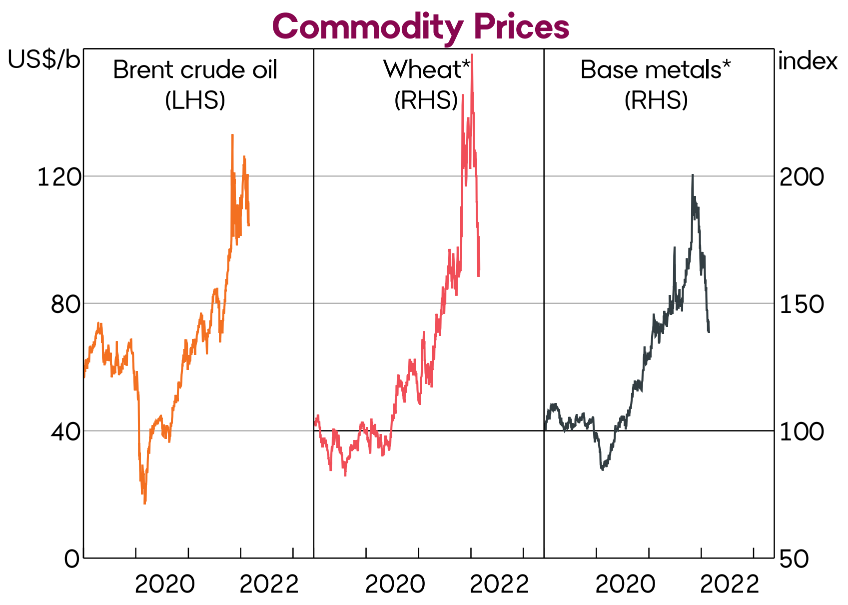
July 2022

Economic and market update

Economic Overview – as at 21st July 2022

Global markets

There is still little evidence of any easing in global inflationary pressures, so most central banks have continued to increase the size of their rate rises- including a 100-basis point hike from the Bank of Canada to 2.5%. Despite this more aggressive path bond yields have eased as the focus moves from where rates might be in six months' time to the likelihood that these countries will fall into recession by then, so much lower growth profiles ahead. Similarly, commodity prices have given up some of their gains on the prospect of lower demand but still remain elevated due to the ongoing impact of the Russian invasion of Ukraine on energy prices, adding to supply chain constraints and disruptions.



* January 2019 = 100.
Sources: Bloomberg; RBA

The sequence of rate hikes from the US Federal Reserve is 0, 25, 50 and 75; so market participants are naturally contemplating the possibility of a full one percent increase later in July; although Fed officials are strongly hinting a preference for another 75 basis points, to 2.5%. The US CPI rate is now 9.1% and their yield curve has again inverted (the two-year bond rate now 20 basis points above the ten-year) adding weight to the expectation of a US recession- the timing of the recession is more contentious than its likely occurrence. Q1 GDP contracted 1.6% but Q2 is expected to be a small gain- so a textbook recession (two consecutive quarters of contraction) is more likely to be in 2023, after the rate hikes take their toll on business investment, demand for labour and the housing market.

The euro-zone remains in the highly challenging position of having to deal with its dependence on Russian gas and the inflationary impact of higher energy costs, while at the same time trying to impose more sanctions in support of Ukraine. The European Central Bank are set to increase official rates this week for the first time since 2011, but the euro has briefly fallen below parity with the US Dollar as EU growth projections are again slashed (now down to 1.4% for 2022). This is all coinciding with strains in European bond markets; 'fragmentation risks' not helped by Italian PM Mario Draghi offering to resign, and ten-year Italian bond yields trading around 2% higher than German Bunds. The outlook in the UK is also clouded by the resignation of Boris Johnson (his successor will either be Liz Truss or Rishi Sunak, but won't be known until 5 September) and UK CPI is now running at 9.4%.

The latest data from China showed a sharp contraction in Q2 in line with the aggressive COVID lockdowns but an uptick in activity in June. Achieving the stated aim of 5.5% growth for 2022 appears well out of reach, although official numbers will probably be flattering. Stimulus measures continue to be implemented (including allowing local government to sell 'special bonds') however the Chinese property sector remains troubled and there appear to be renewed concerns around construction delays and heavily indebted developers. The strict zero-COVID strategy is adding to uncertainty of the viability of a sustainable recovery, but the consensus for Q3 GDP is at least a 10% rebound quarter on quarter.

In summary the global economy faces risks skewed to the downside driven by falling demand as financial conditions become more restrictive, while dealing with sharply higher energy and food costs. There are hopes that global supply chain bottlenecks will gradually improve, and fiscal policy remains supportive alongside resilient consumer spending and demand for labour. However the era of benign inflation and interest rates at their floor is behind us, at least in the short term, and probably for many years. Risk appetite has improved a little over the last fortnight as these risks are weighed up and as the US corporate earnings season starts (with some notable upside surprises).

Domestic economy

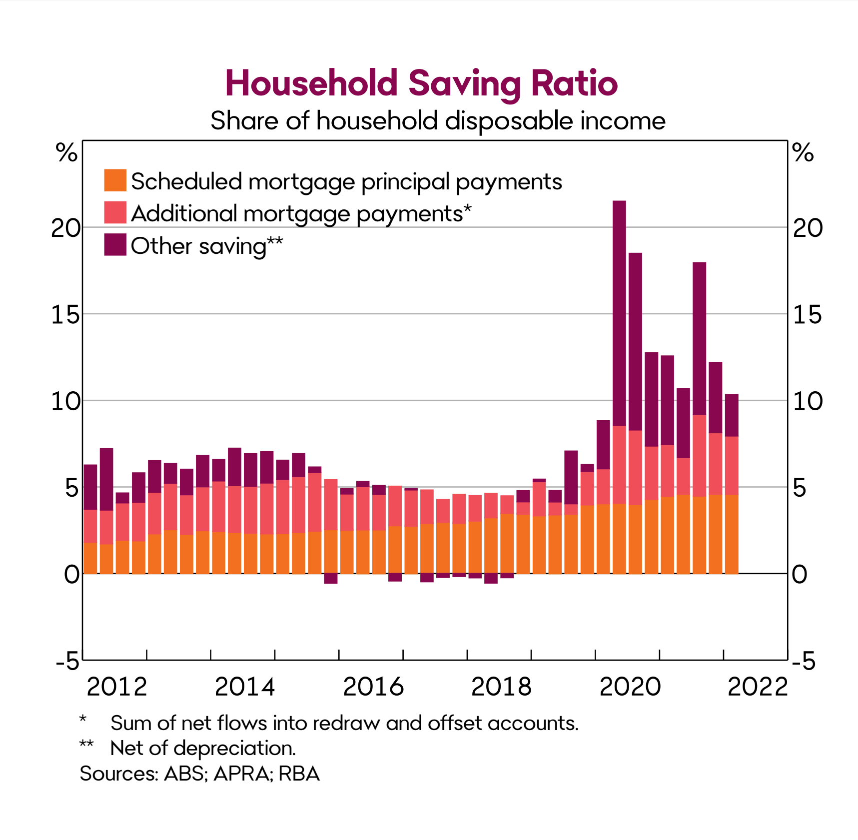
The latest RBA minutes from their Monetary Policy Meeting and speeches this week from Phillip Lowe and Michele Bullock all point to the risk of larger rate hikes in the months ahead, but also some reassurance that the aim is to temper demand to manage inflation without damaging the jobs market. Estimates of the 'neutral real interest rate' for Australia featured in all of these RBA publications, although seemed to vary depending on the author. The minutes stated "the neutral rate is challenging in practice because it cannot be directly observed and must instead be inferred from the data." However, Deputy Governor Bullock commented that "the neutral real rate was 0.5 – 1.5%" (i.e. a nominal rate of around 3.5%), while in Q & A Governor Lowe said the neutral rate could be as low as 2.5%.

Perhaps the most telling part of these minutes and speeches was Bullock's reference to a 300-basis point increase in variable rate mortgages "broadly informed by recent market-pricing to mid-2023". The fact that the RBA modelled their analysis on this assumption appeared to confirm the market is on the right track. The speech was comforting in suggesting that households would on balance cope with a three percent increase in interest rates, despite noting that recent borrowers would be more susceptible, and it made the case that:

- Household savings have risen sharply, providing large liquidity buffers **(refer chart next page)**
- These buffers included significant flows into offset and redraw accounts, making the household 'credit to income' ratio stable to lower over the last decade **(refer appendix)**
- The sizeable increases in property prices over recent years (including during the pandemic) have greatly reduced the proportion of high LVR borrowers, and modelling a 10 – 20% fall in house values still left the LVR distribution in a stronger position than pre-pandemic
- Around one third of variable rate borrowers are already making average monthly loan repayments that would cover a 300 basis point rate rise scenario
- Roughly 1/3 of households have a mortgage (1/3 own outright and 1/3 rent) and of those with a mortgage around 40 % are currently fixed: the fourth chart in the appendix shows the run-off rate, with the peak in fixed-rate loans expiring in the second half of 2023.

The conclusions of the speeches could best be summarised as:

- The RBA have more work to do in normalising monetary policy, and want to get to a neutral rate quickly.
- Their best estimate of a neutral (nominal) cash rate is around 3 to 3.5% with some caveats attached.
- They want a 'credible path' to returning core inflation to 2 to 3% to ensure inflation expectations do not become unanchored, but they are committed to achieving a soft-landing (and they believe that 3% in cumulative rate hikes will be tolerable for households).



Against this backdrop of tightening monetary policy and the global energy and inflation shock, the jobs market continues to perform very strongly, with unemployment down to 3.5% in June and another 88k jobs added to 13.6 m (vs 13.0 m in March 2020). There are now 494,000 unemployed people and 480,000 job vacancies, so demand for labour is as tight as ever and labour shortages the primary theme. Unemployment will likely edge lower from here but may not be sustainable in the threes as the economy slows- refer Economic Forecasts table below, with the basecase scenario of Australia's economy slowing but (unlike much of Europe and North America) narrowly avoiding recession.

Consumer confidence is still languishing with the WBC MI monthly survey down to 83.8 (30% below its April 2021 peak). However retail sales data shows that consumers are still spending (23% above pre-pandemic levels) and business confidence is holding up at +1 in the June survey- business conditions impressively at +13. Businesses are still employing (or trying to) and capacity utilisation is near record highs, while forward orders remain strong even in the face of rising costs. How demand for labour performs next year as higher interest rates slow the economy will be dependent in part on how quickly access to migrant workers and international students return, to support sustainable business investment. The impending Jobs and Skills Summit in September will be crucial for medium term labour productivity.

The next inflation data to be released 27 July will be important for RBA monetary policy decisions over the next few months, although is unlikely to surprise on the downside- more likely it will show our CPI and core inflation matching the path of other comparable economies and testing the RBA as to whether they chose 50 or 75 basis points for the August hike. 50 appears a much more likely outcome for now, after which the increments may be pared back to 0.25% before a December plateau.

Interest Rate Outlook

The tightening cycle has accelerated with the RBA moving to frontload rate hikes. Based on the latest RBA comments including their estimate of a 'neutral cash rate' and the pace of rate hikes in other countries, the likely path from here is another 0.5% in August (to 1.85%) then followed by 0.25% in September, October and November, i.e. a cash rate of 2.6%. A pause at this level would give the RBA the opportunity to review the impact in early to mid-2023, but further hikes in 2023 can't be ruled out. There is a risk of a 75 basis point hike in August; CPI data on 27 July will be important for this.

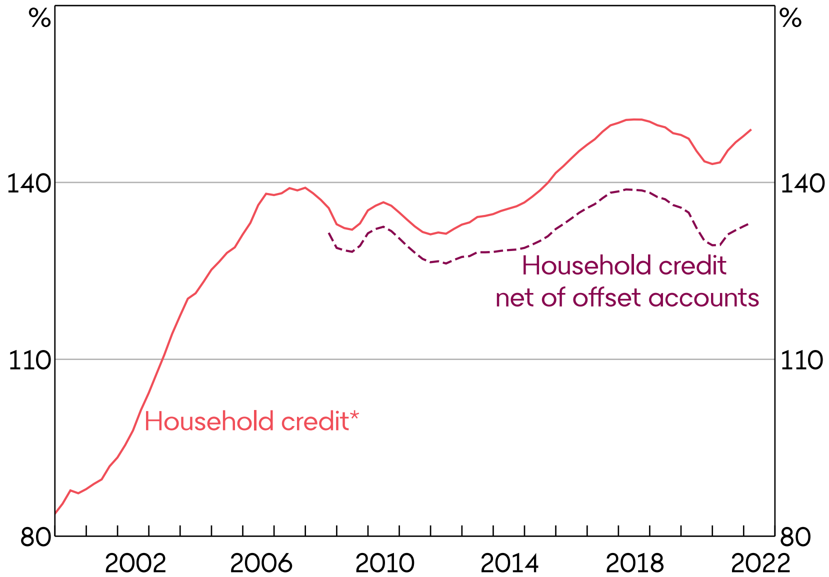
	31 / 5 / 21	31 / 5 / 2022	30 / 6 / 2022	21 / 7 / 2022
90-day bills	0.04%	1.18%	1.81%	2.22%
3-year swap	0.39%	3.16%	3.66%	3.62%
5-year swap	0.91%	3.47%	4.02%	3.85%
AUD/USD	.7730	.7175	.6905	.6910
ASX 200	7 162	7 211	6 568	6 767
Credit Index (iTraxx- 5 yr)	60	94.7	126	129

Economic Forecasts: basecase scenario

	2021	2022				2023			
% (actual, forecast)	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
GDP q/q	3.6	0.8	1.4	0.8	0.8	0.4	0.3	0.4	0.6
GDP y/y	4.4	3.3	4.0	6.6	3.8	3.4	3.2	1.9	1.7
Unemployment	4.2	4.0	3.5	3.4	3.3	3.5	3.8	4.0	4.2
CPI (q/q)	1.3	2.1	1.7	1.0	2.0	1.1	0.7	0.6	0.6
CPI (y/y)	3.5	5.1	6.0	6.0	6.8	5.8	4.8	4.4	3.0
CPI (core y/y)	2.6	3.7	4.6	5.0	5.0	4.5	3.8	3.5	3.2
RBA cash rate	0.1	0.1	0.85	2.1	2.6	2.85	3.0	3.25	3.25
AUD / USD	.7270	.7485	.6905	.72	.74	.76	.78	.79	.80

Appendix:
The impact of higher interest rates on Australian households

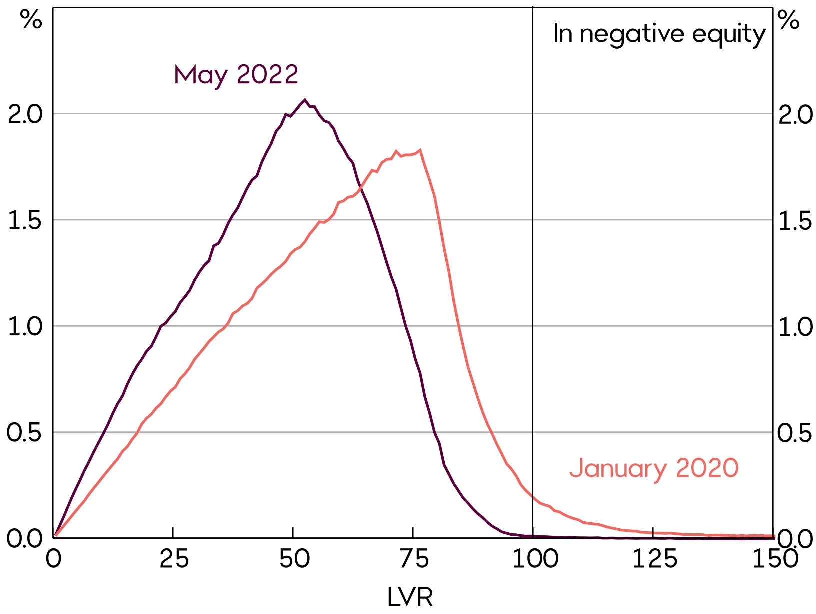
Household Credit-to-income Ratio



* Sum of housing credit and personal credit; housing credit is net of redraw balances.
Sources: ABS; RBA

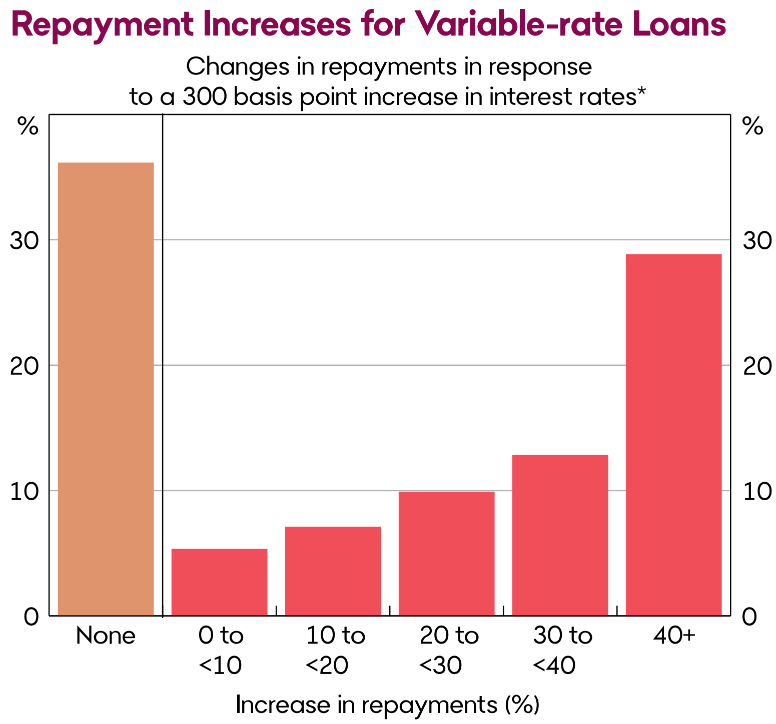
Outstanding LVR Distribution*

Share of balances



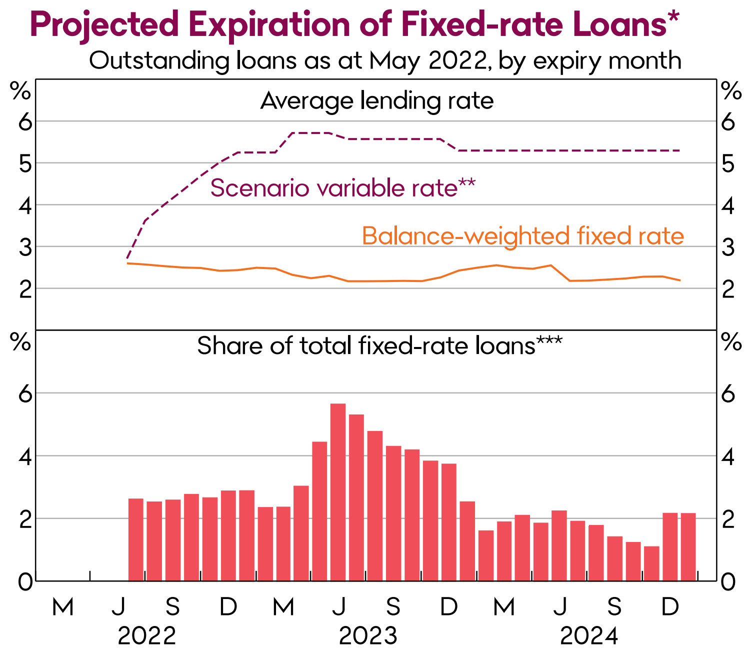
* Loan balances adjusted for redraw and offset account balances; property prices estimated using SA3 price indicies.
Sources: ABS; Core Logic; RBA; Securitisation System

Repayment Increases for Variable-rate Loans



* Changes between new required repayments and average monthly payments over the past year; share of variable-rate loans (excluding split loans) as at May 2022.
Sources: RBA; Securitisation System

Projected Expiration of Fixed-rate Loans*



* Assumes fixed-rate loans are not repaid early or refinanced.
** Assumes future variable rates increase by 300 basis points to mid-2023; timing of rate increases broadly informed by market expectations.
*** Another 13 per cent of fixed-rate loans will expire beyond 2024.
Sources: RBA; Securitisation System