RBA may link rate cuts to progress on financial stability

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The RBA is likely to await clearer evidence that banks are tightening lending conditions for mortgage lending before cutting rates. Rather than cutting in November, it will probably make this link clearer. Weaker Chinese industrial data and soft metals markets should keep the AUD recovery in check, but domestic indicators are providing support and the market has built in perhaps too much rate cut potential over the next few months. CAD has benefited from the election result, little is expected from the BoC rate decision today. Oil prices are stable, we see potential for further strength in CAD.

RBA may link possible rate cuts to progress on financial stability

The market started to back away somewhat from expecting a rate cut from the RBA in November following the RBA October meeting minutes released on Tuesday and the Financial Stability Report released last Friday. These reports discuss in detail the central role that the housing market has in the RBA's perception of the financial stability risks for the country.

While keeping an eye on global uncertainty, the RBA said, "to date these global factors have not had a material impact on Australia's financial system". However, it said, that "domestic sources of risk to financial stability in Australia continued to revolve mainly around developments in local property markets."

Regulators in Australia have been addressing risks in the property market since late last year, but there was little traction until around the middle of this year when banks started to tighten lending conditions to investors (as opposed to owner-occupiers) in the property market, the area of most concern for financial stability.

Complementary to this, banks have been enacting plans to raise more capital overall and specifically to increase the average risk-weighted capital held against mortgages in response to the recommendations made by the Financial Systems Inquiry that was tabled late last year. Belatedly, the government released its response to the FSI ("Murray Inquiry") on Tuesday, implementing most of the key measures recommended in the FSI, including all those requiring higher capital requirements at banks.

The RBA noted some progress in addressing financial stability risks in its FSR and minutes, but it is tentative and comes from a higher level of concern.

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Firstly, the RBA noted that banks had been taking liberties through late last year and early this year. It said, "Enhanced scrutiny of housing lending practices" undertaken by regulators since the end of 2014 "had shown that investor activity was considerably higher – and lending standards in some parts of the market weaker – than had originally been thought."

The RBA also noted that while banks have "taken steps to slow the pace of growth in investor lending towards the prudential regulators expectations", they had also "intensified" completion in the owner-occupied segment of the housing market.

In the early stages of the banks' belated response to regulatory pressure to control their lending, since around mid-year, while they began to tighten on one segment (investor loans) they eased on the other segment (owner-occupier loans). As such, the overall housing market has remained relatively strong in Australia and progress on improving financial stability probably still has some ways to go.

Encouragingly for the prospect of rate cuts, the RBA did acknowledge that there were "some signs of an easing in the strong rate of increase in dwelling prices in Sydney, in particular, although trends had been more varied in a number of other cities." And it said, there were, "signs that the response of the banks to supervisory measures implemented by APRA were helping to manage risks in the housing market."

The decision by Westpac bank announced last week to raise their variable rate for owner-occupier lenders is the first clear sign that banks are responding more broadly to tighter capital restrictions on mortgage lending. Until then it appeared banks were still competing fiercely in this space. However, as yet no other lender has announced that it will follow the lead of Westpac. RBA Watcher at the Australian financial Review, Alan Mitchell, initially noted a heightened risk that the RBA cut rates in response to the Westpac move (Why a rate cut is suddenly on the cards – AFR.com), but on Friday after the FSR he back-tracked a bit noting a cut was unlikely unless the other major banks followed suit (Property prices are now officially the biggest risk to economy's recovery – AFR.com).

The RBA minutes suggest that the desire to increase activity and boost employment is not pressing enough to consider cutting rates and risk fuelling further price appreciation and lending in the housing market. It appears that it wants to see clearer evidence that prudential measures are more genuinely changing bank behaviour and tightening credit available for housing.

There are a range of indicators that suggest the economy is rebalancing towards non-mining sector growth. While more rapid growth might be welcome, the cost of undermining financial stability presented by the high exposure of banks to mortgage debts and households to leveraged property investment suggests rate cuts are unlikely unless the housing market and bank lending to this sector is cooling more permanently.

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The November RBA policy statement closely followed by the RBA quarterly forecast round and a key speaking engagement by the Governor Stevens creates an opportunity to reset the policy agenda and cut rates. However, the statements this week on financial stability suggest that the RBA may prefer to wait for clearer evidence that lending conditions for housing have tightened along their long desired lines.

That evidence may indeed come over the next six months with banks moving to shore up their capital base as directed by the regulators and in particular against mortgage assets that dominate their loan books. However the RBA appears unlikely to rush to pre-empt what to-date has been a relatively slow response by banks.

The RBA could use its upcoming events to outline an easing bias that is conditional on further progress on financial stability (code for a weaker housing market and slower mortgage loan growth). A key RBA voice on this matter is Assistant Governor for the Financial System, Malcom Edey. He speaks at a conference in Sydney on Thursday morning, and may provide important clues for the RBA views on housing, banks response to prudential measures, and consequently to case for further RBA rate cuts. In data this morning, the recent improvement in domestic indicators continued with a 1.8%m/m rise in the trend data for skilled vacancies, the highest reading since 2010, and a significant turnaround from a falling 1.0% trend in April this year.

However, this week Chinese industrial activity data weakened more than expected and iron and coal prices in China are still threatening to slide further. The RBA has noted that the fall in the AUD has helped lift service sector activity in Australia, but this only emphasises the need for a persistently lower AUD to keep the rebalancing in the economy moving forward. As such a further rise in the AUD towards .75 as commodity indicators weakened may increase the dovish tones in up-coming statements.

Canada election win positive for CAD

Trudeau's Liberal Party policies include higher infrastructure spending and middle class taxes financed by budget deficits of about C$25bn over three years and tax hikes on higher incomes over C$200,000 pa. Presumably this plan reduces the potential for the BoC to consider rate cuts and should tend to support the CAD. The decisive and surprise extent of the victory should also reduce political uncertainty.

What they said

- UK CBI says leaving the EU would have "serious downsides" for the UK economy.
- BoE hawk McCafferty said recent global factors add to risks to UK outlook, but as yet there is little evidence that these are actually transmitting to the economy. Macafferty is the lone vote in favour of a hike at recent meetings, but he said that there isn't such a difference in the range of views at the MPC.

In the news

- Canada: Liberal Party win a majority in the national election. New PM Trudeau has the mandate and numbers to implement his policies including modest fiscal expansion. Liberals won 184 seats out of 338, conservatives won 99 and New Democratic Party won 44, Bloc Quebecois won 10 and the Green Party won 1 seat. This is a big comeback from only 34 Liberal seats won in the 2011 election.

Economic news

- New Zealand net long term migration people inflow rose from 5480 in Aug to 5550 in Sep, continuing around its record highs. 12-month ended immigration rose to 61,200 a record. Arrivals rise 13%y/y, departures fall 4%y/y. Immigration led by India, China, Philippines and UK.
- Australia skilled vacancies rose 1.8%m/m in trend terms in Sep, the fastest pace since 2010, well up on the low in April of -1.0%.
- Japan trade balance a modest deficit of JPY356bn in Sep, little changed from a month earlier, somewhat wider than -64bn expected. Exports rose 0.6%y/y, below 3.1% expected. Imports fell 11.1%y/y, a bit above -12.0% expected.
- US housing starts rose 6.5%m/m in Sep, up from -1.7%m/m in Aug, revised up from -3.0%, above +1.4% expected. The number of starts revisits the high in June, the high since 2007. From a year earlier starts are up 17.5%y/y (apartments +27.7%, single-family +12.0%).
- However, US housing permits fell 5.0%m/m in Sep and were revised down from +3.5% to +2.7%m/m in August, weaker than +0.8% expected. Permits are at their low since March. Permits rose 4.7%y/y. The volatility in both starts and permits data was related to the naturally more lumpy apartments.
- Eurozone current account balance fell from a surplus of EUR25.5bn in July to 17.7bn in Aug, a low in 12 months
- Taiwan Export order growth improved from -8.3%y/y in Aug to -4.5%y/y in Sep, stronger that -11.4% expected.
- Japan department store sales slowed to +1.8%y/y in Sep, down from +2.7%y/y in Aug.
- RBA Policy minutes maintain neutral tone. "Signs that the response of the banks to supervisory measures implemented by APRA were helping to manage risks in the housing market. Credit growth overall had been moderate."
- Australian weekly consumer confidenceeased last week from 115.6 to 113.3, around average for the year.

On the Radar

- Canada BoC Rate Decision and quarterly Monetary Policy Report
- Australia RBA Assistant Governor Edey speech
- China President Xi State visit to the UK

Later this week

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- Australia 22 Oct – RBA Assistant Governor Edey speech
- Australia 22 Oct – RBA annual report
- China 23 Oct – Property Prices
- Japan 23 Oct – PMI flash
- New Zealand 22 Oct – Job ads
- USA 22 Oct – Chicago Fed National Activity Index, Existing Home Sales, Leading index, Kansas City Fed Mfg Index, Markit PMI flash
- Canada 22 Oct – Retail sales
- Canada 23 Oct – CPI
- Eurozone 22 Oct – ECB
- Eurozone 22 Oct – Consumer confidence
- Eurozone 23 Oct – PMI flash for mfg and services
- UK 22 Oct – BoE Jon Cunliffe speech to BBA, international banking conference
- Taiwan 23 Oct – Commercial Sales & Industrial Production
- Malaysia 22 Oct – Foreign Reserves
- Malaysia 23 Oct – CPI
- South Korea 23 Oct – GDP Q3
- Singapore 23 Oct – CPI
- India 23/30 Oct – Eight infrastructure industries production

Further out

- Australia 28 Oct – CPI
- Australia 3 Nov – RBA rates policy
- Australia 5 Nov – RBA Governor Stevens speaks
- Australia 6 Nov – RBA Statement on Monetary Policy
- Japan 29 Oct – IP
- Japan 30 Oct – Employment, Household spending, CPI, BoJ policy and semiannual outlook report.
- Japan 4 Nov – Japan Post IPO
- China 27 Oct – Industrial profits
- China 28/31 Oct – Leading Index
- China 1 Nov – Manufacturing and Non-Manufacturing PMI
- China 2 Nov – Caixin Mfg PMI
- China 4 Nov – Caixin Services PMI
- USA 26 Oct – New Home Sales
- USA 27 Oct – Durable goods orders
- USA 28 Oct – FOMC
- USA 29 Oct – GDP Q3
- USA 3/19 Nov – Congressional Debt ceiling approach. (WSJ article)
- USA 5 Nov – Fed Vice Chair Fischer speaks at the National Economists Club
- USA 6 Nov – Payrolls
- New Zealand 27 Oct – Trade balance
- New Zealand 29 Oct – RBNZ Official Cash rate (OCR) review
- New Zealand 30 Oct – Building Permits, ANZ business survey, Credit growth
- New Zealand 2 Nov – Treasury monthly economic indicators report
- New Zealand 4 Nov – Labour report Q3
- Eurozone 30 Oct – Unemployment and CPI first estimate

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Markets on the Move

- NZD moved below the range lows set over the last few sessions in offshore trading on Tuesday.AUD/NZD rose above the highs of the last few sessions to a high since Thursday last week. The Global Dairy Trade auction resulted in a 3.1% price fall overnight. However, net immigration to NZ was strong this morning.
- CAD rose in European and early American trading, but gave back some gains in the afternoon American session. Decisive Trudeau election victory supports, languishing oil prices dampen.
- USD/JPY firms in offshore trading, establishes support around 119.50, rising steadily over the last three days from a low on Thursday last week in the low 118s, may be gravitating towards the psychologically comfortable 120. Has traded between 118/122 since August global market upheaval and fall from 125.
- Most Asian currencies are mildly weaker so far this week. Although KRW and TWD have firmed relative to Southern neighbours.

- US 2yr swap rates rose around 3.5bp, more than reversing falls in late-American trading on Monday, now firmer on the week, at a high since Tuesday last week. 2yr Government yields are 4.3bp higher, at a high since Monday.
- Canadian 2yr swap rates rose 2.5bp. 3mth bank bill acceptance futures March-16 contract rose 3bp, suggesting risks towards policy cuts have diminished in response to the election. 2yr government yields rose 3.1bp and 10 year yields rose 8.5bp, perhaps reflecting the prospect of more fiscal spending.
- Euro 2yr swap rates rose 1.7bp to 0.043%, off their record low on Monday. German government 2yr yields rose 2.3bp and 10 year yields rose 6.1bp, a little more than US government 10 year yields that rose 4.4bp. UK 2yr swap rates rose 1.1%
- Australian 3mth bank bill futures March contract yield rose 2bp in Australian trading and a further 4bp in offshore trading. RBA minutes seen offering no hints on cuts. 2yr swap rates up around 4.5bp over 24 hours, and a high since Monday last week when Westpac announced its mortgage rate rise. Odds of a 25bp cut in two weeks have fallen from a recent high of 69% to 51% according to the CS index.
- New Zealand 2yr swap rates are 2bp firmer this morning, a high since 9-Sep.

- Oil prices largely stable or a tad weaker after their fall on Monday. The Brent contract is trading on its low last week, testing support. There is a gradual rising trend-line from the lows in Sep, coming in near-by at around $48. So far the lows have been getting higher since the low in August. Performance in the next week or so may set the tone for coming months.
- USA Gasoline futures fell on Monday to a low since January.
- Another day another low in Chinese thermal coal futures, continuing a steady drift over the last month.
- Coking coal stable but still around the lows over the last three months and long term lows. Iron ore flat since a low last week since 30-Sep; Dragging along a neck-line on a possible head-and-shoulders, a troubling appearance of struggling

to bounce off-support and preparing for another move lower. Still largely in the middle of its range since its sharp falls in July.
- The GlobalDairyTrade price index fell 3.1% in the bi-weekly auction, the first fall in the five auctions since the low on 4-August, still up 57.8% from the low, but down 45% from the peak in 2014.

- US stocks stable. Healthcare sector fell 1.5%, steel sector fell 1.6%, and homebuilders rose 2.1%.
- Shanghai stocks firm to a high since the 21-August sharp fall. Korean and Taiwanese equities also firming to highs over same period
- New Zealand equites have risen strongly over the last week to a high since 10-August.Australian equities down in recent days with weaker mining sector equities. Its banks are also slightly under-performing the overall index.

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