CIO MONTHLY NOTE

August 2016

RBA cuts to record low as reporting season gets underway

On the first Tuesday in August, the RBA cut the official cash rate to a record low of 1.50%. Why did they do it? And are there any more rate cuts to come?

The RBA decision was almost entirely due to weak inflation. Late in July, the ABS reported that headline inflation came in at only 1.0% and underlying inflation 1.5%. Both measures are well below the RBA's 2-3% inflation target.

Following the rate cut, the RBA released its quarterly Statement on Monetary Policy which contained the bank's updated forecasts for both growth and inflation. Real economic growth is forecast to be solid at around 3% but inflation is expected to remain below the mid-point of the target band until at least the end of 2018.

What's driving this trend in inflation? There are a number of factors that have all come together to drive inflation lower. Firstly, Australia no longer has the mining boom to support prices in the economy. This drag is most apparent in nominal GDP which is actually growing slower than real GDP—a very rare occurrence.

Secondly, Australia is a small open economy and is beholden to global economic forces. The global economy is currently battling outright deflation and Australia can only swim against the tide for so long.

Thirdly, the Australian economy is facing increased competition in some key industries which is putting downward pressure on prices. These include the NBN disrupting the telco industry and international competition entering the local retail industry.

Finally, wages growth is at historic lows. This is partially due to the weak nominal GDP growth environment but also the switch from high paying mining jobs to lower paying and mostly casual services jobs.

Is the RBA finished cutting rates? Given the persistent nature of some of these disinflationary forces, in my view, it is unlikely that the RBA has finished cutting rates. Rates are indeed heading even lower.

A key factor in the RBA's decision will be the Australian dollar. Surprisingly, the AUD actually rose after the RBA's rate cut which is a strange outcome until you consider the broader global monetary environment.

Currently, the ECB, BoE and BoJ are all undertaking, or expected to undertake, additional easing and the Fed is on a very gradual tightening path. With Australia's still relatively high interest rates, it is hard to see a structurally lower AUD any time soon which will be a challenge for some companies going forward.

As we head into the critical August reporting period, where the report card on the health of Australian companies are dissected publicly, a persistently lower cash rate is important to help drive a broad based recovery for corporate profits.

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