move next year is likely to be too hawkish, but the RBA's updated guidance remains too dovish.

Fed Holds the Keys to Global Rate Pulse

A key signpost for the Fed's rate lift-off is the wind down of its QE program. The Federal Open Markets Committee (FOMC) formally announced the commencement of its QE taper program after its November meeting last week. Beginning later this month, purchases will be reduced by $15bn per month ($10bn for Treasury securities and $5bn for mortgage backed securities). This roadmap is consistent with a mid-2022 end to the QE program as previously guided. This would allow a 3-6 month pause to assess the economy before the first step to tighten policy is taken. An initial 25bp increase in the federal funds rate somewhere between September and December 2022 seems likely, albeit current market pricing sits a touch ahead of this. We doubt the RBA's lift-off will be too far behind despite the RBA's ongoing dovish rhetoric.

Exhibit 6: House price gains should moderate but should continue over the coming year as rates stay low



Source: Refinitiv, Wilsons.

Very Early Days in the Great Policy Unwind

The global shift towards monetary tightening likely signals more moderate share market returns. Still, the primary trend should remain positive as the impact of gradual monetary tightening is offset by economic recovery and ongoing solid profit growth.

Importantly, monetary policy settings are still very easy and will remain so for some time, particularly in respect of the Fed and the RBA. Bull markets typically only end when monetary policy tips over to a tight stance. While the reaction of the real economy and investment markets to the withdrawal of such highly stimulatory conditions is somewhat uncertain, we are a couple of years away, at least, from anything approaching tight policy conditions.

House Prices, Household Debt and the Neutral Policy Rate Debate

From Australia's perspective, the path of house prices will also be important to monitor, given the huge price surge over the past year and the high levels of household debt currently prevailing. While the RBAs abandonment of control over 2-3-year interest rates signals the end of ultra-low fixed-rate mortgages, the cash rate is set to stay anchored at 10bp for another year, at least, in our view. This suggests that further house price gains are likely over the coming year.

As rates finally move up, conditions are likely to be become more difficult in 2023 and beyond. The large household debt burden also likely means that Australia's neutral cash rate is fairly low and likely lower than the neutral rate in the US. The US Fed estimates the neutral cash rate at 2.5%. We would suggest 2% is a reasonable estimate for Australia, but some analysts are suggesting it could even be lower. Certainly, Australia's relative sensitivity to rising cash rates is an important medium-term issue for both investors and the RBA.

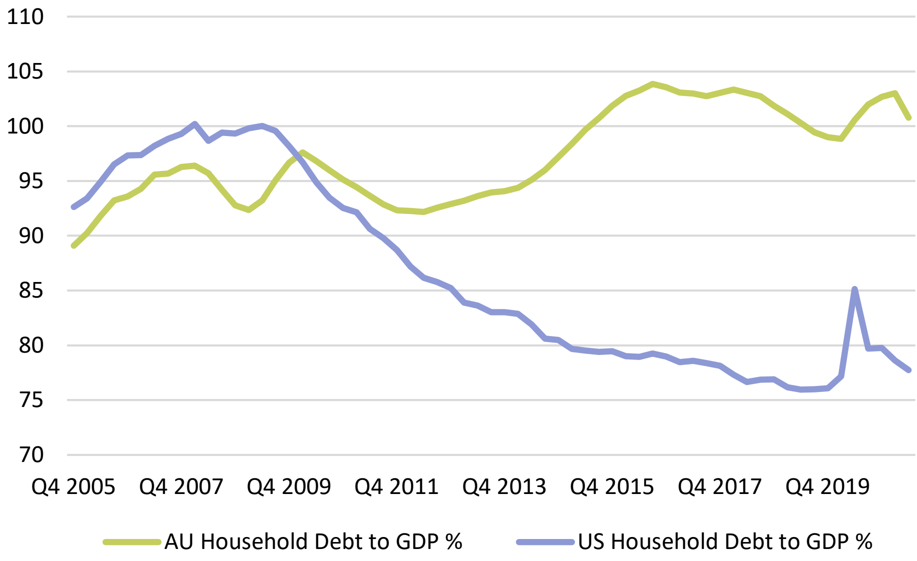
The Risks for Risk Assets

Forecasting interest rates is always difficult, and we believe it is arguably even more difficult at present with such uncertainty in respect of the inflation backdrop. As we have previously discussed, a key short-term risk (3-6 months) is that inflation proves stickier than expected, making both bond and equity markets nervous.

We still have fairly high conviction that inflation does come down on a 12-month view, which should negate the risk of a significant pull-forward of Fed or RBA tightening relative to our base case view. The key medium-term uncertainty is likely the medium-term trend in inflation beyond the transitory impact of COVID distortions.

It is possible that inflation (and wages) surprise to the upside over the next 2-3 years, both in the US and Australia. This could push cash rates and long-term bond yields into the uncomfortable zone from a stock-market perspective and impact house prices in Australia's case. This is not likely a significant risk for the coming year, but we expect it will be a key risk to monitor over the next 2-3 years. For now we remain moderately overweight equities with a cyclical preference for Australia. We remain underweight global and domestic fixed interest and overweight Alternatives.

Exhibit 7: Australia's high debt burden likely makes us especially sensitive to rate rises



Source: Refinitiv, Wilsons.

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