**NAB Business Markets Podcast – RBA & US Fed Christmas Messages**

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PH: Hello and welcome to the Nab Business Markets podcast. I’m Peter Hartley and I’m here today with Mark Todd who is one of our Directors in Capital Finance. Mark has a regular contribution to the Sky Business channel and is talking with clients all the time. He has great views on economics and we are here to pick his brain on what’s been happening with the interest rate markets around the world. So this week’s been incredibly busy from a central bank perspective, we have had the Reserve Bank on hold yesterday, we’ve got the European Central Bank coming up and the biggest event that we’re probably interested in before Christmas will be what happens with the US Federal Reserve on the 17thof December. So, Mark thank you for joining us.

MT: Thanks, Pete.

PH: Can you tell us what you’re seeing as themes coming up, for the next few weeks in term of interest rates in the global economies.

MT: Yeah, the year ends certainly very interestingly. I think if I could encapsulate it in one way, it’d be the story of “forward guidance”. It would be the idea that the fed in December, will in all probability lift rates for the first time since 2006. The fed has stressed that the first move, isn’t the important move, it’s about the pathway to normalising rates and they are asking the markets to believe in their forward guidance and they been challenged by that. It’s a difficult conversation for the Fed to have. To provide the market with confidence and remember central banks don’t like volatility, so they have been at pains, in September there was too much volatility, they’ve been at pains to let everyone know that markets need to be smooth. And if you look across the Atlantic to Mario Draghi, who comes out this weekand talk about his next plank of QE. The forward guidance there is again central to the market’s reactions and one of the things that would seem clear to me is that Mario Draghi’s, reputation and his capacity to calm markets is you know extraordinary and that the market takes what he says, as he said in 2013 ‘we will do whatever is necessary to save the Euro’. The market believed it and acted on that. The Fed is in a more challenging position because its lifting rates, but I think they would love to have some of the gravitas that Draghi has. If they said do something and the market reacted in a way that is positive. I think that would be what the Fed would love to have, so they don’t want volatility.

PH: So Mark, December 17th the fed decides to make their announcement, what is their most likely move, what is their most likely commentary to go with it, and how that might impact the Australian dollar?

MT: Some of the themes in the fed have been maybe they’ll go less than 25 basis points. It will be hard to imagine that they will go by more than 25, so I believe the Fed try to give some comfort around 25 basis points, is where we will make the move, it is a normal rate hike it’s not anything different. I think they will then try and talk about the smoothness of the path and how consistently they will come to markets and what they will do and they’ll talk about looking at the data.

The projections on most of the markets participant, is that high US rates means a stronger US dollar, as people take advantage of higher rates and better return and therefore corresponding currencies go lower in price. I think that it is a view that has been in existences for quite a long time, so the one concern I have is that everyone is the same way, everyone is long dollars. But at the same time that is the major themes of markets and have been for last 6 – 7 months, it would be hard to say that it will go against it. But the really important thing to remember is, if you are all along the same way just be ready for the fact that you need to have an exit strategy in case the market starts to turn, cause when it turns, it’s quite viscous in the turn.

PH: Mark you mentioned previously that the market has a traditional mentality of one rate rise, must equal 3 more in the next few months, equals another big increase by the end of the year. Do you think that something the Fed going to try and hose down?

MT: Definitely. I think the global anchors of a lower china, slowing china, lower rates. The European situation where it is definitely lower and continues to stay lower, with no sign that it will get any higher, anytime soon. Will mean that there is a limitation on what the US can do, because they don’t need a stronger currency, when I think about the fed, I think about this theme that all markets work on, is that “you don’t fight the Fed”. At this point in time, in my mind the Fed is not really fighting. If the US dollar rallied too far, and is a natural brake on their economy, I think they would use their resources to take some of the heat out of the US dollar. They would try and do it firstly I think through forward guidance, to say look this is just one move. It might take an awfully long move for us to take another move, and try to diminish some of that goal of higher rates, better returns as a theme. That would be sort of consistent with what corporate America wants and its certainty consistent with more vocal pieces of corporate America towards the Fed,

PH: So, we’ve been talking about interest rate rises in America since mid-2015 and now we are approaching the end of the year. Is December the last chance for the Fed to pull the trigger or do they kick the can down the road again?

MT: Peter, that’s a good point. The Fed said in mid-year there would be 2 rate hikes, that the dot points suggested 2 rate hikes. In September they said there would be one (rate hike). This is their last opportunity to lift rates. It has to be some very significant data point to stop them. The way to look at it is, again it comes around to the Fed credibility and I think that has some value. The Fed wants to be seen as an organisation that’s in control of the economy. If they weren’t to lift rates they would have to have a really strong capacity to articulate that reason for not doing it. It would have to be a reason for not doing it that wouldn’t scare markets. So I think they’d want to say ‘we said it would happen, it is going to happen, we’ve done it and then everyone should be calm’. And then it’s really that calmness. Central banks hate volatility and they are the firemen to the heat of volatility. They just want to hose it out and that’s what they will try to do.

PH: So what does this mean for the Aussie dollar?

MT: Standard operating procedure is the Aussie will go lower on a net relative value basis via rates. We (RBA) don’t move, that spread creates less demand for Aussie.

PH: Especially with the knowledge that the RBA won’t move rates again until at least February because we have our Christmas break.

MT: Yep. I think that most people would assume that the US would have some capacity to go a little bit lower. Not a lot, but a little bit. I would imagine that if you think of the interest rate settings for Australia, it’s not so much about our economy, and the benefit has been to our economy of the lower rate is obvious to everyone. It goes across the curve. The interest rate setting story I think for 2016 will be around currency. If our currency doesn’t go lower, if our currency rallies on the basis that the Fed does the job it wants, (and it’s important to understand what the Fed’s goal is, the Fed’s goal is not to have too strong a currency), and so if the Fed engages in that fight and somehow convinces the market not to buy the US dollar, because their interest rate settings will stay really low for a long time, so it’s a very flat curve, it might go up 25basis points but not move for another year if the market starts to think that. Then, on a relative value basis we may look attractive, and that might mean that people have to buy Aussie (dollars) to buy our assets, buy our bonds and the like.

PH: So our 2.00% (Cash rate) could still be very attractive to international investors?

MT: When you think about Europe going lower, if you were in a money market account in Europe and you could get 2.00% here (in Australia) and you get negative 50basis points there, that is a massive spread, so it’s about, how would people look at Australia, with a very good economy (in relative terms), solid growth in basically all the metrics that you want. Inflation is ok, the economy is moving well, interest rates are nice, rule of law is fine. If you were looking at Australia as a safe haven investment, it sort of ticks a lot of boxes.

PH: In terms of the RBA cash rate now, most of the Aussie banks are talking about no chance of a rate cut. If the Fed raises rates and the Aussie dollar moves a bit lower, is that enough for the RBA to avoid any future rate cuts?

MT: I think so. I think the stimulus that the rate cuts offer versus the lower currency, it’s more in favour of the lower currency. I think it creates economic activity. Which, I do feel like the GFC continues to dominate all the themes of investments and behaviour. And that will mean if you make a little bit more money you will spend a little bit more money. You don’t necessarily double down, and borrow as much as you can, and go for it. I think lower rates have stopped having the same stimulatory effect. I think the lower rates might help people on mortgages and the like, but I don’t know that it would make corporate Australia go out and do more. I think a lower currency makes them do more.

PH: Ok, so we don’t have total short term vision… moving past the Fed on December 17, what else do you see coming up in the next few months, over the Christmas period, over the break, that people should keep an eye on, that you will be watching in early 2016?

MT: I think for me, the outlier is the election in the US. Now the Presidential election is going to be in November, and it is important to appreciate the fact that when a President changes, like all Western powers when they change the government, it does have significant impact. I’m just trying to understand how that election is going to unfold. The Republicans, the nominations for both the Republicans and Democrats start taking place in January, so you will start to look at trends in the polls and see who is the frontrunner for that. And you think about how the economy goes forward under different leadership. It’s important because it’s such a huge economy. Think about how China has changed its leadership. And the impact it had in terms of the way they approached the fraud, the way they approached different parts of their economy.

PH: Yeah, like the stock market.

MT: Yeah, so you think about the US economy having a different political leadership. What’ll they do with the big issues that affect the US? It will impact investors, it will impact currencies so I feel it would be worth considering. So it’s just worth doing a little bit of homework and working out who the frontrunner is.

PH: What will the RBA be looking at once they come back to work in late January, early February?

MT: For them it will be really the performance of the Fed. How the Fed fought the good fight, in their mind. How the Fed keep their economy (going), and remember this is THE economy. Britain is going well, but the US is THE economy because it’s the one that’s charging. If Europe was charging, you’d say look ok it’s a global story, but it’s not. It’s the story of the US, and can the Fed lift rates and keep the economy with its momentum and I feel that our RBA would look at that and say, how have they done it? Our RBA has done a fantastic job and I would imagine they will be looking to see, and wishing the Fed well, so they can keep that economy going, because that’s the big one.

PH: Mark we’ve had a very interesting 2015, do you have any reflections or any messages you want to pass on to our NAB clients, just to finish off the year, to wrap up 2015?

MT: I think we would get, if you look at our performance we would get a B+, almost an A. If you consider how everyone viewed the change in the mining circumstances, the end of the mining boom. There was a lot of trepidation about our economy and our capacity to diversify. I think it’s all credit to the economy and to the NAB customers, that they have been able to adapt to that lower currency and find new sources of clientele. I think that’s a real credit to the Australian economy. Very rarely would you talk about the nimbleness of the Australian economy. But it’s shown it. When it gets the tailwind of a lower currency it’s reacted really well. I think its hats off to the Aussies, we’ve done really well.

PH: Mark thank you for sharing your insights with us and thank you very much for listening. We wish you all the best for the end of 2015 and into 2106, and look forward to continuing to do business with you. Thank you kindly.