Tuesday, 4 April 2023

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RBA Board Meeting

Done and Dusted?

- **Reserve Bank (RBA) hit the pause button, leaving the cash rate at 3.60%. It is the first pause in eleven meetings.**
- **Growing evidence that inflation has peaked and economic activity is slowing, especially household spending, has given the RBA room to go on hold and assess further data.**
- **It begs the question, is the RBA done and dusted? Markets think so! Our Group view is one more hike in May. But as we have been flagging for the past month, the growing risk is the RBA is finished hiking.**
- **One of the biggest standouts in the statement is the RBA's assessment of the slowdown underway in household spending – the engine of the economy – as "substantial". Monetary policy has long lags and 880,000 fixed-rate home loans are set to expire this year, a further pull back in spending is, therefore, likely.**
- **Paving the way for a pause were also the monthly inflation results for January and February, which undoubtedly gave the RBA comfort that inflation, one, has peaked, and two, is coming down, possibly quicker than expected.**

The RBA paused hiking rates today – leaving the cash rate at 3.60%. It's the first time it has paused in 11 meetings.

Easing inflationary pressures and increasing signs of slowing economic activity are the likely catalyst. The RBA noted it was appropriate to take time to pause and assess how households and businesses are responding to the cumulative 3.5 percentage points of rate hikes delivered since May.

It begs the question is the RBA done and dusted?

Interest-rate markets think so. They're pricing the next move to be a cut with a quarter of a per cent rate cut almost fully priced for the end of this year. We also see a real risk the tightening cycle is over.

The flavour of the statement suggests they could well be done – although the RBA has maintained that further tightening might be needed, keeping the door open, depending on the flow of data.

One of the biggest stand outs in the statement is that "there is further evidence that the combination of higher interest rates, cost-of-living pressures and a decline in housing prices is leading to a <u>substantial</u> slowing in household spending". Household spending is the engine room of the economy and recent retailing numbers have been tepid. Retailing rose only a tad in February and when we looked over the past three months and adjusted the data in per capita terms, it was the sharpest contraction on record, outside of covid.

The RBA notes that some household have substantial savings buffers, but others are "experiencing a painful squeeze of their finances". With 880,000 fixed-rate home loans due to expire this year, this painful squeeze risks turning into a crush.

In addition to the remarks on household spending, this statement also removed references to the outlook for business investment being positive, suggesting that the RBA's view on the economy has soured recently.

The RBA Assistant Governor, Kent, recently highlighted the long and variable lags with monetary policy. Indeed, as of December only half of the full effect of the rate hikes to date – 350 basis points in total – were felt by borrowers. Kent noted that "45 per cent of the rise in the cash rate to date had passed through to total scheduled mortgage payments at the end of 2022, though slightly more will have passed through in the early months of this year."

Paving the way for a pause were also the monthly inflation results for January and February, which undoubtedly gave the RBA comfort that inflation, one, has peaked, and two, is coming down, possibly quicker than expected. Indeed, the monthly annual inflation rate has stepped down from 8.4% in December 2022 to 6.8% in February.

The monthly inflation data is a guide to the quarterly inflation report, but it doesn't provide a comprehensive pre-read on the quarterly result. However, we also know that a bunch of temporary factors pushed up the quarterly outcome for the December quarter. These temporary factors include the unwinding of the fuel excise, HomeBuilder and electricity-related subsidies from state governments. This adds to our expectations that inflation is headed in the right direction – down. And will continue to moderate through this year.

The RBA arguably appears more relaxed about the areas of inflation that could prove sticky, namely services inflation, which is heavily impacted by wages growth.

On wages growth, they repeated that they remain "alert to the risk of a prices-wages spiral". However, the labour market is showing signs of easing, albeit from a very tight level. They conceded there are some reports of an easing in labour shortages. The massive ramp up in net overseas migration is providing an injection of much needed labour supply. Forward-looking indicators of employment are also softening, for example, candidates per vacancy are rising and job ads are declining. Furthermore, there are increasing reports of redundancies and increased outsourcing offshore from our own customer liaison.

The reference to services inflation being high in the March statement was not carried across to the statement today; it was removed. Certainly, the monthly prices data has suggested that inflation for some services – such as in travel and accommodation – have dropped sharply in the first two months of this year.

The RBA is playing it safe and talking tough about possible further tightening whilst it awaits the March quarter inflation report and other important data, including jobs and business confidence and conditions. However, the forward guidance was still softened via the insertion of the words "some" to further tightening and "may well" to tightening being needed.

It is possible the March quarter inflation report published on April 26 leaves the RBA with one more rate hike to do (consistent with our Group view). However, the growing risk is that with the pace of inflation headed down, the RBA remains comfortable with keeping the cash rate at 3.60%. Adding to the economic developments have been the ructions across the banking sector in the US and Europe. The RBA expects these recent problems to lead to tighter financial conditions, suggesting that central banks will have less work to do than they would have otherwise.

Ultimately, much will depend on the data flow over coming months. But before then, the RBA Governor takes to the podium tomorrow at the Press Club.

Besa Deda, Chief Economist
Ph: +61 404 844 817

Contact Listing

Chief Economist
Besa Deda
dedab@stgeorge.com.au
+61 404 844 817

Senior Economist
Jarek Kowcza
jarek.kowcza@stgeorge.com.au
+61 481 476 436

Senior Economist
Pat Bustamante
pat.bustamante@stgeorge.com.au
+61 468 571 786

Economist
Jameson Coombs
jameson.coombs@stgeorge.com.au
+61 401 102 789