

Rate Expectations!

Bookmakers sometimes refuse to offer odds on a particular horse if it's seen as a sure thing. So it was recently when a betting agency declined to take bets on the Reserve Bank of Australia raising official interest rates because the outcome was "as close to a guaranteed certainty as possible".¹

Media commentary ahead of the first meeting for 2010 of the central bank's policy-making board was also unequivocal. "RBA to Lift Interest Rates", trumpeted *ABC Radio*; "Rates Almost Certain to Rise", said *The Sydney Morning Herald*, while *The Australian Financial Review* chose to look even further into the future to ask whether retail banks would move more aggressively than the anticipated quarter percentage point rise.

To be fair to the reporters, they merely were reflecting what the market was saying. All 20 economists in a Reuter's poll had forecast a 25 basis point increase in the cash rate to 4 per cent, the fourth such move since September and making Australian rates among the highest in the developed world.²

The economists' confidence was also reflected in the futures market, where bill traders put the odds of a rate rise at almost 80 per cent.

So the market professionals, the economists, the journalists and even the bookmakers were speaking as one — this was a done deal, a sure thing, a short-odds favourite and as good as money in the bank.

This is why there was a lot of scraping of egg off faces on the afternoon of 2nd February 2010 when the RBA announced that it had in fact decided to leave its benchmark lending rate at 3.75 per cent.

The "surprise" outcome of the bank's monthly policy meeting had an immediate and dramatic market impact, with the Australian dollar dropping by a full cent against the US dollar and yields on short-dated bonds tumbling.³ The local share market also rose strongly after the announcement, ending up 1.8% on the day and near its highs for the session.

Naturally enough, some economists lined up to provide ex-post rationalisations for the on-hold decision, despite many of them having offered just hours before equally confident sounding explanations of why rates were almost certainly going up. Others, obviously feeling aggrieved at being made to look silly, took another tack and accused the bank of making a mistake. A third group just took it on the chin and admitted they got it wrong.

Suffice to say, it is a tough job being a market commentator. You have to make every market event — no matter how surprising — seem quite logical and part of a coherent, pre-ordained narrative. So when events change, you have little choice but to change the narrative without it seeming too obvious.

What does this mean in understanding how markets work? If the market on the morning ahead of the announcement was fully priced for a rate increase, did that make the pricing wrong in retrospect?

No, because the pricing in share, bond and currency markets *before* the RBA statement reflected the best estimate of market participants based on the information available *at that time*. When the information changed, the pricing changed.

Is there a case, then, for investors second guessing the market if they suspect it has got it wrong and seeking to make a profit from those mistakes? A brave individual could have attempted to make a profit by betting against the consensus, but this essentially would have been a speculative bet. If they got it right, all well and good, but this is no different to betting on a horse.

An alternative way of looking at it is to say that if the people who are paid to analyse interest rate movements, who obsessively parse central bank statements and who crunch numbers for a living can't get these calls right, what chance has the individual?

Better to accept that it is extremely difficult, if not impossible, to accurately forecast future events in a consistent way. Market pricing is only ever a best guess of the future based on current information. It incorporates the opinions of millions of individual investors and changes as events change.

The media in the prior week to the RBA decision was full of speculation about the outcome of the meeting and the likely consequences of another credit tightening. Many reporters were looking ahead to what would happen after the "inevitable" rate rise.

But then when the predicted event didn't occur, the slate was wiped clean and the story became "what does the Reserve Bank know that we don't? Maybe the economic outlook is worse than they are letting on?"

Essentially, the pundits are trying to build coherent narratives for their readers and customers out of unpredictable and haphazard events. Their running game analysis makes for entertaining reading. But at the end of the day, it's just noise and it's not something to base an investment strategy on.

¹ 'Rate Rise a Guaranteed Certainty: Centrebet', ABC news, Feb 2, 2010

² 'Aussie Up Ahead of Rate Call', Reuters, Feb 2, 2010

³ 'Australian Dollar Drops After Central Bank Leaves Rates on Hold', Bloomberg, Feb 2, 2010

Do not act on this information alone!

If you would like to discuss this in more detail, please contact:

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