Liquid Insight

RBA preview: Tone it down

07 March 2024

Rates and Currencies Research
Global

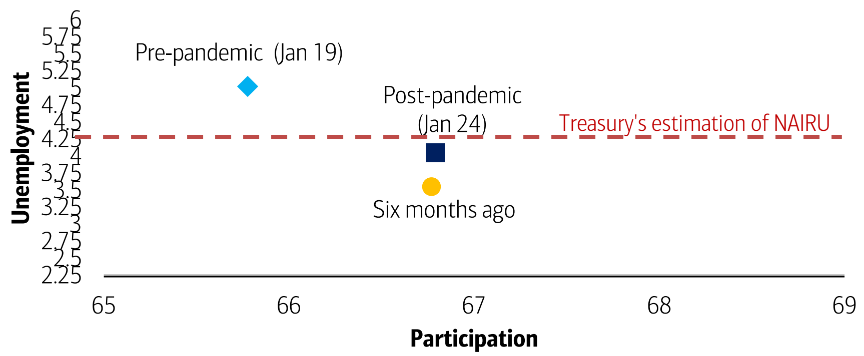
Key takeaways

- The RBA is expected to keep the cash rate unchanged at 4.35% in March. Weak economic data argues for a less hawkish tone.
- GDP slowed further, inflation was unchanged so focus shifts to the labor market. We see risk for easing in 2H 2024.
- RBA bond sales are unlikely to be discussed until after TFF June maturities. By this point, we see active QT as unlikely.

By Micaela Fuchila/Oliver Levingston /Adarsh Sinha

Exhibit 1: The labour market tightness is easing

...despite a sharp rise in participation



Source: ABS, Macrobond

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On hold in March, but a test to the hawkish stance

The Reserve Bank of Australia (RBA) meets on March 19 and we expect rates on hold at 4.35%. Economic data since February suggests economic momentum has weakened further into 2024. GDP data showed ongoing constraints in the household sector with little spending on discretionary items, including services.

Higher frequency data such as retail sales disappointed and CPI monthly was unchanged in Jan. The nominal side of the economy is also showing slower price growth. Unit labour costs and wages have peaked. These developments mean the labour market will likely continue to loosen in the near-term, in our view. While unemployment has risen over the last six months, it remains below Treasury's estimation of neutral (NAIRU) and well below pre-pandemic levels. Hence, easing isn't imminent, but risks for easing in 2H 2024 have risen, in our view. The RBA will focus on upcoming labour market data.

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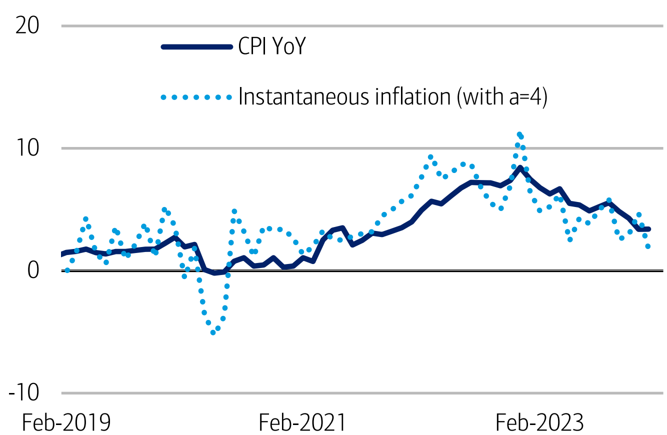
Prices move down, unemployment is the key

Monthly CPI for January was unchanged at 3.4% suggesting inflation momentum continues to slow (see: Australia Watch: Monthly CPI steady at 3.4% 28 February 2024). While the monthly index accounts just for over half of the official quarterly CPI, these measures are highly correlated and provide the RBA with higher frequency information on prices ahead of the Board's policy decisions.

The RBA's forecast for CPI is 3.3% by June 2024. This means the RBA is likely to be surprised to the upside on inflation again. Indeed, our instantaneous inflation measure (which places more weight on recent observations and removes base effects) has fallen below 2% (Exhibit 2). Conversely, services inflation remains sticky and high, but we note it has become more narrow-based with rents driving the rises.

The RBA guidance in the February minutes indicated "some components of services inflation were unlikely to be responsive to monetary policy in the near term" so tighter policy would not help bring these prices down any further. However, with very weak demand from households despite large population growth (Exhibit 3) and very little services spending we would expect demand-driven inflation to trend lower in the near-term. Notably, GDP data showed prices pressures in GDP are also slowing (see: Australia Watch: GDP review: Soft growth and softer prices 06 March 2024)

Exhibit 2: Instantaneous inflation falls below 2%
In January



Source: Macrobond, ABS

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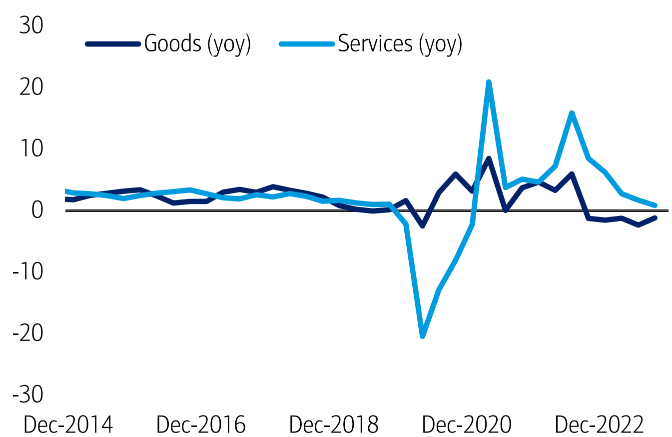
Exhibit 3: Spending is weak across categories
The consumer is no longer resilient



Source: ABS, Macrobond

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What could trigger early easing?

As discussed in our Year Ahead Report (see report), the RBA has been reluctant to ease in the absence of a shock. However, the Board has been consistently responsive to sustained rises in unemployment given the Bank's dual mandate and their willingness to preserve labour market gains given pre-pandemic unemployment was resistant to fall below 5% (Exhibit 1).

Unemployment remains low relative to history and inflation is yet to fall into the band suggesting no imminent easing. This remains consistent with our view for 75bps of rate cuts from February 2025. Indeed, the economy is soft, but growth remains at 1.5%yoy and a recession is still not our base case. However, the unemployment rate has increased for the last six months, and leading indicators are pointing to further weakness in the near-term. The latter along with softer than expected inflation could see the RBA easing slowly from 2H 2024.

The RBA's careful approach to strike the balance between preserving employment gains and pushing inflation down means we will need to see a few more prints of soft labour market and no upside surprises on inflation to consider earlier easing. February labour market data is due after the RBA March meeting and there is no board meeting in April. Inflation data for 1Q 2024 is due on April 24 but monthly inflation for Feb will be out on March 27. Our initial estimation for 1Q CPI is 0.8%qoq which would push annual inflation down to 3.5%yoy, slightly below the RBA's assumption.

RBA Guidance has already turned

BofA's RBA Sentiment Index BofA RBA Sentiment Indicator: RBA sentiment has turned: the labour market holds the key 07 March 2024 reflects guidance has become more consistent with soft data and while the Board retains optionality open and does not "rule out" further tightening, communication from the RBA Governor implied she would not wait until inflation falls into target to ease should economic conditions require policy support. The deterioration in economic data over the last month is consistent with a more neutral tone and more emphasis on the labour market, in our view.

Could the RBA commence bond sales?

Funding pressures will step up in May and June. More than 87% (AUD 90bn) of Term Funding Facility loans due in 2024 mature in May and June. The shape of the maturity profile means that banks may pay a higher premium over expected cash rates to issue during this period. We expect any additional funding pressure at a system-wide level to be contained for 2 reasons:

1. cash balances at the RBA (in exchange settlement accounts) will remain elevated (AUD 250-300bn) relative to the pre-pandemic levels (around AUD 100bn) (Exhibit 4).

2. The Federal Reserve has started to discuss slowing the pace of balance-sheet run-off, which would reduce its call on bank reserves and deposit-like facilities at money market funds.

Why does Federal Reserve balance-sheet run-off matter for Australian banks?

Australia's five largest banks (ANZ, CBA, NAB, Westpac, Macquarie) maintain an active presence in US commercial paper (CP) markets to plug short term gaps. The banks generally issue US CP to cover short-term funding gaps and will expand their offshore program CP issuance is cheaper than AU bank bill issuance or during periods of extraordinary stress when US money markets offer unique liquidity (for example, in March 2023).

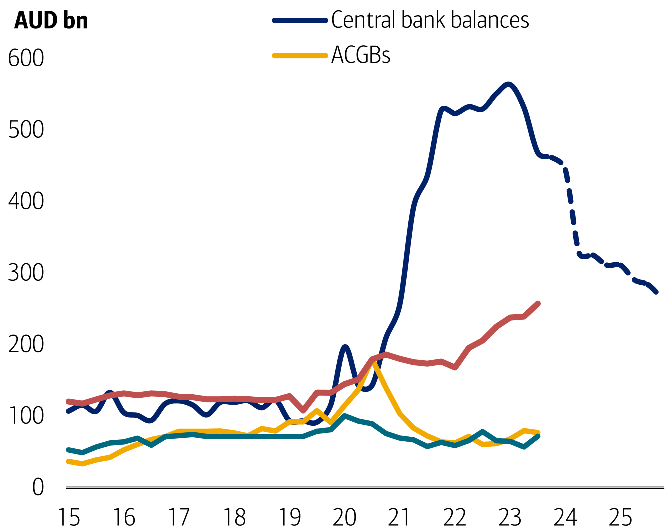
US CP funding costs have fallen on a relative basis vs Australian bank bill issuance. If the Federal Reserve lowers its cap on Treasury redemptions, the Australian banks might find CP issuance even more attractive, and this should cap any increase in funding pressures created by TFF repayments.

RBA bond sales are a risk scenario

The major risk of more persistent funding pressures could arise from more aggressive- RBA balance-sheet drawdown. The RBA noted in the minutes of its December 2023 meeting that it had discussed the prospect of bond sales from its portfolio with the government's funding agency, the Australian Office of Financial Management. Bond sales drain cash from the system in the same way that bond purchases increased cash in the system during the pandemic (i.e., deposits swapped for government securities). RBA asset sales would return cash levels to pre-pandemic levels faster than the current pace and would likely increase the premium that banks pay for wholesale funding (Exhibit 5).

We see RBA bond sales as unlikely given how quickly economic data has softened - asset sales are unlikely during an interest-rate easing cycle, in our view.

Exhibit 4: RBA balance-sheet drawdown to lower bank cash holdings
System-wide cash levels to remain elevated vs pre-2020 levels



Source: BofA Global Research, APRA

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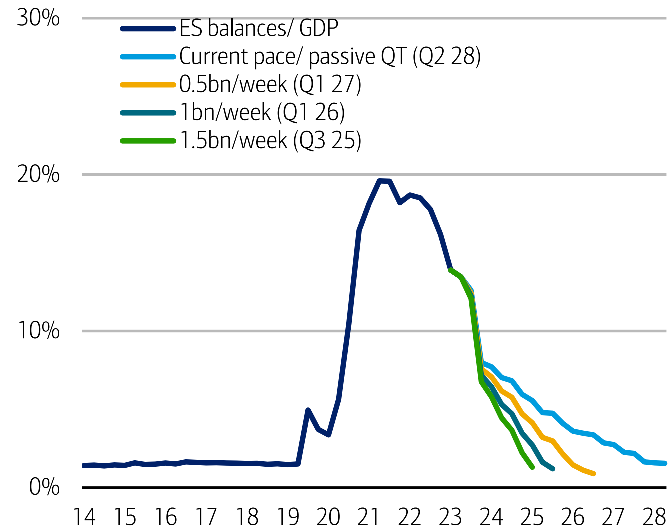
Exhibit 5: RBA asset sales scenarios (return to pre-pandemic levels)
More aggressive RBA balance-sheet drawdown could impact funding costs



Source: BofA Global Research, RBA

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Market implications

The December 2024 bank bill future looks increasingly attractive on an outright basis given our view that the probability of an earlier start to the easing cycle is rising but offshore-led moves pose a high risk. In the near term, we decline to add a trade given the risk that US non-farm payrolls beats estimates and leads a global repricing of policy-rate cycles.

We have previously expressed a preference for receiving December 2024 bank bill-OIS basis (BOB) hedged with a paid June 2024 BOB position to fade tightness in the funding market. The curve continues to look too steep, in our view.

Themes: Constructive on AUD crosses in 2024

In FX markets, we have been neutral AUD near-term on China risks (Q1 AUDUSD forecast: 0.66) but signs of bottoming in China sentiment suggests value in owning upside. The larger-than-expected 5yr LPR cut signaled intent to strengthen support for the property sector (China Watch 20 February 2024). While this is not yet evident in new home sales, the LPR cut should help restore some housing confidence in the near term. China's property sector matters most for Australia's bulk commodity exports and therefore AUD.

Softer than expected economic data poses a downside risk to our 2024 base case for AUDUSD but we continue to see much stronger case to sell NZD and CAD given cross-market growth divergence. While AUD remains a "high beta" currency, an improving NIIP should also reduce its sensitivity to risk over time, something that is already evident in its weaker spot-volatility correlation in 2023 despite China pessimism. If this persists, superannuation funds may consider reducing their unhedged exposure to listed international equities, which could further support AUD (Liquid Insight 22 February 2024).

Forecasts: AUDUSD to 0.71 by end-2024, focus on crosses in 1Q

We forecast AUDUSD at 0.71 by end-2024 but with the bulk of appreciation from 2Q onward when we see sequential improvement in China growth, alongside weaker USD. Near-term we expect AUD to remain supported against non-USD crosses. There are downside risks to our forecasts if China growth disappoints again in 2024.

Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **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
- When in doubt…, **Liquid Cross Border Flows**, 26 Feb 2024

Rates, FX & EM trades for 2024

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: June a big deal, but still far 01 March 2024

Global Rates Weekly: Leap fear 01 March 2024

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