BULLETIN

28 April 2023

RBA Board to pause again at its May meeting: 3.6% now the likely cash rate peak

The Reserve Bank Board meets next week on May 2.

Following the release of the March quarter inflation report Westpac now expects the Board to extend the pause it instigated at its April meeting to the May meeting.

This decision will be despite the likelihood that the FOMC will announce the decision to lift the federal funds rate by 0.25% to 5.125% two days after the RBA meeting (see below). However, as with the RBA, we do believe that this decision will mark the peak of the cycle.

We have always argued that May would likely be the peak of the tightening cycle so we are now lowering our forecast cash rate peak from 3.85% to 3.6%.

Given the uncertainty around the current outlook and a need to contain inflation expectations, the Board is almost certain to maintain its clear tightening bias. However, as we move through the remainder of 2023 the credibility of that bias is likely to fade.

In his recent speech on April 4 the Governor justified the pause in April by saying that it would: "give the Board more time to assess the economic outlook and the impact of the increases in interest rates so far." He expanded that: "This approach is consistent with our practice in earlier interest rate cycles … to move interest rates multiple times then wait for a while to assess the pulse of the economy and move again if the situation warranted doing so … it is a return to that world."

The key information available between the two meetings has been around the labour market and inflation.

The March employment report was relatively strong, indicating that, for now, the unemployment remained near 50-year lows. Given that the Board is aiming to return inflation to its target while retaining, as far as possible, the employment gains in recent years, this would not necessarily be viewed as 'bad news' if there was satisfactory progress on achieving the inflation objective.

The Governor describes the inflation objective in terms of reaching the top of the of the 2–3% target range by mid-2025.

That path has been laid out in the Bank's forecasts in the February Statement on Monetary Policy (SOMP). These have trimmed mean inflation slowing from 6.9%yr in December 2022 to 6.2%yr by June 2023, while headline inflation slows from 7.8%yr in December 2022 to 6.7%yr in June 2023.

These forecasts imply an expectation that the March inflation report would print at around 6.5–6.6%yr for trimmed mean and 7.2–7.3%yr for headline inflation.

It seems very unlikely that the staff's refreshed forecasts, which will be supplied to the Board at the May meeting, will indicate that the timing of the achievement of the inflation target needs to be pushed out further – a change that would require an immediate policy response from the Board.

Instead, it seems likely that the staff's forecasts for household spending and GDP growth in 2023 will be lowered somewhat, supporting the view that there is scope to pause (see below).

The March quarter inflation report printed 6.6%yr for the trimmed mean and 7.0%yr for headline inflation. The trimmed mean path is in line with expectations while the headline print looks to be slightly lower than expectations.

That result for the trimmed mean contrasts with the December quarter which printed 6.9%yr compared to the Bank's expectations of 6.5%yr – an upside surprise that prompted the hawkish shift in rhetoric following the February Board meeting.

With the inflation result in line with the Bank's forecast path for eventually achieving its inflation target, the Board can take time to allow a further assessment of the cumulative impact of 350bps of tightening. That includes assessing the lagged impact on the roughly 35% of mortgages that are progressing from fixed rate to much higher floating rate terms over the course of the next year or so. In this unusual cycle, rate increases do not end just because the RBA goes on hold.

The RBA Governor's comment in the speech about "a return to that world" points to linking further decisions to quarterly inflation reports. While useful, the monthly inflation indicators do not provide measures of underlying inflation, and a reliable link between the monthly headline measures and the quarterly headline measures has not yet been established.

If we look forward to the Bank's June quarter forecasts of 6.2%yr trimmed mean and 6.7%yr headline inflation, we expect these 'milestones' to be easily achieved. Indeed, our own forecasts have headline Inflation back to 4% by December 2023, compared to the Bank's current path which sees it back at 4.8%yr.

Indeed, our weaker growth and inflation path means that the need for further tightening will fade decisively in the second half of 2023.

We have argued for the last six months that the peak in the current cycle will be the May Board meeting. Our preference was for that peak to be 3.85%, with a final 25bp hike in May based on the 'here and now' – record low unemployment and very high inflation – rather than relying on forecasts. We still believe this would be the better policy approach given the risks, but it appears to be out of line with the Board's intentions.

If, as we now expect, the peak will be 3.6% there are now some upside risks to our growth and inflation profiles through the second half of 2023, although there also look to be downside risks to the first half forecasts.

These upside risks are also associated with our recently revised view that the housing market has stabilised and that immigration has lifted markedly.

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On the downside, our already very weak profile for household spending may see a further downgrade given the prospect of a contraction in real retail sales in the March quarter. We are currently forecasting annual household spending growth to slow to 1.8% in the year to the June quarter and 0.7% in calendar 2023.

We currently forecast growth at 1% for 2023 with headline inflation at 4%.

These dynamics – materially below-trend growth and inflation closing in on the top of the inflation target – would be consistent with a rate cut cycle beginning in the March quarter.

The upside risks to the growth and inflation outlook in the second half of 2023 raise the possibility that the rate cut cycle may begin somewhat later, although this is balanced somewhat by downside risks to our near-term profile.

With the uncertainty around next week's meeting, we will review these issues in light of the Board's decision next week.

Revised forecasts in the Statement on Monetary Policy

In his April 4 speech the Governor gave considerable attention to household spending. He revealed the Bank's forecast for spending growth in the March quarter of 0.2%qtr. That implies a likely downward revision to the February SOMP forecast for household consumption over the year to June 2023, from 2.5% to 2% or less. Household consumption growth for calendar 2023 could be lowered from 1.7% to 1% or less, in turn implying a possible downward revision to GDP growth in 2023 from 1.6% to 1.3-1.4%. At the margin these numbers will also have to incorporate a higher profile for population growth.

Conclusion

The inflation report is in line with the Board's path to achieving its stated objective of having inflation back at the top of the 2–3% target by mid-2025. This provides the Board with further scope to extend the pause we saw in April.

The Board will still retain its tightening bias but given that the next 'live' meeting is likely to be in August (following the release of the June quarter inflation report) and that the need for further tightening will have eased further by then, the cash rate appears to have peaked at 3.6%.

Change to FOMC Forecast for 2023

The FOMC also meet for their May meeting next week. Recent data has continued to point to the US economy losing momentum and growing downside risks related to activity and the labour market. Concerns around credit availability following the disruptions to the regional banks are also prevalent.

Regardless, comments made by FOMC members ahead of the pre-meeting blackout point to a desire to take out a little more insurance against inflation risks. Recognising this, we now forecast one final 25bp hike by the FOMC in May to 5.125%.

A lengthy pause thereafter is still expected, but the deterioration evident in consumer and business investment partials, the ongoing softening in the labour market and risks surrounding the banking system most likely mean that the first cut will now be seen in December, leaving the federal funds rate at 4.875% at end-2023, unchanged from our prior forecast.

By December 2023, we expect inflation to be back near the 2.0% target on an annualised basis, making way for an additional 200bps of cuts during 2024, leaving the fed funds rate at 2.875% end-2024.

The easing cycle we envisage for the FOMC will begin earlier and be more rapid than the RBA in recognition of the highly contractionary starting point and the likely more severe downturn than we are forecasting for Australia.

Bill Evans, Chief Economist (WestpacGroup)

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