To Hike or not to Hike? Now That is the Question.

Economists are at odds over whether the Reserve Bank of Australia should suspend rate hikes in April or raise the cash rate by another 25bps, as the RBA confronts how to bring inflation down with higher interest rates while not sending the economy into recession. The bond market is indicating rate increases are over… but inflation remains uncomfortably high. Will the RBA hike again?

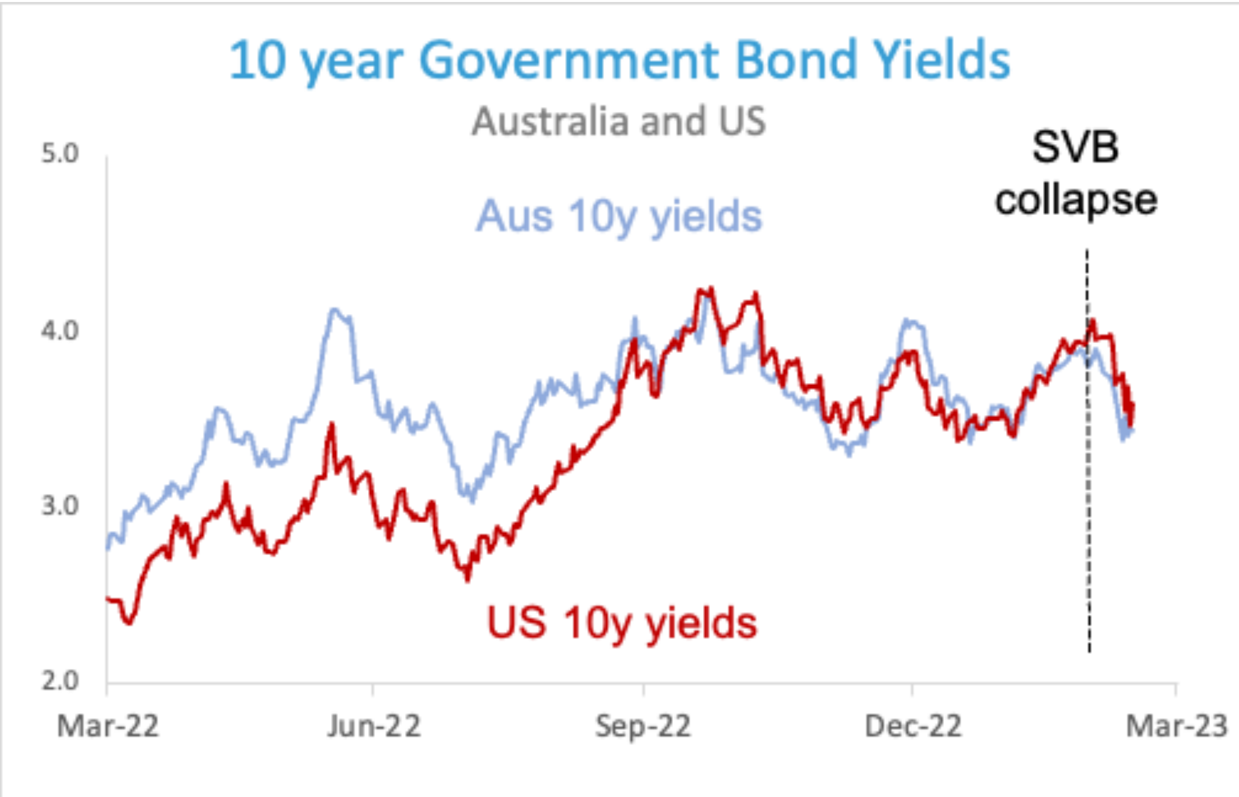
The collapse of several US regional banks and the global bank Credit Suisse has had a dramatic effect on the market's expectations for future interest rate moves. The bond market is indicating that the aggressive tightening campaign by global central banks is over amid growing concerns that contagion sparked by Silicon Valley Bank's collapse will end in global recession. Markets around the world have fallen, with bank stocks being particularly hard hit.

In early March RBA governor Philip Lowe confirmed that the central bank was closer to a pause and said that the board would be carefully assessing the monthly employment and business indicators, along with retail trade figures and the monthly consumer price index (CPI) indicator. But this was before recent global banking crisis.

Reading bond yield tea-leaves – have we seen the end of higher rates?

Yields on bonds are seen by market watchers as an indicator of future interest rates. After the collapse of the Silicon Valley Bank the Australian three-year bond yield plunged from 3.4% per cent down to under 3% - this is a dramatic move in the bond world. Given that the official cash rate is currently 3.6 per cent it would appear traders have now eliminated any further tightening by the RBA from their rates profile, and in fact have started to factor in a small risk of a rate cut later this year.

This follows a similar pattern in the US, where the yield on the two-year US Treasury bond, which is sensitive to interest rate expectations, plunged more than a half a percentage point on March 13th, posting the biggest three-day fall since the Black Monday crash of October 1987. Reading yield curve tea leaves, traders are now expecting around 0.75 percentage points of Federal Reserve rate cuts implied by year-end.



But yield curves are not only a reflection of interest rates – the yield on bonds is driven by supply and demand dynamics, which take into account estimates of future economic activity, that *includes* a collective view of future cash rates but also encompasses views on national productivity, unemployment and inflation.

Importantly, bonds are also seen as a safe haven asset. The collapse of Credit Suisse and the US banks are seen by some as a precursor to global recession, and this is where the flight to safety comes in, driving a greater demand for bonds, which pushes yields lower.

Inflation is easing – but not fast enough

Despite the large and sudden drop in bond yields, the Federal Reserve in the US pressed ahead with another 25 bps at their most recent meeting on March 22nd, setting a new target range of 4.75% to 5%, the highest level since 2007. While most economists were predicting this latest rate rise, it still surprised many. US inflation eased in February but remained stubbornly high, presenting a challenge for the Federal Reserve as it confronts how to slow the economy with higher interest rates while not sending the economy into recession.

The RBA now face the same challenge - have they done enough to slow the economy and bring inflation back down to their target band of 2% - 3% or do they need to keep raising rates and risk sending the economy into recession.

So will the RBA keep raising rates or are we done for this cycle?

While inflation is slowing both here and in the US, it isn't going away as quickly as many may have hoped. Federal Reserve officials have continued to beat the drum on their aggressive inflation fight, saying the central bank will keep hiking interest rates until it's under control.

The issues are the same for Reserve Bank of Australia. Market pricing for RBA's terminal rate has moved considerably. But the strong underlying momentum in the economy, as evidenced in the robust level of business conditions and a solid labour market, suggests further tightening may be needed.

The RBA may indeed pause another rate rise at its April meeting, or it may follow the US with another 25bps increase. We will find out on April 4th at 2:30pm (AEST). While another hike will be hard for those with mortgages and continue to put pressure on the housing market, the cost of living for Australians will only reduce as inflation comes down to the RBA's target band.

The positive news for investors is that inflation is moving in the right direction, and we expect that interest rates are now very close to their "terminal rate" for this cycle.

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