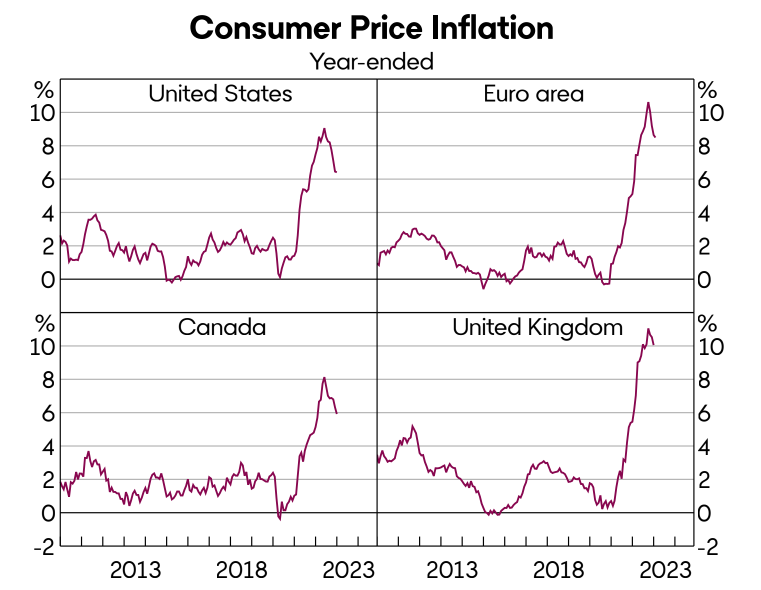
March 2023

Economic and market update

Economic Overview – as at 23rd March 2023

Global markets

Further progress on inflation is evident around the world thanks to central bank tightening, however the impact of higher interest rates is also becoming seen in unexpected arenas including US and European banks. The well documented recent challenges with Silicon Valley and Signature Banks were swiftly managed by authorities who guaranteed all deposits in the banks, but the events were somewhat driven by the sharp rise in bond yields over the last year. The subsequent demise of Credit Suisse was caused by a range of factors, ultimately resulting in a 'merger' with UBS, but for central banks does add complexity to policy deliberations. Dealing with inflation is distinct from dealing with financial instability: inflation demands tight monetary policy while financial instability is managed by adding liquidity- however any tightening in credit conditions from these events will do some of the heavy lifting that monetary policy would otherwise have had to do single handed.



Sources: RBA; Refinitiv

The US Federal Reserve pressed on with another 25 basis point rate hike this morning (4.75 – 5% band), but acknowledged that turmoil in the US banking sector would impact confidence and demand. The Fed noted that 'recent developments are likely to result in tighter credit conditions for households and businesses, and weigh on economic activity, hiring and inflation'. We have likely seen the last hike in this cycle, and expectations of a H2 '23 US recession are as widespread as ever. The timing of the next easing cycle is much harder to anticipate, as US labour markets still appear healthy despite the slight uptick in the unemployment rate from 3.4% to 3.6% in February. US core CPI is 5.5%, but as the economy slows the focus will move from inflation to supporting jobs, manufacturing and stability. Bond yields have fallen sharply as the US banking sector turmoil played out. The Bank of Canada have paused their rate hikes (at 4.5%) with CPI now down to 5.2%, and core inflation down to 4.7%.

The European Central Bank delivered another rate hike last week (+50 bp to 3%) as promised the month before, and to have not proceeded with this ostensibly due to the Swiss banking drama would have potentially created even more instability. From here, there are much lower expectations of further rate rises, and while some euro-zone recession fears had subsided earlier in the year the March ZEW economic sentiment survey saw a sharp fall for Germany and for the euro area. Volatility in European gas markets has been building, potentially exacerbated by strikes in Britain's oil and gas sector. UK inflation is proving most stubborn (refer chart above) and for February, again surprised on the upside with CPI at 10.4%, although core inflation is 6.2%.

In contrast, activity data from China points to a strong rebound as hoped, with a leap in consumer spending and gains in industrial production and fixed asset investment. The recent National People's Congress disappointed some observers by only setting a 5% growth target for 2023, but this data and the recent cut to the Reserve-Requirement Ratio suggests that this target will be easily achieved. Property investment has picked up tentatively after widespread weakness last year, and house prices have stopped falling. The extent of lockdowns in '22 was always going to be followed by a sharp recovery, but further policy support suggests that the rebound will extend through the year. China's reopening and related demand for Australian exports remains a vital offset to global recession risks.

In summary, the recent banking sector stress in the US and Europe confirms the recession risks to the North Atlantic economies referred to in these monthly reports over the last 9 months, but doesn't currently pose global contagion risks. Contagion is much less likely today than in the 2007-09 GFC as

- Lending standards around the world (and in particular in the US) have improved markedly
- We don't face the transfer mechanism of extensively securitised US assets such as CDOs
- Banks have much higher levels of capital and more rigorous liquidity today vs 2007

As such, a North Atlantic region recession in 2023 appears to be more likely than a global recession, and Australia's major trading partners appear far less likely to fall into recession this year.

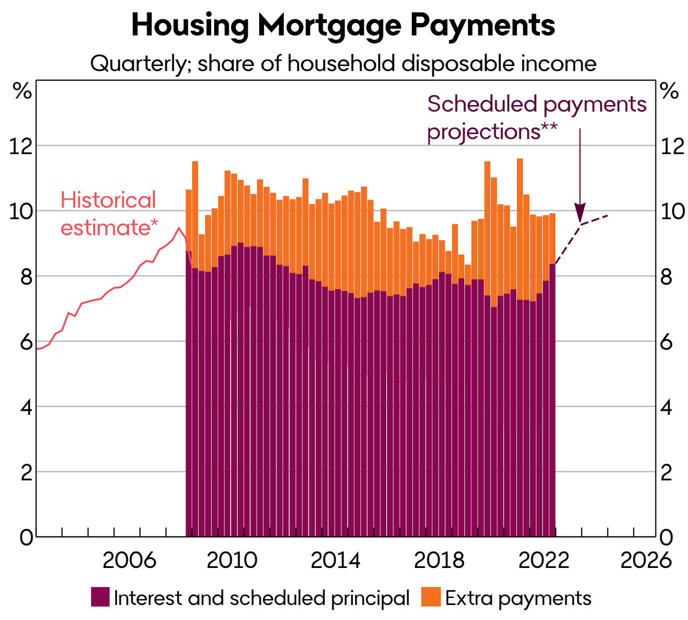
Domestic economy

The RBA are well positioned for a pause in rate hikes in April after their tenth successive increase to 3.6% in early March, having softened their language as per minutes released this week, and after further evidence that the economy is slowing and responding to higher rates. The latest developments in the US and European banking systems (detailed above) add weight to the arguments for a pause in the global context, although financial system contagion here appears most unlikely. Data pointing to an imminent peak, or at least pause in RBA rate hikes, includes the fall in CPI based on the monthly series from 8.4% to 7.4% in January, although the quarterly CPI data (for Q1) to be released on 26 April will be more influential for the RBA.

Q1 core inflation is hoped to fall from 6.9% to around 6.5% - only a mild improvement but potentially enough to indicate that the peak has been seen and further rate hikes may overshoot.

Indeed, the aspirational comment from Philip Lowe after the March hike that if the RBA can 'successfully navigate that narrow path, inflation will return to target in a reasonable time and we will be able to preserve some of the gains in the labour market' shows they genuinely want to avoid overshooting, and are committed to managing inflation but protecting jobs.

The latest jobs data appeared strong at face value with a fall in unemployment from 3.7% to 3.5%, however on closer inspection the fall was from 3.67% to 3.54%, and the trend data was less emphatic. Tight labour markets were a key feature of 2022 but an easing in job vacancies and a return of net migration (on top of a slowing economy) should see the unemployment rate gradually rise from here. Moreover, the lower read on the Wage Price Index last month, and the latest fall in the nab business survey (with business confidence falling from +6 to -4), may ease some of the RBA's concerns of wages growth feeding unhelpfully into inflation.



* Estimated scheduled payments using credit foncier model.

** Based on cash rate increases to date. Projections incorporate the observed gap between cash rate increases and increases to variable loan rates.

Sources: ABS; APRA; RBA

The Q4 GDP data released at the start of March showed a deceleration in real growth (although the nominal economy was still growing very strongly), but importantly also showed household consumption slowing sharply. A larger share of household budgets will gradually move to mortgage payments, and as the chart to the left shows this is approaching a record percentage. The chart also shows that over the last decade households have been making extra payments via offset and redraw accounts (the orange portion of the bars in the chart) which suggests that the move to higher interest repayments will be helped by these buffers, but that they will be needed for debt servicing rather than discretionary spending. The appendix shows further data and charts on this transition, including borrowers moving from fixed to floating and the expected decline in savings (and spending) ahead.

The other factor suggesting that the RBA can sit out April and wait to see how markets and data evolve is the latest fall in consumer confidence. The Westpac MI survey for March was 78.5 (where 100 is neutral), while the weekly ANZ-Roy Morgan reading fell to 77.0. Last year confidence was low but consumers were still spending - we now face near-record low sentiment and a greater share of income required to support mortgage repayments; plus inflation is still making all good and services more expensive.

All of the above explains why the yield curve is suddenly factoring in rate cuts, however for the RBA to cut rates it would either need to be comfortable with inflation (which it clearly is not), or it would need a bigger issue than inflation to change its focus, e.g. a GFC style event. The last paragraph of the Global Markets section explains why this is not expected, but markets are clearly hedging their bets.

The Aussie dollar has been weighing up these pros and cons; a lower peak for US rates (and higher risk of US recession) is providing support, as is the rebound in demand from China, but a lower peak in RBA rates and volatility in global risk sentiment are headwinds. The basecase forecasts below show an expected appreciation of our dollar, assuming a 'softish' landing.

Meanwhile the Productivity Commission released its five-yearly Report last week, with a very sensible list of recommendations which (if adopted by federal, state and territory governments) can deliver sustainable real wages growth. A precursor to this is ensuring inflation returns to near target, but assuming inflation is contained then the blueprint for future prosperity lies in this report. It recommends reforms and ideas that can create a more dynamic and productive workforce (that will lift real wages) by education reform, migration, harnessing data and technology, competition and more adaptable workplaces.

Interest Rate Outlook

The RBA are likely to pause their hiking cycle in April ahead of key CPI data on 26 April and to assess the impact of recent financial instability offshore on credit and sentiment more broadly. Another hike to 3.85% in May is still possible, data dependent, although a plateau in rates with an ongoing tightening bias remains the basecase in the absence of a sharp deterioration in global conditions.

Interest Rate Outlook

	31 / 1 / 22	31 / 1 / 2023	28 / 2 / 2023	23 / 3 / 2023
90-day bills	0.08%	3.37%	3.56%	3.70%
3-year swap	1.55%	3.62%	4.11%	3.36%
5-year swap	1.92%	3.82%	4.27%	3.59%
AUD/USD	.7070	.7055	.6730	.6735
ASX 200	6 972	7 477	7 258	6 969
Credit Index (iTraxx- 5 yr)	75.5	80.3	87.3	97.3

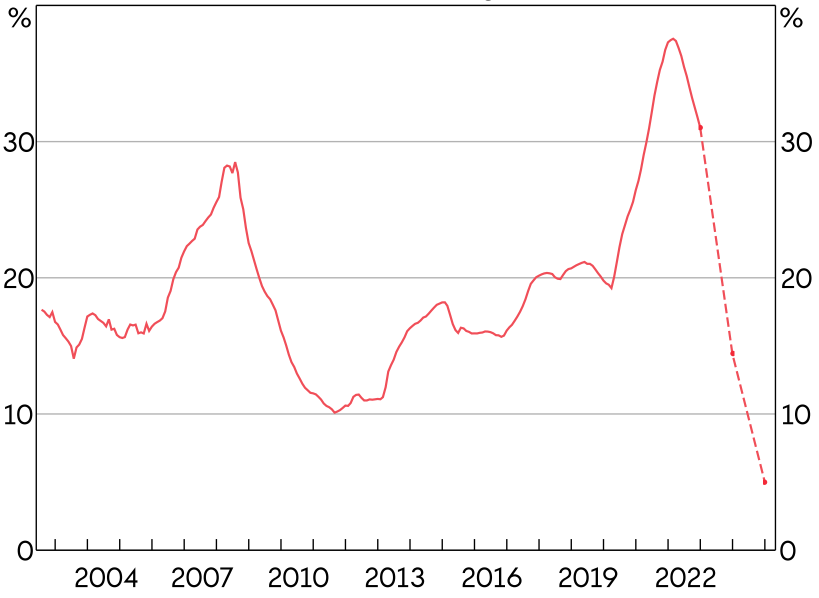
Economic Forecasts: basecase scenario

	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	3.6	3.9	4.2	4.5	4.7	4.9
CPI (q/q)	1.3	2.1	1.8	1.8	1.9	1.2	0.8	0.7	0.6	0.9	0.8
CPI (y/y)	3.5	5.1	6.1	7.3	7.8	6.6	5.6	4.5	3.3	3.0	3.0
CPI (core y/y)	2.6	3.7	4.9	6.1	6.9	6.5	5.4	4.5	3.6	3.4	3.3
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	.69	.71	.73	.75	.76	.77

Appendix: Rising interest rates and home lending

Fixed-rate Housing Loans

Share of outstanding credit*

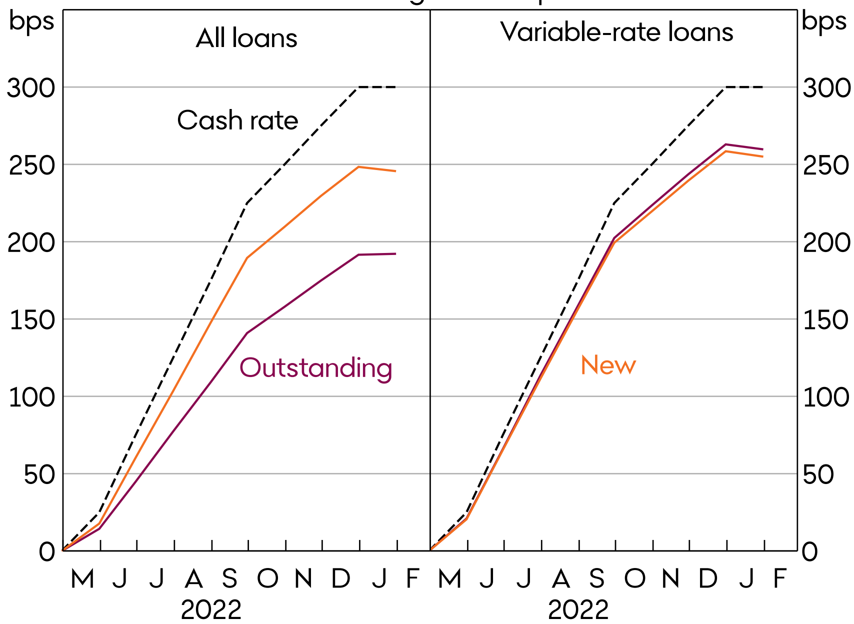


* Dashed line assumes housing credit remains constant and all fixed-rate loans roll-over to variable rates; alternative scenarios assuming the current share of fixed-rate lending continues yields similar estimates. Smoothed across end 2023 and end 2024.

Sources: APRA; RBA

Change in Housing Lending Rates

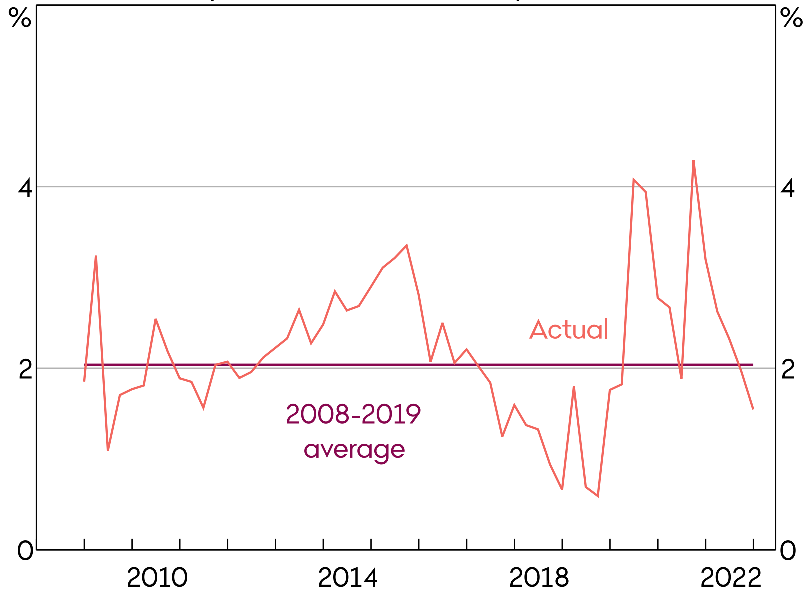
Cumulative change since April 2022



Sources: APRA; RBA

Extra Mortgage Payments*

Quarterly; share of household disposable income

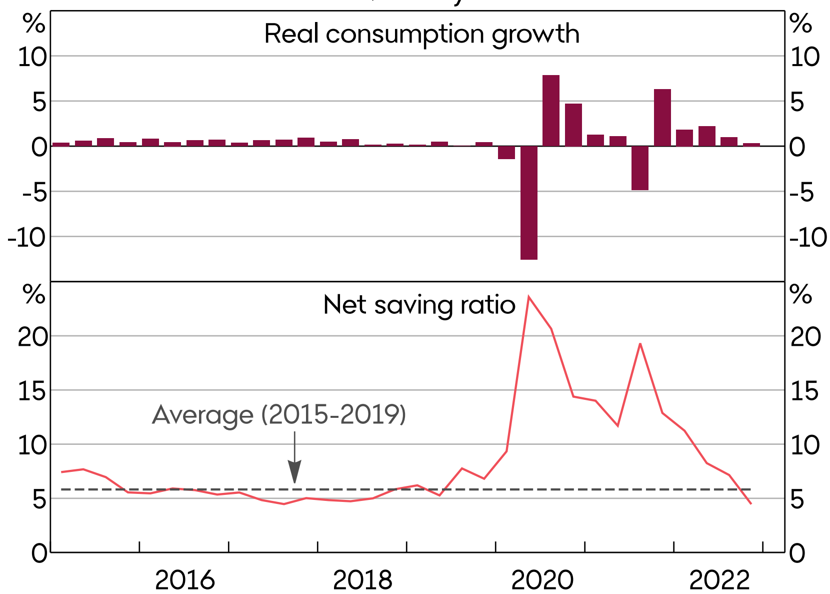


* Net payments into offset and redraw accounts.

Sources: ABS; APRA; RBA

Household Consumption and Saving

Quarterly



Sources: ABS; RBA