

Overnight Cash Rate to fall to 5.0%

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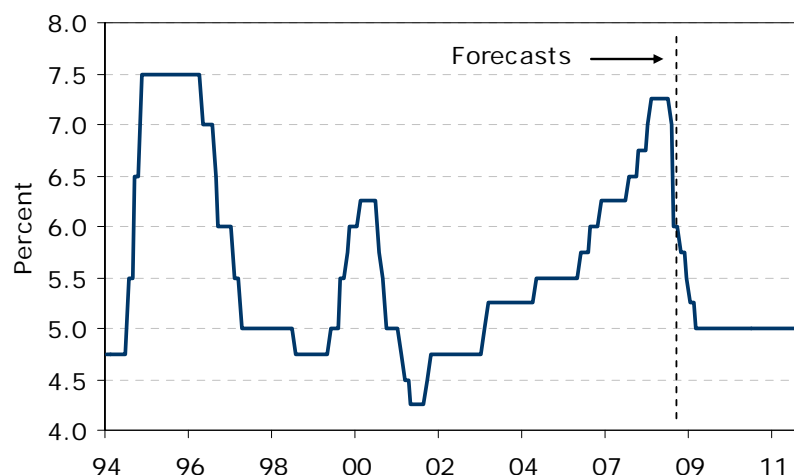
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Key Points

- The RBA has front loaded rate cuts with the 100bp easing yesterday. **We expect the easing process to be more gradual going forward.** We expect a further 100bps of rate cuts over the next six months, taking the cash rate to 5%. This should see the 90 day BBSW rate settle down to around 5.5% to 6% over the next six months.
- **We regard a 5% cash rate, given current strains in credit markets, as broadly neutral to economic activity.** We are not forecasting a recession in Australia in 2009 or 2010 and thus do not expect the RBA to set an easy stance of monetary policy in these forecasts.
- **However, if we see further downgrades to Australia's economic growth outlook, then the cash rate could go back to previous cyclical low points of 4.25%.** Indeed, if credit strains remain (or intensify), then the case for new lows on Australian interest rates could readily be made in the next 18 months.
- **Term interest rates are not projected to fall much further from current levels.** Australian government bond yields have plunged in recent weeks and we cannot forecast further substantial falls so long as Australia avoids recession and the cash rate is projected to remain at or above 5%. Swap yields of 3 and 5 year tenor are expected to drift down gradually as credit strains ease and swap spreads contract.
- **The RBA continues to use its open market operations to try and address money market stresses,** announcing a further expansion of its domestic market facilities today.

Figure 1: RBA official overnight cash rate



Source: RBA and ANZ

We now expect interest rates will fall to 5.0% by mid-2009

The end-point has been lowered

Following yesterday's surprise 100bp cut in the official cash rate, we have revised our Australian interest rate forecasts. We still expect interest rates will return to a neutral level by mid- 2009. However, given elevated market funding costs, we now believe that the neutral level of policy rates is lower at 5.0% from our estimate of 5.5% previously. This should see the 90-day BBSW rate settle down to around 5.5% to 6.0% over the next six months.

Our new forecasts are set out in Figure 2. It must be noted that these forecasts are based on the assumption that the unusual strains in debt markets will ease gradually through the course of 2009. Our interest rate forecasts for 2010 and 2011 suggest a return to normal relationships (ie. a normalisation of OIS/LIBOR spreads and swap spreads).

Figure 2: Key interest rate forecasts

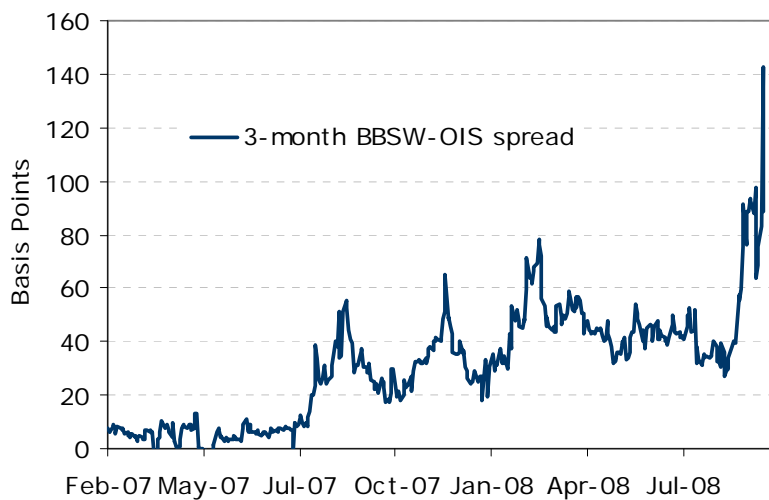
	Current	Dec-08	Mar-09	Jun-09	Sep-09
Key interest rates % per annum					
RBA cash rate	6.00	5.75	5.25	5.00	5.00
90-day bill rate	6.33	6.00	5.70	5.50	5.45
3-year bond	4.70	4.55	4.75	4.85	4.90
10-year bond	5.20	5.05	5.25	5.45	5.55

Source: ANZ and Bloomberg

A fall to 5.0% is required to see retail return to neutral, given the impact of elevated funding costs

Prior to the current crisis, most economists would regard a cash rate of around 5.5% as a neutral policy setting. On our figuring, heightened funding costs (see Figure 3) have caused the spread between official mortgage rates and the overnight cash rate to widen by around 75bps since the beginning of the onset of the crisis. This now means the RBA will have to cut its policy rates by an additional 50-100bps in order to help retail interest rates fall to a level that could be considered neutral for households. This suggests the neutral cash rate may be somewhat lower – say 4.75% to 5.0%.

Figure 3: There is little relief in wholesale funding pressures



Source: ANZ and Bloomberg

The timing of the RBA's next move is extremely uncertain

Given the quickly evolving global and local landscape the timing and magnitude of the RBA's next move remains extremely uncertain. The market is now looking for the RBA to quickly move interest rates back to a neutral setting. Current pricing is for 50bp cuts at the November and

After front-loading policy, we expect the RBA to take a more gradual approach from here.

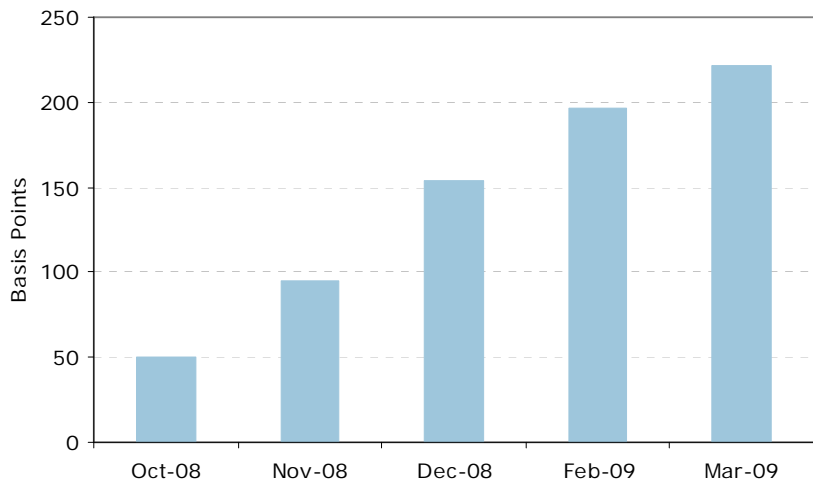
The market however expects the RBA to remain aggressive over the coming months

December meetings with the cash rate falling to 4¼% by March 2009 (see Figure 4).

At this stage, a November interest rate cut is not our key call. Front-loading its policy approach and delivering a large 100bp rate cut in October, we believe, has seen the RBA buy some time to see how the local economy responds. We therefore expect the easing process to be more gradual going forward.

That said, yesterday's move sends a clear message that the RBA will be pre-emptive, not reactive, in this environment. We have little doubt that if the global environment and financial market conditions deteriorate even more sharply over the coming weeks, the RBA will seek to pre-empt further damage to the Australian outlook and cut interest rates again next month. Likewise, the RBA would likely cut rates again in November if clear evidence emerges, via the more timely indicators of business liaison, housing auction clearance rates and credit growth, that Australian businesses and households have been significantly damaged by the turmoil of the last month.

Figure 4: Expected easings (cumulative) over the next five RBA meetings



Source: ANZ and Bloomberg

Further downgrades to Australia's economic growth could see the cash rate fall to its previous cyclical low or 4.25%, or below

Not expecting easy policy, as yet...

The Australian economy is set to slow further over the coming year. However, at this stage we are not forecasting a recession in Australia in 2009 or 2010. Therefore, we do not expect the RBA to cut rates to an easy stance of monetary policy over the forecast period.

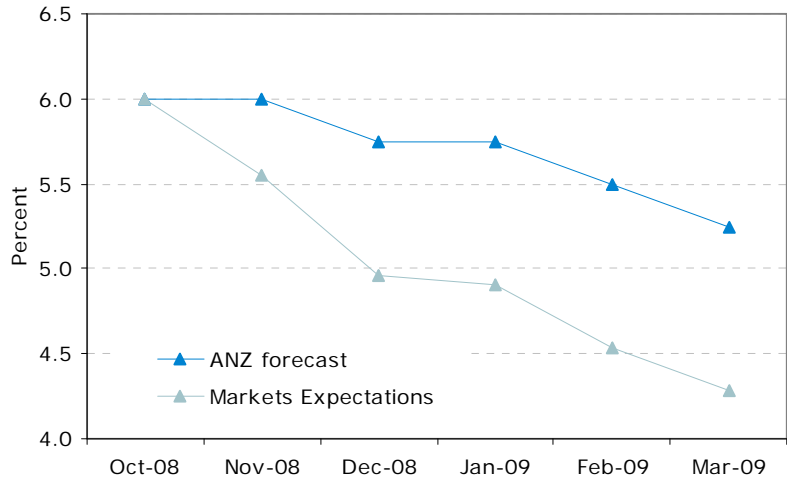
However, with the global economy now facing the most challenging environment since possibly the Great Depression, the outlook for Australia is extremely uncertain. If we see further sharp falls in commodity prices and/or further disruption and destruction in local financial markets, the outlook for the Australian economy will continue to deteriorate. Further downgrades to Australia's economic growth outlook could prompt the need for 'easy' monetary policy, which in turn could see the cash rate go back to previous cyclical low points of 4.25%. Indeed, if credit strains remain (or intensify) then the case for new lows on Australian interest rates could readily be made in the next 18 months.

Term rates may need a recession to fall further

Term interest rates are not projected to fall much further from current levels. Australian government bond yields have plunged in recent weeks. The 3-year yield is currently 4.50%, down from a cyclical high of over 7.0% in early June and the 3s10s curve has steepened to 54bps. The

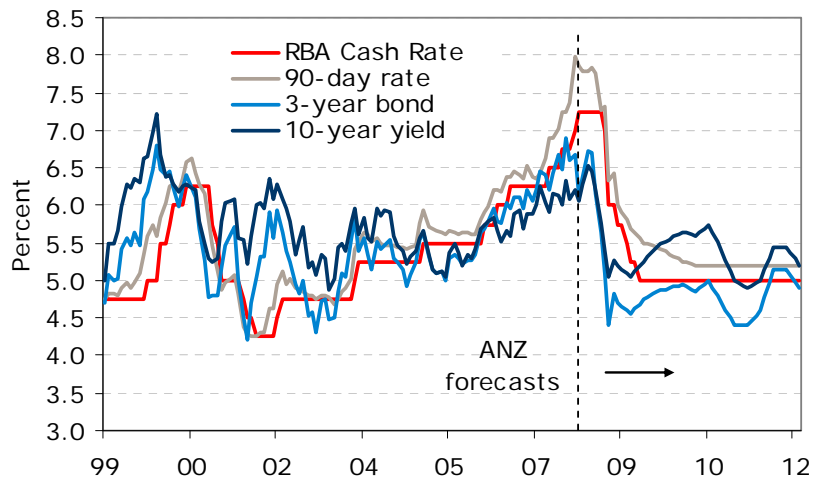
sharp move in term rates reflects both safe-haven buying as well as market expectations for aggressive RBA cuts in the coming months. Given we are not forecasting interest rates to fall as quickly, or as far, as the market (see Figure 5) it is therefore difficult for us to forecast further substantial falls in term interest rates, so long as Australia avoids recession (see Figure 6).

Figure 5: A comparison of ANZ and Market expectations for official interest rates



Source: ANZ and Bloomberg

Figure 6: Term interest rate forecasts



Source: ANZ and Bloomberg

Swap yields of 3 and 5 year tenor are expected to drift down gradually as credit strains ease and swap spreads contract. The 3 and 5 year Australian swap yields are projected to remain between 5% and 6% over the next few years.

RBA continues to widen its market operations

While helpful for the real economy, cutting the official cash rate is unlikely to do much to ease the stresses in local money markets. Like its global counterparts, the RBA is continuing to widen the scope of its domestic open market operations in an attempt to support the proper functioning of money markets and ensure that sufficient liquidity is available.

It is difficult to see term rates fall sharply lower from here

Swap yields should slowly drift down as credit strains ease

The RBA will now accept a wider range of collateral in its open market operations

Today the RBA has announced further changes to its domestic market facilities:

- Allowing institutions to use residential mortgage-backed securities (RMBS) and asset-backed commercial paper (ABCP) of a related party as collateral in its repo operations. This also applies to the US dollar term repo facility.
- The RBA will now offer six-month and one-year repos each day in its market operations.
- The removal of restrictions on substituting collateral within an existing repo. Where the substitution includes a change in the asset class of collateral, the margin applying to that collateral will be adjusted accordingly.

While these changes are certainly welcome, it is not clear that they will, for now at least, have a meaningful impact on wholesale funding costs. We will need to see a significant restoration of investor confidence in the global banking system and improvement in perceptions around counter-party risk.



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