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Liquid Insight

Australia: RBA preview – Are we done yet?

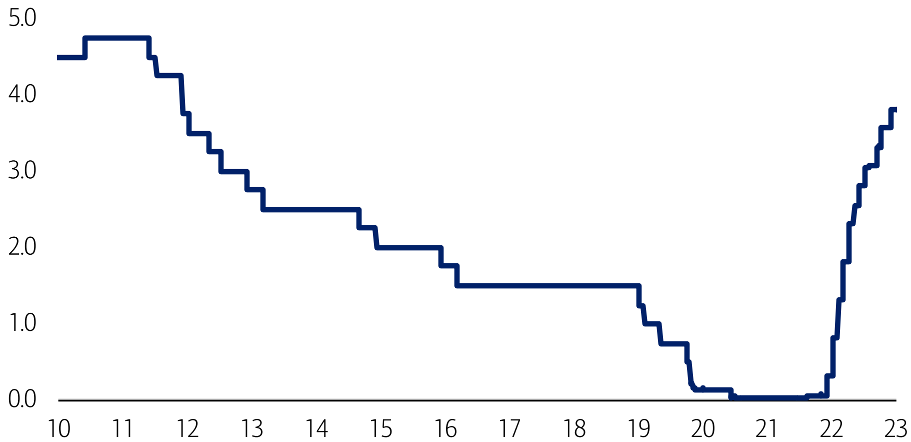
Key takeaways

- Having surprised markets with a hike in May we expect the RBA to keep the cash rate unchanged at 3.85% at its 6 June meeting.
- April CPI surprised on the upside but uncertainties around the monthly CPI data suggest the RBA will look through the print.
- However, the risks are for a slower decline in inflation than the RBA expects and, hence, additional hikes in 3Q.

By Izumi Devalier/Devika Shivadekar/Oliver Levingston/Ting Him Ho/Takayasu Kudo/Adarsh Sinha

Exhibit 1: Chart of the day: RBA policy path (%)

RBA has hiked 11 times in the last year



Source: Bloomberg

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The Reserve Bank of Australia (RBA) meets on Tuesday, June 6. We expect the Board to take a breather and keep the cash rate unchanged at 3.85% following the surprise 25bp hike in May. However, with the RBA seemingly more worried recently about a slower-than-expected return of inflation back to target, a hike cannot be ruled out. All in all, we think the case is building for additional hikes, perhaps as early as the July meeting, if the May monthly CPI print points to a disappointingly slow decline in inflation. We recommended paying July OIS last week on this reacceleration risk. AUD FX will likely continue to be driven more by China sentiment than RBA expectations.

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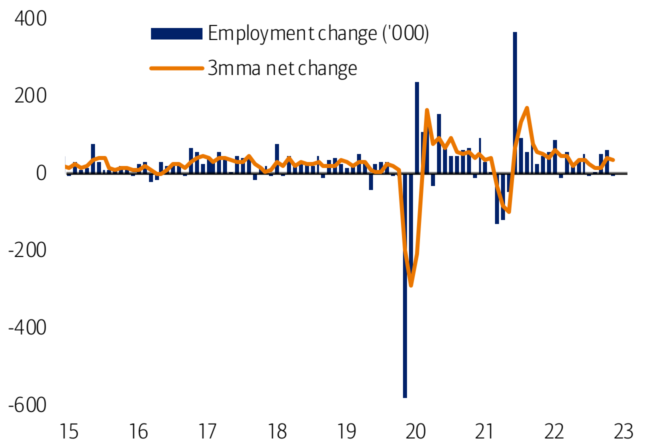
Australia in Focus

The Reserve Bank of Australia (RBA) meets next Tuesday, June 6. The RBA surprised markets with a 25bp hike at its last meeting and maintained a hawkish bias in its guidance (see [RBA review: Never leave a job unfinished](), 2 May 2023)—the minutes of the meeting noted that, "members...agreed that further increases in interest rates may still be required, but that this would depend on how the economy and inflation evolved."

Data released since the May meeting have been mixed:

April employment data showed total employment falling 4.3K, down from an upwardly revised 61.1K in March (Exhibit 2). In addition, the unemployment rate rose to 3.7% from 3.4% previously. It is important to keep in mind that the weakness in April employment followed strong gains over the previous two months. Hence we think it's too early to conclude that a material downturn in labor markets is underway. That said, forward-looking data, such as job ads, show that labour demand is cooling (Exhibit 3).

Exhibit 2: Change in employment
Fall in employment following solid gains earlier in the year



Source: ABS

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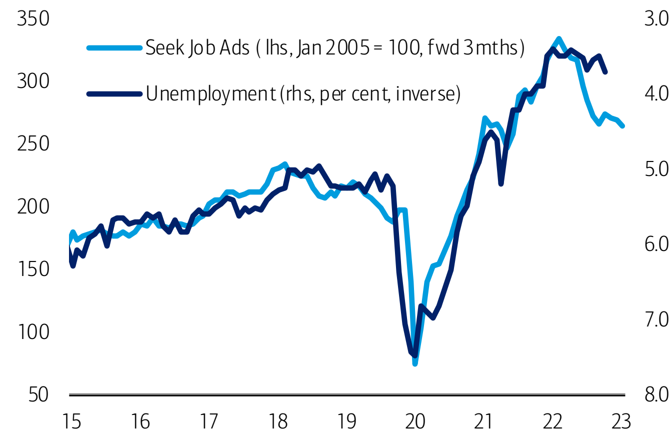
Exhibit 3: Job ads and unemployment rate
Indicators showing easing labour demand



Source: SEEK, ABS

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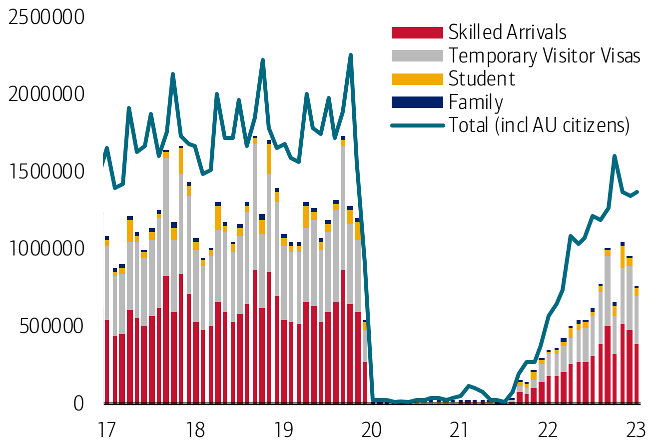
Furthermore, the sharp pick-up in net migration is also aiding labour supply : population growth had been stronger than expected, reflecting a robust pick-up in net overseas migration as foreign students, skilled professionals and working holiday makers' return to Australian shores (Exhibit 4). As policies to increase migration gain further traction, we expect the demand-supply imbalance in labor markets to ease. (See: [Australia Watch: Apr labour markets; 1Q wages: Still hot, but past the peak 18 May 2023]())

1Q wages rose 3.7%yoy in 1Q23, marking the fastest pace of growth in a decade (Exhibit 5). In sequential terms, wages growth remained unchanged at 0.8% from previously. The result was slightly softer than consensus expectations and the RBA's implied projection of 0.9% per the May Statement on Monetary Policy (SMP). In the minutes of the May policy meeting as well as the SMP, the RBA highlighted that wages growth is expected to reach a peak of 4% in 2H23 before starting to trend down. RBA continues to see wages growth in the 3.5%-4% range as consistent with its inflation target, contingent on productivity growth picking up.

Exhibit 4: Arrivals by type of visa
Improvement in skilled arrivals positive to ease labour supply



Source: ABS

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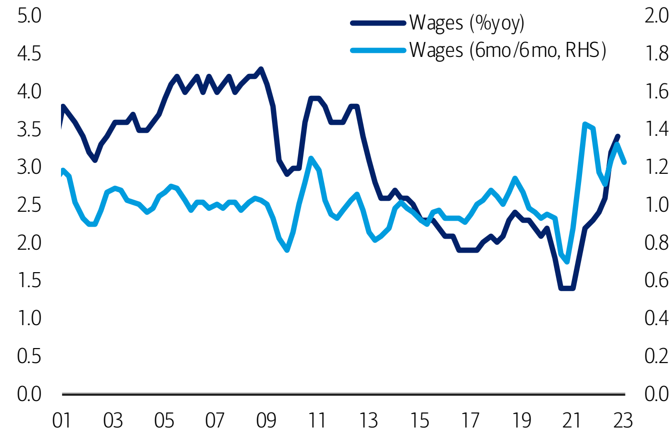
Exhibit 5: Wage price index (hourly rates of pay excl bonuses)
1Q wage growth was in line with expectations



Source: ABS

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Retail sales for April was soft, printing 0.0% MoM against consensus expectations of a 0.3% rise. Given the strong increase in population, and still-high inflation, the momentum in underlying spending is much weaker than the headline suggests. Increased cost of living pressures and rising interest rates are squeezing household budgets as consumers reign in discretionary spending. The 1Q GDP/national accounts report, published a day after the RBA Board meeting, should offer further clues as to the state of the consumer in early 2023.

Meanwhile, the Treasury's **2023/24 Federal Budget**—which was handed down after the May RBA meeting, points to a moderately positive fiscal pulse over the medium-term as deficits resume for 2023/24 (see Back in the Black: 2023/24 AU Budget Review, 9 May 2023). However, we do not think it will be a meaningful source of additional upside inflation pressures, a point echoed by Governor Lowe at his appearance before the Senate Economics Committee on May 31.

While the spending programme aimed at cost-of-living relief is likely to inject around AU$15bn into the economy, bracket creep has pushed more people into higher income tax brackets offsetting the "expansionary" aspect of fiscal policy in the long run. As such, Governor Lowe was clear when he said that the budget "didn't alter macroeconomic outcomes" for the central bank, hinting that the RBA does not view the Budget as inflationary.

But upside risks are brewing...

While the above developments support our base case for an extended pause from the RBA at a terminal rate at 3.85%, we see several new risks that could tip the central bank towards delivering further hikes in the next couple of months:

The first is the outlook for **wages.** The Fair Works Commission's (FWC) announced the results of annual wage review on June 2. The decision calls for an increase to the National Minimum Wage rate and minimum award pay rates by 5.75% each, with effect from July 1, 2023. In addition to increases in pay rates, the FWC also ended the historical alignment between minimum wages and the C14 classification rate in awards. The decoupling is expected to push minimum wages up by almost 8.6% for around 180k workers. The FWC's awards system meanwhile has around 2.5 million workers under its cap.

The FWC downplayed the impact that these revisions are likely to have on the wage price index (WPI) and inflation. According to their statement, the total wages cost of the modern award-reliant workforce constitutes only ~11% of the national 'wage bill' and therefore the revisions are unlikely to have any "discernible macro-economic effects." Indeed, we think the FWC wage revision outcome is largely in line with the RBA's latest forecasts in the May Statement on Monetary Policy (SMP), which called for peak WPI growth of 4% in 4Q 2023. However, the RBA will still be vigilant about the impact of the FWC annual wage revision on individual bargaining outcome, as workers may try to negotiate higher awards amidst a tight labour market.

Secondly, the **April monthly CPI (31 May)** surprised on the upside of consensus expectations (6.4% yoy), rising 6.8%YoY vs. 6.3% in March. Though the jump was partly driven by unfavorable base effects due to the expiration of the fuel excise tax, housing inflation jumped strongly, driven by a sharp increase in rental costs. Note that, after a four month hiatus, the Australian Bureau of Statistics reinstated the trimmed mean measure in its monthly CPI indicator release, though only as a year on year growth rate. This showed the monthly indicator trimmed mean rise to 6.7%YoY, up from the 6.5%YoY reading recorded over the previous there months, though still down from the peak of 7.2%YoY.

It is important to remember that the April monthly CPI print reflects updates to 65% of the CPI basket, leaving plenty of room for volatility. Thus the May CPI, which will reflect updated price information for 76% of the quarterly CPI, will offer a more reliable early reading on 2Q inflation. Needless to say, upside risks to the RBA's June '23 trimmed mean inflation forecast of 6.0%YoY (per the May Statement on the Monetary Policy) are building.

Bottom line

The uncertainty around the monthly inflation numbers, coupled with the softness in recent labor market and consumption data, are likely to keep the RBA on pause at its 6 June meeting.

However, with the RBA's reaction function seemingly changing again to one that is less tolerant of a delayed normalization of inflation (it currently does not see inflation reaching the top of its 2-3% target band until mid-2025), the risks to our 3.85% terminal rate forecast are firmly tilted to the upside.

Though we think the RBA prefers to wait till the release of the 2Q Quarterly CPI print to make a call on additional rate hikes, making the 1 August meeting the most likely timing, a hike in July is very well possible if underlying inflation continues to run hot in the May monthly CPI print (due 28 June).

Exhibit 6: Australia: Upcoming key releases

The Jun RBA minutes, 2Q CPI and employment releases will be closely watched

6-Jun	**RBA Cash Rate decision (Jun)**	**4-Aug**	**RBA Statement on Monetary Policy (Aug)**
7-Jun	**GDP (1Q)**	15-Aug	RBA Minutes (Aug)
15-Jun	**Employment (May)**	**15-Aug**	**Wages (2Q)**
20-Jun	RBA Minutes (Jun)	**17-Aug**	**Employment (Jul)**
28-Jun	Monthly CPI (May)	28-Aug	Retail Sales (Jul)
29-Jun	Retail Sales (May)	30-Aug	Monthly CPI (Jul)
4-Jul	**RBA Cash Rate decision (Jul)**	**5-Sep**	**RBA Cash Rate decision (Sep)**
18-Jul	RBA Minutes (Jul)	**6-Sep**	**GDP (2Q)**
20-Jul	**Employment (Jun)**	19-Sep	RBA Minutes (Sep)
26-Jul	**Quarterly CPI (2Q)**	27-Sep	Monthly CPI (Aug)
28-Jul	Retail Sales (Jun)	28-Sep	Retail Sales (Aug)
1-Aug	**RBA Cash Rate decision (Aug)**		

Source: Bloomberg, BofA Global Research

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Rates strategy: Positioning for reacceleration risk

Regional bank stress is now firmly in the market's rearview mirror as the spread between 3y bond futures (YM) and 10y bond futures (XM) flattens close to decade lows (Exhibit 7). A full hike is now priced by August and last week we recommended paying July OIS as the near-term catalysts for cheaper swaps looked strong (Australia Rates Alpha: RBA reacceleration risk underpriced: pay July OIS 01 June 2023). As anticipated, Friday's Fair Work Commission decision on minimum and award wages saw pricing inch closer to our target and we still recommend positioning for cheaper front-end swaps as reacceleration risk becomes a major driver of market pricing.

For investors looking to position for upside risk from the RBA outside front-end swaps, positioning in the ACGB/ futures curve is starting to look stretched and we prefer curve flatteners in bank bill futures. The spread between September 2023 (U3) and September 2024 (U4) bills (last priced at 38 bps). has completed a round trip from early March (Exhibit 8). In the near term, it seems likely the market will continue fading the soft landing narrative and we also like U3/U4 curve flatteners for investors with a bearish tactical view on the front end.

Exhibit 7: YM/XM spread flattens to new lows
Bearish positioning into Tuesday's RBA meeting

Source: BofA Global Research, Bloomberg

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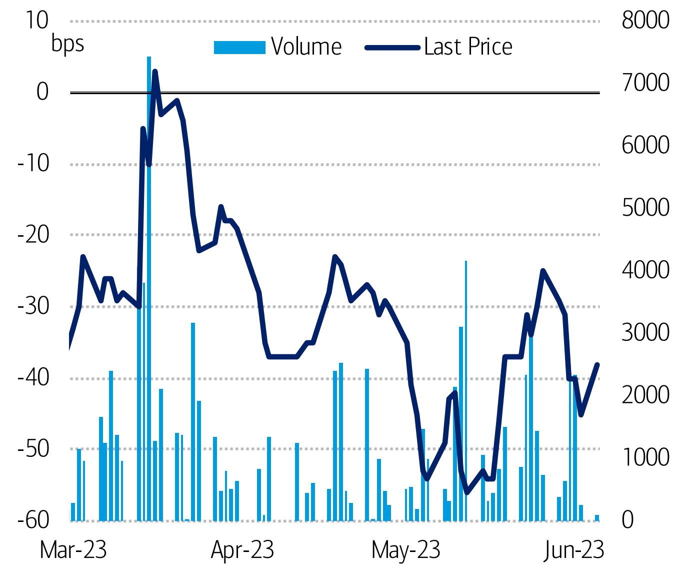
Exhibit 8: Regional bank stress in the rearview mirror
Round trip from 1 March as shorts rebuild



Source: BofA Global Research, Bloomberg

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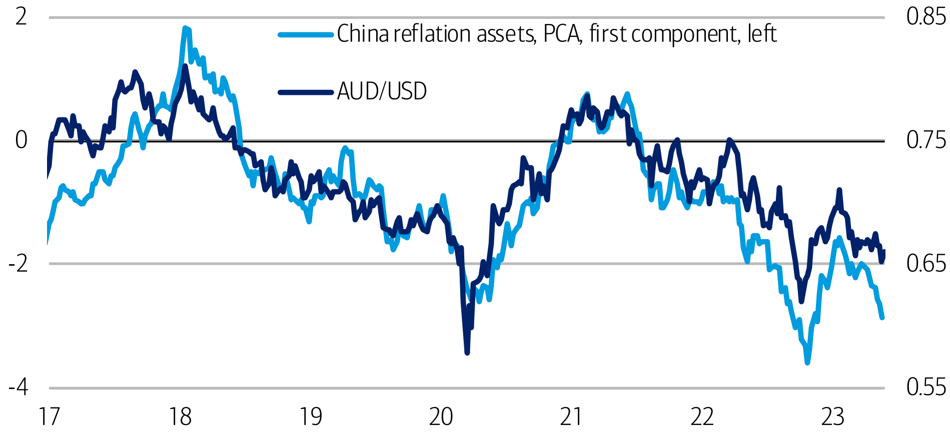
FX strategy: China sentiment trumps RBA expectations

While domestic factors – especially the possibility of further RBA tightening as discussed above – are helping AUD FX at the margin, China sentiment remains paramount. China growth bearishness may constrain AUD rallies in the near term (Exhibit 9); while we are constructive AUD medium-term, broader policy easing in China is necessary for meaningful recovery. China's property sector (commodity demand) and service imports (tourism and education) are the primary channels for Australia. Reports of China preparing new measures to support the property market likely contributed to AUD outperformance last week but the still-targeted approach means investors will err on the side of caution for now. Meanwhile, a recovery in flight capacity should further boost Australia's service sector over time.

Exhibit 9: China reflation sentiment vs. AUD/USD

AUD recovery requires a trough in China sentiment – policy easing most likely trigger



Source: Bloomberg

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – [Year Ahead 2023: Pivot ≠ Peak]**, 20 Nov 2022
- **At some point we have to land, Global FX Weekly**, 02 June 2023
- Hop, skip & a supply jump **Global Rates Weekly**, 02 June 2023
- China pessimism & US debt limit hopes and fears, **Liquid Cross Border Flows**, 22 May 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: At some point we have to land 02 June 2023

Global Rates Weekly: Hop, skip & a supply jump 02 June 2023

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