May 2024

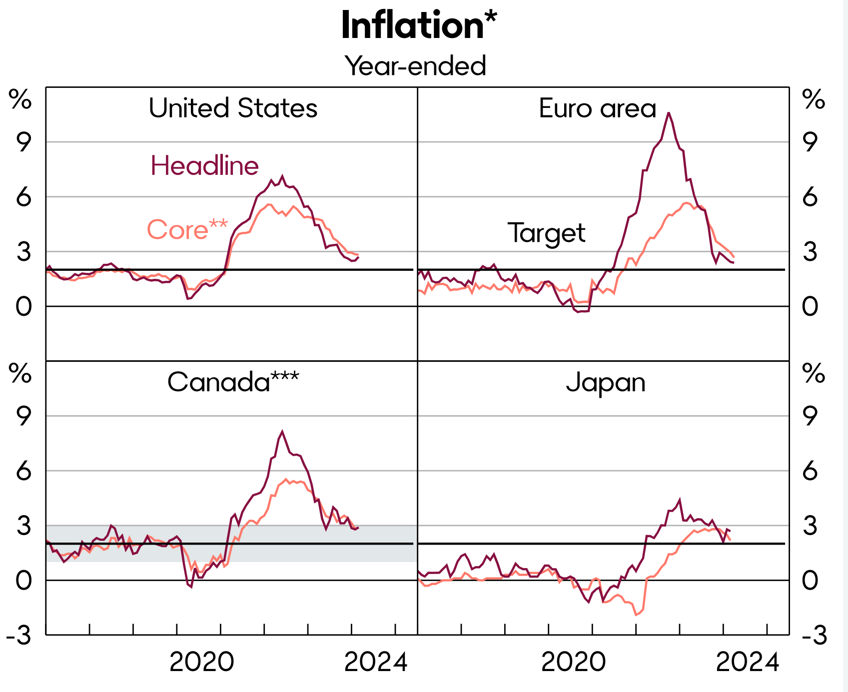
Economic and market update

Economic Overview – as at 22nd May 2024

Global markets

The transition from tightening cycles to easing cycles continues to dominate global financial markets but with a wide range of timelines, and with other factors (detailed below) helping stock markets. North Atlantic central banks are soon expected to embark on rate cuts (the Swiss and Swedish easing cycles already underway) with the ECB and Bank of Canada now expected to lead the charge in June, followed by the Bank of England closer to August, ahead of the US Federal Reserve. Markets continue to ebb and flow on the precise timing, but progress on lowering inflation has been pleasing.

The posting of fresh record highs for US equities has coincided with renewed confidence that the Fed will cut rates twice this year (starting around September), but has also been driven by AI exuberance and related earnings expectations. The fact that US economic data has been on the soft side has only added to rate cut expectations rather than fears of a harder landing, and the contrast between tight monetary policy versus supportive fiscal policy complicates the outlook. In the May FOMC policy meeting, Chair Powell highlighted the need for more evidence of moderating inflation but the subsequent core inflation and PCE data appeared sufficiently progressive to drive markets higher.



*   PCE for the United States, CPI for others.
**   Core is headline inflation excluding food and energy.
***   Shaded area represents target range for inflation.
Sources: LSEG; RBA.

The Bank of Canada are now favoured to initiate their easing cycle on 5 June after CPI fell to 2.7% in April and after slowing wages growth, sluggish GDP and unemployment rising to 6.1%. This timing would be one day prior to the European Central Bank, where the latest inflation data was unchanged at 2.4% - low enough to deliver the promised first cut on 6 June, but further progress on core inflation (currently 2.7%) will be needed to extend this to a string of ECB cuts.

Japan's economy contracted in Q1 by 0.5% based on the preliminary data from the Cabinet Office, with consumption and capex disappointing, suggesting the first hike in their new cycle will not be followed by another quickly. Weakness in the Yen, which softened to 160 against the USD for the first time since 1990, and the largest wage hikes since then, have added to expectations of further policy tightening. More broadly the Japanese economy is expected to benefit from improved household consumption and nominal GDP is growing at its fastest pace in four decades.

Announcements late last week from Chinese authorities supporting their property market were welcomed by markets in the region, with the iron ore price rising back above US$120/tn and Chinese/Hong Kong equities hitting their highest level in 9 months. The measures included debt for State Owned Enterprises to acquire unsold properties (much for affordable housing) and lowering the minimum deposit required. While some were disappointed by the size of the overall package, it should help China to get near its 5% aspirational growth target, although weak retail sales data suggest that further rate cuts and infrastructure investment is still going to be required.

In summary, the complex geopolitical backdrop and imprecise timing of easing cycles, together with recession-like conditions, all suggests sub-trend global growth this year, but steady progress on moderating inflation has kept hopes high for a stronger 2025. Equity markets are pricing in rate cuts in most advanced economies, and the recent record highs for gold and copper point to resilient demand.

Domestic economy

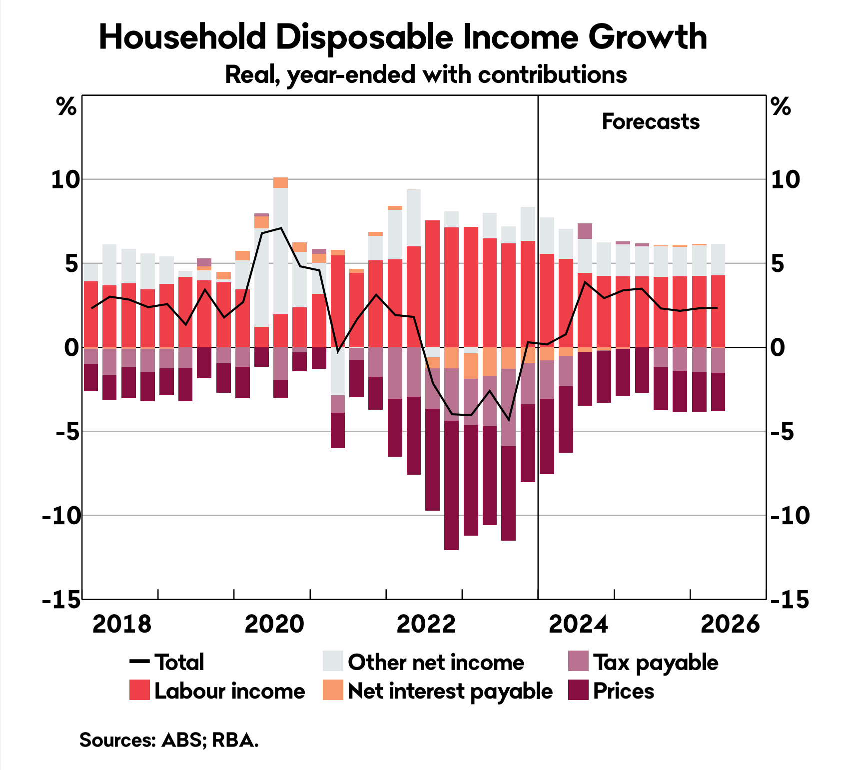
The Australian economy continues to decelerate in aggregate and is contracting in per-capita terms suggesting that official rate cuts will be needed, but slower progress than hoped for inflation and relatively tight labour markets will limit the ability of the RBA to ease policy. For most of the year markets had priced RBA cuts in September and November (if not earlier), but the fall in unemployment in March to 3.8%, together with the first quarter CPI data saw a sharp movement higher for bond yields, and the first cut pushed back to 2025 (matching our forecasts throughout this year).

Indeed a number of market participants suddenly argued that the RBA will need to tighten policy further given the lack of progress on inflation; and while another hike is clearly still possible the recent Federal Budget announcements, global trends detailed above, and then weaker domestic data have left us today with a remarkably flat yield curve. With cash at 4.35%, the 90-day bill rate at 4.34%, and swap rates from one year out to 20 years all between 4.1 to 4.6%, the market doesn't have conviction for significant moves in any direction – although flat yield curves tend to have short life spans.

The Federal Budget (refer summary here) included forecasts and assumptions that were to some degree at odds with the May RBA Statement on Monetary Policy, especially CPI to fall to 2.75% by June 2025 (vs RBA 3.2%). The revamped stage 3 tax cuts have been priced into markets and growth/ CPI forecasts for months (notwithstanding the debate as to how much of this $20 bn lift in household income will be saved vs spent) – but the $300 electricity rebates for every household and eligible small businesses will have a dual impact on inflation: mechanically lowering CPI via the contribution from utilities, but potentially adding to demand together with the tax cuts.

More importantly for the RBA, core CPI won't benefit to the same extent - and adding to the 'rates on hold for 2024' outlined in the basecase scenario below, presumably the RBA will need time and evidence to see how this plays out. The budget is in surplus for FY24 (helped by the Iron Ore price assumed to be US$60/tn) and strong labour markets lifting income tax receipts, so it was pleasing this windfall wasn't spent indiscriminately in the name of 'cost of living support'.

The primary headwind to household incomes is prices (i.e. inflation) as the following chart shows, so in addressing the problem of cost of living, the solution needs to eliminate inflation, not add to it. The second largest factor in household disposable income contracting is 'tax payable' which has been driven by bracket creep and low unemployment. So the stage 3 tax cuts are welcome in this respect, but with ever widening deficits ahead given necessary spending on NDIS, defence and the transition to net zero etc, the budget's lack of focus on meaningful tax reform as argued by the Productivity Commission and others is disappointing.



The improvement in household income evident in the chart above will be driven by the tax cuts in the first instance, then in a smaller drag from prices/ inflation, and thirdly rate cuts that can be delivered next year if the RBA has confidence that inflation is in check. The May RBA SOMP and the related press conference and minutes from the policy meeting, all suggest that the RBA considered another rate hike but importantly preferred not to, coming to the conclusion that they have tightened rates sufficiently with Governor Bullock stating the board 'believes we have rates at the right level'. Since this meeting we have had the federal budget and some mixed economic data including the April labour force, where:

- Unemployment rose to 4.1% (s.a.) from an upwardly revised 3.9%
- The participation rate rose to 66.7%
- Employment rose by 38k, but unemployment rose by 30k
- Hours worked were flat (-0.8% y/y)
- As we saw in January, an unusual rise in people that had a job but were yet to start it.

All a mixed bag, but generally on the weak side and not adding any weight to the argument for additional RBA hikes.

House prices rose again in April, up 0.7% m/m with the strongest gains in Perth, Brisbane and Adelaide. The appendix shows a number of charts from a recent RBA speech on the topic of housing supply and demand, which explain the ongoing surge in prices. They are also relevant to the budget (which identified opportunities to lift supply - while the opposition reply suggested limiting migration as a handbrake on demand), and also relevant to inflation given the housing shortages are continuing to feed into inflation via rents and the cost of building new dwellings. The market consensus for property prices is around a 5% increase on average this year, but any acceleration in supply (and assuming rate cuts aren't likely before November at the earliest, and more likely in February) may see this number closer to 4% - especially dragged down by slower growth in NSW and Victoria.

Interest Rate Outlook

The RBA Official Cash Rate is most likely at its cycle peak at 4.35%. Rates are expected to be on hold for most of 2024. A longer cycle (into 2025) as core inflation persists above 3% is still the basecase scenario outlined below, while other advanced economies are much closer to their easing cycles with many commencing around mid-2024. Earlier RBA cuts are still possible but would require faster progress with inflation than forecast, and/or a much sharper slowdown for our economy.

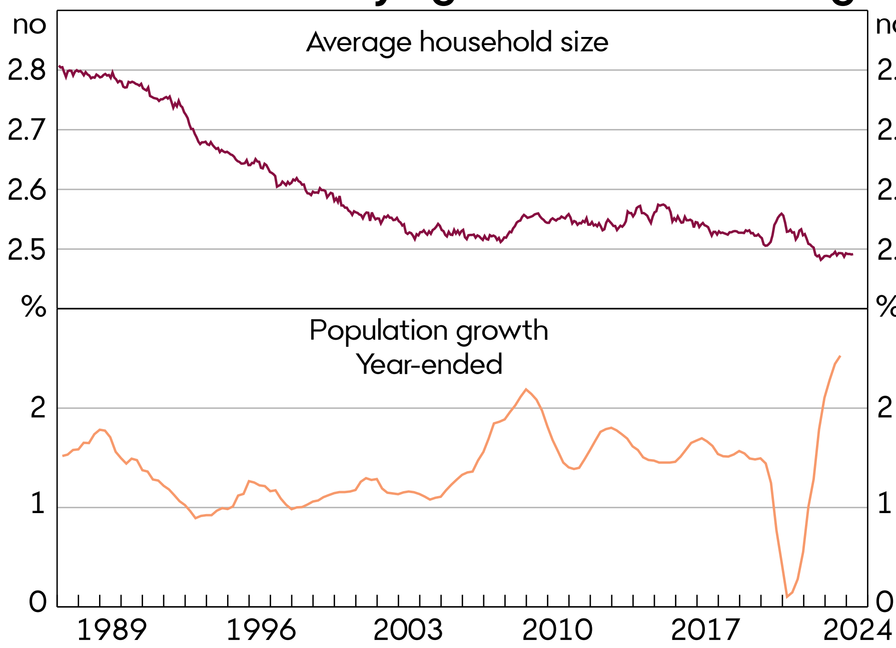
Economic Forecasts: basecase scenario

	2023				2024				2025		
% (actual, forecast)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q4
GDP q/q	0.5	0.5	0.3	0.2	0.2	0.1	0.4	0.4	0.5	0.6	0.6
GDP y/y	2.4	2.1	2.1	1.5	1.2	0.8	0.9	1.1	1.4	1.9	2.4
Unemployment	3.5	3.5	3.5	3.6	3.9	4.2	4.4	4.7	4.8	4.9	5.2
CPI (q/q)	1.4	0.8	1.2	0.6	1.0	0.8	0.8	0.5	0.9	0.8	0.6
CPI (y/y)	7.0	6.0	5.4	4.1	3.6	3.6	3.2	3.1	3.0	3.0	2.9
CPI (core y/y)	6.6	5.9	5.2	4.2	4.0	3.7	3.3	3.2	3.1	3.0	2.9
RBA cash rate	3.6	4.1	4.10	4.35	4.35	4.35	4.35	4.35	3.85	3.60	3.1
AUD / USD	.669	.666	.6435	.682	.6515	.67	.69	.73	.74	.75	.77

Benchmark rates

	31 / 3 / 2023	31 / 3 / 2024	30 / 4 / 2024	22 / 5 / 2024
90-day bills	3.70%	4.34%	4.41%	4.34%
3-year swap	3.43%	3.81%	4.25%	4.05%
5-year swap	3.62%	3.96%	4.42%	4.20%
AUD/USD	.6690	.6515	.6475	.6670
ASX 200	7 178	7 897	7 664	7 872
Credit Index (iTraxx- 5 yr)	92.0	65.2	71.7	63.2

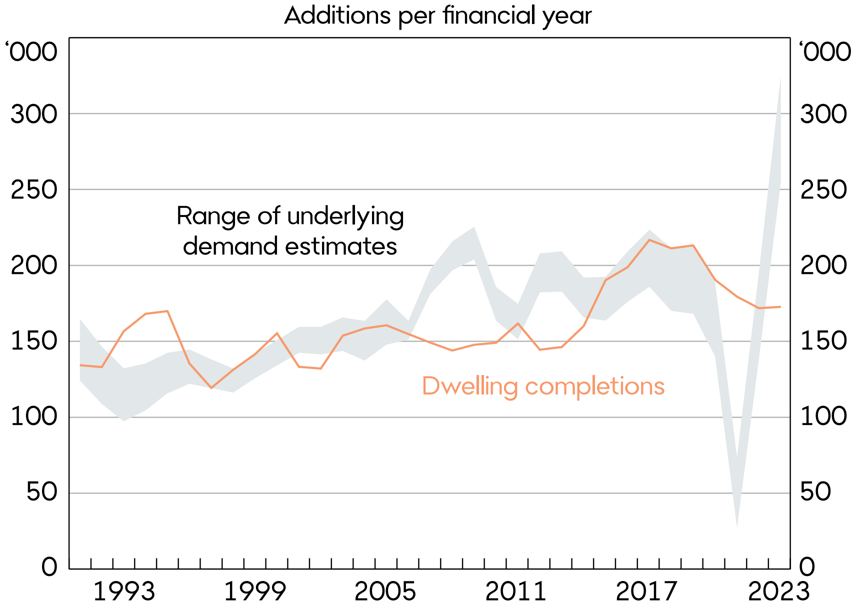
Drivers of Underlying Demand for Housing



Sources: ABS; RBA.

Underlying Demand and Supply

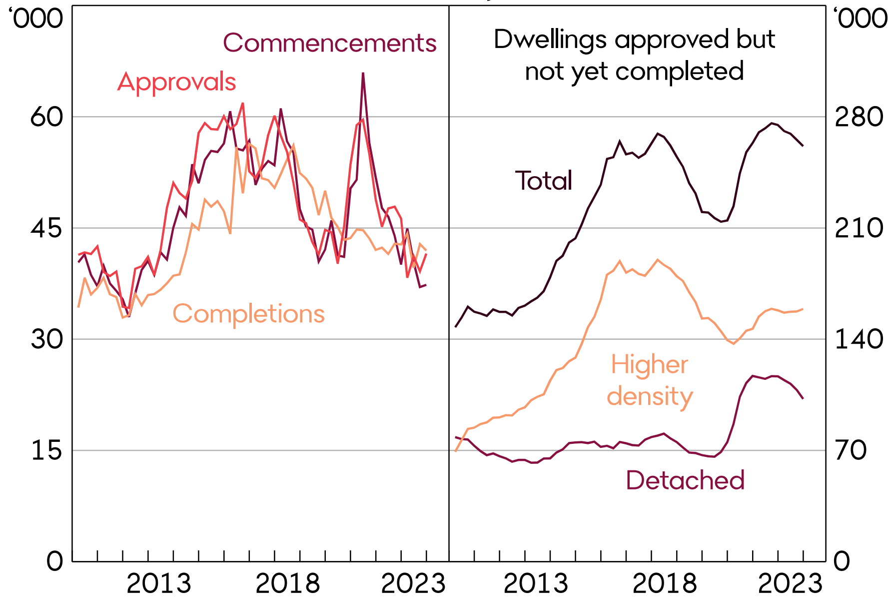
Additions per financial year



Sources: ABS; RBA

Residential Pipeline

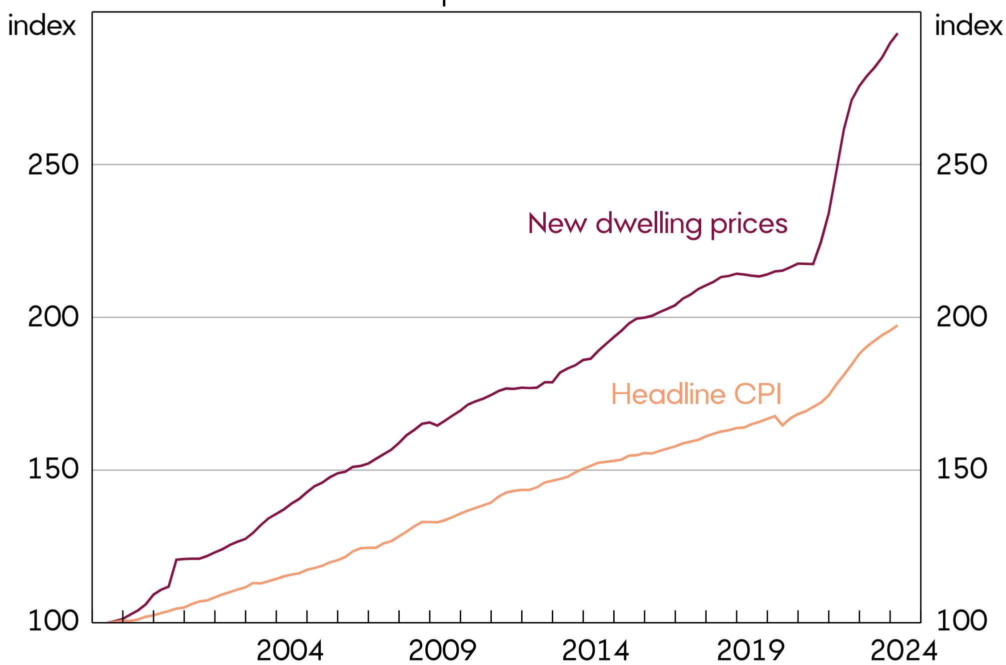
Quarterly



Sources: ABS; RBA.

New Dwelling Prices

June quarter 1998 = 100



Sources: ABS; RBA.