National Australia Bank

31 July 2013

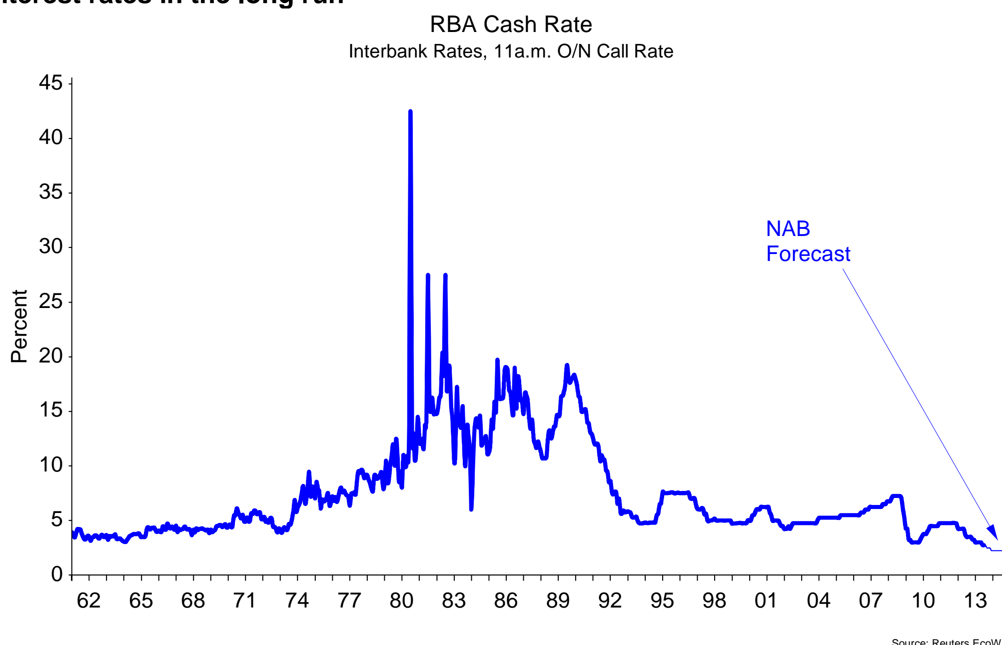
NAB changes rates call: Two cuts by year end.

- **Throughout this year we have been pointing to the ongoing sources of weak domestic demand as the economy faces a downturn in mining investment.**
- **Until yesterday the RBA had been expressing optimism about other drivers of growth picking up. Yesterday Glenn Stevens provided a much more sober and realistic outlook, suggesting that the economy cannot rely on housing and consumption to plug the growth hole. This is in line with our forecasts and suggests that having recognised the reality of lower growth with benign inflation more rate cuts are likely.**
- **We had already been forecasting a 25bps rate cut in August to 2½% and with the Governor giving the green light for lower interest rates this now looks a sure thing. We now also expect an additional 25bps cut to 2.25% before year end – most likely in November after the Q3 CPI although it could be earlier. Beyond this, we expect the Australian economy will continue to grow below trend, income growth to be weak, and the unemployment rate to rise to and possibly above 6¼%. So the RBA will retain a bias to ease well into 2014 and a cash rate below 2 ¼% remains a real possibility.**

For some time now we have been expecting an interest rate cut in August, with downside risk to interest rates after that. Over the past month, the magnitude of that downside risk has been increasing.

Retail sales in early July were weak; the unemployment rate in June rose to 5.7%, a cyclical high; job vacancy measures continued to fall; building approvals have fallen for the past two months; consumer confidence is steady and in line with long run averages; credit growth continues to be weak, especially for businesses and consumers; and our Business Survey for June was very weak, dragged down by extremely poor Business Conditions for Mining, Retail and Manufacturing. Despite the drop in the Australian dollar, Business Confidence was soft at an index of 0, up from -1, well below the long run average of 5.

Overnight interest rates in the long run



Since early 2013 NAB has been concerned that the rotation of growth away from mining investment to other drivers of activity might not go smoothly.

At the start of the year, we initially expected three more rate cuts ahead (so far we have had one in May). However, we changed our forecast to two cuts after a series of optimistic pronouncements from the RBA.

The RBA's optimism seems to have evaporated over the past month, if the speech yesterday by Governor Glenn Stevens to the Anika Foundation is any guide. It seems that the RBA has changed its way of thinking on the economic outlook to something much more akin to our view.

That view, as laid out in Glenn Stevens' speech and Q&A, can be summarised as follows. The inflation outlook provides more scope to ease monetary policy, if needed and last week's CPI did not change that outlook. The currency fall does not derail that good inflation outlook (because wages growth is slowing and demand is weak). Consumption growth should strengthen ahead but we cannot expect a return to the rates of growth evident prior to 2007. Hence, other areas of demand will be important to replace mining investment. Export growth will help but this will not generate many jobs. Fiscal policy is likely to be tightened further in coming weeks – offsetting the automatic stablisers of weaker growth. There will be some pick up from housing construction. That leaves business investment outside of mining. Weak business confidence is working against non-mining investment as are four year lows for capacity utilisation. A fall in the currency would help. The end result is weak domestic demand and rising unemployment (we have domestic demand forecast at 1.8% for the year to December 2013 and only 0.8% through 2014).

It is obvious that lower interest rates would encourage a lower currency and by themselves lower interest rates can help to boost domestic demand and confidence. After Glenn Stevens' speech, it is clear that the RBA has had a pretty important re-think and now sees the weak domestic demand outlook continuing for some time ahead. That almost guarantees that rates will be cut in August.

The question is what will the economy look like next year? We are not optimistic.

Unemployment must surely rise further - we expect it to be around 6% by the end of this year and to continue to rise next year. This won't help consumer or business confidence. Investment is likely to be subdued and mining company pain will continue. Inflation should remain subdued, as wages growth slows and weak demand makes it difficult for retailers to pass on higher import prices due to the currency fall. Hence, after another good inflation read in October, another cut of 25bps in November taking the cash rate to 2¼% seems likely to be needed. Today we are changing our cash rate forecast to 2.25% for November.

Beyond that, the risk will be for more rate cuts ahead, provided the currency does not fall out of bed and assuming that the economy can respond only slowly to the RBA's stimulus and the falling currency (we see USD 0.83 by the end of 2014).

2014 will be a long year for the economy and a cash rate even lower than our 2¼% forecast is now a distinct possibility.

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