Stamford Capital
AUSTRALIA

Interest Rate Outlook

Sometimes it can be hard to fight City Hall. The RBA has delivered a much expected interest rate cut and yet most of us don't feel that bullish about economic conditions. An explanation for part of this feeling is the much tighter capital conditions that are apparent in the bank debt funding market and subsequent increased cost of borrowing. One could almost feel that any benefit offered by the RBA is countered by prudential and policy directives.

Whilst recent consumer and business confidence indices are showing a reasonable measure of positiveness, is anyone been trying to arrange property finance from a bank recently? Liquidity is extremely tight. This is as good a segueway as any to address the impact of existing monetary policy and an interest rate outlook. We will address this in a point format for now:-

- Fact 1 – interest rates do not have the same impact that they used to have.
  The economic sensitivity is clearly not the same to interest rate adjustments at this level as it once was, especially with backdrop of near zero or zero rates around the major economies.
- Fact 2 – inflation is below the RBA's target band.
  As has been stated over several interest rate outlook articles, inflation is not be feared as it is usually a good measure of economic growth. It is the main alarm bell for the RBA and clearly has their vision focused on such a low number and impact on domestic growth from local and global trading conditions.
- Fact 3 – AUD is a resilient currency.
  For now at least the currency has been behaving in a recalcitrant like fashion. We have learnt' that fighting city hall may work for a short time, but in the end, the RBA will win this battle.
- Fact 4 – The RBA is becoming more powerless with a cash rate @ 1.50%.
  This is fallacy as the RBA has a number of other options and levers to engage.
- Fact 5 – The AUD won't decline in value.
  Over time, a lower yielding rate environment should have the desired effect, combined with other external factors.

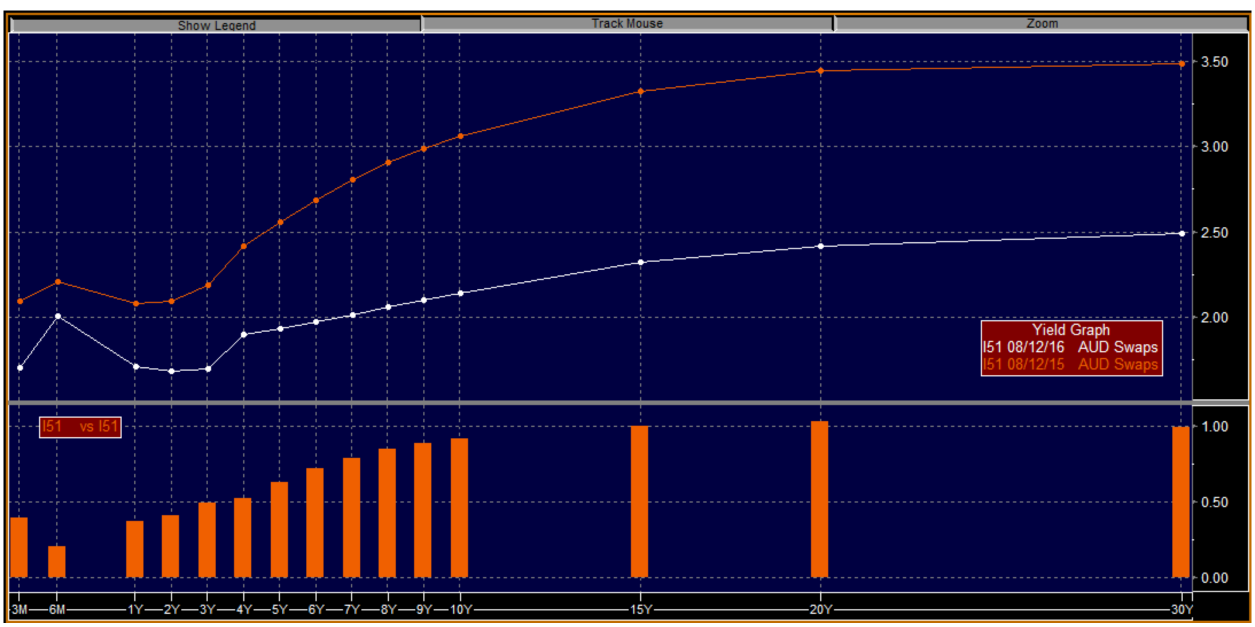
- Fact 6 – Monetary policy alone can provide the heavy lifting.
  False. Governments and fiscal restructure needs to work in tandem with monetary policy.

So where to next?
Many market forecasters and indeed the price expectation of the RBA cash rate going lower is priced for another rate cut in March 2017 as an 88% probability. This has been as high as 100% over the past week. The challenge/problem with a market skewed one way is that the majority consensus can on the odd occasion be proven wrong.

Our view is that the cash rate is likely to be cut but not this year. With wage inflation non existent and underemployment, there are some real challenges for the ruling government and RBA. The RBA is only part of the solution and as is seen around the globe, zero and indeed negative interest rates are the new norm…. for now anyway.

Rates
The yield curve is a happy place on the debt side. Bank funding is cheap and liquidity plentiful. However, borrowing margins have widened as nominal rates have decreased to offset some this benefit. Current swap rates are below BBSW and at unprecedented low yields. Best practice treasury risk management highlights that a level of hedging should be in place on variable exposure. Whilst riding the yield curve lower, and it has cost in the form of carry, it is cheap insurance in the advent of something untoward occurring. Whilst head winds are always foreseen, event risk does occur. (Donald Trump addressed as Mr. President?)

An interesting chart below highlights a snapshot of just how far the AUD yield curve moved in a twelve-month period.



Could the curve go lower? Absolutely, but if so, does the crystal ball highlight when it will be at its lowest point? Clearly not.

Of further interest is the cost of carry chart highlighted below. The cost of carry, or positive carry, is the difference between the floating rate and the fixed rate. Whilst this chart is purely a mid-market graph, it is presenting interesting patterns whereby the spread of cost of carry over the past twelve months has been narrow or even positive.

The above BB chart highlights that the 5 year quarterly swap rate was higher than 90 day BBSW in 2015, but over the past twelve months, that pattern and spread has broadly reversed, i.e. fixed rates below variable rates. Typically this occurs when the expectation of an adjustment in cash rate is forecast.

Will this trend continue? It may very well, but regardless for now, rates are as low as has been in history in Australia's economic development.

Regards,

Russell

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