WILSONS

The Australian Economy, the RBA and Interest Rates

Our weekly view on asset allocation.

14 February 2022

Our Views on the Domestic Outlook

The RBA has recently released its quarterly assessment of the economic outlook and expectations for monetary policy in its Quarterly Statement of Monetary Policy.

It is noteworthy that the economic growth and inflation backdrop have both been significantly stronger than the RBA expected, prompting the RBA to upgrade its forecasts.

The good news is that economic growth (GDP) and the labour market are significantly stronger than the RBA expected just 3 months ago and way ahead of their forecasts of 12 months ago.

The RBA noted that the Australian economy has bounced back strongly from the lockdowns associated with the outbreak of the Delta variant of COVID-19 in the third quarter of 2021. Real GDP is estimated to have grown by 5% over the 2021 year despite the lockdowns.

Moreover, the RBA remains upbeat on the growth outlook for 2022. Again, this is despite the recent Omicron wave disrupting growth. Omicron will take the edge off growth in the first quarter of this year, but it is forecast to have significantly less impact than last year's lockdowns.

The RBA is looking for a robust post-Omicron recovery in domestic demand. Aggregate economic activity is now expected to return to a level implied by the pre-pandemic forecasts by late 2022. The sources of this more bullish medium-term outlook come from faster consumer spending thanks to stronger growth in labour income and an improved outlook for public spending than previously expected.

GDP is expected to grow by around 4.25% in 2022 (5% on a year average basis) and 2% in 2023 (2.5% year average growth).

Exhibit 1: The economy has rebounded strongly in 2021 and should to continue to recover in 2022

Source: Refinitiv, Wilsons.

Exhibit 2: The RBA is expecting unemployment below 4% by year end - a 48 year low

Source: Refinitiv, Wilsons.

The RBA also acknowledged that the labour market has recovered more quickly than expected. The unemployment rate declined to 4.2% in December, which compares to a pre-COVID level of 5.2%. Labour force participation has also recovered to high levels.

While the Omicron outbreak is expected to have reduced hours worked significantly in January and early February as workers recover from illness or are required to self-isolate, overall employment is likely to have been relatively resilient. With job vacancies and other indicators of labour demand remaining strong, further improvement in the labour market is anticipated over the course of this year and into 2023.

The central forecast is for the unemployment rate to fall below 4% later this year. Indeed, the RBAs end 2022 forecast of 3.75% unemployment is below the 4% multi-decade low achieved in Australia's economic boom just pre-GFC and would be Australia's lowest unemployment rate since 1974. Guiding to a central case of no rate rise this year against a 48 year low in unemployment is certainly new age thinking from the RBA.

Exhibit 3: The economy has surprised the RBA to the upside in 2021

	RBA Forecast Jan-21	Actual Dec-21	Forecast Error
GDP growth	3.5	5*	1.5
Unemployment Rate	6	4.2	1.8
CPI Inflation	1.5	3.5	2
Underlying Inflation (trimmed mean)	1.25	2.6	1.35
Wage Price Index	1.5	2.25	0.75

*RBA estimate

Source: RBA, Wilsons

Outlook for Inflation Significantly Higher but Rate Guidance Still Dovish

While the growth outlook appears very robust, the other side of the coin is that the RBA has had to adjust its outlook for inflation significantly. This follows a higher than expected lift in consumer prices through the December quarter, with the headline consumer price index jumping 3.5%. The "trimmed mean" CPI - the RBA's preferred core inflation gauge - jumped 2.6%, the highest level since 2014.

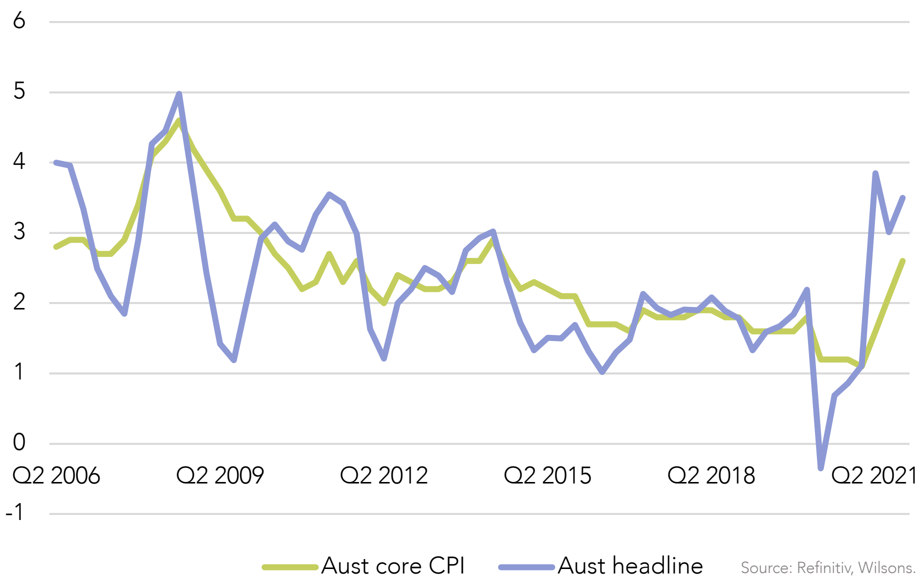
The RBA now sees core price rises are peaking at 3.25% across Q2 and Q3 before falling back to 2.75% next year.

This shift in inflation expectations has triggered a notable shift in policy guidance, with Governor Lowe now conceding that policy tightening "could" occur this year. This compares to the previous guidance that interest rates were not likely to rise until 2024.

Despite this, the RBA still wants to see more evidence of faster wage growth (~3% versus the current 2.2%) before committing to a rate hike. While the RBA did flag some evidence of rising labour pressures that are not yet evident in the headline wage price index, the RBA is still not confident of a significant lift in wage growth even with its freshly lowered unemployment forecast. Therefore, the RBA still does not expect to raise rates this year in its central case.

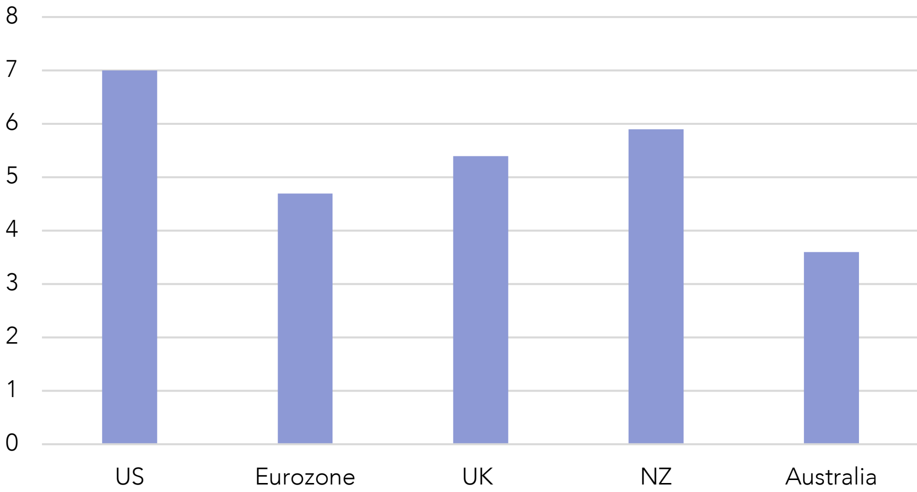
So, while the RBA has shifted its view on rates from its previous ultra dovish view, it remains relatively dovish versus other central banks and the domestic interest rate markets where four rate rises are fully priced for this year.

Exhibit 4: Australian inflation is no longer surprising the RBA to the downside



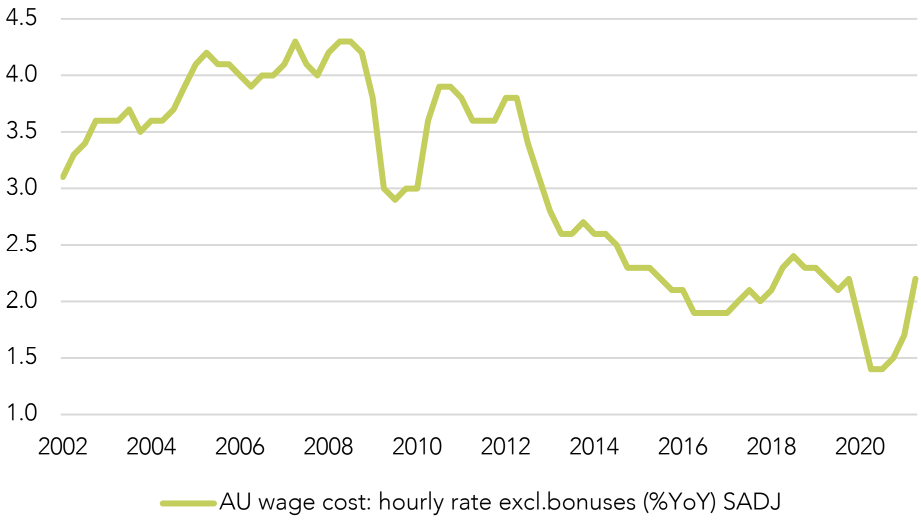
Source: Refinitiv, Wilsons.

Exhibit 5: Australian inflation has picked up but not to the extent seen overseas



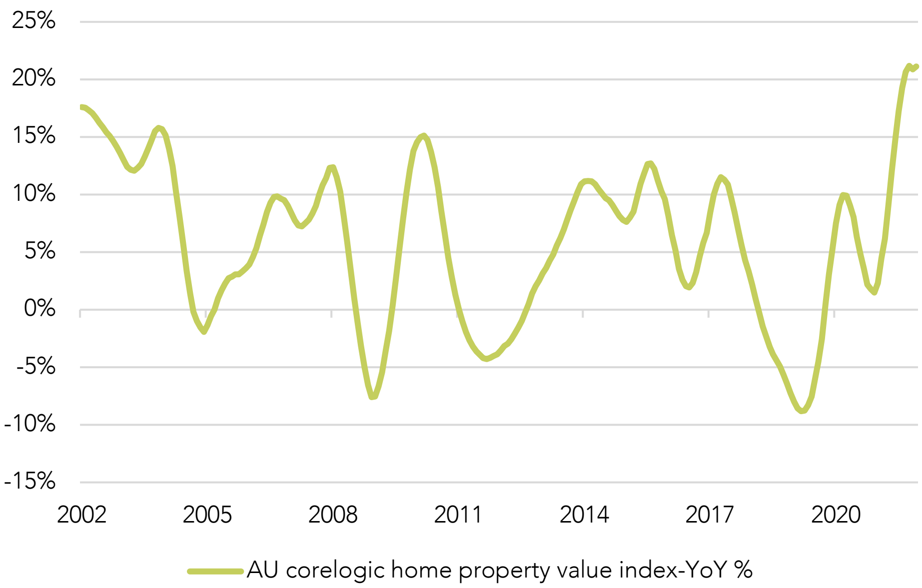
Source: Refinitiv, Wilsons.

Exhibit 6: The RBA is looking for a futher acceleration in wages growth before lifting rates



Source: Refinitiv, Wilsons.

Exhibit 7: Australian house price gains will slow with headwinds building through 2023



Source: Refinitiv, Wilsons.

The RBA noted that our increase in actual or expected prices is not as large as in some other economies. In part this is why the RBA continues to be relatively patient, watching both CPI and wages data before signalling that monetary policy needs to start being tightened.

This follow-through from CPI inflation to wages inflation remains a key signpost for the RBA in terms of lifting the cash rate this year. The next wages reading on February 23rd will be closely watched.

We expect broad measures of inflation to rise a little more quickly than the RBA expects over the next 6 months. We believe Australia will not be as insulated from the global inflationary upswing as the RBA believes, with Australia's economic strength this year also feeding into the inflation picture for both prices and wages. We consequently expect a rate hike in August this year, followed by another one before the end of 2022.

While we think the RBA remains too dovish in its guidance for only an outside chance of a rate hike this year, the four rate hikes being priced by the local interest rate markets this year still seems too aggressive to us. The market seems to be mirroring expectations for the Fed hiking cycle this year which seems a little too simplistic in our view.

The Interest Rate Outlook and Asset Market Implications

A moderate second half 2022 start to the rate cycle suggests relatively benign conditions for mortgage holders, even though the era of super-cheap fixed-rate mortgages is progressively coming to an end.

Australian house prices should continue to grind higher in 2022. A stiffer test will come in 2023. We see the potential for four rate rises in 2023, which suggests a cash rate around 1.5% or a touch high by late 2023. This would likely pose a challenge to further gains in the housing market beyond the next 12 months.

Indeed, the point at which interest rates turn to a significant headwind or downdraft for both the housing market and the broader economy is interesting given the degree of household leverage in the economy. A likely slow start to the rate hike cycle suggests the 12-month outlook looks supportive for both housing and economic growth.

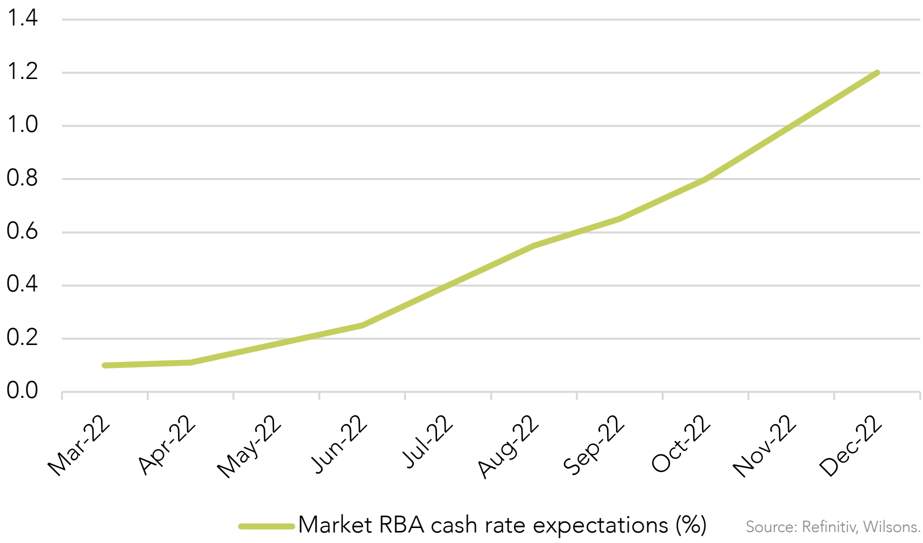
In terms of other asset markets, short-term bonds (3 year terms or less) may enjoy a rally if hawkish market 2022 interest rate views fail to materialise as we expect.

The picture for longer-term bonds is less clear. With global influences on the long end of the yield curve typically more significant, Australian bonds do look good value versus US yields in our view. Albeit rising US long yields are placing upward pressure on Australian yields.

The likelihood of only modest tightening is supportive for the local sharemarket. As always, global influences will be critical, but the market's heavy banking and resources structure does suggest the market should be unfazed (all things equal) by a moderate increase in local rates this year.

The outlook for A$ is interesting in the context of the RBA's still dovish policy stance. The A$/US$ has weakened in recent months. This is in part a function of broad-based US$ strength. Interestingly, the softness in the A$ is occurring against buoyant commodity prices. Indeed, our fair value model, which is partly based on commodity price levels, suggests a "fair value" above 85c.

Exhibit 8: The market has priced just over 100bp of hikes in 2022. This looks too aggressive



Source: Refinitiv, Wilsons.

It is difficult to judge which way the A$ will move if the RBA capitulates to a more hawkish view on rates later this year, but market interest rate pricing proves too hawkish (i.e. our view). It is quite likely that global factors, i.e. the broader US$ trend, will remain the key. The US$ should remain well bid if near-term risk asset volatility persists. However, if "risk-on" reflation sentiment gains the upper hand later in 2022, we would expect some catch up for the A$ (mid to high 70s) relative to our buoyant terms of trade position.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au