December 2024

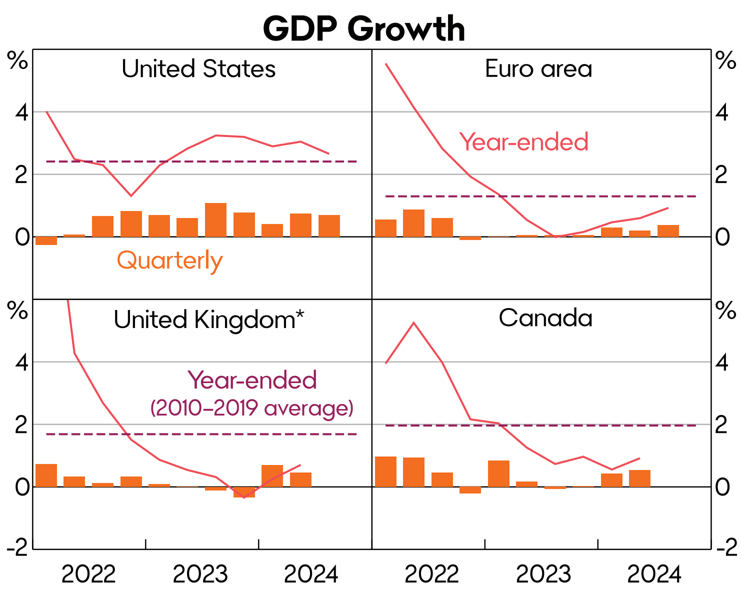
Economic and market update

Economic Overview – as at 13th December 2024

Global markets

Tumultuous political developments have continued to unfold this year (most recently in France, Korea and Syria) creating considerable global uncertainty ahead for 2025. Nevertheless equity markets recorded fresh record highs in a range of locations last week as investors downplayed trade (and other) risks and concentrated on the technology boom and stimulus measures. Optimism that recessions are now behind us (or in the case of the US avoided altogether), and that further monetary and fiscal stimulus will steadily keep being delivered appears to outnumber more conservative views that trade wars and unsustainable fiscal deficits will increasingly restrict recoveries from the global inflation shock. The 'Trump trade' is yet to fade, with the consensus view apparently that his presidency may be messy and disruptive but not sufficiently so to derail recoveries. Time will tell.

The US Federal Reserve are still on track to cut rates for the third time this cycle on 18 December after core CPI rose 0.3% m/m, although the bigger question is how viable it will be for the Fed to keep cutting to a more neutral policy setting. A cut next week will take the upper end of the policy band down to 4.5% but prior to Trump's election victory the terminal rate implied from the Fed's dot plot was below 3%. The combination of promised tax cuts, well publicised tariffs and mass deportations is universally seen as inflationary, despite suggestions the tariffs may be more-so a negotiating tool than the main game.



* Year-ended GDP growth for the March quarter of 2022 was 11.5 percent.

Sources: LSEG; RBA.

Markets are now only pricing in another 60 bp of cuts next year. Taking Trump at his word the tariffs (at least 60% for China, up to 25% for Mexico and Canada and at least 10% elsewhere) pose considerable threats to US growth - and a wide range of consequences for US trade partners. The period of US 'exceptionalism' evident in the chart above may persist for another few quarters but stagflation risks will rise in line with the dosage of tariffs being imposed. US economic data remains resilient although the latest uptick in jobless claims could be a sign of a weaker labour market report for December. NFIB small business optimism leapt higher in November after the election, leaving bond yields higher but braced for volatility leading up the January 20 inauguration.

The Bank of Canada cut rates by another 50 bp this week to an overnight rate of 3.25%, and while another two cuts are expected early next year these will more likely be 25bp to a 'neutral' 2.75%. With unemployment in Canada at 6.8% (its highest level since 2017 outside the pandemic), and a technical recession narrowly avoided, the economy faces ongoing challenges including the 'major new uncertainty' from US trade policies noted by the BoC in their latest policy statement.

The European Central Bank also cut rates but only by 25bp (the fourth cut in the cycle) to 3.0% and another four cuts are expected in 2025. Europe remains in one of the toughest positions of all advanced economies, with high wages growth keeping core and services inflation higher than hoped, insipid economic growth and its vulnerability to US trade (and other) policy threats. France's recent political impasse may be a stepping stone to a broader Euro-zone debt crisis ahead. Meanwhile the Bank of England is expected to keep rates on hold at 4.75% next week after the recent uptick in core inflation and caution after the October Budget. The UK is out of recession, but core CPI is 4.1%.

Chinese authorities continue to drip feed stimulus measures but the latest announcements were more targeted and potentially forceful than previous iterations including the language of 'moderately loose' monetary policy and 'more proactive' fiscal policy. The announcements via the Politburo and the annual Central Economic Work Conference targeted boosting consumption and are expected to be supplemented with lower interest rates and further cuts to the RRR in the months ahead. The timing of imminent US tariffs and any retaliatory trade responses are an obvious unknown however recent economic data has been encouraging and activity data to be released next week should show more evidence of momentum in the recovery. Chinese exports slowed to 6.7% y/y in November, although shipments to the ASEAN region were more resilient. China's economy is expected to have grown by just under 5% this year, with a similar rate next year as stimulus measures offset US tariffs.

In summary, North Atlantic economies face a highly uncertain period ahead as new US policies are rolled out presenting downside risks to growth and upside risks to inflation amid stretched fiscal positions. Divergent impacts of these policies will be evident with China, Mexico and Canada in the spotlight initially, however the global economy is still likely to expand by close to 3% in 2025. A firm US Dollar is expected to persist for some months, challenged eventually by a slowing growth outlook.

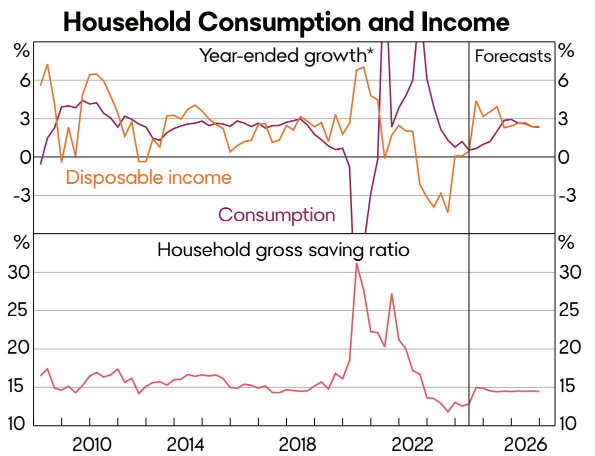
Domestic economy

The December monetary policy meeting appeared to mark a material change in language from the RBA with the removal of familiar phrases such as 'not ruling anything in or out' and 'policy will need to be sufficiently restrictive' as the RBA expressed more confidence that inflation is subsiding. Markets initially took this very literally by suddenly pricing in a 75% chance of a cut in February, but backed away after the latest jobs data reminded the market that a lower chance of another hike isn't a guarantee of an imminent cut. The outlook is as uncertain as ever (particularly as Trump's trade agenda becomes closer to implementation) and two RBA speeches this week very helpfully explored this uncertainty and its link to monetary policy, including an excellent primer from Sarah Hunter.

The unexpected fall in unemployment from 4.1% to 3.9% in November released yesterday, was much stronger than expected and at odds with our unchanged basecase forecast (below), which continues to anticipate weaker jobs growth ahead in line with further weakening in job advertisements. The rise in employment (36k) only just stayed ahead of population growth, and hours worked were only flat m/m, however underemployment fell so labour markets remain very tight and we are well below rates consistent with 'full employment'. This makes it difficult for the RBA to cut rates until the long-awaited slowdown in job creation occurs, which still appears inevitable but unlikely to occur before February.

GDP for the third quarter was close to forecast at 0.3% but the year-on-year fall to 0.8% growth (its lowest level outside the pandemic since the '91 recession) and the seventh straight quarter in a 'per-capita recession' seemed to surprise the market and media. Had public investment and population growth not been so aggressive we would of course be in a 'real recession' like New Zealand, the UK and parts of Europe have experienced. It's an interesting debate as to whether our more benign outcome partially helped by the RBA dual mandate (meaning they didn't hike as aggressively than elsewhere) has been a desirable outcome or not. Critics of the RBA advocating for earlier cuts don't seem to also have argued that the RBA should have gone harder hiking rates to make faster progress with CPI. Economic growth is anaemic but not negative, which keeps a soft(ish) landing in play.

The monthly indicator for inflation in October saw CPI remain at 2.1% but underlying measures were less encouraging with the Trimmed Mean rising to 3.5% (its highest level since July), highlighting the impact of electricity rebates and one-off measures. While these rebates and other cost-of-living support may be extended for another year, they aren't helping with services inflation and we need to see meaningful progress in the full quarterly numbers to be released on 29 January. These should reveal the Trimmed Mean down to around 0.6% in Q4 but even this would keep annual core inflation at 3.4% : still too high for an RBA cut in February, unless labour markets are much weaker or consumption data shows unexpected stress. The improvement in real disposable income is underway thanks to tax-cuts, moderating inflation and plentiful jobs, but a key variable ahead is the extent to which improving income will be spent versus saved.



* Outliers during the COVID-19 pandemic have been truncated.
Sources: ABS; RBA.

Recent deposit growth across the banking system suggests that savings are outperforming spending, and this trend may well continue until rate cuts impact the psyche of households. Consumer sentiment rose in the monthly survey by over 5% to 94.6 in November, but weekly surveys have subsequently eased back while retail sales data showed an uptick in October. Business confidence fell in November by 8 points to -3 with weakness particularly evident in retail and manufacturing.

The Aussie Dollar has fallen steadily over the last month as US dollar strength has dominated and also with expectations that China's response to tariffs may include a sharp devaluation of the CNY. It has been pleasing to have been on the right side of RBA cash rate forecasts over the last 18 months in this report and its basecase scenarios, but the inability of the Australian Dollar to break 70c is a reminder of the need for humility in forecasting!

2025 presents numerous challenges for our economy as we bounce back from the cost-of-living/ inflation shock, including the necessity of the RBA to lag other central banks in cutting interest rates, but the greatest challenge lies in tariffs and their unknown impact on global trade. Speech of the year from the RBA surely goes to Andrew Hauser with his summary of Australia's exposure to the 'New Trading Order' and his analogies with Dickens' *A Christmas Carol*. As he concludes, Australia is one of the least directly impacted by tariffs, but indirectly (especially via China) needs close ongoing scrutiny. Trump 2.0 will keep markets on edge and policy makers highly vigilant.

Interest Rate Outlook

The RBA should be in a position to initiate an easing cycle by mid-next year and have this week expressed more confidence that inflationary pressures are sustainably declining. The most likely month for the first cut remains May '25 although developments in labour markets could impact this timing, with a February or April cut possible should unemployment rise faster than currently expected. Conversely unemployment remaining below 4% would likely defer the initial cut beyond May.

Economic Forecasts: basecase scenario

	2023		2024				2025			
% (actual, forecast)	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP q/q	0.5	0.2	0.2	0.2	0.3	0.4	0.5	0.6	0.4	0.8
GDP y/y	2.1	1.5	1.1	1.0	0.8	1.1	1.4	1.8	1.9	2.3
Unemployment	3.6	3.9	3.9	4.1	4.1	4.1	4.3	4.5	4.6	4.8
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	3.0	2.9	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	.64	.67	.70	.73	.76

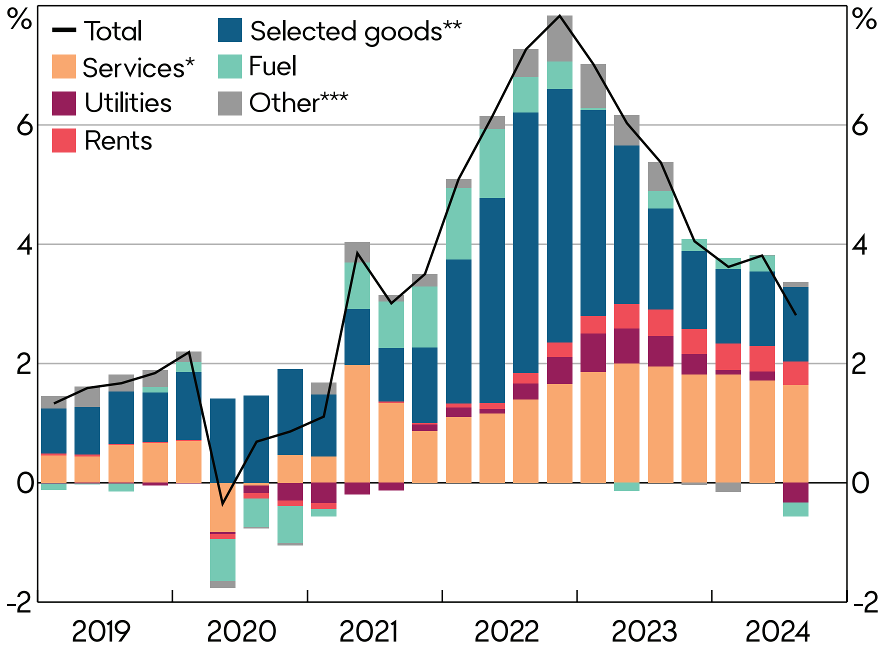
Benchmark rates

	31 / 10 / 23	31 / 10 / 2024	29 / 11 / 2024	13 / 12 / 2024
90-day bills	4.35%	4.41%	4.43%	4.46%
3-year swap	4.64%	4.04%	3.93%	3.83%
5-year swap	4.94%	4.27%	4.15%	4.08%
AUD/USD	.6340	.6580	.6520	.6365
ASX 200	6 781	8 160	8 436	8 296
Credit Index (iTraxx- 5 yr)	97.6	65.2	66.2	63.7

Appendix: Inflation

CPI Inflation

Year-ended with contributions



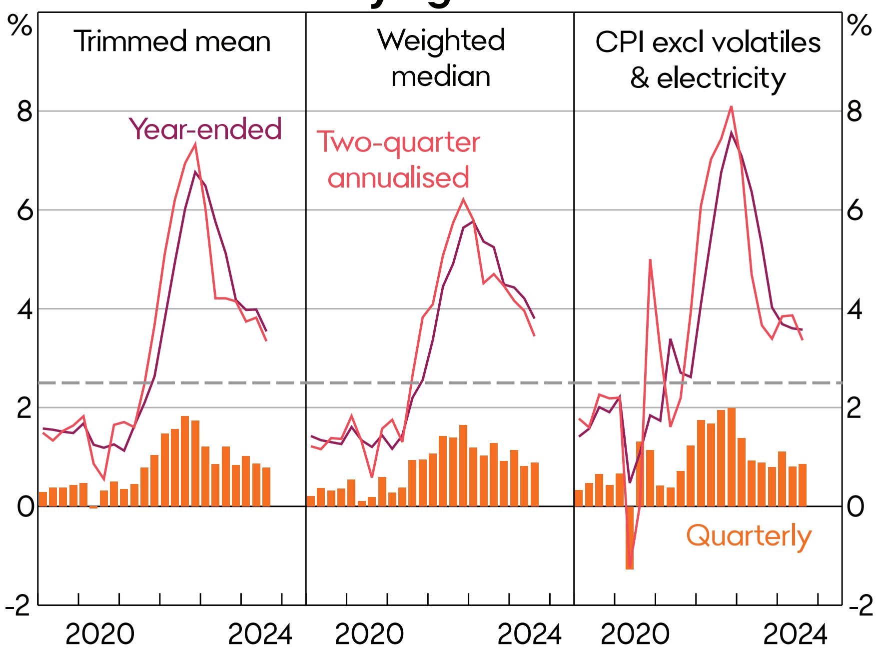
* Includes market services and administered items; excludes utilities, rents and holiday travel & accommodation.

** Includes groceries, alcohol & tobacco, consumer durables and new dwellings.

*** Primarily holiday travel & accommodation.

Sources: ABS; RBA.

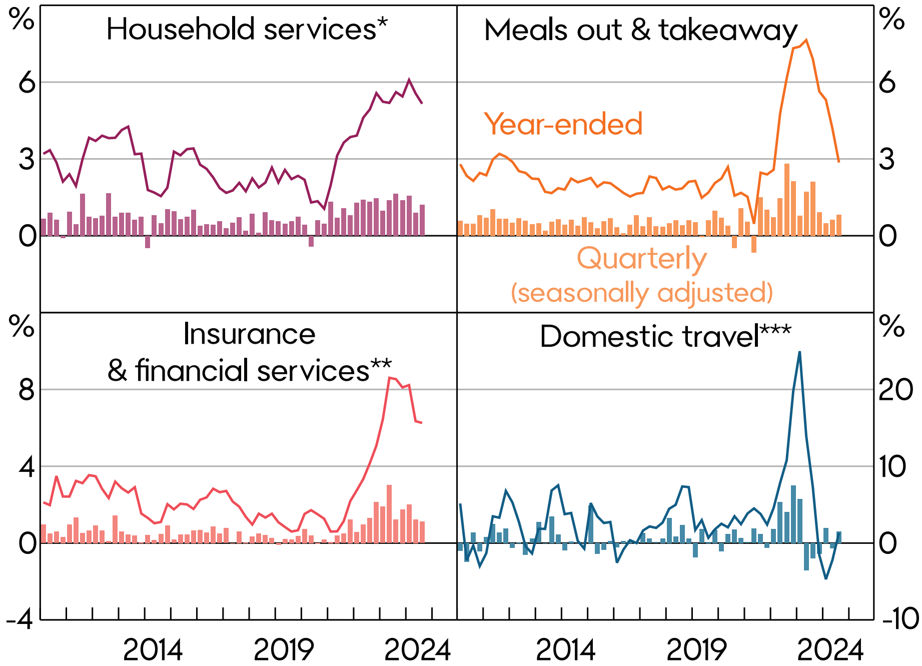
Underlying Inflation*



* Dashed line indicates the midpoint of the inflation target.

Sources: ABS; RBA.

Market Services Inflation



* Includes home cleaning, vehicle repairs, hairdressing, veterinaryser-vices, sports and leisure services.

** Excludes deposit & loans to June quarter of 2011.

*** Imputed using headline CPI in the June and September quarters of 2020 and September quarter of 2021.

Sources: ABS; RBA.