Australia: Reserve Bank hikes 50bp

The Reserve Bank of Australia (RBA) has surprised markets with a larger than expected hike of 50bp, taking the cash rate target to 0.85%. When it comes to the Aussie dollar, we continue to see downside risks in the short-term, as a more bullish RBA has failed to lift the currency and China's economic outlook remains highly uncertain.

Reserve Bank of Australia Governor Philip Lowe

Source: Shutterstock

0.85%

Cash rate target

+50bp

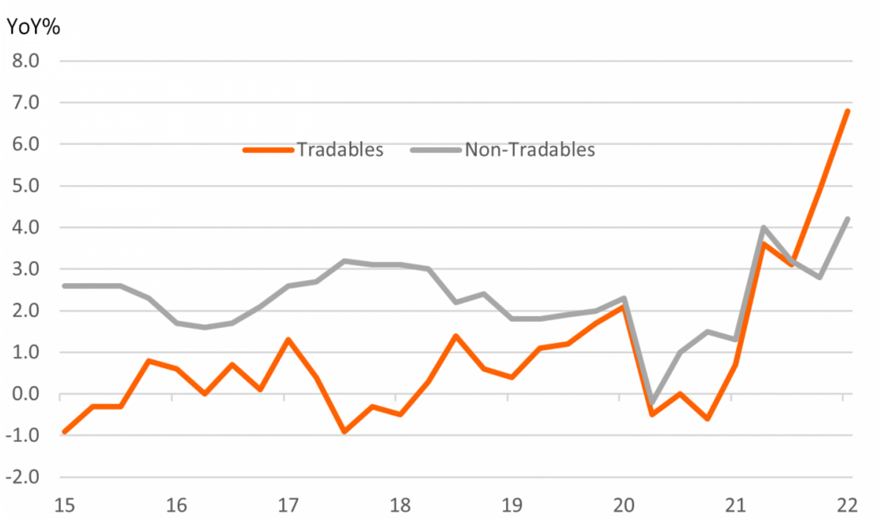
Higher than expected

25bp hike would have been a disappointment

We are a little surprised that before this latest RBA decision, the market felt that a 25bp rate hike was more probable than a larger amount. The main uncertainty for us was that the RBA might choose to demonstrate a slightly more dovish stance than the US Fed to prevent the AUD from rallying too hard, which might explain why there were one or two 40bp rate hike predictions buried in the consensus.

But the argument for a larger 50bp hike was strong. The CPI inflation rate is well above the RBA's target (2-3%) at 5.1% YoY. Global price pressures - while maybe peaking in some places - don't show much sign of a reversal. Add to that the robustness of the Australian domestic economy (consumer spending and construction are both strong), and a 25bp hike would have looked pretty lame. As things stand, it feels like without some fairly punchy central bank action, it could take a long time before Australian inflation drops back to an acceptable level.

Australian inflation - Tradable vs non-tradable



Source: CEIC, ING

Tradable vs non-tradable

Governor Lowe's statement doesn't say anything too specific about the future, with this extract from the final paragraph probably the most pertinent "*The Board expects to take further steps in the process of normalising monetary conditions in Australia over the months ahead. The size and timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market*".

With inflation released only quarterly, we won't get any new insights into how this is shaping up until late July, when 2Q CPI is released. The 2Q22 wage price index is not released until even later (August 17).

That probably means that the RBA will in the near term have to put greater weight on more timely indicators, such as developments in the labour market and the unemployment rate, as well as the RBA's liaison programme which is delivering real-time information about wage growth to the Bank. We don't have access to that wage information, so will have to rely more heavily on the labour data plus any hints about wages that the RBA drops into speeches.

What comes next? The RBA has maybe bought itself a bit of time with this larger-than-expected hike. As it meets more frequently than the US Fed, it doesn't need to keep up this pace of tightening at each meeting to remain more or less in step with the Fed. So we may see a reversion to 25bp at the next meeting. However, there is still a long way to go. Many analysts reckon

Australia's neutral interest rates lie somewhere around 3.5%. With a lot of Australia's inflation being imported from overseas, it may not require rates to rise quite that high at their peak in order to choke off inflation.

FX: AUD downside risks persist

The Aussie dollar showed an unusual reaction to the above-consensus rate hike by the RBA, jumping to the 0.7250 mark before immediately reverting to sub-0.7200 levels, and now trading at pre-meeting levels. All this happened despite 2-year AUD swap rates jumped more than 20bp to 3.50% this morning. We see two reasons behind the AUD's very short-lived positive reaction:

First, the link between AUD/USD and short-term rate differentials has been very weak since the start of the year, and our short-term fair value model shows that global and domestic equity performance explain a much larger chunk of short-term moves in the pair

Second, AUD remains an unattractive currency due to the high uncertainty surrounding China's economic outlook, and markets may well maintain a somewhat structural bearish stance on AUD until they see China regaining economic momentum.

All in all, we see downside risks for AUD/USD from the current levels, given projected dollar strength during the summer and lingering uncertainty about China's demand outlook. We expect a return to 0.7000 in the short term, and a recovery to current levels only towards the end of this year.

Authors

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com