

RBA has more to do - how low will the cash rate go?

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Key points

- > The Reserve Bank of Australia (RBA) will have to cut interest rates further to boost the non-mining sectors of the economy as the mining boom fades at a time when the Australian dollar remains strong and fiscal cutbacks are intensifying.
- > After the global financial crisis (GFC) caution has likely resulted in a reduction in the neutral level for bank lending rates, as they are only now starting to become stimulatory.
- > Our assessment remains that standard variable mortgage rates will need to fall to around 6%, which implies that the official cash rate will need to fall to 2.5%. We expect this to occur over the next six months, with the RBA cutting again next month by another 0.25%.
- > Bank deposit rates will fall further, but the Australian share market is likely to be beneficiaries as lower interest rates eventually boost housing activity and retailing.

Introduction

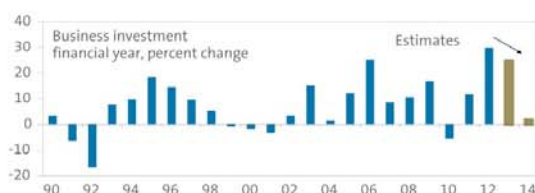
The Australian economic outlook has deteriorated. Recognising this, the Reserve Bank of Australia (RBA) has cut interest rates. Our assessment remains that the RBA has more work to do. But how low will rates go? What does it mean for investors?

The growth outlook

While economic growth in Australia has been reasonable of late, approximately 3.7% over the year to the June quarter, and well above growth in comparable countries, our assessment is that storm clouds are brewing and that growth will slow to around 2.5% in the year ahead, which is well below trend growth of around 3%-3.25%. The basic issue is that the mining boom is losing momentum at a time when the non-mining part of the economy is weak and fiscal austerity is intensifying:

- > Mining investment looks like it will peak next year. For the first time in years the June quarter survey of mining investment intentions did not show an upgrade in plans for the current financial year and projects under consideration have peaked. Falling mining sector profits suggests mining projects remain at risk. Investment outside the mining sector remains weak. This all points to a sharp slowing in business investment in 2013-2014.

Peak in mining investment to lead to a sharp slowing in business investment in 2013-14



Source: Thomson Reuters, AMP Capital

- > At the same time, a sharp fall in Australia's terms of trade is leading to a loss of national income which will also slow spending and growth. Stronger mining exports will provide a boost to growth but this may not become evident until around 2014-2015.

Iron ore price slump points to a further terms of trade fall

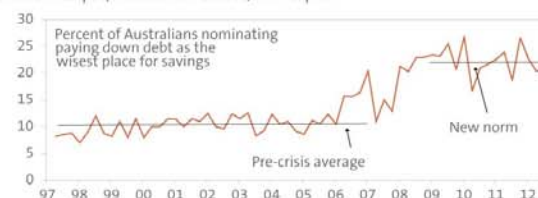


Source: Bloomberg, AMP Capital

- > This is all occurring at a time when non-mining indicators for the economy remain soft. Consumer and business confidence are sub-par, despite being almost a year into an interest rate cutting cycle.
- > Retail sales remain subdued, with government handouts providing a brief boost in May and June, only to see softness return again. Annual retail sales growth is stuck in a range around 3%. With confidence remaining sub-par, job insecurity running high and interest rates still too high, it's hard to see a strong pick up in the near term. Ongoing consumer caution in terms of attitudes towards debt and spending is highlighted by the next chart showing a much higher proportion of Australians compared to the pre-GFC period continuing to nominate paying down debt as the wisest place for savings.

A higher proportion of Australians are focussed on paying down debt

Source: Westpac/Melbourne Institute, AMP Capital



- > While, on average, housing related indicators have probably bottomed, taken separately they present a very mixed picture. House prices are up over the past few months. Housing finance, housing credit and building approvals look like they have bottomed, but remain soft. In addition, new home sales are still falling. The fact that there has only been such a tentative response to lower mortgage rates indicates that mortgage rates have not fallen enough.
- > The jobs market remains soft with weak job vacancies pointing to soft employment and rising unemployment ahead. Whereas anecdotal news of job layoffs was previously limited to the non-mining sectors of the economy, it has now spread to the mining sector. This is likely fuelling ongoing household caution, acting to constrain retail sales and housing demand.

The bottom line is that with the mining boom likely fading over the year ahead, the non-mining part of the economy (e.g. retailers, tourism, manufacturing, and housing and non-mining construction) needs to pick up to fill the breach. The good news is that the RBA appears to recognise this. The bad news is that its task is being made challenging by two factors:

- > First, the continuing strength in the Australian dollar, presumably on the back of safe haven buying, and moving out of the US dollar and euro in the face of QE3. In addition, the Australian dollar has a high correlation to the US share market as part of a 'risk on/risk off' trade, which has meant that it has not provided the shock absorber it usually does to falling commodity prices.
- > Second, having seen the budget handouts around mid-year, fiscal tightening will now kick in at the federal level and may even intensify if the government seeks to retain its projected surplus for the current financial year. At the same time, various states are announcing budget cutbacks, including job cuts.

In order to offset these forces and ensure that non-mining demand strengthens sufficiently, interest rates will have to fall further.

The cash rate is low but lending rates are not

While the RBA has cut the official cash rate to within 0.25% of its GFC low, because of bank funding issues lending rates are still well above their 2009 lows.

Basically banks have been seeking to reduce their reliance on non-deposit funding which has proved unreliable since the GFC. To do this they have had to offer higher deposit rates relative to the cash rate than would normally be the case. This has resulted in higher lending rates relative to the cash rate than was the case pre-GFC. Banks have done well to raise the proportion of their funding they get from deposits to 53% from around 40% pre-GFC, but they still lag behind banks other major countries and tougher capital requirements mean they are under pressure to do more.

The standard variable mortgage rate is below its long term average of 7.25%. It is currently around 6.6%, assuming banks pass on around 0.2% of the RBA's latest 0.25% rate cut. However, normally rates need to fall well below their long-term average to be confident stronger growth can be delivered. In an environment of household and business caution post-GFC, the neutral rate has likely fallen, probably to around 6.75%, which is shown as the 'new neutral' level in the next chart. This would suggest that current mortgage rate levels are only just starting to become stimulatory.

In the last two easing cycles the mortgage rate had to fall to around 6.05% in 2002 and to 5.8% in 2009. Given the fall in the likely neutral level for mortgage rates and the current headwinds coming in the form of the strong A\$ and fiscal tightening, mortgage rates will at least need to fall to these lows. Given the ongoing issues with bank funding, to achieve a circa 6% mortgage rate the cash rate will need to fall to around 2.5%.

Interbank lending spreads have collapsed in Europe



Chart assumes average large bank standard variable mortgage rates fall to 6.6% following latest RBA rate cut. Source: RBA, AMP Capital

Our assessment is that the RBA is coming around to this view. As such we expect another 0.25% cash rate cut next month on Melbourne Cup day, followed by a cut to 2.5% in the March quarter next year.

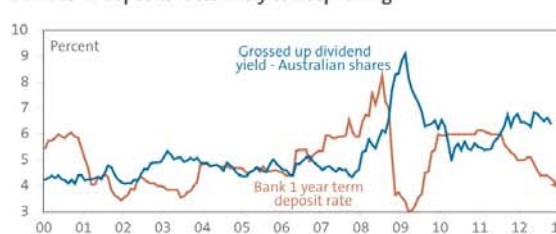
Based on the assumption that the RBA cuts interest rates further, the global economy stabilizes and growth in China stabilizes around 7.5% next year then Australian economic growth should pick up again by the end of 2013.

Implications for investors

There are a number of implications for investors.

- > Interest rates need to fall a lot further. This means that term deposit rates are likely to fall further in the years ahead, even though the size of the decline will lag that of the official cash rate given bank funding reasons. As a result, the attractiveness of bank deposits for investors will continue to deteriorate.

Bank term deposits rates likely to keep falling



Source: RBA, Bloomberg, AMP Capital

- > While record low bond yields mean bonds are poor value for long term investors, yields will likely remain lower as the RBA cuts interest rates. However, if foreign investors start to develop concerns surrounding Australia, international bonds will do better than Australian bonds.
- > Australian shares should benefit from interest rate cuts and cheaper valuations. We continue to see the Australian share market being higher by year end. Key sectors likely to benefit from lower rates are retailers, building materials and home builders.
- > Declining interest rates in Australia will take pressure off the Australian dollar. However, a fall in value is likely to be constrained by quantitative easing in the US and central bank buying. Overall we see the Australian dollar stuck in a range around US\$ 0.95 to US\$ 1.10. The best has likely been seen for the Australian dollar.

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