Australian interest rates on the move

Official commentary ...

During October we were inundated with a stream of communication from the RBA that indicated a more urgent approach to the early stages of the tightening cycle than we had laid out. That forecast profile envisaged a 25bp rate hike in November to be followed by a pause in December with cash rates reaching 4% by mid 2010, with rates then remaining on hold for the rest of the year. We contrasted that profile with market pricing that anticipated the cash rate reaching around 5.5% by the end of 2010.

... while abundant ...

In response to the seemingly more urgent rhetoric, we accelerated our forecast for the early stages of the rate hike cycle, expecting the cash rate to reach 4% by March rather than by June next year. The expected peak in 2010 was somewhat higher at 4.5%, although that was still substantially lower than market expectations.

... is offering both good oil ...

On November 3 the Reserve Bank Board decided to raise the official cash rate by 25bps to 3.50%. Such was the hawkishness of those earlier communications from the RBA that we gave a decent chance to a 50bp increase. However, the sentiment in the accompanying statement was considerably more dovish than the recent Minutes and the Governor's October speech. If anything, it was more dovish than the statement following the October rate hike. The art of picking the very near term profile of interest rates is heavily dependent on gauging the current sentiment of the Bank rather than pure economic forecasting. That task is proving to be more challenging than normal.

... and red herrings.

For example, one of the key indicators that we have tracked to gauge this sentiment was the use of the word "gradually" in official communications. In the October Statement, the Governor referred to "gradually lessening the stimulus", whereas in the Minutes and the subsequent speech, "gradually" was conspicuously absent. The term "lessen gradually" was then reinstated in the November statement accompanying the rate hike.

The Bank is apparently content ...

The other important aspect of not only the Minutes and the Governor's speech, but also the statement in October, was the clear implication that there was a degree of concern about the inflation outlook. The November statement in no way confirms that suspicion. In November "Both [headline] CPI and underlying inflation are expected to be consistent with the target in 2010". That apparent comfort was confirmed with the quarterly Statement on Monetary Policy (released on November 6) where the Bank raised its underlying inflation forecast from 2.00% to 2.25% in 2010, which will prove to be the lowpoint in this inflation cycle. Our forecasts cannot see a justification for such an optimistic inflation outcome. However, a number like the more reasonable 2.5% would be a very uncomfortable admission for any central bank. Note that it has a formal target to hold inflation between 2% and 3% on average through the cycle. If the low point of the cycle was just the mid point of the target range that is hardly a convincing performance and is definitely not consistent with rates remaining near record lows.

... with the inflation outlook ...

While we are comfortable with the most important aspect of our RBA forecast – the 2010 peak in rates and the length of time that rates will be on hold in 2010 – we accept that the short term profile is uncertain. Predicting which particular month the Bank will choose to edge rates up in this "gradual" process is subject to a high degree of uncertainty. In fact, such has been the softening in the Bank's current rhetoric that markets are seriously contemplating a pause in the rate hike process in December. Supportive of this point is that there has never been a sequence of three consecutive meetings when rates have been raised. However, significantly offsetting that point is that rates have never been close to these current emergency levels.

... indicating "gradual" ...

Upcoming data will also play a role. The retail sales report for September printed a softer than expected result although annual growth and trend growth remain respectable. Of more importance will be confidence measures; any further updates on house prices; and employment. We are expecting a resilient consumer and business confidence; and further evidence of the current boom in house prices (the ABS measure shows national house prices up by nearly 9% over the last 6 months).

... will remain the catch cry.

Given that data flow we would be surprised if the Bank pauses in December. Note there will be no Board meeting in January. Therefore a pause will effectively mean keeping rates near emergency lows for three long months.

Australian interest rates on the move

Chart 1.

RBA: begins gradual tightening

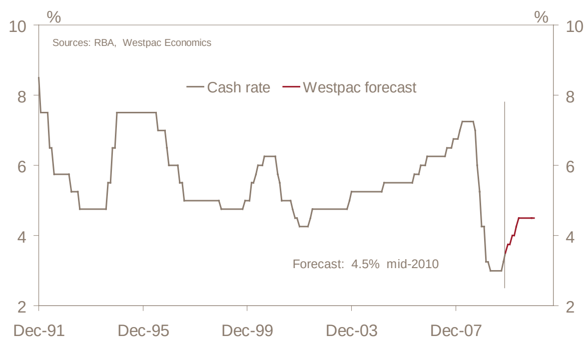

Chart 2.

Market rates up, RBA shifting into gear

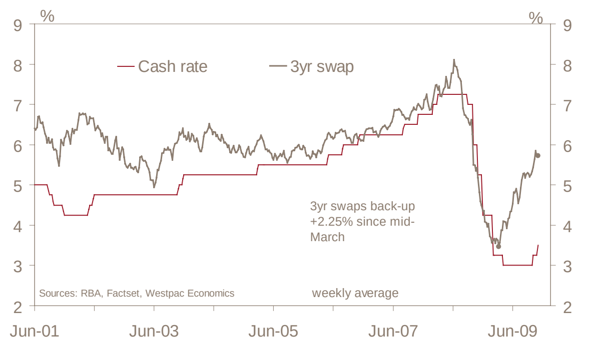

Chart 3.

Australia US 10 yr spread

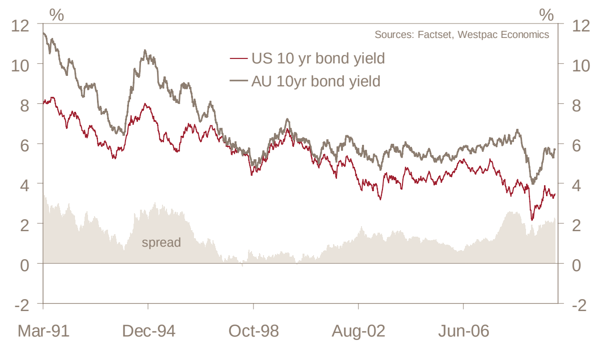

Chart 4.

Confidence climbs

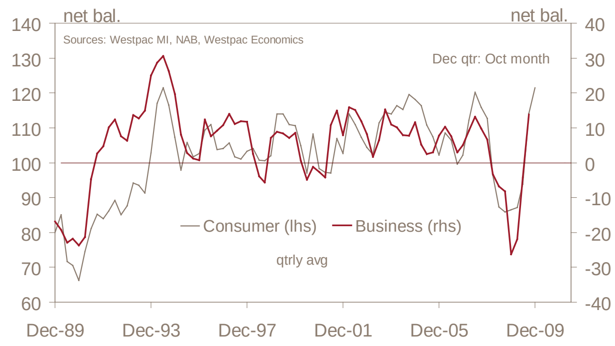

Chart 5.

Established house prices jump

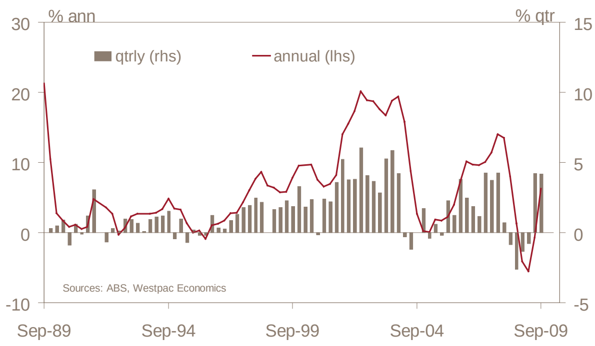

Chart 6.

CPI core inflation: RBA vs Westpac f/c