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Liquid Insight

RBA: A hawkish hold to end 2023

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Rates and Currencies Research
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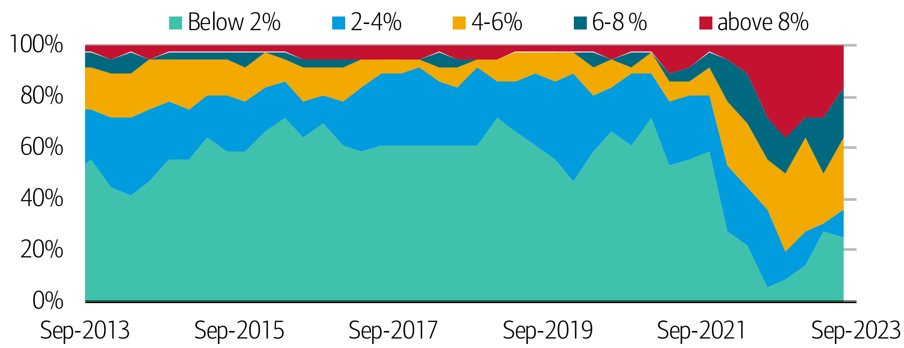
Key takeaways

- The RBA is set to keep the cash rate unchanged in December, but a hawkish bias will be maintained into February 2024.
- The breadth and composition of inflation remain a concern for the RBA, but data has softened of late. GDP 3Q will be soft.
- Hawkish RBA rhetoric justifies a small steepening bias in early 2024 OIS pricing. We recommend Feb/Mar OIS steepeners at 0bps

By Micaela Fuchila/Oliver Levingston /Adarsh Sinha

Exhibit 1: The breadth of inflation remains an issue for the RBA
But monthly data has provided a breather



Source: ABS, Macrobond

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On hold for Christmas, all eyes on February

The Reserve Bank of Australia meets one last time this year on Dec 5 and is set to keep the cash rate unchangd at 4.35% following a hike in November. While the Bank Governor has recently strengthened her hawkish bias suggesting "the remaining inflation challenge we are dealing with is increasingly homegrown and demand driven", economic data has been soft since. Further tightening is a risk if CPI prints stronger than expected in late January, but this is not our base case.

Strategy: Feb/Mar 2024 OIS steepeners look attractive

Market pricing is somewhat at odds with the RBA's rhetoric. Governor Bullock has highlighted the risk of persistent, demand-driven inflation. After such a substantial rally, we see the risk/reward of OIS steepeners as attractive given the RBA is highly likely to remain hawkish (even if only for presentation purposes) into Q1 2024. We recommend **Feb/Mar 2024 OIS steepeners** and **we enter the trade at 0bps, target 15bps, stop -7.5bps**. Risk: a rally in US Fed fund futures could impact the AU OIS curve.

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OIS = overnight indexed swaps

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Hawkish RBA but soft growth

At a speech last week, RBA Governor Bullock reinforced her hawkish bias indicating that "the remaining inflation challenge we are dealing with is increasingly homegrown and demand driven". In her view, policy response should vary if inflation is rising due to supply factors versus demand. If inflation is the product of global supply disruptions or other price rises that monetary policy has little influence over such as fuel, electricity or rents then the monetary policy response should be limited. Conversely, inflation that results from aggregate demand exceeding the economy's potential to meet that demand should be addressed by more substantial tightening.

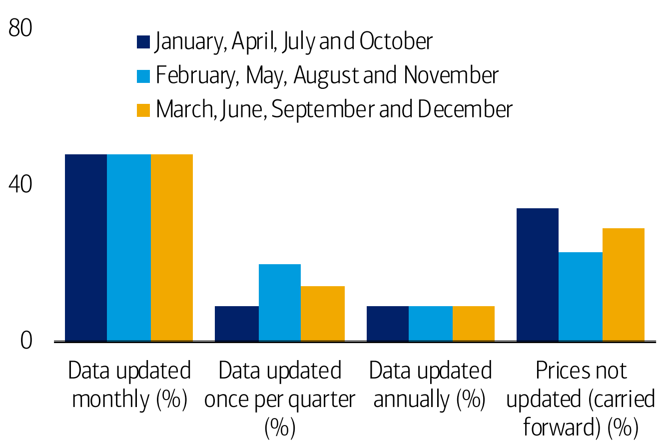
The RBA is now of the view that there are several signs suggesting Australia's inflation is largely demand-driven. The breadth of inflation, especially in the services sector, and high rates of labour utilisation are concerning signs of persistent inflation for the Bank.

Yet while the RBA remains committed to bring inflation back down to target (by the end of 2025), its willingness to preserve gains in the labour market suggests for further tightening is limited, in our view. As we discussed in our year-ahead report, the RBA is likely to remain on hold in 2024 as inflation eases and growth remains below-trend. See Australia Economic Viewpoint: Year Ahead 2024: No landing down under 22 November 2023.

Guidance at the December meeting is likely to remain hawkish ahead of the first Board meeting of 2024 in February. By this meeting the Bank will have an update on 4Q CPI and further updates on the state of the labour market. Another persistent rise in core inflation in 4Q could trigger further tightening though this is not our base case.

Since the November hike (see Australia Economic Watch: RBA review: The reluctant hiker's last raise? 07 November 2023) unemployment rose to 3.7% despite large employment gains, while retail spending softened, house prices rose and monthly inflation surprised to the downside falling to 4.9%yoy from 5.6%yoy in October. Notably, collection issues with the monthly series mean October is one of the months with the least updated items, particularly for services (Exhibit 2). This suggests the RBA will take these data with a grain of salt. In spite of this, inflation has continued to ease across the main household's living costs components (Exhibit 3)

Exhibit 2: October CPI data is not the best reflection of inflation.
As it has the least updated prices



Source: ABS

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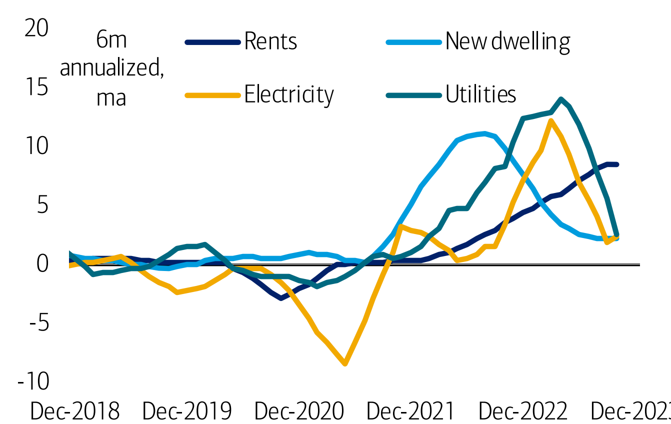
Exhibit 3: In annualized terms, inflation is easing
For household related components



Source: ABS

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The RBA has argued of late that a supply-demand imbalance in the economy continues to boost aggregate demand. GDP data for the September should reflect weak household spending and soft private investment. See BofA Australia Household Consumption Tracker: Household spending: Decline, but no cliff 12 October 2023.

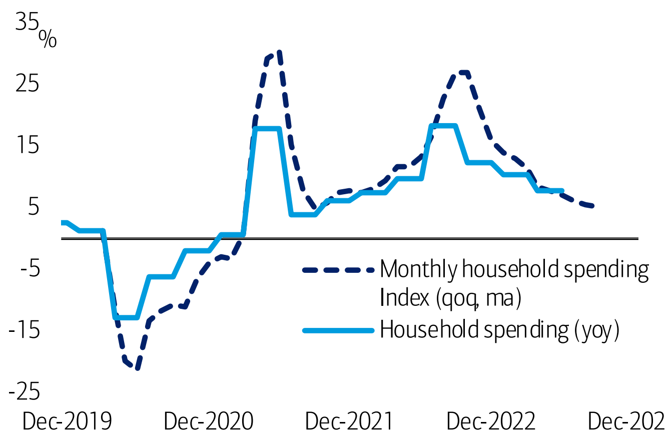
After the November hike, data has given RBA a breather

Retail spending declined by 0.2% in October, house prices recorded the smallest monthly gain since February, the unemployment rate rose to 3.7% from 3.6% despite large employment gains and monthly CPI disappointed in October, down to 4.9%yoy from 5.6%yoy. We think these outcomes are enough for the RBA to pause at this meeting, but further tightening in February will depend on how the data evolves from here. Key release to watch ahead of the February meeting will be 4Q CPI that will be released in late January. Our initial estimation is for a 1%qoq/4.5%yoy rise. This is consistent with the RBA.

GDP data for 3Q will provide more information on measures of income, productivity growth, unit labour cost and household spending. We see a 0.3%qoq rise that would push annual growth down to 1.7%yoy from 2.1%. See our preview here: Australia Economic Watch: RBA & GDP preview: Hawkish bells 01 December 2023

Higher frequency data has softened of late. Following a strong rise in September, the decline in retail spending pushed annual growth down to a very soft 1.2%yoy, with even services such as cafes, restaurants and takeaway food services recording a second straight fall. Measures of household spending also point to weaker spending ahead (Exhibit 4).

Exhibit 4: The ABS monthly household spending series is soft
Suggesting household spending softened in 3Q



Source: ABS, Macrobond

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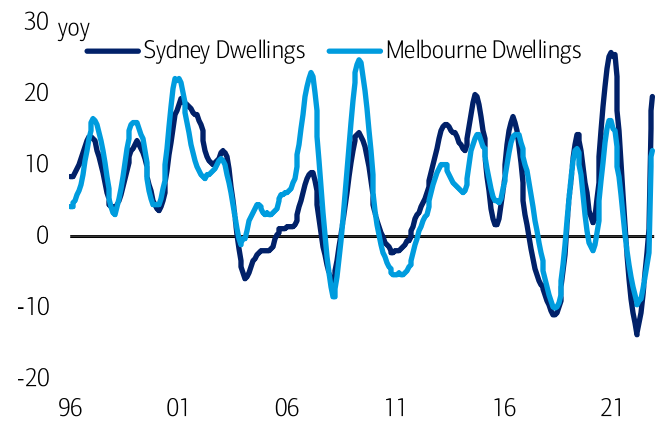
Exhibit 5: Home prices grow at a slower pace
But they keep rising despite tight monetary policy



Source: Corelogic

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While home values recorded the smallest monthly gain since the growth cycle commenced in February. the national index reached a new record high in November, with both Sydney and Melbourne prices up yoy despite higher rates and low affordability (Exhibit 5). After falling -7.5% from a peak in April 2022 to a trough in January 2023, housing values have bounced 8.3% higher over the past 10 months, demonstrating a clear 'V' shaped recovery.

Divergence across regions has become increasingly evident across the capitals, with three cities recording a decline in values over the month of October. These were Melbourne and Hobart, both down -0.1%, and Darwin, down -0.3%. Growth in Sydney home values also slowed sharply, reducing to 0.3%, the smallest monthly gain through the recovery cycle to-date. With Sydney home values slipping into negative growth over the last week of the month, we could see Sydney following Melbourne's lead, with home values stabilising or dipping lower in December. Annual growth in these cities remains strong (Exhibit 5).

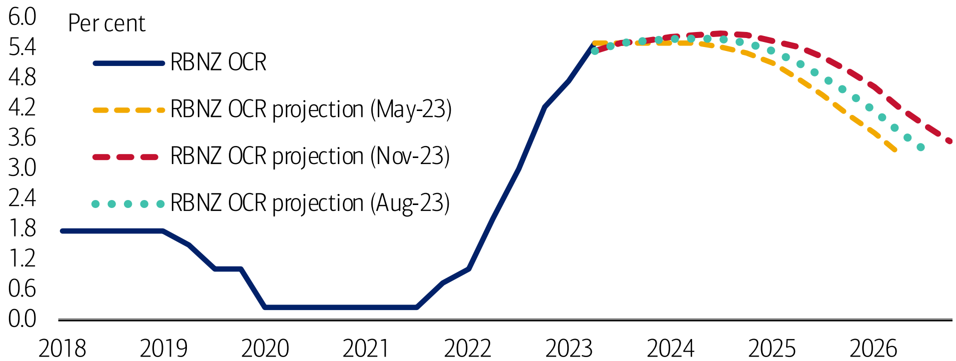
On the flip side, Perth housing values accelerated in November, posting the largest monthly gain since March 2021 at 1.9%. Brisbane (1.3%) and Adelaide (1.2%) also stand out with a resilient and rapid pace of growth.

Divergence across regions and a slower pace of home price increases is evidence of policy traction and provides another reason for the RBA to stay on hold in December and for the next 12 months, in our view.

A hawkish end for RBNZ, too

The RBNZ kept the official cash rate (OCR) unchanged at 5.5% as widely expected. However, guidance, including changes to the bank's forecasts and the OCR track, were more hawkish than we had anticipated (Exhibit 6). While the Bank is confident that high rates are restricting spending and reducing inflation, the progress is slower than expected. In their view, "inflation remains too high and inflationary pressures continue to emerge". The OCR track now reflects even higher rates than in August, but economic data has continued to slow to reflect traction from restrictive policy.

Exhibit 6: OCR track moves higher
To strengthen hawkish guidance



Source: RBNZ

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We still think cuts are likely in New Zealand

The RBNZ discussed the possibility of the need for further tightening but concluded that interest rates are already restrictive, and it is appropriate to wait for further economic data to "observe the speed and extent of easing in capacity pressures in the economy". The RBNZ believes impact from hikes on CPI is most evident around eight quarters after the tightening cycle. Notably, while the Bank has upgraded its estimation of neutral rate from 2.5% from 2.25% policy is still restrictive, in their view. We think there are several downside risks ahead for New Zealand (see New Zealand Economic Watch: RBNZ preview: Last hold of 2023, cuts next? 27 November 2023). The labour market is clearly weaker, and interest rate-exposed sector of the economy are showing traction from policy.

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- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Investors chasing the USD lower, **Liquid Cross Border Flows**, 20 Nov 2023

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