FINANCIAL MARKET UPDATE

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Summary:

- **Financial markets are saying the next rate move is up, but not for some time;**
- **Monetary policy can do more, but not much more;**
- **It is up to fiscal policy to do the economic heavy lifting;**
- **My 'simple' AUD model has fair value at 73c;**

Right now the expectations are that the next move in the cash rate in Australia (and most other developed countries) will be up. The move up is not expected for some time. But it is a forecast that the economy will improve enough for the next rate move to be a hike. The clear risk for at least the next 12-18 months is that the Australian economy will need more assistance.

The RBA believes that it is far from clear that the benefits of negative rates outweigh the costs. I agree. Interest rates could decline a little further, but not by much. There are scenarios when negative interest rates can occur although at this point these look unlikely. Overall, monetary policy has only a little more it can give. Fiscal policy is the main game.

The AUD has had a good past few weeks reflecting the bounce-back in the global economy, lower volatility, relatively high interest rates and a current account surplus. The AUD is getting closer to my 'fair value' estimate of 73c (and close to its long-term average). My preferred scenario is that the economy over the next year travels in a two-steps forward one step back way until a vaccine/treatment is found. In that event the AUD should head higher. But a return to pessimism about the global economy could see a renewed move back under 70c.

Interest rate update

The title of the REM song 'The end of the world as we know it' came to mind as I was thinking about the world we are now living in: the headline is always about the latest virus news, the restrictions on movement, worries about crowds. In economics land we will likely to find out that the economy in Q2 slowed at its sharpest rate since the Great Depression (as it has done in most other countries). In the same quarter Australia suffered deflation (the two are linked). And in financial markets interest rates are not only at historic lows but expected to remain there for some years.

Right now the expectations are that the next move in the cash rate in Australia (and most other developed countries) will be up. There has been increasing hope that a vaccine/treatment will be found (albeit unlikely to be widely available until at least the second half of next year). And while the Australian economy (and that of many other countries) have taken a step back because of the appearance of a 'second wave', the economy will still end the third quarter in a better place than it entered the second quarter.

The move up is not expected for some time. Most forecasters forecast that the unemployment rate will be too high for at least the next couple of years and inflation/wages growth too low. At the time of writing financial markets had not priced any significant chance of a higher cash rate for at least the next 3-4 years.

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But it is a forecast that the economy will improve enough for the next rate move to be a hike. The clear risk for at least the next 12-18 months is that the Australian economy will need more assistance. What are the options if the RBA decides more needs to be done?

It is possible interest rates can go lower. In a recent speech the RBA Governor alluded to the possibility that the 'target' cash rate could have been reduced to 0.1% instead of its current level of 0.25%. Indeed, the Bank of England already has taken the cash rate down to that level.

I can understand why the RBA did not take the cash rate that low. Even at 10bp there is the concern that with all of the excess liquidity sloshing around the financial system money market rates could enter negative territory. And like Mordor in the Lord of the Rings, negative rates is a territory that ideally should not be explored.

Negative interest rates

The RBA believes that it is far from clear that the benefits of negative rates outweigh the costs. I agree. As the RBA noted, the biggest benefit of a negative rate is a weaker exchange rate. But that can't be easily achieved if everyone has negative rates. A negative cash rate might appear to be a very good deal for borrowers. Certainly very low rates makes it easier to repay debt. The proportion of household incomes used to meet interest payments is currently at its lowest level in nearly twenty years. But it is far from clear that very low interest rates encourages new borrowing. Credit growth to households and business in Australia is currently moderating.

Very low interest rates does support asset prices (such as equities and house prices), boosting business and consumer wealth and the value of collateral against which they can borrow. But the uncertain economic environment is constraining business and consumer desire to either consume or invest.

And if equity and house prices rise mainly because of very low interest rates that can create its own issues. Rising prices benefits current owners of housing and equities, but creates affordability problems for those that don't. Rising asset prices can create an incentive for people to borrow to purchase existing assets instead of investing in the wider economy (although right now the uncertain economic environment is keeping a lid on asset prices).

The biggest problem of negative interest rates is that it crimps bank interest rate margins creating a disincentive to lend. Banks in the countries that have had negative interest rates for some years are also ones with low profitability (although other factors than interest rate margins have played a role). The RBA also notes that negative interest rates has been consistent with a rise of saving in a number of countries.

But as Frodo found out, sometimes there is no choice but to head to Mordor. The toughest scenario for the RBA is if the rest of the world took their cash rate negative. Japan, the Euro Zone and Switzerland are already there. The UK and New Zealand have indicated that a negative cash rate is a possibility.

Along with the RBA the US Federal Reserve has expressed the most reservations about travelling down the negative rate path. But if the global economy did take a sharp turn south and all other

central banks took their cash rate negative (or further negative) the Federal Reserve might feel it has little choice but to follow. And in that scenario it becomes very hard for the RBA to not enter the negative rate land.

The other scenario where the RBA may have to contemplate a negative cash rate is if there is sustained deflation (falling prices). The reason is that if deflation did occur that would lead to a rise in 'real' interest rates (interest rates after taking account of inflation). In such a scenario households and firms would find that the prices they charge or wages they receive would decline at the same time the size of their interest payments stays unchanged.

At this point the chances of deflation over the next year is remote. While inflation did decline sharply in the June quarter this is widely expected to be a one-off associated with the extraordinary circumstances of having to shut large parts of the national economy for a number of weeks. The massive fall in Childcare and school fees in Q2 due to Government action will be unwound in the September quarter. Oil prices going negative as it did in the June quarter is unlikely to be repeated (although falling rents will remain part of the landscape for some time).

Also, the inflation expectations of businesses, consumers and financial markets are all consistent with rising prices (albeit by less than the RBA's 2-3% target). In the US, a St Louis Federal Reserve model indicates a negligible risk of deflation over the next year.

So while interest rates could decline a little further, it is not by much. There are scenarios when negative interest rates can occur although at this point these look unlikely. And let's hope it remains that way.

What else can they do?

So what else could the RBA do? Through a combination of 'yield curve control' (ie, RBA setting the level of interest rates for more than just the cash rate) and forward guidance on the outlook for the cash rate, the RBA could reduce interest rates for longer maturities (it already is doing that out to three years). This would be helpful for long-term borrowers (such as infrastructure providers and governments). But its wider impact on the economy would be limited given that the majority of borrowing is relatively short term.

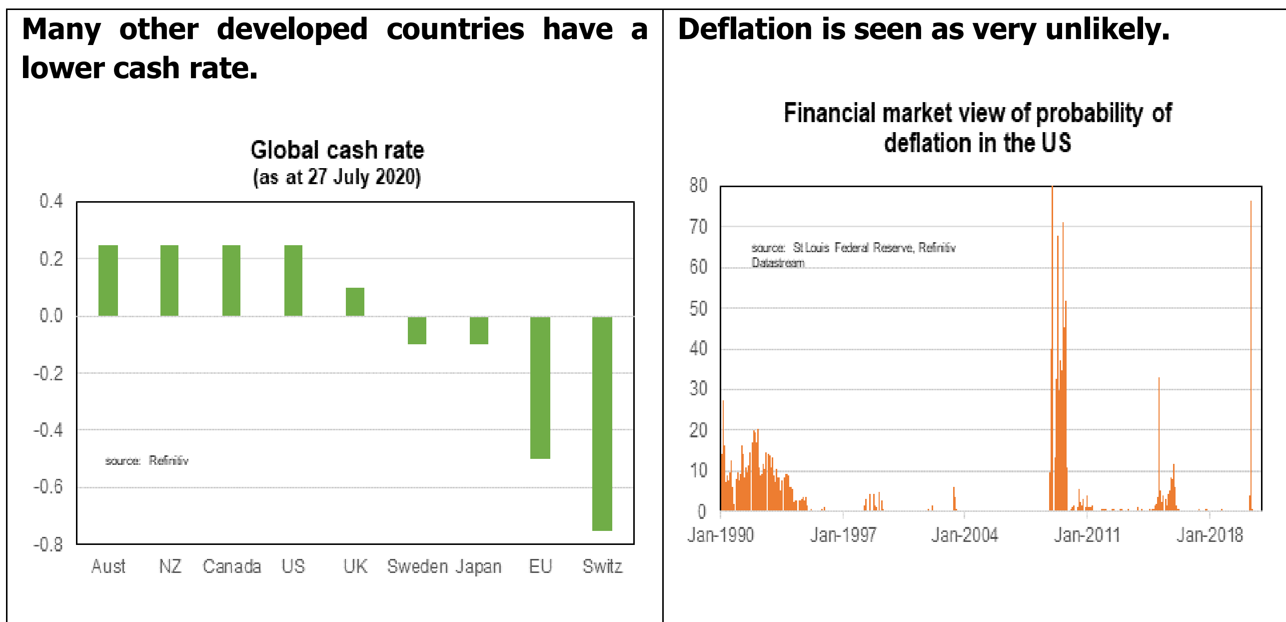
The RBA is unlikely to announce a target amount of bonds they wish to purchase (quantitative easing). Other central banks have done this with an aim to reduce interest rates. But to date the RBA has got more bang for its buck (literally) by a mixture of forward guidance and yield curve control. So it is difficult to understand what additional benefit a sizeable bond buying program would bring. The exception is if there was a rise in financial market volatility such as what was experienced earlier this year when interest rates rose sharply. The RBA has already said that in this scenario it would buy bonds (potentially significantly) until interest rates declined back towards 'normal' levels.

Other central banks have purchased highly-rated corporate bonds. Some have bought equities (via ETF's). The Federal Reserve has even got into the lending game to smaller corporates. The aim of all these actions is to ensure that cheap funding is widely available in the economy. The problem with these options is that even indirectly it involves the central bank making decisions as to which

parts of the economy receives monetary support. To some extent that happens anyway with asset owners and borrowers benefitting when interest rates decline at the cost of savers. But purchases of listed company equities or highly-rated corporate debt benefits a smaller segment of the economy.

By and large the RBA does not purchase non-government debt (although it might lend against certain high-rated private-sector debt). The only direct purchasing of private sector liabilities (for small lenders that provide consumer and business finance) is being conducted by the Australian Office of Financial Management (AOFM). The AOFM is essentially the Federal Government's debt management arm. So it is the Government of the day that is making the decisions as to which areas of the economy get financial support (as they do all the time with fiscal policy decisions).

A concern for the RBA would rise if households or firms were unable to access credit or equity markets because of either a lack of lenders or buyers. But that scenario is a low probability. In this crisis the banks are well capitalised and are able to lend. And Australia has one of the largest superannuation markets in the world that focus upon achieving long-term returns. So a problem with the availability of funding for the economy looks unlikely.



The biggest issue for the economy is neither the cost nor availability of funding but the lack of demand. And if households and business are unable (or unwilling) to provide that demand then the only body(s) that can are governments.

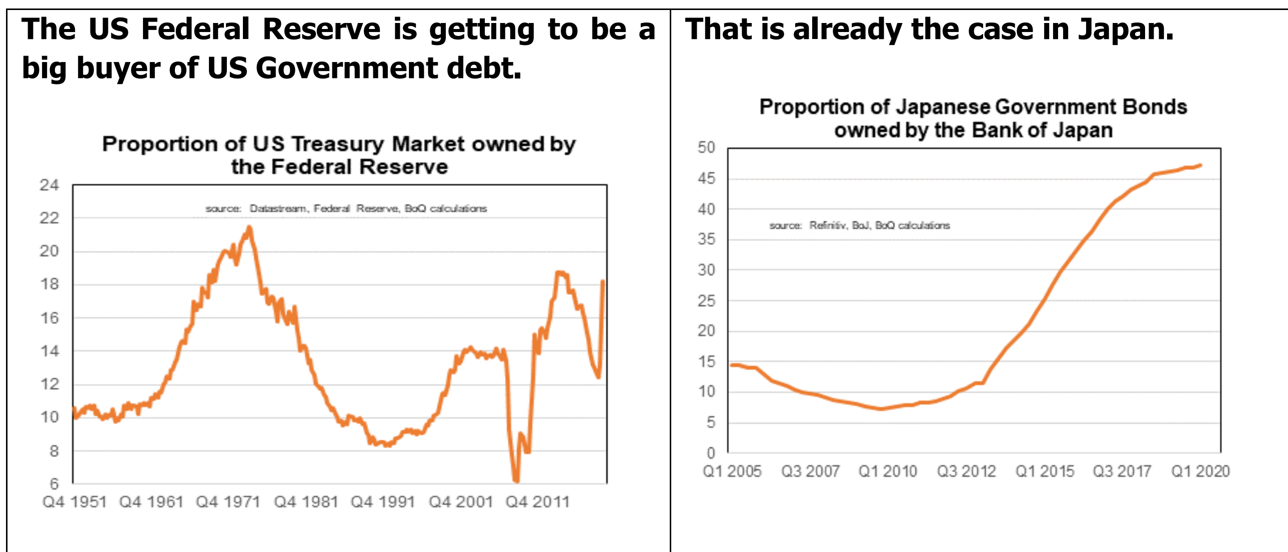
And Governments have stepped forward. We found out recently that the Federal Government budget has moved from a forecast surplus of $5b for 2020-21 in December to an $184b deficit. State Government's will also be running deficits. And given the economic uncertainty the clear risk is that Governments will need to do more and deficits will need to widen.

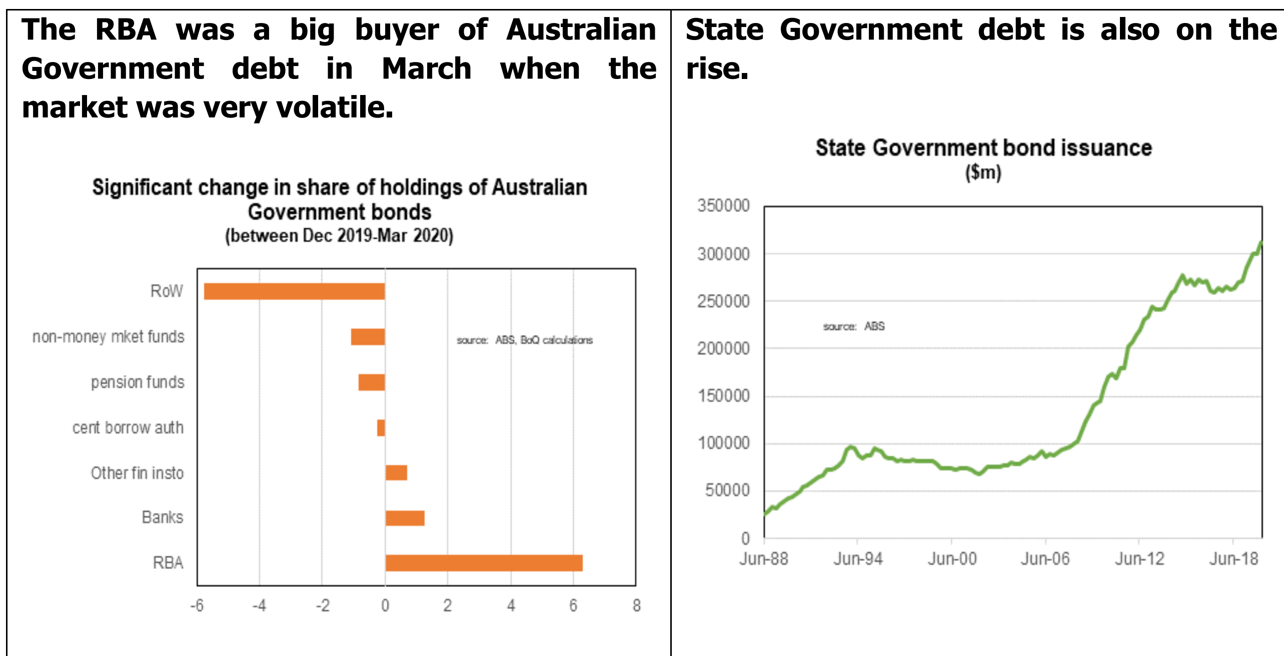
In a speech recently, RBA Governor Lowe addressed the issue as to whether the RBA could 'fund' Government deficits. The thinking is that with inflation low and forecast to remain so for some time there is little risk of (developed country) central banks funding government deficits. It is known as Modern Monetary Theory (MMT). Some very respected economists have suggested that in some circumstances (the usual monetary policy tools are not working, the economy needs help, government debt is high and the deficit can't be funded) central bank deficit funding might be appropriate.

Governor Lowe poured cold water on the arguments. He noted that right now the Australian Government has been easily able to fund itself. And with debt levels likely to remain low by global standards that is likely to remain the case (as evidenced by rating agencies keeping the AAA credit rating unchanged). More generally, he noted that central bank deficit funding always comes with a cost (such as an eventual rise of inflation or savers having to hold assets providing negative real returns).

The biggest issue I have is that even if MMT is appropriate in certain scenarios it is not appropriate most of the time. The risk is that once governments and the community get used to 'free funding' it would be very hard to stop. And that is when the problems begin.

In summary, there are further things that the RBA can do if required. But their economic impact is likely to be limited. If the economy does take a step down it will require fiscal policy to step up. The evidence from this year to date is that Government's will do what is required.





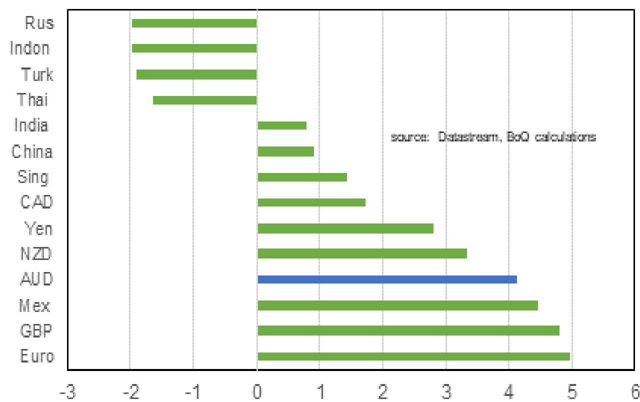
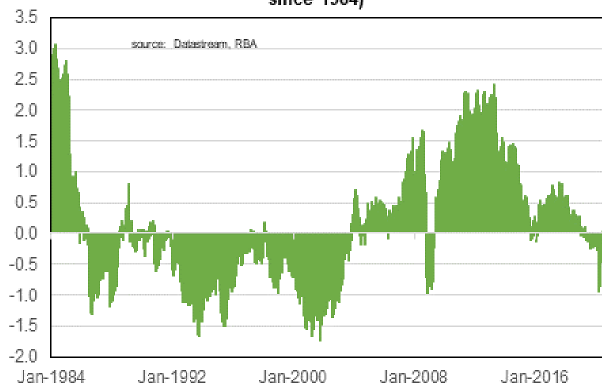
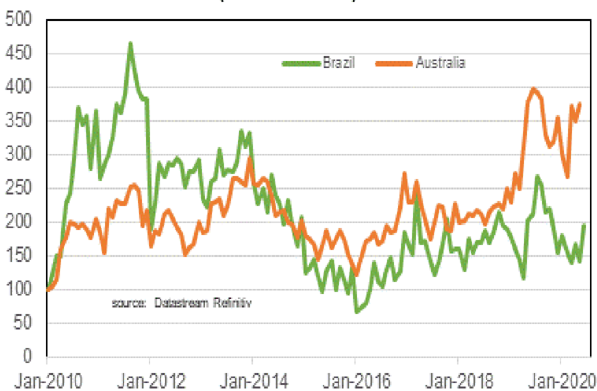
Foreign exchange market update

The AUD has had a good past few weeks (only the major European currencies have done better) reflecting the bounce-back in the global economy (particularly China). This benefited our main exports (commodities such as iron ore). It also enabled a reduction in financial market volatility that provided global investors with more comfort to invest in smaller markets such as Australia (and New Zealand). Relatively high interest rates also provides investors a reason to invest in Australia. And running a current account surplus means that even modest inflows of money can boost the $A.

At the time of writing the AUD was getting close to 72c (at the time of writing my 'simple' AUD model was 73c). From here the $A journey gets tougher. After a (brief) period of being too low, the AUD has moved back to be close to its fundamentals and around its long-term average. My preferred scenario is that the global (and domestic) economy keeps improving (albeit along a bumpy path) over the next year. A vaccine/effective treatment is found over the next six months and is available for widespread use by the second half of next year. Ample fiscal and monetary policy support remains in place until it is clear the economic path becomes easy. In this scenario the AUD heads up towards 75c, and possibly as high as 7750c.

But while the AUD has had a better couple of months, there are potential pitfalls. Even in a good scenario we are going to have to live with the virus for another 12-18 months. At a minimum this will lead to a bumpy run in the economic data (which we about to see in the US). Even in countries that have had relatively good health outcomes consumer confidence has remained subdued as they worry about the virus' next reappearance. Brazil's bad luck with the crimping of their iron ore exports over the past year has been Australia's good luck. At some stage this must change. More generally, high rates of unemployment could weigh down growth.

In a downside scenario the AUD would head back below 70c and towards 68c. A clear move under that level means a trip to 65c becomes a possibility.

The AUD has had a good few weeks.	**And is not far from its long-term average.**
	
Australian iron ore exports has benefited from a reduction in Brazilian production.	**Foreign exchange volatility has declined over recent weeks.**
	

For Frodo his Lord of the Rings journey was the end of the world as he knew it. Right now the world is not as we knew it. Better days will return. How long and bumpy our journey to that day is the unknown.

We live in interesting times.

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