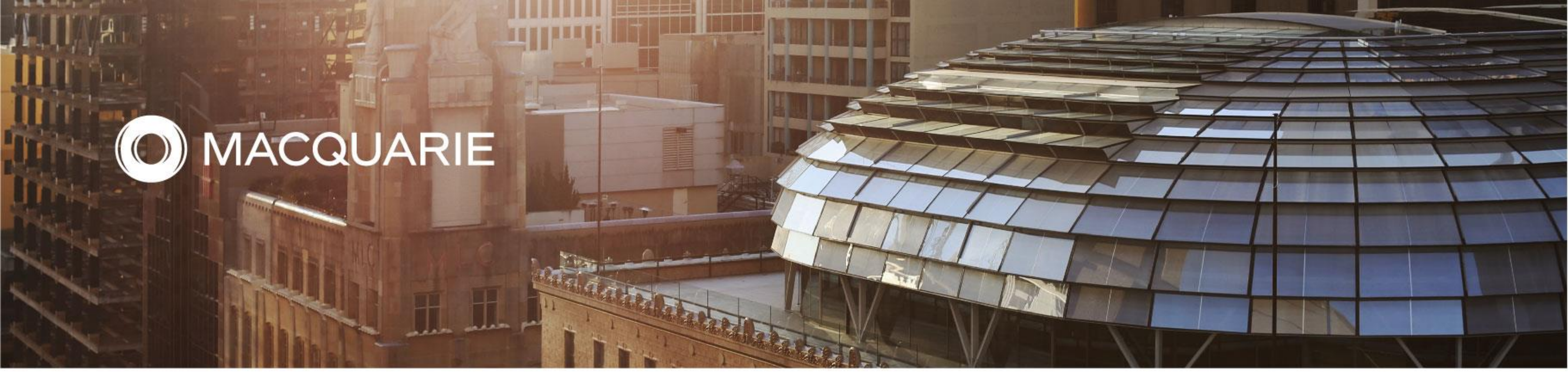


Global Economic and Markets Outlook - June 2022

Part 2 – Australia: Growth slowing but recession avoided

- Our Head of Investment Strategy, Jason Todd, sat down with Macquarie's Australian Economist, Justin Fabo, to discuss Australia's economic outlook via a series of questions which we believe are at the forefront of investors' minds. This included:

  1. How resilient is Australia's economic outlook?
  2. Has inflation peaked and/or how sticky will it remain?
  3. How fast / far will the RBA raise interest rates and what are the implications?
  4. How vulnerable are house prices to rising rates and deteriorating consumer sentiment?
  5. Is a global recession imminent and what will it take to avoid this outcome?

- Despite expecting a significant economic growth slowdown Macquarie does not forecast Australia to fall into recession in 2023. However many sectors within the economy will experience recession-like conditions (i.e. consumer spending, housing) while others will remain reasonably well supported (i.e. business investment, corporate profits and unemployment).

- Like the rest of the world, Australia has an inflation problem. Despite already elevated levels (5.1% y/y in Mar-22) Macquarie expect inflation to rise further, hitting 7% by end-2022. Thereafter we expect quite a rapid decline to between 3-5% over the following 12-18 months. However it is not likely to get back down to RBA's 2-3% target band before 2024.

- Central banks are behind the inflation fight. Following the 50bp hike in May, Macquarie expect another two 50bp hikes over July and August with the cash rate to reach 2.60% by year end before peaking at 3.10% in 1H23. After a brief pause, the RBA will be forced to reverse its policy tightening in order to reduce recession risks. We are forecasting cuts of 100bps to come by end-2024.

- House prices will come under significant pressure from a rapid rise in borrowing costs, with nationwide declines of ~15%. There will be pockets of stress, pushing bad and doubtful debts higher but this is unlikely to become systemic. Structural demand drivers (i.e. undersupply and immigration) alongside improving affordability will ultimately help stabilise prices, but without lower borrowing rates house price gains will revert to more normalised levels (~5-7%).

- The global economy will escape recession, but many economies will not. The US, UK, Europe and Japan are all on a path to recession according to Macquarie's Macro Strategy team but a lack of structural excesses suggest these growth downturns will be short and shallow. However, there remains a great deal of uncertainty around the growth outlook as a consequence of uncertainty around the commitment of global central banks to bring inflation down. If we have underestimated their commitment then we are too bullish on the growth backdrop.

Please see Global Economic and Markets Outlook - June 2022 Part 1 – Recession the price to pay for lower inflation for our report focussed on the global economic outlook.

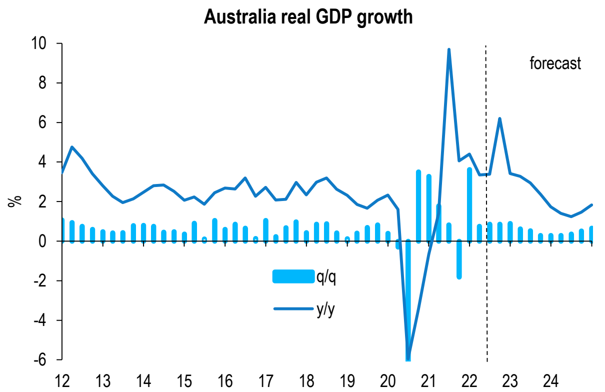
1. How resilient is the Australian outlook?

Macquarie's Macro Strategy team has downgraded the domestic growth outlook for the remainder of 2022 and into 2023, with **GDP now forecasted to grow 3½% on a year-ended basis in 2022** (versus 4½% previously) and 1¾% in 2023 (versus 2% previously). Still, the team expects Australia's growth to remain solid relative to other economies such as Europe and the US as stimulus continues to wash through the economy. The two key reasons for that are:

1. Monetary policy is not expected to tighten as much as the other economies, given inflation pressures are less intense.
2. Australia has more direct exposure to China, which should provide some support to growth over the next couple of years.

In terms of the likelihood of a recession, Macquarie's macro team estimates the current probability to be higher than average (20-30% chance versus an average of 15%) over the next 12-24 months given the lateness of the cycle – **but a recession is not Macquarie's central case at this stage.**

Macquarie has downgraded the GDP growth outlook



Source: ABS, RBA, Macquarie Macro Strategy, June 2022

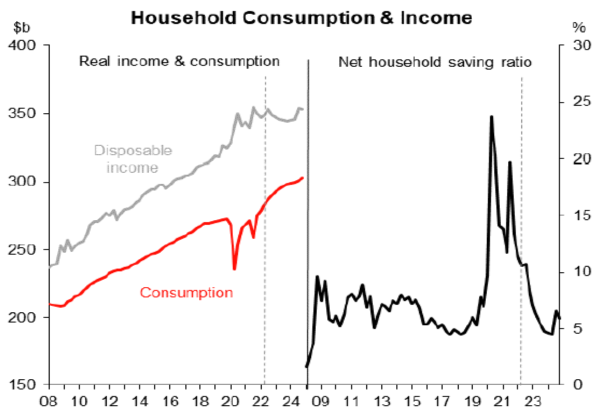
Still, higher unemployment may be necessary to help take the steam out of inflation, and Macquarie has the **unemployment rate to increase from a low of ~3.5% this year to 4.25-4.5%**, which would still be just modestly above 'full employment' estimates. A more disorderly weakening in economic activity would likely see a higher unemployment rate.

Labour market to remain close to 'full employment'

Source: ABS, RBA, Macquarie Macro Strategy, June 2022

Consumer spending is to remain strong in the near term supported by still elevated household saving rates and leaving further room for 'catch up' (services). However, consumption numbers may not necessarily be fully reflected in domestic activity levels, particularly as consumption patterns rebalance towards pre-COVID trends (outbound travel). Discretionary spending also faces several headwinds: housing market activity and 'wealth' effects are turning, and high inflation / rising rates will further dampen disposable income growth / eat into real incomes. While domestic consumer spending has already recovered to well above pre-COVID levels, Macquarie expect growth to slow markedly by 2023.

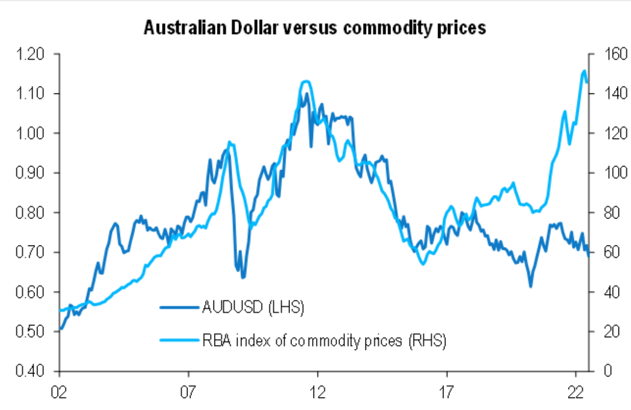
Spending growth to slow materially in 2023 amid weaker real income growth



Source: ABS, Macquarie Macro Strategy, June 2022

Macquarie has downgraded its outlook for the Australian Dollar, forecasting a decline from current levels towards 65c against the US Dollar by 1Q23. The recent rise in commodity prices has not been reflected in the AUD as it has in the past given the strength in commodity prices is not expected to persist. Macquarie forecast commodity prices to trend lower over the next 12-18 months given weaker global growth, issues in China's property sector and supply side constraints. This will put downward pressure on Australia's terms of trade, which currently have risen back to an all-time high.

AUD has diverged from recent commodity price rises

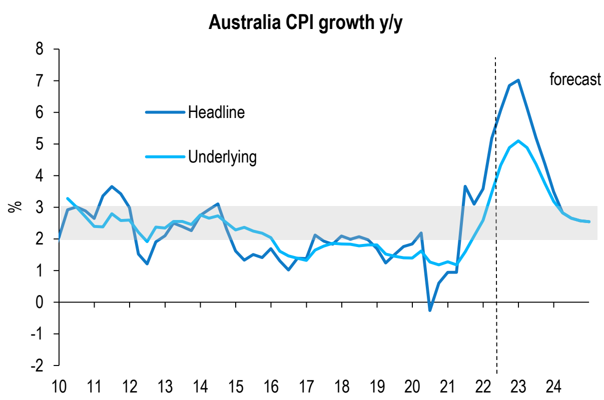


Source: Factset, MWM Research, June 2022

2. Has inflation peaked and/or how sticky will it remain?

Macquarie's Macro Strategy team have upgraded their inflation forecast for Australia; **inflation is expected to continue to accelerate over 2H22 before peaking at ~7%** on a year-end basis. In addition to upward pressures coming from petrol prices, issues in the utilities industry and energy (albeit to a lesser extent than Europe), inflation has also broadened out to other core sectors. Over the medium term, inflation is expected to remain in the range of 3-5% over the next 12-18 months before getting back down to RBA's 2-3% target band in 2024.

Australian inflation to peak at ~7%



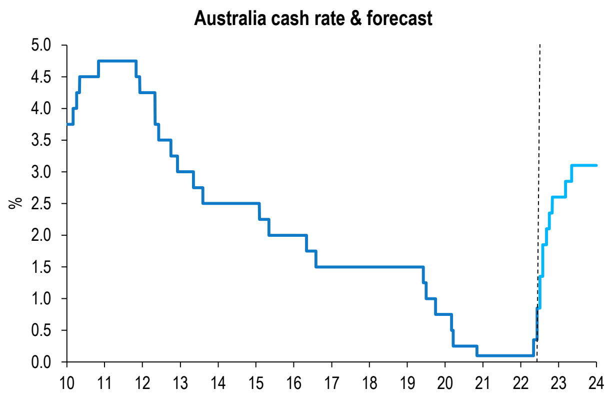
Source: ABS, Macquarie Macro Strategy, June 2022

Risks are to the upside should supply side disruptions persist and inflation stays elevated for longer. On the downside, risks are the reverse, i.e., should supply side factors ease quicker than expected (recent declines in shipping rates and freight costs have been encouraging) or we see further declines in commodity and food prices. Another major factor is the sensitivity of demand to the tightening of monetary policy; if demand slows more sharply than expected as monetary policy is tightened, then disinflation could also be sharper than expected.

3. How fast / far will the RBA raise rates and what are the implications?

The backdrop of high inflation has seen a sharp change in the RBA's rhetoric, with Governor Lowe now an inflation fighter. Macquarie's Macro Strategy team is less bullish than the market, expecting the RBA Board to hike by 50bps in both July and August, followed by 25bp hikes for September, November and December, taking the **cash rate to 2.60% by year-end** (versus market pricing of ~3.25%) and 3.10% by May 2023. By late 2023, however, Macquarie's expectation for much slower growth and sharply lower inflation should provide scope for the cash rate to be lowered, with 100bps of rate cuts pencilled in by end-2024.

RBA cash rate heading to 3.10% by mid next year



Source: Macquarie Macro Strategy, June 2022

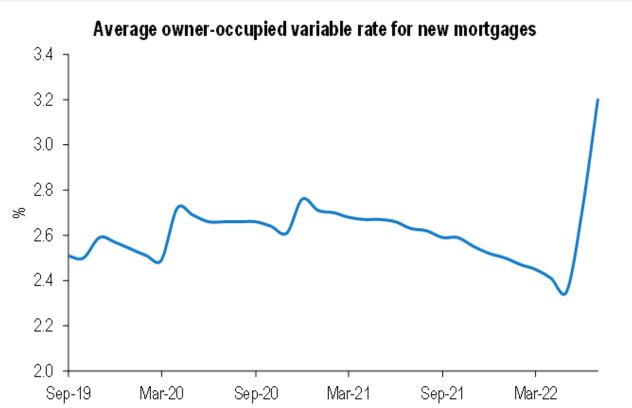
The risk of a more aggressive rate hike path by the RBA, such as the 75bps hike seen at the Fed's last meeting, is reasonably low given:

1. RBA Governor Lowe has stated that the near-term deliberations of the Board will be for hikes of 25bps or 50bps.
2. The higher frequency of the RBA board meetings provides some latitude to move in smaller steps than what the Fed and other Central Banks have done.
3. The problems around inflation in the US are much more severe at the moment than in Australia. While inflation has picked up sharply in Australia, we are not experiencing a wage price spiral like in the US.

4. How vulnerable is housing to rising rates and deteriorating consumer sentiment?

As interest rates continue to rise, Macquarie expect to see further falls in housing prices, with **the central case now for a ~15% peak-to-trough decline in nationwide prices** (versus a ~10% decline previously) – particularly in the markets that went up the most (Sydney, Melbourne and regional areas). But, put into context, national prices are still up 25% over the past couple of years, so a drawdown of ~15% will still see prices above pre-Covid levels.

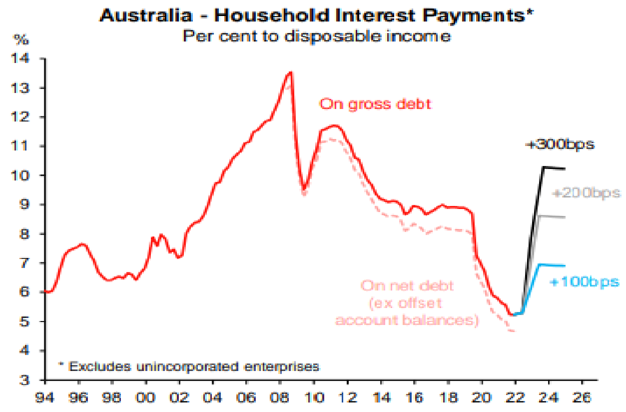
Rate hikes have been passed through in full to variable mortgage rates



Source: Factset, Macquarie Macro Strategy, June 2022

Still, falling house prices will see pockets of stress materialise, putting upward pressure on bad and doubtful debts, and impacting household behaviour and spending. However we do not see a systemic issue emerging around default rates or loan serviceability given the liquidity buffers that households are sitting on and a healthy labour market.

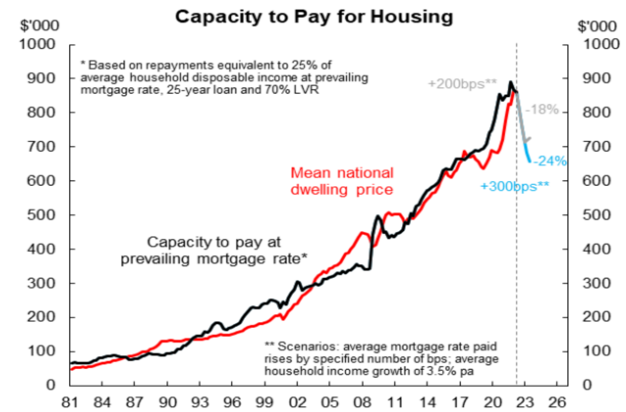
Rising rates will put stress on household repayment burdens



Source: Macquarie Macro Strategy, June 2022

For the rental market, vacancy rates in most capital cities have fallen to very low levels, with Sydney and Melbourne the exception as they have been most affected by the lack of immigration over the last couple of years. Still, looking forward Macquarie expect most rental markets to stay tight or tighten further as borders reopen and immigration picks up, putting upward pressure on asking rents, which will eventually flow through to rents for the stock of housing and CPI inflation.

A mortgage rate increase of 300bps will reduce housing affordability by ~24%



Source: ABS, CoreLogic, RBA, Macquarie Macro Strategy, June 2022

On the construction side, home construction is coming off an extremely strong period as the effects of low interest rates and government stimulus roll through the system. But this sector is now under significant strain as bottlenecks in the industry (supply chain issues, costs / profitability pressures) restrict capacity. Construction is lagging behind approvals numbers and as such, Macquarie expect residential building activity levels to stay higher for longer than normal before activity begins to subside as monetary policy tightens and cost of credit increases.

5. Is a global recession imminent and what will it take to avoid this outcome?

Macquarie's macro team have lowered their global growth forecasts recently (see *Global Economic and Markets Outlook Part 1*), with the base case now for a **global recession, or a recession in advanced economies, to hit in 2H23**. The US, the UK, Europe and Japan have been pencilled in for technical recessions with modest falls in GDP and unemployment rates going up (2-3% in those economies).

Risks are to the downside and that a recession could happen earlier than expected; recent activity indicators, particularly in manufacturing, have weakened considerably, elevated inflation could become a persistent drag on real incomes, affect consumer spending more than is currently expected and bring down overall activity.

In terms of the probability of not going into a technical recession, we would need to see monetary policy tightening pause or slow earlier than currently expected, which may then result in a less sharp downward growth trajectory and a more persistent period of just "weak-ish" growth.

On the other hand, upside risks to growth at such a late point in the cycle is very hard to see. This may come from:

1. Stronger than expected growth out of China, however this is hard to see given the weakness year to date and absent a much bigger stimulus coming from the government, which they don't appear to want to do at this stage; or
2. If some of the supply chain restraints on growth and capacity lessen much more quickly than expected, for example, an end to the conflict in the Ukraine would provide a noticeable boost to market sentiment and ameliorate some of the supply side issues. However, this seems to be very low risk at this point.

Australia economic forecasts

		2021	2022	2023
GDP	y/y	4.8	4.1	2.6
CPI	y/y	2.9	6.3	4.8
Core CPI	y/y	1.9	4.4	4.0
A$/US$		0.73	0.67	0.69
RBA cash rate	%	0.10	2.60	2.60
3-yr yield	%	0.91	3.50	2.60
10-yr yield	%	1.67	3.70	2.80

Source: Macquarie Macro Strategy, June 2022

Macquarie WM Investment Strategy Team

This report was finalised on 1 July 2022.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at https://www.macquarie.com.au/advisers/financial-services-guide.html.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e -mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research.

Important disclosure information regarding the subject companies covered in this report is available at macquarie.com/disclosures.