

NAB MONETARY POLICY UPDATE 7 APRIL 2022

RBA TO HIKE RATES IN JUNE, JULY, AUGUST AND NOVEMBER, FOLLOWED BY A MORE GRADUAL PATH THROUGH 2023 AND 2024



NAB Economics

Key points

- As flagged on Tuesday, we now expect the first cash rate increase to occur in June, (15bps), followed by 25bps increases in July, August and November. That would see the cash rate target at 1.00% by the end of the year. From there we expect a more gradual path, with the RBA raising rates a further 5 times over 2023 and 2024, taking the cash rate target to 2.25% by the end of our forecast horizon.
- Strong recent activity data, including NAB's business surveys, elevated job vacancies and last month's labour force data suggest labour demand remains very strong, while wages are still expected to strengthen gradually. We also expect consecutive strong inflation prints in the near term.
- Critically, this week's Board statement revealed a shift – long expected – removing any reference to a willingness to be “patient” with a focus instead on assessing data over “the coming months”. By June the Board will have data on Q1 CPI, WPI, and the National Accounts showing that wage pressure is building, and price rises have become more widespread.
- Ahead of raising rates, we expect the RBA to confirm in May that it will not reinvest maturing bonds, which would see bond holdings decline over an extended period. We do not see the RBA actively selling its holding of bonds in the near-term, though it may be an option further in the future.

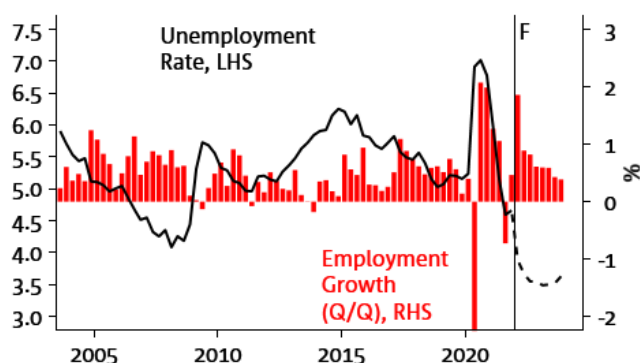
Change in RBA's outlook brings forward rates lift-off

In March, we upgraded our forecasts for the labour market and inflation and brought forward our call for a first rate rise to August. Since then, data have largely confirmed these expectations. The unemployment rate has fallen to 4% and job vacancies indicate ongoing strength in labour demand, pointing to further falls in the unemployment rate. The ongoing tightening in the labour market will see further gains in wage growth. NAB's business surveys and other indicators point to core inflation above 1% in Q1 and remaining elevated in Q2 as supply disruptions and elevated commodity prices continue to buffet the global economy. The sheer strength in demand will likely be enough to see the ongoing passthrough of cost pressures to consumer prices.

Our August rate rise call reflected an expectation that the RBA would wait for the Q2 CPI to assess the breadth of price pressures and whether any resolution to supply chain factors had begun to occur. At the time, we highlighted the risk that a change in the RBA's strategy could see it move sooner and the Board's statement this week did just that, removing any reference to a willingness to be “patient” and pointing to “important additional evidence” available “over the coming months”.

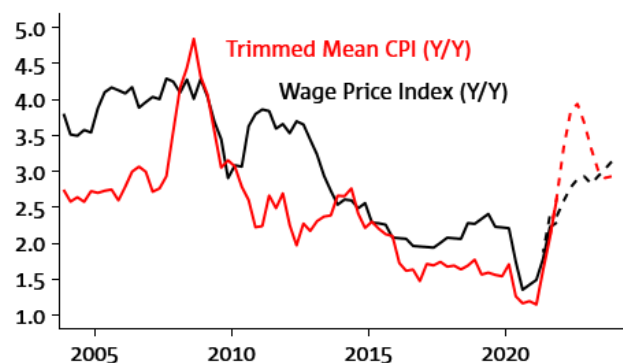
That evidence will include Q1 CPI in April, Q1 WPI in May and Q1 National Accounts on June 1 (ahead of the Board meeting the following week), as well as two additional labour force prints. We expect these data will show strong growth, unemployment below 4%, strengthening wage growth and core inflation nearing 4% y/y. Indeed, a very high CPI print could push the RBA to respond in May (ahead of the election), albeit we expect them to wait for data on labour costs before moving.

Chart 1: NAB's labour market forecasts



Source: National Australia Bank, Australian Bureau of Statistics

Chart 2: NAB's WPI and CPI forecasts



Source: Macrobond, NAB Economics

Gradual normalisation to follow initial lift-off

We expect an initial 15bp hike in June to be followed by 25bp hikes in July and August, taking the target cash rate to its pre-pandemic level of 0.75%. The ES rate will most likely move in tandem, maintaining a floor 10pbs below the target.

From there, the RBA is likely to move more gradually as it assesses the impact of the initial adjustment on households and businesses, while also monitoring progress on wage growth and any easing in supply-side pressures. We expect a further 25bp rise in November to end the year at 1.00%, with three further increase in 2023 and two in 2024, bringing the target cash rate to 2.25%.

This rates profile would be consistent with continuing growth in Australia's economy, which we expect to slow from the current pace to around trend (full details will follow in our monthly forecast update next week). It sees the unemployment rate settling at a level consistent with full employment and inflation returning to the middle of the target band over time.

Market pricing continues to reflect an upside scenario

Market pricing currently suggests interest rates will rise much more rapidly, with rates above 2% priced by end-2022 and above 3% by mid-2023. Such a rapid and sustained increase in rates would likely be justified by ongoing above trend growth, unemployment falling and persisting at a substantially lower level (~3%) and little correction in prices as supply chains recover, which could see a stronger rise in inflation expectations feed back into the wage bargaining process. While such a scenario is plausible, for now it does not appear to be the most likely path forward.

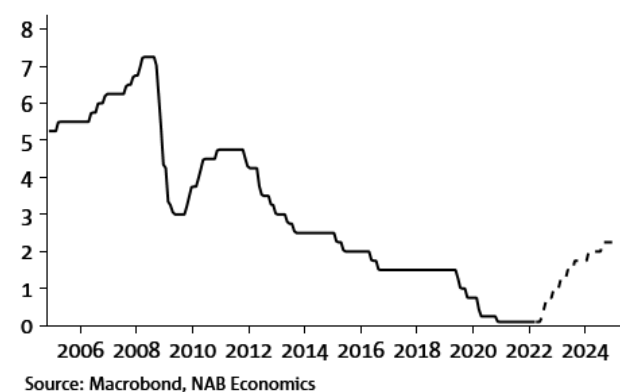
Alternatively, if supply-side pressures ease rapidly through the second half of 2022 and wage growth remains closer to pre-COVID levels, policy makers could opt to maintain rates at or around 1% for longer. There is also a small risk that early rate rises have stronger-than-expected effects on consumption as household budgets adjust. In addition, the pandemic and the Russia/Ukraine conflict continue to pose risks for global growth. On balance, we see gradual rate rises across 2023 and 2024 as most likely.

May meeting to confirm no reinvestment of bond holdings

The May Board meeting will see a decision on the management of maturing bonds held by the RBA. Maturities are relatively small in the next 12 months but larger in 2023 and beyond. We expect the RBA will confirm it will allow bonds to roll off its balance sheet as they mature.

Reinvestment is unlikely given the sooner than expected move to begin lifting rates, while there are unlikely to be any digestion issues in the bond market with the AOFM facing a smaller than expected funding task over the next couple of years. Active selling is considered unlikely in the near-term but given the extended maturity profile of the balance sheet, could become an option following the maturity of the TFF. The cash rate will remain the primary tool of monetary policy.

Chart 3: NAB's cash rate target forecast



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