Liquid Insight

RBA and RBNZ: a hawkish hold

29 September 2023

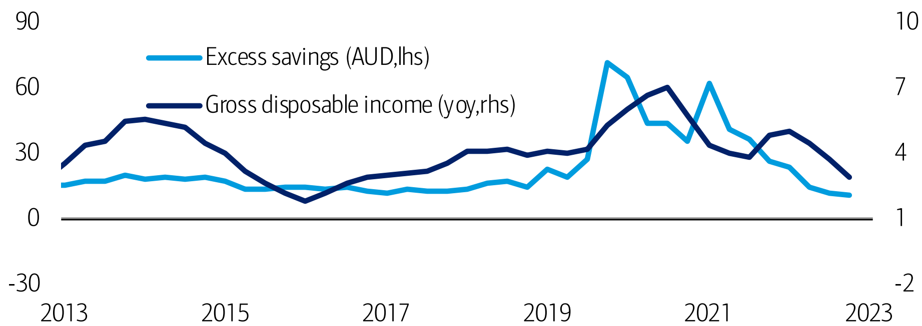
Rates and Currencies Research
Global

Key takeaways

- The RBA and RBNZ meet next week. We see rates on hold with a hawkish bias despite weak domestic and global conditions.
- Front-end swap curves looks too steep but offshore-led moves remain a risk and we prefer long-end expressions.
- End-of-cycle trades like receiving 10y swap EFP, YM/XM steepeners or 10s30s IRS steepeners look attractive at these levels.

By Micaela Fuchila/Oliver Levingston/Adarsh Sinha

Exhibit 1: Savings are falling sharply
As is disposable income



Source: Macrobond, ABS

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The consumer is rolling over

There is clear evidence that suggests the Australian consumer is under pressure as households draw down savings, and inflation/ bracket creep erodes disposable income (See Chart of he Day). We see the RBA and RBNZ leaving rates on hold in October, but there is some risk for further hikes in November (especially from the RBA). In our view, current economic conditions do not justify a hawkish stance, but elevated inflation means both Reserve Banks will retain their hawkish bias to ensure inflation expectations do not re-accelerate on the back of higher oil prices.

The RBA's meeting next Tuesday will be Michele Bullock's first appearance as Governor and there is a risk she seeks to reset the tone of the RBA's communications. Yet there is little evidence to justify excessively hawkish rhetoric and we continue to see front-end swaps as pricing in too many hikes out to Q2 24. Given price action has been driven by offshore moves, though, our favourite expressions are outside the front end. We like to receive swap spreads (i.e. cheaper bonds vs swaps) and add curve steepeners in the long end of the AU bond/swap curve. Potential for China policy surprise best expressed through AUD FX crosses than AUDUSD.

Global Rates & Currencies Research
MLI (UK)

Micaela Fuchila
Economist
Merrill Lynch (Australia)
+61 2 9226 5337
micaela.fuchila@bofa.com

Oliver Levingston
Rates Strategist
Merrill Lynch (Australia)
+61 2 9226 5173
oliver.levingston@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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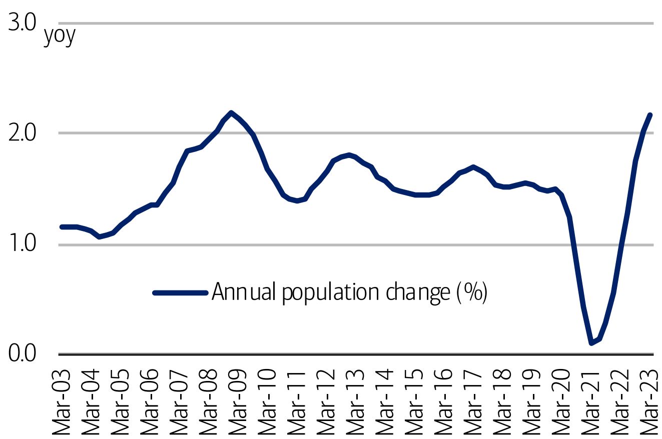
Timestamp: 29 September 2023 12:52AM EDT

More people in, but growth is still weak

The Reserve Bank of Australia meets on Tuesday October 3 and the Reserve Bank of New Zealand follows on Oct 4. We see rates on hold again and increased focus on traction from rates in th consumer sector. However, sticky inflation along with the recent rise in oil prices means a hawkish bias is likely to be retained for longer. Indeed, there is some risk for further policy tightening in November. In Australia, a new RBA Governor takes over so guidance could change slightly to reflect the new leader.

Improved demographics (Exhibit 2) have supported aggregate demand despite significant headwinds for households on the back of higher living costs, higher rates and high inflation. Economic data for 2Q showed growth is currently being supported by the external sector and public spending (Exhibit 3). This is the case for both Australia and New Zealand. See: Australia Economic Watch: GDP review: Constrained households 06 September 2023 and New Zealand Economic Watch: GDP review: Too good to be true 21 September 2023. With weak economic growth, a turning labour market (albeit very slowly) and slowing inflation from its peak, we think there is no case for further hikes.

Exhibit 2: Sharp increase in population growth in AU
2.2%yoy in March



Source: ABS

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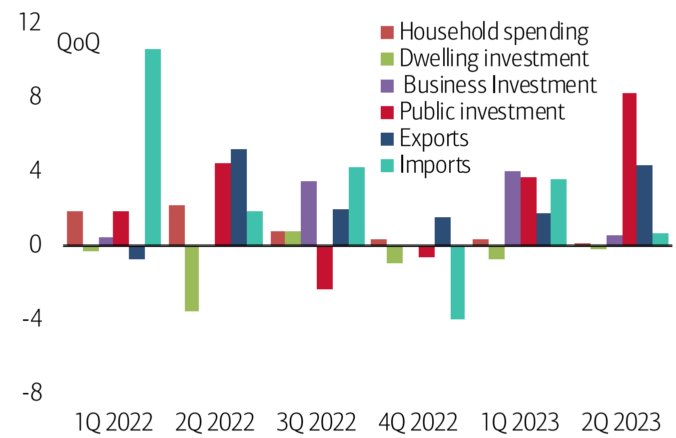
Exhibit 3: Net exports and investment drive growth
Households weaken further



Source: ABS

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However, fuel prices rose 13.9% in the twelve months to August in Australia. This is the highest annual movement since November 2022. In monthly terms, Automotive fuel prices rose 9.1% in August, following -0.2% in July. Rent prices increased 7.8% in the twelve months to August 2023, up from 7.6% in July, reflecting strong demand for rental properties and tight rental markets. The latter is unlikely to change, in our view Petrol prices and higher rent prices will boost the official 3Q CPI print that is due in late October, just before the RBA meeting in November.

While inflation outcomes remain consistent with the RBA's assumptions a higher-than-expected print could see increased risk for a hike in November. This is not our base case. The RBA is currently forecasting CPI to reach 4.1% by year end. This implies two prints of around 0.9%qoq for both 3Q and 4Q. We think this is likely. A sustained rise in petrol prices could see an upside surprise in CPI, but the RBA's current flexible assumption for inflation to return to target in "late-2025" along with guidance that the return to target could be "uneven" due to volatile items means the Bank is unlikely to react to a temporary rise in inflation. See: Australia Economic Watch: RBA preview: Wake me up when Nov ends 28 September 2023

In New Zealand, However, while headline inflation and inflation expectations have declined, measures of core inflation remain too high and the recent increase in oil prices contribute to the RBNZ's "high rates for the foreseeable future" stance. CPI data for the September quarter will be released on October 17 and will reflect the impact of higher petrol prices and local body rates rises. The RBNZ assumption for 3Q was already strong at 2.1%qoq which keeps annual inflation unchanged at 6%yoy. This means further hikes on the back of the transitory rise in inflation are unlikely. See: New Zealand Economic Watch: RBNZ preview: A confident hold 29 September 2023

Sluggish growth in China doesn't help

Ongoing concerns around the outlook for China has been a key focus area for both the RBA and the RBNZ. Weaker global growth adds to the case for an extended pause, in our view. Despite the soft economic conditions in China, the external sector of late has made positive contributions to growth in both the countries. In New Zealand, export credits continue to moderate, reflecting declines in prices of commodities such as dairy and meat. The RBNZ expects restrain in overall export demand and prices over the coming three years.

While goods exports have been moderating, services exports seem to be largely getting back on track. Education-related travel services are the most important Australian and Kiwi exports to China. Education and tourism sectors are only just returning to pre-pandemic levels. Peak Covid saw extended border closures in all three countries, which significantly impacted the flow of inward migration of Chinese nationals to Aussie and Kiwi shores. Since the borders have reopened, Indian international students are the largest group studying in Australia, while Indian migrants are making up the largest share of the workforce in New Zealand followed by Chinese and Filipinos.

Although the trajectory of growth has been closely linked to external demand from China, for both Australia and New Zealand, there has been some divergence of late. Both the Aussie and the Kiwi economies have expanded a lot slower in 1H23 versus China. As much as the external sector factors into their growth profiles, the muted expansion has largely been a result of policy tightening by the RBA and the RBNZ gaining traction. The interest rate hikes not only dampened consumption but also led to a material decline in profit margins for businesses. The external sector has in fact continued to be supportive of growth, offsetting the weakness in the domestic market. See: Asia Economic Weekly: AU and NZ: Weak China means steady rates 29 September 2023

Trading the RBA and Australia's economic cycle

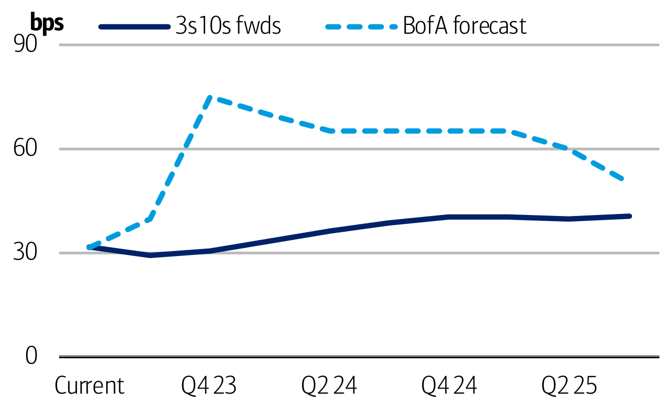
Against a backdrop of a softening economy, we like YM/XM steepeners (entry at 28bps, current level 31.5bps, target 65bps). We see three catalysts for this trade:

1. Over the four hiking cycles since the 1990s, the curve has never flattened in a pause after rate hike. The risk to the trade is further hikes (Exhibit 5).
2. Steepening usually occurs against the backdrop of falling term premia and we see a potential program of asset sales to be announced in Q4 2023 as adding about 37bps of term premium, which could mean 10y bonds lag any rallies more materially (Australia Rates Watch: Prepare for landing: add curve steepeners, buy AUD rates cross-market 30 August 2023).
3. Finally, unlike the US, our forwards curve is pricing almost no steepening over the next two years (Exhibit 4).

On a recent trip to Hong Kong and Singapore, clients tended to see better steepeners in other G10 and select EM markets (e.g., NZ/ Korean/ US Treasury curves). One popular expression has been a 10s30s IRS steepener, which has a more attractive carry profile (Exhibit 6, Exhibit 7). Both trades are attractive although 20y-30y IRS will be impacted by fluctuations in long-dated callable issuance and a 2054 ACGB syndication in Q4 2023 so we prefer YM/XM steepeners as an expression of our cyclical view.

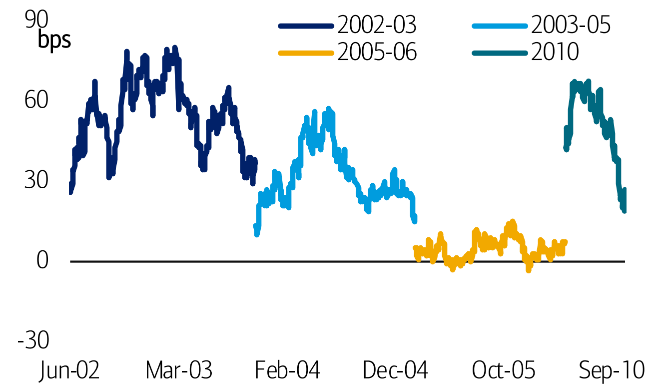
Other expressions include receiving 10y swap EFP and 5y5y IRS on a cross-market basis vs USD swaps. We continue to recommend receiving 10y swap spreads although recognize the trade is now closing in on its target (Australia Rates Viewpoint: The cycle is ending: time to receive swap EFP 19 July 2023). The 5y5y AUD/USD spread has narrowed to 99bps but is still wide on a five-year basis. We still like this trade and would recommend receiving any moves above 100bps. The risk is that both trades have performed well over the past few months and a wave of profit-taking could act as a headwind in the near-term.

Exhibit 4: 3s10s to steepen in post-hiking cycle pause
Forwards pricing in less steepening than other markets



Source: BofA Global Research, Bloomberg

Exhibit 5: Steepeners underperform in pauses followed by a hike
Not our base case – but a major downside risk to steepeners



Source: BofA Global Research, Bloomberg

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Exhibit 6: AUD 10s30s IRS steepener has attractive carry and roll
Popular trade in AUD market

	Spot	Fwd rate	Carry	Roll	3M c+r
USD	-29.4	-27.4	2	-0.3	1.7
EUR	-29.5	-28.4	1.1	-0.5	0.6
GBP	-14.9	-12.9	2	0	2
CAD	-28.1	-26.6	1.6	-0.2	1.4
CHF	-0.6	-0.7	-0.1	-0.6	-0.7
JPY	58	57.1	-0.9	-1.4	-2.3
AUD	-17.1	-17.9	-0.8	-1.5	-2.3
NZD	23.3	24.9	1.7	0.1	1.8
NOK	-85	-83.7	1.3	-1	0.3
SEK	-39.5	-38.4	1.1	-0.2	0.9

Source: BofA Global Research, Bloomberg

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Exhibit 7: …unlike 3s10s steepeners
Carry and roll more attractive to pay in NZD/USD

	Spot	Fwd rate	Carry	Roll	3m c+r
USD	-49.8	-45.3	-4.5	-5.3	-9.8
EUR	-30.7	-27.8	-2.9	-4.2	-7.1
GBP	-61.2	-58.6	-2.7	-4.2	-6.9
CAD	-69.2	-68.1	-1.1	-4.9	-6
CHF	6	6.2	-0.2	-0.9	-1
JPY	55.7	54.8	0.9	0.8	1.8
AUD	29.4	29.8	-0.4	-2.6	-3
NZD	-40.8	-39.5	-1.2	-4.5	-5.8
NOK	-56.3	-52.8	-3.5	-0.7	-4.1
SEK	-48.2	-46.6	-1.6	-3.1	-4.6

Source: BofA Global Research, Bloomberg

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In FX, the backdrop for AUDUSD remains difficult given the growth divergence with the US, weak China demand and technical risks – we maintain our year-end forecast of 0.64. However, with China sentiment approaching bearish extremes, positioning for some reversal is prudent. This is especially since our China economists think "big bang" stimulus, while uncertain, is more likely than market pricing. Our bullish USD forecast means we prefer expressing this view against the crosses (FX Viewpoint: AUD: cloudy with silver linings 20 September 2023), having recently closed our short GBPAUD recommendation (FX Alpha 22 September 2023).

We had flagged positioning as a short-term risk for AUD/NZD but the recent pullback offers opportunity to reenter longs. Despite some positive surprises to growth and BoP, NZD remains more vulnerable to any global risk-off episodes and even if China surprises positively, the AUD is better positioned to benefit. We expect a gradual trend higher in AUD/NZD towards 1.10.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The path of least resistance **Global FX Weekly**, 22 Sep 2023
- High & tight **Global Rates Weekly**, 22 Sep 2023
- Three standout flows, **Liquid Cross Border Flows**, 18 Sep 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: The path of least resistance 22 September 2023

Global Rates Weekly: High & tight 22 September 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com