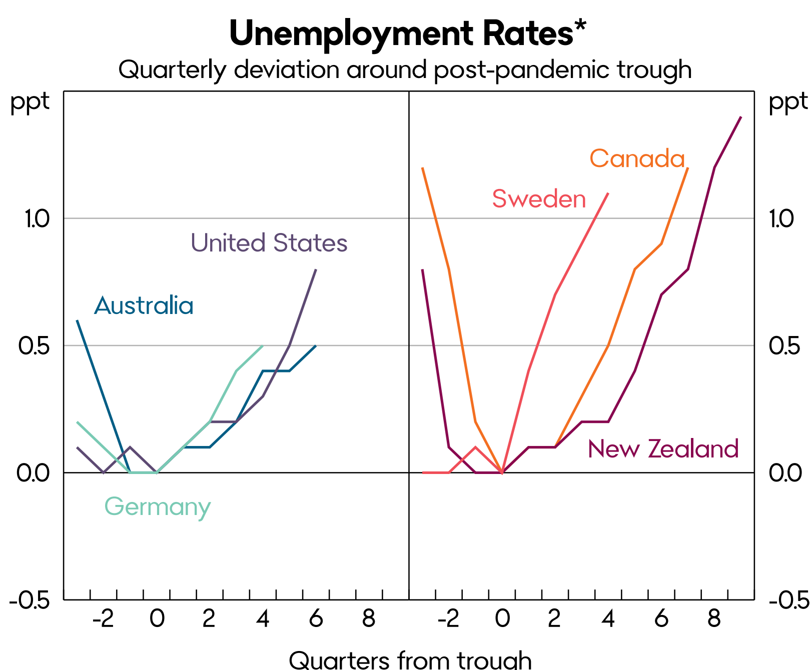
August 2024

Economic and market update

Economic Overview – as at 22nd August 2024

Global markets

The sudden sharp spike in volatility across financial markets in early August was the most prominent feature this month, initially driven by a jump in US unemployment and concerns that the assumed US soft landing may be at risk. The leap in the VIX index of stock market volatility to its highest level this century - outside the GFC and the pandemic - was matched by extreme volatility in FX markets (especially the Japanese Yen), but the subsequent calming of the markets and 10 straight sessions of gains on Wall Street has the focus back on policy easing cycles, in particular the US Federal Reserve. The timing of cuts (with the RBNZ and Bank of England now having followed suit from the Bank of Canada, ECB and other European central banks) is in no small part dependent on labour markets.



Minutes from the latest FOMC meeting show that some Fed members saw the case for a July cut, but the majority felt it 'would likely be appropriate to ease policy at the next meeting'. Jerome Powell is expected to confirm this timing in his Jackson Hole symposium speech this weekend, although the market is now only pricing in a 25bp cut (having fully priced 50bp in the immediate wake of the market meltdown a fortnight ago). The impact of the extreme volatility was understandable at the time, but we would need to see a more severe and lasting dislocation in the markets (as was the case in the GFC) to drive larger rate cuts. Having said this, the jump in US unemployment and other recent weak data makes a succession of rate cuts more likely, and a US recession remains a possibility - recall the 2/10 yield curve has been inverted for two years

now, well ahead of the recent 'Sahm Rule' trigger. Meanwhile the US Presidential election appears a much closer race than a month ago, with Kamala Harris slightly ahead of Donald Trump in most polls and in traded probabilities.

The next ECB rate cut is still expected in September amid tepid growth although eurozone inflation ticked up from 2.5 to 2.6%, pushing the euro to its highest level against the US Dollar in over a year. Sweden's Riksbank cut rates for the second time (to 3.5%) in their new easing cycle this week and signalled further cuts as inflation has returned to target and their economy remains in recession. The Bank of England initiated their easing cycle earlier this month in a tight 5-4 vote with headline CPI back at target but services inflation and wages growth still uncomfortably high. From here the BoE are expected to cut rates again in November, having started the cycle from a 16 year high of 5.25 %.

The Bank of Canada cut rates for the second time this cycle in late July to 4.5% and are expected to continue in September, October and December; unemployment is elevated at 6.4% and youth unemployment is up to 14.2%. The Canadian rail shutdown is adding to pessimism in the region.

Japan was hit hardest by the market turbulence in early August with the Nikkei losing more than 10% in one session (and peak to trough down almost 27% from its July record high), and similar volatility for the Japanese Yen as the 'carry trade' was put through an extreme stress test. This followed the surprise hawkish BOJ rate hike in late July coinciding with the weaker US Dollar, but the subsequent recovery makes this event appear a one-off more so than a precursor to further extreme price action.

China's challenging economic environment continues to trouble policymakers, with the PBoC cutting official rates by a larger than usual 20bp in late July. Further rate cuts and other policy support is expected later this year which should be sufficient to achieve growth close to the 5% target, but structural imbalances may make this growth profile much more difficult in the years to come.

In summary, global growth is expected to remain below trend and the consequences of the global inflation shock (and the required policy response) amid ongoing geopolitical tensions continue to test economies. Most countries that have inflation back on target experienced recession-like conditions, so the US soft landing scenario (which has driven risk appetite this year) is being questioned.

Domestic economy

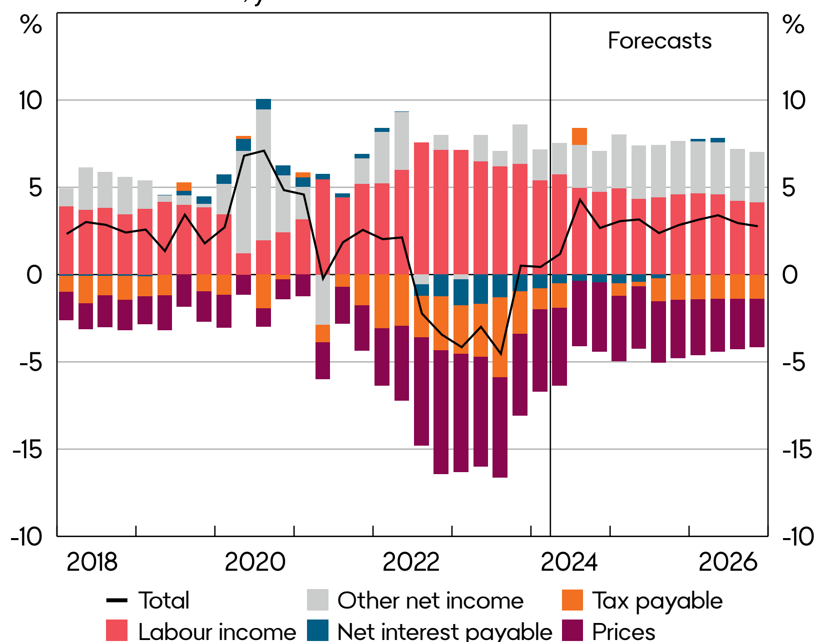
Australia faces the same challenges as other advanced economies but our cycle is a little later than comparable countries for a number of reasons, including the more resilient performance of our labour markets than elsewhere (refer chart above). The latest rise in unemployment to 4.2% was consistent with global trends but employment continues to grow and the participation rate is also at a fresh record high. So while labour markets are easing, there continues to be a large number of people looking for and finding jobs. Where the unemployment rate heads from here will be critical for RBA official rates as 'full employment' is estimated to be around 4.5%, while the latest RBA forecasts only have the jobless rate reaching 4.4%, and not exceeding this level for two years! A faster path to a less inflationary level of unemployment (i.e. at or above 4.5%) would allow for earlier RBA rate cuts.

Other reasons the RBA will likely lag other central bank easing cycles (detailed above) include:

- We were later to embark on a tightening cycle, and didn't increase rates by as much
- Population growth and our inability to match this with building new dwellings
- Recent fiscal stimulus including the stage 3 tax cuts and 'cost of living' support

Given these complexities and the roller coaster of events overseas it is no wonder that such a wide range of opinions have been expressed as to where official rates are heading and likely timelines. However (as noted in this report throughout 2024), the stubborn nature of services inflation in Australia makes rate cuts this year very hard to reconcile with the RBA's mandate to achieve price stability. Equally their obligation to attempt to achieve optimal employment levels makes further rate hikes unlikely. As such the economic basecase scenario detailed below still shows no move up or down from the RBA in 2024, but three cuts in 2025 once core inflation is closer to 3%.

Given the extreme volatility in the markets it is timely to consider upside and downside scenarios that could alter this basecase; and a recent logical and thought provoking speech from RBA deputy governor Andrew Hauser (oddly criticised by a range of commentators - presumably because they haven't embraced the reality of probability distributions) gave excellent examples of these scenarios. One of the key unknown outcomes ahead is the degree to which recent fiscal



stimulus will be spent or saved. The RBA noted in their recent Statement on Monetary Policy that household demand had been a little stronger this year than expected, but from here the impact of the stage 3 tax cuts and 'cost of living support' in federal, state and territory budgets (e.g. electricity rebates) will be critical.

The SOMP and Hauser's speech discussed the modelling of scenarios for household consumption, and the implications of this unknown on savings, underlying inflation and labour markets. Those hoping for earlier RBA rate cuts might need to see a much weaker outcome for consumption, hand in hand with a sharper rise in unemployment and thereby faster progress for core inflation. But as the following chart shows, real disposable income is forecast to improve steadily this financial year, driven by the tax cuts, a smaller drag from inflation and (eventually) rate cuts. As a result household consumption is unlikely to collapse.

To add even more complexity to the outlook it is important to keep in mind how uneven conditions are by state (the unemployment rate in WA is 3.7%. while in Victoria it is 4.6%). And as detailed in the appendix, conditions in regional Australia (in particular 'commutable regional' locations) are in general much stronger than in the capital cities. But the RBA only has one official cash rate.

Two other considerations to monetary policy lie in offshore demand (which has been relatively strong, although the outlook for China remains uncertain) and the RBA's view that the economy has less spare capacity than previously thought, so supply is still struggling to match demand. This mismatch is evident in housing markets and (while easing) remains a challenge in labour markets, while our lack of progress in lifting productivity growth (with wages growth above 4%) leaves the 'narrow path' of policy settings as challenging as ever for the RBA to navigate. Still, after a long per-capita recession and with population growth set to ease, consensus for GDP growth is a steady improvement to around 2.5% by the end of 2025.

The Australian Dollar remains within recent ranges after surviving a dive to 63.50 US cents during the Yen carry-trade unwind event, but was still unable to break 68 c with the subsequent rebound. The gold price at fresh record highs above US$2500 / oz, together with the expected widening interest rate differential with the US (as the Fed eases rates while the RBA doesn't), both suggest upside risk for the Aussie, but the falling Iron Ore price and fears of a deeper global slowdown have capped the upside. Technically a break of 68-69 c should confirm the next up-leg, but the build-up (discussed here throughout 2024) has been excruciatingly slow.

Interest Rate Outlook

The RBA cash rate is most likely at its cycle peak at 4.35%, and an easing cycle is expected to take shape in early to mid-2025. Another hike is possible but would require a fresh acceleration in core inflation which isn't considered likely, nor is a cut this calendar year expected to be a realistic option. Headline CPI will fall sharply in Q3 mainly as a result of electricity bill rebates, but underlying inflation is unlikely to approach 3% until the Q1 '25 CPI data to be released on 30 April. Earlier rate cuts would presumably require a bigger problem than inflation e.g. a more dramatic hit to labour markets.

Economic Forecasts: basecase scenario

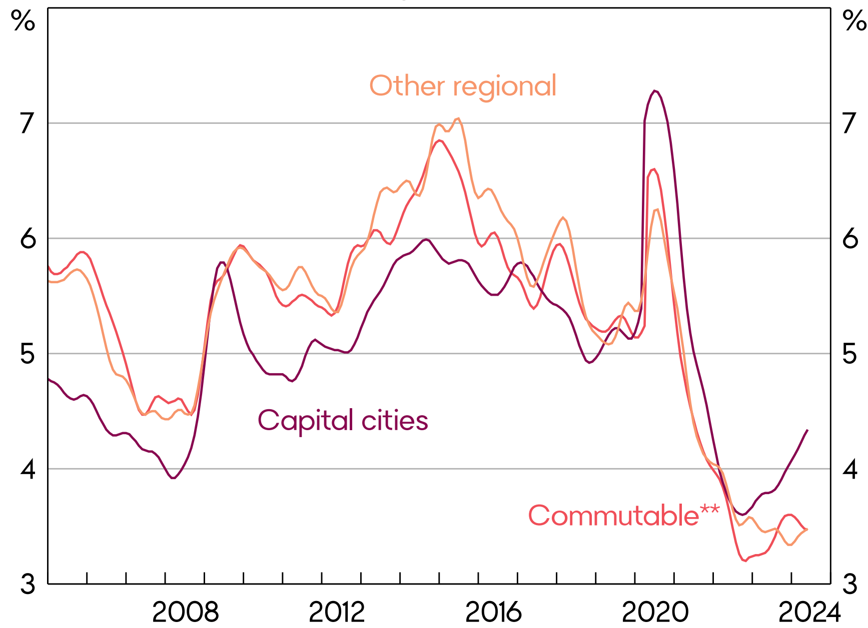
	2023				2024				2025		
% (actual, forecast)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q4
GDP q/q	0.6	0.4	0.2	0.3	0.1	0.2	0.4	0.4	0.5	0.6	0.8
GDP y/y	2.3	1.9	2.1	1.6	1.1	0.8	1.0	1.1	1.5	1.9	2.3
Unemployment	3.5	3.5	3.6	3.9	3.9	4.1	4.3	4.5	4.7	4.9	5.2
CPI (q/q)	1.4	0.8	1.2	0.6	1.0	1.0	0.3	0.6	0.7	0.9	0.8
CPI (y/y)	7.0	6.0	5.4	4.1	3.6	3.8	2.9	2.9	2.6	2.5	3.1
CPI (core y/y)	6.6	5.9	5.2	4.2	4.0	3.9	3.4	3.4	3.1	3.0	2.9
RBA cash rate	3.6	4.1	4.10	4.35	4.35	4.35	4.35	4.35	4.35	4.1	3.6
AUD / USD	.669	.666	.6435	.682	.6515	.667	.68	.72	.73	.74	.77

Benchmark rates

	30 / 6 / 23	30 / 6 / 2024	31 / 7 / 2024	22 / 8 / 2024
90-day bills	4.35%	4.38%	4.49%	4.37%
3-year swap	4.29%	4.21%	3.82%	3.57%
5-year swap	4.34%	4.32%	3.99%	3.75%
AUD/USD	.6660	.6670	.6535	.6740
ASX 200	7 203	7 768	8 092	8 032
Credit Index (iTraxx- 5 yr)	82.1	69.8	65.3	64.7

Appendix:

Unemployment Rate*



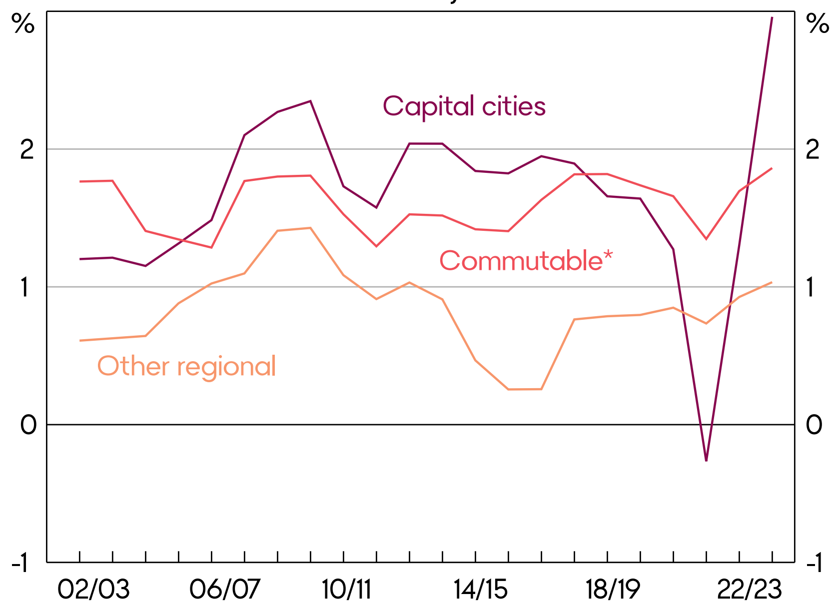
* 13-term Henderson trend; seasonally adjusted.

** Commutable defined as regional areas less than 150km from capital city GPO.

Sources: ABS; RBA.

Population Growth

Financial year



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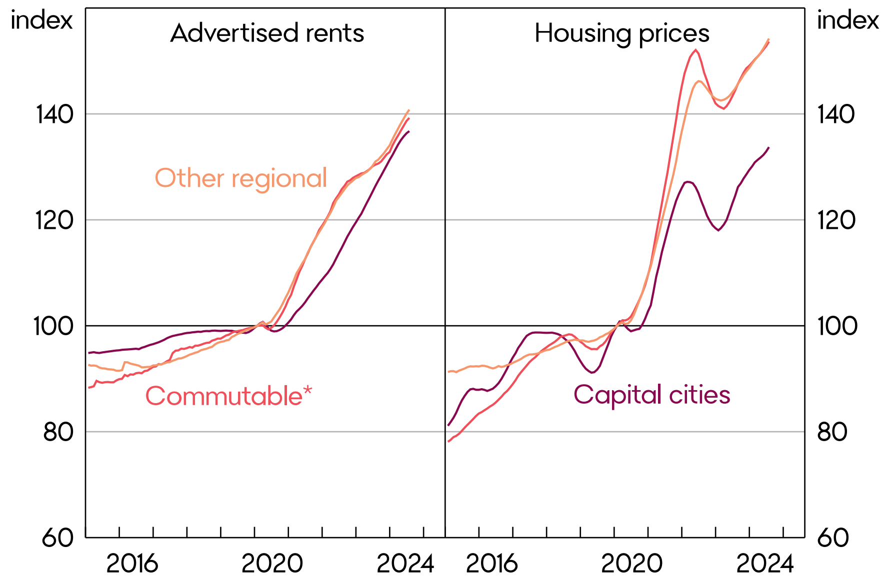
Sources: ABS; RBA.

Housing Costs

January 2020 = 100



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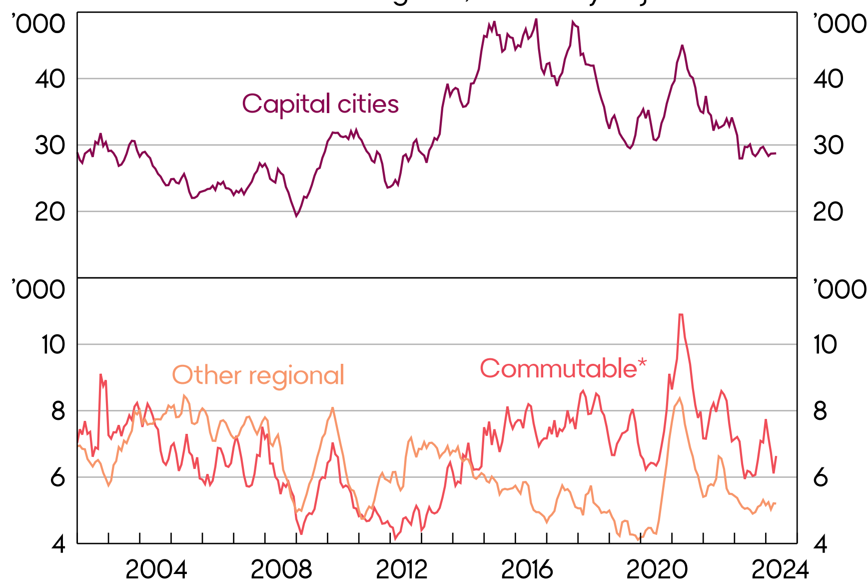
Sources: CoreLogic; RBA.

Residential Building Approvals

Three-month moving sum, seasonally adjusted



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Sources: ABS; RBA.

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