May 2022

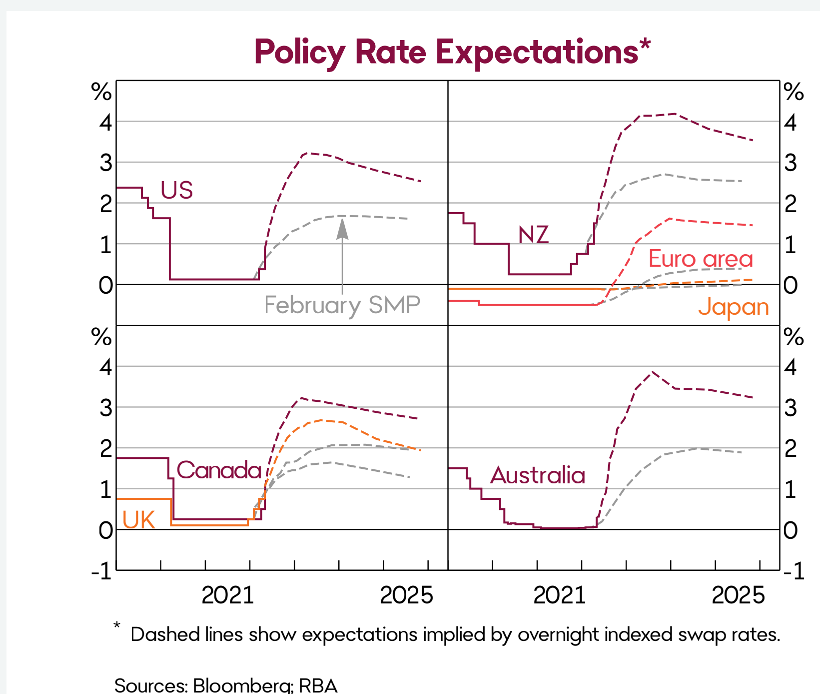
Economic and market update

Economic Overview – as at 19th May 2022

Global markets

Market participants and economists continue to contemplate several crucial questions: will the global inflationary shock peak in the coming months? How long will it take for elevated energy and commodity prices to normalise? And how effective will monetary policy be in managing inflation by lowering demand? The challenges in accurately answering these questions are underscored by the volatility in the markets.

An extrapolation of these questions is: how realistic are expectations of a soft landing, given how sharply official interest rates are forecast to rise in most countries? Graphs in the appendix show a range of recession indicators and signals; and the chart below shows the market expectations for policy rates versus where they were in early February, before the Russian invasion of Ukraine.



The US Federal Reserve increased the Fed funds rate by 0.5% in May (to a target range of 0.75 -1%) and remain vocal and resolute in their commitment to deal with inflation and achieve price stability. The next two rate hikes (in June and July) are also expected to be 0.5% each, with a 3% official rate forecast by year-end. The comment from Fed chair Jay Powell that "the American economy is very strong and well-positioned to handle tighter monetary policy" sounded encouraging, but his follow up that it would be a "soft or softish landing" was less convincing. Of the last 14 US hiking cycles, 11 have resulted in recession, and the recent yield curve inversion (refer appendix) is a concern. US economic data has been mixed (falls in consumer sentiment and weak Q1 GDP growth, versus strong retail sales and manufacturing output), but more importantly the inflation rate and core CPI are showing little sign of easing off, so 2023 will be challenging even if economic growth is maintained this year.

The European Central Bank are now expected to initiate a tightening cycle in July and finally exit the world of negative interest rates later in the year, despite the impact of the war in Ukraine being much greater in the EU than elsewhere. The European Union is aiming to greatly reduce its dependence on Russian oil and gas via a sixth round of war sanctions, but the viability of managing this transition is questionable and its implications for even higher levels of inflation and recessionary risks are clear.

China's economy remains an outlier to the G7 nations and the challenges outlined above. Inflation isn't a material risk so rate cuts are underway with more expected, and the zero-COVID policy is having a material impact on the Chinese economy, and on the rest of the world via trade delays. The People's Bank of China kept their 'one-year medium term lending rate' on hold at 2.85% on Monday, but reductions are expected and the interest rate on new home loans was cut last week by 0.2%. The lockdowns in Shanghai and around 40 other cities saw retail sales plunge by 11% in April, and the Chinese economy will need a sharp recovery in the second half to achieve their 5% growth target.

In summary the global economy faces its largest inflationary test for decades, with receding prospects of inflation moderating this year, meaning most central banks have no choice but to dampen demand even though the bulk of the inflationary pressures are supply driven. Energy and commodity exporting countries (including Australia) are more likely to cope better with the energy and inflation shock than those with higher levels of imports. However, the fragile position of the global economy emerging from the pandemic, together with the range of supply chain disruptions and sharply higher energy and food costs, have resulted in downgrades to growth forecasts for a range of countries this year and next.

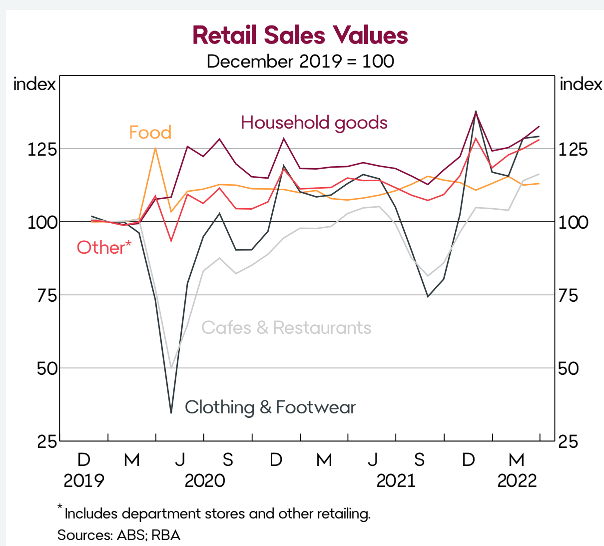
Domestic economy

The May RBA decision to increase official rates became a near certainty after the Q1 CPI data (released in late April) was much higher than forecast at 5.1% headline, and core inflation also higher than expected at 3.7%. The quarter-on-quarter numbers (2.1% headline and 1.4% core) were the highest since RBA 'inflation targeting' began in 1993. Minutes from the RBA Monetary Policy Meeting revealed that an increase of 15, 25 or 40 basis points were all considered, but (despite market consensus and this author expecting 15 bp) the RBA settled on 25 as "a move of this size would help to signal that the Board was now returning to more normal operating procedures". This quote suggests that subsequent rate hikes in the series will also be 25 bp, although it may be tempting to throw in a super-size 40 bp to return to an even 0.75% or 1% by July. The current 0.35% OCR is a unique setting, but so is almost every aspect of this economic and market environment.

Wages and jobs data released this week were promising but perhaps not sufficiently strong to sway the RBA towards a 40 bp hike in June. The Q1 Wage Price Index rose 0.7% q/q and 2.4% y/y, which was a fraction under consensus forecasts. Looking at the details, the average size of private-sector hourly wage rises for the quarter was 3.4% - the highest since 2013 - even though only 15% of private sector jobs received an increase. The WPI is expected to be sharply higher in Q2, amid ultra-tight labour markets.

The unemployment rate recorded its lowest read since 1974 with March revised down to 3.9% and April maintaining this 48-year low. Pleasingly, underemployment fell to 6.1%, and employment and 'hours worked' rose nationally to fresh record highs. The increase in employment of only four thousand was lower than expected, but full-time employment rose by 92 k, and the number of unemployed people is now 537 k, versus 700 k in January 2020. The latest RBA forecasts for unemployment, via their Statement on Monetary Policy, are consistent with this solid data and outlook.

The prospect of higher interest rates and the well-publicised rise in living costs in the build-up to the federal election saw a 5% fall in consumer sentiment - in the May WBC-MI survey - to 90.4, This plunge was in contrast to business conditions and business confidence which continue to run above the long-term trend (confidence in the April survey printed at +10, and conditions at +20). Businesses are clearly eyeing off the expected rebound in international and domestic tourism, and it is interesting to note that while consumer sentiment has fallen retail sales have powered ahead. Retail goods won't get cheaper as inflation hits prices, but Q1 data showed that retail volumes rose 1.2% in the quarter to be 10.7% above pre-COVID levels, so sales values are not solely increasing on price alone.



Despite Omicron infection numbers remaining stubbornly high and more weather-related disruptions in May, activity is expected to pick up as restrictions continue to be lifted, although spending may rise more sharply in the services sector as compared to goods. Household savings and strong labour markets will also offset the obvious challenges ahead from rising interest rates and inflationary pressures.

Another hot topic in the election campaign has been housing affordability and the challenges for first-home owners to enter the market, but at the same time we are still seeing quite divergent outcomes for property prices by state and city – for example, residential property rose 0.6% in April despite Sydney and Hobart prices falling modestly and Melbourne flat for the month, with regional property still powering ahead. The debate on which policies will be most effective to address affordability still frequently seems to miss the point that supply will alleviate the problem rather than short term concessions. Either way the market is likely to become more affordable once interest rates rise by around 2 %.

The Aussie Dollar has traded in a wide range since the CPI data, with a 72.7 cent high ahead of the rate hike, but a 68.3 cent low, as the outlook in China became more worrying. The strong correlation between the A$ and commodities is temporarily on hold as our largest trade partner attempts to manage COVID with lockdowns rather than 'living with the virus' (presumably due to low vaccination rates). This and other unique factors make forecasting the exchange rate and the peak in the interest rate cycle in the coming financial year most challenging - but while the US and euro-zone appear to face high recession risks, it is difficult to envisage an Australian recession with unemployment in the 3's.

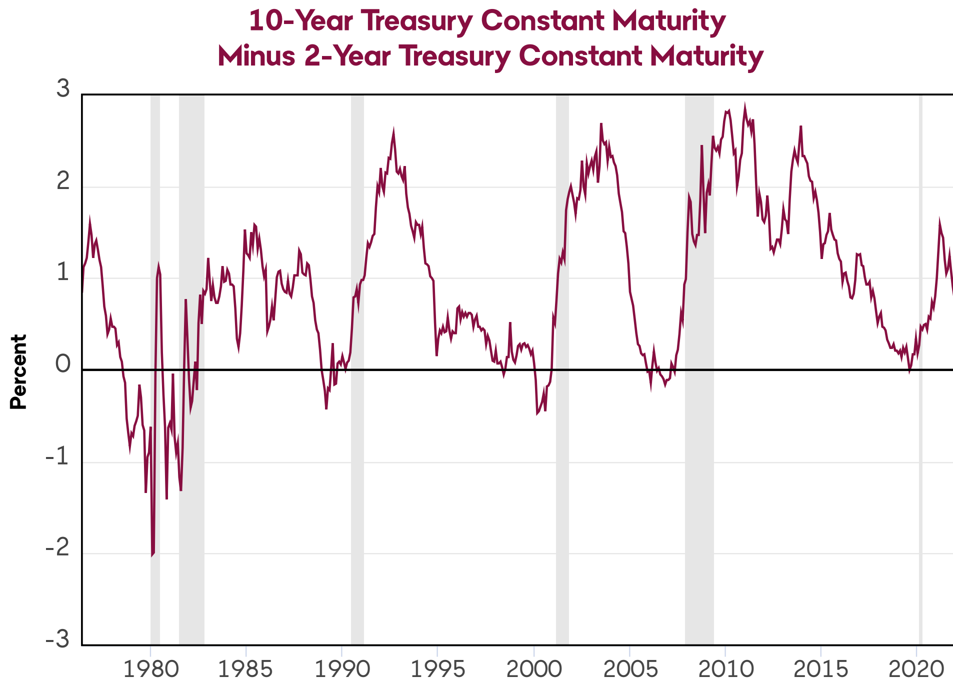
Interest Rate Outlook

The RBA have commenced their tightening cycle with the 0.25% hike in May and are most likely to proceed with a series of rate hikes of this size, until the Official Cash Rate is around 1.5% - 2% by year end. The June hike could be a more aggressive 40 basis points to revert the OCR to its pre-pandemic level of 0.75%, but the more critical issue is how far the RBA will need to tighten rates to sufficiently dampen demand, in order to minimise the risks that inflation poses to 'price stability'. The market implied peak above 3% appears much too high based on RBA statements and forecasts.

	31 / 3 / 21	31 / 3 / 2022	29 / 4 / 2022	19 / 5 / 2022
90-day bills	0.035%	0.23%	0.71%	1.04%
3-year swap	0.35%	2.61%	3.08%	3.17%
5-year swap	0.91%	2.96%	3.37%	3.47%
AUD/USD	.7595	.7485	.7430	.7015
ASX 200	6 791	7 500	7 435	7 071
Credit Index (iTraxx- 5 yr)	64	93.2	96.0	103.7

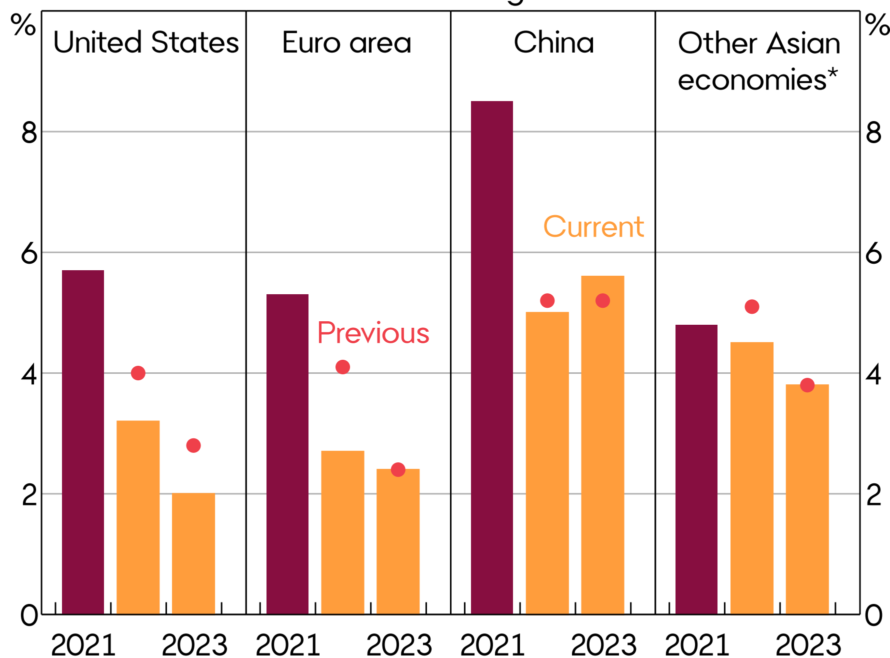
Appendix: *Recession risks and indicators: US, Europe and Australiar*

US curve inversion: 10-Year minus 2-Year Treasury yields.
Curve inversion (i.e. the 2 year yield exceeding the 10 year) has a perfect correlation to US recessions since 1980, although with varying time lags:



Source: Federal Reserve Bank of St. Louis

GDP Growth Forecasts
Year-average

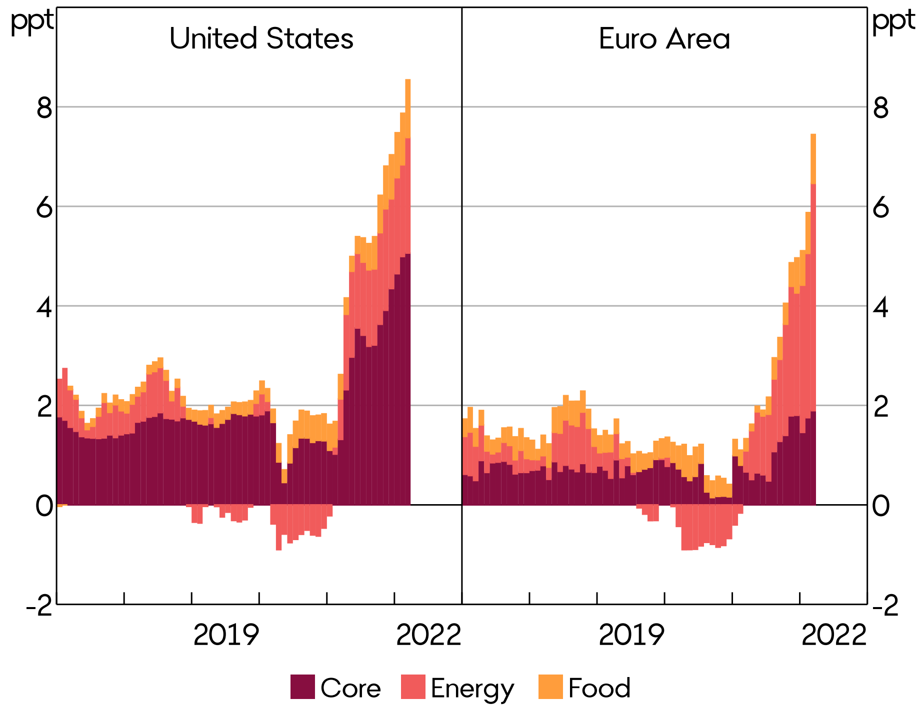


*Exports-weighted average of major Asian economies excluding China.

Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv

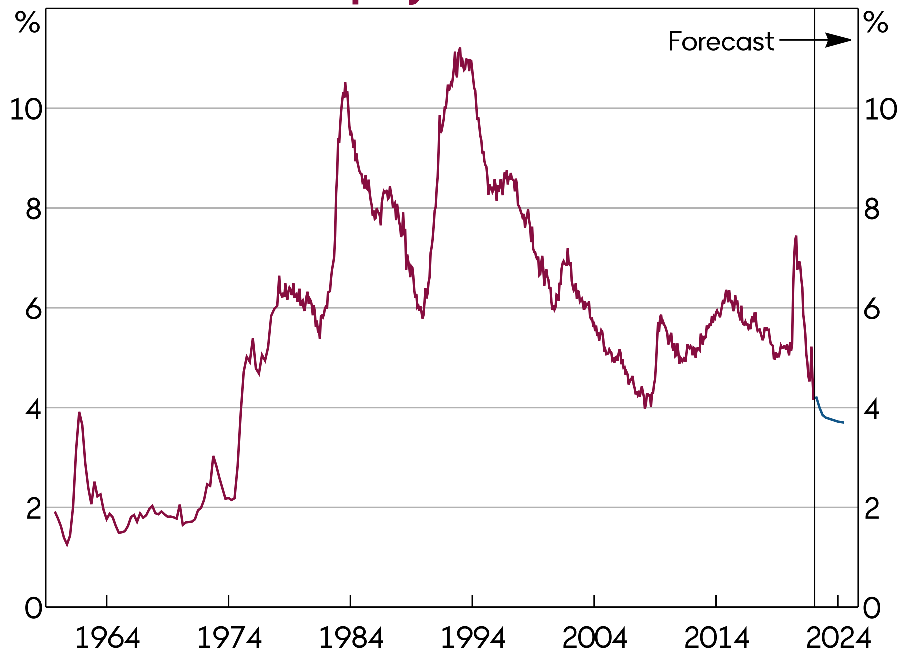
Contributions to Headline Inflation

Year-ended



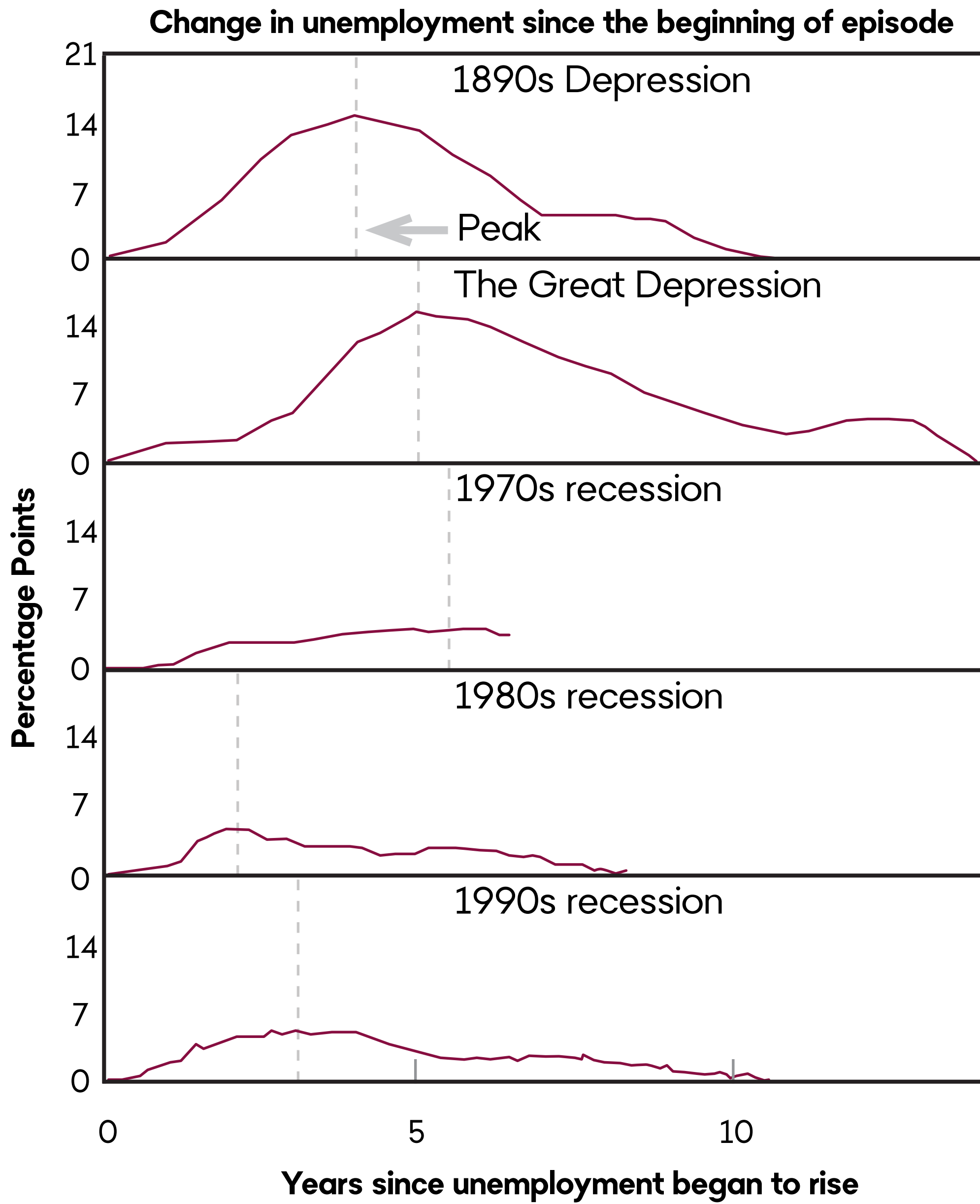
Sources: BLS; Eurostat; RBA; Refinitiv

Unemployment Rate*



* Forecast is quarterly and as at the February 2022 SMP.

Sources: ABS; RBA



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