Aggressive RBA Policy Easing in November

Kieran Davies, Chief Macro Strategist, Coolabah Capital Investments

For a number of months now Coolabah Capital Investments (CCI) has forecast that the RBA would embark on another round of policy easing, which is a view that markets have gradually come to embrace. This note summarises our current expectations regarding the precise policy mix the RBA will consider adopting in November. Our central case is that this includes:

- Cutting the cash rate/3-year bond yield target/Term Funding Facility rate from 0.25% to 0.10% (market: 0.1% for all rates).
- Cutting the deposit rate on exchange settlement balances from 0.10% to 0.01%, although it may opt for 0.05% given earlier concern about a zero deposit rate (market: 0.01%; range: 0.00-0.05%).
- Potentially adopting a 5-year bond yield target of 0.1% (market: no target; range: target to no target). The board has not discussed this option, but staff may be considering an additional target. A target would suggest the RBA expects a longer period of a near-zero cash rate, although the RBA would likely promote it as a tool to lower long-term bond yields.
- Introducing outright QE involving, on CCI's estimates, approximately $140bn (range of $115-180bn) of purchases of Commonwealth and semi-government nominal bonds, initially over a year and tied to economic objectives (market: $100bn over 1 year; range: $75-180bn/7-18 months). This estimate is based on the required increase in the RBA's balance sheet to achieve full employment, allowing for the increase in RBA assets due to purchases related to the existing 3-year target and a further drawdown on the Term Funding Facility. It is also similar to international experience.

CCI's estimate of QE is at the high end of market expectations reflecting the challenge in reducing unemployment towards its full-employment level. The actual amount of purchases will depend on the how the economy evolves, but strategically the RBA may opt for a larger amount to have a greater effect on market expectations and to avoid revising the estimate in the short term (e.g., the RBNZ has revised the ceiling for its current LSAP programme up over time). These purchases might also be spread across a potential 5-year yield target and longer-term 5-year to 10-year purchases of Commonwealth government and semi-government bonds.

Given that a key input into this calculation is the NAIRU, we explored the impact of alternative scenarios on the estimate of QE. If the NAIRU is unchanged from the RBA's pre-virus estimate of 4.5% – or, more plausibly, it was lower than the RBA's figure – the RBA would have to do about twice as much QE as we have estimated and/or call on additional government support. Alternatively, if the NAIRU is more like 5.5%, the analysis suggests that the RBA can broadly rely on existing policy settings, including a full drawdown of the Term Funding Facility, to eventually achieve full employment. Note, though, putting aside the difficulty in measuring the NAIRU, the RBA must also be concerned that further policy easing by other central banks would place pressure on it to try to stop the AUD from appreciating.

Expected conventional and unconventional policy package in November

In terms of conventional and unconventional monetary policy, CCI expects the RBA to:

1. Cut the official cash rate target, Term Funding Facility rate, and 3-year Commonwealth bond yield target to 0.1%

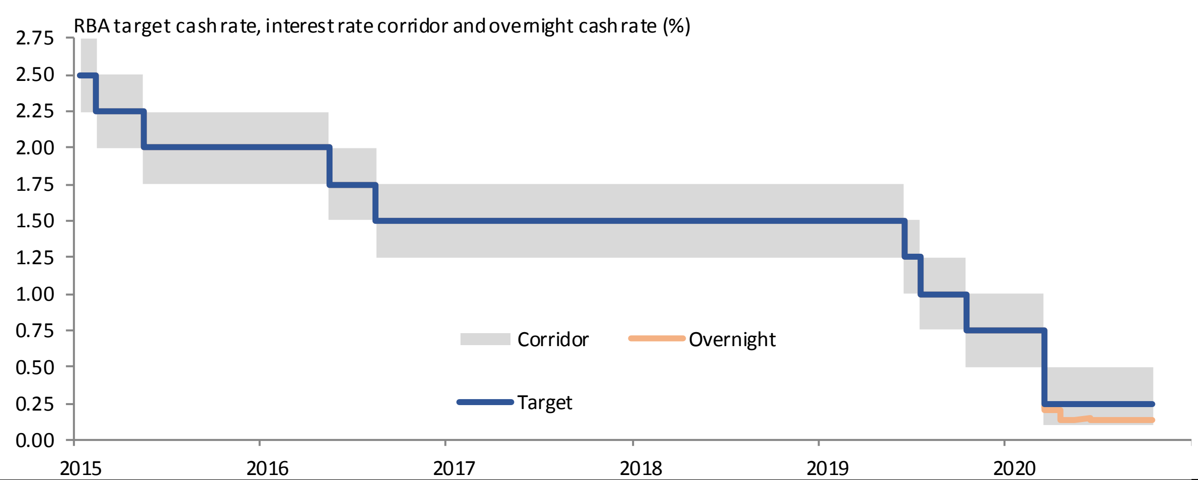
Matching the unanimous market projection, CCI expects a cut in all three rates from 0.25% to 0.10%. This has been clearly signalled by the RBA through speeches and key media commentators.

2. Cut the deposit rate on exchange settlement balances to 0.01% with a risk it opts for a higher rate of 0.05%

We expect the deposit rate on exchange settlement (ES) balances could be lowered from 0.10% to 0.01%, with a risk the RBA opts for 0.05% given its earlier concerns about avoiding a zero rate (see below). This would likely to continue to see the actual cash rate trade below the target rate. Only about half of banks forecast the deposit rate, with a median forecast of 0.01% (range: 0.00-0.05%).

The RBA's policy interest rate corridor around the target cash rate comprises: (1) a floor of the RBA deposit rate on excess ES balances; and (2) a ceiling of the RBA lending rate on ES balances borrowed by banks. Historically, the corridor was the target cash rate +/-25bp, but when the target rate was cut to 0.25% in March the RBA changed the corridor to -15/+25bp, such that the deposit rate was reduced to 0.1% rather than zero. The 18 March board minutes said that the RBA wanted to avoid a zero deposit rate because it would "increase the costs to the banking system" given the significant increase in ES balances "resulting from the combined effect of the [RBA's] enhanced liquidity operations, bond purchases and the [Term Funding Facility]".

Figure 1: The RBA has accepted the cash rate trading closer to the deposit rate



Source: Reserve Bank of Australia, Coolabah Capital

Since March, the overnight cash rate has averaged 0.14% as the RBA has purposefully not drained excess liquidity from the cash market (see Kent (2020.10)). The persistently large deviation from the target cash rate is the largest since the corridor was introduced in the mid to late 1990s, where historically large deviations usually reflected difficulty in mopping up excess liquidity from the RBA's intervention in the foreign exchange market.

3. Potentially extend price-based QE via an additional 5-year bond yield target

The RBA could adopt an additional target for the 5-year bond yield according to some media commentators. This policy has not been discussed by the board to date (see Debelle (2020.09)), but that is not to say that it hasn't been considered by RBA staff. Only one bank expects an additional bond yield target. That said, several banks expecting QE in November argue against announcing a dollar amount of bond purchases, which is one of the key attractions of price-based QE.

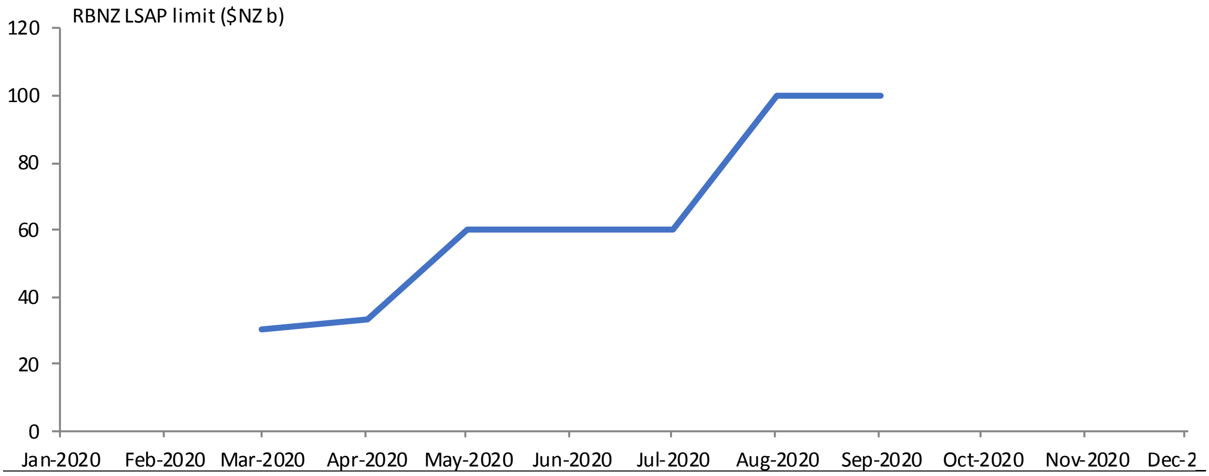
Introducing a 5-year yield target would suggest that the RBA was revising its economic outlook to factor in a much longer period of a near-zero cash rate, although the RBA may promote it more as part of a yield curve strategy aimed at dragging down longer-dated yields. This judgment reflects the RBA view that the existing 3-year yield target is an extension of the cash rate target. For example, Debelle (2020.09) said that in the bank's central forecast scenario it "would be more than three years before sufficient progress was being made towards full employment to be confident that inflation will be sustainably within the target band … [such that] it is highly unlikely that the cash rate will be raised over that time horizon … [which] aligns with the target for the 3-year bond yield".

4. Introduce quantity-based QE with an initial estimate of $140bn (range of $115bn-180bn) of purchases of Commonwealth and semi-government bonds over a year, likely tied to unemployment objectives more than time

The RBA is likely to adopt quantity-based QE, with an initial CCI estimate for purchases of $140bn (range of $115-180bn) of 5- to 10-year Commonwealth and semi-government bonds over an initial one-year period and emphasising the purchases are aimed at reducing unemployment. This is in addition to the increase in its balance sheet due to further buying related to the 3-year yield target and take-up of the Term Funding Facility (TFF). The actual amount of purchases will depend on the how the economy evolves, but strategically the RBA may opt for a larger amount to have a greater effect on market expectations. It may also express the amount as a floor to give it flexibility and to avoid needing to revise the estimate in the short term (e.g., the RBNZ has revised the ceiling for its current LSAP programme up over time). Purchases should span Commonwealth and all state bonds and are likely to be less skewed to the Commonwealth than in 2020 to date. Purchases will probably exclude bonds with maturities greater than 10 years and inflation-indexed bonds. A weekly timetable of purchases is likely.

The market also expects QE in November, although a few banks are either unsure of the timing or forecast it to commence in early 2021. The consensus among banks expecting QE in November is that the RBA will buy $100bn of 5- to 10-year Commonwealth and semi-government bonds over a 12-month period (range: $75-180bn/7-18 months). Some banks think the RBA should avoid nominating a dollar figure of purchases to retain flexibility. A minority forecasts an eventual extension.

Figure 2: The RBNZ has revised the ceiling for its LSAP programme up over time



Source: Reserve Bank of New Zealand, Coolabah Capital

4.1 We estimated the QE package by calculating the increase in the balance sheet required to reach full employment and examining international experience

Tying QE to economic objectives would be consistent with the RBA 3-year bond yield target, which was framed in terms of "support[ing] the economy … and assist[ing] with a strong recovery once the COVID-19 outbreak has been contained". This view is reinforced by international experience, with the BIS (2019) reporting that QE policies aimed at traditional economic objectives have evolved over time. Initially central banks adopted fixed size/end-date strategies (e.g., the Fed's LSAP2 in 2010), but more recent programmes have "tended to begin with a monthly pace of purchases … made contingent on the economic and inflation outlook" (e.g., the ECB's APP in 2014, the Fed's LSAP3 in 2012 and the BoJ's QQE and YCC in 2016). More recently, the RBNZ LSAP programme in 2020 aimed to provide "further support to the economy, build confidence, and keep interest rates on government bonds low".

Accordingly, we took two approaches to estimate the dollar amount of QE. Firstly, solving for the amount of purchases by calculating the increase in the size of the RBA's balance sheet required to return the labour market to full employment points to new purchases of $140bn (range $115-180bn). Secondly, we looked at international experience, which pointed to new purchases of $160bn.

4.1.1 Estimating bond purchases required to achieve full employment

Estimating the bond purchases required to achieve full employment, we proxied full employment using the NAIRU, which we set at 5%. This is higher than the RBA's pre-virus estimate of 4.5% given structural unemployment always increases during recessions, and is at the top end of Treasury's latest estimated range of 4.75-5.0%. Using Commonwealth budget forecasts as a proxy for the RBA's soon-to-be-released November outlook, unemployment is forecast to peak at 8% in Q4 2020, slowly falling to 6.3% by Q4 2022 and 6.0% by Q2 2023. Concentrating on the Q4 2022 and Q2 2023 forecasts given the lags involved with monetary policy, this points to excess capacity in the labour market of 1.5pp and 1.3pp, respectively.

Given that the anticipated reduction in the cash rate from 0.25% to 0.1% will have only a marginal effect on spare capacity, the burden of adjustment falls to unconventional policy. Expressing this task in a different way, the RBA's MARTIN model indicates that a 1% increase in GDP will reduce the unemployment rate by 0.4pp, which suggests that the RBA will have to boost output by 2.5-3.2% to achieve full employment by late 2022/mid 2023. International research suggests that a 1% increase in a central bank's balance sheet as a share of GDP will boost GDP by 0.2%, although this estimate is highly uncertain. Making the strong assumption that the same result would hold for Australia, this indicates that the RBA would need to increase its balance sheet by 13-16% of GDP, or $250-315bn given annual GDP is currently almost $2 trillion.

Excluding the expected increase in the RBA's balance sheet reflecting purchases to maintain the existing 3-year bond yield target – which we arbitrarily put at $20bn – and the further likely $114bn take-up of the Term Funding Facility, this puts net new purchases at $115 180bn. Taking the average and applying judgment, this points to net purchases of $140bn.

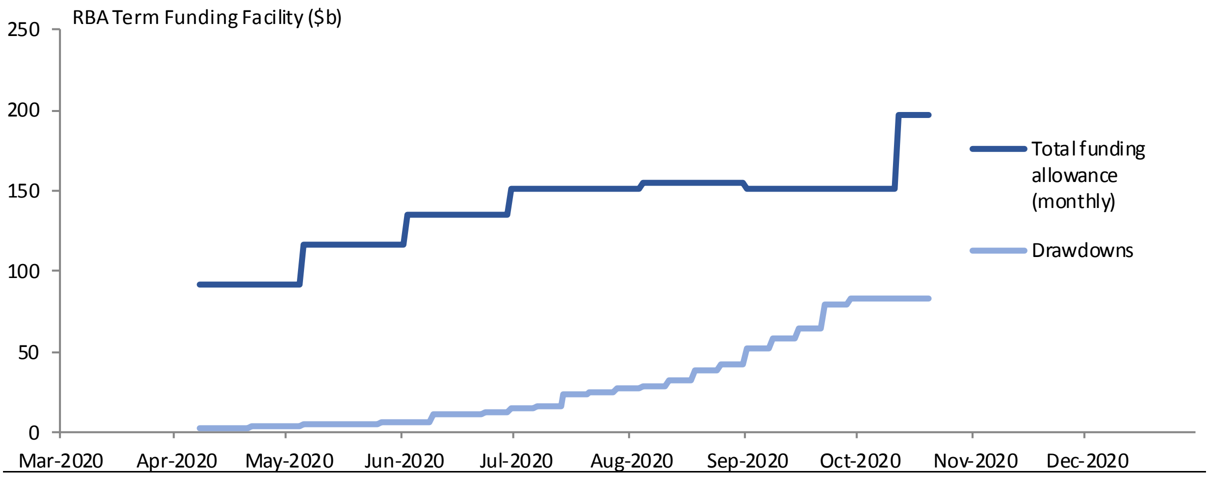
Given that a key input into this calculation is the NAIRU, we explored the impact of alternative scenarios on the estimate of QE. Assuming that the NAIRU is unchanged from the RBA's pre-virus estimate of 4.5% – or, more plausibly, it may have been lower than the RBA's figure – the RBA would have to do about twice as much QE as we have estimated and/or call on additional government support. Alternatively, if the NAIRU is closer to 5.5%, the analysis suggests that the RBA can broadly rely on existing policy settings, including a full drawdown of the Term Funding Facility, to eventually achieve full employment.

Figure 3: The impact of alternative scenarios for the NAIRU for QE

Assumed NAIRU:		RBA pre-virus estimate	CCI assumption	
	4.0%	4.5%	5.0%	5.5%
Estimated QE $bn	404	272	140	8

Source: Coolabah Capital

Figure 4: Take-up of the RBA's Term Funding Facility



Source: Reserve Bank of Australia, Coolabah Capital

4.1.2 International experience points to QE of $160bn

The BIS (2019) survey of central banks reported that QE aimed at traditional monetary policy objectives typically averaged about 15% of GDP (or 10% of the eventual stock of outstanding bonds). Translating this to Australia would put QE at almost $300bn or about $160bn net of further purchases to underpin the 3-year yield target and the further take-up of the Term Funding Facility.

4.2 A weekly timetable of purchases seems likely

We think the RBA will adopt a weekly timetable of planned auctions, with recent RBA commentary mentioning regular purchases as an option. There is no strong market view regarding the timing of purchases. Debelle (2020.09) said the board was considering additional purchases "on a regular basis", a point repeated in the Q&A session of Kent (2020.10). By way of comparison, the current RBNZ LSAP programme announces every Friday afternoon auctions for Monday, Wednesday and Friday of the following week.

4.3 Buying Commonwealth and semi-government bonds with no announced mix, although with less skew towards Commonwealth bonds than in 2020 to date

The RBA is likely to buy both Commonwealth and semi-government bonds. The mix of purchases is unlikely to be announced and depend on market conditions. In practice, we expect less skew towards Commonwealth bonds than in 2020 to date, with semi purchases across the states likely to be close to index weights. We assume that the RBA will focus on nominal bonds and is unlikely to include inflation-indexed bonds. All banks forecasting QE in November expect purchases of Commonwealth and semi-government bonds. Most banks to not have a strong view on the mix between Commonwealth and semi-government bonds.

Debelle (2020.09) said that the board was currently considering buying government bonds further out along the curve, supplementing the three-year yield target. Although not explicit, he subsequently discussed how "the current level of government bond rates is not a constraint on the fiscal decisions of the Australian and state governments", which suggests that the option before the board was the purchase of both Commonwealth and semi-government bonds.

This would be consistent with practice to date., with the RBA's March announcement outlining its decision to buy both Commonwealth and semi-government bonds to achieve its 3-year yield target and address dysfunction in the market at the time. In March, the RBA did not provide the fine details of its plans, saying the size and mix of purchases would be "determined subject to market conditions" and "vary across auctions". In practice, purchases to date have been dominated by Commonwealth bonds, with semis purchased earlier in 2020 when the RBA bought bonds across all states and territories.

Note that current RBA purchases for the 3-year yield target are of "government securities", which suggests it has the ability to buy inflation-indexed bonds. However, to date the RBA has only bought nominal bonds with Debelle (2020.06) suggesting there was little point in buying inflation-indexed bonds because they are not widely used as financial benchmark. In comparison, the RBNZ LSAP programme announced in March initially excluded inflation-indexed bonds, but that decision was later reversed.

Figure 5: RBA long-dated open market operations in semis in 2020 to date

Source: Reserve Bank of Australia, Coolabah Capital

4.4 Bond purchases should focus on 5- to 10-year maturities

We expect the RBA will buy bonds in the 5- to 10-year segment of the yield curve, in addition to the purchases are required to achieve the existing 3-year yield target. The market has the same expectation.

The Lowe Q&A session (2020.10) focused on whether the high level of Australian 10-year bond yields relative to other countries reflected the fact that the RBA was yet to buy bonds in the 5- to 10-year segment of the yield curve. He said that the "question the board is working through, and it's a difficult question, if we buy government bonds in the 5-10 year range, is that going to create more jobs and how would it create more jobs".

This was similar to Debelle (2020.09), who said, "purchases would still be conducted to maintain the [3-year yield] target… but additional purchases could occur further out the curve … [which] would have the effect of further lowering government bond rates at longer maturities". Earlier Debelle (2020.06) also indicated the RBA saw little value in buying bonds beyond 10 years given they "very few other financial instruments price off them".

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