

Summary

- The RBA has made it clear that it think there will be no cash rate hike until 2024;
- But financial markets are thinking higher rates might begin earlier;
- The \$A (and most currencies) have struggled against the \$US in recent weeks;
- My fair value model says the \$A should be higher;
- But likely data flow means it might take some time before the AUD heads higher.

The Australian economy will face a period of turbulence in coming months as it adjusts to the end of JobKeeper and the potential for further virus 'waves'. But the economy has been substantially stronger than expected, including by the RBA.

Even if the RBA gets its (revised) unemployment rate forecasts right from now it still will take its time to raise rates. That is because of the lessons learnt from the previous decade. Then inflation remained stubbornly low. A key reason was the modest pace of wages growth.

The stronger economic growth and vaccine rollout has led financial markets to start speculating that a rate hike could begin by early 2023. A stronger Australian economy is one reason. But it may not just be domestic matters that are driving financial market views. Global central bank actions may also be playing a part. Over recent weeks financial markets have been marking up their probability of a Fed rate hike sometime in 2023.

The performance of the traditional drivers of the \$A have been mixed over the past month. Commodity prices have been high (notably iron ore) a sign of the growing strength of the global economy. Volatility in equity markets has fallen a little although remains above average (probably reflecting worries about the impact of higher rates). Short-term interest rate differentials with the US have been largely unchanged.

My simple 'fair value' model says the \$A should be 82c. And in the medium term I do think we will get a higher \$A reflecting the prospects of a stronger global economy and the positive impact that will have on commodity prices.

But over the next few months that might be hard as we will start to see data that will highlight the strength of the US economy (a result of the very large fiscal stimulus).

Interest rates: Things are getting better

The RBA recently couldn't have been clearer: there will be no rate change until 2024. Partly that is because (and as the recent Brisbane lockdown reminds us) there remains clear and present dangers to the economic outlook. The Brisbane news comes as JobKeeper has come to an end. Some household disposable incomes will also be hit by the end of rent and interest payment holidays.

So there are risks. And I think it is likely that the Australian economy will face a period of turbulence in coming months as it adjusts to the end of JobKeeper and the potential for further virus 'waves'. But the economy has been substantially stronger than expected. That strength meant the unemployment rate hit 5.8% in February 2021 far quicker than generally expected. When they released their latest forecasts in early February the RBA thought that that the unemployment rate would not get under 6% until next year.

Certainly the forward indicators indicate that there are more new jobs on the way. And workers are increasingly confident that there will not be widespread layoffs. But the impact of the end of JobKeeper (particularly on SME's) could be an important offset.

How big the end of JobKeeper will be is not clear. The Federal Treasury estimates that up to 150,000 people could lose their jobs. Some will enter unemployment. But a number will find other work (particularly given the growing number of firms worried about skill shortages). And some may decide to leave the workforce (reducing the participation rate and therefore the measured unemployment rate).

But once we get through the turbulence there is a realistic scenario that the unemployment rate could then resume its decline quicker than expected. The strength of the economy will obviously be important. But the other factor is the very slow growth of the labour force. There are few immigrants to fill vacant jobs. So all new workers must be come from the current labour force. This means that until the immigration program gets cranked up again (and that won't be until at least next year) strong jobs growth would lead to the unemployment rate falling sharply.

But even if the RBA gets its (revised) unemployment rate forecasts right it still will takes its time to raise rates. That is because of the lessons learnt from the previous decade. Then inflation remained stubbornly low. A key reason was the modest pace of wages growth. It is why the RBA is looking to push the unemployment rate to as low the 'low 4's or high 3's' before hiking rates. That is the unemployment rate they think is now consistent to get wages growth above 3% (the consistent with their inflation target).

To me the lesson from the past decade was that the economy was not strong enough for long enough. Prior to COVID there was still too many people looking for a full-time job (as measured by the underutilisation rate) to ensure that wages growth had reached a decent level.

The underutilisation rate has declined sharply from its peak reached last year. But in recent months it has not declined as much as the unemployment rate. And it remains above its long-run average. This means the RBA should be keeping rates where they are. But the longer jobs growth remains good and population growth low the more likely that there will be a substantial fall in the underutilisation rate. And this will lead to stronger wages growth.

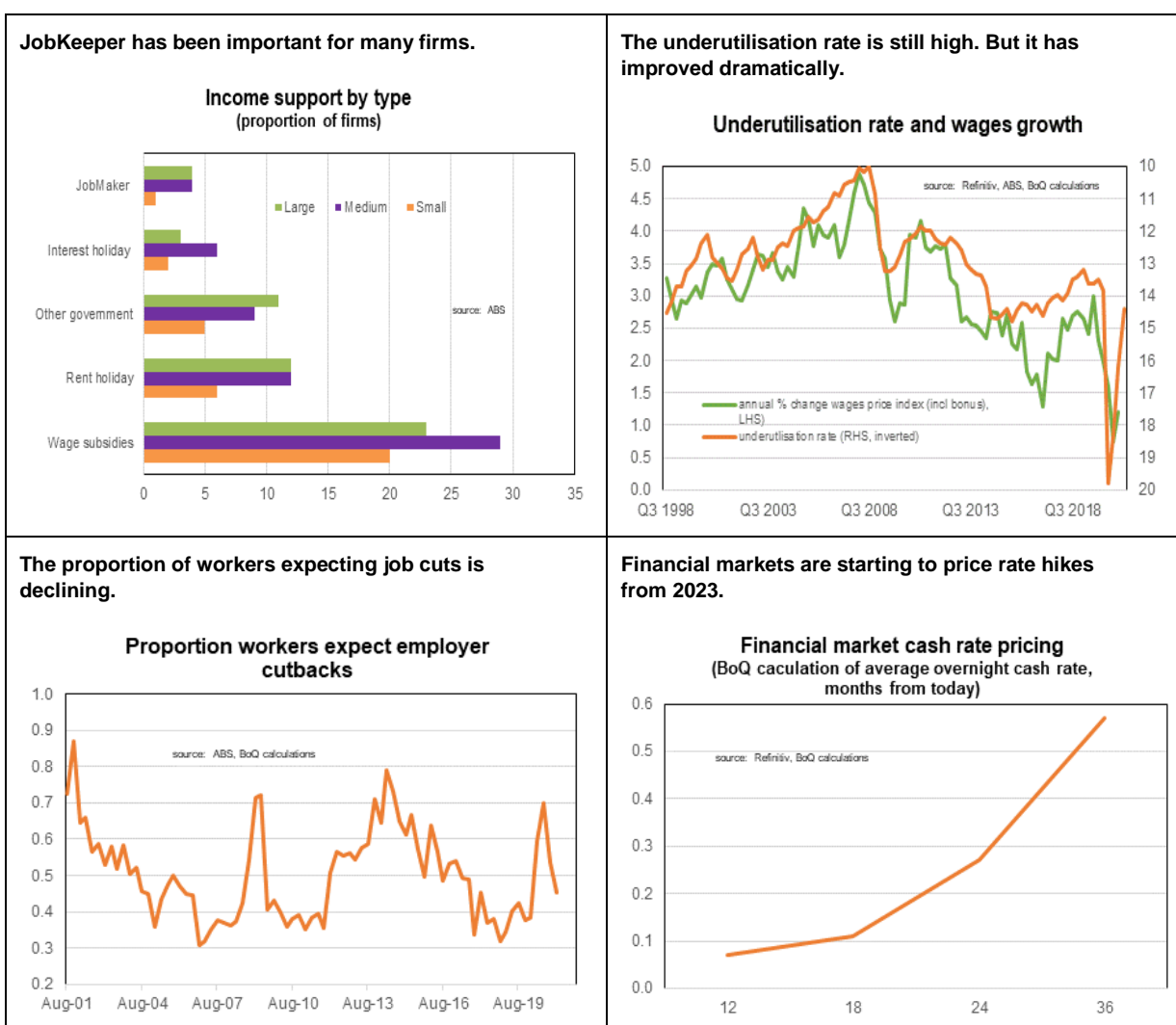
The stronger economic growth and vaccine rollout has led financial markets to start speculating that a rate hike could begin by early 2023. Current pricing suggests that the first move could be small (a move in the cash rate back up to 0.25%). But then a 0.5% rise is priced over the following 12 months. All this is a little earlier than the RBA's current pronouncements.

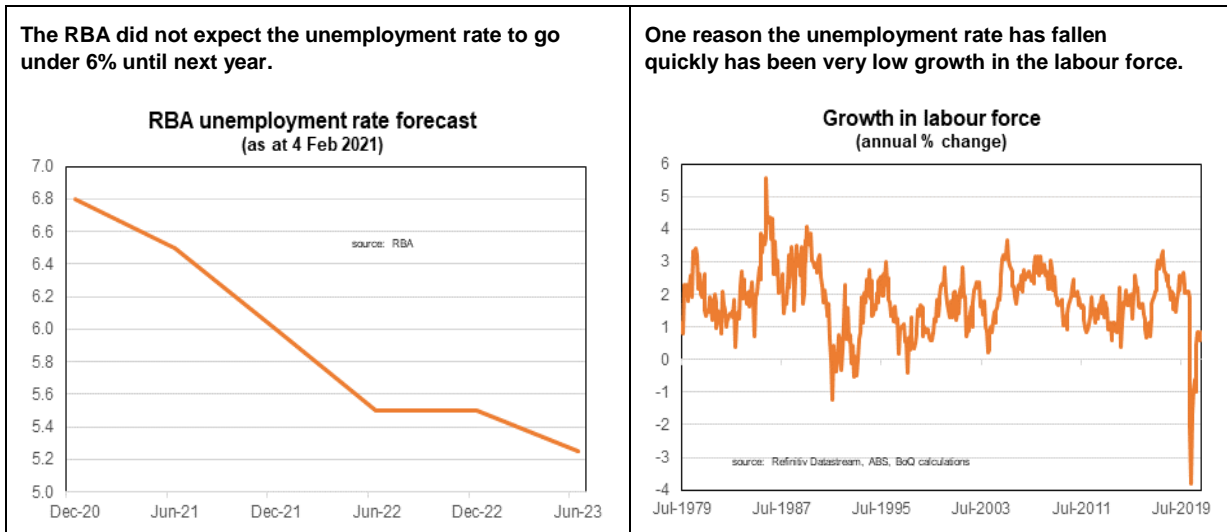
It may not just be domestic matters that are driving financial market views. Global central bank actions may also be playing a role. Both the US Federal Reserve and the European Central Bank have indicated they don't intend to change policy any time soon. But over recent weeks financial markets have been marking up their probability of a Fed rate hike sometime in 2023. This view gained further credence following the extremely strong fiscal stimulus that has started to hit the US economy.

And other central banks have indicated that they are likely to start tightening monetary policy in the foreseeable future. The Bank of Canada has indicated that it may reduce the size of its Quantitative Easing (buying bonds to keep long-term interest rates low) program in the second half of the year. The Norwegian central bank has said that it may start raising interest rates by end-2021. The Chinese Central Bank has already reduced the size of its monetary support to the economy.

Under virtually any scenario interest rate rises by the RBA are still a fair way down the pike. Inflation will have to clearly be sustainably above 2% and wages growth above 3% for the rate hike button to be pushed. And we are still some distance from those numbers.

We will get our first indication whether the RBA can see the possibility of a rate hike sometime in the (distant) future when they soon decide what (if any) changes it will make to its yield curve control policy. Currently the RBA's view is that it is unlikely to change the cash rate for at least 3 years. It reinforces that view by keeping Government bond yields out to three years at the same level as the cash rate. But the stronger economy of recent times means that they might move to targeting a particular date (ie, stating that it is unlikely to change interest rates until at least mid-2024). This is what I think they will do. This decision will need to be made by August.





Exchange rate: The mighty ‘Big Dollar’

The \$A has declined against the \$US over the past month but been flat against the currencies of a weighted basket of major trading partners. Partly the strength of the \$US was a result of big upward revisions to US economic growth. And this reflected the vaccine rollout and large fiscal stimulus. Currency traders were also caught on the wrong side of the \$US move and had to unwinding their trades further boosting the \$US.

The performance of the traditional drivers of the \$A have been mixed over the past month. Commodity prices have been high (notably iron ore) a sign of the growing strength of the global economy. Volatility in equity markets has fallen a little although remains above average (probably worried about the impact of higher rates). Short-term interest rate differentials have been largely unchanged following the very clear message from both the Australian and US central banks that the cash rate would remain unchanged for some time.

The underlying demand for \$A remain strong, with the basic balance of payments (the current account surplus plus foreign direct investment into Australia net of our direct investment offshore) unchanged at a high level.

The combination of these factors suggest that typically the \$A would be trading higher. Indeed, my simple ‘fair value’ model says the \$A should be 82c. And in the medium term I do think we will get a higher \$A reflecting the prospects of a stronger global economy and the positive impact that will have on commodity prices.

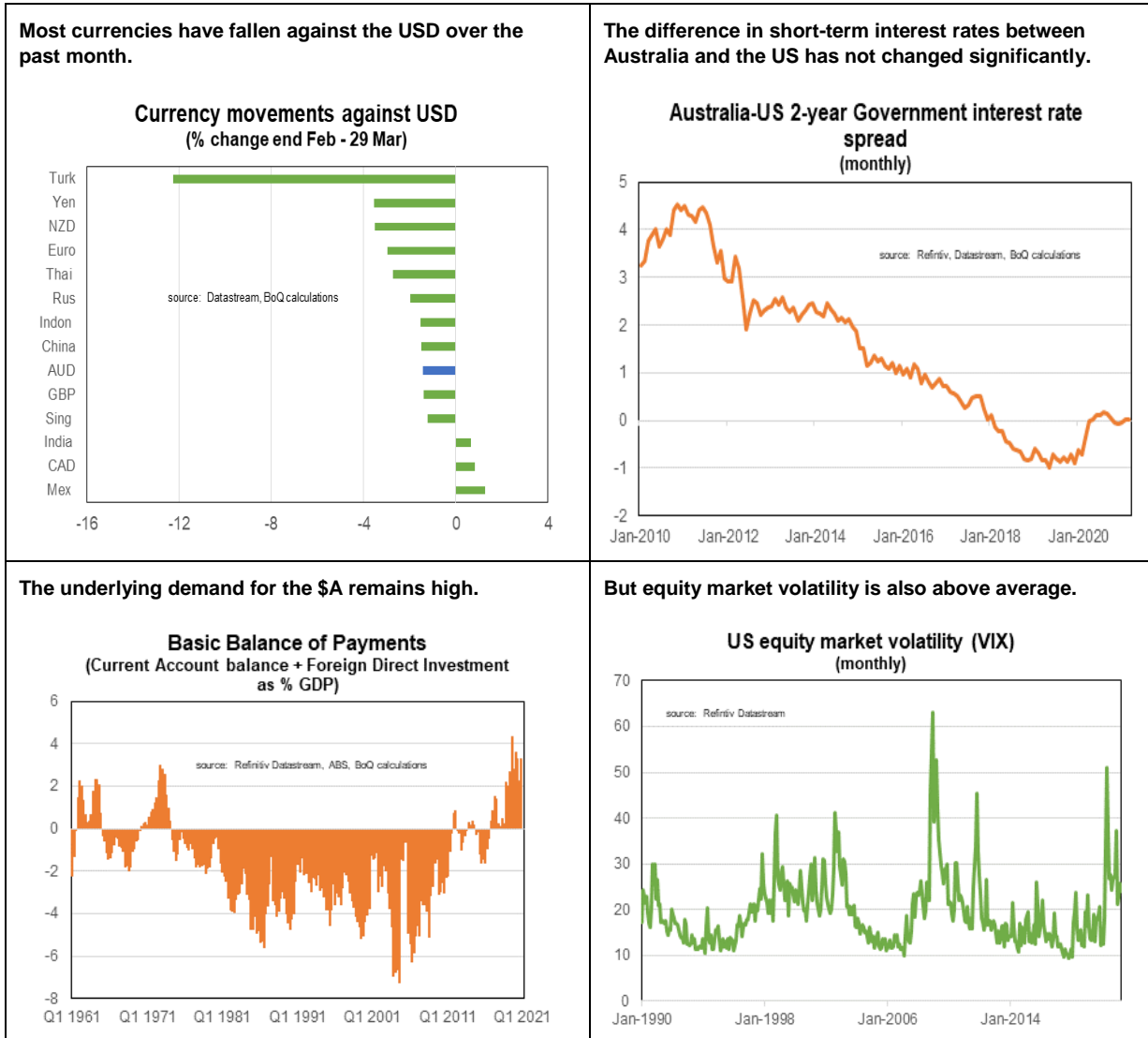
But over the next few months we will start to see data that will highlight the strength of the US economy as a result of the very large fiscal stimulus. At the same time the end of JobKeeper could see the Australian economy hit a flat spot for a few months. The better US data could cause higher interest rates and therefore lead to more financial market volatility (a negative for the \$A).

Overall, a higher \$A over the next 12-18 months remains my view. That was also the view of most forecasters in a survey by Reuters conducted earlier this month (admittedly when the \$A was closer to 78c). The recent performance of the \$A has been a hard slog. And it might find the going remains tough, at least for the next few months.

FINANCIAL MARKET UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 2ND APRIL 2021



We live in interesting times.

Regards,

Peter Munckton

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Bank of Queensland**