

Summary

- Financial markets have moved at light speed to price higher interest rates;
- Certainly the economy has improved;
- But the timing of the first hike appears inconsistent with current economic forecasts and central bank talk;
- My simple 'fair value' model suggests the \$A should be trading around 82c.

Financial markets have started to speculate that the RBA will have to raise the cash rate prior to 2024. At the time of writing one quarter percentage point rate hike had been fully priced by the end of next year. The move to start pricing in rate hikes has been a global one.

Thoughts turning to rate hikes are understandable given the greater confidence about the economic outlook. But current financial market pricing looks increasingly at odds with stated global central bank policies. Central banks (including the RBA) have made it clear that interest rates will rise later in this economic cycle than they have done over the past twenty-plus years. So it is possible that interest rates may need to rise earlier than the RBA's current projection of 2024. That would be because the economy turns out to be a lot stronger than what they have been thinking.

The \$A has had a strong start to the year but it is not the only currency to have made a fast start against the 'big dollar'. There have been a number of factors that has kept the \$A strong. Investors have become increasingly confident about the economic outlook. Global central banks have made it clear that they intend to keep interest rates very low for some time yet. There is a (further) big fiscal stimulus on the way in the US. All of this has helped push most commodity prices (notably iron ore) up, a big plus for the \$A.

At the time of writing my 'simple' fair value model for the \$A was at 82c. It is now within spitting distance of that 'fair value' target. It might be hard to get through that 80-82c area at least for a while as a lot of good economic news has already been priced in.

Monetary Policy in this cycle

Since the start of COVID the RBA has helped the economy in a number of ways. Initially they provided 'liquidity' to the banking system and financial markets (to make sure there was enough money splashing around to pay the bills). They also acted to reduce financial market volatility. Both policies were short-term in nature, designed to buffer the economy and financial markets from the initial COVID shock.

To counter the subsequent economic downturn the RBA implemented four policies:

- In February they reduced the cash rate to 0.25%, with a further reduction to 0.1% in October.
- Implemented 'Yield Curve Control' (YCC). Practically that meant keeping the 3-year federal government bond rate at around the same level as the cash rate. Three-years' was chosen as it is the length of period that the majority of (business) borrowing is done. It was also the length of time that the RBA felt comfortable forecasting as to how long they would keep the cash rate unchanged.
- Implemented Quantitative Easing (QE). This is where the RBA buys 5-10 year federal and state government debt with an aim to keep longer-term interest rates low. This has some impact on

borrowing costs for the economy (most directly for the federal and state governments). The bigger impact is that the major global central banks had already undertaken a QE program. If the RBA did not the result would have likely been a lot higher \$A.

- Instituted a Term Funding Facility (TFF), a fancy term for allowing banks to borrow cheaper from the RBA than they could in the financial markets. The Facility was structured to encourage lending to SME's. Separately the Federal Treasury purchased types of financial market debt (mortgage backed securities) that helped reduce financing costs for non-banks.

February 2021 Board meeting

Which brings us to the February 2021 Board meeting. The RBA announced that they would end the TFF at the end of June. This was always going to be the first of the policies that the RBA would end as they prefer not to provide direct financing to the private sector (apart from extreme events such as when financial markets are excessively volatile). The short-term impact of the announcement will be negligible (banks can still borrow cheaply until June and credit growth is currently only modest). But in time it does mean that banks will again need to borrow from financial markets. And this will put some upward pressure on interest rates.

The RBA also made a change to its YCC policy. Formerly it had said that it intended to keep the cash rate unchanged 'for at least three years'. At its February meeting that changed to a nominated time ('2024 at the earliest'). By making the change the RBA has provided a little more certainty as to how long interest rates may remain unchanged.

Recently financial markets have started to speculate that the RBA will have to raise the cash rate prior to 2024. At the time of writing one quarter percentage point rate hike had been fully priced by the end of next year. The move to start pricing in rate hikes has been a global one.

Thoughts turning to rate hikes are understandable given the greater confidence about the economic outlook. The timing of the RBA's first move will be down to how the economy performs. In particular, how long it will take for inflation to sustainably get above 2.25%, the unemployment rate below 5.5% and wages growth above 2.5%.

Current financial market pricing looks increasingly at odds with stated global central bank policies. The domestic economy has suffered its biggest peacetime decline since the Great Depression. Even before COVID the economy was not in top gear. And inflation has not been within the RBA's target band for much of the past five years. One result of sustained low price growth was that inflation expectations started to fall to dangerously low levels (because it might have made it difficult to get inflation higher again).

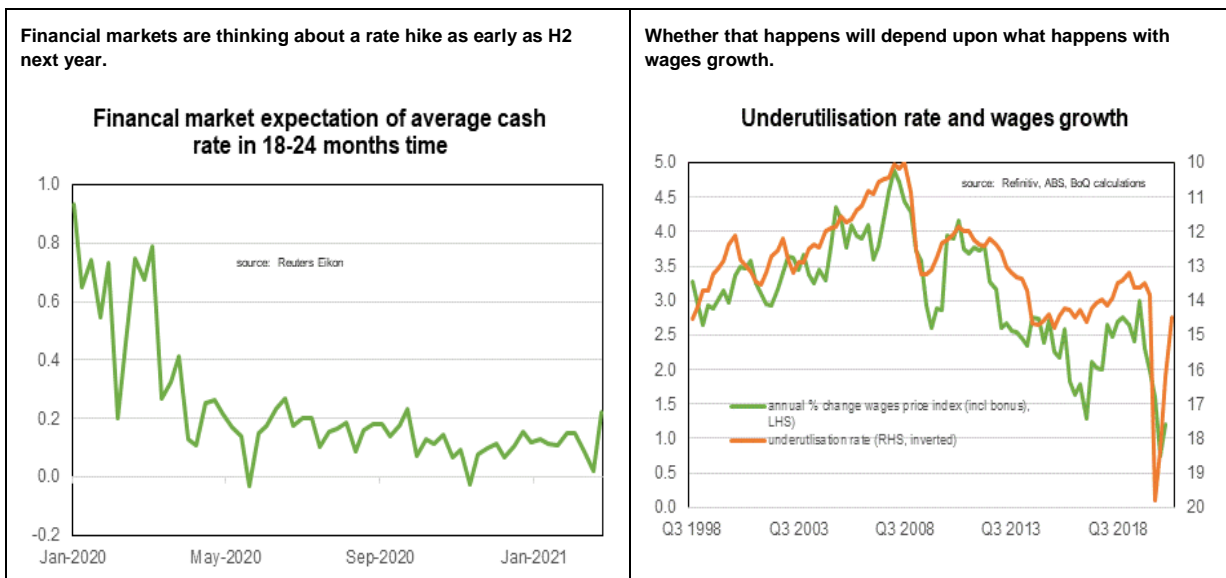
The result is that central banks (including the RBA) have made it clear that interest rates will rise later in this economic cycle than they have done over the past twenty-plus years. The RBA will wait to see the whites of inflation's eyes before they move as opposed to relying on forecasts of inflation arriving as they have in the recent past. So it is possible that interest rates may need to rise earlier than the RBA's current projection of 2024. But that would be because the economy turns out to be a lot stronger than what they have been thinking. The current financial market projection of a move in late 2022 does look early based on current consensus economic forecasts.

How high could the cash rate go in this cycle? My calculation of current financial market pricing is that investors currently expect the cash rate to average around 2.25-2.5% in the medium term (5-10 years). A couple of years ago the average cash rate was thought to be 3.5-3.75%. It is possible that the average cash rate might be now 3%. We don't know for sure, but it is likely to be above investors' current guess.

There is still a lot of territory to be covered until we get interest rates higher. Most obviously whether there will be sustained strength of the economy and higher inflation. Over the past few months there has been plenty of good news, from the better economic performance during COVID (thanks to big fiscal support), the economic bounce-back from COVID (the end of lockdowns) and the discovery and rollout of the vaccine.

But there is still uncertainty as to whether the economic bounce-back from the lockdowns can be sustained. Business surveys indicate that some of the sting has come out of forward order books. Certainly Capex spending is currently on the up, helped by a residential construction boom and the equipment tax write-off. But firms are also indicating that the growth of Capex spending will be flattish next financial year. And the residential building boom will peak around Q2-Q3 this year. All of that is fine providing household and business spending takes the turn in carrying the growth baton. And that is far from certain.

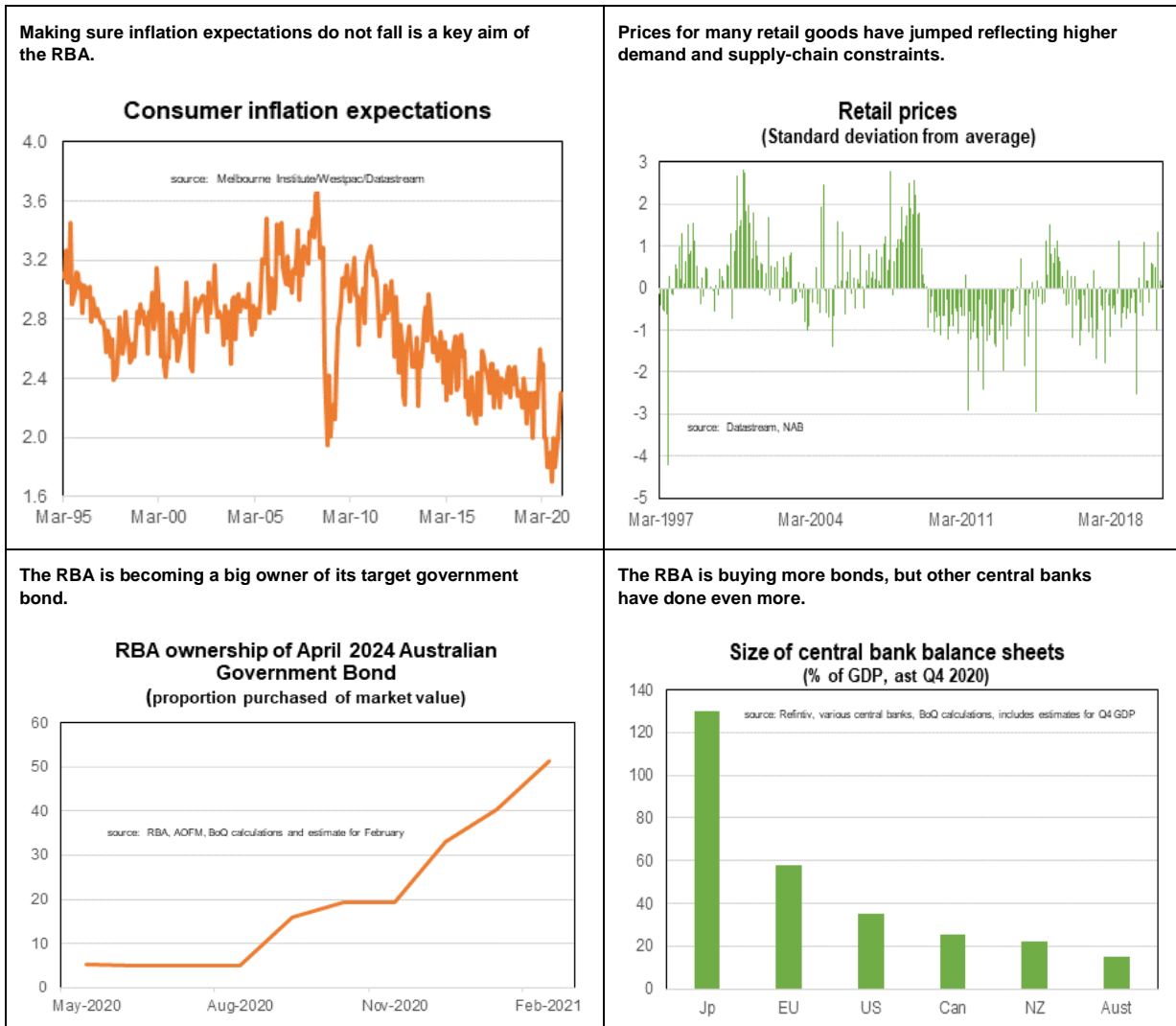
A message of uncertain economic outlook and a very low level of inflation has been coming from virtually all major central banks over recent weeks. And is the reason why they have all indicated that they intend to keep the current stance of monetary policy unchanged for some time to come.



FINANCIAL MARKET UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 26TH FEBRUARY 2021



Foreign Exchange

The \$A has had a strong start to the year, up over 3% against the USD. But it is not the only currency to have made a fast start against the 'big dollar'. All of the other major commodity currencies (\$NZ, \$Canada) are also up. As are many of the 'emerging market' currencies (notably the Turkish Lira).

There have been a number of factors that has kept the \$A strong. Investors have become increasingly confident about the economic outlook. Global central banks have made it clear that they intend to keep interest rates very low for some time yet. There is a (further) big fiscal stimulus on the way in the US. And there is plenty of government spending still on the drawing board in Europe. All of this has helped push most commodity prices (notably iron ore) up, a big plus for the \$A.

Further, Australia has handled COVID as well as anyone. And this has meant that its economy is doing better than most. For the past few months the economic data in Australia has been stronger relative to forecasts than in the US. The participation rate in Australia is near its record high. In the US it is well below its pre-COVID level.

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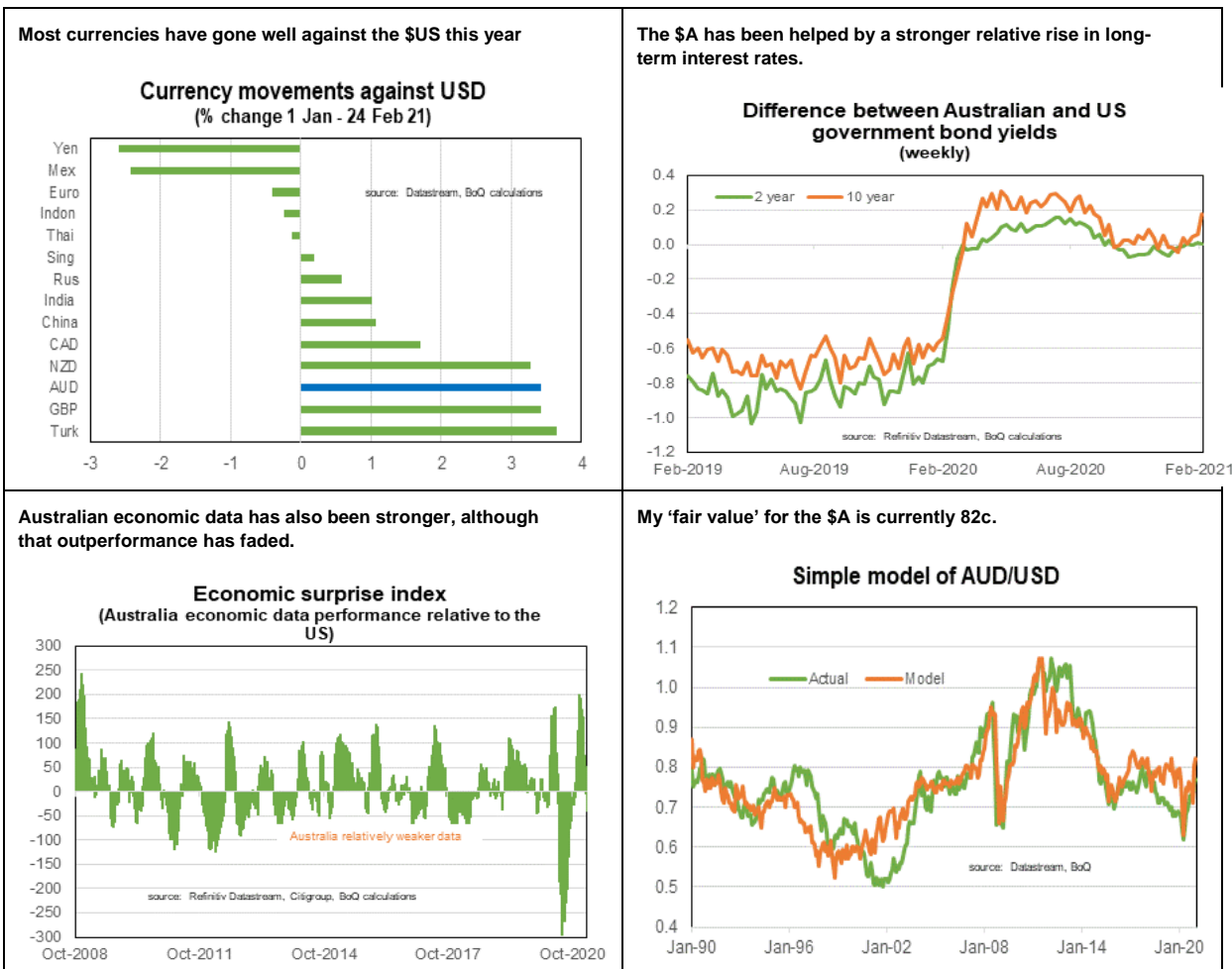
WEEK ENDING 26TH FEBRUARY 2021



Normally this would see interest rates in Australia rise relative to the US. This has not been the case for short-dated interest rates (2-years) reflecting the RBA's YCC policy that minimises changes in yields. But longer-dated yields (10 years) in Australia have risen relative to the US, putting some upward pressure on the \$A.

At the time of writing my 'simple' fair value model for the \$A was at 82c. Last month I thought that the \$A would get to 80c. It is now within spitting distance of that target, and looks good to head up towards the 'fair value' result.

But it might be hard to get through that 80-82c area, at least for a while. Certainly central banks' determination to get the global economy fired up would be expected to help the \$A. But a lot of good news has been priced in. Equity markets are starting to look expensive, particularly given the notable rise in bond yields over the past few weeks. And less of the economic data released in Australia is surprising analysts with strength.



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WEEK ENDING 26TH FEBRUARY 2021



We live in interesting times.

Regards,

Peter Munckton
Chief Economist
Bank of Queensland