December 2023

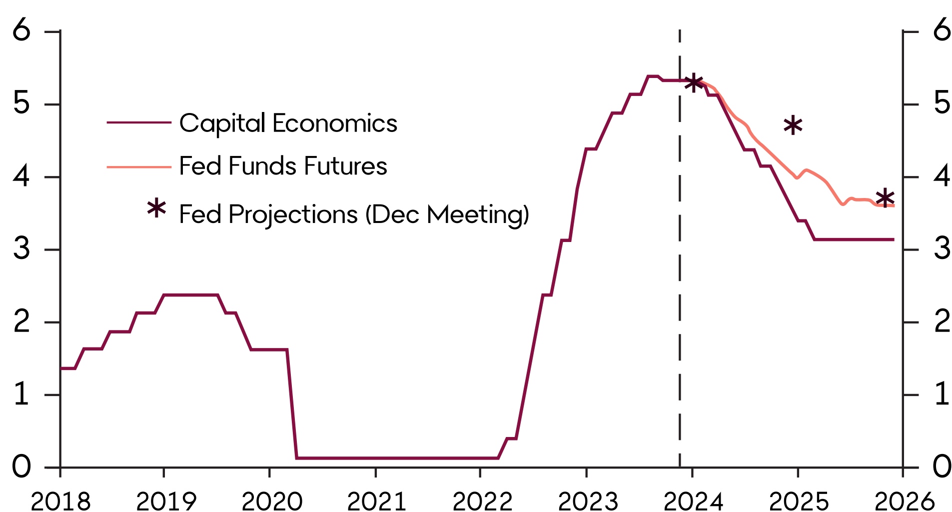
Economic and market update

Economic Overview – as at 14th December 2023

Global markets

The universal expectation of rate cuts in the US and Europe by mid-2024 is now being matched by less hawkish central bank comments and further evidence of slowing demand, although the precise timing and pace of the cuts remains unclear. The likelihood of other advanced economy central banks joining the Fed and ECB has increased with the Bank of Canada and even the Bank of England poised to cut rates earlier than previously expected (but the Bank of Japan is an obvious outlier).

US Fed Funds Rate Expectations



Sources: Refinitiv, Federal Reserve, Capital Economics

The Federal Reserve kept rates on hold as expected this week, however comments from Fed Chair Powell in the post FOMC press conference on 'when it will become appropriate to begin dialling back the amount of policy restraint in place' were significant. The FOMC 'dot plot' rate projections (above) are now more aligned to market expectations, although as always there are a wide range of forecasts in play. US inflation continues to moderate: core CPI only rose 0.3% in November, and while year-on-year is double the Fed's target at 4%, other measures including core PCE inflation are making steady progress. The markets are now considering the possibility of rate cuts as soon as March, although May appears more likely and naturally this timing remains data dependent.

US bond yields again fell sharply after the FOMC with the ten-year yield down to just below 4% (an amazing move from above 5% less than two months ago), but the curve remains steeply inverted. Equity markets (refer appendix) continue to take comfort in the prospect of lower rates arriving more quickly, although they don't seem too concerned about the prospect of earnings being challenged by the expected economic slowdown ahead. This is the second longest period since 1940 for US yield curve inversion – so, should we interpret this 18 month period of inversion as a precursor to a deeper recession, or just a reminder of how utterly unique financial conditions are in the post-pandemic economic environment? Perhaps both, but the 90% + correlation of inverted curves to hard landings is important to keep in mind.

The European economy continues to languish and resembles stagflation more-so than the US, with euro-zone GDP growth for 2023 expected to land at just 0.5%, including a contraction in Q3 but core inflation still around 3.75%. ECB cuts are now expected from April, with five cuts fully priced in the curve in 2024, although the risk is that only three may be delivered as inflation moderates more slowly. The Bank of England are now in a better position to cut rates in mid '24 after softer wages growth and the monthly GDP data showing the economy contracted by 0.3% in October. Despite the lack of economic growth in the UK or EZ, equity markets continue to rally. In the case of the German DAX index, the record high this week over 16 700 coincides with Germany remaining in recession.

The Japanese Tankan survey revealed improved business conditions with the highest sentiment score since 2018, matching currency strength with the US Dollar falling from almost 152 last month to below 142 Yen. Admittedly, Q3 GDP for Japan was revised down to a 2.9% contraction as household consumption remained weak, however the outlook for 2024 is more optimistic. The BOJ are expected to commence tightening policy around April, but with a baby first step from -0.1% to 0.0%.

The Chinese economy appears to be responding positively to policy support and stronger demand for exports with activity data continuing to recover, although the property sector remain problematic. CPI is still negative with food prices experiencing deflation and energy prices also deflationary, so another PBoC rate cut is expected. Moody's has downgraded the outlook for China's sovereign rating to negative, but the growth outlook is favourable: just over 5% GDP growth in '23 and the mid 4's in '24.

In summary, the new year promises to be almost entirely in contrast to 2023: most central banks moving from policy tightening to rate cuts; much slower growth for those economies yet to enter recession; and inflation approaching target. How this all flows through to equity markets, bonds and credit spreads is far less certain, but financial markets continue to lean to softer landings compared to a year ago when global recession risks were more elevated.

Domestic economy

The latest jobs and GDP data sets the scene for 2024 with a likely ongoing trend of economic data showing weaker growth and activity, complicated by high population growth and public demand, and accompanied by frustratingly stubborn inflation. All of this suggests that further RBA rate hikes are less likely, and that a 4.35% official cash rate will be sufficient to temper demand, but equally that rate cuts will be further down the track - at the earliest by November '24, but more likely in early 2025.

The November labour report was a good example of these themes:

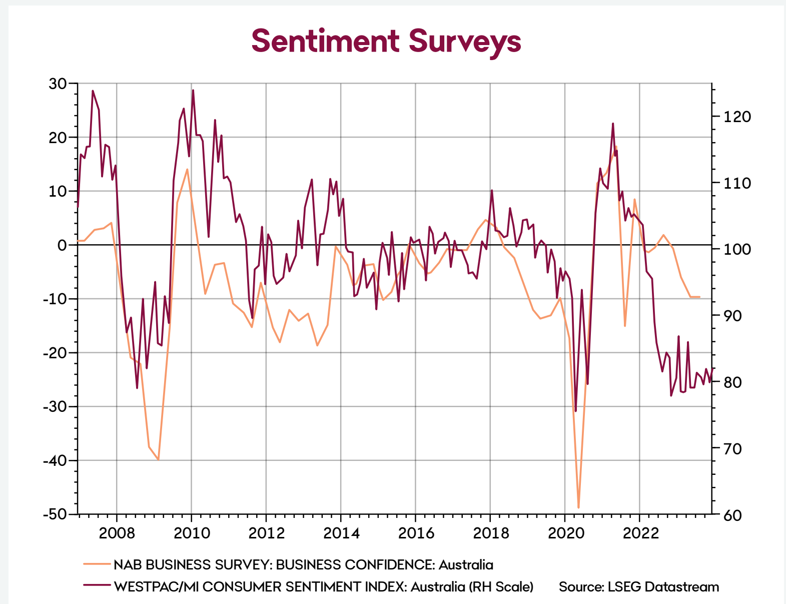
- Unemployment rose to 3.9%, however total employment rose by over 60k
- The participation rate rose to a new record high of 67.2% (more people looking for work)
- Underemployment rose from 6.3% to 6.5% and 'monthly hours worked' was flat.

This suggests a weaker outlook in line with the recent fall in job advertisements and job vacancies, but while supportive of 'rates on hold' for the RBA, it didn't add to any urgency for rate cuts given ongoing tightness in labour markets, and with population growth running at 3% year-on-year.

Similarly the Q3 National Accounts showed a slowing economy, with real GDP only increasing 0.2% in the third quarter, but still up 2.1% through the year - the eighth straight quarterly rise in real GDP. The drivers of growth were primarily public demand (with Government spending up 1.1% in the quarter) and increased mining industry investment, but household spending was flat and the household saving ratio was only 1.1%, its lowest level since 2007. Compensation of employees rose 2.6% in the quarter, and population growth was again influential: Australia remains in per-capita recession as per-capita GDP fell 0.5% in Q3 after contracting 0.1% in the June quarter.

Looking to 2024, GDP growth is likely to be less supported by population growth as net migration slows, and the tailwind from public demand may be lower as infrastructure projects are rationed. Our basecase forecasts below continue to factor a technical recession, although if we are correct that the unemployment rate will only rise to the mid to high 4's next year, then this wouldn't resemble a hard landing. Nevertheless, the RBA forecast of unemployment only exceeding 4.2% in 2025 still appears very ambitious, as do the latest MYEFO forecasts.

The latest sentiment surveys show further evidence of the stress that households are experiencing with Consumer Sentiment still near record lows, suggesting weak consumption ahead. Business Confidence fell to -9 (the lowest level since December 2021) and business conditions were also lower: however within the business survey price pressures remained elevated.



Other factors suggesting the RBA are probably on hold for the bulk of 2024 include:

- The latest fall in CPI in the monthly data from 5.6% to 4.9% (although the core measure only fell to 5.3%)
- A moderation in house price appreciation, and the prospect of less gains ahead as population growth eases and supply picks up
- Lower oil prices on international markets, as fears of more OPEC production cuts are offset by the expectation of lower demand next year.

...all of which allows the RBA to simply retain the tightening bias, rather than actually lift the OCR.

On the 40-year anniversary of the float of the Australian Dollar, the Aussie has rallied above 67 US cents as perceptions of interest rate differentials lean to Australia over the North Atlantic economies, and as the outlook for China continues to stabilise. The Iron Ore price above US$130/tn, and the recent rally in the gold price to a record high above US$2100 /oz, does suggest further upside risks to the Aussie, although the 69c resistance level remains crucial. The Federal Government MYEFO report revealed a $40 bn improvement in the budget position (helped by higher tax revenue - and the perennial understatement of the Iron Ore price, still only budgeted at US$60/tn!), but banking the bulk of the windfall. Net debt is down to $491 bn, or around 20% of GDP. Like the RBA SOMP, the MYEFO forecasts unemployment remaining benign at only 4.25% and growth recovering to 2.25% in FY25. Our forecasts below are less optimistic about the impact of higher rates on top of the cost of living challenges that high inflation has delivered for households and businesses.

Interest Rate Outlook

The RBA Official Cash Rate is most likely at its cycle peak at 4.35%, although another increase to 4.6% after the next few quarterly CPI data prints remains a risk (around a 25% chance). Rates are expected to be on hold through February, when the RBA moves to meeting 6 weekly. A longer cycle (into 2025) as core inflation persists above 3% is still our basecase scenario outlined below, while other advanced economies are much closer to their easing cycles, commencing around mid-2024.

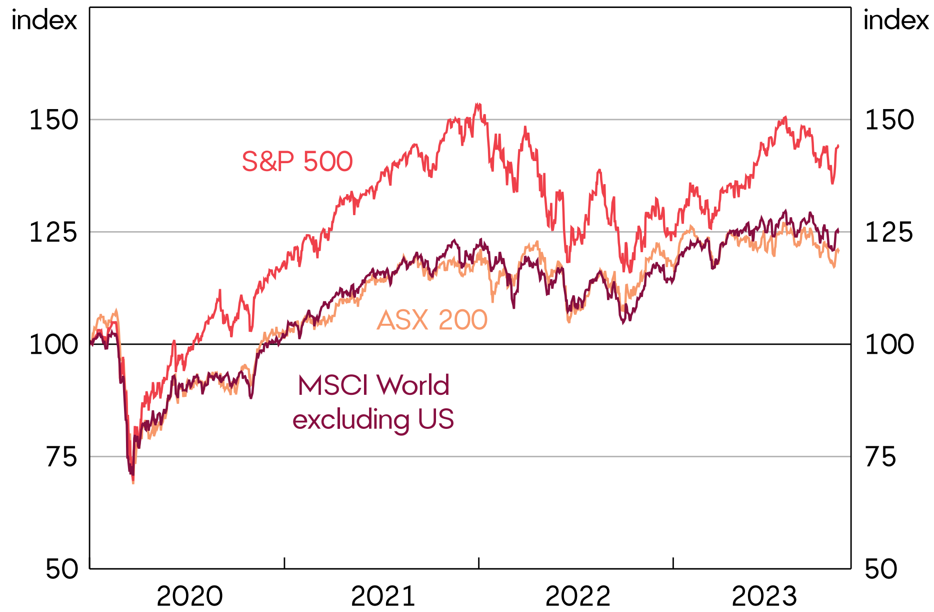
Economic Forecasts: basecase scenario

	2022			2023				2024			
% (actual, forecast)	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP q/q	0.8	0.2	0.9	0.5	0.4	0.2	0.2	-0.2	-0.2	0.4	0.5
GDP y/y	3.5	5.8	2.3	2.4	2.1	2.0	1.3	0.6	0.0	0.2	0.5
Unemployment	3.6	3.6	3.5	3.5	3.5	3.6	3.9	4.3	4.6	4.8	4.9
CPI (q/q)	1.8	1.8	1.9	1.4	0.8	1.2	0.9	0.8	0.7	0.7	0.7
CPI (y/y)	6.1	7.3	7.8	7.0	6.0	5.4	4.3	3.7	3.6	3.1	3.0
CPI (core y/y)	5.0	6.1	6.8	6.6	5.9	5.2	4.3	3.9	3.8	3.3	3.1
RBA cash rate	0.85	2.35	3.1	3.6	4.1	4.10	4.35	4.35	4.35	4.35	4.35
AUD / USD	.6905	.6410	.6815	.669	.666	.6435	.67	.69	.71	.73	.75

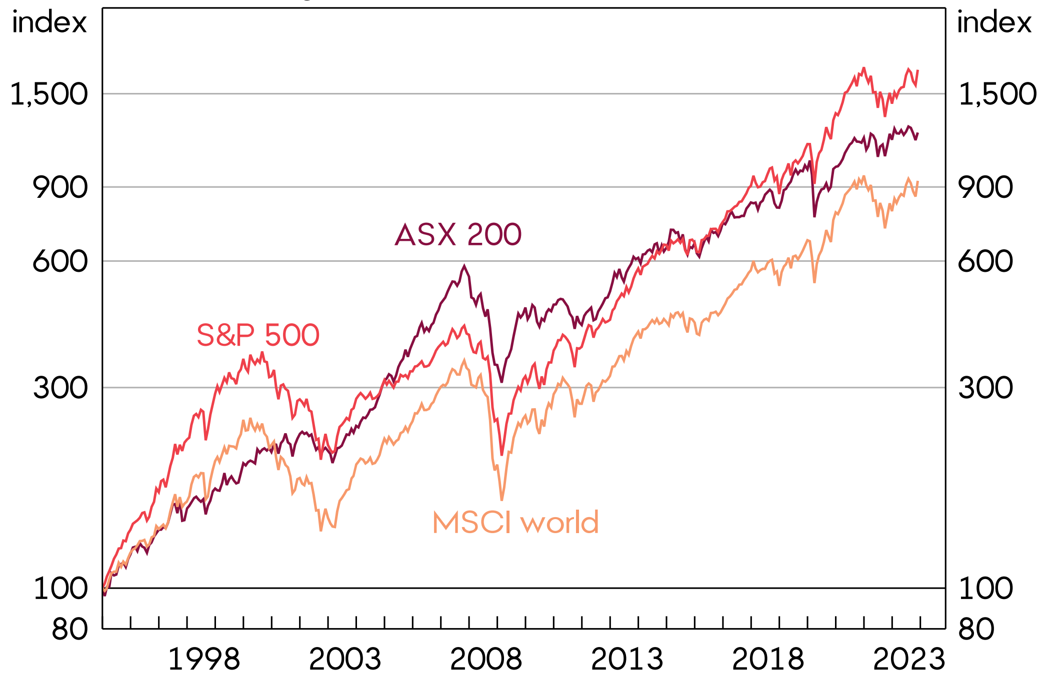
Benchmark rates

	31 / 10 / 22	31 / 10 / 2023	30 / 11 / 2023	14 / 12 / 2023
90-day bills	3.09%	4.35%	4.37%	4.35%
3-year swap	3.97%	4.64%	4.20%	3.91%
5-year swap	4.23%	4.94%	4.45%	4.12%
AUD/USD	.6395	.6340	.6605	.6710
ASX 200	6 864	6 781	7 087	7 378
Credit Index (iTraxx- 5 yr)	137	93.5	75.1	72.2

Appendix: Share Markets



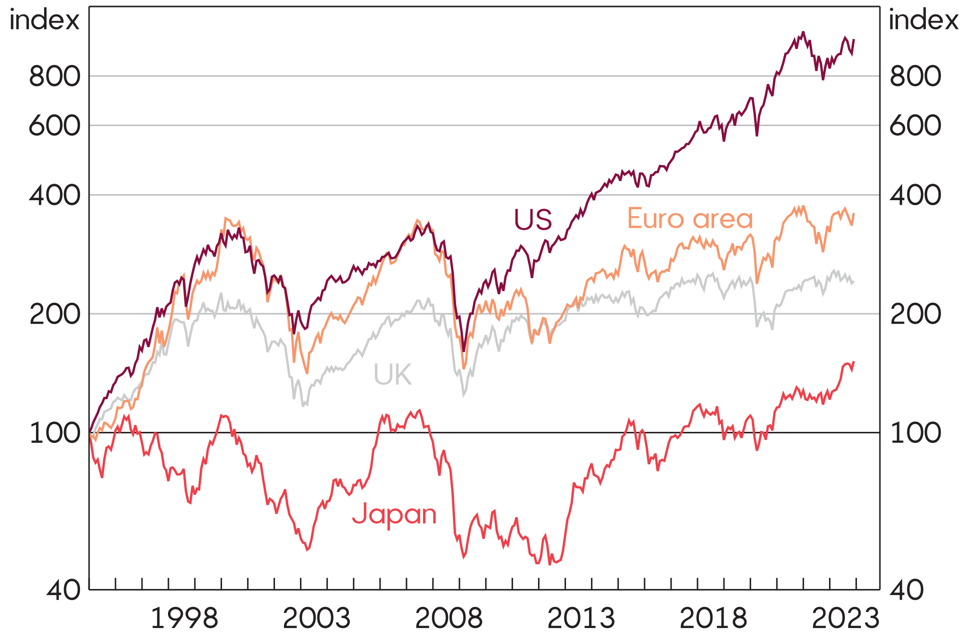
Sources: Bloomberg; RBA; Refinitiv Datastream.



Sources: Bloomberg; RBA.

Advanced Economies’ Share Price Indices

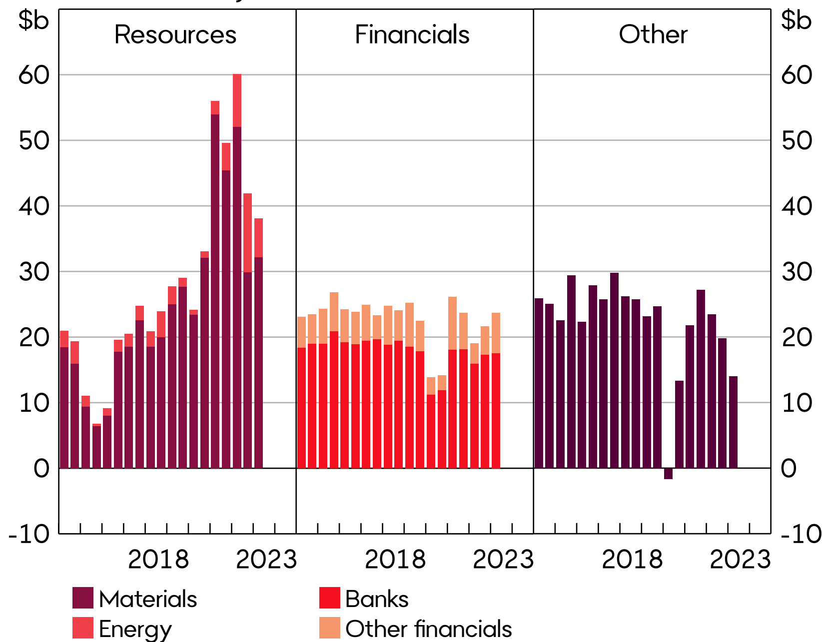
Log scale, end December 1994 = 100



Sources: Bloomberg; RBA.

ASX 200 Underlying Profits*

Adjusted for inflation, semi-annual**



* Results for companies with reporting dates in the half are rolled forward. Underlying results adjust for on-off items such as asset revaluations.

** Latest observation is nominal and previous observations are adjusted using CPI growth.

Sources: ABS; Bloomberg; company reports; Morningstar; RBA.

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