Macquarie Investment Management

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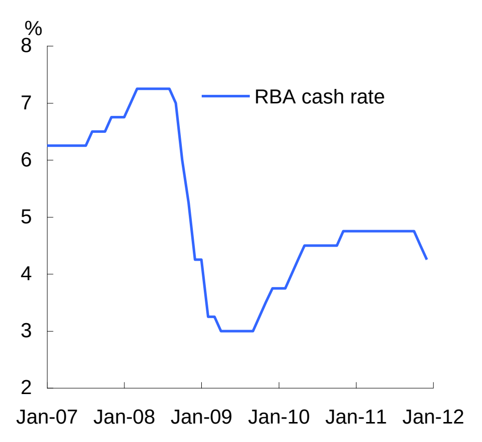
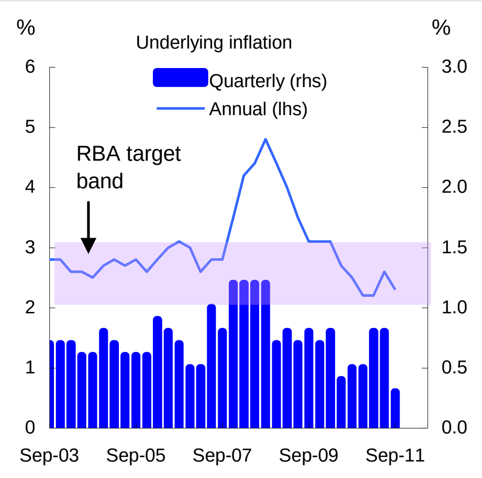
AUSTRALASIA

RBA extends the easing cycle



Source: RBA, Macquarie Research, December 2011

Lower inflation opens the door for further rate cuts



Source: ABS, Macquarie Research, December 2011

7 December 2011

RBA eases policy again

What this means for 2012

Event

- The Reserve Bank of Australia (RBA) decided to reduce its key policy rate by 25bps to 4.25% at its December Board meeting.

Impact

- The RBA's decision to ease monetary policy again in December reflected its increasingly cautious outlook for the global economy and its increasingly optimistic view of domestic inflationary pressures.
- The more pessimistic global outlook not only reflects the deteriorating situation in Europe but also slower growth in China and a European-induced slowing in Asian trade. Together that has been one of the factors weighing on commodity prices. And with the RBA not expecting a rebound in commodity prices, it has also flowed through to fewer domestic inflationary risks.
- While the RBA has not pre-committed itself to further rate cuts, we believe that the RBA won't hesitate to continue easing policy if there are any further signs of rising unemployment, low inflation and/or weaker global growth. In our view, there is a substantial risk of all three developments materialising.
- As such we expect the RBA will cut interest rates by a further 50 bps in 1H 2012, with the risk of a more protracted – and larger – easing cycle the major risk.

Outlook

- The Reserve Bank of Australia (RBA) decided to cut interest rates by 25bps at its December Board meeting. While markets were almost fully priced for a rate cut, analysts were evenly divided as to whether the RBA would follow up its November easing with another rate cut in December.
- We thought a rate cut became likely following the decision of the Chinese authorities to ease monetary policy and the co-ordinated policy actions of the six central banks last week, as this highlighted that the global growth outlook had continued to deteriorate.
- Consistent with that, our China economist Paul Cavey expects further weakness in Chinese manufacturing in coming months and thinks the risk of Chinese growth temporarily slipping below 8% has increased. And, indeed, the RBA does imply that it is the slower global growth outlook and the impact on commodity prices – and hence inflation – that was one of the key reasons for easing policy again.
- The RBA cites slowing growth in China and the impact of weaker European growth on Asian trade, as well as the impact of financial market volatility stemming from the European debt crisis, as the key reasons to think that global growth will be much weaker.
- In contrast to the increasingly sombre view of the global economy, the RBA is certainly not exhibiting any signs of panic about the domestic economic outlook yet.

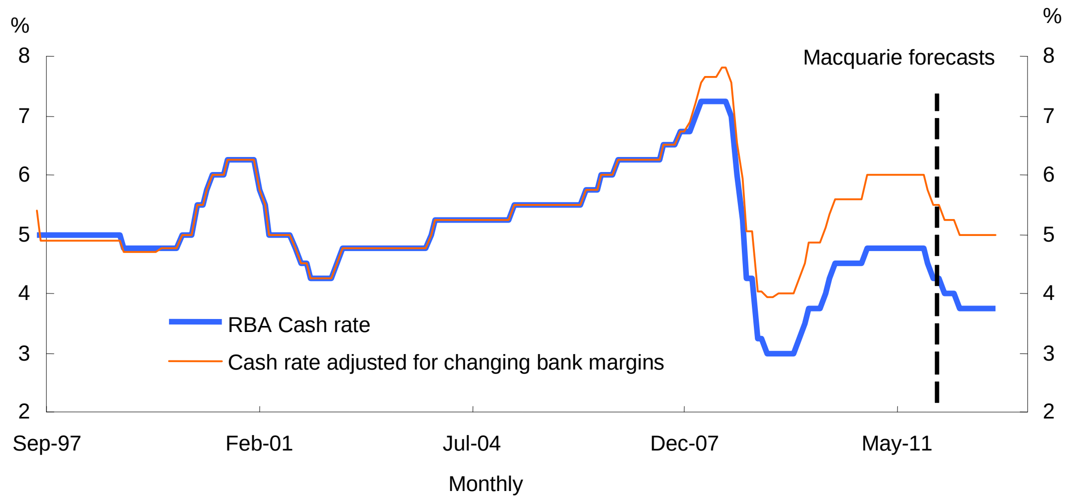
Analysis

- To be sure, the RBA does seem to be more convinced that the moderation in consumer spending may be more lingering and it is also more cognisant of the impact of the strong $A. But overall it doesn't seem too unhappy with the current pace of activity.
- What has clearly changed is that the slight weakness of the labour market which -- together with the moderation in commodity prices -- means that the RBA is much more comfortable with the inflation outlook. And this was reflected in the RBA's conclusion that it was "the inflation outlook (that) afforded scope for a modest reduction in the cash rate."

Implications for the interest rate outlook

- What does this decision mean for the possibility of future rate cuts? The RBA doesn't provide any encouragement for the view that it is poised to embark on an aggressive easing of policy from here. That said, the statement clearly highlights where the RBA's sensitivities are. First, further confirmation of slower global growth and commodity prices. Second, further weakness in the labour market. And third, better inflation news.
- In that respect, a key factor to watch will be the next inflation reading which will be released at the end of January, just ahead of the next scheduled RBA policy meeting on 7 February. Partial indicators suggest that this will again be very benign -- at present we are looking for a ¼ppt reading for underlying inflation. This would take annual inflation down to 2.2% and open the possibility that underlying inflation could undershoot the RBA's inflation target in 2012. As such, it would likely prompt the RBA to again revise down its inflation profile for 2012 and provide a clear rationale for further rate cuts.
- We are also more cautious about the outlook for unemployment and expect it to rise to 6% by mid 2012. And clearly the risks surrounding global growth are also heavily skewed to the downside. Thus, the conditions for further rate cuts are clearly there.
- As such, while the RBA hasn't pre-committed itself to cutting rates further, if we do get a further deterioration in unemployment, low inflation and/or further downgrades to the global growth outlook, the RBA will not hesitate to respond. On that basis, we still anticipate that the RBA will cut rates at its next Board meeting in February 2012, as well as the May Board meeting.

Fig 1 The RBA will have to keep cutting in 2012

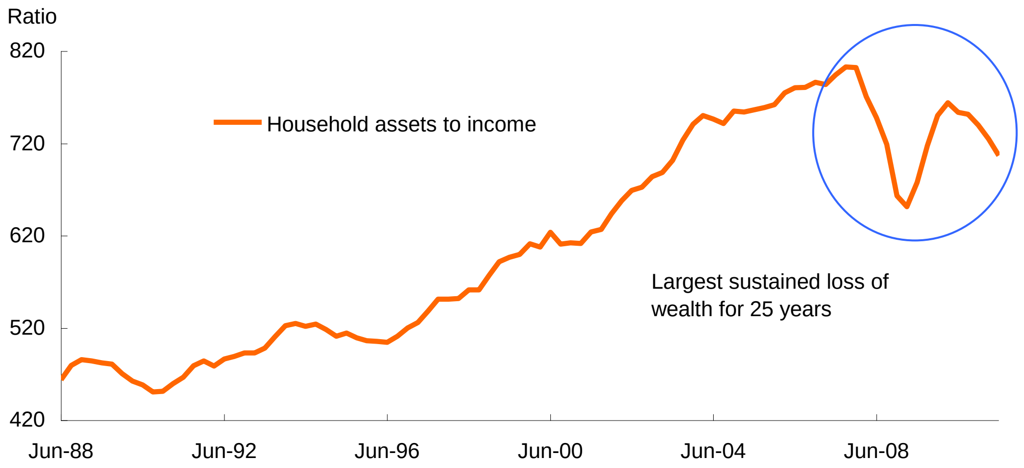


Source: RBA, Macquarie Research, December 2011

How will it affect the economy?

- In our view, the December rate cut will offset some of the downside risks to growth in 2012, but is not yet the signal for a rapid turnaround in activity. First, note that monetary policy is only now back at a neutral setting. That is, the brake on growth has been released, but the new setting of interest rates won't yet be stimulating activity. And when the high level of the currency is taken into account, together with the weakness of financial markets and tight fiscal policy, it is clear that the domestic economy is still facing considerable headwinds.
- Second, we also think the background environment is crucial in determining how monetary policy will affect the economy. When household borrowing is strong and asset prices are rising sharply, a reduction in interest rates will encourage households to access the unrealised capital gains in their property by gearing up further. At the same time, if household wealth is rising sharply, households will be more likely to boost consumer spending and run down savings. Furthermore, property investors are likely to see falling interest rates as the green light to increase their exposure to the housing market.

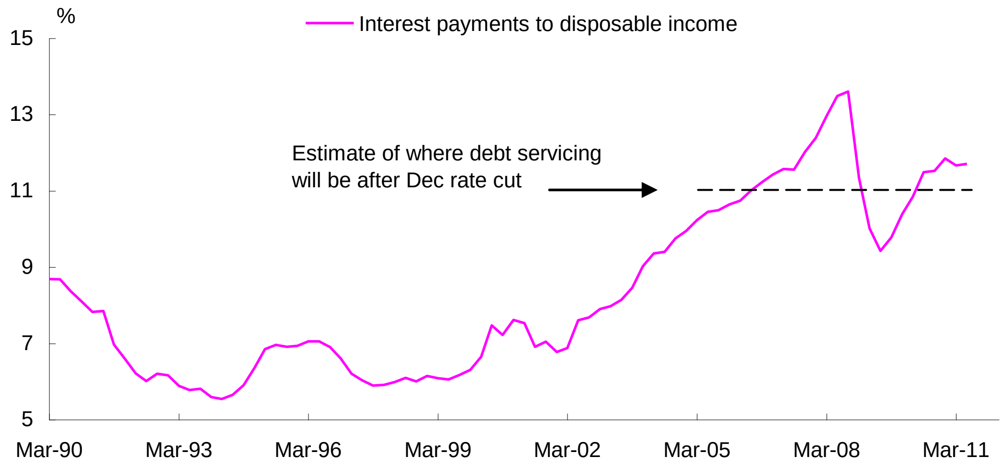
Fig 2 Falling asset prices may dull the impact of monetary policy easing



Source: Macquarie Research, December 2011

- Clearly that is not the environment facing the economy at present. Assuming that the interest rate cut is fully passed on by the banks, we suspect that some potential property investors will be deterred from entering the market because of falling house prices. At the same time, those households with an existing mortgage may be more likely to maintain their current monthly mortgage repayments and simply use the interest rate cut to repay the mortgage more quickly, rather than boost spending. Similarly, in the world of falling house prices, fewer people will attempt (or be able) to withdraw equity from their home to fund additional spending.
- That said, there will clearly be some benefits from the interest rate cut. The average new mortgage is a little under $300,000, so the two interest rate cuts so far will save the average new borrower about $100 per month, which is equivalent to about 2% of income. Of course, less than 40% of households have a mortgage, so the impact on overall household income is closer to 0.7ppt. Clearly this is a step in the right direction, but it isn't a game changer. So how will it help the economy?

Fig 3 Interest payments are still relatively high for most households



Source: Macquarie Research, December 2011

- First, some potential first-home buyers who have been deterred from buying a property will now enter the market as affordability improves. At the same time, those households which have been struggling to meet their monthly mortgage repayment will find some relief which will prevent a possible cutback in consumer spending that might have otherwise occurred. And potentially just as important is that the RBA's decision to ease monetary policy again will take some pressure off the A$ which might otherwise have risen strongly over the next couple of months.
- The bottom line, however, is that the RBA's current easing of monetary policy may have a smaller impact than similar rate cut cycles have had in the past. Thus, we expect to see a slow improvement in activity over 2012, as increased housing finance flows through to increased housing construction, firmer employment and finally some increased spending.
- But that outlook is also predicated on the RBA easing policy further. If the RBA is content to leave monetary policy at a neutral setting and indicates a strong reluctance to cut rates further, then there is little reason to expect consumers to relax their current caution let alone return to their previously profligate ways.

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South - South Africa
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie - Canada
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie - USA
Outperform (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell)– return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ/Canada stocks only

Recommendations – 12 months
Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 30 September 2011

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	57.35%	65.88%	56.94%	46.54%	74.68%	47.85%	(for US coverage by MCUSA, 11.63% of stocks covered are investment banking clients)
Neutral	31.99%	20.68%	31.94%	50.00%	23.42%	34.66%	(for US coverage by MCUSA, 9.30% of stocks covered are investment banking clients)
Underperform	10.66%	13.45%	11.11%	3.46%	1.90%	17.49%	(for US coverage by MCUSA, 0.47% of stocks covered are investment banking clients)

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