Curve

RBA Recap

- The RBA lifted the cash rate another 25bp to 3.10% at the December meeting.
- There was little change in the accompanying statement with only a few insights into any change of narrative in the new year.
- Looking back over the last 12 months and monetary policy is a long way from where, economists, market commentators and market pricing were suggesting.
- Will we see a similar a similar phenomenon over the year ahead?

Market Dynamics

- Competition for funding heated up heading into the holiday break.
- Smaller ADIs are having to go above and beyond to sure up funding.
- The shorter end of the Curve is seeing very rare margins and rates. But how long will the squeeze last?

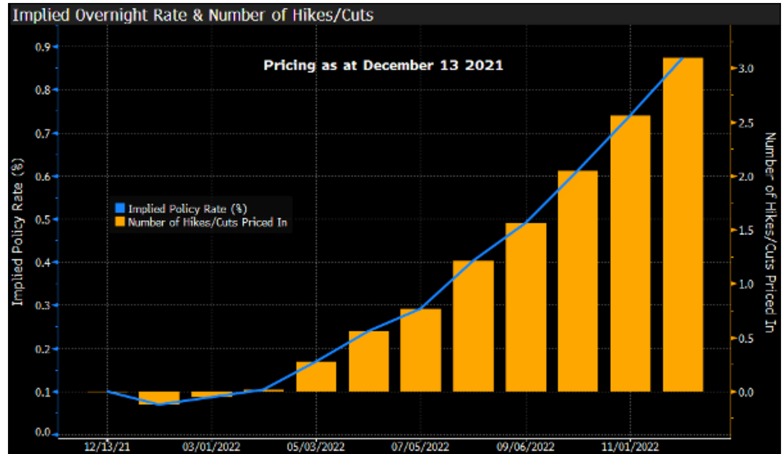
The Australian Economy

- The Australian economy experienced a robust resurgence over 2022.
- Activity accelerated as restrictions eased back and a more normal operating environment resumed.
- Data over the last month suggests that the speed of expansion has peaks and activity is under pressure from rising rates and inflation.
- What can we expect from the economy going into the new year?

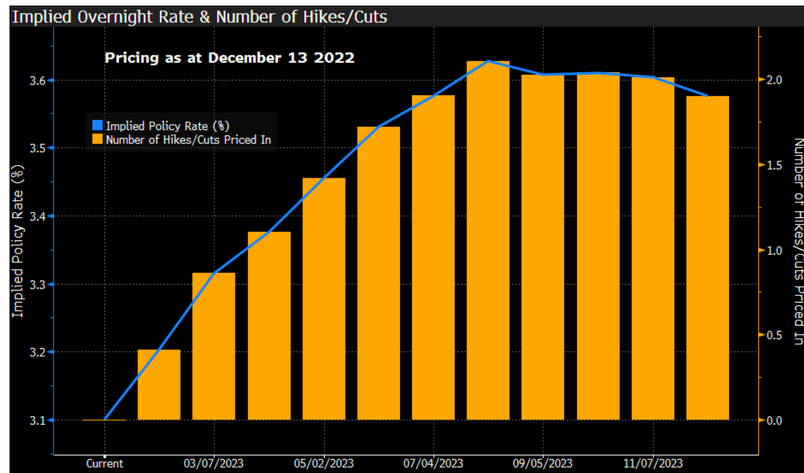
RBA Recap

RBA: Expect the Unexpected, Expect the Extreme

What a difference a year makes. This time 12 months ago, the market was still timid in its rate hike expectations despite forcing the RBA to walk away from its yield curve target a couple of months earlier. For 2022, the market was expecting the first rate hike of the forthcoming tightening cycle to come in August. It was only expected to be a 25bp move followed up by two further increases in October and December, leaving the cash rate at 0.85% at the end of the year. This was despite the RBA still articulating that they didn't expect the cash rate to rise until early 2024



When it comes to financial markets, one should expect the unexpected and expect the extreme. While trends can become obvious, often the speed, and scale of moves in markets can catch even the most avid market watchers out. For example, who would have thought that oil futures could of fall below $0, let alone fall to almost -$40 a barrel as we saw in 2020.

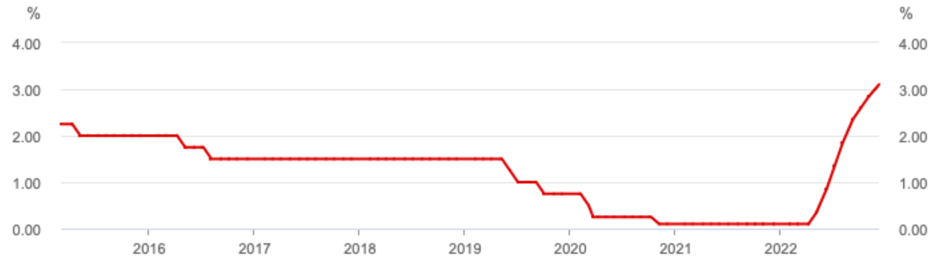


Such was 2022 when it came to the economy and interest rates. Australia was long left behind as inflation surged around the globe. However, inflation eventually kicked, and the economy roared back to life as restrictions were lifted. After staunchly providing strong forward guidance designed to underpin business and consumer confidence in the outlook, the RBA was forced into an about face and embarked on the tightening cycle 3 months earlier than the market had been expecting in December in 2021.

With such a strong inflation impulse coming from offshore at a time of improving domestic demand, the RBA needed to remove the emergency levels of stimulus that the record low cash rate was providing and needed to remove it quickly. After an initial 25bp move that reset the narrative, the RBA then lifted the cash rate by 50bp in 4 consecutive meetings. While the size of the increases was smaller than some implemented by other central banks, the more frequent meetings of the RBA compared to other central banks meant our tightening cycle was one of the quickest by developed central banks.

Three more 25bp moves later and the cash rate target has risen by a cumulative 300bp in the space of 8 months. That is something not even the most aggressive of forecasts would have anticipated 12 months ago.

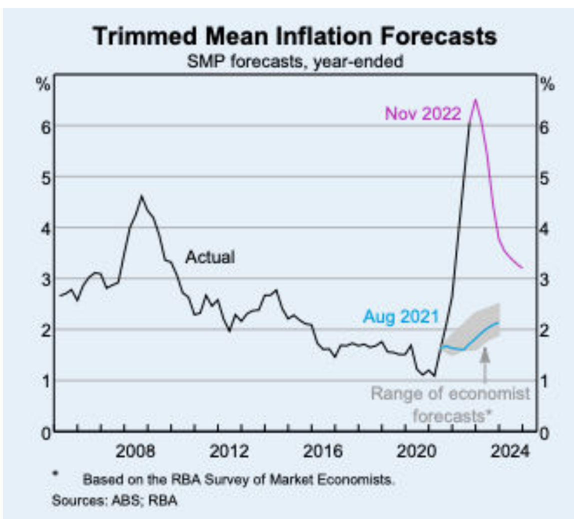
Curve



Following their latest meeting in December, the RBA indicated that the job of taming inflation is not done yet. They indicated that further tightening would be required, saying *"The Board expects to increase interest rates further over the period ahead, but it is not on a pre-set course."* So, what can we expect from the RBA and interest rates in the year ahead?

Current market pricing suggests that the RBA will deliver two more 25bp rate hikes in 2023, taking the cash rate to 3.60%, before we see an extended pause. Timing on exactly when they will occur is not clear. The median forecast of economist also sees the cash rate peaking in this cycle in the second quarter of 2023, suggesting at least one tightening in Q1 followed by one final increase March or in Q2. The range of forecasts is quite wide with some expecting that the RBA will pause at the current cash rate target level of 3.10% in 2023, while others have the cash rate heading north of 4%.

One thing that seems more certain is that the end of the tightening cycle is close. Inflationary headwinds from offshore are easing. Inflation data in other developed nations appears to have peaked, most commodity prices are off their highs, shipping costs are easing and supply chains issues are dissipating. Demand side data is also rolling over with composite PMI survey's falling back towards 50, suggesting expansion has stalled in the manufacturing and consumer sectors.



The challenge for the RBA is that given we have lagged the global cycle on inflation, and we still heavily rely on quarterly inflation data for decision making, it will take longer for the peak in inflation in Australia to become widely apparent.

With no scheduled meeting for the RBA in January, the next update we will received is at their February meeting. Between now and then we will get plenty of updates on the state of economy, monthly inflation reads and the Q4 inflation data in late January. We will also get a further two months of international data which should paint a much clearer picture of the international outlook.

By the time we get to the RBA's February meeting, it will likely become clear that the RBA will need to do less, not more, to return inflation to the target band. Tighter monetary policy along with inflation are already starting to have an impact on aggregate demand and as more fixed rate mortgages reset in 2023, this impact will only grow. As such, if the RBA is going to tighten any further, we should see it at the February meeting along with a shift in the narrative that will be accompanied by a pause.

David Flanagan – Head of Money Markets

Markets Recap

Funding Dynamic

The past month has seen competition for wholesale funds pick up significantly. Initially, liquidity was abundant at times and like previous months, was characterised by healthy competition that benefited investors. However, this month's competition has increased markedly. Many ADIs seem to be pre-emptively seeking funds in order to sure up positions before holiday outflows. This dynamic has seen an increase in rates over the past two weeks as liquidity is sparse.

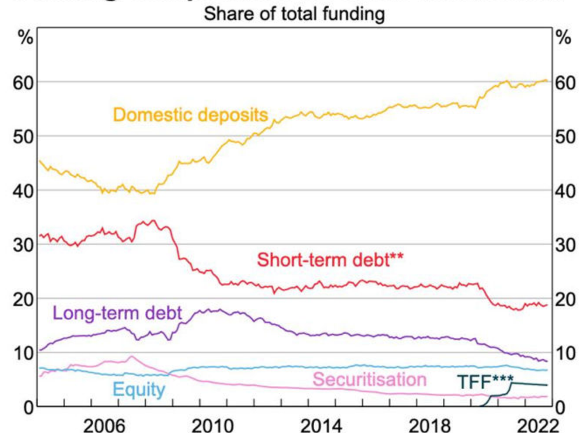
Currently, the wholesale term deposit market is experiencing a liquidity squeeze as we head into the holiday season. Historically, the period ahead is typified by increased outflows as consumers spend money on travel, leisure, and family activities. Paired with this, is an activity downturn as most investors are running on limited resources and staff. A proactive approach by most middle/small sized ADIs has been taken over November/December to counter this. ADIs have elected to compete, paying elevated rates across the curve, to minimise the risk of potential cash flow or liquidity risk further down the road.

With reference rates largely stable over the period, a widening of margins has been driven mainly by this increased demand resulting in some ADIs willing to pay elevated rates to attract deposits.

On a broader note, big banks push to seek out funding through deposits has seen retail rates rise significantly, further driving elevated rates across all deposit areas. As investors begin to move cash away from at-call and notice accounts, which during the pandemic offered relative value, the competition to entice deposits has increased. All forms of deposits account for 60% of banks funding in Australia.

Funding Composition of Banks in Australia*

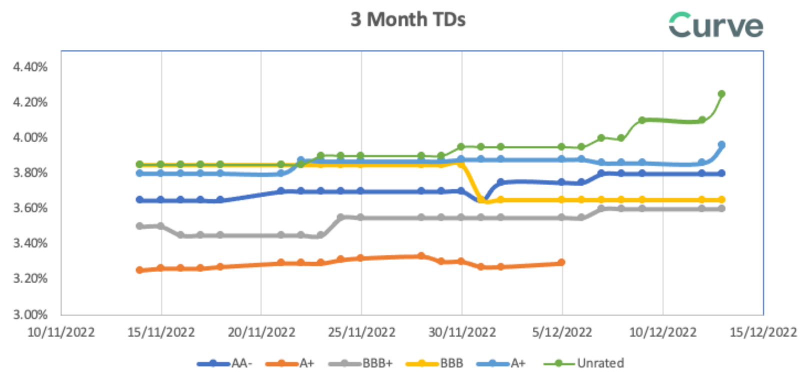
Share of total funding



* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis.
** Includes deposits and intragroup funding from non-residents.
*** Term Funding Facility.
Sources: ABS; APRA; Bloomberg; RBA; Refinitiv; Standard & Poor's

To attract term deposit funds, which from a regulatory perspective are favourable on the calculation of liquidity positions, there has been significant increase in retail and business deposits. This has heated up across the whole market from the big four down to small mutuals. This dynamic puts upward pressure on interest rates, driving wholesale rates even further up and seeing a significant margin materialise above reference rates.

Rate Movements



There has been a lot of movement in the Term Deposit spreads over the month with elevated rates producing substantial uplift in returns. BBB rated ADIs were the most impressive credit rating sector, with liquidity demand providing daily off rate sheet specials from numerous ADIs. 12 month TDs peaked at 4.70%, while 6 month peaked at 4.40%. However, as we headed into December, we saw a squeeze in 3 month funding. Consistent rates around 4% were offered from Unrated ADIs, with the highest offer being seen at 4.35%.

Key Market Moves

	Latest	1 Month Ago	Change
Cash Rate	3.10	2.85	0.25
3M BBSW	3.15	3.03	0.12
6M BBSW	3.56	3.55	0.01
1 Year Swap	3.59	3.64	-0.05
3 Year Swap	3.62	3.85	-0.23
5 Year Swap	3.80	4.14	-0.34
3 Year Futures	3.12	3.33	-0.21
10 Year Futures	3.45	3.77	-0.32
AUD	0.69	0.67	0.02
ASX 200	7251	7142	110
US 2 year	4.21	4.39	-0.18
US 10 year	3.47	3.85	-0.38
US 30 year	3.52	4.04	-0.51
USD Index	103.59	106.66	-3.07
Dow Jones	33966	33537	430

With the swap curve flattening and the one year swap even dropping below 6 month BBSW at the time of writing, it is clear we are now in a supply and demand dominated market, as TD rates are being set off demand rather than spreads. Whilst there is likely still more interest rate movement to go for the RBA in 2023, it is clear we are starting to slow down. This is reflected with the back end of the curve flattening, and 2yr BBB TDs hovering around the 4.60% mark, down from 5% last month.

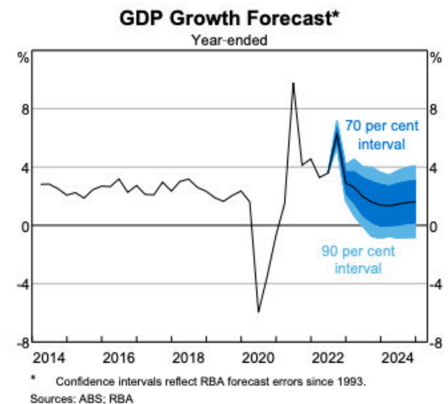
With NCD margins consistently hovering around the +30-35 mark for the past few months, we started to see an increase over the month of November to +40 and peaking around +50 in the first weeks of December. With TD rates being detached from spreads, the gap between NCDs has widened, resulting in less flow.

Hilton Ovenden & Jack Pedersen – Associate, Money Markets

The Australian Economy

Australian Economy – Stall Speed

The Australian economy had been a picture of health throughout most 2022 and it was one of the big reasons behind the speed in which the RBA has reduced the level of stimulus being provided by monetary policy. As restrictions ease and things got back to normal, activity was robust as consumers and businesses played a bit of catch up.



As we close out the year, the latest data suggests that the peak acceleration in activity witnessed throughout the year is fading and the economy slowing to a level more akin to stall speed. Stall speed is usually the term used to describe a low growth environment that is susceptible to an economic shock, resulting in a fall in activity, or even a recession.

Monthly Data

	Period	Value/Index	MoM	YoY
TD-MI Inflation	November	128.24	1.0	5.9
TD-MI Trimmed Mean	November		0.7	4.9
Unemployment Rate (%)	October	3.4	-0.1	-1.9
Total Employment ('000)	October	13,618	32.2	762.0
Full Time Employment ('000)	October	9,526	47.1	576.2
Part Time Employment ('000)	October	4,092	-14.9	186.0
ANZ Job Advertisements	October			
NAB Business Confidence	November	-4.4	-4.2	-27.1
NAB Business Conditions	November	20.3	-1.7	10.2
NAB Employment Index	November	12.5	-1.7	6.4
Consumer Confidence	November	80.29	2.3	-25.0
Retail Sales	October	$35,018	-0.2	12.5
Trade Balance ($m)	October	$12,217	-$227	$2,083
Exports ($m)	October	$60,066	-0.9	38.4
Imports ($m)	October	$47,850	-0.7	43.8
Housing Finance Ex-Refi ($m)	October	$25,786	-2.7	-17.1
Housing Finance O/O Ex -Refi ($m)	October	$17,165	-2.9	-17.2
Housing Finance Inv Ex-Refi ($m)	October	$8,622	-2.2	-17.0
Building Approvals Total	October	$15,382	-6.0	-6.4

Some of the data over the month consisted of a fall in retail sales (October), a fall in building approvals (October) for both private housing and multi-density dwellings, a fall in house prices (November), a fall in the pace of new lending across all metrics (October), and a fall in both imports and exports (October). On a slightly more positive note, employment growth was ok, and wages growth was a little stronger than expected.

Capping off the data run for the month was the latest national accounts data, which saw the economy grow by 0.6% for the third quarter. The increase in activity saw the annual rate rise to 5.9% which was short of the 6.3% pace that was expected. The jump in the annual rate was largely a result of the big negative quarter from the same time last year dropping out of the calculation. We will see a reversal in Q4 when the quarterly jump of 3.8% in Q4 drops out.

According to the RBA, growth is expected to continue to slow, with the annual rate to drop below 2% over the year ahead. That will take the growth rate into the 'stall speed' territory. That is why the RBA continues to reference the "narrow path" they are walking in order to get inflation back into the target band, while not knocking the economy over.

Quarterly Data

	Period	Value/Index	QoQ	YoY
GDP ($m)	Q3	$552,547	0.6	5.9
CPI	Q3	126.1	1.8	7.3
CPI - Trimmed Mean	Q3	124.7	0.7	6.1
House Prices	Q2	196.1	5.3	27.5

The RBA expected growth to slow to between 1% to 2% by mid next year and remain there until the end of 2024. That gives the economy very little wiggle room to withstand an economic shock,

should we experience one over that time frame. It also gives the RBA little breathing room should they overstep the mark and tighten policy too far in their attempt to get inflation back to the target band too hastily.

David Flanagan – Head of Money Markets

This document is intended to provide you with general information only. It does not take into account your investment objectives, financial situation or particular needs. Before acting on this information, you need to consider the appropriateness of the information in lieu of your investment objectives, financial situation or needs.