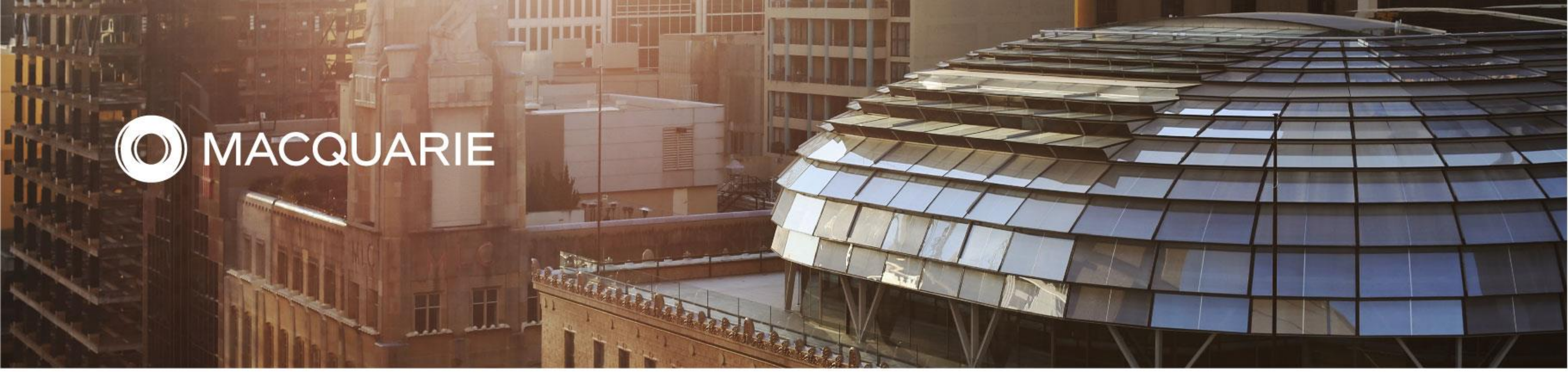


Investment Strategy Update #145

Australian economy: Stickier inflation, higher rates & slower growth

- Australia's macroeconomic outlook has now converged on other major developed economies with the prospect of stickier than expected inflation driving a higher peak in policy rates and a slightly deeper economic downturn.

- The good news is that Australia should still avoid a recession (unlike the global economy and many other developed economies such as Canada, Europe, NZ and the US), with positive contributions coming from a rebound in population growth and moderate fiscal support. However, this is now a finely balanced call and is dependent on how much further the RBA raises policy rates.

- We don't think "recession" is the line in the sand between a good or bad economic outcome. Australia is about to enter its weakest economic growth period since the GFC and for many households and businesses, conditions will feel recessionary as cost of living pressures persist and the labour market weakens.

- The concern is that after 400bps of policy tightening in a little over a year, the RBA is still not done. Inflation remains above the target band and services inflation is proving stubborn. In addition, the labour market has stayed resilient. As such, Macquarie is forecasting two more rate hikes by September, taking the cash rate to a peak of 4.60%.

- Household incomes are bearing the brunt of rate hikes, with consumer spending (discretionary in particular) already slowing sharply. No near-term reprieve to consumption growth is coming with Macquarie expecting it to remain muted over the coming year (+0.4% over 2023).

- In contrast, the housing market has bounced back in recent months (likely a reaction to the expectation that the RBA was already done raising rates). Despite further rate hikes and a pending mortgage cliff, Macquarie think nationwide prices have already bottomed and that they will rise by ~2% over the remainder of 2023.

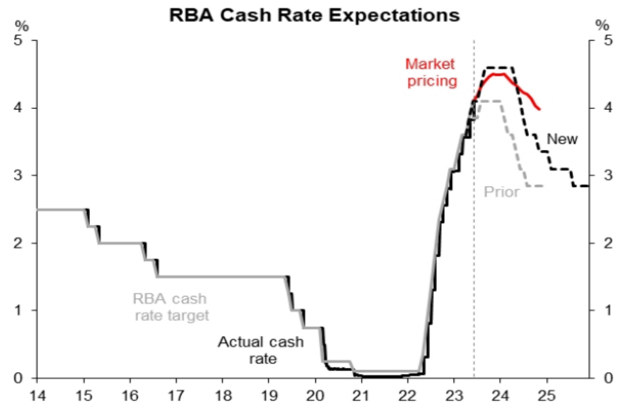
- The combination of stickier inflation, higher policy rates and a weaker consumption outlook has seen a minor downgrade to economic growth, with Macquarie lowering its growth outlook to 1.3% y/y for 2023 (from 1.9% previously), with 2024 falling further to only 0.8% y/y.

This is a summary of a recent report from Macquarie's macroeconomics team titled Mid-Year Economic and Market Outlook – Slow train coming, 21 June 2023.

Further hikes to come, dampening growth

Australia's economy had remained relatively resilient compared to global developed peers coming into the year, with strong consumer spending, a tight labour market and a high household savings buffer supporting economic activity. However, like the rest of the world, Australia is battling sticky inflationary pressures even after a large amount of monetary tightening (400bps of rate hikes have been passed through so far).

Cash rate forecast to peak at 4.60% by September



Source: Bloomberg, Macquarie Macro Strategy, June 2023

With inflation still well above target, the RBA's job does not yet appear to be done, and Macquarie is expecting two more rate hikes to come through by September, taking the peak cash rate to 4.60%. Macquarie also expect rates to remain higher for longer, pushing out the date of the first rate cut from 1Q24 to 2Q24. This sees inflation coming down faster than previously forecast, falling to 3.9% y/y by

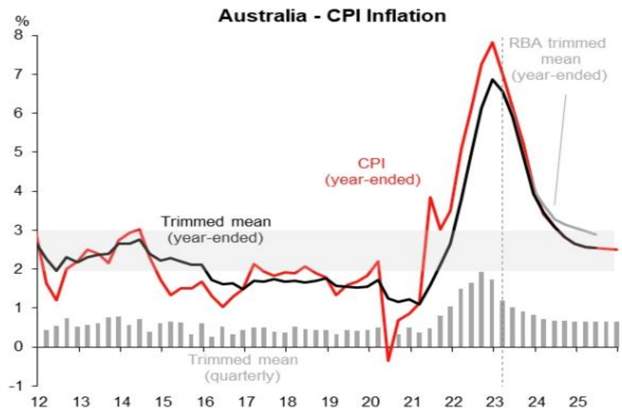
December versus 4.5% previously, and 3.1% y/y by 2Q24 versus 3.2% previously. But consequently, Macquarie's macroeconomics team has also downgraded Australia's growth outlook to 1.3% y/y for 2023 (from 1.9% previously), with growth in 2024 falling further to only 0.8% y/y.

Growth to remain weak despite avoiding recession

Source: ABS, RBA, Macquarie Macro Strategy, June 2023

Although headline inflation peaked at the end of 2022, underlying inflation data remains disparate. While goods inflation has slowed noticeably and should moderate further if Australia follows the path of global peers, services inflation has remained strong and is expected to stay elevated in the near-term, with solid unit labour costs adding pressure for labour-intensive market services. Furthermore, rental price inflation is expected to increase in the coming quarters as stronger population growth contribute to further tightness in rental markets.

Inflation to fall back to target by 1H24



Source: ABS, Macquarie Macro Strategy, June 2023

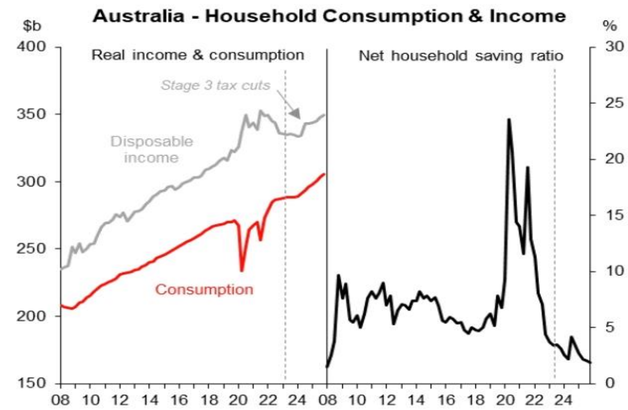
In addition to sticky services inflation, Australia's headline employment numbers have also remained strong, with the unemployment rate falling to 3.6% in May (versus consensus of 3.7%). Employment rose 77k m/m, which was much stronger than market expectations of 17.5k m/m.

However, looking through the surface, signs of labour market softness are now starting to emerge: 1) the male unemployment rate has lifted from the recent low, with average hours worked moving sideways, 2) youth labour market outcomes have softened, which historically has occurred prior to broader labour market deterioration, and 3) rates of underemployment and broader labour underutilisation are gradually trending higher. Macquarie still sees labour market conditions to gradually ease throughout the rest of the year, although at a slower pace than previously expected, with the unemployment rate now forecast to rise to 4.0% by end-2023 versus 4.2% three months ago.

Consumer spending is weakening as real incomes fall…

Household consumption has come under pressure as real disposable income continues to retreat from Covid highs, with real consumer spending up just 0.2% q/q in 1Q23 after rising 2.6% over 2022. The majority of this has been seen in discretionary spending, which has faced pressures from weaker housing turnover and normalising spending patterns, in combination with falling real incomes. Furthermore, spending on outbound travel (which had accounted for most of the growth in consumption in 1Q23) remains well below pre-pandemic levels and is now fading.

Falling disposable income weighing on consumption



Source: ABS, Macquarie Macro Strategy, June 2023

Looking ahead, real household disposable income is expected to fall further amid elevated (but lower) inflation and easing labour market conditions. The scope for the household saving ratio to decline further and support consumption is limited; although significant 'excess' savings is likely providing some support to spending, an uncertain economic backdrop will more likely see households treating this as a buffer rather than a source of liquidity to increase spending. In addition, rising interest rates and the upcoming step-up in fixed-rate mortgage resets will result in further increases in households' interest-servicing burden, acting as a further drag on disposable income.

As a result, Macquarie now expect real consumption to grow just 0.4% over 2023. There may be some upside risk to the outlook for parts of consumer spending from the recent improvement in housing prices, but this may be tempered by further interest rate rises before rate cuts are expected in 1H24.

…but housing and population growth to provide support for economic activity

The Australian housing market appears to have passed what had been a relatively short (although sharp) downturn, and Macquarie's base case now is for nationwide dwelling prices to rise by ~2% over the remainder of 2023. We expect some weakness across dwelling investment to detract from growth in the short term as areas such as renovations activity and new home construction slow. However, longer term, we anticipate housing investment to be supported by lower interest rates (from 2Q24), a strong rebound in population growth and extremely tight home rental markets (see our *Investment Strategy Update #141: Australian Residential Property: Prices appear to have bottomed but the pace of the upswing remains uncertain*).

Likewise, returning population growth is also expected to add some support for education and travel exports, as well as alleviate labour shortages in select industries while also adding to aggregate demand across the economy. Further supports for domestic growth include government spending, which is forecast to grow with spending programs such as the National Disability Insurance Scheme (NDIS) and a pipeline of public engineering work that should provide support for public capital expenditure levels.

Monetary policy works with long and variable lags, and we expect the economic backdrop will continue to slow more meaningfully until the RBA sees clearer signs that labour market conditions are easing more quickly than they have up to now, or something "breaks" in the financial system. While progress has been made on bringing inflation down (and survey data suggests further declines are coming), it has not fallen to levels that the RBA would be happy with yet.

Nevertheless, with population growth coming back, housing prices on the rise again, and relatively steady government spending, at this stage we don't expect the imminent slowdown to turn into a recession. There is upside risk should the global growth backdrop deteriorate quicker or worse than expected, which may lead to earlier rate cuts, supporting growth. Conversely, should economic growth hold up better than expected and labour markets stay resilient, then this may lead to higher for longer rates, which will continue to place downward pressure on consumer spending and broader economic growth.

Macquarie WM Investment Strategy Team

Australian economic forecasts

		Quarterly									Annual*			
		Dec-22	**Mar-23**	**Jun-23**	**Sep-23**	**Dec-23**	**Mar-24**	**Jun-24**	**Sep-24**	**Dec-24**	**2021**	**2022**	**2023**	**2024**
GDP	q/q	0.6	0.2	0.2	0.1	(0.2)	0.1	0.4	0.5	0.7				
	y/y	2.6	2.3	1.7	1.1	0.4	0.2	0.4	0.8	1.7	5.2	3.7	1.3	0.8
CPI (nsa)	y/y	7.8	7.0	6.2	5.2	4.1	3.4	3.1	2.8	2.7	2.9	6.6	5.6	3.0
Core CPI**	q/q	1.7	1.2	1.0	0.9	0.8	0.7	0.7	0.7	0.6				
	y/y	6.9	6.6	5.9	4.9	3.9	3.4	3.1	2.8	2.7	1.9	5.5	5.3	3.0
Unemployment rate	%	3.5	3.6	3.6	3.7	4.0	4.3	4.4	4.5	4.6	4.7	3.5	4.0	4.6
AUD USD		0.68	0.67	0.68	0.64	0.67	0.69	0.69	0.69	0.69	0.73	0.68	0.67	0.69
Policy rate***	%	3.10	3.60	4.10	4.60	4.60	4.60	4.10	3.60	3.35	0.10	3.10	4.60	3.35
3-yr yield	%	3.50	2.94	3.95	3.60	3.50	3.35	3.10	2.85	2.75	0.91	3.50	3.50	2.75
10-yr yield	%	4.05	3.30	3.95	3.70	3.60	3.40	3.20	3.00	3.00	1.67	4.05	3.60	3.00

Source: ABS, Bloomberg, Macrobond, Macquarie Macro Strategy, June 2023. *Year-average for GDP and CPI; year-ended for FX, rates and unemployment **Trimmed mean CPI ***RBA cash rate.

The report was finalised on 26 June 2023.

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

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