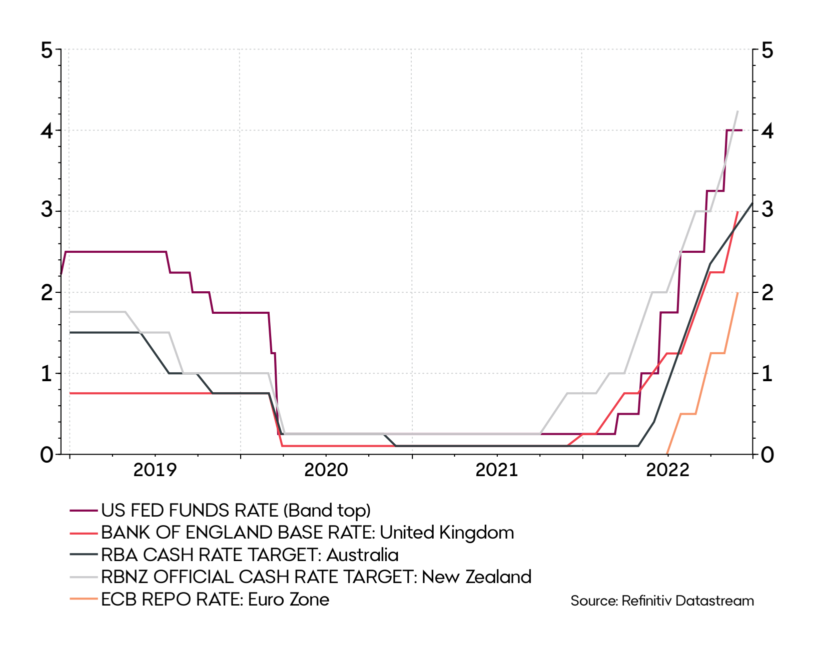
December 2022

Economic and market update

Economic Overview – as at 15th December 2022

The year ends with central banks closer to their likely peaks for cash rates but as US Federal Reserve chair J. Powell stated today "more work to do", even after his latest 50 basis point hike to 4.5%. The inflation rate appears to be close to its peak or in some cases just past it in many countries, however the task of returning inflation back down to target is immense and very much a work in progress. The expectation of a global recession remains high, with G7 economies most at risk as previously noted. Despite this consensus view, additional Chinese policy announcements have soothed equity markets.



The latest US tightening was a step down from 75 basis points to only 50, and a further slowing in the pace of rate hikes to 25 bp is expected at the next meeting on 1 February - however the 'dot plots' from the FOMC meeting still point to a 5% Fed Funds rate. The market is pricing in cuts after this level but only in the context of a hard landing - which historically has been the only way to defeat inflation. The lower US CPI read of 0.1% for November (+ 7.1% y/y), with core inflation down to 0.2% for the month and 6% y/y, was a step in the right direction, helping to ease bonds yields further. The US ten year is down to 3.5%, well below its peak of around 4.25 %, however the yield curve remains steeply inverted. The economy has responded to higher rates with slowing growth and housing activity, but elevated wages pressure and solid jobs data. Forecasts from the FOMC show expectations of sharply lower growth and the unemployment rate rising to 4.6% (from 3.7% today).

The European Central Bank, Bank of England, Swiss National Bank and Norges Bank are all also expected to increase rates by 50 basis points later this week, as the 2022 central bank 'rates show' reaches a crescendo ahead of Christmas. The outlook for the region remains very challenging. The euro-zone is probably already in recession, and despite UK GDP rebounding 0.5% in October the quarterly rate is still in contraction and expected to remain so for all of 2023.

The Russian invasion of Ukraine and its impact on global gas and food prices (on top of already strained supply chains as the world reopens from the pandemic) is having an impact everywhere, but still most so in Europe.

More Chinese policy announcements and stimulus, including further easing of COVID-19 restrictions, have been welcomed by the markets, with Chinese GDP growth hoped to rebound over 5% in 2023 as their economy reopens. Further measures and more cuts to the Reserve Requirement Ratio are likely, with the RRR having been eased by another 25 bp on 25 November, and the Hong Kong stock market (an excellent barometer for progress in reopening) has recovered strongly. The Hang Seng index is up from below 15,000 at the start of November to almost 20,000. China's emergence from its COVID-zero strategy to 'normal' conditions will see a lift in consumer spending and hopefully will be matched by an improvement in its troubled property sector, however demand for exports remains a key variable for the year ahead. Chinese exports contracted in November by the largest rate since the start of the pandemic, and the prospect of a global recession is an obvious concern. Retail sales fell to -5.9% y/y in November, so the move away from COVID-zero cannot come quickly enough.

In summary the mood globally is a little more positive as we approach or pass the peak in inflation, but global growth is expected to slow to only 2% next year and there are wide variations likely to be seen by region and by country. The key variables for 2023 will be how successful monetary policy has been in tackling inflationary pressures, the pace of return back to target inflation, and how each economy copes with the accumulation of rate hikes.

Domestic economy

The rebound in economic growth in the third quarter, the $12.2 Bn trade surplus for October and the latest very strong read for labour markets suggests that the Australian economy is in a healthy condition; however these metrics are likely near their peak. This 'as good as it gets' outlook is supported by signs of stress in the fourth quarter for household budgets and property markets, and the cumulative impact of a 3% increase in interest rates via eight successive RBA rate hikes; and inflation at a thirty year high. Nevertheless, the Q3 GDP data revealed GDP growth of 5.9% y/y, driven by household spending, with a rebound in dwelling construction and a 2.7% rise in exports (although a 3.9% rise in imports!). The household savings ratio fell to 6.9% from 8.3% last quarter and 19.4% a year ago, so the cost of strong domestic consumption is growing due to rampant inflation, despite a sharp jump in 'compensation for employees' of 3.2% (its largest jump since 2006).

Consistent with the global commentary above the key questions for 2023 here are:

1. How quickly will CPI and inflation peak?
2. How soon will core inflation return to the RBA target band?
3. How far will the RBA have pushed monetary policy to help with the above?
4. How resilient will our economy prove to be in coping with this tightening in monetary policy?

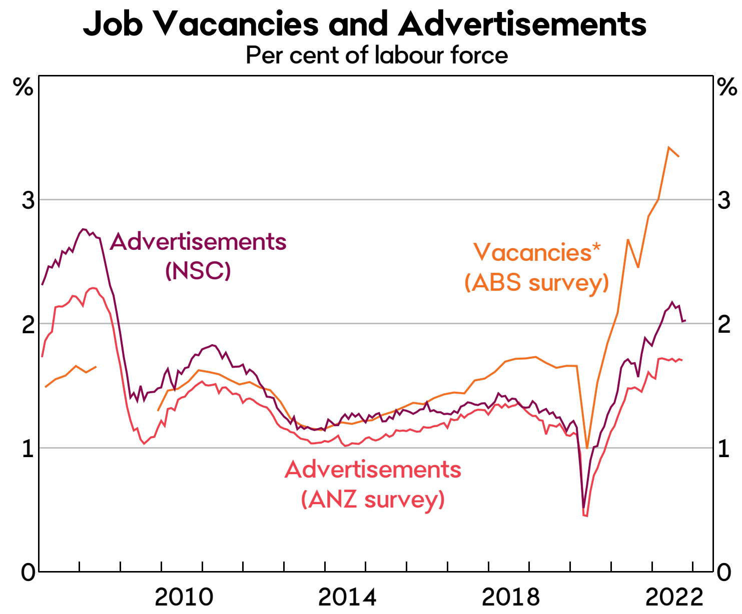
The answer to all these questions presumably links back inevitably to labour markets, via wages growth and demand for labour, and as a metric for this likely resilience. The November jobs report saw a stunning 64,000 increase in employment (seasonally adjusted) to 13.77 million. Despite an increase in the participation rate to a record 66.8%, the unemployment rate remained at a 50 year low of 3.4%. Underemployment fell to 5.8%, 3% below the pre-pandemic rate. The data release also included upward revisions to population growth since April and evidence of an increase in net migration.

As pleasing as this data is for job seekers it will do nothing to dissuade the RBA from another hike in February given the tightness of labour markets and the likely pressure on wages. As argued here before, real wages growth is a vital priority and has serially disappointed over the years. However, it is achieved by taming inflation in the first instance and by lifting labour productivity, and not by lifting nominal wages unsustainably (with the risks of a feedback loop to inflation). Previous experiences of the 1970s and 1980s highlight the peril of failing in this regard, and the consequences for jobs if central banks have to induce a recession to defeat central banks have to induce a recession to defeat inflation, having moved too slowly initially.

Next year will likely see job creation reverse as the impact of higher interest rates on households and businesses grows, and as demand for labour recedes. Recent job vacancy and job advertisement measures have eased with the SEEK job ads series down another 5% m/m in November (its sixth monthly decline in succession), and down 18.5% below their peak (although well above pre-pandemic levels). The chart below shows further evidence of this likely turning point.

The extent of the decline in employment, and therefore rise in unemployment, is subject to a wide array of forecasts, with the RBA still projecting unemployment to be 3.7% at the end of 2023, but our basecase scenario (below) is a more cautious 4.5%. A lower read in the second half of next year would presumably lead to more pressure on wages and less progress on reducing core inflation, adding to monetary policy tightening.

Other factors for inflation next year beyond wages will be energy costs (likely to be sharply higher), hopefully offset by improved supply, so the latest news on legislation for domestic price caps is significant.



* This survey was suspended between May 2008 and November 2009.
Sources: ABS; ANS; National Skills Commission (NSC); RBA

A potential deal with the Greens to back the law - in exchange for 'electrification reform' to help households transition from gas to electric appliances - may see the caps pass through parliament, although the details of this package won't be clear until the federal budget in May.

Meanwhile the monthly inflation rate fell from 7.3% y/y to 6.9%, but being a relatively new series it's unlikely to influence the RBA versus the quarterly data series. The Q4 inflation data will be released on 25 January, just before the next monetary policy meeting.

The Aussie Dollar has recovered impressively from its dip to below 62 US cents two months ago to reach 68.9 this week, although the gains have mainly been against a weaker greenback. On a trade weighted basis the Aussie rose solidly over the last two months, and modestly over the year.

Interest Rate Outlook

The RBA are getting closer to a pause in its sequence of rate hikes, but are still expected to increase in February to 3.35%, after which one more hike may occur around May. Beyond this level in the 'mid threes', the most likely scenarios appear to be rates on hold but with a tightening bias, or a shift back to a possible easing cycle, as the global economy moves into recession. A third scenario is the hikes to 3.6% failing to shift the dial on inflation, leaving the RBA with no choice but to press on with rate hikes beyond 4%, which would be the least desirable outcome and would come with the risk of an FY24 recession.

Interest Rate Outlook

	31 / 10 / 21	31 / 10 / 2022	30 / 11 / 2022	15 / 12 / 2022
90-day bills	0.07%	3.09%	3.09%	3.17%
3-year swap	1.44%	3.97%	3.73%	3.66%
5-year swap	1.82%	4.25%	3.93%	3.85%
AUD/USD	.7525	.6395	.6790	.6835
ASX 200	7 332	6 737	7 130	7 212
Credit Index (iTraxx- 5 yr)	67	137	90.5	83.1

Economic Forecasts: basecase scenario

	2021	2022				2023			
% (actual, forecast)	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP q/q	3.8	0.4	0.9	0.6	0.6	0.4	0.2	0.2	0.3
GDP y/y	4.6	2.9	3.2	5.9	2.6	2.5	1.8	1.4	1.1
Unemployment	4.2	4.0	3.5	3.5	3.4	3.6	3.9	4.2	4.5
CPI (q/q)	1.3	2.1	1.8	1.8	1.8	1.2	0.8	0.7	0.6
CPI (y/y)	3.5	5.1	6.1	7.3	7.8	6.6	5.6	4.5	3.3
CPI (core y/y)	2.6	3.7	4.9	6.1	6.4	5.8	5.0	4.1	3.4
RBA cash rate	0.1	0.1	0.85	2.35	3.1	3.35	3.6	3.6	3.6
AUD / USD	.7270	.7485	.6905	.6410	.67	.69	.71	.73	.75