

The turn in the cycle - implications of falling interest rates



Oliver's insights

Key points

- The RBA has kicked off an easing cycle with a 0.25% rate cut. While the RBA was circumspect about future moves we expect soft economic conditions to result in more cuts taking the cash rate to 6% in a year's time.
- One rate cut won't see a sustained improvement in the economy or shares, but it's going in the right direction.

First interest rate cut in over six and a half years

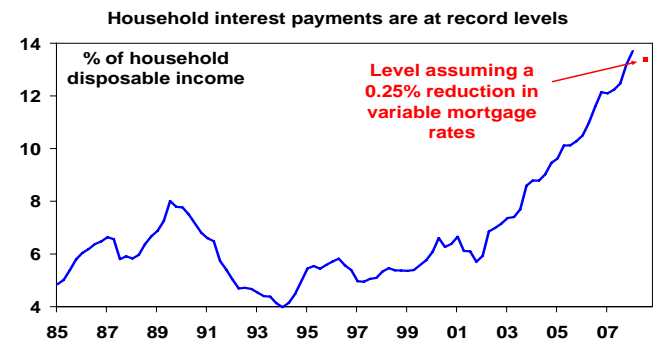
For the first time since December 2001 the Reserve Bank of Australia has cut interest rates, with the official cash rate falling from 7.25% to 7%. **The recent run of economic data and anecdotal evidence suggests the significant slowdown in domestic demand the RBA has been looking for in order to slow inflation is underway.** Without an easing in financial conditions a hard landing, if not recession, was looking increasingly likely. The RBA statement announcing the cut was relatively circumspect about the prospect of more rate cuts and highlighted the balancing act between high inflation and weak overall demand growth. But the RBA has left the door open for further cuts and it is likely interest rates will fall further as sub-par growth adds to confidence that inflation will fall.

Rate cuts and the economy

Rate cuts are good news for the economy. The tightening in financial conditions as a result of 12 consecutive 0.25% increases in the official cash rate since May 2002, an additional 0.5 to 0.6% increase in bank lending rates on the back of the credit crunch, a 30% slump in the share market, falling house prices, the surge in petrol prices and the \$A near parity were all combining to significantly increase the risk of recession in the economy. While the July tax cuts and Budget goodies worth about \$50 a week for a typical family were nice, they were more than offset by an extra \$75 a week in interest payments since mid last year and an extra \$20 a week in petrol bills faced by a key consumption driving family with a \$250,000 mortgage and two cars. The result has been an abrupt downturn in the economy evident in a slump in consumer and business confidence to recessionary levels, falling retail sales volumes in the March and June quarters, a slump in housing related indicators, a sharp slowing in credit growth and a softening job market. The list of companies announcing major layoffs has gone from a trickle to a torrent over the last couple of months, and includes: Holden, Ford, IAG, Qantas, Starbucks, Don KRC, NAB, Cadbury, Boeing, Fairfax, Babcock & Brown and Allco.

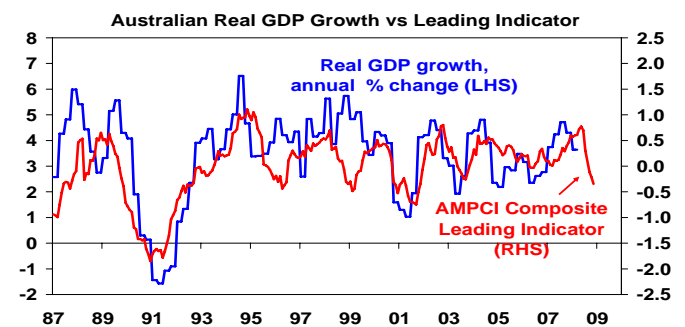
Fortunately, the RBA has seen the evidence and has done an about face. However, there are several things to note.

First, **apart from an initial confidence boost, one rate cut on its own won't have a big impact.** For a family with a \$250,000 mortgage a 0.25% cut in interest rates amounts to a \$12 a week saving. But **this is a long way from reversing the extra \$75 a week needed to service the mortgage when mortgage rates rose from 8.05% mid last year to just over 9.6% in July.** Household interest payments relative to household disposable income will still be pretty close to record levels. See the chart below.



Source: Thomson Financial, AMP Capital Investors

Secondly, the lag from rate cuts to the economy is long and variable, usually around 12 months or so. Given that the massive tightening in financial conditions over the last year is still working its way through the economy, **it's likely we will see a further deterioration in economic growth over the next six-12 months or so.** In fact, our leading indicator (based on building approvals, business and consumer confidence, the share market, the shape of the yield curve and money supply growth) is still falling.

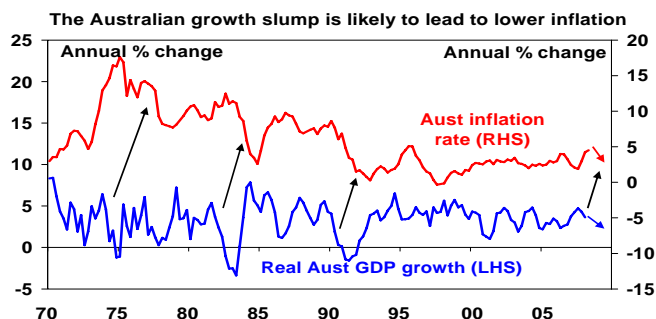


Source: Thomson Financial, AMP Capital Investors

In addition to this, the worsening slump in the global economy with Europe and Japan reporting negative growth in the June quarter, the US remaining very weak and Asian countries including China and India now starting to slow suggests further downwards pressure on commodity

prices, which may start to soften the mining boom in the short term. It's also worth noting that rate cuts haven't yet prevented economic slumps in the US, UK and Canada.

This suggests more rate cuts are likely. But what about inflation? The slump in growth suggests inflation will fall and this will be helped by falling oil prices. **With growth likely to remain sub-par and inflation likely to fall over the year ahead our assessment is that the cash rate will fall to around 6% over the next 12 months.**



Source: Thomson Financial, AMP Capital Investors

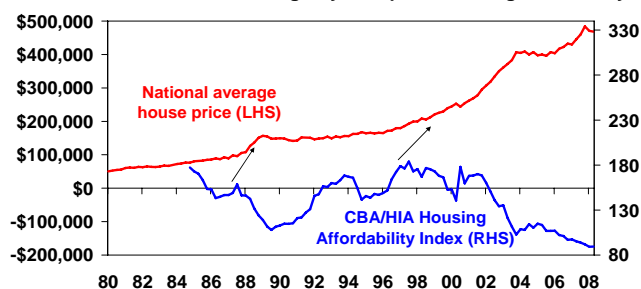
Applying the normal lag and assuming more rate cuts, the commencement of an easing cycle should help Australia's growth rate to start improving from around mid next year.

Finally, without a cut in bank lending rates RBA rate cuts are academic so it's good to see the major banks immediately cutting their mortgage rates by 0.25%. While its unclear how they will respond to subsequent RBA rate cuts, bank funding cost have been falling and it's worth noting the RBA can just keep cutting the cash rate until it gets the mortgage rate it feels is appropriate.

Lower interest rates and the housing market

The move to lower interest rates coming into the spring home buying season may see the housing market perk up a bit in the next month or so. However, this is likely to be temporary as a range of factors point to continued tough conditions. Firstly, housing affordability remains terrible and it will take several mortgage rate cuts and a decent decline in house prices to result in any significant improvement.

Interest rates need to fall a long way to improve housing affordability



Source: REIA, CBA/HIA, AMP Capital Investors

The late 1980s and mid 1990s to 2004 house price booms began with much higher levels of housing affordability. Secondly, Australian house prices remain very overvalued relative to rents and average household income levels. Thirdly, the downturn in the economy is likely to result in rising unemployment over the year ahead and this is likely to see increased uncertainty which will largely offset the initial impact of lower interest rates and keep buyers essentially sidelined for a while. On top of this, the ongoing credit crunch is likely to ensure the availability of mortgage credit will remain constrained. The shortage of houses relative to underlying demand will likely prevent a US style

collapse in house prices, but for all these reasons the housing market is likely to remain weak in the year ahead.

What do lower interest rates mean for shares?

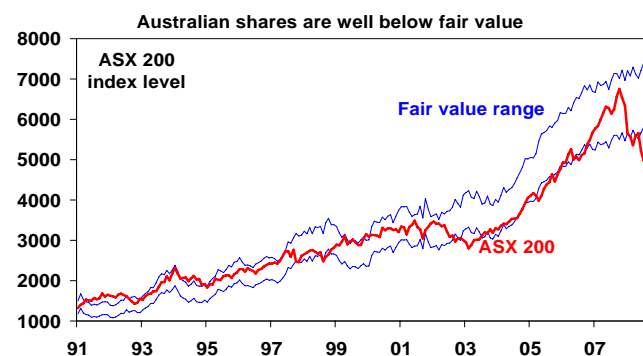
Falling interest rates are normally good for shares because they help future profit growth and make shares more attractive compared to cash. The table below shows the Australian share market's response after the first rate cut at the start of an easing cycle.

Australian equity performance (ASX 200), %change, months after first RBA rate cut in an easing cycle

First rate cut	+3mths	+6mths	+12mths
May 82	-7.6	1.0	19.8
Jan 86	12.7	17.6	45.7
Jan 90	-10.9	-3.8	-23.9
July 96	6.5	11.1	23.4
Feb 01	0.5	2.6	3.8
Average	0.2	5.7	13.8

Recessions for the Australian economy are highlighted in red. Source: Thomson Financial, AMP Capital Investor

On average, shares are up 3, 6 and 12 months after the start of rate cutting cycles. But the experience is mixed in times of recession. However, with shares having already fallen sharply and looking very cheap (see the next chart – which shows an improvement in fair value recently thanks to the fall in bond yields) and with strong resource sector profits likely to underpin overall profit levels there is good reason to believe shares will be up on a 12 month horizon.



Source: Thomson Financial, AMP Capital Investors

However, the next few months are likely to see the news flow remain poor with more earnings downgrades, more bank provisioning for bad debts and more bad global news. So the ride is likely to remain rough for a few months yet. But with interest rates falling there is reason to be more confident about the 12 month outlook.

What about the \$A?

While the \$A has the potential to bounce back to around \$US0.90 after its sharp fall, the cyclical trend is now down. The combination of falling Australian interest rates and a correction in commodity prices suggests the \$A has more downside ahead of it over the next six months or so, possibly to around \$US0.80. However, the long-term trend is likely to remain up on the commodity super cycle.

Conclusion

One interest rate cut on its own won't necessarily lead to a sustained improvement in the economy or shares. But it is a move in the right direction and suggests there is light at the end of the tunnel.

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