

Australia – the RBA, the economy and shares

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Oliver's Insights



Key points

- > Benign March quarter inflation has cleared the way for a Reserve Bank of Australia (RBA) interest rate cut in May. A cut of 0.25% is most likely, but 0.5% would be best to ensure a decent cut in mortgage rates.
- > Given global uncertainties, the softness in the Australian economy, borrower caution, an approximately A\$40 billion turnaround in the budget and a benign inflation outlook, interest rates should fall between 0.75% and 1% over the next six months.
- > Lower interest rates, the Australian dollar (A\$) having fallen back from its highs and lessening concerns about a Chinese hard landing are likely to be positive for the relative performance of Australian shares.

Introduction

For some time, our view has been that Australian interest rates need to be lower. The RBA at its last meeting seemed to be finally coming around to this view, but preferred to wait for the release of March quarter inflation data. Well the inflation data is now out and it's far weaker than expected, clearing the way for a cut in May. The question then becomes how far should interest rates fall? How will the budget influence this? Will banks pass it on? And what will all this mean for the economy and share market?

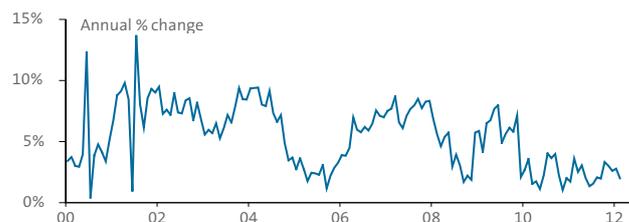
Australian interest rates are way too high

The case to cut interest rates is very strong. First, while there is no doubting the strength of the mining investment boom, it is not delivering anything like the trickle down boost to the economy seen during the first mining boom last decade. There is no huge revenue windfall for the Federal Government to allow annual tax cuts, the impact on the labour market has been minor (perhaps because the mining sector only employs 3% of the workforce) and there is likely substantial leakage from mining investment into imports. At the same time, the non-mining economy is suffering under the impact of the strong A\$ and relatively high bank lending rates. The result is parts of the economy are in recession and overall gross domestic product (GDP) growth is sub-par, for example:

- > GDP growth in the second half of 2011 was 2.4% annualised and just 1.6% annualised in the December quarter. This is well below trend growth of around 3.25% per annum (pa).
- > Retail sales remain very weak. Trend monthly growth in retail sales is now zero and they are up just 2% over the year to March, having fluctuated in a low 1 to 4% year-on-year growth range since late 2009, in contrast to past experience where such low growth during cyclical downturns had been limited to a few months. Retailers are struggling due to job insecurity, a newfound desire by households to reduce debt levels and save more following the global financial crisis, rising costs for

utilities and rents eating into spending power, a rise in online shopping and more Australians shopping overseas on holiday. These trends are unlikely to change any time soon.

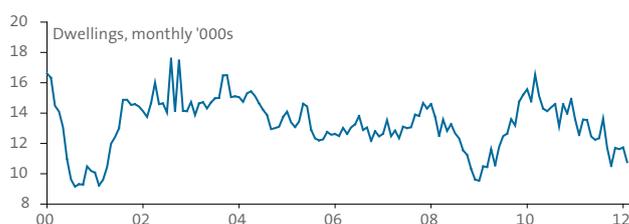
Retail sales still struggling



Source: Bloomberg, AMP Capital

- > Similarly, housing related activity is soft, with building approvals near global financial crisis lows, house prices down 6% or so from 2010 highs and high levels of listings and subdued auction clearance rates suggesting no relief in sight.

Dwelling approvals are very weak



Source: Bloomberg, AMP Capital

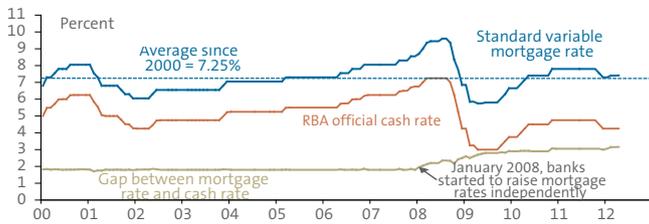
- > The labour market is softening. Over the last year, jobs growth has been just below 38,000 whereas Australia needs to generate around 148,000 jobs a year to stop unemployment from rising. Increasing anecdotes of job losses suggest unemployment is likely to rise to around 5.7% over the next six months as companies seek to reduce their cost bases in the face of soft demand. This will only weigh further on consumer confidence.

Second, interest rates are arguably well above 'neutral' levels. Following the cash rate cuts of late last year, much commentary, including from the RBA, has focused on the observation that bank lending rates such as standard variable mortgage rates are now back in line with their long-term averages, the implication being that monetary policy is neutral, i.e. neither acting to boost or slow the economy. After these rate cuts the standard variable mortgage rate fell to 7.3%, against an average of 7.25% since 2000.

Our assessment though is that such an approach is fallacious for two reasons. Since February the banks have raised rates independently of the RBA, pushing them back above longer-term averages (to a current average of around 7.4% depending on the bank), as shown by the next chart.

What's more, in the current environment of consumer caution and desire to reduce debt, it's likely the so called 'neutral' level for borrowing rates has fallen below the average of the last decade, perhaps by 0.5%. In other words, mortgage rates should now be 6.75% not 7.4%. Such an approach also ignores the influence of the strong A\$, which amounts to a de facto monetary tightening. All of this suggests monetary conditions are still tight, i.e. a long way from neutral.

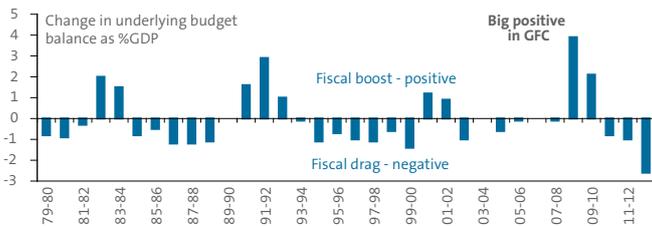
Mortgage rates drifting back above their long term average



Source: RBA, AMP Capital

Third, fiscal policy is becoming contractionary, with the projected turnaround in the budget deficit from 2011-12 to 2012-13 on current policies equal to around 2.6 percentage points of GDP, resulting in the largest fiscal drag on record.

Fiscal thrust to turn strongly negative in 2012-13



Source: Australian Treasury, AMP Capital

This reflects the winding down of earlier stimulus measures and tightening announced last year. Of course the recent admission of revenue running below target means the most recent Mid-Year Economic and Fiscal Outlook projection from November last year of a A\$37 billion deficit for 2011-12 has likely blown out to A\$41 billion, suggesting that the starting point surplus for 2012-13 of A\$1.5 billion has likely turned into a circa A\$2 billion deficit. In other words another A\$3 billion in savings may be required, increasing the size of the fiscal drag to around A\$42 billion or nearly 3% of GDP. While there is no precise relationship between fiscal and monetary policy, the record level of fiscal drag adds substantially to the case for rate cuts.

Fourth, the risks regarding Europe and global growth remain, with a softer run of data from both Europe and the US emerging recently and renewed concerns regarding Spain.

Finally, all of this is occurring when inflation is benign. March quarter inflation data showed headline inflation of just 1.6% and underlying inflation of just 2.2%, which is at the low end of the RBA's target range. Price discounting appears to be substantial in consumer sensitive parts of the economy with falls in prices for clothing, household items, cars, sporting goods, etc. and this is likely to continue as demand remains soft. On top of this, a deceleration in producer price inflation shows upstream price inflation is fading and wages growth is benign.

None of this is to say the economy is collapsing. Rather the key point is that for trend growth of around 3.25% to be achieved, interest rates need to be lowered significantly and benign inflation provides plenty of scope to do so.

The obvious concern is that "banks are now moving independently of the RBA, so we can't assume they will pass

it on." However, this started back in 2008 when banks raised rates in January independently of the RBA, but it didn't stop mortgage rates following the RBA cash rate down to the lowest levels since the late 1960s in 2008-09, as shown in the first chart on this page. The same would apply again as the cash rate still has a large impact on the banks' funding costs. If the RBA cuts rates by 0.25% in May, the banks will likely cut their mortgage rates by 0.10 to 0.15%. Therefore there is a strong case for the RBA to cut rates by 0.5% in May to ensure a decent mortgage rate cut is passed on to households.

Taken together, all this suggests mortgage rates need to fall by at least 0.75% and to ensure this happens a total fall in the cash rate of 1% is likely required by year end.

The 2012-13 budget

There is much debate about the merits of returning the budget to surplus by 2012-13. Weaker than expected revenues, due to a softer economy, have necessitated even more budget cutbacks. With the non-mining economy very fragile this is a dangerous time to be undertaking fiscal cutbacks, so the government needs to be careful, hopefully better targeting spending rather than cutting excessively and threatening savings, productivity or future growth.

From an economic perspective, it's neither here nor there whether the surplus is reached in 2012-13 or the year after. However, I think the government should stick to returning to surplus for 2012-13. First, a delay may be greeted dimly by foreign investors who hold 75% of Australia's public debt. This would mean higher long-term borrowing costs for ordinary Australians. Second, we need to start putting money aside for a rainy day. While times are tough, they are not disastrous. If we can't run surpluses when commodity prices are high and unemployment is around 5%, when will we? The global economy is still fragile and we need to start reducing public debt so that if things really turn sour, the government has the firepower to undertake another round of stimulus.

With the non-mining part of the economy struggling, it is clear the economy needs a bit of fine tuning. But it's the RBA not the Federal Government that is best placed to do this.

The Australian share market

While US shares went to new recovery highs early this month, the ASX 200 is well below its post global financial crisis high of 5000. Three things have held back the Australian share market relative to global markets since October 2009: relatively high interest rates, the strong A\$, and worries about a hard landing in China. If the RBA eases as we expect, then it could usher in a period of relative outperformance from the Australian share market, particularly with the A\$ down from its high earlier this year of \$US1.08 and concerns about a Chinese hard landing starting to fade a bit. The relative resilience of Australian shares over the last month suggests this may already be getting underway.

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