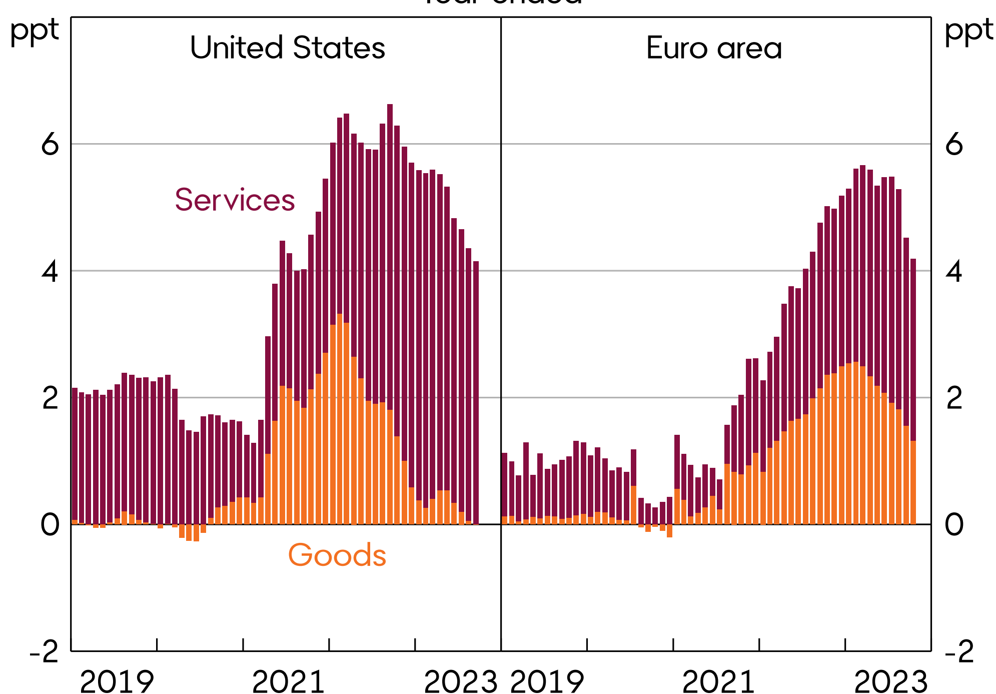
November 2023

Economic and market update

Economic Overview – as at 16th November 2023

Global markets

Bond markets remain volatile as opinions fluctuate regarding the pace of inflation returning to target in advanced economies, and as central banks remain hawkish even as core inflation moderates. Yield curves are no longer pricing in further increases to official rates in the US, Canada, Eurozone or the UK, and the combination of lower headline CPI with slowing economic growth has rate cuts back in focus. However the timing of core inflation allowing easing cycles to commence is highly speculative.



US CPI for October was one tenth lower than expected for both headline and core inflation, leaving year-on-year CPI at 3.2% and core inflation at 4.0%. While services inflation is likely to remain persistent (we are a long way from the 2% target), another Fed hike appears most unlikely (at least in the short term) - but equally the cuts priced by mid-2024 are a goldilocks scenario. Nevertheless, bond yields have fallen significantly from their brief foray above 5%, and equity markets welcomed the CPI data with another strong rally: up around 10% from the late October lows.

The prospect of higher energy prices amid the conflict in the Middle East, and also risks to food prices as El Nino impacts crops, remind us how temporary this confidence may prove to be, but US economic data has been resilient including jobs, household consumption and business investment. Still, the US yield curve remains inverted and slower growth is widely expected ahead.

The European economy is on the verge of recession with the eurozone having contracted 0.1% in the third quarter equating to only 0.1% growth year-on-year. Business activity data for October was also weak suggesting Q4 will be equally problematic, although labour markets have held up better thus far. The ECB left official rates unchanged in October after ten consecutive hikes, and markets are now gearing for the next move to be a cut by mid-next year. The outlook is similar for the UK although core inflation is still at 5.7% - a more meaningful measure than headline CPI which has fallen to 4.6% due to base effects.

The market expects that the Bank of England will cut rates next year as their economy falls into recession, but UK wages growth at 7.9% together with unemployment only 4.2% makes this easing cycle timing as difficult to forecast as anywhere.

Chinese activity data for October was again stronger than expected with retail sales up 7.6% y/y, suggesting consumer confidence has responded to policy support despite the weak property sector. Industrial output also accelerated, and while infrastructure spending has been slow to pick up, the expectation is for a surge into year end, helping authorities to achieve their 5% growth target. The PBoC left rates unchanged this week, but another cut in official rates is expected by year end.

Australia's second largest trade partner Japan experienced a sharp contraction in GDP in Q3 (down 0.5%) with falls in consumption and business investment, perhaps justifying the Bank of Japan's incredibly patient approach to policy. The BoJ are yet to lift the official rate from -0.1% and still have a 1% target for ten-year bonds, despite revising the FY24 CPI forecast up to 2.8%.

In summary, the global economy faces relatively low growth in 2024 (around 2% vs long run average of 3.5%) and recession risks remain elevated in advanced economies, despite equity markets pricing in softer landings. The theme of rates 'higher for longer' is being contested by evidence of inflation receding more quickly and hopes for easing cycles around mid-next year in advanced economies. However, risks still lie to the downside including higher energy prices and tighter external funding conditions.

Domestic economy

The RBA hike in November followed comments from Governor Michele Bullock that she will 'not hesitate to raise the cash rate further' should inflation fail to moderate. In the days following that quote, the third quarter CPI rose to 1.2% for both CPI and core measures of inflation, from less than 1% in Q2. This, together with stronger than expected retail sales and household spending data, on top of the September fall in unemployment, left no room for hesitation; although the language in the policy decision statement hinted that this may be the last increase in the cycle - a 'reluctant' rate hike.

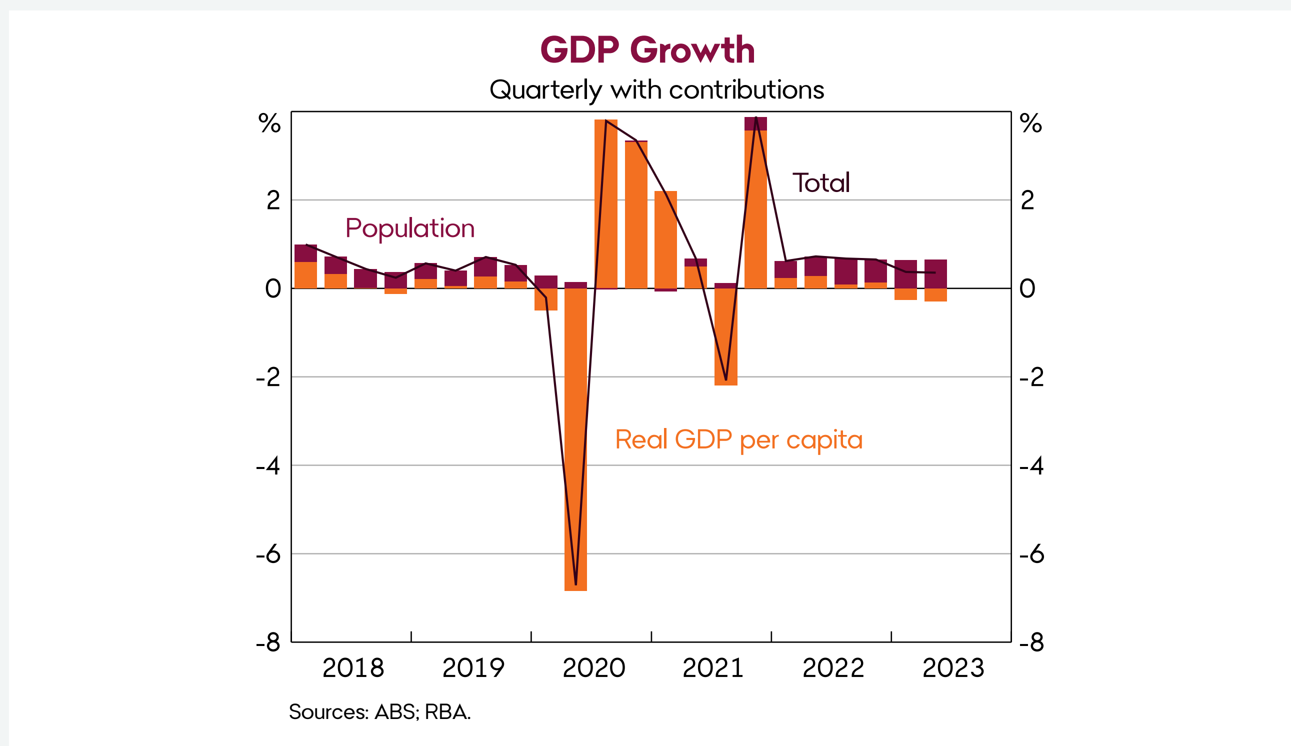
Since then, data has continued to support the latest increase in the cash rate with the Wage Price Index rising by a series record of 1.3% in Q3 (up 4.0% y/y), and the October labour report beating expectations for jobs growth. Employment rose 55k and the participation rate rose to 67%, taking total employment to a fresh record high of 14.174 million, but the unemployment rate was back up to 3.7%.

As mentioned here for some time Australia's lack of productivity makes the combination of tight labour markets with rising wages an ongoing challenge for services inflation, although the Q3 WPI rise did have some on-off factors. Nevertheless, as discussed in the latest RBA Statement on Monetary Policy, inflation is stronger now than had been hoped in the wake of the 4% of rate hikes, so the question remains: how much more policy tightening is needed for the RBA to be comfortable?

The RBA SOMP went into great detail on how other advanced economies are coping with inflation and their policy responses, as well as our domestic economic and financial conditions, and the range of upside and downside risks to their core forecasts ahead. The risks were stated to be 'broadly balanced' although the downside risks (inflation taking longer to return to target, via e.g. services inflation, supply shocks, higher energy prices and further rises to rent inflation) appear to outnumber upside risks. The resilience of our economy (GDP growth, low unemployment and rising house prices) was noted, and as a result RBA forecasts for 2024 and 2025 were upgraded - but the timing of the return of core inflation to target was deferred. This translated to:

- An upgrade in real GDP growth (no longer forecast to slow to 1%, instead bottoming out at 1.5% by end of this year and back to 2% by December '24)
- A slower increase in the unemployment rate, only forecast to reach 4% by June '24 and no higher than 4.25% in 2025
- Core inflation still above target at the end of 2024.

In many respects this RBA outlook is a goldilocks scenario: the economy bouncing back in 2024 after a weaker end to this year, but maintaining most of the gains in employment. However if conditions are indeed so resilient next year (and inflation is still above target) it makes rate cuts difficult to reconcile. One of the challenges with recent data and projecting forward is population growth and net migration: as the chart below shows, our economy has just experienced a per-capita recession but population growth rescued GDP. Net migration is now more than double its pre-pandemic rate, so it will be interesting to see where this trends next year.



In contrast to the RBA forecasts, our basecase below has a less optimistic view of the ongoing impact of tighter monetary policy on top of the cost of living pressures - it assumes unemployment will rise fairly steadily and real GDP will briefly move into reverse. Should population growth continue to surprise on the upside this will further defer the economic downturn; but equally, more resilience in jobs markets and household spending will only add to the task of the RBA in managing inflation. Labour markets have been remarkably strong, but the long lag of policy impacting the real economy is likely to be near its completion, suggested by falling job advertisements (and other leading indicators).

Economic data ahead is expected to be weaker, and further falls in consumer sentiment and business confidence suggest a challenging period ahead, but for the RBA their policy settings will be driven almost entirely by inflation and its path back to target. As a result, the next two quarterly CPI reports (out on 31 January and 24 April) will be crucial for 'hike or hold' decisions for the RBA on 5-6 February and 6-7 May. A back-to-back hike in December is unlikely given the vibe of the RBA statements and commentaries since the Cup Day hike, and given global developments since then (detailed above).

Interest Rate Outlook

The RBA Official Cash Rate is closer to its likely peak after the hike to 4.35%, although the slow pace at which inflation is easing still risks another increase to 4.6% after the next few quarterly CPI data prints. Rates are expected to be on hold until February, when the RBA moves to meeting 6 weekly. A longer cycle (into 2025) as core inflation persists remains the basecase scenario, outlined below. Other advanced economies appear closer to easing cycles commencing around mid-2024, having commenced their tightening cycles earlier than the RBA.

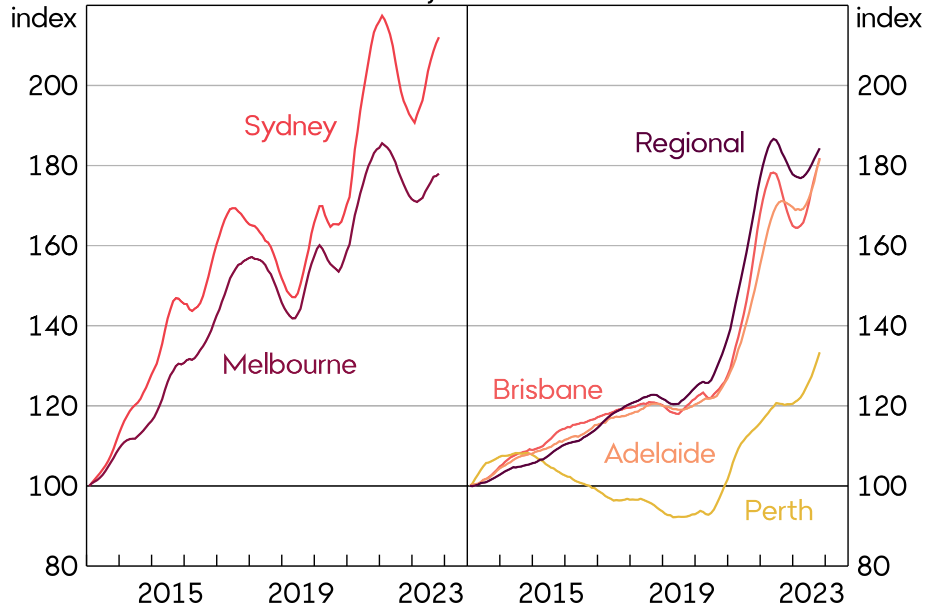
Economic Forecasts: basecase scenario

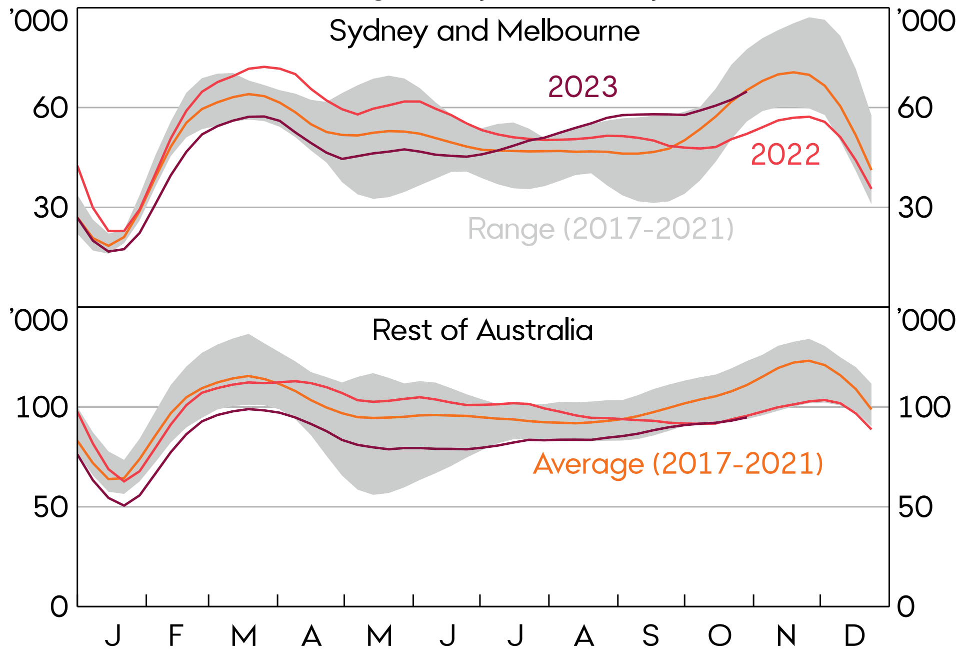
	2022			2023				2024			
% (actual, forecast)	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP q/q	0.7	0.7	0.7	0.4	0.4	0.2	0.1	-0.2	-0.2	0.4	0.5
GDP y/y	3.1	6.0	2.7	2.4	2.1	1.6	1.1	0.5	-0.1	0.1	0.5
Unemployment	3.6	3.6	3.5	3.5	3.5	3.6	3.9	4.3	4.6	4.8	4.9
CPI (q/q)	1.8	1.8	1.9	1.4	0.8	1.2	0.9	0.8	0.7	0.7	0.7
CPI (y/y)	6.1	7.3	7.8	7.0	6.0	5.4	4.3	3.7	3.6	3.1	3.0
CPI (core y/y)	5.0	6.1	6.8	6.6	5.9	5.2	4.3	3.9	3.8	3.3	3.1
RBA cash rate	0.85	2.35	3.1	3.6	4.1	4.10	4.35	4.35	4.60	4.60	4.60
AUD / USD	.6905	.6410	.6815	.669	.666	.6435	.67	.69	.71	.73	.75

Benchmark rates

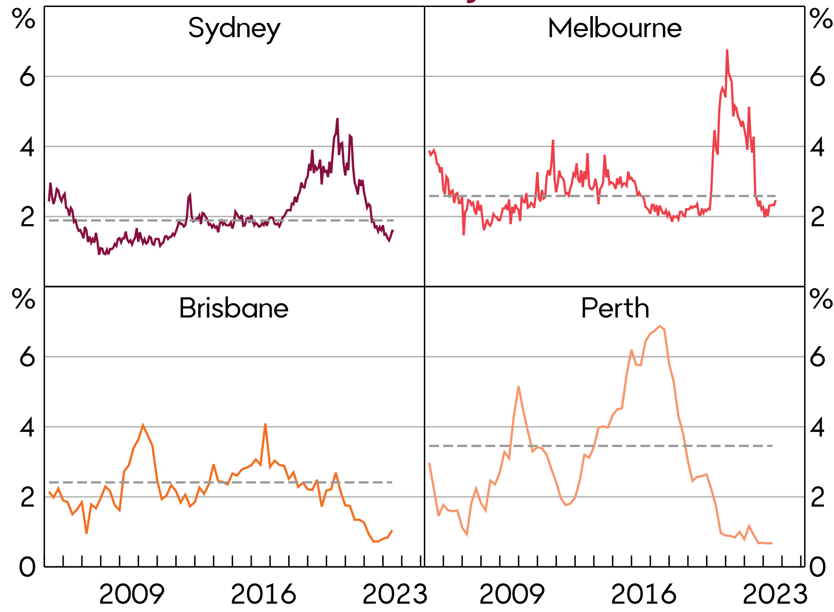
	30 / 9 / 22	29 / 9 / 2023	31 / 10 / 2023	16 / 11 / 2023
90-day bills	3.06%	4.14%	4.35%	4.40%
3-year swap	4.01%	4.27%	4.64%	4.40%
5-year swap	4.22%	4.47%	4.94%	4.57%
AUD/USD	.6410	.6435	.6340	.6490
ASX 200	6 474	7 049	6 982	7 122
Credit Index (iTraxx- 5 yr)	150	87.5	93.5	78.1

Appendix: Residential housing and rental markets





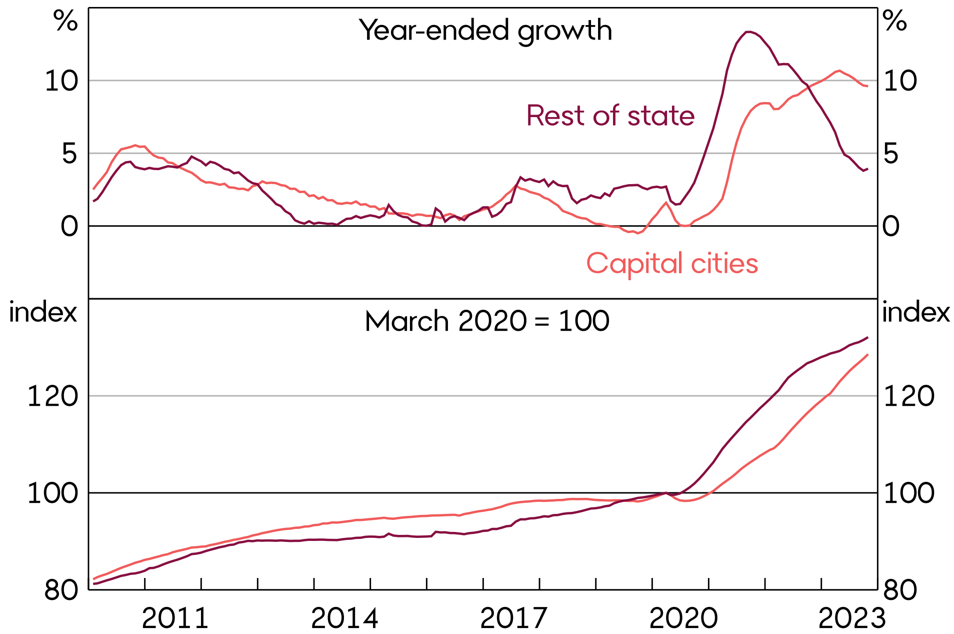
Rental Vacancy Rates*



* Data is monthly for Sydney and Melbourne, and quarterly for Brisbane and Perth; dashed lines represent historical (2005-2019) averages.

Sources: RBA; REIA; REINSW; REIV.

Advertised Rents*



*Hedonic; seasonally adjusted.

Sources: CoreLogic; RBA.

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