

Australia Watch

RBA review: Wait for more data

The RBA keeps rates unchanged in July

In line with our expectations, the RBA has kept the cash rate on hold at today's meeting. The decision followed softer-than-expected monthly inflation and 1Q GDP data, as well as a mixed labour market report. The Board decided to assess current economic conditions, the economic outlook, and associated risks. See: [Liquid Insight: RBA preview: an uncomfortable pause 29 June 2023](#).

Guidance remains on the hawkish side with "some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve" (See Exhibit 1). We continue to expect a further 25bps of hikes to take the cash rate to 4.35% in August as the Bank will have access to updated inflation data for 2Q and will have the opportunity to update views and forecasts in the Statement on Monetary Policy. In our view, the Board has focused on its full employment mandate at this meeting, but this is likely to shift back to inflation as new economic data becomes available.

Focus shifts to CPI and labour force data

CPI data for 2Q will be released on July 28th. Our initial estimation is for a 1% qoq rise to take the annual rate down to 6.2% from 7% on the back of base effects—a touch below the RBA's May SMP projection of 6.3%. While the easing in global costs, commodity prices and shipping rates will reduce tradable inflation pressures, consumer goods and services price inflation is still too high. Indeed, rent inflation, utilities and seasonal factors will push CPI higher into 2H 2023. This suggests that the case to hike further remains intact. Indeed, in today's statement the Board noted that it remains "alert to the risk that expectations of ongoing high inflation will contribute to larger increases in both prices and wages, especially given the limited spare capacity in the economy and the still very low rate of unemployment."

However, labour market conditions are set to soften, and wages growth will stabilize after the 3Q public sector increases. There has also been little change in inflation expectations. With the RBA data dependent, we will be watching these releases carefully.

Rates strategy: short belly of Sep23/ Dec23/ Mar24 fly

The RBA's decision to pause but retain its guidance that "further tightening of monetary policy will be required" has seen markets move closer to our economists' forecast. The decision and tone of the statement today strengthens the case for markets to price in a higher probability of hikes in Q4 and we still like to short the belly of the Sep23/Dec23/Mar24 fly as the RBA signals it is likely to keep hiking. The decision to deliver its second skip of the hiking cycle indicates the Board is prepared to move at a more gradual pace and we expect market to price a longer journey to the terminal rate.

As expected, the front wing of the fly (Sep23/Dec23 steepener) has outperformed as the back wing (Dec23/Mar24 flattener) has lagged steepening moves, but we remain alert to the risks of a change in sentiment. We still favour shorting the belly of the fly as global central banks move closer to the end of the cycle and markets look to fade a recent steepening of 2023/2024 spreads in bank bill futures and front-end swaps.

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The balance of risks

The RBA has previously expressed its concerns that a more prolonged period of above-target inflation would increase the risk that firms' and households' expectations for inflation rise. If this occurred, high inflation would become more persistent with the result that interest rates would need to be higher for longer. This would increase the risk of a sharp rise in unemployment. The latter suggests upcoming reports on inflation expectations measures as well as leading indicators for employment and price pressures will remain critical ahead of upcoming RBA meetings. The monthly household spending indicator as well as retail spending and weekly confidence will provide a gauge on economic growth in 2Q along with labour market data.

In addition, The Reserve Bank of New Zealand (RBNZ) meets on July 12 and we expect no changes to the official cash rate (OCR). At its last meeting, the RBNZ raised the cash rate by 25bp but kept its peak OCR projection unchanged at 5.5%, signaling that it is done with tightening for now. Data releases following the policy meeting point to a continued softening in demand, with 1Q GDP contracting 0.1% QoQ, much lower than the RBNZ's projection of +0.3% QoQ growth. The results should support the RBNZ's on-hold stance, as it looks for further evidence that the reduction in demand-side pressures lowers inflation.

Exhibit 1: Evolution of the RBA's policy guidance (Jul-2022-Jul-2023)

Guidance remains hawkish despite the pause

| Date | Chg in cash rate | Policy guidance |
|-------|------------------------|--|
| 7-Jun | 0.35 -> 0.85% (+50bp) | The Board expects to take further steps in the process of normalising monetary conditions in Australia over the months ahead. |
| 5-Jul | 0.85 -> 1.35% (+50bp) | The Board expects to take further steps in the process of normalising monetary conditions in Australia over the months ahead. |
| 2-Aug | 1.35 -> 1.85% (+50bp) | The Board expects to take further steps in the process of normalising monetary conditions over the months ahead, but it is not on a pre-set path. |
| 6-Sep | 1.85 -> 2.35% (+50bp) | The Board expects to increase interest rates further over the months ahead, but it is not on a pre-set path. |
| 4-Oct | 2.35 -> 2.60% (+25bp) | The Board expects to increase interest rates further over the period ahead. |
| 1-Nov | 2.60 -> 2.85% (+25bp) | The Board expects to increase interest rates further over the period ahead. |
| 6-Dec | 2.85 -> 3.10% (+25bp) | The Board expects to increase interest rates further over the period ahead, but it is not on a pre-set course. |
| 7-Feb | 3.10 -> 3.35% (+25bp) | The Board expects that further increases in interest rates will be needed over the months ahead |
| 7-Mar | 3.35 -> 3.60% (+25bp) | The Board expects that further tightening of monetary policy will be needed. |
| 4-Apr | 3.60% -> 3.60% (unch) | The Board expects that some further tightening of monetary policy may well be needed to ensure that inflation returns to target. |
| 2-May | 3.60% -> 3.85% (+25bp) | Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve. |
| 6-Jun | 3.85% -> 4.10% (+25bp) | Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve. (unchanged from previously) |
| 7-Jul | 4.10% -> 4.10% (unch) | Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve. (unchanged from previously) |

Source: BofA Global Research, RBA

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