March 2024

Economic and market update

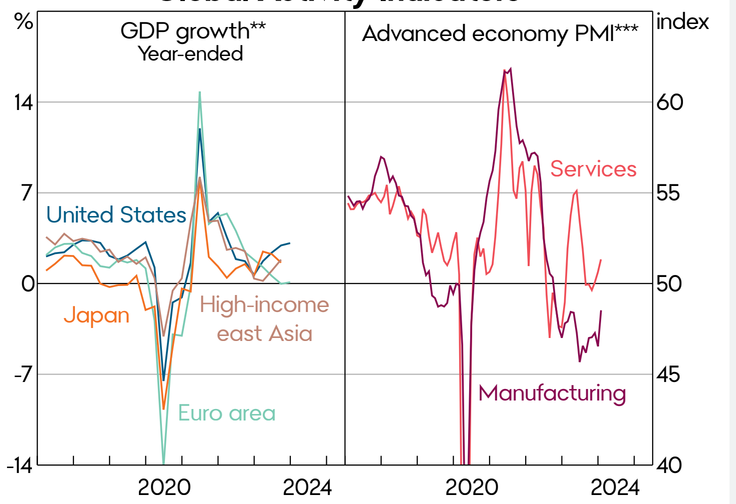
Economic Overview – as at 21st March 2024

Global markets

The divergent paths of larger economies over the last year, and divergence for services vs manufacturing sectors, has added complexity to assessing the state of the global economy, but in general, growth continues to decelerate in the aftermath of the global inflation shock to varying degrees. The most resilient regions remain the US and the higher-income economies of east-Asia (refer chart), while the euro-zone, UK and Canada are in or at risk of entering technical recession. Most central banks are close to initiating easing cycles as inflation moderates (and as their economies slow) but the divergent economic outcomes will be matched by timing mismatches for rate cuts.

The Federal Reserve kept US rates on hold as expected in March but retained the three cuts implied via the 'dot plot', and an optimistic view of the economic outlook. The US economy is still expected to slow this year justifying Fed rate cuts as inflation moderates, and recent data, while resilient, does show signs of stress for small businesses and an uptick in unemployment. Nevertheless, Fed chair Powell sounded very confident that recession would be avoided and labour markets would only soften modestly, while the FOMC economic projections showed inflation still heading to 2.0% amid steady rate cuts. Market participants are now wavering between a June or July cut to start the easing cycle, and the yield curve now closely resembles the Fed's projections (unlike earlier in the year when a much sharper easing cycle had been anticipated by the market). The latest US CPI data did see a small uptick in inflation in February, leaving core CPI at 3.8% y/y, but there remains a confident view that the core PCE measure will be around 2% by June – a goldilocks scenario all round.

Global Activity Indicators*



* Outliers during the COVID-19 pandemic are truncated.

** High-income east Asia is a PPP-weighted average of South Korea, Taiwan, Singapore and Hong Kong.

*** Purchasing Managers' Index; PPP-weighted average of the United States, euro area, United Kingdom and Japan.

Sources: CEIC Data; LSEG; RBA; S&P Global.

The sharp slowdown in Europe and the UK continues with very little real growth expected in 2024, and as a result (with core inflation now close to target in Europe) the ECB are expected to start cutting official rates around June. The expectation of rate cuts has added to business confidence with the European ZEW economic sentiment survey jumping from +25 to +33.5 as export demand showed signs of improvement. The UK are already in technical recession, although their inflation rate (especially core services) is higher than in Europe so rate cuts will be a little later (consensus is around August).

Japan's economy is in a very different position to other G7 countries after the Bank of Japan finally exited the world of negative interest rates with their first rate hike since 2007. Wages growth in Japan has leapt to above 5% and while economic growth was slow in 2023, the Q4 GDP figure was recently revised up from -0.1 to +0.1 % thanks to a strong read on capital expenditure, meaning technical recession was avoided. The small increase in official rates won't have a material impact on the economy but are indicative of a confident mood, and the Nikkei stock index has just traded above 40k for the first time ever.

The Chinese economy showed signs of improvement in the activity and spending data for January/ February, and the recent NPC meeting again set an aggressive target of 5% growth for China in 2024. Achieving this number in the absence of significant policy support appears ambitious, however the property sector continues to languish so further stimulus and targeted support is likely. The stronger data for the start of the year was driven primarily by stronger exports rather than consumer demand, with retails sales slowing from 7.4% y/y to 5.5%. Urban unemployment edged higher again to 5.3%, however industrial production and fixed-asset investment were well above forecasts. The challenges in the property construction market have been evident with a fall in the iron ore price, although it has stabilised just above US$100/tn.

In summary, North Atlantic economies are close to initiating easing cycles from as early as June although some are likely to wait for August, with progress on inflation continuing but the last leg towards 2% likely to remain uneven. Meanwhile Asia continues to outperform economically in general with a lift in trade volumes, and in the case of China, an aggressive growth target should see further policy support. On balance, global growth is expected to be below trend at around 2.5 -3% in 2024.

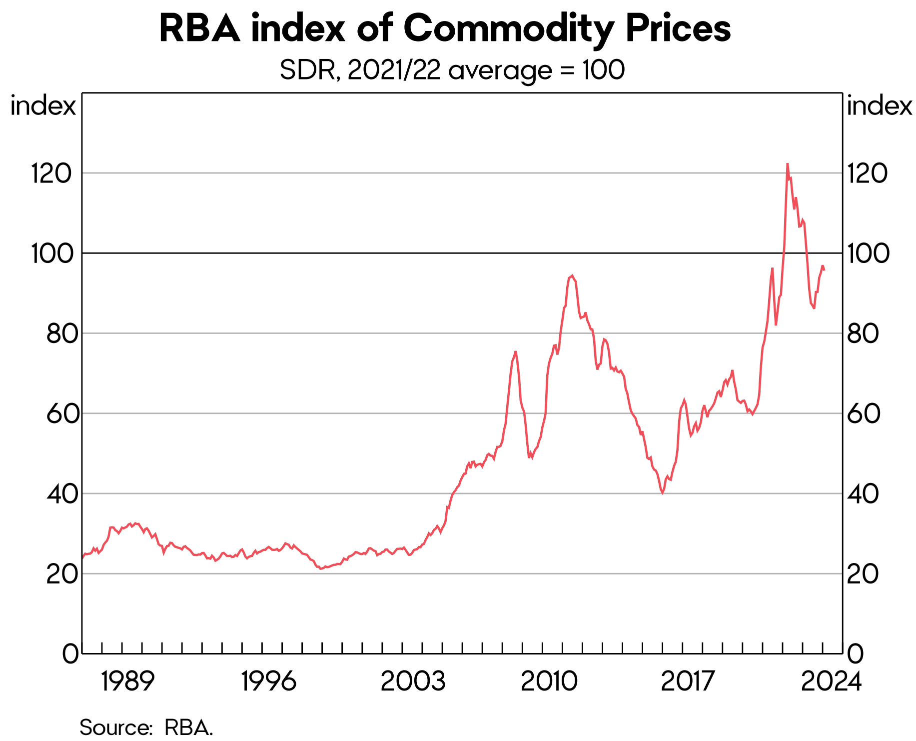
Domestic economy

The RBA moved to a neutral setting for monetary policy in March, with the subtle change from 'a further increase in interest rates cannot be ruled out' to 'the Board is not ruling anything in or out'. No longer explicitly referring to hikes doesn't guarantee that the next move will be down. However, the backdrop of other advanced economy central banks easing (detailed above) and further progress with inflation should build a compelling case for RBA rate cuts. Assuming this is correct, the two big questions that follow are a) when, and b) will inflation continue to fall after the RBA start to lower official rates?

The timing of the first cut will be dependent on the path of core inflation, balanced by trends in labour markets. The RBA's dual mandate of price stability (i.e. inflation near target) and maintaining full employment, means that earlier cuts - even with core inflation above 3% - are plausible should the unemployment rate rise sharply, but the February labour force data was remarkably strong, suggesting this scenario is unlikely for now. The market had fully priced RBA cuts in September and November ahead of the jobs report, but may now be deferring the first cut in a similar fashion to offshore trends. Our basecase forecast remains for the easing cycle to commence in February '25 (as detailed in the summary table below), where core inflation will only approach 3% in Q4. Earlier cuts as per the consensus view may depend on the RBA feeling the pressure to cut to preserve gains in labour markets, despite stubborn services inflation. However, the risk is that this approach would lock in a higher ongoing level of inflation, and therefore only allow two or three cuts, not the 5 we have forecast in '25. If the RBA would prefer a more sustainable inflation rate in the two's, they will need to be patient.

The appendix shows further details of the drivers of domestic inflation with services inflation the primary culprit (like the rest of the world), but steady progress with headline CPI, especially via the monthly indicator. Consecutive reads of 3.4% in December and January added to some market expectations of an RBA cut prior to spring. However, the core measures were still around 4% and the RBA will be more focussed on the quarterly report out on 24 April where the trimmed mean is expected to still show 3.8% annual core inflation in the March quarter. The latest jobs data adds upside risks to this forecast and makes a faster return to the 2-3% target band hard to reconcile.

Australia's economy grew by 1.5% last year with real GDP growth of 0.2% in Q4, although given population growth is over 2.5% we remain in a per-capita recession. The surge in net migration has been helpful in addressing labour shortages and offsetting the fall in household demand, but population growth is expected to slow in 2024. Our economic growth has been primarily driven by government spending and business investment, although there remains a shortfall of dwelling investment and private consumption is flat.



Nevertheless, the nominal economy grew 1.4% in Q4 and 4.4% y/y showing the damage that inflation imposes by diluting growth. The GDP data also revealed an uptick in household savings and productivity, however unit labour costs remain too high at 6.6%, again adding to our forecast of rates higher for longer through the bulk of 2024.

Another factor of note for this year includes the ongoing trade surplus helped by firm commodity prices and a low Aussie Dollar, despite the recent fall in iron ore due to China's property market woes.

Recent comments from Federal Treasurer Jim Chalmers that the May budget will be challenged by lower iron ore prices and a weaker jobs market seem at odds with the reality that iron ore was budgeted at US$60 /tn for FY24 (vs US$106 today) - and the latest fall in unemployment to 3.7%.

However, it does suggest that fiscal support via the stage three tax cuts won't be accompanied by aggressive spending in the federal budget, in order to protect a budget surplus.

Residential property prices again rose in February with fresh record highs in Brisbane, Adelaide and Perth, and in a number of regional locations. Higher property prices (despite higher interest rates) still reflect a lack of supply versus the surge in population, and while helpful for those with equity to balance falling household income, there remains an urgent challenge for policy support to improve affordability.

Interest Rate Outlook

The RBA Official Cash Rate is most likely at its cycle peak at 4.35%. Rates are expected to be on hold for most of 2024. A longer cycle (into 2025) as core inflation persists above 3% is still the basecase scenario outlined below, while other advanced economies are much closer to their easing cycles, with many expected to commence around mid-2024. Earlier RBA cuts are possible but would require faster progress with inflation than forecast, and/or a much sharper slowdown for our economy.

Economic Forecasts: basecase scenario

	2022	2023				2024				2025	
% (actual, forecast)	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP q/q	0.9	0.5	0.5	0.3	0.2	-0.1	-0.1	0.4	0.5	0.5	0.6
GDP y/y	2.3	2.4	2.1	2.1	1.5	0.9	0.3	0.4	0.7	1.3	2.0
Unemployment	3.5	3.5	3.5	3.6	3.9	4.2	4.4	4.6	4.8	5.0	5.1
CPI (q/q)	1.9	1.4	0.8	1.2	0.6	0.8	0.7	0.8	0.7	0.7	0.7
CPI (y/y)	7.8	7.0	6.0	5.4	4.1	3.2	3.3	3.0	3.0	2.9	2.9
CPI (core y/y)	6.8	6.6	5.9	5.2	4.2	3.8	3.7	3.3	3.1	3.0	3.0
RBA cash rate	3.1	3.6	4.1	4.10	4.35	4.35	4.35	4.35	4.35	3.85	3.35
AUD / USD	.6815	.669	.666	.6435	.682	.67	.69	.72	.74	.76	.77

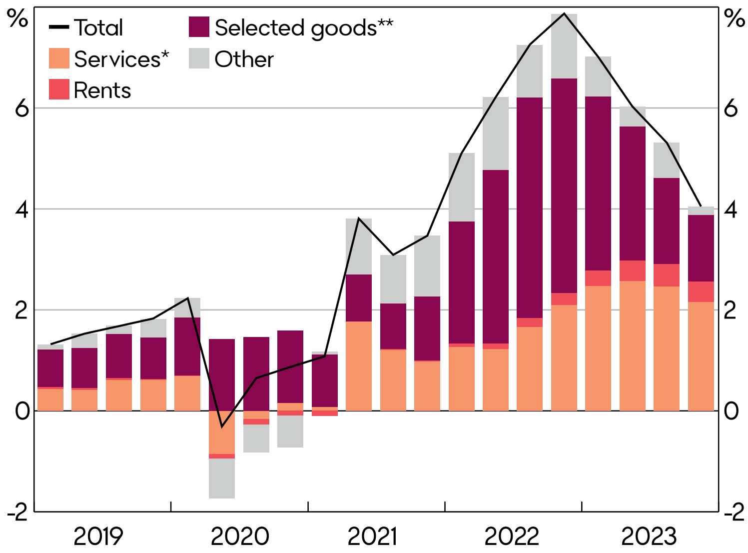
Benchmark rates

	31 / 1 / 2023	31 / 1 / 2024	29 / 2 / 2024	21 / 3 /2024
90-day bills	3.37%	4.35%	4.335 %	4.35%
3-year swap	3.62%	3.81%	3.90%	3.88%
5-year swap	3.82%	4.02%	4.14%	4.06%
AUD/USD	.7055	.6570	.6495	.6625
ASX 200	7 477	7 681	7 699	7 785
Credit Index (iTraxx- 5 yr)	80.3	71.9	64.3	65.6

Appendix: Domestic Inflation

CPI Inflation

Year-ended with contributions

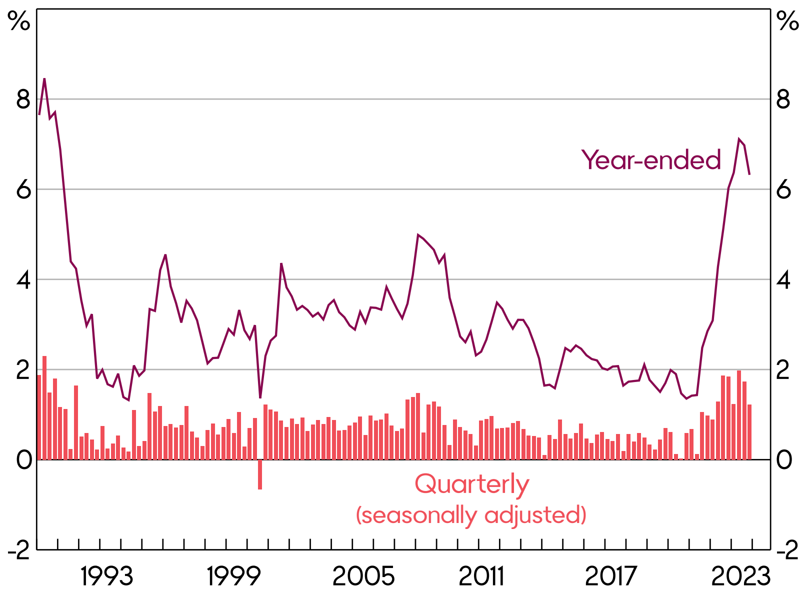


* Includes market services and administered items; excludes rents and holiday travel & accomodation.

** Includes groceries, alcohol & tobacco, consumer durables and new dwellings

Sources: ABS; RBA.

Market Services Inflation*

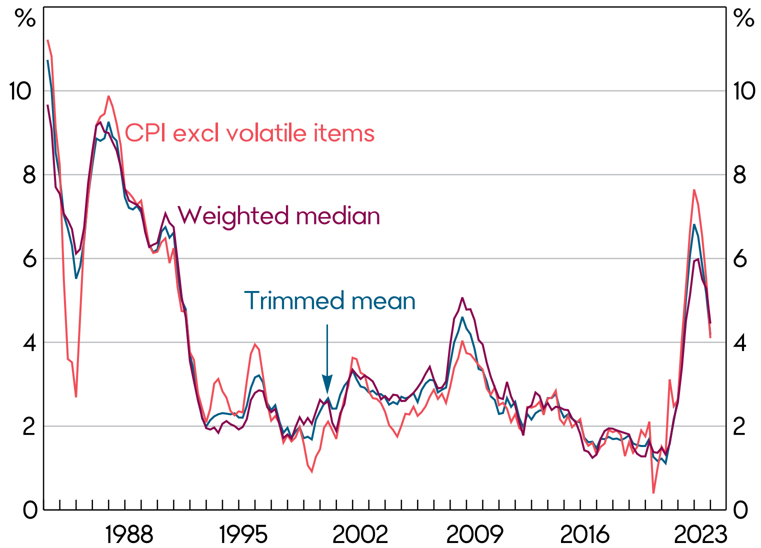


* Excludes domestic holiday travel & accommodation and telecommunications; adjusted for the tax changes of 1999-2000.

Sources: ABS; RBA.

Measures of Underlying Inflation*

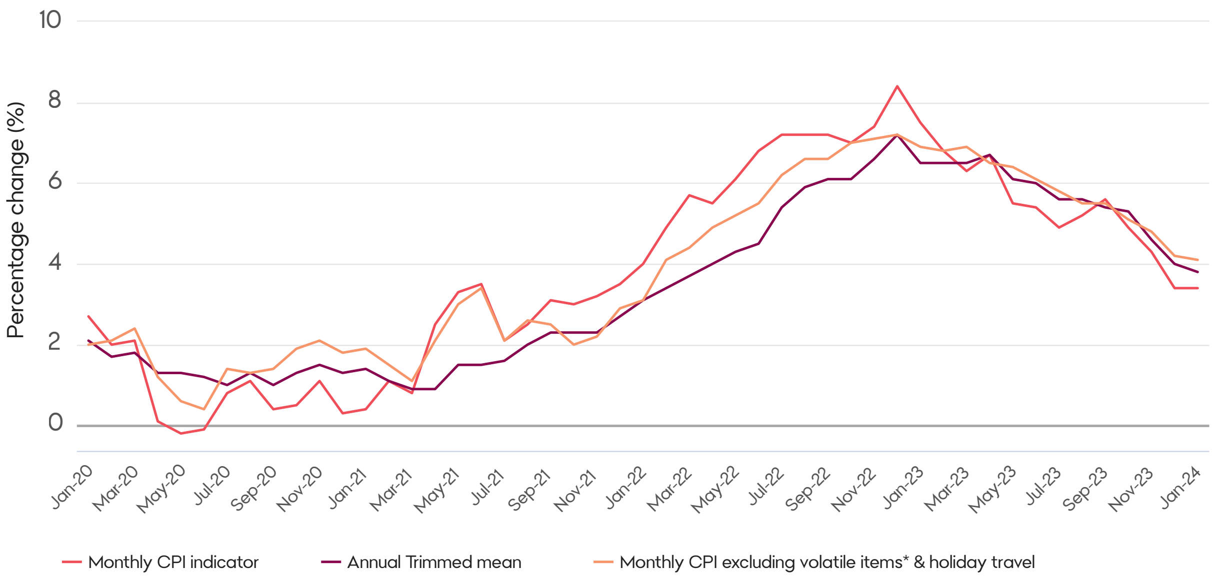
Year-ended



* Excludes interest charges prior to September 1998 and deposit & loan facilities prior to September 2011; adjusted for 1999-2000 tax changes.

Sources: ABS; RBA

Monthly CPI indicator, Australia, annual movement (%)



Source: Australian Bureau of Statistics, Monthly Consumer Price Index Indicator January 2024