

Macro  
Australian Economics

## The RBA Observer

On hold next week: easing phase may be done

- ▶ **We maintain our non-consensus call that the easing phase of the RBA's rates cycle is done**
- ▶ **The recent rise in commodity prices, driven by a pick-up in China's growth, should support Australian incomes**
- ▶ **We expect the weak patch in Australia's economy is behind us and forecast growth to lift in H1 2013, supported by rising commodity prices and already low interest rates**

### Soft patch may be behind us

Locally, much of the recently published data have been on the weak side, including retail sales, employment and trade. The CPI for Q4 2012 showed that inflation was fairly benign. But, critically, almost all of these data pre-date the RBA's last rate cut and certainly pre-date its impact. These data have confirmed that there was a soft patch in the economy in late 2012 and vindicated the two rate cuts the RBA delivered in Q4 2012. But this is history.

Indeed, the soft patch appears to be behind us. We expect growth to pick up in H1 2013, supported by the recovery in China and already low local interest rates.

The very timely indicators for the Australian economy provide a hint of improvement. The weekly consumer sentiment measure has risen sharply and daily housing price data showed a pick-up in January. Business sentiment bounced back in December and new home sales have risen solidly. Equity prices have rallied recently, hitting a 20-month high.

China's growth has also picked up, driving a solid rise in commodity prices. HSBC's house view has China's growth rising to 8.6% in 2013 from 7.8% last year. Local income growth should be lifted by recent commodity price rises. The downside risks from the US fiscal situation and the possibility of a eurozone break-up have been pushed into the background and global risk assets suggest the world economy may have turned a corner.

Add to this that local policy settings are conducive to growth. The RBA cash rate is already at its historical low, mortgage rates are around 100bp below average, and we are yet to see the full impact of the RBA's last cut. Fiscal policy is also likely to be looser than previously expected, given the government's pre-Christmas announcement that it is no longer committed to pursuing a budget surplus in 2012-13. The federal election, which has been called for 14 September, may also see a further rise in government spending.

We retain our non-consensus call that the easing phase of the RBA's rates cycle is done.

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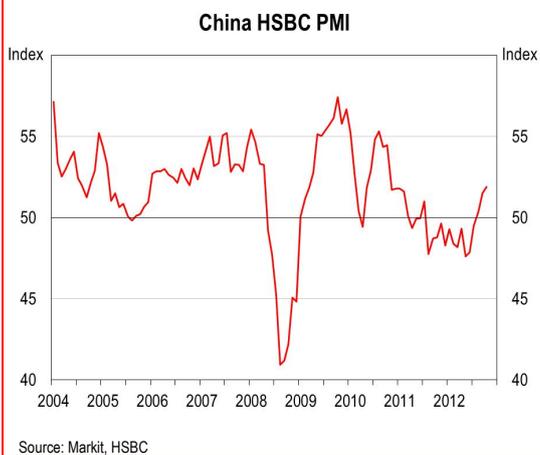
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1. China's growth is rising, driven by infrastructure spending



2. Chinese infrastructure investment has picked up



## China's cycle has passed its trough

China's economy has picked up further in the past couple of months. This has seen the HSBC PMI rise again in January to reach a 24-month high, now well above the survey's breakeven level (Chart 1).

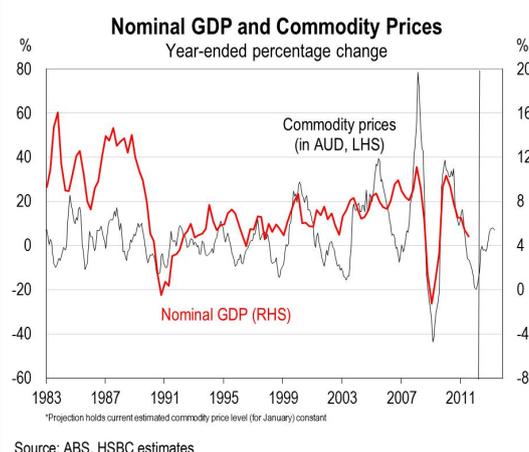
China's economy has been supported by a rise in infrastructure investment, as the authorities pulled forward work on over 20 subway lines, 12 major highways and a number of rail and airport projects. Infrastructure investment is now growing at over 20%, after falling around the middle of last year (Chart 2). The pick-up in China has lifted demand for commodities and seen a sharp rise in the iron ore price, in particular (Chart 3).

As many of these infrastructure projects are large and take a number of years to complete – the average duration is over five years – we expect them to support growth for some time and to support commodity prices. The recent bounce in commodity prices suggests that Australia's income growth is likely to have passed its trough in Q4 2012 (Chart 4). For further details on Australia's link to China, see [Downunder digest: Commodities, China and Australia](#), 24 January 2013.

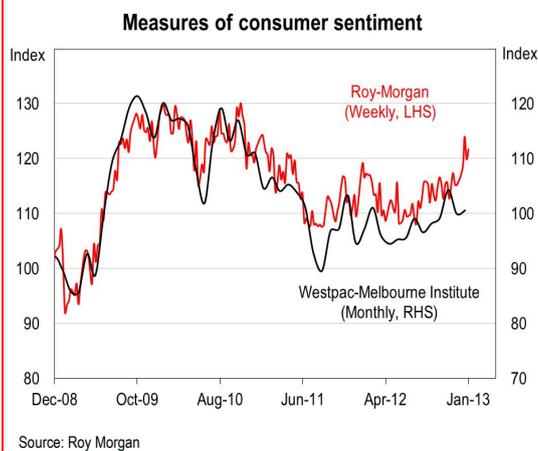
3. Commodity prices have bounced, due to China's pick-up



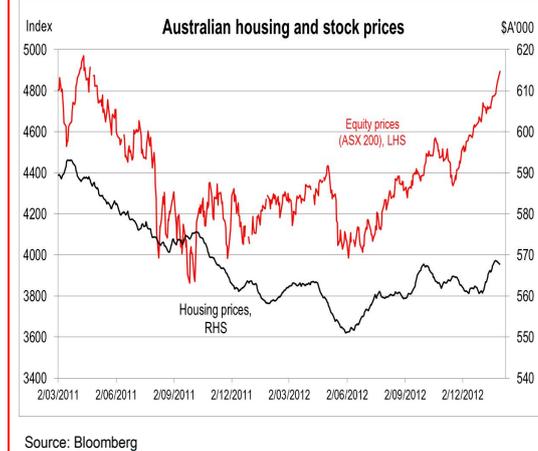
4. Incomes will be supported by commodity price bounce



5. Weekly consumer sentiment rose sharply in January



6. Housing and equity prices rising solidly in January



## Early signs that the local economy is lifting

Much of the recently published official data for the Australian economy have been on the weak side. Of course, not much of this data is for *this* year. Almost all the indicators that are typically tracked – retail sales, employment, trade, CPI and the main sentiment surveys – are for November, December or Q4 2012.

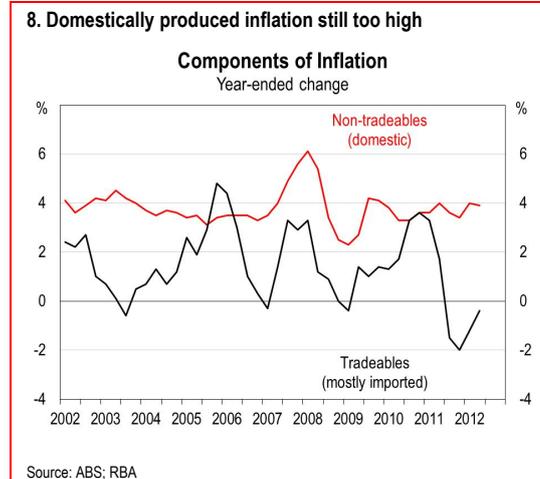
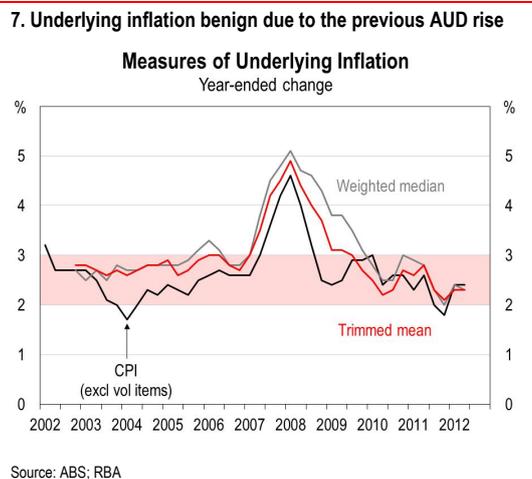
These data points have confirmed that there was a soft patch in the economy in late 2012 and vindicates the two rate cuts the RBA delivered in Q4 2012. But this is history. This information pre-dates the RBA's most recent cut and certainly pre-dates the impact of the cut on the economy. It also pre-dates the government's change of its fiscal stance.

The very timely indicators suggest economic conditions are improving. The weekly consumer sentiment measure has risen sharply (Chart 5). Daily housing price data also showed a pick-up in January and equity prices recently hit a 20-month high (Chart 6). This is expected to support growth in household wealth, which should encourage spending and bolster confidence. Even some of the December data provide some hints of improvement, with business confidence bouncing back strongly after a dire reading in November.

## Inflation low, but expected to rise

Some may argue that inflation is low, so the RBA can afford to cut further. Our view is that Q4 2012 inflation numbers are less important for the rates decision than on previous occasions. This is largely because we see the RBA as already having responded to their expectation that inflation would remain low in Q4 2012 by cutting in December, and the impact of this cut is yet to fully flow through to the economy.

There are also some worrying signs in the inflation numbers. Even though the underlying measures were well contained in Q4 2012, with the trimmed mean running at 0.6% q-o-q and 2.3% y-o-y, the domestically produced component of inflation – non-tradables – has remained stubbornly high (Chart 7 and 8). Indeed, the reason why inflation has fallen in recent years is because the prices of imported goods have fallen due to the appreciation of the AUD in 2009-10. But there are signs that the disinflationary impact of the AUD on inflation is starting to wear off. However, there are few signs that domestic price pressures have eased, partly because productivity growth remains weak. As such, we expect that inflation has probably passed its trough.



## Australia's great rebalancing act

We remain optimistic that Australia will see a smooth rebalancing of growth, from being led by the mining sector, as it was in 2012, to being supported by growth in the interest-rate sensitive sectors such as housing and retail sales (we set out this case in [Australia's great rebalancing act: Looking beyond the mining investment boom](#), 7 December 2012). Current policy settings seem appropriate to support that rebalancing, in our view.

A key factor supporting this view is that the mining story is not over yet. There is still further support for GDP growth from rising mining investment in H1 2013, as there is still significant work yet to be done on projects that are being built, particularly the large LNG projects. This means there is time for the other sectors of the economy to take over as the key drivers of growth.

A possible constraint to this smooth rebalancing of growth may be the high level of the AUD. However, much like its effect on inflation, our central view is that the drag on growth from the AUD will also wear off. Firms and households are adjusting to the new higher level of the AUD, with the biggest drag on growth is now likely to be behind us.

## Bottom line

We expect the RBA to be on hold next week, leaving the cash rate at a historical low of 3.00%.

We think that the easing phase of the RBA's rate cycle is done, which differs from the consensus view that there will be another cut in Q3 2013, and market pricing, which suggests 40bp of cuts over the next year.

### 1. HSBC's main forecasts for Australia

	Year-average (%)			Year-ended (%)							
	2012e	2013e	2014e	Q312	Q412e	Q113e	Q213e	Q313e	Q413e	Q114e	Q214e
GDP	3.5	2.9	3.1	3.1	2.8	2.4	2.7	3.1	3.5	3.4	3.2
CPI**	1.8	2.8	3.2	2.0	2.2	2.9	3.0	2.2	3.0	3.0	3.2
Trimmed mean**	2.3	2.8	2.9	2.3	2.3	2.6	2.7	2.8	2.9	2.9	2.9
Unemployment rate	5.2	5.2	5.1	5.2	5.4	5.3	5.2	5.2	5.2	5.1	5.1
Cash rate*	3.00	3.25	4.00	3.50	3.00	3.00	3.00	3.00	3.25	3.50	3.75

Source: HSBC estimates; \*end-period; \*\*Includes effect of carbon tax from Q3 2012

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