PAS Insights

September 2022

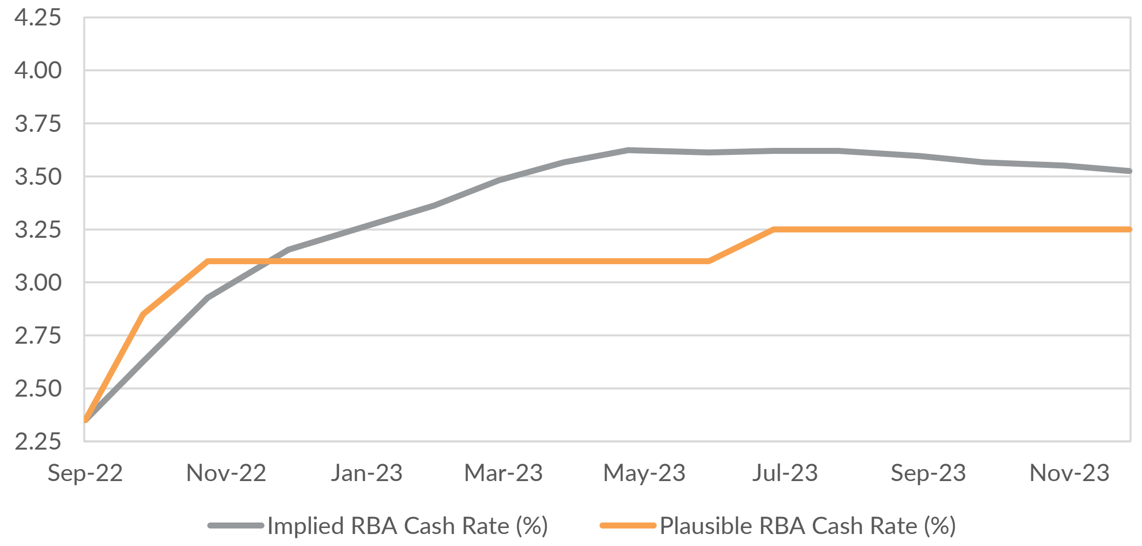
What does an RBA pause mean for Australian assets?

Australia's economy is remarkably strong right now. And it has momentum carrying it into year-end. Rates are accommodative. Monetary policy needs to tighten. And it will. But this is not a recessionary scenario. After severely damaging its credibility earlier this year, the RBA has a clear playbook for the year ahead. And that is going to be a good outcome for Australian assets.

How aggressively will the RBA hike?

We think the neutral level for the Australian cash rate is around 3.00%. The RBA needs to get rates to modestly restrictive territory. The market is pricing a very restrictive policy rate by early-2023. The RBA will cause a recession if it follows market pricing. No wonder the market is pricing rate cuts by end-2023.

The market is pricing a very restrictive rate path, then rate cuts. We expect hikes, then a pause.



Source: Bloomberg LP, Oreana Portfolio Advisory Service

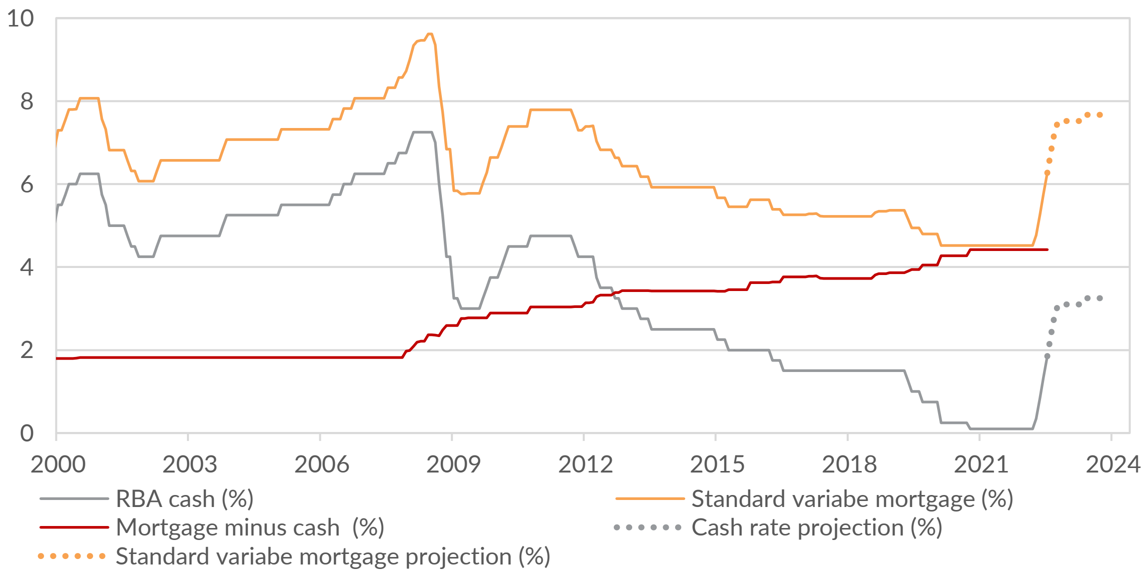
We disagree with the market pricing. Instead, we think the RBA will get to restrictive territory later this year. But then we expect they will pause for a long period. This will be a relatively good outcome for the economy – and not one where recession takes place next year.

Will house prices collapse?

A modestly restrictive cash rate will push house prices lower. But we think the consensus view for house prices to fall as much as 20% is overdone. Sure, if the RBA forced market pricing for the cash rate down the throat of the economy, then we could see that type of a correction.

But the RBA has no business doing that. Our plausible path for rates described above would take the standard variable mortgage rate to the highest level since 2011.

A move to modestly restrictive rates will cool housing activity, house prices and inflation.



Source: RBA, Oreana Portfolio Advisory Service

We project debt servicing costs will be as high as they have been since the GFC in this scenario. That will restrict housing activity, house prices, household spending, and household borrowing. And that will bring down inflation, allowing the RBA to hike less than the market expects. And allow house prices to decline less than consensus expects – we think 10% is probable.

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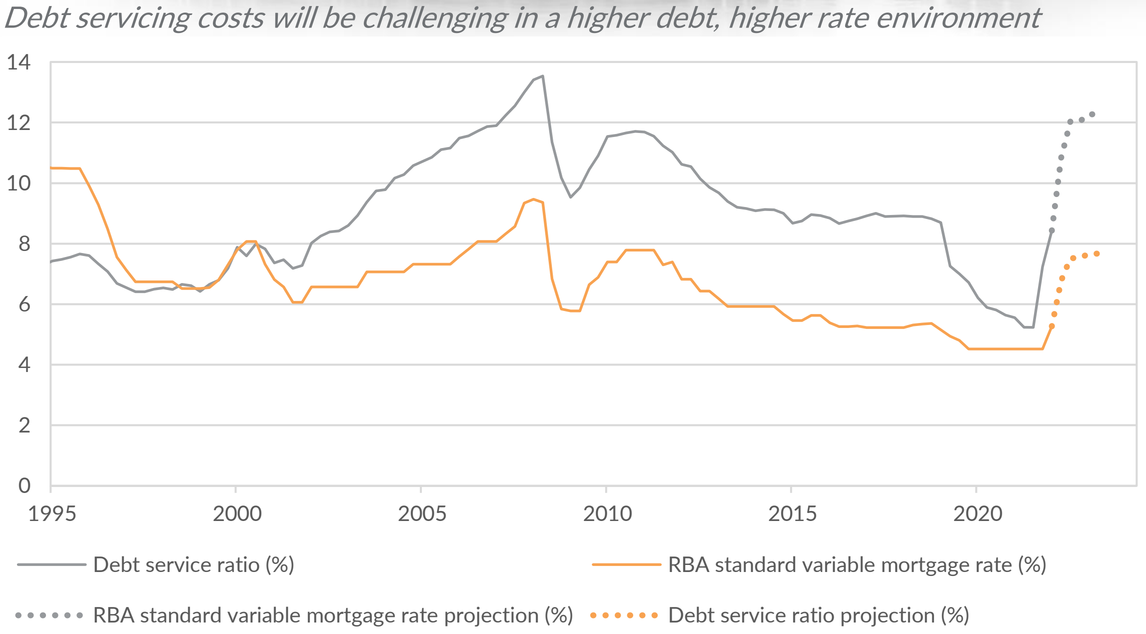


Source: RBA, Oreana Portfolio Advisory Service

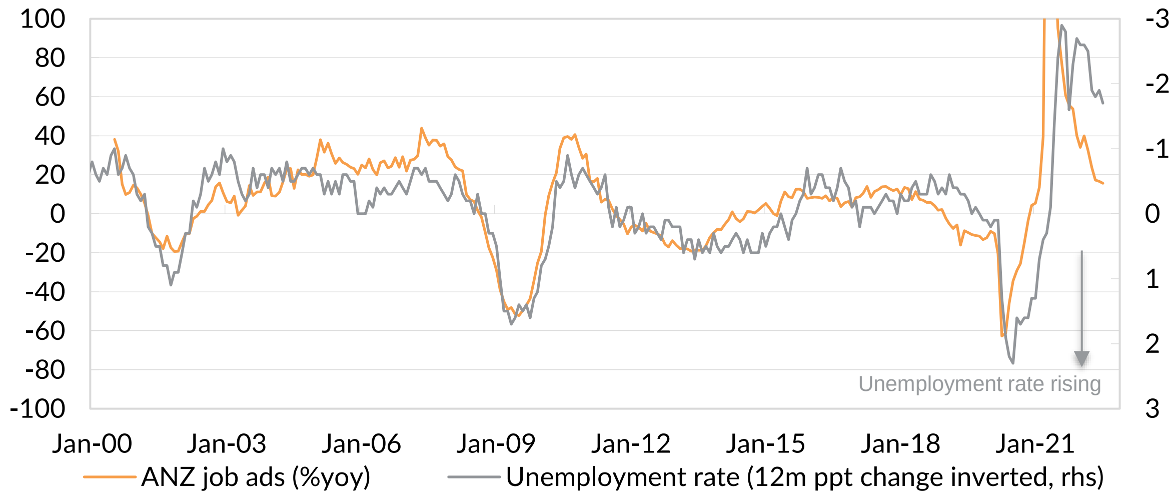
Will we have a recession?

A recession is a clear risk if the RBA hikes too far. But a 10% correction in house prices will not drive a recession. It would be a welcome cooling in a market that had overheated. The RBA will view that correction as a job well done.

Outside of the housing market, Australia's economy as a whole is still motoring along. It has been supported by a blistering increase in the terms of trade. Australia has benefited from this income boost and will continue to do so through 2023.

The RBA has taken rates close to neutral, but they are not yet restrictive. When the RBA does move to restrictive policy settings, we expect to see the economy slow to below trend growth rates. The unemployment rate will initially stop falling. And judging by the rapid cooling in ANZ job ads, the unemployment rate will move higher. Modestly higher unemployment will reinforce the RBA's pause and extend the cycle, delaying recession for some time.

The rapid cooling in ANZ job ads will lead the unemployment rate higher in 2023.



Source: Bloomberg LP, Oreana Portfolio Advisory Service

What does it mean for Australian assets?

In January this year, we moved our Australian equity rating to overweight relative to the US and the rest of the world. Australia's equity market has outperformed the US through 2022, albeit still delivering negative returns.

We think the shift to a pause in rates from the RBA may allow a resetting of the bearish recession expectations. And that could provide some upside to Australian equity markets.

The Australian government bond market has priced an aggressive rate hike cycle. Government bonds now offer reasonable income if a recession is avoided. And if the RBA does pause, as we expect, a compression in term premia could provide capital gains for investors. On the other hand – if we are wrong and the RBA does hike to recession, then government bonds at current yields will play a critical role in protecting to the downside for investors.

What can investors do?

The RBA damaged its credibility early this year by denying rate hikes were needed. It has now pivoted, and the rate hike cycle is moving towards restrictive monetary policy. We expect the RBA will pause at modestly restrictive settings, allowing the Australian economic cycle to extend through 2023.

Investors should avoid knee-jerk reactions through this uncertain environment. All investors have suffered through a challenging first half to 2022. And uncertainty around the pathway for global central banks is keeping volatility high. A recession is a possibility but not inevitable.

In this environment, our DAA process has increased our exposure to government bonds but held exposure to equities largely unchanged. Overall, we have focused in increasing the quality of our fixed income exposure (i.e, reducing default risk) and increasing the resilience of our equity exposure. While we do not think a recession is the most likely outcome, we have looked to manage the downside risk while remaining exposed to better outcomes than the market has currently priced.

Contact PAS for more information.

The Portfolio Advisory Service has been working with clients across Australia and Asia to help manage investment solutions. This includes a clear move towards managed accounts within the Australian and Hong Kong markets, as well as a focus on investment governance and investment process. The Portfolio Advisory Service can help build custom-made investment solutions including managed accounts, or by providing access to our own range of Active Alpha, Active Beta Plus and Active Beta portfolios. Our work is supported by deep asset class research and manager review expertise within the team – delivering great outcomes for our partners. Reach out to our Portfolio Advisory Service to find out how we can assist you with managing your investment challenges.