2 June 2023

RBA Board to hold the line at the June meeting

The Reserve Bank Board meets next week on June 6. The meeting is live in that the case for a further rate increase is likely to be seriously discussed. However, we expect the Board to decide to hold the cash rate steady at 3.85% while continuing to emphasise its tightening bias.

The line: “Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable time frame, but that will depend on how the economy and inflation evolve” is likely to be repeated in the Governor’s statement following the meeting.

Note that the qualifier “may be required” was used despite the Minutes for the May meeting showing that the Board had become more concerned about range of issues including: immigration; house prices; and the inflation forecast being to only reach the top of the target range by mid-2025.

Since the May Board meeting the Governor has been publicly voicing more concerns about inflation risks, particularly relating to wages.

However, it seems unlikely that he will choose to use stronger language than we saw in May. For example, stronger language would see “may be required” be replaced with “will be required”.

There are still too many uncertainties for him to choose to strengthen the guidance.

In particular, the March quarter national accounts are set to be released on June 7 – the day after the Board meeting.

The May Board Minutes correctly highlighted concerns about household spending, members observing that “the outlook for consumption was weak.”

Consumer spending slowed from 1% in the September quarter to 0.3% in the December quarter. Westpac notes that real retail sales contracted by 0.6% in the March quarter (compared to a decline of ‘only’ 0.3% in the December quarter) and vehicle sales have been flat while we have seen a marked deterioration in Westpac’s debit and credit card activity.

Overall we are expecting consumer spending to be flat in the March quarter, held up by services spend, but there are clearly some downside risks. Even a flat outcome will be a disturbing result and something that the Board should treat with care.

Due to upside surprises for construction and equipment investment, the headline GDP result is still expected to be positive but come in at a tepid 0.2% growth for the quarter – only just avoiding a contraction. With uncertainty, particularly around net exports, inventories and services spend, the Board should be deliberating on the basis that a negative GDP result is entirely possible.

With Board meetings every month and given the rapid increase in rates since May last year waiting for the national accounts report seems to be the most prudent approach.

This report will also provide important updates on other areas of concern for the Board, including the savings rate; productivity; labour costs and inflation.

Other data since the May Board meeting also emphasises uncertainty – most notably, a surprise lift in the unemployment rate in April, from 3.5% to 3.7% . We assess that this increase has been due to seasonal anomalies in April associated with the timing of Easter but, once again, it would be prudent for the Board to wait for further information to clarify the employment data.

The quarterly growth rate of the Wage Price Index held at 0.8% in the March quarter – the same as December, which had slowed from 1.1% in the September quarter. That came as a surprise to most commentators who were expecting a modest lift in wage momentum. The contribution from wages set by ‘individual arrangement’ – a highly cyclical segment – also slowed. Against this, the just-announced 5.75% increase to the national minimum and award wage rates is higher than last year’s average increase of 4.7% (and looks to be materially higher than Treasury’s assumptions) but is broadly in line with what our aggregate wage growth forecasts were already implying for 2023.

The monthly inflation indicator showed an increase in annual inflation to 6.8% up from 6.3% in March. The average monthly increase in the indicator in the first three months of 2023 was 0.1% compared to the 0.8% for April. A significant part of the increase in annual inflation was explained by fuel – reflecting the temporary halving in excise duty introduced in April last year. However, the strong April month rise came from rents; house purchase costs; and holiday travel and accommodation.

Because the Board has discussed the stickiness of services as an issue offshore the 7.2% increase in travel and accommodation might raise a few eyebrows but this highly volatile series follows +27% in December; and -7.2%; -14.6%; and +1.5% in the following months. Some of the April rise is also clearly seasonal – even with COVID effects, the monthly history back to 2019 shows a consistent pattern of price gains in April (averaging +7%) and falls in May (averaging –5.7%).

Volatile month to month moves mean the April result is not sufficiently definitive to trigger an immediate rate response. The full picture for inflation in the quarter will be released on July 26, ahead of the August Board meeting.

We suspect the Board is still not recognising the full extent of the impact of rate tightening to date. It discusses the lagged effect of the rate hikes since May last year but does not set out just how much of this is yet to come through. As at March (the latest month available), the average mortgage rate on outstanding loans has only lifted by just over 225bps since the start of the cycle, despite a cash rate rise of 325bps (with a further 50bps in tightening since then). About 25bps of this gap reflects lags in the pass-through of official rate moves to borrowers on standard variable rates. The rest reflects the high proportion of borrowers, around 30%, on fixed rate loans.

Many of these borrowers are still only rates of 2-3% due to extraordinary fixed-rate offers that were available when the RBA was providing lenders with three-year money at 0.1%.

As these fixed rate loans mature and are rolled over into floating rate at 5-6%, the average mortgage rate will continue to increase. The combination of lagged effects from official pass-through and this roll-over effective mean average mortgage rates will lift close to 100bps by year end, with more modest rises coming in 2024. In effect even once the RBA goes on hold mortgage borrowers on average will still see significant effective rate increases through the rest of this year and next.

Another concerning drag on households has been the surge in rents. There appears to be angst in the Board about the impact of sharply rising rents on inflation but our estimates indicate that wider housing cost inflation is likely to moderate as growth in construction costs cools rapidly – outright price declines even possible given the downturn in new residential building (note the 8.1% drop in dwelling approvals in April, now down a steep 24.1% for the year).

With around 30% of households being renters, sharp increases in rents are likely to further constrain household spending. That said, rents are largely a transfer between households – hence rises will provide some offset to the cost of living and interest rate pressures bearing down on other households.

Overall, these developments still make a strong case for the Board to take an extended pause, to get a clearer picture on demand and inflation, and to allow the automatic further increases in average mortgage rates and the financial squeeze on renters to work their way through the economy.

From the perspective of inflation, weakening demand will put significant downward pressure on inflation and eventually ease the demand for labour and therefore the more persistent pressure on services inflation.

We remain comfortable with our 4% inflation forecast by year's end with no need for any further increases in the cash rate.

Markets are now pricing in a 100% chance of a further rate increase by August. The odds should probably be more evenly balanced than that given the extraordinary in-built lags in the system. Market pricing has already been wildly out of line on three occasions in this unique cycle: in June, October and May.

In terms of the global policy backdrop, FOMC speakers have effectively ruled out another move by the FOMC in June but markets are already speculating on a July move. In this cycle the FOMC is using a less effective instrument (the federal funds rate) than the RBA's cash rate given that US household borrow is typically on fixed-rate terms of 20-30 years - the federal funds rate operates primarily through business lending; credit card rates and asset market channels rather than directly through the cash-flow of the household sector. In this cycle, US households have been more resilient than we are seeing in Australia, allowing the RBA to achieve its objectives with a more moderate tightening cycle. Despite the significant gap that is opening up between the federal funds rate and the cash rate, the RBA should not be seeking to chase the FOMC.

Conclusion

There is too much uncertainty for the RBA Board to raise the cash rate again next week. In particular the outlook for household spending is very worrying especially with inbuilt lags associated with this unique cycle. An extended pause to allow full evaluation of these lags is the best policy.

Bill Evans, Chief Economist (WestpacGroup)

DISCLAIMER

Things you should know.

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary only and is not intended to constitute or be relied upon as personal financial advice. To the extent that this material contains any general advice, it has been prepared without taking into account your objectives, financial situation or needs, and because of this, you should, before acting on it, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs, and, the disclosure documents (including any product disclosure statement) of any financial product you may consider. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a client of Westpac.

For XYLO Foreign Exchange clients: This information is provided to you solely for your own use and is not to be distributed to any third parties. XYLO Foreign Exchange is a division of Westpac Banking Corporation ABN 33 007 457 141 and Australian credit licence 233714. Information is current as at date shown on the publication. This information has been prepared without taking account of your objectives, financial situation or needs. Because of this you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs. XYLO Foreign Exchange's combined Financial Services Guide and Product Disclosure Statement can be obtained by calling XYLO Foreign Exchange on 1300 995 639, or by emailing customercare@XYLO.com.au.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking and Insurance Regulatory Commission (CBIRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Disclaimer continued overleaf

DISCLAIMER

Disclaimer continued

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

I. Chinese Wall/Cell arrangements;

II. physical separation of various Business/Support Units;

III. Strict and well defined wall/cell crossing procedures;

IV. a “need to know” policy;

V. documented and well defined procedures for dealing with conflicts of interest;

VI. reasonable steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.