BULLETIN

23 September 2022

We have lowered our AUD forecast to US 65¢ by end 2022

Following the September meeting of the FOMC we have raised our terminal forecast rate for the federal funds rate from 4.125% to 4.625% peaking at the January 2023 FOMC meeting.

That forecast follows the near term guidance we saw from the FOMC in their latest Report.

That entails us lifting our expectation for the November move from 50bps to 75bps; no change from our 50bps call for December; and a final 25bp movement in late January (revised up from “on hold”).

The Committee’s estimates are finely balanced for November/ December with only one member needed to tip the median down to a total of 100bps from the current median of 125bps. But we assess that, based on the press conference, Chairman Powell is in that more hawkish group.

Despite increasing the terminal rate for the federal funds by 50bps we have held the expected terminal rate for Australia steady at 3.6%.

The expected timing of the final RBA hike is unchanged for the February Board meeting in 2023, coming just after the final increase in the federal funds rate in late January.

We expect that both central banks will choose to hold their rates steady through the remainder of 2023 until there is convincing evidence that they are nearing their inflation targets.

Over the course of 2023 we expect that the Australian economy will slow to a growth rate of 1% with the US growing even more slowly at 0.5%. Classical recessions cannot be ruled out in either jurisdiction.

Given we have lifted our federal funds rate terminal by a further 50bps (after the 75bp lift following the recent US Inflation Report) why not lift Australia’s rate further?

Recall that when we recently lifted the federal funds rate target by 75bps we lifted the RBA terminal rate by 25bps.

But the Australian economy is more sensitive to the overnight cash rate than the US economy will be to the federal funds rate.

Recall that 60% of Australian mortgages are floating rate and around 80% of the fixed rate mortgages are set to run off by end 2023, around 90% of Australia’s mortgage market will be directly impacted by the overnight cash rate by end 2023.

Even though only one third of households in Australia hold mortgages, with one third tenants and one third outright owners, interest rates affect all households.

Mortgage borrowers’ cash flows are impacted; investors try to pass on their higher funding costs to tenants, especially in those cities where vacancy rates are near historical lows; and outright owners are suffering significant negative wealth effects.

The RBA has moved rates very quickly to 2.35%, which is below the assessed neutral level of at least 2.5%.

We continue to expect that once the rate is increased by 50 basis points to 2.85% at the October 4 meeting, which is into the contractionary zone, the Board will slow the pace back to 25 basis points for the November, December, and February meetings.

Two of those meetings (November and February) will follow Inflation Reports and while we expect those Reports to signal the need for higher rates, we expect the response will be 25 basis point moves, given the “treacherous lags” that will have built up in the system following the rapid increases since May.

If the RBA does not respond to the likely higher profile for the US federal funds rate, the adjustment will occur through the Australian dollar.

We have lowered our forecast for the AUD by year’s end from USD0.69 to USD0.65.

We still expect the AUD to lift against the USD in 2023, with most of the recovery occurring in the second half of 2023 but have lowered our forecast for end 2023 for AUD from USD 0.75 to USD0.72.

The case for a rising AUD in 2023 is supported by:

- Our “above Consensus” forecast for growth in China; and the Asian region in 2023.
- Australia’s commodity export prices holding up better than current market expectations.
- The importance of a return to some certainty around central banks and inflation. Markets will respond to slowing inflation and acceptance that central banks have gone on hold. We expect the “on hold” signal to be clearly embraced by markets by the second quarter of 2023 – ahead of current market expectations.
- That return to some policy certainty will boost “risk on” appetite.
- Recognition of the damage to the US economy from FED policies and the need for rate cuts by the FED in 2024. This recognition will see an easing in bond rates through 2023 in anticipation of 150bps in fed rate cuts in 2024.
- That 150bps will compare with a likely 100bps of rate cuts expected for the RBA in 2024, narrowing the expected yield differential.

There are two standout risks to this scenario:

- The global economic downturn that is expected for 2022H2 and 2023 is deeper and more sustained than we currently expect. Uncertainty about the depth and duration of the downturn will constrain any move to “risk on”.

- Inflation proves to be much “stickier” than we currently expect, forcing central banks to “restart” their tightening policies, or, at best, delay rate cuts.

We have significantly lowered our 2022 end year “target” for the AUD to USD0.65. That means that over the remainder of 2022 there will be periods when the AUD will trade below the USD0.65 level given the high volatility in currency markets to date.

Despite the higher base level of the federal funds rate over the forecast period we have neither accelerated or extended the likely easing in the federal funds rate in 2024. We still expect 150bp of easing in the rate in 2024. That compares to the 100bp of easing we expect for the RBA in 2024. By end 2024, that would have the fed funds rate at 3.125% and the RBA cash rate at 2.60%.

Furthermore, we continue to expect both central banks to keep rates on hold from the March quarter 2023 – an earlier peak than is current expected by markets.

For the higher federal funds rate profile, we have added 20bps to the US 10 year profile and 30bps to the US 3 year profile.

We have narrowed the spread between US and AUD long bonds from 20bps to 10bps and lifted the AUD 3 year bond rates by 20bps to reflect the higher US rates.

The market’s adjustment to the recent repricing has been to boost the RBA terminal rate to 4.1% (well above our 3.6%) and as a result the market repricing of Australian bond rates has been significantly more extreme than we envisage to be sustainable.

Bill Evans, Chief Economist

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