The RBA is still not there yet – expect more cuts

- 5 DECEMBER 2012

Key points

- While the Reserve Bank of Australia (RBA) has cut the official cash rate back to its post GFC record low of 3%, overall policy settings are nowhere near as stimulatory as they were in mid-2009. Bank lending rates are much higher, the A$ is way higher and fiscal policy is being tightened rather than loosened.
- Even lower rates will be needed to boost the economy's non-mining sectors as the mining boom fades at a time when the A$ remains strong and fiscal cutbacks are intensifying.
- Post GFC caution has likely resulted in a reduction in the neutral level for bank lending rates, such that they are only just mildly stimulatory.
- Standard variable mortgage rates will need to fall to around 6% at least, which implies that the official cash rate will need to fall to at least 2.5%. This is expected to occur during the first six months of next year, with the RBA cutting rates again in February by another 0.25%.
- Bank deposit rates will fall further but the Australian share market is likely to be a key beneficiary as lower interest rates eventually boosts housing and retailing.

Introduction

While the global outlook has improved a bit, the Australian outlook has become more uncertain as evidence continues to build that mining investment - the key driver of Australian economic growth in recent years, is peaking at a time when the rest of the economy is still subdued. Consistent with this, the RBA has cut interest rates again. Our assessment remains that the RBA has more work to do.

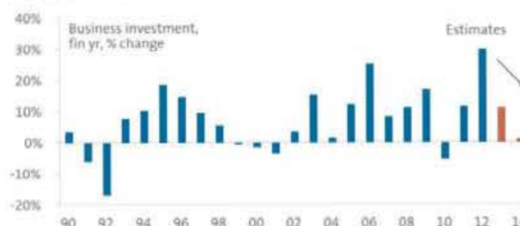
Growth in mining investment fading rapidly

While Australian economic growth has been reasonable of late and well above that in comparable countries, it has been slowing and our assessment remains that growth will slow further to around 2.5% over the year ahead, which is well below trend growth of around 3-3.25%. The risks are clearly on the downside.

The basic issue is that the mining investment boom is rapidly losing momentum. Mining investment looks like it will soon peak if it hasn't already, with investment intentions for 2012-13 falling sharply in the ABS' most recent survey (conducted through October/November). In fact, the implied rate of growth in mining investment for this financial year has halved from around 40% to below 20%. Given current levels, this implies that mining investment could actually fall slightly for the final three quarters of the current financial year.

This is occurring at a time when investment plans outside the mining sector are also still deteriorating. This all points to a sharp slowing in business investment going forward.

Peak in mining investment is leading to a sharp slowing in business investment



Source: Thomson Reuters, AMP Capital

Non-mining growth needs to pick up quickly

The trouble is that growth in other areas of the economy is soft. While the Reserve Bank has been cutting interest rates for just over a year, the response has been subdued. The table below shows the change in key indicators for the economy observed during the last three rate cutting cycles, which commenced in July 1996, February 2002 and September 2008.

Key variables, 12 months into rate cutting cycles

Variable	Jul 97	Feb 02	Sep 09	Average	Latest
NAB Business Confidence (index level)	+15	+19	+14	+16	-1
Consumer confidence (index level)	98.8	113.7	119.3	110.6	104.3
Nominal retail sales (annual change)	+3.1%	+7.3%	+6.1%	+5.5%	+3.1%
Dwelling approvals (annual change)	+5%	+49%	+18%	+24%	+15%
Auction clearance rate - Sydney (4-week average)	N/A	N/A	67.6%	N/A	58.0%
Auction clearance rate - Melbourne (4-week average)	N/A	N/A	80.8%	N/A	60.4%
House prices (annual change)	+9.3%	+19.8%	+7.1%	+12.1%	-0.1%
Employment (annual change)	+0.8%	+1.9%	+0.5%	+1.1%	+0.6%
Private sector credit (annual change)	+10%	+8.6%	+1.7%	+6.8%	+3.8%

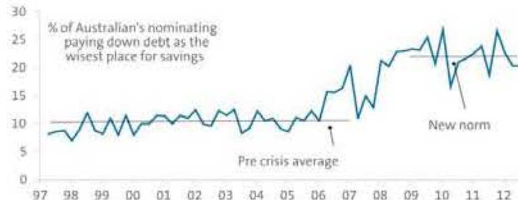
Source: NAB; Westpac/Melbourne Institute, ABS, Australian Property Monitors, RP Data/Rismark, RBA, AMP Capital.

All of these indicators are currently well below the average level they attained this far into past easing cycles. In summary:

- While consumer confidence has improved from recent lows, it is still 6% lower than would normally be the case at this point in the cycle.
- Business confidence readings are well below average.
- Retail sales annual growth is still stuck in the 1 to 4% range it has been in since 2010, despite a mid-year pick up thanks to Government handouts.
- Dwelling approvals along with other housing related indicators such as auction clearance rates have improved, but the uptrend is very mild by past standards - likewise for house prices.
- Employment growth is also very subdued, with sharp falls in job vacancies pointing to further softness ahead.

Several factors are driving the subdued response to interest rate cuts. The main factor is post GFC caution. Immediately after the GFC, Australian consumers responded as if it was back to normal. The last two years have shown that it's anything but normal. Households are worried about job security after further rounds of layoffs and have lost confidence in their wealth after extended periods of weakness in house prices and share markets. This has been reinforced by a nightly dose of bad news regarding the world economy, which has all led to a more cautious approach to debt and spending, as highlighted by the next chart showing a much higher proportion of Australians nominating 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

The situation is a similar one for businesses. They hired aggressively into 2010, expecting a quick return to normal demand levels, only to see margins and revenue under pressure from poor demand and the strong A$.

And of course, this is all occurring at a time when fiscal tightening is kicking in both at a federal and state level.

While the softness in non-mining activity didn't matter much for the big macro picture when mining investment was booming, it matters a lot more now that mining is slowing.

In order to offset these forces and ensure that non-mining demand strengthens, interest rates will have to fall further. Our assessment is that the modest response in the economy so far from lower rates is not a sign that rate cuts don't work anymore. Rather, it's a sign that rates have not been cut enough given the changed circumstances.

Borrowing rates are not low enough

Although the RBA has cut the official cash rate to its GFC low, bank lending rates are around 0.6-0.8 percentage points above their 2009 lows because of bank funding issues.

The standard variable mortgage rate at around 6.42% (which assumes banks pass on around 0.2% of the RBA's latest 0.25% rate cut), is below its long term average of 7.25%. Interest rates normally need to fall well below their long term average to be confident stronger growth can be achieved. And in an environment of household and business caution post the 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 5.75% in 2009. Given the fall in the likely neutral level for mortgage rates and the current headwinds coming from the strong A$ and fiscal tightening, mortgage rates will at least need to fall to these lows. Given ongoing issues with bank funding to achieve a circa 6% mortgage rate, the cash rate will need to fall to around 2.5%. It's a similar issue with business borrowing rates.

Bank lending rates still need to fall further

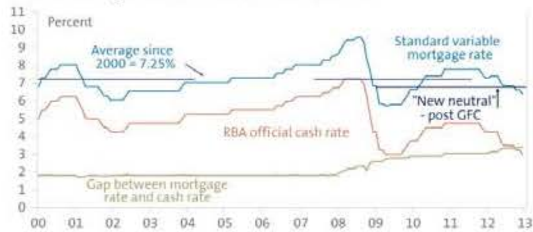


Chart assumes average large bank standard variable mortgage rates fall to 6.4% following latest RBA rate cut. Source: RBA, AMP Capital

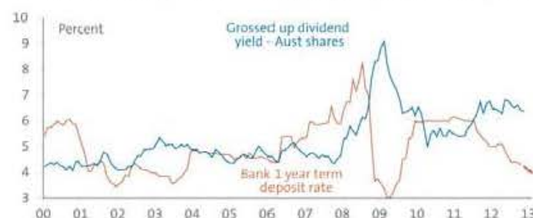
And with inflation remaining benign, there is no barrier to the RBA cutting further. Our assessment is that the RBA will follow up yesterday's cut with two 0.25% cuts in February and April. Based on this assumption and that the global economy stabilises, Australian economic growth should pick up by the end of 2013.

One should not underestimate the boost lower mortgage rates will ultimately provide. A fall in mortgage rates to 6% from the 2011 high of around 7.8% is equivalent to around A$4,500 p.a in interest savings on a A$300,000 mortgage. Ultimately some of that will be spent.

Implications for investors

- The attractiveness of bank deposits will continue to deteriorate, given term deposit rates are likely to fall below 4% over the next six months, even though the size of the decline will continue to lag the official cash rate.

Shares are offering an increasingly higher yield than deposits



Source; RBA, Bloomberg, AMP Capital

- While record low bond yields mean bonds are poor value for long term investors, yields will likely remain low as the RBA cuts interest rates.
- Australian shares should benefit from interest rate cuts and has done so since mid year. As such, we continue to see the Australian share market trending higher. Sectors likely to benefit from lower rates are retailers, telecommunications, banks, building materials and home builders. However, yield-bearing sectors will also do well as the chase for yield intensifies and deposit rates fall.
- Declining interest rates in Australia will take pressure off the A$. However, falls are likely to be constrained by US quantitative easing and central bank reserve buying. Overall, the best has likely been seen for the A$ and we see it stuck in a US$0.95 to US$1.10 range.

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