Interest rates will rise in 2018 – but Australia, don't you cry

"So it's back beach for the summer…"

James Reyne was the founder and lead singer of the iconic band Australian Crawl. His distinctive vocal twang resulted in largely unintelligible lyrics, yet his songs provided the soundtrack for two decades of Australian summers from the late-1970s. Songs such as 'Beautiful People' and 'Reckless' crackled intermittently on AM radios throughout the childhood ritual of being crammed into impossibly overloaded cars destined to join the convoy of Holdens and Fords rumbling towards Australia's coastlines. Windows wound down in search of a cool breeze, legs sizzling on hot car seats and the taste of Aerogard errantly sprayed in a protesting mouth, marked the start of the summer for many Australians and the excitement and optimism for the weeks ahead.

By 2018, dirt tracks to the back beach are now dual carriageways, camp sites have been turned into condominiums, beach shacks replaced with mini-mansions, and the solitary fish n' chip shop has given way to artisan bakeries, specialist roasted coffee houses and $30 gourmet hamburger franchises complete with lycra clad bike riders resting high-tech machinery against the al-fresco tables.

Whether these changes are for the better is debateable, but what is clear is that the wealthier Australians have become, and the longer the economic expansion has gone, the greater the pessimism and scepticism that has built up within the commentariat that Australia's good fortune can continue.

Currently the threat of a solitary interest rate hike is met with apoplectic articles pointing to record debt levels, a tapped out consumer, and a dangerously unbalanced economy with the twin threats of a China bust or a housing collapse dangling like Damocles' sword over Australia's economic future. Analysts whose job it is to provide balanced and even handed assessments of the economy's progress and outlook have parochially taken sides in the economic contest. Most appear to be cheering for the next downturn and staunchly defending the position that the RBA should remain on hold if not ease interest rates in coming quarters.

Fear almost always sells. Yet the case for optimism has been in place for well over 12 months, and in contrast to the consensus view, we have been gradually positioning for higher Australian yields over recent months. We believe the case for normalising interest rates in Australia is continuing to build and the vulnerabilities within the economy are too often overstated. In this article, we make the case for why the RBA will soon outline the case for a gradual increase in interest rates and why we believe the economy can absorb a cycle of interest rate hikes in its stride.

Australians have never been wealthier, are getting happier, and wisely have lowered their leverage.

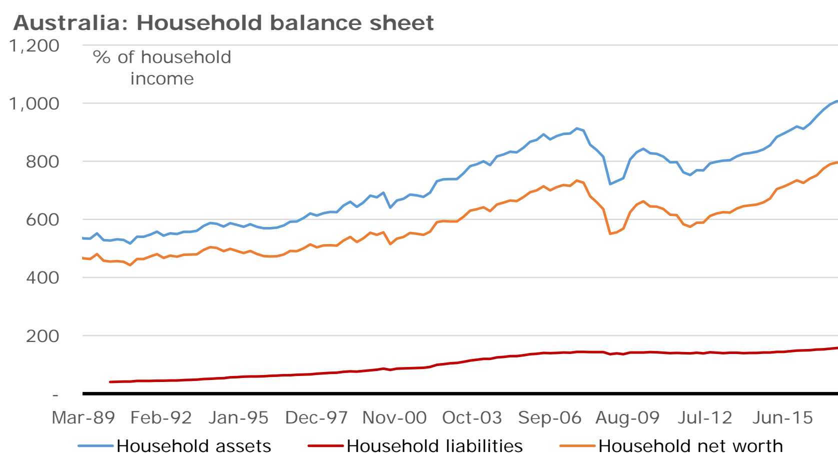
"…chalet for the snow…"

One of the most persistent touchstones for those harbouring negative views on the economic outlook for Australia is how indebted households are and the vulnerability this presents to an ongoing expansion. The most common chart deployed to prove the thesis is the ratio of total household debt to household income.

Despite the common use of this indicator, there is no accepted economic theory that relates the ratio of household debt (a stock) to income (a flow). These simple ratios also do not make any allowance for the changing demographic characteristics of the population, shifting tax incentives over time, the trend towards offset accounts, and globalisation of asset and debt markets, let alone the different definitions used in both the numerator and the denominator of the calculation across countries. Nor do they adjust for lower terminal interest rate targets now embedded in central bank long run forecasts around the globe. Yet despite the questionable logic of using debt to income ratios as a relative vulnerability indicator, Australia (an economy still enjoying the longest economic expansion in modern history) is most often compared directly to the US (an economy only recently moving beyond its largest debt deflation cycle since the Great Depression), rather than comparing to other small open economies such as Sweden, Norway, Canada and New Zealand. Currently there is very little difference in household debt to income levels in Australia, Sweden, Norway, Canada and New Zealand both in terms of levels or rates of change. Moreover, interest rate markets appear to be having little problem visualising interest rate hikes in the Nordic countries and Canada has already delivered 3 interest rate hikes this financial year with markets expecting several more over the coming 12 months. Meanwhile, Australian analysts wring their hands over the 'damage' any realignment of interest rates would present.

Focusing on just one side of the balance sheet is also a curious approach. The reality is that households have never been wealthier, both in gross and in net terms. Exhibit 1 puts the rise in household debt into context. The ratio of household debt to income has risen from 140% of income at the start of 2011 – which marked the peak of the RBA cash cycle at 4.75% – to 158% of income currently. Over the same period the ratio of household assets to income rose from 800% of household income to 1000%. Net worth has not only increased rapidly against a comparatively flat trend in household debt accumulation, net worth is now well above the 2007 peak.

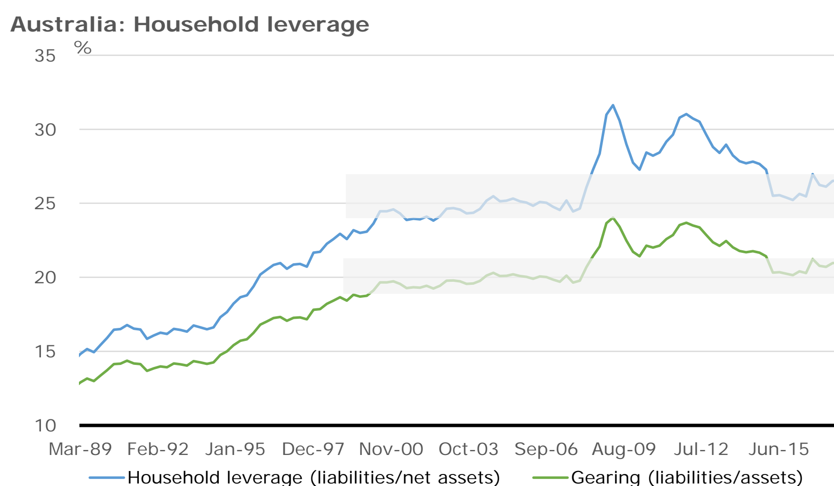
Exhibit 1: Households have never been wealthier.



Source: Ellerston GMF, ABS

Rising wealth has also facilitated the return of household leverage back into the relatively stable range that households enjoyed over the 1997-07 decade. Naturally sharp declines in asset prices are attended with a sharp rise in involuntary leverage and an extended period of more conservative spending. This was the case from 2008-2014. However, since 2015 Australian households have largely repaired their leverage ratio to the pre-crisis level, helping to lift household optimism and tilt households to consuming more of each monthly pay cheque.

Exhibit 2: Leverage is back to its pre-crisis 'equilibrium'.

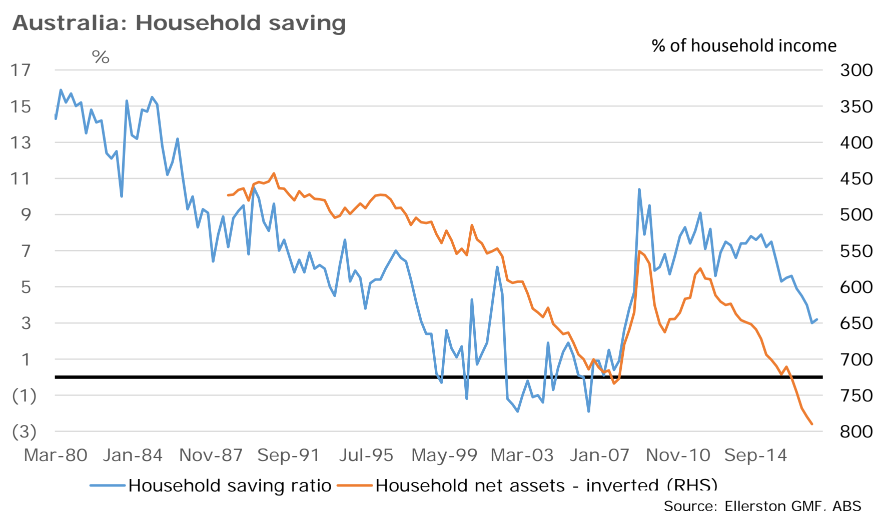


Source: Ellerston GMF, ABS

The resulting run-down in the household saving rate (a flow measure) has alarmed some local economists, fretting that consumers have already consumed the accumulation of wealth gains. Moreover, while everyone else that lives outside of Sydney rolls their eyes at the 'calamity' of Sydney house prices dipping modestly over the past 6 months after a 70% increase in the prior 6 years, financial wealth continues to surge.

Indeed, if history is any guide, as Exhibit 3 shows, the prior rise in wealth is more consistent with the household saving ratio moving closer to zero in coming quarters – helping to facilitate an ongoing recovery in consumption spending in the face of poor household income growth.

Exhibit 3: The household saving rate may well fall back towards zero.

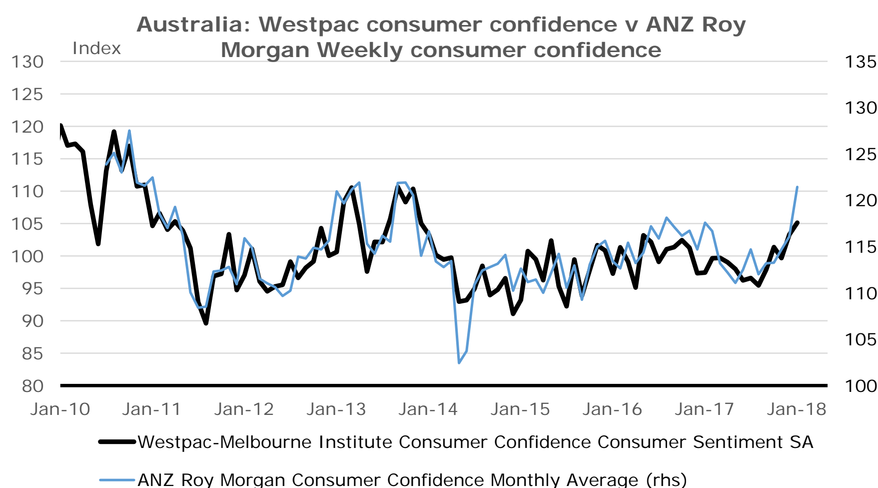


Australian households have already detected the combination of a robust global backdrop, rising wealth and a strong employment market and their confidence levels have risen as a result. If consumer confidence holds at the levels suggested by the ANZ survey (see Exhibit 4) then retail sales growth can be expected to accelerate towards 7.0%yoy from its current lacklustre pace of 2.9%yoy.

Income tax cuts are also highly likely to be announced in the May Budget, which we estimate will be in the order of 0.7% of household income. It's also likely that they will be skewed to the lower to middle income brackets. This also assists in sharing the benefits of the economic recovery, and will likely underwrite consumer confidence and provide an immediate fillip for retail spending.

Indeed, as Australia's summer holiday period draws to a close, it's likely consumers are already running their eyes through the accommodation listings of the local ski resorts for the winter break – many for the first time since prior to the financial crisis.

Exhibit 4: Consumers are now decidedly more upbeat.



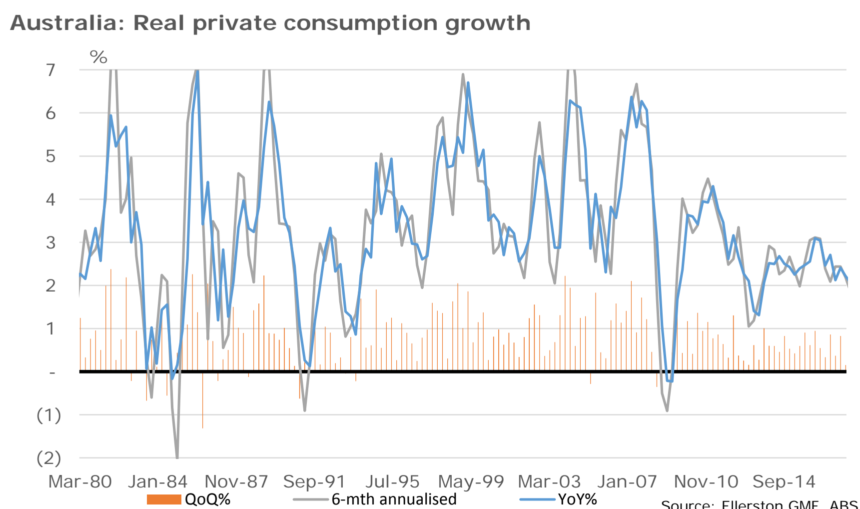
The retail spending slump in 2H17 has been misunderstood. Households weren't floundering under the weight of utility prices and IO loan rejections – they were ploughing funds into their super schemes.

"Everyday I see you wearing things that have never been worn before..."

So is the consumer slump finished? And why are house prices slipping while confidence is rising?

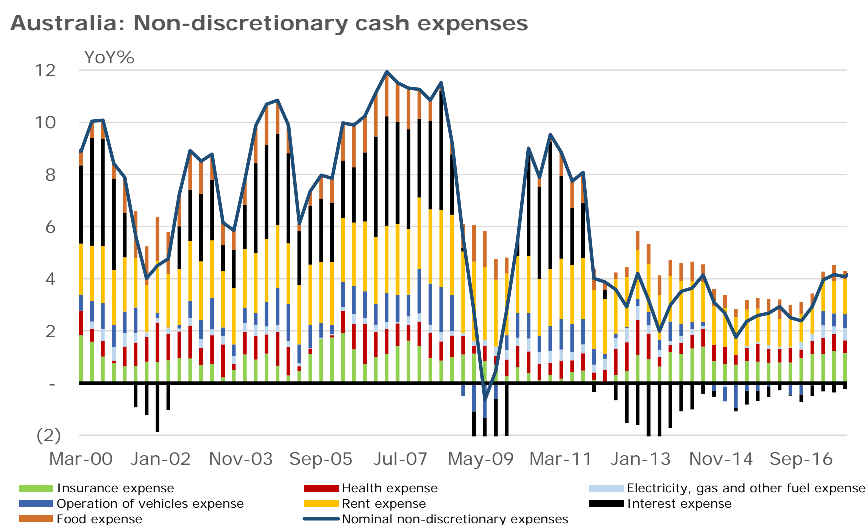
Firstly, there really hasn't been a broad-based consumer spending slump. Real consumption growth is currently expanding at the same pace it has averaged over the past 5 years and is half a percent below the 10 year average. A more apt description is that real consumption growth is expanding at slightly below its average pace.

Exhibit 5: Consumption has been much more robust than retail sales.



Secondly, the current narrative from analysts and the retail industry alike is that the combination of surging utility, health and petrol prices is crushing discretionary spending. However, the evidence is that nominal non-discretionary cash expenses has risen only modestly – remaining well below the post-GFC average growth rate – with utility expenses contributing only half a percent to the 4%yoy growth in non-discretionary expenses. The biggest contributors to the rise over the past year were insurance and rent. However, even this was mostly a function of more people being housed following the surge in home construction than rising costs.

Exhibit 6: 'Surging' household costs are more hyperbole than reality.

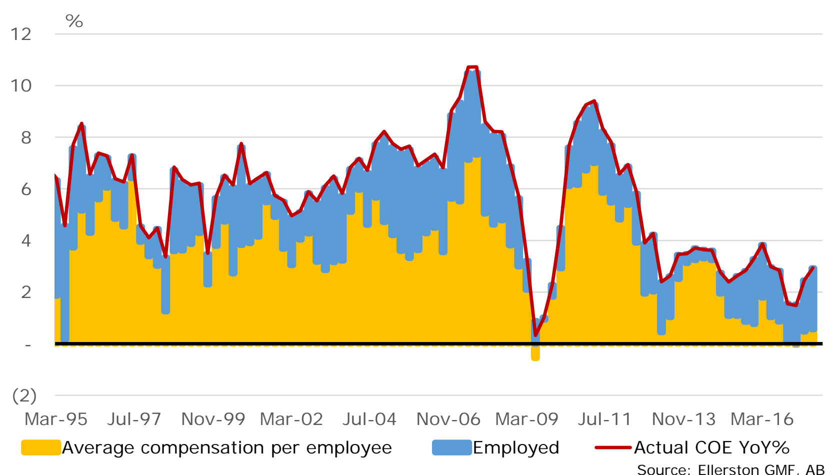


So that leaves the question of why did retail sales fall slow so sharply through 3Q17?

The answer is not that wage income growth collapsed. It's true that the growth in compensation of employees remains weak, however, as Exhibit 7 shows, compensation of employees has accelerated from the start of 2017 driven almost exclusively by strong employment gains. Clearly, for household consumption to become the driving force of the recovery average compensation per employee will need to lift or employment growth will need to continue to exceed expectations. However, as we pointed out in October 2017, one needs to be careful in interpreting slow average earnings per employee as individual employees failing to receive higher income. Strong employment growth has drawn in large numbers of marginal workers into the workforce, who by definition attract marginal pay. Somewhat paradoxically, at this stage in the economic cycle average wage growth actually slows even as the economy accelerates. Moreover, the unique occurrence of accommodating the Millennials and the Baby-boomers in the workforce simultaneously has also lowered average wages as highly skilled and highly paid Baby-boomers are progressively replaced by less experienced and hence lower paid Millennials.

We have outlined our expectations and formal modelling of wages previously, and won't repeat the analysis here. Our conclusion was that once accounting for the demographic distortions the combination of rising profit margins, rising inflation expectations, and tightening of the NAIRU gap suggests that wage rates will progressively accelerate from this point of the economic cycle. We believe it would be a mistake to extrapolate recent low wage growth into the future.

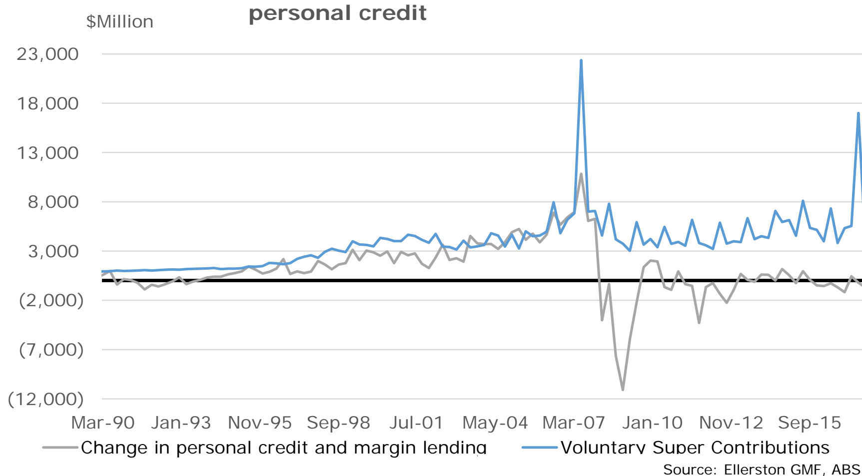
Exhibit 7: Total compensation is rising.



Average wages are low but important cyclical and demographic reasons suggest a turn is coming.

There is some evidence that interest only mortgagees were unexpectedly forced onto principal and interest loans by the domestic banks during the September quarter to meet APRA's new directive to reduce the share of interest only loans and this may have impacted retail spending. However, even here the impact doesn't seem large enough to be a genuine concern. No doubt being refused an interest only loan would have caused unrest, annoyance, and cash flow issues for some IO borrowers but the actual cash flow impacts of the forced changes are not large in aggregate. We estimate that the changes equate to 0.1% per quarter of household income over the next 2 years that will now be diverted to paying off principal. Hardly enough to prompt a sharp slowdown in discretionary spending.

Exhibit 8: What did analysts miss? The 2nd biggest surge into super on record as households sort to beat changes limiting voluntary inflow.

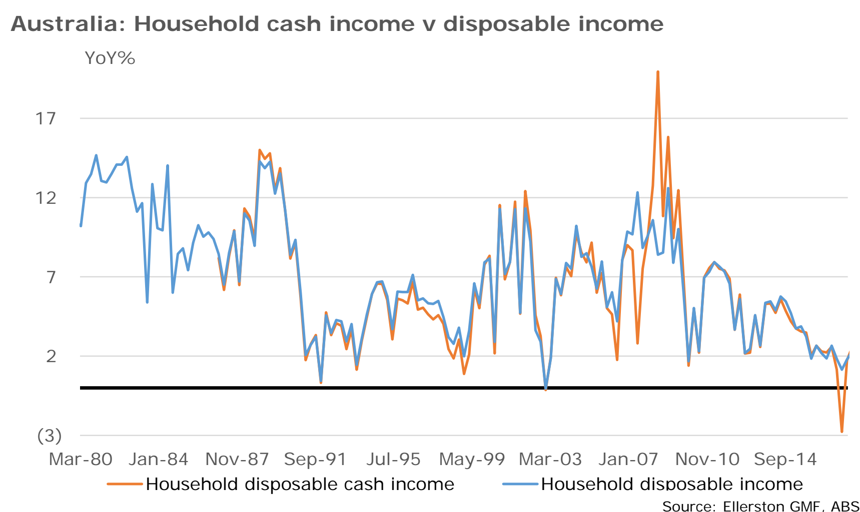


So what did happen to impact retail spending so acutely? We believe, analysts have missed something very large. Indeed, it is far more important than the combined impact of rising non-discretionary expenses and a forced shift from IO loans. The decision by the federal government to close the window for large voluntary contributions into superannuation schemes at the end of the 2017 financial year resulted in a highly unusual voluntary surge of funds into superannuation schemes (see Exhibit 8). This has happened once before. An even larger surge occurred when ex-Prime Minister Howard allowed up to $1 million in individual contributions into superannuation in 2007, which had the unfortunate timing of predating the commencement of the financial crisis. However, the impact upon discretionary spending of the 2007 diversion of income into the superannuation system was mitigated by strong underlying momentum in household income growth at that time. The same could not be said of 2017.

As Exhibit 9 shows, our measure of household disposable cash income which nets off voluntary super contributions declined by the most since our data set commenced in 1984. The decline was unprecedented and was worse than that recorded at the depth of the 1990s recession. Again, this is not because wage income decelerated nor was it due to higher household costs. This was an opportunistic allocation of funds and diversion

of income to take advantage of the taxation advantages from Australia's superannuation system before legislation to limit the voluntary inflows came into effect – an opportunity that by definition was one-off in nature.

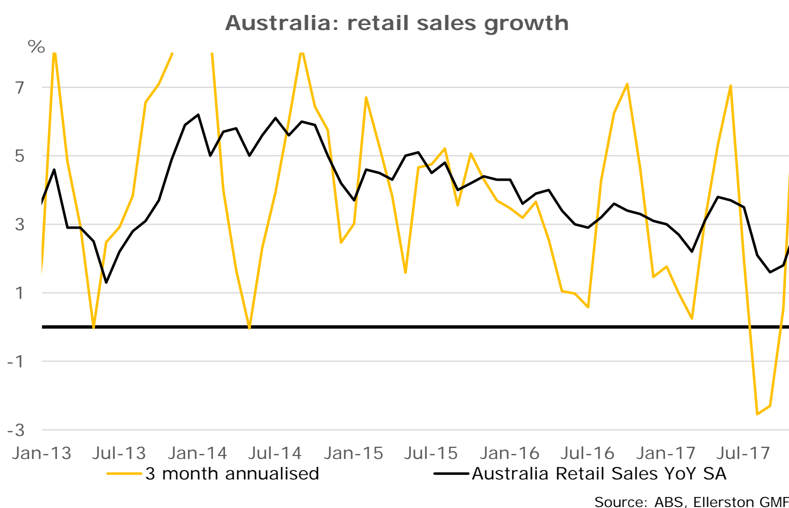
Exhibit 9: The voluntary super surge resulted in the biggest decline in disposable cash income on record.



Source: Ellerston GMF, ABS

There is little doubt that the sharp slowdown in discretionary spending in 3Q was driven by the spike in superannuation inflows. The size of the diversion of income from spending into superannuation we estimate was over 18 times the size of the combined impact of the increased expenditure required for essential spending items and the impact of the shift from IO loans. As such, there is little surprise that discretionary retail sales spending was so volatile during 2H17. It is also highly likely that this voluntary reallocation of funds into super was also a significant factor behind the recent slowdown in Sydney and Melbourne house prices – capital was merely diverted from one tax effective form of saving into another.

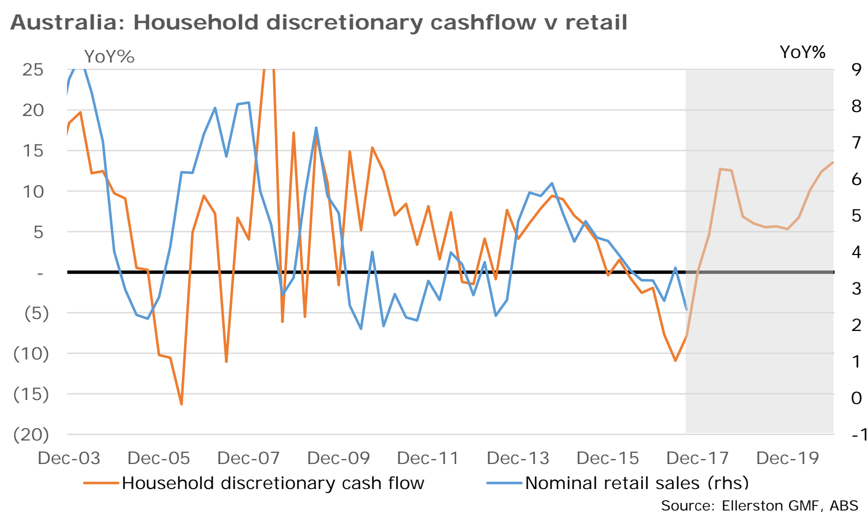
Exhibit 10: Income voluntarily diverted into superannuation sharply constrained households discretionary spending in 3Q17.



Source: ABS, Ellerston GMF

So what happens next? Subtracting non-discretionary spending (see Exhibit 6) from discretionary cash income (see Exhibit 9) results in our preferred income measure, discretionary cash flow. It is this measure of income that has the greatest signal for retail sales growth. Exhibit 11 shows our discretionary cash flow measure and our forecast for discretionary cash flow over the next 3 years. Even allowing for further acceleration in non-discretionary expenditure, the combination of an ongoing recovery in the compensation of employees, the passing of the impact of the spike in voluntary super contributions, together with the return of mortgage equity withdrawal as a driving force behind spending growth, suggests a much improved retail environment is likely in 2018 and 2019.

Exhibit 11: Prospects for a strong recovery in household discretionary cashflow look promising for retailers.

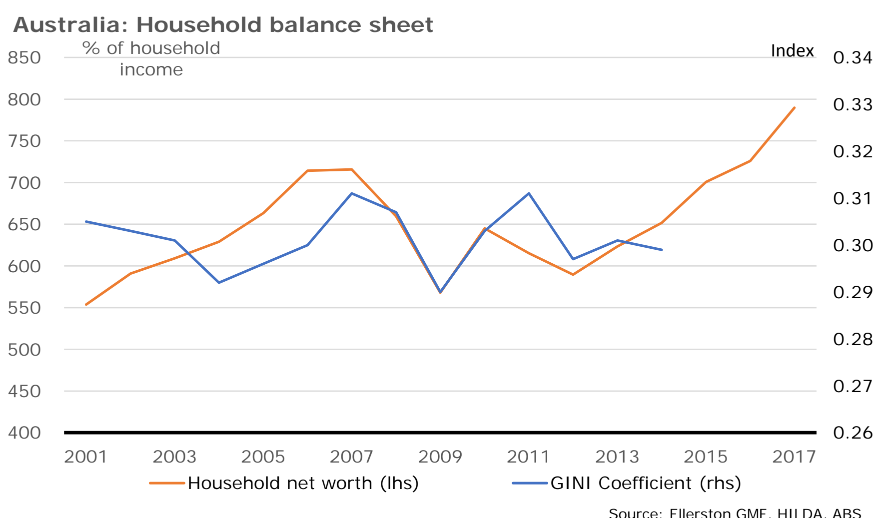


Wealth gains may not be evenly spread, but income gains are. A surging workforce and rapidly tightening labour market is good news for a more durable recovery.

"While the children at the government schools send money for the poor..."

The most common criticism of a recovery driven by low interest rates and rising wealth relative to income is that it only benefits the rich. This is a contentious topic. Obviously those with assets and ready access to credit do well from a wealth perspective in falling interest rate environments. However, the impacts on income distribution throughout society can be more ambiguous. Fortunately, Australia does have a comprehensive annual study that tracks over 17,000 households through time which enables detailed assessment of income and wealth distribution. The Household, Income and Labour Dynamics in Australia (HILDA) survey reveals that the widely used GINI coefficient to measure income inequality (where a score of 1 indicates complete inequality and 0 complete equality of income) has remained remarkably stable through time in Australia. Moreover, Australia's GINI coefficient remains well below that the US, UK, NZ and several of the major European countries. While we would be surprised if the GINI coefficient didn't rise back to the top of the historical range through 2016 and 2017 once the data become available, there is no clear evidence that income inequality has deteriorated since the survey commenced in 2001.

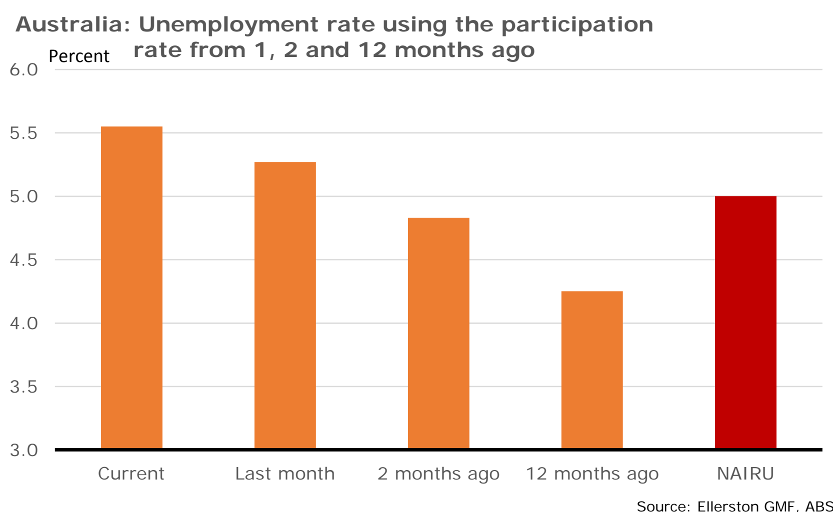
Exhibit 12: The surge in net wealth may not be evenly spread, but the income gains from the recovery remain evenly distributed.



The best single indicator of whether the benefits of the recovery are being shared through the economy remains the unemployment rate. Although the unemployment rate has been in a trend decline for more than 3 years, the recent surge in employment creation (403k over the past 12 months) has been met by an extraordinary surge in people joining the workforce (395k over the same period). Indeed, had the participation rate held at the same level as only 2 months ago the unemployment rate would have fallen to 4.8% – below the RBA's updated estimate of NAIRU. While it's possible that new entrants to the labour force could continue to meet new employment

demand for a few more months, labour force growth always gravitates back towards underlying population growth, suggesting an ongoing fall in the unemployment rate has likely merely been delayed.

Exhibit 13: Unemployment falling and a surging workforce suggest recovery benefits are being shared. Tax cuts will also share the gains.



For those who continue to stress that the central bank is awaiting broader measures of unemployment such as the underemployment rate or the underutilisation rate to decline, we would suggest they are not listening to what the RBA Governor is saying. The commonly quoted underemployment and underutilisation rate measures of spare labour market capacity are conducted on a headcount basis. If a person would like to work one or more hours a month, they are classified as underemployed. However, more comprehensive and accurate assessments of labour market capacity based on the volume of available hours that could re-enter the workforce, are rarely shown in Australia. Yet the RBA Governor has attempted to re-orientate attention to these volume measures of spare labour capacity. It's an important distinction. Since the RBA decided to commence a rate cutting cycle in November 2011 the unemployment rate rose by 119ppts over the next 3 years and has since fallen to be just 20ppts above the pre-easing cycle level. Headcount measures of underemployment and underutilisation remain 100ppts and 120ppts above their pre-easing cycle levels, leading most analysts to conclude there is still ample spare capacity in labour markets. However, the technically superior volume of hours available measures of underemployed labour are just 40ppts above their pre-easing cycle levels and are mapping the decline in the unemployment rate directly. The RBA are actively telling the market there is less spare labour capacity than commonly assumed, yet few analysts appear to be listening.

In the meantime, consumer expectations for the unemployment rate continue to fall sharply, suggesting what spare capacity does exist in the labour market will be absorbed relatively quickly.

Exhibit 14: Be careful assuming there is ample spare labour capacity. It's not what the data, nor what the RBA are saying.

Debt servicing is now a lot less than you think, and non-labour income is likely higher than you think. Raising rates are less likely to cause financial distress in 2018 compared to most of the post-GFC period.

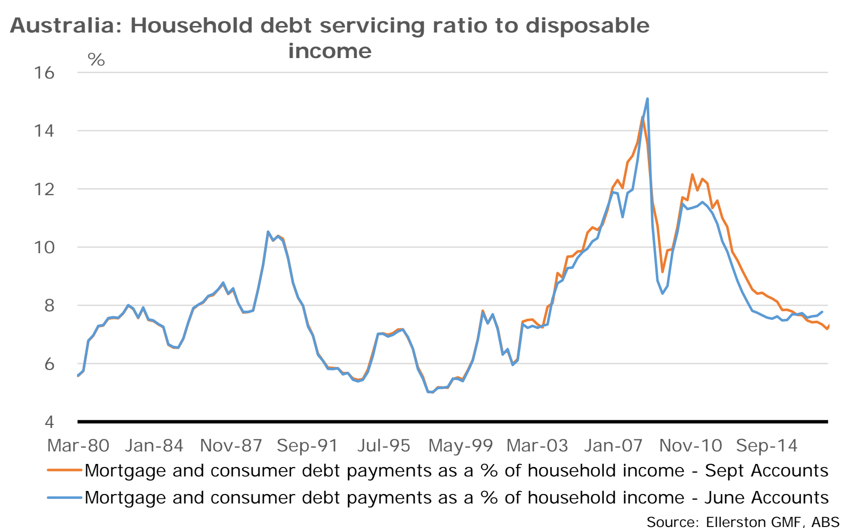
"Oh hoochie gucci fiorucci mama…"

The fear that raising interest rates will crush household income growth via higher debt servicing costs is perhaps the biggest overstated risk in Australia. Our rationale is twofold.

Firstly, the statisticians have sharply revised their estimates of debt servicing costs lower in recent months as illustrated in Exhibit 15, which shows Australian household debt servicing costs as at the June set of National accounts and the September quarter National Accounts. The most important point from this exhibit is that the RBA's picture of how much relief they provided to households relative to the relief provided at the GFC lows has changed materially. In the June quarter of National Accounts household debt servicing was 0.6% lower than the emergency relief provided at the height of the GFC. In the September quarter National Accounts household debt servicing was 2.6% lower in 2Q17 than during the lows of the GFC.

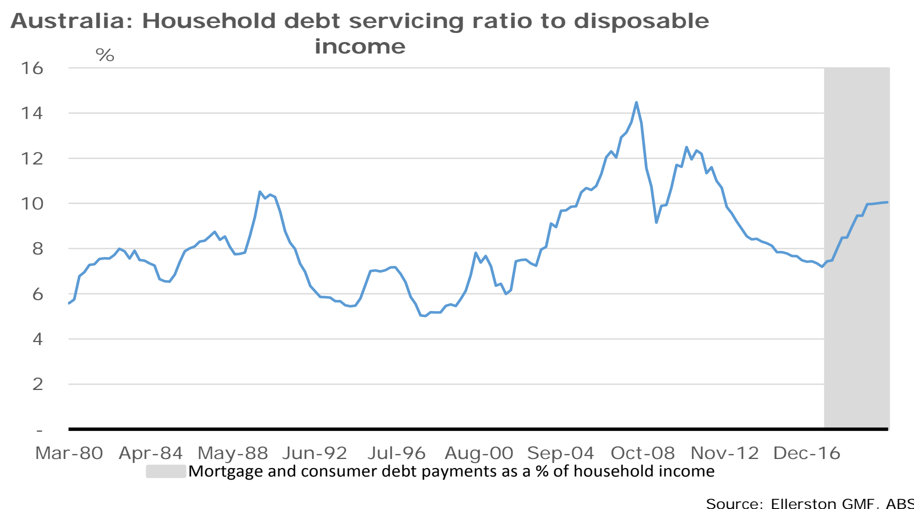
Moreover, the trend in debt servicing has changed from a picture of stability over the prior 3 years to a picture of a steady downtrend in servicing costs.

Exhibit 15: Data revisions have dramatically altered the RBA's understanding of just how much financial relief they have provided.



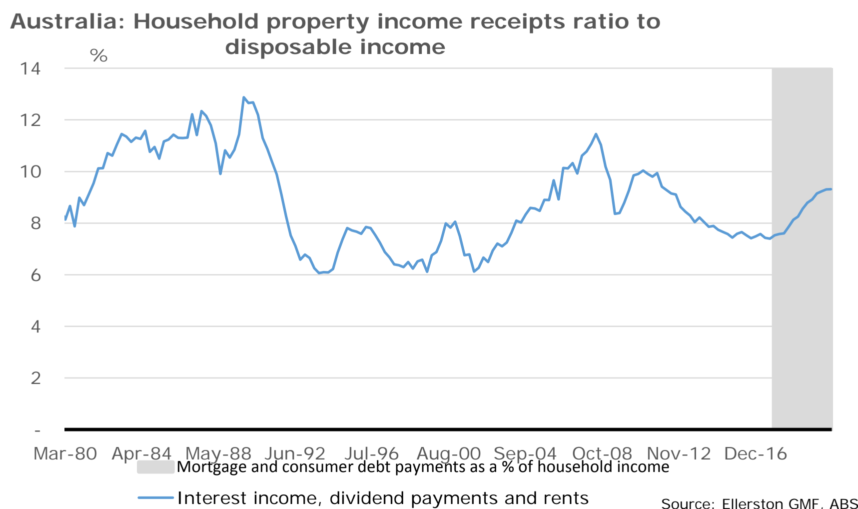
Obviously, that is a very large change. Central bankers often lament that setting policy is like driving a car while looking in the rear view mirror, but the task is made all the more difficult when the landscape behind you continues to change as you drive. On this basis, the revisions imply RBA have eased policy more than they intended. Even assuming household debt growth exceeds income growth in the period ahead, just to return the debt servicing cost back to the lows recorded during the GFC requires 125bps of tightening! And this is indeed our expectation, commencing from 2H18.

Exhibit 16: 125bps of hikes would only return debt serving to the lows recorded during the 'emergency easing' of the financial crisis.



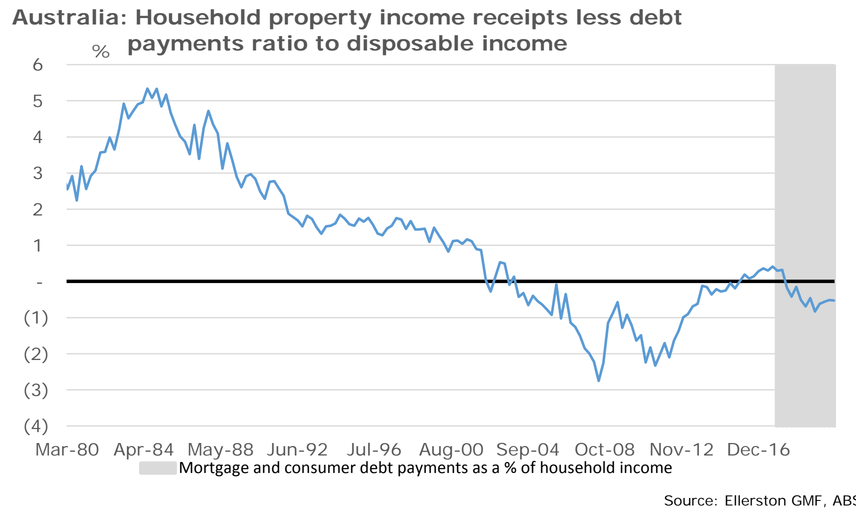
Secondly, just as analysts have a tendency to focus on the debt side of the balance sheet to the exclusion of the large changes in asset values, so too do they emphasise debt servicing costs at the exclusion of the cash income generated from the assets households own. Looking at interest costs without also looking at what is happening to dividends, term deposit interest income and rents received is somewhat naïve. It is also unfortunate, since forecasting the path for dividends, term deposits and rents from a forward path of interest rates is relatively straight forward. The income receipts from assets is shown in Exhibit 17 together with our forecasts. Even assuming a flat profile for rental growth the combination of rising dividend payments in tandem with earnings growth and rising terms deposit rates in tandem with movements in the cash rate provides good cause to expect a recovery in asset receipts.

Exhibit 17: Looking just at debt servicing is naïve. Trends in deposits, dividends and rents relative to the cost of debt is what matters most.



Naturally the interest payments on debt to purchase assets and income receipts from assets held by households tend to move in a similar cycle. However, at times the two series become attenuated and impart financial stress upon households. Looking at the net payments (income from assets less debt servicing payments) is more instructive. Exhibit 18 shows that the despite the RBA cutting interest rates aggressively through the financial crisis large cuts to dividend payments by Australian corporates, led by the banks, in concert with sharp falls in term deposit rates resulted in household asset receipts less interest payments moving sharply negative over the 2007-2012 period. The recovery over the past 3 years is notable, and currently net income receipts are as high as any period since 2003.

Exhibit 18: Household income from their assets less the cost of serving their debt is in the best position since 2003.



Source: Ellerston GMF, ABS

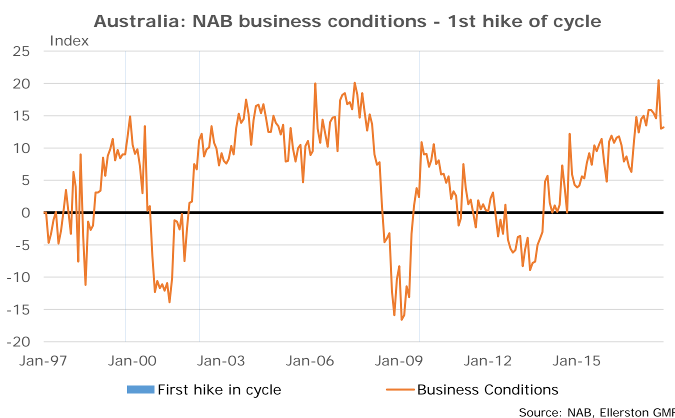
On our forecasts, the net impact of raising interest rates by 125bps on household income over a three year period would be entirely manageable. Indeed, the Australian household sector in aggregate is unlikely to shed too many financial tears as the RBA steadily recalibrates policy settings towards neutral.

But is the time right to start the crawl back to neutral? Benchmarking the start of a tightening cycle.

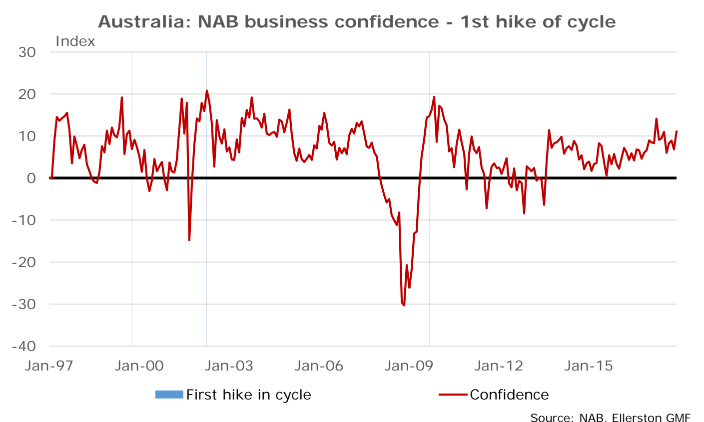
"…Don't you cry."

The real question is, is now the right time to begin the tightening journey? Benchmarking when the RBA has previously commenced rate tightening campaigns across a wide range of data suggests the answer is yes. Exhibit 19 illustrates a wide selection of traditionally important data series for the RBA against the timing of the first interest rate hike of the cycle.

Exhibit 19: Benchmarking the start of hiking cycles: the data suggests we are now in the hiking zone.



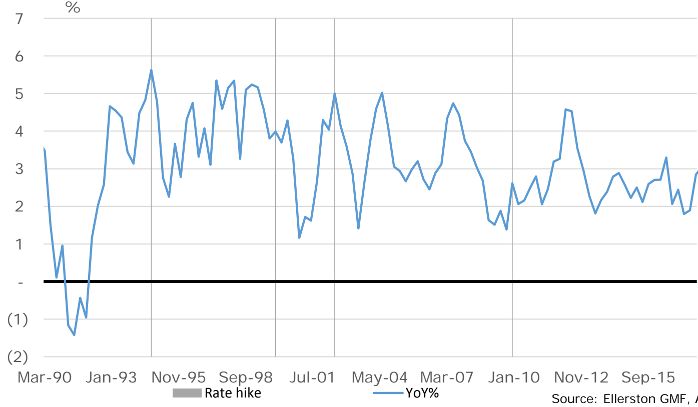
Source: NAB, Ellerston GMF



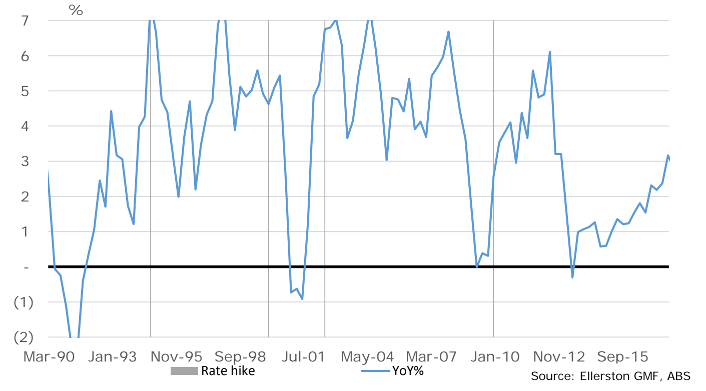
Source: NAB, Ellerston GMF

Australia: Employment - 1st hike of cycle
Index
First hike in cycle
Australia Labor Force Employed Persons SA
Source: ABS, Ellerston GMF

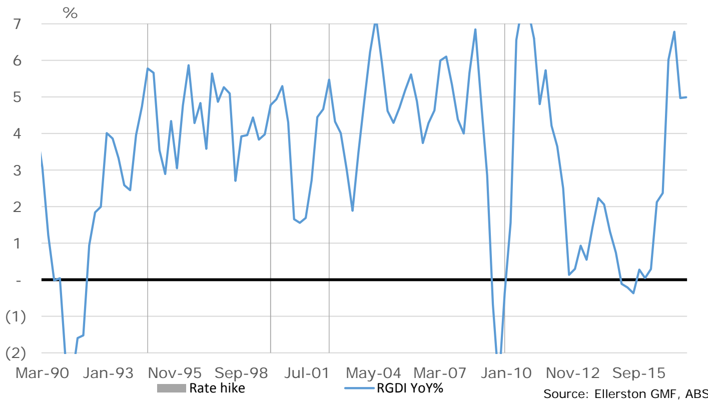
Australia: Unemployment rate - 1st hike of cycle
Index
First hike in cycle
Australia Labor Force Unemployment Rate SA
Source: ABS, Ellerston GMF



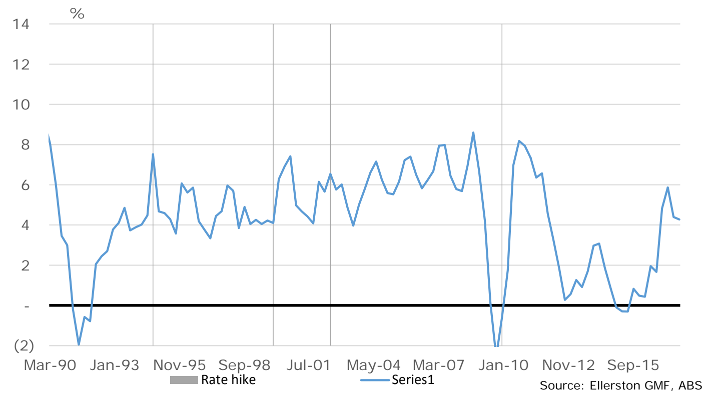
Australia: Real GDP growth
%
Rate hike
YoY%
Source: Ellerston GMF, ABS



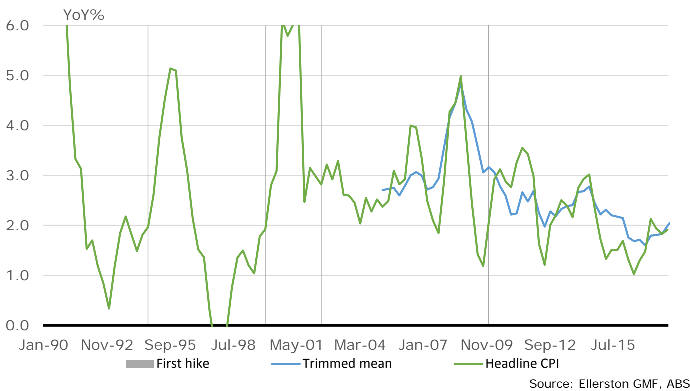
Australia: Domestic demand growth
%
Rate hike
YoY%
Source: Ellerston GMF, ABS



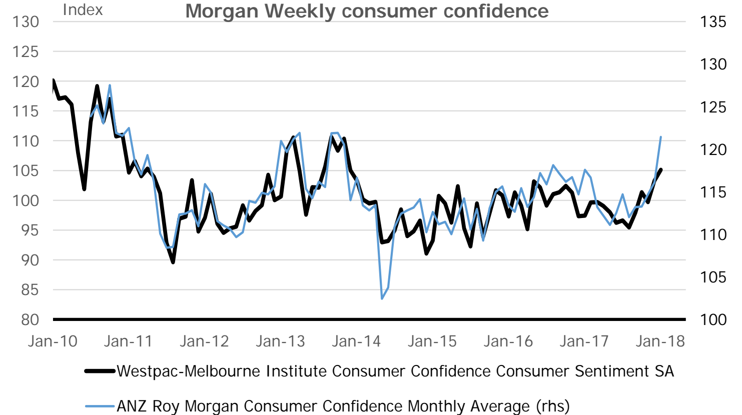
Australia: Real Gross Domestic Income growth
%
Rate hike
RGDI YoY%
Source: Ellerston GMF, ABS



Australia: Nominal GDP growth capita growth
%
Rate hike
Series1
Source: Ellerston GMF, ABS



Australia: CPI
YoY%
First hike
Trimmed mean
Headline CPI
Source: Ellerston GMF, ABS



Australia: Westpac consumer confidence v ANZ Roy Morgan Weekly consumer confidence
Index
Westpac-Melbourne Institute Consumer Confidence Consumer Sentiment SA
ANZ Roy Morgan Consumer Confidence Monthly Average (rhs)
Source: Westpac, ANZ, Ellerston GMF

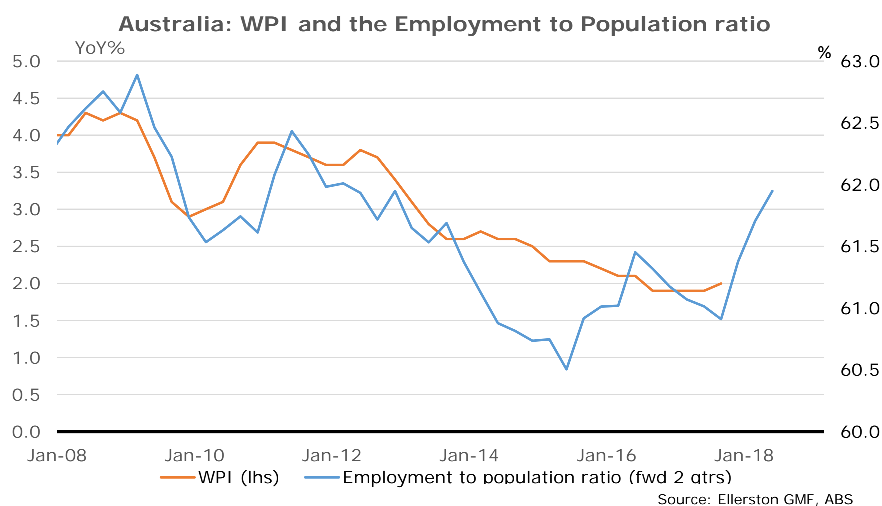
In short; business conditions are well above the average starting point for a tightening cycle, business confidence is now at the bottom end of the range when the RBA has hiked, consumer confidence has also reached the bottom end of the range, job ads are well above the traditional starting point, employment growth has boomed (only coming out of the 1991-92 recession did the RBA wait until employment growth was this robust), the unemployment rate is in steady trend decline, real GDP growth has accelerated to be above the new lower estimate of 'potential' growth and both the RBA and ourselves expect economic growth to accelerate well in excess of 3%yoy through 2018, domestic demand is expanding at the same pace that the last rate cycle commenced (albeit it is still well below the prior 3 cycles), real gross domestic income is well above all prior rate cycle starts, and nominal GDP per capita has also returned to the level consistent with the beginning of a rate tightening cycle.

What about inflation? As an inflation targeting central bank this clearly remains the most important consideration. Market reaction to the December quarter CPI print was decisive, aggressively reducing the odds that the RBA would consider raising interest rates in 2018. Given the RBA forecast for underlying inflation of 1.75%yoy in December 2017 compared to the actual result of 1.94%yoy the market reaction was a little surprising. Indeed, it's borderline what the RBA will do with their underlying inflation forecast in the upcoming Statement of Monetary Policy. If the RBA assume no further acceleration in underlying inflation, that is, if it forecasts 0.42%qoq for each of the next 2 quarters then they can comfortably leave their underlying forecast unchanged over the year to June 2018 at 1.75%. Anything greater than 0.51%qoq per quarter will require them to upgrade to 2.0%. This would be important for financial markets as it brings forward by 12 months the period where the RBA envisions underlying inflation will return to the target zone.

Given the distribution of the components in the inflation basket seems to be improving, upstream price pressures are elevated, online price measures showing sequential momentum, inflation expectations are creeping higher and firms are indicating robust sales growth, it seems feasible that the RBA would have underlying inflation showing a slight sequential acceleration. Moreover, there is some residual seasonal bias. The average for underlying inflation in the 1H of a calendar year for the past 7 years has been 0.57%qoq, and that time period coincides with the weakest period for global inflation pressures. It's far from certain that the RBA will not upgrade its underlying inflation forecast in coming weeks.

Moreover, at the headline level for inflation, the re-weighting of the CPI basket looks to have subtracted just under 0.2%qoq on our calculations. That's a little more than we thought feasible, so on an unchanged weights basis the CPI print would have been 0.82%qoq at the headline level and 2.1%yoy.

Exhibit 18: Wages may rise sooner than many suspect.



As things currently stand, headline inflation is 1.95%yoy. Much has been written about how the pace of inflation is too weak to expect the RBA to even consider increasing interest rates. However, as the bottom left chart in Exhibit 19 shows, if there is one indicator that has been a necessary condition to commence a tightening cycle it is when headline inflation reaches 2.0%yoy. To make it a sufficient condition the RBA would no doubt like to see some signs that wage income is accelerating and underlying inflation pressures are more broad-based. That will be the task for 1H18, however, with global economic growth likely to exceed 4% and a broad sweep of local indicators already suggesting that the time to adjust policy has arrived, the time for recalibration is fast approaching.

As the RBA returns from its summer break, along with most of the Australian financial community, its attention will soon turn to expressing the next leg in its increasingly optimistic outlook, and set the scene for Australia to join the global crawl of normalising interest rates. For all those packing away the board shorts, welcome back.

"Everyday I see you wearing things that have never been worn before
While the children at the government schools send money for the poor
And all you buy you bargain for, with your little man
So that from your silks down to your paramour
Your tres, tres, paragon
So it's a backbeach in the summer
Chalet for the snow
You poor hoochie gucci fiorucci mama
You got really no place to go"
Hoochie gucci fiorucci mama – Australian Crawl.

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