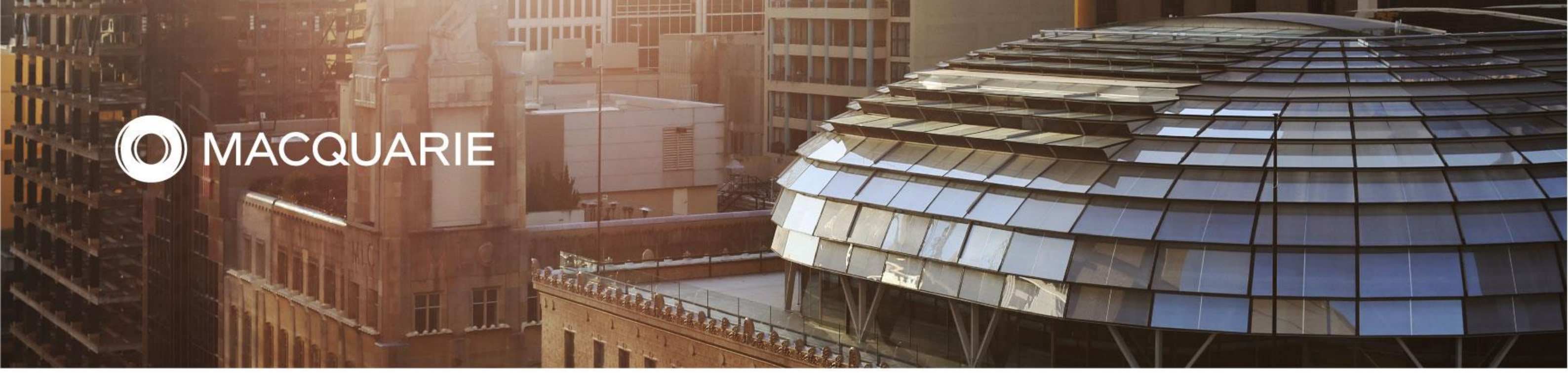


Investment Strategy Update #109

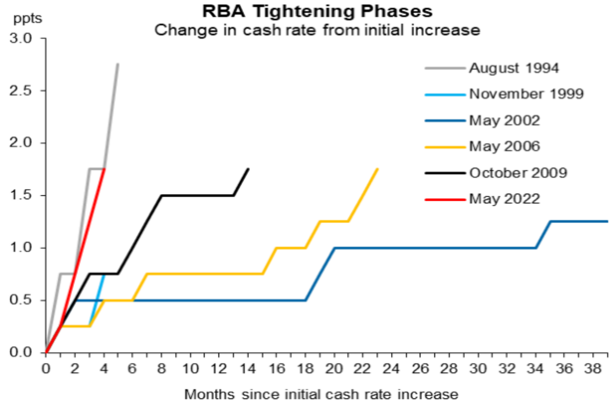
RBA Watch: Another 50bps rate hike with more to come

- The RBA Board raised the cash rate by another 50bp yesterday, continuing what has been the most aggressive pace of monetary policy tightening since 1994.
- Yesterday's move was expected by the market, and markets interpreted the accompanying commentary as particularly dovish, but investors can expect the RBA to continue to push on with further (and aggressive) rate hikes as it seeks to bring inflation back down from lofty levels.
- Worryingly, the RBA once again raised its inflation outlook and is now forecasting a peak of 7¾% in 2022. In addition, they have also slowed the path of deceleration and do not expect inflation to fall back to 3% until 2024. It is clear, that despite further rate hikes and pain for borrowers, Australia will have to deal with inflation that sits well above the RBA target level of 2-3% for the coming few years.
- There was little to be encouraged about in yesterday's messaging by the RBA. Not only do they expect inflation to rise further than previously forecasted, but they expect it to stay higher for much longer. The governor also made clear that the path for rates is not pre-set and that a faster pace of rate hikes cannot be ruled out.
- Macquarie's macro team are not optimistic that central banks will achieve their inflation objective without a larger rise in unemployment rates and the RBA has also made clear that they are treading a fine line and that keeping the economy "on an even keel" will be extremely difficult with the RBA's updated forecasts for the unemployment rate to rise to only 4%, and inflation to fall to ~3%, by end-2024, as close to a Goldilocks forecast as you'll see.
- At this stage, rates are still set to rise, financial conditions are still tightening and the impact on the real economy is underway. There is significant pain to come for the real economy with the risk of a policy mistake high. We think investors should wait to see how the path of policy evolves before chasing risk assets higher.

RBA delivers another 50bp rate hike

As expected, the Reserve Bank of Australia (RBA) Board increased the cash rate by 50bps to 1.85% at their latest meeting, continuing what has been the most aggressive pace of monetary policy tightening since 1994. Macquarie expect another 50bp hike in September before the pace of tightening slows, with a cash rate of 2.85% anticipated by year-end. Thereafter, they expect rates to peak at 3.10% by early 2023.

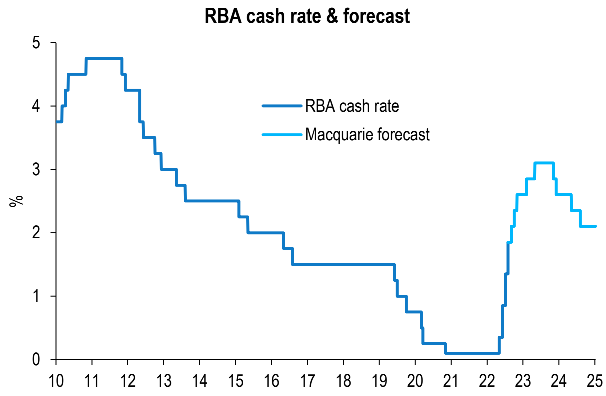
RBA continues on an aggressive tightening path…



Source: Macrobond, RBA, Macquarie Macro Strategy, August 2022

In recent weeks, markets have significantly wound back the degree of expected RBA rate hikes and now anticipate a cash rate peak of a little more than 3%, in part reflecting that high inflation is more or less priced in and markets are shifting their focus now to the potential downside risks to the global growth outlook. Markets are betting that central banks can successfully "thread the needle" and are able to fine tune policy tightening to the extent that they bring inflation back under control and avoid a recession. We think this will be a difficult ask.

…with further tightening still to come



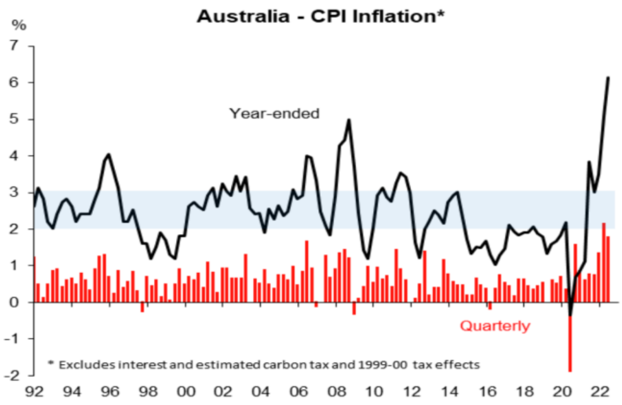
Source: Macquarie, MWM Research, August 2022

Inflation has yet to peak…

Accompanying the rate rise, the RBA has also once again raised its inflation outlook and is now forecasting a peak of 7¾% in 2022 (versus a forecast peak of 7% just 2 months ago). In addition, they have also slowed the path of deceleration and do not expect inflation to fall back to 3% until 2024 (versus its previous forecast of inflation falling back towards the 2-3% range over 2023). It is clear, that despite further rate hikes and pain for borrowers, Australia will have to deal with inflation that sits well above the RBA target level of 2-3% for the coming few years.

Although the market interpreted the commentary as particularly dovish, Macquarie's macro team are more cautious about the path ahead. Not only do the RBA expect inflation to rise further than previously forecast, but they expect it to stay higher for much longer. The governor also made clear that the path for rates is not pre-set and that a faster pace of rate hikes cannot be ruled out. With Governor Lowe acknowledging that keeping the economy "on an even keel" will be extremely difficult, Macquarie sees the RBA's updated forecasts for the unemployment rate to rise to only 4%, and inflation to fall to ~3% by end-2024, to be as close to a Goldilocks forecast as we will get.

Inflation is still rising and broadening out



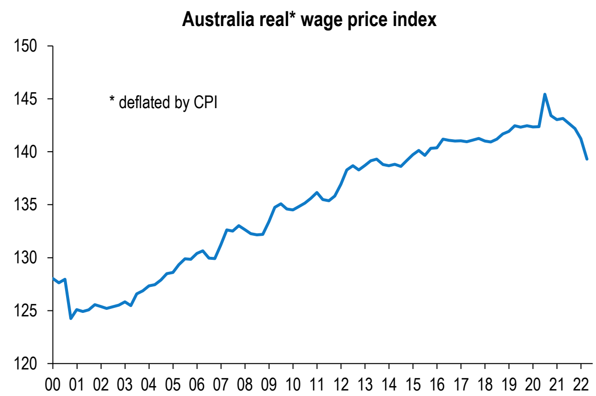
Source: Macquarie Research, August 2022

We think it is too early to suggest that central banks are now more dovish on inflation than they have been in prior months. It is more likely that policy tightening expectations became too pessimistic and they are now coming back to more realistic levels but we think that the tug-o-war between inflation (aka policy tightening) and growth remains intact even if inflation peaks and drops back quickly into 2H22 and beyond. While it is possible that central banks might begin to soften their narrative as economic growth risks rise, it is also possible that they push on with policy tightening and show little tolerance level for inflation to remain above their desired target - at this stage we don't know what "success" looks like for central banks (or the RBA for that matter).

…and growth headwinds are building

The RBA had also downgraded its forecasts for economic growth to 3¼% over 2022, and 1¾% in 2023 and 2024 (versus 4¼% in 2022 and 2% in 2023 and 2024 previously). Although domestic data appears intact for now, with unemployment at a near 50-year low, solid business investment, and household consumption still holding, growth headwinds are building and not falling – and will only increase as we get deeper into the tightening cycle. Current conditions are expected to act as a buffer against a deep downturn rather than prevent further economic weakness.

Real wages have fallen 4% from their peak



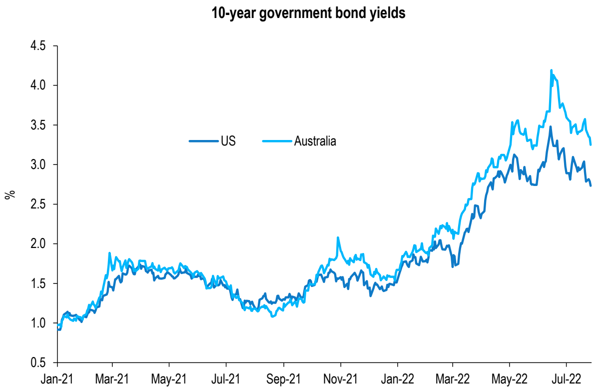
Source: Factset, MWM Research, August 2022

For now, inflation has still yet to peak and we expect policy conditions to continue to get tighter as the RBA fights to control inflation. While the labour market is tight, this is a lagging indicator and consumers will face rising pressure, with sentiment already declining. Real incomes have already fallen ~4% from their peak (largest fall since the early 2000s), debt servicing costs will continue to rise, and collateral values (housing) are declining. Australia's inflation problems are lagging the world and still rising, and if Australia is set to follow the path of the US and other economies, then there is more pain to come.

Investment implications

We moved overweight sovereign bonds at the start of June and we think they are a strong hedge against rising growth risks. For equities, we still think it is too early to bet on a policy pivot and on central banks being able to engineer a soft landing (when history says this rarely if ever happens). We don't think it is wrong that risk assets have rallied as peak rate expectations have fallen given the decline has been substantial (from 3.9% a month ago to only 2.9% at present), but it is concerning that bond yields have not stabilised through this period. Instead, they have continued to decline which suggests that the bond market is getting more and not less concerned about growth vis-à-vis equities which are signalling the reverse.

Bond yields appear to have peaked



Source: MWM Research, Factset, August 2022

It appears the best-case scenario is that central banks can drive a small increase in unemployment, a small decline in aggregate demand, a short correction in investment spending and a moderate decline in consumer spending. We think there is still some pain to come for the real economy here in Australia and for other economies as well before conditions begin to improve and we can be comfortable that risk assets have the support of policy conditions and growth momentum.

At this stage, rates are still set to rise, financial conditions are still tightening and the impact on the real economy is still underway. To assume this is not to assume we are preparing for a hard landing, but we would rather see some signs in the data that conditions are improving and that central banks are prepared to pivot. For Australia we think this is still some way off. Time will tell whether recent rallies will last but we would rather wait and see some evidence before betting that the markets have found a sustainable bottom.

Macquarie WM Investment Strategy Team

The report was finalised on 3 August 2022.

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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