NAB CHANGE IN CASH RATE CALL DECEMBER 2018

FIRST 25BP INCREASE NOW EXPECTED H2-2020

NAB Group Economics

- **We have delayed our expectation for the first RBA increase in the cash rate to the second half of 2020.**
- **While output growth has been largely as expected over the 2018, wages pressure remains weak and hence inflationary pressure has remained low, with the core measures continuing to track below the RBA's target band. We expect that will continue through all of 2019.**
- **Our forecasts see a moderation in growth back to potential of around 2.3 to 2.5% and unemployment falling a little further to 4.75% and then remaining at that level. Falling house prices suggest a bigger impact on housing construction than previously incorporated and additional concerns about the consumer, though low rates and unemployment are important offsets.**
- **The past year, despite growth being stronger than expected, the RBA has overall proven more relaxed about current policy settings than we expected – largely as wage growth failed to lift significantly on the stronger growth outcomes - and we don't see that changing any time soon.**
- **The Bank will be looking very carefully at the extent of the slowing in house prices – and in particular that the adjustment remains orderly. That is still our expectation - see our Forward View released today – an expectation supported by the response to a special question on house prices in this month's NAB Survey, which revealed very few businesses had seen any significant impact from lower Melbourne and Sydney house prices.**
- **In brief we still see the economy moving in the right direction, with growth although slowing, remaining solid, the labour market tightening into mid-2019 with wages to lift moderately. The upcoming Budget is also likely to be consumer friendly.**
- **In those circumstances, we can see the case for a forward-looking central bank beginning to very moderately start increasingly rates from the second half of 2020. As always the exact timing will be data dependent – with a lift in both wages growth and the inflation forecast particularly important in this regard.**

Our RBA rate view in the past year has been characterised as data dependent. Looking back to this time last year our GDP, unemployment and inflation forecasts have been quite accurate (albeit ABS revisions initially boosted published growth rates and then lowered them). Clearly the Reserve Bank will now need to revise down their view that "growth would average around 3½%over the next few years". However, most forecasters have been surprised by the continued weakness in wage growth, even as unemployment fell more sharply than most anticipated. In those circumstances the RBA has essentially been happy to keep rates unchanged and watch.

The other surprise has been somewhat larger than anticipated falls in house prices in Sydney/Melbourne in an environment of undersupply, low interest rates and low unemployment. Clearly credit supply issues have been involved (as banks looked more closely at borrower expenses and tightened supply to investor housing). That combination together with changing buyer expectations from very high house price levels have seen falls from recent peaks of nearly 10% in Sydney and 6% in Melbourne. Importantly to date the adjustment process has remained orderly.

Clearly the RBA will be looking very closely at how that process unfolds – larger falls and any spreading to other capital city markets would bring weakness in the consumer spending increasingly into the core of the RBA forecasts rather than its current status as a risk. As we have noted in today's Forward View we are now expecting peak to trough falls in Sydney/ Melbourne of around 15% - equivalent to Australia-wide housing down around 5% in both 2018 and 2019 and down a touch into 2020. In our view, that adjustment would still satisfy the criteria of an orderly correction. Also the special housing questions in this month's Business Survey suggest that house price falls to-date have not played much of a role in easing business conditions. Despite that markets have become very concerned and are now toying with the possibility of the risk of an interest rate cut in the next 6-9 months.

While that is a possibility we would not rate it as more than a 30% probability. Indeed the rate cut view underplays the strength currently evident and likely to remain elsewhere in the economy. In particular areas of strength include public sector demand – both infrastructure spending and NDIS-related public consumption.

Contacts: Alan Oster – Chief Economist

We also expect non-mining business investment to benefit from additional spill-overs from infrastructure. Mining is also still a potential upside factor to the forecasts, with that sector now clearly reporting strong business conditions and confidence. Exports are expected to continue to grow relatively strongly - as the last of the large LNG projects reach full production capacity – and then level off.

The labour market also remains strong – with our business survey for November pointing to on- going growth in employment of around 20k per month – and on that basis unemployment is likely to fall to around 4¾% by early / mid-2019. And we hope wages will edge up – as obtaining suitable labour becomes a more important factor in the wages dynamic.

Developments in unemployment – and forward looking indicators of the labour market – will remain key in coming months for the outlook for the economy, housing markets and monetary policy. Lower unemployment is likely a pre-requisite for stronger wages growth, in turn necessary to deliver inflation back to target. And continued employment, is likely necessary for Australia to successfully negotiate the current orderly correction in the Sydney and Melbourne property markets.

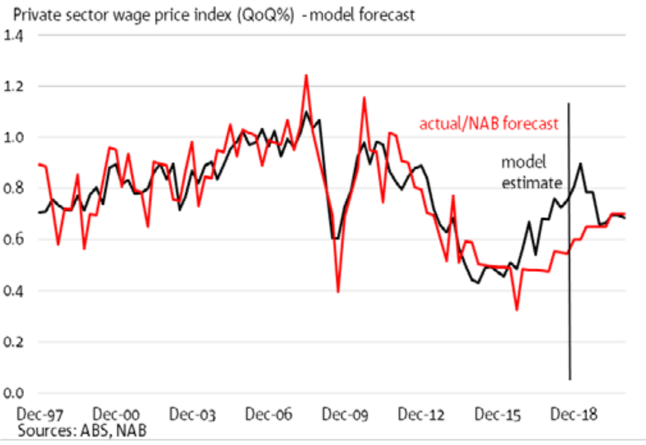
Our growth forecasts have been revised down a touch in 2019 to 2.5% and 2020 to 2.3% as wealth effects of lower house prices and slower housing construction bear more on the outlook with house prices now expected to decline further.

However these growth rates are not poor. Indeed through 2019 they would imply further reductions in excess capacity. While not explicitly factored into our forecasts the upcoming Budget is likely to be "consumer friendly" and "infrastructure rich".

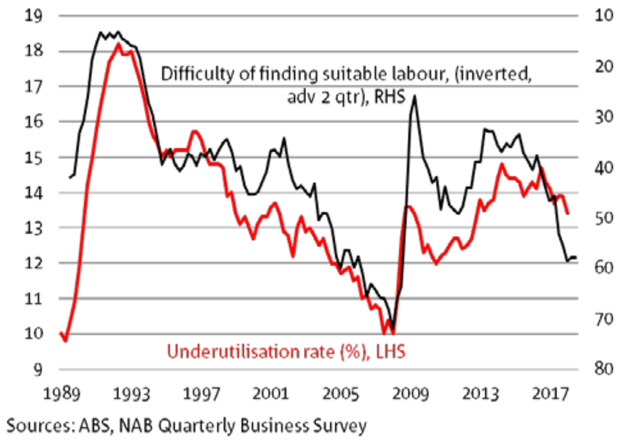
By early 2020 our wage price forecasts also see core inflation moving towards the 2¼% rate with likely higher rates in 2021. In that case, a forward looking inflation targeting central bank would need to start reviewing the need for continued ultra-low interest rates – and by the second half of the year is likely to start a gradual process of removing monetary accommodation. As shown by the attached chart a Taylor Rule approach would imply the RBA by then might be a touch behind the curve.

As always much of the above will be very data dependent – both locally and globally. And on the latter fears that the US will go into recession in 2020 are in our view overblown (we see a substantial slowing but still have growth of around 1.6%).

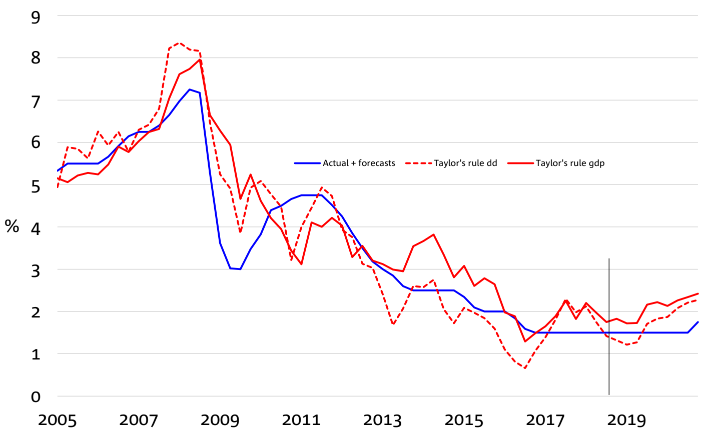
Private Sector Wage Price Index (QoQ%)



Labour underutilisation and constraints



Taylor Rule – Based on Nab Forecasts for Domestic Demand and GDP



*Taylor's rule adjusted for widening spread between cash and home loans

AUTHORS

Alan Oster, Group Chief Economist
Peter Jolly, Global Head of Research
Ivan Colhoun, Chief Economist, Markets
Gareth Spence, Senior Economist

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Dean Pearson
Head of Economics
+(61 3) 8634 2331

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

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

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

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Senior Analyst – Behavioural & Industry Economics
+(61 3) 9208 2929

International Economics

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

John Sharma
Economist – International
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836