ECONOMIC INSIGHTS

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ECONOMIC INSIGHTS: 10 AUGUST 2016

KEY POINT

In our view the growth fade, and a likely cut to the cash rate in November, means the hunt for shares which can sustain their dividend yields will be a recurrent theme for quite some time.

The great fade

The RBA made virtually no changes to its growth and inflation forecasts in its quarterly Monetary Policy Statement released last week. Real GDP growth is forecast in 2.5% to 3.5% y-o-y range through to the end of 2017 before lifting slightly to 3.0% to 4.0% range in 2018 while headline CPI and underlying inflation is mired in 1.5% to 2.5% y-o-y range throughout 2017 and 2018. This forecast growth and inflation combination is not good enough as far as the RBA is concerned. Inflation forecast to run below the RBA's 2.0% to 3.0% y-o-y through to the end of 2018 implies lost opportunity in terms of growth that could have run faster and unemployment that could have run lower without risking unacceptably high inflation. The RBA's forecasts also imply that they have more monetary policy easing to go given that there are no other Australian growth priming factors sitting somewhere in the wings.

The type of factors that might lift Australian growth and/or inflation beyond the RBA's latest set of forecasts include unexpectedly strong growth in Australia's major trading partners; a much stronger-than-expected lift in wages and household disposable income; a turn towards much stronger spending by the Government and away from primary focus on budget restraint; and sharp and sustained depreciation of the Australian dollar exchange rate. All of these factors seem unlikely to eventuate, other than perhaps the chance that the currency might depreciate and that contingent in part upon the RBA reducing its cash rate nearer to the very low official interest rates prevailing elsewhere internationally.

Like it or not, the RBA is really on its own in terms of having any policy capacity to help lift Australia's growth prospects. There is an issue that cash rate cuts are becoming much less effective in helping to prime stronger growth. The cash rate has become less of an influence on commercial banks' cost of funds, part of the reason why banks pass on only a proportion of any cash rate cut to their borrowers, as they did with the latest 25 bps cash rate cut last week.

There is also an issue that cash rate cuts, while benefitting borrowers, can also reduce the income of bank depositors, although quirkily this was not a problem last week as banks responded to the cash rate cut both by reducing lending interest rates while at the same time lifting some term deposit interest rates. This unusual response is probably a one-off – commercial banks more normally do everything in their power to protect their interest earning margin – so it may not be repeated with any further cash rate cuts.

Even with what might be considered a more 'growth beneficial' response from the commercial banks to the latest cash rate cut by reducing borrowing interest rates while at the same time rewarding some depositors, the RBA's latest economic forecasts still spell the need for more cash rate cuts.

If it were just a case of taking the latest RBA forecasts as an accurate assessment of what might be, there would likely be only one more 25 bps cash rate cut to come down to 1.25%.

Our view, however, is that as more economic information comes to hand over the next month or two there is a strong likelihood that the RBA will need to adjust lower its growth and probably its inflation forecasts too in its next quarterly Monetary Policy Statement in early November.

Essentially, the RBA's latest GDP growth forecasts show the annual and relatively high pace of growth in Q1 2016, 3.1% y-o-y being maintained throughout this year and next year before accelerating slightly in 2018. Already there are signs that growth is starting to fade, especially growth in domestic demand where household spending is coming under pressure from the relentless softness in wages growth. Retail spending growth was again quite soft in June, up only 0.1% m-o-m. Real retail spending rose by 0.4% q-o-q in Q2 compared with 0.5% in Q1. With wages growth struggling to rise by 2% y-o-y (the Q2 report is due next Wednesday) retail spending looks set to struggle in Q3 and beyond.

Home building activity is set to weaken

Apart from the crumbling strength in household consumption spending home building activity looks set to weaken later in 2016 and through 2017. Home building approvals fell by 2.9% m-o-m in June after falling 5.4% in May. The stories are becoming more widespread of over-supply of new home units in Melbourne, Brisbane and parts of Sydney. Foreign investment interest in Australian housing is fracturing under tighter restraints on capital outflow in the likes of China plus changes in Australian lenders requirements for foreign-based borrowers. Australian home unit developers are finding it increasingly hard to obtain bank finance under much tighter lending requirements. It is not just a case that home building activity will soften from later this year, but rather how big the reduction in activity will be.

By November, the RBA will have to hand retail trade and home building approvals data for July and August plus the Q2 GDP report. We expect these readings to confirm economic growth momentum is fading and will necessitate the RBA revising lower its GDP growth forecasts. By November, the RBA will also have to hand the Q2 wages and Q3 CPI reports, both likely to confirm that inflation is tracking and will continue to track nearer to 1.0% y-o-y, rather than 1.5% the current bottom of the RBA's inflation forecast range for 2017 and 2018.

The growth fade makes it very likely, in our view, that the RBA will cut the cash rate another 25 bps to 1.25% in early November. The changes we expect to the RBA's growth and inflation forecasts a few days after the next cut are likely to recalibrate market expectations of the cash rate to 1.0% or less in 2017. The hunt for shares that can sustain reasonably high dividend yields looks set to be a recurrent theme for quite some time.

About the Author

Stephen Roberts is Altair's Chief Economist and provides Altair's team with a comprehensive review and outlook of macro-economic factors likely to influence financial markets.

Stephen is an economist and investment strategist who has worked for over 40 years in the finance industry with extensive experience in banking, broking and funds management.

During his career Stephen has been Australian Chief Economist for SBC, Fay Richwhite, Equitilink, UBS, Grange Securities, Lehman Brothers and Nomura. He has also worked as a portfolio manager specialising in strategic asset allocation overlays for Westpac Investment Management, Sagitta and BT. In addition, Stephen was a contributing author to the Campbell Committee Report relating to the conduct of monetary policy, foreign exchange controls and floating the Australian dollar.