Economics | May 5, 2022

Interest rates lift: What happens next?

Economic and financial market issues

- The Reserve Bank (RBA) has lifted the cash rate for the first time in 11½ years. So what happens next for interest rates, the broader economy, the sharemarket and the property market?

First rate hike in 11½ years

- A lot can happen in a short space of time. In late January 2022, Commonwealth Bank (CBA) Group economists were one of the first economic groups to predict a near-term rate hike. At that time the CBA Group economists tipped the first rate hike to occur in August. Then in February, following a speech from the Reserve Bank Governor, the CBA Group economists brought forward the expected timing of the rate hike to June. In the end, the forecast was only out by a month, the Reserve Bank lifting the cash rate this week by 25 basis points or a quarter of a per cent.
- Clearly, cash rates couldn't stay at emergency levels forever. And that is especially the case with the economy growing strongly, unemployment at 48-year lows, headline inflation at 21-year highs and wage growth starting to lift.

Monetary Policy Tightening Cycles since 1990

First Hike	Last Hike	Lows	Highs	months
Aug 94	Dec 94	4.75%	7.50%	5
Nov 99	Aug 00	4.75%	6.25%	10
May 02	Mar 08	4.25%	7.25%	71
Oct 09	Nov 10	3.00%	4.75%	14
May 22		0.10%		

Source: RBA, CommSec

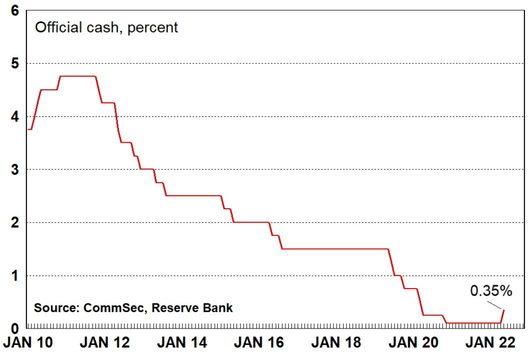
So where do rates go from here?

- As always there is no shortage of views from economists. CBA Group economists tip rate hikes, each by 0.25 percentage points, in June, July, August and November in 2022 and then in February 2023. That would take the cash rate to 1.60 per cent – still historically low, despite an active rate hiking cycle. The Reserve Bank Governor has indicated that the cash rate could lift to 2.5 per cent, but with no guidance on how quickly this would be achieved.
- While the Reserve Bank Governor noted that *"further increases in interest rates will be necessary over the months ahead"*, the RBA Board declared that it is not on a pre-set path.

Why lift rates?

- Rates were cut to record lows to support the economy over the period when the pandemic reigned. But now with the economy performing more 'normally', record low interest rates are no longer needed. The big question now is what does a more 'normal' interest rate look like for a more 'normal' economy?
- When the Reserve Bank lifts rates, those people that are paying off loans have fewer dollars to spend. That means that businesses, especially retailers, need to keep prices low to keep people spending. So slower growth in spending (or demand for goods) has the potential to restrain price increases or inflation

Still stimulatory



more broadly. In terms of the theory, less demand for goods in relation to supply puts downward pressure on prices.

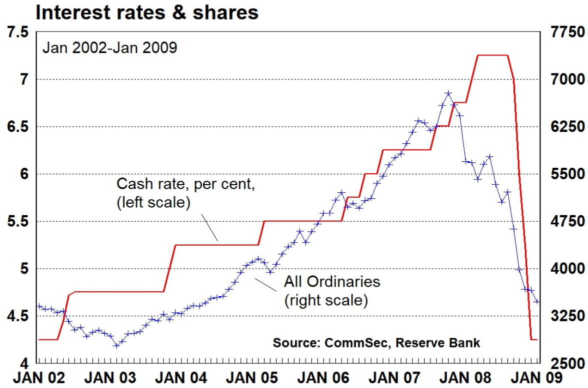
- The recent lift in the inflation rate mainly reflects global factors. Covid and the war in Ukraine have pushed up fuel prices. Covid has also served to lift prices of a range of goods. Rising virus case numbers mean fewer people are working at factories so the supply of goods has fallen in relation to demand, pushing up prices.
- While global factors dominate, the Reserve Bank said that domestic factors were also playing a role with more businesses prepared to pass on cost increases to consumers. The Reserve Bank is trying to influence these domestic factors by lifting interest rates and by 'jawboning' – stressing at every opportunity that it is determined to get the rate of inflation back into the target band.

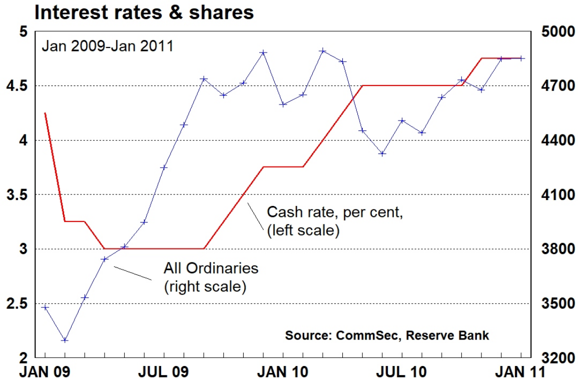
Lower inflation is the goal?

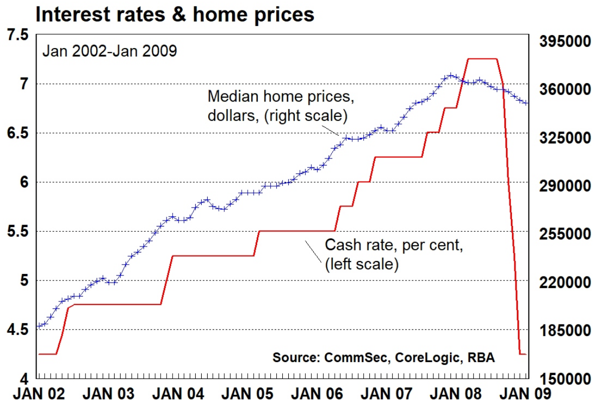
- The goal of the Reserve Bank is to keep the annual rate of inflation between 2 and 3 per cent. And it is clear from the statements from the Reserve Bank on Tuesday that the latest inflation results have come as a shock. Not only has inflation exceeded RBA forecasts, it has 'significantly' exceeded those forecasts.
- Now comes the hard part – keeping the economy going at a solid clip, keeping unemployment low, and returning inflation to the 2-3 per cent target band.
- The Reserve Bank won't rush the process of getting inflation back into the target band. If interest rates rose too fast, too soon that could cause a recession.
- But the Reserve Bank also has to be careful that it doesn't take too long to address higher rates of inflation. If consumers and businesses believe that inflation will stay at 5 per cent, then they could factor that into business and investment decisions. So instead of falling back into the 2-3 per cent target band, inflation may get locked in closer to 5 per cent.

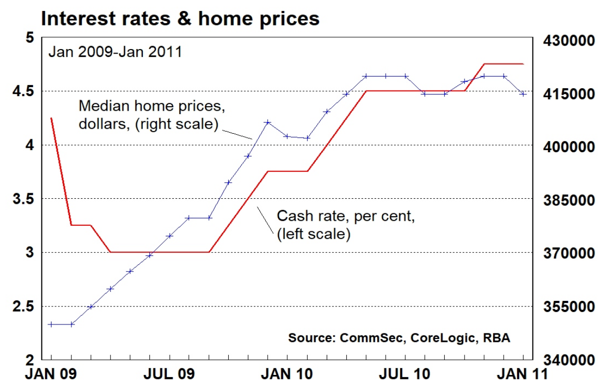
What does this mean for the sharemarket?

- Every economic cycle is different. Every interest rate cycle is different. While interest rates are now rising, they are rising from a far lower base than in the past – from record lows near zero. And key factors such as Covid and the war in Ukraine have no parallels in the past.
- So this interest rate cycle will be different. Investors need to be wary of drawing parallels with the past. The rate hike cycle from August to December 1994 took five months with rates up by 2.75 percentage points. In contrast, the rate hike cycle from May 2002 to March 2008 lasted 71 months with rates lifting by a similar magnitude of 3 percentage points.
- Provided the Reserve Bank is successful in maintaining solid economic growth and low interest rates, while at the same time lowering inflation, then downside risks for the sharemarket should be limited.









- But it's important to remember that interest rates are rising across the globe in response to higher inflation. So the risks of policy mistakes are just not limited to Australia.
- Financial stocks tend to benefit from rising rate cycles as there is scope for financial institutions to increase interest rate margins – the gap between borrowing and deposit rates.
- Meanwhile consumer-focussed sectors such as Consumer Discretionary may be less favoured by investors as higher borrowing costs serve to reduce the spending capacity of shoppers.
- And investors in growth-focussed sectors like Information Technology are on the look-out for Reserve Bank policy mistakes. That is, the risk that rates are increased too far, too soon and cause a marked slowdown of the economy.

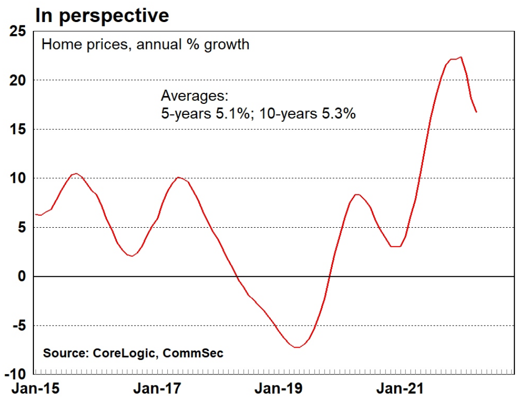
CBA Dwelling Price Forecasts

	2021 (a)	2022 (f)	2023 (f)
Sydney	25	-3	-9
Melbourne	15	-3	-9
Brisbane	27	7	-7
Adelaide	23	6	-8
Perth	13	2	-6
Hobart	28	7	-8
Darwin	15	2	-8
Canberra	25	5	-9
Australia*	**21**	**0**	**-8**

** 8 capital city average; source: CBA, Corelogic*

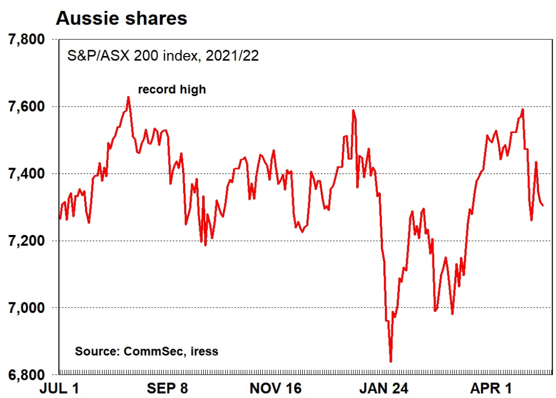
What does this mean for property prices?

- Growth of home prices has been slowing for a number of months. Arguably, speculation of higher interest rates has been a key factor driving the slowdown together with concerns about weakening housing affordability.
- After rising 21 per cent in 2021, CBA Group economists expect Australian home prices to be flat in 2022 before falling 8 per cent in 2022. If the RBA embarks on a more aggressive rate hiking cycle, downside risks apply to our forecasts.
- What happens next with property prices is a function of where property prices have been over the past few years as well as a raft of factors like the amount of new building (supply), unemployment, interest rates and affordability. Since the cash rate was cut to a record low of 0.1 per cent (18 months ago), national dwelling prices have risen by a strong 27 per cent. So even without higher interest rates, it was always on the cards that property prices would consolidate at the higher levels.
- In the last rate hike cycle from October 2009 to November 2010, home prices rose by just 5 per cent. But over the long rate hike cycle from May 2002-March 2008, home prices rose by a strong 60 per cent.



Bottom line

- When interest rates are 'normalising' – that is, in the process of returning to levels consistent with a more 'normal' operating economy – there are risks. Central bankers must be careful about how fast they lift rates and how high rates are lifted. The aim is not to markedly slow the pace of growth, but slow growth to a pace that is consistent with inflation holding in the 2-3 per cent target band.
- Past interest rate cycles provide guidance about what worked and didn't work in the past. But every interest rate cycle is different.
- CommSec expects modest gains for the sharemarket over coming months. The S&P/ASX 200 is expected to end 2022 in a range of 7,300-7,500 points.
- CBA Group economists expect flat Australian property prices over 2022 before prices ease by 8 per cent in 2023.



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