Weekly Economic Outlook

Bank of Melbourne

Monday, 24 January 2022

“May You Live in Interesting Times”

- **The last Venice Biennale was inauspiciously titled “May You Live in Interesting Times”. The expression “interesting times” evoked the idea of challenging or even “menacing” times. By the time the Biennale ended in November 2019, a pandemic was almost upon us.**
- **Consumers and businesses have had to adapt. Economists have also had to adapt because forecasting has become more uncertain than any time in our lives. And indeed, events over recent months warrant an update to our forecasts.**
- **Our central view is that a rate-hike cycle in Australia will start in August this year with a move of 15 basis points. A 25 basis point hike should follow in November 2022.**
- **More tightening in 2023 is likely, with the cash rate peaking at 1.75%.**
- **Employment has picked up much faster than forecast by the RBA. An unemployment rate below 4% is on the cards later this year and wage pressures are building with ongoing staff shortages. The unemployment rate has not flirted with a ‘3’ in front on a sustained basis since the 1970s!**
- **Relatedly, we expect a further lift in consumer-price inflation. By August, we expect to have observed several quarters of underlying inflation in the RBA’s 2-3% per annum target band and two quarters in the upper part of this band. This is a critical hurdle for the RBA to lift rates and is consistent with our view that the RBA will start tapping the brakes in August 2022.**
- **Given the fast rebound in late 2021, our GDP forecast for 2021 has been revised up to 3.2%. And reflecting the ‘shadow lockdown’ underpinned by Omicron, we’ve pared our 2022 GDP forecast to 5.6%. That remains a solid pace of growth, but has downside risks attached to it.**
- **We expect the US Federal Reserve to hike four times this year, kicking off in March. The Fed meets this week with a decision revealed on Thursday morning AEDT.**
- **We expect the Fed Chair to signal strongly that lift off is in March. Inflation in the US has reached record levels, according to some metrics.**
- **Australian swap and bond rates will be pressured higher over this year, although there is some room for shorter-dated swap rates to pull back given the very aggressive RBA tightening priced in this year by markets.**

The last international trip I took was in September of 2019. As part of that trip, my family and I visited Venice to see its Biennale. I've often thought back to this Biennale and how art (not economics) foreshadowed what would soon strike the world.

This international art exhibition was inauspiciously titled "May You Live in Interesting Times". The President of the Biennale said the expression "interesting times" evoked the idea of challenging or even "menacing" times, but it could also be an invitation to see and consider the course of human events in their complexity. By the time the Biennale ended in November 2019, a pandemic was almost upon us.

We are still in the grips of this pandemic more than two years later. The vaccines were seen to be a holy grail. And whilst they have helped, they are not yet the antidote the world was hoping for. Medical advances are progressing every day. The hope is that future variants will be less severe and future vaccines will be more effective.

Businesses and consumers have had to adapt. Some businesses have not survived; I've been disappointed to see more vacant shopfronts over the past two months.

Economists have also had to adapt. Economic forecasting is never an exact science, but it is a particularly humbling experience during a pandemic. Our forecasts have changed throughout the pandemic, alongside the changes in virus and the government's response.

And indeed, they have changed following the developments over recent months. In this report, we lay out our updated views for 2022.

Reserve Bank of Australia

A reality that is approaching is the start of a rate-hike cycle by the Reserve Bank (RBA). The RBA is not alone. Other central banks in the major economies are also set to raise rates this year. The Bank of England and the Reserve Bank of New Zealand kicked off tightening last year. The US Federal Reserve and Bank of Canada are likely to start soon.

The RBA cut the cash rate to a historical low of 0.10% in November 2020. It has remained there since. And since late 2020, the RBA has mostly held its line that the cash rate would not be rising until 2024 at the earliest. This rhetoric softened over the second half of last year, as signs of inflationary pressures continued to build.

Unconventional monetary policy measures have already been pared. Yield curve control, which involved the RBA buying bonds to target a rate of around 0.10% on the 3-year government bond yield, has been dropped. The government bond-buying program of maturities between 5 and 10 years has been cut back and is set to be scrapped when the RBA meets next month.

Our house view since June 2021 was that the RBA would first lift the cash rate in early 2023. For several months we have been flagging the risk that the start of the rate-hike cycle could come sooner, in the second half of 2022.

Given developments over recent months, our central view now is that the first rate hike of 15 basis points will come in August 2022. A rate hike of 25 basis points should follow in November 2022, taking the cash rate to 0.50% at the end of 2022.

More tightening in 2023 will occur, with cash rate peaking in this tightening cycle at 1.75%.

Interest-rate markets are pricing in more aggressive tightening; they're fully pricing in three rate hikes totalling 75 basis points by early November. It is reflected in a probability of 314% attached to a 25 basis point hike in November (using Friday's close of 30-day cash-rate futures data).

What is Driving our RBA View?

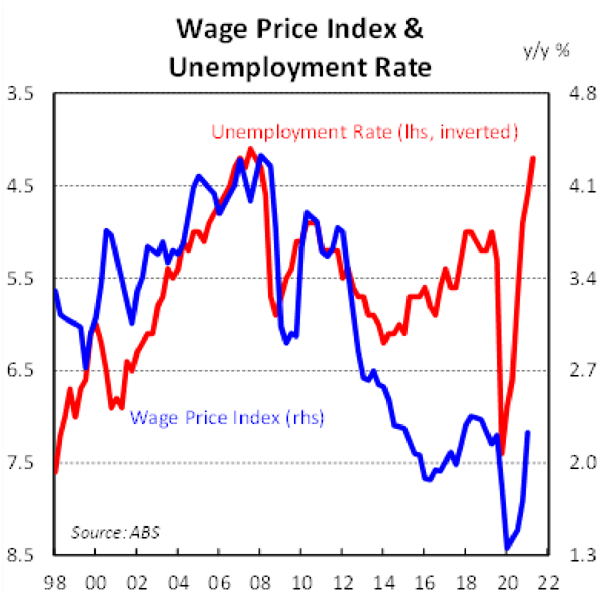
Labour Market Tightening

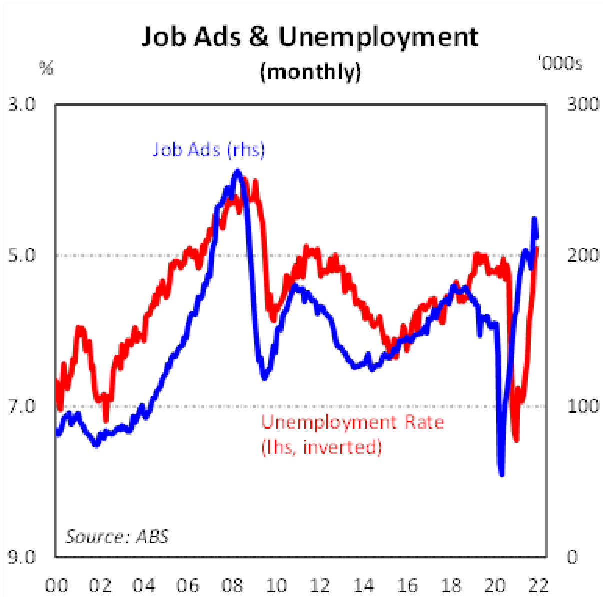
The RBA will be guided critically by its actual and expected progress towards the goals of full employment and inflation.

The jobs market has tightened faster than anticipated by policymakers. The unemployment rate in December fell to 4.2% - well under the 4.75% forecast by the RBA. And December 2021's rate of 4.2% is only a 'smidgen' under where the RBA has forecast unemployment to be at the end of 2022!

The Reserve Bank estimates full employment in the economy is around 4%. At full employment, wage pressures are likely to accelerate. The unemployment rate in Australia is set to have a '3' in front of it later this year. Australia has not witnessed a sustained rate of unemployment under 4% since the 1970s!

Wages growth in Australia has trended down since 2012. Annual wages growth, using the wage price index measure, troughed at a record low of 1.4% in the September quarter of 2020. Wages growth lifted to 2.2% in the September quarter of 2021, returning to around the rates prevailing before the pandemic. While annual wages growth is still low, the rapid tightening of the jobs market and widespread staff shortages, are likely to drive wages growth higher.





The 'line in the sand' for annual wages growth is 3%. The RBA has outlined it expects we need wages growth over 3% to see inflation sustainably in the 2–3% per annum target band.

The important point is that with the jobs market tightening fast and staff shortages widespread, wages growth is likely to continue to rise.

Staff shortages have been prevalent for some time. Our business customers as far back as late 2019 were reporting issues with labour shortages and finding the right type of labour. In October of last year, an internal survey of 1,000 of our business customers revealed 72% of business leaders anticipated they would be raising wages over the next 12 months. More recently, shortages have been exacerbated by absenteeism from surging COVID-19 infections, which have forced millions of Australians into isolation.

Considering these factors, we expect wages growth to pierce 3% in the second half of this year.

Inflation Pressures

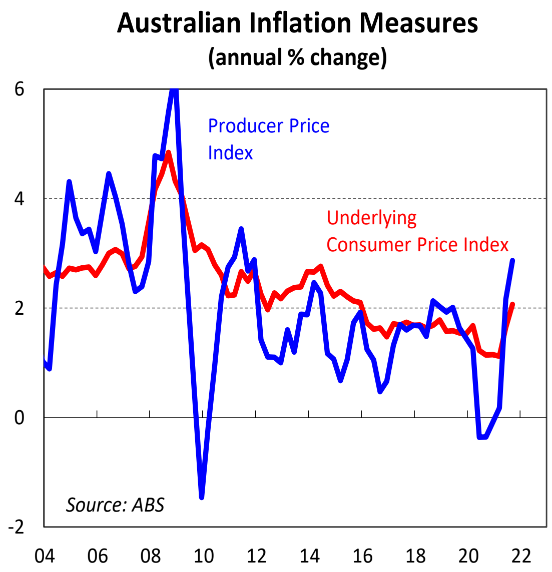
The expected pick-up in wages growth is likely to be associated with a further lift in consumer-price inflation.

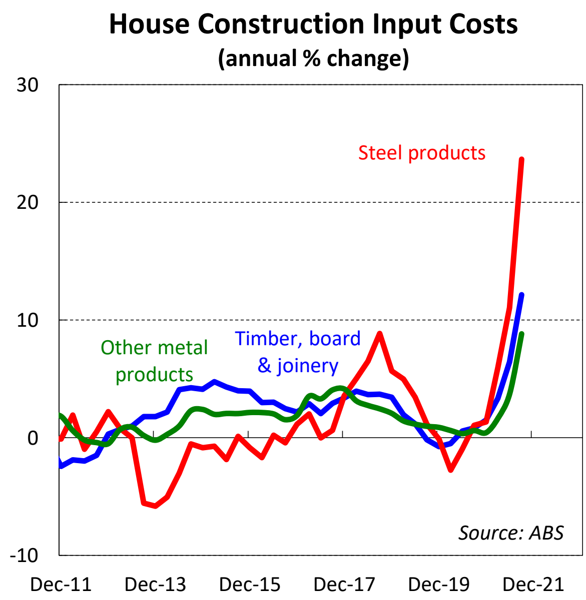
Concerns about inflation have moved to the centre of people's radars. Again, this is not isolated to Australia. In many major economies around the world, inflation has moved up sharply, after undershooting inflation targets for a long time.

The pace of consumer price inflation in Australia has been picking up over the past few quarters. Inflationary pressures in the wholesale pipeline have also been growing at a faster pace, which means businesses that are not passing on these higher costs have been a facing margin squeeze. Many businesses were absorbing these price pressures last year. But customer liaison and anecdotes suggest these price pressures are now increasingly being passed on.

Supply-chain disruptions, which include stock shortages, have added to the price pressures. A good example of these pressures is evident in the higher cost of building a new home. Late last year, our business customers revealed shortages of pallets, timber and other inputs into housing construction were an issue. Many businesses are now having to order with significantly longer lead times.

Tomorrow, we receive an update on the consumer price index (CPI) for the December quarter. We expect prices grew 0.7% in underlying terms, to take annual inflation to 2.4%. In the September quarter, underlying inflation rose to 2.1% in annual terms. It was the first time underlying inflation had entered the RBA's 2-3% per annum target band in almost 6 years.



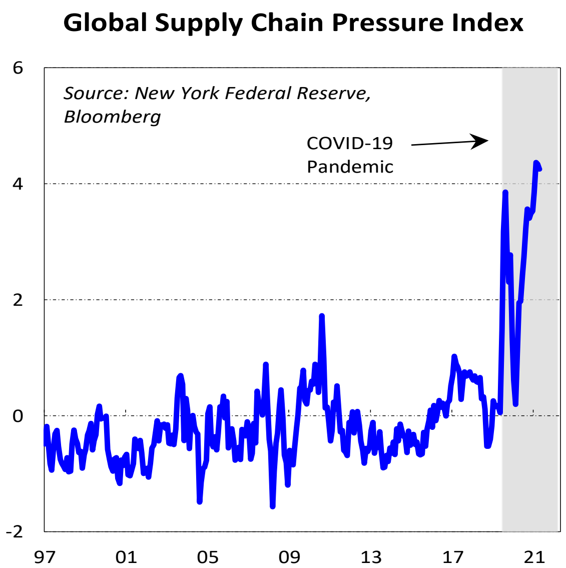


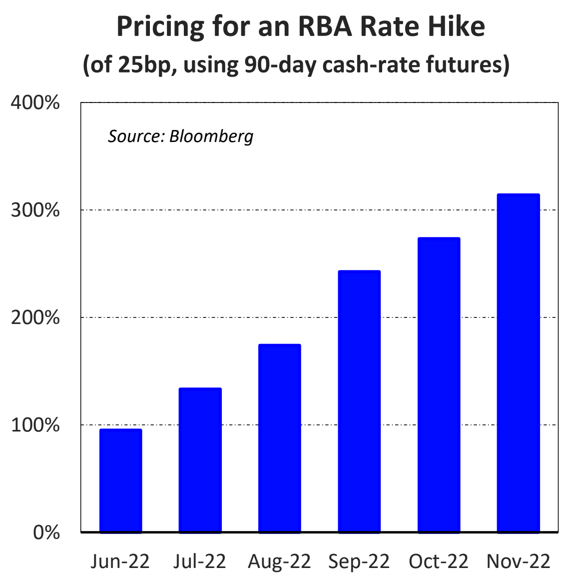
An outcome in line with our forecasts means the RBA is making faster-than-expected progress towards its inflation target, warranting an earlier move in the cash rate.

The RBA Governor, in a speech in September 2021, gave us very important clues as to what would move the dial on the cash rate. He stressed that the RBA would not increase the cash rate until inflation is "sustainably" in the target range. What does sustainably mean? Well, Lowe added that "it won't be enough for inflation to just sneak across the 2 per cent line for a quarter or two. We want to see inflation around the middle of the target range and have reasonable confidence that inflation will not fall below the 2–3 per cent band again."

Our house forecasts outline underlying annual inflation reaching 2.6% in the March quarter and 2.9% in the June quarter. This would mean by the time of the August board meeting, the RBA would have observed several quarters where it had achieved its inflation target. It would also have observed two quarters of underlying inflation in the upper part of the band. Such outcomes set up what's needed for the RBA to start moving the dial on the cash rate.

The other question on everyone's lips is when will supply-chain disruptions end? In November last year, we published a report on supply chains. The supply-chain disruptions and accompanying price pressures are being spurred by very strong demand for goods, combined with a hit to productive capacity. Back then, we flagged that supply-chain disruptions and delays in deliveries are likely to persist in some form for at least another 12 months. With the Omicron wave and the potential for further spikes in infections come winter, at least 12 months remains a reasonable timeframe.





The US Federal Reserve

Another key factor for the RBA's outlook is the actions of other central banks. The RBA is eyeing the US Federal Reserve carefully. One reason is because the actions of the US Federal Reserve influence the US dollar heavily, and by consequence, the Australian dollar's value against the US dollar.

If the RBA were to scrap its bond-buying program and start raising rates ahead of the Fed, the Australian dollar's value could soar, in turn putting pressure on Australia's exporters.

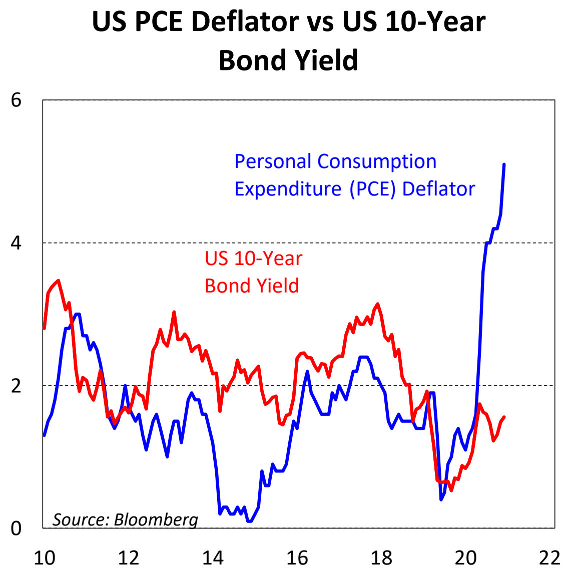
We anticipate the US Federal Reserve is set to hike its Federal Funds Rate four times this year, with the first rate hike of 25 basis points likely in March, ahead of the RBA.

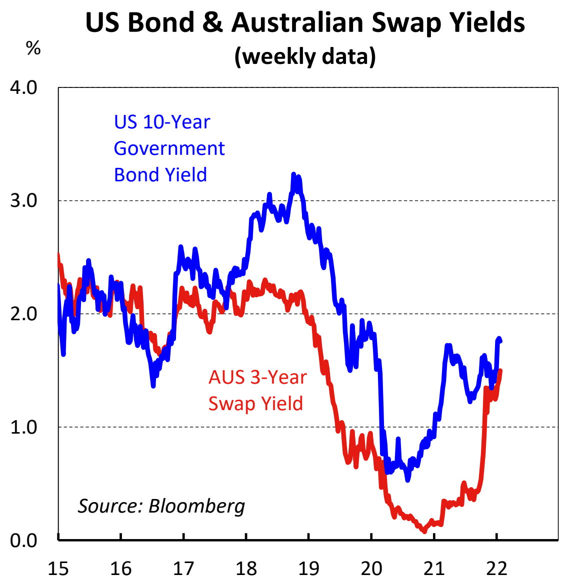
US unemployment has fallen dramatically in the US and inflation pressures have mounted. Indeed, US headline inflation hit 7% in December – the highest rate since June 1982. The Fed's more closely-watched inflation measure is the personal consumption expenditure (PCE) deflator. It rose to a record high of 5.7% in November. The core PCE deflator, which excludes volatile items such as food and energy, also lifted to a record high, of 4.7%.

Throughout much of 2021, Federal Reserve Chair Jerome Powell characterised inflationary pressures as "transitory". So did many other central bankers, including our own Phillip Lowe. But more recently, Powell and other central bankers have tweaked their language, acknowledging that inflationary pressures may be more persistent than they initially expected.

The Federal Reserve meets Wednesday for a two-day meeting; the outcome of their meeting will be known at 6am on Thursday AEDT. We expect they will send a strong signal that a rate-hike cycle will start in March. We expect the Fed Funds rate to hit 1.125% by the end of this year and 1.875% by the end of next year.

Some market participants are expecting the Fed to abolish its bond-buying program this week and rate hikes to start this week. Other participants expect the first rate rate hike to be 50 basis points (rather than 25 basis points). These are not our core views, which means there might be some potential for share markets and bond prices to post a 'relief rally' after the Fed's statement on Thursday morning AEDT if our views come to fruition.





And with the Fed moving in March, this gives the RBA room to follow without causing an unwelcome appreciation in the Aussie dollar.

Economic Outlook

The economy embarked on a V-shaped recovery in the December quarter, after NSW and Victoria emerged from lockdowns. Consumer spending had considerable momentum driven by pent-up demand, high household savings, rising wages as companies scramble for scarce workers, low interest rates and the strong housing market. A bring forward of Christmas shopping and Black Friday and Cyber Monday sales also spurred the recovery.

Given the strength of the rebound, we've revised up our growth forecast for 2021 to 3.2%, from 2.8%. The GDP figures for calendar year 2021 will be published by the Australian Bureau of Statistics on March 2.

However, this year, the recovery has paused as infections and hospitalisations accelerated to record high levels. The emergence of Omicron has led to a spike in uncertainty and caution. Various consumer surveys attest to the impact of Omicron on sentiment. The Roy Morgan survey showed consumer sentiment plunged 7.6% in the week ending November 16, the biggest fall since March 2020.

Surging case numbers have underpinned a 'shadow lockdown'. Millions of Australians have been forced to isolate after contracting the virus or being identified as close contacts. Many others have been more cautious about leaving home.

Subsequently, consumer spending has taken a temporary hit, reflected in high frequency indicators such credit card and mobility data. Google mobility data reveals foot traffic has dropped sharply at retail and recreation outlets. As of 16 January, foot traffic in retail and recreation venues has dropped 6% compared to the end of December 2021 and is 13% down on pre-pandemic levels. In addition, supply bottlenecks have been exacerbated.

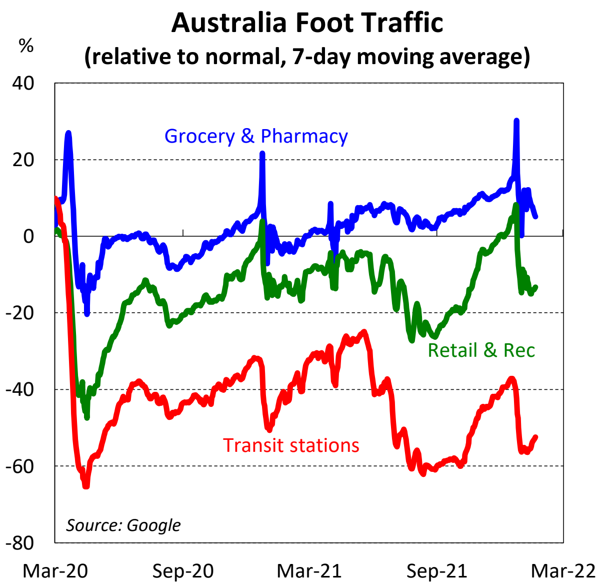
The Federal and state governments expect infections in this current wave to peak at the end of January. After infections peak, we expect a recovery in activity, including spending, to flow through to the economy. This recovery is likely to come through in February or March.

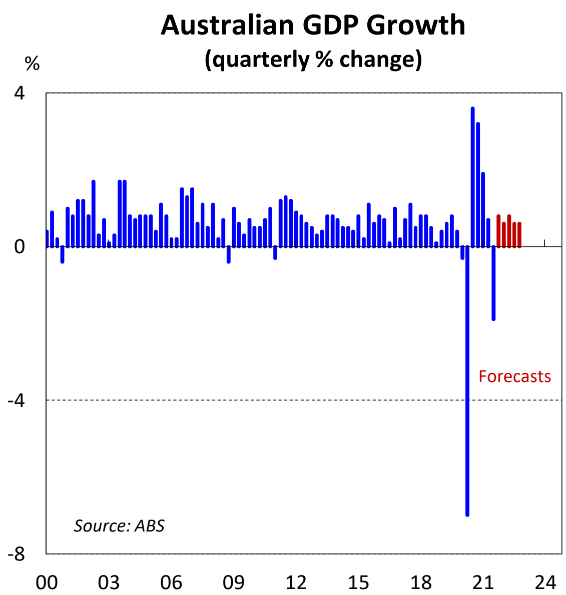
On this basis, we expect GDP growth will be flat in the March quarter of 2022, as the recovery over February and March offsets the weakness in January.

Therefore, we have cut our GDP forecasts for this year to 5.5%, from 6.4%. This rate of growth is still very solid, at more than twice the long-run average. In 2023, we are anticipating GDP to grow 2.7%.

In terms of the balance of risks to our GDP forecasts, the risks lie to a softer GDP outcome this year. The downside risk is due to the possibility of another wave of infections in the winter season, although medicine is advancing and the roll out of a fourth jab is being trialled already in Israel.

When the rate hike cycle starts in Australia, the air will be taken out of the sails of the housing market. Dwelling price growth is likely to soften, which will pare back some of the wealth gains for homeowners. The ascent of share markets are also likely to become more fragile with companies facing higher borrowing costs and inflationary pressures.





Swap and Bond Rates

With the Fed raising rates as early as March and the RBA expected to follow in August, we expect Australian swap and bond rates to be pressured higher. Indeed, there is a close correlation between US and Australian long-end yields, and the inflation story in the US suggests US bond yields are headed higher.

We expect the 3-year swap rate in Australia to end this year at 1.50%, from 1.48% Friday's close, and the Australian 10-year yield to finish at 2.50%, from Friday's close of 1.91%.

Shorter-end yields have some room to pull back modestly in the first half of this year, given the very aggressive tightening priced in by markets for this year versus what we think will transpire.

Businesses

Businesses are facing fresh challenges with the rise of Omicron. They have the triple whammy of rising prices, staff shortages and supply-chain disruptions. Many businesses have been resilient throughout 2020 and 2021 by adapting and pivoting their operations. However, this resilience is being tested again.

Some businesses have been forced limit their trading hours because of the number of staff in isolation. Other businesses have had to close stores altogether. However, these pressures are expected ease as case numbers drop.

Customer liaison suggests some businesses are calling on relief, albeit this relief is short term of 30-90 days. Business cash deposits for our customers have also lifted in the first half of January, although only modestly. It does not suggest businesses are rushing to hoard cash or build liquidity buffers due to higher uncertainty in the economy. If we assume cash balances in mid January remain the same at the end of the month, the lift in cash balances was larger in June 2021 when NSW entered lockdown. That lockdown was soon followed by a lockdown in Victoria.

A recent poll of members of The Australian Retailers Association (ARA) found that 76% of retailers currently have staff in isolation, highlighting some of the challenges facing businesses currently.

It is too early to throw the baby out with the bath water. Australia's economy and businesses have continued to prove their mettle under challenging circumstances. This time is not likely to be any different.

Government support measures for businesses remain available, in particular, the instant asset-write off and loss carry-back schemes (to end June 2023). Press reports suggest more support is forthcoming, at least in NSW – the hardest hit state alongside Victoria. The package is expected to be like the previous Job Saver assistance scheme, which gave fortnightly payments for small and medium sized businesses. Other measures in the package could include business support grants, payroll tax abatement and waivers. Interest rates are low. The residential property cycle is in an upswing and there are plenty of infrastructure projects in the pipeline underpinning activity, jobs and businesses.

There is no doubt the near-term will be challenging for the economy and businesses. But beyond this period, the economic outlook is brighter.

The Milk of Dreams

Will art once again give us some direction? This year's Venice Biennale is titled The Milk of Dreams. It suggests a world that can be set free, brimming with possibilities. Let's hope it predicts 2022 as the year the pandemic loses its grip on the world.

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Forecasts

		2022				2023	
End Period:	**Close (21 Jan)**	**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, %	0.07	0.10	0.10	0.35	0.60	0.95	1.20
3 Year Swap, %	1.48	1.50	1.45	1.45	1.50	1.50	1.70
10 Year Bond, %	1.91	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, %	1.76	2.00	2.30	2.40	2.50	2.50	2.40
USD Exchange Rates:							
AUD-USD	0.7198	0.71	0.70	0.71	0.73	0.75	0.76
USD-JPY	113.71	116	116	117	117	118	118
EUR-USD	1.1328	1.10	1.08	1.09	1.10	1.11	1.12
GBP-USD	1.3597	1.36	1.37	1.38	1.38	1.37	1.37
NZD-USD	0.6737	0.67	0.66	0.67	0.69	0.70	0.71
AUD Exchange Rates:							
AUD-USD	0.7198	0.71	0.70	0.71	0.73	0.75	0.76
AUD-EUR	0.6354	0.65	0.65	0.65	0.66	0.68	0.68
AUD-JPY	81.848	82.4	81.2	83.1	85.4	88.5	89.7
AUD-GBP	0.5294	0.52	0.51	0.51	0.53	0.55	0.55
AUD-NZD	1.0685	1.06	1.06	1.06	1.06	1.07	1.07

	2020	**2021 (f)**	**2022 (f)**	**2023 (f)**
GDP, %	-0.8	3.2	5.5	2.7
CPI (Headline), %	0.9	3.2	2.6	2.7
CPI (Trimmed mean), %	1.1	2.4	2.8	2.8
Unemployment Rate, %	6.8	4.7	3.8	3.9
Wages Growth, %	1.4	2.3	3.1	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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