

MNI RBA Review - May 2021

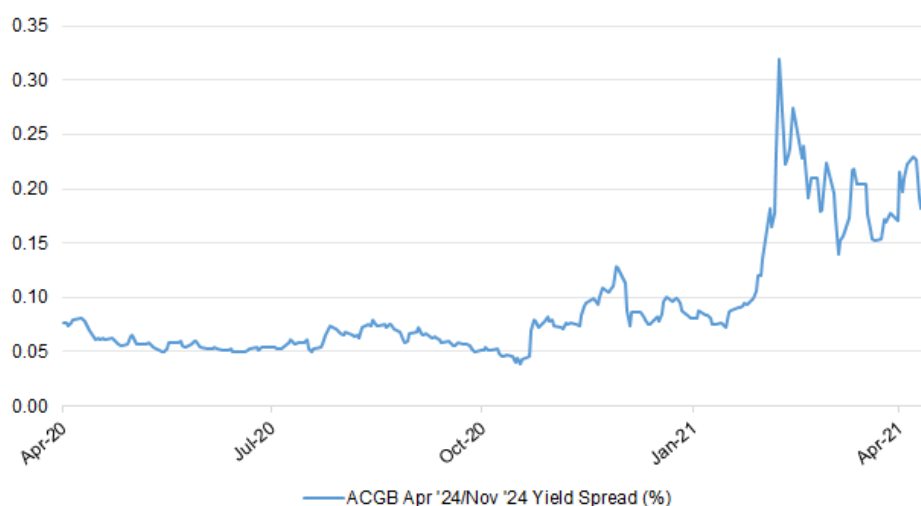
Meeting Date: Tuesday 4 May 2021

Link To Statement: <https://www.rba.gov.au/media-releases/2021/mr-21-06.html>

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Fig.1: ACGB Apr '24/Nov '24 Yield Spread (%)



Source: MNI - Market News/Bloomberg

MNI POV (Point Of View): Setting The Staging Posts

The Bank left its broad monetary policy settings unchanged, as expected, while updating its assessment of the domestic economy ahead of the official release of the SoMP on Friday. These updates, coupled with some tweaks to the wording deployed in the statement, provided a hawkish tinge. The Bank now expects GDP growth of 4.75% in '21 (prev. 3.5%) & 3.5% in '22 (unch. from prev.), while it sees unemployment at ~5.0% at the end of '21 (prev. 6.0%) and ~4.5% at the end of '22 (prev. 5.5%). On the inflation front, the Bank noted that “despite the strong recovery in economic activity, the recent CPI data confirmed that inflation pressures remain subdued in most parts of the Australian economy.” Still, it now looks for underlying inflation of 1.5% come the end of '21% (prev. 1.25%) and 2.0% in mid '23 (prev. 1.75%), which is a little more upbeat, and, more importantly, revealed that the Bank expects underlying inflation to operate around the lower end of its target band by the end of its forecast horizon.

The main point of note in the statement saw the Bank reveal that “at its July meeting, the Board will consider whether to retain the April 2024 bond as the target bond for the 3-year yield target or to shift to the next maturity, the November 2024 bond. The Board is not considering a change to the target of 10 basis points.” The Bank also stressed that “the Board is prepared to undertake further bond purchases to assist with progress towards the goals of full employment and inflation. The Board places a high priority on a return to full employment.” The highlight of its priority in the final sentence of that passage is a new inclusion to the statement but isn't particularly shocking.

The Bank further increased the importance of its July meeting as it revealed that “at the July meeting, the Board will also consider future bond purchases following the completion of the second \$100 billion of purchases under the government bond purchase program in September.” Sell-side views are split re: the future of the RBA's government bond purchase scheme, with 2 major camps forming: 1) an extension of A\$100bn over a 6-month horizon 2) a tapering of bond purchases to A\$50bn over a 6-month horizon. We will tabulate the views of the sell-side ahead of the July decision in an attempt to streamline consensus surrounding this matter and the potential extension of the 3-Year yield targeting scheme to cover ACGB Nov '24 (which most do not expect).

The announcements re: the decisions that will come in July caught most off guard, with the broader assumption being that the Bank would wait until August (when armed with a fresh SoMP and the release of Q2 CPI data) before making decisions on such matters. This will mean that the monthly labour market reports covering April and May will provide the key data inputs for these decisions. We also highlight that today's statement saw the Bank remove reference to 'considerable spare capacity' and suggestions that 'unemployment is still too high.'

The Bank confirmed that “the date for final drawings under the Term Funding Facility is 30 June 2021.”

The Bank repeated its commentary surrounding the housing market, in that it “will be monitoring trends in housing borrowing carefully and it is important that lending standards are maintained.” There were some tweaks to the passage employed ahead of that sentence to encompass broader based demand and wider-reaching price rises.

The Bank concluded with “the Board is committed to maintaining highly supportive monetary conditions to support a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, the labour market will need to be tight enough to generate wages growth that is materially higher than it is currently. This is unlikely to be until 2024 at the earliest.” The final sentence previously read “the Board does not expect these conditions to be met until 2024 at the earliest.” This tweak was likely a product of the aforementioned updated projections surrounding inflation and unemployment and provides slightly less assurance re: monetary policy further down the line.

In terms of market reaction, the ACGB Apr '24/Nov '24 spread widened by ~2.5bp post RBA (see Fig. 1), unwinding a chunk of the Q1 CPI-inspired narrowing, with the move based on the more upbeat economic view at Martin Place and the previously highlighted lower degree of assurance in the RBA's guidance paragraph, which participants equated to a lower chance of the RBA rolling the 3-Year yield target scheme to cover ACGB Nov '24.

Outside of any seismic shifts in the domestic and/or international outlooks, June's meeting should prove to be a bit of a non-event, although it will give the RBA a chance to finesse its messaging ahead of the now key July decision.

A reminder that RBA Deputy Governor Debelle will speak on “Monetary Policy during Covid” on Thursday.

RBA 4 May 2021 Meeting Statement

At its meeting today, the Board decided to maintain the current policy settings, including the targets of 10 basis points for the cash rate and the yield on the 3-year Australian Government bond, as well as the parameters of the Term Funding Facility and the government bond purchase program.

The global economy is continuing to recover from the pandemic and the outlook is for strong growth this year and next. The recovery remains uneven, though, and some countries are yet to contain the virus. Global trade in goods has picked up strongly and commodity prices are mostly higher than at the start of the year. However, inflation remains low and below central bank targets.

Sovereign bond yields have been steady recently after increasing earlier in the year due to the positive news on vaccines and the additional fiscal stimulus in the United States. Inflation expectations have lifted from near record lows to be closer to central banks' targets. The 3-year government bond yield in Australia is at the Board's target of 10 basis points and lending rates for most borrowers are at record lows. The Australian dollar remains in the upper end of the range of recent years.

The economic recovery in Australia has been stronger than expected and is forecast to continue. This recovery is especially evident in the strong growth in employment, with the unemployment rate falling further to 5.6 per cent in March and the number of people with a job now exceeding the pre-pandemic level.

The Bank's central scenario for GDP growth has been revised up further, with growth of 4¾ per cent expected over 2021 and 3½ per cent over 2022. A pick-up in business investment is expected and household spending will be supported by the strengthening in balance sheets over the past year. The unemployment rate is expected to continue to decline, to be around 5 per cent at the end of this year and around 4½ per cent at the end of 2022.

Despite the strong recovery in economic activity, the recent CPI data confirmed that inflation pressures remain subdued in most parts of the Australian economy. A pick-up in inflation and wages growth is expected, but it is likely to be only gradual and modest. In the central scenario, inflation in underlying terms is expected to be 1½ per cent in 2021 and 2 per cent in mid 2023. In the short term, CPI inflation is expected to rise temporarily to be above 3 per cent in the June quarter because of the reversal of some COVID-19-related price reductions.

Housing markets have strengthened further, with prices rising in all major markets. Housing credit growth has picked up, with strong demand from owner-occupiers, especially first-home buyers. Given the environment of rising housing prices and low interest rates, the Bank will be monitoring trends in housing borrowing carefully and it is important that lending standards are maintained.

At its July meeting, the Board will consider whether to retain the April 2024 bond as the target bond for the 3-year yield target or to shift to the next maturity, the November 2024 bond. The Board is not considering a change to the target of 10 basis points. At the July meeting, the Board will also consider future bond purchases following the completion of the second \$100 billion of purchases under the government bond purchase program in September. The Board is prepared to undertake further bond purchases to assist with progress towards the goals of full employment and inflation. The Board places a high priority on a return to full employment.

The date for final drawings under the Term Funding Facility is 30 June 2021. Given that financial markets in Australia are operating well, the Board is not considering a further extension of this facility. Authorised deposit-taking institutions have drawn \$100 billion so far and a further \$100 billion is currently available. Given the facility provides funding for 3 years, it will continue to support low funding costs in Australia until mid 2024.

The Board is committed to maintaining highly supportive monetary conditions to support a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, the labour market will need to be tight enough to generate wages growth that is materially higher than it is currently. This is unlikely to be until 2024 at the earliest.

MNI STATE OF PLAY: RBA Leaves Option Of Further Bond Buys Open

By Lachlan Colquhoun

SYDNEY (MNI) - The Reserve Bank of Australia upgraded its assessment of the economy Tuesday but took a pass on fresh policy decisions until the July meeting, leaving open the option of extending its period of forward guidance rates and an increased package of bond purchases.

Policymakers left official interest rates at the record low 0.10%, as expected, but said it would consider additional bond purchases and an extension of its yield target to later maturing bonds at its July meeting.

The current AUD200 billion quantitative easing program is due to be completed by September and a decision will be made ahead of that as to whether further purchases would be needed. The RBA will also decide whether to extend its yield target from bonds maturing in April 2024 to the November 2024 bond.

YIELD TARGET

The bank added it was not considering any change to the yield target of 0.10%, the same as official interest rates and as the RBA has previously indicated that it wants to keep the yield target and official rates aligned, this would suggest the bank is not currently pondering further rate cuts.

Earlier in the year the RBA was considering extending the yield target to the November 2024 bond as a signal to the market on interest rates, which it has said will not increase until 2024 "at the earliest."

Delaying a decision on the target and upgrading 2021 growth suggests the RBA is satisfied at the pace of the economic recovery, which could also receive a boost from the Federal Budget next week which is expected to include around AUD100 billion in job creation stimulus.

GROWTH BOOST

RBA Governor Philip Lowe said the central bank had revised its 2021 GDP forecasts, with growth of 4.75% expected over this year but maintaining the 3.5% forecast for 2022.

"A pick up in business investment is expected and household spending will be supported by the strengthening in balance sheets over the past year," Lowe said.

"The unemployment rate is expected to continue to decline, to be around 5% at the end of this year and around 4.5% at the end of 2022." The March unemployment level was at 5.6%, and while the bank has never specifically given a figure for full employment it has always hinted it is in the mid 4-5% range.

A fuller outline of the RBA's thinking on the economic outlook is expected Friday, when the quarterly Statement of Monetary Policy is published.

Sell-Side Analyst Views

ANZ: The RBA Board's May statement contained two surprises for us and a subtle but important change to the wording around the cash rate guidance. First, the forecast for inflation by June 2023 has been revised up to 2% from the 1¾% expected in the February statement. We thought the RBA would leave its forecast for mid-2023 inflation at 2%, even as the forecast for the unemployment rate was (as expected) revised down to 4½%.

- While the RBA, "will not increase the cash rate until actual inflation is sustainably within the 2 to 3 percent target range", the forecast for inflation to return to 2% by mid-2023 matters for market expectations. And it also matters for the decision on whether the 3y yield target of 10bp will be rolled from the Apr-24 ACGB to the Nov-24 ACGB. We thought the yield target would not be rolled to the Nov-24 bond, and we think the forecast of 2% inflation by mid-2023 makes it even less likely. After all, this forecast implies that the RBA will expect inflation to be above 2% through 2024.
- The second surprise is that the RBA Board stated that decisions about the rolling of the 3y bond target and the extension of quantitative easing (QE) beyond the current program will be made at the "July meeting." We had thought it would wait until August when it will have forecasts out to the end of 2023 at hand (as well as June quarter CPI data).
- Finally, there has been an important, if subtle, change to the wording of the forward guidance on the cash rate. The word "expect" in the April wording has been replaced by "unlikely". We think this is an important shift in thinking and is a result of the forecast of 2% inflation by mid-2023. This forecast implies an upside scenario which has inflation above 2% by mid-2023. In turn this implies some prospect, even if "unlikely", of a rate hike before 2023.

Barclays: In our view, the overall tone of the statement was unequivocally more positive than it was in April.

- If the unemployment rate increases, we think the bank will be more comfortable maintaining the 3y risk-free yield - against which most borrowing in Australia is benchmarked - at a low level. Therefore, we think it is likely that the bank will extend its yield target to the November 2024 bond, in line with its commitment to maintain "highly supportive monetary conditions".
- With major global central banks communicating that policy will remain accommodative for longer, we continue to expect the RBA to announce an extension of its bond purchase plan to keep yields low and reduce pressure on the exchange rate (our US economists expect the Federal Reserve to start tapering only next year). However, we think the pace of purchases will be slower, as the strengthening Australian economy will not need as much stimulus in H221, in our view. Indeed, the bank's communication has been explicit that it is "prepared to undertake further bond purchases to assist with progress towards the goals of full employment and inflation."

CBA: We believe the upgraded forecasts previewed in the Governor's Statement today pave the way for the RBA to announce in July that they will maintain the April 24 bond as the target bond for yield curve control (i.e. not shift to the Nov 24 bond). And that they will deliver a smaller, but still significant, extension to their bond buying program. We retain our call for QE3 to be \$A50bn over six months.

- Here it is worth noting that the RBA will not release any further economic forecasts before the July Board meeting. And the July Board meeting will occur before Q221 CPI is published (due 28 July).

Goldman Sachs: Today's statement provided additional guidance on the future of the YCC and QE programs - broadly in line with our expectations.

- The most notable forecast change was the downward revision to the RBA's path for the unemployment rate - to 4.5% by end-2022 (previously 5% v RBA NAIRU est. ~4%). Inflation was also revised slightly higher, but only to the lower bound of the RBA's 2-3% target band - in line with our expectations. On the policy front, in the broader context the RBA appeared to flag that July's Board meeting would see both i) the April 2024 Bond confirmed as the fixed end-point for the YCC program, and ii) an announced third extension to

the conventional QE program. While still uncertain, this sequencing of policy decisions would be in line with our central scenario since February.

- Overall, notwithstanding today's forecast upgrades, the RBA continues to forecast persistent spare capacity in the labour market over the coming years and inflation well below the mid-point of the 2-3% target band. Particularly given the increasing emphasis on full employment as a "high priority", we expect the RBA to delay the cash rate lift-off to May 2024 and note a rising risk that the conventional QE program is extended on an ongoing basis until strong growth in wages confirms that full employment has been achieved.

J.P.Morgan: Before today, the concluding sentence was that the Board "does not expect these conditions (to hike) to be met until 2024 at the earliest." Now, it is "unlikely to be until 2024 at the earliest". The distinction between a baseline expectation, and the distribution around that baseline ("unlikely" to be wrong) is important for YCC, which is based on grounds of the board's confidence that the cash rate won't be going up by 2024.

- The governor's statement also commits for the first time to the future decision date on YCC. This decision will be made in July (the natural midpoint between bonds is either July or August). Moving in July means this week's quarterly SoMP will be the last one before the next YCC decision, so the staff's forecasts for wages (and the upside scenario) in that document will be important.
- The decision on QE3 is also going to be made at the July meeting, three months before the current program ends. Most roads lead to extension. Deciding early means the Fed's tapering discussion will be less advanced, increasing the likelihood of another round. And were the Board not to roll YCC at that meeting, the motivation to extend QE would no doubt be stronger, as some sort of offset. The language on QE recently has suggested the bar to extend is low (it will happen if it will "assist" objectives), and today's statement continues that tone. Of course, it still seems that YCC is a lot more powerful than QE, and RBA officials appear to think this too. So it's not clear why, in the current framework and given their forecasts, they would extend the weak instrument instead of the strong one.
- Today's statement previews the staff's SoMP forecasts, which as expected will involve upgrades. The labour market has performed well and the unemployment rate is now expected to be 4.5% at the end of 2022 (previously 5.5%). Notwithstanding the "strong recovery", CPI data showed "inflation measures remain subdued...a pick-up in inflation and wages growth is expected, but it is likely to be only gradual and modest." Further, the central bank is swinging for the fences on unemployment, as the board "places a high priority on a return to full employment."
- Commentary on housing is also evolving in a dovish direction, in that it is becoming more difficult to describe the uplift as an orderly early-cycle upswing without well-preserved lending standards. Previously the commentary had noted the strength of first home buyers at the expense of (presumably, riskier) investors. Reference to "strong demand from owner-occupiers, especially first home buyers" remains, but mention of the investor segment which has sharply accelerated was pulled. Given the assumed long road to monetary policy targets, the natural resolution here is a tightening of prudential standards, which we expect to happen relatively soon.

NAB: NAB's view has been that the RBA's unconventional policy settings would be increasingly challenged this year by a sharper than expected fall in the unemployment rate. The RBA today sharply upgraded its baseline forecasts for economic growth and substantially reduced its unemployment forecasts, to be in line with NAB's forecasts. The changes confirms our view that the RBA will not extend their 3yr yield target from the April 2024 bond to the November 2024 bond. Today's Statement noted that the Board will make this decision at the July 2021 Board Meeting. It will also decide at that meeting whether to undertake a 3rd round of QE. Supporting our assessment on YCC, the RBA has lowered its unemployment rate forecasts to 4.5% by the end of 2022 (previously 5.5%), which is at the bottom end of model-based NAIRU estimates (NAIRU is pegged around 4.5-5.0%). In the February 2020 (pre-Covid) SoMP, the RBA's low forecast for unemployment was 4.8%!

- While there is a lot of uncertainty around where NAIRU is, the RBA has fed some of this improved outlook into its core inflation forecasts, which are now expected to touch the bottom of the 2-3% target band by mid-2023 (previously 1¾%). In NAB's view, with core inflation likely to be back within the band in H223 and more sustainably in 2024, this is another reason the RBA does not need to extend its YCC target. As for QE, it is more likely the RBA will taper purchases in a 3rd round, though we will wait until the Federal Budget next week (11 May) for the profile of government debt issuance. To be clear, our view of the RBA

not extending YCC and tapering QE in another round does not affect our view on the main monetary policy tool, the cash rate, which we still expect to be on hold until 2024. A decision not to extend YCC however would enable the RBA to move back more fully to outcomes-based guidance, which would make monetary policy more flexible to developments in the economy, especially wages.

RBC: The RBA's post board meeting statement struck a hawkish tone in our view strengthened by material although not unexpected revisions to its key macro forecasts which will be detailed in full in Friday's SoMP. There were several important takeaways.

- Firstly, the macro revisions confirm a stronger recovery and faster progress on labour market slack. GDP for 2021 has been revised up to 4¾% (from 3½%) and the UR is now expected to be 5% by end 2021 (prev. 6%) and 4.5% by the end of 2022 (prev. 5.5%). Importantly, core CPI is now expected to be 2% by the end of the forecast period, Jun 2023, (prev. 1¾%) and effectively back within target. We had flagged this possibility in our Q1 CPI note despite the miss in Q1 inflation.
- Secondly, the RBA has suggested that it will consider whether to shift the 3y YCC target bond to the Nov-24s and whether to expand QE further at its July meeting. This is slightly earlier than our base case of August although we did toy with July given that the RBA will have the key April and May labour force reports by then where the bulk of the impact of the end of JobKeeper will likely emerge. It suggests that labour market developments remain key in policy deliberations and we note the stronger starting point, elevated leading indicators, and encouraging partial data from the ATO post the end of JobKeeper. As has been the case for much of 2021 thus far, the RBA looks to be on the front foot with this July commitment.
- Thirdly, the key final paragraph has been tweaked less dovish in our view. The RBA now suggests that it is committed to highly supportive conditions to "support a return" to full employment and within target inflation rather than "until its goals are achieved". We may be reading too much into this but coupled with the macro revisions suggests that the bar has been lowered somewhat to maintain these highly supportive conditions.
- These takeaways are consistent with our base case - the end of the TFF in June, no extension of the 3y target bond to the Nov-24s and a QE3 program towards the bottom of our A\$75-100bn range. Like fiscal policy, monetary policy is being recalibrated for recovery. Key measures implemented at the depths of recession and uncertainty can be pared back as confidence in the recovery strengthens. We expect a step up in discussion around QE3 in the coming months and can see merit in greater flexibility in the next program to accommodate changing circumstances in recovery including global policy settings. A QE3 program of A\$100bn over a longer time frame has merit as does a weekly purchase program that is open ended. To capture this emerging shift in policy settings, we continue to monitor an appropriate level to enter a paid front-end position.

TD Securities: The RBA left all policy settings unchanged, yet the RBA managed to surprise us, upgrading all key forecasts more than we anticipated. Further the RBA stated the decision on the Yield Curve Control (YCC) Target bond and QE will be made at the July meeting, not August as we had expected.

- The RBA tempered its key economic upgrades by indicating inflation pressures remain subdued. With the RBA not having the Q2 CPI print in hand before the July meeting and assuming no change to the economic outlook, the Bank essentially has the May and June employment prints for guiding policy.
- The most notable shift apparent in today's statement was the Bank's thinking around employment and inflation. The Bank removed reference to 'considerable spare capacity', that 'unemployment is still too high' and 'underlying inflation is expected to remain below 2 per cent over the next few years'.
- In light of this hawkish interpretation, we reaffirm our change of view we issued last week - we don't expect the RBA to extend the YCC target bond to Nov'24s, but expect the Bank to deliver A\$100b in QE3. While Nov'24s are closer to pricing for no YCC extension, expect these bonds to underperform while forward starting swap steepeners should perform.

Westpac: While we expected the Bank to revise its forecasts for the unemployment track the revisions are slightly more optimistic than we had expected.

- In turn that fed into a substantial lift in the 2021 growth forecast to well above Consensus (AFR April 6 survey Consensus was 3.8% when Westpac was at 4.5%) and a modest 0.25% lift in the inflation forecasts.
- It will now be interesting to see in the May SOMP on May 7 the size of the revision to wages growth (mid 2023) which is currently 2%.
- Even if it is lifted to 2.5% in the SOMP on Friday it will still be difficult to see wages growth at 3% + through 2024 supporting the view that the conditions for a rate increase will not be met “until 2024 at the earliest”.
- As noted above Westpac confirms that it expects an extension of YCC and a new \$100 billion QE program to be announced at the July Board meeting.