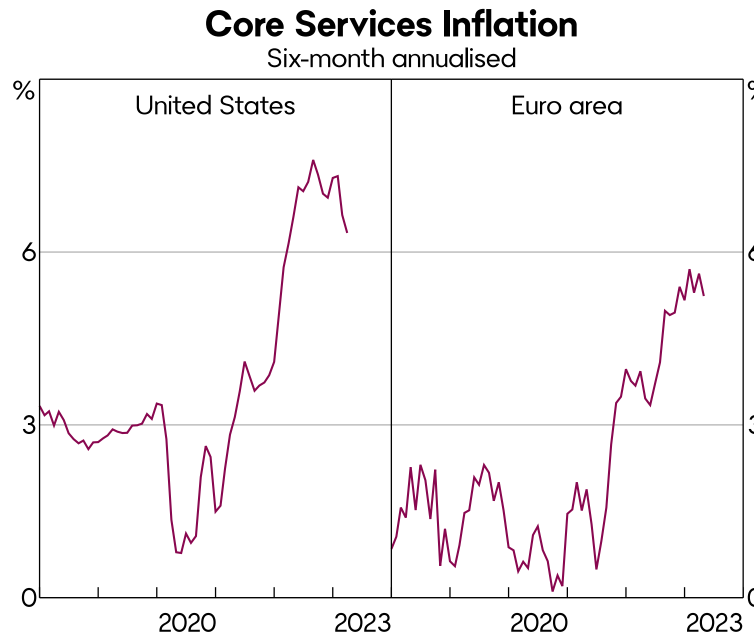
June 2023

Economic and market update

Economic Overview – as at 22nd June 2023

Global markets

Markets have refocused (as expected) on the two core questions for 2023: how high do central banks need to take official rates to dampen inflation, and will the resulting economic downturns be mild or deep? Bond yields continue to consolidate higher suggesting that the peak in rates is yet to be seen in G7 economies, and that subsequent easing cycles will be further down the track than previously hoped. This is consistent with the reality that core services inflation is very stubborn, in contrast to goods inflation which is rapidly improving. The impact of higher rates on most economies is thus far less conspicuous than expected by now, especially for labour markets, which is best explained by the extent of policy stimulus during the pandemic and labour shortages around the world. However, this longer lag in the impact of tighter policy on economies is simply deferring inevitable hard landings.



Sources: BLS; ABS; Refinitiv.

The US Federal Reserve finally paused tightening in the June FOMC meeting after ten previous consecutive rate hikes to just above 5%, although their dot plot projections imply two more hikes later this year. Fed officials remain vocal in their determination to tackle inflation despite the peak being clearly visible (US CPI peaked at 9.1% a year ago and is now 4.1%). The chart above explains the forecast of further tightening, and other measures of core inflation such as the core PCE index remain in the mid 4s. Whether there is one or two more hikes isn't the crucial question: the depth of the impending recession (likely around year-end) is more important for global markets. The inversion of the US yield curve is more pronounced than any time since the

1980s (100% correlated to recession) so it appears to be a case of when the economy goes into reverse, not if. When that happens, the jobless rate is expected to rise steadily from its current level of 3.7%.

The euro-zone economy is officially in technical recession after back to back quarterly contractions of 0.1%, and while the second quarter should see a rebound of 0.5%, the risk of a double dip recession is real given the latest central bank forecasts. The ECB lifted rates 0.25% to 3.5% last week and raised its headline and core inflation expectations for this year and next, so a classic example of stagflation.

The German economy was more decisively in recession as GDP contracted 0.3% in Q1 after a 0.5% decline in the fourth quarter of last year, driven by a greater reliance on Russian energy than other EU countries. Meanwhile, the UK remains one of the most impacted by the global inflation shock with core inflation rising to 7.1% in May (versus 5.4% in Germany and 5.8% in France), not helped by the fact that it imports over half its food, much of it from the EU. For the Bank of England their next policy meeting (tonight) will be a question of whether to hike rates by 25bp to 4.75% or accelerate to 5%.

China's economic position remains a remarkable contrast to the rest of the world given their core inflation rate is 0.6% (year-on-year!), although the impressive recovery in the Chinese economy in Q1 after easing COVID restrictions has lost momentum to a degree. As a result, policy support has been added with a 10 bp cut in the 7-day reverse repo rate (to 1.9%) and other key benchmark lending rates were cut by the same amount.

China's cabinet met last week to discuss support measures, and beyond further rate cuts and decreases to the reserve requirement ratio for banks, there is likely to be more infrastructure spending, household subsidies and local government bond issuance. This will shore up the 5% growth target for 2023, and it is hoped will add directly to demand for Australian exports, at least in the near term. Meanwhile, Australia's second largest trade partner, Japan, is still yet to kick off its tightening cycle despite inflation remaining above the 2% target for 13 straight months. The BOJ kept the short-term interest rate at -0.1%, with no change to 'yield curve control' despite core consumer inflation reaching 3.4% and reported pay rises the highest since 1990. Coincidentally the Nikkei stock index last month hit its highest level also since 1990.

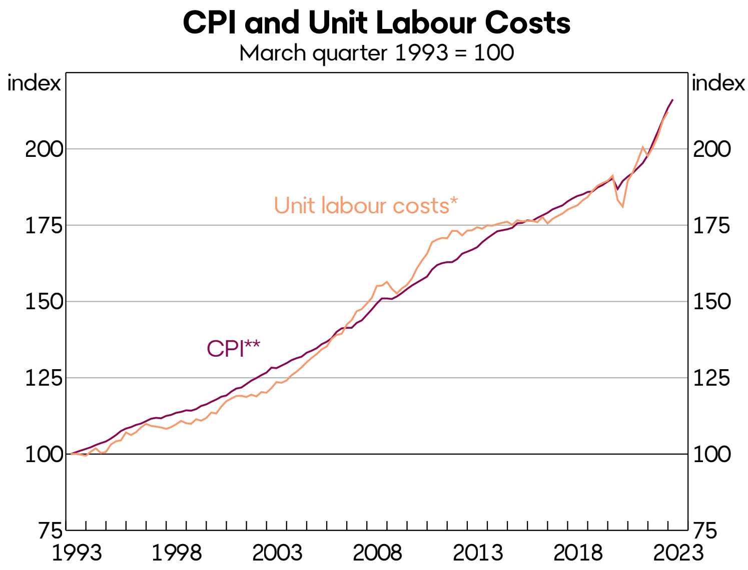
In summary, most major economies still have their most challenging economic periods ahead of them in this cycle, despite resilient labour markets. In some respects, it is because of resilient labour markets, which add to the task of central banks in managing inflation by adding spare capacity via lifting unemployment. The lag of monetary policy is longer than usual in this unique environment, which adds to the risk that central banks will overshoot with rate hikes.

Domestic economy

Minutes from the latest RBA policy meeting stated that the hike to an official cash rate of 4.1% was a finely balanced decision with serious consideration to another pause, although the language from Philip Lowe in his speech the day after the meeting was far more decisive. Lowe argued in the speech (as he no doubt did in the policy meeting) that the risk in delaying hikes - and that as a result inflation 'stays too high for too long' - is far more harmful than the shorter-term pain that higher rates will place on households. So the RBA's dual mandate of achieving price stability while 'keeping the economy on an even keel' is intact, but there is clearly a prioritisation of addressing inflation over a soft landing, and acceptance that a hard landing is preferable to risking unanchored inflation.

A cash rate above 4% makes a soft landing much less likely to occur, so our base case scenario now includes an economic contraction in the third and fourth quarters- full details are below; however it is important to note that this scenario is only narrowly favoured over a softer landing, with roughly a 60/40 split. Some of the offsetting factors (population growth, strong labour markets and robust exports) suggest that even a technical recession will not equate to a deep contraction nor the 7-10% fall in aggregate employment that previous Australian recessions have entailed.

Our economy continues to be better positioned than most to deal with the global inflation shock, and the recent rebound in population growth will help with tight labour markets (refer appendix). However the RBA are clear in their assertion that (in the absence of productivity growth) wage increases, driven by tight labour markets and the 5.75% increase in the award rate, will feed into unit labour costs. The chart below shows the strong correlation between unit labour costs and inflation, and the appendix shows Australia's lack of progress with labour productivity. As such, the rate hikes bluntly look to add spare capacity by lifting the unemployment rate: estimates for NAIRU (the non-accelerating inflation rate of unemployment) are around 4.5%, so presumably the RBA would like to return closer to this level. The latest jobs data would have only added to concerns of tight labour markets, given the fall in unemployment back to 3.6%, and a stunning 75k increase in employment (62k full time) to a new peak of just over 14 million



* RBA measure; adjusted for JobKeeper subsidies in 2020-2021.
** Seasonally adjusted; excludes interest charges prior to the September quarter of 1998; adjusted for the tax changes of 1999-2000.
Sources: ABS; RBA.

Prior to the jobs data the market was resigned to one more rate hike: now the majority of forecasts have back-to-back RBA hikes to 4.6%. To avoid this outcome, we will presumably need to see a downward surprise in the monthly CPI read for May out next week, and the quarterly data late next month. Our forecast below also shows a cash rate at 4.6%, but the timing very much data dependent.

The GDP data released earlier in June showed the economy only grew 0.2% in real terms in the first quarter, making annual growth 2.3%. The details in the national accounts included:

- Despite lower discretionary spending, another fall in household savings (down to 3.7% of income, the lowest since the GFC) as interest paid on mortgages grew 11.5% in the quarter
- Compensation of employees grew by 2.4% in the quarter
- Labour productivity was weak with GDP per hour worked down 0.2% for Q1 and unchanged from late 2019 levels

Consensus for Q2 GDP growth is only another 0.2%, so quarterly contractions in the second half of the year will equate to negligible real growth through 2023 at best- well below the RBA forecast of 1.2%. Population growth (while welcome to deal with chronic labour shortages) will complicate this data, and also adds to rental and affordable housing challenges. The Federal government was unable to get its Housing Australia Future Fund through parliament but did commit to an additional $2 bn of new funding for public housing. Property prices are dealing with opposing forces of shortages and a rebound in net migration, versus the challenges of higher interest rates and very low consumer confidence.

The Australian Dollar reached a 4-month high at 69 cents last week as a higher peak in rates became more likely, on top of a weaker US Dollar, and also as China cut rates to boost demand. The correlation for the Aussie Dollar with China's outlook is evidenced by the sharp rise since the .6460 low earlier this month, but uncertainty around the effectiveness of stimulus measures will keep volatility elevated. Meanwhile the New Zealand Dollar also rallied on the weaker greenback, but given their economy is now officially in technical recession and a deeper contraction awaits, the RBNZ has likely completed its tightening cycle.

Interest Rate Outlook

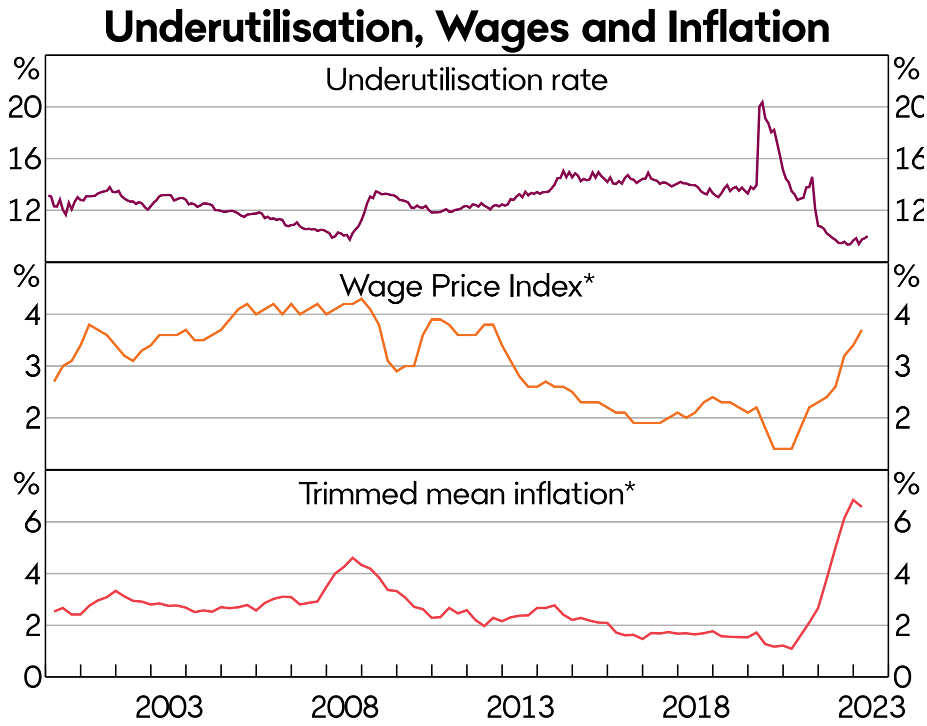
The accelerated path of RBA policy tightening with a less patient attitude to inflation returning to target, together with the latest fall in the unemployment rate suggests that another one to two hikes are imminent by August. A pause is then likely but with the tightening bias remaining in place, and rate cuts not likely until deep into 2024. The timing of rate cuts will be determined by the path of core inflation (not by the timing of the likely economic contraction ahead).

Interest Rate Outlook

	30 / 4 / 22	30 / 4 / 2023	31 / 5 / 2023	22 / 6 / 2023
90-day bills	0.71%	3.69%	4.01%	4.28%
3-year swap	2.60%	3.42%	3.74%	4.26%
5-year swap	2.96%	3.57%	3.84%	4.30%
AUD/USD	.7485	.6615	.6510	.6780
ASX 200	7 500	7 309	7 214	7 196
Credit Index (iTraxx- 5 yr)	95.5	87.0	83.0	78.8

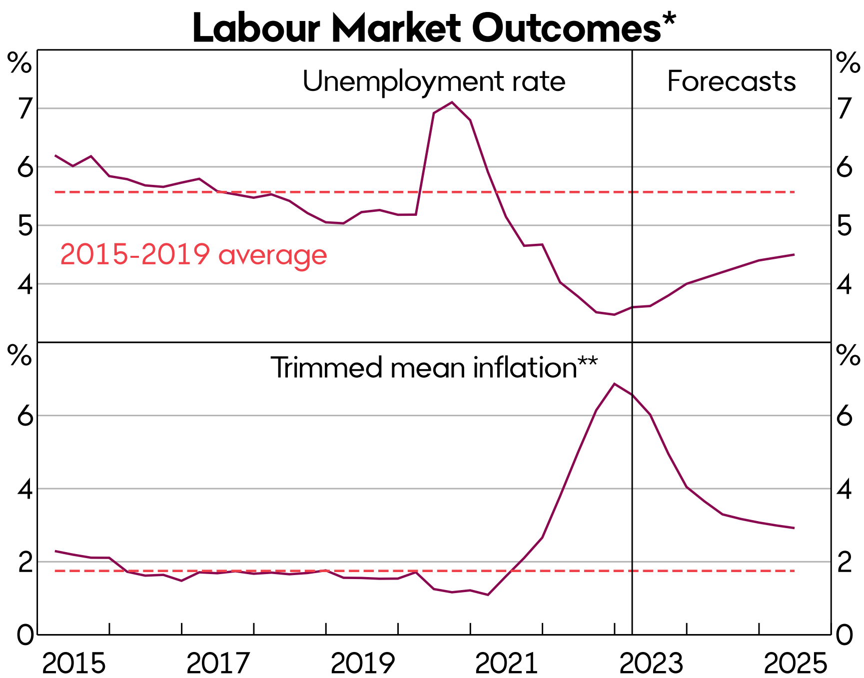
Economic Forecasts: basecase scenario

	2021	2022				2023				2024	
% (actual, forecast)	Q4	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q4
GDP q/q	3.9	0.8	0.6	0.6	0.2	0.2	-0.1	-0.3	0.2	0.3	0.4
GDP y/y	4.6	3.1	6.0	2.6	2.3	1.7	0.9	0.0	0.0	0.2	1.3
Unemployment	4.2	3.6	3.6	3.5	3.5	3.7	3.9	4.5	4.7	5.0	5.5
CPI (q/q)	1.3	1.8	1.8	1.9	1.4	1.1	0.7	0.6	0.9	0.8	0.6
CPI (y/y)	3.5	6.1	7.3	7.8	7.0	6.2	5.1	3.8	3.3	3.0	3.0
CPI (core y/y)	2.6	4.9	6.1	6.9	6.6	5.8	4.9	3.9	3.5	3.3	3.0
RBA cash rate	0.1	0.85	2.35	3.1	3.6	4.1	4.6	4.6	4.6	4.6	3.85
AUD / USD	.7270	.6905	.6410	.6815	.669	.68	.71	.73	.74	.75	.77



* Year-ended.

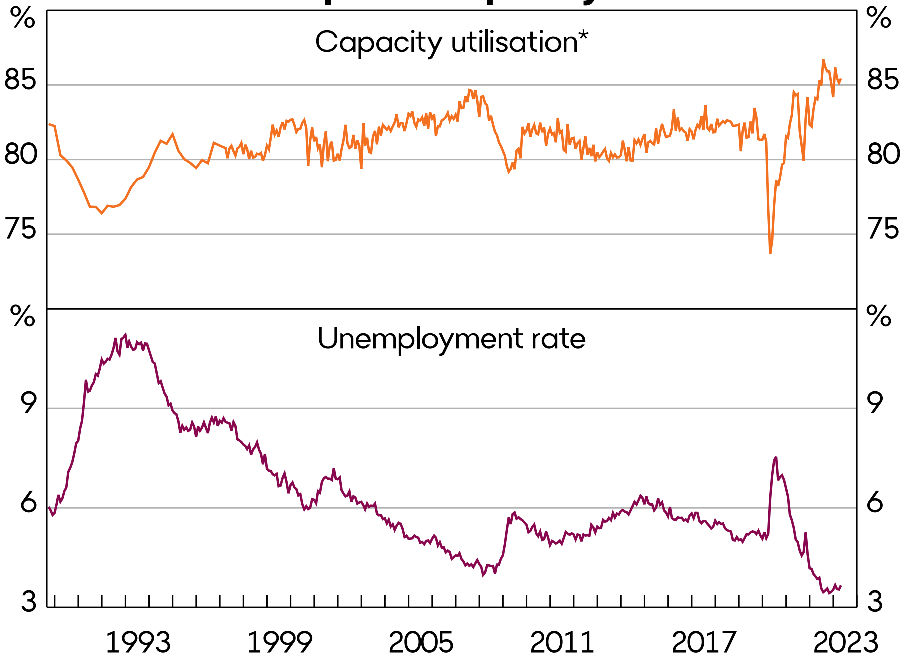
Sources: ABS; RBA.



* Forecasts are as at the May 2023 Statement on Monetary Policy.
** Year-ended.

Sources: ABS; NAB; RBA.

Space Capacity

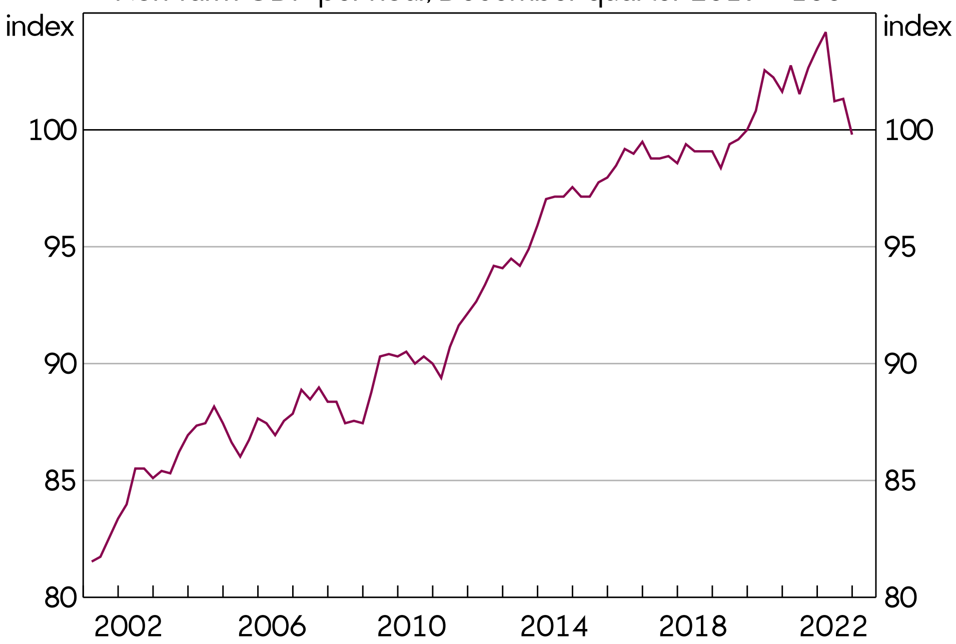


* Non-mining capacity utilisationl investment share weighted.

Sources: ABS; NAB; RBA.

Labour Productivity

Non-farm GDP per hour, December quarter 2019 = 100



Sources: ABS; RBA.