September 2024

Economic and market update

Economic Overview – as at 19th September 2024

Global markets

The 50 basis point cut from the US Federal Reserve was larger than expected although financial markets had lifted expectations of deeper cuts leading up to the decision, and continue to welcome the prospect of steadily lower rates throughout 2025. Equity markets shook off the extreme volatility from a month ago by recapturing record highs in a range of locations, and the assumed US soft landing scenario appears more likely thanks to the Fed's largesse. However economic conditions in all the G7 countries remains patchy at best in the wake of the global inflation shock, and the recent fall in oil prices to some extent reflects pessimism for international demand next year.

Stock markets (indexed to 100 on 1/9/ 2019)

Fed chair J. Powell emphasised the word 'recalibration' in his post-FOMC press conference and warned against assuming future cuts would be as large, talking up the strength of US labour markets. He noted the balance of risks had become more even between inflation and supporting jobs, which justified the move towards a more neutral setting for rates (although the pace of this transition would depend on data and events). The 'dot plot' and associated comments suggest two more 25bp cuts are very likely in November and December, with another four cuts also implied in 2025. US data has been mixed with a fall in the pace of job creation and the recent triggering of the Sahm Rule (a rise in the average unemployment rate of 0.5% in less than a year); but retail trade and Industrial Production data in August were resilient after a better than expected US GDP outcome for Q2. The yield curve is no longer inverted, after a record period of over two years for the 10-year rate trading below the 2 year; although this 'dis-inversion' itself is considered by some to be a forewarning of recession!

Canadian inflation, like the US also appears benign allowing another rate cut in September (their third down from 5% to 4.25%) as CPI dropped to 1.95% and the trimmed mean down to 2.4% in August. Labour markets in Canada are weaker than the US (or here) with unemployment up to 6.6%, and another Bank of Canada rate cut is likely in late October.

The latest Europe Central Bank cut to 3.5% was as forecast but the ECB may now pause in October before resuming their easing cycle in December as wages growth and wide variations in conditions by region complicate the central bank's task. The ECB downgraded it GDP forecasts for the euro-zone to 1.3% in 2025 but also marginally lifted its estimate for core inflation next year to 2.3%. In the UK headline CPI was unchanged in July at 2.2% however services inflation rose to 5.6% y/y, suggesting the Bank of England will pause on further rate cuts until Q4.

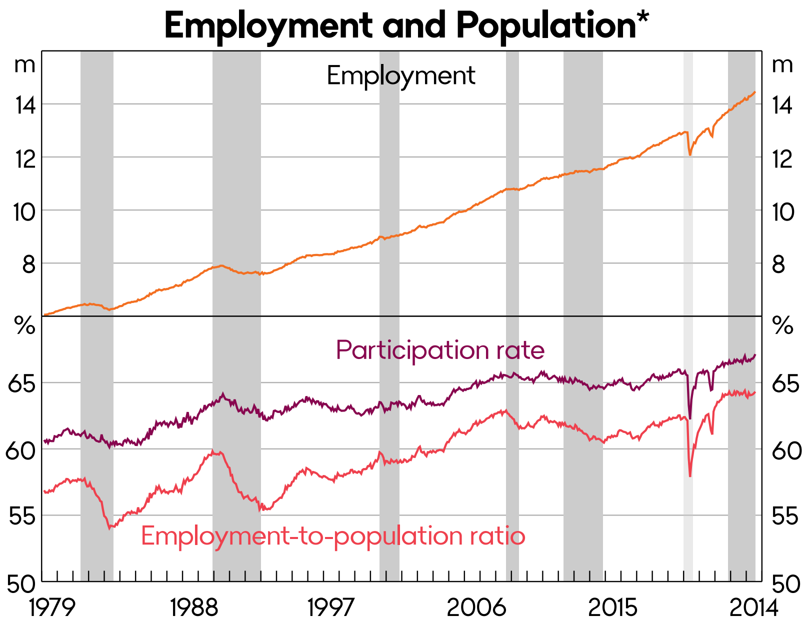
Japan's equity markets (having outperformed through the first half of 2024) continue to remain volatile ahead of further BoJ rate hikes expected later this year and into next, but the outlook is relatively positive after recent corporate profit and wages data. Export markets remain important for the Japanese economy, and while export growth slowed to 5.6% y/y in August and remains at the mercy of US demand (making the impending US election a crucial outcome) nevertheless regional conditions are favourable.

The Chinese economy continues to undershoot based on recent data leaving the 5% growth target at risk, but also suggesting further policy support is imminent. Retail sales in August slowed to 2.1% y/y and Industrial Production also decelerated to 4.5%, and while more policy stimulus is expected and President Xi urged central and local government to 'fully implement policies and measures to promote the development of the private economy', most analysts have again downgraded their forecasts. Property prices continue to decline and weakness in local equity markets have seen a flight to government bonds. Short term issues will likely be helped by more policy support, but the structural challenges facing China's economy will be much harder to overcome in the coming years.

In summary, the leadup to the US presidential election and ongoing geopolitical tensions may temper optimism associated with the faster pace of rate cuts in advanced economies, and sub-trend growth amid rising unemployment points to a challenging period ahead. Nevertheless progress on containing inflation is allowing central banks to return to more neutral interest rates, at various speeds.

Domestic economy

Unlike the vast majority of central banks who have initiated their easing cycles (or in some cases are considering their third or fourth cut) the RBA are no closer to easing monetary policy after another strong labour report released today. Our unemployment rate has risen from 3.7% in February to 4.2% in July and remained at that level in August, but is one of the lowest in the world and our vacancy to unemployed ratio demonstrates tighter labour markets than comparable economies. The RBA are left in the undesirable position of feeling the public (and to an extent political) pressure to cut rates as the US deliver a 50bp cut, and observing weak household spending and private demand, but by their own forecasts not expecting underlying inflation to return to target until late 2026. A weaker labour market may accelerate this timeline, and the appendix shows further details of the unwinding of tight labour markets and how this may progress, but the evidence isn't there yet. A premature RBA cut (which oddly the market has been pricing in at around 90% by year-end, despite the RBA governor specifically saying it won't happen) runs the risk that this path back to target inflation will take even longer, and could even derail disinflation altogether.



* Shading indicates labour market downturns, as indicated by persistent increases in the unemployment rate.
Sources: ABS; RBA.

The GDP data for Q2 certainly painted the picture of an economy that is struggling under the collective weight of inflated prices, the rising tax burden for households and the higher cost of debt, with 1% real GDP growth the lowest rate outside the pandemic since the '91 recession. Even this level was only achieved through public spending and population growth so we remain in a per-capita recession, but as much as the RBA may want to support the economy, the lack of progress on core inflation doesn't allow this luxury. Headline CPI will continue to fall fairly quickly in the wake of the federal, state and territory budget measures (e.g. electricity rebates) but underlying inflation measured by the trimmed mean won't enjoy the benefit of these rebates.

Consumer sentiment hasn't yet benefitted from the stage 3 tax cuts with the Westpac MI survey for September fell from 85 to 84.6, leaving it similar to levels seen in the '91 recession, the GFC and the Pandemic. Households are clearly more worried about higher interest rates and cost of living pressures (and potentially a harder landing) than the recent tax cuts, easing inflation and the prospect of rate cuts next year; and the divergent outcomes by state and region complicate the data. Similarly business conditions and confidence fell in the latest nab survey, but the wide distribution of outcomes by location are unusual (WA and SA have an unemployment rate of 3.9%, while in Victoria it is 4.5%). We are in an economic downturn (evidenced by the per-capita recession) that is unique when considering record highs for labour participation and total employment.

Looking forward, while acknowledging the uncertainty and uniqueness of the environment including the variations by state and urban vs regional, this should mark the low ebb for Australia's economic growth rate and for household incomes. How much of the improvement in incomes translates to demand (via consumption) or is saved remains a key unknown factor, and recent population growth and overhang from pandemic policy have skewed some of the data discussed above, but outlook is promising. The key risks to these tailwinds from improved household conditions probably lie in

- The risk that labour markets weaken more quickly (although this would speed up rate cuts)
- Weaker demand from overseas (refer comments on China above, sub-par global growth and the perplexing decision to put a cap on international students)
- Inflation failing to moderate, especially in the absence of improved productivity growth

A firmer Australian Dollar would help with countering imported inflation, and the divergence of policy easing in the US and other North Atlantic economies with Australia continues to be the basis of the forecast upside for the Aussie in the basecase scenario below. Resistance around US 68 ¼ to 68 ¾ c continues to cap rallies, and beyond these technical levels the questions on China's economy add to fundamental concerns, but interest rate differentials have historically been a crucial driver of the AUD.

Interest Rate Outlook

The cash rate is very likely at its cycle peak at 4.35%, and an easing cycle is expected to take shape in early to mid-2025. Another RBA hike is possible should core inflation unexpectedly lift against the current trend (although unlikely), and similarly a cut this calendar year would require data surprises. Headline CPI will fall sharply in Q3 as a result of electricity bill rebates, but underlying core inflation is unlikely to fall below 3.5% until the Q1 '25 CPI data to be released on April 30th. The most likely timing for the first RBA cut is therefore May '25, but markets are pricing at least one cut by February.

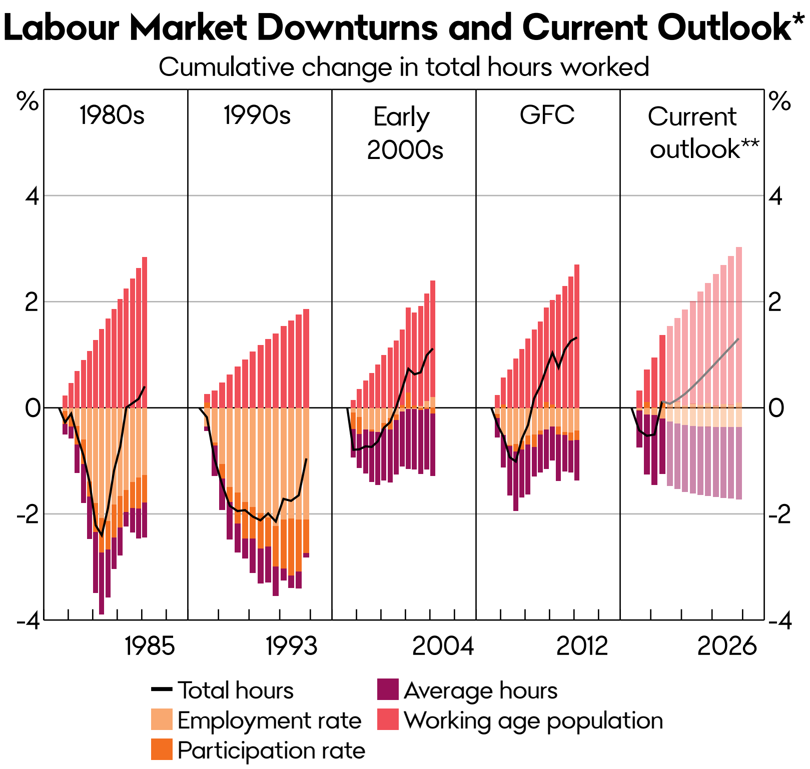
Economic Forecasts: basecase scenario

	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	4.3	4.5	4.7	4.9	5.0	5.2
CPI (q/q)	1.2	0.6	1.0	1.0	0.2	0.6	0.7	0.9	0.7	0.8
CPI (y/y)	5.4	4.1	3.6	3.8	2.8	2.9	2.5	2.4	2.9	3.1
CPI (core y/y)	5.2	4.2	4.0	3.9	3.4	3.4	3.1	3.0	2.9	2.9
RBA cash rate	4.10	4.35	4.35	4.35	4.35	4.35	4.35	4.1	3.85	3.6
AUD / USD	.6435	.682	.6515	.667	.68	.72	.73	.74	.75	.77

Benchmark rates

	31 / 7 / 23	31 / 7 / 2024	30 / 8 / 2024	19 / 9 / 2024
90-day bills	4.35%	4.49%	4.39%	4.42%
3-year swap	4.20%	3.82%	3.58%	3.54%
5-year swap	4.31%	3.99%	3.79%	3.75%
AUD/USD	.6720	.6535	.6765	.6800
ASX 200	7 410	8 092	8 092	8 188
Credit Index (iTraxx- 5 yr)	82.1	65.3	61.4	62.7

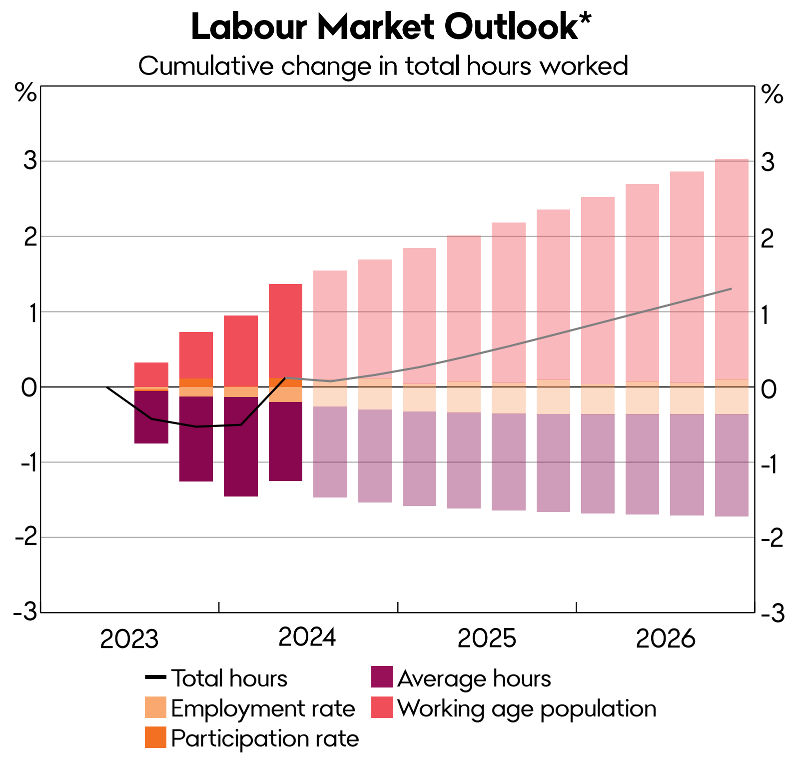
Appendix:



* Change relative to quarter coinciding with peak in total hours (that is, 1981:Q3, 1990:Q2, 2000:Q3, 2008:Q3 and 2023:Q2).

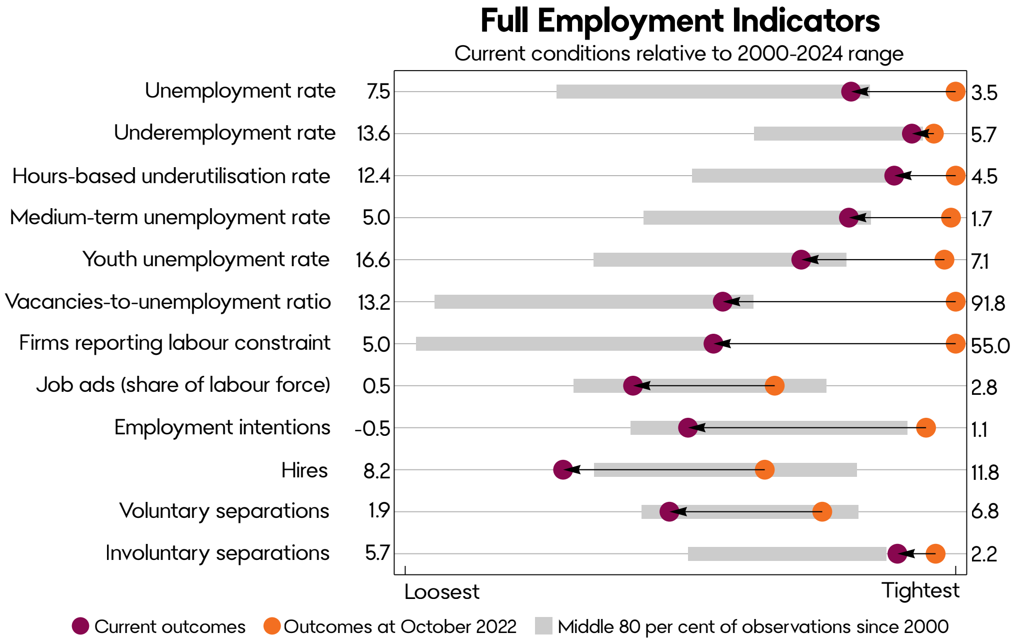
** Bars with transparency, and the lighter line represent August 2024 SMP forecasts.

Sources: ABS; RBA.

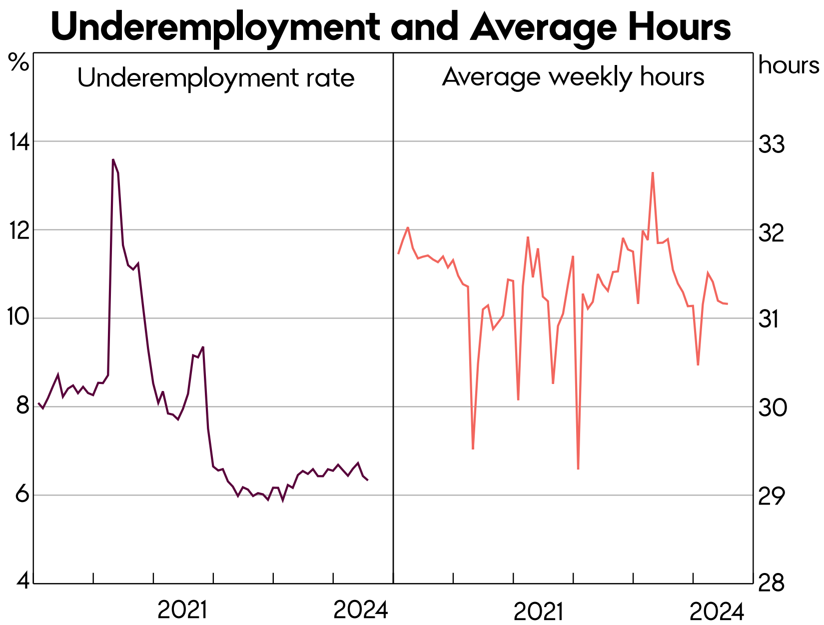


* Change relative to the most recent peak in total hours (June quarter 2023); bars with transparency, and the lighter line represent August 2024 SMP forecasts.

Sources: ABS; RBA.



Sources: ABS; JSA; NAB; RBA.



Sources: ABS; RBA.