Shane Oliver, Head of Investment Strategy
& Chief Economist

The RBA is still not there yet – expect more cuts

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Key points

> While the 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 not loosened.

> Even lower rates will be needed to boost the non-mining sectors of the economy 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 2.5% at least. This is expected to occur during the first six months of next year, with the RBA cutting 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 boost housing activity & retailing.

Introduction

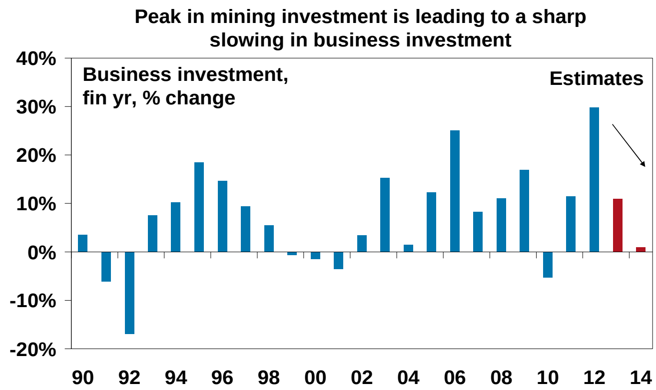
While the global outlook has improved a bit, the Australian outlook has become more uncertain as evidence continues to build that mining investment, the key driver of Australian economic growth in recent years, is peaking at a time when the rest of the economy is still subdued. Consistent with this the 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 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. Mining investment intentions for 2012-13 fell 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 for mining investment 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.



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 level or annual rate of growth in key indicators for the economy compared to where each were one year after the last three rate cutting cycles commenced in July 1996, February 2002 and September 2008.

Key variables, 12 months into rate cutting cycles

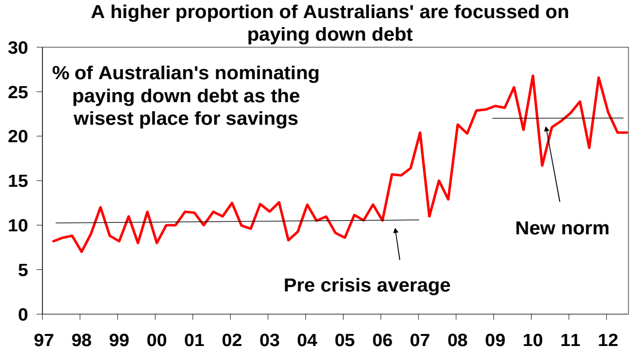
Variable	Jul 97	Feb 02	Sep 09	Average	Latest
NAB biz confidence, index level	+15	+19	+14	**+16**	-1
Consumer conf, index level	98.8	113.7	119.3	**110.6**	104.3
Nominal retail sales, % yr on yr	+3.1%	+7.3%	+6.1%	**+5.5%**	+3.1%
Dwelling approvals, % yr on yr	+5%	+49%	+18%	**+24.0%**	+15%
Auction clear rate, % – Syd, 4 wk avg	NA	NA	67.6%	**NA**	58.0%
Auction clear rate, % – Melb, 4 wk avg	NA	NA	80.8%	**NA**	60.4%
House prices, % yr on yr	+9.3%	+19.8 %	+7.1%	**+12.1%**	-0.1%
Employment, % yr on yr	+0.8%	+1.9%	+0.5%	**+1.1%**	+0.6%
Private sector credit, % yr on yr	+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:

- While consumer confidence has improved from recent lows its 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 on 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 business and consumers responded as if it was back to normal. The last two years have shown that it's anything but. Households are worried about job security after rounds of layoffs, have lost confidence in their wealth after extended periods of weakness in house prices and share markets and this has been reinforced by a nightly does of bad news regarding the world economy. This 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.



Source: Westpac/Melbourne Institute, AMP Capital

Similarly for businesses. They hired aggressively into 2010 expecting a quick return to normal demand levels but instead have seen margins and revenue under pressure from a combination of poor demand and the strong Australian dollar.

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, because of bank funding issues bank lending rates are around 0.6-0.8 percentage points above their 2009 lows.

The standard variable mortgage rate at around 6.42%, assuming banks pass on around 0.2% of the RBA's latest 0.25% rate cut, is below its long term average of 7.25%. But normally rates need to fall well below their long term average to be confident of stronger growth. And 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 5.75% 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.

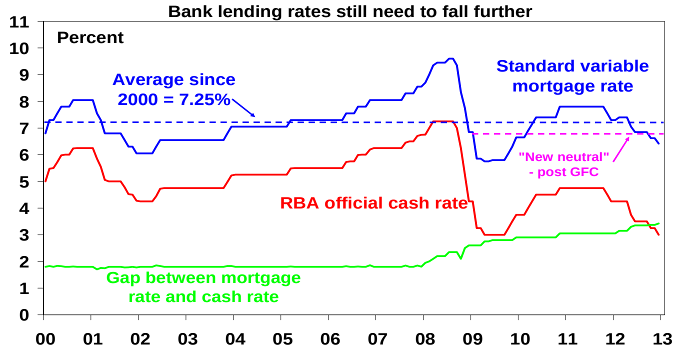


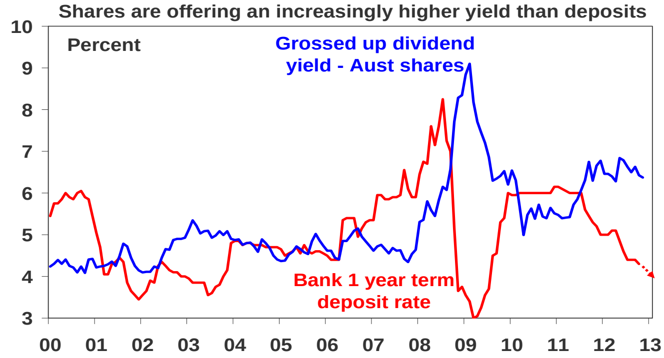
Chart assumes average large bank standard variable mortgage rates fall to 6.4% following latest RBA rate cut. Source: RBA, AMP Capital

And with inflation remaining benign there is no barrier to the RBA cutting more. Our assessment is that the RBA will follow up today's cut with another two 0.25% cuts in February and April.

Based on the assumption that the RBA cuts interest rates further and the global economy stabilizes then Australian economic growth should pick up by the end of next year. 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 $4500 pa in interest savings on a $300,000 mortgage. Ultimately some of that will be spent.

Implications for investors

- Term deposit rates are likely to fall further in the next six months taking them below 4%, even though the size of the decline will continue to lag that of the official cash rate. As a result the attractiveness of bank deposits for investors will continue to deteriorate.



Source; RBA, Bloomberg, AMP Capital

- While record low bond yields mean bonds are poor value for long term investors, yields will likely remain lowish as the RBA cuts interest rates.
- As we have seen since mid year, Australian shares should benefit from interest rate cuts. As such we continue to see the Australian share market trending higher. Key sectors likely to benefit from lower rates are retailers, building materials and home builders. However, yield bearing sectors will also do well including telcos and banks as the chase for yield intensifies as 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 we see the $A stuck in a range around $US0.95 to $US1.10. The best has likely been seen for the $A.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital