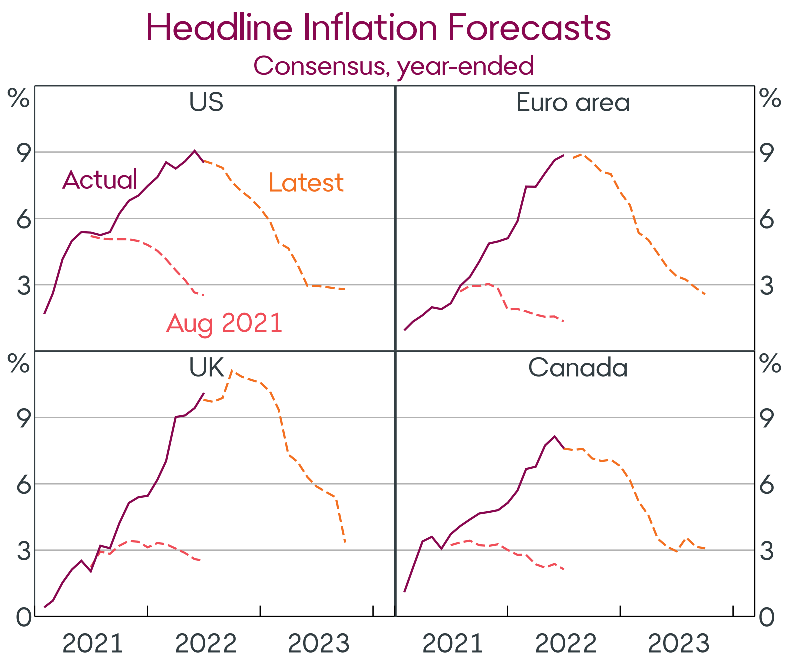
Economic and market update

Economic Overview – as at 21st September 2022

Global markets

Markets are back in defensive mode after the higher-than-expected US inflation data released last week quashed any hopes of an imminent peak in interest rates. The market reaction was a little surprising given headline CPI eased back to 8.3% but the focus was on core inflation rising 0.6% in August and 6.3% year-on-year. As noted in last month's report 'core inflation is still increasing and likely to peak later than consensus forecasts'. In reality, headline CPI has probably peaked (refer chart below) and there are some promising signs for supply this week including an easing of various restrictions in Chengdu and Hong Kong. Canadian CPI actually fell 0.3% in August; but more broadly Central Banks will need to be convinced that core inflation is completely tamed, so most CBs will retain a tightening bias for some time.



Sources: Consensus Economics; RBA

The Federal Reserve are set to tighten the Fed funds rate by another 75 basis points tonight (a full 1% is possible, but less likely). The market is now pricing in a terminal rate above 4% before cuts in late 2023- the curve remains inverted and yields continue to push higher. The dot-plot from tonight's FOMC meeting will show the ongoing resolve of the Fed to fight inflation with a commitment to exceed the Fed's neutral estimate of 2.5%, even as the economy slows and consumption begins to falter. The appendix shows a range of economic indicators (contrasting the US experience with Australia) including US labour markets still struggling to recover from the pandemic, and an exchange rate reflective of safe haven appeal rather than economic outperformance per-se.

European countries remain in the most challenging position given their energy dependencies and also their unique position exiting negative official interest rates. The ECB increased rates by 75 bp and another 2% of rate hikes are expected over the next twelve months, while non-EU countries face the same challenge: Sweden's Risksbank surprised markets last night with a 100 bp hike to 1.75%. Recession risks in Europe are even higher than in the US, and while the UK economy managed to grow 0.2% in July, new PM Liz Truss inherits an economy facing a long recession. The Bank of England are also expected to increase rates 50 basis points later this week, however the new PM has announced an Energy Price Guarantee running for 2 years, potentially taking 5% off inflation. Meanwhile the faltering Russian invasion in Ukraine might suggest some easing in oil prices. However, Putin's latest move to try to legitimise Russian-occupied parts of Ukraine via referendums (thereby making any NATO activity in them a direct conflict with Russia) threatens to escalate tensions.

The Chinese economy held up fairly well in August with retail sales up 5.4% y/y, although this was primarily driven by base effects from Delta a year ago, and August sales were impacted by virus disruptions and weather-related events.

Industrial Production and Fixed Asset Investment were helped by infrastructure spending and support measures; however China's property sector remains stressed. Their economy is likely to grow less than 3% this year (even via official numbers), but regional demand should help the recovery in 2023, hand in hand with further government support. The end of the COVID-zero strategy remains a key turning point ahead.

In summary the risks to the global economy of stagflation have not eased at all, and global growth is likely to just exceed 2% this year before slowing further in 2023. As previous reports have noted these risks remain much higher in North Atlantic economies than in Asia. Markets are likely to remain volatile, but the trend of rising bond yields and tighter monetary policy appears well entrenched.

Domestic economy

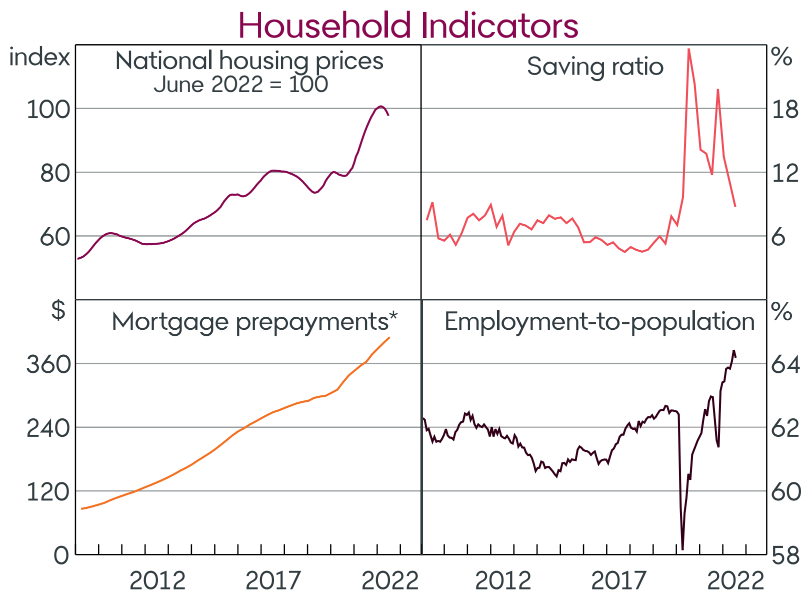
The Reserve Bank's September minutes from their policy meeting had very few surprises with no change in the emphasis on managing inflation to 'create a more sustainable balance of demand and supply in the Australian economy'. The RBA continue to highlight the need to tackle inflation head-on, and in a separate speech from Philip Lowe, he noted that failing to do so even with rising wages would leave households worse-off over time. In other words, even a short-term contraction or a recession is preferable to allowing inflation to become entrenched.

However the minutes still committed to the aim to 'return inflation to target while keeping the economy on an even keel'. This aspiration, together with the admission that the RBA considered a 25 or 50 basis point hike (before settling on 50), offers some hope that October could see a step down to 25 bp. This is supported by Lowe's comment in his recent speech that 'the case for a slower pace of increase in interest rates becomes slower as the level of the cash rate rises'. A compromise could be a 40 bp hike to 2.75% signalling the step-down; neat but unlikely - more importantly, the latest data continues to suggest that core inflation will remain above target for this financial year and probably much of next. As such a tightening bias is likely to be in place for a number of years, and thoughts of an easing cycle appear premature.

The latest jobs data clearly showed ongoing demand for labour with employment rising by 33.500, and the participation rate higher at 66.6% (although unemployment was a fraction higher at 3.46% (vs 3.38% previous). Underemployment fell to 5.9% and total hours worked rose strongly (up 8% y/y) - all of which underscores the strong position of labour markets. This is good news in the context of likely falls in property prices (more on this below), but confirmation that inflation isn't just about low supply at present - it's also being driven by demand. The slight uptick in consumer confidence in the monthly WBC/MI survey still leaves sentiment at very low levels. However, business confidence again rose in August, confirming (along with strong retail sales data) that household demand is intact and enabling businesses to pass on higher input costs to consumers.

The Australian economy grew by 0.9% in the second quarter, equating to 3.6% growth y/y and showing consumer demand as the primary driver (mainly funded by a fall in the savings ratio, from 11% to 8.7%); but housing was the weak link with dwelling investment down 3% as capacity constraints and rising interest rates hit the residential construction sector. The Q3 annual growth rate will jump (refer forecasts below) as base effects from Delta lockdowns a year ago impact the equation, but growth in Q4 and through 2023 is expected to be materially lower, as rising interest rates start to take their toll.

The most sensitive sectors to interest rates include residential property and those dependent on discretionary spending. As the appendix shows, domestic consumption has picked up in services over household goods - and the focus now is on just how far property prices are about to decline, and the impact of rising rates on the Property Market.



* Stock of offset and redraw balances; seasonally adjusted and break-adjusted.
Sources: ABS; APRA; CoreLogic; RBA

The following chart from the latest RBA speech on this topic sums it up well. Prices have begun to fall, and will continue to do so for some time, but households have built up large savings during the pandemic (many of these are in offset and redraw accounts) and we have unemployment at a 50 year low. The speech also notes the different pace of declines in prices by location and by 'dwelling value'- there appears to be a sharp compression in housing prices underway, with the premium of inner city capitals losing its value.

The next data of significance for interest rates and RBA decision making is August Retail Trade (out on 28 September) and Job Vacancies to be released the following day, together with the first in the new series of monthly CPI indicators from the ABS. These data points, together with the pace of rate hikes from the US Federal Reserve and other central banks, will be critical in guiding the RBA with their rate decision on 4 October. A reduction to a 25 basis point hike would be popular, but markets are currently leaning towards 50 bp. Meanwhile, the Aussie Dollar continues to lose ground to the incredibly strong US Dollar, but is holding up very well to the yen, euro, pound and NZ dollar.

Interest Rate Outlook

The RBA are now much closer to achieving their aim of a neutral Official Cash Rate (around 2.5 to 3.25%) and are therefore close to stepping down from 50 basis point hikes to 25 bp. October is a good candidate to start moderating the pace, but it is likely that the OCR will exceed 3% next year, as core inflation remains persistently above target. A tightening bias will be in place for some time.

	31 / 7 / 21	31 / 7 / 2022	31 / 8 / 2022	21 / 9 / 2022
90-day bills	0.03%	2.11%	2.46%	2.88%
3-year swap	0.38%	3.03%	3.71%	3.77%
5-year swap	0.71%	3.24%	3.91%	3.96%
AUD/USD	.7340	.6985	.6840	.6675
ASX 200	7 393	6 945	6 987	6 709
Credit Index (iTraxx- 5 yr)	58	112	104	108

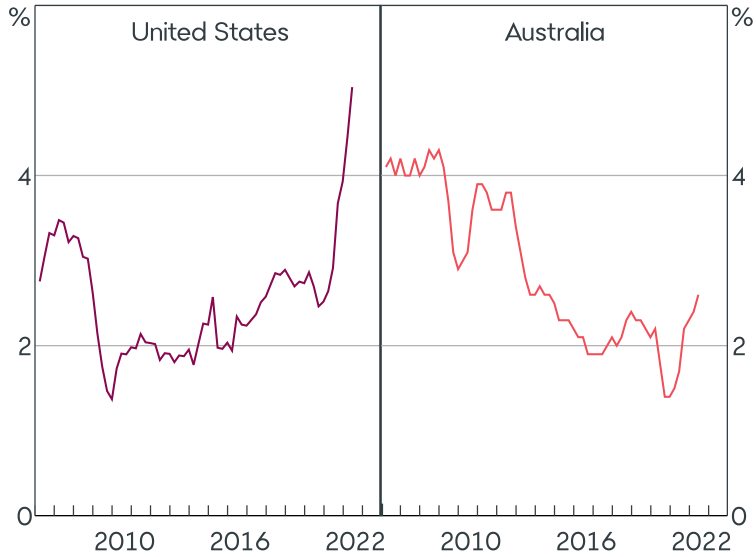
Economic Forecasts: basecase scenario

	2021	2022				2023			
% (actual, forecast)	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
GDP q/q	3.9	0.7	0.9	0.8	0.7	0.3	0.2	0.4	0.4
GDP y/y	4.5	3.3	3.6	6.3	3.1	2.7	1.7	1.6	1.3
Unemployment	4.2	4.0	3.5	3.4	3.1	3.3	3.6	3.9	4.2
CPI (q/q)	1.3	2.1	1.8	1.0	2.2	1.2	0.8	0.6	0.6
CPI (y/y)	3.5	5.1	6.1	6.3	7.1	6.2	5.2	4.8	3.2
CPI (core y/y)	2.6	3.7	4.9	5.5	5.7	5.1	4.4	3.7	3.3
RBA cash rate	0.1	0.1	0.85	2.35	2.85	3.1	3.35	3.35	3.35
AUD / USD	.7270	.7485	.6905	.67	.65	.67	.69	.72	.75

Appendix: Australia vs USA economic indicators

Wages Growth*

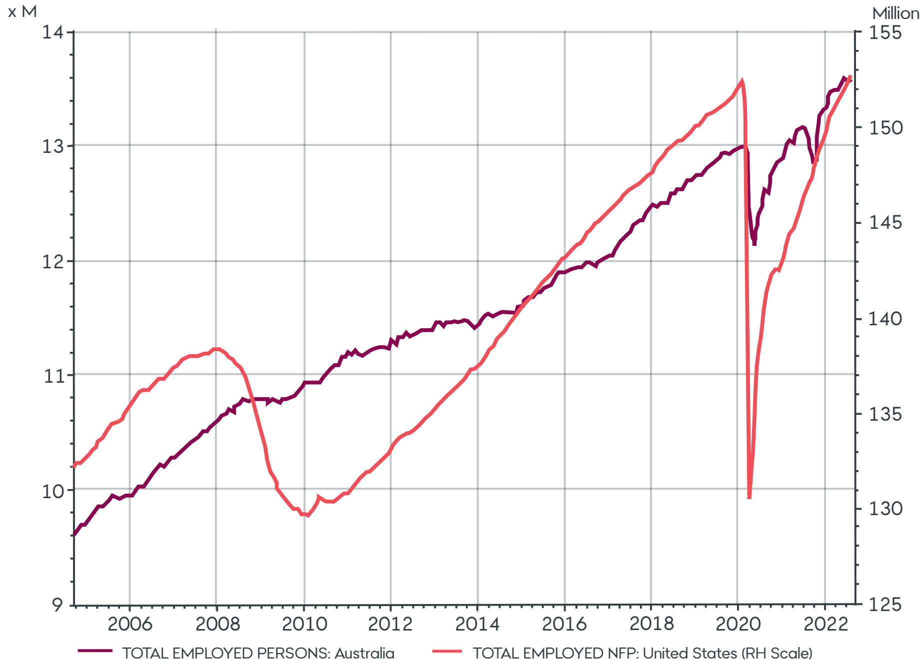
Year-ended



* Measured by the Employment Cost Index for the United States and the Wage Price Index for Australia.

Sources: ABS; Refinitiv

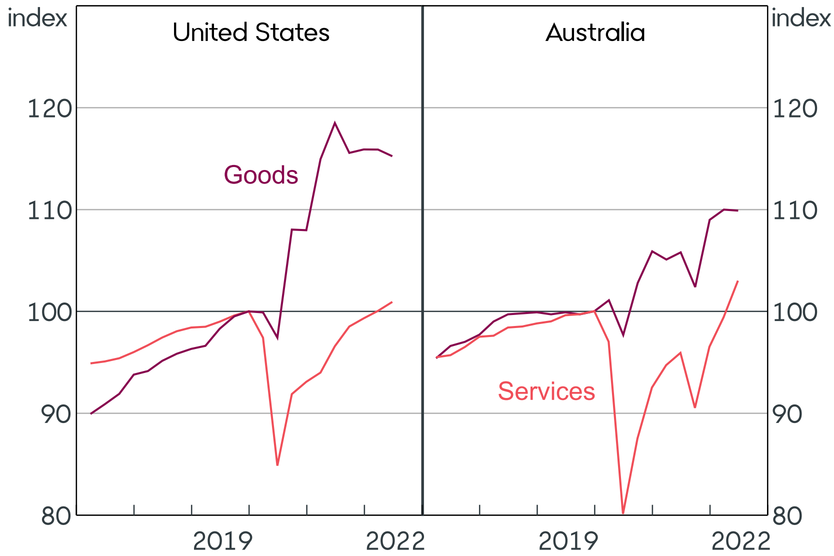
Employment (total number employed)



Source: Refinitiv Datastream

Consumption

December 2019 = 100



Sources: ABS; RBA; Refinitiv

AUD/USD exchange rate