BULLETIN

17 March 2023

# RBA to pause in April before final rate hike in May

We have lowered our terminal rate for the RBA in this tightening cycle from 4.1% to 3.85%.

We now expect a pause in April to be followed by a final increase of 0.25% at the May meeting.

Prior to the Governor's surprisingly hawkish response to the December quarter Inflation Report where he effectively signalled consecutive rate hikes in both March and April, Westpac had expected that there would be a pause in April with a final hike in May.

The Governor has had an 'about-face' following the March Board meeting. He responded to the disappointing growth print for the December quarter; the slower than expected wages gain in the December quarter; and the 0.4% fall in the monthly inflation index in January.

In the Statement following the March decision he noted: "The Board expects that further tightening of monetary policy will be needed … assessing when and how much further interest rates need to increase…"

So, the tentative signal in March was much changed from the confident signal in February.

Following a speech the next day (March 8) the Governor noted that a pause in April would be considered in the light of the data flow out to the Board meeting on April 4 – specifically: the business surveys; the February employment report; the February retail sales report; and the monthly inflation indicator report for February.

We have now seen the main business survey (NAB) which showed that business confidence fell quite sharply, although business conditions, while weaker still held at above average levels.

The employment report for February was relatively strong – a lift in employment of 64,600 jobs and a fall in the unemployment rate from 3.7% to 3.5% (to two decimal places the fall was a more modest 0.13pts from 3.67% to 3.54%).

This report is significant as it means the view that unemployment had bottomed out and was starting to trend higher now requires more information to be confirmed.

In terms of the Governor's check-list, confirming a sustained shift towards easing labour market conditions would be a particularly encouraging sign that domestic wage-driven price pressures were likely to remain contained.

The other really important data series – the monthly inflation indicator report for February – does not print until March 29th. In January the Index fell by 0.4% from December with some key components slowing, including: new dwelling costs (from 0.9% in December to 0.5% in January); holiday travel (+27.0% to -7.2%); and clothing (+2.1% to -5.0%).

The February report will be important confirmation of this sudden turnaround in inflation trends. Westpac is sceptical and expects the monthly indicator to lift again, by 0.6% in February, with the January update overstating the extent of slowing.

**Global financial market developments**

But the major change since the March RBA Board meeting has been the adverse developments in global markets.

At the start of the month there was active discussion about whether the FOMC would hike by 50bps at its March 21/22 meeting. Now markets and many analysts are contemplating no move at all.

We think a shift to no change is a bridge too far for the FOMC and still expect it to raise the cash rate by 25bps at next week's meeting. But we anticipate real uncertainty will continue to surround the prospects for policy thereafter.

As we write, the most realistic risk scenario for the US economy involves a credit squeeze from regional banks (generally those with assets below $250bn, and that are not subject to the strict Dodd–Frank regulations, having been exempted following active lobbying of the Trump government in 2018). As markets, regulators and rating agencies restrict the capacity of these smaller banks to support SMEs and small business (around 50% of total market coverage) a new drag will emerge for the US economy. This is also likely to undermine confidence and raise some questions about the stability of the global banking system.

Wildly gyrating markets are highlighting the uncertainty around this scenario.

Despite current market pricing, which anticipates a series of rate cuts by the FOMC in 2023, we continue to favour an easing cycle that only begins in 2024. Inflation will remain too high through most of 2023 to allow the FOMC to start cutting rates any earlier.

By 2024, inflation will have fallen to a level consistent with the FOMC easing off on the monetary pressure and moving policy to a less restrictive setting.

If credit developments intensify beyond our current expectation, then more drastic action will be required from the FOMC.

**Change to FOMC view**

Our current prior, that the FOMC will extend the tightening cycle to cover both the May and June Board meetings, now looks less likely given the realistic chance that a credit slowdown will do some of the Fed's work for it.

Accordingly, we now see the March hike as the final move in the FOMC's tightening cycle.

While hiking cycles continue near-term for the FOMC and ECB (which has just raised rates by 50bps) we expect the RBA to pause at its April meeting.

Positioning prior to the recent market turmoil is key here.

Whereas the FOMC and ECB have both been 'talking up' the prospect of rate hikes, the RBA has adopted much less hawkish rhetoric following the March meeting, signalling that a pause on hikes was already on the table for its April meeting. Despite the better than anticipated employment report, we expect the risks around financial market developments and the evidence of the soft data since the February Board meeting will prompt the RBA to use its 'pause option' in April.

Even if the markets settle by the time of the RBA's April Board meeting there will be sufficient uncertainty for a prudent Board that was already clearly open to a pause to take that option.

**Pause in April followed by hike in May**

For the following Board meeting in May the issues will be more clear-cut.

The Board will have the benefit of refreshed staff forecasts, especially for inflation following the March quarter inflation report (due April 26). Note that the monthly inflation indicator reports do not include estimates of core inflation measures such as the trimmed mean.

We expect the March quarter report will show core inflation still running at 6.7%yr, down only slightly from 6.9%yr and that the RBA's updated forecasts will show no marked improvement in the inflation outlook.

We do not think that a further pause would be credible in the face of ongoing high inflation and prospects of not returning to the target band until mid-2025.

Recall that the RBA currently forecasts headline inflation to still be holding at 4.8% in 2023.

We expect a further lift in the cash rate from 3.6% to 3.85% at the May meeting.

By the time of the June meeting, with the cash rate deeply in contractionary territory, the economy slowing at a more rapid pace, and evidence from the March quarter wage price index that the trajectory for wages growth remains moderate, it will be appropriate to delay any further tightening until the next quarterly inflation report, released ahead of the August Board meeting.

We expect that by August the case for pushing the cash rate even further into contractionary territory will be weak as the economic slowdown becomes more entrenched and as we start to see real progress in lowering inflation, especially if global credit issues continue to impact growth and markets.

**Rate cuts to follow in 2024**

We maintain our call that the preconditions for the beginning of the easing cycle will be apparent in the March quarter of 2024. These include a fall in the inflation rate to below 4%; policy deeply in contractionary territory (we see the neutral cash rate as being around 2.75–3.0%); the economy stagnating through the second half of 2023 and the prospect of continued weakness in the first half of 2024; the unemployment rate heading towards 5% by end 2024; and wages growth slowing from a 2023 peak of 4%.

As discussed, we also expect that the FOMC will have succeeded in driving down US inflation by holding the federal funds rate at a clearly contractionary level through 2023 allowing the beginning of an aggressive easing cycle by the FOMC.

The RBA will always respect guides on policy from the FOMC. Note that our revised RBA and FOMC profiles restore a natural order for the tightening cycles. With wages growth lifting in Australia and Australia's credit market much more resilient than the US it seems appropriate that Australia's tightening cycle (peaking in May) will lag the US cycle (peaking in March).

**Bill Evans, Chief Economist (WestpacGroup)**

## INTEREST RATE FORECASTS

| Australia | 17-Mar-23 | Jun-23 | Sep-23 | Dec-23 | Mar-24 | Jun-24 | Sep-24 | Dec-24 | Mar-25 | Jun-25 | Sep-25 | Dec-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash | 3.60 | 3.85 | 3.85 | 3.85 | 3.60 | 3.35 | 3.10 | 2.85 | 2.60 | 2.35 | 2.35 | 2.35 |
| 90 Day BBSW | 3.66 | 3.95 | 3.95 | 3.97 | 3.72 | 3.47 | 3.22 | 2.97 | 2.72 | 2.48 | 2.60 | 2.60 |
| 3 Year Swap | 3.55 | 3.65 | 3.60 | 3.50 | 3.40 | 3.20 | 3.00 | 2.90 | 2.80 | 2.70 | 2.60 | 2.60 |
| 3 Year Bond | 3.03 | 3.20 | 3.20 | 3.15 | 3.10 | 2.95 | 2.80 | 2.70 | 2.60 | 2.50 | 2.40 | 2.40 |
| 10 Year Bond | 3.44 | 3.60 | 3.40 | 3.20 | 3.00 | 2.80 | 2.70 | 2.50 | 2.45 | 2.45 | 2.45 | 2.45 |
| 10 Year Spread to US (bps) | –14 | –10 | –10 | –10 | –10 | –10 | –10 | –10 | –5 | –5 | –5 | –5 |
| **US** | | | | | | | | | | | | |
| Fed Funds | 4.625 | 4.875 | 4.875 | 4.875 | 4.375 | 3.875 | 3.375 | 2.875 | 2.375 | 2.125 | 2.125 | 2.125 |
| US 10 Year Bond | 3.58 | 3.70 | 3.50 | 3.30 | 3.10 | 2.90 | 2.80 | 2.60 | 2.50 | 2.50 | 2.50 | 2.50 |

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