January 2024

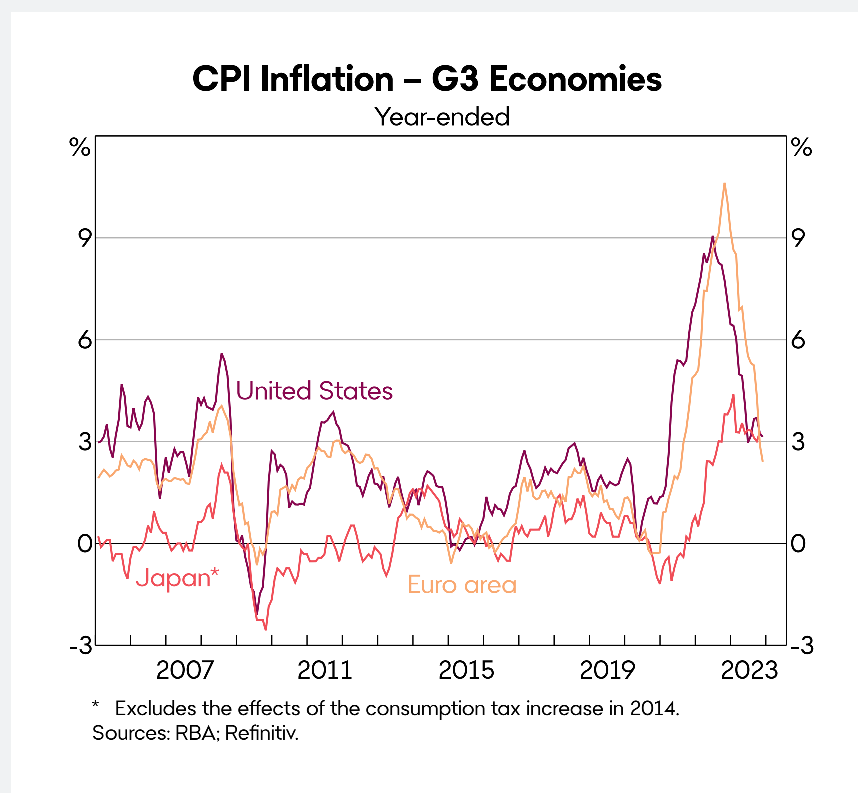
# Economic and market update

## Economic Overview – as at 18th January 2024

## Global markets

Rate cut euphoria drove an impressive rally in equity markets through year-end, coupled with expectations of soft landings in the US and more broadly for the global economy. While central banks have clearly opened the door for lower official rates this year, they are pushing back to varying degrees on the timing for policy easing to commence, and meanwhile economic data is far from convincing regarding soft landings (including the German economy contracting 0.3% in 2023). Progress on inflation thus far has been impressive (refer chart below), however the 'last mile' will be difficult and geopolitical tensions have intensified, adding risks to renewed supply chain disruptions and possibly to higher energy prices. Equity markets have corrected in the last few days as a result.

The rally on Wall Street in January to record highs for the Dow, and near-record peaks for other US indices, coincided with a US rate cut being fully priced into markets for March, although since then inflation data has been mixed, including core CPI +0.31% month-on-month in December, or +3.9% year-on-year. Subsequently, the Producer Price Index was -0.1% m/m, leaving traders still leaning to a March cut based on inflation projections - however a stronger read on retail sales, and some cautious Fed comments suggest a May cut is more likely. Fed voting member Christopher Waller noted that rate cuts should be 'carefully calibrated and not rushed'. Bond yields have consolidated above 4%.




* Excludes the effects of the consumption tax increase in 2014.
Sources: RBA; Refinitiv.

While markets grapple with the timing and extent of Fed rate cuts as inflation normalises, two other factors of note are the sustainability of momentum in the US economy, and the long lead-up to the November Presidential election. US GDP growth for 2023 is likely to land just below 3%, after Q3 grew 5.2% saar, and the unemployment rate ended the year at 3.7%. None of this sounds remotely like a recession, however manufacturing surveys are showing stress, interest rates are 5.25% higher than two years ago, and the yield curve is (still) inverted. If the Fed does achieve a soft landing it will be their first in such circumstances since 1966 - and meanwhile the Iowa caucus landslide win for Donald Trump brings his protectionist policy agenda into sharp focus. As such, risks appear elevated for a sharper US slowdown than markets have factored this year in the face of higher interest rates (despite this not occurring in 2023) - and also for a tumultuous end to the year as the election unfolds.

The European economy remains at risk of extending its period of stagnation with its largest economy, Germany, contracting another 0.3% in Q4 (first estimate) and a range of indicators demonstrating the harsh impact of ECB rate hikes on consumers and businesses. In contrast to the US, the lack of growth in the euro-zone economy should incentivise the central bank to cut rates as soon as practical. However, like the Fed, the ECB continues to emphasise the importance of completing the task of fully containing inflation. The first ECB rate cut is fully priced in the market by April, and while markets are very good at getting ahead of themselves with easing cycles, core inflation may well be back at or below target in April, allowing cuts by mid-year. The UK are also at risk of falling into recession having contracted marginally in Q3, however December inflation data showed an unhelpful uptick with core CPI sitting at 5.1% y/y. The Bank of England have likely completed their tightening cycle, but cuts are unlikely until August given the more elevated levels of inflation.

Japan remains an obvious outlier with an official cash rate still at -0.1%, but the long-awaited start of the tightening cycle is more imminent than ever. Inflation is running at a level the BoJ would consider sustainable and household consumption has picked up, leaving businesses in an encouraging position. The Nikkei index is back above 35k for the first time since 1990, and a fresh record high is in sight - so after decades of underperformance, Japan may be the star performer for 2024.

The Chinese economy hit the growth target set at the start of 2023 landing at 5.2%, but not without significant stimulus and policy support, and not with the momentum authorities would have hoped for. Over 2023 deflation meant that nominal growth was actually slower at 4.6%, despite recent rate cuts. Premier Li Qiang noted yesterday that officials did “not seek short-term growth while accumulating long-term risk” so a lower growth rate will be tolerated this year, and China’s property sector remains a constraint. Economic growth slowed from 1.5% in Q3 to 1.0% in the last quarter, and retail sales data was disappointing, however base effects helped with industrial production growth, and exports have picked up thanks to trade partners in the region. Further rate cuts should deliver growth in the 4’s this year, but it will be hard yards - although from a geopolitical perspective the more challenging environment may sooth some of the tensions that would be more elevated in a more bullish economy.

In summary, this year will see numerous central banks cutting rates as consensus forecasts suggest, however the timing of these cuts will probably disappoint the markets. Cuts do appear more likely in H2 (in general), with central banks probably being patient and careful not to move pre-emptively.

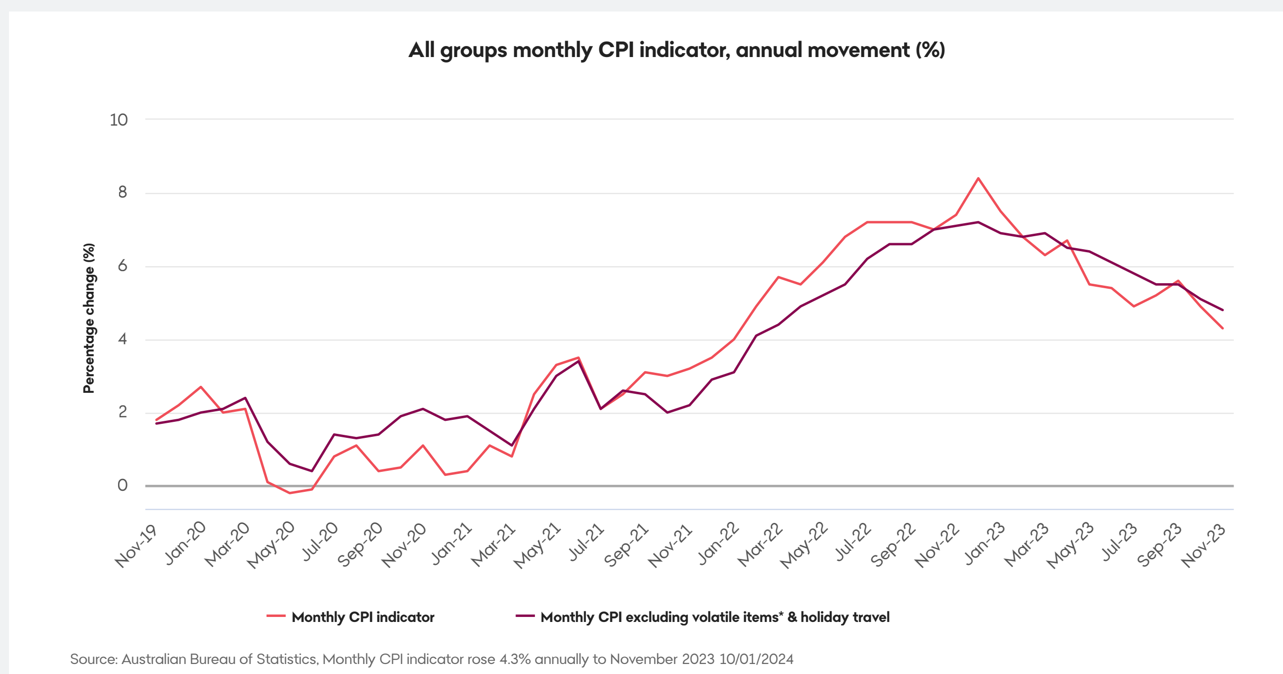
# Domestic economy

As opined in last month’s report, 2024 will likely see an ongoing trend of economic data revealing weaker growth and activity, complicated by high population growth and public demand, but still with frustratingly stubborn inflation. All of this still suggests that further RBA rate hikes are unlikely, 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 than consensus - at the earliest by November, but more likely in Q1 2025.

The jobs report for December showed a sharp fall in employment - down 65k seasonally adjusted and with another fall in hours worked (total hours worked are now back to where they were in February). While the surge in net migration last year had a significant impact supporting employment (and propping up demand) and job vacancy levels remain high, suggesting that labour markets remain tight, the outlook for 2024 is weaker with unemployment and underemployment set to steadily rise.

Given a neutral NAIRU unemployment rate is estimated around 4.5%, this outcome would support a more benign path for inflation, and would build the case ultimately for rate cuts. However, the RBA are unlikely to cut pre-emptively, particularly with the May Federal Budget likely to be stimulatory and the impending stage 3 tax cuts (whilst helpful as part of broader tax reform) deferring the goal of 2.5% core inflation.

The monthly CPI read for November was an impressive fall to 4.3% y/y and 4.6% core inflation, adding to the chorus of market economist forecasts of earlier rate cuts. However, the quarterly data will be more influential for the RBA, and almost no-one (including the RBA) are suggesting that core measures will be anywhere near 2.5% this year. So again, 2024 RBA rate cuts would demand a pre-emptive approach, or a bigger problem than inflation to emerge. Both of these scenarios are possible, but it is interesting that so many forecasts reflect a benign outcome for jobs and growth (a soft landing) and predict core CPI clearly above target at year end, but nevertheless rate cuts by November. The key to early rate cuts presumably will be an earlier return to target for inflation, which is possible (as the chart below suggests) but isn't close to the consensus view, nor RBA forecasts.



Source: Australian Bureau of Statistics, Monthly CPI indicator rose 4.3% annually to November 2023 10/01/2024

While markets are predictive of two rate cuts in H2, consumer sentiment isn't taking any comfort falling to 81 in the Westpac/MI survey. Other surveys suggest willingness to buy a house is also low as housing affordability remains a constraint. The appendix shows these dynamics: property is expensive vs income levels, not helped by lack of new stock combined with higher interest rates. The lack of 'dwelling commencements' sets the scene for population growth to continue to outpace construction, putting a floor under prices but making housing and rental shortages an ongoing issue. The consensus view for residential property prices in 2024 is around a 5% gain, however relativities around population growth, affordability and state-specific tax imposts will see very different outcomes by region (as was the case last year).

The Aussie Dollar had a volatile period through year-end rallying to US 68.7c around Christmas, in line with a much weaker US Dollar, but then falling steadily in January as US rate cuts became less imminent and Chinese economic data disappointed. As detailed above the geopolitical backdrop is both complex and subject to sudden swings in sentiment, so the 3.5c fall in under a month is understandable but leaves the outlook for FX markets this year as uncertain as ever. The basecase scenario detailed below shows a widening interest rate differential with the US that (normally) would support an appreciating Aussie Dollar - and our forecast does include an eventual break of the 69c key resistance level to 71c by June and 75c by December. However, forecasting the path of the US Dollar leading up to the US Presidential Election has a high degree of difficulty.

## Interest Rate Outlook

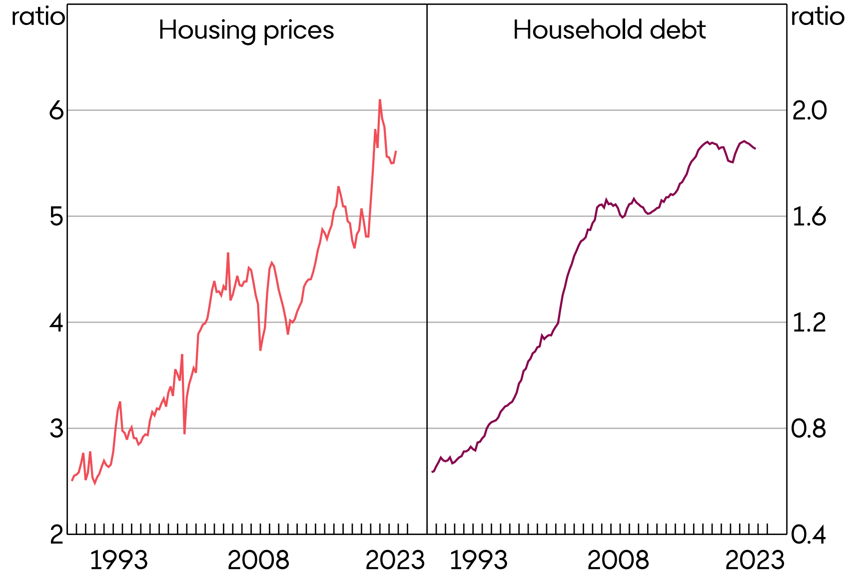
The RBA Official Cash Rate is most likely at its cycle peak at 4.35%, although another increase to 4.6% after the next few quarterly CPI data prints is possible (around a 15% chance). Rates are expected to be on hold through February, when the RBA moves to meeting every 6 weeks. A longer cycle (into 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. Earlier RBA cuts are possible but would require faster progress with inflation than forecast.

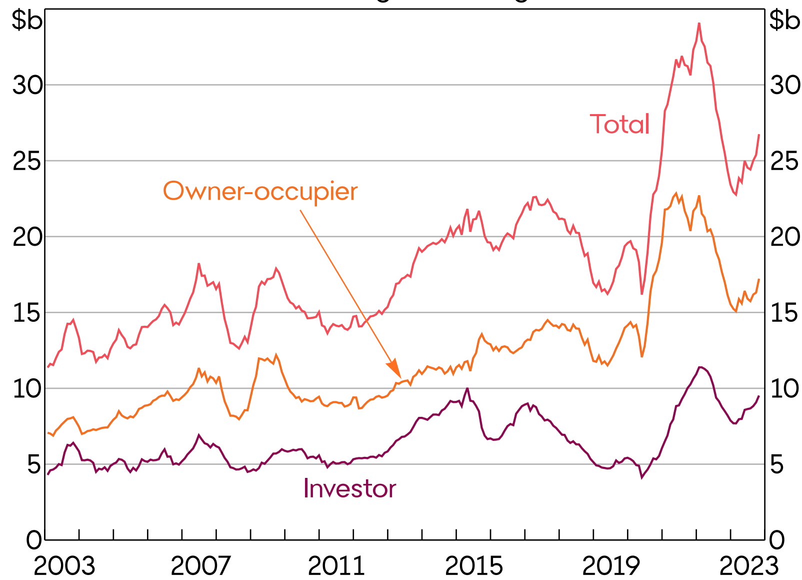
## Economic Forecasts: basecase scenario

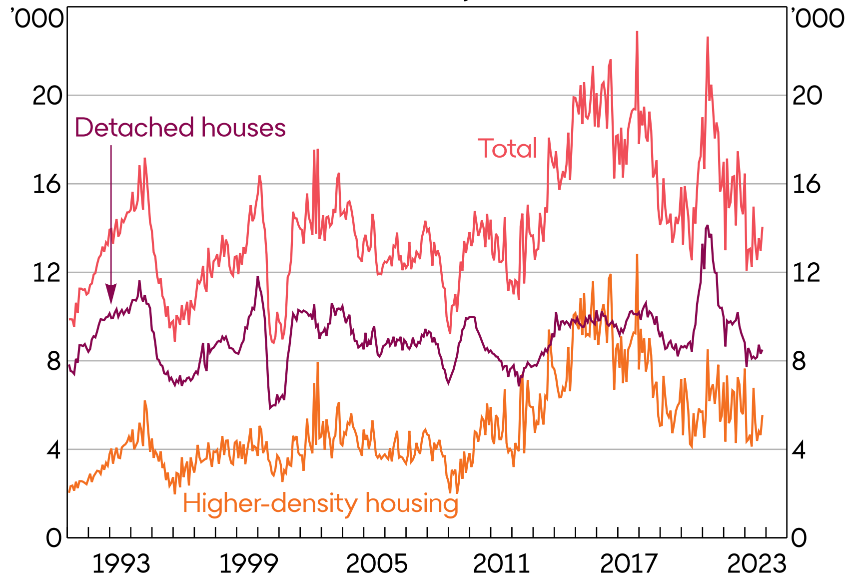
| | 2022 | | | 2023 | | | | 2024 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| % (actual, forecast) | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| GDP q/q | 0.8 | 0.2 | 0.9 | 0.5 | 0.4 | 0.2 | 0.2 | -0.1 | -0.2 | 0.4 | 0.4 |
| GDP y/y | 3.5 | 5.8 | 2.3 | 2.4 | 2.1 | 2.0 | 1.3 | 0.7 | 0.1 | 0.3 | 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 | 0.8 | 0.8 | 0.7 | 0.8 | 0.7 |
| CPI (y/y) | 6.1 | 7.3 | 7.8 | 7.0 | 6.0 | 5.4 | 4.2 | 3.6 | 3.5 | 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 | .682 | .69 | .71 | .73 | .75 |

## Benchmark rates

| | 30 / 11 / 22 | 30 / 11 / 2023 | 31 / 12 / 2023 | 18 / 1 /2024 |
|---|---|---|---|---|
| 90-day bills | 3.09% | 4.37% | 4.35% | 4.35% |
| 3-year swap | 3.73% | 4.20% | 3.78% | 4.01% |
| 5-year swap | 3.93% | 4.45% | 3.93% | 4.22% |
| AUD/USD | .6790 | .6605 | .6820 | .6560 |
| ASX 200 | 7 284 | 7 087 | 7 591 | 7 347 |
| Credit Index (iTraxx- 5 yr) | 90.3 | 75.1 | 70.2 | 71.9 |


Housing Prices and Household Debt*
Ratio to household disposable income
ratio
Housing prices
Household debt
ratio
6
5
4
3
2
2.0
1.6
1.2
0.8
0.4
1993
2008
2023
1993
2008
2023
* Household disposable income is after tax, before the deduction of interest payments, and includes income of unincorporated enterprises.
Sources: ABS; CoreLogic; RBA.


Housing Loan Commitments*
Excluding refinancing
$b
$b
30
25
20
15
10
5
0
Total
Owner-occupier
Investor
2003
2007
2011
2015
2019
2023
* Seasonally adjusted.
Sources: ABS; RBA.



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