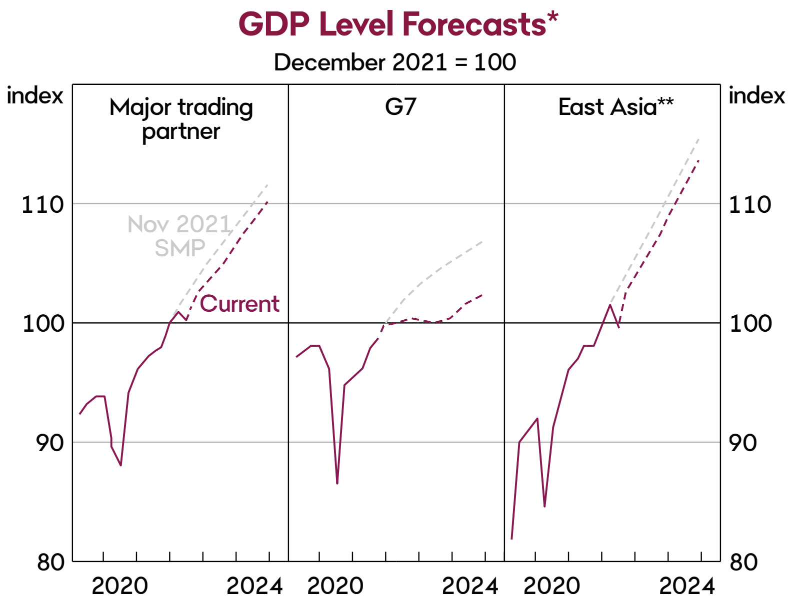
Economic and market update

Economic Overview – as at 17th November 2022

Global markets

A sharp improvement in risk appetite evident over the last fortnight has been driven by a range of factors, primarily reflecting confidence that official rates may peak lower in some countries; but not a change in expectations of recessions in G7 countries. The following chart shows the diverging likely GDP outcomes for the G7 – US, Canada, Germany, UK, France, Italy and Japan – who will struggle to experience any growth at all in 2023, versus East Asia where the recovery has been deferred but not dismantled. Setbacks to economic growth versus 2021 forecasts have mainly been driven by the war in Europe, the resulting surge in energy costs and inflation, and central bank policy tightening. For East Asia (and Australia's major trading partners) the impact appears less conspicuous.



* Dashed lines represent forecasts.
** Major East Asian economies excluding Japan.
Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv.

The nascent 'risk-on rally' for stocks was greatly assisted by the lower than expected read on US inflation a week ago and further enhanced by policy announcements from China (on COVID-19 and on measures to support the property sector – more details below). The fall in US core inflation to 6.3% will likely encourage the Fed to step down its rate hikes from 75 basis points to 50bp in December, especially after the core PPI fell to +6.7% (its lowest year-on-year growth rate in over a year).

Despite this optimism the US yield curve remains inverted (very strongly correlated to US recessions) and manufacturing data continues to show weakness. Bad news is this sector is probably good news for a lower peak in Fed rates, but this is still feared to be close to 5%. Conversely, US retail sales are showing ongoing resilience, justifying further hikes, albeit at a slower pace. The appeal that the US Dollar has held throughout the year both as a safe haven investment in uncertain times, and also due to rising US interest rates, has suddenly evaporated thanks to the improvement in risk appetite, and as US ten-year bond yields fell back below 4%. The US midterm elections delivered a majority for the Republicans in the House, but the Democrats held control of the Senate.

The outlook for the European Union has not improved with the deepest recessions in 2023 most likely in Europe (and the UK). As the EU economic commissioner, Paolo Gentiloni, noted last week: "The energy crisis is eroding households' purchasing power and weighing on production" – the expected peak in EU inflation around 9.5% and the massive terms-of-trade shock will take years to repair. Some optimism from Ukraine reclaiming territory in Kherson was lost when missiles hit Polish territory yesterday, although these appear to have been stray Ukrainian defence missiles rather than Russian. The UK have a third PM in 2022 with Rishi Sunak taking over from Liz Truss, so some political stability from here will be helpful. However the Bank of England increased the Bank Rate by 75 bp on 2 November (its largest increase since 1989) and a prolonged recession is expected through to '24.

The Chinese policy announcements covering an easing of pandemic restrictions, and also support for the property sector, were widely welcomed given their consequences for global trade, and coincided with more weak activity data in China for October. Retail sales slowed from +2.5% y/y to -0.5%, due to virus outbreaks and disruptions, and Industrial Production also decelerated. The easing of some of the strict COVID-19 rules (including shorter quarantines and an end to secondary contact tracing) are timely and hoped to be a precursor to exiting 'COVID-zero' policy in 2023. The recent 26% rally in Hong Kong stocks is evidence of this expectation, enhanced by the announcement of 16 financial and credit measures to support the property sector. These came at the same time that President Xi joined other world leaders in Bali for the G20 summit, amid an apparently constructive stance of diplomacy and dialogue. Chinese GDP growth is now expected to rebound back to above 5% in 2023.

In summary, the likelihood of a global recession remains high for 2023, but like so many aspects of the pandemic and the interrupted recovery, there are huge variances by region and by sector- remarkably uneven, economically and socially. The G7 economies remain most at risk of a double dip recession.

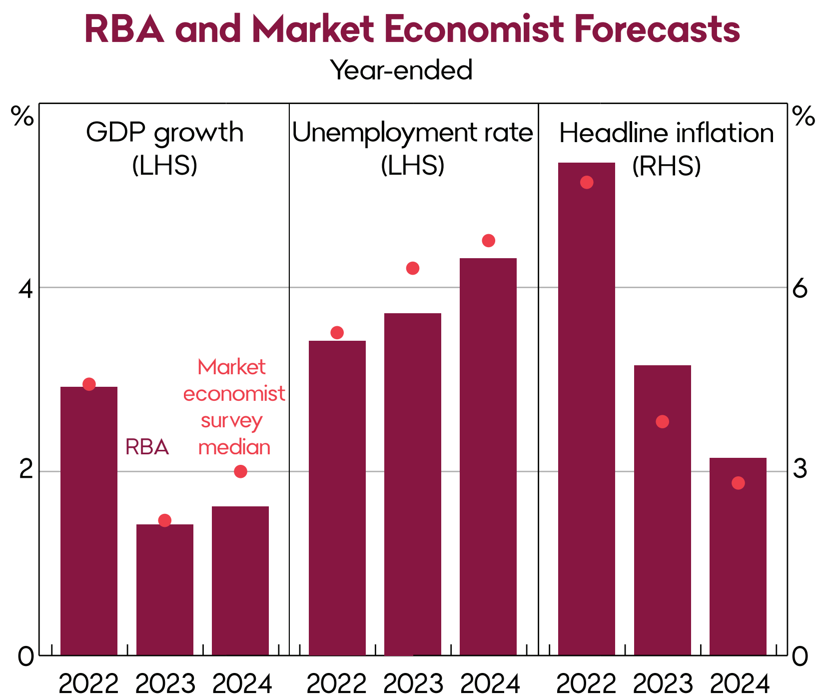
Domestic economy

The Australian economy remains an economic outperformer based on a range of metrics. These include GDP growth (currently 3.6%), unemployment at 50-year lows, a $12.4 billion trade surplus in September, and a strong fiscal position with net debt-to-GDP a relatively low 22.5% (forecast to reach 28.5% in FY26). The Federal Budget highlighted some of these strengths while recognising the challenges of structural deficits due to an ageing population and a lack of recent progress in labour productivity. Those challenges can be addressed by structural reform, some of which may commence in the May '23 Budget, but in the short term our primary challenge is dealing with inflation.

Third quarter CPI rose to 7.3% y/y and core inflation was more than double target at 6.1%, so the RBA has no choice but to continue increasing the Official Cash Rate to better match low supply with resilient demand. Their decision to step down the pace of rate hikes from 50 bp to 25 was somewhat vindicated by the recent US experience detailed above, but they remain on track to get the OCR up to a 'neutral' level of around 3.5% by early next year. A hike in December to 3.1% and another in February to 3.35% both appear very likely given the latest inflation data as well as this week's jobs data.

Unemployment fell to 3.4% in October with employment rising by 32,200, the underemployment rate falling to 5.9% and a sharp rise in 'monthly hours worked'. When combined with the strong Q3 wages data also released this week, the tightness of labour markets is clear, matching the anecdotal evidence from businesses around severe difficulties filling vacancies. This will be assisted by the improved trends for net migration, with overseas arrivals back to 1.2 million in September and an increase for inflows of international students. However, the jump in the Wage Price Index to 3.1% (up 1% for the quarter, and 1.2% for private sector wages) does highlight the risk of the tight jobs market feeding into inflation. The appendix shows further inflation data, including upgraded forecasts from the RBA (similar to our forecast in the table below, and to consensus from market economists in the chart below), the improving trends around shipping supply, wages data and the components of the recent surge in CPI.

While the fall in unemployment is welcome as another sign of Australia's economic outperformance it is important to note that this is likely to be near the low ebb for the jobless rate. The economy will slow markedly as rising interest rates combine with the surge in inflation.



Sources: ABS; RBA.

In addition, many households on a fixed rate will return to variable through 2023, which means falling household consumption will start to hit retail sales and aggregate demand early next year, not helped by falling house prices. As the chart below shows, the RBA anticipate the unemployment rate to rise back above 4% in 2024. However, this appears too optimistic when considering GDP will only just be positive next year, and interest rates will have risen over 3% in less than a year. A sharper rebound to 4% mid to late next year shouldn't be discounted.

The improvement in risk sentiment driven by developments in the US and China has seen a sharp reversal in the strength of the US Dollar, helping the Aussie Dollar up from a low of 61.75 US cents a month ago to almost 68 cents yesterday. This level seems to better match the outperformance of our economy, but clearly also reflects confidence in the policy decisions out of China and thawing diplomatic tensions between Australia and China. The meeting between PM Albanese and President Xi at the Bali G20 was a major development, and presumably augers well for some progress in removing tariffs. The economic forecasts below (like last month) still assume a steadily firming Australian Dollar based on elevated commodity prices, economic outperformance and the pickup in net migration. The Iron Ore price is back towards US $100 per tonne – it is still only forecast at $55 in the Federal Budget, which assumed the worst case for Chinese demand.

The latest flooding in NSW and the range of weather-related events around the country have been a huge challenge and set-back following Australia's second wettest October on record. The damage to crops and livestock is widespread, and beyond the impact on affected communities, will add to supply disruptions and elevated food prices.

The next GDP data is due for release on 7 December and, while Q3 growth is likely to be a fairly modest 0.8%, the yearly growth should be above 6% due to base effects from the Delta period just over a year ago. It will then sharply fall in 2023. Other key events ahead include Retail Trade for October out on 28 November; November property prices on 1 December; the RBA decision on 6 December; and Labour Force on 15 December.

Interest Rate Outlook

The RBA are very likely to increase official rates by another 25bp in December to 3.1%, and another hike in February is also likely, but dependent on Q4 CPI to be released on 25 January. Having reached this 'neutral' level in the mid 3's, a plateau in official rates for much of 2023 appears a more plausible scenario than a peak and easing cycle, given core inflation will still be well above target.

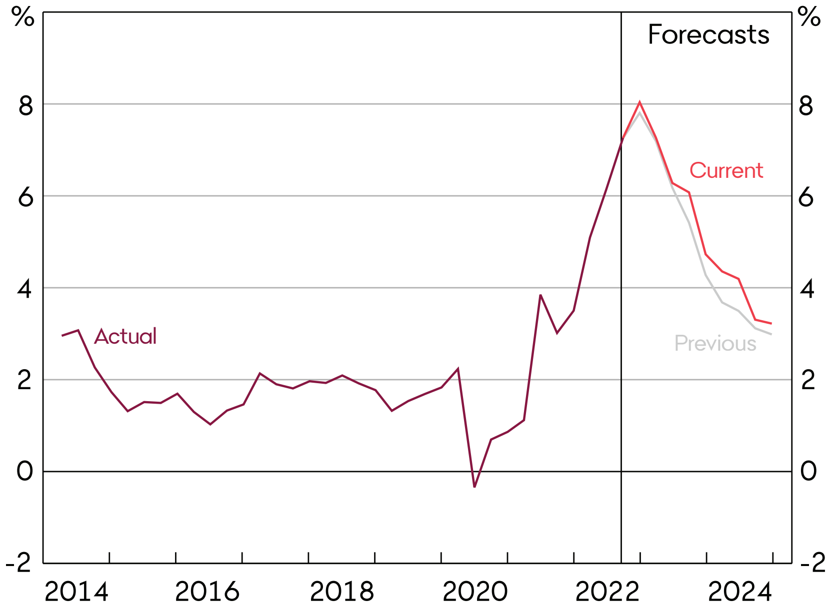
	30 / 9 / 2021	30 / 9 / 2022	31 / 10 / 2022	17 / 11 / 2022
90-day bills	0.02%	3.06%	3.09%	3.04%
3-year swap	0.54%	4.01%	3.97%	3.73%
5-year swap	1.03%	4.22%	4.25%	3.96%
AUD/USD	0.7230	0.6410	0.6395	0.6715
ASX 200	7 332	6 474	6 737	7 130
Credit Index (iTraxx- 5 yr)	67	141	137	96.5

Economic Forecasts: basecase scenario

	2021	2022				2023			
% (actual, forecast)	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
GDP q/q	3.9	0.7	0.9	0.8	0.7	0.3	0.2	0.4	0.4
GDP y/y	4.5	3.3	3.6	6.3	3.1	2.7	1.7	1.6	1.3
Unemployment	4.2	4.0	3.5	3.5	3.4	3.4	3.7	4.0	4.2
CPI (q/q)	1.3	2.1	1.8	1.8	2.2	1.1	0.8	0.7	0.6
CPI (y/y)	3.5	5.1	6.1	7.3	7.9	6.9	5.9	4.8	3.4
CPI (core y/y)	2.6	3.7	4.9	6.1	6.5	5.8	5.0	4.2	3.5
RBA cash rate	0.1	0.1	0.85	2.35	3.1	3.35	3.35	3.6	3.6
AUD / USD	0.7270	0.7485	0.6905	0.6410	0.64	0.67	0.69	0.715	0.74

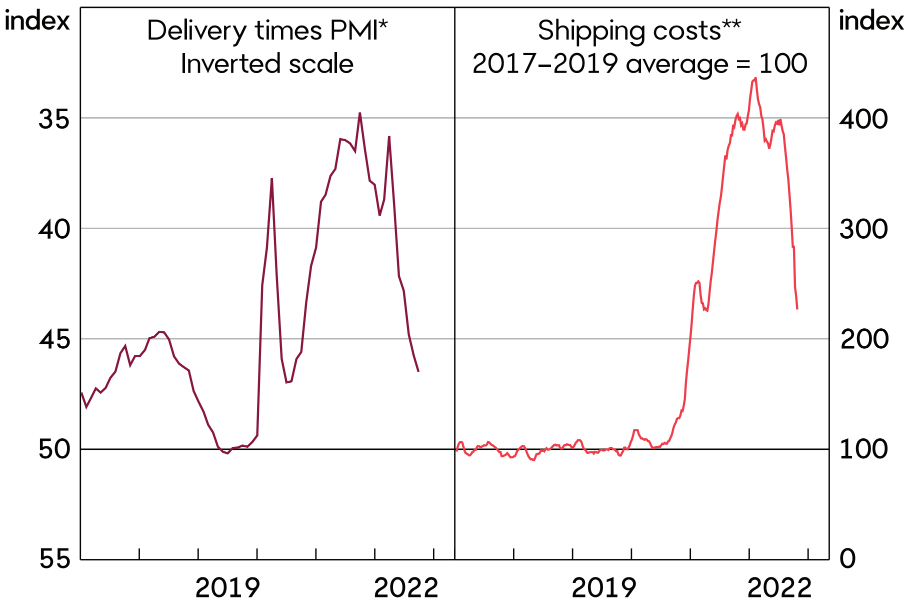
Headline Inflation Forecasts

Year-ended



Sources: ABS; RBA

Supply Indicators



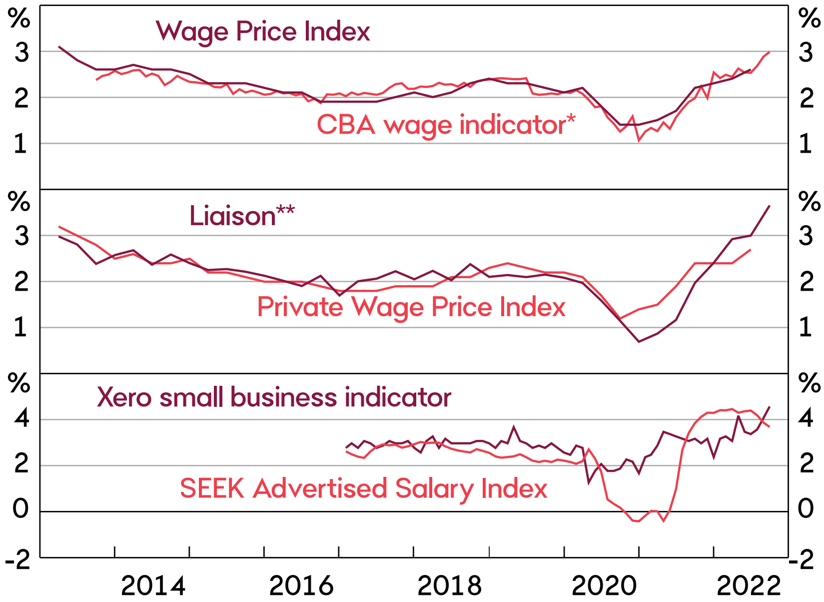
* Purchasing Managers' Index.

** Index of spot and contract container rates by route from China.

Sources: IHS Markit: RBA; Refinitiv.

Timely Measures of Wages Growth

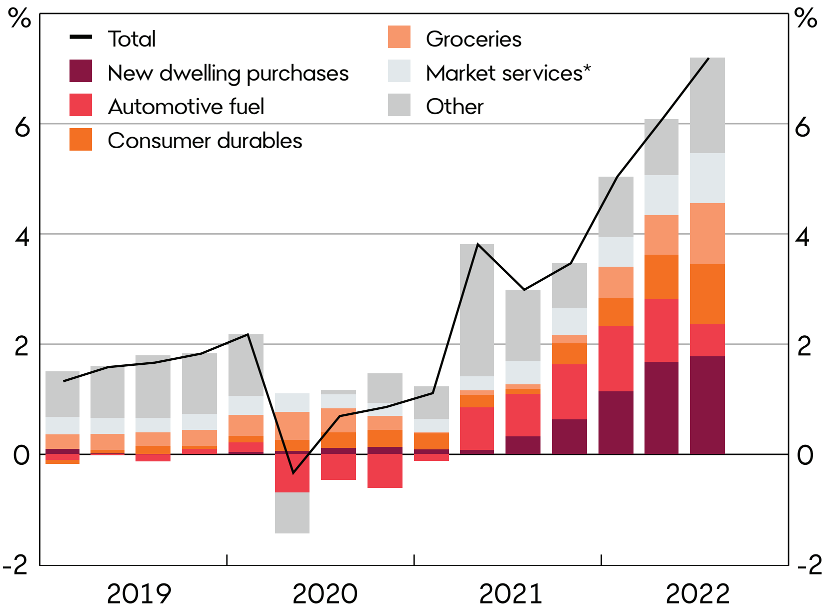
Year-ended



* Changes in base wages based on a sample of CBA retail banking transactions.
** Private sector; trimmed mean; rescaled to have the same mean as the private Wage Price Index.
Sources: ABS; CBA; RBA; SEEK; Xero Small Business Insights.

CPI Inflation

Year-ended with contributions



* Excludes domestic travel and telecommunications.
Sources: ABS; RBA