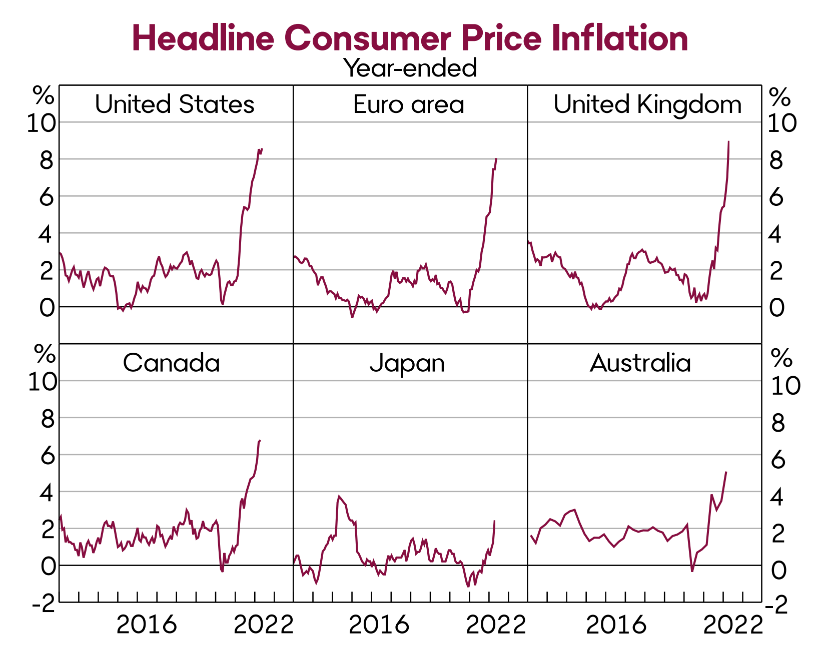
Economic and market update

Economic Overview – as at 21st June 2022

Global markets

The lack of easing in inflationary pressures resulting from the energy shock and supply chain disruptions already in place prior to the Russian invasion of Ukraine, has led to further sharp falls in global equity markets and risk appetite. This widespread shock to all economies is also increasingly disrupting food supply and prices. Not surprisingly there have been further downgrades to growth forecasts, including from the World Bank, and increased conjecture of recession risks ahead as central banks tackle inflation with rate hikes.



Sources: ABS; RBA; Refinitiv

The US Federal Reserve's commitment to deal with its highest CPI rate since 1981 is unambiguous with a 75-basis point rate increase to 1.75% and comments from Jerome Powell that "my colleagues and I are acutely focussed on returning inflation to our two per cent objective". His colleague, Christopher Waller, followed with a prediction of another 0.75% hike in July and asserted "the Fed is 'all in' on re-establishing price stability". The market has interpreted this language as abandoning any thought of a soft-landing, doing whatever it takes to tackle inflation. The US ten-year bond yield has jumped to 3.5% for the first time in a decade. Meanwhile the two-year briefly reached 3.4%; not quite yield curve inversion again, but ominously close to it. For now, the US economy appears to have rebounded this quarter after contracting in Q1. Recession fears are mainly for 2023 rather than now.

The euro-zone is in an even more challenging economic position than the US given the complexities of the EU financial system, their dependence on Russian energy and the bleak outlook for inflation. The European Central Bank has locked in a 25-basis point hike for July with the promise of more increases later in the year. However, ten years on from Mario Draghi's 'whatever it takes' speech which rescued the European Union from its debt crisis in 2012, a new danger of 'fragmentation risks to the euro-system' is capturing the headlines. Fragmentation refers to sovereign bond spreads widening within the EU and higher inflation rates (and debt levels) in some countries compared to others. The Swiss National Bank increasing rates by 50-basis points (their first rate rise since 2007) is further evidence of just how unique the current environment is. The Bank of England also increased official rates last week (their fifth successive rate hike) with a forecast of UK inflation reaching 11%.

The Chinese economy is facing very different challenges than the North Atlantic region. Inflation is still benign, but their property market remains in decline even with recent rate cuts and other policy support measures. The improvement in COVID numbers this week is encouraging given the severity of lockdowns and the lack of appetite for 'living with the virus', unlike much of the rest of the world. But can this zero-COVID strategy work instead of relying on vaccinations?

In summary, the global economy is facing an inflation and energy surge that increasingly resembles the 70s when most economies experienced at least two deep recessions. Central banks are running up the hill of rate hikes with diminishing hopes of soft landings from such a fast transition to these heights. However, we are coming off record lows for rates and extraordinary levels of fiscal support so we shouldn't assume worst-case outcomes for the very uncertain path ahead.

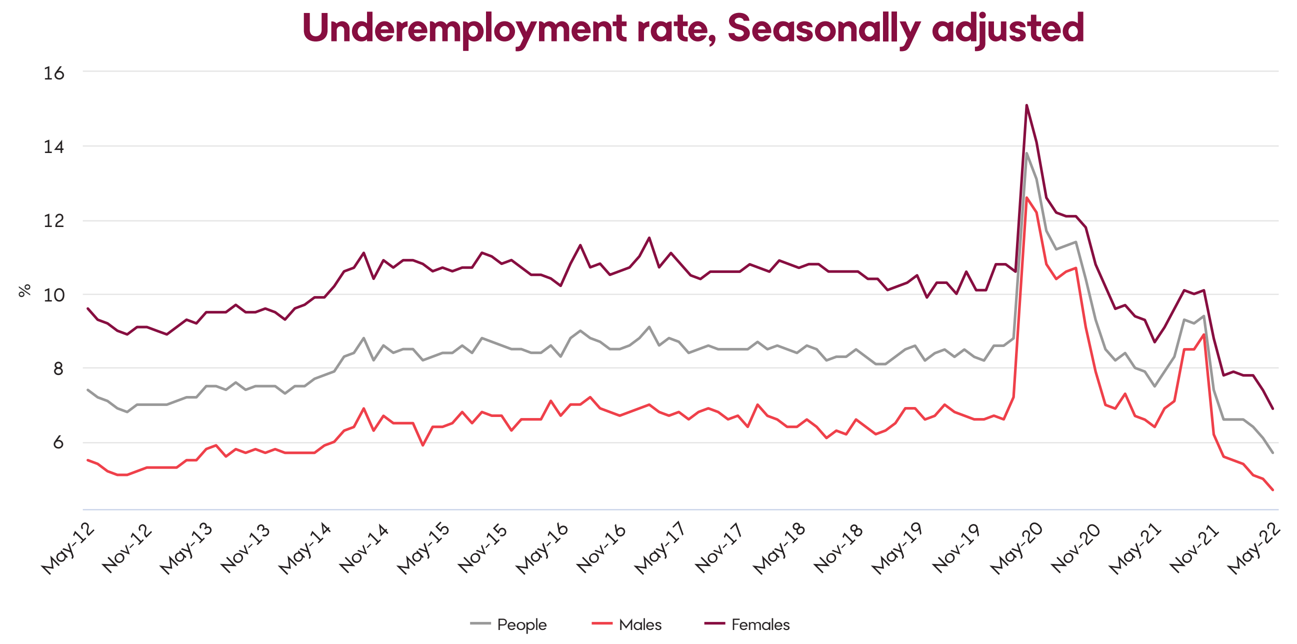
Domestic economy

Like May, the RBA delivered a larger rate hike in June than market consensus. However, those expectations were low mainly due to previous forward guidance. Now that the RBA has shown its hand and is overtly 'front loading' jumps in the Official Cash Rate, the rest of the year looks more predictable. Another 50-basis point hike in July looks a done deal to maintain the RBA's commitment to "chart a credible path back to an inflation rate of 2 to 3 per cent". Given Philip Lowe admitted this week that the RBA now expects CPI to peak at 7% (versus the start of May when the forecast was 6%) it would not appear credible to ease back on the size of rate hikes so soon. A subsequent rise of 40-basis points in August may show greater confidence in the outlook and be a suitable segue to 'normal' 0.25% hikes. Three more hikes (September to November) would take the OCR to 2.5%.

The crucial question after arriving at this cash rate will be how our economy is coping? Will we be on track for a soft landing (a decelerating economy with lower demand and discretionary spending) or will the economy start to contract, perhaps driven by stress in property and/or labour markets? The current jobs market appears to be as tight as ever, evidenced in May's report by record job vacancies, employment growth and a sharp fall in underemployment (refer chart).

Underemployment fell 0.4% to 5.7%, its lowest level since 2008, with female underemployment at its lowest level since 1990. As outlined in last month's report, it is difficult to reconcile the prospect of a recession in Australia with our lowest unemployment rate since 1974 and expectations of further falls to below 3.5% (historically the unemployment rate rises by around 5% in a recession). The challenge for businesses is arguably not rising interest rates, but rising input costs and access to suitable labour (refer appendix). The flipside to low unemployment is a lack of available workers.

The residential property market is equally perplexing in the context of its stunning price rises through the pandemic (with the total value of residential dwellings passing $10 trillion) and also the divergence between the larger capital cities and regional property. This trend started to take shape through the 2021 lockdowns but the contrast has never been so stark. In May the price of residential property in Sydney fell 1% and Melbourne fell 0.7%, while regional NSW and Victoria both rose 0.4% according to CoreLogic. How these, and other regions, cope with interest rates rising by around two per cent over the next year or so will be critical for the optimal path of monetary policy.



Other factors to consider when assessing the viability of a soft landing in Australia (unlikely in many parts of the world) include:

- Demand from China and other key export markets - will we continue to run trade surpluses of around $10 billion per month?
- The level of the Australian Dollar - devaluations in the Aussie Dollar helped us avoid recession in the Asia crisis (1997/98), the GFC (08/09) and the pandemic in 2020.
- Our AAA credit rating and comparatively low levels of government debt (especially net debt measured as a percentage of GDP at around 30% presently). This is front of mind for new Treasurer Jim Chalmers ahead of his first budget on 25 October.

Landing the economy safely without wrecking growth, while dealing with an inflation shock of this magnitude may test the RBA's aeronautical skills. But, for the moment, business confidence is still above trend, consumer savings are at elevated levels and demand for labour is very strong.

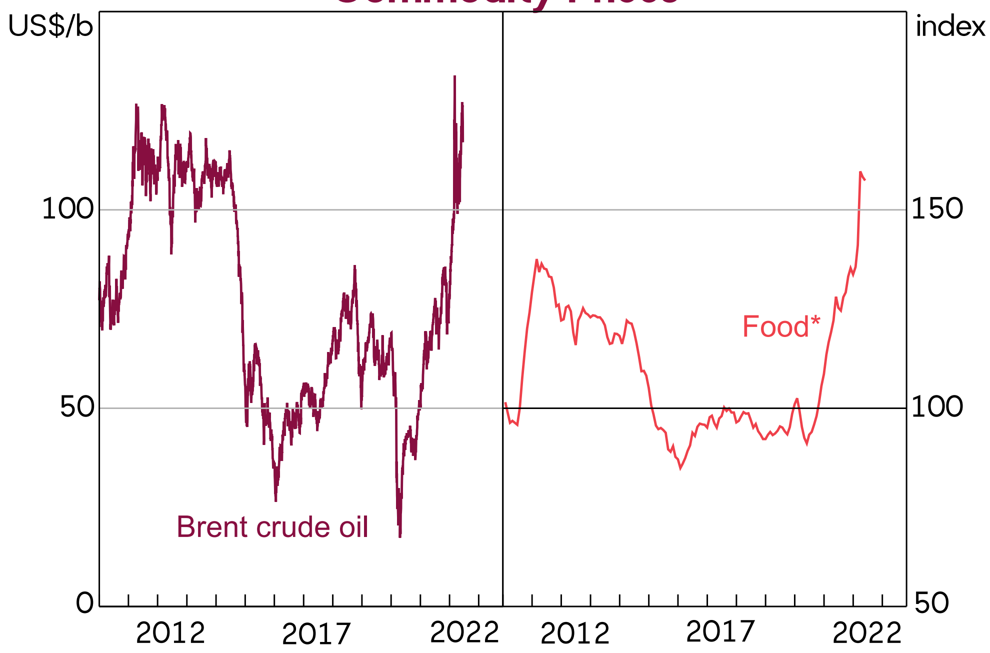
Interest Rate Outlook

The tightening cycle from the pandemic cash rate low of 0.1% has become much steeper with the RBA moving to 'frontload' rate hikes. Based on the latest RBA comments and the pace of rate hikes in other countries, the likely path from here is another 0.50% in July, perhaps 0.40% in August, and then 0.25% hikes in September, October and November (culminating in a cash rate of 2.5%). A pause at this level would give the RBA the opportunity to review the impact in early to mid-2023.

	30 / 4 / 21	30 / 4 / 2022	31 / 5 / 2022	21 / 6 / 2022
90-day bills	0.4%	0.71%	1.18%	1.86%
3-year swap	0.32%	3.08%	3.16%	4.03%
5-year swap	0.89%	3.37%	3.47%	4.35%
AUD/USD	.7715	.7060	.7175	.6955
ASX 200	7 026	7 435	7 211	6 524
Credit Index (iTraxx- 5 yr)	62	96.0	94.7	115

Appendix: The global inflation and energy shock- impact on Australia

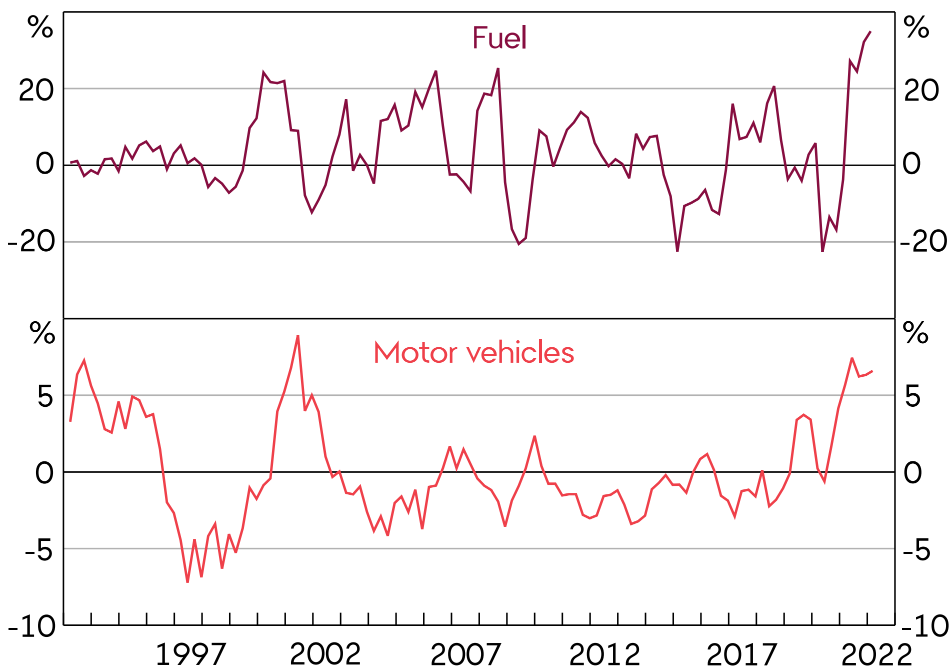
Commodity Prices



* FAO Food Price Index; average of 2014-2016 = 100.
Sources: Bloomberg; RBA; UN FAO

Fuel and Motor Vehicle CPI Inflation*

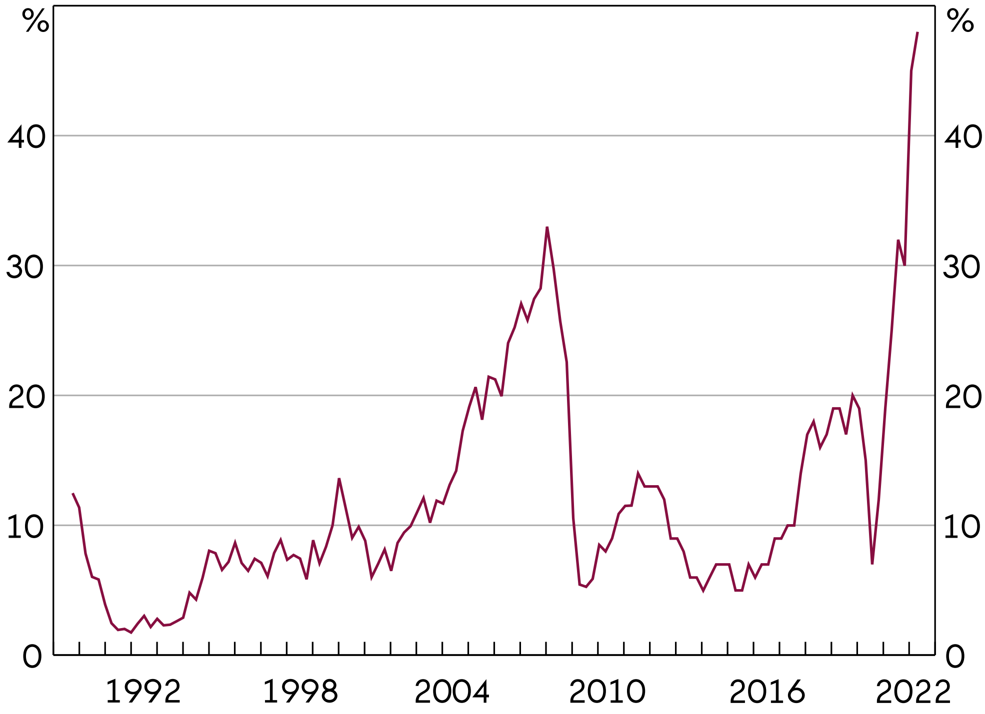
Year-ended



* Adjusted for the tax changes of 1999-2000.
Sources: ABS; RBA

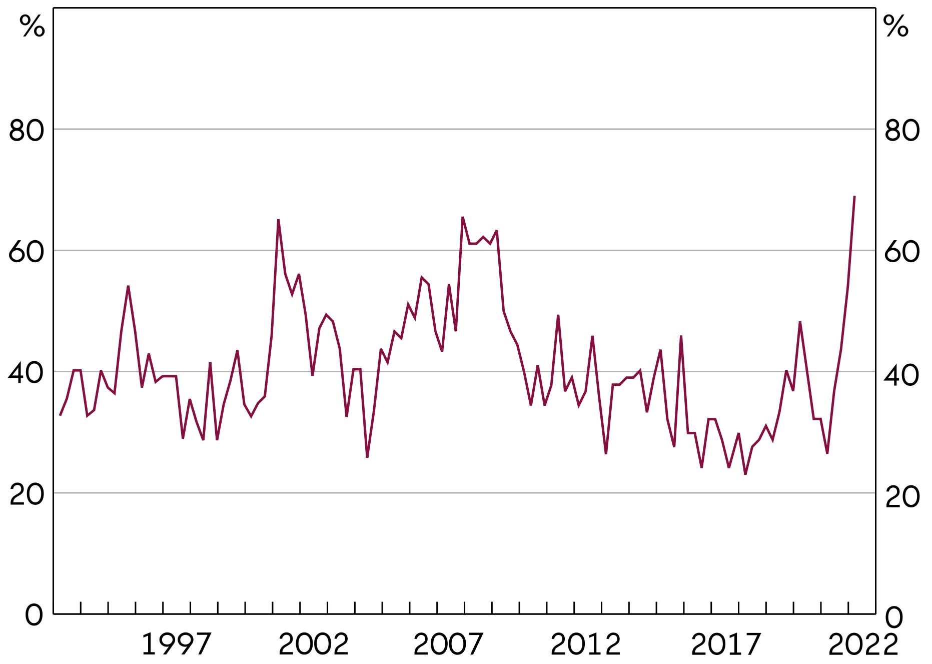
Difficulty in Finding Suitable Labour

Share of firms reporting labour as a significant constraint



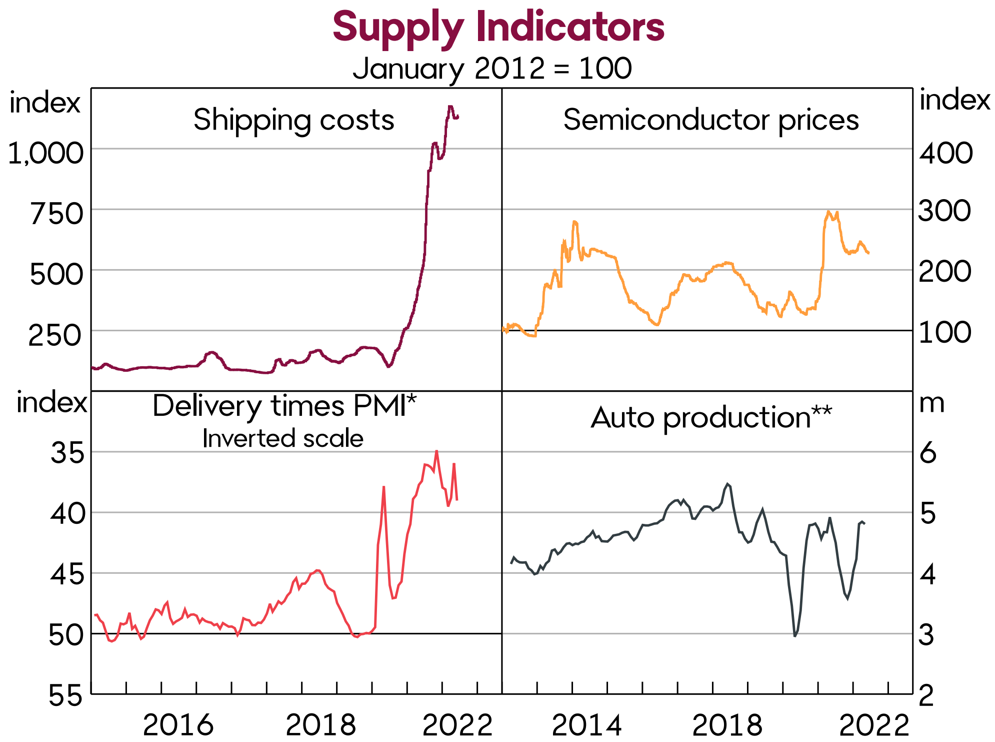
Source: NAB

Share of CPI Items Rising by More than 3 Per Cent*



* Proportion of CPA items by number with annualised quarterly growth more than 3 per cent; based on seasonally adjusted data; adjusted for the tax changes of 1999-2000.

Sources: ABS; RBA



* Purchasing Managers' Index.
** Top five producing countries; three-month moving average.
Sources: IHS Markit; RBA; Refinitiv