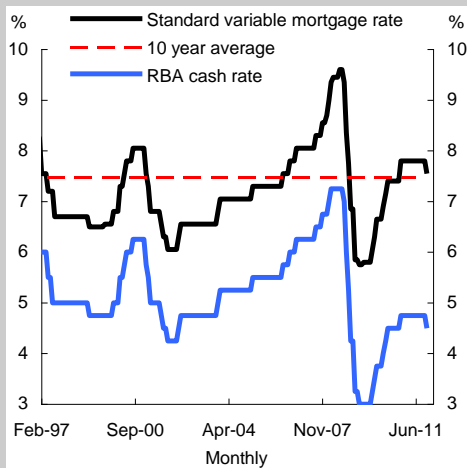


AUSTRALASIA

Reserve Bank eases policy and banks quickly pass it on to mortgage rates



Source: RBA, Macquarie Research, November 2011

Here come the rate cuts

Economic Spotlight

Event

- The Reserve Bank of Australia reduced its policy rate by 25bps following its November Board meeting, to 4.5%.

Impact

- The RBA's decision to cut rates indicates that it is alert to the downside risks facing the economy and the improved inflation outlook. In the short term, we expect the RBA will cut rates again in coming months in order to shift policy back to a clear neutral stance. The question then will be whether that will be sufficient to stabilise growth or whether further easing will be required.
- The hurdle for moving policy to an explicitly expansionary stance is obviously much higher than for simply shifting policy back to neutral. And it will only occur if unemployment continues to drift higher. Ultimately, we think the RBA will be compelled to cut rates by 100bps in total. But in the short term the question is whether the RBA will go back-to-back in December or wait until February before achieving neutral policy.

Outlook

- The Reserve Bank of Australia cut interest rates by 25bps following its November Board meeting. The RBA had signalled that it was prepared to cut rates if it was comfortable that the outlook for inflation had improved and the Q3 inflation data certainly provided that reassurance.
- While there is no sign of panic in the RBA statement that would suggest the RBA has embarked on an aggressive rate cutting cycle, nor does the statement suggest that this rate cut is a one off. The RBA concludes its statement by noting that "the Board concluded that a more neutral stance of monetary policy would now be consistent with achieving sustainable growth and 2-3 per cent inflation over time".
- In our view, with inflation likely to be in the middle of the RBA's target band and growth only "moderate", there is no reason to have tight policy. At worst, policy should be neutral. So, if the RBA had indicated that policy had already been moved to neutral, then it could be argued that the central bank's work was done.
- The way the RBA worded the statement, however, does suggest that rates will need to be cut again before they have been moved to neutral. The question for 2012 will be whether having neutral interest rates will be sufficient to stabilise the housing market and consumer spending or whether even lower rates are needed. But that is a debate for next year.

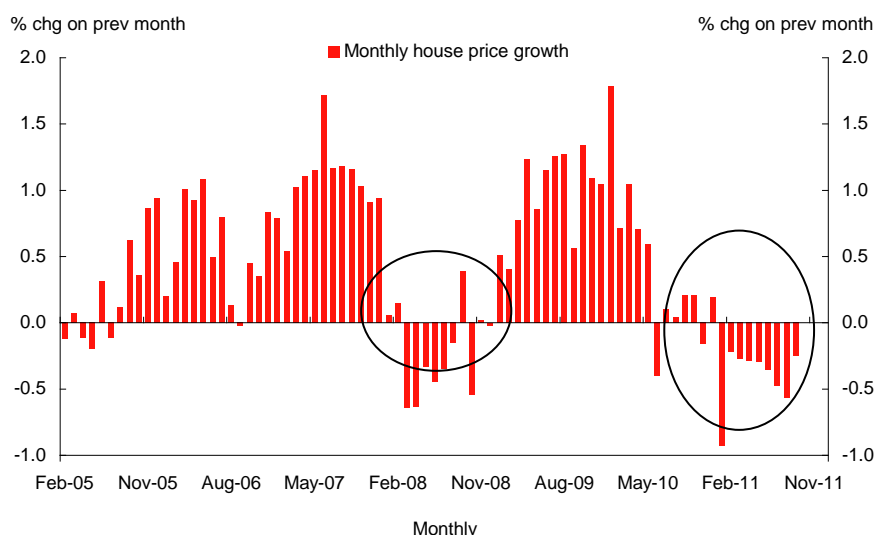
What effect will this rate cut have on the economy?

- The 25bps cut in rates will reduce the average monthly mortgage payment by around \$50 per month assuming that this is fully passed on by the banks (several banks have already announced 25bps reductions). So will this unleash a resurgence in retail spending? In our view, the answer is no.

Analysis

- At the margin, those households that had fallen behind their mortgage repayments will certainly welcome any interest rate relief. But, relatively speaking, this will only affect a handful of people – something like 0.1% of households.
- Of the 40% or so of households who currently have a mortgage, more than half of them are already paying more than their minimum monthly repayment. As such, we think that most of these households will simply take advantage of the reduced interest payment to increase their principal repayment and pay off their mortgage more quickly.
- Obviously, there will be some positive effect on consumer spending. But this will be only modest. And one rate cut won't be sufficient to turn a sombre Christmas into a boom.
- Where the reduction in interest rates may have more of an effect is on the housing market. Lower interest rates boost the purchasing power of potential homebuyers. This means that there are more potential buyers for any particular property. That will provide some support to home prices which have been consistently falling over 2011. Indeed, we think that falling house prices – by reducing household wealth – have been one of the factors contributing to the cautiousness of consumers over the past year.

Fig 1 Falling dwelling prices over 2011 reflect tight monetary policy



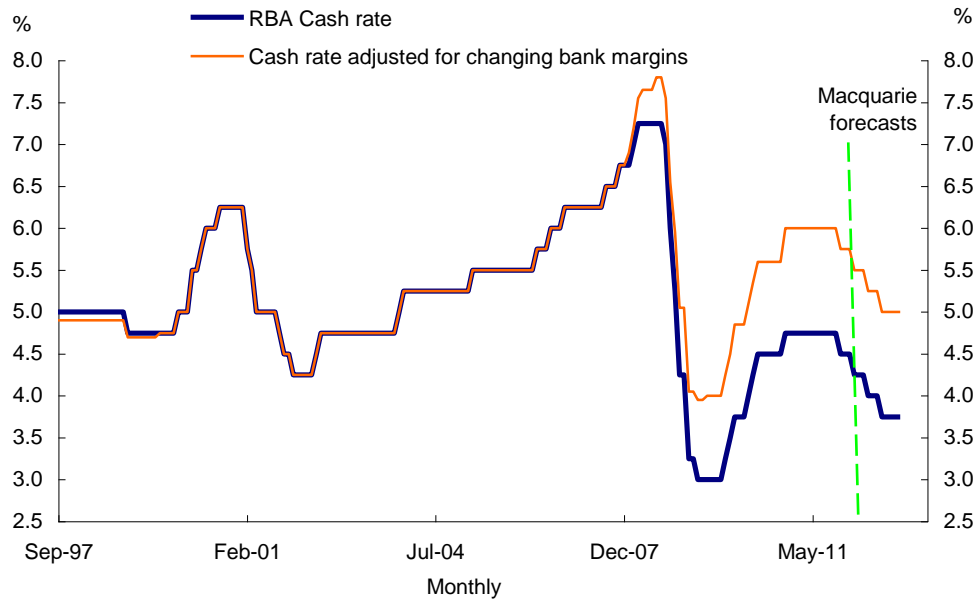
Source: RP Data, Macquarie Research, November 2011

- Alongside increased housing turnover and firmer prices, lower interest rates will also support construction activity. Again, those potential households that have deferred entering the housing market because of low affordability may now be emboldened to dip their toe into the market.
- It is important, however, to be clear when this change in behaviour may be reflected in increased activity. Assume, for example, that someone decides to build a new house. First, they have to find the site and then obtain finance to purchase it. If someone moved very quickly, this might be achieved before Christmas but could easily slide into January 2011. Then, they have to find a builder and get plans approved by council. If they are lucky, this could be achieved by, say, March 2012 and actual construction might begin to occur in April or May.
- The average house takes around seven months to complete, so if all goes well, this home owner could be moving into their new home by Christmas 2012. And it is when they do so that they start buying new furniture and floor coverings and retail sales get a boost. Of course, the lift in housing construction also supports employment and incomes and so will also support spending in the second half of 2012. What is clear, however, is that retail spending in the first half of 2012 may still be lethargic.
- The other important point to make is that if people believe that the November rate hike is a one-off, then it is more likely that they won't change their behaviour and the economy won't get a boost in the middle of 2012. Paradoxically, by suggesting that rates won't be cut further, the RBA may increase the likelihood that they will need to fall further in 2012.

Where to from here?

- The statement the Reserve Bank released after the November Board meeting does suggest that it is not in any hurry to cut rates aggressively. Of course, if the European policymakers' attempt to resolve its sovereign debt problem unravels, then the RBA could quickly follow the November rate cut with another cut in December. But while we think the RBA will be compelled to cut rates further, we suspect that it will pause temporarily before easing policy further. The next employment reading could be crucial in determining whether rates are cut again next month.

Fig 2 The outlook for interest rates



Source: RBA, Macquarie Research, November 2011

- As noted, we don't think a solitary rate cut will be sufficient to materially stimulate consumer spending or the housing market. And as retail spending over Xmas remains lacklustre and firms continue to trim payrolls in order to protect profits, the RBA will be forced to resume the rate cutting cycle. In our view, three further 25bps rate cuts in February, May and August 2012 appear most likely (if the RBA did cut rates in December, then it may pause at the February meeting). Such a reduction would be necessary to provide support to the housing market and stabilise unemployment. And by that point the RBA should start to be confident that its policy easing has had the desired effect.

Important disclosures:

Recommendation definitions**Macquarie - Australia/New Zealand**

Outperform – return >3% in excess of benchmark return
 Neutral – return within 3% of benchmark return
 Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie First South - South Africa

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie - Canada

Outperform – return >5% in excess of benchmark return
 Neutral – return within 5% of benchmark return
 Underperform – return >5% below benchmark return

Macquarie - USA

Outperform (Buy) – return >5% in excess of Russell 3000 index return
 Neutral (Hold) – return within 5% of Russell 3000 index return
 Underperform (Sell) – return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high-highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low-medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

* Applicable to Australian/NZ/Canada stocks only

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / epowa*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 30 September 2011

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	57.35%	65.88%	56.94%	46.54%	74.68%	47.85%	(for US coverage by MCUSA, 11.63% of stocks covered are investment banking clients)
Neutral	31.99%	20.68%	31.94%	50.00%	23.42%	34.66%	(for US coverage by MCUSA, 9.30% of stocks covered are investment banking clients)
Underperform	10.66%	13.45%	11.11%	3.46%	1.90%	17.49%	(for US coverage by MCUSA, 0.47% of stocks covered are investment banking clients)

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