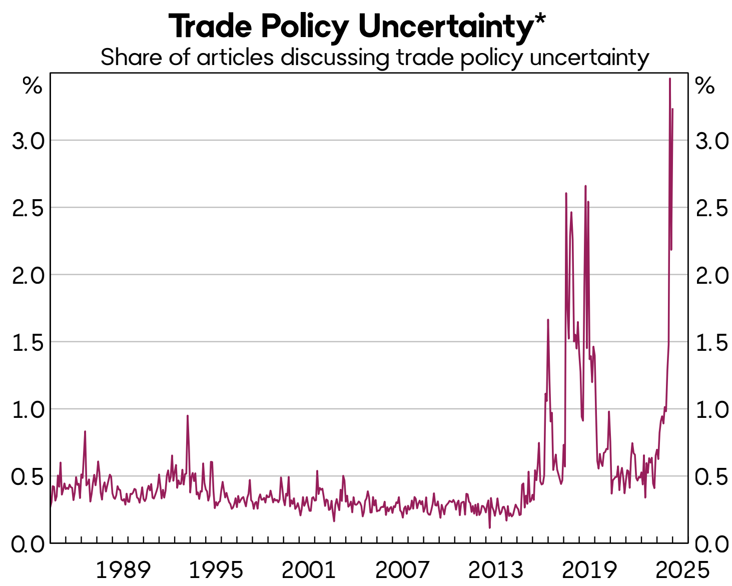
Economic and market update

Economic Overview – as at 20th March 2025

Global markets

The escalation of US trade policy from threats to the actual imposition of tariffs appeared to catch markets off guard, and the subsequent 10% fall in equity markets in the US (albeit off record highs) coincided with a sharp jump in the VIX index of stock option volatility. The 25% tariff on US steel and aluminium imports had no exemptions, and the commitment for additional 'reciprocal tariffs' including on GST/ VAT on 2 April has seen downgrades to growth forecasts for a range of countries, especially Canada, Mexico and the US itself. Geopolitical uncertainty is also at extreme levels after recent developments with respect to Ukraine and threats that the US administration may pull back from its long-standing commitment to protecting allies on the continent. No wonder gold has set new record highs above US$ 3k/oz - the US appears no longer prepared to underwrite the 'global order'.



* Share of articles mentioning trade policy uncertainty in automated text searches of mostly US newspapers: Boston Globe, Chicago Tribune, Guardian, Los Angeles Times, New York Times, Wall Street Journal, and Washington Post.

Sources: Caldara et al (2019); RBA.

The adverse impact of this uncertainty on confidence and perceptions that the tariffs (and other policies) will see a spike in US prices has been evidenced by a range of recent US data, including:

- The NY Fed's Empire manufacturing index plunged by 26 points to -20 in March
- March preliminary Uni of Michigan consumer confidence fell 7 pts to 57.9
- 5 - 10 year inflation expectations rose 0.4 to 3.9%, their highest level since 1993!

The US Federal Reserve kept rates on hold overnight despite the Atlanta 'GDP now' forecast for Q1 falling to -1.8%, and a number of US banks increasing their recession risks probability estimates. The comments from Trump and Scott Bessent that a US recession was possible and the downturn was a necessary 'detox period' added to market volatility, but the Fed sounded more comforting saying 'economic activity has continued to expand at a solid pace' and labour markets 'remain solid'. The FOMC maintained two rate cuts in its median projections, but also announced a tapering in its QT program (its balance sheet run-off, trying to unwind the massive money-printing QE through the pandemic). The Fed has an unenviable task ahead dealing with a slowing economy but with inflation at risk of reemerging: but Jay Powell recycled 'transitory' as the word to sum up this effect: too soon?

Canada has faced the brunt of the US tariffs with 25% on a wide range of goods and threats of more to come as new PM Mark Carney imposed retaliatory tariffs. The latest OECD forecasts have halved Canadian GDP growth this year and next, and the Bank of Canada cut rates last week by another 25bp to 2.75%. Two more cuts are expected, but inflation was a little higher in the latest data.

In Europe, the blunt message to NATO that traditional US allies must increase their own defence spending (and the subtext that they can't assume the US will come to their rescue) has seen a swift response, most notably in Germany. The new German coalition succeeded in agreeing to a €1 trillion spending package, mainly for defending Ukraine and for infrastructure spending. Financial markets took a very positive view of this development, with German stocks moving in the opposite direction to the US setting new record highs, and bund yields rising to almost 3%. The 30 bp jump in 10-year bunds was the largest increase since the Berlin Wall fell in November 1989. A partial ceasefire in Ukraine appears to be in place but a permanent ceasefire with lasting peace will take time: however the European commitment to increased defence spending and fiscal expansion is significant news.

The Chinese economy continues to perform better than expected with the January/February activity data suggesting that fiscal stimulus and policy support has been effective, helping retail sales and fixed-asset investment to lift to 4% year-on-year and industrial production growing 5.9% y/y. The additional 20% US tariffs on Chinese exports were countered by China imposing their own on US agricultural exports, so the extent of escalation of these tariffs is a key risk ahead. This week's policy stimulus directly aimed at consumer demand was encouraging although lacked thorough details.

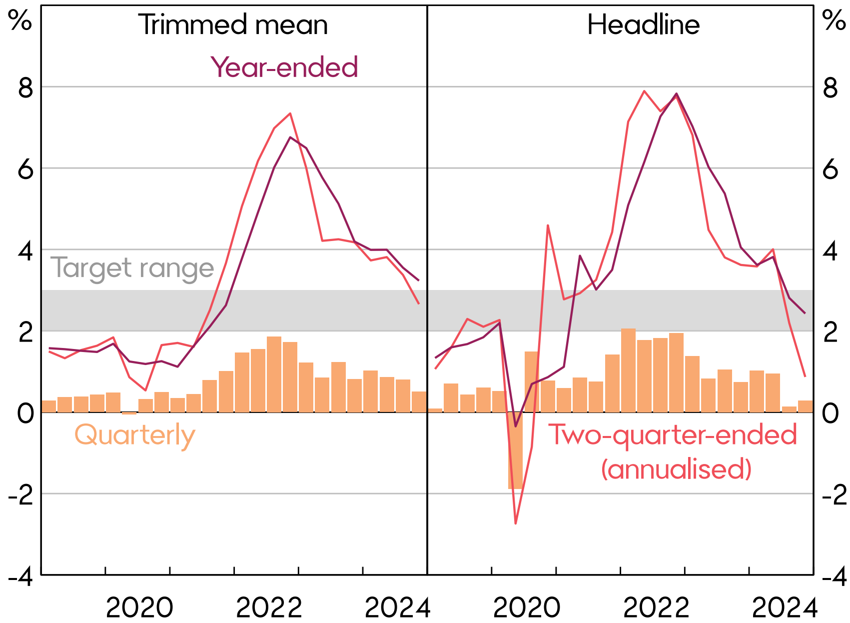
In summary, markets and economic sentiment will continue to be driven by announcements on tariffs and the extent of retaliation - will a global trade war result in a severe downturn or will policy responses be sufficient to cushion individual economies from this challenge? The US administration are hoping this will generate US$1 Tn in revenue - but who will shoulder this cost, should it transpire?.

Domestic economy

The RBA continues to sound very cautious about the outlook (in line with above commentary on the complex global backdrop) and Deputy Governor Hauser was on the hawkish side in his latest speech, which explained the rationale for the rate cut but the areas of uncertainty that may constrain further cuts. Global trade policy was prominent in this ambiguity, although these are two-sided risks: there may be a higher probability of slower growth and demand - especially from China - driving deeper cuts than the risk of tariffs pushing local inflation higher, so less cuts.

The other primary source of uncertainty comes from labour markets, which have been assessed as clear evidence of a lack of spare capacity in the economy but are uniquely uneven and skewed by post-pandemic factors. Population growth has slowed to 1.8% y/y with annual net-migration down to 380k from 560k a year ago, but the latest jobs data didn't add any clarity to the debate around capacity, with total employment falling by 53k and unemployment steady at 4.1%. The participation rate fell from its record 67.3 to 66.8% (blamed on 'fewer older workers returning in February'), so we will need a few more months before a conclusion could be drawn that labour markets are materially weakening. Our basecase forecast below continues to assume a higher unemployment rate ahead towards a less inflationary rate, but debate rages as to how tight labour markets really are and whether the 'non-accelerating inflationary rate of unemployment' is a little lower than the 4.5% previously estimated.

Measures of Inflation



Sources: ABS; RBA.

The monthly CPI indicator for January showed CPI was exactly on target at 2.5% and the Trimmed Mean at 2.8% y/y (from 2.7% in December), so this progress is thoroughly consistent with the first RBA rate cut in the cycle and more to come: but how many more this year will depend on:

- The extent of household demand as inflationary pressures moderate
- The impact of government stimulus: more on the Federal Budget below
- Further evidence of inflation returning sustainably to target, including via the jobs market.

GDP per capita rose (after 7 quarters of contraction), indicative of a turning point in the economy. Productivity was again weak (contracting 1.2% last year - refer Appendix) but growth was evident quite broadly via private and public investment and a rise in net exports. The household saving ratio rose to 3.8% consistent with the recovery in incomes going mainly to savings (but some pickup in household spending). Consumer sentiment rose 4% to 95.9 in March: still below the neutral 100 level, but its highest reading since March 2022 when the inflation rate first broke above 4%.

The Federal Budget released on 25 March will be unusual given how closely the election will follow, so is more likely to resemble a campaign launch than anything else, but will show a deficit (around A$20 Bn for FY25 - an improvement on the MYEFO estimate of 27 Bn) after two years of surpluses. Spending on Medicare, pharmaceuticals, NBN and cyclone Alfred have already been announced, and increases/extensions to electricity rebates, Future Made in Australia and possibly defence are in play. None of this should impact the RBA's plans for monetary policy, but somewhat expansionary fiscal policy was one of the factors that influenced the later timing of the first cut in the cycle. A federal election may be called as soon as Budget week is behind us, but for the RBA the key variable for the next rate cut will be the Q1 CPI data out on 30 April: too late for the next meeting on 1 April.

The Australian Dollar has recovered a little ground as the US Dollar lost some of its appeal in March amid the tariff turmoil and stock market volatility, but remains stable around 60 on a trade-weighted basis. The basecase scenario below shows little change in the next few months, but USD weakness later this year as US stagflation risks grow.

Interest Rate Outlook

The RBA will most likely deliver a shallow easing cycle this year patiently lowering the cash rate back to a more neutral level, with the next quarterly CPI data (to be released on 30 April) encouraging the next rate cut on 20 May. Ahead of this the 1 April rate decision is expected to be 'on hold, awaiting further evidence of moderating inflation'. A sharper deterioration in global conditions could accelerate rate cuts, but we (and our major trading partners) appear better positioned to cope with US tariffs.

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	0.6	0.5	0.6	0.5	0.8	0.7	0.7
GDP y/y	1.1	1.0	0.8	1.3	1.6	2.0	2.2	2.4	2.6	2.7
Unemployment	3.9	4.1	4.1	4.0	4.2	4.4	4.6	4.8	5.0	5.2
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

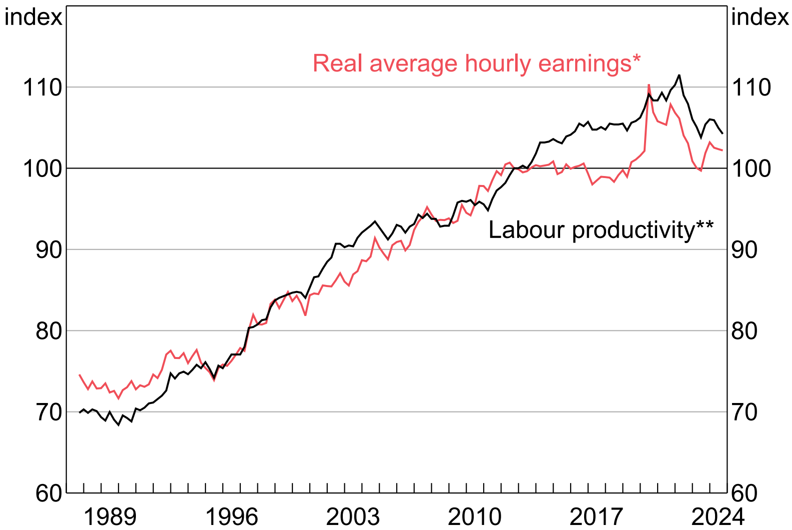
Benchmark rates

	31 / 1 / 24	31 / 1 / 2025	28 / 2 / 2025	20 / 3 / 2025
90-day bills	4.37%	4.25%	4.15%	4.12%
3-year swap	3.95%	3.78%	3.73%	3.65%
5-year swap	4.02%	4.08%	4.00%	3.95%
AUD/USD	.6570	.6215	.6210	.6305
ASX 200	7 591	8 532	8 305	7 919
Credit Index (iTraxx- 5 yr)	75.1	66.8	62.8	73.0

Appendix: Productivity

Real Wages and Productivity

September quarter 2012 = 100, quarterly



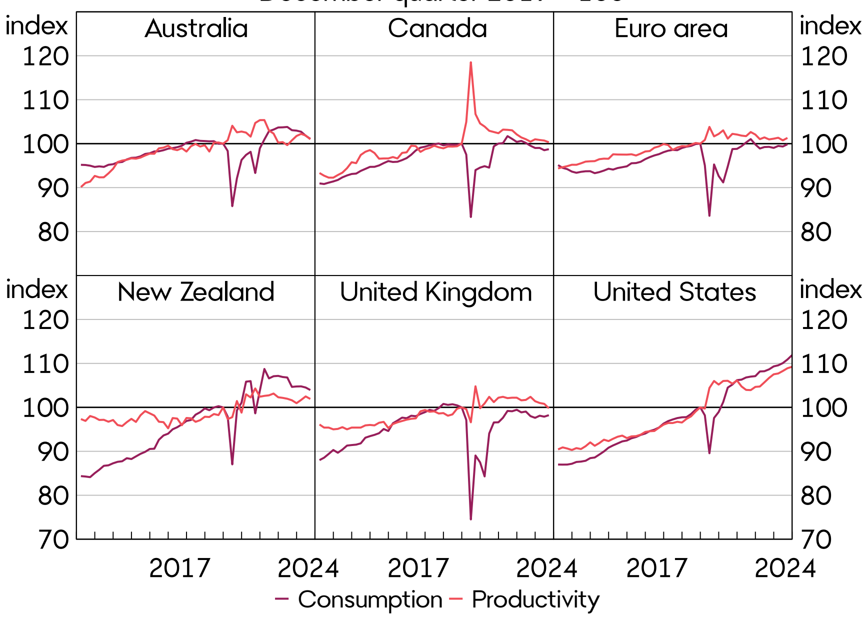
* Real average hourly earnings is the ratio of average hourly earnings (AENA) to the consumer price index; AENA includes all parts of compensation to employees, including bonuses, superannuation and the effect of labour compositional change.

** Non-farm GDP per hour worked.

Sources: ABS; RBA.

Consumption Per Capita and Productivity*

December quarter 2019 = 100

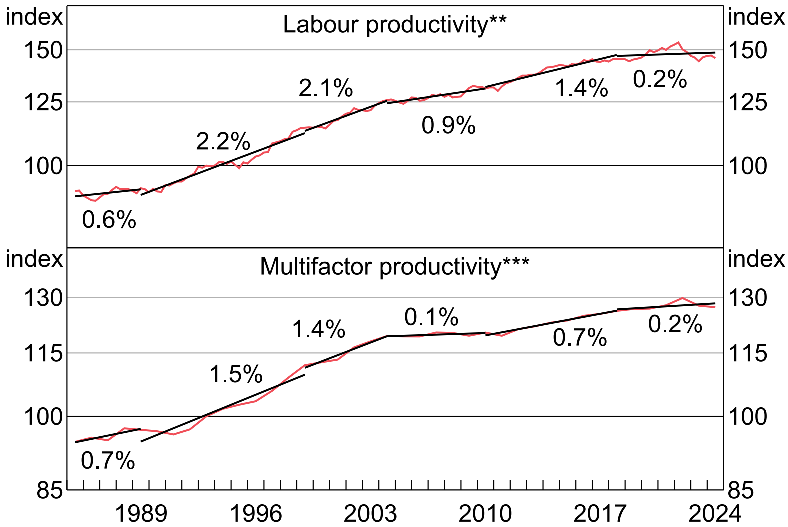


* Productivity presented as GDP per hour worked for New Zealand, and non-farm market sector GDP per hour worked for other economies.

Sources: ABS; CEIC Data; LSEG; RBA.

Productivity*

June 1993 = 100, log scale



* Black lines denote linear trend; labels show average annual growth; cycles defined by the ABS; the recent period has been combined with the 2017/18–2021/22 productivity cycle.

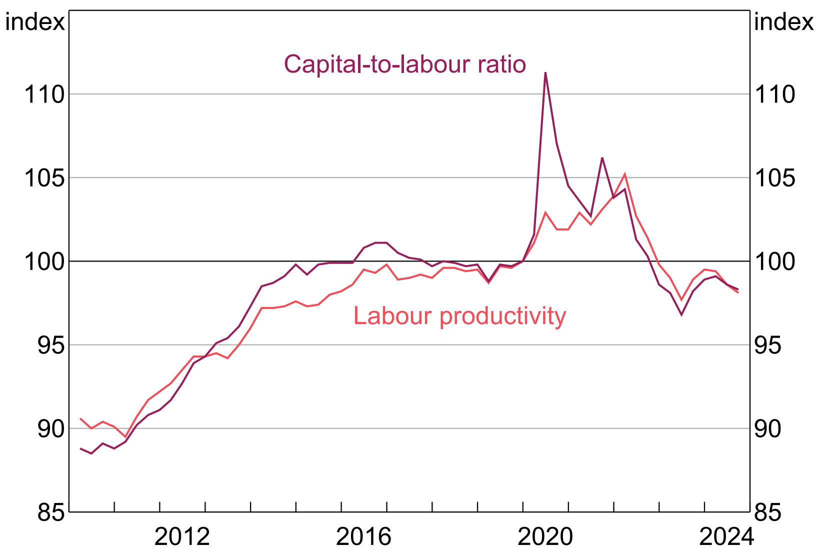
** Quarterly GDP per hour worked.

*** Annual hours-worked basis.

Sources: ABS; RBA.

Labour Productivity and Capital Deepending*

December quarter 2019 = 100



* Non-farm.

Sources: ABS; RBA.