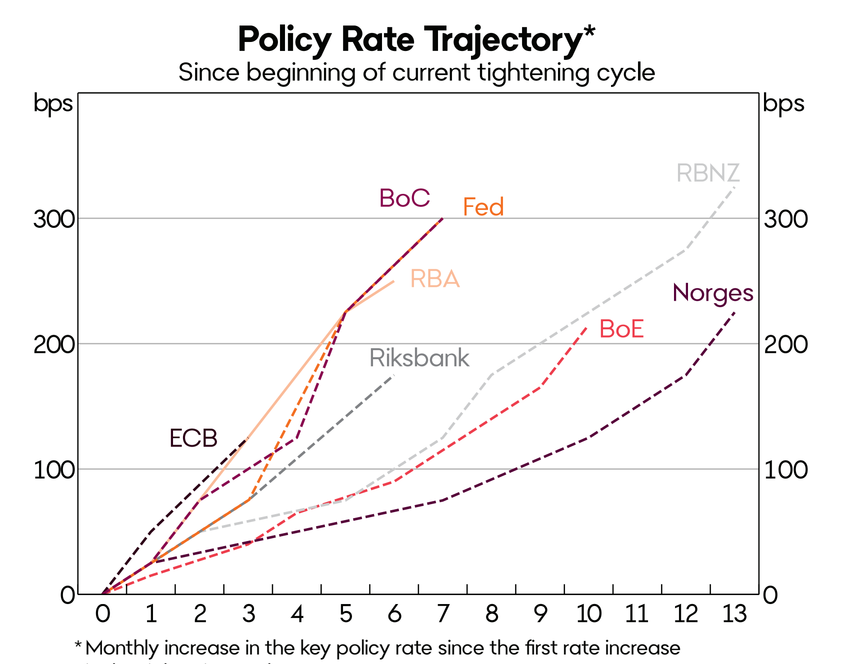
Economic and market update

Economic Overview – as at 20th October 2022

Global markets



* Monthly increase in the key policy rate since the first rate increase in the tightening cycle.

Source: Central banks

The consistent trend of further downgrades to growth estimates, more persistent core inflation and even higher recession risks continued, with the October IMF outlook being even more gloomy than the recent OECD and World Bank forecasts. Recession signals have been evident for some time (the US yield curve inverted more than six months ago), however the task of estimating the pace of monetary policy tightening around the world has been a work in progress. Central banks are understandably prioritising tackling inflation over short term post-pandemic recoveries, given the much larger risks posed by inflation taking hold, especially in the wake of the trillions of dollars/ euros/ pounds and yen of Quantitative Easing. The recent experience of the Bank of England needing to add to QE to support the gilt market underscores the challenges of sharply higher bond yields, and fiscal discipline.

US inflation has continued to disappoint the US Federal Reserve with last month's rise in core inflation up to 6.3%, and further evidence this month that any easing in goods inflation is being more than offset by the rise in services inflation. The Fed are poised to increase rates by another 75 bp on 2 November (to a 3.75 - 4% band) and then another similar increase in December. The chart above shows the Fed leading the pack in its pace of tightening rates. In the current environment of 'good data is bad news for rates', the latest manufacturing and jobs data supports market expectations of rates peaking close to 5% (before an easing cycle as the economy sinks into recession).

Despite recession risks the US dollar continues to power ahead, with investors choosing cash (especially US cash) as the safest bet. Canadian inflation only improved from 7.0 to 6.9% in September, showing the long lag between policy tightening and having any meaningful impact on reducing price pressures.

European economies are facing recession not just due to rising rates but being most exposed to higher energy prices. European gas and coal prices have eased from their peaks but remain elevated leading into their winter, and the fallout from the Russian invasion of Ukraine is not dissipating. Putin's announcement of martial law in the annexed regions of Ukraine (and the recent attack on the bridge connecting Crimea with the Russian mainland) show the lack of progress the Russian military has made, but also suggests the lasting impact of the war.

Meanwhile, the UK has endured one of its most politically volatile periods, mirroring the extreme volatility on the markets (with the British Pound sinking to a record low of 1.033- below its 1985 low), as new PM Liz Truss promised tax cuts, then abandoned them and sacked her Chancellor Kwasi Kwarteng (replacing him with a likely rival for PM Jeremy Hunt). UK 10-year gilts rose to 4.5% (from 3.3% a month ago) before easing back to 3.9%.

The Chinese economy continues to struggle with no relief from the zero-COVID policy and its weak real estate market barely noticing efforts from authorities to support development projects. The 20th Party Congress this week appeared to secure President Xi's third five-year term but failed to give any indication of a change to Covid Zero, disappointing the markets. The policy priorities didn't address short-term growth but instead looked to longer term self-sufficiency and 'Chinese-style modernisation'. In contrast to the chart above, Chinese interest rates are on hold having been cut steadily this year.

In summary, the same risks remain to global growth and especially to North Atlantic economies as has been the case since the war in Ukraine started, but the extent of the downturn and the associated volatility in the markets continues to build. There are some more signs that supply chains are gradually improving, including falling supplier delivery times, shipping costs and some energy prices, but the pace of this normalisation is as challenging to project as the peak in central bank rates.

Domestic economy

The Australian economy continues to display its resilience in the face of rising interest rates and price pressure evidenced by tight labour markets, strong retail sales and relatively firm levels of business confidence. The fresh challenges of more floods, this time primarily in Victoria, are adding to cumulative stress and trauma over the last few years and will only add to price pressures. In the short term the next read on inflation (on 26 October) is expected to see CPI rise to just shy of 7% and core inflation closer to 5.5%.

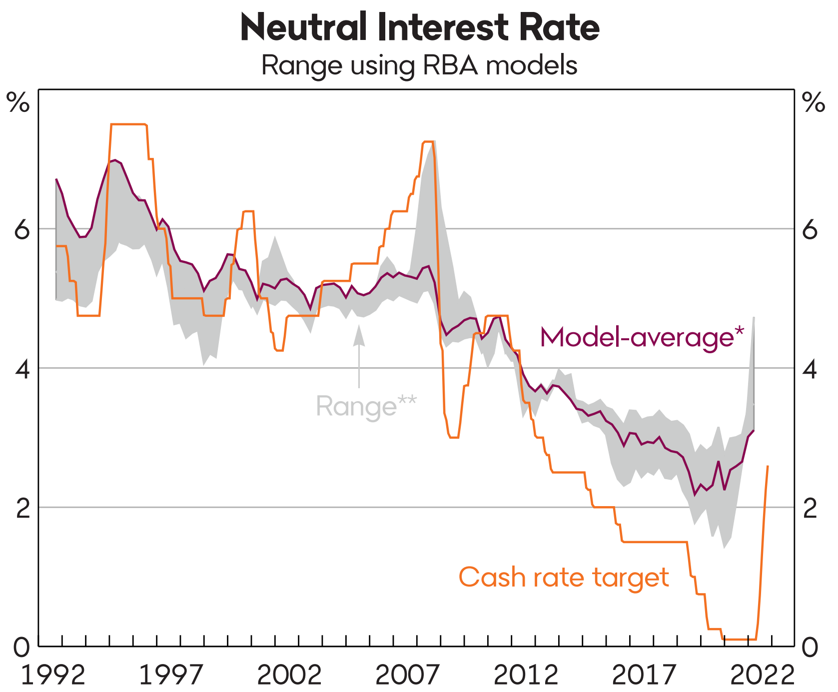
Against this backdrop of a healthy economy but rising inflation, the Reserve Bank of Australia chose to step down the pace of rate hikes to 25 basis points from 50 bp, meeting our forecast but surprising the market given the global trends detailed above. The RBA made the case that (unlike most other central banks) they meet monthly, so as the chart above comparing tightening cycles shows, their six months of 2.5% is in line with other central banks, although the RBA are the first to decelerate.

Other arguments from the RBA slowing down the pace included the tentative improvement in supply chains, the recent falls in property prices and the important point that there is a lag of around six months between increasing official rates and the 'real economy' reflecting the policy tightening. In addition, they could have mentioned the recent surge in imports in the latest trade data, showing that while we continue to run a strong trade surplus, the level of imports has dramatically lifted (further evidence of an improvement in supply chains); as well as the lower level of observed core inflation in South East Asia and among our trade partners, compared to Europe and North America.

The latest jobs data out today further supports slightly less urgency in pushing official rates higher with unemployment steady at 3.5% and a perplexing lack of employment growth in September. Nevertheless, unemployment is still near fifty-year lows, and the ratio of job vacancies to job seekers is near a record low, so the tight labour markets will be with us for some months, until higher interest rates start to materially bite.

The arguments to maintain 50 bp hikes included the necessity to keep households on notice that inflation expectations need to be kept in check, and to ensure that there is no question that tackling inflation remains the absolute priority of the RBA. In the end the reality that most major economies will likely be in recession next year, and the weaker outlook for the Chinese economy as detailed above, may have swayed the vote, as global headwinds will do some of the work of encouraging households to save rather than spend. The RBA only need to temper demand and slow the economy down; they don't have to force it into recession. As such, a 'neutral rate' is required, but not yet a restrictive policy setting.

On this point, the estimate of neutral is an important metric, and Assistant RBA Governor Luci Ellis' speech on this topic last week gave some insights into where nominal and real rates sit on the scale of low to 'normal' to high. In short, while the RBA concede the science is less than definitive, they estimate a neutral real rate at just under one percent, meaning a nominal (actual) official cash rate in the threes would meet the definition of neutral.



* Inflated using expected inflation
** Inflated using the inflation target or trimmed mean inflation.
Source: RBA

Given this estimate and the step down to 25 bp hikes for all the reasons outlined above, the base-case forecasts below (unchanged for the RBA cash rate, and largely unchanged for economic indicators) remain on track. These suggest Australia can avoid recession and instead experience slow but stubborn growth between 1 and 2% next year. This would also align to residential property prices falling by a record peak to trough percentage nationally (around 15%) with the larger capitals more at risk than smaller capitals and regional property prices, but against the backdrop of the 28% rise in values during the pandemic.

Further charts on residential property are outlined in the appendix. The downside scenario where the soft landing becomes at risk is most likely going to arise if the RBA need to move from neutral to restrictive rates later in 2023, presumably due to inflation failing to respond to higher official rates.

The much stronger US dollar detailed above partially helps to explain the recent plunge of the Aussie to below 62 cents. While we had been outperforming most other currencies, the weaker outlook for China and potentially commodity prices (should the global economy fall into recession next year) has seen a fall back to around 60 on a trade weighted basis: only mildly higher over the course of 2022.

Interest Rate Outlook

The RBA are likely to increase official rates by another 25bp in November to 2.85%, and then hikes around February and May 2023 would take the OCR to 3.35%. It is hoped that this neutral setting will be sufficient to temper demand, while inflation peaks as supply chains gradually repair.

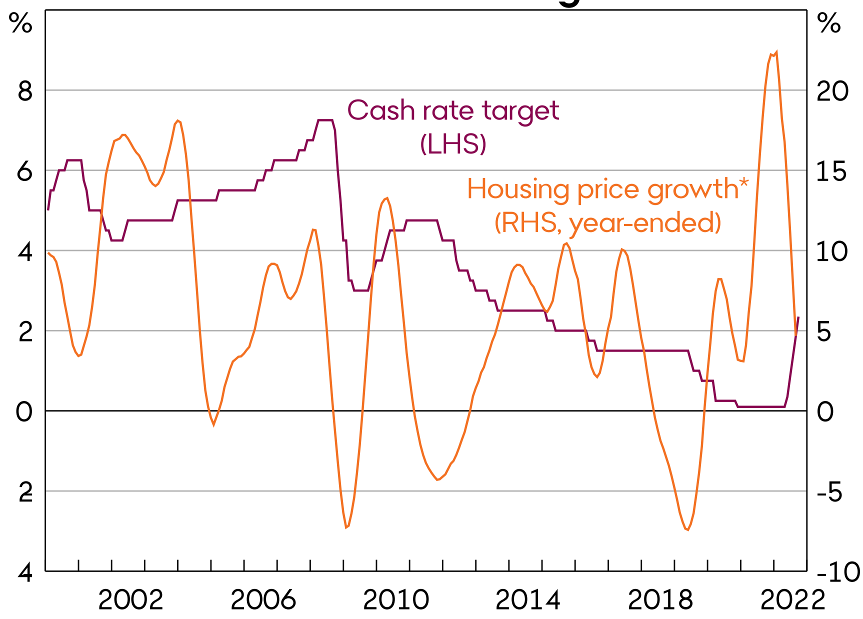
	31 / 8 / 21	31 / 8 / 2022	30 / 9 / 2022	20 / 10 / 2022
90-day bills	0.01%	2.46%	3.06%	3.00%
3-year swap	0.44%	3.71%	4.01%	4.18%
5-year swap	0.80%	3.91%	4.22%	4.45%
AUD/USD	.7375	.6840	.6410	.6260
ASX 200	7 393	6 987	6 474	6 737
Credit Index (iTraxx- 5 yr)	59	104	141	142

Economic Forecasts: basecase scenario

	2021	2022				2023			
% (actual, forecast)	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
GDP q/q	3.9	0.7	0.9	0.8	0.7	0.3	0.2	0.4	0.4
GDP y/y	4.5	3.3	3.6	6.3	3.1	2.7	1.7	1.6	1.3
Unemployment	4.2	4.0	3.5	3.5	3.2	3.3	3.6	3.9	4.2
CPI (q/q)	1.3	2.1	1.8	1.0	2.2	1.2	0.8	0.6	0.6
CPI (y/y)	3.5	5.1	6.1	6.3	7.1	6.2	5.2	4.8	3.2
CPI (core y/y)	2.6	3.7	4.9	5.5	5.7	5.1	4.4	3.7	3.3
RBA cash rate	0.1	0.1	0.85	2.35	2.85	3.1	3.35	3.35	3.35
AUD / USD	.7270	.7485	.6905	.6410	.63	.66	.69	.715	.74

Appendix: Rising interest rates and the housing market

Interest Rates and Housing Prices

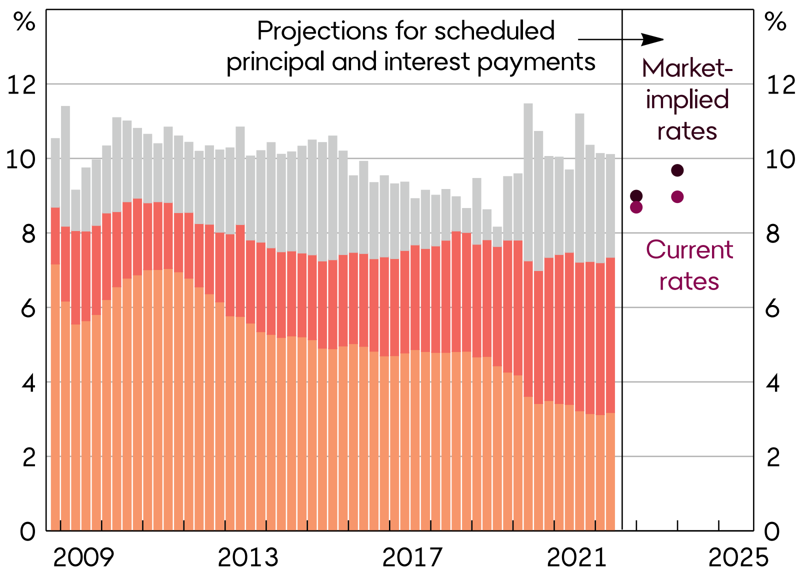


* Seasonally adjusted.

Sources: CoreLogic; RBA

Housing Mortgage Payments*

Quarterly, share of household disposable income**



Interest ■ Scheduled payment ■ Excess payments

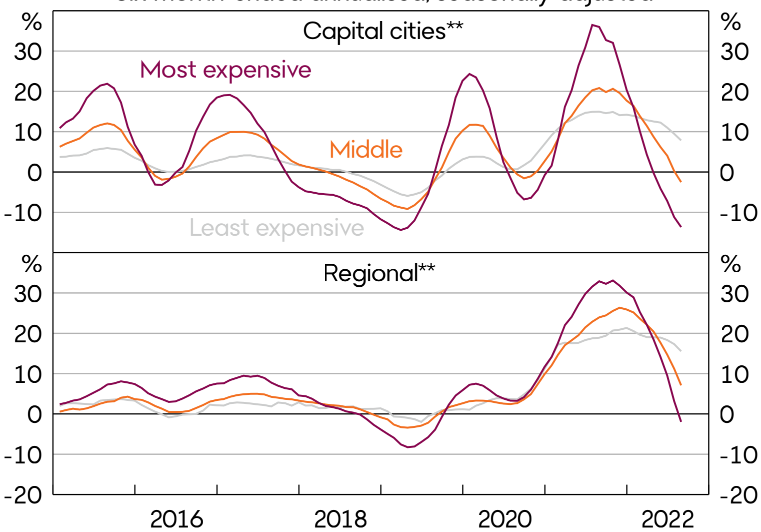
* Dots show projections for the sum of interest and scheduled principal payments as a share of income. Based on OIS projections for the case rate as end 2022 and end 2023. Assumes full pass-through to variable-rate mortgages and that fixed-rate loans roll onto variable-rate mortgages.

** Seasonally adjusted and break-adjusted.

Sources: ABS; APRA; RBA

Housing Price Growth by Dwelling Value*

Six-month-ended annualised, seasonally adjusted



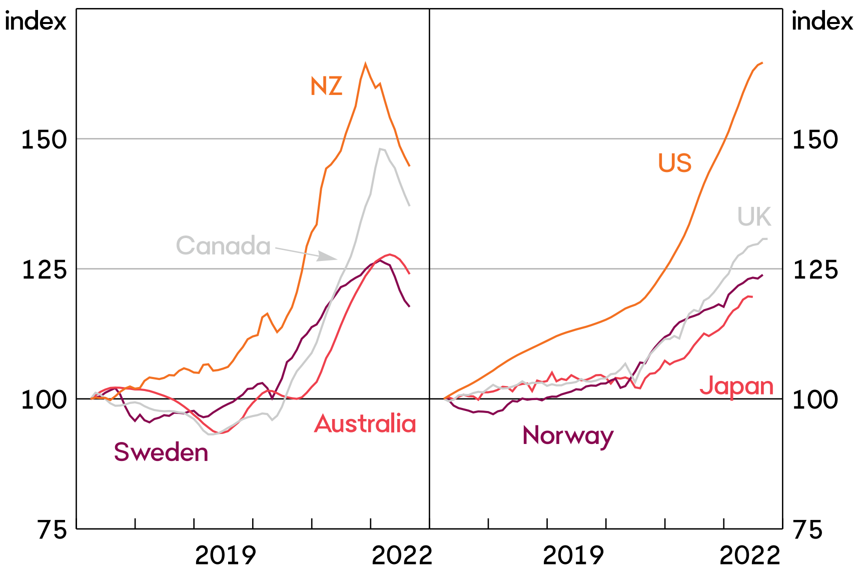
* Least expensive (5th-25th percentiles), middle (25th-75th percentiles), most expensive (75th-95th percentiles).

** Capital cities price indexes are for the eight capital cities and regional prices are for the rest of Australia.

Sources: CoreLogic; RBA

Housing Price Indices

March 2017=100, seasonally adjusted



Sources: national sources; RBA; Refinitiv