ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 5TH NOVEMBER 2021

Key points

- **It was anticipated that the RBA would end its yield curve control policy at its November meeting;**
- **The RBA is open to a rate change in 2023, but thinks moves in 2022 unlikely;**
- **The timing of the first rate move will depend upon wages growth;**
- **The big issue for the equity market is the level of the cash rate peak.**

Summary

Interest rate views have changed dramatically in just a few weeks. The reason is that financial markets are increasingly worried about inflation. Domestically, firms' have become concerned about price pressures and consumers' have started to feel the impact of those pressures.

As economies have re-opened demand has risen quicker than supply. Government restrictions and consumer confidence across the world have limited the ability of firms to crank up production. The result has been higher prices and supply bottlenecks. There are signs that these pressures are easing. Shipping prices have fallen and the price of many household appliances have declined in each of the past four quarters.

There are plenty of reasons to think that wages growth across the economy should increase. Employer hiring intentions and job vacancy data indicates a strong demand for workers. Workers are indicating they are not fearing unemployment. But wages growth is likely to take some time to reach the 3% mark that the RBA indicates would be consistent with its inflation target (and therefore to raise the cash rate). The underutilisation rate is currently a bit above its long-term average. The participation rate is below its historically high level it hit in the first half of 2021. And after an extended period of low outcome, worker expectations of wages growth remains low.

The RBA made three announcements followings its November Board meeting. The first was that they decided to maintain its $4b weekly pace of buying of federal and state government bond. An increasing number of analysts believe that the RBA may stop buying bonds altogether by May. But I think it might be later as the RBA may well be happy to lag behind other central banks (particularly the US).

The second decision was that the RBA would cease its yield curve control policy. It had become increasingly clear that stronger demand and supply problems would mean that the cash rate would most likely need to rise earlier than the RBA's view of 2024. Other financial market interest rates (notably swap rates) had already risen and leading to higher borrowing cost (such as fixed rate mortgages).

The third announcement was that the cash rate would remain unchanged at 0.1%. Financial markets can see an interest rate rise on the horizon and expect the cash rate to be at least 0.75% by end-2022. That appears excessive given that inflation and wages growth in the US is higher than in Australia but financial markets are pricing bigger cash rate moves by the RBA.

The updated RBA forecasts are consistent with a rate move in 2023 (consistent with my view). The RBA has indicated that there are scenarios that could see the first cash rate rise occur in 2024. But they see very little probability that there will be any rate moves in 2022. I agree a first move in 2024 remains a possibility. But so is 2022 if wages growth ends up being above 3% and (underlying) inflation above 2%.

The bigger issue for equity markets is not when the first rate hike occurs but how many rate hikes will take place. As it currently stands financial markets have a peak cash rate in this cycle of 2-2.5%. If current financial market pricing is correct then interest rates will be negative after taking into account inflation (in the jargon, 'real' interest rates will be negative). The concern for equity markets is if real interest rates turn positive (ie, the expected top in the cash rate is higher than inflation).

September quarter inflation outcomes

'Be careful for what you wish for lest it come true'
Aesop's Fables

Aesop, the famous Ancient Greek storyteller, knew a thing or two. His collection of writings became known as Aesop's Fables, and has been mentioned across history by many sources including Aristotle. The above saying is one of his most famous and has been used in many forms over the centuries.

His famous phrase is currently relevant because we have been wishing for a return to 'normal' after the economy and wider society has been smashed by the pandemic. A return to 'normal' for the economy means good things: more jobs, higher wages, increased spending.

But it is also will likely mean higher interest rates. Certainly views about the outlook for interest rates have changed dramatically in just a few weeks. Financial markets have gone from umming and ahhing about the potential for a rate hike late in 2022 (and getting blowback from the RBA that they were jumping the gun) to pricing in the cash rate rising to at least three quarter of one percentage point by the end of next year.

What has changed? This has been the year that the world has started to worry about inflation. The extent of those worries has differed between countries. It has been most acute in the US, Europe and New Zealand, but (to date) less of a worry in China and Japan.

Until the September quarter CPI data inflation had also been less of a concern in Australia. Energy prices had been less of a domestic worry. Government programs (such as HomeBuilder) reduced price pressure for consumers (while turbo-charging demand in the housing sector). Still firms' had become increasingly worried about price pressures. And consumers' have now started to feel the impact of those pressures.

There should be some caution about reading too much into the September quarter CPI numbers. It was after all only one number. And guesses needed to be made on the prices of a number of goods and services that didn't trade because of the lockdowns in Sydney, Melbourne and Canberra. Nonetheless, the Q3 inflation number was confirmation that Australia could not stand apart from the inflation pressures building globally.

The key issue is whether higher inflation is sustained

As economies have re-opened demand has risen quicker than supply. Government restrictions across the world have limited the ability of firms to crank up production. The result has been both higher prices and supply bottlenecks.

The good news is that there are signs that these pressures are easing. Shipping prices have fallen by around one-third over the past month. Coal prices have declined dramatically as China has ramped up production (not so good for the environment). Oil and gas (as well as many other commodity) prices have been flat to down over the past month. Production is rising again in many Asian countries, a critical part of many global supply chains. Surveys indicate that there has been a notable decline in the backlog of orders for US manufacturer's not filled over the past few months (although that index remains near historically high levels). Domestically, the price of many household appliances that were in strong demand last year has fallen in each of the past four quarters.

The evidence suggests that the inflation caused by material shortages should by this time next year be largely under control. This assumes that government restrictions continue to ease, including re-opening borders.

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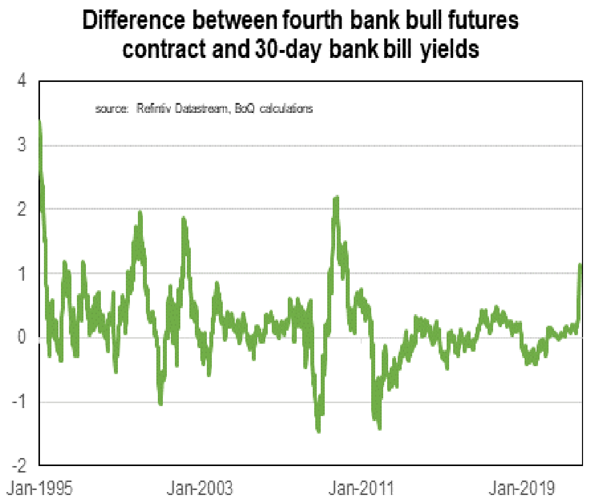
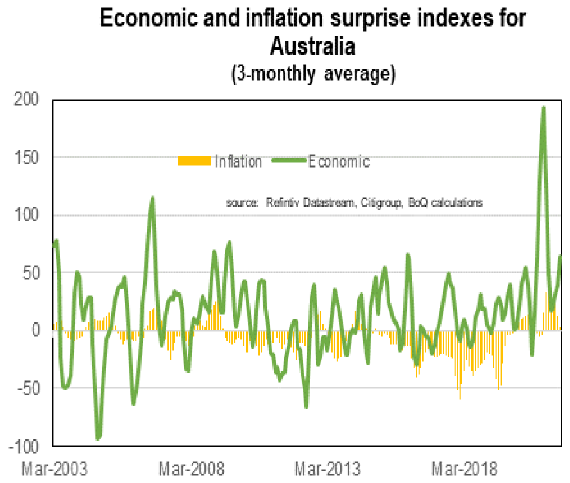
There has been a sharp jump of interest rate expectations in recent weeks.

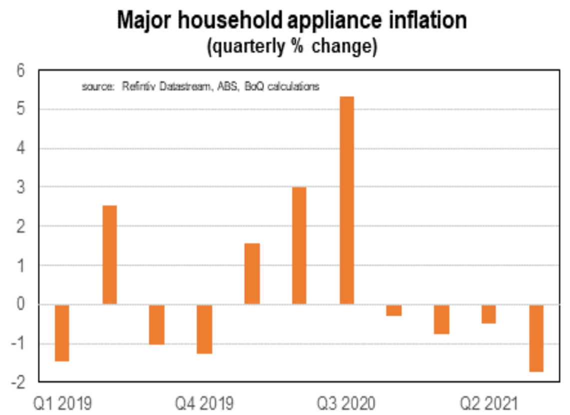


Both inflation and activity data are surprising economists with their strength.



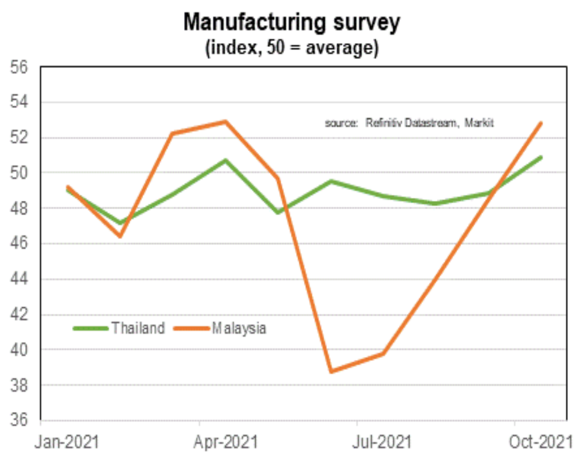
Shipping costs are starting to decline.

And so is the price of household appliances.



US manufacturers are starting to work through the backlog of orders.

ASEAN economies are starting to re-open following a COVID wave.



Wage growth is the key

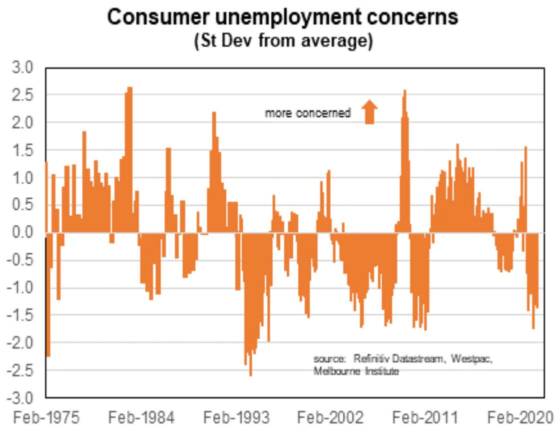
While goods and materials should be flowing more easily in 6-12 months' time, the problem with the shortage of workers' may take longer to be resolved. A strong economy has led to rising demand for workers. But closed borders has reduced the availably supply of workers.

In time you would expect that the combination of strong demand and reduced supply should see higher prices (stronger wages growth). And in some sectors (such as professional services) we already are. This is important as the RBA is strongly of the view that for inflation to sustainably remain high will require stronger wages growth.

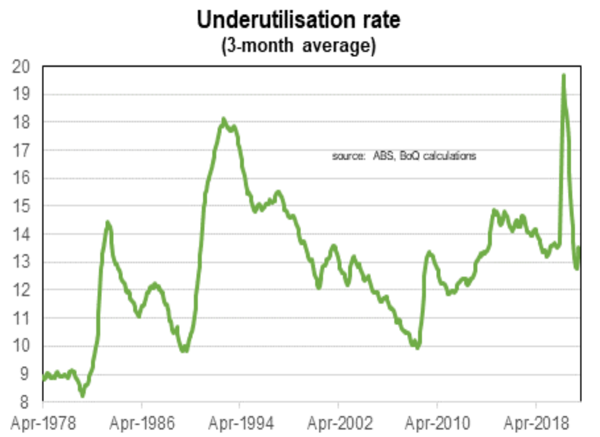
And there are plenty of reasons to think that wages growth across the economy should increase. Employer hiring intentions and job vacancy data indicates a strong demand for workers. Border closures (and in some industries mandatory vaccinations) are limiting the supply of workers. Workers are indicating they are not fearing unemployment. No surprise then that the quit rate is near record highs in Australia for full-time employees. Higher inflation means workers might be looking for a higher wage rise.

The quit rate amongst full-time workers is near a record high.

Consumers have little dear about unemployment.

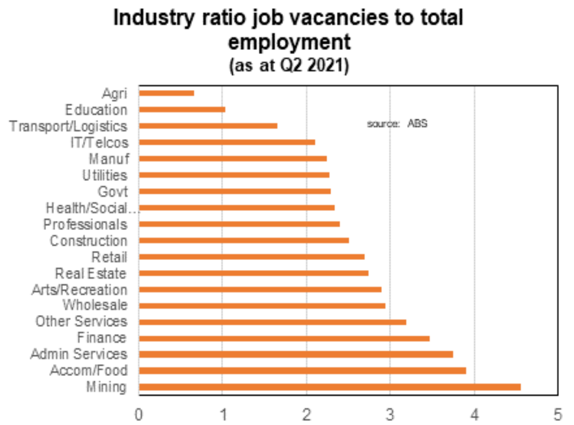


The underutilisation rate is still too high, but it will decline.



One reason to think there will be a strong jobs markets is that there are plenty of job vacancies around.

But wages growth is likely to take some time to reach the 3% mark that the RBA indicates would be consistent with its inflation target (and therefore to raise the cash rate). The underutilisation rate is currently a bit above its long-term average (although it should decline as the economy re-opens). The participation rate is below its historically high level it hit in the first half of 2021. The pressure to find workers is stiffer in some sectors of the economy than others. And after an extended period of low outcome, worker expectations of wages growth remains low. Most state governments' have caps on wage rises as they try to keep a cap on the size of their budget deficits.

Household expectations of wage rises remain muted.	Labour market tightness differs between industries.
	

Outlook for interest rates

The RBA made three announcements followings its November Board meeting. The first was that they decided to maintain its $4b weekly pace of buying of federal and state government bonds, with that decision to be reviewed at its February meeting. I (along with most in the financial markets) expect that the RBA will decide to reduce the pace of buying (because of the evidence of a stronger economy) at that meeting.

An increasing number of analysts believe that the stronger economy means the RBA will stop buying bonds altogether by May. That might be the case but the RBA has indicated that its decisions on what it will do with its bond buying program will partly depend upon the action of other central banks. By May a number of central banks would have either stopped (Reserve Bank of New Zealand, Bank of Canada) or close to stopping (Federal Reserve) their programs. But the European Central Banka and the Bank of Japan will still be going. And unless Australia's inflation data strengthens relative to other countries in the next few months the RBA might be happy to lag the decisions of other central banks (particularly the US).

The second decision was that the RBA would cease its yield curve control policy, where they fixed the government bond rate to be equal to the cash rate for a period they believed that monetary policy would be unchanged (most recently, early 2024). It had become increasingly clear that stronger demand and supply problems would mean that the cash rate would most likely need to rise earlier. It is possible that the RBA could have continued to fix the Government bond rate. But (as they noted) that might have meant they owned all of the relevant bond and that would have reduced the efficiency of the financial markets. Also, other financial market interest rates (notably swap rates) had already risen and was leading to higher borrowing cost (such as fixed rate mortgages). So the benefits of the yield curve control policy was diminishing.

The third announcement was that the cash rate would remain unchanged at 0.1%. But the debate has been increasingly not if but when the RBA might need to increase interest rates. The combination of stronger than expected CPI in Australia, higher inflation globally and global central bank announcements (and actual moves) to tighten monetary policy has led to financial markets to (at the time of writing) price in the first rate hike in Australia by mid-2022. The cash rate is expected to be at least 0.75% by end-2022.

The amount of rate hikes priced in for next year appears excessive. Wages growth is currently low (we get the next update later this month) and may not be above 3% until 2023. Both inflation and wages growth in the US is higher than in Australia but financial markets are pricing bigger cash rate moves by the RBA.

The updated RBA forecasts are consistent with a rate move in 2023 (consistent with my view). That is the year when the RBA expects (underlying) inflation to be at 2.5% and wages growth to be 3%. I have sympathy with the wages growth forecast, although expectations that underlying inflation will be around 2.25% at the end of both this year and next might be a bit of a stretch given the extent of the material and labour market shortages.

The RBA has indicated that there are scenarios that could see the first cash rate rise not happen until 2024. But they see very little probability that there will be any rate moves in 2022. It is true that 2024 for the first rate move remains a possibility. But so is 2022 if wages growth ends up being above 3% and (underlying) inflation above 2.5%. But those outcomes will almost certainly not take place in the first half of next year, and probably not until the end of 2022.

The bigger issue for equity markets is not when the first rate hike occurs but how many rate hikes will take place. As it currently stands financial markets have a peak cash rate in this cycle of 2-2.5%. Some economists believe that the end point of rates in this cycle will be lower (1-1.5%). This reflects the view that high household debt limits how far interest rates can go up. Maybe, but substantial household saving has improved balance sheets. And interest rates are unlikely to go up until wages growth is higher and the unemployment rate lower.

If current financial market pricing is correct then interest rates will be negative after taking into account inflation (in the jargon, ‘real’ interest rates will be negative). The expectation that real interest rates may remain negative is the reason why equity markets are still going up despite speculation about rising interest rates. The concern for equity markets is if real interest rates turn positive (ie, the expected top in the cash rate is higher than inflation).

Rising interest rates are a ‘good’ thing. They are a sign of an economy returning to ‘normal’. But a ‘normal’ economy will lead to a higher interest rate than we have got today. And could mean interest rates being higher than current financial market expectations. If that happens then Aesop’s saying about what you wish for will become front of mind.

We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland