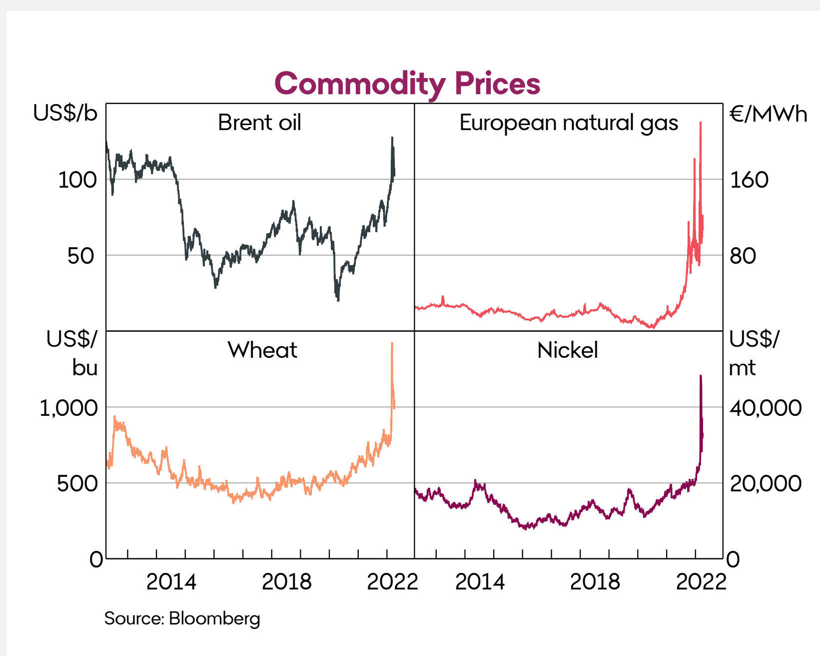
April 2022

Economic and market update

Economic Overview – as at 21st April 2022

The IMF released its revised forecasts this week which significantly downgraded global GDP growth while upgrading inflation estimates - which neatly sums up the change in the outlook since the Russian invasion of Ukraine. Inflation (and interest rates) were already on the rise ahead of the war as economies reopened from the pandemic but will now be higher for longer. The impact will differ by region, as evidenced by the different stages that central banks are at in their tightening cycles (it's worth noting the IMF upgraded its GDP forecast for Australia), however no country will avoid the global surge in inflation as commodity prices, and in particular energy prices, respond to the supply shock.



Downgrades to GDP forecasts were most evident in Europe given their dependence on Russian oil and natural gas; and euro-zone inflation is now estimated at 7.5%. The German Producer Price Index rose 4.9% in March, or 30.9% year-on-year! An ECB rate hike is now expected in July. The primary cause of this inflation shock (the war in Ukraine) appears to be no closer to compromise or resolution. UK inflation is 7% and after three rate hikes thus far - the first time the Bank of England have raised rates in three successive meetings for over 20 years - two more increases are priced in this year.

The IMF downgraded US GDP to 3.7% (from 4%) which still appears very ambitious given the path that US interest rates are about to take - the Federal Reserve are favoured to hike rates by 50 basis points in May, June and July, and the two-year bond yield is up to 2.6%. The ten-year yield is close to three percent, meaning the curve is no longer inverted - but how resilient the US economy will be in the face of these rates (and the ability to avoid a recession in 2023) will be tested to the full. US labour markets have tightened further with unemployment down to 3.6%, however wages growth is a long way from keeping up with inflation, and rising input costs are being passed on to consumers.

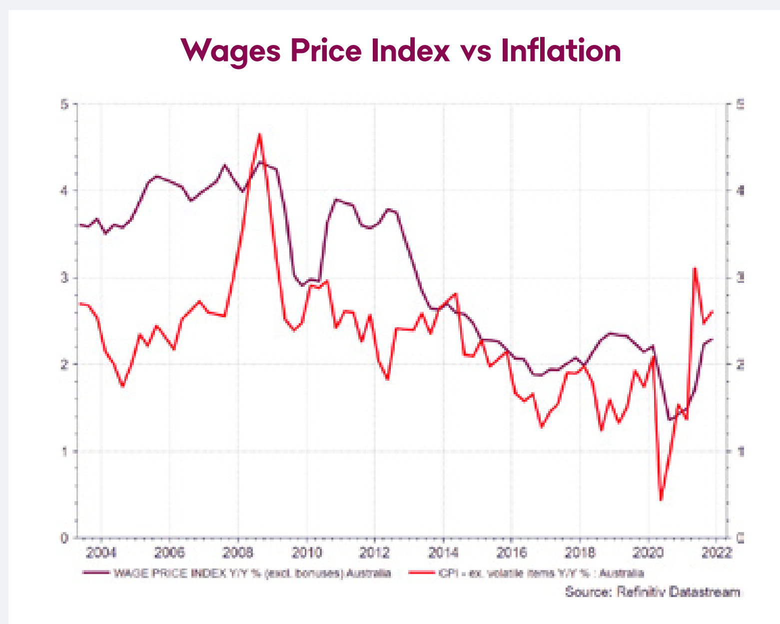
The outlook for the Chinese economy remains complicated by the 'zero-tolerance' approach to COVID-19 and associated lockdowns in Shanghai and other cities, although there are signs that case numbers outside of Shanghai have peaked. China's property sector remains weak, however Friday's cut in the reserve-requirement ratio and the expectation of further policy easing are likely to help the Chinese government in their pursuit of 5% growth this year (at least via the official data). Q1 growth of 1.3% (4.8% year-on-year) was better than forecast, as was industrial production and 'fixed asset investment' year-to-date, but retail sales missed expectations and the Services PMI survey fell to its second-lowest level on record.

The Chinese economy is likely to achieve a soft landing despite these challenges and the over-reliance on infrastructure spending, given authorities still have the capacity to lower interest rates (with Chinese inflation only at 1.5%). However, the pandemic containment measures are adding to supply-chain pressures for their trading partners, including Australia.

In summary, the global economy will continue to be challenged by the prospect of an inflation and energy shock, and the extent to which central banks prioritise tackling inflation over economic repair. The transition to treating COVID-19 as endemic rather than pandemic has been accelerated by variants becoming less lethal (but more transmissible) e.g. most recently Omicron XE, helping economic recoveries via faster easing of restrictions. However, the war in Ukraine has changed the focus from post-pandemic economic growth (which is still going to be above trend for most countries this year), to dealing with much higher interest rates, and the impact of inflation on purchasing power.

Domestic economy

The April RBA Monetary Policy Meeting effectively locked in a June rate hike after the phrase 'the Board is prepared to be patient' (which had been in the minutes of each meeting since October) was replaced with an acknowledgement of growing inflationary risks and 'these developments have brought forward the likely timing of the first increase in interest rates.' A May rate hike is considered unlikely as this would precede wages data for Q1 to be released on 18 May, and the RBA noted 'important additional evidence will be available on both inflation and the evolution of labour costs'.



The next question is the size of the first rate hike, which could be 15 basis points (to 0.25%) or 40 bp to an Official Cash Rate of 0.5%. On this front the RBA appeared to lean to 15 bp, based on their observations on exchange settlement (ES) balances and the margin between ES and the OCR. More modest increases (including subsequent 25 bp hikes) would be consistent with the RBA's very cautious language over the last year (in October 2021 they were still indicating no rate hikes until 2024), but from here the pace of rate hikes will clearly be driven primarily by CPI, core inflation and wages.

Wages growth and its inability to keep up with inflation has been a hot topic in the debates ahead of the federal election on 21 May, although that discussion via press conferences and the media seems to miss the point that while the wage price index has been declining since 2009, so has inflation. As the chart above shows, it is only since the recent inflation surge that the WPI is being outpaced by core inflation - but given CPI and core inflation are now set to be higher again (next read 27 April) it is true that real wages growth will remain negative, as they have been since the start of 2021. Tight labour markets should see the WPI quickly back to 3%, but core inflation will be closer to 4%. Longer term wages growth will primarily rely on productivity enhancement, assisted by structural reform.

Politics was also in focus this month after the Federal Budget in late March (where the bulk of the $114 billion fiscal windfall was saved rather than spent) provided modest policy support. The 50% cut in the fuel excise will assist to an extent with short-term living cost pressures and with inflation.

Consumer sentiment has fallen on the prospect of higher interest rates although retail trade remains strong. As the charts in the appendix explore, rate hikes of around 2-2.5% over the next 12-18 months will see the property cycle turn down (with the RBA modelling a 10% fall in house prices), however:

- Household balance sheets are in good shape (as a share of median disposable income)
- LVRs are in general lower than pre-pandemic, and households have built 'excess buffers'
- Around 40% of borrowers are on fixed rates, double the rate at the start of 2020

Our economy will be tested by rising interest rates, but our economic resilience, as evidenced by the V-shaped recovery last financial year and again since Delta, will provide a solid foundation. It will be supported by our AAA sovereign rating (with net debt to GDP peaking at only 33%, making 'budget repair' less urgent), and by the resumption of international and domestic travel helping with labour shortages and tourism/hospitality.

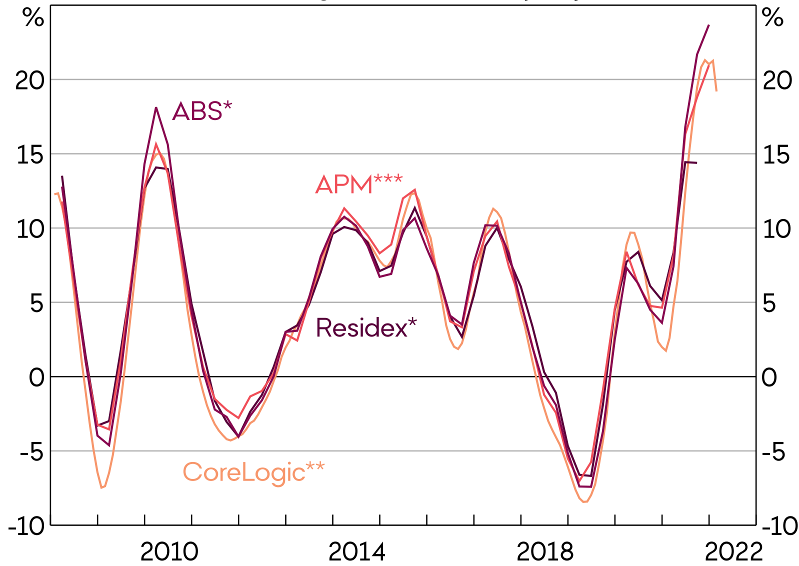
Interest Rate Outlook

The RBA have finally conceded the need to start lifting interest rates and have strongly hinted that the first hike will be in June. A likely path for rate hikes based on current economic data (including an unemployment rate set to trend to around 3.5% this year) is a **15 basis point hike in June, followed by 25 basis point increases in July, August, September, November, and December.**

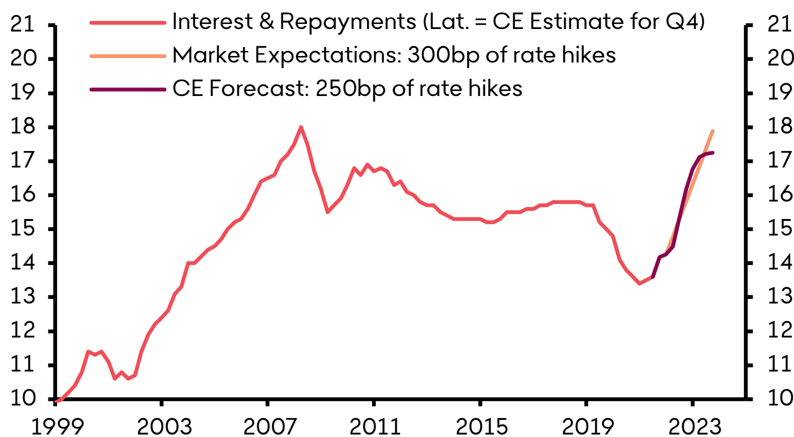
This would result in an OCR of 1.5% by year end and perhaps as high as 2.5% by mid-2023, although the market is far more aggressive, pricing in 2% by year end and 3.25% by late 2023. The key unknown is how responsive our inflation rate will be to these rate hikes, and the global backdrop driving the supply disruptions. Markets are pricing in the inflationary shock to remain in place through 2023.

	28 / 2 / 21	28 / 2 / 2022	31 / 3 / 2022	21 / 4 / 2022
90-day bills	0.03%	0.08%	0.23%	0.41%
3-year swap	0.39%	1.83%	2.61%	2.80%
5-year swap	0.95%	2.20%	2.96%	3.12%
AUD/USD	.7715	.7265	.7485	.7430
ASX 200	6 607	7 049	7 500	7 570
Credit Index (iTraxx- 5 yr)	58.5	75.5	93.2	88.0

Appendix: *Residential property ahead of RBA rate hikes*



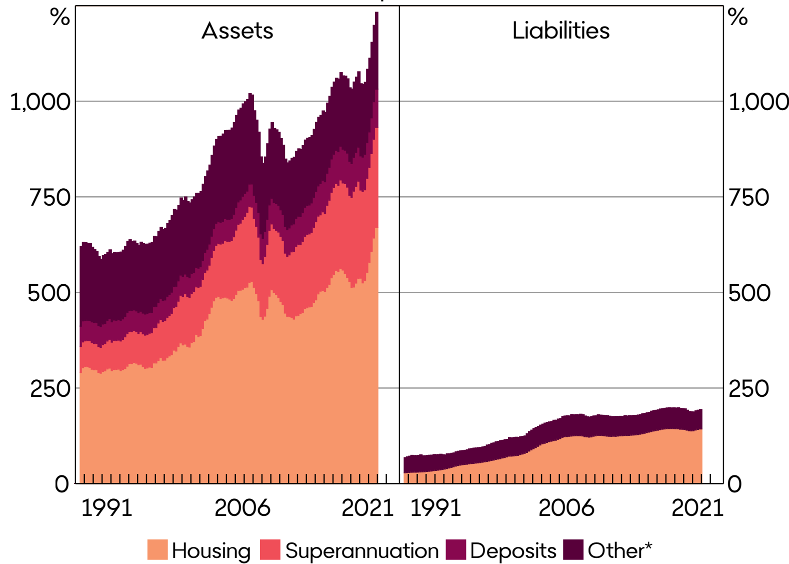
* ABS is a quarterly stratified median price index; Residex is a quarterly repeat sales price index.
** Monthly hedonic price index; non-seasonally adjusted.
*** Quarterly stratified median price index.
Sources: ABS; APM; CoreLogic; RBA; Residex



Sources: Refinitiv, BIS, RBA, Capital Economics

Household Balance Sheet

Share of disposable income

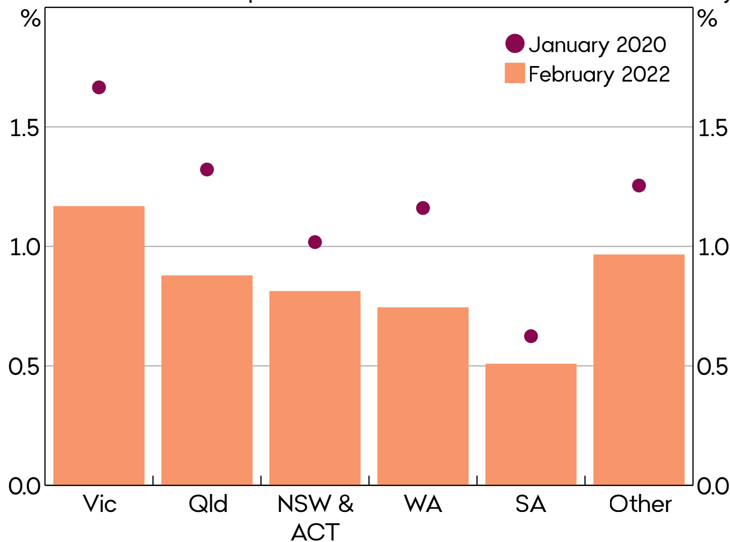


* Other assets include financial assets held outside of superannuation or deposits, consumer durables and all other non-housing non-financial assets; other liabilities include personal credit, student loans and all other non-housing liabilities.

Sources: ABS; APRA; RBA

High Debt and Low Buffer Households*

Share of owner-occupier variable-rate loans in each state/territory



* Those with a loan-to-income ratio above six and less than one month of excess payment buffers (offset and redraw balances, measured in months of minimum repayments).

Sources: RBA; Securitisation System

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