ECONOMIC UPDATE

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WEEK ENDING 16 DECEMBER 2022

Key points

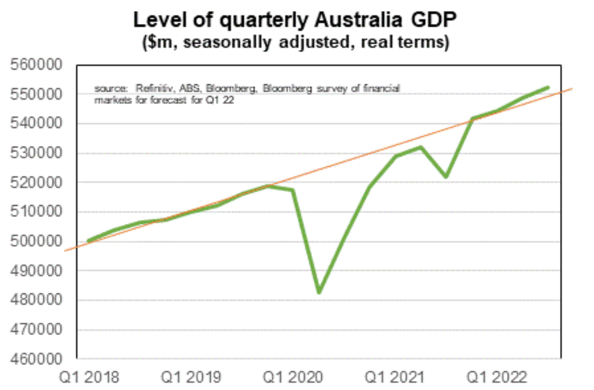
- **The Australian economy did well in Q3;**
- **Economic growth is likely to remain decent for the next couple of quarters although an increasing proportion of the population is feeling economic pain;**
- **The economy will likely slow notably in the second half of 2023, and into 2024;**
- **But there are good reasons to think the downturn will not be too sharp.**

Economic growth in the September quarter was good

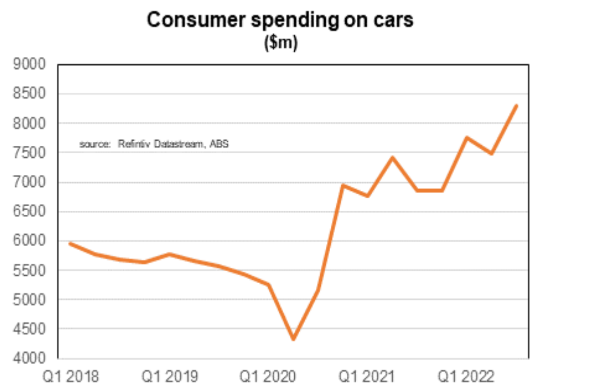
The economy grew by 0.6% in the September quarter. The consumer carried the day, notably catch-up spending on services (restaurants, holidays). Inflation was prominent. The tight jobs market at a time of strong labour demand meant a big jump in the wages bill.

There was a tone of commentary following the GDP release that the data was consistent with a weakening economy. Sure, the declining housing market led to a fall in ownership transfer costs (the costs of transferring assets such as selling a house). But, the 0.6% quarterly rise was in line with the average quarterly economic growth rates in the years' before COVID. The growth rate would have been stronger but for the loss of hours due to illness (COVID, flu), the impact of bad weather, and higher-than usual number of workers taking holidays after the lockdowns of the previous two years. More generally, worker shortages and lingering supply-chain issues continued to hold down the pace of economic growth.

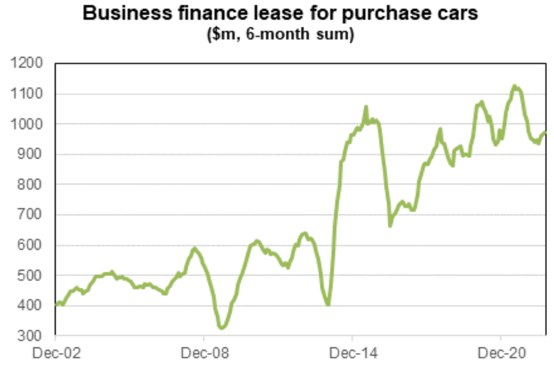
The Australian economy is now above its pre-pandemic growth path.



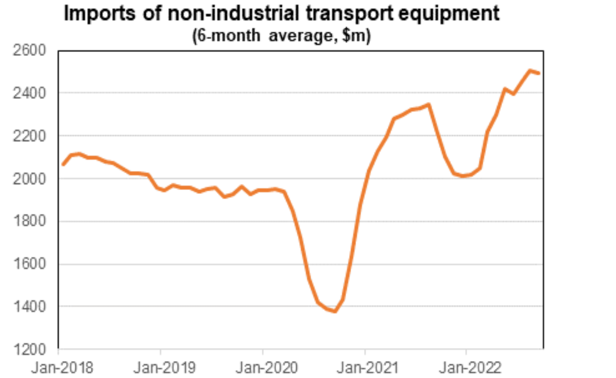
Car purchases have jumped since the pandemic reflecting WFH and reduced desire to catch public transport.



Strong balance sheets, a robust economy and tax incentives has also seen increased demand for cars from business.



Combined that led to a rise in the number of imported cars.



GDP growth over the next couple of quarters will be decent but with slowing momentum

There are good reasons to think that the next couple of quarters' economic growth will still be decent. It looks like we will have our first 'normal' Xmas in four years following bushfires and COVID. The experience of the US and New Zealand economies that are further advanced in their economic cycle suggests that consumer spending (including retail) holds up longer than expected due to strong jobs market and ability to run down savings.

The ongoing easing of global supply chain problems from the re-opening of the global economy post-COVID means there is less delay in purchasing goods. An example has been the increase in demand for cars from both households (due to working from home and reduced desire to use public transport) and firms (due to strong balance sheets, low interest rates and tax incentives). The problem was that demand could not be met as a result of global supply chain problems. But with those supply chain issues gradually easing, there was a rise in car imports in the September quarter. Such 'delayed purchases' will continue over the next couple of quarters'.

In addition, there is still a catchup of consumer spending on travel that will take place over the December and March quarters. This includes the large amount of travel credit still outstanding from flights that could not take place due to COVID.

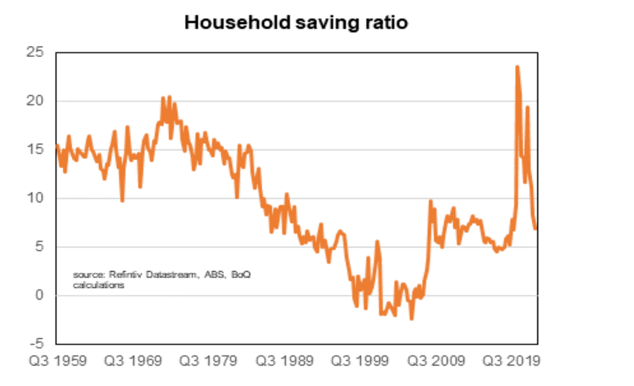
Most firms' balance sheets are in good shape. Strong consumer spending means businesses report that conditions are generally good, and capacity usage is high. Capex budgets are on track to be substantially bigger this financial year. Reduced impact from COVID as well as improved weather (if sustained) means there will be fewer working hours lost over the next couple of quarters.

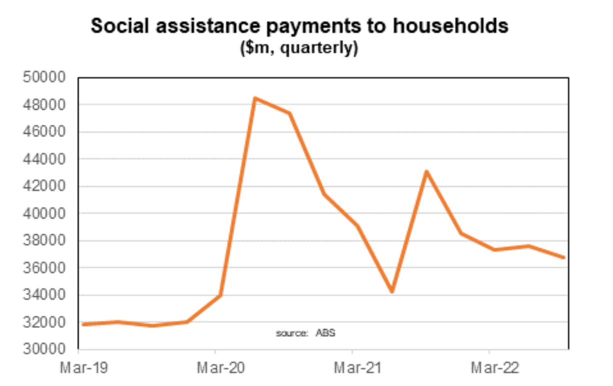
The declining housing market has had a direct impact on economic growth.

The inventory-to-sales ratio has risen towards its pre-pandemic trend.

The household saving ratio has declined sharply although is still a bit above its pre-pandemic average.

Government payments remain above their pre-pandemic level.





But weaker growth a near certainty in 2023-24

While the economy may still do ok for the next couple of quarters, a period of below par economic growth thereafter is a near certainty. The impact of the rise in interest rates will increasingly be felt next year. Historically, the maximum impact of higher interest rates has been 1-2 years after the change in the cash rate. The first rate hike in May suggests that the full impact of higher rates will not be felt until mid next year. This is particularly the case in the current economic cycle with the bulk of the fixed rate home loans rolling off next year.

Consumers will increasingly feel the impact of negative real wages growth and rising interest rates. Households have been offsetting this cash flow drag by running down their saving. This will soon come to an end with the household saving ratio on track to be below its 2009-19 average level by mid next year.

The forward indicators (such as building and finance approvals) point to a decline in residential construction in the second half of next year. The inventory rebuild that was necessary for many firms following the COVID shutdowns has substantially progressed. The rebuild of inventory is most advanced amongst manufacturers, less so amongst wholesalers. New orders are still rising at a decent clip, albeit well down on the pace of earlier this year.

A slowing global economy is another negative. Finally, inflationary pressures and rising Government debt is limiting the amount of fiscal stimulus hitting the economy.

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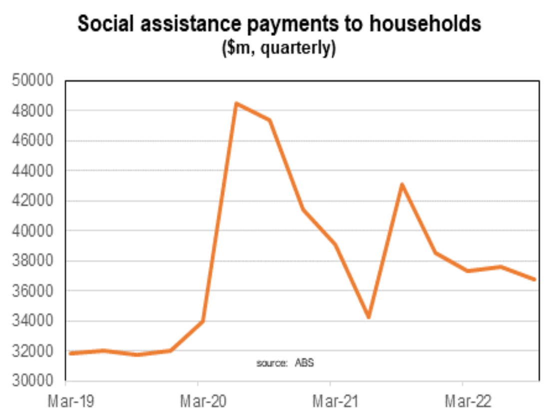
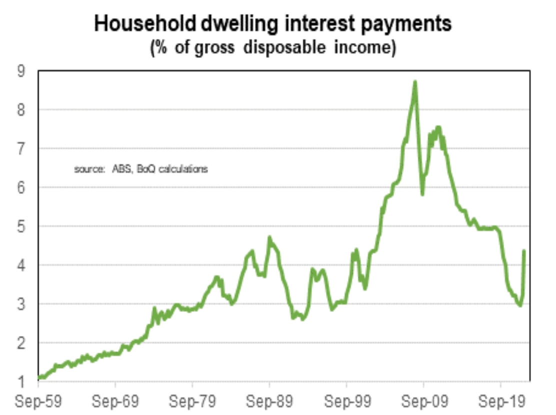
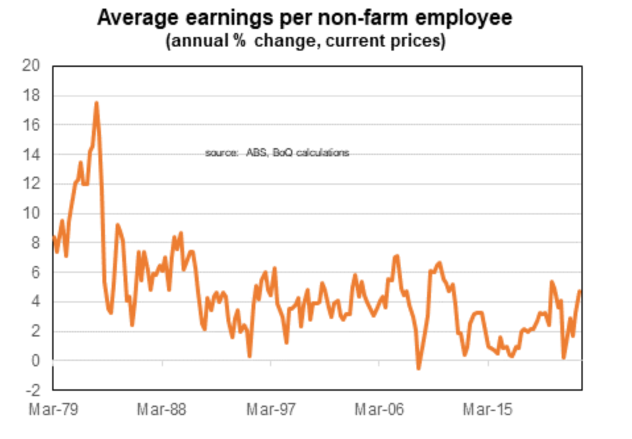


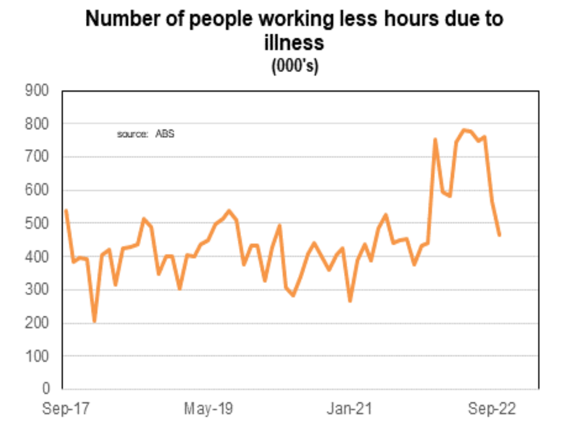
Interest payments are taking a growing chunk out of consumers' disposable incomes.



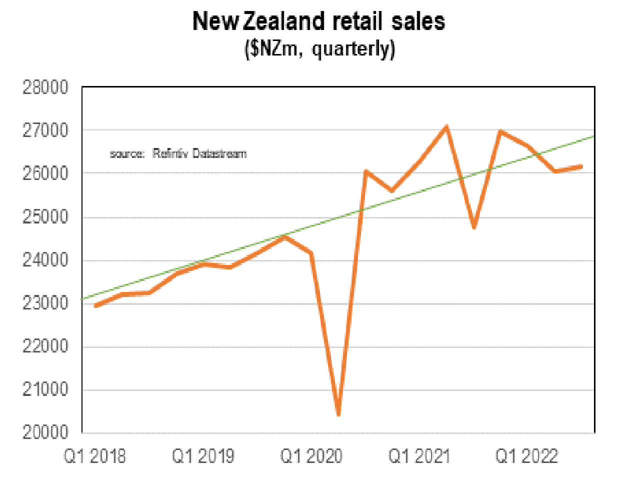
Growth in the economy-wide wages has returned to its pre-GFC level.

Work absences due to illness (as well as weather and holidays) was high during the September quarter.

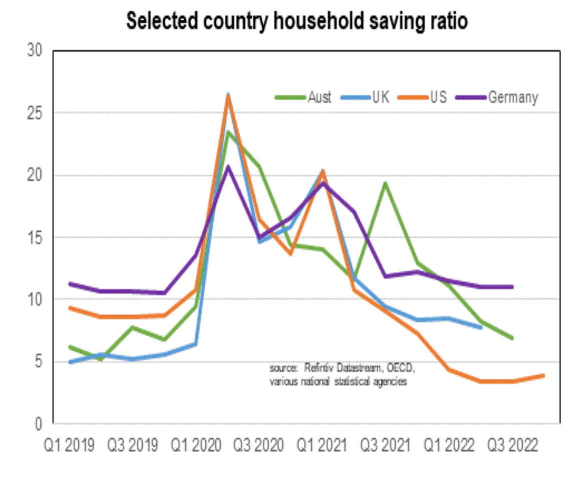




Retail sales in NZ have so far only declined modestly despite the sharp rise in interest rates.



Household saving ratios are back at pre-pandemic levels in most countries. They are below that in the US.



I expect only a modest slowdown

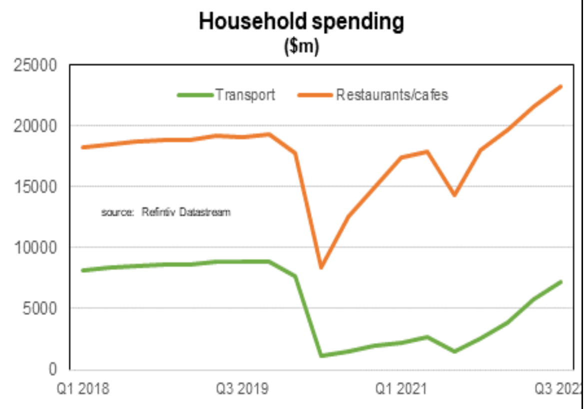
There are reasons not to be unduly pessimistic about the economic outlook. The maximum negative hit to disposable incomes will take place in the second half of 2022. That negative hit diminishes in 2023 as inflation falls and wage growth rises. Real disposable income growth will start to turn positive in 2024 as wages growth outpaces inflation and households benefit from the scheduled income tax cuts.

Rising immigration and the current low vacancy rate across many regions could lead to a pickup in residential construction in 2024-25. Residential construction may also get a boost from government attempts to boost affordable housing, as well as reconstruction activity as a result of the floods.

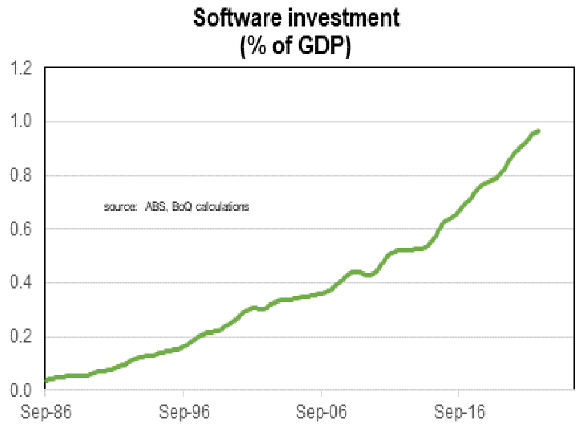
Any decline in the terms of trade will be mitigated by ongoing supply constraints for energy and wheat. And the experience of other countries is that the Chinese economy will get a bounce as it re-emerges from COVID lockdowns in 2023.

There are a large number of infrastructure projects to be built across all states reflecting the strong population growth of the past couple of decades and a period of under investment. Increased spending will be required on defence and climate change. There will be further investment in digitisation across government and the private sector at a pace stronger than GDP growth. And finally, the RBA will have room to reduce the cash rates with inflation likely to be heading back towards their 2-3% target in 2024.

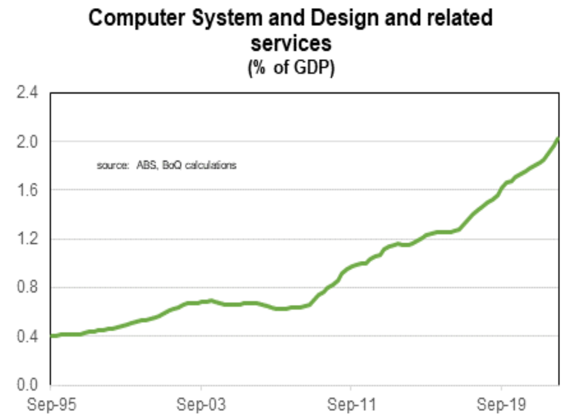
Spending on restaurants is above pre-pandemic levels. Not so much for transport.



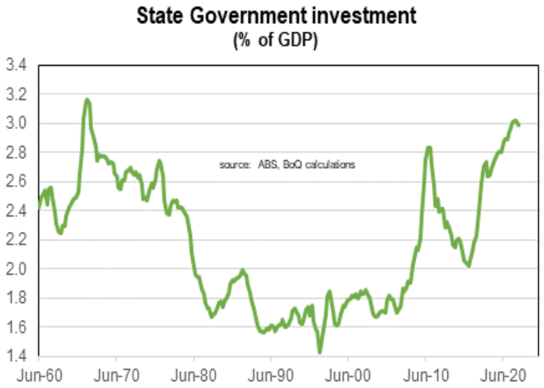
Spending on digitisation continues to rise….



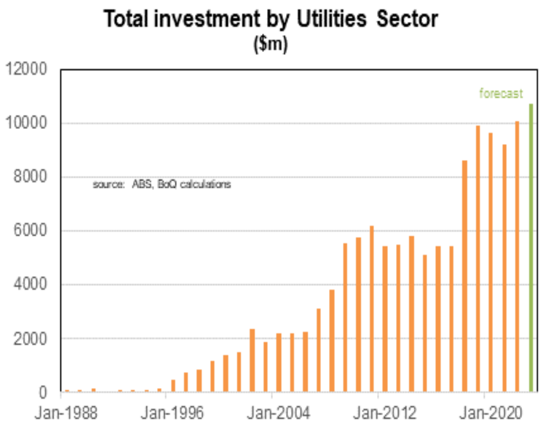
This has led to an expansion of the local IT industry.



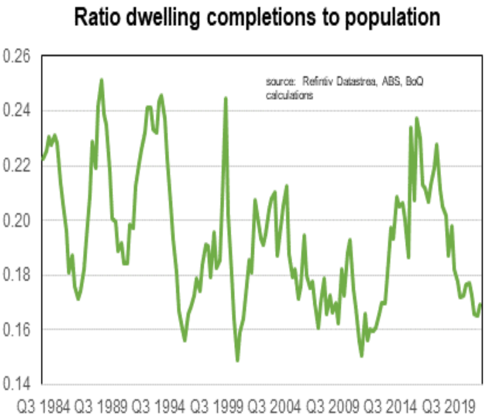
Infrastructure investment by state governments is at a high level.



Capex in the utility sector (including on renewables) is at a high level.

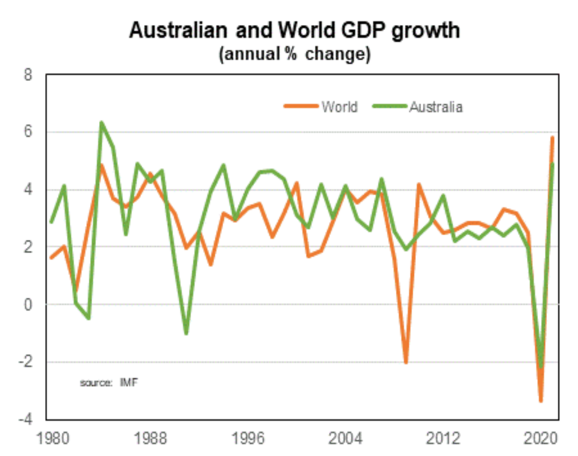


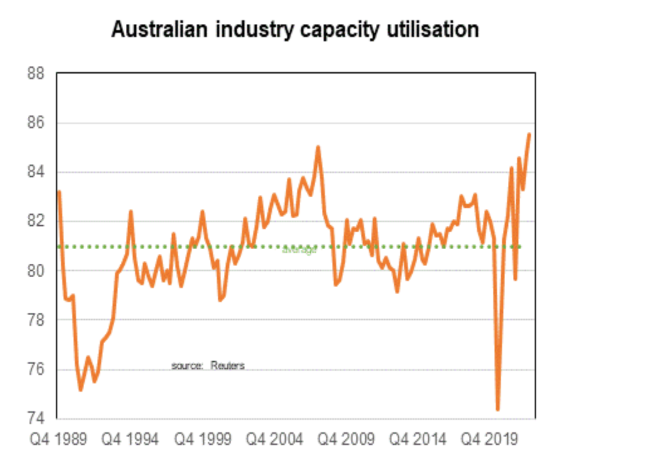
There are few signs of over building in residential construction.



Global developments impact the local economy.

Capacity utilisation is at a very high level.





The economy will end 2022 on a good note, albeit with a proportion of the population already feeling the pain of rising interest rates and high inflation. While economic momentum will slow into the first half of next year, aggregate economic outcomes will likely still be ok. Sub-par economic growth is probable in the second half of next year and into 2024. There are good reasons to think the slowdown will not be too sharp.

This is the last note for 2022. I wish all readers a fantastic festive season and a prosperous and healthy 2023. Next year will be an interesting one for the economy. And hopefully a good one.

We live in interesting times.

Regards

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