WILSONS

The RBA's Last Cut as it Moves Into New (QE) Territory

Our weekly macroeconomic view.

2 November 2020

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

End of the Line

The RBA has stepped up its dovish rhetoric over the past few weeks in a series of speeches from key personnel including Governor Philip Lowe.

The RBA is now widely expected to cut interest rates by 15bps this Tuesday November 3 to take the official cash rate to 10bp. The market's pricing for a cash rate cut this week is now at around 85%.

We also expect the 3-year government bond yield target (yield curve control policy - YCC) and the rate on the $200bn bank term funding facility (TFF) to be reduced to 0.1% from 0.25%. The interest rate on bank exchange to settlement balances with the RBA will likely also be cut from 10bps to either 5bps or 1 bps (the RBA deposit rate).

Search for Yield Gets Even Harder

These cuts, while small in size, will no doubt intensify the search for yield, with recent guidance from the RBA stating market participants should not be surprised if the bank bill market slips to a negative rate from time to time. This will likely provide incremental support for both corporate credit and equities.

RBA to Fully Embrace QE

At this stage, the largest area of debate is centred on the potential broadening of the RBA's bond purchase program (quantitative easing - QE).

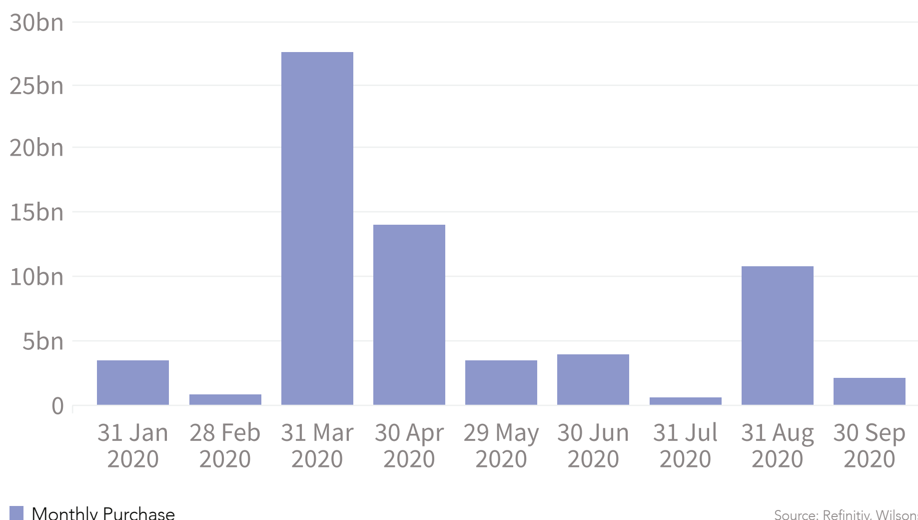
The RBA has signalled strongly that it will soon commence a program of outright QE bond purchases aimed at 5-10-year maturities. This is likely to be announced this week at the November 3 meeting, alongside the cash rate cut.

The market will be looking for guidance around the quantity, timing and duration of any QE program. Will the RBA announce a monthly purchasing run rate, a 12 or 18-month quantity target, or will the length of commitment be open-ended?

Exhibit 1: RBA cash rate target - end of the line for the RBA

Source: Refinitiv, Wilsons

Exhibit 2: RBA bond purchases this year "only" A$60bn



Source: Refinitiv, Wilsons

Consensus expectations are fairly wide. We expect either a monthly purchase target of between A$5bn-$10bn or a guide to the potential quantity of bonds that may be purchased over the next 12-18 months (A$75-$175bn). The RBA may come in at the lower end of the range initially but with the guidance that this can be increased if needed.

We expect the RBA will favour a flexible and measured program, and there is some risk the RBA may underwhelm the market versus expectations on November 3rd.

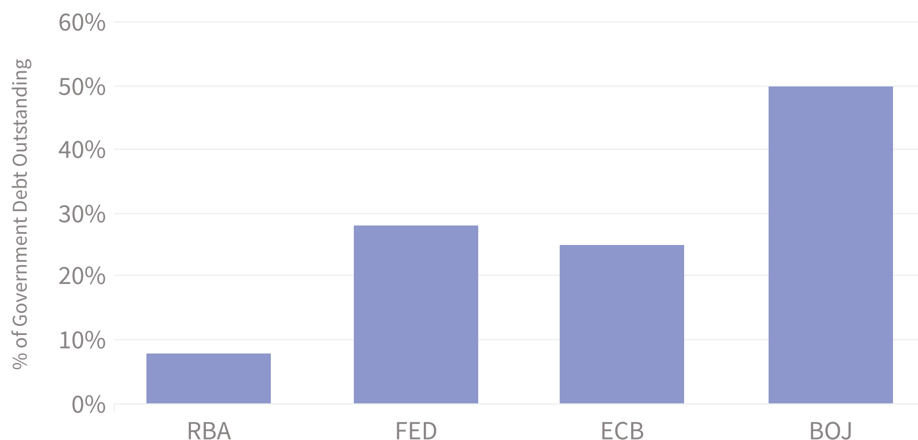
What is the RBA Trying to Achieve?

The RBA's recent commentary around central bank balance sheet size and longer-term yields has focused on levels relative to other economies. This appears consistent with RBA research suggesting the primary impact of lower longer-term yields for the economy is through the exchange rate. As such, we expect the RBA will focus on relative, not absolute yields, with the exchange rate being the primary, if not explicitly stated target of the expanded QE program.

The A$ is in part a function of global interest rate differentials, but it is also a function of global risk aversion and the global growth pulse (as often proxied by commodity prices). There are no guarantees the A$ will not appreciate even in the face of QE, though an expanded QE program should put some downward pressure on the A$, all things equal. The risk of a sharp appreciation from here will be reduced but we still see a moderate upward bias to the A$ over the coming year. The RBA is not conducting its monetary policy in a vacuum (its balance sheet is tiny in a global context) and our expectation of a progressive recovery in the local and global economy should ultimately place some upward pressure on the A$. We have not made a change to our 75c 12-month fair value target but now see the 12-month risk case of 80c as significantly diminished.

Read our report on The Resurgent Australian Dollar and the Case for Currency Hedging.

Exhibit 3: RBA government bond holdings are small in a global context

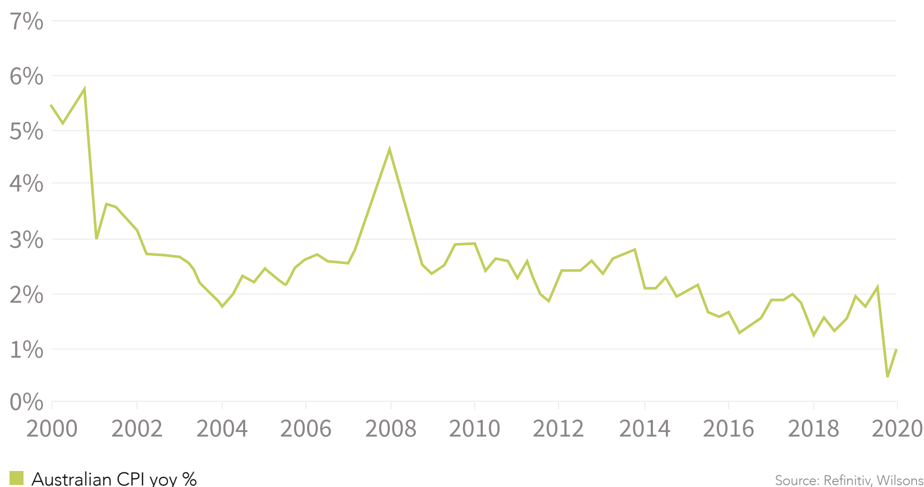


Source: Refinitiv, Wilsons

The Bigger Picture: Falling Into Line with a More Dovish Fed

The RBA recently revised its forward guidance by suggesting interest rates will not be increased until actual inflation is sustainably within the 2-3% target, which will require the return to a tight labour market (less than 5% unemployment). This will likely take some years, reinforcing the RBA's outlook for an extended period where interest rates do not increase. The RBA has suggested not to expect a rate hike for at least 3 years.

Exhibit 4: Australian CPI inflation rate stuck below the 2-3% target



Source: Refinitiv, Wilsons

The other significant pivot from the RBA over the past few weeks has been its explicit embrace of a backward-looking inflation target similar to what the US Federal Reserve (US Fed) has recently shifted to. While the RBA's inflation target of "2-3%" is in effect an average inflation target, the RBA has explicitly noted they will not be shifting rates until actual inflation is "sustainably" above the 2% target band and the unemployment rate is lowered (<5% unemployment rate) as an "important national priority". This is very much in line with the recent shift in thinking from the US Fed in signalling a lower for longer approach.

Read our report on Experimental Policy, Inflation Risk and Investment Markets.

Exhibit 5: RBA wants the unemployment rate back below 5%

Source: Refinitiv, Wilsons

An Incremental Rather Than Monumental Shift

With the RBA likely to deliver its final conventional interest rate cut (we concur with the RBA logic to resist a move to negative policy rates) the focus will shift to the specifics of its flagged QE program across the 5 to 10-year portion of the yield curve.

While it is a new and shiny area of focus for market participants, the incremental impact on the real economy is likely to be limited with the primary channel of influence likely to be via the exchange rate, where we expect the impact to be moderate.

From a market perspective, the expected cash rate cut plus expanded QE, as well as the RBA's explicit guidance for a cash rate at near zero for at least 3 years will continue to intensify the "search for yield", providing support for both corporate credit and equities.

The elevation of the employment target alongside a now backward-looking inflation target is very much in line with the Fed's recent dovish shift. Monetary policy will continue to provide substantial support to the economy for some time, as will fiscal policy. We do think sustained supportive policy, plus Australia's relatively promising reopening, places Australia in relatively good stead. Australia appears well-positioned to be at the forefront of a global recovery over the coming year. A global vaccine is the missing piece of the puzzle, but Australia looks in better shape than most to ride out the storm in the interim.

Read our Fourth Quarter Asset Allocation Strategy: Balancing Uncertainty and Opportunity.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

www.wilsonsadvisory.com.au