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AUSTRALIA

RBA Preview: A tough call, but not a hard decision

There are good reasons for the Reserve Bank of Australia to cut at its meeting on Tuesday. Good ones to pause too. This is a hard one to call. One thing is clear, they haven't stopped easing yet



Reserve Bank of Australia Governor Philip Lowe

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1.25%

RBA current cash rate target

Consensus is for a cut to 1.0%

A cut or a pause - it doesn't really matter

Whether or not the RBA decides that a back-to-back cut is warranted at this meeting, or whether they decide to leave things for a bit and ease further at a future meeting, say August, will make very little difference to the economy. Not will it make much difference to the unemployment rate outlook, and consequently the future for inflation relative to its 2-3% target. So, let's take a look at the pros and cons.

All those in favour...

The following is not an exhaustive list, but represents what we believe to be the main arguments for a rate cut at this week's meeting.

1. The market has priced it in (78% anyway), though simply doing what the market wants merely increases its appetite for more. It's a dangerous way to play policy, as the US Fed will likely soon find out.
2. The consensus forecast leans slightly in favour of a cut, with the big Australian Bank Chief Economists, many with an RBA pedigree, almost all veering towards a cut. But then they may be being swayed by the market pricing. There could be a bit of what the statisticians call multicollinearity here, or in English, 1 and 2 are different ways of saying the same thing.
3. The rate cut last month won't be enough to make a meaningful dent in the RBA's inflation target gap, so more needs to be done.
4. With the Fed leaning towards an easing, this diminishes the likely effectiveness of the AUD depreciation channel, so the RBA will need to do more than if they were keeping policy unchanged. Indeed, the AUD has recovered back to over 0.70 since its run at 0.68, and the RBA would probably like to see it back below 0.70 again.

All those against...

On the other side of the argument:

1. Since last month's decision, there has been minimal newsflow - services and manufacturing PMIs have actually improved. 1Q19 GDP at 0.4% wasn't all that bad. The labour data was weak, but that often precedes a better month, with part-time jobs converting to full-time. Importantly, we have no new data on inflation or wages.
2. Knowing full well they have limited ammunition, the RBA will be keen not to squander it unnecessarily. If a cut isn't needed this month, then a further rate cut is best saved until it *is* needed. It would be awkward to need to cut in several months and have nothing left.
3. The Trade war hasn't actually got any worse, and the Osaka meeting at least opens the door to a deal at some stage, though maybe not imminently.
4. The Fed didn't cut at their last meeting, though it looks pretty clear that it is only a matter of time. Nevertheless, there is no catch-up to be done.

And the winner is...

For completeness, here are some of the most recent quotes from RBA governor, Phillip Lowe, with our take on whether they represent a marginal argument for cutting (dovish) or a pause (hawkish).

- Philip Lowe is "very hopeful" that policy rates will not need to go into negative territory (hawkish)
- "A cut of a quarter percent in interest rates has helped but realistically, it, by itself, is not going to be enough" (dovish)
- "...it's reasonable to expect a further cut in interest rates at some point, whether it will be (at the July 2 policy meeting) in Darwin or at some other point. We'll have to wait and see." (dovish)
- "I don't expect that we'll have to get down to the very low interest-rates that other countries did. We have the capacity to do it if we need to" (hawkish)
- "What we're hoping to do is put ourselves on a better path and we don't need a massive change in interest rates to do that." (hawkish)
- "Fiscal policy and structural policies have a role to play, so I'm hopeful, and I think it's realistic to expect us to be able to keep away from these very low rates and unconventional measures." (hawkish)
- "It's clearly the case that a weaker U.S. dollar, whether that would come from lower U.S. interest rates, would be a complication for us. Because a weaker U.S. dollar, all else equal, means a stronger Australian dollar and we don't need that at the moment. (dovish)

As we said at the beginning, it doesn't really matter all that much what the RBA does at this meeting. We think the balance of risks is actually that the RBA pauses, but they will raise rates soon after if so; in the greater scheme of things, the difference between a cut and a pause is marginal.

AUD: the long-term outlook remains clouded

The trade truce between the US and China has been a short-lived boosting factor for AUD, as a weak Chinese PMI read lifted concerns on the export-oriented Australian economy. Given such contrasting drivers, the RBA meeting will be crucial to either fuel a further drop or a rebound in AUD/USD.

We believe that, on the day, the balance of risks for the AUD appears skewed to the upside, considering that the markets may have overstated (78%) the probability of a rate cut at this meeting. Furthermore, the persistent market's short positioning on the AUD suggests a higher potential for upside pressure as positions are squared.

In the longer term, external factors will likely be the predominant drivers of AUD/USD and the lack of a clear resolution in the US-China trade tensions suggests that a re-escalation is still possible. A cut in July or August by the RBA may, therefore, have a limited impact on the long-term AUD outlook. As long as the central bank maintains its easing bias, the upside potential for AUD will likely be limited, leaving it to trade-related news to move the market.

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