Point of view

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What do changes in the RBA cash rate really mean for investors?

There has been a lot of media attention recently on possible interest rate rises by the Reserve Bank of Australia (RBA) and the implications for Australia's two speed economy.

In this Point of View, AXA's Chief Investment Officer Mark Dutton takes a different angle and also looks at what changes in the RBA's cash rate really means for investors.

Setting the level

The RBA's official cash rate is a target interest rate set by policy. In economic jargon, this is referred to as 'monetary policy'. By setting a target interest rate level for cash, the RBA is effectively determining the benchmark rate for borrowing and lending transactions across the whole economy.

The RBA's official cash rate is set by members of the RBA board, who meet every month, except in January – although if needed they can call a special meeting anytime.

In setting the official cash rate at a certain level, the RBA is effectively either putting its foot on the accelerator to stimulate growth, or putting on the brakes to slow growth and reduce inflationary pressures.

The RBA has historically viewed a 'neutral' level for the official cash rate to be around 5.25 per cent.

This means that with the current official cash rate sitting at 4.75 per cent, monetary policy is still below 'neutral', and could be expected to rise further in the future.

What's the likely path ahead?

The *Reserve Bank Act* states that RBA is responsible for economic prosperity, stability of currency and prices, and full employment.

However, the only economic policy tool the RBA has is 'monetary policy' – the rest is up to the government, business and consumers.

Since the early 1990s the RBA has pursued the 'practical expression' of these objectives by explicitly declaring a target range for inflation of 2 to 3 per cent.

If inflation looks to be trending above this range, we can expect to see the official cash rate go up.

The old cliché – 'it's a blunt instrument'

A key difficulty with using monetary policy to target inflation is that it's a blunt instrument.

It changes the cost of borrowing and lending across the entire economy.

Australia's economy is currently often described as running at 'two speeds'. The mining and energy related sectors are booming, while some other sectors, such as manufacturing, retail and tourism are still doing it tough.

Market participants are particularly concerned that even small rises in the official cash rate in the coming months could slow these sectors further.

The RBA acknowledges this risk, but is clear that containing inflation is a higher priority.

What this means for investors

<u>Good news for savers, bad news for borrowers</u>

In our current environment, saving and lending rates are influenced by movements in the RBA's official cash rate and the risks and costs of accessing funds from wholesale markets, including overseas markets.

For most of the 15 years prior to the global financial crisis (GFC), Australian bank term deposit rates were below the official cash rate, and moved in line with changes to it, as shown by figure 1.

This relationship changed when the market hit rock bottom in March 2009. After this point, the rate of return on term deposits shot ahead of the RBA's official cash rate.

When the assessment and pricing of risk changed, Australian banks could no longer rely on relatively cheap funding through overseas markets.

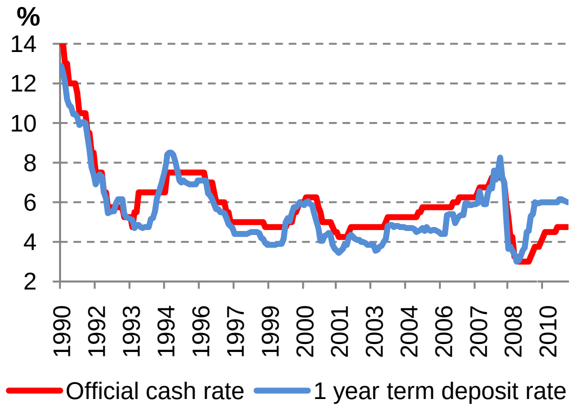
This meant that Australian banks had to intensify their competition with one another in an attempt to gain market share of local term deposits.

The rise in term deposit rates has been a positive development for savers. They are now able to get a relatively high 'risk free' rate of return above the current inflation rate.

But it hasn't been such a positive result for borrowers. The banks have cited increased funding costs as the main reason for moving out of sync and raising lending rates by more than the RBA's changes to the official cash rate.

Australians hold around 140 per cent of disposable income in debt rating to housing (both residential and investment). This sector is vulnerable to both further rises in the official cash rate and adverse developments in overseas wholesale markets.

Figure 1: 1 year term deposit versus the Official cash rate

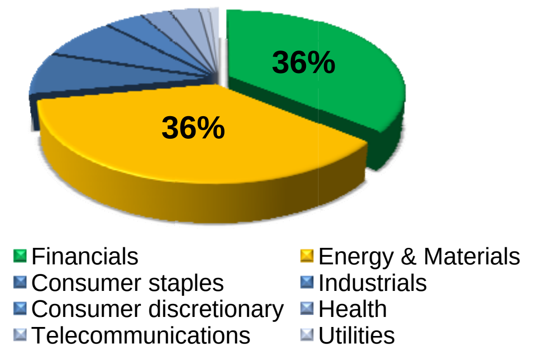


Source: The Reserve Bank of Australia, as of June 2011.

<u>Risks for Australia's concentrated sharemarket</u>

Rising funding costs haven't been a positive development for Australia's sharemarket, partly because it has a high, 36 per cent concentration in financials stocks, as shown by figure 2.

Figure 2: Australian sharemarket



Source: Bloomberg. ASX300 as of June 2011.

According to an RBA September 2010 bulletin, 'mum and dad' investors are twice as exposed to the Australian financial sector as institutional investors.

These 'mum and dad' investors hold on average 65 per cent of their portfolio in financial stocks, while institutional investors hold around 30 per cent.

The benefits of investing directly in the Australian sharemarket include relatively high rates of dividend income and franking credits to help reduce tax obligations.

However, such a high exposure to one sector of the sharemarket could leave investors exposed to specific events – like rising interest rates or further disruptions to global credit markets.

Australia may still be the 'lucky country', but investors should always be looking to ensure that they have a well diversified investment strategy, which may include cash and assets outside of Australia.

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