

The reasons why Australia's economy is slowing

Australia's economy is showing clear signs of slowing and will drop further in 2023. House price growth appears to be on the cusp of turning negative and provides a rationale for a peak cash rate at the relatively low level of 3.6%. We believe the economic slowdown will be accompanied by a similarly rapid decline in inflation



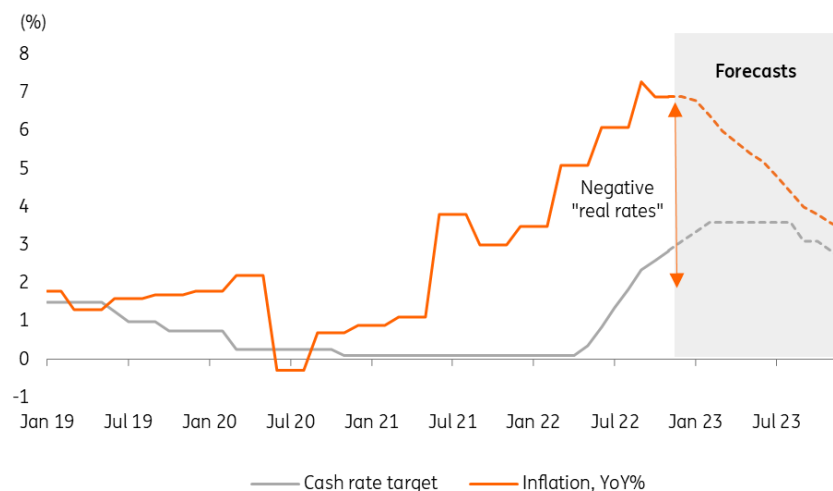
Source: Shutterstock

Macroeconomy: inflation outlook turning down

A lot has changed in the last year. In October 2021, the Reserve Bank of Australia (RBA) was still maintaining that the inflation target would not be sustainably met until 2024. A month later, it was abandoning its yield curve control in the face of market pressures. By May of this year, the RBA was hiking rates, throwing in the towel on its previous stance that concluded inflation would not sustainably be up to the RBA's target until wage growth exceeded 3.5% (it still isn't based on the 3Q22 wage price index).

Inflation hit 7.3% year-on-year in the third quarter of this year, with rises also in core measures, although the October monthly series has raised hopes that inflation may already have peaked, dropping to 6.9%YoY. We think it will now slow quite rapidly.

Policy rates nearing a peak

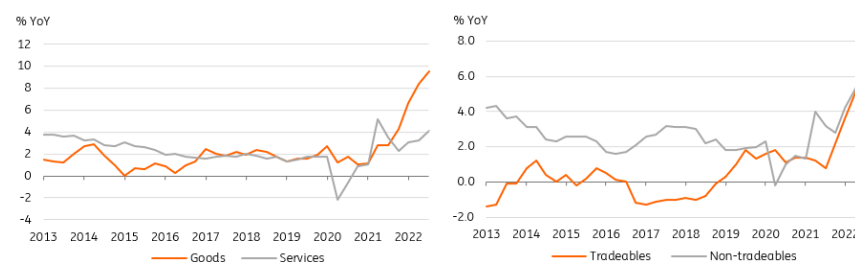


Source: CEIC, ING

Inflation is mainly due to goods, not services

Most of Australia's inflation comes from goods rather than the service sector. But this is not simply an imported phenomenon. Inflation in the tradeable sector is no higher than in the non-traded sector. However, what this does mean is that this is less likely a labour-cost-driven event than a discrete price-level shock (or series of shocks), and as such, is probably easier to squeeze out of the economy.

Inflation by source (goods vs services and tradeable vs non-tradeable)



Source: CEIC, ING

Don't blame inflation on wages growth, which remains negative in real terms

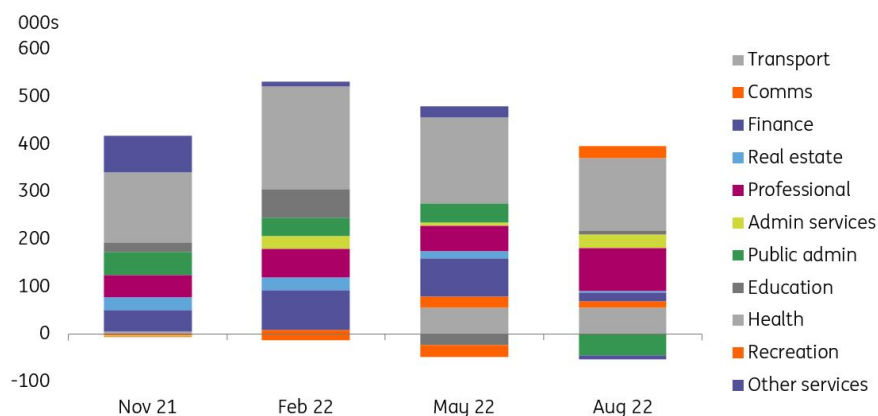
By sub-component, there are few inflation standouts. Certainly, the transport sub-component was swollen earlier in the year by high oil prices, although with Brent crude now back below \$90/bbl, oil is no longer contributing to higher inflation, and may even be a slight drag in the near future. Widespread flooding this year across many parts of the country has also pushed up food prices at times. Everything from cereals to dairy was looking more expensive. Though even this looks to be normalising.

In the near-term, inflation is likely to remain the focus for policy-setters and the investment

community. But on the assumption that energy prices remain roughly where they are now and do not re-accelerate upwards from here, we look for inflation to rapidly subside over 2023 and could be as low as about 3.0%YoY by the end of 2023.

One thing that policymakers obsess over is second-round price effects – wage-price spirals for example. RBA anecdotes point to a pick-up in wages, which fills in the gaps left by the wage-price index, which is only released quarterly and with long lags. That is only showing a growth rate of 3.1%YoY (3Q22). The wage price index inflation rate will surely rise further, but the large current gap between wages and prices shows that wages are being dragged higher, rather than driving prices higher. In the end, the wage component of the economy is becoming less of a cost issue than other components. We do not need to worry unduly about the cost implications of this. The labour market as a whole is not squeezing margins, though admittedly there will be pockets of the service sector where it is.

Employment growth by sector



Source: CEIC, ING

Household spending is running out of sources of growth

So far this year, consumer spending has by far contributed to the bulk of GDP growth. And that is not just because consumer spending accounts for the bulk of GDP. It has also been growing unlike most other parts of GDP.

Underpinning that real spending growth – which as we have determined is not a function of wages (which are falling in real terms) – is employment growth. The last 12 months have seen Australia adding around 400,000 jobs to a labour force of just over 14 million. More than half of these jobs were full-time (generally better-paying) jobs.

Comparing employment against its values four quarters ago, we see that the gains are not in manufacturing or agriculture. Lately, jobs in the hospitality industry have been on the rise (some of which may be part-time), as well as in the wholesale and retail sectors. Construction jobs have also gained ground recently. Within the other service sector jobs, not surprisingly in the wake of the Covid-19 pandemic, healthcare-related jobs, as well as professional and scientific jobs, rose consistently, although growth in these areas is now beginning to slow. Jobs growth in public administration is also slowing down now after rising in the previous three quarters, and so too are jobs in finance.

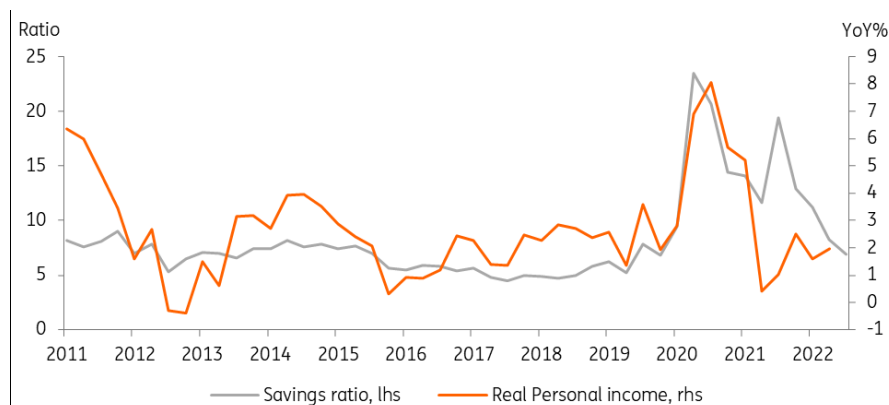
In the three months since July, the number of employed has stagnated at just over 13.6 million. It

looks like the boost to spending likely to come from employment growth is slowing. And with wages negative in real terms, the only way household spending is going to continue to boost economic growth in the quarters ahead is if households draw down savings (e.g. borrow more).

That doesn't look as if it is going to happen to any large extent. Household balance sheets received a big boost during the pandemic, mainly from markets juiced up by easing monetary policy pushing up equity prices and reserves held in superannuation accounts. Liquid savings in the form of currency and deposits also picked up.

But household balance sheets peaked at the turn of the year and have since begun to decline. And while liquid assets will provide a solid buffer, the household savings ratio has now fallen to 6.9%, well below the post-war historical average of 9.5%, so further declines are probably going to be limited unless they are a response to crisis conditions. And if that is the cause, then it probably won't matter all that much. Rising interest rates will also deter discretionary dis-saving.

Savings ratio and personal income growth (YoY%)



Source: CEIC, ING

Rent-reset shocks should be modest in 2023

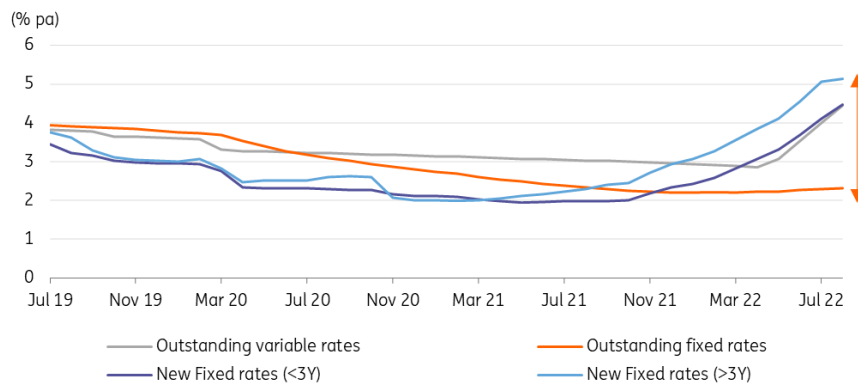
Another factor that could weigh on household spending is that a sizeable number of Australian households will be facing much higher mortgage payments shortly after the New Year.

[The latest Financial Stability Review by the Reserve Bank](#) has a detailed chapter on the impact of rising interest rates and inflation on indebted households' cash flows.

Households that are owner-occupiers with variable-rate mortgages account for about two-fifths of outstanding housing credit. Many of these are making sizeable prepayments on their mortgages, which they could trim back as rates rise. Some (about 15% according to the RBA) might see their spare cash flow turn negative, requiring a drawdown of savings buffers, with the possibility that some owners might even fall into arrears.

Using scenario analysis based on market expectations for the likely further increase in the cash rate, the RBA analysis noted that: "Just over half of variable-rate owner-occupier borrowers would see their spare cash flows decline by more than 20% over the next couple of years, including around 15% of households whose spare cash flows would become negative as the combined burden of higher interest payments and the higher cost of essential goods and services exceed their initial spare cash flows."

Mortgage rates to reset



Source: Reserve Bank of Australia

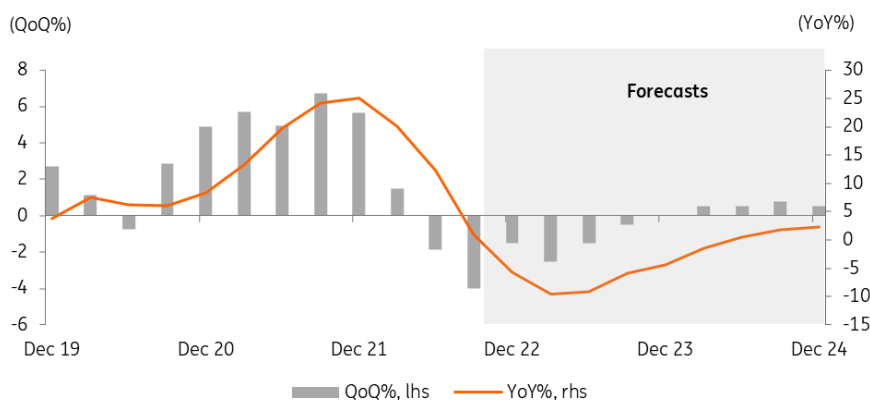
House price inflation likely to turn even more negative in 2023

Around 35% of outstanding household credit is for fixed-rate mortgages (including split-rate loans). And around two-thirds of these are due to expire by the end of 2023. The RBA estimates that most fixed-rate borrowers will face a discrete rise of 3-4 percentage points in their mortgage rates when they re-set. Some will face this re-set as early as January 2023. That being said, the current household finance ratio is still close to all-time lows at around 5-6% of disposable household income, so this would only take it back to historical norms.

The rate of quarterly increase in mean house prices peaked in the third quarter of 2021 at 6.7% quarter-on-quarter, but it has been slowing ever since. In the second quarter of this year, house prices registered a small (-1.8%QoQ) decline, which was followed by a larger decline in the third quarter (-4.0%QoQ). Annual house price growth has now dropped to only 1.1 %YoY.

We anticipate this price decline continuing through at least the first half of 2023 before prices begin to stabilise and then slowly turn around again. Year-on-year house price growth will turn negative in the first quarter of 2023 and could show something close to a 10%YoY decline at its worst in the second quarter before starting to stabilise. Year-on-year house price declines will likely persist until early 2024, and while they do, they should put a further dampener on household spending.

House price inflation already dropping sharply

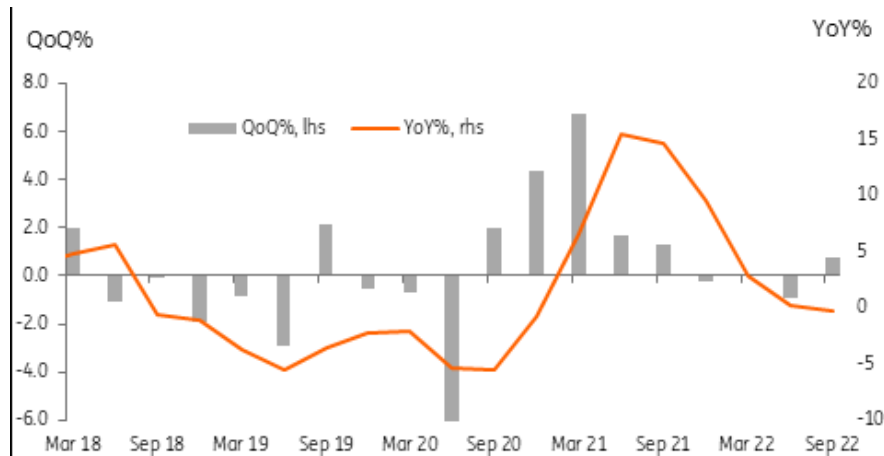


Source: CEIC, ING

Business investment: not coming to the rescue

Business investment is a much smaller proportion of Australian GDP than consumer spending, but its importance for the business cycle is not to be underestimated, since it is the variance of GDP components, as well as their absolute size that provides the impetus to cyclical swings.

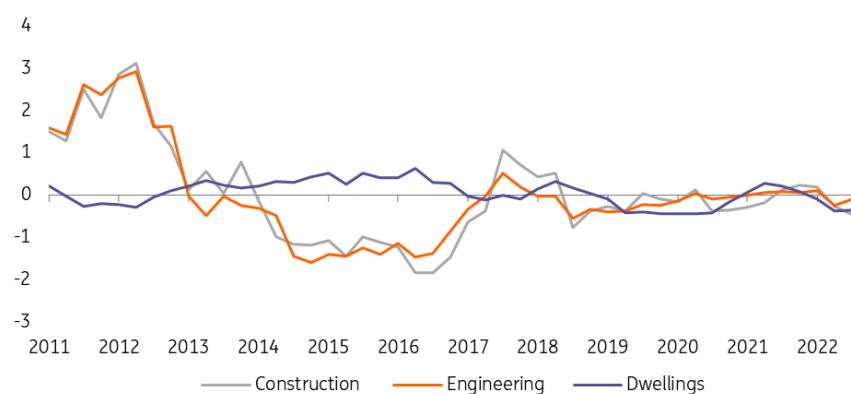
Business investment



Source: CEIC, ING

Gross fixed capital formation is the official GDP term for such business investment, and this grew by 0.7%QoQ in the third quarter of this year, however this wasn't enough to prop up the year-on-year growth rate, which showed a contraction of 0.3%YoY. As rates continue to rise, the domestic economy slows, and Australia's main trading partners skirt recession, it is hard to believe that there won't be a further slowdown in the pace of business investment.

Construction by type (contribution to GDP YoY%)



Source: CEIC, ING

Construction going nowhere

For the subset of business investment that falls under the generic term “construction”, there has not been any contribution to GDP from this sector for several quarters. Residential construction (on dwellings) has been a recent underperformer, dragging on year-on-year GDP growth by more than 0.2pp in the last two quarters. This could well deteriorate further given what is happening to the

housing market.

There is a marginally less dour story emerging on engineering construction. This comes mainly from electricity generating expenditure and roadbuilding, and less from the extraction industries, where spending is softening.

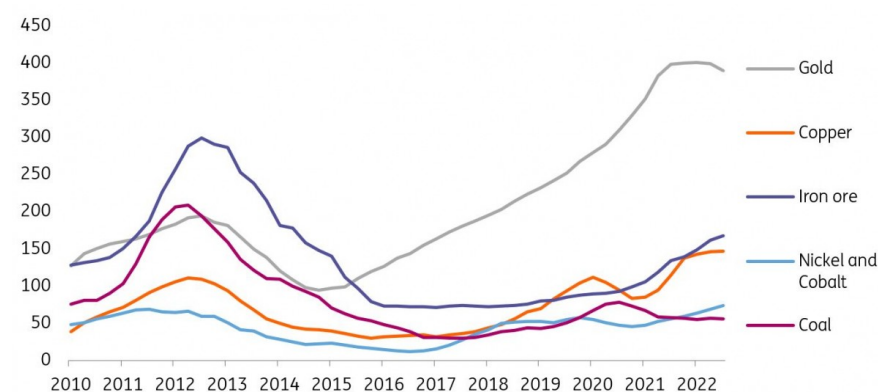
Extraction exploration: no longer following the money

Normally, we would expect exploration expenditure in the extraction industries to follow the price of the underlying commodity.

That would support spending on coal extraction, and maybe natural gas. Instead, what we see is that the liveliest investment part of this industry in recent years relates to gold, though this too is beginning to peak out. It is possible that this mix of exploration spending reflects new attitudes to fossil fuels and the financing of their extraction. Indeed, we also see relatively muted exploration expenditures in onshore and offshore petroleum (including natural gas) which would tie in with that hypothesis.

In short, while there remain some pockets of resilience, business investment overall is flat to slightly down, and we anticipate the going getting even tougher during 2023 before recovering in a more supportive lower rates environment in 2024.

Extraction exploration (AUDm four quarter moving average)



Source: CEIC, ING

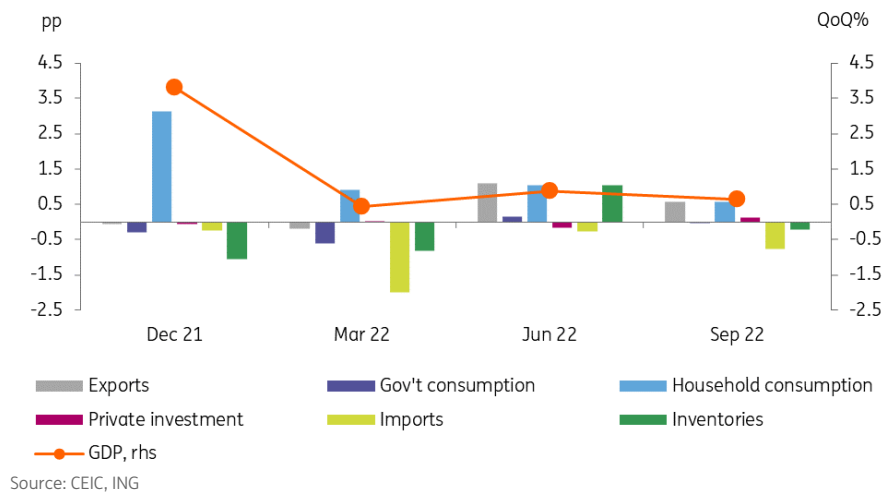
Trade is already dragging on growth, but this should slow

One bright spot in the economy has been international trade. Thanks in part to some extremely helpful swings in Australia's terms of trade (the ratio of export prices to import prices), what was once a long-standing deficit and leakage from the economy has provided a consistent surplus since late 2016. The 12-month average trade surplus is now more than AUD10bn and is still trending higher, though more slowly than it was.

That slowdown in trade surplus expansion means that the contribution to year-on-year GDP growth from net exports actually turned to a small drag at the end of 2021, and has subtracted from year-on-year growth in three out of the last four quarters. That contribution could change as the domestic economy, in particular household consumption, slows further, causing import growth to decelerate. Though it may have to slow quite a lot if it is to outweigh the slowdown in external demand likely to stem from the US, Europe and China all effectively going into recession in 2023

and weighing on exports. The external environment could begin to turn around in the second half of 2023. But that's not a foregone conclusion.

Contributions to Australian GDP (QoQ%)

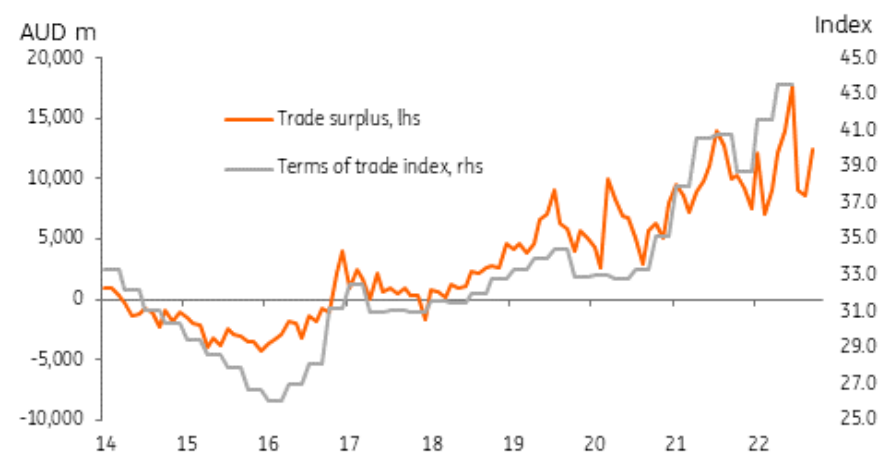


Terms of trade have helped create Australia's external surplus

The upswing in Australia's terms of trade implies a much stronger AUD/USD exchange rate than has actually been the case, and this will also have helped to keep Australia's exports very competitive. The fact that the currency has not absorbed more of the terms of trade shift owes a lot to the RBA's seemingly conscious decision to always pitch monetary policy on the dovish side of the US Federal Reserve and will have helped keep the AUD weaker and more competitive than it would otherwise have been.

Considering how important China has been to Australia's export success, it is perhaps even more surprising that Australia's trade surplus has held up so well. Digging into the data, after China closed some export avenues with Australia following political disagreements, export flows into China seem to have been steadily improving again. It may be that given China's domestic economic weakness and the stresses following the Russia-Ukraine war, the authorities have decided to take a more pragmatic approach to trade with Australia. We think this will continue, however China's domestic weakness remains a concern, and it is not clear that recent efforts at re-opening will bear fruit quickly – though in time this approach is probably the right way forward

Terms of trade and trade surplus



Source: CEIC, ING

Financial markets: a more positive outlook despite the economic slowdown

The Reserve Bank of Australia successfully adopted what might be described as a "dovish pivot" at its October meeting, slowing the pace of tightening from 50bp to only 25bp, and taking greater account of the current level of rates and the absolute change in the policy rate from its pandemic low. Following [the latest 25bp rate hike](#) at the December meeting, the current cash-rate target is 3.10%, up 300bp from its pandemic low of 0.1%.

This finessing of the tightening that the RBA is implementing has been vindicated by subsequent inflation data and also the slowdown becoming more apparent in GDP growth and the housing market.

Recent RBA statements still claim that policy will respond to the flow of data. However, it looks more like policy is not particularly data-dependent, but is instead, "state-dependent". And the current "state" is that policy may now be in mildly restrictive territory and has already tightened a lot. We don't, therefore, expect policy tightening to deviate on the upside from the current 25bp per meeting approach over the next few months, whatever the data delivers, and look for rates to get up to no more than 3.6% in the first quarter of next year. At this point, with inflation clearly on its way down, we think the RBA will opt to keep rates on hold.

Australian bond yields



Source: CEIC, ING

This approach to monetary policy is considerably less hawkish than that suggested by the Federal Reserve. And so while longer-dated Australian government bonds are very heavily influenced by US treasuries (correlation coefficient of 0.98 over the last two years) Australian 10Y yields have recently traded lower than their US counterparts, following a long period of trading above them. This looks set to continue and the negative spread could even widen further – though we have to add that the actual path of both US Treasuries and Australian government bonds is subject to considerable uncertainty.

That Fed/bond yield view is also likely to play a large role in the outlook for the AUD. You can do lots of fancy analysis about iron ore futures, terms of trade, trade surpluses and relative producer prices and rates of productivity. But in the end, like the importance of Treasury yields for AUD government bond yields, the direction of EUR/USD is likely to explain most of the variance of the AUD over the next 12 months. A sense of peak Fed funds and bond yields is likely to correlate with a shift out of the USD and into everything else. It is possible this has already started, though there is still a tail risk of a further down leg in sentiment as the global recession is priced into risk assets more fully than it currently is.

The year ahead for Australia is likely to exhibit considerably slower growth, but also a peak in inflation, which raises the prospects of a shift in domestic and foreign monetary policy. And it is this elimination of inflation and turning rate cycle that will usher in an eventual improvement in market sentiment and eventually the real economy. Even with growth slowing, we still look for growth to come close to (but below) 2% for the full-year 2023 (and not much more in 2024). On paper, that is still a fairly soft landing, though we concede that it could be harder, especially if we get a more violent correction in real estate prices than we are anticipating, or if financial markets fall more heavily. In this respect, the RBA's recent caution seems much better suited to the economic backdrop than a more hawkish "higher for longer" approach.

Summary forecast table

	4Q22	1Q23	2Q23	3Q23	4Q23	FY2022	FY2023	FY2024	FY2025
GDP (YoY%)	2.5	2.3	1.9	1.7	1.7	3.6	1.9	2.0	3.1
Inflation (YoY%)	6.8	5.4	4.4	3.1	2.8	6.3	3.9	2.5	2.7
House prices (YoY%)	-5.8	-9.5	-9.2	-5.9	-4.4	6.3	-7.3	0.8	3.4
Unemployment rate (%)	3.5	3.6	4.1	4.7	4.8	3.5	4.8	3.9	3.6

	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	4Q24	4Q25
Cash rate target	3.1	3.6	3.6	3.1	2.6	2.35	2.35	2.35	2.6
10Y bond yields	3.4	3.3	3	2.9	2.7	2.7	2.7	2.7	3.2
AUD	0.68	0.68	0.69	0.70	0.71	0.72	0.72	0.72	0.68

Source: CEIC, ING

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