

Investment Strategy Update #131

The Reserve Bank of Australia – The A-Z of Interest Rate Policy

- The RBA is navigating a fine line. It seems comfortable inflation is near its peak but is not confident it is on a path back to target. Governor Lowe has made it clear that more insurance needs to be taken out to see this occur. Implied pricing is for the Bank to raise rates twice more by mid-year, although this is data dependent, and it is possible more hikes are coming. Unfortunately, tightening policy is like stretching a rubber band – the more it is stretched the closer it is to breaking.
- Policy transmission is mostly occurring as normal. The interest rate sensitive sectors such as housing have felt the pain early and the consumer is starting to show some weakness. But the goal in the tightening campaign is to raise the unemployment rate and this is yet to happen. Only then will the Bank be confident inflation is tracking back towards target.
- This time around, transmission has been blunted by the high levels of cash on household balance sheets (still >\$200bn). However, savings is slowing rapidly because of the increase in interest rates and the rise in cost of goods and services. Competition in the mortgage market has also blunted transmission, with not all interest rate increases (as yet) passed on to borrowers.
- An RBA pivot is off the agenda for now and equities are premature to begin pricing this in (or expecting an RBA “put” to underwrite the market). But we expect the data to weaken as the year evolves and before year-end the bank should feel comfortable inflation is tracking back to target and less restrictive policy will be appropriate. However, Macquarie does not expect the start of the rate cut cycle to begin until 2024.

The inflation playbook

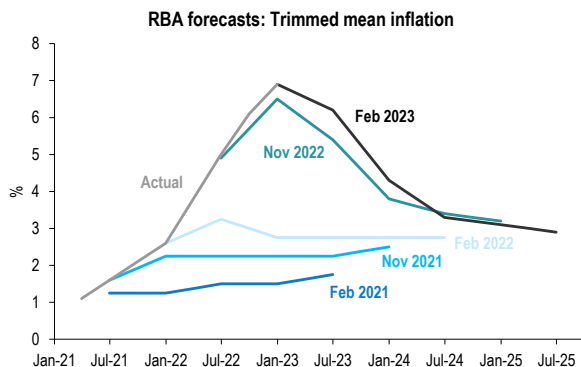
Inflation only rises when demand exceeds the ability of the supply side to meet it. Central banks have the right tool (control of interest rates) to adjust the demand part of the equation. But it is only the business sector and government that can bring about the supply-side adjustments. Typically, when interest rates rise and demand slows, the business sector will react to retain profitability by cutting staff and streamlining business processes so that firms are more aligned with weaker demand.

However, when demand is stronger than firms' ability to supply goods and services, they will increase prices, resulting in rising inflation, and this was the situation in 2022.

The global nature of supply chains and the pandemic meant that last year, the RBA faced similar challenges to other major central banks.

- Inflation accelerated due to strong demand from monetary and fiscal stimulus put in place during the pandemic and economies reopening for business. The reopening brought not only strong demand from freer movement of people, but also supply-chain disruptions, particularly where workers were forced to isolate after being in contact with someone who had COVID.
- Initially most central banks thought the sharp increase in inflation would be temporary, given the global economy had been through a 10-year period where many central banks were struggling to bring inflation up to target. But the issues causing inflation were persistent and ultimately, they were forced to withdraw stimulus rapidly. Inflation lags changes in both demand and supply, so less collateral damage is done when the central bank can adjust demand prior to it impacting inflation.
- As we approached the end of last year there were significant improvements in supply chains and the work done by the RBA had impacted parts, but not the economy in aggregate. Nonetheless, the net result by year-end was signs inflation had peaked. The RBA reacted to this positive development by reducing the size of interest rate increases (December and February).

The RBA thinks inflation has peaked



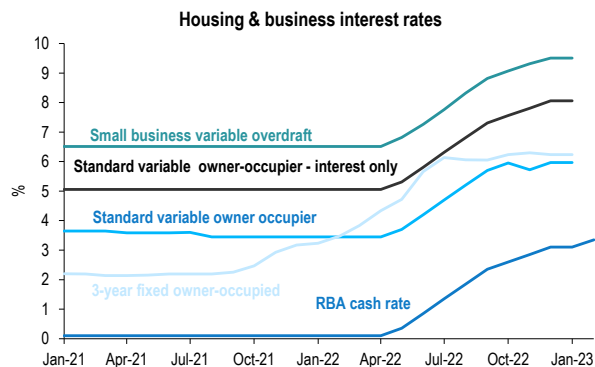
Source: ABS, RBA, MWM Research, February 2023

The path back to the 2-3% target

The RBA’s path back to the 2-3% target will depend on several factors.

- It needs to be confident that inflation has peaked. The stronger-than-expected Q4 22 inflation reading raised some doubts about this and the RBA reacted by not only raising rates by a further 25bp in February, but also sending out the message that more will be required.
- It will monitor how the work already done is impacting the economy, or the transmission mechanism of monetary policy.
 - a. Interest rate sensitive sectors of the economy began weakening after the initial increases in the cash rate and continue to weaken. Highly indebted households will be more sensitive to rate increases than those households with a relatively small mortgage. It is not surprising then that both Sydney (14%) and Melbourne (9%) have seen the sharpest house price declines from their peak.
 - b. However, not all borrowers have been affected by policy changes in the same way. Small business borrowers and households not repaying loan principal have seen the sharpest rise in interest rates. But new fixed rate borrowers have not seen rate increase since July last year and those borrowers on discounted standard variable loans have not seen interest rates increase since October last year. Competition tends to suppress the pass-through of policy tightening and that appears to be occurring this tightening cycle.

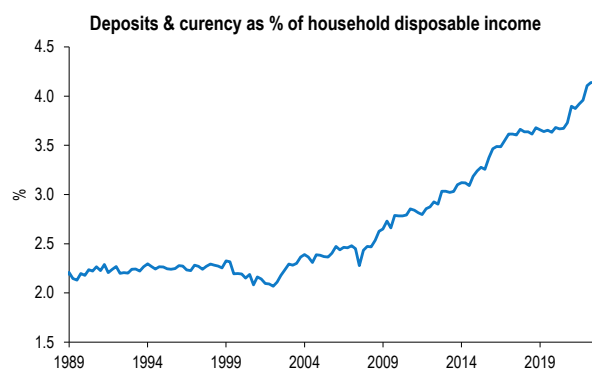
Policy changes and changes in key interest rates



Source: RBA, MWM Research, February 2023

- c. One factor that can slow the impact transmission of policy changes is high levels of household savings and even though the savings rate is declining as disposable income is being reduced by rising interest rates, and the increasing cost of goods and services, the level of savings is high and continuing to rise.

Cash on the balance sheet at high levels

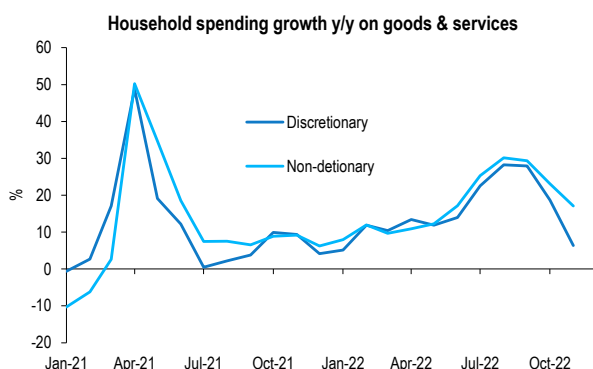


Source: ABS, MWM Research, February 2023

- d. Another factor that the RBA needs to account for in setting policy is the upcoming reset of fixed rate mortgages. The Bank is fully aware that a large number of borrowers (~two-thirds by year end 2023) will soon see their mortgage payments increase sharply as fixed term loans set at around 2.2% reset to between 5-6% (variable and fixed rate terms). This sharp increase in mortgage payments will significantly reduce their spending power.
- e. The Bank will be looking for signs that the weakness in the interest rate sensitive sectors is spreading throughout the economy. It will want to see consumer spending weaken. The consumer is around 55% of the economy and if inflation is to ease inflation, then consumer spending must weaken first.

- f. A slowdown in consumer spending should then signal that policy is beginning to impact the economy more broadly. However, the end game will be when the unemployment rate begins to rise. This will tell the bank that services inflation and wages should soon begin to ease. ***This sounds like a controlled incremental process, but in practice it's like stretching a rubber band, pain is felt and it keeps increasing until households snap.***

Signs the pain is broadening



Source: RBA, MWM Research, February 2023

Light at the end of the tunnel

In our 2023 outlook (see **2023 Outlook: Better Days Ahead**) we forecast Australia should avoid recession even though the US and Europe would not. The risk Australia joins these major economies will depend upon how quickly pressure is taken off the RBA to raise rates further.

- Australia lagged other major countries in seeing inflationary pressures and the improvement in supply chains already seen in other countries haven't yet fully flowed through. This is clearly a positive development that can't happen quick enough.
- Improvements on the supply-side will help the RBA, but the Bank will still need to see the unemployment rate

rise to a higher level before it becomes comfortable that inflation is tracking back to target. The Bank's latest projections expect the unemployment rate to drift up to 3.9% by year end – a meaningful rise that will ease wage pressures and help lower inflation somewhat.

- Australia's two largest cities have already seen significant dwelling price declines and if the RBA is forced to raise rates further this will add to the downward pressure with ultimately flow-on effects to consumer spending. Other markets such as Brisbane are starting to see price declines accelerate.
- Markets keep looking for a pivot by central banks. However, feeling comfortable inflation has peaked is not enough. Rate cuts are well and truly off the agenda for the time being. But the trigger for rate cuts will likely need: 1) the global outlook deteriorating more rapidly than the bank expects, 2) the unemployment rate rising more rapidly than the bank expects. A further decline in house prices of the magnitude we saw last year will not be enough.

Macquarie Australian economic forecasts

		2022	2023	2024
GDP	y/y	3.6	1.7	1.5
CPI	y/y	6.5	5.5	3.0
Core CPI	y/y	5.0	5.0	3.0
Unemployment rate	%, sa	3.5	4.0	4.7
A\$/US\$		0.68	0.69	0.70
Cash rate	%	3.10	3.35	2.60
10-yr yield	%	4.05	2.80	2.75

Source: Macquarie Macro Strategy, February 2023

Please see our “2023 Outlook: Better Days Ahead” for more detail on our investment views, asset allocation and key recommendations.

Macquarie WM Investment Strategy Team

The report was finalised on 10 February 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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