

# Interest rates still falling, more to go

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## Key points

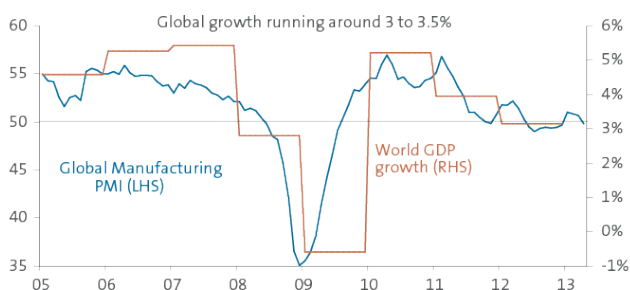
- > The Reserve Bank of Australia (RBA) has cut interest rates again and they are likely headed even lower, probably to 2.5%. Global interest rates also appear to be remaining low for an extended period.
- > Low and falling interest rates mean low and falling bank deposit rates. The chase for yield will continue.

## Introduction

When interest rates in major countries fell to zero through the course of the global financial crisis, most investors would have thought it would be temporary. But here we are five years later and there is no end in sight. The global economy is growing but not at a pace that uses up spare capacity, inflation is actually falling and there is still a debate in the US, Europe and Japan as to whether even more monetary stimulus is required. Similarly in Australia interest rates are still falling with the RBA cutting the cash rate to a record low of 2.75% and likely to have to cut even lower.

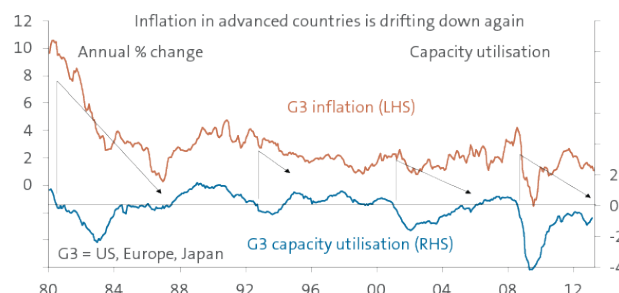
## Global rates to stay low

The risks to global growth have receded with Eurozone financial risks coming under control as evident by sharp falls in Italian and Spanish bond yields, strength in US housing providing an offset to fiscal tightening and China appearing to stabilise. However, global growth indicators are pointing to growth only slightly up from that seen last year. For example, global business conditions purchasing managers' indices (PMIs) are running around levels consistent with around 3% to 3.5% global growth.



Source: Bloomberg, AMP Capital

This is far better than the feared return to recession of the last few years. But it's still below potential and not enough to use up spare capacity. Put another way the world is still awash in excess savings. Reflecting this, there is no sign of the hyperinflation some had feared would follow from monetary printing. In fact, quite the reverse, inflation rates are now falling with US inflation just 1.5% in the year to March and Eurozone inflation just 1.2%. This is being reinforced by a downtrend in commodity prices.



Source: Thomson Reuters, Bloomberg, AMP Capital

Against this backdrop, it's virtually impossible to see global interest rate hikes this year and hard to see them next year.

## Australian interest rates still headed lower

The basic issue in Australia is that the slowdown in mining investment growth is now looming and we need to see a pick-up in non-mining activity to fill the gap in terms of the contribution to gross domestic product growth. While this was never expected to occur smoothly, the evidence to date points in the direction of non-mining activity not picking up quickly enough. To be sure interest rate cuts have got some traction: the home buyer market has improved with increased sales, auction clearances and house prices, consumer confidence is up and retail sales are up. But the response has been tentative and weak. It's now 18 months since the RBA first started cutting the cash rate from 4.75% in November 2011. The next table shows the level or percentage gain in key economic indicators 18 months after the first rate cut for the current and last three interest rate cutting cycles that started in July 1996, February 2001 and September 2008.

### Key variables, 18 months into rate cutting cycles

Variable	July 1996	Feb 2001	Sept 2008	Average	Latest
NAB business confidence index level	+5.7	+12.6	+16	<b>+11.4</b>	+2
Consumer confidence index level	101.7	105.6	117.3	<b>108.2</b>	104.9
Retail sales % gain since first cut	+5%	+9.8%	+8.4%	<b>+7.7%</b>	+4.5%
Home approvals, % gain since first cut	+18%	+60%	+35%	<b>+38%</b>	+5%
Auction clear rate, % Sydney, 4-week average	n/a	n/a	70.6%	<b>n/a</b>	73.6%
Auction clear rate, % Melbourne, 4-week average	n/a	n/a	78.7%	<b>n/a</b>	68.9%
Home prices % gain since first cut	+13%	+30%	+11%	<b>+18%</b>	+1.9%
Employment % gain since first cut	+2.1%	+2.4%	+1.5%	<b>+2.0%</b>	+1.5%
Private credit % gain since first cut	+14%	+16%	+2.5%	<b>+11%</b>	+4.5%

Source: NAB; Westpac/Melbourne Institute; ABS; Australian Property Monitors; RP Data/Rismark, RBA, AMP Capital

Apart from auction clearance rates, which look solid, all of these indicators are currently below the average level they attained this far into past easing cycles. Importantly:

- > While consumer confidence has picked up, business confidence remains subdued;
- > Retail sales picked up in January and February but the level of sales is still well below where it would normally be this far into an easing;
- > It's the same story with dwelling approvals which are off their lows but haven't seen the average 38% gain they would have normally seen by now;
- > Employment growth is also lagging; and
- > House prices are up, but their rate of increase is modest.

Several factors are driving the subdued response to interest rate cuts. Caution post the global financial crisis is a big part of the explanation. Immediately after the global financial crisis Australian business and consumers responded as if it was back to normal. The last few years have shown that it's not. Households are worried about job security after rounds of layoffs and asset price volatility which has affected their wealth. This has all led to a more cautious approach to debt and spending. This along with the strong Australian dollar has affected business confidence outside the mining sector.

In short, post the global financial crisis the neutral level of interest rates has arguably fallen and bank lending rates need to fall back to the lows seen around early 2009, which saw the standard variable mortgage rate fall to around 5.75%.

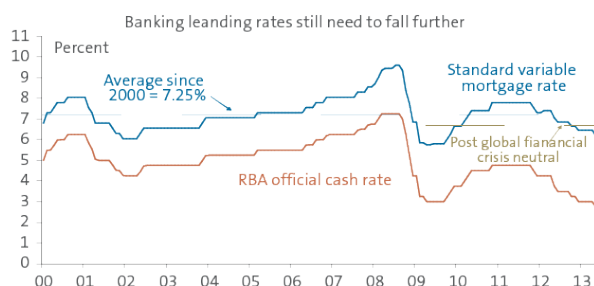


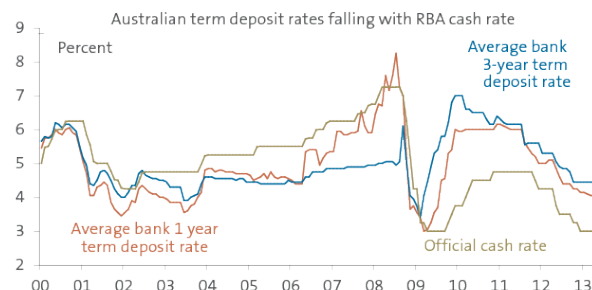
Chart assumes all banks pass on the latest rate cut in full to home borrowers.  
Source: RBA, AMP Capital

In addition the downtrend in commodity prices is acting as an ongoing drag on national income, but so far this hasn't been offset by a fall in the Australian dollar which remains strong. Inflation also remains benign at around 2% after adjusting for the impact of the carbon tax providing plenty of scope for further easing.

Against this backdrop the RBA has now cut the official cash rate to a record low of 2.75% and a further fall looks likely. I expect the cash rate to fall to 2.5% in the next few months, but to get standard variable mortgage rates back to the lows of 2009 may require another cut again.

## Implications for investors

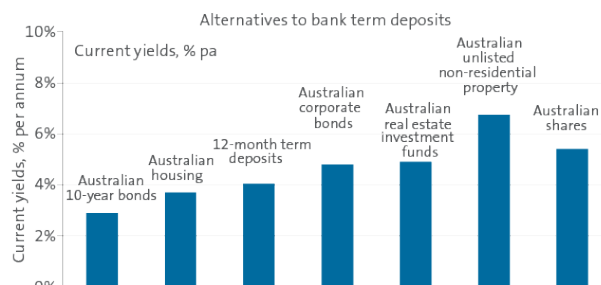
Continuing low interest rates with more to come in Australia has several implications for investors. First, term deposit rates are likely to remain low or fall further. For the major banks in Australia they are currently averaging around 4% for 12 months and 4.4% for three years. They are likely to head down towards 3%.



Source: RBA, AMP Capital

This means the desire for better-performing investments and specifically higher yielding investments will remain. In this regard:

- > Sovereign bond yields are likely to remain low. While their low yields point to low medium-term returns, in the absence of expectations for higher short-term interest rates it is hard to see bond yields rising much. However, in the absence of significant further declines in yield boosting capital returns their low yields make them a relatively unattractive investment in terms of return potential. See the next chart.



Source: Bloomberg, AMP Capital

- > Housing rental yields are also relatively low at around 4% (or less once allowing for costs) and while prices are likely to rise over the next year or two, returns are likely to be constrained by still high price-to-income ratios.
- > Corporate bond yields have already fallen a long way, but their yields remain above term deposit rates and are a good alternative.
- > Commercial property (office, retail and industrial) continues to offer relatively attractive income yields, particularly for unlisted property.
- > Australian shares have rallied strongly over the last year which has seen average dividend yields decline. But once allowing for franking credits, the dividend yield on shares at around 5.5% remains well above the yield available on term deposits. Lower interest rates will also help boost the outlook for profits and may help by lowering the value of the Australian dollar taking pressure off trade exposed companies. The broad rising trend in the share market is likely to continue.
- > While valuations for high yield shares like banks have been pushed to extremes, with interest rates still falling they are likely to remain well supported.

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