Wednesday, 8 November

'The Meeting That Stops the Nation'

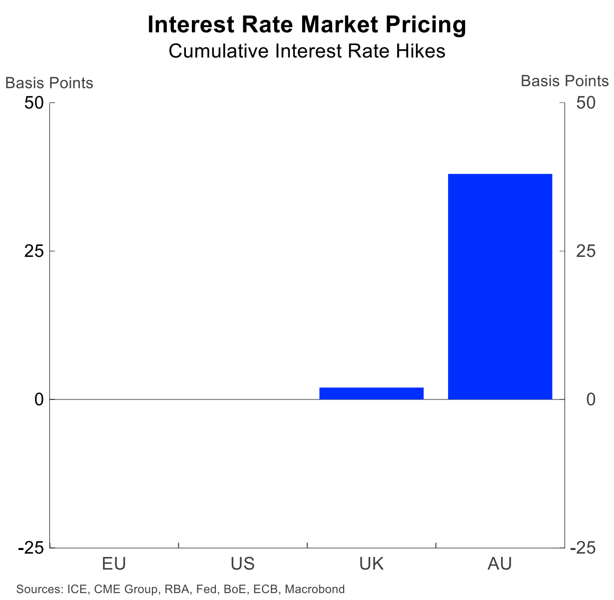
Central banks will continue to dominate the economic headlines this week. Last week we saw the US Federal Reserve, Bank of England and European Central Bank remain on hold after hiking aggressively for the past eighteen months. These decisions have helped cement expectations that the tightening cycles in the US, UK and EU are largely done.

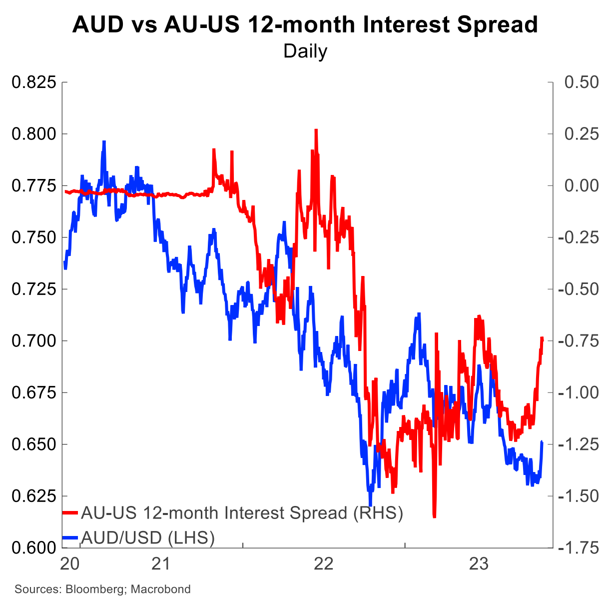
In addition, US Fed Chair Powell sparked a significant market reaction when he confirmed that the US Fed will explicitly consider financial conditions alongside the incoming data and the economic outlook when setting policy. This is important because the recent increase in longer term yields has resulted in tighter financial conditions, which may do some of the Fed's heavy lifting. Following last week's meeting financial conditions have eased as US equities have jumped, bond yields have fallen, and the US dollar softened. Markets are now effectively pricing in zero chance of another rate hike.

The Reserve Bank's Board November meeting and update forecasts

Enter the Reserve Bank of Australia (RBA). This Melbourne Cup Day some punters may shift their focus away from the 'race that stops the nation' to the 'meeting that stops the nation'. Markets have fully priced in one more rate hike this cycle with some chance of another. However, the timing of the increase remains unclear, with the odds of Melbourne Cup hike sitting around 50%, compared to around 30% before the release of the September quarter inflation numbers.

The RBA finds itself in an unfamiliar position – markets are betting that the tightening cycle in major economies have largely come to an end, while the cycle in Australia still has a bit to play out. This difference has given the Aussie dollar some support, particularly against the US dollar.





Our current view is for the RBA to hike by another 25 basis points tomorrow, before going on an extended pause. Given inflation remains above the RBA's target, we expect the RBA to remain hawkish and to include a statement to the effect that further tightening may be needed to ensure inflation returns to target within an appropriate timeframe.

While this is our central scenario, we don't think it's a done deal. It's quite possible that the RBA interprets the stronger than expected September quarter inflation read as an outlier driven by one off factors such as the annual increase in award and minimum wages and seasonality in the data – after all a large share of market and administered prices are reset in the quarter for the year ahead. They could argue that the June quarter inflation read which was benign, more accurately reflecting underlying trend in the data. This is consistent with the Melbourne Institute's monthly inflation gauge released earlier today, which showed a 0.1% fall in October, after a flat read in September. This was the first time in fourteen months that the gauge recorded a monthly fall.

Our view is that given the balance of risks, the RBA will not roll the dice and wait to see which scenario is correct but instead proceed with another hike to protect against the upside inflation risks.

A key unknown at this point is the updated forecasts in the RBA's Statement on Monetary Policy (SoMP) which will be released this Friday. The RBA Governor drew a line in the sand when she appeared before the Australian Senate, making it clear that the RBA Board would not tolerate any slippage in the expected timeframe for inflation to return to target – currently 2025. If the RBA updated forecasts suggest that further tightening is required to get back to target by 2025, the RBA Board will increase rates. We're anticipating an increase in near term inflation forecasts consistent with the higher-than-expected outcome for September, but the remainder of the profile is unclear.

Inflation Expectations

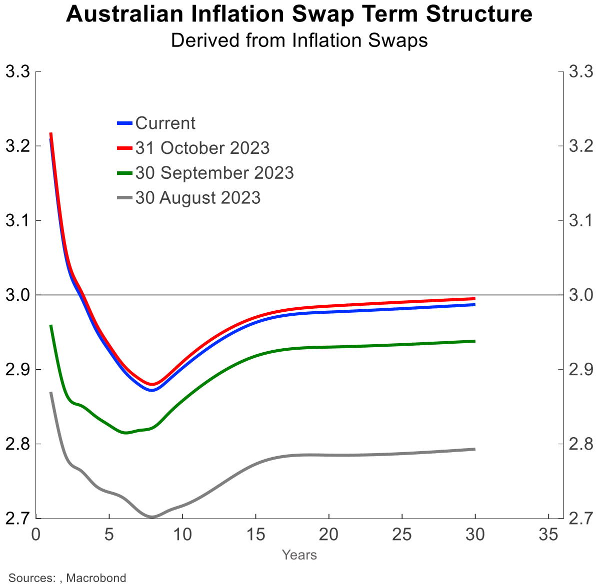
The key risk the RBA is trying to manage is inflation expectations becoming unanchored. If this occurs, inflation will become more persistent and harder to bring down. Businesses and workers will demand higher prices and wages respectively, as compensation for the higher inflation.

We know that near term expectations are above the RBA's target – that's to be expected given elevated recent inflation outcomes. What's important is for medium term expectations to remain well anchored.

We can gauge medium term expectations by looking at implicit expectations in longer term market instruments such as inflation linked bonds and inflation swaps. If investors are expecting inflation to remain above the RBA's target, they will need to be compensated for the higher inflation and this is reflecting in market pricing.

The 10-year breakeven inflation rate and the 10-year inflation swap rate - which are market-based measure of inflation expectations – have ticked up recently. The swap rate has increased towards the top of the target band and is sitting at around 2.9%, while the breakeven rate remains around 3%. We can isolate medium term inflation expectations by looking at expectations for inflation over 5 years, starting from 5 years into the future. This medium term read is now also sitting around 2.9%. And across the yield curve, over the past two months we have seen expectations shift slightly higher. These moves have been larger in Australia than overseas.

So, while we can conclude expectations remain consistent with inflation returning to the target, it appears investors are losing some patience with the return to the inflation target and are attentive to the risk that the RBA may have more difficulty taming inflation. A hike at tomorrow's meeting could help the RBA rubber stamp its commitment to fighting inflation and keep expectations well anchored.



International economic data

There will also be important global economic news.

We will receive an updated inflation read for the Chinese economy along with international trade data. The RBA and Treasury have identified the underwhelming recovering in the Chinese economy as a risk to the outlook. Better than expected reads could provide confidence that the economy is back on track. The outcomes could impact on the Aussie.

There will also be economic activity data coming out of the US and Europe. The outcomes could help cement expectations that central banks in key economies have come to the end of their hiking cycle.

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Group Forecasts

		2023	2024				2025
End Period:	**Close (27 Oct)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.35	4.35	4.35	4.10	3.85	3.60
90 Day BBSW, %	4.31	4.55	4.55	4.47	4.22	3.97	3.72
3 Year Swap, %	4.54	4.40	4.30	4.20	4.10	4.00	3.80
10 Year Bond, %	4.81	4.70	4.60	4.50	4.40	4.30	4.15
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.125	4.875	4.625	4.375	4.125
US 10 Year Bond, %	4.83	4.80	4.70	4.60	4.50	4.40	4.20
USD Exchange Rates:							
AUD-USD	0.6335	0.66	0.67	0.68	0.69	0.70	0.71
USD-JPY	149.66	147	145	143	141	138	135
EUR-USD	1.0565	1.08	1.09	1.11	1.13	1.14	1.15
GBP-USD	1.2122	1.23	1.24	1.25	1.26	1.27	1.28
NZD-USD	0.5811	0.61	0.61	0.62	0.62	0.62	0.63
AUD Exchange Rates:							
AUD-USD	0.6335	0.66	0.67	0.68	0.69	0.70	0.71
AUD-EUR	0.5996	0.61	0.61	0.61	0.61	0.61	0.62
AUD-JPY	94.80	97.0	97.2	97.2	97.3	96.6	95.9
AUD-GBP	0.5225	0.54	0.54	0.54	0.55	0.55	0.55
AUD-NZD	1.0901	1.08	1.09	1.10	1.11	1.12	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.2	1.6
CPI (Headline), %	3.5	7.8	4.6	3.4
CPI (Trimmed mean), %	2.6	6.8	4.4	3.3
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.3	3.4	3.8	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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