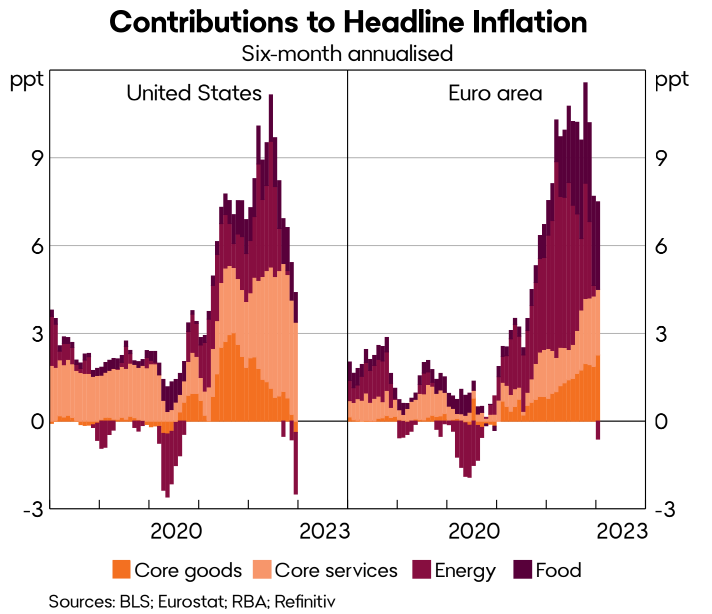
Economic and market update

Economic Overview – as at 22nd February 2023

The more optimistic tone from January, driven by the benefits of China reopening and hopes for inflation receding, have given way to a recognition of more persistent global inflationary pressures. This 'higher for longer' scenario for rates has also doused most expectations of earlier peaks in rates and the timing of central bank rate cuts, reflecting evidence of resilient economic activity despite tighter policy, with stronger than expected jobs and activity data. However, these higher peaks in rates are probably just deferring inevitable recessions; despite inflation having clearly peaked in most countries, with a rotation of inflationary pressures from goods, food, and energy, to 'services inflation'.



The US experience is a clear example of this deferral of expected recession timing - so while housing and manufacturing sectors continue to struggle, the jobs market and consumer spending is showing remarkable resilience. US unemployment fell to 3.4%, its lowest level since 1968 with 517 000 jobs added in January - hardly consistent with a recession, despite some recent high profile job lay-off announcements. Retail and motor vehicle sales rebounded impressively in January, so with the latest jump in PMI surveys the economy is still running too strongly for the Federal Reserve, suggesting two more hikes in the Fed funds rate to above 5%. Subsequent rate cuts have been pushed back to later in 2024, hence the US ten-year bond yield is back up to almost 4%, its highest level since September.

Similarly in the euro-zone the services sector has outperformed, helping the composite PMI up to a 9-month high of 52.3 (where 50 is neutral), with relief that lower energy prices and improved supply chains have lifted manufacturing output. However, inflation in the service sector is expected to be stubborn, and the latest upgrade of GDP forecasts to 0.9% for 2023 suggest the ECB will need to extend rate hikes (already up 3% since July) by another 0.75% in the coming months. The UK economy was flat in the fourth quarter of '22 (after a 0.2% contraction in Q3) – so avoiding technical recession, and like elsewhere enjoying a rebound in the services sector. UK inflation stood at 10.1% in January, but core inflation slowed to 5.8%. Another BoE hike to 4.25% appears likely, even as inflation begins to decelerate and on the cusp of an expected four-quarter recession in 2023.

Data from China has been sparse over the last fortnight with the normal trade data deferred to March due to Lunar New Year holidays. The only highlights being a jump in overseas travel after the lifting of restrictions, and new home sales finally picking up thanks to ongoing policy support and the reopening of the economy. The Caixin manufacturing PMI survey was slightly lower than expected despite the pick-up in services activity, although new orders rose and supply chain problems appear to be slowly easing. Official lending rates were left unchanged in February, but aggressive growth targets for the year suggest PBOC rate cuts are likely, to lift demand and household consumption.

In summary, despite resilience in a range of advanced economies, especially in labour markets, the growth outlook for 2023 remains weak, even with some recession forecasts being deferred. Policy expectations continue to evolve but are typically implying later peaks in rates with even more distant easing cycles. Equity markets continue to assess the short-term respite of domestic demand holding up, versus the implications that this has for elevated inflation and longer tightening cycles.

Domestic economy

The minutes from the February RBA policy meeting left little doubt regarding the prioritisation of the RBA board in dealing with inflation ahead of everything else (including a soft landing) - although they did retain an aspiration to keep the economy 'on an even keel'. Their recognition of the increasingly narrow path to achieving these dual aims is sobering, and there was an acknowledgement that they may overshoot on policy tightening. However, there was probably also a deliberate emphasis of their resolve to manage inflation and thereby keep inflation expectations anchored. This could quite effectively maintain the tightening bias even while a plateau in rates emerges, putting consumers and businesses on notice that further hikes are in play, without actually needing to deploy them.

Nevertheless, the market is convinced we will see at least two more hikes, and March now appears very likely with a subsequent rise to 3.85% expected by May. Some forecasts (and the overnight index swap implied curve) extend the tightening cycle above four percent, however this is not a given.

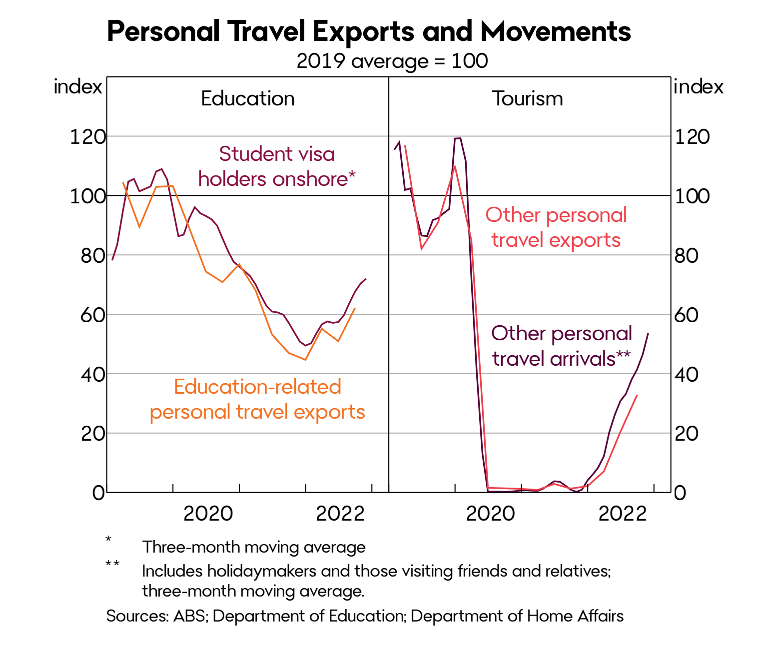
Evidence that inflation has peaked should be clear in the first quarter CPI to be released on 26 April, but ahead of this key data we should already have some helpful data points with

- January retail trade estimates to be released on 28 February (after the fall in December)
- February labour force data on 16 March (after the recent rise in unemployment to 3.7%, as detailed below)
- Monthly inflation data on 1 March and 29 March...albeit this monthly series is in its infancy

None of this data is likely to dissuade the RBA from hiking official rates to 3.6% in March based on the forecasts and messaging in the latest Statement on Monetary Policy (SOMP), nor Philip Lowe's comments in recent parliamentary testimonies. However the rise in the unemployment rate in January, together with lower than expected rise in the Wage Price Index, leaves a pause in April very much in play. The RBA have rightly expressed concerns that a sharp rise in the WPI could feed into an inflation spiral, as was the case in the 1970's and 80's inflation shocks; so the lower than forecast outcome of 0.8% growth in wages for the quarter, and 3.3% over the year, must leave the door open for an overdue pause. This would buy time ahead of the first quarter CPI data and would shorten the odds of a softer landing - and maintaining the tightening bias with ongoing verbal intervention can do some of the heavy lifting ahead rather than excessive blunt rate hikes.

The fall in employment (and rise in unemployment) in January was a surprise for the market given most market participants expected a pay-back from the unexpected fall in December. There remains some scepticism that labour markets have really lost this many jobs (with some theories that there is a pool of people 'waiting to work' that aren't counted in this data). The counter view is we have seen a fall in job vacancies and job advertisements coinciding with a welcome return to net migration and a lift in international students and working visas, so an easing in tight labour markets. As argued in last month's report, we continue to expect a rising unemployment rate in 2023 as the economy slows and as monetary policy bites (refer basecase forecasts below) - and it was perplexing to see the RBA continue to forecast an unemployment rate still in the 'threes' until mid-2024 in SOMP forecasts.

The opposing forces for the domestic economy are still expected to be a positive rebound in service exports, including tourism and education supported by China reopening and post-pandemic consumer preferences, versus the obvious challenges of rising interest rates suppressing domestic demand and weighing on the housing sector.



The recent policy announcement from Chinese authorities that international study must occur in-person on-campus should see a more rapid return to pre-pandemic levels of student numbers. The latest forecasts for an increase of net migration to 235k in FY23 will complement the rebound in tourism. This demand will be vital given consumer spending will fall sharply under the weight of RBA rate hikes: refer appendix for more details.

Over and above service exports, there is also ongoing demand for our iron ore, coal, and other resources. Beyond the focus on the strong trade surplus in this data, it was interesting to see the fall in freight costs and other evidence of improvements in global supply chains - adding to expectations that the worst of elevated import costs (and imported inflation) is behind us.

Considering these primary drivers of the economy the three most plausible scenarios are:

1) As outlined in the basecase forecasts below, a much slower economy in 2023 with growth only around 1%, rising unemployment and stubborn inflation: with two RBA hikes expected.

2) A downside scenario of a harder landing potentially due to the RBA overshooting on monetary policy to above 4%, driving a deeper fall in property values, employment, and GDP.

3) A (less likely) upside scenario of a resilient economy shrugging off rate hikes with still tight labour markets and ongoing household demand, meaning an even softer landing, but ultimately more RBA rate hikes, as inflation fails to moderate.

The first of these scenarios is favoured given the likely offsetting of the opposing forces detailed above: strong offshore demand from our major trade partners versus constrained domestic demand.

Interest Rate Outlook

The RBA added to expectations of impending rate hikes with numerous references to 'further increases in interest rates'. This suggests that a March hike to 3.6% is highly likely, although we remain close to a peak or plateau in official rates. Inflation is very likely to have peaked late last year and should fall steadily thorough '23. However the pace of this normalisation is difficult to anticipate and will be crucial to RBA policy. A plateau in cash rates at (or below) 3.85% by May is the favoured basecase, which would enhance a soft-landing scenario, while hikes into the 4's risk a harder landing.

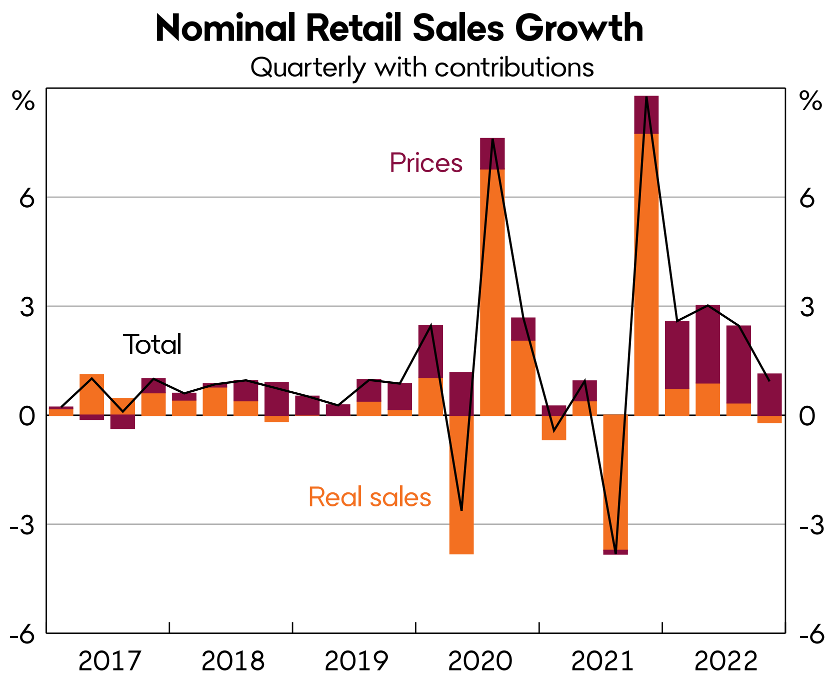
Interest Rate Outlook

	31 / 12 / 21	31 / 12 / 2022	31 / 1 / 2023	22 / 02 / 2023
90-day bills	0.11%	3.29%	3.37%	3.52%
3-year swap	1.28%	3.99%	3.62%	4.00%
5-year swap	1.66%	4.25%	3.82%	4.16%
AUD/USD	.7270	.6815	.7050	.6835
ASX 200	7 445	7 039	7 477	7 315
Credit Index (iTraxx- 5 yr)	71.1	94	80.3	88.6

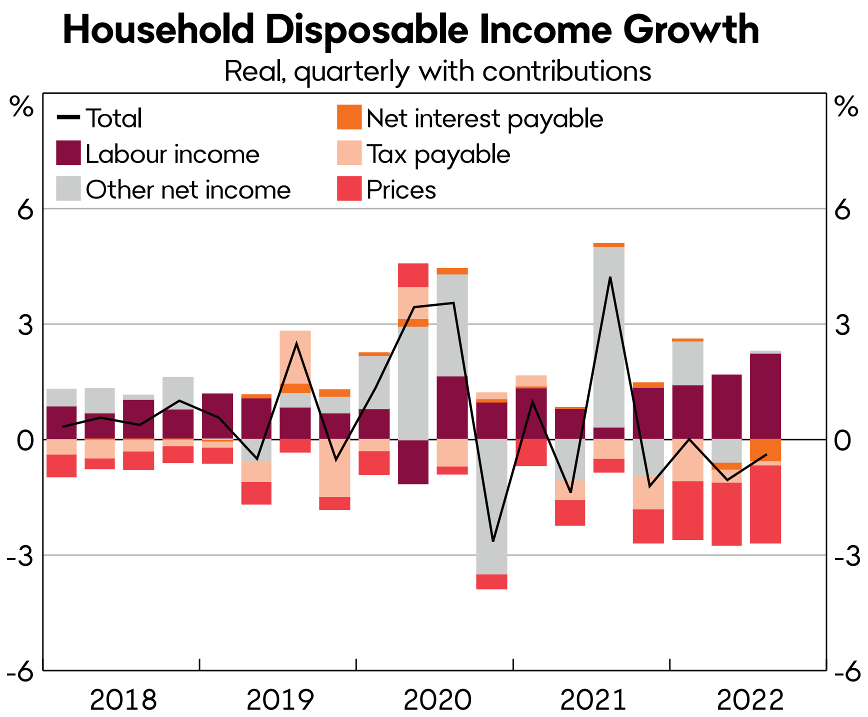
Economic Forecasts: basecase scenario

	2021	2022				2023				2024	
% (actual, forecast)	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP q/q	3.8	0.4	0.9	0.6	0.8	0.3	0.2	0.2	0.3	0.4	0.5
GDP y/y	4.6	2.9	3.2	5.9	2.8	2.6	1.9	1.5	1.0	1.3	1.4
Unemployment	4.2	4.0	3.6	3.6	3.5	3.6	3.9	4.2	4.5	4.7	4.9
CPI (q/q)	1.3	2.1	1.8	1.8	1.8	1.2	0.8	0.7	0.6	0.8	0.8
CPI (y/y)	3.5	5.1	6.1	7.3	7.8	6.6	5.6	4.5	3.3	2.9	2.9
CPI (core y/y)	2.6	3.7	4.9	6.1	6.9	6.2	5.4	4.5	3.6	3.4	3.3
RBA cash rate	0.1	0.1	0.85	2.35	3.1	3.6	3.85	3.85	3.85	3.85	3.85
AUD / USD	.7270	.7485	.6905	.6410	.6815	.69	.71	.73	.75	.76	.77

Appendix: Household spending and demand



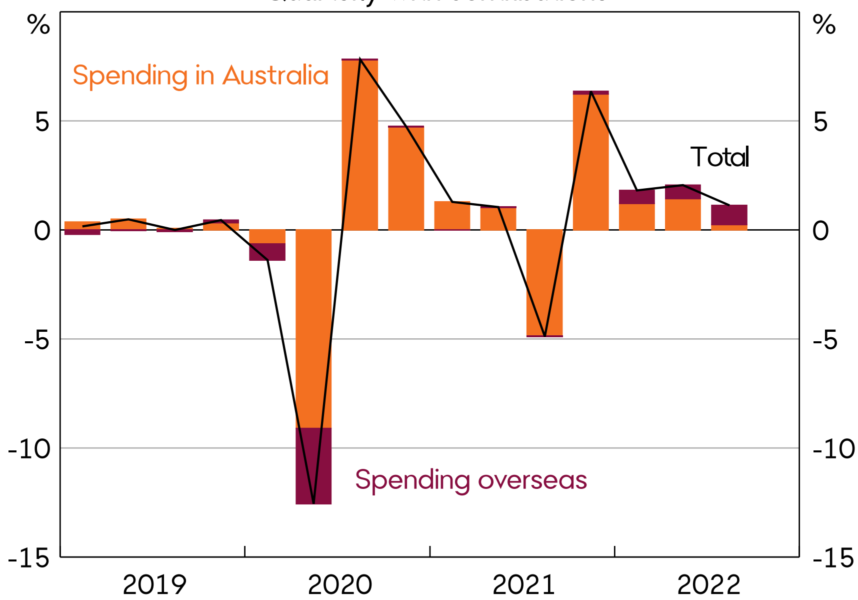
Sources: ABS; RBA



Sources: ABS; RBA

Household Consumption Growth*

Quarterly with contributions

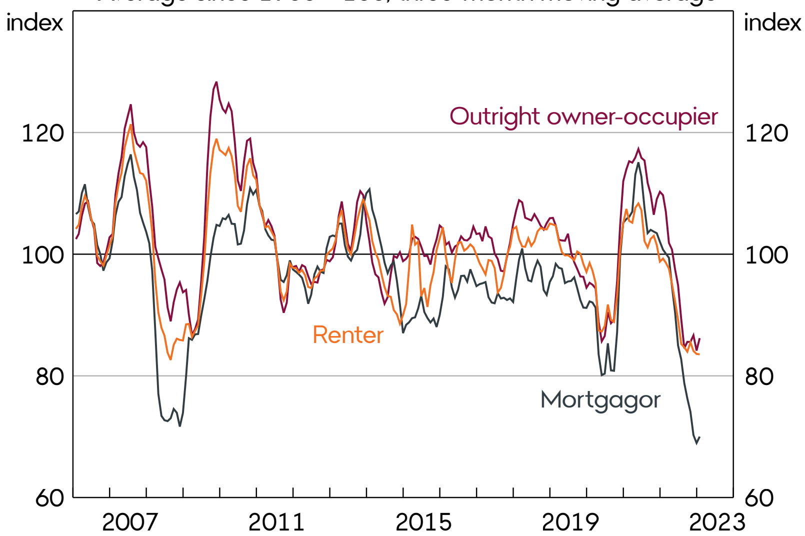


* Household consumption in the national accounts measures spending by Australian residents

Sources: ABS; RBA

Consumer Sentiment by Housing Tenure

Average since 1980 = 100, three-month moving average



Sources: RBA; Westpac–Melbourne Institute