NAB CHANGE IN CASH RATE CALL

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By Group Economics

NAB ECONOMICS CHANGES CASH RATE VIEW TO ONE 25BP CUT IN LATE 2017

- **Solid economic momentum in the near-term will likely keep the RBA on the sidelines through most of 2017.**
- **Renewed emphasis on financial stability by new Governor Lowe is also reason for pause, particularly given the surge in house prices in key markets in late 2016.**
- **A pull-back in economic growth in 2018 however is forecast, as the contributions from LNG exports, temporarily higher commodity prices and residential construction fade, while household consumption remains constrained by weak labour income growth - our year-ended growth forecasts drop to 2% by Q4 2018, much lower than the RBA's 2¾ - 3¾%.**
- **Current RBA optimism is expected to fade about the outlook later in 2017, with easing in late 2017 necessary to prevent a rise in unemployment and inflation undershooting again in 2018.**
- **We have removed our mid-year rate cuts, and now expect one 25bp cut to the cash rate in November 2017, taking it down to 1.25%.**

The RBA's latest *Statement on Monetary Policy* and other communications have contained a sense of optimism that stimulatory monetary policy settings will eventually see economic growth return to an above-potential rate (despite a sensible downward revision to the Bank's household consumption forecasts) and inflation return back to the 2-3% target band. Their forecasts continue to include real GDP growth of around 3% in H2 2017 and H1 2018 and then ticking up to a mid-point of 3¼%. Underlying inflation returns to 2% by late 2017/early-18 and then remains there until picking up slightly in 2019. This is despite the unemployment rate remaining elevated at around 5¾% through their forecast horizon, and minimal upward pressure on wages growth.

This positivity from the RBA is unlikely to be dampened in the near term. Real GDP growth will bounce back in Q4 2016, following the 0.5%q/q contraction in Q3-2016 which has been largely attributed to temporary factors - our preliminary forecast is 0.9% q/q, and the RBA's is between 0.8-1.0%q/q. In addition, recent outcomes from the NAB business survey have been reassuring following a soft patch through much of H2 2016. **Business conditions bounced up to +10 in January and +16 in February**, up from +6 in December and a long-run average of +5. Business confidence also jumped to +10 in February after hovering around +6 for the previous 12 months. While a confluence of seasonal factors suggests it is unwise to get too carried away with these recent results just yet, especially given some key industries such as retail remain fairly weak, these data do suggest a pickup in momentum as we enter 2017. **Moreover, for the remainder of 2017, quarterly real economic growth outcomes are likely to be solid**, with the drag from mining investment reducing, LNG exports adding strongly to growth, the global backdrop somewhat more supportive and higher commodity prices supporting nominal income growth and government revenues. This will see the year-ended pace of growth pick up to around 3% by Q3 2017 on both our and the RBA's forecasts, although the annual average pace of growth for 2017 will be lower at 2.3%.

NAB Economics however remains concerned about a likely softening in growth in 2018. At this time, LNG exports and residential construction start to flatten off, while commodity prices retreat and drag again on national income and government revenue. Meanwhile, household consumption will be constrained by weak wages growth, contributing to a drop in our year-ended growth forecasts to 2% by Q4 2018. Without further monetary policy easing and further AUD depreciation, our forecasts for unemployment would start to rise in 2018. **If our forecasts are correct, the RBA will need to revise down its 2018 growth and inflation figures** – this however is unlikely in the near-term given the solid activity outcomes expected. **As such, we have removed our rate cuts in May and August and have now pencilled in one further rate cut in November 2017 of 25bp, taking the cash rate down to 1.25%.**

Renewed emphasis by new RBA Governor Lowe on financial stability is also a reason for pause, and for why our previous forecast of two 25bp cuts in May/August 2017 is unlikely to be achieved. At the current juncture, the RBA is likely uncomfortable with the acceleration in house prices in key markets following last year's rate cuts, despite the dampening impact of regulatory restraints on investor lending. By end-2017 however, house price growth is likely to have moderated to 3.4% y/y nationally, while apartment prices will have fallen moderately in Melbourne and Brisbane.

The biggest risk near term remains for an increase in unemployment, which may indeed bring forward a rate cut. This is a possibility, particularly if the participation rate picks up after falling through most of 2016. However given the difficulties in assessing the degree of labour market slack and momentum in employment at present, particularly the mixed signals given by official and unofficial data, it may take some months for the RBA to determine if any further increases in unemployment signal the beginning of a new trend.

Authors: **Alan Oster+(61 3) 8634 2927; Riki Polygenis +(61 3) 475 986 285; Peter Jolly +(61 2) 9237 1980; Ivan Colhoun +(61 2) 9237 1836**

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 2) 9237 8017

Vyanne Lai
Economist – Australia
+(61 3) 8634 0198

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Amy Li
Economist – Australia
+(61 3) 8634 1563

Industry Analysis

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Industry Analysis
+(61 3) 8634 3837

Steven Wu
Senior Analyst – Industry Analysis
+(61 3) 9208 2929

International Economics

Tom Taylor
Head of Economics, International
+(61 3) 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Alex Stanley
Senior Interest Rate Strategist
+61 9237 8154

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Jason Wong
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44 207 710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Julian Wee
Senior Markets Strategist , Asia
+65 6632 8055