Liquid Insight

Bullish on Bullock, bearish on growth

15 August 2023

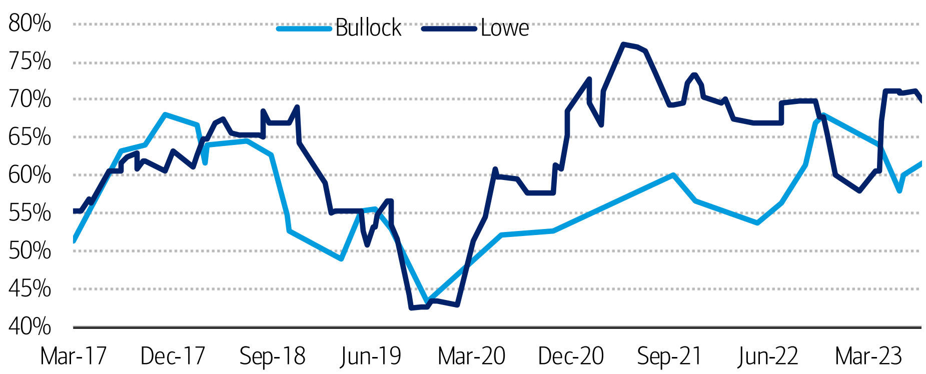
Rates and Currencies Research
Global

Key takeaways

- Our RBA sentiment indicator suggests incoming RBA Governor Michele Bullock will be more dovish than Governor Lowe.
- Economic data supports our view for an extended RBA pause. Active QT could address upside risk to CPI and financial stability
- We continue to recommend receiving 10y swap EFP. Selling bonds vs OIS also looks attractive.

By Oliver Levingston, Micaela Fuchila & Devika Shivadekar

Chart of the Day: BofA RBA Sentiment Indicator suggests Bullock is more dovish than Lowe
Bullock to replace Lowe as RBA Governor next month



Source: BofA Global Research, RBA

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Governor change to transform focus

Michele Bullock will take over from Phil Lowe next month and our RBA Sentiment Indicator suggests she will be more dovish than her predecessor. The latest reading for Bullock (61%) has a dovish bias vs Lowe (69%), confirming our view that the RBA is likely to remain on hold. (Chart of the Day). The incoming Governor's expertise in financial stability and her focus on the labour market in recent communications confirms our view that balance-sheet policy (i.e. active QT/ bond sales) is now more likely and the RBA remains on extended pause (albeit with risks skewed to further hikes) (Exhibit 1).

Our favourite expression of this view to receive 10y swap EFP, which we entered at 51bps with a target of 20bps (current level 35bps) (See report: Australia Rates Viewpoint: The cycle is ending: time to receive swap EFP 19 July 2023). Risk to the trade is a more elongated hiking cycle than we forecast, which could place upward pressure on swap spreads Selling bonds vs OIS also looks attractive given our high-conviction view that bond richness has passed its peak.

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QT = quantitative tightening

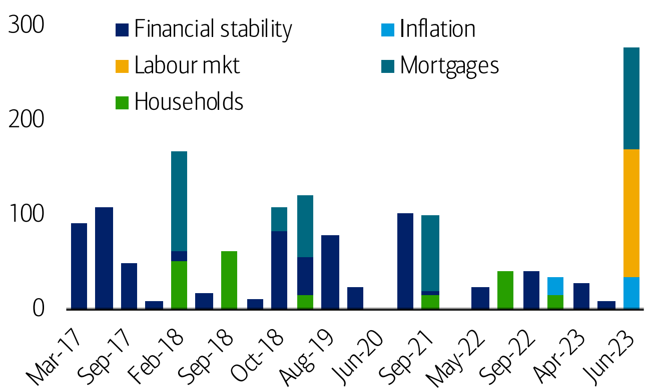
RBA sentiment dovish, balance sheet policy in play

As we have previously highlighted, our RBA Sentiment index has shown a turn in sentiment, suggesting the RBA is near the end of the hiking cycle. After including the minutes of the RBA's July meeting, the latest reading of the sentiment indicator confirmed dovish sentiment, shifting down from 71.1% to 69.5% (Exhibit 2). There has also been a noteworthy convergence across the constituent series (Statement on Monetary Policy (SMP), Speeches and Minutes), suggesting the RBA's communications have been atypically uniform.

The change in RBA Governor has added uncertainty around the outlook but communication from the new Governor (currently Deputy Governor) suggest an ongoing focus on financial stability and the labour market rather than inflation (Exhibit 1). We see Bullock's dovish bias and expertise in financial stability as an indicator the RBA is more likely to calibrate late-cycle policy using its balance sheet. There are two reasons balance-sheet policy is uniquely suited to the RBA: (1) balance-sheet policy is likely to be less contentious and (2) the Australian Government's borrowing program has been repeatedly downgraded and the government looks set to deliver a second fiscal surplus in 2023/24 (Australia Rates Watch: Back in the Black: 2023/24 AU Budget Review 09 May 2023). A very limited government funding task means the RBA is highly unlikely to cause disorder by adding to ACGB supply.

Exhibit 1: Words used in Michele Bullock's communication

Focus on labour market*



Source: BofA Global Research, Bloomberg *Count of top 10 words in each speech Financial stability = financial, supervision, regulation, banking or stability, Labour mkt = unemployment or employment or labour, Mortgages = stress, borrowers, mortgage, housing or lending

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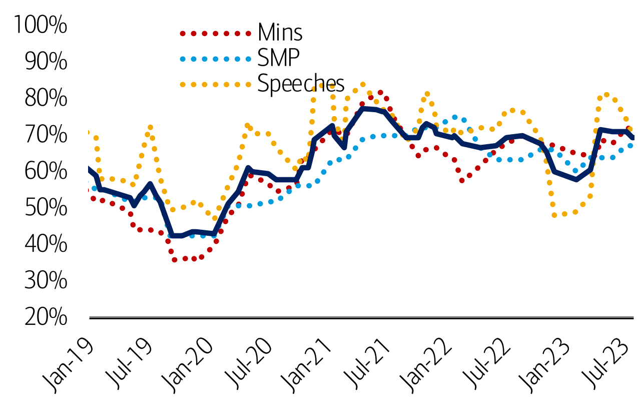
Exhibit 2: RBA Sentiment Indicator confirms dovish moves

Note convergence across indicators



Source: BofA Global Research, RBA

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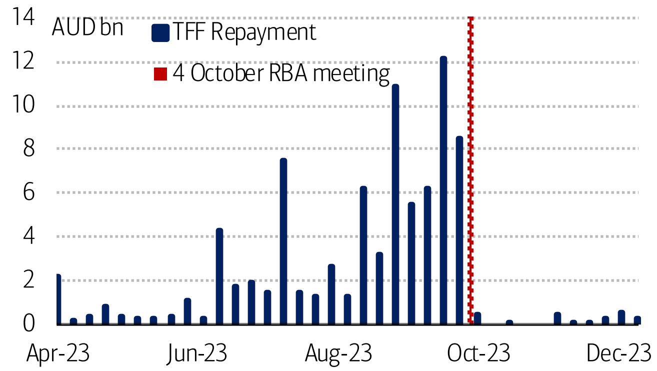
Timing and mechanics

in the minutes of its May meeting, the RBA Board noted passive QT was "appropriate for the time being" but "the Bank's large holdings of government bonds exposed its balance sheet to a significant level of interest rate risk", suggesting periodic review would be appropriate On the question of timing, the minutes noted "the initial tranche of Term Funding Facility [TFF] maturities would occur in coming months and would provide information on how financial markets respond as the Bank's balance sheet declines (Minutes of the RBA's Monetary Policy Meeting, 2 May 2023).

Given the first tranche of TFF maturities concludes around the end of September, we see the RBA's meeting in October as the first 'live' meeting for an announcement (Exhibit 3). In our view, an announcement is likely in Q4 with sales to commence around the beginning of 2024. We see sales of $25bn in 2023/24, $50bn in 2024/25 and $37.5bn in 2025/26. Asset sales at this pace will return liquidity (in this case, exchange settlement account balances held at the RBA) to its pre-pandemic levels by Q1 2026, which is when we see the RBA concluding the program.

We do not see asset sales of semi-government bonds (around 20% of the portfolio) at this stage, given the higher likelihood that asset sales in this market would cause bond-market disorder and the lower accumulated losses from semi holdings.

Exhibit 3: Active QT likely up for consideration at October RBA meeting
First tranche of TFF maturities are mostly complete by end of September 2023



Source: BofA Global Research, RBA

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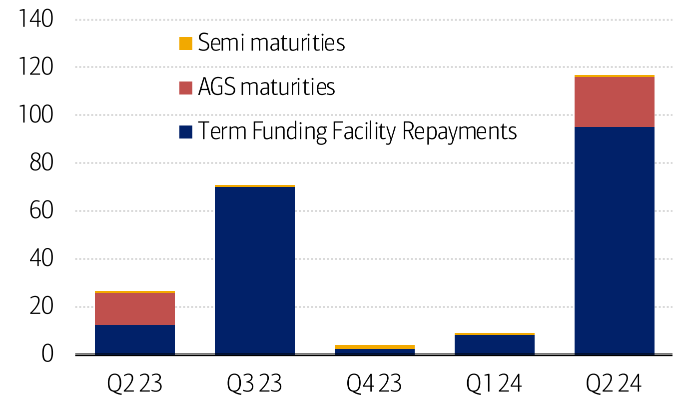
Exhibit 4: Maturities skew to Q2 24 but sales likely from Q4 23
Active QT likely an option from October 2023



Source: BofA Global Research, RBA

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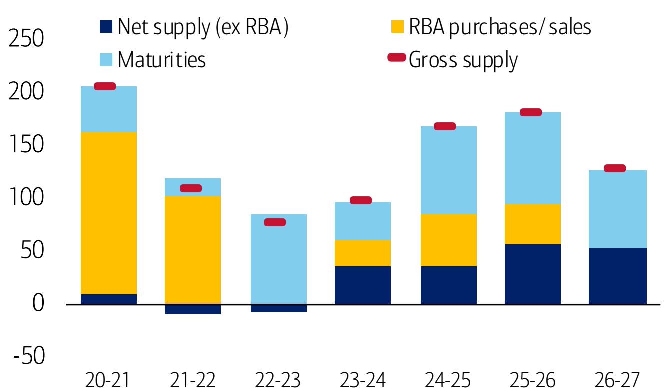
Exhibit 5: RBA sales would increase gross bond supply
Bonds have remained scarce since 2024



Source: BofA Global Research, RBA, AOFM

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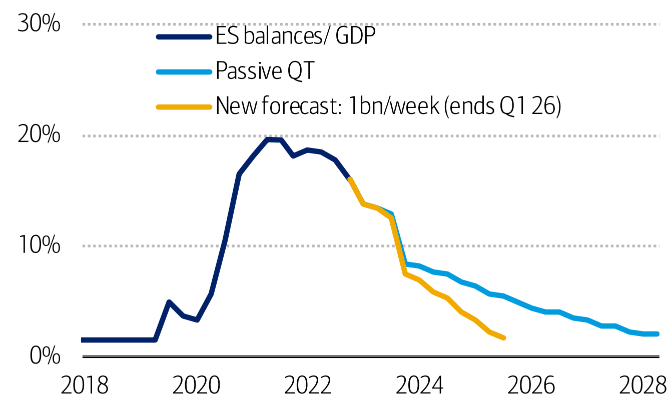
Exhibit 6: We see 1bn/ week in sales starting Feb 1, 2024
Program to conclude in Q1 2026



Source: BofA Global Research, RBA

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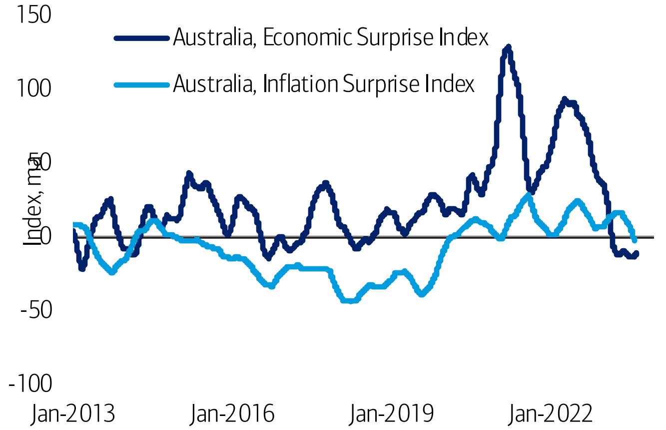
The RBA's triple mandate vs current conditions

The RBA's focus on price stability, financial stability and full employment has seen guidance shifting between the three as the economic cycle matures. While the Bank intends to retain its hawkish bias as inflation remains too far above the target, recent communication suggests an increased focus on the labour market and broader economic activity. Economic data has surprised to the downside of late, but inflation surprises have been more mixed (Exhibit 7).

The RBA Board will continue to meet on a monthly basis for the rest of the year and September will be the last meeting with Governor Lowe in charge. Upcoming changes to the RBA, volatility in economic data and a very mixed global backdrop has increased the likehood for RBA surprises (Exhibit 8). Four weeks between meetings does not provide enough new information to assess current economic conditions. Therefore, the RBA's data-dependant reaction function becomes increasingly unclear and the markets and economists place too much weight on one piece of data. In our view, inflation will remain stickier for longer, while economic conditions will continue to weaken. However, a tight labour market, early signs of a turnaround in the housing sector and a weaker currency means the RBA's focus will likely shift back to inflation.

Exhibit 7: Economic data surprises to the downside

Inflation is more mixed



Source: Citi, Macrobond

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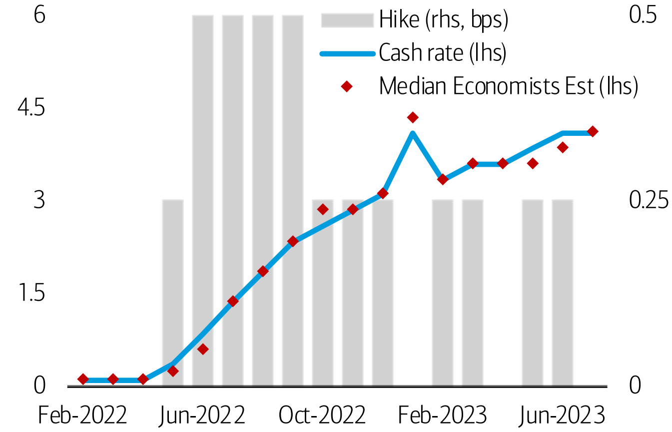
Exhibit 8: Market Economists

Expectations vs rate changes



Source: RBA, Bloomberg Survey

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On hold for the rest of 2023 with risk of further hikes

Ahead of Phil Lowe's last meeting in September, 2Q wages growth rose by 0.8%qoq, 3.6%yoy in line with our expectations, but slightly softer than the RBA's 3.7%yoy assumption. Wages is a slow moving series and this particular release will not reflect the impact of the minimum wage increase from July 1, but there are early signs of a peak in wages (Exhibit 10) . Additionally, labour market data for July will be released later this week, and we expect a small rise in unemployment to 3.6%, which is still a multi-decade low. This is on the back of a slower pace to employment growth and record-high participation. Overall, we are confident the RBA will keep rates unchanged at the September meeting and for the rest of the year, but upside risks for inflation should weigh more than supporting the labour market for now.

In four plausible scenarios with lower participation and fewer jobs, the unemployment rate struggles to rise sharply. The RBA's view of the neutral rate of unemployment (NAIRU) at around 4.5% suggests a condition for rate cuts would be an unemployment rate above 5%. However, experience from previous cycles suggest the RBA is more likely to keep rates unchanged if employment growth is positive and unemployment moves sideways around the 5-5.5% level.

The level of household debt is the key reason why the RBA is reluctant to deliver sharp policy moves. Notably, the risk for a mortgage cliff increases as fixed mortgages roll over. This is expected to peak in 3Q. While we think a strong labour market and some buffers in households balance sheet offsets this risk, the fixed rates rollover places more pressure on households whom are already experiencing high living costs. See report: [Global Economic Viewpoint: Is refinancing the kryptonite of monetary policy? 14 August 2023]

Exhibit 9: Scenarios on unemployment
Unemployment is unlikely to rise sharply

Job losses	Participation	Unemployment
180k	~66.83%	4.92%
180k	~67.33%	5.60%
100k	~66.83%	4.37%
100k	~67.33%	5.08%

Source: BofA estimations, ABS

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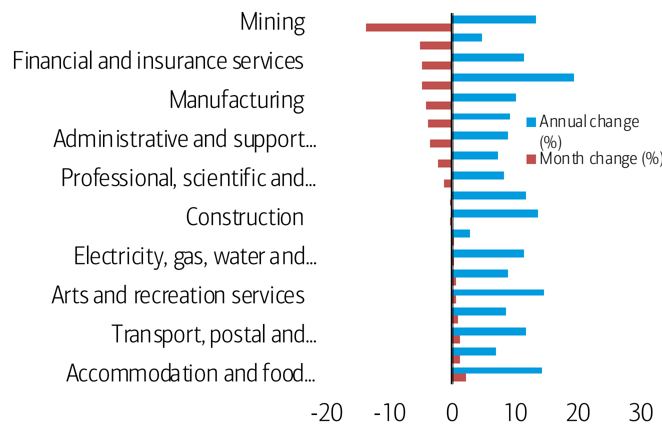
Exhibit 10: Wages seem to be falling across industries
Based on monthly indicators



Source: ABS

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QT as a macroprudential tool

We believe the main near-term risk ahead is un upside suriprise on inflation. 3Q data is seasonally strong and electricity prices have increased from July 1 along with petrol prices, a weaker AUD and phone bills in addition to persistent rent inflation (that is unlikely to fall given improved demographics). On the downside, the mortgage cliff (See report :Global Economic Viewpoint: Is refinancing the kryptonite of monetary policy? 14 August 2023) increases financial stability concerns as households leverage remains high. However, soft growth and household spending suggests the RBA will avoid further tightening to support the economy, in our view.

We think the RBA could tighten financial conditions to address inflation and financial stability risk by performing a more aggressive balance sheet reduction. This would avoid damaging consumer sentiment further while addressing inflation and financial stability concerns. Active QT is less aggressive than hikes. For instance, the Bank of England estimates around $35bn of QE2 was equivalent to one 25bps cut, but the multiplier for QT is not as impactful as it wouldn't provide a signal on future policy rates.. See report: UK Viewpoint: How should the BoE do QT? Very carefully 28 January 2022 . While difficult to calculate its impact, we estimate around $70bn QT would be equivalent to one 25bps hike. This means, the RBA would be delivering one hike over nine quarters. Therefore, the impact on growth would be very modest.

Cylical bias to steepeners but fair value challenges view

Exhibit 11 presents four macro regimes over the past 30 years based on the stage of the RBA's cash-rate cycle – rising rates, pause after rising rates, falling rates and pause after falling rates. 3s10s steepeners underperform in a rising-rate environment and in a pause after falling rates but outperform after a cycle of rate hikes concludes. The 3s10s curve has outperformed in the first three months after a final pause by 59bps on average.

We continue to have a bias towards curve steepeners but the negative carry is unattractive and our fair value models suggest rates are very close to our year-end forecasts so we wait for better levels to add a recommendation (Exhibit 13, Exhibit 14, Exhibit 12). For now, our preferred expression is to position for cheaper bonds to swap by receiving 10y swap EFP and to trade a normalisation of funding markets by paying 6m 6s3s starting on 7 March 2024.

Exhibit 11: Curves steepen after final pause

30-159bps of steepening seen after terminal rate reached in previous cycles

Macro regime	End date	Change in nominal 10y	3s10s shift	3s10s shift (3m post-regime)
Rising rates	1994	76	-99	68
Rising rates	2000	-61	-56	-4
Rising rates	2008	-17	-65	-78
Rising rates	2010	-1	-9	-20
Rising rates	2023	-14	-2	-4
Pause after rising rates	**1996**	**-159**	**62**	**30**
Pause after rising rates	**2001**	**-91**	**52**	**37**
Pause after rising rates	**2008**	**-34**	**34**	**159**
Pause after rising rates	**2011**	**-83**	**40**	**10**
Falling rates	1996	-48	19	5
Falling rates	2001	-6	50	-3
Falling rates	2009	-118	85	-32
Falling rates	2016	-259	-19	68
Falling rates	2020	-62	23	10
Pause after falling rates	1994	248	-19	-102
Pause after falling rates	1999	-119	-31	64
Pause after falling rates	2002	99	-52	-12
Pause after falling rates	2009	67	-66	-16
Pause after falling rates	2019	-32	-6	-4
Pause after falling rates	2022	252	-23	-71

Source: BofA Global Research, Bloomberg *all figures in basis points

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Exhibit 12: 10y slightly cheap vs fair value

We decline to add a trade given our outlook for a potential QT program

Source: BofA Global Research, Bloomberg

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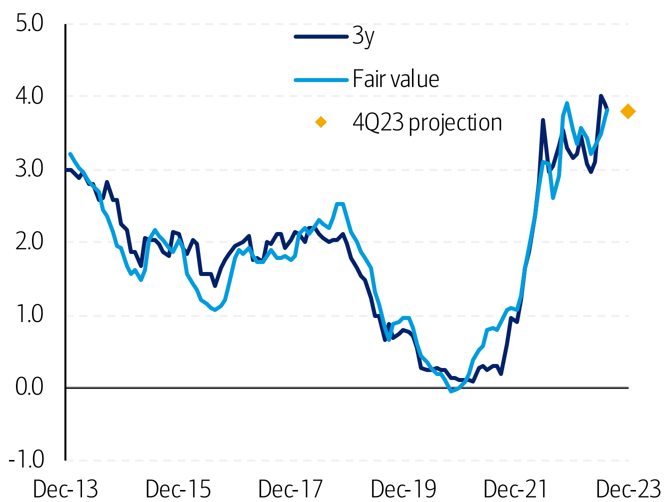
Exhibit 13: 3y at fair value

3y bond fair value just 1 basis points shy of year-end forecast



Source: BofA Global Research, Bloomberg

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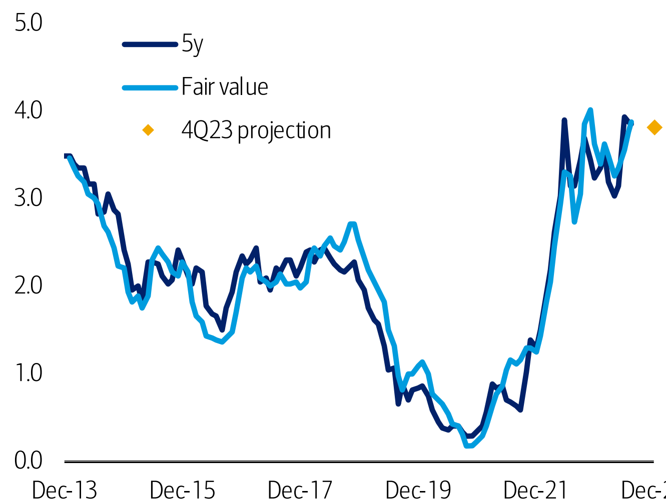
Exhibit 14: Belly in line with fair value, year-end forecasts

Wait for better levels to add outright trade



Source: BofA Global Research, 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
- Miracle on Main Street **Global FX Weekly**, 11 Aug 2023
- R*s be our guide **Global Rates Weekly**, 11 Aug 2023
- The market bias against the USD, **Liquid Cross Border Flows**, 7 August 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: Miracle on Main Street 11 August 2023

Global Rates Weekly: R*s be our guide 11 August 2023

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