BULLETIN

23 June 2022

RBA to hike rates by 50 basis points in both July and August – terminal rate to reach 2.6%

Last week we lifted our forecast for the terminal US federal funds rate in December from 2.675% to 3.375%.

We now expect this more aggressive approach to see the US economy stalling, with the risk of a mild recession in the second half of 2023.We expect a need for a series of rate cuts from December 2023 eventually taking the federal funds rate back to 2.125% through 2024.

That cycle for the remainder of 2022 will entail increases of 75bps in July; 50bps in September; 25bps in November and 25bps in December.

This shift toward higher global rates has also led us to lift our terminal rate for the RBA's tightening cycle, from 2.35% to 2.6%. Note that this is still significantly short of the market's forecast terminal rate of around 4.5% and only a 25bp upward revision compared to the 75bp lift in the federal funds profile.

The 2.6% is broadly in line with the '2.5% guideline' the RBA Governor has given in speeches and other commentary (from his ABC interview on June 14: "I think it's reasonable that the cash rate gets to 2½ per cent at some point").

The sensitivity of the Australian economy to the RBA cash rate is markedly higher than the sensitivity of the US economy to the federal funds rate. Around 60% of Australian mortgages are on floating rate terms with a further 75% of the remaining fixed rate loans set to mature by the end of 2023.

Effectively 90% of mortgage borrowers are directly exposed to moves in the RBA cash rate over the next year and a half. The rate affects borrowers and homeowners through multiple channels, including: the cash flow of existing borrowers; the capacity of prospective borrowers to obtain and service new loans; the wealth effect from associated adjustments in house prices; and via confidence effects.

In the US, the current surge in the mortgage rate only affects new borrowers directly as existing borrowers typically have fixed rate mortgages up to 30 years.

The more direct impact of the federal funds rate on financial assets in the US is through the equity market and confidence.

This 25bp upward revision in the forecast terminal rate is likely to manifest as a 50bp increase in the cash rate at the August Board meeting – revised up from our previous forecast of 25bps.

That would push the cash rate from our forecast 1.35% (following the expected 50bp lift at the upcoming July meeting) to 1.85% after the August meeting – firmly in our estimated 'neutral zone' for policy in Australia of 1.5-2.0%.

The August Board meeting will respond to what is expected to be a very unsettling June quarter inflation report set to be released on July 27.

We expect headline inflation to lift 1.5% in the quarter taking annual inflation from 5.1%yr to 5.8%yr. Underlying inflation, as represented by the trimmed mean, is expected to print 1.2% in the quarter for a lift in annual inflation from 3.7%yr to 4.5%yr.

We see the risks to these numbers to the upside.

After responding firmly to the further significant uplift in inflation – moving the cash rate into the 'neutral zone' and signalling a clear commitment to containing inflation and inflationary expectations – we expect the RBA to pause.

Consistent with our previous view, we expect the pause for two months to assess the impact of the rapid cumulative 175bp increase over four months.

As the Governor noted in this week's speech to the American Chamber of Commerce, the key high frequency data he will be watching will be around consumer spending, particularly consumer durables and the housing market – not just house prices (as a pointer to wealth effects) but also with respect to dwelling construction and other housing-related expenditure.

It is noteworthy that a swift move to 1.85% will still only restore the cash rate to slightly above the 1.5% that held for nearly three years between August 2016 and May 2019, when inflation persistently undershot the Bank's 2-3% target zone.

Moving swiftly to reverse what is clearly an over-stimulatory policy setting and then pausing before moving into the 'contractionary zone' is the best approach, and one that is most likely to avoid the damaging overshoot we are forecasting for the FOMC.

Such a strategy would also assist in the central objective of the tightening cycle: to signal clearly to economic agents – households and trade unions in particular – that the Bank is committed to returning inflation to target over the medium term, thereby containing any lift in inflation expectations.

In his speech, the Governor made a major point around the key objective of containing inflationary expectations.

Our central case remains that, following the release of the September quarter inflation report on October 26, a further tightening will be seen as necessary at the November Board meeting.

In that report we expect annual headline inflation to be steady at 5.7%yr (due in part to state government subsidies temporarily forestalling the effect of a big rise in electricity costs), but underlying inflation to have lifted from 4.5%yr to 4.8%yr.

The next move would put policy into the contractionary zone. As such, it would be prudent to revert to proceeding in 25bp increments given the added uncertainty around the impact of each move.

We continue to expect a further move in December and a final 25bp lift at the February Board meeting in response to the December quarter inflation report.

The December quarter is expected to see the peak in both headline and underlying inflation. (6.6% and 4.8% respectively). Having responded to that move it would be prudent to go on hold to assess the economy's response to a cumulative increase in the cash rate over nine meetings of 250bp.

Such a move would be the second fastest tightening cycle since 1990, exceeded only by the 275bp increase over five meetings in the second half of 1994.

Our forecast is that, along with the clear slowing in the economy over the December and March quarters in particular, the March quarter inflation report will provide evidence that the slowing in demand and the freeing up of supply has brought demand and supply into closer alignment easing inflation pressures.

In the March inflation report we expect annual headline inflation to have fallen from 6.6%yr to 5.6%yr and underlying inflation to have fallen from 4.8%yr to 4.2%yr.

That evidence would be available by the May 2023 Board meeting, allowing the Board to move to a 'wait and see' approach, potentially signalling the end of the tightening cycle with the cash rate having reached 2.6%.

We also expect that the evidence around the sharp slowdown in the US economy will be a signal to the Board that steady policy is appropriate.

Markets have no sympathy with our view that the RBA can chart this course. They would point to the unsustainability of Australia's cash rate settling 87.5bp below the federal funds rate.

Australia's soft landing will allow the RBA to hold rates steady in 2023 and 2024 as inflation gradually eases back into the 2-3% target zone.

On our forecasts, after the FOMC is forced to reset policy in the aftermath of its economy stalling and potentially falling into recession, the RBA cash rate would settle around 50bps above the federal funds rate by the second half of 2024.

We accept that our forecasts for the cash rate assume a successful navigation of a very narrow path towards a soft landing.

In particular, the risks that we have seen recently with large increases in wage settlements are unsettling. That is why it is so important for the RBA to be decisive in the early stages of the tightening cycle with that clear message that it is committed to containing inflation risks.

A swift move into the neutral zone is a critical step and we strongly support adopting those three consecutive 50bp moves before a pause in September.

Bill Evans, Chief Economist

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