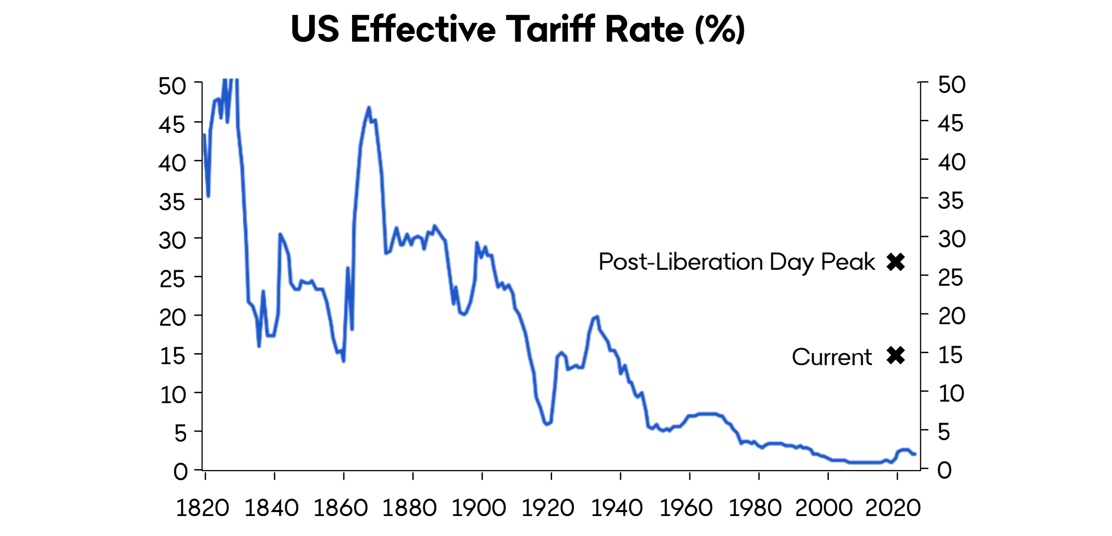
May
2025

Economic and market update

Economic Overview – as at 21st May 2025

Global markets

The volatility and uncertainty driving markets since the shock of the initial 'liberation day' US tariffs is intact although the perceived de-escalation of trade wars after China and the US agreed to a 90-day truce of sorts leaves the world in the eye of a storm. Stock markets have clawed back most of their losses after the sharp falls in early April, e.g. the US S&P 500 having fallen over 21% peak-to-trough is now only 3.4% below its record high set in mid-February. However the extent of this relief rally is perplexing - as the chart below shows, recent 'deals' and deferrals of threatened tariffs mean the effective tariff rate is 'only' around 15%: better than 25% initially feared, but still the highest level since the 1930s. The Great Depression of the 30's wasn't solely caused by tariffs, but the vast majority of economists and historians agree they exacerbated a recession into a depression. At this stage the most likely outcome will be a flat 10% US tariff on all countries other than China (around 40%).



Sources: LSEG, Capital Economics.

Stagflation risks in the US remain high given these historical experiences, however the timing and extent of higher inflation coinciding with slower growth by virtue of the tariffs is dependent on some known unknowns. Will tariff deferrals be permanent or just a delay; and what will the 'deals' needed to negotiate lower tariffs actually look like? Similarly, will Congress be able to redirect any tariff revenue quickly back into the US economy - and will the tax cuts actually get approved? The latest US data has been reasonable with 2.3% CPI in April and signs that GDP in Q2 will recover from the 0.3% contraction in the first quarter, but recession risks are likely to rise in H2 as the full tariff impact gradually materialises. The US Federal Reserve will struggle to justify rate cuts in this context should inflation rebound as is expected, despite lower growth ahead.

This report now normally runs through the outlook for key regions beyond the US, however at this stage it is probably more helpful to simply note that for each region the next few months will be characterised by:

- Most countries trying to convince the US administration to drop punitive tariffs permanently down to a maximum of 10% (or if possible 0%) via 'deals' or other forms of negotiation.
- While that is happening countries and regions such as the EU will be working on fast tracking free-trade agreements and doing more with other partners, to reduce their reliance on the US.
- Policy support – fiscal and monetary will continue to attempt to cushion the blow from trade wars, albeit with some constraints dependent on the outlook for inflation in each country.
- Sentiment will be dependent on all of the above, and the degree of decoupling from the US.
- Global growth will likely decelerate, with the largest falls in the US and neighbouring countries.

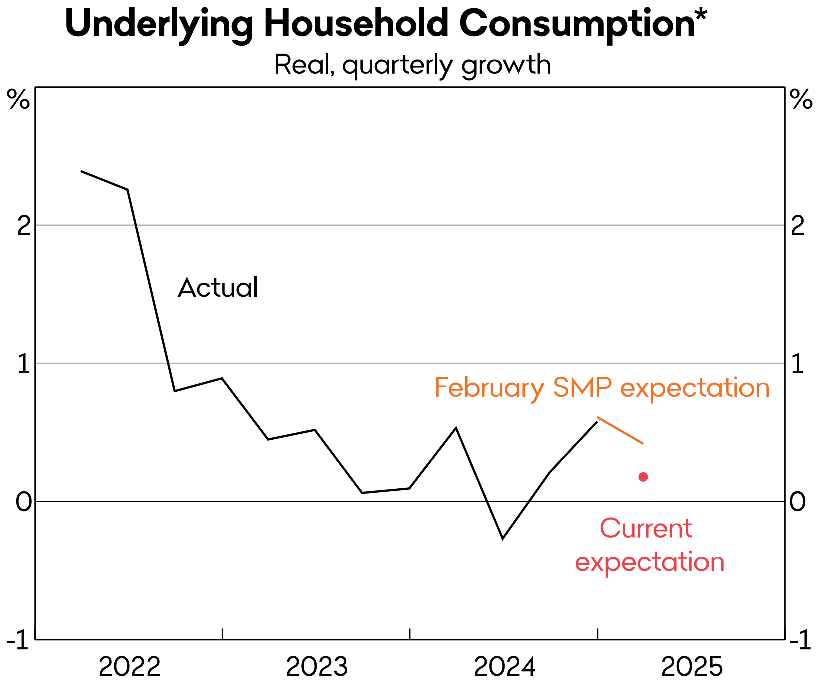
In summary, the outlook is as uncertain and complex as ever as the world rebalances in reaction to US trade threats coinciding with existing geopolitical tensions. Even with lower tariffs (temporarily) between the US and China than those first flagged in April, the uncertainty of the extent of these barriers will weigh on global activity and market volatility will likely remain elevated. As the appendix details there is a wide distribution of direct exposures to tariffs, and significant uncertainty as to how US trade policy will evolve and how its trading partners will respond. For most countries this will primarily create challenges for sustaining growth, while in the US it also adds to upside risks for inflation. Rising bond yields in the US add another dimension to risks ahead, but it is difficult to distinguish between this being just another example of volatility versus a potential emerging trend.

Domestic economy

The second RBA rate cut in the easing cycle was delivered as expected although there was debate around the need for a larger cut than 25 basis points in recognition of the global risks outlined above: " The Board considered a severe downside scenario and noted that monetary policy is well placed to respond decisively to international developments if they were to have material implications for activity and inflation in Australia".

As discussed in this report a month ago, the RBA will increasingly need to consider jobs and growth risks rather than being primarily focused on inflation, so it wasn't surprising to hear a more dovish view from the RBA including greater comfort in the moderation of inflation and some adjustments to their forecasts – although the market was surprised by a number of comments. In her press conference Michelle Bullock added to the dovish tone confirming that consideration was given to a 50bp cut (although it's unclear if they considered our suggested 35 bp cut!), and it was pleasing to hear the view that 'global trade developments will overall be disinflationary for Australia', as we argued in last month's report vs the school of thought that trade wars could see inflation imported. The RBA also materially lowered its modelled estimate of a 'neutral' cash rate (down to around 3% from 3.5% previously).

It isn't a given that the RBA will take the official cash rate back to their (revised) estimate of neutral especially given loose fiscal policy and public investment at a state and federal level, but the RBA now forecast core inflation to fall to 2.6% by June and then to stay at that level sustainably for some time. Fiscal policy may be slightly more stimulatory in the wake of the Federal Election with the ALP having a clear mandate for their policy platform including stimulus and tax cuts outlined in the March budget. More importantly, the need for bold structural reform to improve Australia's lagging performance on productivity has never been more urgent.



* Excludes the estimated effect of household energy subsidies from ABS published consumption growth.

Sources: ABS; RBA.

Another surprise for the market from the RBA detailed in the Statement on Monetary Policy was a more cautious view presented on the outlook for household consumption. This supports our view stated in these reports for some months that the recent pickup in real household disposable income will initially be directed mainly to savings rather than spending. The RBA noted that recent data "suggest that the pick-up will be a little slower than was expected three months ago...resulting in continued subdued growth in aggregate demand and a sharper deterioration in the labour market".

The Australian economy faces the same risks and uncertainties as the rest of the world detailed above in the global markets section, but two differences are worth emphasising:

1. Less direct exposure to US tariffs than almost any other country (but still uncertainty around indirect effects, and a clear dependence on how China responds to US trade policy).
2. Lower unemployment than peer economies, which continues to help insulate our economy from the impending global downturn - although doesn't add urgency to rate cuts. The RBA now forecast the unemployment rate to edge higher to 4.3%, while our basecase scenario detailed below has a larger increase in unemployment as businesses potentially defer investment decisions amid the global uncertainty, and as the public sector moderates their jobs growth.

Another source of uncertainty comes from the exchange rate, where the welcome fall in the value of the Aussie Dollar, especially against the USD, has provided relief against the risk of lower offshore demand. The subsequent recovery to above 64c (a five-cent rally from the early April lows) aligns to our view that through the year the US Dollar will come under pressure as the impact of US tariffs damages their outlook, while Australia and our major trading partners may outperform.

Recent debate that our AAA credit rating may be under pressure appear most premature given our very low debt to GDP at a federal level. However it does serve as a reminder to achieve more sustainable growth via improved productivity, which primarily rests with Canberra (and taking more notice of the recommendations from the Productivity Commission, for example with helping to solve housing affordability).

Interest Rate Outlook

The RBA are now two cuts into their easing cycle with the path back to a more neutral official cash rate likely to continue via quarterly 25 basis point cuts (after each quarterly CPI data). The pace of cuts may increase should global conditions sharply deteriorate, which remains quite possible but is highly uncertain. The RBA has lowered its estimate of a neutral rate down closer to 3%, which coincides with our current forecast of a 3.1% terminal low and also aligns with the market curve.

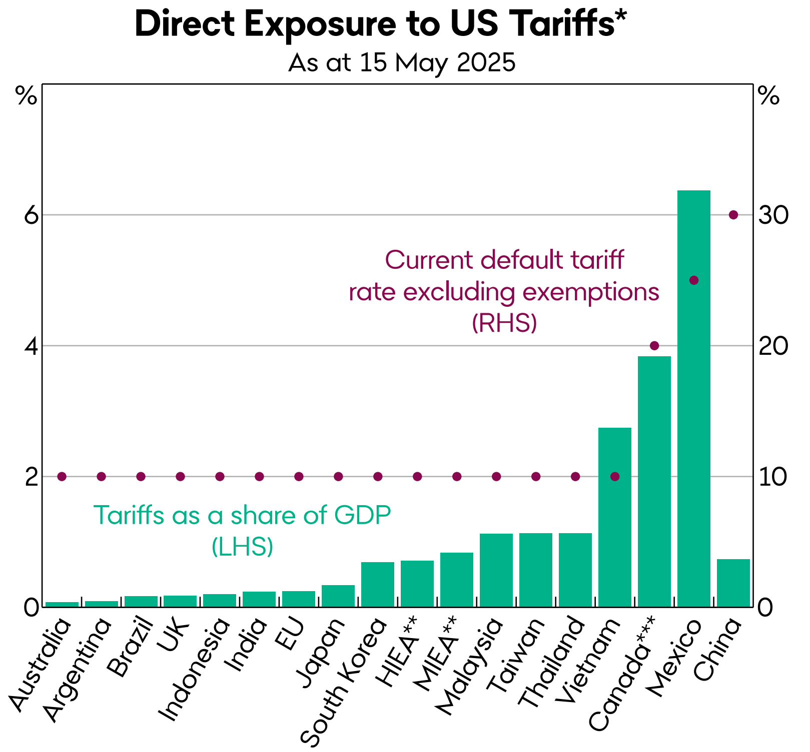
Economic Forecasts: basecase scenario

	2024			2025				2026				2027
% (actual, forecast)	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q2
GDP q/q	0.2	0.3	0.6	0.5	0.5	0.5	0.5	0.5	0.7	0.6	0.6	0.7
GDP y/y	1.0	0.8	1.3	1.6	1.9	2.1	2.0	2.0	2.2	2.3	2.4	2.6
Unemployment	4.1	4.1	4.0	4.1	4.4	4.6	4.8	5.0	5.2	5.1	5.0	5.0
CPI (q/q)	1.0	0.2	0.2	0.9	0.9	0.9	0.6	0.6	0.7	1.0	0.7	0.6
CPI (y/y)	3.8	2.8	2.4	2.4	2.1	2.8	3.2	3.0	2.8	2.9	3.0	3.0
CPI (core y/y)	4.0	3.6	3.3	2.9	2.7	2.6	2.8	2.9	2.8	2.8	2.9	3.0
RBA cash rate	4.35	4.35	4.35	4.10	3.85	3.60	3.35	3.10	3.10	3.1	3.1	3.6
AUD / USD	.667	.691	.619	.625	.64	.66	.68	.70	.725	.73	.74	.75

Benchmark rates

	31 / 3 / 24	31 / 3 / 2025	30 / 4 / 2025	21 / 5 / 2025
90-day bills	4.34%	4.13%	3.90%	3.73%
3-year swap	3.80%	3.65%	3.22%	3.35%
5-year swap	3.96%	3.95%	3.58%	3.79%
AUD/USD	.6515	.6250	.6405	.6425
ASX 200	7 897	7 843	8 126	8 387
Credit Index (iTraxx- 5 yr)	64.3	82.9	98.0	77.5

Appendix: Australia's exposure to US trade and tariffs

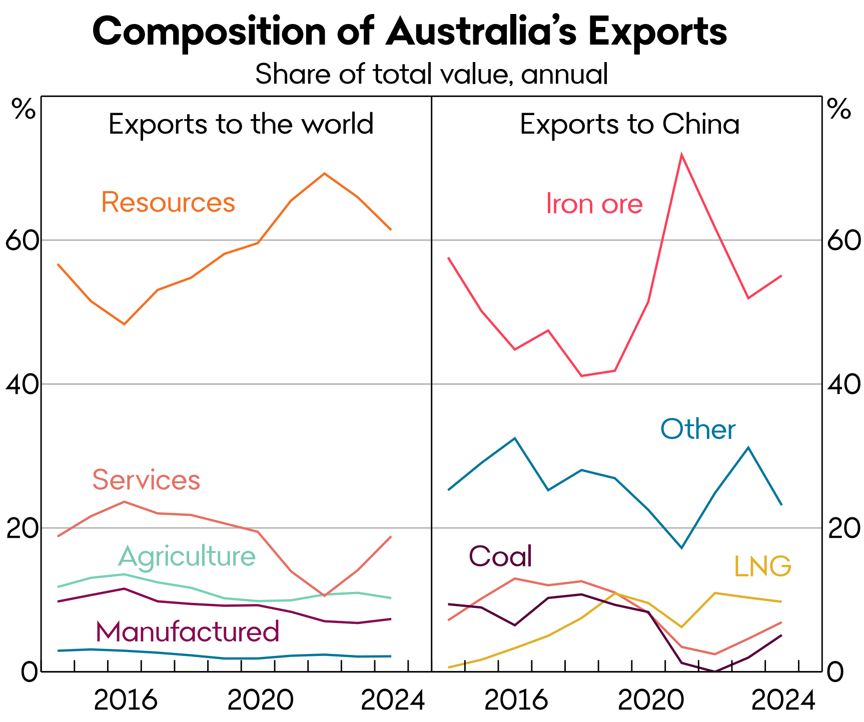


* Calculated as tariff rate multiplied by value of 2023 exports to the US divided by GDP in current US$; accounts for tariff pauses but not for exemptions, trade redirection, tax incidence, or price changes.

** Middle-income east Asia comprises Vietnam, Thailand, Malaysia, the Philippines and Indonesia; high-income east Asia comprises Hong Kong, Taiwan, Singapore and South Korea.

*** Reflects 10 per cent tariff on energy exports and 25 per cent tariff on all other exports.

Sources: OEC; RBA; UN Comtrade; World Bank.



Sources: ABS; DFAT; RBA.

* All goods exported to the US by the manufactures sector excluding aircraft parts, medical instruments, and pharmaceuticals.

** Includes all goods exports to the US that do not fall into categories in the graph.

Sources: ABS; DFAT; RBA.