ECONOMIC & MARKET COMMENTARY
JANUARY 2021

RBA - Options

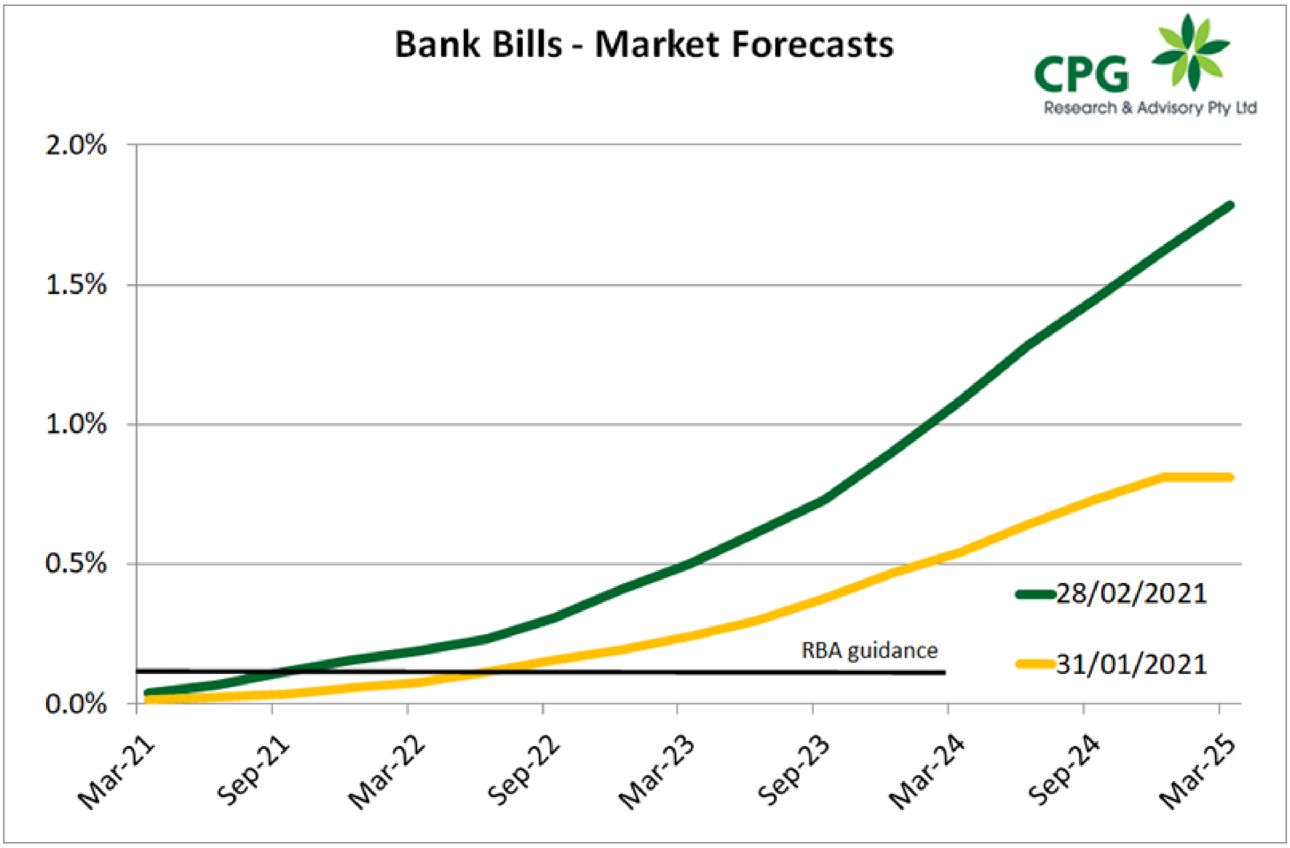
What's making Australian interest rate expectations soar? What policy options are available?

At the Australian close, the 10-year bond yield had soared almost 80bp in a month – almost all that in a fortnight. *Why?*

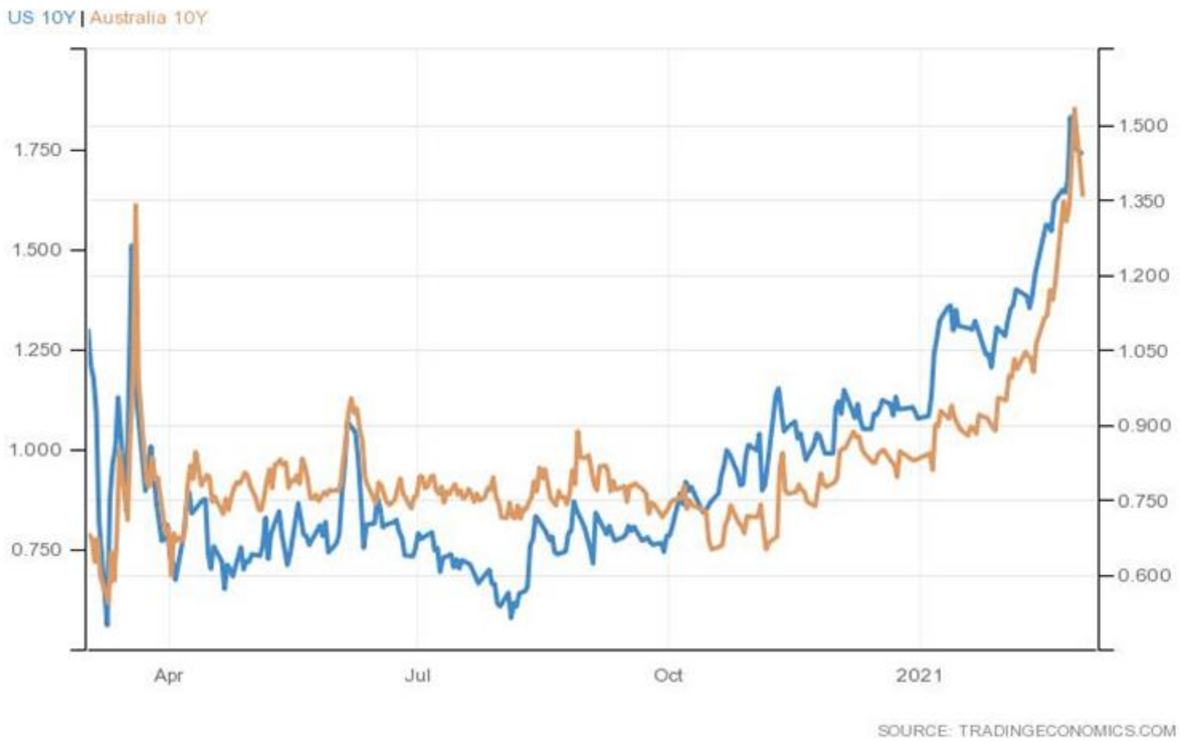
Usually when a market crashes, the blame is obvious. Shock inflation data, massive policy shift *etc*. Not this time. **The RBA reiterated existing policies** and extended quantitative easing (QE) beyond April. They did not even taper it – QE2 will continue at the current pace of $5bn a week.

But the market stopped believing the RBA's "at least 2024" guidance. That happened before. In 2008, they had been listening to Treasury, and was grossly overestimating the path of interest rates. And in 2011 as the global economy weakened, **the RBA had it horribly wrong** and was guiding interest rate increases that never came.

The current level of March 2024 bill futures is around 10 times the official forecast, and that creates a ***very unusual divergence between markets***. Bills today are well below the Official Cash Rate. But bill futures average ¼% above the 3-year bond. The futures reflect market participants' outlook; ***the 3-year bond cannot move***, and the RBA can intervene in unlimited volume to ensure it does not.



Yes, there was a US lead. And the two markets have been correlated. But the scales are different – **Australian bonds weakened twice as much as US**, unlike the previous year of being closely linked.



The following table highlights the worst performers for the month:

	Major 10Y	Yield		Day	Weekly	Monthly	YTD	Date
	US	1.44	▼ 0.02	-0.02%	0.07%	0.33%	0.53%	Mar/01
	UK	0.79	▼ 0.03	-0.03%	0.11%	0.44%	0.60%	Mar/01
	Japan	0.16	▼ 0.01	-0.01%	0.04%	0.11%	0.14%	Mar/01
	Germany	-0.30	▼ 0.00	0.00%	0.09%	0.22%	0.28%	Mar/01
	Greece	1.04	▼ 0.07	-0.07%	0.15%	0.36%	0.41%	Mar/01
	India	6.21	▼ 0.02	-0.02%	0.01%	0.08%	0.32%	Mar/01
	Italy	0.71	▼ 0.06	-0.06%	0.12%	0.06%	0.19%	Mar/01
	Australia	1.65	▼ 0.20	-0.20%	0.03%	0.47%	0.67%	Mar/01
	Brazil	8.19	▲ 0.05	0.05%	0.13%	0.47%	1.21%	Feb/26
	Canada	1.41	▲ 0.05	0.05%	0.18%	0.50%	0.73%	Mar/01
	France	-0.06	▼ 0.05	-0.05%	0.04%	0.17%	0.28%	Mar/01
	Mexico	6.25	▼ 0.06	-0.06%	0.52%	1.01%	0.95%	Feb/26
	Netherlands	-0.24	▲ 0.05	0.05%	0.11%	0.24%	0.31%	Mar/01
	New Zealand	1.78	▼ 0.15	-0.15%	0.11%	0.53%	0.76%	Mar/01
	Portugal	0.27	▼ 0.05	-0.05%	0.05%	0.21%	0.21%	Mar/01
	Spain	0.38	▲ 0.00	0.00%	0.11%	0.26%	0.32%	Mar/01
	Switzerland	-0.20	▲ 0.08	0.08%	0.14%	0.26%	0.35%	Mar/01

It may not be a coincidence that NZ was the worst developed market.

PM Ardern flagged in November that the RBNZ would have become a **tool for managing property prices** – affordability is a strategic priority for the government.

The RBNZ opposed this – if they have to take into account housing affordability at the government's direction, then why not any other policy objective? This was seen as compromising independence, and investors had hoped it would not pass. But in February, this mandate became law.

The conclusion is that ***NZ rates will be higher if the RBNZ are to consider rising property prices*** – perhaps much higher. NZ yields have rerated on the news.

To some extent, **underperformance by Australian markets is "*guilt by association*."**

There were no obvious domestic triggers in the data. Inflation remained below 1% even as temporary COVID subsidies expired.

What can the RBA do?

Their initial emergency response (just before the psychological 2% barrier) was to do two weeks of QE in one week. Seeing the RBA unexpectedly in the market on the last trading day sent traders scurrying to close out their bets. This produced a partial recovery on Friday and into the weekend session.

It's entirely possible that this is enough. Inflation is under 1%, so a bond yield approaching 2% is actually an attractive real yield by global standards.

Or that if US policies are the dominant influence, there may be nothing they can do.

But the initial response was a token one, and they may be tested again. The potential steps to escalate are:

- **Expand and accelerate QE** – something that the monthly commentaries already say the RBA is open to (maximising the announcement effect while not doing anything)
- Buying even **longer-dated bonds** in QE
- Further **yield curve targeting** beyond 3 years
- **Additional guidance** about their likely policy beyond 2024
- Further **rate cuts** into negative territory

Of these, only **expanded QE is currently on the table**.

QE has the advantage that it can be **readily scaled up and down** as conditions dictate. Guidance and yield curve targeting (which are related) lock the RBA into policy for many years, which can prove entirely inappropriate. Then escaping from the guidance is extremely difficult.

And negative rates have all kinds of adverse implications on the banking system. They are **probably counter-productive**, according to European studies.

How much will investors tolerate?

Only at month end did the stockmarket show signs of reacting specifically to bond yields. **1½% (or 100bp above the August low) seems to be where investor tolerance runs out**.

Again, this is not a great story for the "bonds as hedge" theory.

Leading Markets

US markets pared back early gains. The S&P500, Dow Jones and NASDAQ gained +2.8%, +3.4% and +1.0% respectively; MSCI World ex-AUS gained +2.7% in local terms. Emerging Markets rose +0.8% in $US with India up and Brazil down; Frontier Markets were +0.1%. Yields rattled investors at month end. Property was stronger on vaccines.

US 10-year bonds sold off, closing at 1.44% (+33bp). High yield closed at +357bp (-27bp tighter), matched pre-COVID tights. Distressed credit was the tightest since 2007. But emerging markets debt underperformed.

Other Highlights

COVID-19 deaths reached 2.5m from 114m cases, but the 3rd wave has now clearly peaked. Vaccine rollouts are progressing, with very high take-up at vulnerable ages. At month end, Israel had vaccinated 92%, UAE 60% UK 30% and USA 22%. This will start to deliver reliable data on efficacy against new strains.

The US House sent a $1.9tr bill (9% of GDP) to the Senate.

US Q4 GDP grew +1% (4.1% p.a.) on the 2nd estimate, meeting economists' forecasts. The year's GDP fell -2½%.

US unemployment fell to 6.3% (-0.4%) in January, despite Non-farm payrolls just +49k. Youth unemployment dived to 11.2% (-1.3%). CPI rose +0.3% to remain +1.4% YoY; core inflation eased to 1.4% (-0.2%). CPI-linked bonds factored decade-high inflation expectations. Retail sales jumped +5%.

Eurozone unemployment was steady at 8.3% despite participation rebounding to 56.8% (+1.2%). YoY inflation reversed to +0.9%, from -0.3% with core inflation at +1.4% from 0.2%. Retail sales recovered +2%. December's current account surplus of +EUR51bn set a record.

Japan's CPI was -0.6% YoY after a +0.6% month, the highest in decades (barring GST increase months). 2020 GDP contracted just -1.2%. The 10-year bond reached +0.15% and has not been below zero since May.

Domestic

Travel bans were extended to at least July.

Craig Kelly's resignation reduces the government numbers to 75 of 150 in the House, but with little practical impact.

The RBA announced an early extension of quantitative easing at the February meeting, extending it beyond April at an unchanged pace. They affirmed current policy rates until 2024 "*at the earliest*."

They were forced to intervene at month end as bond priced collapsed.

The ASX200 returned +1.45% while Smallcaps added +1.55%.

The 10-year bond crashed to 1.87% (+78bp), almost touching 2% late in the month. This spooked the RBA, but the response (bringing forward next week's QE purchases) underwhelmed investors. Local REITs underperformed.

CoreLogic's home price index rose +2.1% in February, the strongest month since 2003, with all capitals firmer.

Wages rose +3.2%, slightly offset by reduced overtime. AWOTE is inflated by loss of low-end jobs. The wage price index was steady at a record low 1.4%.

Exports and imports both fell in Jan after one off factors in Dec, leaving the trade surplus estimated at $8.75bn.

Retail sales rose +0.6% in January *vs* -4.2% in December to be +10.7% YoY.

Unemployment fell to 6.4% (-0.2%) on +29k jobs in Jan; +59k were fulltime with a -30k reduction in part time. Underemployment fell -0.4% to 8.1%. Youth unemployment was steady at 13.9%.

Commodities and Currency

WTI oil jumped to $US61.5/bbl (+18%), up 75% since the US election. Gold slid to $1735/oz (-6%).

Iron ore closed $173 (+11%) on Brazilian supply difficulties.

Base metals gained: Nickel (+5%), Tin (+16.3%), Copper (+16.5%), Aluminium (+10.9%) and Zinc (+10%).

The $A closed at 78c (+2.4%), having reached a 3-year high near 80c.

KEY FINANCIAL MARKET DATA – AS AT 28TH FEBRUARY 2021 (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	0.00%	0.00%	0.03%	0.21%	0.75%	1.16%	1.44%

Key Rates	Feb-21	Jan-21	Dec-20
Australian Cash Rate	0.10%	0.10%	0.10%
90 day BBSW	0.03%	0.01%	0.01%
3 Yr Commonwealth Bonds	0.12%	0.11%	0.10%
10 Yr Commonwealth Bonds	1.87%	1.09%	0.98%
CDX North American 5 Yr CDS	56bp	56bp	50bp
iTraxx Europe 5 Yr CDS	51bp	52bp	48bp
iTraxx Australia 5 Yr CDS	62bp	63bp	57bp
US Fed Funds Rate	0-0.25%	0-0.25%	0-0.25%
US 10 Yr Bond Rate	1.44%	1.11%	0.93%

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	1.45%	3.00%	11.47%	6.48%	7.55%	7.39%	10.74%
S&P/ASX Small Ord Acc. Index	1.55%	4.08%	12.05%	17.18%	9.13%	7.21%	11.70%
S&P/ASX 200 A-REIT Acc. Index	-2.64%	-6.20%	4.24%	-11.95%	-0.79%	5.37%	4.72%

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 ($US)	2.76%	5.63%	9.74%	31.29%	19.18%	14.14%	16.82%
US: NASDAQ ($US)	1.01%	8.32%	12.43%	55.27%	33.59%	23.17%	24.99%
MSCI World Acc. (Local Currency)	2.65%	5.43%	11.14%	26.08%	15.24%	10.84%	13.58%
MSCI World Acc. (AUD)	1.64%	0.74%	6.73%	7.72%	11.52%	11.01%	12.28%
FTSE 100 (£)	1.19%	3.47%	8.72%	-1.48%	-4.27%	-3.58%	1.24%
MSCI Emerging Markets ($US)	0.76%	11.49%	22.32%	36.05%	15.54%	6.35%	15.24%

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)	-1.56%	-1.87%	-0.99%	-0.18%	4.47%	4.19%	3.54%
AusBond Composite Bond Acc.	-3.58%	-4.25%	-3.05%	-2.80%	2.92%	3.99%	3.25%
ICE BoAML High Yield TR ($US)	0.35%	2.65%	6.14%	8.62%	7.26%	6.25%	8.84%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	January	29,100	December	50,000
Unemployment Rate	January	6.40%	December	6.60%
Participation Rate	January	66.10%	December	66.20%
Lending Finance				
Housing Finance	January	10.50%	December	8.60%
Personal Finance	January	0.20%	December	-0.50%
Business Finance	January	-32.90%	December	109.90%
Other				
Balance on goods and services	December	6,785m	November	5,022m
Retail Sales	December	-4.10%	November	7.10%
Building Approvals	January	-19.40%	December	10.90%

*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	2.27%	3.61%	13.15%	7.51%	7.21%	5.74%	9.16%
Australian Equity Small Cap	2.21%	5.04%	13.75%	21.42%	11.88%	7.91%	11.66%
Global Equity Large Cap	2.22%	2.90%	11.02%	9.36%	10.50%	9.67%	11.20%
Global Equity Small Cap	3.36%	8.88%	21.11%	20.79%	13.54%	10.12%	11.78%
Australian Fixed Income	-3.63%	-4.26%	-2.84%	-2.58%	2.91%	3.66%	2.96%
Global Fixed Income	-1.83%	-2.08%	-0.96%	-0.25%	4.22%	3.76%	3.09%
Australian Listed Property	-2.38%	-5.36%	5.27%	-12.29%	-1.20%	4.26%	3.97%
Australian Cash	0.00%	0.02%	0.03%	0.21%	0.76%	1.15%	1.44%
Conservative[1]	-1.27%	-1.23%	0.75%	-0.51%	2.41%	2.38%	2.77%
Moderate[2]	-0.42%	-0.26%	2.51%	1.46%	3.53%	3.49%	3.86%
Balanced[3]	0.21%	0.83%	5.12%	4.18%	5.10%	4.71%	5.80%
Growth[4]	0.71%	1.86%	7.34%	5.55%	6.02%	5.33%	7.04%
Aggressive[5]	1.65%	3.16%	10.31%	8.06%	7.65%	6.49%	9.16%

[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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