Weekly Economic Outlook

Bank of Melbourne

Monday, 21 February 2022

Geopolitics Keep Oil Near 7½-Year Highs

Petrol prices at the pump are elevated across the country, driven by surging oil prices. World oil prices are edging closer to breaking the US$100 a barrel mark. In the past week, the West Texas Intermediate price for oil on the futures exchange has risen to $95.82 a barrel – the highest price since September of 2014. It is currently trading near this elevated level.

The recovery in world economic activity and depleted inventories have led to stronger demand for oil amid supply concerns. A soft supply response has also added upward momentum to oil.

The Organisation of Petroleum Exporting Countries (OPEC) made record cuts to production last year and pledged to unwind these this year. However, so far OPEC have under-delivered. Non OPEC producers are set to lift supply and some large economies like China are expected to release strategic reserves this year, while reserves have already been tapped in the United States. The International Energy Agency (IEA) predicts global supply could reach 6.4 million barrels per day this year if the remaining OPEC+ cuts are fully unwound. This would help address supply-demand imbalances and take some of the heat out of oil prices.

However, fears of an imminent Russian invasion of Ukraine remain heightened, fuelling concerns that oil supply will be disrupted. Russia is one of the world's largest oil producers. The conflict could mean the supply response will be slow, leaving oil prices higher for longer.

Higher fuel prices have contributed to rising inflationary pressures around the world, including in Australia. The last inflation report revealed consumer prices rose by 3.5% in the year to the December quarter. One of the biggest catalysts for the spike was automotive fuels, which jumped 6.6% in the December quarter and 32.3% in the year – it was the sharpest annual gain in 31 years.

Underlying inflation pressures have also been mounting amid a tightening labour market. The combination of elevated inflation and low unemployment means the Reserve Bank (RBA) has little room for error. The RBA Governor in recent speeches has stressed he is prepared to be patient in raising rates and he has singled out wages as one of the key reasons for this patience.

The RBA wonders if there is a sort of inertia attached to wage-setting in Australia, such that wage pressures may be slow to build up. The RBA expects wages growth to reach the 'magic' 3% per annum figure in the June quarter of next year; we think it will be reached around one year earlier, necessitating the need for the RBA to start raising rates in August. An earlier move can't be ruled out. Much will depend on the wages report out this Wednesday.

We expect the wage price index to rise by 0.7% in the December quarter, pushing up the annual rate to 2.3% - which would be the highest annual pace in 2½ years, but still modest. A much stronger outcome would fuel expectations the RBA could move earlier rather than later and lead to more upward pressure on short-dated swap and bond rates.

Interest-rate markets have less aggressive pricing for the RBA this year than most other major central banks. Markets are pricing the US Fed to move 5.8 times, the UK's Bank of England to move 5.3 times, Canada's Bank of Canada to hike 6.7 times and Eurozone's European Central Bank to tighten 4.0 times. New Zealand leads the pack with cash-rate futures pricing in almost 7.0 rate hikes this year. In comparison, cash-rate futures are pricing in 4.6 rate hikes for the RBA this year.

Certainly, customer liaison and business surveys reveal staff shortages remain an ongoing issue. Finding the right type of labour is also an issue. International borders reopened today and could help alleviate some staff shortages, but stronger demand with the economy awash with liquidity suggests borders are not the whole story.

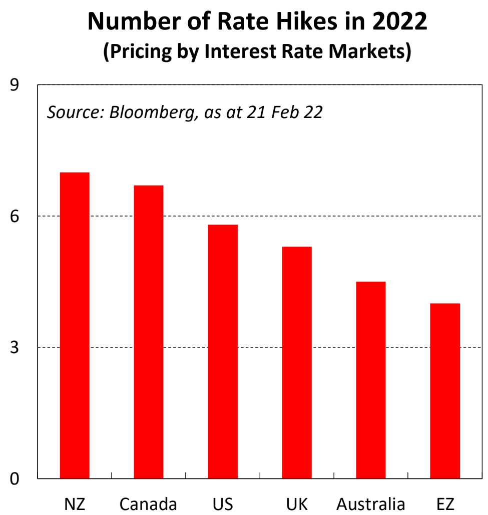
Staff shortages are an ongoing concern for businesses, as are supply-chain disruptions and building inflationary pressures. Nevertheless, businesses have remained relatively resilient through the Omicron wave. Hospitalisations peaked in mid January, coinciding with a trough in consumer and business sentiment in more recent times.

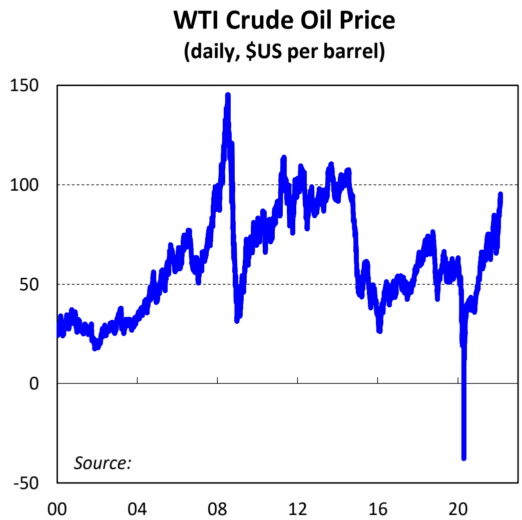
There is evidence of an upswing resuming in business spending and business credit growth. On Thursday, we receive an update on actual spending done by businesses in the December quarter and their updated plans for the current and 2022/23 financial years.

Business spending has been underpinning by underlying strength in demand and the availability of generous government incentives (namely the loss carry back and instant asset write-off schemes). We expect new private capital expenditure (CAPEX) rose 3.0% in the December quarter, which would more than recover the Delta-lockdown-related fall of 2.2% in the September quarter. Such an outcome would take annual growth to 11%.

On business plans, we expect the fifth estimate for 2021/22 to come in at $140 billion, a modest increase from the fourth estimate. That would mean a lift in CAPEX of around 13% on 2020/21 – a solid result. For 2022/23, we receive the very first estimate. There are six estimates published (a new one each quarter) before the actual outcome is printed. We expect the first estimate to land at $122 billion, up 16% on the first estimate in the previous year and suggesting about a 10% lift in business investment for 2022/23 compared to 2021/22.

CAPEX will give us some pieces of the GDP puzzle. GDP for the December quarter is out early next week. Another release that will give us a piece of the puzzle is construction work done – out Wednesday. Construction activity was robust throughout last year, supported by very low rates and the HomeBuilder scheme. The Delta lockdowns during the September quarter temporarily slowed the construction sector upswing. With the reopening of the economy, the uptrend in work likely resumed in the December quarter. We anticipate a 2.5% lift in construction work in Q4, after a slight drop of 0.3% in the September quarter.





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Forecasts

		2022				2023	
End Period:	**Close (18 Feb)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.25	0.50	0.75	1.00
90 Day BBSW, %	0.08	0.10	0.10	0.35	0.60	0.95	1.20
3 Year Swap, %	1.88	1.75	1.75	1.80	1.90	2.00	2.10
10 Year Bond, %	2.23	2.15	2.40	2.40	2.50	2.50	2.40
US Interest Rates:							
Fed Funds Rate, %	0.125	0.375	0.625	0.875	1.125	1.375	1.625
US 10 Year Bond, %	2.02	2.00	2.30	2.40	2.50	2.50	2.40
USD Exchange Rates:							
AUD-USD	0.7195	0.70	0.70	0.71	0.73	0.75	0.76
USD-JPY	115.19	116	117	117	118	118	119
EUR-USD	1.1368	1.13	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.3604	1.36	1.37	1.38	1.38	1.38	1.37
NZD-USD	0.6707	0.65	0.65	0.66	0.68	0.69	0.70
AUD Exchange Rates:							
AUD-USD	0.7195	0.70	0.70	0.71	0.73	0.75	0.76
AUD-EUR	0.6329	0.62	0.63	0.63	0.65	0.66	0.66
AUD-JPY	82.879	81.2	81.9	83.1	86.1	88.5	90.4
AUD-GBP	0.5289	0.51	0.51	0.51	0.53	0.54	0.55
AUD-NZD	1.0729	1.08	1.08	1.08	1.08	1.09	1.09

	2020	**2021 (f)**	**2022 (f)**	**2023 (f)**
GDP, %	-0.8	3.2	5.5	2.7
CPI (Headline), %	0.9	3.5	3.3	2.5
CPI (Trimmed mean), %	1.2	2.6	3.3	2.5
Unemployment Rate, %	6.8	4.7	3.8	3.9
Wages Growth, %	1.4	2.3	3.2	3.5

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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