Thursday, 7 April 2022

Reserve Bank's Cash Rate Outlook
More Rate Hikes & Hiking to Start Sooner

- We now expect the Reserve Bank (RBA) will begin hiking the cash rate in June. We previously underscored there was a rising risk of a move as early as June. There were critical changes in guidance from the RBA this week, which have tilted the needle in favour of a June start.
- We anticipate four further hikes in July, August, October and November. This will take the cash rate to 1.25% by the end of the year. More rate hikes should follow in 2023.
- This is consistent with the remarkable strength in the labour market, which will put upward pressure on underlying inflation. We expect the unemployment rate will fall below 3.5% by the end of the year and that wages growth will accelerate to peak at 4.0% in 2023.
- Strong growth, low unemployment, rising wages and elevated inflation, amid global-supply chain disruptions, spells a higher cash rate.
- Our base case is that the terminal rate, or peak in the cash rate, will be 2.00% around the middle of next year, although there is considerable uncertainty around this estimate. This is much lower than in earlier hiking cycles, reflecting higher levels of household debt.
- Financial markets have aggressive tightening priced in with a cash rate over 2.00% for the end of this year.

On Tuesday, the Reserve Bank (RBA) made several critical changes to its guidance. We flagged that these developments shortened the odds of a rate hike as soon as June. We've also been flagging for some time that a move before August could not be ruled out due to growing inflation pressures and falling unemployment.

We now formally expect the RBA to begin hiking the cash rate in June, brought forward from August. Tuesday's developments tilted the needle in favour of a June start.

The RBA will keenly eye the next inflation (April 27) and wages reports (May 18). We expect underlying inflation to move from 2.6% per annum to above 3% in Q1, moving the RBA closer to raising rates. The wages report should also spur the RBA to make a move on hiking rates.

We have also upgraded our forecast for the labour market. We now expect a lower unemployment rate and higher wages growth. And in turn, we expect four further hikes in July, August, October and November, as well as three rate hikes next year.

Our forecasts include an expectation that the RBA will move quickly to take back the emergency rate cuts (65 basis points) it made in the wake of the pandemic. This is expected to occur between June and August, before the RBA takes a small breather.

These hikes will take the cash rate to 1.25% by the end of the year, above our previous forecast of

0.75%, and to a peak in the cash rate in this cycle next year of 2.00%.

Interest-rate markets are more aggressively priced. They have a cash rate over 2.00% priced in for the end of this year.

Change in RBA guidance

In the statement following the board meeting, the last paragraph outlines the monetary policy outlook. This week, there were four key changes to this paragraph.

First, the word "patient" was dropped. Previously, the RBA repeatedly pledged patience around raising rates. It especially wanted further evidence of a pick-up in wages growth to be assured inflation would be sustained in its 2–3% per annum target band. Additionally, the RBA no longer stated that it is "too early to conclude" that inflation is sustainably within the band. Instead, it said that inflation has picked up and that a further increase is expected.

Second, the RBA dropped the sentence "there are uncertainties about how persistent the pick-up in inflation will be", suggesting perhaps it's more convinced about the upward trajectory of inflation.

Third, the RBA noted "over coming months, important additional evidence will be available to the Board on both inflation and the evolution of labour costs". The new sentence points to a rate hike in the coming months, hinging on upcoming data. We expect the RBA wants to see another consumer prices report (April 27) and wage price index (WPI) report (May 18).

Finally, the RBA dropped the reference to being "committed to maintaining highly supportive monetary conditions", underscoring a change in policy settings is on the horizon.

In addition, the RBA adjusted its rhetoric on wages, which have been a key sticking point for the central bank. Previously, the RBA emphasised they want more evidence of a pick up in wages before lifting the cash rate. Importantly, on Tuesday, the RBA stated "a further pick-up in aggregate wages growth and broader measures of labour costs is in prospect". The words "in prospect" are stronger language than in the previous statement. The RBA also acknowledged there are "some areas where larger wage increases are occurring".

The RBA does not have a lot of wiggle room to wait before raising rates, particularly given commodity prices are elevated, and global-supply chain disruptions are persistent.

The US Federal Reserve already commenced hiking in March. The next meeting is in May. Markets are almost fully priced for a 50 basis point hike. Such a move could make the RBA feel more comfortable about moving in June, given the implications for the Australian dollar.

Stronger labour market

The jobs market has gone from strength to strength. In February, the unemployment rate fell to 4.0% – the lowest rate in 13½ years. Australia has not had an unemployment rate consistently below 4.0% since the 1970s.

The Reserve Bank has indicated full employment is consistent with an unemployment rate around the high 3s or low 4s. The unemployment rate is already in this territory. Around these levels, a more material pick up in wages growth is expected.

At the same time, leading indicators of jobs growth point to further gains in the months ahead. Job vacancies hit a record high in February, with data dating back to the late 1970s. In fact, vacancies are up over 80% relative to their pre-COVID level in February 2020. Reports of higher rates of job switching and of businesses paying bonuses to both attract and retain staff are also becoming

more prevalent.

Given the remarkable strength of the rebound in the labour market, we have lowered our forecast for unemployment to fall to under 3.5% by the end of this year. In turn, we also raised our forecast for wages growth to peak at 4.0% in 2023.

The tighter-than-expected labour market will add to inflationary pressures and subsequently necessitate a faster lift in the cash rate. Hence, alongside the upgrade to our labour market forecasts, we now expect a total of five rate hikes in 2022, taking the cash rate to 1.25% by the end of the year.

The terminal rate

A critical question is where will the cash rate peak? Our base case is that the terminal rate, or peak in the cash rate, will be 2.00% around the middle of next year. However, it is important to caveat that there is considerable uncertainty around this estimate. Indeed, amongst economists there is a wide range of estimates of the terminal rate.

If the cash rate were to peak at 2.00% in May 2023 after lift-off in June 2022, this would imply 190 basis points of tightening over 12 months. For comparison, in the four hiking cycles from the 1990s, the amount of tightening has ranged from 150–300 basis points over 5–71 months. Our profile falls within this range for both the magnitude of tightening and length of the hiking cycle.

Table: RBA Tightening Cycles

First Hike	Last Hike	Cycle Length (Mths)	Cash Rate Range (%)	Cash Rate Change (bps)
Aug 1994	Dec 1994	5	4.75 - 7.50	275
Nov 1999	Aug 2000	10	4.75 - 6.25	150
May 2002	Mar 2008	71	4.25 - 7.25	300
Oct 2009	Nov 2010	14	3.00 - 4.75	175

Notably, we are expecting the cash rate to peak much lower than in previous cycles. This is because household debt is much higher than in the past. In recent years, household debt has been around 200% of household disposable income. For comparison, in the mid-1990s when the cash rate was sitting at 7.50%, household debt was around 100% of disposable income. The debt repayment burden faced by households (measured by the household debt-servicing ratio) will limit how far the RBA can tighten without risking a material slowdown in the economy. In other words, as interest rates increase, the spending power of indebted households will decline as mortgage repayments eat up a larger share of their income.

The large excess savings accumulated by households during the pandemic will provide a temporary buffer from higher debt-servicing requirements for some households. However, these savings will eventually be reduced. Moreover, the vast majority of the savings are sitting on the balance sheets of high-income households. As such, lower income households are less likely to be cushioned from increases in rates.

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