Monday, 18 September 2023

Near Certain Fed Pause But Risks Remain

International developments will garner the most attention this week. The domestic data calendar is light. The key domestic release will be the minutes from the Reserve Bank's (RBA) September Board meeting tomorrow. Internationally, all eyes will be on the US Federal Reserve policy meeting and Fed Chair Jerome Powell's press conference afterwards. Decisions from other central banks will also be watched, including the Bank of England (BoE) and Bank of Japan (BoJ).

The RBA Board's September meeting was the final one for outgoing Governor Philip Lowe, who finished his 43-year career at the RBA on Friday last week. New Governor Michele Bullock begins her seven-year stint today.

The September meeting offered little in the way of surprises as economists and financial markets almost universally expected the RBA to extend its pause for a third consecutive month. The post-meeting statement also contained relatively minor changes. The RBA Board remains data dependent and continues to monitor the effects of the 400 basis points of tightening done to date.

While unlikely to be groundbreaking, the minutes from the meeting will be worth a look to gauge how the views of the Board are developing given the data flow in the lead up to the meeting. Economists will also be looking for hints to better understand how the Board are currently assessing the balance of risks, as inflation is slowing, but challenges remain and policy makers need to remain vigilant. Economic growth is also slowing materially and risks are becoming more balanced. This has been reflected in the RBA's recent communications, which have placed more emphasis on the downside risks to economic growth.

International

US Federal Reserve

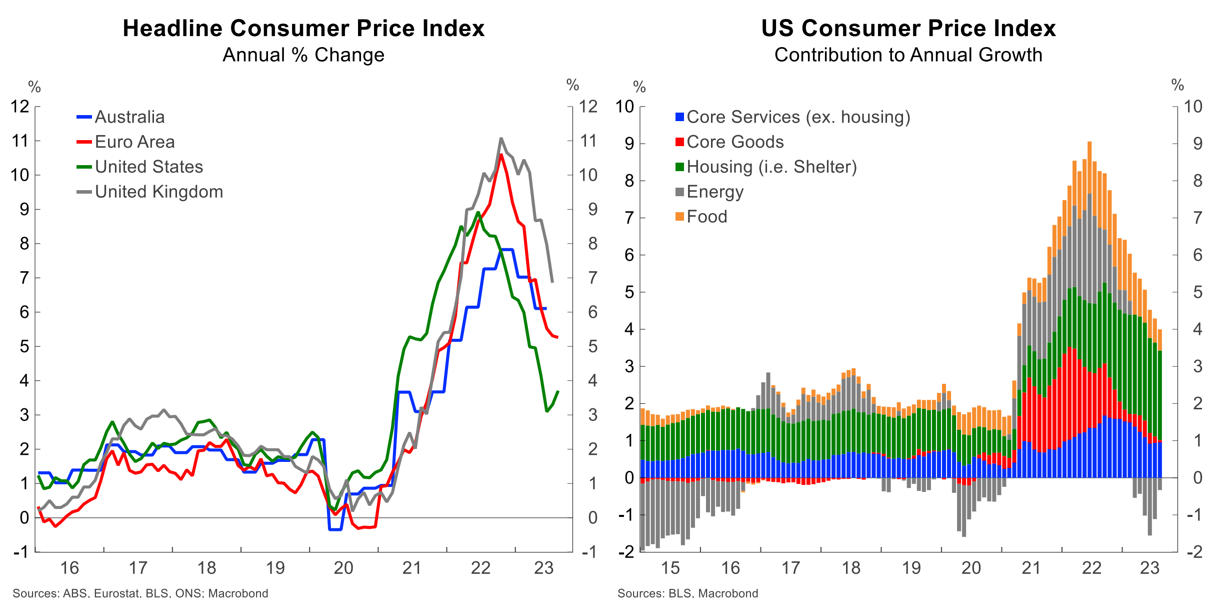
The key event will be the meeting of the Federal Reserve early Thursday morning AEST. The Fed is widely expected to keep rates on hold in the current 5.25% - 5.50% range (5.375% mid point). Indeed, of the more than 100 economists surveyed by Bloomberg recently, almost all expect this decision. Financial markets are also expecting rates to stay put, with effectively a 1% probability of a hike.

While an on-hold decision is all but a lock, that doesn't necessarily mean that there is no further risk of a hike. Financial markets currently attach a slightly more than 40% chance of one more hike by the end of 2023. In 2024, a minimum of three 25-basis-point cuts continue to be priced.

Our Group view is that the Fed will remain on hold from here and that cuts will be on the horizon from March next year. Our Group view is that there will be one 25-basis-point cut per quarter until the end of 2025.

While the Fed is expected to pause, a hiking bias will remain, as the work is not yet done and rates will need to remain in restrictive territory for some time.

The US has been leading this global cycle by around six months. US inflation has pulled back materially since peaking at 9.1% in June 2022, while the pullback is still underway across Europe, Australia and other developed economies. The disinflationary process has helped to bring inflation down. In particular, core goods (goods excluding food and energy) inflation has slowed materially and has made next to no contribution to annual headline inflation in the last few months. This reflects the unwinding of pandemic-era supply-chain disruptions, a gradual easing in labour market pressures, lower commodity prices after they peaked following Russia's invasion of Ukraine, and a better alignment of supply and demand as tighter monetary impacts the economy. Energy prices have been detracting from annual inflation over recent months, reflecting lower commodity prices. Food inflation has also slowed. These are all positive signs and have been expected.



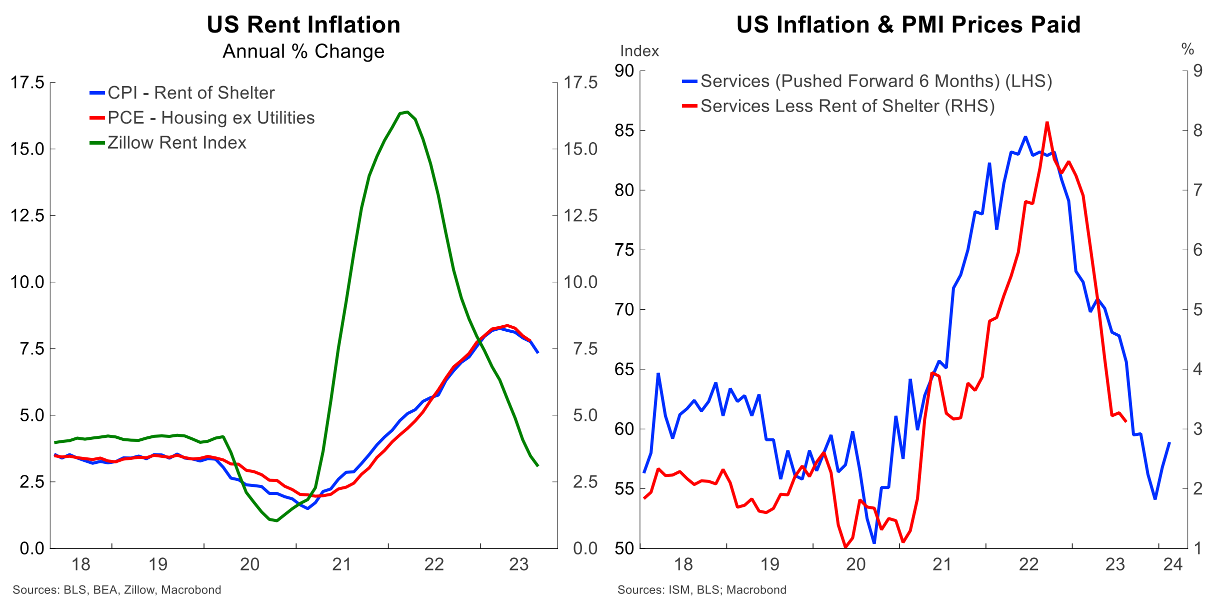
As we have been saying for quite some time, services inflation is the key challenge now and into the future. The prices of services are more reflective of domestic supply/demand conditions, rather than international factors as it is harder to trade services. The labour market has a bigger impact on services prices because labour is a major component to the costs of delivering services. The prices of services were also less impacted during the pandemic and are coming off a lower base. These factors all contribute to the stickiness of services inflation.

Indeed, housing inflation and core services ex. housing (i.e. services ex. food, energy & housing) are the key drivers of annual inflation at the moment. They are also likely to continue to be the main drivers going forward and are being closely watched by the Fed.

But there is some good news on the horizon. Leading indicators of rents and housing inflation show that market rent inflation has pulled back significantly. However, this takes time to flow through to shelter inflation. The shelter component measures all rents paid, not just those being negotiated now, in addition to owner-occupied imputed rents (i.e. the rent that owner-occupiers effectively pay themselves to live in their property). These dynamics create a considerable lag, such that the expected slowing in the shelter components will take time to appear.

On services more generally, prices paid by services firms from the Institute for Supply Management (ISM) Purchasing Managers' Index (PMI) are a good leading indicator of inflationary pressures. These typically lead inflation by around six months. This survey suggests that a

disinflationary process should continue for the next few quarters and that services inflation ex. housing should pull back further. However, recent surveys have reported an emerging and worrying uptick in price pressures. This shows that the US is certainly not out of the woods yet in tackling inflation and that risks of a re-acceleration of price pressures are not completely off the table. The Fed will be watching these and other leading indicators closely over coming months to ascertain whether services inflation is coming down as quickly as they would like and where it might settle.

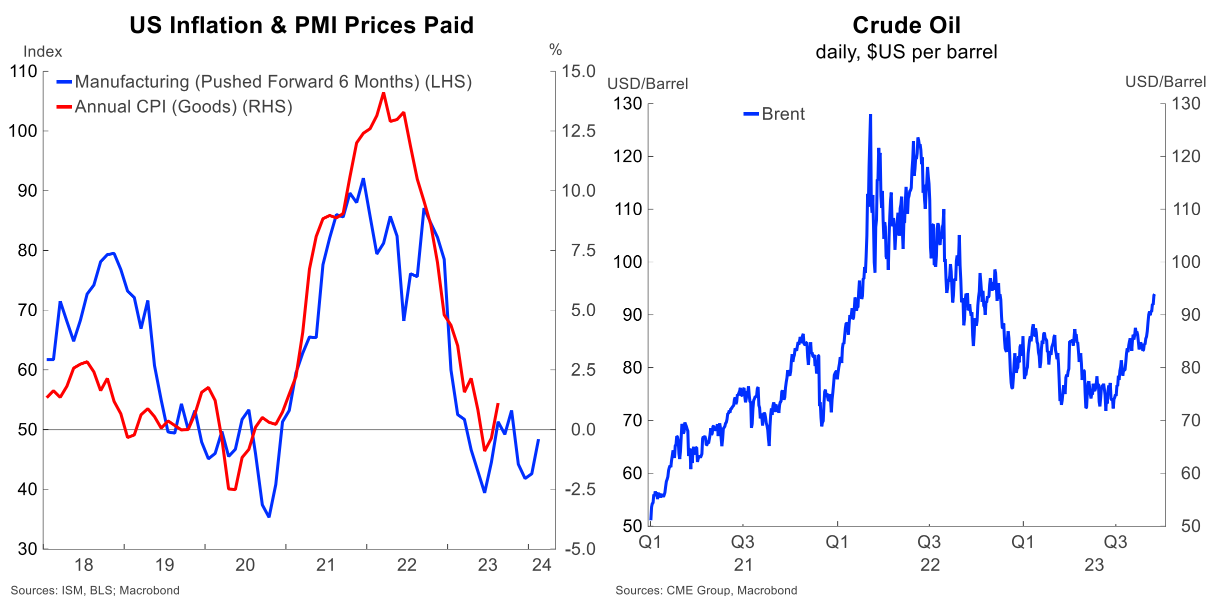


When it comes to the inflation outlook, there are some other risks worth monitoring. While goods disinflation has been a key component of slowing inflation so far, this process won't be working in our favour forever. Firstly, inflation is coming from a very high base. As a result, the annual pace falls rapidly due to base effects as high historical growth rates are replaced with lower current rates. But more importantly, the goods deflationary/disinflationary process will eventually run its course and prices will start increasing again in the future. When this occurs, goods prices will again add to inflationary pressures, rather than being neutral or even detracting as they currently are.

Some leading indicators point to the risk of this disinflationary process slowing. Prices paid from the ISM Manufacturing PMI are a good leading indicator of inflation. These predicted the significant slowdown in goods inflation that has been seen, as the manufacturing sector came under immense pressure in the US and globally from higher rates. However, over recent months, this indicator appears to have bottomed and has been moving sideways and input prices paid for manufacturing goods appears to be bottoming out. While goods prices are still contracting as prices paid remain below the neutral 50 level, the pace of contraction has slowed to a crawl.

The goods disinflationary process is facing other risks as well. Oil prices have risen rapidly over recent months, to over US$90 per barrel, from recent lows of around US$70 per barrel. Higher oil prices reflect a combination of restricted supply as OPEC+ nations, in particular, Saudi Arabia and Russia, have cut supply to bolster prices. Additionally, demand has remained more robust than previously expected as US economic growth has surprised to the upside. In the short term, oil prices mainly flow through to higher fuel prices for motorists and the transport industry. These show up in headline inflation but are stripped away from core measures, which are monitored more closely by central banks. However, given the importance of oil as an input to production, the longer prices remain elevated, the more risk there is of second-round effects and a spillover to

prices further down the supply chain. This is another area for central banks to monitor closely.



On top of this, food inflation may be more volatile in the period ahead as an expected El Niño weather pattern is likely to negatively impact global food production. This has the potential to negatively affect food prices in the US and other countries.

Overall, the picture is certainly much brighter than it was only a few months ago. Inflationary pressures are expected to continue to gradually recede and the illusive 'soft landing' looks to be coming into sharper focus as Jerome Powell and the Fed prepare to lower the landing gear. However, we cannot be complacent. These data are important reminders that the war is not yet won on inflation and that interest rates will need to remain higher for some time to confidently see inflation return to target.

<u>Other central banks</u>

The BoE is expected to hike rates by another 25 basis points as inflationary pressures are still prevalent in the UK economy. Despite anaemic economic growth, the UK continues to face challenges on the inflation front. The latest data showed that wages growth is still running at a solid clip after average weekly earnings (including bonuses) accelerated to 8.5% through the year to the July quarter. This upside surprise shows that wages continue to grow at a rate inconsistent with the BoE 2% inflation target. The BoE is in a tight spot as economic growth continues to weaken and the economy risks entering a recession.

On the other hand, the BoJ is expected to sit tight and maintain negative interest rates. The BoJ has recently opened the door to eventually walking back from its ultra-easy monetary policy once they become confident that inflation will sustainably remain around their target. A few months ago, the BoJ also increased the band around which they will tolerate 10-year bond yields fluctuating, as they very gradually shift policy. However, adjustments will be slow and it is expected to be some time yet before material changes are made.

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Group Forecasts

		2023	2024				2025
End Period:	**Close (15 Sep)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.10	4.10	4.10	3.85	3.60	3.35
90 Day BBSW, %	4.13	4.30	4.30	4.22	3.97	3.72	3.47
3 Year Swap, %	4.09	3.95	3.90	3.80	3.70	3.60	3.50
10 Year Bond, %	4.10	4.00	3.80	3.60	3.40	3.30	3.22
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.125	4.875	4.625	4.375	4.125
US 10 Year Bond, %	4.29	4.10	3.90	3.70	3.50	3.40	3.30
USD Exchange Rates:							
AUD-USD	0.6432	0.66	0.67	0.68	0.69	0.70	0.71
USD-JPY	147.85	144	142	140	138	136	133
EUR-USD	1.0657	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.2383	1.27	1.28	1.29	1.30	1.30	1.30
NZD-USD	0.5899	0.61	0.61	0.62	0.62	0.62	0.63
AUD Exchange Rates:							
AUD-USD	0.6432	0.66	0.67	0.68	0.69	0.70	0.71
AUD-EUR	0.6032	0.60	0.60	0.61	0.61	0.61	0.62
AUD-JPY	95.08	95.0	95.1	95.2	95.2	95.2	94.4
AUD-GBP	0.5195	0.52	0.52	0.53	0.53	0.54	0.55
AUD-NZD	1.0904	1.08	1.10	1.10	1.11	1.13	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.2	1.6
CPI (Headline), %	3.5	7.8	3.9	3.2
CPI (Trimmed mean), %	2.6	6.9	3.8	3.1
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.3	3.4	3.8	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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