

Consumer Sentiment resilient to higher rates – for now

- **The Westpac–Melbourne Institute Consumer Sentiment Index increased by 0.2% in March from 117.0 in February to 117.3 in March.**

This is a solid result given the backdrop of a fourth official rate rise. However the previous rate hike cycle and the March sentiment reading suggests mortgage rates have not reached the point where increases have a major impact on confidence.

Since the last survey the Reserve Bank raised the overnight cash rate by 0.25% from 3.75% to 4.0% and the banks increased their variable mortgage rates by an equivalent amount. The variable mortgage rate is now averaging around 6.9%.

History suggests 7% is a significant threshold mortgage rate for consumers. When the RBA raised the overnight cash rate in December 2003 from 5.0% to 5.25% the average variable mortgage rate increased to a comparable 7.05%. The Westpac Melbourne Institute Index of Consumer Sentiment was reasonably stable falling by only 1.9%. When the Bank next increased the cash rate, by 0.25% in March 2005, the variable mortgage rate rose to 7.3% and confidence plummeted by 15.5%. Over the 2006–2008 period the Bank increased the overnight cash rate on seven further occasions in tranches of 0.25% with the variable mortgage rate reaching 9.35% in March 2008. The average fall in the Index following each of those rate hikes was 8.5%.

Based on this evidence alone we may be nearing the point where Confidence becomes much more sensitive to increases in interest rates.

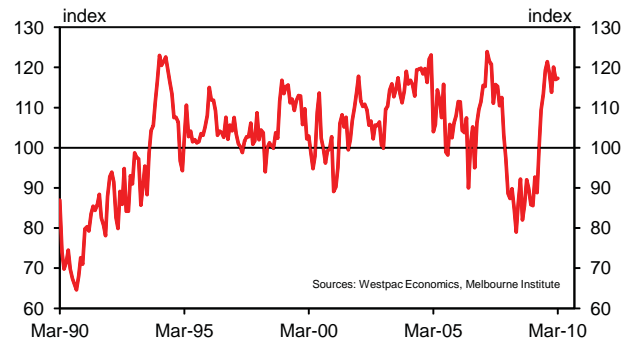
Of course households are holding significantly more debt than during that last period. Debt to income ratios are around 20% higher today than they were in 2003. And that may make them more sensitive to rises this time around.

Other factors would have contributed to the muted response to the March rate hike. In particular the labour market has been having a positive impact on confidence. Since the last survey it was reported that Australia's unemployment rate had surprisingly fallen from 5.5% to 5.3% with nearly 53,000 new jobs being reported. Our survey found "economic conditions" is the most widely recalled news item with assessments being solidly positive. Not surprisingly "interest rates" are the next most recalled news item although sentiment is slightly less unfavourable in March than it was in December following the three consecutive rate hikes.

Other positive impacts on sentiment have been the Australian dollar and respondents' assessments of "international conditions". Since the last survey the Australian dollar has increased by 3.8% while, globally, share markets have reversed much of the weakness in January. In particular the Australian share market has risen by 4.9%. Petrol prices have increased by a modest 2.5% with little likely influence expected on confidence.

Despite confidence being up around 16% over the long term average, households continue to be quite risk averse. The proportion of households who see the "wisest place for savings" as a bank deposit or "paying

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down debt" increased from 49.7% in December to 53.8% in March. The proportion of respondents who favour real estate or shares as the wisest form of savings fell from 29% to 25.3%. This conservative approach to risk is consistent with the more modest recovery in growth in consumer spending than would have been expected given the strong print for the Consumer Sentiment Index.

Some observations are relevant with respect to the components of the Index. Consumers are slightly more positive with respect to their family finances with responses to "family finances compared to a year ago" increasing by 1.4% while responses to "family finances over the next 12 months" increasing by 5.5%. The economic outlook deteriorated a little: views on "economic conditions over the next 12 months" fell by 1.9% while expectations for "economic conditions over the next 5 years" were down by 2.7%. There was little change in spending intentions. Opinions on "whether now is a good time to buy a major household item" were down by 0.5%.

The Reserve Bank Board next meets on April 6. We expect that the Board will decide to pause at that meeting. We assess that the Bank now believes that rates are only around 50bp's below neutral and the urgency associated with the three consecutive moves between October and December last year has passed. However, we are forecasting a further 25bp rate hike following the next board meeting on May 4. The resilience of confidence and the continuing improvement in the labour market will be key factors emphasising to the Board that policy still needs to be normalised reasonably quickly. However we expect that once rates have risen by another 50bp's the Bank will opt for a longer pause. A key to that decision will be in the expected greater sensitivity of households to rate hikes. As we saw in the last cycle, once the variable mortgage rate reached 7.25% households' responses to rate hikes became much sharper. How consumer sentiment reacts in the months ahead will be a critical guide to whether policy tightening has passed this important threshold

Bill Evans, Chief Economist

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