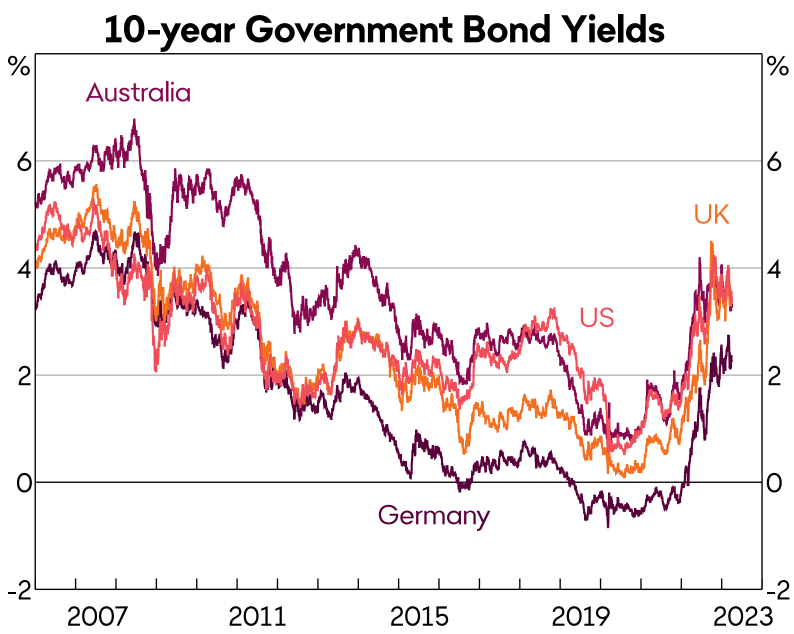
Economic and market update

Economic Overview – as at 20th April 2023

Global markets

A month on from the sudden failure of three US banks, together with the fallout from Credit Suisse's demise, we have seen a rebound in risk appetite evidenced by recoveries in stock markets but a renewed focus on central bank policy tightening. While hiking cycles are still approaching their peaks the timing of cuts that markets had priced in has been deferred, and bond yields are back on the rise. It's easy to be distracted by short-term events and volatility in the markets, however the big picture is unchanged from the start of the year: monetary policy is restrictive and will remain so for some time, and the resulting economic downturns will be significant. The latest gloomy IMF World Economic Outlook summarises this outlook, although notes likely outperformance in the Asia Pacific region.



Source: Bloomberg

Bond yields were back on the ascent in the US in April as Federal Reserve officials continued to warn of another rate hike and pushed back on the notion that financial sector stress will tighten credit conditions. This is despite some weaker manufacturing, retail sales and housing data, and despite the latest read on inflation where headline CPI fell to 5% year-on-year (from 6% y/y last month). Core US inflation was stubbornly high at 5.6% y/y, and while another hike on May 3 isn't certain, this core measure is a reminder that the timing of policy easing may be deferred due to a longer than normal time lag for the impact of tighter monetary policy on the economy. History shows us that US hard landings invariably follow Fed tightening (and inverted yield curves), but the timing of the recession is the hard part to predict, not the recession itself.

The reality of further rate hikes from the European Central Bank and the Bank of England hasn't prevented equity markets from continuing their march back to near record highs despite dismal growth forecasts for the region. The ECB has raised rates by 50 basis points at its last six policy meetings, and while a step down to 25bp is likely in May, euro-zone inflation is still up at 6.9%. The rise in bond yields in this region is sharper than anywhere (refer chart above), and the latest UK inflation data showed there is still much work ahead for the Bank of England with UK CPI at 10.1% and core inflation unchanged at 6.2%. Markets are now pricing in at least another 25 bp hike for the May 11 BoE monetary policy meeting. UK inflation is most noticeable via food prices: like everywhere driven up by the war in Ukraine, but exacerbated by Brexit / labour shortages, surging energy costs and weather-related events. Milk is up 40% y/y in the UK and cheddar cheese up 49%!

The contrast in Chinese data and activity versus the North Atlantic economies is like chalk and cheese: GDP growth accelerated in Q1 to 4.5% and exports grew by 14.8% y/y. This was matched by a strong rebound in retail sales and industrial production. Property investment remains the only weak link in the chain, but the worst for this sector appears to be behind us. Policy settings have been eased modestly over the last year (again in contrast to G7 economies) and inflation is still below 2%. Growth is expected to easily exceed the target of 5% set by officials for 2023, and the impact for the region should be very helpful: perhaps only for this calendar year, but a welcome offset to the global headwinds documented above and by the recent IMF report.

In summary, geopolitical tensions remain elevated and the global slowdown will make 2023 a most challenging one for most countries, however the Asia Pacific region appears most likely to avoid hard landings. Inflationary pressures will take time to respond to tighter policy settings in most economies.

Domestic economy

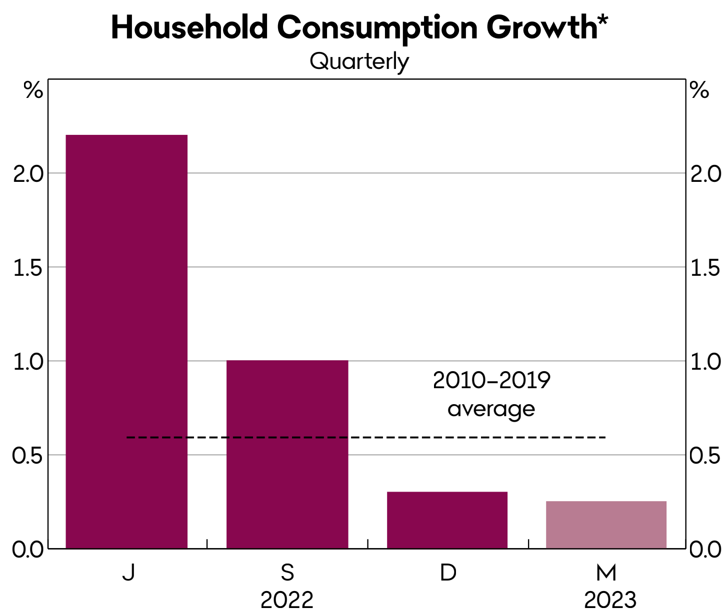
The yield curve is remarkably flat with the Official Cash Rate at 3.6%, the one-year 'overnight index swap' around 3.7%, and the three-year swap at 3.6% - suggesting an extended period of rates on hold, possibly with one more rate hike. This shouldn't be confused with an expectation of low volatility for markets - the flattening in the curve (after earlier in the year pricing in hikes for the OCR well above 4%, and then more recently pricing in a series of cuts around year-end) now reflects an expectation that the pause in RBA rate hikes in April will see a more patient approach. More importantly it also suggests that rate cuts are much further down the road - as argued here for some months. But the yield curve today is just the average of market views, and upside and downside scenarios need to be considered.

An upside scenario that is frequently overlooked is the quite plausible outcome that inflation remains elevated, meaning policy remains restrictive for much longer with more hikes in '24, but our economy copes and keeps growing near trend, even as household spending goes into reverse. This is assessed as a 10% probability, but the basecase scenario in forecasts below is less optimistic: it has just one more hike before an extended pause, and growth slowing sharply with unemployment rising steadily. The obvious downside scenario of a hard landing - not just a technical recession but a 'real recession' with 3-5% of the workforce losing their jobs - has become more likely in lieu of recent bank failures in the US and Europe, and their likely impact on tighter credit globally, but is currently assessed as a 30% probability. A recent Bloomberg survey rated recession in Australia as a 35% chance.

The latest jobs data once again beat forecasts, and with unemployment still down at 3.5% doesn't in the slightest resemble recession; employment grew by 53 k seasonally adjusted in March, although underemployment rose to 6.2%. The low point for unemployment at 3.4% last October is very likely to remain the turning point in the cycle, and a steadily higher jobless rate is expected as the economy slows, and as the recent welcome rise in net migration alleviates labour shortages. Nevertheless, the March job report was strong enough for the RBA to consider another hike in May if the quarterly CPI print next week has any upside surprises, i.e. doesn't match the recent fall in monthly inflation. Headline CPI is expected to be 1.2% for Q1 (6.7% y/y), however the core inflation measure will probably need to be lower than this to encourage a further pause from the RBA. As the first chart in the appendix shows, Australia has a faster 'transmission mechanism' for monetary policy than other countries, as we have a higher proportion of borrowers with a variable rate - which helps to explain why 3.5% of RBA hikes may be sufficient to dampen demand and reduce inflation compared to larger increases elsewhere.

The strength in labour markets will be important to help offset the impact on businesses from the clear slowdown in household spending, evident in the chart to the right. Retail sales only rose 0.2% in February so are still below the November peak and discretionary spending will almost certainly fall as rate hikes on top of the inflated cost of goods and services coincides with falling house values and rent rises.

The other offsetting factor for local businesses will be the rebound in international tourism, student numbers and demand for our exports; in the absence of these tailwinds, hard-landing probabilities would be much higher. However, the favoured soft-landing scenario is predicated on the RBA only lifting rates at the most, once more this year, and that will require steady progress on inflation. Working in favour of an expected moderation of CPI, we should see base effects start to assist as the year progresses, and the appendix shows the relatively benign outcomes for wages growth and also for shipping costs as supply chains continue to repair. Challenges ahead for inflation lie in much higher electricity and energy prices, and in the increases seen in services sector costs (as consumption moves from goods to services).



* March quarter 2023 is an estimate based on partial data received to date.
Sources: ABS; RBA

The well-publicised review of the RBA released this week had few surprises and maintained the 2-3% inflation target (without justifying why this band is the optimal target). The review included a split of the RBA board into a Monetary Policy Board and a separate Governance Board. The MPB will only meet eight times a year (v 11 at present) and there will be a press conference after each meeting, explaining the policy decision. The MPB will have six external experts joining the RBA Governor, Deputy Governor and the Treasury Secretary, with (unattributed) votes released for greater transparency. The other major change was a clarification of the 'dual objectives of price stability and full employment' and associated accountability. In total there were 51 recommendations in the review, all of which have been supported by the Government, with Treasurer Jim Chalmers stating they would be implemented by mid-2024.

Interest Rate Outlook

The RBA will maintain a tightening bias for some time as inflation slowly moderates from current levels, but are unlikely to lift the cash rate above 3.85%. A hike in May from 3.6% remains plausible but is heavily dependent on Q1 CPI to be released on 26 April.

Rate cuts would require a more rapid return to target for core inflation, but this is not expected in the next 18 months as per basecase forecasts below. This soft-landing scenario is assessed as a 60% probability with the chances of a hard-landing recession around 30% (and 10% for upside surprises).

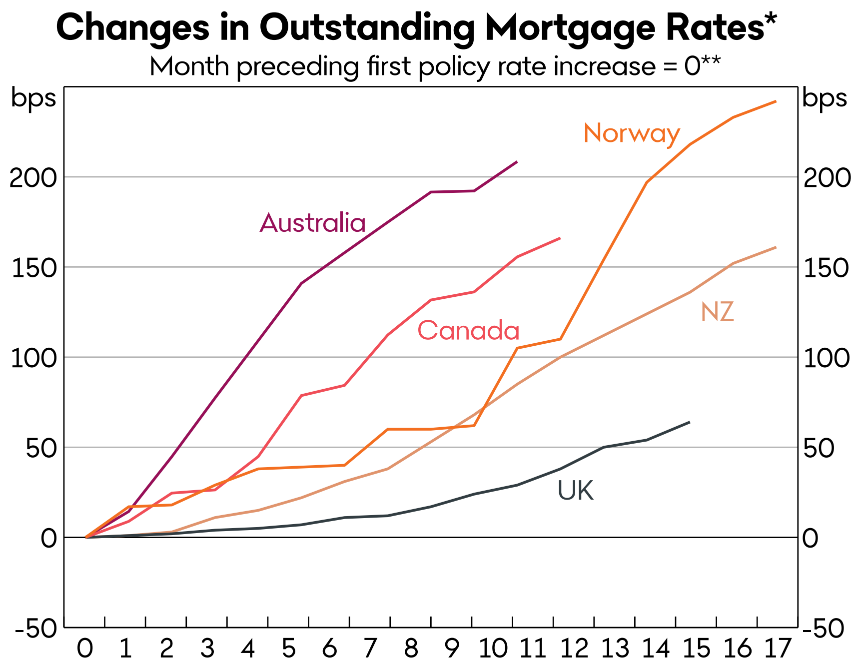
Interest Rate Outlook

	28 / 2 / 2022	28 / 2 / 2023	31 / 3 / 2023	20 / 4 / 2023
90-day bills	0.08%	3.56%	3.70%	3.69%
3-year swap	1.83%	4.11%	3.43%	3.59%
5-year swap	2.96%	4.27%	3.62%	3.75%
AUD/USD	.7265	.6730	.6680	.6710
ASX 200	7 049	7 258	7 178	7 370
Credit Index (iTraxx- 5 yr)	92.0	87.3	86.8	84.7

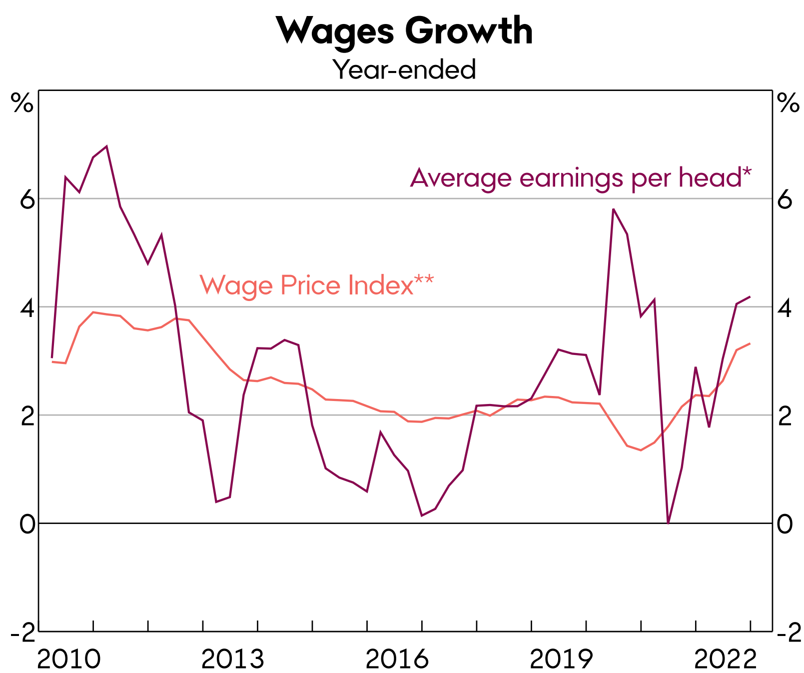
Economic Forecasts: basecase scenario

	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	0.7	0.5	0.3	0.1	0.2	0.4	0.4	0.5
GDP y/y	4.6	2.9	3.1	5.9	2.7	2.4	1.6	1.1	1.0	1.1	1.5
Unemployment	4.2	4.0	3.6	3.6	3.5	3.5	3.8	4.1	4.5	4.7	4.9
CPI (q/q)	1.3	2.1	1.8	1.8	1.9	1.2	1.0	0.7	0.6	0.9	0.8
CPI (y/y)	3.5	5.1	6.1	7.3	7.8	6.7	5.9	4.8	3.5	3.2	3.0
CPI (core y/y)	2.6	3.7	4.9	6.1	6.9	6.4	5.6	4.7	3.7	3.6	3.2
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	.669	.69	.72	.74	.76	.77

Appendix: Inflation/ CPI outlook



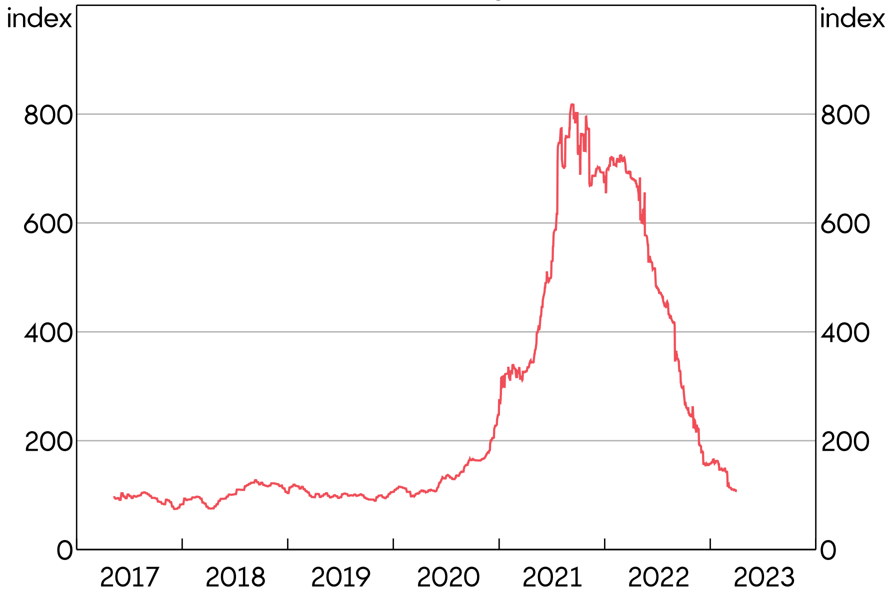
* Data for Canada and NZ to January, remainder to February.
** Cumulative basis point increase in the average outstanding mortgage rate relative to the month immediately preceding first policy rate increase since the onset of the pandemic.
Sources: APRA; central banks; RBA



* Non-farm.
** Excluding bonuses and commissions.
Source: ABS

Global Container Shipping Rates

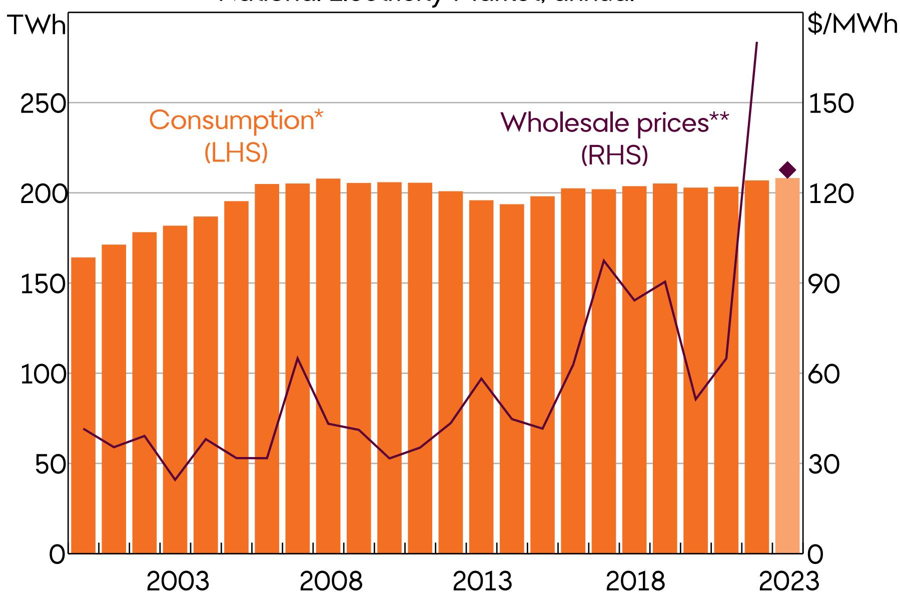
2017–2019 average = 100



Sources: RBA; Refinitiv

Electricity Consumption and Prices

National Electricity Market, annual



* Lighter colour shows annualised consumption so far in 2023.

** Diamond shows average of prices to date in 2023 and futures prices for the rest of 2023.

Sources: ABS; AEMO; ASX; OpenNEM; RBA