October 2024

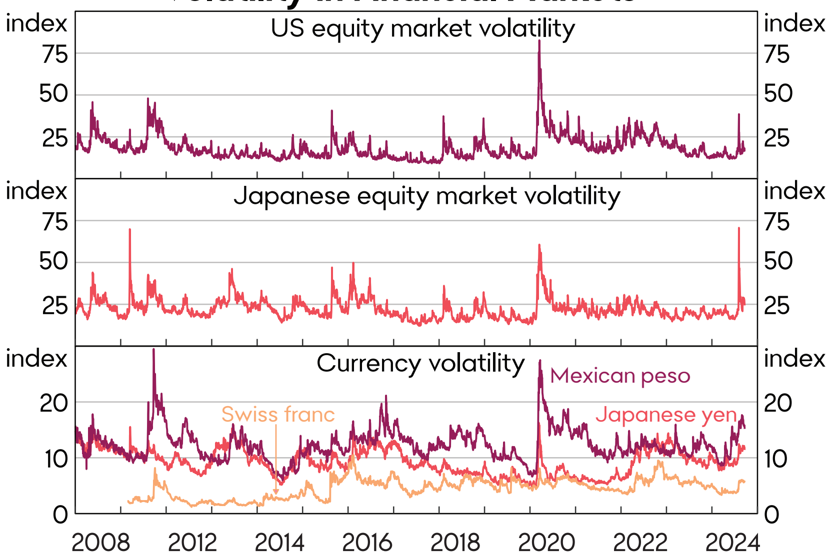
Economic and market update

Economic Overview – as at 17th October 2024

Global markets

Markets remain skittish ahead of the US Presidential election next month and as central banks cut rates to varying degrees, but equity markets have continued to post fresh record highs on a range on indices. The diverging pace of rate cuts for most central banks (or in the case of the Bank of Japan their hiking cycle) has added to currency market volatility on top of gyrations in the US Dollar driven by rapidly changing perceptions of the US economy. For now stock markets are factoring in ongoing cuts and a soft landing in the States; and the strong start to reporting season has added to optimism.

Volatility in Financial Markets*



* Equity market volatility is the one-month option implied volatility in the S&P 500 and Nikkei 225 indices. Currency volatility is three-month option implied volatility in respective currencies against the US dollar. Latest observation 20 September 2024.

Sources: Bloomberg; RBA.

Since the 50 basis point US rate cut last month data has generally printed on the upside, including the strong jobs report for September (with a 254k gain in payrolls and unemployment falling to 4.1%) and a slight uptick in core inflation, so any thought of another 50bp cut in November has been replaced with a view that the Fed may skip a month! This about-face appears an overreaction and far more likely is consecutive 25bp cuts to round out the year, but the US Dollar has appreciated rapidly and even the latest change in opinion polls (with Trump now just leading Harris) hasn't deterred equity markets. Manufacturing data has been less encouraging and weather-related events add to inflationary risks, so the outlook is mixed (and very dependent on the election outcome). A Trump victory promises significant increases in tariffs and other populist policies, but their timing (and size) would depend on which party will have control of Congress; while a Harris victory may pose less inflationary risks and have different geopolitical consequences. Either way financial market volatility is likely to remain elevated until the outcome is clear, and even then global tensions will remain a factor.

The other primary driver of markets over the last few weeks has come from China with the initial euphoria on the announcement of a stimulus package driving risk appetite and some currencies (especially the Australian Dollar) higher, but the lack of details including the size of the package saw a reversal for markets. The scope of the package does appear promising including:

- A significant increase in government debt (via Local Government Bonds)
- A commitment to utilise existing 'unused funds'
- Ability for local governments to buy unused land and unsold homes via LGBs
- An injection of tier one capital to a range of banks

However, the drip feeding of the nature and size of the policies has frustrated the market, and direct fiscal support to households via handouts to consumers remains a sketchy commitment. The reality that the package needs approval via the coming National People's Congress explains the delays, but irrespective the 'too large to fail' view on China's property sector remains our basecase, and the package should help Chinese growth to achieve the high 4's, if not the full 5% target this year. Beyond these short-term measures however, the structural issues will be harder to resolve – but for the moment the firmer Iron Ore price (around US$105/tn) is helpful for Australian exports.

Japan's new Prime Minister Shigeru Ishiba has committed to continue his predecessor's policies to 'ensure Japan fully emerges from deflation' which has coincided with expectations of a pause in Bank of Japan rate hikes later in October, but still high expectations of another hike in December. The prospect of a soft landing in the US has added to confidence that the Japanese economy will recover strongly next year, but the US election remains a key factor. The Nikkei stock index has endured a torrid stretch of volatility but has nearly recovered all of its 17.5% decline from the July record high.

Europe remains one of the weaker regions and the European Central Bank is expected to cut rates tonight to 3.25% (the third cut in the sequence, matching the Swiss National Bank and Sweden's Riksbank). The further decline in eurozone business activity evident in the latest PMI surveys and the fall in inflation below 2% makes for an easy decision for the ECB, and another cut in December looks equally likely. UK CPI also fell in September to 1.7% although core inflation was 3.2%.

In summary, record highs for US stocks (and even the German DAX reaching new highs) together with sharp rallies in China and Hong Kong bourses, seem to reflect confidence in the US soft landing scenario despite geopolitical tensions, with monetary and fiscal policy support from central banks in a range of forms. The sustainability of these policies (and debt levels) and their impact is harder to quantify and subject to impending elections, hence elevated volatility on the markets.

Domestic economy

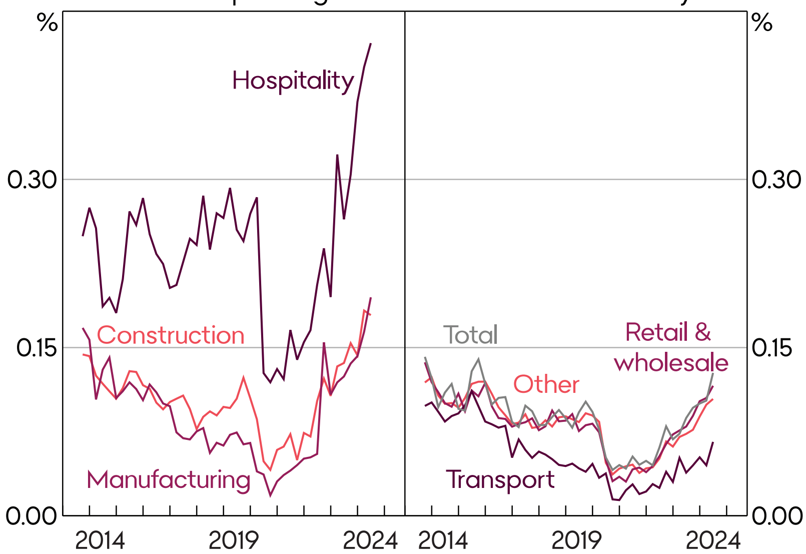
Once again the Reserve Bank have needed to plead patience to the media, markets and borrowers who are hungry for interest rate relief, especially when observing overseas trends, reminding them that more evidence is needed here on the sustainable path for inflation back to target. The late September data release for the Monthly CPI Indicator in August appeared to put to rest any thought that the RBA may need to hike rates any further, and markets suddenly were fully pricing in a cut by December, but the RBA feedback was clear. Yes, headline CPI is back in the target range based on the monthly data and is also expected to be below 3% in the full Q3 report out on October 30, but underlying inflation will take more time. Core inflation is still at risk given wages growth amid low productivity, ongoing population growth, the slow pace of housing construction, recent tax cuts and 'cost of living relief'. In short the RBA noted that "weak growth in output was closing the gap between aggregate demand and the economy's estimated supply capacity, but that the two were not yet aligned." Or in other words, households are under pressure and discretionary spending is very low so the economy is barely growing, but demand still remains higher than the economy's ability to meet that demand.

As a result, our long-held view (reflected in the economic basecase scenario below) that the RBA will only start to ease rates next year is unchanged, despite some comparable central banks now cutting by 50 bp (e.g. in New Zealand). The three primary reasons for this later easing cycle remain:

- The RBA didn't start hiking rates until May '22, later than others
- We only hiked by 4.25% leaving our OCR only around 1% above 'neutral'
- Our labour markets have remained tighter and more resilient than elsewhere.

Company Insolvencies by Industry

Share of operating businesses within each industry*



* Quarterly company insolvencies divided by the number of businesses operating in that industry at the end of the financial year. Company insolvencies is seasonally adjusted. Latest observation June 2024.

Sources: ABS; ASIC; RBA.

Any thought that the market and some outlier forecasters held that the RBA may still initiate their easing cycle this year (despite the fact that Michele Bullock has said that they won't), appeared to be shut down by the latest jobs data, where unemployment remained at 4.1% in trend terms and fell to that level seasonally adjusted. Record highs for the participation rate and total employed were impressive despite the recent easing in job vacancies, and the fall in the underutilisation rate (unemployment plus underemployment) to 10.4% show tightness in labour markets that won't give the RBA any urgency to cut rates, despite the stagnant economy. As Bullock has correctly pointed out, the root problem is inflation (not rates) so the solution for households and by extension businesses lies in eliminating inflation. Given this, presumably the only scenario where a 2024 RBA rate cut could still occur would be major downside surprise for core inflation in the Q3 data, but it would probably need to be 3.2% or lower to justify a pre-emptive rate cut while core inflation is still above the target band.

Consumer sentiment was mildly higher in the latest surveys helped by recent tax cuts and moderating inflation, but is still near historical lows suggesting that discretionary spending will remain inhibited. The implications for small businesses lie in low consumer demand, and while insolvency rates are in aggregate near medium term averages, the higher representation of hospitality businesses (refer chart) is a consequence of this low household confidence and demand.

Fortunately the expectation for 2025 is a recovery in household disposable incomes as headwinds slow and assuming labour markets continue to be supportive, although conditions remain uneven and unpredictable. Another factor for the outlook is elevated residential house prices which are resilient in most states (other than Victoria and Tasmania where listing levels are much higher) adding to household wealth, but of course the flipside to this increased equity is affordability. Indeed the lack of progress building new dwellings continues to add to inflation via rents and the cost of new dwellings, and as the appendix shows our experience is stronger than most other countries. The link to domestic demand is also clear given roughly 5% of borrowers are experiencing a 'cashflow shortfall' – although the appendix shows RBA forecasts for this to moderate next year.

The Aussie Dollar hit an 18-month high around .6945 after the Chinese stimulus package news and as expectations of RBA rate cuts continued to be deferred, but fell almost 3 cents in October as US rate cuts appeared more modest ahead and as the news from China lost its impact. The forecasts below continue to show appreciation, but the technical 'key reversal' has deferred the rally for now.

Interest Rate Outlook

The cash rate is very likely at its cycle peak at 4.35%, and an easing cycle should take shape in early to mid-2025. Headline CPI will fall sharply in Q3 as a result of electricity bill rebates, but underlying core inflation is unlikely to fall below 3.2% until the Q1 '25 CPI data to be released on 30 April. The most likely timing for the first RBA cut is therefore May '25, but markets are pricing in around a 75% probability of a cut by February. The US Presidential election will likely keep market volatility elevated.

Economic Forecasts: basecase scenario

	2023		2024				2025			
% (actual, forecast)	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP q/q	643	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	4.4	4.6	4.8	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	3.2	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	.691	.71	.73	.74	.75	.77

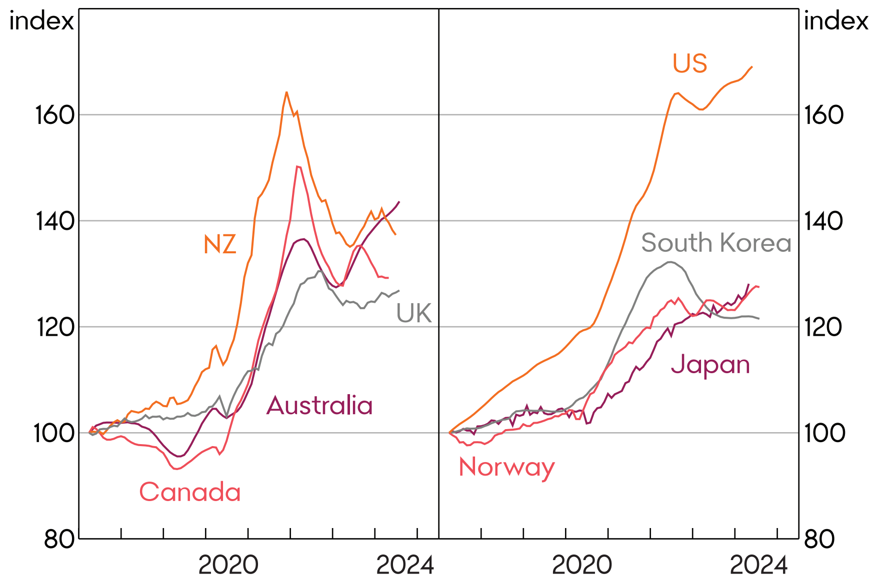
Benchmark rates

	31 / 8 / 23	30 / 8 / 2024	30 / 9 / 2024	17 / 10 / 2024
90-day bills	4.13%	4.39%	4.43%	4.37%
3-year swap	4.20%	3.58%	3.51%	3.83%
5-year swap	4.41%	3.79%	3.70%	4.04%
AUD/USD	.6485	.6765	.6915	.6680
ASX 200	7 305	8 092	8 270	8 356
Credit Index (iTraxx- 5 yr)	79.1	61.4	61.9	65.2

Appendix:

Housing Price Indices

March 2017 = 100

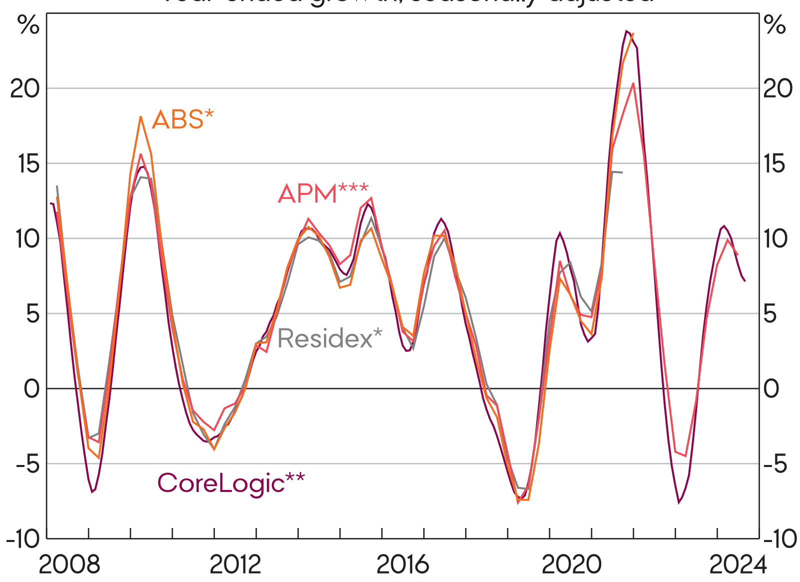


* Latest observations are April 2024 (Canada and Japan), May 2024 (New Zealand and United States), and July 2024 (Australia, United Kingdom, Norway and South Korea). Data are seasonally adjusted.

Sources: LSEG; national sources; RBA.

Housing Prices

Year-ended growth, seasonally adjusted



* ABS is a quarterly stratified median price index; Residex is a quarterly repeat sales price index.

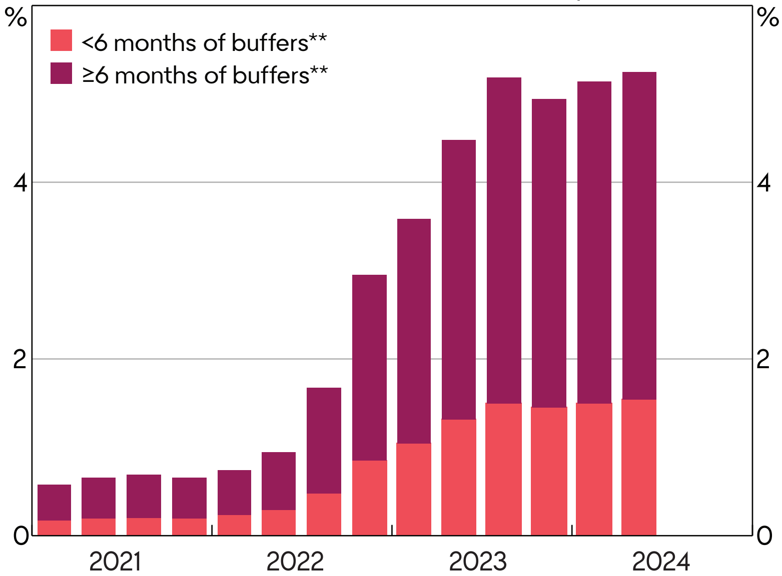
** Monthly hedonic price index; non-seasonally adjusted.

*** Quarterly stratified median price index.

Sources: ABS; APM; CoreLogic; RBA; Residex.

Borrowers with Cash Flow Shortfall*

Estimated share of variable-rate owner-occupier borrowers



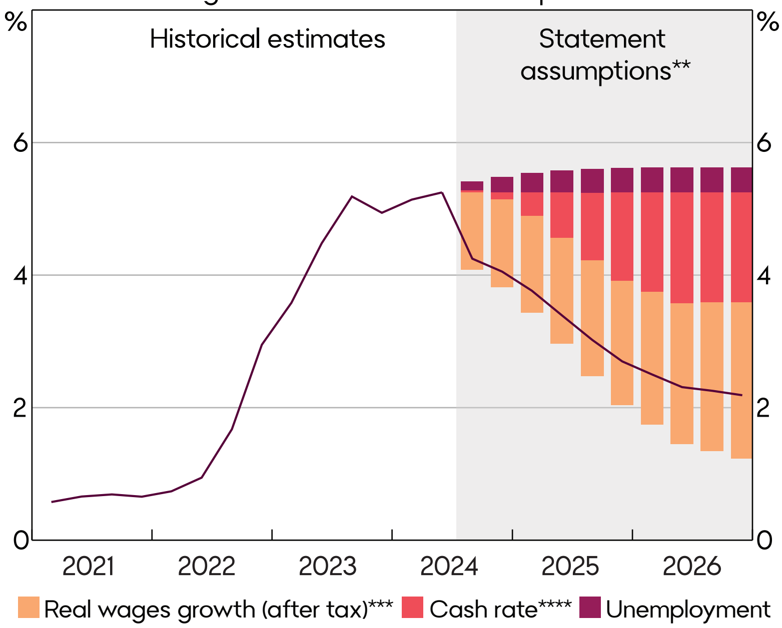
* Estimates of borrowers with minimum scheduled mortgage payments and essential expenses (proxied by HEM) exceeding their income. Excludes borrowers in arrears, which accounted for around 0.6 percent of loans in June 2024. Earliest observation March 2021. Latest observation June 2024.

** Buffers expressed relative to cash flow shortfall.

Sources: ABS; Melbourne Institute; RBA; Securitisation System.

Borrowers with Cash Flow Shortfall*

Share of variable-rate owner-occupier borrowers, August 2024 Statement assumptions



* Estimates of borrowers with mortgage payments and essential expenses (HEM) exceeding their income. Earliest observation March 2021. Projection to December 2026, based on current borrowers not in arrears as at June 2024.

** The sum of the bars does not exactly equal the estimate (line) due to small interaction effects between the individual factors. Bars representing interaction effects are omitted from the graph.

*** Factor represents growth of trimmed mean inflation and WPI, adjusted for legislated changes in personal income tax rates.

**** Cash rate implied by market pricing as at the August 2024 Statement.

Sources: ABS; Melbourne Institute; RBA; Securitisation System.