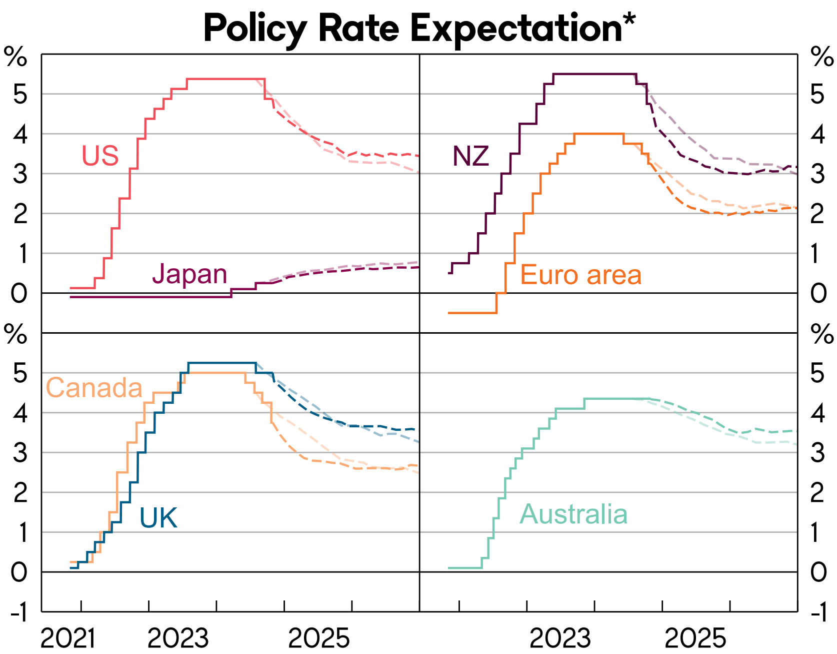
Economic and market update

Economic Overview – as at 21st November 2024

Global markets

Easing cycles have continued in most advanced economies as the global inflation shock has further dissipated, however bond yields have risen over the last month as the likely depth of the cycle has been reassessed. Geopolitical tensions have risen again in Europe and the Middle East, and the outlook for global trade is most uncertain in the wake of the US Presidential election and the promise of much higher US tariffs ahead. Safe-haven assets are in demand in line with these tensions, while the 'Trump trade' of higher stock markets, bond yields and a stronger US Dollar is in place for now.



* Darker dashed lines show expectations implied by current overnight index swap rates; lighter dashed lines show the same expectations as of 31 July 2024.

Sources: Bloomberg; RBA.

The US Federal Reserve are still expected to steadily reduce interest rates but the pace and extent of easing will probably be slower and shallower, partly due to resilient US economic data continuing but also with uncertainty ahead of how new policies will impact demand and ultimately prices. The promise of tariffs may see a short-term build-up of inventories and associated spike in activity, while the medium-term consequences of tariffs is universally expected to be inflationary (in the US). Federal Reserve comments continue to emphasise being data dependent - but that data may over time resemble stagflation (after the initial flurry), depending on the timing and sequencing of new policies. The Republican 'clean sweep' suggests an easier path for the policy platform, but the financial market reaction to all of this may impact the willingness of Donald Trump (or his party) to disrupt too quickly.

The largest US tariffs have been flagged for exports from China, with a blanket 60% rate expected to be one of the first policies implemented (given it can be imposed by 'executive order' without Congress approval). In 2018 the imposition of US tariffs created a trade conflict that quickly escalated but ultimately didn't slow down China's growing share of global goods exports, and (as the first chart in the appendix shows) today 1/6th of China's exports are with the US. Goods from China are roughly 14% of total US imports, down from above 20 % prior to the first trade war. China's recent stimulus package was primarily targeted at the property market and supporting local government, while further policy support is likely to intensify in response to the tariffs and should be more broadly based to support domestic demand. Further rate cuts (refer appendix) and larger deficits will presumably be linked to the timing and impact of the impending trade war, and further depreciation of the Chinese Yuan may offset some of the impact of the potential tariffs.

Meanwhile, activity data for October showed an encouraging jump in China's retail sales of 4.8% y/y together with firm industrial production (up 5.4% y/y) and even the property sector gaining traction - all suggesting that recent stimulus measures have been effective to some degree. Infrastructure investment also rose in October and the Iron Ore price is back above US $100/tonne.

The European Central Bank is still expected to cut rates for the fourth time this cycle in December despite a jump in wages growth, as the euro-zone economy continues to struggle and the latest Financial Stability Review warning of risks associated with high sovereign debt. Economic growth in 2025 is forecast at just over 1% and recent events in Germany - with the collapse of the ruling coalition and the snap election on 23 February - point to challenges ahead coinciding with uncertainty via Trump's views on NATO. The conflict in the Ukraine took another turn with the US and UK allowing Kyiv to launch long-range cruise missiles into Russia. The euro has fallen below US 1.05 for the first time in over a year. The UK economy is bouncing back more solidly and core inflation is back up to 3.3% so further Bank of England rate cuts are unlikely until next year.

In summary, while equity markets continue to trade near record highs and investors tolerate low risk premiums, the ability of central banks to keep cutting rates in 2025 may be inhibited to a degree by trade tensions and geopolitical risks ahead. Tariffs pose the greatest threat to the country imposing them, but will add to market volatility and uncertainty in a range of locations, and present downside risks to global growth. Fiscal policy in many countries will likely attempt to compensate, although this clearly adds to sovereign debts risks in the years to come.

Domestic economy

None of the local economic data or global events over the last month have added to the case of an imminent RBA rate cut, however the third quarter inflation data confirmed that any further rate hikes appear most unlikely and that a series of cuts in 2025 remains on track. The Q3 data was almost exactly as forecast at 0.2% headline inflation for the quarter, which equated to 2.8% annual CPI, but as widely expected the core inflation rate (best measured by the trimmed mean) was materially higher at 0.8% q/q and 3.5% annually. Since this data we have seen a rise in consumer sentiment and business confidence, another strong read for labour markets and the US Presidential election with its consequences (detailed above) for potentially shallower easing cycles than previously estimated.

Even prior to these events, minutes from the November monetary policy meeting implied that the RBA board would like to see two good quarters of lower core inflation. At face value this takes a February cut out of the equation, however the monthly CPI indicator accompanying the Q3 data was a reminder that progress is still being steadily made, with CPI down to 2.1% and the

Annual Trimmed Mean at 3.2%. The minutes did at least seem to be contemplating rate cuts ahead: " members recognised it was important to be ready to adjust the future stance of monetary policy as the economic outlook evolves. Members therefore considered the conditions that might warrant either a future change in the cash rate..." but reiterated that returning inflation sustainably to target remained the priority. So perhaps preparing us for a cut in May (after two lower quarters of core inflation to be released in January and April), but not going so far as to expect one earlier.

Since the RBA policy meeting we have seen the outcome of the US Presidential election, which for Australia as a country with a significant trade surplus poses questions on the impact of tariffs - although given we run a trade deficit with the US this impact will be transmitted mainly via our largest trade partners (dominated by China and Japan). The impact on China is detailed above and the appendix provides further context, while for Japan there is similar uncertainty ahead but a smaller tariff (if any) to deal with, and recent Japanese trade data has revealed strong growth through Asia.

Another query for the RBA for monetary policy is determining just how restrictive rates are. The chart below shows we are less than one percent into restrictive territory (based on a 'neutral' cash rate of around 3.5%) which highlights how much less aggressive the tightening cycle was here than elsewhere. This doesn't argue against cuts next year but does explain why only three cuts are now fully priced into the curve. The forecasts in our basecase scenario have the first cut in May at 35 basis points followed by two 25 bp cuts later in 2025 - the logic being we should have ample evidence in May to start cutting but (unlike most of the other central banks) less need to go 50bp to get started.

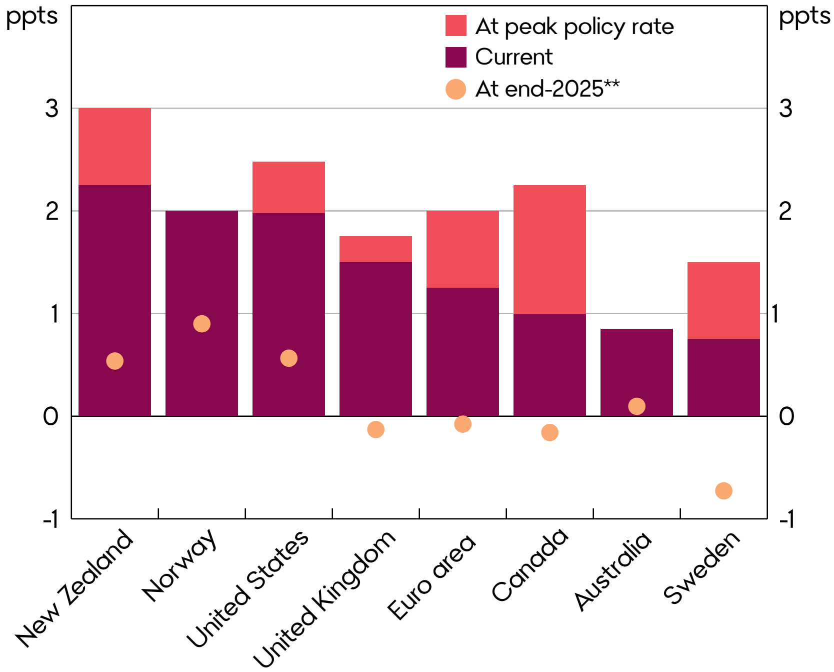
The 5.3% rise in consumer **sentiment** in November aligns to the improvement in real disposable income **underway** but similarly doesn't add to urgency for the RBA to cut rates just yet, with uncertainty as to how much of the improved household budget will be saved and how much spent. Business confidence was also higher in the latest nab survey (helped by the improved outlook for discretionary spending), but some of these gains may be tempered in the months ahead as global conditions evolve, and as expectations for a February rate cut are potentially deferred.

Labour markets remained resilient in October with the jobless rate unchanged at 4.1%, and while jobs growth is decelerating the expected rise in unemployment as job vacancies ease is yet to materialise. This matches one of the findings of the survey that many businesses are still having difficulties filling vacancies, so the RBA continue to note that this rate is tighter than 'full employment' based on their **modelling**. As such, a rise in the unemployment rate towards 4.5% might change the RBA's view that two quarters of lower core inflation are a prerequisite to any rate cuts.

The Aussie Dollar has fallen sharply in the wake of the US Presidential election as US bond yields have risen and the pace of Fed cuts has been reevaluated based on Trump's policy platform. The forecasts below now reflect a stronger US Dollar for the next few months ahead of the adverse impact of tariffs becoming apparent on the US, and as more evidence is needed to convince markets that Chinese stimulus measures will be effective (and will support demand for our exports to China).

Estimates of Policy Restrictiveness

Policy rate minus estimate of nominal neutral rate*



* Estimate of nominal neutral interest rate from central banks for all jurisdictions except United Kingdom, which uses estimate from the Bank of England's survey of market participants.

** Using market participants' policy rate expectations.

Sources: Bloomberg; central banks; RBA.

Interest Rate Outlook

The cash rate is very likely at its cycle peak at 4.35% and an easing cycle should commence in early to mid-2025. Headline CPI fell sharply in Q3 helped by electricity bill rebates, but core inflation is too high at 3.5% and the RBA remains patient (having kept rates at this level for a year). The most likely month for the first cut is May '25 although developments in labour markets could impact this timing.

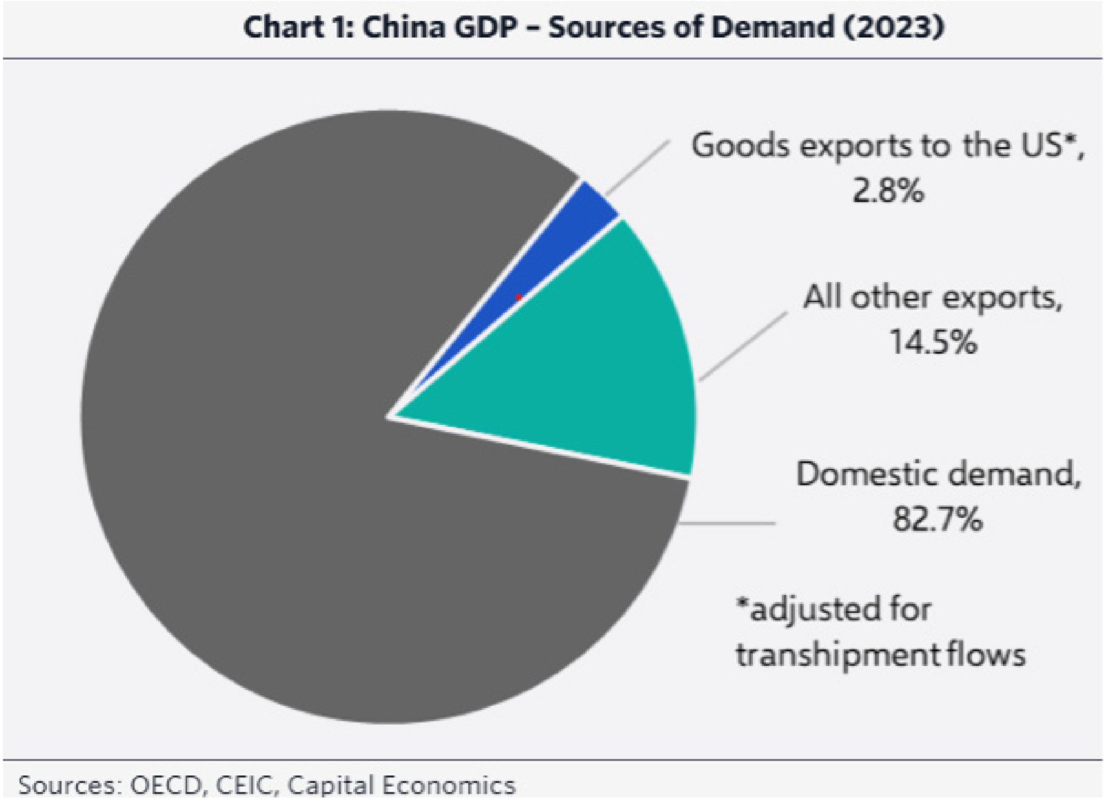
Economic Forecasts: basecase scenario

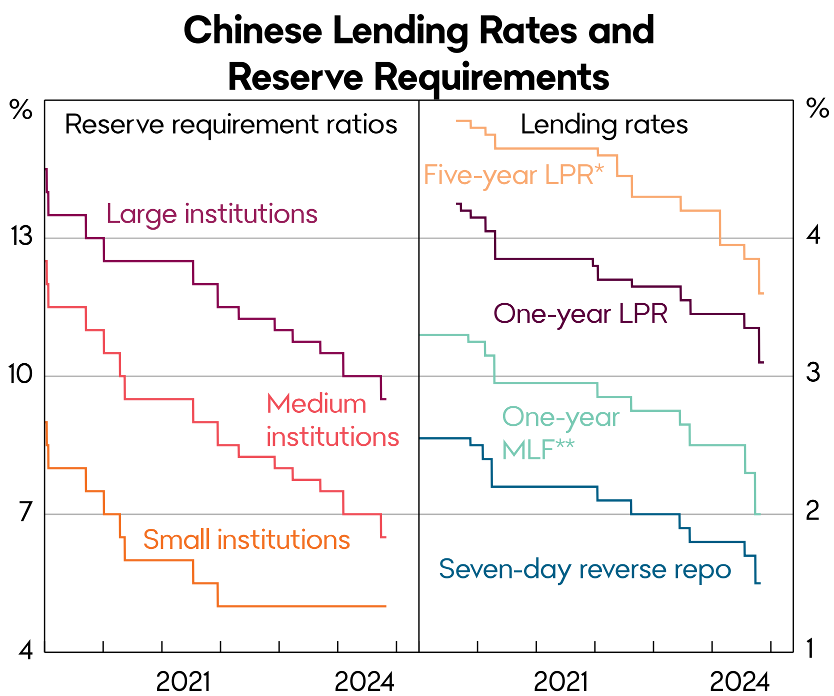
	2023		2024				2025			
% (actual, forecast)	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP q/q	0.3	0.2	0.2	0.2	0.4	0.4	0.5	0.6	0.4	0.8
GDP y/y	2.1	1.6	1.3	1.0	1.0	1.2	1.5	1.9	1.9	2.3
Unemployment	3.6	3.9	3.9	4.1	4.1	4.3	4.5	4.7	4.8	4.9
CPI (q/q)	1.2	0.6	1.0	1.0	0.2	0.5	0.8	0.9	0.8	0.7
CPI (y/y)	5.4	4.1	3.6	3.8	2.8	2.7	2.5	2.4	3.0	3.2
CPI (core y/y)	5.1	4.2	4.0	4.0	3.5	3.4	3.1	3.0	3.0	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	.65	.69	.73	.75	.77

Benchmark rates

	29 / 9 / 23	30 / 9 / 2024	31 / 10 / 2024	21 / 11 / 2024
90-day bills	4.15%	4.43%	4.41%	4.42%
3-year swap	4.26%	3.51%	4.04%	4.05%
5-year swap	4.47%	3.70%	4.27%	4.30%
AUD/USD	.6435	.6915	.6580	.6520
ASX 200	6 781	8 270	8 160	8 323
Credit Index (iTraxx- 5 yr)	87.5	61.9	65.2	65.8

Appendix: China





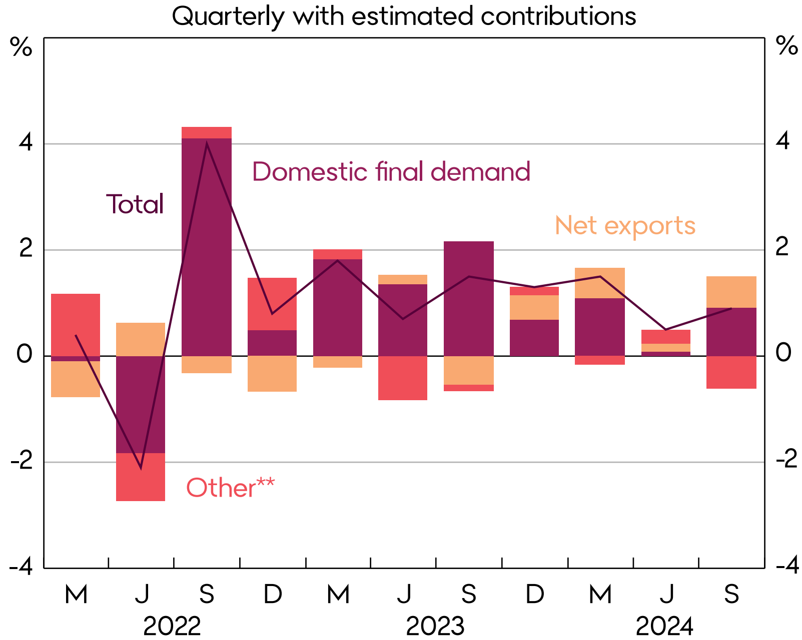
* The average interest rate on loans that commercial banks provide to their most credit worthy customers.

** 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 - GDP Growth*

Quarterly with estimated contributions

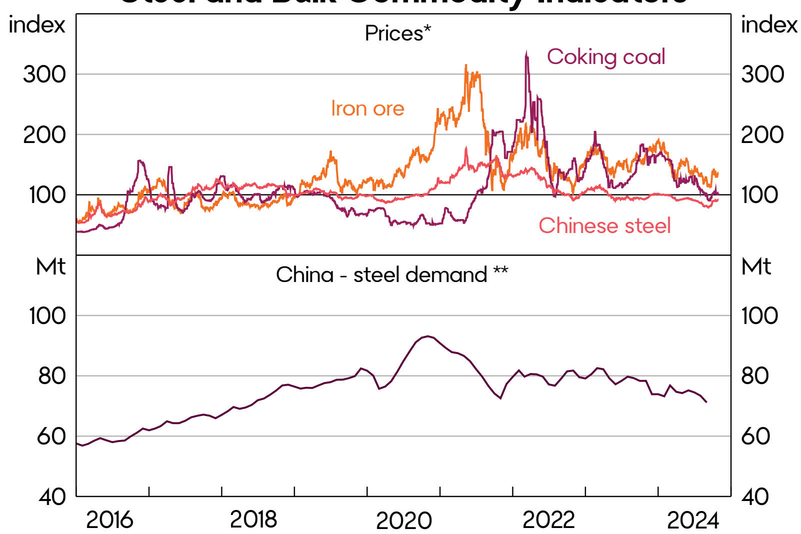


* Components seasonally adjusted by the RBA and their contributions calculated by the RBA.

** Reflects the change in inventories and the difference between RBA and NBS seasonal adjustment.

Sources: CEIC Data; RBA.

Steel and Bulk Commodity Indicators



* January 2019 average = 100.

** Estimated from steel production less net exports and less the change in inventories.

Sources: Bloomberg; CEIC Data; McCloskey by OPIS; RBA.