ECONOMIC UPDATE

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WEEK ENDING 5 OCTOBER 2022

Key points

- **The RBA increased the cash rate by 0.25 percentage point following its October meeting (taking the cash rate to 2.6%);**
- **Financial markets weren't surprised by the need for a rate rise, however, were surprised by the magnitude (they were expecting 0.5 percentage points);**
- **The RBA highlighted that further rate hikes are on the way;**
- **I think the cash rate will peak around 3.5% in this cycle, below current financial-market projections.**

What RBA decided

As widely anticipated, the RBA hiked rates following its October meeting. The arguments for a rate hike are generally agreed. The big surprise for most analysts today was that the rate hike was 'only' a quarter percentage point (BOQ was one of the few banks that got the magnitude of the move right this month). The immediate financial market reaction was what you would expect with the RBA hiking rates less in a world of aggressive central bank actions: the $A declined.

We will see where the $A goes in coming days. The main reason the currency is trading so low against the $US is the strength of the $US. With signs that the US economy is slowing and that the Federal Reserve may not be increasing interest rates as aggressively as previously anticipated there is an argument that the $A may increase in coming months.

I think the reduced size of the rate hike is a reflection of a couple of factors. First, the underlying inflation problems (wage growth, commodity prices) is of less a concern in Australia than it is in other countries. Second, an understanding that the high level of debt owed by Australian households makes them potentially sensitive to rising interest rates. How sensitive, in a world of extraordinary labour market strength, is an important question.

The RBA noted that while the domestic economy is still performing well enough, the risks to the global economic outlook have risen. All three of the major economic regions (US, China and Europe) are all now clearly slowing. There have been promising signs that inflation in the US will slow further in coming months. How much the global economy and inflation declines, is another crucial question.

The RBA made it clear, that it believes the cash rate will need to rise further. Strong demand means that the cash rate should be at least towards the upper end of the so-called neutral range (2.5-3.5%). At the time of writing, financial markets were pricing a peak in the cash rate of close to 4% by mid next year. Views about the peak cash rate have evolved over the past six months between 3.5-4.5% in line with changing views regarding the economic and inflation outlook and the likely global central banks' response. As the global economy slows, I would expect financial markets views on the peak of the cash rate to decline towards the bottom end of their range.

For me that means that the peak in the cash rate in this cycle will be around 3.5%. The economy is very strong, the labour market will remain robust for some months to come, and the inflation rate is high and not forecast to peak for another 3-6 months. Smaller rate moves by the RBA provides them with the option of stopping earlier if the economy weakens or if inflation slows a lot faster than they are currently thinking. The RBA has almost twice as many meetings as most other central banks. Proving the opportunity to increase cash rates in smaller amounts than other central banks.

Demand v supply

One of the questions I have been asked by clients over the past few weeks is why the RBA is so keen to hike rates when much of the inflation is due to supply-side problems that can't be fixed with monetary policy. The RBA has been asked the same question, notably in Phil Lowe's recent appearance before Parliament.

This supply v demand question is one that is being asked globally. The evidence of how much the rise of inflation has been driven by demand or supply varies across countries. For example, it is widely considered that demand is playing a bigger role in driving up inflation in the US (studies say between one-third to 60%) than in, Europe.

There is no doubt that demand has played an important role in driving inflation higher in Australia. Economic growth is now above its pre-pandemic growth path. Despite weak sentiment, consumer spending remains robust as highlighted by strong retail sales. Strong spending means firms remain keen to hold more inventories and need to increase their capex spending. All of this has meant that many firms' order books are looking pretty stacked. Indeed, their number one concern remains the difficulty in recruiting workers.

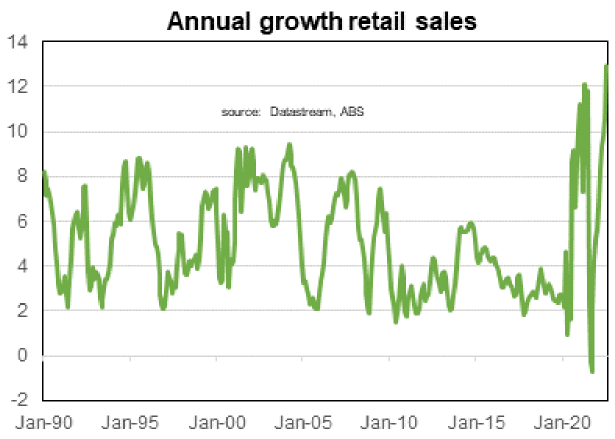
One approximation in determining how much the rise in prices is down to stronger demand is to look at how much household spending has grown over the pandemic and how much of that is a result of buying a higher volume of goods and services and how much is down to higher prices (that potentially could be more driven by supply problems). To isolate how much the pandemic has changed things I have used the difference between how much has actually been spent (in both volume and actual spending terms) versus how much would have been spent if household spending had been maintained in line with its pre-pandemic trend.

In the early part of the pandemic both total spending and volume of goods bought declined at the same pace. Over the next year the volume of goods, outpaced the rise in total spending. This reflected both the pickup in spending due to decent income growth as well as discounts offered by firms (particularly in the services sector).

But this year actual spending has notably outpaced the volume of goods purchased reflecting the significant rise in prices. By my estimation total spending on goods and services was around $9.5b higher in the June quarter relative to its pre-pandemic trend. Of that extra spending about 40% reflected the purchase of higher volumes of goods and services. This proportion of higher spending due to increased volumes is lower than usual and a reflection of the supply-driven response in many prices.

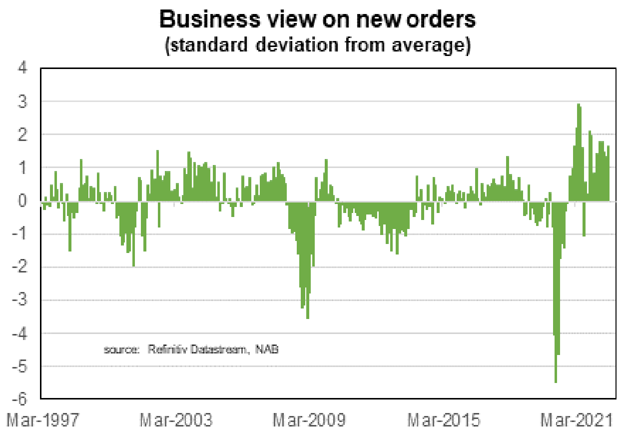
This means that although supply problems are the likely main driver of higher inflation in Australia, demand has played a significant role. Some easing in goods demand will happen naturally, not the least reflecting the number of new homes that are being completed (which generates demand for household goods such as furniture), However, demand is strong enough to require a higher level of interest rates.

Consumer spending is currently strong.

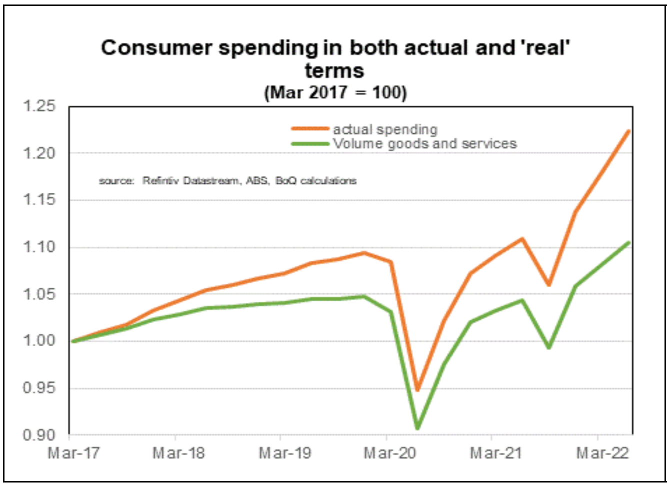


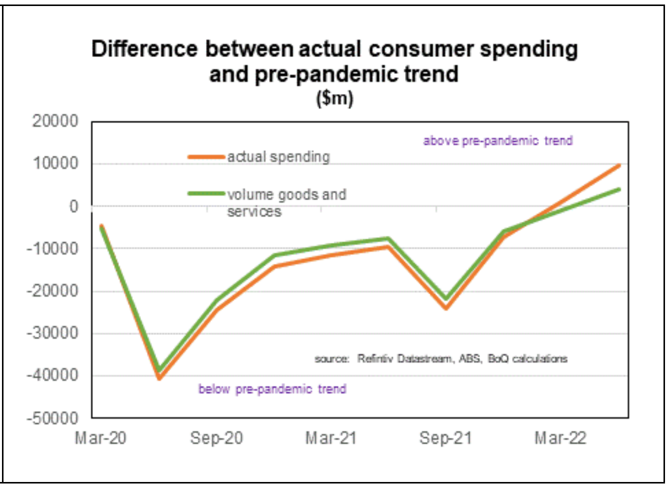
Consumer spending is above its pre-pandemic trend in both nominal and 'real' (or the volume of goods and services) terms.

This is a key factor as to why order books are full.



Price rises have played a bigger than normal role in higher spending. But higher demand has also played a big role.





The supply story

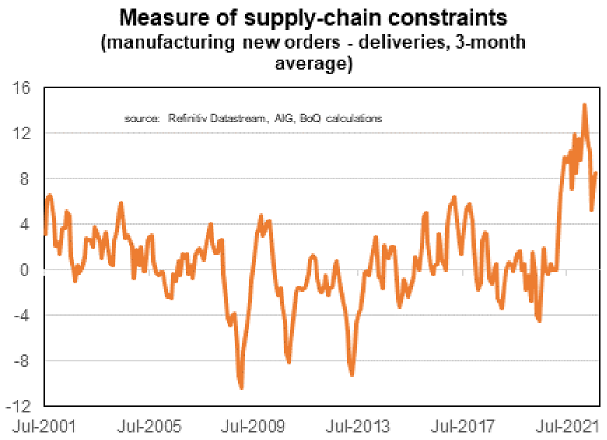
There has been good news on the supply front in recent months. Factories are working their way through the backlog of orders. One benefit of a weaker global economy is that commodity prices have declined from their peak. This has meant that firms have started to see some reduction of input costs (although they remain high). Worker shortages remain a big issue although immigration growth has been strong (certainly stronger than I had anticipated), and changes recently made by the government should help boost worker numbers.

But while things are improving, supply issues will create problems for some time. It is likely that due to the warmer weather, the current high level of lost worker hours due to sickness will decline in coming months, however, the risk remains that illness levels may rise again next winter. It will take time to find the required number of skilled employees given the extent of the current worker shortage. Even when they are hired, new workers will need to be trained (and retained). This suggests that the supply of skilled workers could remain an issue for at least the next 12-18 months. Improvement in the worker shortage problem will also come from weaker demand (higher unemployment). The slowing observed in the job advertisements and vacancy data suggests that the process has started.

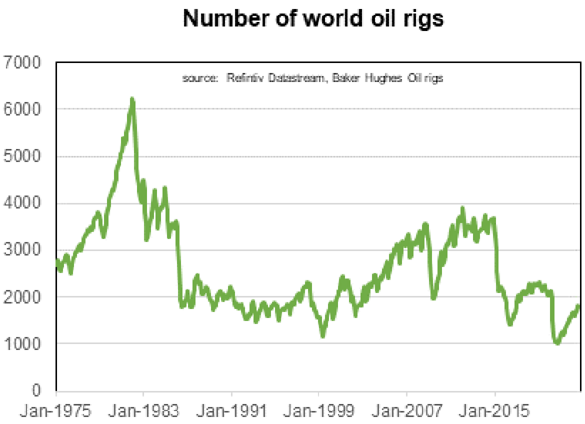
Some of the policies that could help reduce worker shortages are creating other supply problems. The increase of immigration is leading to higher demand for rental accommodation at a time of very low vacancy rates in many areas. Some of this housing demand will be met by a rise in supply as the backlog of residential construction work gets finished over the next year. There is also likely to be some reduction in demand as the increased cost of housing leads to more people moving back into group households or back in with their parents. Higher rents may also attract more investors to switch supply from the short-term holiday market to long-term rentals. Nonetheless, rising rents are likely to be a factor pushing up inflation over the next year.

Commodity prices have declined, recently reflecting weakening demand due to the slowing global economy. But the underlying supply problems that led to higher commodity prices remain. Most obviously this includes the Russia-Ukraine War. More generally, mining investment (particularly into fossil fuels such as oil) has been muted. This means that energy prices may rise again to relatively high levels, when global demand next strengthens.

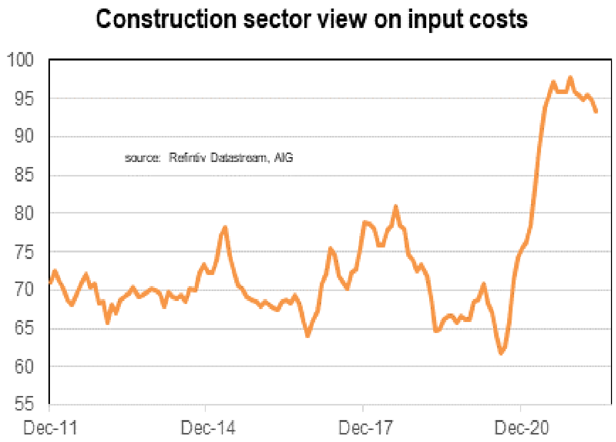
Supply-chain problems are starting to be resolved.



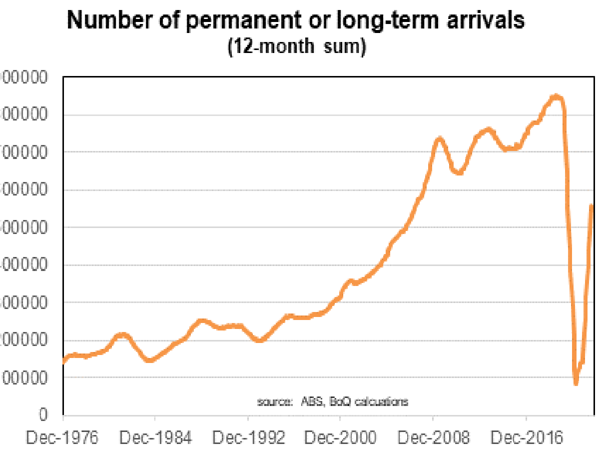
Commodity prices have declined from their peak.



Firms have started to note a decline of input costs.



Rising immigration will start to alleviate some of the worker shortage problems.

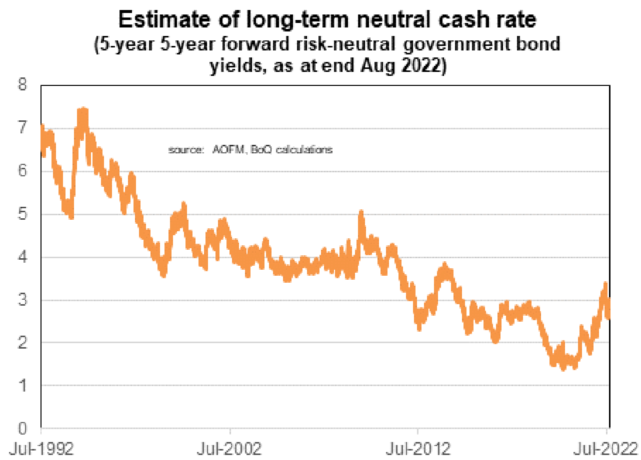


Rates were too low

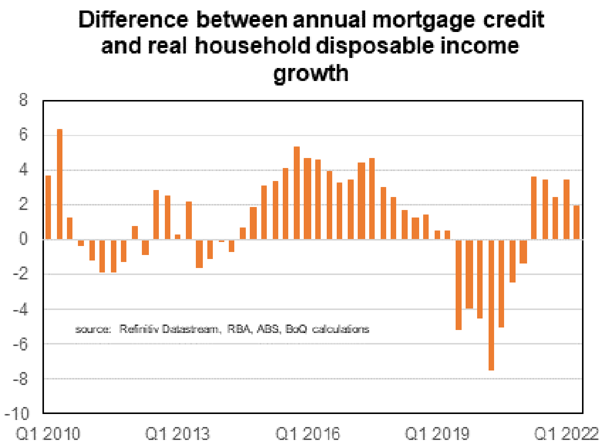
Given the strength of the economy it is clear that interest rates were too low. The cash rate had been set for an expected severe economic recession and was inconsistent with an unemployment rate at its lowest level in fifty years. Working out what is the right level of interest rate, is at least as much an art as it is science. At a minimum, interest rates should be closer to a 'normal' level. Financial markets view of a 'normal' interest rate looks to have fluctuated between 2.5-3.5% for much of the past decade.

A practical way to gauge whether interest rates are too high or too low is to look at the impact on how much households borrow. During periods of very low interest rate growth, household borrowing often exceeds income. That was the case recently, as it was during much of the period between 2014-18. Of course, this benchmark is more of a guideline than a rule. The slowing of credit growth in 2019 was more a reflection of tighter lending standards (and some weakening in economic growth).

One measure of financial market thinking is that the average level for the cash rate is between 2.5-3.5%.



Very low interest rates enables households mortgage credit growth to be in excess of the growth of their disposable incomes.



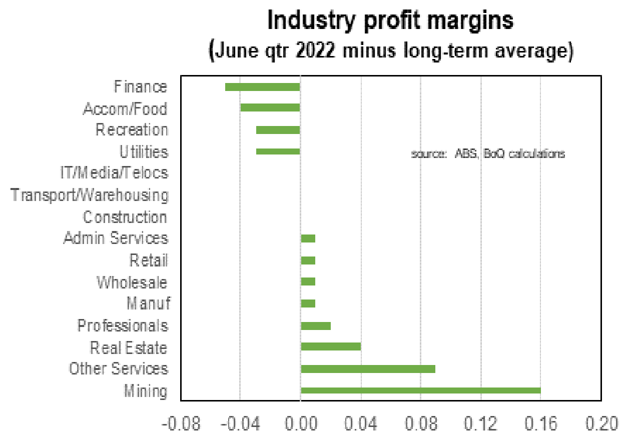
Inflation expectations

Even if inflation had been all supply-side driven, there are reasons that central banks have been concerned. Central banks look through the impact of short-term supply-side problems (such as the impact of a severe one-off weather event such as a cyclone). But if the supply-side problems are longer-lasting, then a lower level of demand is required to keep inflation under control, and the supply problems have lasted longer than expected. As noted, there have been positive signs on the supply-side issues, However, a number of them will take longer to resolve.

The other concern is if inflation remains too high for too long it could lead to expectations that inflation will remain too high. Short-term inflation expectations of both households and firms have risen. The problem is that there are no measures of households and firms longer-term views about prices.

It is probably better to look at what households and firms do than rather what they say. Rising wages growth can be a reflection of workers' desire to be compensated for price rises (as well as an indication of the state of the job market). Wage growth is picking up although to date it remains low by both historical and peer country standards. There has been plenty of talk about rising profit margins as a cause of higher prices. But in the June quarter, outside of mining (and some service sectors), the rise in margins across sectors (relative to the sectors long-run average) was either modest or negative.

Financial markets are comfortable with inflation returning to the target band in the medium term.



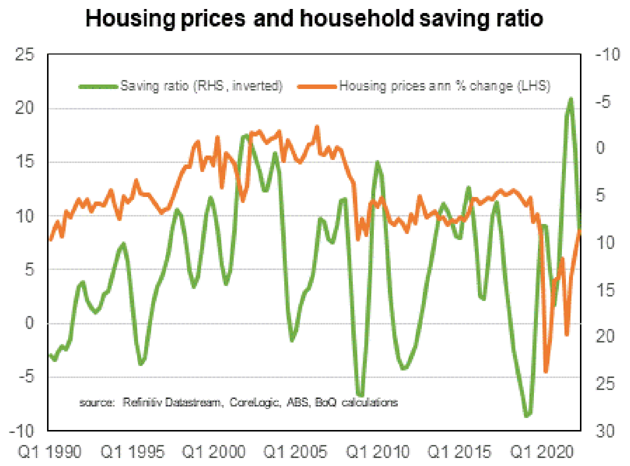
The peak in Australia's cash rate is seen to be below peer countries in this cycle.

Household debt

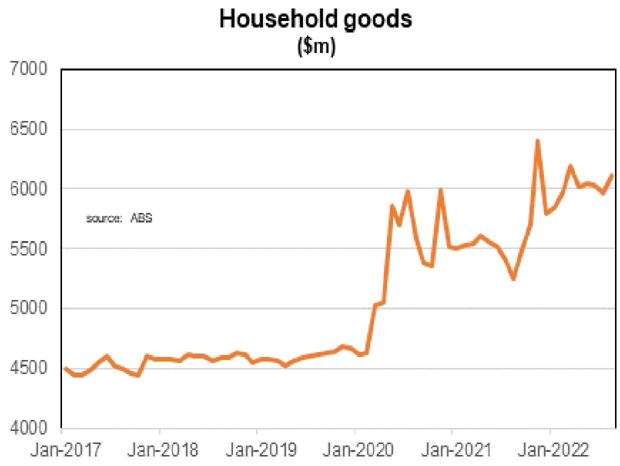
The other issue raised is that the high level of household debt makes rising interest rates a concern for Australian households. It will be difficult to assess how big of an issue this is for some time, given the large number of borrowers that are still on fixed loans (most of which will roll off next year). Many households are also well ahead of their repayments.

There have been concerns expressed that declining house prices could lead to a rise of consumer caution and therefore increased saving. But the historical relationship between movements in house prices and household saving has been mixed. Spending on areas most impacted by higher interest rates (such as household goods) remains high.

The relationship between house price growth and household saving has been mixed.



There has been no sign yet of consumers easing up on buying new stuff for the house.



What this means for the cash rate

Monetary policy is not the only factor that drives the economic outlook. Fiscal policy is also important. We recently received news that the budget deficit will be substantially narrower than what had been forecast at Budget time.

While that is good news it is arguable that the budget should be in even better shape, given the record high terms of trade and the lowest unemployment rate in fifty years. We will get an update on the Budget outlook on the 25t October 2022.

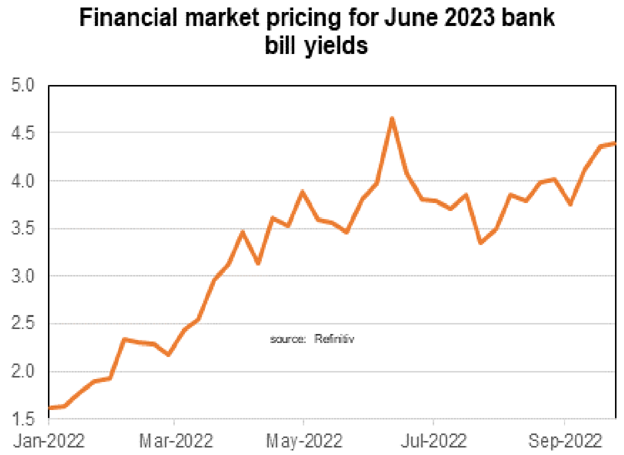
As noted, the terms of trade in Australia is at a record high, meaning the rest of the world is paying a very high price for our exports relative to what we must pay for our imports. Usually at a time of high commodity prices the $A would be riding high. This has not been the case in recent months reflecting the very strong $US (the $A is broadly trading in line with its historical average when taking into account the currencies of all trading partners).

Finally, while the price of money matters, so too does its availability. Tight bank lending standards (or heightened financial market volatility) can make it difficult for borrowers to access funding regardless of price. Surveys note that there has been some tightening of bank lending standards over recent months although they report that standards are not unusually tight.

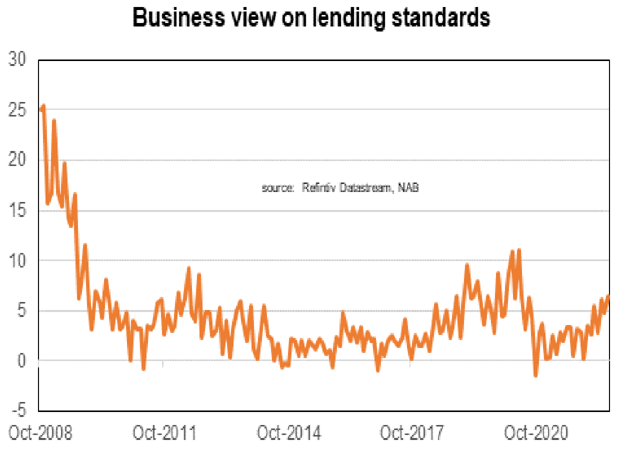
Overall strong demand means that the cash rate should be at least towards the upper end of the so-called neutral range (2.5-3.5%). At the time of writing financial markets were pricing a peak in the cash rate of close to 4% by mid next year. Views about the peak cash rate have evolved over the past six months between 3.5-4.5% in line with changing views about the economic and inflation outlook, and likely global central banks' response. As the global economy slows, I would expect financial markets views on the peak of the cash rate to decline towards the bottom end of the range.

For me, the peak in the cash rate in this cycle will be around 3.5%. The economy is very strong, the labour market will remain robust for some months to come, and the inflation rate is still high and is not forecast to peak for another 3-6 months.

Financial markets have priced the peak of the cash rate to be between 3.5-4.5% in this cycle.

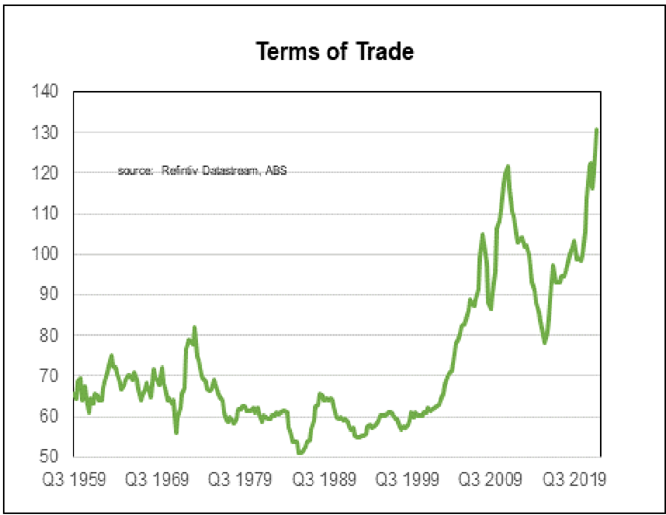


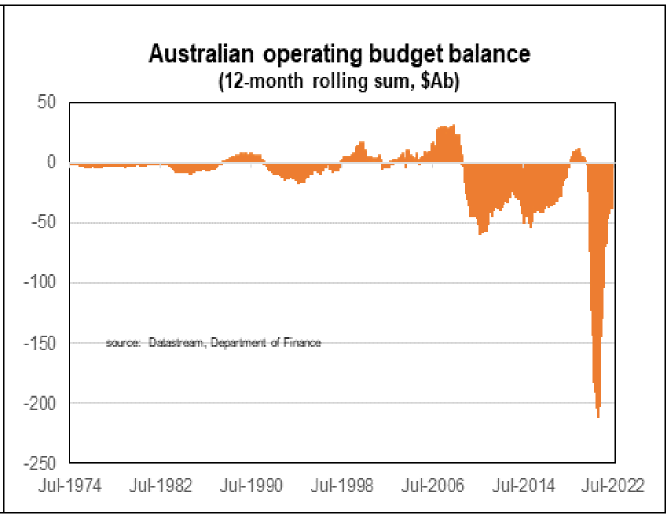
Firms report that there has been a tightening of bank lending standards, although they remain easy by historical standards.



A record terms of trade is helping to power Australia's national income growth.

Although the budget deficit has narrowed significantly fiscal policy remains more supportive of the economy than it should.





We live in interesting times.

Regards

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