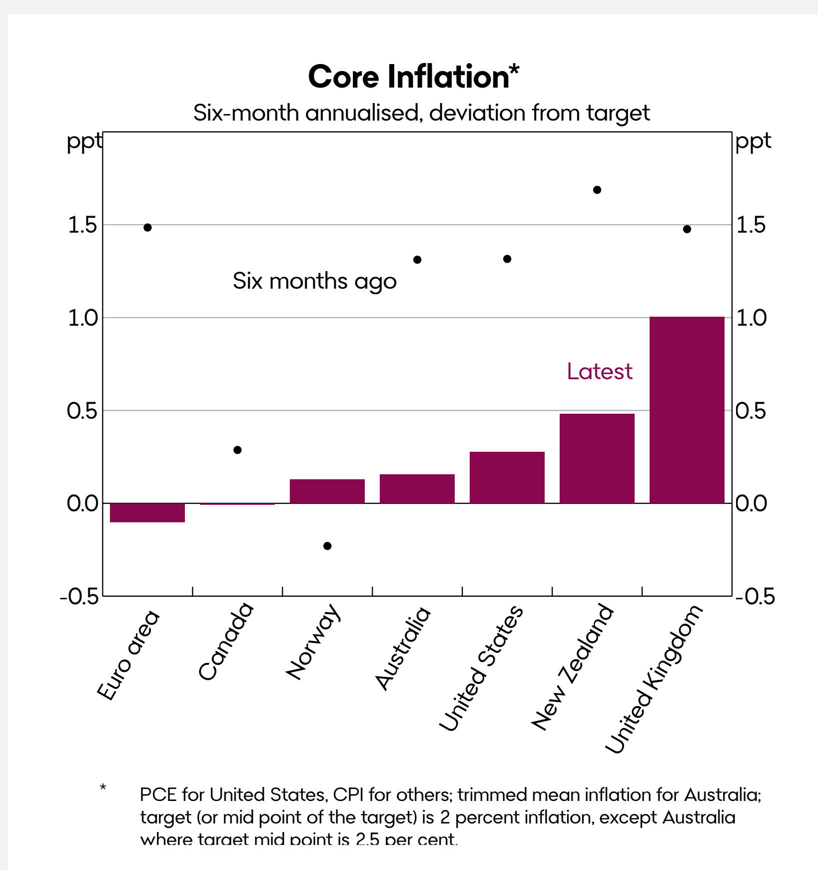
February 2025

Economic and market update

Economic Overview – as at 20th February 2025

Global markets

The battle against inflation in major economies continues to progress constructively despite a small number of exceptions (as per the chart below) but central banks face fresh challenges in assessing the impact of tariffs and other US policies on the global economy and local consequences. Global growth was around 0.9% in the last quarter of 2024 (around 3.25% y/y) while consensus is closer to 3% for 2025, with further risks to the downside in 2026. Fiscal policy constraints and trade wars are a problematic combination, and their impact on inflation and monetary policy ahead is most unclear.



The US Federal Reserve kept rates on hold as expected in January, as the resilient US economy maintained its momentum from last year and as the short-term benefits of tax-cuts and less regulatory burden were welcomed by businesses and Wall Street. This optimism does however need context - one of the main reasons the Fed have paused rate cuts (having eased rates by 1% from September) is the recent uptick in inflation expectations as new US policies are rolled out, and (as outlined in last month's report) the stagflation risks that come with imposing broad-based tariffs are significant. The size, sequencing and nature of the tariffs is a fast-changing equation, but the latest threats of 'reciprocal tariffs' may be much larger in size than the initial flat 10% proposition.

The consequences for financial markets is still hotly debated (including this summary from the RBA) but equity markets remain near record highs. This may be because the tariffs don't take effect until April, and there remains a school of thought that they are primarily a bargaining tool rather than the main game. However history reminds us that in general tariffs are bad for everyone, and particularly damaging for the country imposing them. Meanwhile US unemployment fell from 4.1% to 4.0% in January while retail sales fell sharply, and long-term government bond yields have increased as fewer Fed cuts (and potentially higher inflation ahead) is expected in the medium term.

The European Central Bank cut rates by another 25bp in late January to 2.75% (from a peak of 4%) but signalled this week that the risks to inflation may be tilted back to the upside, driving down market pricing of another cut in April after the (fully priced) cut expected in March. Ostensibly the job is done with respect to returning core inflation to target, but ECB officials are now publicly debating just how neutral current policy is, as well as upside and downside risks ahead to euro-zone inflation and growth. The unevenness of economies in the region clearly adds to this challenge. In the UK the task of returning inflation to target has proved even tougher as the chart above shows, although the UK economy unexpectedly grew by 0.1% in Q4 after a flat third quarter. Wages growth rebounded to 6% partly driven by labour shortages, so the Bank of England are expected to only ease rates at a very gradual pace from their current level of 4.5%.

The Chinese economy appeared to respond well in Q4 to ongoing stimulus measures with the official GDP growth rate ticking up to 5% (and consensus unofficial growth around 4.5%) while credit growth rebounded in January led by corporate loans. Household lending remained subdued although property sales picked up, and further policy assistance is expected. Government officials indicated support to Vanke (a large property developer) in issuing special bonds to fund the purchase of unsold properties and vacant land. GDP growth in 2025 is forecast to slow to around 4%, but the full extent of US tariffs remains a critical unknown. Trade and technology tensions will remain elevated after the recent rivalry to OpenAI via DeepSeek, and after President Xi Jinping's recent meeting with high profile technology entrepreneurs in a perceived show of support to the Chinese technology industry.

In summary, the majority of advanced economies have dealt with the global inflation shock via effective monetary policy, but all economies now face fresh global policy uncertainty amid elevated geopolitical risks, especially via tariffs. Financial markets are experiencing heightened volatility as a result, however risk sentiment including in commodity markets has remained resilient thus far.

Domestic economy

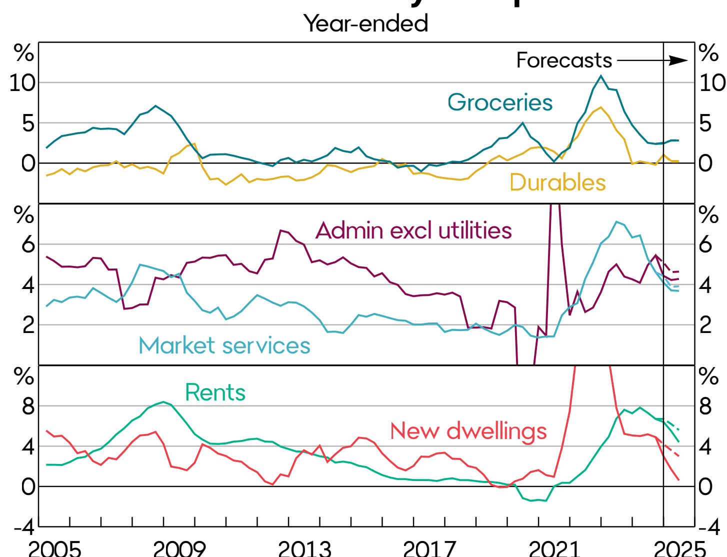
The long-awaited cash rate cut initiating the easing cycle was delivered on 18 February. However Governor Bullock went to great lengths to temper expectations for further cuts alongside some subtle changes to RBA forecasts, which appeared to confuse many market analysts and the media. The confusion probably lies in a lack of appreciation that the RBA would prefer households to initially save rather than spend additional income (hence the advantages of talking down the prospects of further cuts, even though they remain very likely) and analysts reading too much into the RBA's updated forecasts including core inflation to 'only' reach 2.7% and not 2.5%. This surprising reaction to what have historically proved to be somewhat inaccurate and regularly updated forecasts, has flowed through to futures and bond markets with one less cut now priced in (matching our basecase forecast below). However the degree of uncertainty ahead is elevated for both upside and downside surprises, and importantly, the faster path back to sub 3% core inflation was an obvious trigger for the first OCR cut.

Other nuances that much of the subsequent commentary and analysis have generally missed are

- Policy remains restrictive after this cut: we are still at least two cuts from a neutral cash rate
- If core inflation does indeed bottom out at 2.7% and stay there for 2 years as the RBA now forecast, why would this suggest that the cut was in any way premature or lacking conviction?
- Tariffs (as detailed above in the global markets section) pose inflationary risks to the country that imposes them but the impact on Australia (or China) is far less clear, and could result in the need for deeper cuts - hence the need to start moving back to a neutral rate.

Inflation Forecasts by Component*

Year-ended



* Groceries excludes fruit & vegetables; market services excludes domestic holiday travel & accommodation and telecommunications; dashed lines are previous forecasts; outliers during the COVID-19 pandemic have been truncated.

Sources: ABS; RBA.

Of course there is the risk that RBA rate cuts will only see inflation rebound, which would put the monetary policy board in a very challenging position, but as Bullock noted, this is why they have only started now (and not last year as the majority were calling for) and why the cut was only 25bp. Earlier or larger cuts would have put at risk the sustainable return to a core inflation rate near 2.5%.

The fourth quarter 2024 CPI data released in late January made the case for a February easing compelling, not so much due to CPI falling to 2.4% but with underlying inflation (measured by the Trimmed Mean) only rising 0.5% in the quarter. This made the annualised rate of core inflation 2.6% based on the second half of 2024, and the fact that the monthly CPI indicator showed annual core inflation at 2.7% in December suggests the next quarterly read (on 30 April) will also be benign. A read of 0.6% for the Trimmed Mean in Q1 would equate to around 2.8% y/y, paving the way for another 25bp cut in May. As the chart above shows, most of the drivers of core inflation over the last 3 years have moderated (and are forecast to continue to), including market services, rents and the cost of new dwellings.

Tight labour markets were the only factor that could have conceivably swayed the RBA to delay rate cuts any further, although the slightly lower than expected wage price index (0.7 % in Q4) would have alleviated concerns around wages feeding into inflation. This is despite poor productivity growth (refer appendix for a range of charts on labour markets) which remains Australia's economic Achilles heel. Jobs data since the RBA meeting was consistent with slow but steady rate cuts ahead - unemployment rose to 4.1% in January, with a rise in employment of 44k offset by a rise in the participation rate (to a new record high of 67.3%).

The uneven nature of our economy by industry and by region was still apparent: Western Australia and Queensland continue to see strong jobs growth while unemployment in Victoria rose to 4.7% (s.a.). Underemployment remained low at 6%, pointing to healthy labour markets; consistent with only taking the OCR down to 'neutral' and not lower. Forward looking indicators (refer appendix) suggest a slightly higher underutilisation rate ahead.

The Australian Dollar fell to .6090 in early February as the US Dollar extended its gains, but since then uncertainty around the timing and impact of US tariffs together with weakness in bond markets has seen a correction for the USD and an impressive recovery for the Aussie to around .6375. The basecase forecast below continue to reflect short-term appeal for the US Dollar ultimately succumbing to the implications of US stagflation, and so a firmer Aussie Dollar over time.

Interest Rate Outlook

The RBA is expected to take the official cash rate back to a more neutral level (around 3.5%) this year with the second cut in the easing cycle most likely in May, after Q1 CPI data to be released on 30 April. A cut in the 31 March – 1 April meeting is unlikely in the absence of a sharp rise in unemployment (released 20 February) or a global shock.

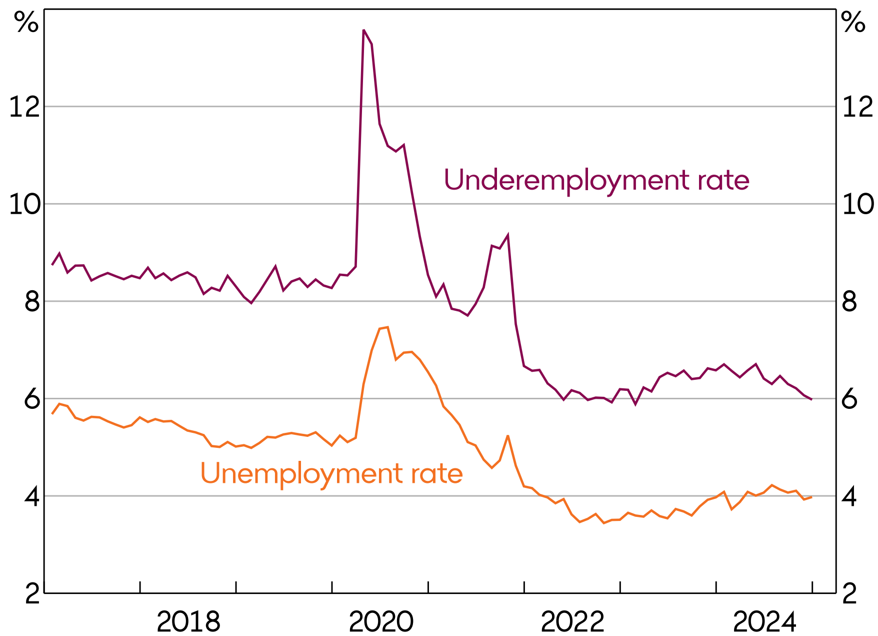
Economic Forecasts: basecase scenario

	2024				2025				2026	
% (actual, forecast)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP q/q	0.2	0.2	0.3	0.4	0.5	0.6	0.5	0.8	0.7	0.7
GDP y/y	1.1	1.0	0.8	1.2	1.5	1.9	2.0	2.4	2.6	2.7
Unemployment	3.9	4.1	4.1	4.0	4.2	4.4	4.6	4.8	5.1	5.4
CPI (q/q)	1.0	1.0	0.2	0.2	0.8	0.9	1.1	0.5	0.6	0.7
CPI (y/y)	3.6	3.8	2.8	2.4	2.2	2.1	3.0	3.2	3.1	2.9
CPI (core y/y)	4.0	4.0	3.5	3.2	2.8	2.7	2.7	3.0	3.1	3.0
RBA cash rate	4.35	4.35	4.35	4.35	4.10	3.85	3.60	3.60	3.60	3.60
AUD / USD	.6515	.667	.691	.619	.625	.65	.675	.70	.725	.75

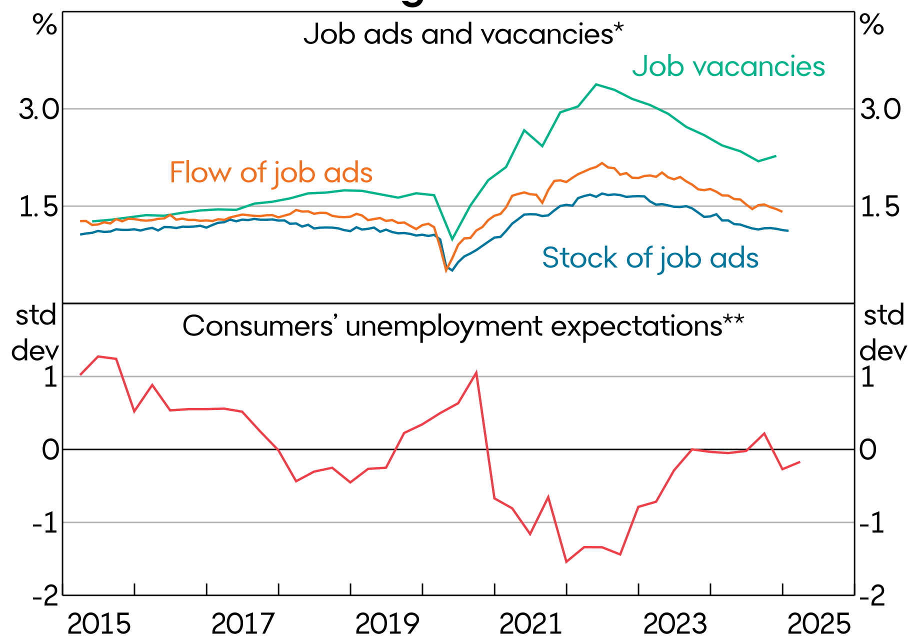
Benchmark rates

	31 / 12 / 23	31 / 12 / 2024	31 / 1 / 2025	20 / 2 / 2025
90-day bills	4.37%	4.42%	4.25%	4.15%
3-year swap	3.78%	3.79%	3.75%	3.92%
5-year swap	3.93%	4.05%	4.08%	4.22%
AUD/USD	.6825	.6190	.6215	.6370
ASX 200	7591	8159	8532	8323
Credit Index (iTraxx- 5 yr)	75.1	67.7	66.8	62.8

Appendix: Labour markets



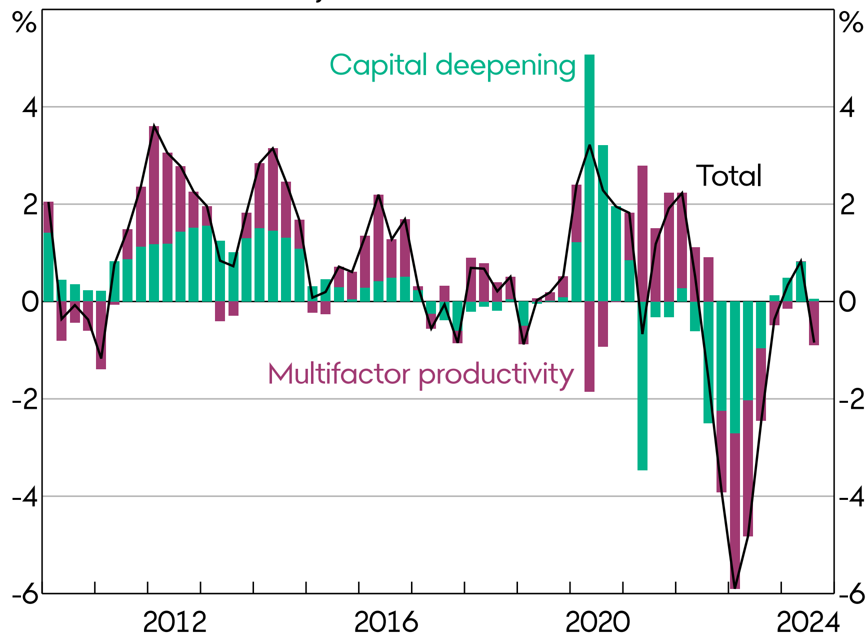
Source: ABS.

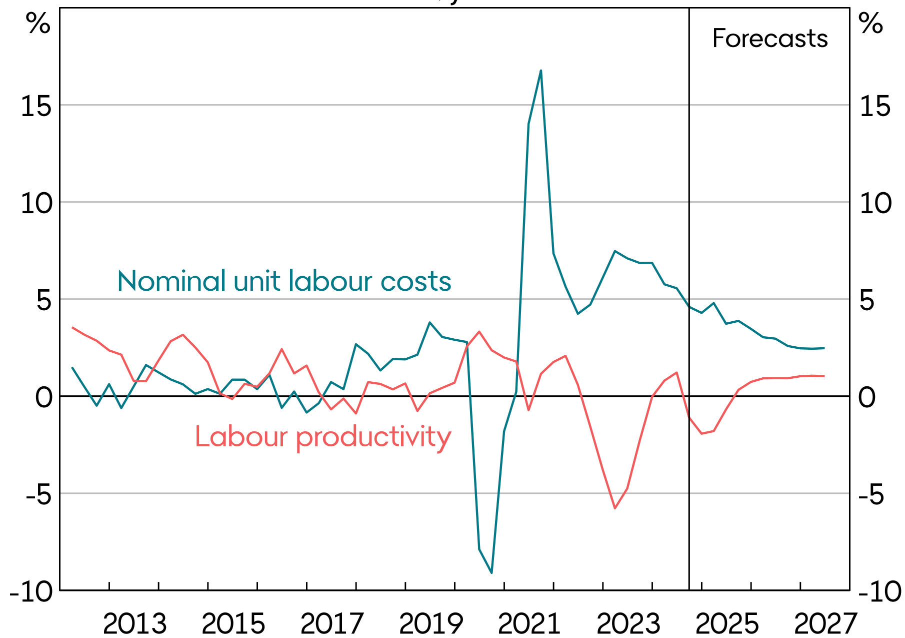


* As a share of the labour force.

** Standard deviations from 1980–2025 average; an increase indicates more consumers expect unemployment to rise over the year ahead; quarter average; survey by the Westpac–Melbourne Institute; seasonally adjusted by the RBA; March quarter 2025 outcome is the average of the January and February 2025 outcomes.

Sources: ABS; ANZ-Indeed; JSA; RBA; Westpac–Melbourne Institute.





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