Cash rate: lower for longer won't rule out volatility in sentiment

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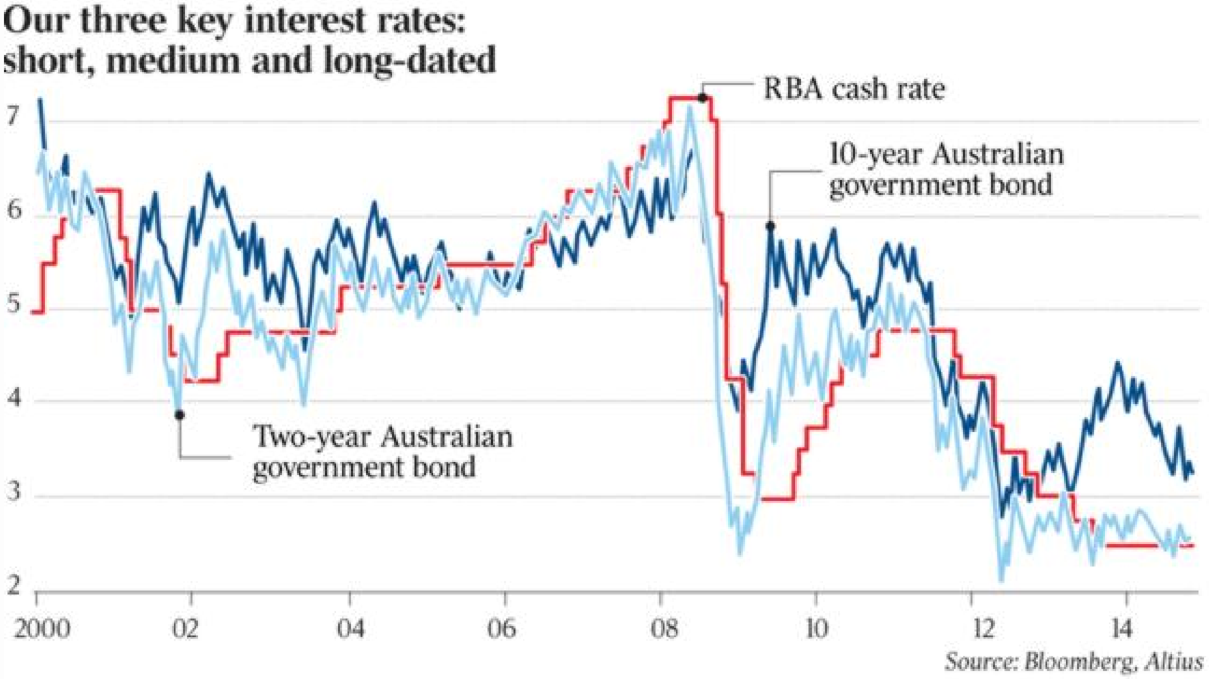

Chart of key interest rates *Source:* TheAustralian

AT times, interest rates on financial assets or liabilities with different maturities move to their individual drumbeats. Investors should prepare for this to be a recurring experience next year.

The key short-term interest rate is the cash rate, set by the Reserve Bank, and it is the main instrument of monetary policy. The level of the cash rate has a big effect on the interest rates banks and cash trusts pay the public on at-call and short-dated term deposits, and on what interest rates they charge for variable-rate borrowings.

Recently, people involved in financial markets have been confident our cash rate, which has been held at the record low of 2.5 per cent since August last year, will be left unchanged for another 12 months or so. (They're also confident that the next move in the cash rate, when it comes, will be upwards; and that the return to the long-term average of 5-5.5 per cent will be a drawn-out affair).

Certainly, the odds of our cash rate being left at very low levels for quite a while look compelling.

There's not much inflation to worry about for a year or two; the sharp fall in capital spending in resources is likely to mean the Australian economy has a lacklustre year; unemployment hasn't yet peaked; and there's no need whatever for Australia to match the increase or increases in the US cash rate likely to be made next year.

As the Reserve Bank often states, "the most prudent course is likely to be a period of stability" in our cash rate.

Of course, a further reduction in the cash rate would help to bring about a lower exchange rate. But the Reserve Bank doesn't want to give an extra boost to house prices (and is working on "macroprudential" controls to take some of the zest out of investment housing).

But if Australian inflation remains benign, the possibility of the cash rate remaining at 2.5 per cent well into 2016 can't be ruled out. Were house prices suddenly to weaken or were a recession in China to drive our unemployment rate noticeably above 6.5 per cent, another cut in the cash rate couldn't be ruled out.

The current view on the outlook for the cash rate, naturally enough, is comforting to borrowers — but it's a concern to people with savings, many of whom fear their interest earnings, particularly on at-call and short-dated deposits, will be gobbled up by even mild inflation.

Medium-term interest rates are headlined in Australia by the rates paid on term deposits with maturities of two to five years and the rates charged on fixed-rate housing loans. Medium-term rates are strongly influenced by market expectations of what will happen to the cash rate over the next few years. That's because borrowers and lenders can finance medium-term commitments by borrowing or lending for the whole term or by rolling over shorter-dated funding. My guess is market expectations on the outlook for the cash rate will swing widely next year — even if the rate is left unchanged — and medium-dated interest rates will often be volatile.

In Australia, the key long-dated interest rate is the yield on a 10-year government bond, which is often used to represent the "risk-free" rate of return in financial calculations. Our long-term bond yield usually follows the lead from US 10-year bonds (where the yield, currently 2.3 per cent, is likely to move higher next year).

At times, our long-term yield is also affected by changes in the spread on 10-year yields between Australia and the US. That spread is currently about one percentage point; it would be likely to narrow a little if US growth strengthened while our economy remained lacklustre.

Next week: This column will look at how investors can learn to handle these diverse signals for future interest rate movements.

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