October 2023

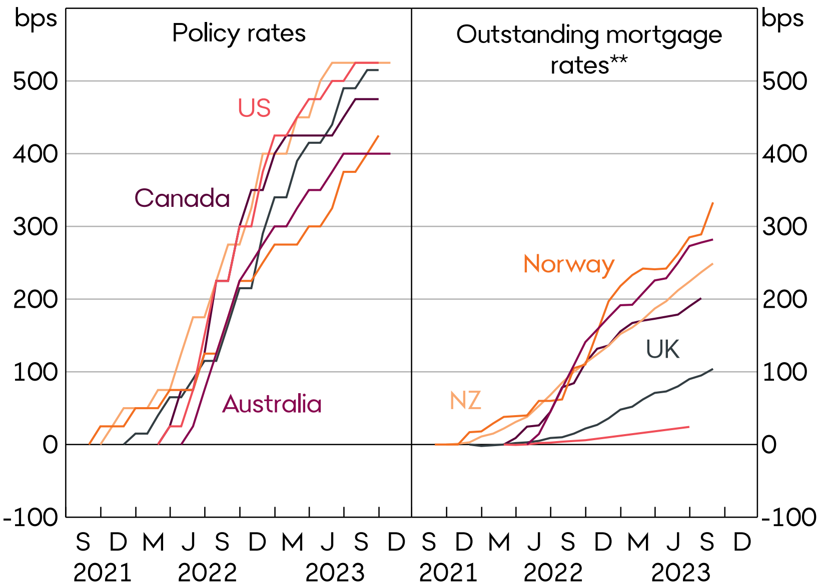
Economic and market update

Economic Overview – as at 19th October 2023

Global markets

Higher interest rates in advanced economies continue to gradually dampen inflation by a number of transmission channels, but resilient labour markets and household demand suggests that the 'rates higher for longer' theme will keep building. Headline inflation has continued to moderate, however core measures remain less responsive to monetary policy, and higher energy prices risk a further lag particularly with higher oil prices amid production cuts and heightened geopolitical tensions. The latest IMF report notes slowing growth (well below average) but growing hopes for soft landings.

Changes in Policy and Mortgage Rates*



* Cumulative basis point increase in the policy rate and average outstanding mortgage rate relative to the month immediately preceding first policy rate increase since the onset of the pandemic.

** Data for the US is interpolated between September 2022 and June 2023, Canada data to July 2023, and remainder to August 2023.

Sources: APRA; Black Knight; central banks; RBA.

Rate hikes generally impact economies more quickly where a larger share of borrowers are on a variable rate (refer to chart on previous page). In the case of the US, almost all home loans are fixed for 30 years, however other transmission channels are effective, including via asset prices, incentives to save and business investment. The Federal Reserve have delivered 5.25% of rate hikes this cycle and expectations for cuts continue to be deferred as the US economy displays ongoing resilience. US bond yields are at their highest level since 2007, and while their yield curve remains inverted (still implying that recession risks are elevated) the cycle is taking longer than expected to play out. As such (in contrast to the IMF's forecasts) a 'later landing' is suggested as rates stay higher for longer, rather than assuming this all implies a soft landing. Nevertheless, higher bond yields are doing some of the job for the Fed, so another US hike appears unnecessary at present.

The European Central Bank are also likely to be on hold (at 4%) but not in a position to ease policy due to elevated core services inflation, despite anaemic economic growth. The weakest regions in Europe based on GDP trends currently are Germany and Scandinavia, while southern countries appear to have benefitted from the rebound in global tourism. Meanwhile the UK is still at risk of falling into recession and the Bank of England are unlikely to have finished their tightening cycle just yet, with CPI in the mid sixes and rising oil prices continuing to bite.

The Chinese economy remains on track to achieve the 5% growth target for 2023 but only with the help of ongoing stimulus, including the rumoured one trillion CNY additional injection (expected to be announced later this month). Further monetary policy easing is also expected by the market, and the most recent data does show that the economy is responding to policy support, although the property sector remains very weak. The year-on-year GDP growth rate was 4.9% in September, but Q3 saw 5.3% annualised growth and consumption levels improved from weaker activity mid-year. Stimulus measures are still expected to favour Australian exports in the short term, and the price of iron-ore remains close to US$120 per tonne. Media reports that a resolution to Australian wine tariffs is imminent would also be a very welcome outcome, and auger well for other export opportunities.

Domestic economy

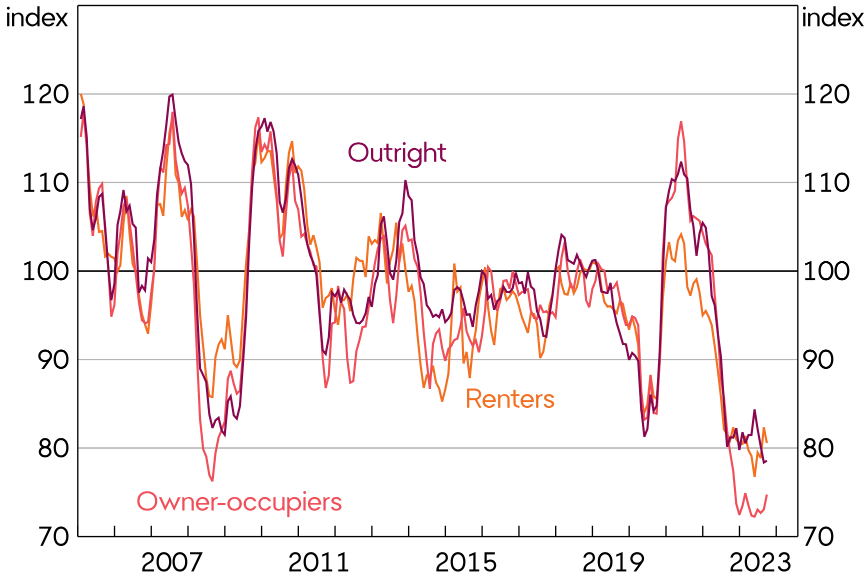
The resilience of the Australian economy, evidenced by another fall in the unemployment rate and the rebound in property prices, has in many respects made the Reserve Bank's job more difficult in managing inflation. In line with other advanced economies it is consistent with the 'rates higher for longer' theme. The unemployment rate fell to 3.6% in September with a small increase in employment, although the participation rate fell and 'total hours worked' also lost ground, so labour markets remain tight but are showing signs of running out of steam.

This will be one of the key variables for FY24: amid likely tepid growth (if not a recession) how quickly will the jobs market lose momentum, and when will the long awaited path back above 4% unemployment commence? For now demand for labour is intact and while the September data didn't lock in a November rate hike, 3.6% unemployment is consistent with tighter policy ahead.

The rebound in property prices is primarily a function of lack of supply together with rebounding population growth, but it also risks more persistent household demand despite higher interest rates.

Residential property prices rose another 0.8% in September to be 6.6% above the January '23 low point, and minutes from the latest RBA policy meeting stated that this 'might provide some support to household consumption in the period ahead'. The minutes also noted that tight conditions in the rental market would be 'an ongoing source of inflationary pressure'. Meanwhile, the six-monthly RBA Financial Stability Review explored the impact of rising official rates on borrowers and concluded that:

- The vast majority of borrowers have adjusted to higher rates, thanks to strong labour markets
- Savings buffers accumulated during the pandemic have helped, although savings have been eroded to a degree
- Around 5% of borrowers on a variable rate are in household financial stress due to the cost of servicing debt, based on HEM calculations, and this percentage would increase should rates rise further
- Many households have adjusted their spending habits and/ or have reduced their rate of saving.



* Latest observation September 2023.

Sources: RBA; Westpac-Melbourne Institute.

Naturally the adverse impact on confidence, and by extension on discretionary spending, is larger for owner-occupiers than households that own property outright, but all categories are near record lows for consumer sentiment and all households are experiencing the cost of living shock. Despite this reality the RBA board continue to warn of the risk of further rate hikes, and the new sentence in the minutes that "The Board has a low tolerance for a slower return of inflation to target than currently expected" was a blunt message.

In line with the above commentary on global markets and other advanced economies, the likelihood of a longer cycle here with a tightening bias in place for longer than previously expected by the market has increased. Some of the factors driving this trend are covered in the appendix:

- The higher oil price is at risk of remaining elevated for longer due to war in the Middle East, and the lower Australian Dollar (while fairly stable on a trade-weighted basis) has added to energy and fuel costs.
- Falling household disposable income is expected to reduce retail sales over time, but strong labour markets and accumulated savings have slowed down this transmission mechanism.
- The strength in labour markets together with rising wages would be welcome (and sustainable) if our economy was enjoying a lift in productivity; however productivity has fallen back to 2015 levels, which is translating to a large increase in unit labour costs.

While all of this could be interpreted as a sign to simply keep rates on hold, rather than further tighten policy, the combination of these factors and more hawkish language from the RBA makes 7 November a live date for another rate hike, dependent on CPI data out next week. Market consensus is for both headline CPI and core inflation to print at 1% for Q3, which would equate to roughly 5.2% year-on-year CPI and around 5% for core inflation. To avoid an imminent hike a read below one percent for the quarter may be necessary for both of these measures. Of all of the factors above, the risks of ongoing higher oil prices may be the most influential on this decision.

Interest Rate Outlook

The RBA board are still expected to increase the Official Cash Rate by 25 basis points in one of the next few meetings, given stubbornly persistent core inflation, although the precise timing remains data dependent. A read at or above 1% for core inflation in Q3 would greatly increase the likelihood of a November hike. Irrespective, rate cuts by early to mid-next year (as forecast by a number of market participants) still appear to be premature and are not reflected in the basecase scenario below.

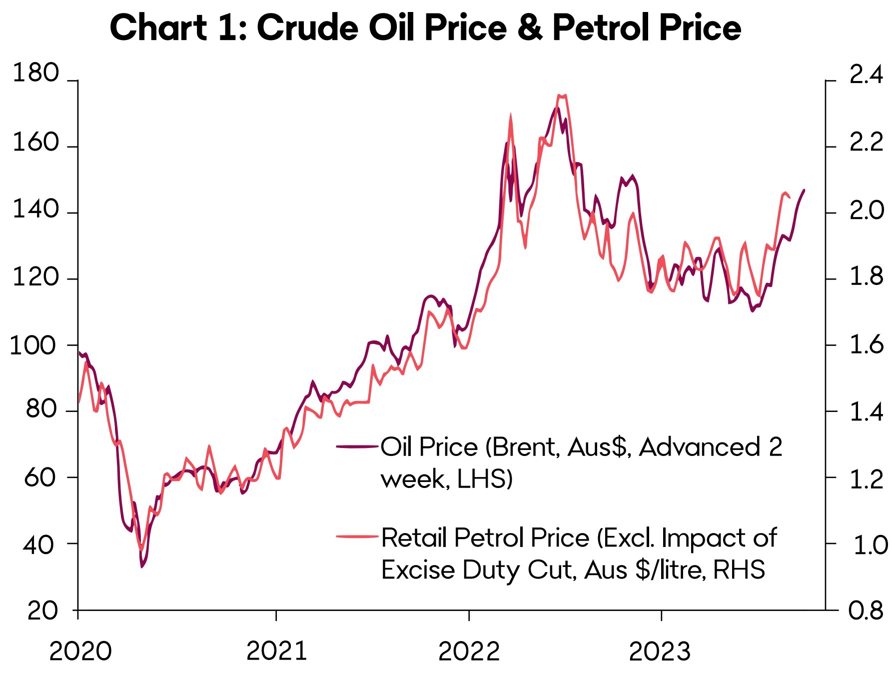
Economic Forecasts: basecase scenario

	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	-0.1	-0.2	0.2	0.3	0.4	0.4
GDP y/y	3.1	6.0	2.7	2.4	2.1	1.4	0.5	0.3	0.2	0.7	1.3
Unemployment	3.6	3.6	3.5	3.5	3.5	3.6	3.9	4.3	4.6	4.8	5.1
CPI (q/q)	1.8	1.8	1.9	1.4	0.8	1.0	0.7	0.8	0.8	0.7	0.6
CPI (y/y)	6.1	7.3	7.8	7.0	6.0	5.2	3.9	3.3	3.3	3.0	3.0
CPI (core y/y)	5.0	6.2	6.9	6.6	5.9	4.9	4.0	3.5	3.5	3.2	3.0
RBA cash rate	0.85	2.35	3.1	3.6	4.1	4.10	4.35	4.35	4.35	4.35	4.25
AUD / USD	.6905	.6410	.6815	.669	.666	.6435	.67	.69	.71	.73	.75

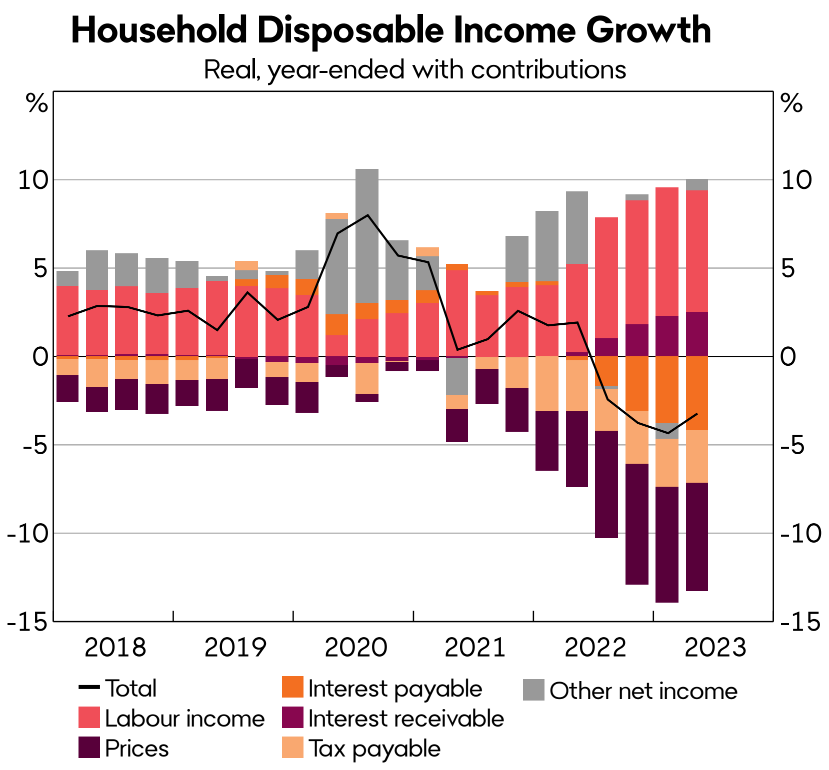
Benchmark rates

	31 / 8 / 22	31 / 8 / 2023	29 / 9 / 2023	19 / 10 / 2023
90-day bills	2.46%	4.12%	4.14%	4.22%
3-year swap	3.70%	4.00%	4.27%	4.42%
5-year swap	3.91%	4.14%	4.47%	4.70%
AUD/USD	.6840	.6485	.6435	.6310
ASX 200	6 987	7 305	7 049	6982
Credit Index (iTraxx- 5 yr)	104	75.0	87.5	93.5

Appendix: Inflation factors

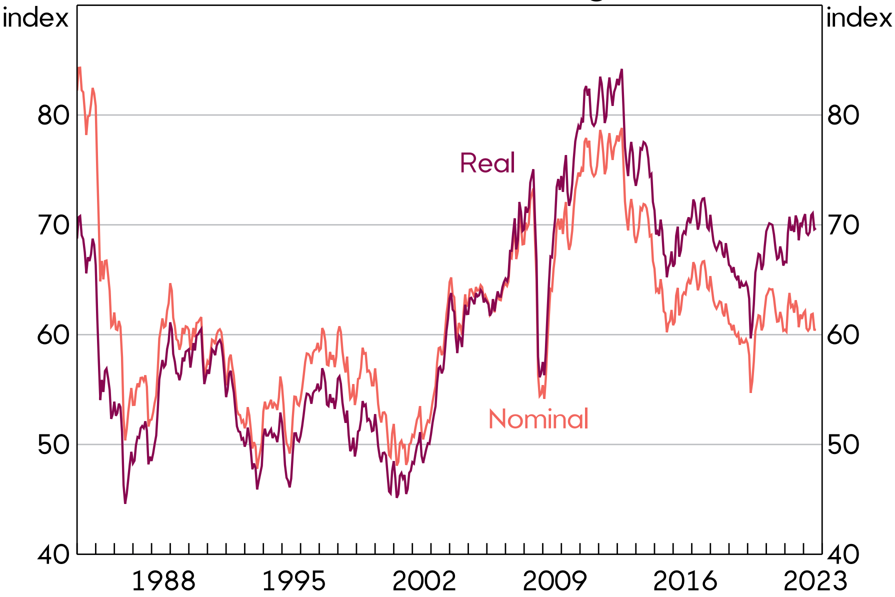


Sources: Refinitiv, Capital Economics



Sources: ABS; RBA.

Australian Dollar Trade-weighted Index*

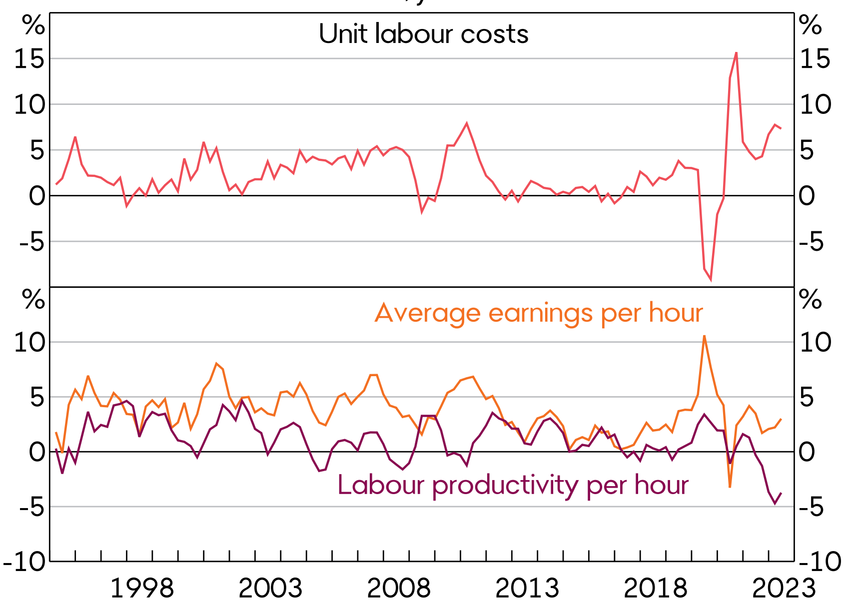


* May 1970 = 100 for nominal; real indexed to equate post-float averages; latest observations for real TWI are estimates.

Sources: ABS; RBA; Refinitiv; WM/Reuters.

Unit Labour Costs Growth

Non-farm, year-ended



Sources: ABS; RBA.