July
2024

# Economic and market update

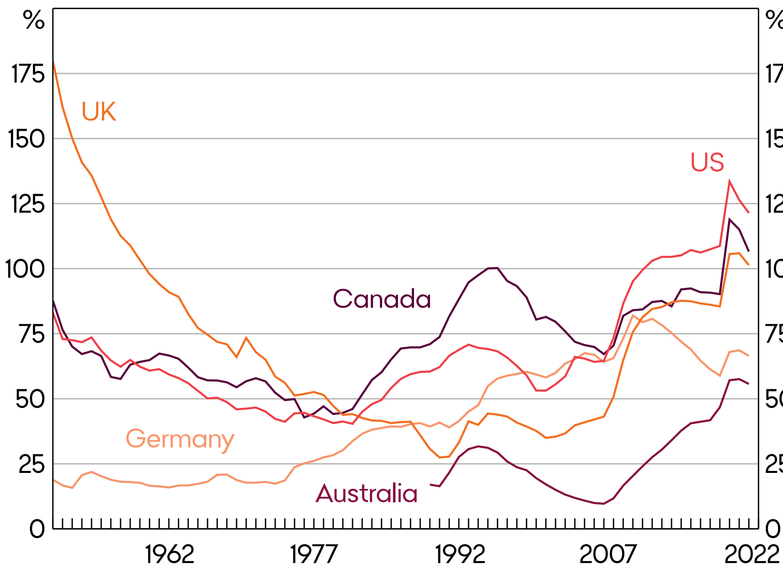
## Economic Overview – as at 23rd July 2024

## Global markets

The geopolitical backdrop continues to capture headlines and adds another dimension to the broad theme of moderating inflation globally, adding volatility to financial markets despite confidence that easing cycles are tracking as hoped. The assassination attempt on former US President Trump and his subsequent (further) lift in opinion polls brings into sharper focus his policy platform, and recent elections in France and the UK demonstrate the challenges for incumbent governments during an inflation shock. How this all plays out amid populist and protectionist policies remains to be seen, however markets may start to increase their focus on public debt and fiscal sustainability.

**Gross General Government Debt**

Per cent of GDP




Source: IMF.

Rate cuts in the US remain on track despite cautious commentary from the Federal Reserve, with Fed chair Jay Powell stating that he is more confident that inflation is returning to target, but still wanting to see more evidence. The latest US CPI and PPI data for June suggest another low read for core inflation after the May core PCE outcome of 2.6%, and beyond moderating inflation the broader economic data is also printing on the soft side. Q2 GDP is expected to land at around 0.6% for the quarter but then decelerate through the second half of the year, as outlined in the Fed's Beige Book. The medium-term outlook will be heavily influenced by the impending Presidential election on 5 November but the first rate cut in the easing cycle is fully priced ahead of then, in September.

The next ECB rate cut is also expected in September although eurozone inflation is still above target at 2.5% and wages growth and energy inflation remain persistently higher than hoped. The French snap election initially saw a lurch to the far right but ultimately a left-wing coalition was formed- removing some of the concerns around public debt, but adding to policy uncertainty.

The Swiss National Bank has cut rates twice and has benign CPI at 1.3%, but growth in the EZ region remains meagre. The UK economy has rebounded out of recession and is seeing a gradual moderation for core inflation (around 3.5%), with markets pricing in a cut by autumn. Labour's landslide election win has helped to lift consumer sentiment to its highest level since 2021, and equity markets remain near record highs. Sterling has also rallied since the election, approaching 1.30 against the dollar, although the slump in June retail sales has markets considering if the BoE may even cut rates next week.

The Bank of Canada are expected to cut rates for the second time this cycle (probably this week) after their retail sales also fell sharply in June, and with core inflation falling again to 2.6%.

China's 'Third Plenum' (a policy reform meeting held every five years by the Chinese Communist Party) disappointed the markets with its lack of economic reform, instead focusing on 'high quality development' and 'social modernisation'. The announcement yesterday of a 10bp interest rate cut tried to reassure and add confidence to property markets and walk the line between monetary support while managing the weak Chinese Yuan. Q2 GDP undershot at 4.7% y/y and weak retail sales and property sales added to concerns, although exports, manufacturing and industrial production held up well in June. The prospect of a Trump presidency with his promise of a 60% lift in US tariffs on Chinese exports will be front of mind, so further PBoC rate cuts are likely.

In summary, global growth is expected to remain below trend and the messy transition from tightening cycles to easing continues to be complicated by geopolitical tensions. Nevertheless, equity markets have posted fresh record highs in a range of countries (helped by the expected benefits of generative AI) and are focussing on short-term earnings and the prospect of rate cuts in North Atlantic economies, and not (yet) worried about fiscal sustainability.

# Domestic economy

The familiar themes for the Australian economy are unchanged: low consumer confidence as inflationary pressures persist, uncertainty due to the unpredictable path ahead for inflation, and highly variable conditions for households and businesses depending on location, cohort and industry. As a consequence of these unique conditions there remains a much wider distribution of forecasts from analysts and economists than is normally observed. In the case of the Official Cash Rate, the market is assigning around a one in four chance to an OCR hike in August with a number of economists continuing to argue this is inevitable, while a similar (but falling) number of analysts still predict an RBA cut in November. Forecasts for employment and economic growth are also widely dispersed, but as argued here for some months this inherent uncertainty will probably give the RBA even more reason to do nothing and keep the OCR on hold, given how long it will take to see

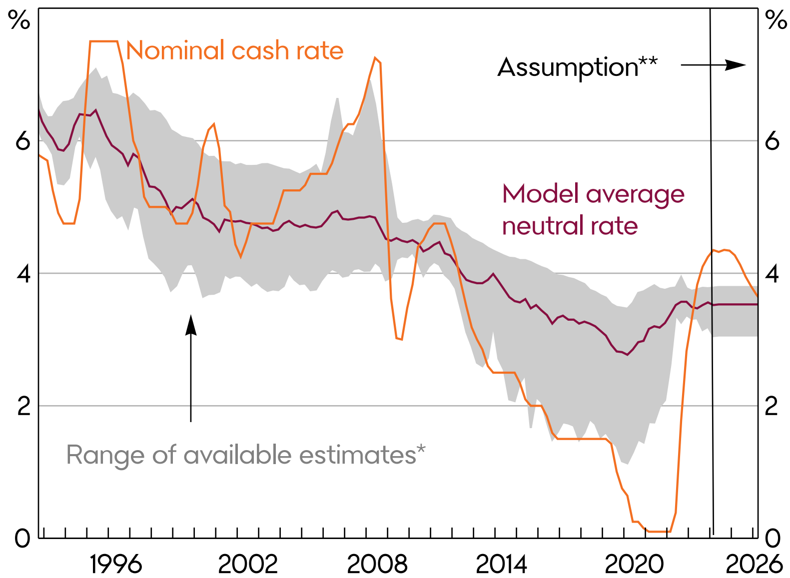
- To what extent labour markets weaken (as the fall in job vacancies and job ads might imply)
- How offshore demand evolves (refer Global Markets above)
- To what degree recent fiscal stimulus is spent vs saved
- How closely Australia's experience with core inflation will mirror other countries

On the last dot point, the view that the Reserve Bank of New Zealand are now on the cusp of an easing cycle after a dovish pivot from the RBNZ is another reason to be sceptical of the notion that the RBA have another hike left in their arsenal. The one in four probability of another hike therefore seems about right, but those odds will drift if the second quarter CPI comes in lower than its monthly indicator equivalent, where headline inflation rose to four per cent and core measures were also higher than expected. Consensus for the full second quarter is 0.9% for both CPI and core measures, equivalent to just below 4% y/y, however any number higher than this will give the market cause to fear another RBA hike; but more important than Q2 is the likely path for the new financial year.

The latest jobs data also added to uncertainty given its conflicting messages: unemployment rose to 4.1% seasonally adjusted, but there were over 50k jobs added and the unemployment rate is in the threes in every state - except for Victoria where it rose to 4.5%. The rising unemployment rate, despite jobs growth, shows the impact of population growth and a higher participation rate: both suggesting healthy demand for labour, but still expected to lose momentum as the economy continues to struggle under the cumulative weight of restrictive interest rates.

Another source of uncertainty is estimating just how restrictive interest rates currently are. In a recent speech RBA assistant governor Christopher Kent noted this uncertainty but (as the chart indicates) estimate that the OCR is around one per cent above 'neutral', which suggests that four rate cuts will be needed to take us back to neutral - more than the 2-3 currently reflected in the curve over the next few years. As noted above for global markets, fiscal policy may constrain the ability to get back to neutral, as may geopolitical tensions e.g. the impact of deglobalisation and elevated energy prices on inflation.

**Nominal Neutral Rate**




* Range of central estimates corresponding to available models. Nominal neutral rates are defined using trend inflation expectation.
** The nominal cash rate assumption is based on market pricing for overnight indexed swaps (OIS) on June 24, 2024.

Sources: LSEG; RBA.

Given these conditions and the mixed messages for households on where inflation and interest rates are heading it is no wonder that consumer confidence is low, although it's remarkable that it has settled at a lower level than in the GFC or during the pandemic lockdown period. Again the experience for owner occupiers and renters is distinct from outright owners so outcomes are variable by cohort and by location; but the stage 3 tax cuts are now in place and labour markets are resilient.

House prices continue to defy gravity despite the prospect of rates remaining at their current level for longer, with dwelling values in WA, SA and Queensland leading the way. While this remains primarily a function of supply falling consistently behind demand amid ongoing population growth, the contrast is stark: in the last three months CoreLogic data showed Perth values rose 6.4% and Adelaide rose 4.7% while Melbourne values fell 0.6%. This is unlikely to have any bearing on RBA policy settings but increased supply will be helpful to reduce rental pressures (and CPI).

The Australian Dollar reached a seven-month high at .6798 earlier this month as firm commodity prices and narrowing interest rate differentials ahead were anticipated, but the inability to break 68 US cents leaves medium term ranges intact. Most cross rates (especially versus the Yen and NZD) are relatively firm however the struggle to outperform the greenback may be a tougher bout. The basecase forecasts below still show an appreciation against the USD as the RBA sit pat while the Fed ease rates, but fears that global growth could slow in 2025 haven't helped bulk commodity prices - although gold remains near a record high (in both USD and AUD terms).

# Interest Rate Outlook

The cash rate is most likely at its cycle peak at 4.35%. The case for another RBA hike is stronger than an imminent cut but isn't terribly compelling. A longer cycle (into 2025) as core inflation persists above 3% remains our basecase scenario outlined below, with no move up or down in 2024. Meanwhile a number of North Atlantic advanced economies have initiated their easing cycles, and the US Federal Reserve are expected to cut rates in September. The depth of easing cycles here and around the world in the medium term may be constrained by fiscal stimulus and ongoing geopolitical tensions.

## Economic Forecasts: basecase scenario

| | 2023 | | | | 2024 | | | | 2025 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| % (actual, forecast) | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q4 |
| GDP q/q | 0.6 | 0.4 | 0.2 | 0.3 | 0.1 | 0.2 | 0.4 | 0.4 | 0.5 | 0.6 | 0.8 |
| GDP y/y | 2.3 | 1.9 | 2.1 | 1.6 | 1.1 | 0.8 | 1.0 | 1.1 | 1.5 | 1.9 | 2.3 |
| Unemployment | 3.5 | 3.5 | 3.6 | 3.9 | 3.9 | 4.1 | 4.3 | 4.5 | 4.7 | 4.9 | 5.2 |
| CPI (q/q) | 1.4 | 0.8 | 1.2 | 0.6 | 1.0 | 0.9 | 0.8 | 0.5 | 0.6 | 0.9 | 0.8 |
| CPI (y/y) | 7.0 | 6.0 | 5.4 | 4.1 | 3.6 | 3.7 | 3.3 | 3.1 | 2.7 | 2.8 | 2.9 |
| CPI (core y/y) | 6.6 | 5.9 | 5.2 | 4.2 | 4.0 | 3.9 | 3.4 | 3.2 | 2.9 | 3.0 | 2.9 |
| RBA cash rate | 3.6 | 4.1 | 4.10 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.1 | 3.6 |
| AUD / USD | .669 | .666 | .6435 | .682 | .6515 | .667 | .68 | .72 | .74 | .75 | .77 |

## Benchmark rates

| | 31 / 5 / 23 | 31 / 5 / 2024 | 30 / 6 / 2024 | 23 / 7 / 2024 |
|---|---|---|---|---|
| 90-day bills | 4.01% | 4.35% | 4.38% | 4.48% |
| 3-year swap | 3.73% | 4.21% | 4.08% | 4.08% |
| 5-year swap | 3.57% | 4.41% | 4.20% | 4.23% |
| AUD/USD | .6505 | .6655 | .6670 | .6625 |
| ASX 200 | 7 091 | 7 702 | 7 768 | 7 971 |
| Credit Index (iTraxx- 5 yr) | 83.0 | 65.4 | 69.8 | 64.6 |