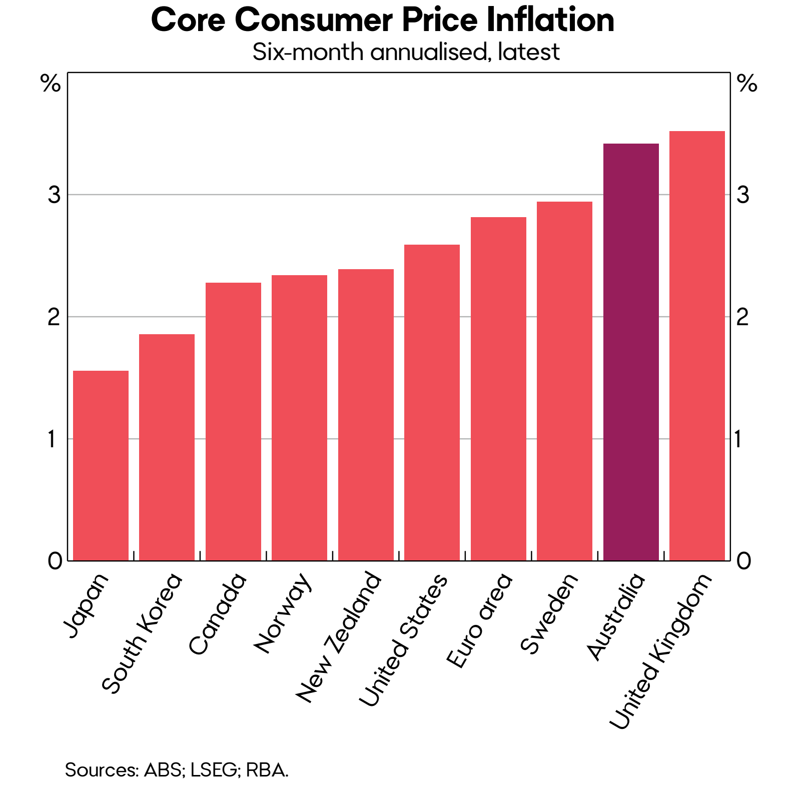
January 2025

Economic and market update

Economic Overview – as at 16th January 2025

Global markets

The new year commenced with further increases in bond yields globally as markets reassessed the extent of easing cycles ahead, but still with ample evidence of moderating inflation. The argument for expecting higher medium-term inflation ahead is compelling: deglobalisation, more frequent weather-related disruptions (due to the lack of progress in lowering carbon emissions) and the higher cost of (the necessary) transition to net-zero. The short-term outlook for inflation is even more complicated with Donald Trump's inauguration next week expected to signal a sudden escalation in US tariffs. For the moment the focus for central banks is on underlying inflation and how to achieve ongoing price stability - the global inflation shock is behind us, but fiscal and trade policies add complexity ahead.



The US Federal Reserve cut rates as expected in December taking the Fed Funds rate down to 4.5% from a peak of 5.5%, however expectations for cuts in 2025 have been pared back from 3 or 4 to only one more as the consequences of Trump's policy platform are digested. There is little doubt that US tariffs (depending on their timing and magnitude) and proposed mass deportations add risks to stagflation in the US through the year, however the short-term boost to activity and confidence through tax cuts and other policies create a challenging environment to analyse and to project ahead. Jobs growth has exceeded forecasts with non-farm payrolls surging over 250k in December and the US unemployment rate dropping to 4.1%. Core CPI fell to 3.2% in the latest data (only up 0.23% m/m) helping equity markets back to near record highs - the threat of trade wars isn't troubling Wall Street.

The outlook for Europe remains uneven and challenging with German GDP officially falling by another 0.2% in 2024 (after -0.3% in 2023) ahead of their elections next month, and in France the ousting of Michel Barnier's government amid a public debt impasse and large swings in energy prices is adding to uncertainty. In contrast southern Europe has outperformed and has avoided recessions leaving the ECB with the unenviable task of lowering interest rates at the optimal pace while dealing with wide variations of inflation and economic activity across the euro-zone. Core inflation in the EZ is 2.7% with unemployment at 6.3%, and the market is expecting the ECB to take rates down to around 2% (from 3% today). The unknown impact of US tariffs and domestic politics will shape this path through the year. UK inflation fell to 2.5% (3.2% core CPI) in December suggesting the Bank of England will also keep gradually easing rates (from the current level of 4.75%) by around 1% in 2025.

China faces the largest direct impact from tariffs should incoming President Trump proceed with his threat of a 60% tariff on imports from China, although as discussed in these reports in previous months the biggest impact of tariffs is generally on the country imposing them, not the trade partner. Nevertheless the timing of potential trade wars is highly inconvenient for China's economy as policy makers continue to struggle to stabilise their property market, and deal with structural challenges. Stimulus measures and targeted policy support has helped in the short term and recent data has been encouraging, but markets are less convinced with the exchange rate weakening further and corporate loans (as opposed to government bond issuance) reflecting low demand. Exports rose strongly in January with some evidence of stockpiling and pre-tariff front-running, so the aim from here will presumably be diversifying away from the US and some relief via a weaker exchange rate with more rate cuts in 2025. Further data on the Chinese economy is included in the appendix below.

Japan's monetary cycle remains an outlier with the Bank of Japan set to hike rates next week by 25 basis points to 0.5%, with wages growth and inflation finally at more sustainable levels to allow the BoJ to normalise rates. US trade policy will obviously be highly relevant however for the moment the outlook is for real GDP growth just above 1% this year, helped by a relatively weak Yen.

In summary, the new year will be dominated by trade tensions and direct (and unintended) consequences of US policies. Central banks of advanced economies will continue to try to adjust monetary policy back to 'neutral' while the post-pandemic and post-'inflation shock' global environment takes shape. Geopolitics (including trade, technology and military tensions) will keep volatility elevated and sovereign debt concerns add another dimension to this complex outlook.

Domestic economy

The Australian economy faces similar challenges to those detailed above but has a number of relative advantages for 2025, including

- Resilient labour markets (further details below)
- Less direct exposure to US tariffs than almost anywhere in the world
- Healthy demand for our exports further enhanced by our (currently) low exchange rate
- Low federal debt to GDP (supporting our AAA credit rating).

Global conditions are likely to be challenging and prone to sudden swings in sentiment amid trade tensions and geopolitical frictions, however Australian households can look forward to improved conditions as real disposable income recovers especially after the RBA initiate the impending easing cycle. Markets are fully pricing a cut by April and at least three cuts by the end of the year, although our basecase scenario (full details in the table below) isn't forecasting the first cut until May. The case for a February easing was enhanced by recent weaker business sentiment and retail spending data and by the monthly CPI indicator for November. The headline CPI rate in the monthly report consolidated below 2.5% and more importantly the Trimmed Mean fell from 3.5 to 3.2%, so a similar fall in underlying inflation in the full quarterly data to be released on 29 January will add to expectations for an imminent RBA cut. At this stage a quarterly read of 0.5% or less would make a February cut the most likely outcome, however if the Trimmed Mean is 0.6% (as forecast) then this would leave May as the favoured timing.

The latest jobs data neither added to nor discounted the possibility of a February rate cut, but did confirm ongoing labour shortages and demand for labour with another record high participation rate. Total employment for December rose by 56k (seasonally adjusted) to 14.6 million jobs, and while the unemployment rate ticked up to 4.0% the details in the report were strong including

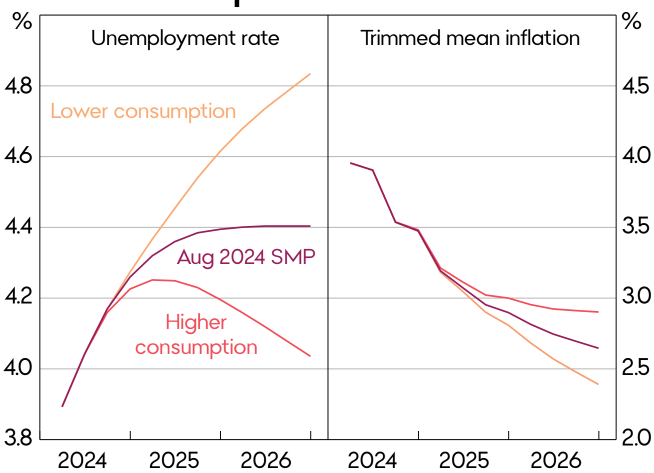
- Hours worked + 0.5% m/m
- Another fall in underemployment to 6.0%
- Jobs growth is averaging around 45k per month (six-monthly average) vs population growth of 40k per month

Given the RBA dual mandate of price stability (managing inflation) in harmony with 'sustainable full employment' it is important to consider what neutral, full-employment looks like; and consensus is an unemployment rate around 4.5%. It is pleasing to see plentiful jobs when household budgets have been under so much pressure, but unemployment around a half a percent below 'full employment' doesn't add urgency to rate cuts. Nevertheless, core inflation does appear to be on the path to 3% by midyear so an easing cycle commencing by May appears very likely. Less certain is how improving household incomes through the year will translate to consumption versus savings. A higher savings and lower consumption outcome (the orange line in the chart below) should equate to more sustainable levels of core inflation, making it easier for the RBA to keep cutting rates.

The residential property market has lost some of its momentum from last year after strong gains in housing values especially in Western Australia, Queensland and South Australia. Prices have been primarily driven by supply and demand imbalances rather than interest rates, and 2025 should see further supply outpacing population growth so (irrespective of RBA official rates) much slower appreciation in these states and modest falls in values in NSW and Victoria. With housing a significant weighting in the CPI basket (especially for rents and the cost of new dwellings) this should support lower inflation in 2025, offset to a degree by rebounding household spending.

The Australian Dollar has remained under pressure against the relentless strength of the US Dollar, falling to a low of US 61.31c (its lowest level since April 2020). At face value this poses risks to inflation via the cost of imported goods although the trade weighted index is relatively stable at 60, so this effect may be modest. As noted in the Global Markets section the lasting impact of incoming President Trump's policies is very difficult to project beyond the short-term reaction already evident, but US stagflation emerging in the second half of 2025 might well be consistent with the current US dollar strength losing momentum. On this basis (and relativities detailed above) forecasts below show the Aussie dollar remaining under pressure for some months, before a recovery later in the year.

Consumption Risks Scenario*



* Scenario assumes exchange rate and policy path are fixed to August 2024 SMP assumptions.

Sources: ABS; RBA.

Interest Rate Outlook

The RBA are expected to initiate the long-awaited easing cycle by May, with recent economic data opening the door for earlier cuts but more evidence needed (especially via the Q4 CPI report to be released on 29 January) to support a change in the February 17/18 policy meeting. Resilient labour markets and a challenging global backdrop may limit the easing cycle to three cuts to around 3.5%, while a harder landing for China by virtue of US trade policies could see a deeper cycle.

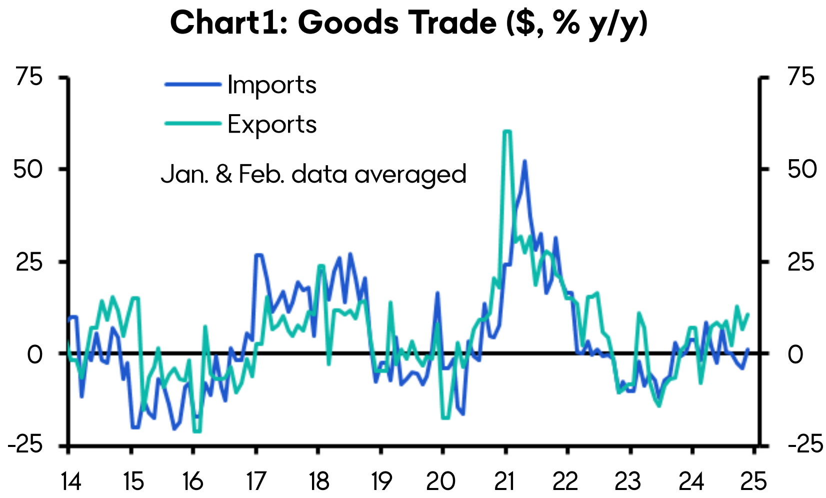
Economic Forecasts: basecase scenario

	2023		2024				2025			
% (actual, forecast)	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP q/q	0.5	0.2	0.2	0.2	0.3	0.4	0.5	0.6	0.4	0.8
GDP y/y	2.1	1.5	1.1	1.0	0.8	1.2	1.5	1.9	1.9	2.3
Unemployment	3.6	3.9	3.9	4.1	4.1	4.0	4.2	4.4	4.6	4.8
CPI (q/q)	1.2	0.6	1.0	1.0	0.2	0.5	0.8	0.9	0.8	0.7
CPI (y/y)	5.4	4.1	3.6	3.8	2.8	2.7	2.5	2.4	3.0	3.2
CPI (core y/y)	5.1	4.2	4.0	4.0	3.5	3.3	2.9	2.8	2.8	3.0
RBA cash rate	4.10	4.35	4.35	4.35	4.35	4.35	4.35	4.0	3.75	3.5
AUD / USD	.6435	.682	.6515	.667	.691	.619	.62	.65	.68	.71

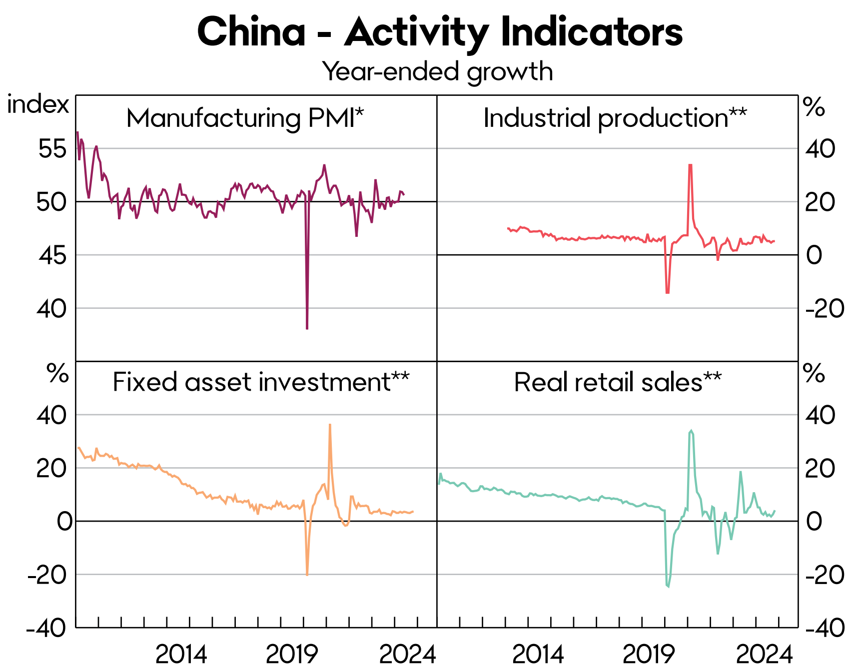
Benchmark rates

	30 / 11 / 23	29 / 11 / 2024	31 / 12 / 2024	16 / 1 / 2025
90-day bills	4.37%	4.43%	4.42%	4.34%
3-year swap	4.23%	3.93%	3.79%	3.90%
5-year swap	4.45%	4.15%	4.05%	4.20%
AUD/USD	.6790	.6520	.6190	.6200
ASX 200	7 087	8 436	8 159	8 327
Credit Index (iTraxx- 5 yr)	75.1	66.2	67.7	72.2

Appendix: China's economy



Source: Capital Economics

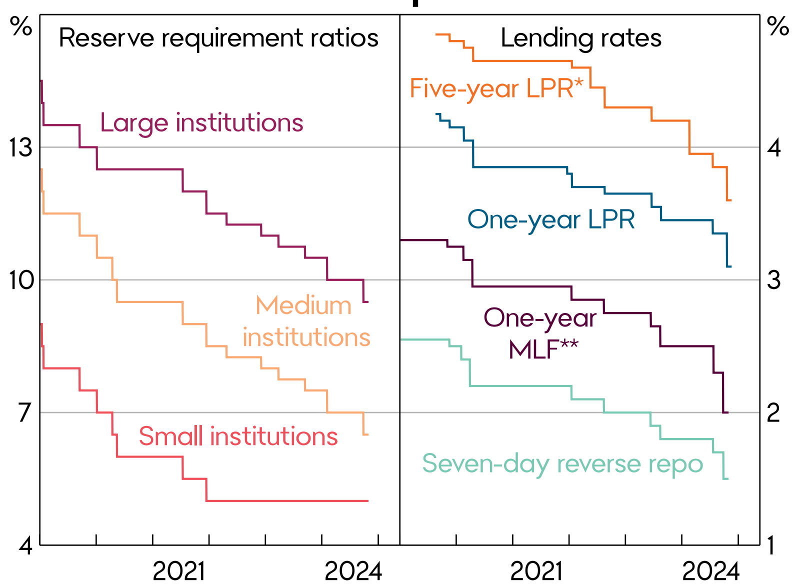


* Diffusion index; average of the official and Caixin.

** Seasonally adjusted by the RBA.

Sources: CEIC Data; Markit Economics; RBA.

Chinese Lending Rates and Reserve Requirements



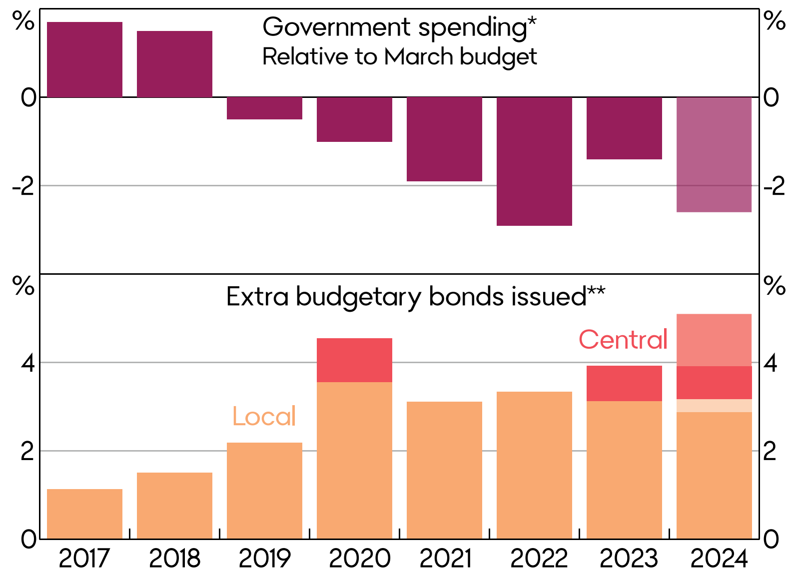
* The average interest rate on loans that commercial banks provide to their most creditworthy customers.

** The rate on medium-term loans that the PBC provides to qualified commercial and policy banks via its medium-term lending facility.

Sources: CEIC Data; RBA.

China - Fiscal Policy

Percent of GDP



* Includes general and government fund expenditure; bar with transparency uses full-year GDP estimate from the 2024 budget and full-year expenditure estimated from data to September.

** 2024 is from quota; bars with transparency show expected additional local and central government bond issuance for 2024.

Sources: CEIC Data; MoF; RBA.