Low inflation may force the RBA's hand in May

Posted on April 24, 2019

The downside miss on inflation in Australia probably forces the RBA's hand to cut rates. The RBA generally doesn't fuss too much with appearances once it changes its mind, so a cut at its next policy meeting as soon as 7 May is likely, even though it would come only weeks before the Federal election on 18 May.

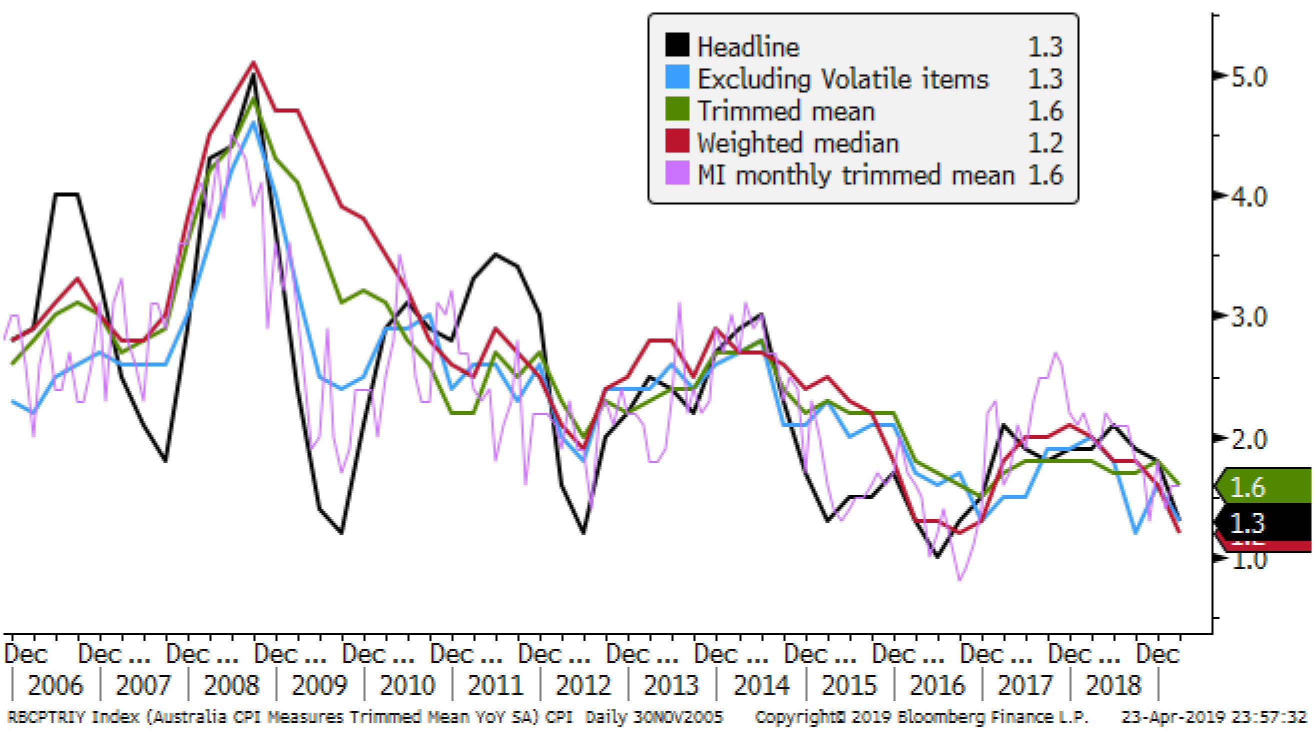
One cut is unlikely to be viewed as significant enough to make a material difference on the inflation outlook, so a second cut is likely before the dust has had time to settle on the first, so within the next Month (4 June) or two (2 July).

The RBA already hinted that it was shifting from an on hold stance to one where they were considering a possible cut in the minutes from their April meeting.

In recent statements, they have focused more on the labour market and the apparent divergence between relatively weak GDP growth and still strong employment growth in Australia, and in several other countries.

They indicated that they were watching closely to see how this divergence might be resolved, either by a recovery in GDP growth or a weaker labour market. Inflation was not necessarily the top priority.

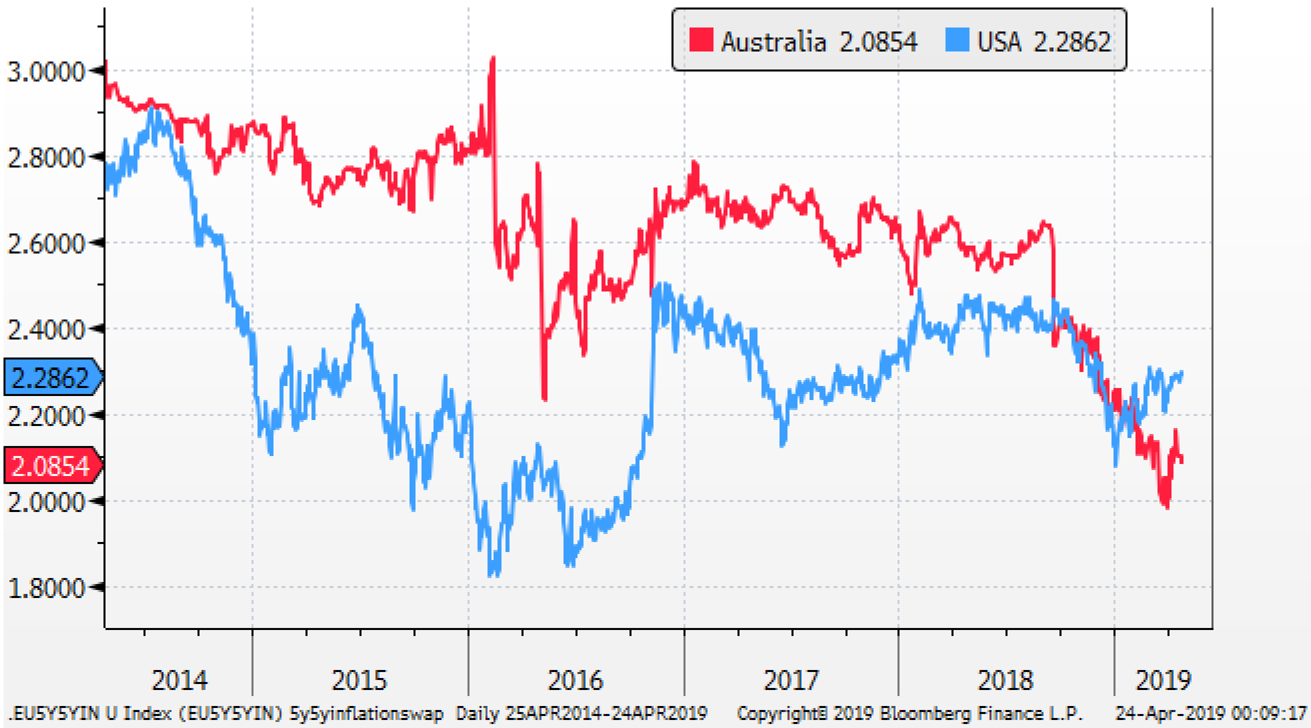
Australian CPI inflation %y/y



The RBA has been undershooting its inflation target (2 to 3%) for several years, willing to be more patient in returning inflation to target in the name of avoiding a further build-up of household debt and higher financial stability risks.

However, with the outlook for growth and employment now less optimistic and policy hanging in the balance, the degree of undershoot in inflation implied by the Q1 data suggests that the RBA will risk de-anchoring inflation expectations if it does not return its focus to directly raising inflation. Market-based measures of inflation expectations have already fallen significantly in recent months.

5yr-5yr forward inflation swaps breakevens – long term inflation compensation in Australia has fallen sharply since September last year to below the USA and well below the RBA's 2.5% inflation target mid-point



The RBA forecast underlying inflation (trimmed mean) at 1.75% in June-2019 in its February Statement on Monetary Policy. At 1.6% in Q1, it is on track to undershoot that. The other key underlying inflation measure (weighted-median) has dropped more sharply to 1.2%y/y in Q1. Excluding volatile items, inflation was only 1.3%y/y in Q1. Non-tradables inflation, more influenced by domestic demand conditions, fell to 1.8%y/y. These underlying measures are at or approaching the previous lows in 2016 that prompted the last rate cuts in Australia, well below the RBA's mid-point of its inflation target (2.5%).

Nothing to lose

It could also be argued that with the pace of credit growth at relatively weak levels and the housing market in retreat for approaching two years, the RBA can fear less the financial stability risks from further lowering interest rates.

International pressure is also increasing for the RBA to cut rates with several other nations adopting less hawkish guidance, not least of which is the Fed that appears to have a new-found desire to raise inflation expectations, and risk inflation overshooting its target for a prolonged period to compensate for years of undershooting.

As is often the case, central bankers will take a cost-benefit analysis of the decision to cut or not to cut. At this stage, it appears to have little to lose by cutting rates.

The RBA minutes indicated that the benefit from a cut might be significantly less in the current environment. It may have only a marginal impact on lifting confidence and spending in the Australian economy. Households may not be as eager to increase credit growth if rates are cut.

However, the RBA did say that it expected the AUD to fall if it cut rates and this may help boost national income and more directly help lift inflation. The RBA would certainly welcome a weaker AUD exchange rate.

Further to run

The AUD has already fallen significantly in recent days. Firstly in response to a stronger USD, but significantly further after the CPI data. The market has moved aggressively to price in rate cuts. 2-year swap rates are down 14bp on the day. The cash rate futures market is pricing in 17bp of cuts at the May policy meeting, or a 68% probability of a rate cut. It has priced in 50bp of cuts by the end of 2019.

The rates market and the AUD have already reacted to the CPI to a significant extent. But they still have some further room to run if the RBA does indeed move ahead with a rate cut In May.

At this stage, the market might be reluctant to push the AUD below its lows around 70 cents which have held since October last year, barring the flash crash in January. But a break of this level might help engender a more sustained bearish outlook for the AUD.

The AUD may yet get some support from stronger global commodity prices and an improved outlook in the global economy. Chinese economic data was significantly better than expected in March, and the US and China are deep in negotiations on a trade deal that most expect to be struck relatively soon.

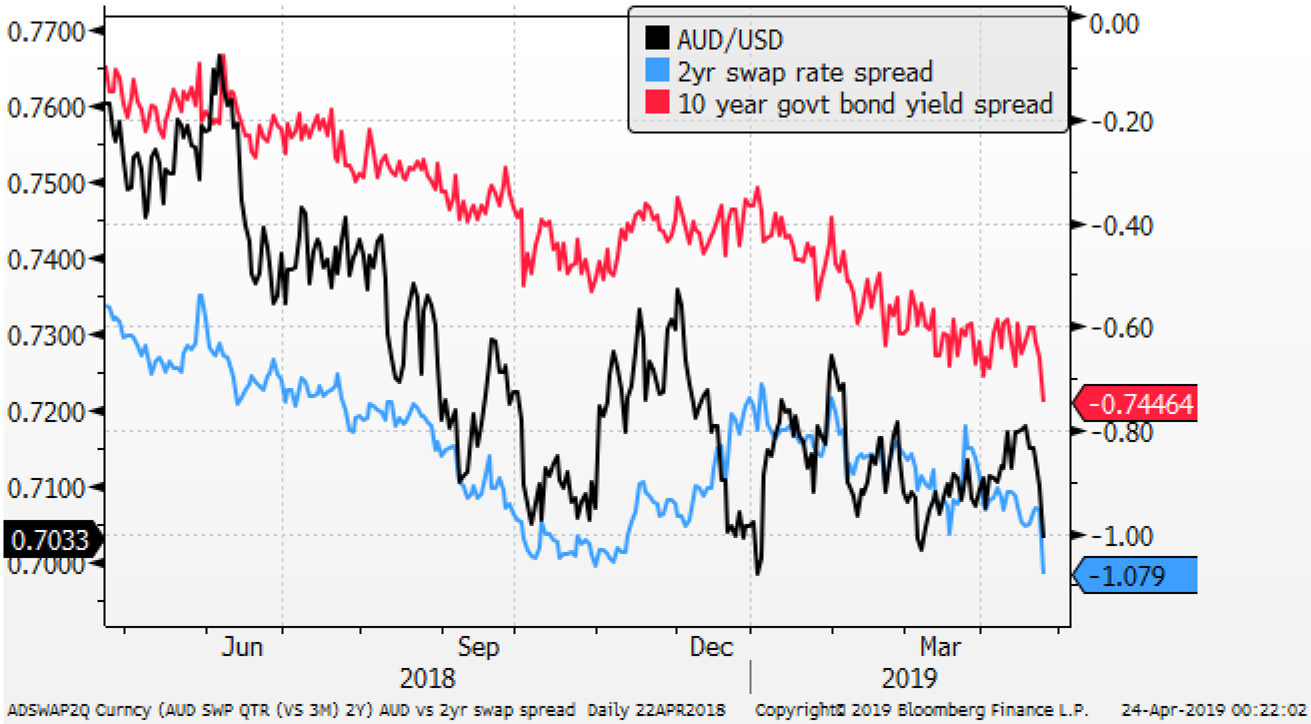
However, global risk appetite has failed to date to take much solace from the stronger Chinese economic data. The USD is testing the strong side of its range for the year-to-date, as US equities appear to be still attracting capital inflows, while the relatively high USA yields are also supporting the USD, even if the Fed has taken out most of its projections for higher rates.

Australian commodity prices are relatively robust. However, the AUD has largely ignored commodity prices for the last year. It may continue to do so.

While China's March activity reports were stronger than expected, other recent global indicators do not back up the China data, including flash manufacturing PMI data for key China trading partners (Japan and the Eurozone), and USA manufacturing indicators have also lost momentum. Furthermore, export growth has remained weak in the rest of Asia. As such, it is far from clear that the recent Chinese data provide an accurate assessment of Chinese demand or its broader impact on the global economy.

As such, the risk is high that a rate cut watch in Australia dominates near term AUD price action and triggers a further significant fall in the currency.

AUD/USD vs yield spreads



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