Monetary Policy

Just a few months ago, the RBA appeared to have found its lower bound (after several attempts). Surely this this time we're at the policy lows. That changed again on Melbourne Cup Day, after some weeks of hinting. Have we gone as low as we can?

It was once believed that zero was an absolute theoretical low for interest rates. A negative interest rate had no meaning, and was nonsensical.

Then central banks created negative interest rates – "fining" investors for not spending. In Europe, ECB rates go down to –½%. Bond yields are lower still.

So the "lower bound" in an Australian context has been defined as "*the level below which policy transmission no longer occurs.*" Further reductions do not get passed on to bank customers, and are even considered destructive to growth!

Sweden's Riksbank ran the world's oldest experiment with negative interest rates in 2015 to tackle deflation (and perhaps prevent SEK/EUR appreciation). Their 2019 conclusion: *Growth was slower than it would have otherwise been*.

> *The policy failed to reach the 2% target **while creating major imbalances in the process**. While the impact of the negative rates on the domestic inflation rate is small (probably negligible), the effects of negative rates **on the housing market and on household debt levels are large**.* [our emphasis]

The ECB and BoJ both found that banks had to maintain 0% on deposit accounts, effectively subsidising retail clients – losing their business means the end of a range of cross-selling opportunities. Bank profits are being squeezed.

So the search for the Australian lower bound has been an exercise in experimentation.

The RBA conducts analysis, profoundly announces that they have done what they can. Declares rates on hold for an extended period. (Even if they don't actually box themselves into categorically ruling out more.)

And then cuts again.

Should we believe that this is the permanent low this time?

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One reason why the RBA has been able to go lower than thought possible is that **banks can securitise mortgages**. In fact, with almost free money from the Term Funding Facility (TFF), they are strongly encouraged to – creating collateral that can be used for the TFF.

Funding costs of securitisation is **directly linked to BBSW**. Point for point. Any structural lower bound imposed by the banking system **only constrains on-balance sheet lending**.

Corporate floating rate loans were often written with "LIBOR floors" in recent years, so this is **less linear than RMBS**.

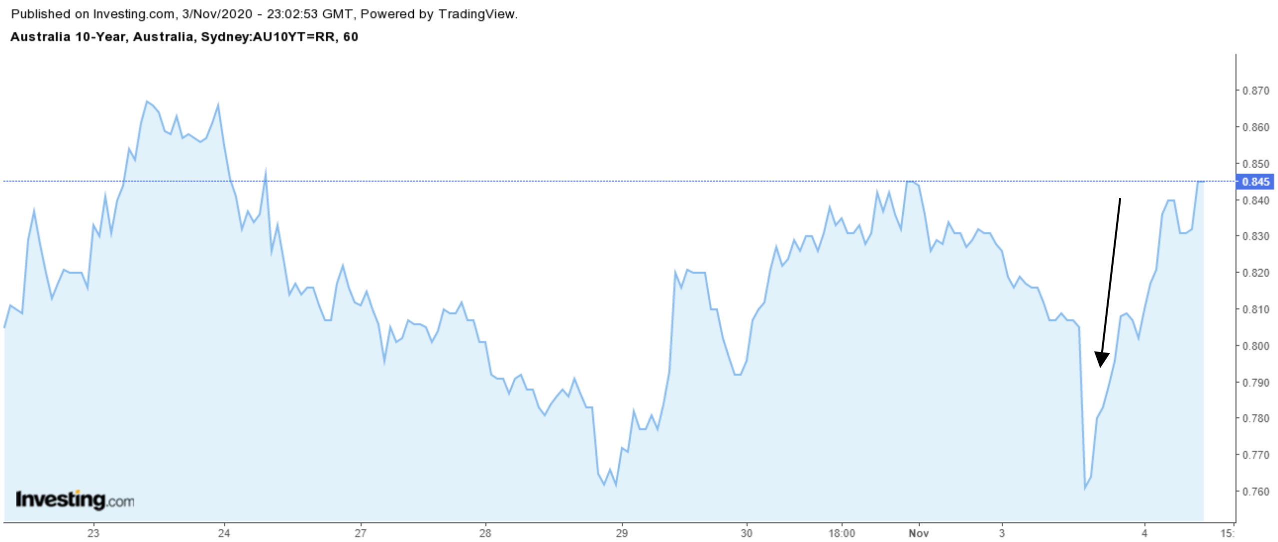
The RBA has been consistent in one respect: **They do not believe in negative interest rates – even in an emergency**. In outlining their hypothetical policy path in 2019, they agreed with the consensus that ***the European experience should be a warning against negative rates***.

The one new tool held back until now is quantitative easing (QE). The RBA denied that bond purchases were QE if they were used for yield curve targeting and if there is not a prescribed volume of bond purchases (the "quantity" in QE). And that is probably a valid argument – the announcement of yield curve targeting was effective, even with no purchases for weeks.

With the COVID-19 second wave now gone, ***this was chosen as the time for maximum stimulatory policy effect***. QE had been debated for some time, and speeches had suggested bond purchases to target the long end of the curve.

<u>In fact, our trading view is that bond yields would be driven lower on QE commencement.</u>

The most remarkable feature of the big announcement was the ***lack of effect***:



Bonds have been trendless in a week with QE and 4 rate cuts. Trendless since April. In fact, trendless since last August!

That does not mean the QE announcement has failed – ***the actual purchases may drive the bond market*** where the announcement has not.

If not, then what? A decade of central bank experience suggests that if QE fails to have the desired effect, the response is to do more of it. ***Expanding QE is the next step – with potential for dropping the Official Rate to zero***.

Leading Markets

The US S&P500, Dow Jones and NASDAQ fell -2.7%, -4.5% and -2.3% respectively after beginning the month strongly. Elections and COVID19 weighed on them. With late-received postal votes and counting pre-polls, a late and contested announcement is probable.

MSCI World ex-AUS fell -3.16% in local terms with Europe down -5%. Emerging Markets rose +2.04% in $US with Frontier Markets +1.05%.

US 10-year bonds sold off to 0.87% (+18bp) on a record GDP rebound.

High yield was near flat at +532bp (-9bp).

The VIX "fear index" touched 40 for only the second time since the March panic.

Other Highlights

COVID-19 deaths reached 1.2m, nearing April's peak. While USA and India lead daily counts, but *per capita* the worst figures are coming from second waves in Europe and Iran, and now Argentina. Experimental vaccines have proved difficult to produce in sufficient quantity.

The UK announced a 4-week lockdown, with 80% of wages subsidised.

USA's Q3 GDP increased by +7½% (33% annualised) to be -2.9% YoY. The Eurozone is -4.3% YoY after +12.7% in Q3 but forecast to underperform in Q4.

The Fed called for more fiscal support as Congress was deadlocked on various bills.

US unemployment fell to 7.9% (-0.5%) after +661k jobs in Sept. CPI rose to +1.4% YoY (+0.1%) after a +0.2% month. Retail sales grew +1.9%.

Eurozone unemployment rose to 8.3% (+0.2%). YoY inflation remained negative (-0.3%) despite a +0.2% month. Switzerland reported a 6th month of YoY price declines, currently -0.6%.

The ECB linked policy to the COVID second wave, flagging expansion of QE and concessional bank lending programmes.

A -0.1% month took Japan's YoY CPI to 0. PM Suga used his first month for regional travel rather than policy changes.

The Pacific moves into cyclone season, with shelter complicated by COVID precautions this year.

Domestic

The ASX200 was a rare winner with +1.89%. Smallcaps gained +0.46%. The 10-year bond closed near flat at 0.83% (-1bp).

Property prices rose +0.4% in October, rising outside Victoria.

Australia has reported occasional days with no new COVID-19 transmission.

The RBA debated a next round of monetary stimulus, as Victoria relaxed its protracted lockdown. Markets factor across the board rate easing, timed as the COVID second wave is extinguished.

The -7% GDP contraction in Q2 was attributable to household consumption.

CPI rebounded +1.6%, after policy-distorted deflation in Q2. Core inflation held at a record low 1.2%.

Retail sales retreated -1.5% in Sept (*vs* -4% August), after an unsustainable spike during lockdowns. But consumer confidence jumped +11.9% in October.

Unemployment rose to 6.9% (+0.1%) with a similar uptick in underemployment, on -29.5k jobs in Sept. Participation eased to 64.8% (-0.1%). Hours worked rose +0.5% but are -5% YoY.

Construction slumped in Q2, with apartment commencements -14.1%. A -42.9% fall for business construction loan commitments and -11% in apartment approvals in August suggest a protracted downturn. Home loan commitments rose +12.6%.

Private sector vacancies increased +65% in the August quarter.

Australia's trade surplus slumped to +$2.6n from +$4.6bn as exports fell -4% while imports rose +2%.

Commodities and Currency

WTI oil fell to $US35.79/bbl (-6.7%) on limited demand recovery. Gold closed lower at $1879/oz (-1.1%), hit by a rising $US. Iron ore closed -0.79% lower at $120.19.

Base metals rose: Nickel (+6.05%), Zinc (+4.62%), Tin (+1.07%), Copper (+1.28%) and Aluminium (+4.81%).

The $A closed at US70.44c (-0.90%) with the JPY firming against third currencies.

KEY FINANCIAL MARKET DATA – AS AT 31ST OCTOBER 2020 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
AustBond Bank Bill Index	0.01%	0.03%	0.05%	0.51%	1.08%	1.35%	1.59%

Key Rates	Oct-20	Sep-20	Aug-20
Australian Cash Rate	0.25%	0.25%	0.25%
90 day BBSW	0.06%	0.09%	0.09%
3 Yr Commonwealth Bonds	0.13%	0.17%	0.28%
10 Yr Commonwealth Bonds	0.83%	0.84%	0.98%
CDX North American 5 Yr CDS	66bp	59bp	65bp
iTraxx Europe 5 Yr CDS	65bp	59bp	54bp
iTraxx Australia 5 Yr CDS	71bp	76bp	64bp
US Fed Funds Rate	0-0.25%	0-0.25%	0-0.25%
US 10 Yr Bond Rate	0.88%	0.69%	0.72%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 Acc. Index	1.93%	0.98%	8.67%	-8.15%	4.67%	4.09%	6.80%
S&P/ASX Small Ord Acc. Index	2.08%	2.24%	10.94%	-6.51%	5.65%	4.78%	7.21%
S&P/ASX 200 A-REIT Acc. Index	-0.37%	5.88%	12.37%	-17.97%	0.68%	2.83%	4.47%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	-2.66%	0.37%	13.29%	9.71%	11.99%	10.42%	11.71%
US: NASDAQ ($US)	-2.26%	1.75%	23.28%	32.84%	23.48%	18.72%	17.93%
MSCI World Acc. (Local Currency)	-3.05%	0.05%	10.88%	3.30%	7.79%	5.85%	7.99%
MSCI World Acc. (AUD)	-1.13%	1.99%	4.90%	2.71%	9.07%	9.25%	8.52%
FTSE 100 (£)	-4.75%	-4.57%	-3.96%	-20.48%	-7.98%	-5.67%	1.36%
MSCI Emerging Markets ($US)	2.06%	2.64%	20.96%	8.25%	10.04%	1.94%	7.92%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
BarCap Global Agg Acc. (Hgd AUD)	0.00%	-0.35%	1.43%	3.76%	6.71%	4.49%	4.41%
AusBond Composite Bond Acc.	0.28%	0.93%	1.91%	4.00%	6.99%	5.67%	4.53%
ICE BoAML High Yield TR ($US)	0.47%	0.40%	11.08%	2.54%	5.39%	3.86%	6.14%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	September	12,572	August	12,583
Unemployment Rate	September	6.90%	August	6.80%
Participation Rate	September	64.80%	August	64.90%
Lending Finance				
Housing Finance	September	5.90%	August	12.60%
Personal Finance	September	8.50%	August	-12.50%
Business Finance	September	57.20%	August	-42.90%
Other				
Balance on goods and services	August	2,643m	July	4,607m
Retail Sales	August	-4.00%	July	3.20%
Building Approvals	September	8.80%	August	0.60%

*All data is seasonally-adjusted.

Median Fund Manager Returns (Morningstar)	1 month	3 month	6 month	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Australian Equity Large Cap	1.61%	1.65%	9.10%	-8.47%	2.57%	2.04%	4.91%
Australian Equity Small Cap	1.14%	6.62%	20.63%	-0.17%	5.74%	5.40%	7.86%
Global Equity Large Cap	0.06%	2.31%	4.85%	1.06%	7.57%	7.53%	7.03%
Global Equity Small Cap	1.66%	4.99%	9.89%	-0.51%	3.76%	2.88%	5.64%
Australian Fixed Income	0.34%	1.04%	2.83%	3.81%	6.64%	5.33%	4.20%
Global Fixed Income	0.12%	-0.32%	2.36%	3.61%	6.42%	4.08%	3.84%
Australian Listed Property	-0.45%	5.92%	12.17%	-18.28%	-0.21%	1.53%	3.57%
Australian Cash	0.01%	0.05%	0.10%	0.42%	0.98%	1.23%	1.52%
Conservative[1]	0.10%	0.31%	1.77%	-0.58%	2.96%	2.35%	2.62%
Moderate[2]	0.12%	0.47%	3.06%	-0.72%	3.27%	2.66%	2.99%
Balanced[3]	0.18%	0.67%	4.51%	-1.88%	3.59%	2.87%	3.99%
Growth[4]	0.23%	0.97%	5.29%	-3.26%	3.70%	3.05%	4.40%
Aggressive[5]	0.24%	1.16%	6.82%	-4.26%	3.95%	3.34%	5.16%

[1] Growth Assets 0% - 20%
[2] Growth Assets 21% - 40%
[3] Growth Assets 41% - 60%
[4] Growth Assets 61% - 80%
[5] Growth Assets 80%+

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