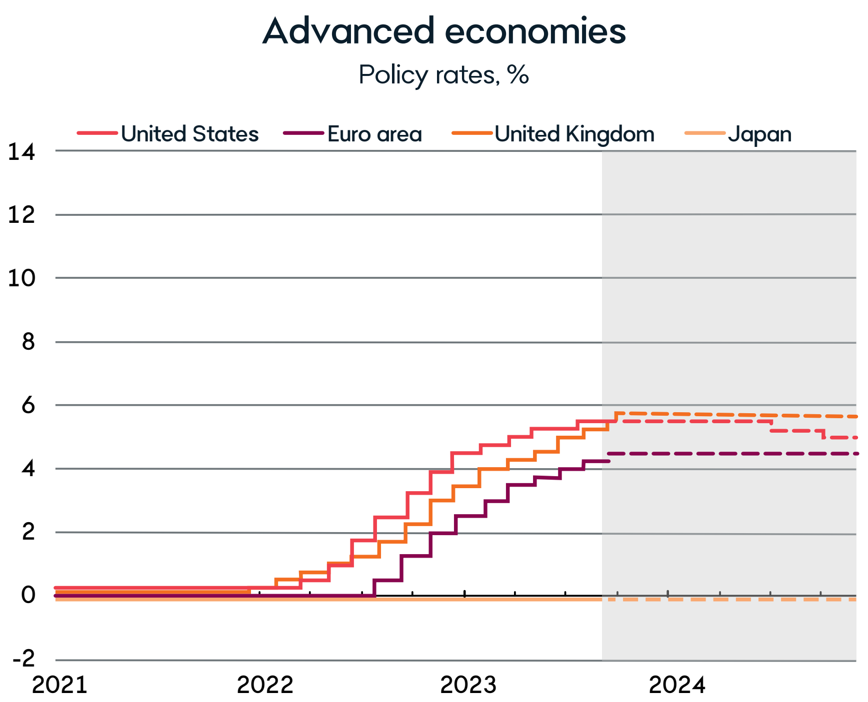
September 2023

Economic and market update

Economic Overview – as at 21st September 2023

Global markets

Expectations that policy tightening is approaching a peak in the cycle continues to be challenged by resilient data (suggesting that more work is needed to reign in inflation) and hawkish central banks around the world, to varying degrees. This 'higher for longer' theme has been building for some time and there now appears even more evidence that aggressive pandemic stimulus is taking longer to dissipate via rate hikes. Calls for soft landings (in contrast to fears 6 months ago that a global recession was inevitable) may be on track in some countries, but the length of the cycle remains the key. The latest OECD report has downgraded global growth for 2024, warning of more persistent core inflation, although doesn't forecast recessions other than in Argentina and in parts of Europe.



Source: OECD Interim Economic Outlook 114 database.

The latest pause from the US Federal Reserve in the September FOMC meeting was as expected, however the 'dot plot' projections imply another hike later this year. More importantly, the extent of cuts forecast next year was reduced from 100 basis points to only 50bp, and the Fed don't see core PCE inflation returning to target until 2026. Drivers of this outlook include higher energy prices, resilient labour markets and a relatively soft landing as household demand withstands rate hikes- but it is important to note that the US yield curve remains steeply inverted. The ten-year bond yield has risen to a 15 year high of 4.4%, but the two-year yield is still 75 bp higher at 5.15%, and the strong correlation of an inverted yield curve to an impending recession hasn't changed. So the challenge is still primarily the timing of the downturn, not its likelihood of occurring. Curve inversion before the GFC was in 2006, but the recession didn't materialise until mid-2008.

The European Central Bank pressed on with another rate hike last week despite the clear underperformance of the region. Germany is in recession and their economy is projected to contract by around 0.5% in 2023, while eurozone growth has been downgraded to less than 1% despite tight labour markets. Core services inflation remains the challenge, suggesting that rate cuts are unlikely before 2025. The Bank of England face a similar dilemma with near-recession conditions likely to set in but (even with the latest deceleration in CPI) core inflation still up at 6.2%.

The Bank of Japan aren't expected to exit the world of negative interest rates until next year despite inflation remaining at 3.3%, although their yield-curve-control mechanism is being reviewed. Prime Minister Fumio Kishida is rolling out further economic support measures that are likely to include more pay hikes, so there is growing uncertainty as to how sustainable ultra-low rates are in Japan.

The one major economy cutting rates at present is China, where a wide range of policy measures continue to attempt to stabilise their property sector and lift consumer confidence. Despite the widespread pessimism surrounding Chinese property developers and the risks this poses to global demand, the latest economic data suggests policy support is bearing fruit. Lending rates were cut in late August (the one-year prime rate by 10 bp to 3.45%) and last week another cut to the reserve-requirement ratio (the sixth since March) was announced. Meanwhile a range of measures including relaxing of purchaser restrictions have added confidence. Industrial Production and Retail Sales have recovered (both are now up 4.5% year-on-year) and the rebound in freight traffic is encouraging. For Australia, the best barometer of this progress is seen in the price of iron ore, back up to US $122 / tn.

The recent surge in the price of oil is a development that adds to the argument for interest rates to remain higher for longer, although it is driven more-so by cuts in production than rebounding demand. Saudi Arabia and Russia have announced production cuts, and the International Energy Agency predict a deficit in supply, while US crude inventories have fallen at the same time that the demand outlook has mildly improved (helped by the latest news from China, detailed above).

Domestic economy

The groundswell of opinion that the RBA has completed its tightening cycle at 4.1% has been matched by growing calls for a soft landing, much like the commentary above for global markets. Economic data has been supportive of this view on balance, including a higher read than expected for Q2 GDP, another pleasing fall in CPI and core inflation in the monthly series, and a resilient labour force report for August. The unemployment rate remained at 3.7%, however there was a 65k increase in employment, and the participation rate rose to 67%, a new record high.

While welcoming these outcomes (especially the rise in the participation rate coinciding with anther sharp rise in Australia's population- refer appendix for details), there are still numerous reasons to refute this consensus view. On the proposition that the RBA have finished tightening, it is interesting to note that the latest RBA minutes appeared in agreement, when justifying their latest pause: "*The recent flow of data was consistent with inflation returning to target within a reasonable timeframe while the cash rate remained at its present level.*"

However, the minutes also reminded us that the tightening bias is in place: "*members noted that some further tightening in policy may be required should inflation prove more persistent than expected. In assessing the need for such a move, members affirmed that they will be guided by the incoming data and how these alter the economic outlook and the assessment of risks.*"

This was Philip Lowe's last meeting as RBA governor, and Michele Bullock does appear to have sympathy to the second part of the dual mandate (in her words) to return inflation to target in a reasonable timeframe and to preserve gains in the labour market.

The risks to this outlook (and the RBA's confidence that inflation will return to target on schedule) are:

- Tight labour markets coinciding with poor labour productivity, adding to unit labour costs
- The recent rise in oil and energy prices
- The rebound in property values amid strong population growth
- The challenges in returning core services inflation to 'normal' as outlined here in previous reports.

Beyond these risks, there is a challenge in reconciling the consensus view that the RBA have finished hiking with achieving a soft landing and RBA cuts by mid next year. If we do avoid a hard landing, this will presumably coincide with resilient consumer spending, which would suggest the tightening bias will be in place for even longer. Meanwhile for the RBA to cut rates, Michele Bullock and her board will need to be convinced that inflationary risks have abated, and core inflation is back within its target band - something the RBA are not forecasting until 2025.

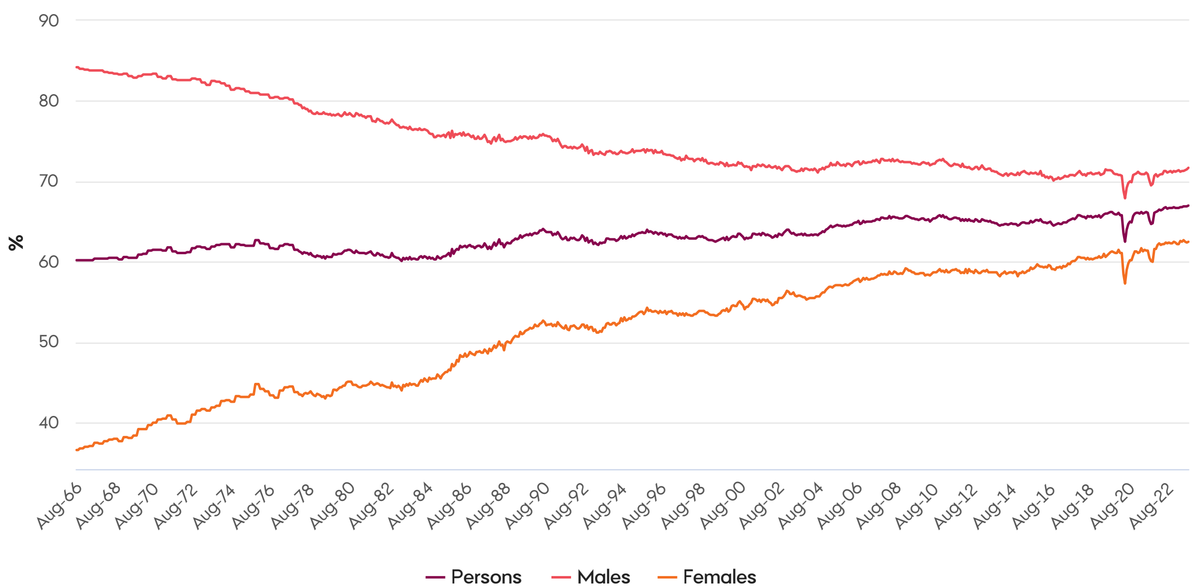
As these scenarios evolve and opinions ebb and flow, the key data to monitor will be:

- Monthly CPI on 27 September and 25 October
- Retail Trade on 28 September
- Labour Force (for September) on 19 October
- Quarterly inflation (Q3) on 25 October

The Australian Dollar remains capped at around US 65.25c, constrained by the ongoing strength of the US Dollar and the prospect that the Fed haven't finished hiking, as well as the questions around the Chinese property sector. Interest rate differentials are working against the Aussie Dollar in the short term, although the rebound in commodity prices (including iron ore) is providing some support.

The latest GDP data showed that growth is being driven by public investment and service exports, but household consumption remains very weak. Since then, the Housing Australia Future Fund has passed parliament and state governments have also committed to an uplift in housing supply. This will be a vital component in addressing our poor record on productivity, and to support population growth. As the recent Intergenerational Report highlighted, longer term standards of living can only be maintained by a balanced uplift in population, productivity and the participation rate (refer appendix).

Participation rate, Australia, August 1966 to August 2023, Seasonally adjusted



Source: Australian Bureau of Statistics, Labour Force, Australia August 2023

Interest Rate Outlook

The more patient tone from the RBA in recent statements and policy meeting minutes adds weight to the 'rates on hold with a tightening bias' view. Another hike to 4.35% remains likely, given how long it is expected to take before core inflation returns to below 3%. The timing of this hike will be data dependent (especially quarterly CPI) so the forecast below for November may be deferred to early 2024. However, 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 our base case scenario.

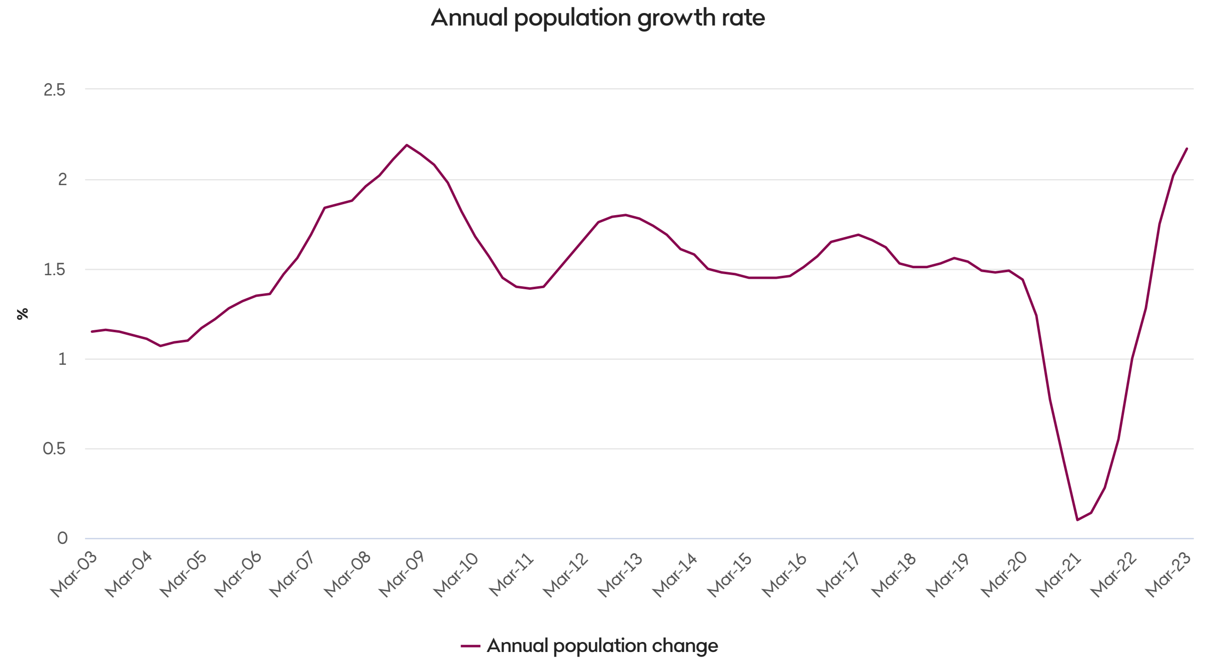
Economic Forecasts: basecase scenario

	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	3.8	4.2	4.5	4.7	5.0	5.2
CPI (q/q)	1.8	1.8	1.9	1.4	0.8	0.7	0.6	0.9	0.8	0.7	0.6
CPI (y/y)	6.1	7.3	7.8	7.0	6.0	5.1	3.8	3.3	3.0	3.0	3.0
CPI (core y/y)	5.0	6.2	6.9	6.6	5.9	4.9	3.9	3.5	3.3	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	.65	.67	.69	.71	.73	.75

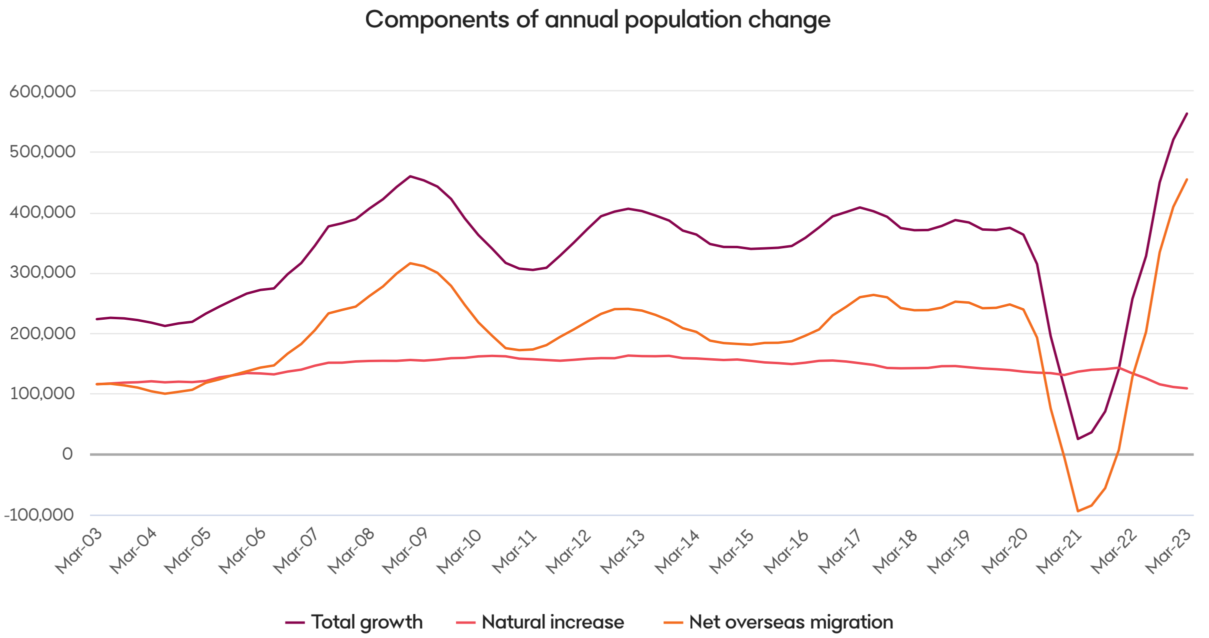
Benchmark rates

	31 / 7 / 22	31 / 7 / 2023	31 / 8 / 2023	21 / 9 / 2023
90-day bills	2.12%	4.30%	4.12%	4.14%
3-year swap	3.04%	4.25%	4.00%	4.25%
5-year swap	3.24%	4.30%	4.14%	4.40%
AUD/USD	.6990	.6720	.6485	.6410
ASX 200	6 945	7 410	7 305	7063
Credit Index (iTraxx- 5 yr)	111.3	76.2	75.0	82.0

Appendix: Population growth

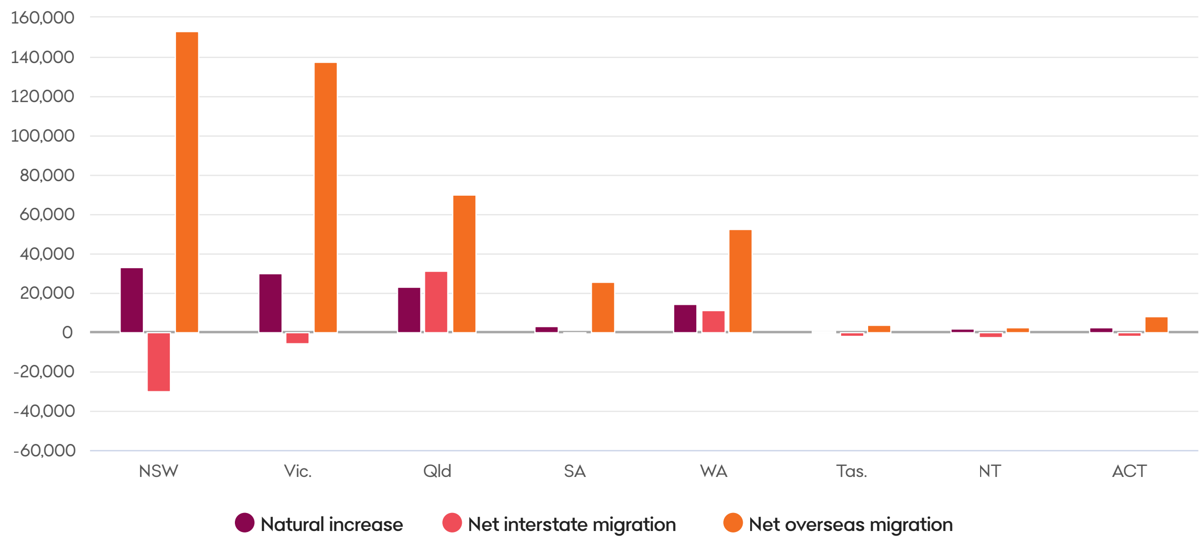


Source: Australian Bureau of Statistics, National, state and territory population March 2023



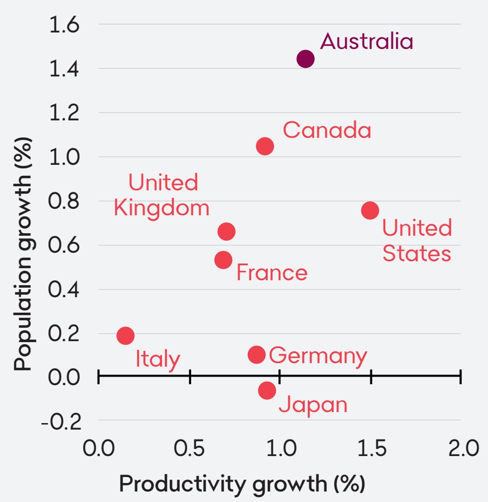
Source: Australian Bureau of Statistics, National, state and territory population March 2023

Components of annual population growth



Source: Australian Bureau of Statistics, National, state and territory population March 2023

Productivity and population growth in Australia and the G7, 20-year averages to 2021



Note: Participation rates cover ages 15 to 64.

Source: 2023 IGR