Key points

- **Pessimism has grown about the economic outlook;**
- **The economy is still likely to do well for the remainder of this year;**
- **Loss of economic momentum will become more obvious over the course of next year;**
- **An economic slowdown does not necessarily lead to economic recessions.**

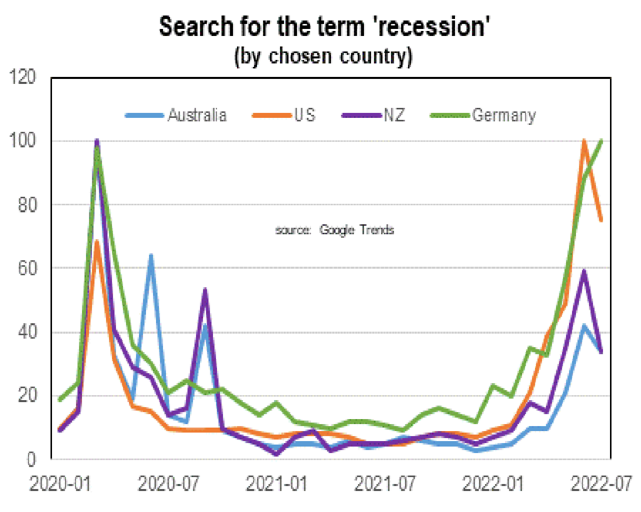
More are seeing the glass as half empty

I have just returned from a fantastic three weeks in South Australia spent in the Flinders Ranges, strolling about various wineries and hanging around the Adelaide Hills. I returned upbeat but at a time when there is downbeat talk about the economy. As an example, the number of people searching for the term ‘Recession’ on Google has picked up notably in recent months. At least by this measure Germans and Americans appear more pessimistic than Australians or Kiwis.

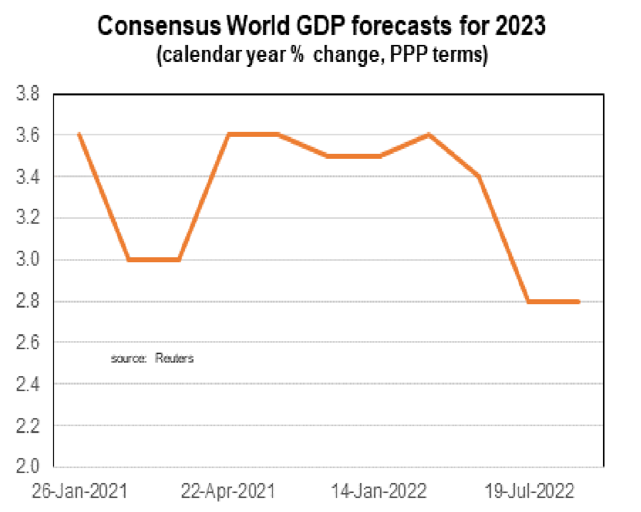
Financial markets have picked up on the downbeat vibe and are pricing a reduction in money-market rates in 2024. More obviously so does the consensus cash rate forecasts of economists (according to a recent Reuters survey). History is on financial markets/economists side. Rate cuts have taken place within 6-18 months of each of the peaks in the cash rate cycle over the past thirty years.

And there are understandable reasons to be concerned about the outlook. The Russian-Ukrainian War is not only smashing both those countries’ economy but is hitting the global economy via higher food and energy prices. If the gas is completely turned off to Europe this winter the economic concerns become a lot bigger. Global supply-chain problems are (slowly) being fixed but they will remain a concern as long as China continues to aim for zero COVID. More generally the Chinese economy is going through a weak patch, exacerbated by worries about the level of debt in the Chinese economy. Wars are not the only reason behind rising prices, and that inflation is eating into household and business incomes in most economies. But the main reason behind the rise in economic concerns has been the sharp increase of interest rates due to the rise of inflation (and the impact that has had on housing and equity prices) with the promise of more to come.

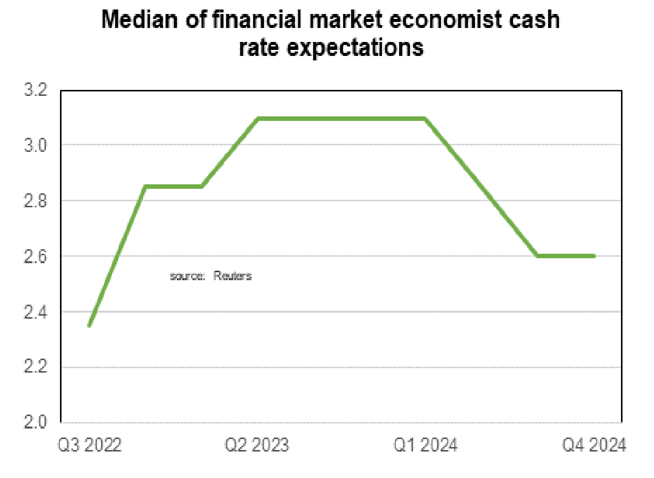
A growing number of people are getting worried about a recession.



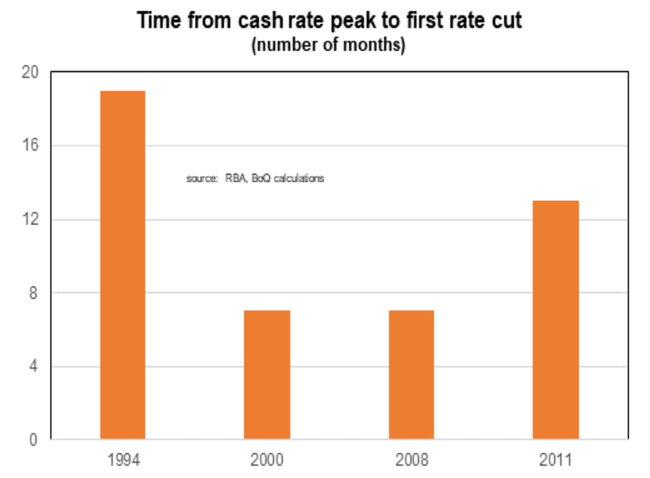
And global economic growth forecasts are being marked down.



Economists think that after the rate hike cycle there will rate cuts.



That has been the case over the past thirty years.



The recent data is consistent with a slowing global economy. The Economic Surprise Index (a measure of how the economic data prints relative to consensus views) is declining in the US, Europe and Japan, and is mixed in China. But that has not (so far) been the case in Australia. Recent earnings reports from companies sensitive to swings in the Australian economic cycle (such as JB Hi Fi) suggest that a slowdown in spending is still so far a forecast not an outcome. Sure the July jobs number was weak. But that has come after a number of months of very strong job gains. The unemployment rate still fell and the underutilisation rate (probably the best measure of the state of the labour market) is at its lowest level in forty years. And the leading indicators all continue to point to ongoing strong job gains in coming months.

So why are analysts still surprised with Australian economic strength? One reason is that they might have underestimated the enormous momentum in the economy. After all the labour market is at its strongest in decades. One of the economic problems punishing most other countries (high commodity prices) is one that the Australian economy benefits. The RBA recently noted that the terms of trade in the June quarter will likely be at its highest ever level.

In any event it will take some time before higher interest rates and falling real wages growth/house prices impacts the economy. The first rate hike was only as recent as May (also when house prices began to decline nationally).

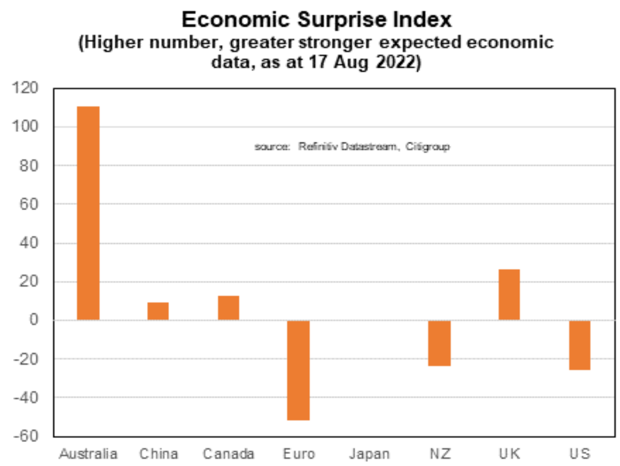
One of the main channels that higher interest rates typically works is via the housing sector. A higher mortgage rate raises the cost for current borrowers so they have to reduce their spending elsewhere in the economy. But as has been widely noted most borrowers are well ahead of their current repayment schedules. Many of the more recent borrowers took out fixed rate loans, and a good proportion of those will not start rolling over until the second half of next year.

Higher interest rates also reduces the likelihood of new borrowing. New lending for homes has started to decline (although mortgage credit growth remains strong). Most directly this will reduce activity surrounding the buying and selling of homes (such as real estate agent fees). The bigger impact on the economy though is via a decline in new home building. The fall in building approvals suggests in time that will take place. But that is sometime down the track given the number of homes that are still to be built. The RBA estimates that will keep housing activity high for at least the next year. More generally, the amount of work to be done in the construction sector is very high.

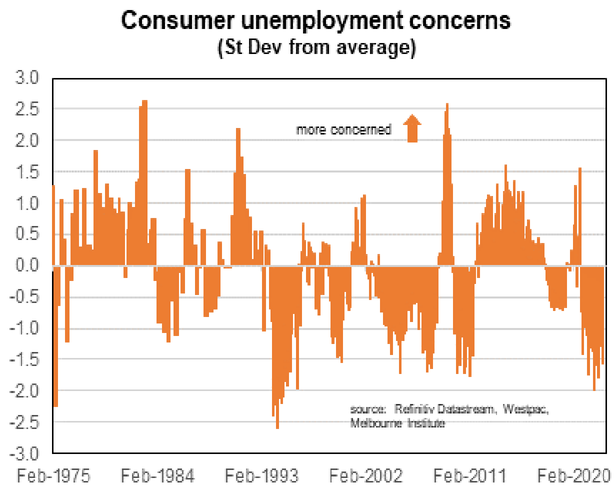
In any event a bit under 40% of households have mortgages. Other households may benefit from higher interest rates via increased income from interest. More generally, most households are comfortable about getting a job and are sitting on a mountain of saving. And after the stresses of the past couple of years many are happy to go on a bit of a spending splurge.

Higher interest rates has less direct impact on businesses whose decisions are typically more influenced by the state of the economy. And given the current economic momentum it is no surprise to see business sentiment is high, capex spending rising and business demand for credit strong. And while the size of deficits has narrowed, the federal and state government budgets remain extremely supportive given the current state of the economy.

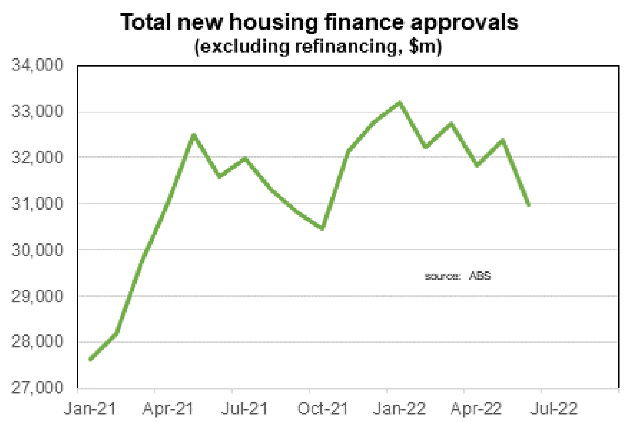
Unlike most countries, the Australian economy has continued to surprise with strength.



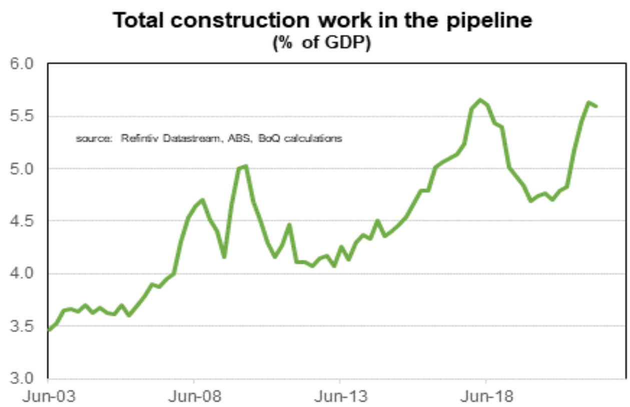
Most households are very comfortable that they can get a job.



Borrowing for housing is starting to decline.



But there is still plenty of construction work still to come.



But slowing in economic momentum is starting

Nonetheless, the economy is beginning to drop down a gear. Job ads (historically a very good lead indicator of the economic cycle) look to have peaked. There have been a number of newspaper reports of rising financial stress amongst some households. Bankruptcies have started to rise, partly a result of some companies being unable to pass on (or absorb) the severe rise in costs. More generally it is the smallest of firms that are finding the current environment the toughest.

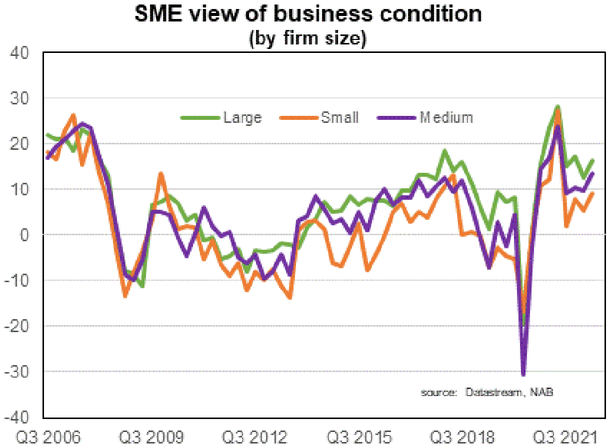
With real incomes (income growth after inflation) likely to be negative for the next 12-18 months the number of households and firms feeling the pinch is likely to rise as we enter next year. The growth of consumer spending will then almost certainly slow as the catch-up spending from the pandemic slump begins to wind down. Builders will eat into their pipeline of work (although this might be slowed by another wet summer on the East Coast). Many commodity prices have already declined from their high indicating that the terms of trade will start to turn negative. The impact of higher interest rates will slowly start to be felt as more borrowers eat into their pre-payment buffers and fixed-rate loans begin to roll off.

It is very hard to believe we will not have a weaker period of economic growth. After all that is what higher interest rates is supposed to do. And the slowdown of global economic growth makes such an outcome even more likely. Such a view is consistent with the recent RBA updated economic forecasts.

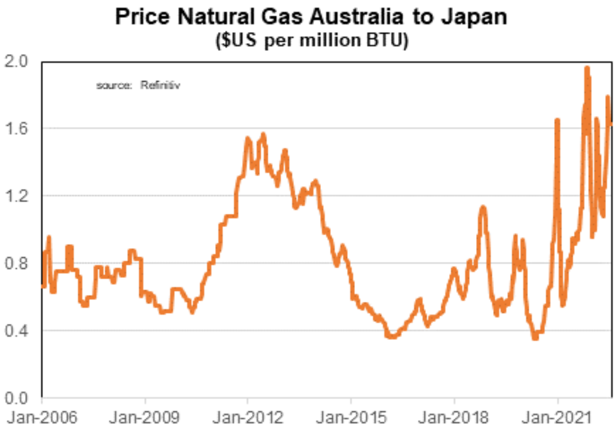
Firms are reporting strong business conditions.

But financial stress is hitting some firms, particularly in sectors such as construction.

And the very smallest of firms are not doing as well.

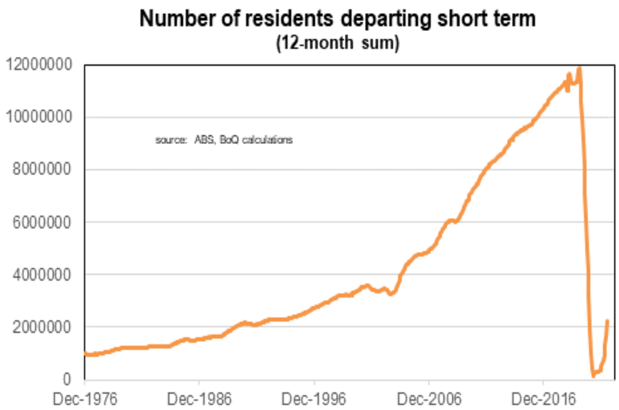


Australia is benefitting from high energy prices.



The demand for workers appears to have peaked.

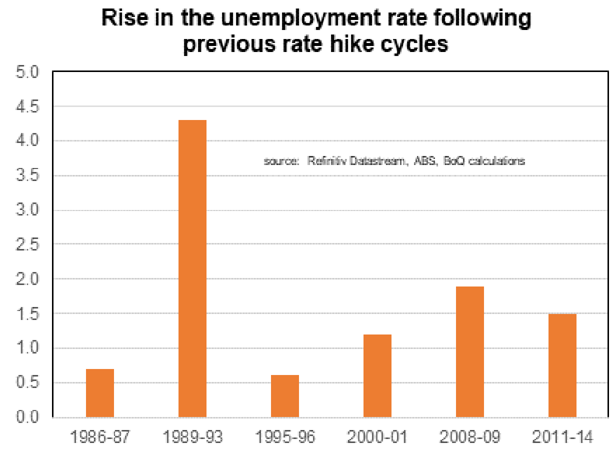
Australians are starting to make up for lost time in overseas travel.



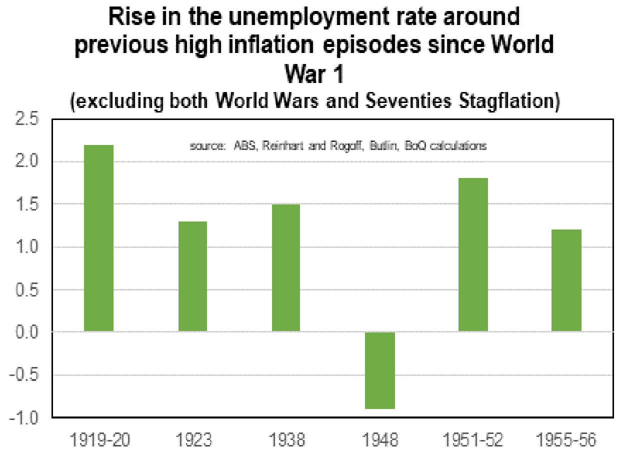
A slower economy though does not necessarily mean a recessed economy. Once or twice a decade for the past forty years there has been a period following rate hikes where there was a modestly rising unemployment rate but without the economy diving into a recession. The only exception was the 1990s recession when the combination of extremely high interest rates, too much corporate debt and problems in the banking sector led to a large economic downturn.

There are reasons to remain positive on the medium-term economic outlook. The rise in population growth and the low vacancy rate means that underlying demand for housing is strong. Not all of that demand will be sated by the number of new homes being built over the next 12-18 months. There will also need to be a mountain of investment in coming years on climate-change mitigation and defence spending. More generally, there is a large amount of government infrastructure work still in the pipeline. Households (particularly without debt) will increasingly find the going easier in the second half of next year as the gap between wages growth and inflation narrows.

There have been regular periods of a rise in the unemployment rate following rate hikes.

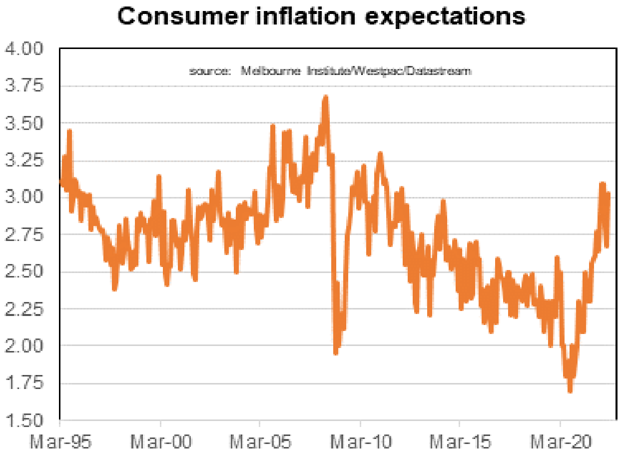


Historically bursts of higher inflation have often led to higher unemployment.



Global supply chain issues are slowly being resolved.

Consumer expectations of inflation have risen, but they are not yet high.



There are two big assumptions behind my relatively positive outlook. The first is that inflation will moderate in coming quarters. The peak of inflation will be both later (and a lot higher) than everyone (including me) had anticipated at the start of this year. There are positive signs that inflation will peak in the second half of this year. Global supply-chain problems are slowly been resolved. One positive from slowing global economic growth is that it has led to lower oil prices. Wages growth is picking it up but is so far nowhere near the level that would create sustained high inflation. One reason is that consumer expectations to date remains consistent with a 2-3% inflation rate.

There is a reason though why most global central banks are still inflation worry-warts. Geo-politics and weather means there is ample potential for further supply-chain issues to develop. The longer that inflation remains too high the more likely that households and firms will expect it to remain too high.

Historically in Australia a burst of high inflation (plus-5%) over 1-2 year period has led to a rise in the unemployment rate of between 1-2 percentage points. Higher interest rates typically play a role. When inflation stayed high for longer (1970s) was also when there was a significantly higher jump in the unemployment rate.

The second key assumption is that the decline in house prices is not too aggressive (no more than down 10-20%). And the decline does not significantly impact household or firm spending decisions. In this respect a sudden rise of interest rates at a time of high level of household debt is clearly a worry. But as already noted many of households with mortgages are comfortably ahead in their repayments. A decline of house prices of around 15% in Sydney would only take them back to the level of the start of last year. And providing any rise in the unemployment rate is limited the fallout from declining house prices should be manageable.

Inevitably the economy would have to come back down following the big bounce it has enjoyed over the past year. But down does not necessarily mean out. I think the economy has still got a few good years yet over the rest of this decade. We shall see.

We live in interesting times.

Regards

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