

Group Economics



Macroeconomics



Industry & Commodity



Markets

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RBA Now Expected to Raise Rates By 25 Points in November.

- The new RBA Governor was more “hawkish” than we expected last week, identifying an overshoot of inflation as the mistake he feared most;
- Mr Stevens questioned the extent to which the economy has slowed. In particular the contrasting messages from GDP data and the labour market estimates;
- It now looks as if only a surprisingly low September quarter CPI outcome will prevent a rate hike in November - that is not our forecast and hence the odds have moved to around 70 per cent in favour of a rate increase;
- Reading between the lines, we would have a weaker assessment of the domestic economy than the RBA, with less concern that high capacity utilisation rates will cause inflation problems than that implied by the Governor’s comment;
- Critically, we see the domestic economy as being in the process of slowing further with confidence, forward orders and credit all slowing and that capacity utilisation has peaked and will fall from here;
- We still however see core inflation rising to peak at 3¼ per cent by end 2006, before moving back into the RBA’s target band by mid 2007;
- Taking on board a rate hike in November and the deteriorating prospects in rural Australia, we have lowered our GDP forecasts by around 0.4 per cent to 2¼ per cent in 2006/07 and 2 ½ per cent in 2007;
- Given that outlook, we expect the November rate hike to be the last in this cycle and the next move could well be a rate cut.

For some time now we have been forecasting that core inflation would continue to rise to above the top of the RBA’s target by end 2006. Our expectation was that evidence of a slowing economy post the recent rate rises would give the RBA sufficient confidence to allow a temporary overshoot with the expectation that core inflation would be moving back into the target range by mid 2007 with the prospect of a mid target outcome by late 2007.

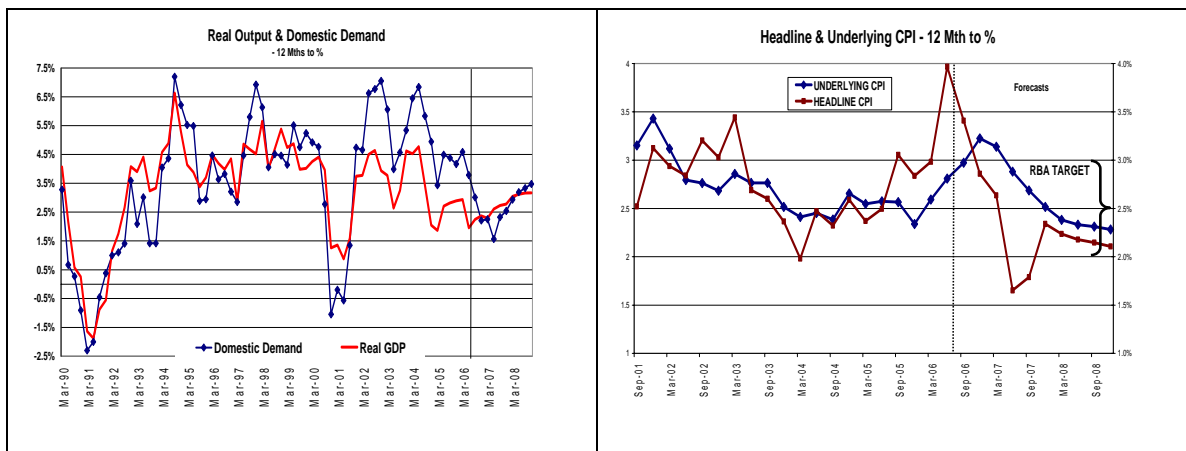
The evidence of a slowdown in activity has started to emerge. That said, so far it is mainly to be found in the business confidence related data, new orders and very recently in the capacity utilisation data and credit. Forward looking data such as business capital plans have also softened – and can only be described as weak. Overall, business conditions, while not as strong as in early 2006, are still solid. The employment data, although very volatile, has surprised everyone by its strength over the past six months.

Indeed the strength of the labour market (even prior to the September estimates) drew new Governor Stevens to reflect on the data puzzles suggesting that it might draw into question the extent of the slowdown in reported GDP estimates. Interestingly, the possible explanations to the “conundrum” he dwelt on increased his concerns about the risks to inflation – either via faster than reported growth or low productivity. Further he

tended to suggest that the official data may not be fully capturing wage increases (albeit no evidence was cited on this score). Whether we agree with him or not on all of the above is not really relevant. What is relevant is the perspective he (and presumably the RBA) are currently viewing economic conditions and prospects. That is, they fundamentally worry about the risks from inflation running above 3 per cent for a sustained period.

Given this focus only a lower than expected CPI result on 25 October will stop them taking out some added insurance. While that is still possible, it is not our core forecast. We expect September quarter underlying inflation to increase by around 0.8 per cent and headline by 0.4 percent – bringing the annual rates to 3.0 and 3.4 per cent, respectively. Those forecasts, given the Governor’s stated perspective that the biggest mistake he could make would be to allow excessive inflation, would produce a November rate increase.

Looking further out, however, the key to rates still lies in where the economy (and with a lag inflation) is headed. Fundamentally, we have not changed our view that domestic demand is slowing and will continue to do so. Tighter monetary policy would act to only lower those projections. After taking the new rate view into account and factoring in a worse drought than previously expected (we now see farm GDP falling by between 10-15 per cent vis a vis 5-7 per cent previously) we have lowered our GDP forecasts to 2.3 per cent in 2006/07 (2.5 per cent previously) and to 2.6 per cent in 2007 (3 per cent previously). Domestic demand forecasts have also been lowered to 2 ¼ in both 2006/07 and 2007. That at the margin also lowers the inflation outlook - see charts below.



We acknowledge that the Reserve might not be too phased by GDP printing around 2½ per cent for 2007. There is also the complication that a further strong fiscal stimulus will be delivered via the 2007 Budget.

For interest rates, the most likely outlook is that rates will remain unchanged out to the end of 2007. However there is a real risk that the next move will down, given the real potential for a more marked slowing in domestic demand than we are currently projecting. Indeed, even on our forecasts, by mid to late 2007 the labour market is likely to be significantly softer than currently is the case. Core inflation will be back into the target band and clearly slowing. Headline inflation, even factoring higher drought associated rural prices, will be below the bottom end of the 2-3 per cent target).

For interest rate markets, we expect the text announcing a November rate increase to be hawkish and to indicate that the RBA continues to have a tightening bias (rates are more likely to rise over the period ahead than to fall). Hence, the short end of the yield curve will be tempted to start to price-in another rate hike in Q1 of 2007.

For the long end of the yield curve, the expectation of higher near term cash rates will tend to keep 10 year bond yields around their current level (5¾ per cent), on our forecast of a stable environment for longer term yields offshore and particular in the USA.

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