Global and Australian Economic & Market Outlook

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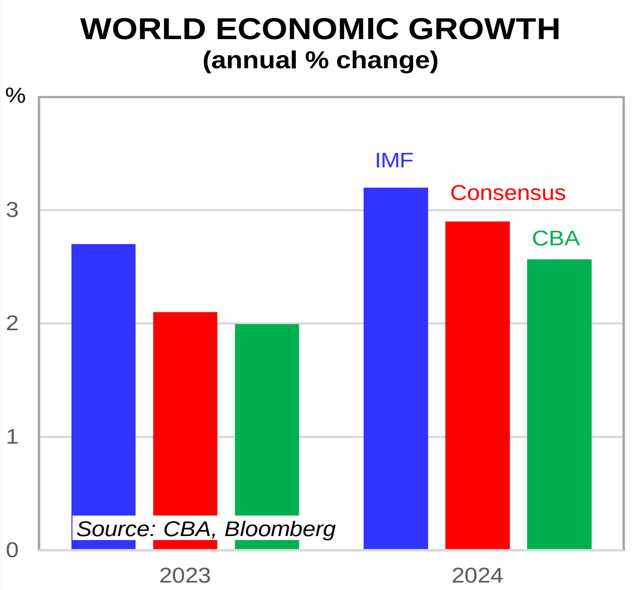
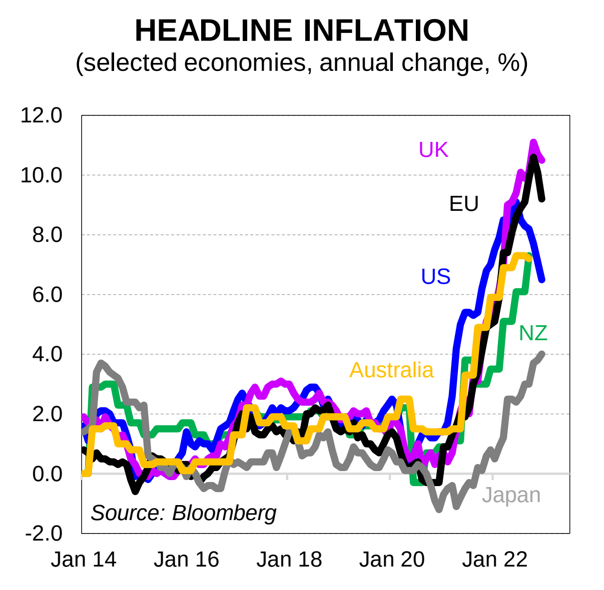
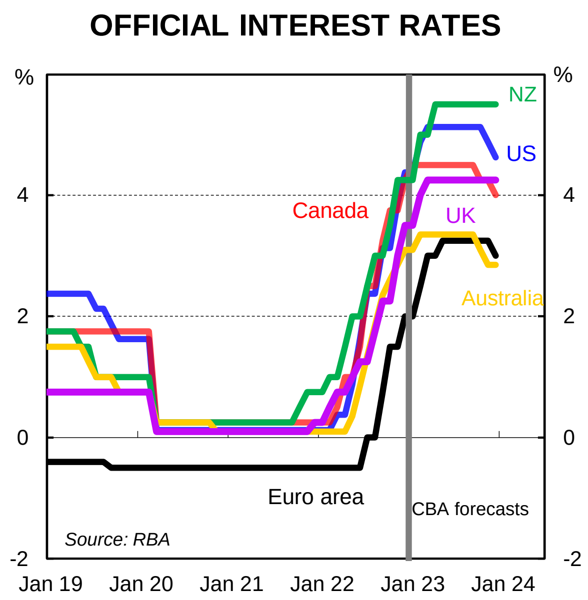
Global Outlook

Major advanced economies heads for recession in 2023







- We upgraded our forecast for the world economy to 2.0%/yr because of China's early reopening and Europe's less severe recession. But we still predict recessions in the major advanced economies.
- 2022 growth is estimated at just under 3%/yr. (Note, the IMF defines a global recession as growth of less than 2%).
- The easing of zero-Covid restrictions and significant policy stimulus will see economic growth in China accelerate in 2023 – but the recent surge in Covid cases is a cause for concern and will create short term disruption.
- The recessions mean that we expect central bank policy tightening will stop by mid 2023 and will give way to policy easing in late 2023 or early 2024. We expect the world economy to expand by 2.6% in 2024.

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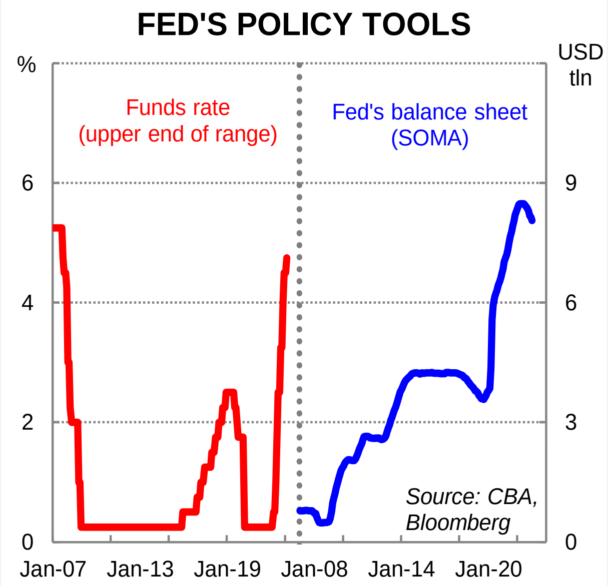
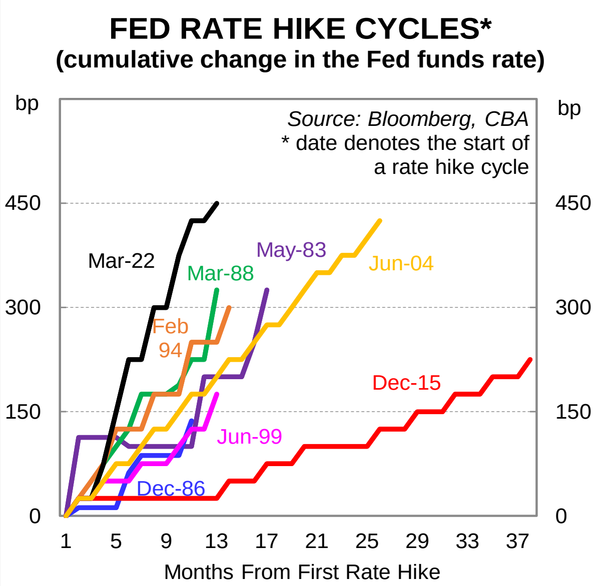
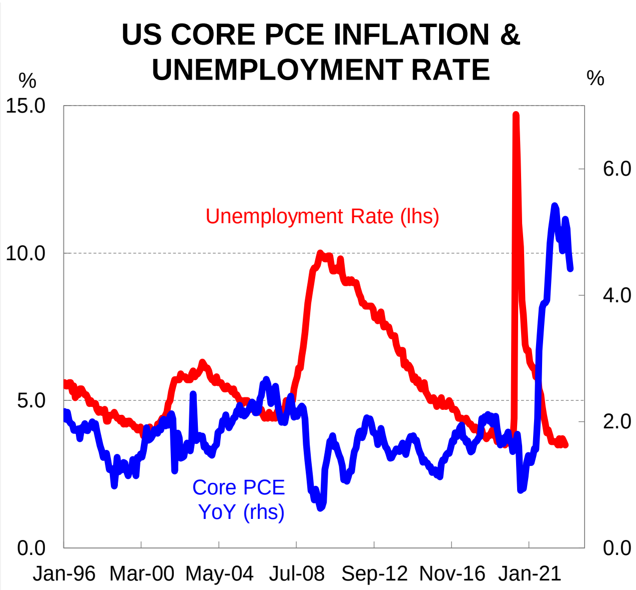
US Fed: Policy tightening moving towards the goal







- The US tightened monetary policy further in early Feb 2023, but further slowed the pace of tightening with a 25bp move to a target Fed Funds rate of 4.5%-4.75%.
- The FOMC continues to signal that further rate hikes will be needed and that monetary policy will be held at a ‘sufficiently restrictive’ level for an extended period to help return inflation to the 2% target.
- We expected a final 25bp move in mid-March to a peak in the Fed Funds target rate of 4.75%-5.0%, although the risk is still higher.
- We expect the FOMC to begin a rate cut cycle in November 2023.

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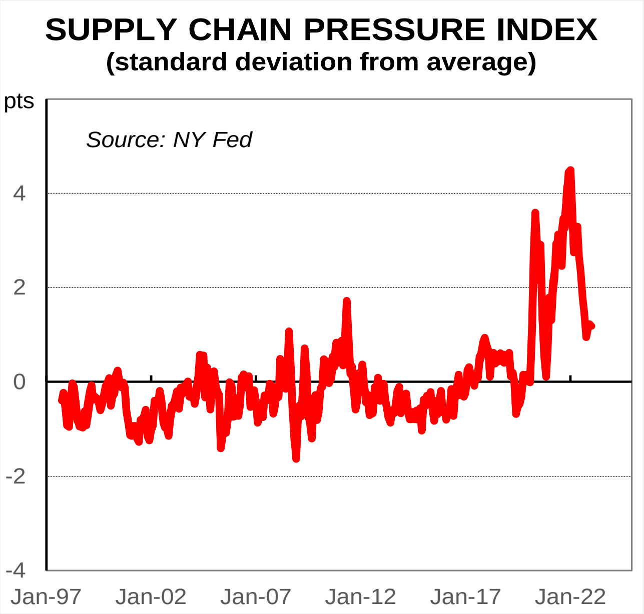
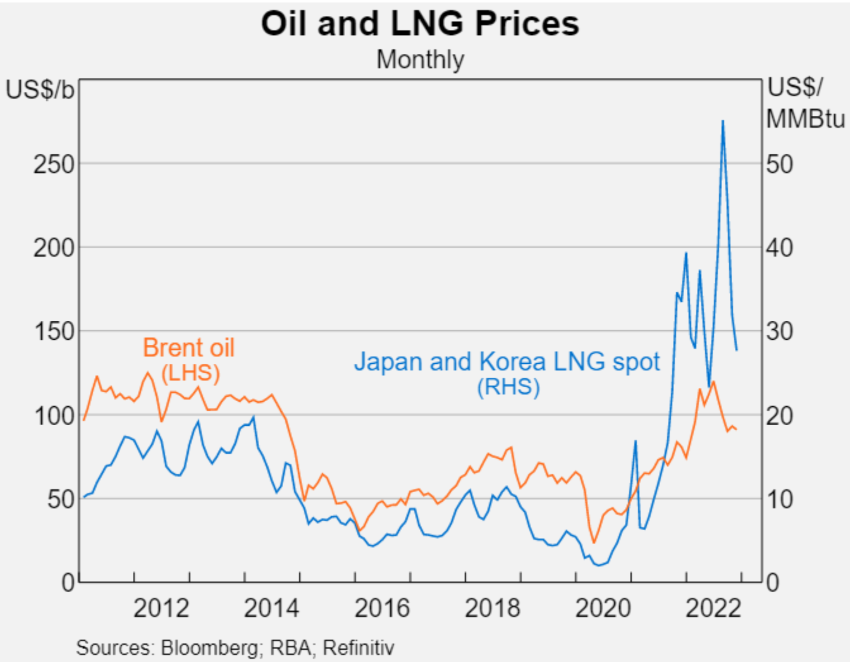
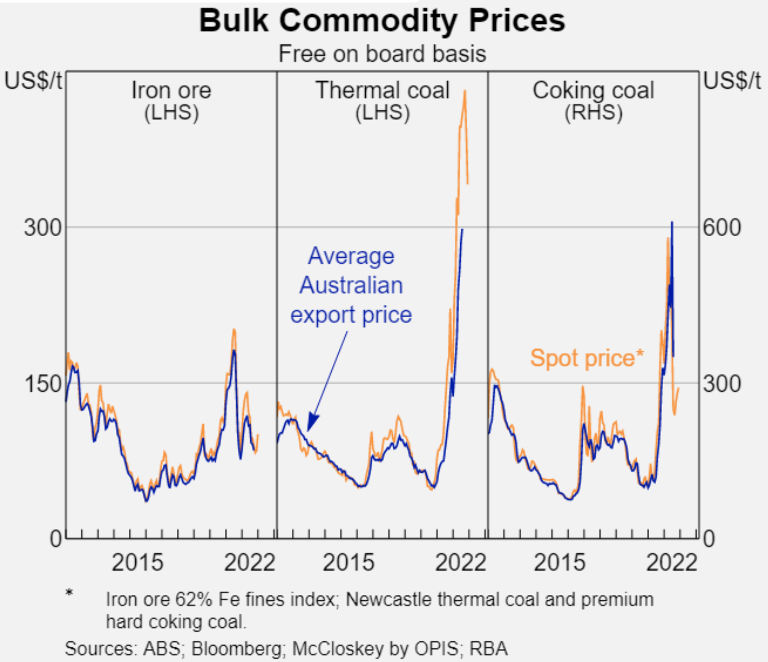
Impact of the Ukraine war – supply chain and commodity prices







- In addition to the human costs, the Russian invasion of Ukraine has disrupted global supply chains and seen increases in key commodity prices.
- The sanctions on Russia could last for years.
- Global supply chains were negatively impacted in late 2022 by the rapid increases in Covid cases in China and will linger in early 2023.

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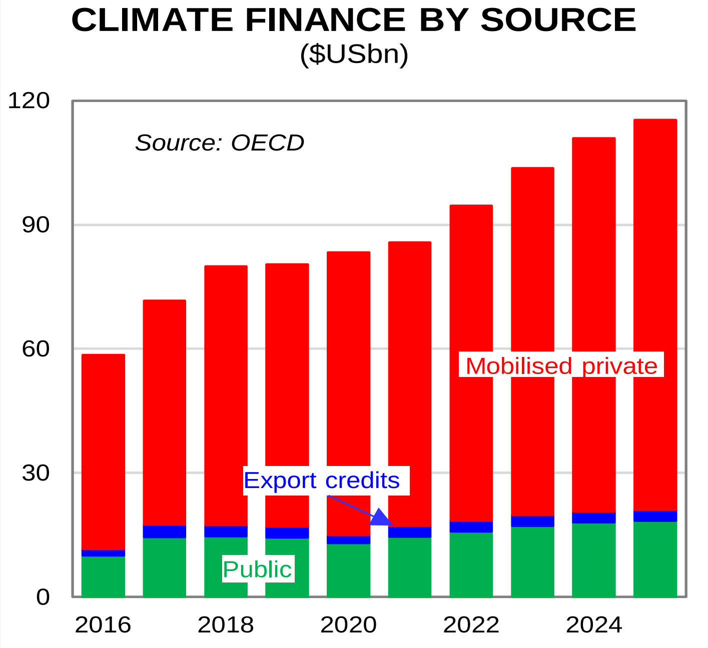
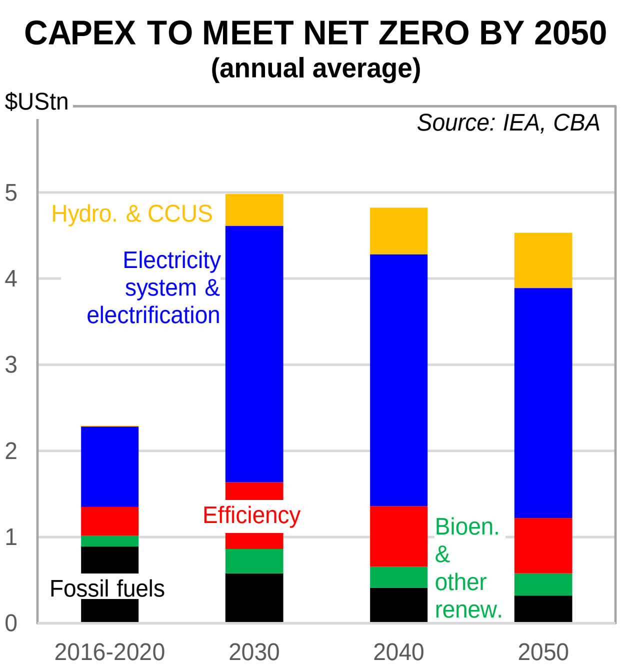
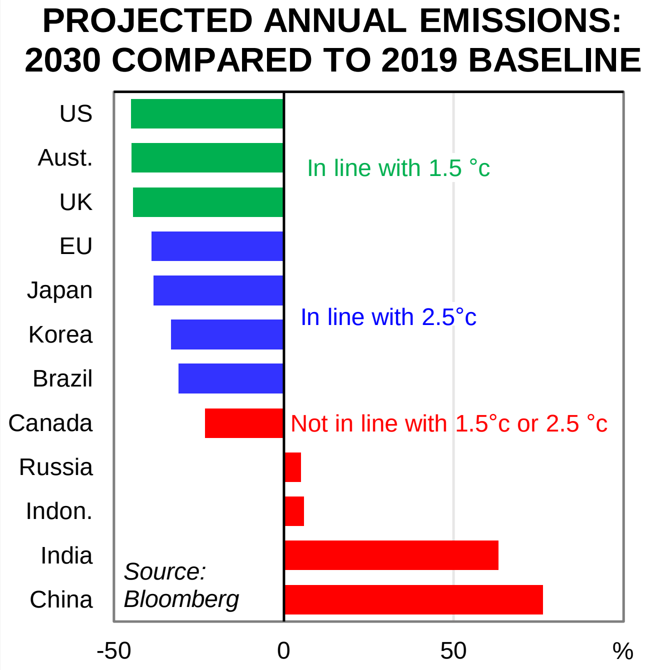
A capex boom is required to meet net zero targets

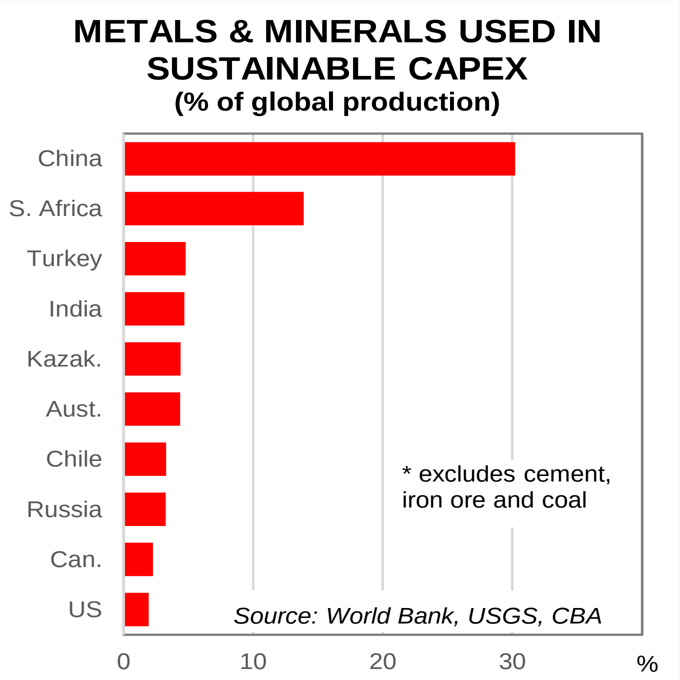


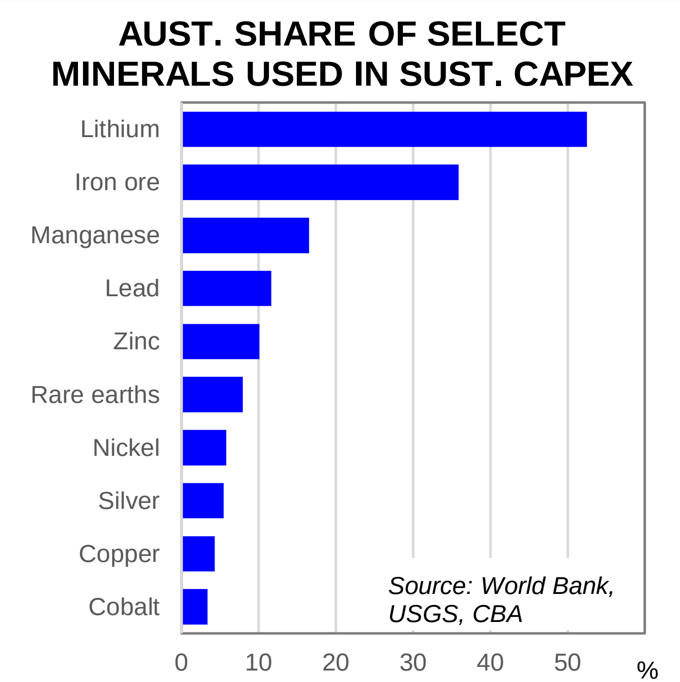




- IEA estimates the world will need to double annual capex in new sources of energy, transport, buildings and infrastructure from $US2¼tn/yr to $US4¾tn/yr for the next three decades to meet the target of net zero emissions (NZE).

China and Australia’s exposure





- China dominates the output of key metals and minerals needed for the carbon transition
- Australia has exposure to a number of metals and minerals needed to build sustainable assets.
- Australia’s previous mining boom (iron ore and LNG) had large and widespread economic impacts.

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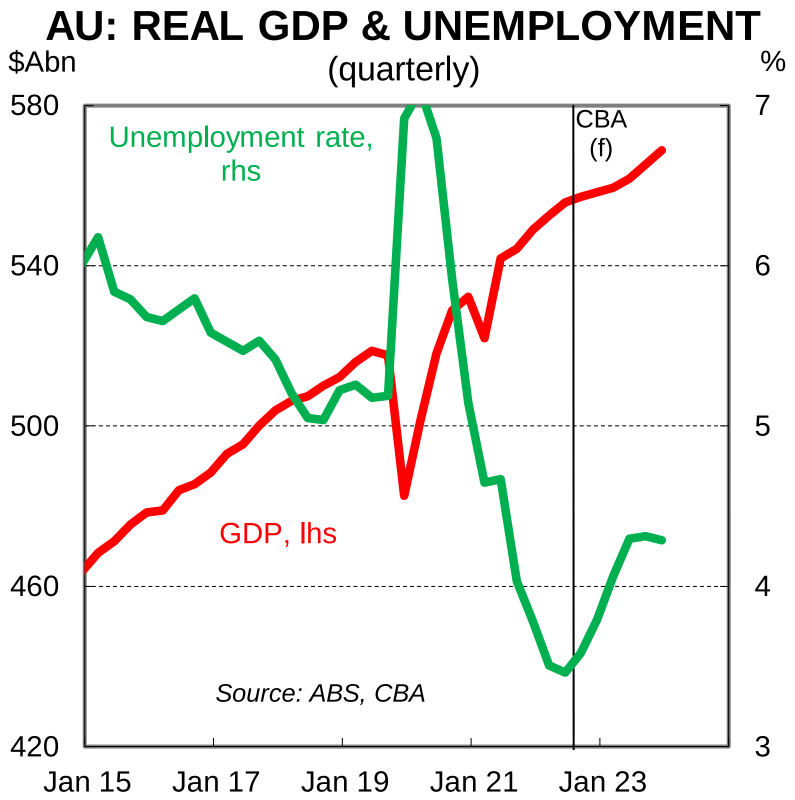
Australian Outlook

Australian economy to lose momentum in 2023 –as higher interest rates impact



The Australian economy is expected to have grown by 3.6%/yr in 2022

Growth expected to moderate to just 1.6%/yr in 2023 – as interest rate hikes impact

The unemployment rate dropped sharply in 2022, to 3.4%-3.5% from June to December - the lowest rate since 1974, but is f/c back at 4.3% by year-end 2023.

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Australian Outlook

- Australian economic growth to moderate over late 2022; below-trend growth 2023 as interest rate hikes take hold and slow consumer spending.
- GDP growth of 2.6%/yr at Q4 22 (3.6% year average); 1.1%/yr at Q4 23 (1.6% year average).
- Unemployment rate 3½% over Q4 22 - move higher to 4¼% H2 2023.
- Headline inflation to have peaked 7.8% in Q4 22; 3.4% in Q4 23, within target early 2024.
- Underlying inflation peaked 6.9% in Q4 22; 3.2% in Q4 23, within target early 2024.
- Wages growth to peak near 3 ¾%yr by mid-2023 (as measured by the wage price index).
- Cash rate increased 325bp from May 22 – Feb 23, to 3.35%.
- We now expect two further 25bp rate hikes in March & April (to 3.85% terminal rate - significantly contractionary). Rate cuts to get underway before year-end 2023 and in 2024.
- National home prices peak to trough fall ~15%. Prices to lift in H2 2023 on rate cuts and stronger population growth.
- Key risks around geopolitics, savings rate, fiscal policy, net overseas migration, services trade, and global backdrop. Climate change policy development to help drive medium-term outcomes.
- The Australian economy is in the RBA's hands – tightening cycle will determine economic outcomes.
- The risks are growing that the 'soft landing' will be a lot 'harder'.

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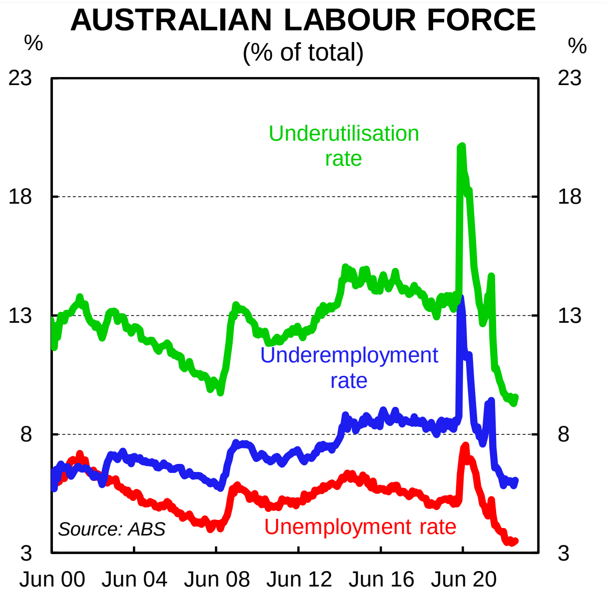
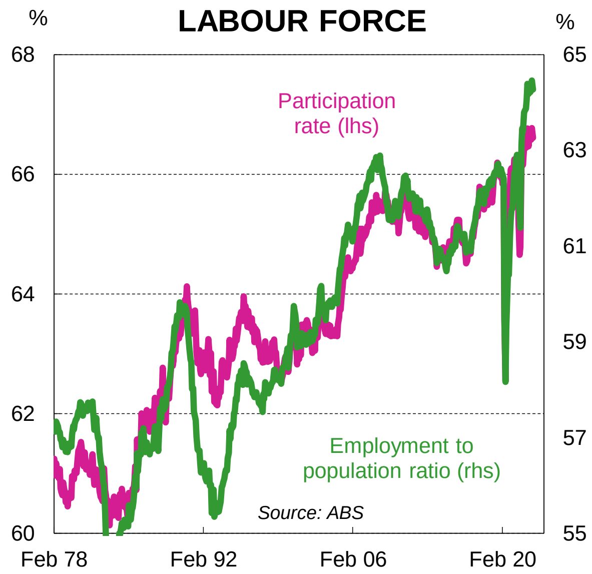
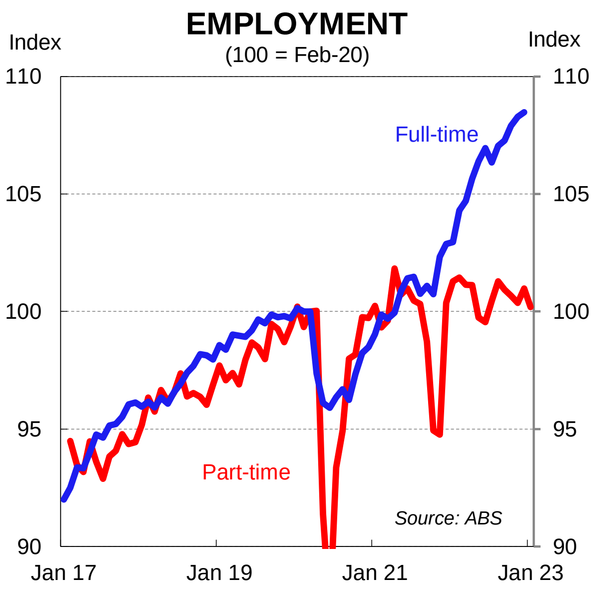
Labour market is tight – but not tightening further







- The unemployment rate has dropped to just 3.4%-3.5% from June to December - the lowest since 1974.
- The underemployment has also fallen substantially, but looks to be bottoming out at around 6%.
- The participation rate rose back to a record high of 66.8% in November, before falling to 66.6% in December and a substantial part of the jobs growth has been full-time.
- The employment/population ratio is near an all-time record high. But trend employment growth is slowing.
- The gap between the number of people unemployed and vacant roles is the narrowest it has ever been – but there is a skills and location mismatch.

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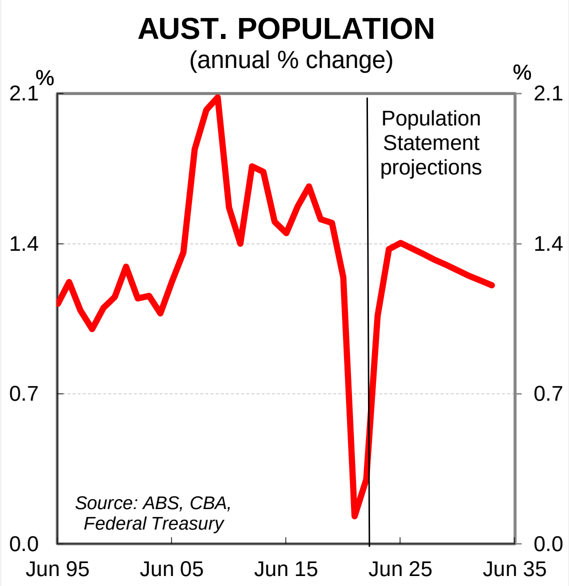
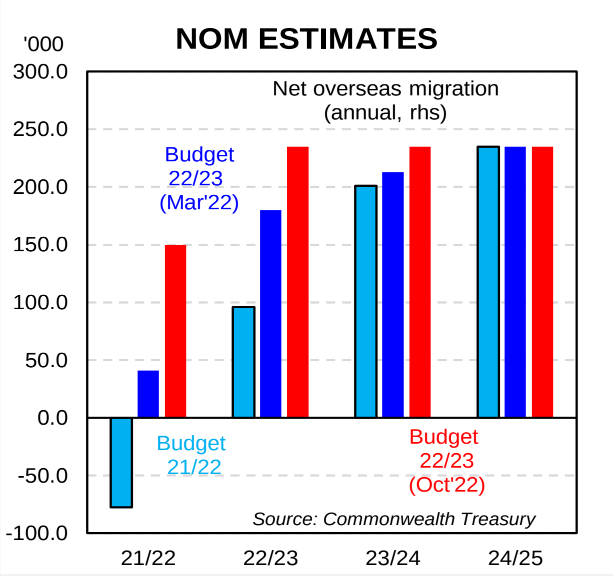
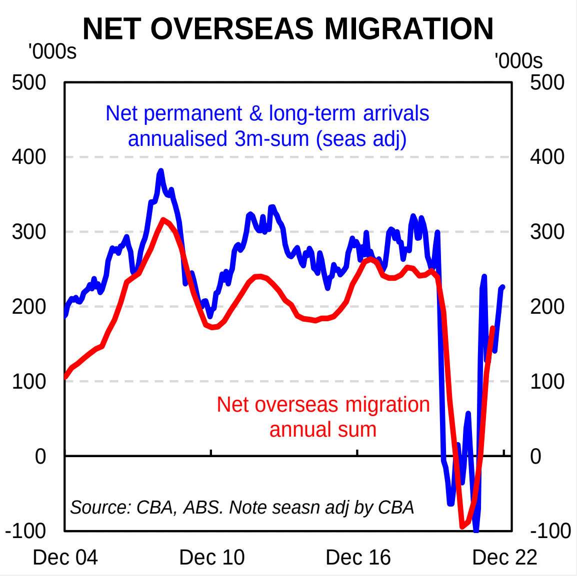
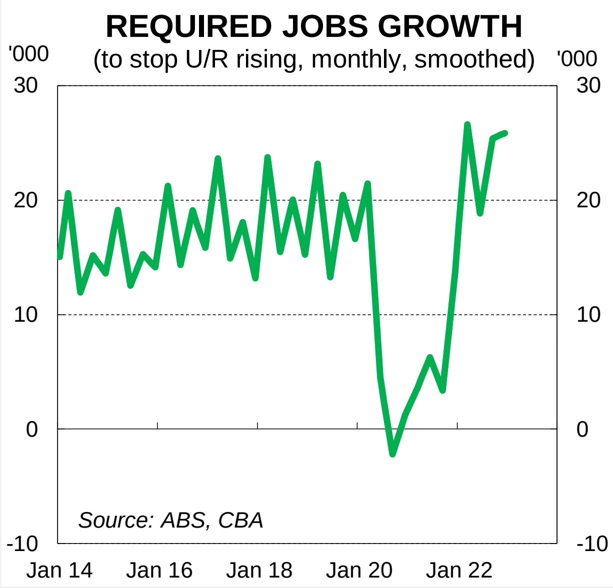
Population growth rate now rising again









- The October 2022/23 Budget had upgrades to population growth forecasts due to the swifter return of Net Overseas Migration.
- 150k net overseas migration in 2021/22 (was 41k in March Budget). 235k now expected in both 2022/23 and 2023/24.
- This will help the current skills imbalances in the labour market and support the economy. But put pressure on housing.
- And it will likely put upward pressure on the unemployment rate as the labour supply expands.

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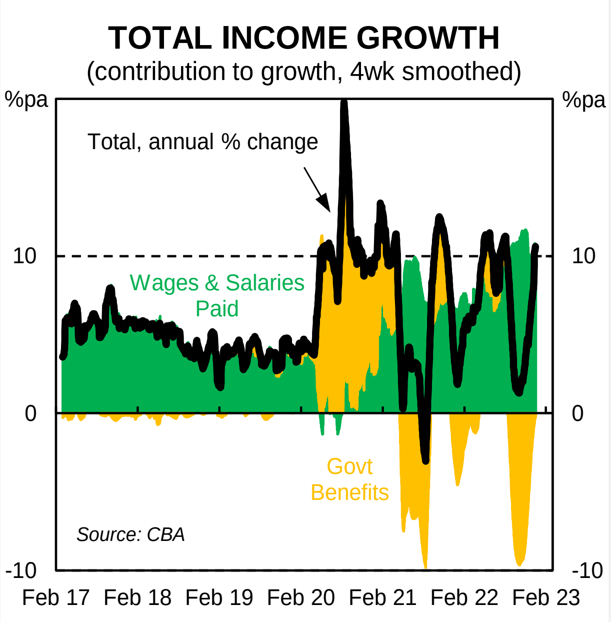
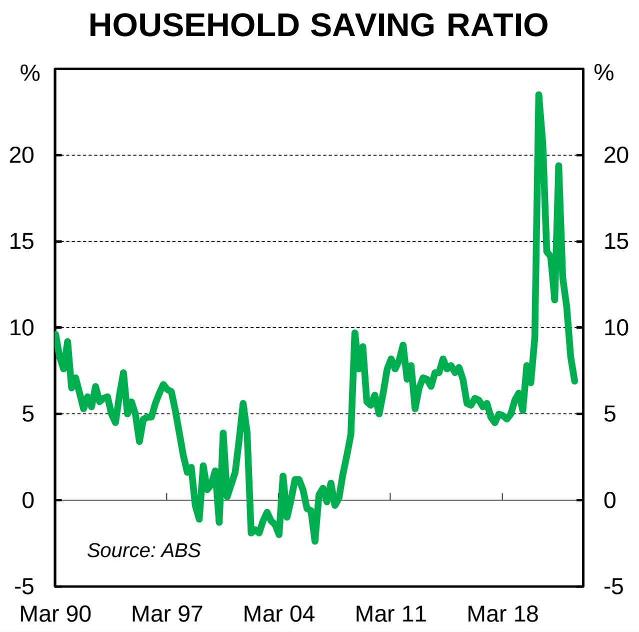
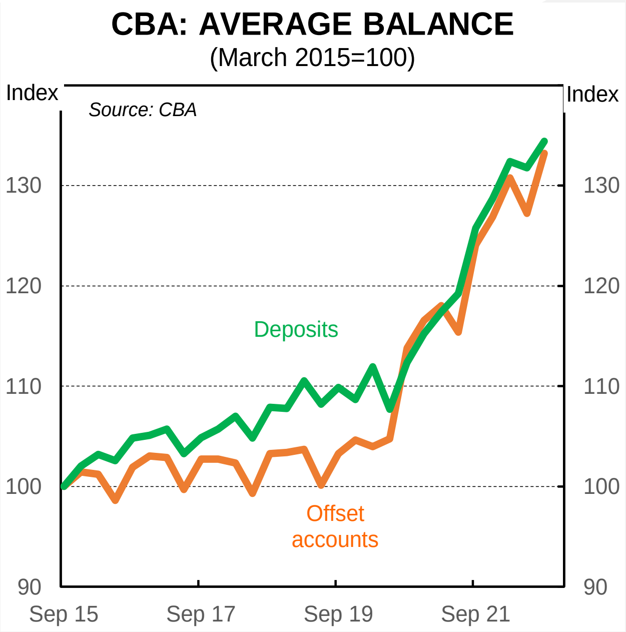
Household income growth now driven by wages

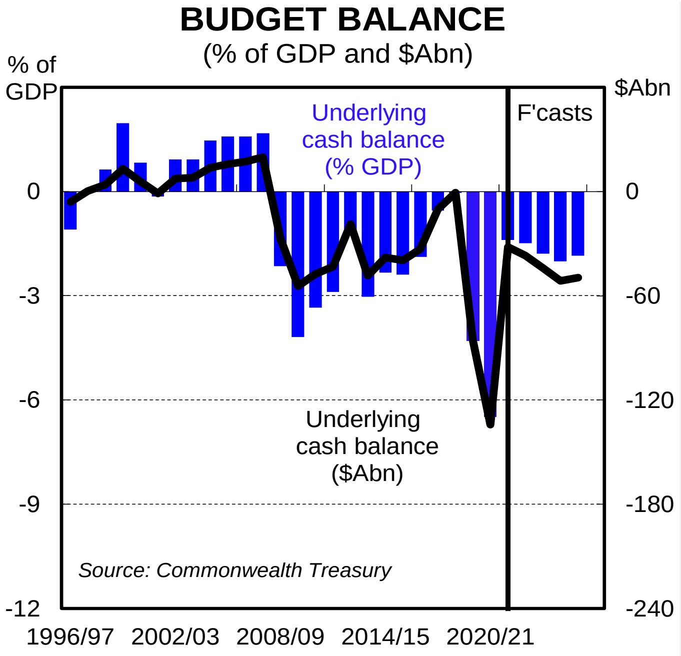


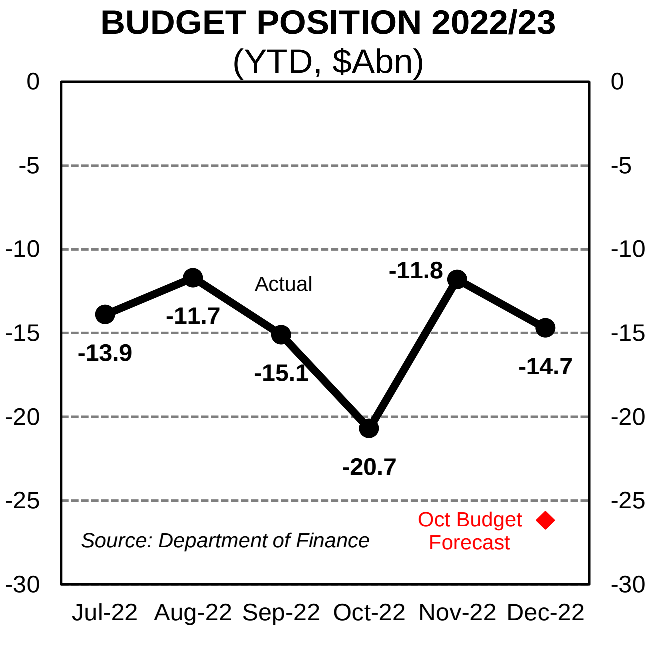


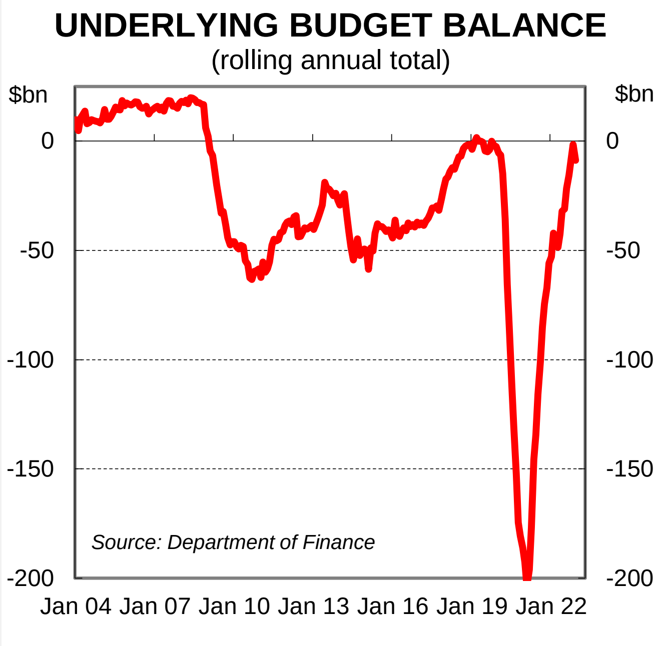


- Income growth was stronger during Covid lockdowns – thanks to government payments.
- Household savings rate jumped during Covid – but is now falling.
- Australians saved an additional $A265bn over past two years.
- The Household savings rate declined to 6.9% in Q3 22, from 8.3% in Q2 22 and a peak of 23.5% during Covid. Expect to move down to just below ~4% through 2023.

Budget coming in better-than-expected; helps RBA fight inflation

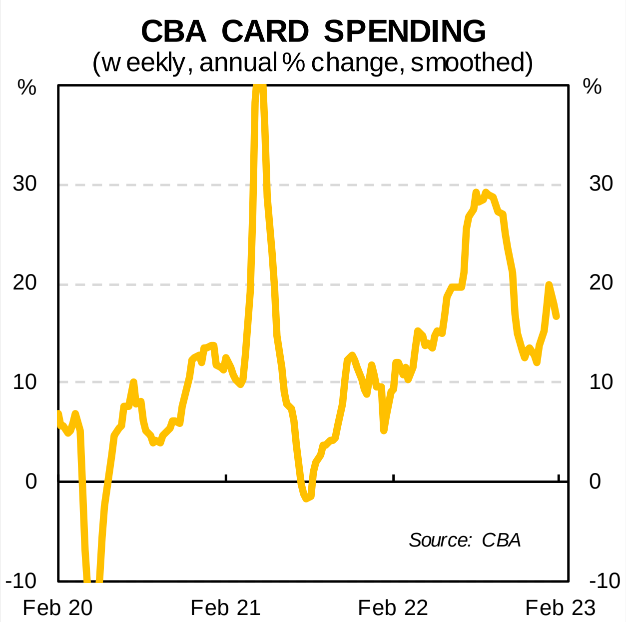


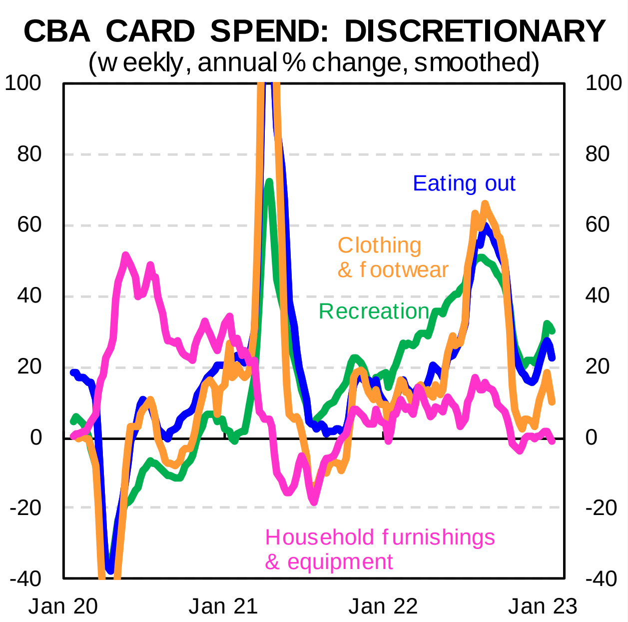


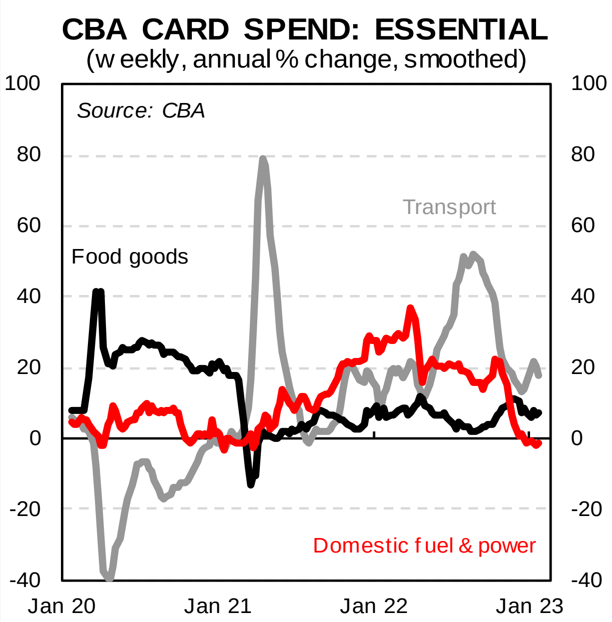


- The October version of the 2022/23 Budget forecast a deficit of $A36.9bn, just 1.5% of GDP. This is well down on the original estimate of $A78bn, 3.4% of GDP – due to higher revenue from higher commodity prices and stronger labour market.
- 2022/23 budget deficit estimate is similar to 2021/22 deficit of $A32bn, 1.4% of GDP. This means the 'fiscal impulse' is close to zero, which will help the RBA achieve its monetary policy objectives.
- To December 2022, the budget deficit stands at $A14.7bn, which is $A11.5bn lower than expected profile. Expenses lower than forecast, with revenue running ~$A8.8bn better than expected.

CBA Credit/Debit card spending growth – to 3 February 2023







- The CBA's internal credit & debit card spending data to early February 2023 shows a slow-down in spending after a pick-up over the Christmas-New Year period.
- Our data shows an increase in spending on 'recreation' and 'eating out' over the summer holiday period, with an increase in spending on 'food' and 'transport'.
- It is important to remember that this data measures nominal $ spent, so some of the increase in spending is related to higher prices, not higher volumes.

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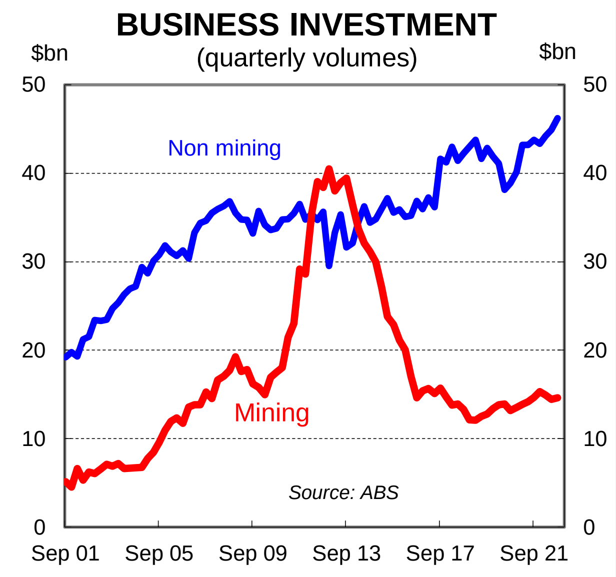
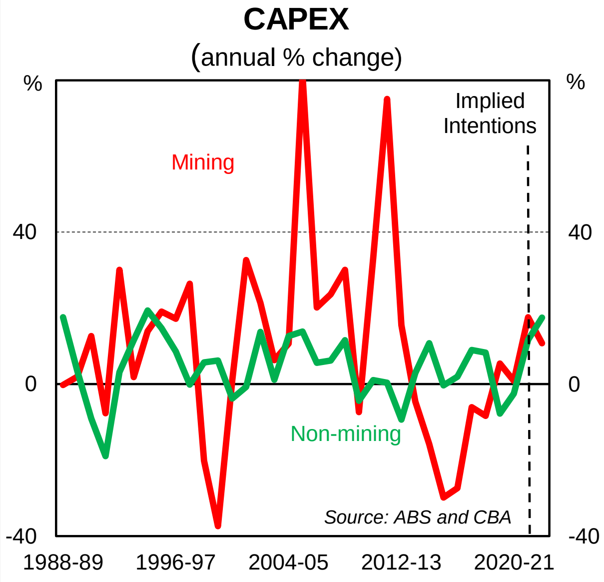
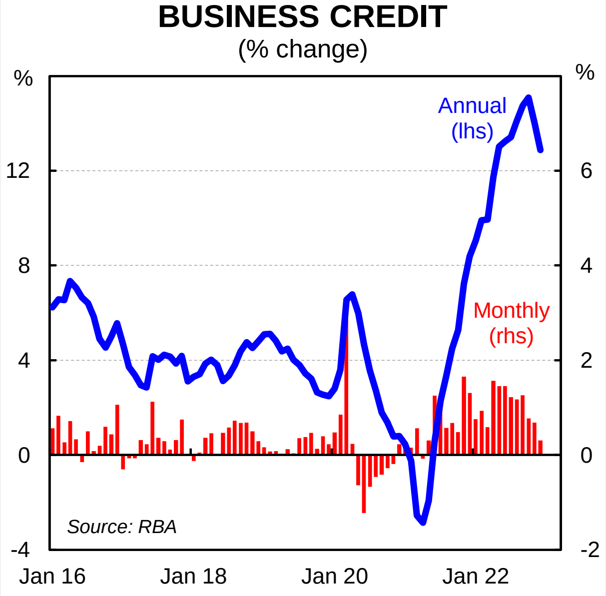
Business investment set to recover – investment is strong

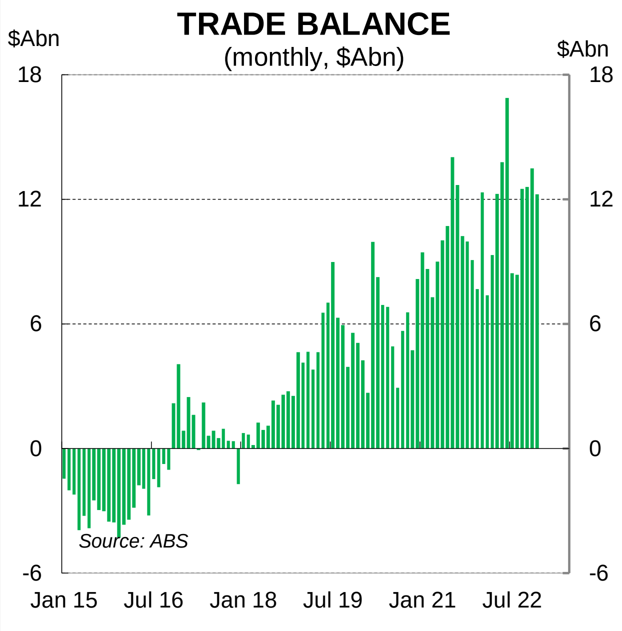


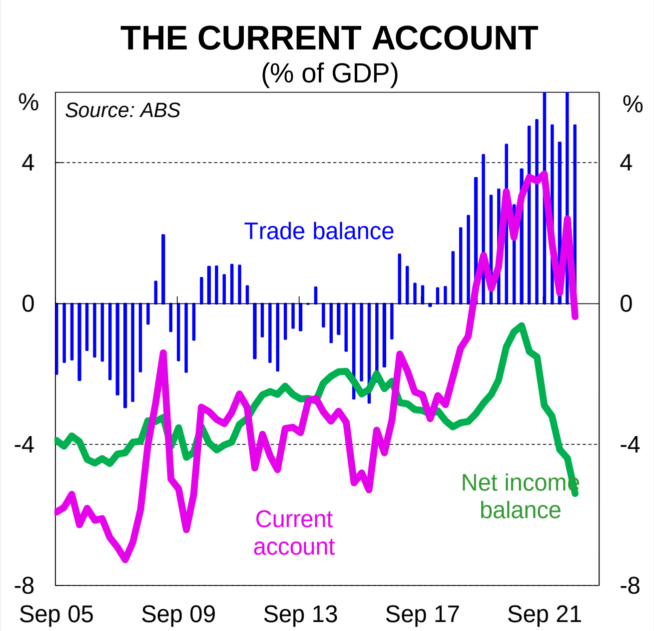


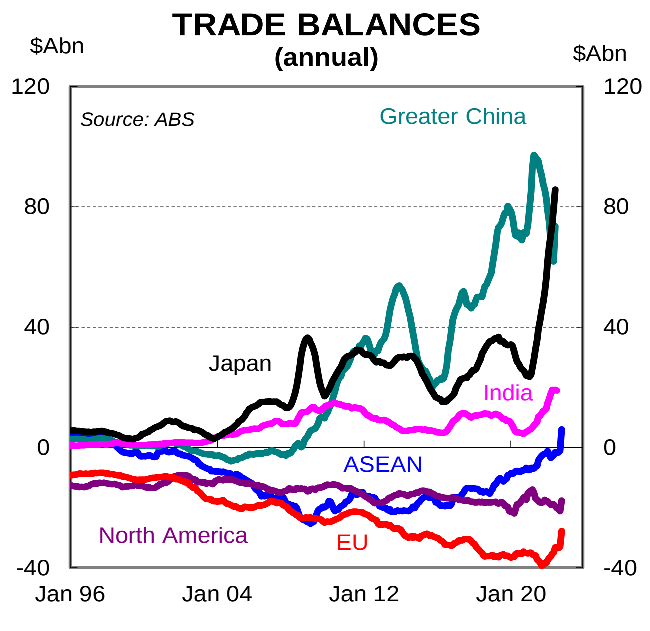


- Business investment (+2.5%/qtr) rose solidly in Q3 22. Non-dwelling construction and engineering, such as infrastructure building, lifted higher (+8.6%/qtr) and added 0.2%pts to economic growth, more than offsetting a decline in machinery & equipment capex (-2.7%/qtr).
- Businesses are expecting to lift capex further in 2022/23. The latest estimate of capex intentions for 2022/23 implies a 17.4% lift in non-mining investment plans and 10% increase in mining capex. Investment intentions have held up well given the growing economic headwinds over recent months.
- Business credit growth was strong in 2022, growing by ~13% over the year to December. But the monthly pace has slowed to 0.7%/mth in November/December from ~1.5%/mth over April – June.

Australia running large trade surpluses







- Australia has been running persistent large trade surpluses – helped by decade high commodity prices. This had helped Australia running a series of current account surpluses, after decades of current account deficits.
- A large rise in the net income deficit saw Australia return to a current account deficit in Q3 22.
- The large trade surpluses are being driven by resources exports to China and, especially, Japan due to higher coal and gas prices.

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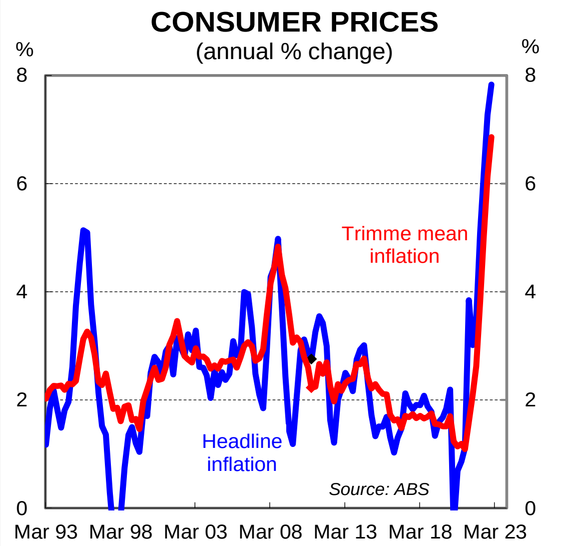
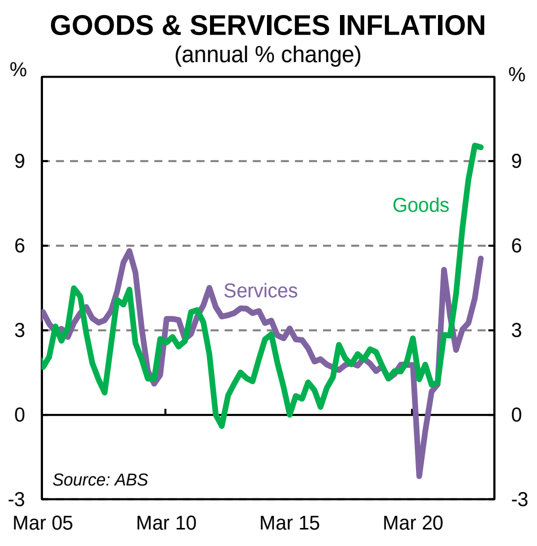
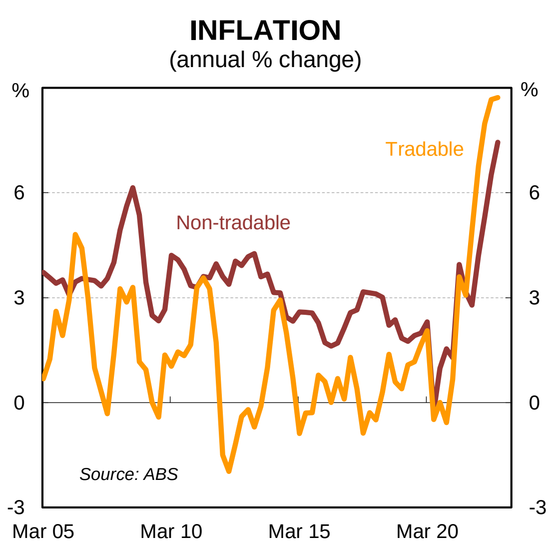
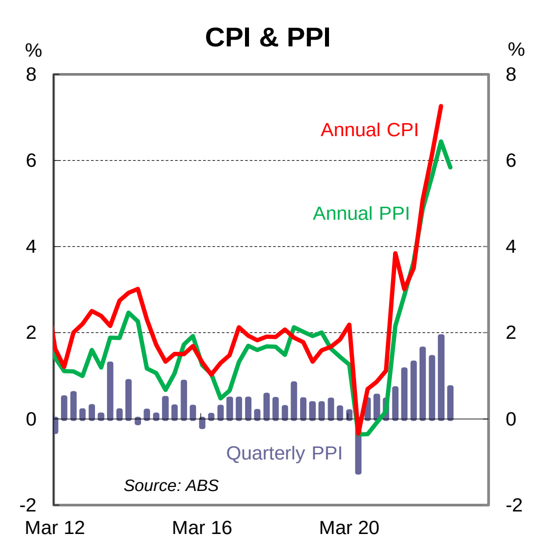
Inflation jumped sharply higher in 2022









- Headline inflation surged higher to 7.8%/yr in Q4 22, from 7.3% in Q3 22.
- The jump in inflation has been driven by an increase in non-discretionary prices, ie. petrol/fuel, electricity & gas, as well as discretionary goods and both traded and non-tradeables.
- Headline inflation is forecast to have peaked in Q4 22, before moderating to an average 5.1% in 2023.
- Underlying inflation jumped to 6.9%/yr in Q4 22 – well above the top of the RBA's 2%-3% target.
- Underlying inflation is expected to average 4.7% in 2023.
- Importantly we have both Headline and underlying inflation back into the 2%-3% target range in early 2024.

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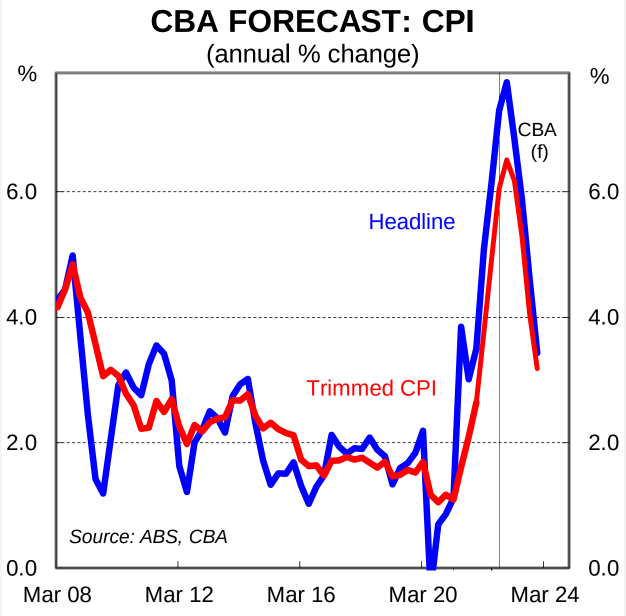
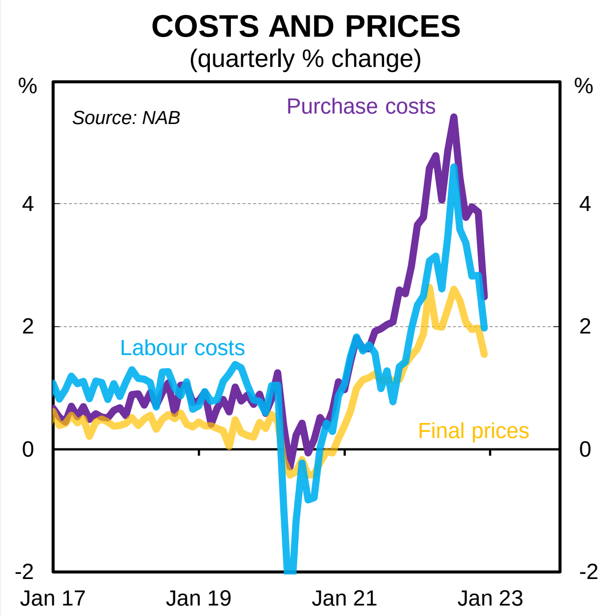
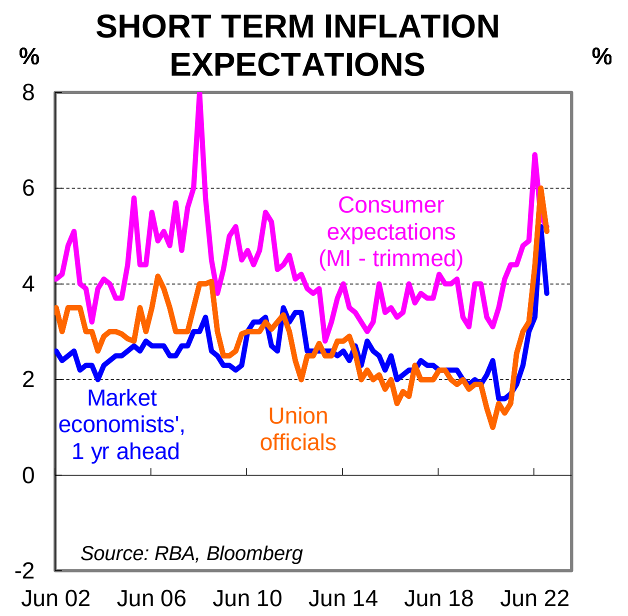
Inflation likely peaked end 2022 – return slowly to target in 2024

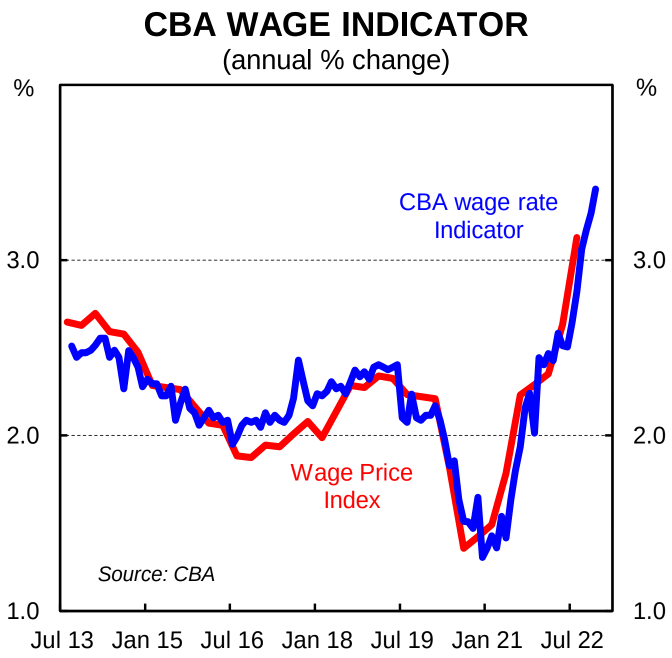


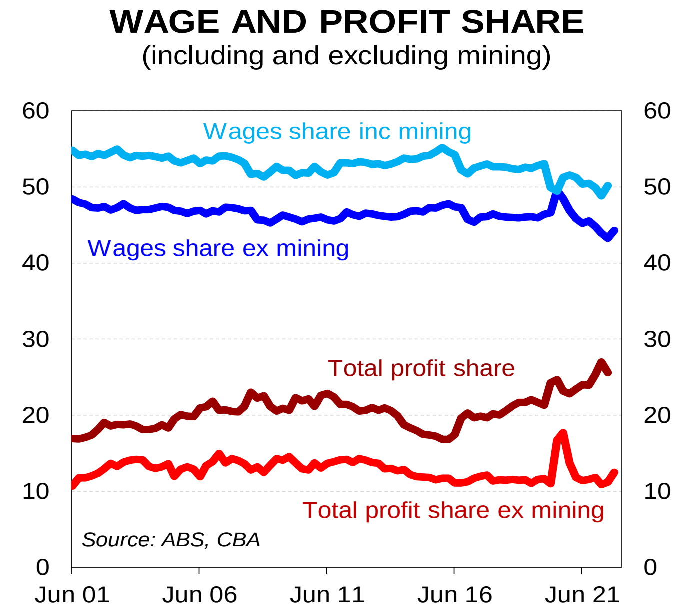




- There are signs that the momentum on inflation is peaking.
- The costs of construction are already on the way back down.
- There has been an observed turn-down in purchase costs and consumer inflation expectations have moderated as the price of petrol has come off its highs.
- Both Headline and Underlying inflation readings look to have peaked in Q4 22 and are expected to moderate throughout 2023.

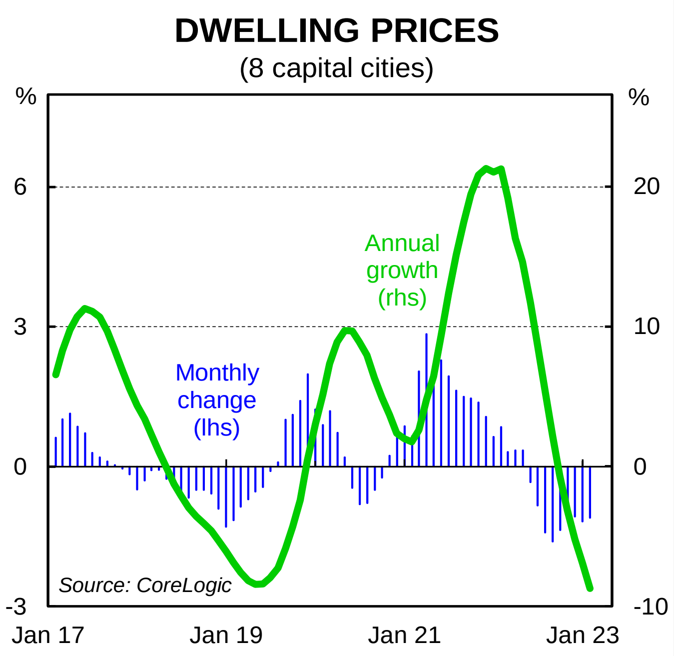
Australia does not have a wages 'problem'

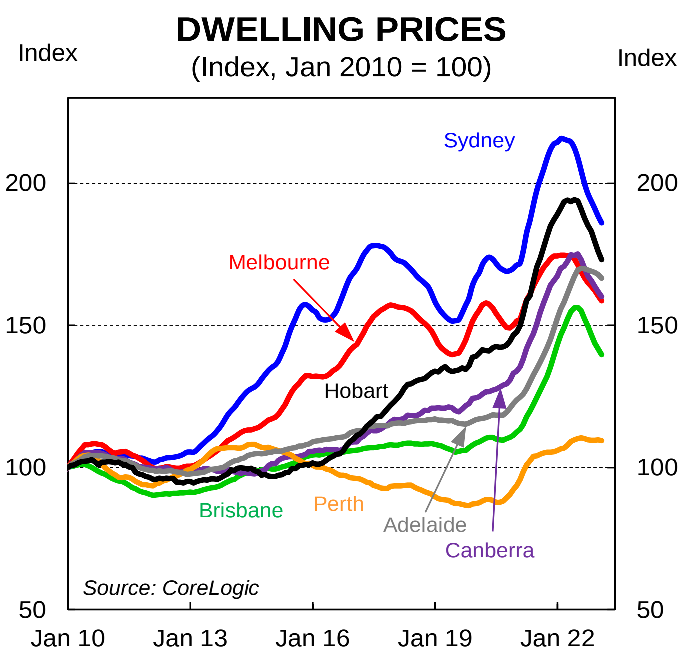


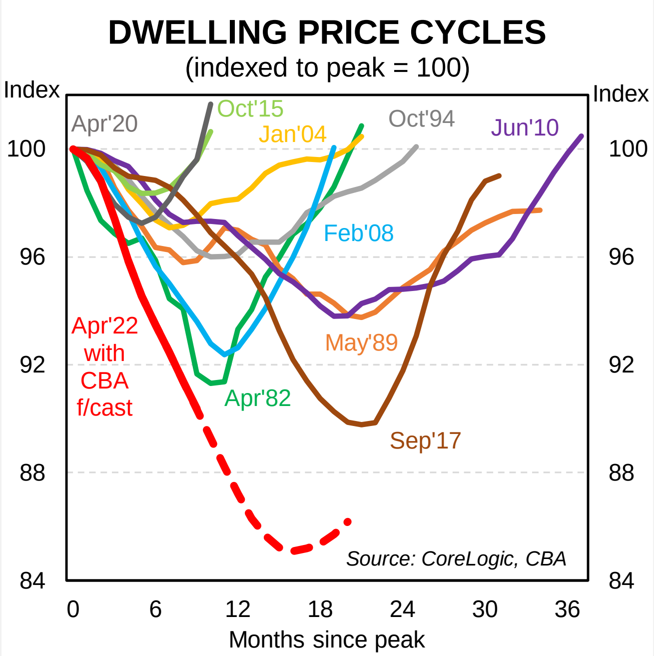


- Wage growth has begun to rise, up 1.0%/qtr and 3.1%/yr in Q3 22, from 2.6%/yr in Q2 22.
- The CBA wage rate indicator points to wages growth of 3.5%/yr in 2023.
- Unlike the US, Australia does not have a wages/inflation problem.
- Excluding the mining sector, the profit share of the economy has increased only marginally.

Home prices falling – as rate hikes take hold







- Dwelling prices fell by a further -1.1%/mth in January 2023, led by falls in Sydney (-1.2%) and Melbourne (-1.1%). Prices in regional Australia were down -0.8%.
- Prices are now down -8.9% from their April 2022 peak.
- House prices started falling concurrently with the RBA's interest rate hikes and higher mortgage rates.
- The pace of this house price downturn is faster than all price corrections over the past few decades – and is expected to extend for a longer period.
- We continue to forecast a 15% decline peak-to-trough in this cycle.

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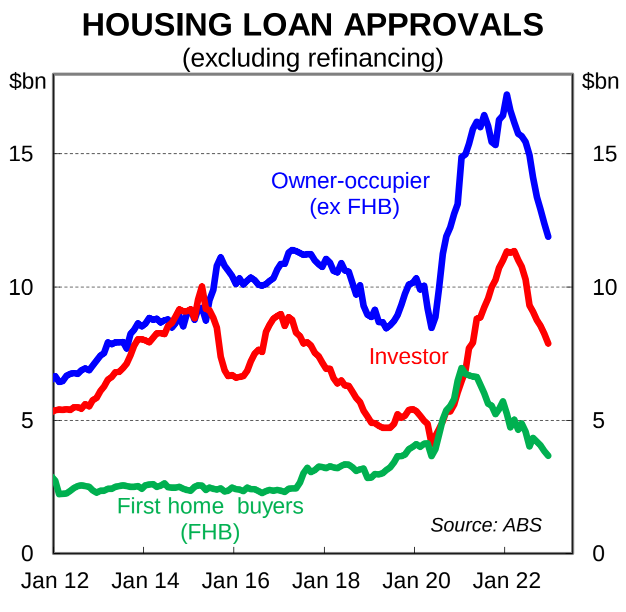
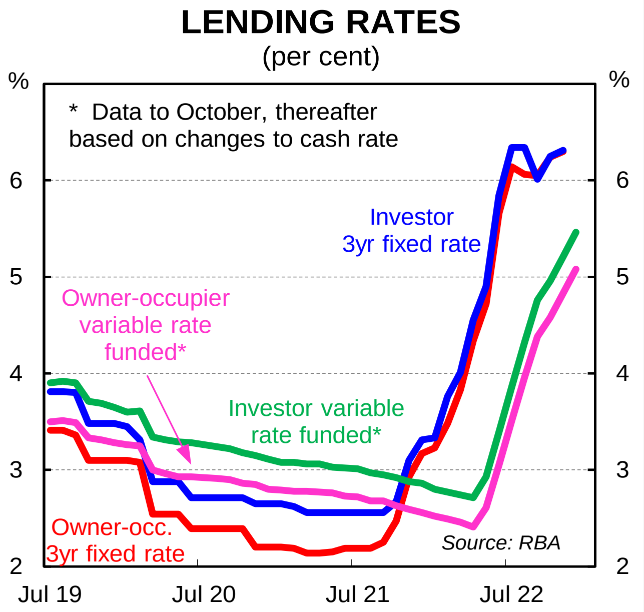
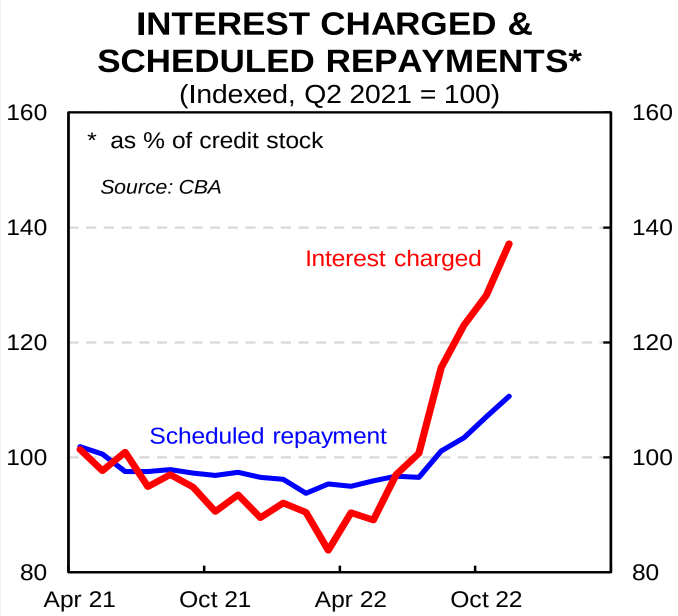
Home lending has slowed quickly – lagged effect of RBA rate hikes



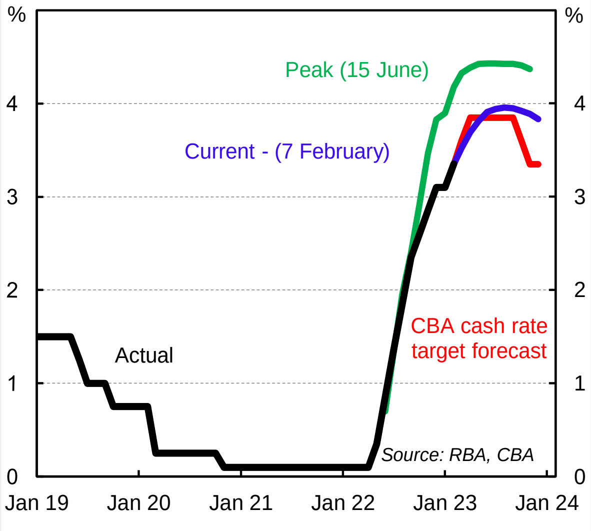




- Home loan approvals are falling fast – for owner occupiers, investors and first home buyers – as interest rates climb higher.
- Fixed rate mortgage lending has fallen quickly - as fixed rate mortgage interest rates rise faster/further than variable rates.
- More weakness expected as the standard variable interest rate for mortgages rises.
- The three month lag between RBA rate hikes and the increase in monthly mortgage repayments means that full effect of the RBA's rate hikes wont be felt by Australian households until around May/June 2023!

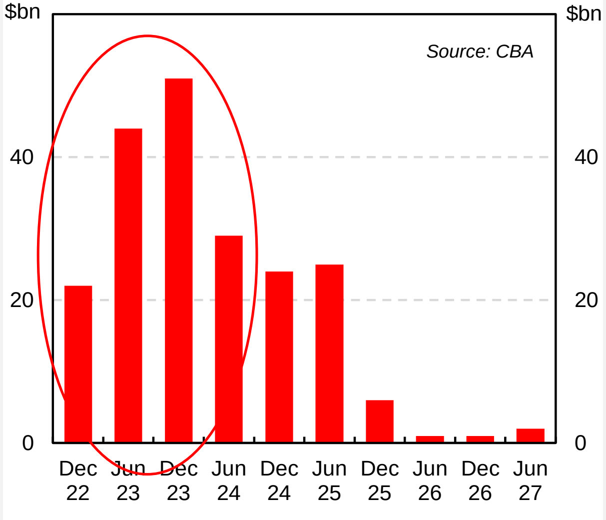
RBA – Monetary policy tightening impact to come

RBA CASH RATE FORECAST



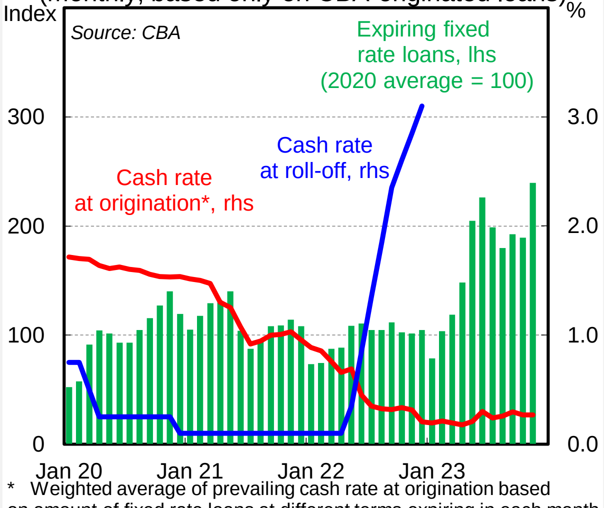
CBA FIXED RATE HOME LOANS

(expiry schedule, $Abn per 6 months)



FIXED RATE LOAN EXPIRY

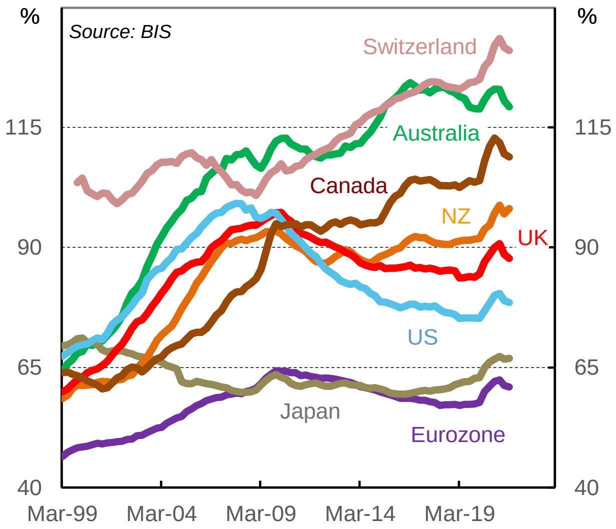
(monthly, based only on CBA-originated loans)



* Weighted average of prevailing cash rate at origination based on amount of fixed rate loans at different terms expiring in each month

HOUSEHOLD DEBT

(% of GDP)



- The RBA has been part of the global monetary policy tightening cycle starting since May 2022.
- The cash rate has been increased by 325bp from May 22 – Feb 23 and stands at 3.35%.
- We now expect two further 25bp rate hikes in March & April 2023 - to a peak of 3.85% due to the higher-than-expected Q4 22 CPI prints.
- We then policy easing in late 2023 and into 2024.
- Relative to the market, we expect a shallower interest rate cycle due to the high volume of fixed rate mortgages to mature in 2023.
- There is a significant lag between RBA rate hikes and when these higher interest rates impact monthly repayments.

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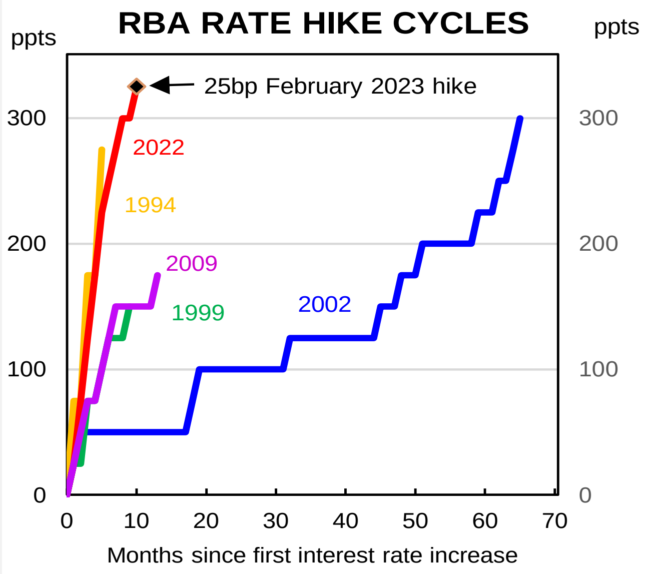
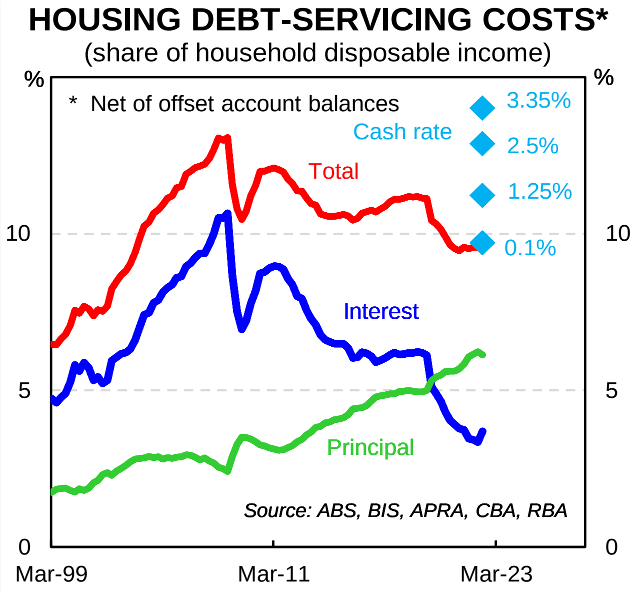
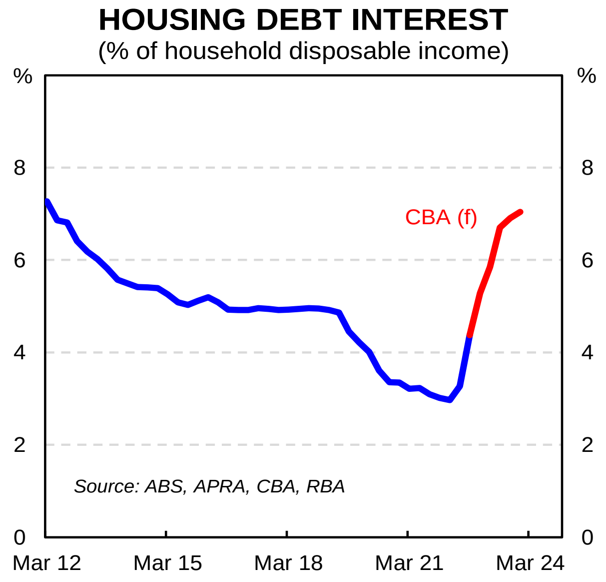
RBA – Monetary policy tightening rapidly



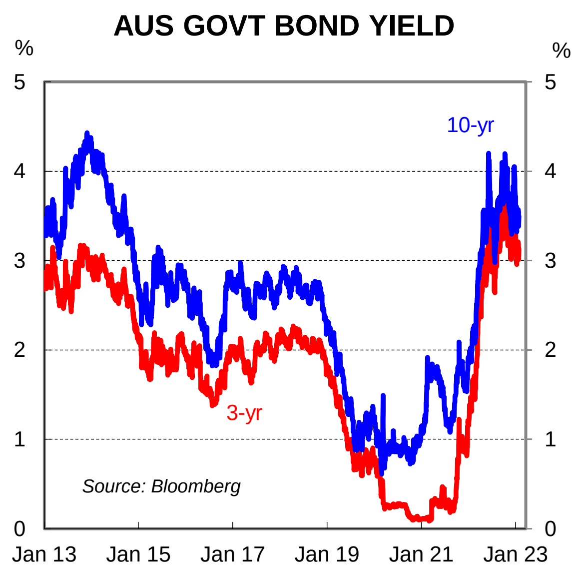


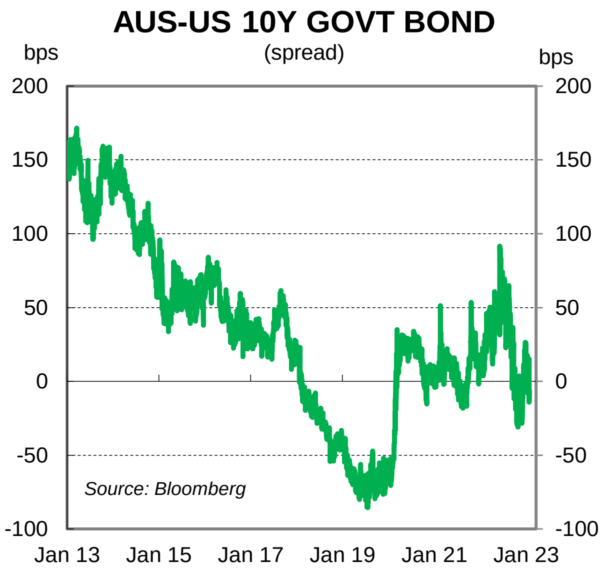


- The 2022-2023 rate hike cycle has been the most aggressive in the inflation-targeting regime for the RBA (which began in 1993).
- At a 3.35% cash rate, mortgage repayments as % of income would be a record high. At 4% (peak market pricing) this would imply a significant downturn in the housing market and broader economy.
- Household debt servicing levels, both in $A terms and as a % of income, are now rising fast.

Commonwealth Bank of Australia

Bond yields up sharply in 2022 – move lower expected in 2023

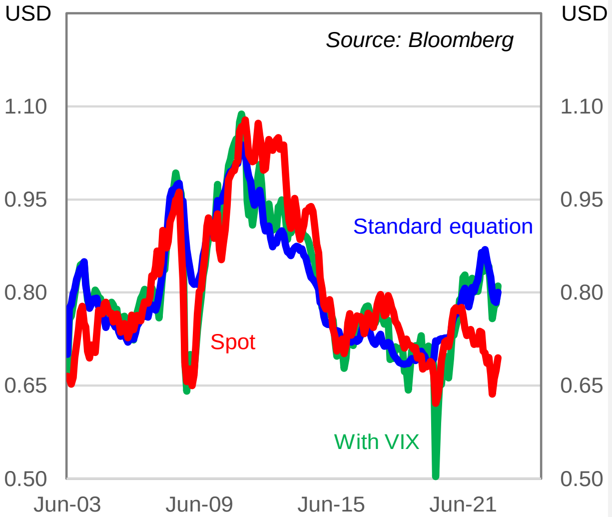




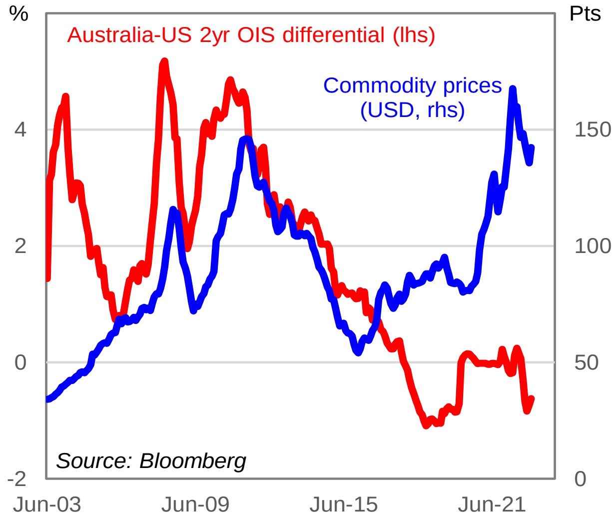
- Australian government bond yields rose significantly through 2022, in-line with global trends, higher inflation and RBA rate hikes.
- Bond yields are expected to move lower throughout 2023 – as the monetary policy tightening cycles of the major central banks (especially the US Fed and RBA) come to and end and global economic growth slows substantially.
- With the Australian cash rate lower than the US, the Australia/US 10yr bond spread is expected to remain around zero.

AUD two-way on stronger China, global economic slowdown

AUD/USD FAIR VALUE ESTIMATES COMPARED



AUD/USD DRIVERS



- AUD spot $US0.6915. F/c $US0.72 Q2 23, $US0.68 Q4 23, $US0.68 Q2 24 and $US0.74 Q4 24.
- We expect two major opposing forces will influence AUD/USD this year:
- The reopening of the Chinese economy, and better Australia-China relationships, would push AUD higher.
- Pulling AUD down will be the coming recession in the major advanced economies.
- These opposing forces are expected to make AUD/USD volatile this year.

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