ECONOMIC UPDATE

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WEEK ENDING 4 NOVEMBER 2022

BOQ GROUP

Key points

- **The RBA increased the cash rate by 0.25% at its November meeting;**
- **The cash rate is now 2.85%, the highest level in over 9 years;**
- **The RBA change in forecasts acknowledges a difficult trade-off with inflation revised up and GDP down;**
- **Another 0.25% point hike is highly likely in December.**

What the RBA did

As generally expected, the RBA hiked rates by 0.25 percentage points following its November Board meeting. The cash rate currently stands at 2.85%, the highest level in over nine years. The RBA modestly revised up its inflation forecasts for both 2023 and 2024 (by about half a percentage point in both years). They also reduced their GDP growth views by a tick. The unemployment rate is projected to stay around its current level until the end of next year before modestly rising to 4% in 2024 (the same forecast as in August). These appear to be reasonable forecasts.

The RBA acknowledges the difficult trade-off. Inflation continues to surprise to the high side, while forecasts for economic growth continue to be revised down. The global economy and household spending (negative real wages, impact of higher rates) were nominated as the two big risks. The RBA explicitly stated that further rate hikes should be expected. It looks probable that we can 'look forward' to another 0.25 percentage point rise in December.

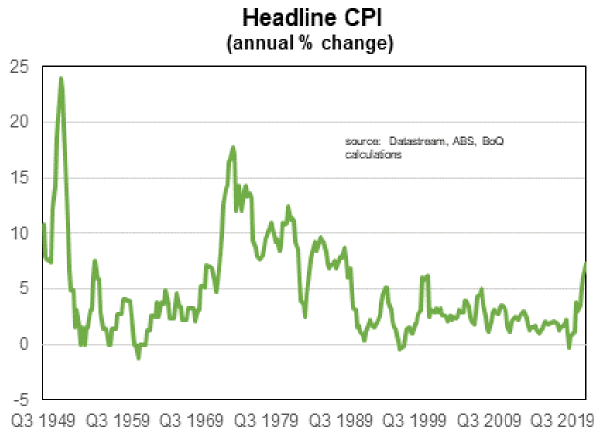
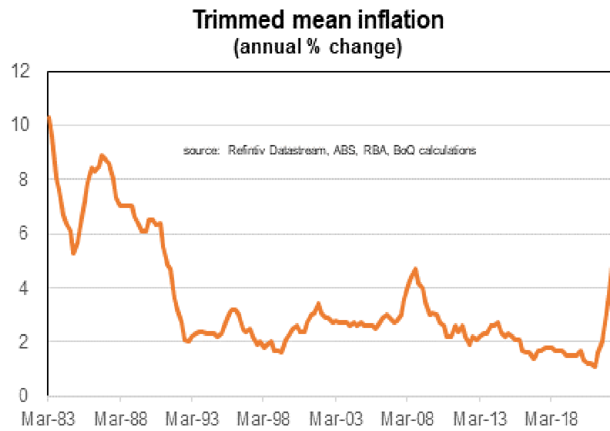
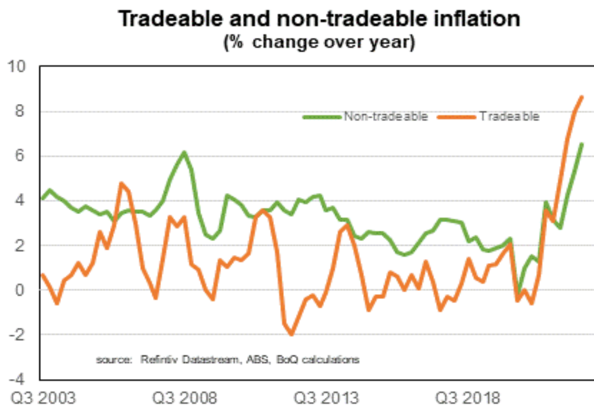
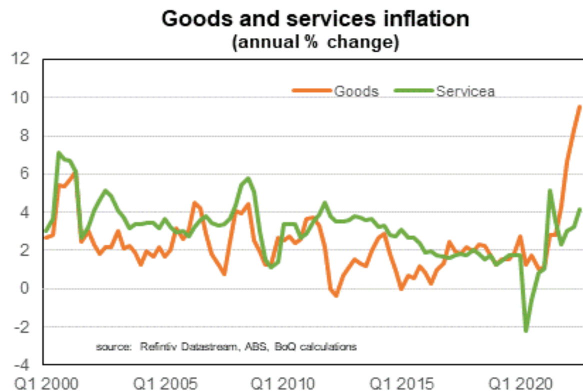
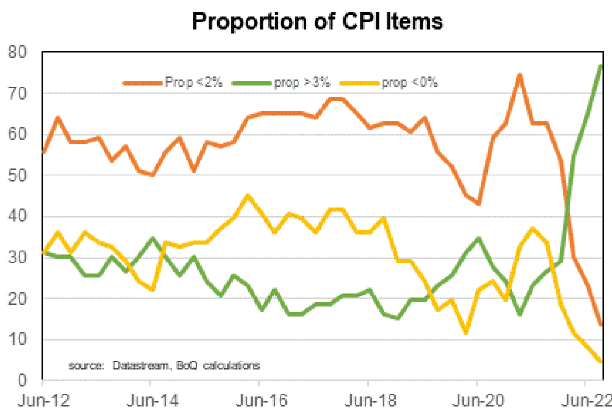
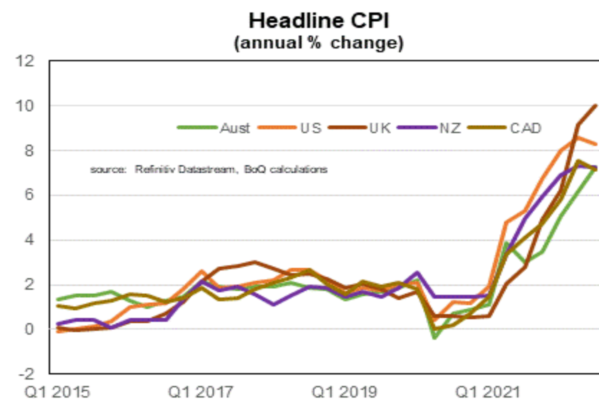
The immediate financial market reaction was bond yields and the $A fell. This reflected some chance of a 0.5 percentage point move by the RBA. At the time of writing, financial markets were still pricing in a peak cash rate of this cycle of around 4%.

From here attention will now shift to the US Federal Reserve November meeting. The result will be particularly important for the immediate future of the $A. The focus of the Fed meeting will not be so much 'how much' interest rates change (0.75 percentage point rise is essentially locked in), but how many more additional rate rises might come. Given the uncertainties about the inflation and economic outlook, it is unlikely that financial markets will get an immediate answer.

Inflation outlook

The cash rate is now back at what the RBA believes is a more 'normal' level of interest rates. The main focus is what level of the cash rate will be necessary to get inflation back to the RBA's target. On face value the current level of inflation is a concern. The headline inflation rate is at its fastest pace in over thirty years and over twenty years for the RBA's preferred measure of 'underlying' inflation. A fair bit of the rise of inflation can be put down to international factors (post pandemic supply chain worries, wars, bad weather). However, non-tradeable inflation (price rises reflecting domestic factors), have also been rising strongly (the floods have played a role).

The super-charge demand boost is still influencing the growth of goods prices (as well as the impact of the weather and war). But service prices are also on the rise, and they tend to be more influenced by domestic factors (notably wages growth). Price rises are widespread. A very small percentage of goods and services bought by households are falling, and only 15% are rising by less than 2%. By contrast, almost 80% of goods and services are rising by over 3%. Australia's inflation rate is looking very similar to that of comparable countries.

Headline inflation has risen the sharpest in over thirty years.	The so-called 'underlying' rate has also risen strongly.
	
The stuff we buy from global markets has risen most strongly.	Prices for goods are still outpacing those of services.
	
The prices for most goods and services are rising by over 3%.	Australia's inflation is looking pretty similar to that of peer countries.
	

Most forecasters expect that inflation will peak around the end of this year. This includes the RBA who now think that the peak of inflation will be around 8%. A key reason for the expected decline is that much of the rise of petrol prices in this cycle should be in the rear-view mirror. Global supply-chain problems are getting resolved. Prices for building new homes has risen strongly although builders are indicating that input cost pressures are (slowly) beginning to ease (from a very high level). Demand is projected to slow.

It has long been assumed that moderating goods prices would, for a time, be offset by rising service prices, reflecting stronger consumer demand and rising labour costs. There are other factors that might keep price growth higher for longer. One is that the recent floods will put upward pressure on fruit and veg prices over the next couple of quarters (the good news is that the weather outlook is more promising). A longer-lasting push to higher prices will come from rising rents. As recently flagged by Treasury, the biggest risk to the 1-2 year inflation outlook is the outlook for electricity and gas prices.

The worst of the petrol price rise is likely over.

Petrol prices
(annual % change)
source: ABS
60 50 40 30 20 10 0 -10 -20 -30
Sep-1973 Sep-1983 Sep-1993 Sep-2003 Sep-2013

The weekly food bill has also jumped sharply.

Grocery products
(annual % change Sept 2022)
source: ABS
Non-durable household products
Non alcoholic beverages
Other food products
Fruit and vegetables
Dairy and related products
Meat and seafoods
Bread and cereal products
0 3 6 9 12 15 18

The cost of building has sky rocketed, although there are signs that pricing pressures are starting to ease.

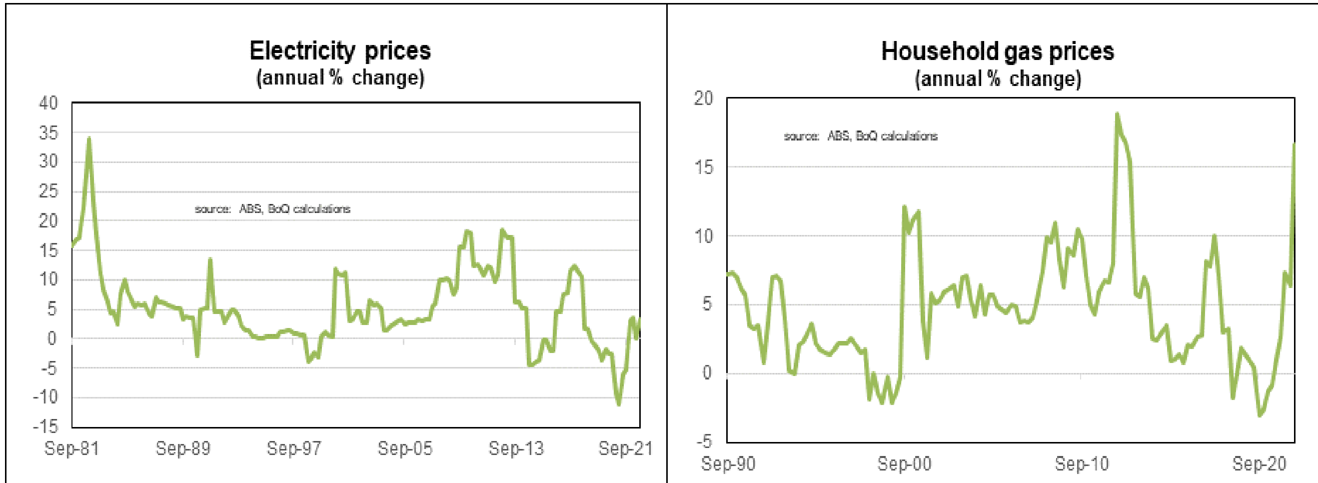
New dwelling purchases by owner occupiers
(annual % change)
source: ABS
25 20 15 10 5 0 -5
Sep-99 Sep-04 Sep-09 Sep-14 Sep-19

Rising rents will continue to be a cost of living problem.

Rents
(annual % change)
Sydney
Melbourne
Other 6 capital cities
source: ABS
6 4 2 0 -2 -4
Sep-12 Sep-15 Sep-18 Sep-21

Electricity prices is the big area of worry.

Gas prices have already risen sharply.

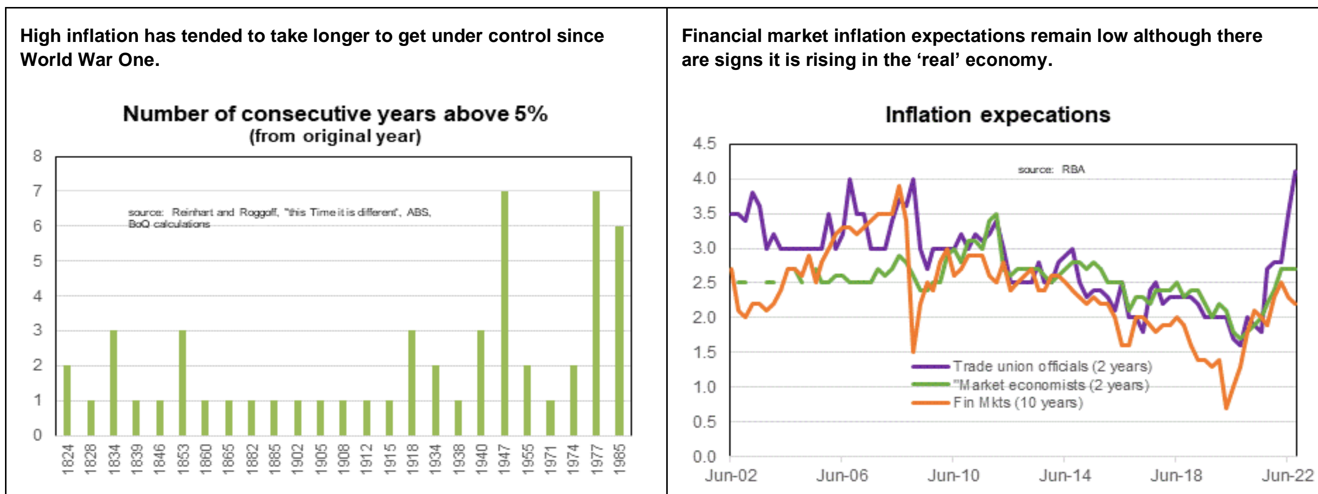


History suggests that it takes longer than one year for a return to low inflation. Prior to World War One, typically high inflation (defined as a year when the CPI goes above 5%) was a one-off experience (although it wasn't uncommon to see inflation above 5% 2 to 3 times per decade in the 1800s). Food was then a bigger part of consumer budgets and so shifts in food prices (because of floods and droughts) had a more significant impact on inflation.

Since World War One higher inflation has tended to last longer. There were three main periods that inflation has been high: after World War One/Spanish Flu pandemic, after World War 2 and in the 1970's and 1980s (the couple of years of high inflation in the 1930s was a bounce back from the deflation of the Great Depression). In each of those period's inflation was driven by a combination of strong demand and supply problems, the same factors driving higher prices today.

This time could be different. After a slow start, global central banks have increased interest rates aggressively. Fiscal policy is not as supportive of the economy as it was last year (although you can debate as to whether it should be even less supportive). And the high inflation of this year followed a decade when inflation was below most central banks targets. This has meant that inflation 'expectations' (particularly in financial markets) are projected to remain low. IMF research indicates that wages growth has not been a concern during similar historical economic episodes as is being experienced today. The one caveat from the IMF was that inflation expectations do not pick up significantly.

The risks are that inflation could be higher for longer. The 'one-off' factors that have helped drive inflation up just seem to keep on coming. A less globalised world economy means less downward pressure on inflation. And there are signs that domestic inflation expectations have started to rise.



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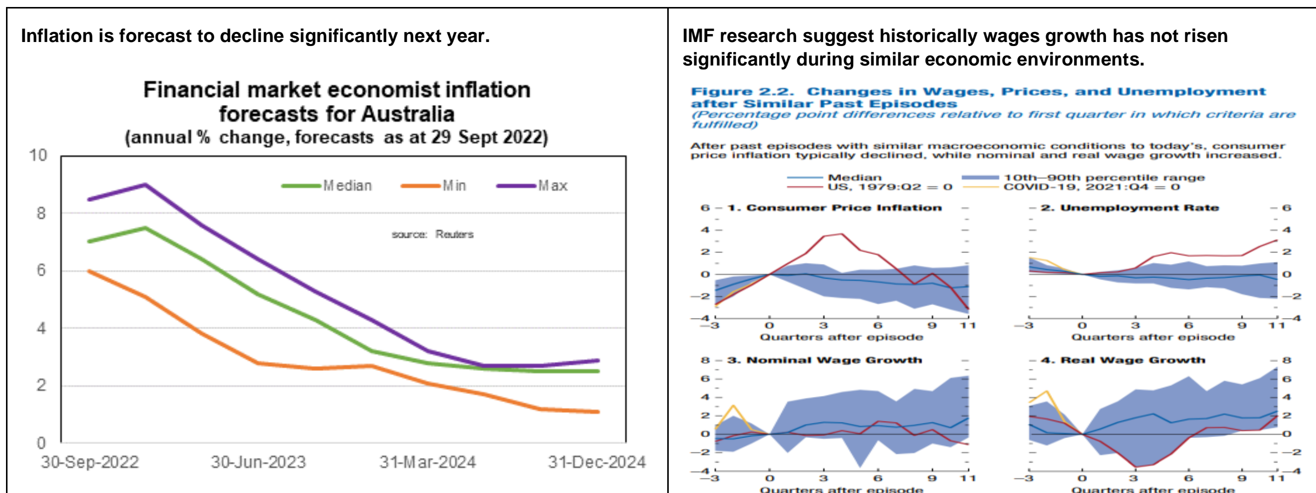


Cash rate view

What does all of this mean? First, there are good reasons to expect that the inflation rate will peak at around 8% at the end of this year. The decline that has taken place in many commodity prices (if sustained), does remove the possibility of substantially higher inflation. The bigger risk in my view is less that inflation will be substantially higher than forecast but that it might remain higher for longer than current forecasts. That would be consistent with how inflation has performed for the past century. The upward revision to RBA CPI forecast to 4.75% captures a fair bit of that risk.

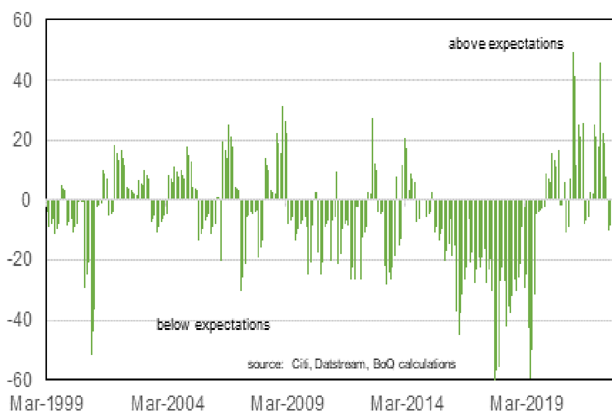
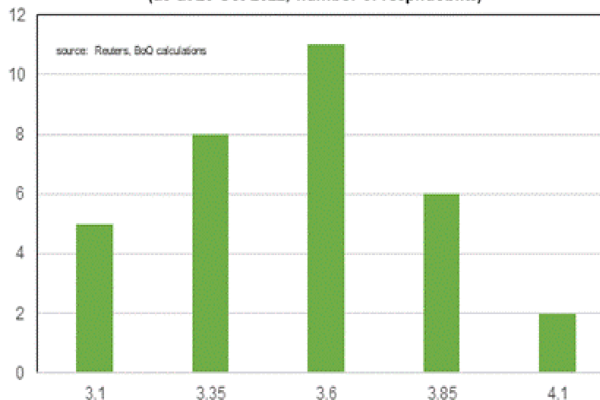
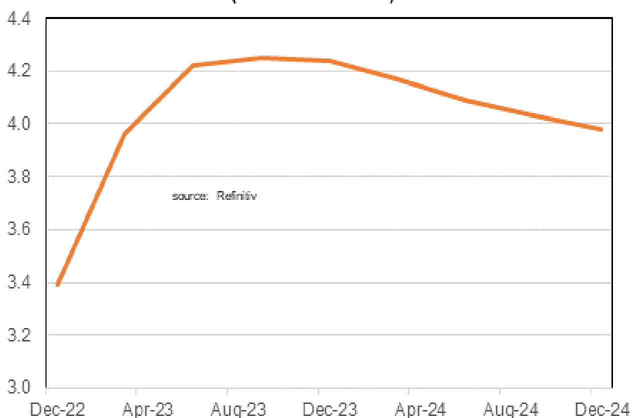
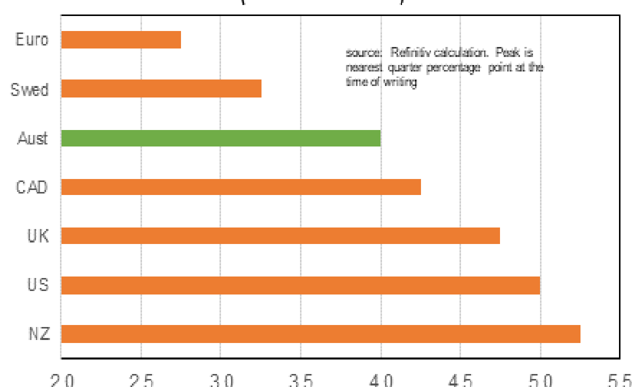
From an interest rate point of view the other unknown is the depth of the likely coming economic slowdown. Financial markets are pricing slower economic growth but are not pricing a recession. For all the pessimistic economic talk most economies are still doing better than forecast.

It cannot be doubted that an economic slowdown is on the way. Cash rates globally have been hiked aggressively in this cycle and the impact is only just starting to be felt (most evident in housing). History suggests that the full impact of higher interest rates is not felt until 6-24 months following the rate rise. The additional economic kicker in this cycle is that the negative real wages growth is hitting many households (although this did follow a period when many households were able to stack away substantial saving). The high level of household debt means that domestic borrowers have become increasingly sensitive to changes in interest rates. The high number of borrowers on fixed-rate loans means the full effect of higher mortgage rates will be delayed.

The inflation outlook means that interest rates need to go up further. But concerns about the economic outlook means that they are going up in smaller steps (0.25 percentage point). Financial market economists expect the peak in the cash rate in this cycle to be around 3.6%, with the bias amongst the group towards a lower cash rate. Financial market pricing though, is for a higher cash rate (closer to 4%, towards the lower end expected for peer countries).

My current expectation for the peak in the cash rate in this cycle is 3.6%. The risk to that view is that the cash rate goes higher. That is partly the lesson of history - that it takes longer to get inflation back under control. It is an acknowledgement that financial market pricing has given a better steer to interest rate outcomes in this economic cycle than economist forecasts.

So, the bad news for borrowers (but good news for savers) is that interest rates have got further to rise. The good news for borrowers is that we are getting close (or are already there) to being three quarters the way through this hiking cycle. And it is likely that this cycle will be finished before this time next year.

Inflation has typically been surprising on the high side in recent years.	Financial market economists expect a peak of the cash rate to be 3.6%, with the bias towards a lower rate.
	
Financial markets expect short-term rates to peak around the middle of 2023 and are pricing only a small amount of rate cuts.	Financial markets expect the peak of the cash rate in Australia to be below that of peer countries.
	

We live in interesting times.

Regards

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