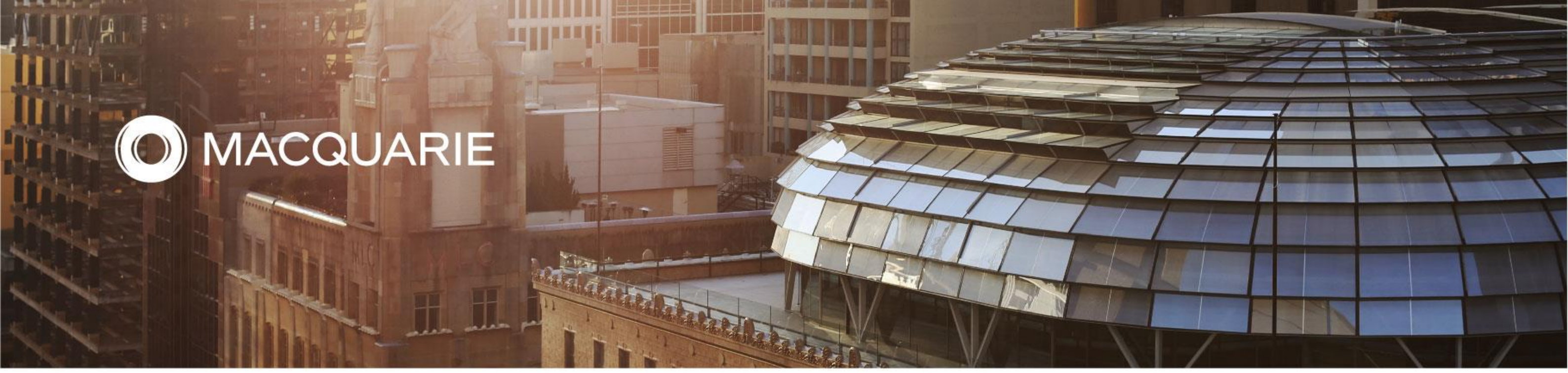


Investment Strategy Update #119

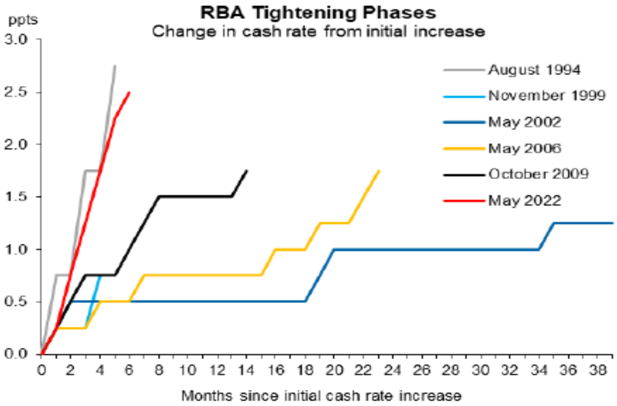
RBA adopts a wait and see approach

- Yesterday, the RBA surprised with a 25bps rather than a 50bps rate hike. But the bigger surprise was how the equity market took this as an unambiguous positive signal and rallied nearly 4%.
- Macquarie's economics team think the RBA has simply extended the duration of its rate hikes without reducing how high rates will go. However, the consensus has moved quickly to reprice short rates and the terminal rate lower, and this helps explain why equities, and in particular long duration / rate sensitive stocks, led the equity market higher.
- The RBA is dealing with an inflation problem (now) and a growth problem (later). We don't think they are dealing with a credibility problem, so we assume that slowing the pace of rate hikes is a pragmatic response to the tightening that has already taken place, giving them some time to assess the implications.
- We don't think yesterday's move by the RBA signals the start of a sustained rally in the equity market, but it does help reduce downside growth risks and boosts sentiment by signalling that they might be closer to the top than expected. However, it is the Fed that will ultimately determine the direction of global markets and Macquarie's economic team believe they still have some way to go in raising rates or approaching a pivoting policy.
- We like the "wait and see" approach by the RBA. It might mean we live with inflation for longer, but they buy themselves some time and the response by the bond market (pushing yields lower) is supportive for equities. We caution against getting overly bullish. The inflation fight is not over and the RBA has not finished. In addition, equities are still up against high inflation, elevated bond yields and a deteriorating earnings backdrop and these are significant headwinds. We maintain our underweight on equities.

For most of this year, we have been honest about what we don't know. We didn't know how aggressive the RBA would be in tackling inflation and we didn't know what their tolerance level was in terms of the amount of growth they would sacrifice to do this. Instead of tying ourselves to point forecasts, we simply took the view that rates had to move higher (at least into restrictive territory) and that growth would need to slow meaningfully (but probably not down to recessionary levels).

We approached the outlook in this way because we doubted the RBA knew the answers to these questions themselves. In effect, they were also flying blind as they attempted to achieve the holy grail of reducing a 40-year inflation high while also avoiding recession. Given how volatile cash rate forecasts and in particularly the terminal rate have been, it's clear that many economists and market participants didn't know either. That's why in the past 6 weeks the terminal rate jumped from 3.8% to 4.2% only to fall to 3.6% yesterday. In other words, there was a lot of guessing, but in reality, everyone gave themselves the right to change their views based on the evolution of economic data and the response of the RBA.

RBA's cash rate increases remain aggressive compared to historical tightening phases



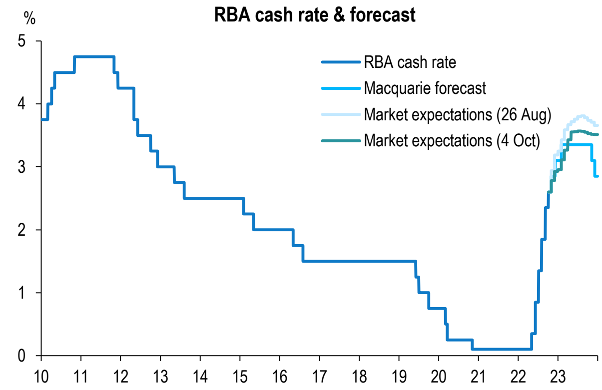
Source: Factset, Macquarie Research, October 2022

This gets us back to yesterday's developments where the RBA raised the cash rate by 25 basis points instead of the 50 basis points that Macquarie (and consensus) had expected. As such, it was a positive surprise but within the bounds of possible outcomes (either 25bps or 50bps). But relatively speaking, this was not really the surprise. The bigger surprise was how the equity market reacted, rising nearly 4%.

Maybe the market was ripe for a rebound and any catalyst would do. Maybe we are underestimating the dovish signal that the RBA just sent. Or maybe it's somewhere in between, but to be honest, we are still not sure. The RBA has shifted towards a more pragmatic approach in dealing with inflation. It has pushed through the fastest rate hike cycle since 1994 and now it has taken its foot off the accelerator - not completely because it still raised rates by 25bps - in order to gauge the effects and reduce the risk that it might over tighten. This seems a sensible way to approach the outlook if the risk to inflation is down. If it isn't, then their actions will look premature and will require an extension of the rate hike cycle a little longer.

Macquarie's economics team are wary of the RBA's actions. They had expected a 50bps hike and for the terminal rate to end at 3.35% by year end. They now think they terminal rate will still end at 3.35% but only that it takes one more meeting to get there (February 2023 instead of December 2022). But, while Macquarie has not had to adjust its terminal rate because it was already on the conservative side, we have seen consensus expectations tumble and this was the fuel for the equity market rally.

Cash rates are forecast to peak in 1Q23



Source: RBA, ASX, Macquarie Research, October 2022

If we are in a backdrop where the RBA does not need to raise rates as far, keep them there as long or cuts them earlier, then the reaction by equities might have been a little exuberant, but it was certainly in the right direction. However, given the rally also came after a period of weakness (the ASX200 had fallen 7.9% in the past few weeks), and off the back of a rebound in global markets, it was probably ripe for a rally - regardless of the catalyst.

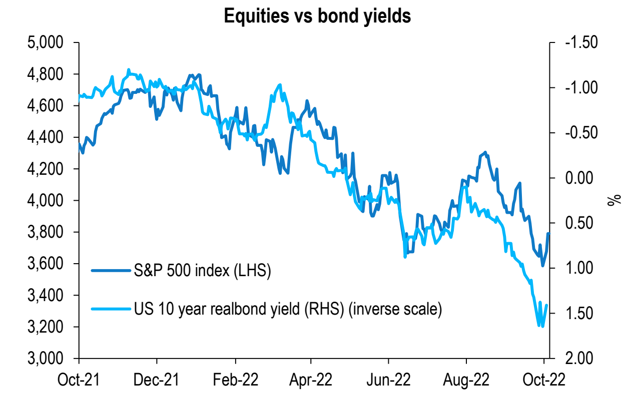
The question is where does this now leave us? A more pragmatic approach by the RBA does reduce the risk of over tightening and this is clearly positive for the economic outlook and equities. In addition, a decline in short rates and terminal rate expectations is also positive for rate sensitive areas and valuations (but given how rate expectations have moved up, down and all around in recent months, we are not so sure they are anchored at the current level either).

The fly in the ointment is that the RBA's highest priority target - inflation - isn't falling and, according to their forecasts, is still set to rise. Similarly, the labour market has shown few signs of slowing and the consumer is still spending at a rapid clip. Granted, policy works with a lag and so we are yet to see the full effects of tightening, but there is also a risk that the RBA is now undercooking it and that it just sent a signal that undermines its intentions of slowing domestic demand.

We like what the RBA did. We didn't expect it, but it is taking a wait and see approach even though it has made little progress on bringing inflation down or slowing domestic demand. The expectation was that policymakers would want to see some evidence that this was happening before they changed their tune and softened their stance. But waiting wouldn't have been a normal course of action because policy works with a lag. Perhaps global developments and the ongoing commitment by the Fed as well as growth weakness throughout Europe is giving the RBA some breathing room and doing some of the hard work for it.

Regardless of the rationale, and only those in the RBA's inner circle will ever know, this was a positive development because it is reducing the tail risk of inadvertently pushing the economy into recession via overly aggressive rate hikes. The RBA can always keep going at a more measured pace if it wants. But it is not all bullish. Rates will rise further (Macquarie expect 25bps in the next 3 meetings). The economic slowdown is still to come and while we are not forecasting recession, we are expecting to see a meaningful slowdown in consumer spending.

Equities are hostage to bond yield movements



Source: Factset, MWM Research, October 2022

Equities have popped. But we would like to see some evidence that there has been a permanent decline in interest rates that can justify a sustained re-rating of high multiple stocks (such as technology) or rate sensitive areas such as real estate, utilities and telecoms. Alternatively, we'd like to see some evidence that risks to the growth outlook have now declined which might be the case domestically, but certainly not globally. Last, if this really is the bottom for the equity market, then it certainly didn't get cheap, and unless rates decline quickly, that will make the valuation optics look tough even if earnings risks have fallen.

At this stage, the bond and equity markets remain closely linked. If yields keep falling, then equities will have a strong tailwind. But if yields have already reset, then equities will once again be hostage to economic and policy developments and these might not be bad, but we suspect they won't be great. At this juncture, we remind investors that Australia's inflation problem has not been solved and that arguing it's not as bad as other developed economies makes no sense. Australia's economic slowdown is coming and avoiding recession doesn't make it good. It just makes it less bad.

Finally, equities upside is driven by two things - expanding valuations or rising earnings. The former requires falling bond yields and/or expanding liquidity. The later requires improving growth (or a rising profit share). The RBA could be closer to a policy pivot than Macquarie expected, but without this, the conditions on the ground are still not ideal.

We think the real upside for risk assets will come when the Fed reaches the same stage and, according to Macquarie's economics team, they are not there yet. Less bad is still not good and we think continued caution is required until we see further evidence that the RBA is shifting the goalpost or that other central banks are closer to the end of their rate hike cycles.

Macquarie WM Investment Strategy Team

The report was finalised on 5 October 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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