Thursday, 28 April 2022

Reserve Bank's Cash Rate Outlook
Inflation Seals a Rate Hike Next Week

- **Yesterday's inflation data has sealed a rate hike next week. Inflation was well above the Reserve Bank's (RBA) forecasts, the RBA's inflation target band and consensus estimates.**

- **Whilst the RBA in its board statement earlier this month suggested it would wait for further inflation (yesterday) and wages data (May 18), the strength of price pressures in the economy means the RBA can no longer afford to wait.**

- **We anticipate the RBA will tap on the brakes by 15 basis points next week, taking the cash rate to 0.25%, and follow up with a 25 basis point rate hike in June. We continue to expect the cash rate to end this year at 1.50%, but interest-rate markets expect it will be 2.50%!**

Earlier this month, when the RBA Board met, they outlined a script for a near-term rate rise. That script suggested "over the coming months" the RBA would be keen to see the inflation report (yesterday) and the wages report (on May 18) before raising rates. However, this script had a major underlying assumption – the assumption being that economic data would evolve as per the RBA's expectations.

Yesterday's inflation data set the cat among the pigeons. Headline inflation shot up to 5.1% – the fastest in more than two decades. Underlying inflation spiked to 3.7% – a 13-year high. Both outcomes were well above consensus expectations and the RBA's implicit forecasts. And critically, both were much higher than the RBA's inflation target band of 2-3% per annum.

Inflation outcomes have a critical influence over the RBA's cash-rate decision. The fact that the inflation data has not evolved how the RBA expected suggests the RBA needs to reassess its script.

The start of a rate-hike cycle next week (rather than June) now has been sealed.

Next week's hike would mean the first rate hike during a Federal election campaign since 2007. The very strong inflation data combined with a robust recovery in economic activity and the unemployment rate near a 50-year low means the RBA cannot wait any longer. Once the genie is out of the bottle, is it hard to get back in. The same goes for inflation. If inflation gets out of hand, more rate hikes could be needed. It means the RBA cannot wait any longer to raise rates.

Interestingly, the last time the RBA raised rates in an election campaign was 2007, and there was a change in government. However, the cash rate this time around is being raised from a historical low of 0.10%. Ahead of the 2007 election campaign, the cash rate was sitting at 6.50% and the hiking cycle had already commenced.

The RBA is likely to start with a hike of 15 basis points next week, to take the cash rate to 0.25%. We continue to anticipate the cash rate will be at 0.50% in June and the cash rate will be at 1.50%

at the end of the year.

So, the May rate hike should be followed by a hike of 25 basis points in June (our central view). There is some risk the June rate rise could be bigger than 25 basis points, especially with other global central banks recently moving in 50 basis point increments (the Reserve Bank of New Zealand and the Bank of Canada) or about to do so (the US Federal Reserve). However, inflation is running at a faster clip in New Zealand, Canada and the United States. A hike bigger than 25 basis points in June would likely need a strong wages report next month, as well as another very strong employment report.

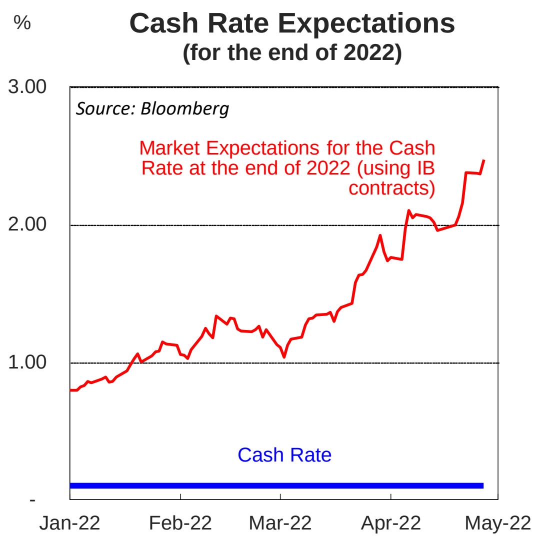
Interest-rate markets are fully pricing a 15 basis point rate hike in May, but are far more aggressive in their tightening expectations for the rest of the year. Markets are almost fully priced for a follow-up move of 50 basis points in June. Furthermore, markets are pricing in a cash rate of 2.50% by the end of this year, which represents 240 basis points of tightening in around 8 months!

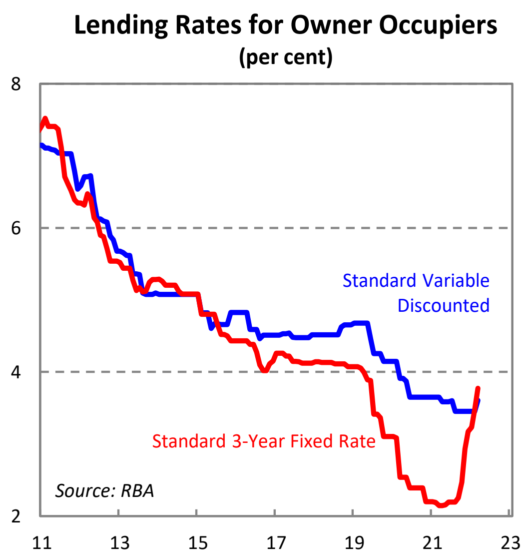
What does it mean for mortgage rates?

These market expectations are reflected in shorter dated swap and bond rates. The significant lift in market expectations and consequent rise in swap rates means fixed home loan rates in the financial services industry have already lifted considerably. Lending data provided by the RBA reveals across authorised deposit institutions, the average 3-year fixed rate home loan for an owner occupier paying principal and interest has risen 152 basis points over the past six months, from 2.25% in September to 3.77% in March.

Historically, variable mortgage rates have typically moved after an official RBA announcement on the cash rate, so there has been little movement in variable mortgage rates over the same period.

A recent assessment of home borrowers by the RBA revealed many households have built up buffers by paying off their mortgage at a faster rate. Indeed, the median excess payment buffer for owner-occupiers with a variable-rate loan was equivalent to around 21 months' worth of scheduled payments in February 2022, up from around 10 months' worth at the start of the pandemic. Households without buffers or with slim buffers, and with higher mortgages relative to their household incomes, will be more sensitive to higher rates.





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