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# THE FORWARD VIEW: AUSTRALIA MAY 2022

## RATES TO RISE FURTHER AS STRONG GROWTH CONTINUES

## OVERVIEW

- **We continue to be optimistic on the economy as we move further past the domestic disruptions to activity over the past couple of years. We see ongoing above trend growth this year and ongoing strength in the labour market. However, this comes with the challenge of high inflation in the near-term and growing uncertainty over global growth.**
- **The key changes to our forecast this month include modest markups to both our inflation and cash rate profiles – incorporating the larger than expected cash rate increase last week and bringing forward an additional hike into 2024. Our outlook for activity and the labour market are largely unchanged.**
- **GDP is still expected to grow by a strong 3.4% this year. We see a moderation in growth to 2.1% over 2023 and close to trend growth of 2.2% over 2024. That sees the level of GDP broadly around its pre-pandemic path.**
- **As a result, we see further gains in employment and further falls in the unemployment rate through 2022. We see an imminent decline in the unemployment rate to below 4% - reaching a 3.5% low in Q3 and staying there for much of the next year. We expect the unemployment rate to drift up slightly at the end of the forecast period but remain historically low.**
- **We now see slightly stronger inflation prints over the next two quarters, which sees underlying inflation reaching 4.6% y/y by Q3 before moderating over the out years – 4.5% y/y at end 2022, 2.9% y/y at end 2023 and 2.7% y/y by end 2024.**
- **The RBA surprised somewhat in May by lifting the cash rate by 25bps to 0.35% (rather than 15bps to 0.25%). This is likely to be the first of a series of hikes over coming months which we expect will see the cash rate target rise to 1.35% by the end of the year, before continuing to rise over 2023 and 2024 – reaching 2.6% by the end of our forecast period.**
- **The key near-term risks to our forecasts on both activity and prices continue to be international factors – with growing concerns over global growth, renewed lockdowns in China and considerable uncertainty over the normalisation of supply chains and commodity prices. Further out, the ongoing normalisation of goods and services spending and international trade remains a key unknown.**
- **With the RBA beginning a new hiking phase, higher interest rates will begin to impact activity and prices through a number of channels. With rates only rising for the first time since 2010 there may be added uncertainty around the speed and magnitude of these reactions. However, a number of sectors will likely face significant adjustments as the RBA begins to remove the exceptional stimulus provided during the pandemic.**

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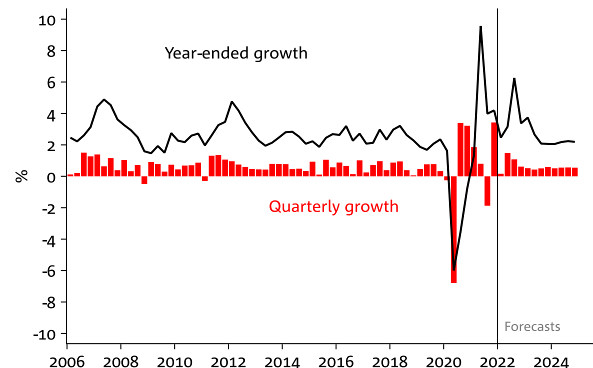
## KEY ECONOMIC FORECASTS

| | 2021 | 2022-F | 2023-F | 2024-F |
|---|---|---|---|---|
| Domestic Demand (a) | 5.9 | 5.7 | 3.5 | 2.7 |
| **Real GDP (annual average)** | **4.7** | **3.8** | **2.6** | **2.2** |
| **Real GDP (year-ended to Dec)** | **4.2** | **3.4** | **2.1** | **2.2** |
| Terms of Trade (a) | 17.7 | 3.7 | -3.9 | -5.9 |
| Employment (a) | 3.4 | 4.2 | 2.3 | 1.1 |
| Unemployment Rate (b) | 4.7 | 3.5 | 3.5 | 3.8 |
| Headline CPI (b) | 3.5 | 5.3 | 2.7 | 2.6 |
| Core CPI (b) | 2.6 | 4.5 | 2.9 | 2.7 |
| RBA Cash Rate (b) | 0.10 | 1.35 | 2.10 | 2.60 |
| $A/US cents (b) | 0.73 | 0.72 | 0.76 | 0.76 |

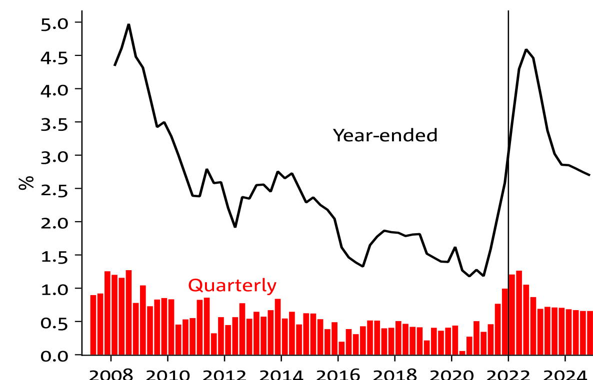
(a) annual average growth, (b) end-period, (c) through the year inflation

## GDP FORECASTS




Source: National Australia Bank, Australian Bureau of Statistics

## UNDERLYING CPI FORECASTS




Source: National Australia Bank

Gareth Spence, Senior Economist | Antony Kelly, Senior Economist | Brody Viney – Senior Economist | Alan Oster, Chief Economist

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# LABOUR MARKET, WAGES AND CONSUMER

**The labour market remained strong in March, with the unemployment rate set to fall below 4% imminently and much anticipated Q1 wage data expected to show a gradual pickup to 2.5% y/y.**

After several months of strong jobs growth, March saw employment inch higher (up 0.1%) and participation steady. That left the unemployment rate at 4% although in unrounded terms the figure was 3.954%, technically breaking the 4% barrier. With job vacancies and job ads still high, further gains are imminent. We see unemployment reaching around 3.5% by around the middle of the year.

With the labour market so tight, attention is now focused on indicators of wage growth for Q1, with the WPI to be released on May 18 and National Accounts to follow on June 1. Anecdotal reports suggest wages growth is picking up as firms compete for increasingly scarce labour, although the nature of the WPI (which excludes bonuses, changes in hours, and job changes) means it will most likely pick up more slowly than broader labour cost measures.

We expect the WPI to print at around 0.7% q/q (2.5% y/y). That would represent a slight pickup after a soft 0.7% (0.65% unrounded) in Q4. With unemployment to remain low, we see wage growth continuing to edge higher over the year, likely passing 3% y/y around December – a rate of wage growth not seen in over a decade.

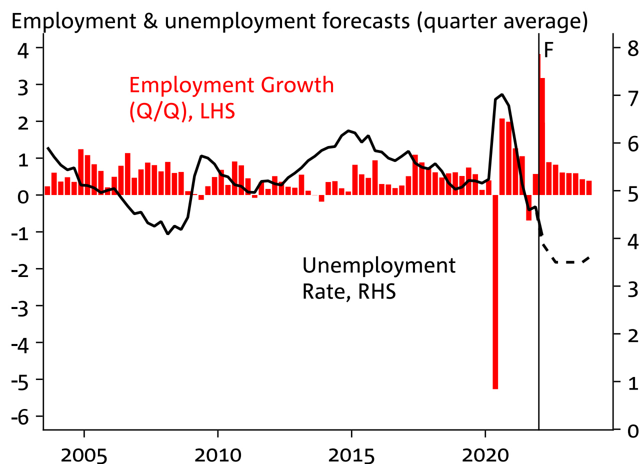
**Indicators of consumption growth continue to point to spending holding up through Q1, though inflation is contributing to growth in nominal measures and may weigh on real consumption going forward.**

Nominal retail trade grew by 1.6% in March, marking three consecutive months of growth to leave total retail trade over Q1 2.9% greater than in Q4. However, a significant proportion of this growth was due to price increases with volumes up by a smaller 1.2%. While this is notably softer than the nominal read, it suggests that goods consumption remained strong in Q1.

Looking more closely, spending at department stores increased 4.1% in March to be 4.5% higher over the quarter, while spending in cafes and restaurants rose 2.0% to be up 9.3% over the quarter. That suggests – as seen in the most recent NAB Business Survey – demand for in-person services like hospitality is recovering.

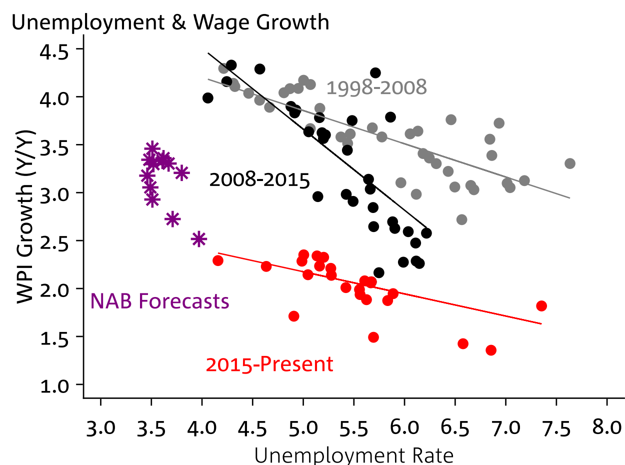
Overall, we expect consumption to have grown fairly strongly in Q1 despite headwinds from Omicron and flooding - albeit more modestly than in Q4 as it rebounded from lockdowns. Further ahead, household budgets face a somewhat more challenging environment with elevated inflation and rising interest rates. However, consumption should be supported by households' accumulated savings and stronger wage growth as well as a step lower in savings rates towards pre-pandemic levels – likely seeing ongoing robust growth through 2022 before more normal rates in 2023 and beyond.

## UNEMPLOYMENT RATE PRINTS BELOW 4% IMMINENT, BEFORE FALLING TO 3.5% THIS YEAR



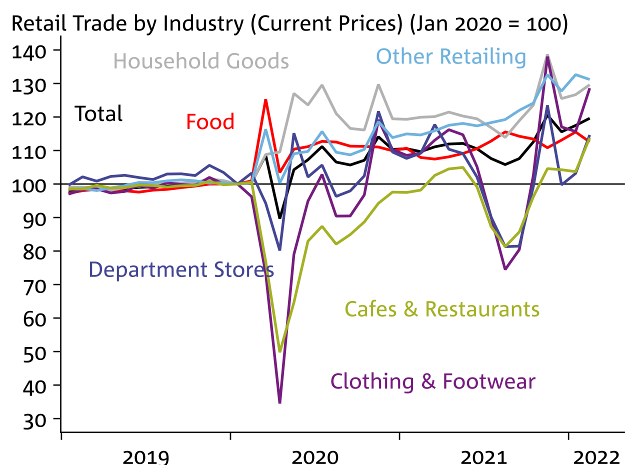

Source: National Australia Bank, Australian Bureau of Statistics

## LABOUR MARKET TIGHTNESS TO DRIVE WAGE GROWTH HIGHER




Source: Macrobond, NAB Economics

## RETAIL TURNOVER NOW WELL ABOVE PRE-COVID LEVELS IN ALL SECTORS




Source: Macrobond, NAB Economics

# HOUSING AND CONSTRUCTION

**The housing market is expected to soften as interest rates rise and pandemic-related stimulus begins to fade. Still, our outlook is not for a disorderly adjustment – prices will fall but remain high and the pipeline of work will continue to support activity.**

The CoreLogic capital city dwelling price index grew by 0.3% m/m in April, a similar pace of growth as the previous month, but continued to moderate in annual terms. The divergence in price growth between Brisbane and Adelaide and the rest of the capitals remains stark with these capitals still rising by a strong 1.5-2% on a monthly basis. This compares with a flat outcome for Melbourne and a small fall in Sydney in April. Price growth in the regions continued to outpace that of the capitals, rising 1.4% m/m.

We expect dwelling prices to decline in aggregate as interest rates rise and pandemic-related stimulus fades. A healthy labour market, strengthening wage growth and a recovery in population growth will be key offsets to rising rates but we nonetheless expect the 8-capital city dwelling price index to decline later this year (to end the year around 3% up) and fall by around 10% in 2023.

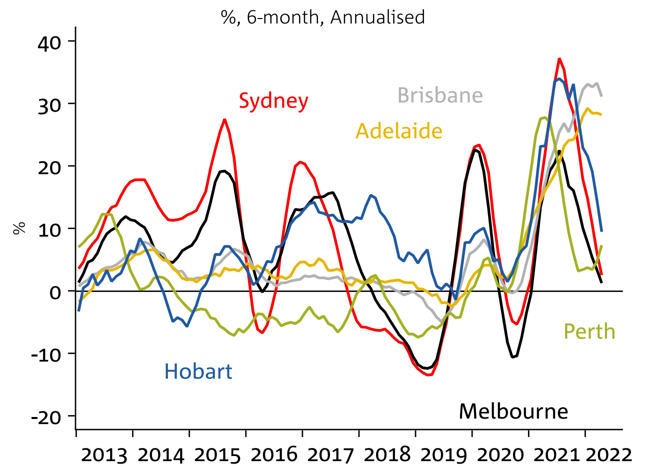
Importantly, we do not expect a disorderly adjustment. With house prices up around 23% since the beginning of the pandemic and 35% since the most recent trough in June 2019, the expected falls are only a modest correction. Ultimately, we do not see a fundamental oversupply of housing.

On the activity side, building approvals have been volatile over the past two months but are broadly tracking at around pre pandemic levels. In March approvals declined by 18.5%, only partially reversing the 42% rise in February. Overall, approvals are now around 36% lower than a year ago and may soften further.

Still, we expect work done (construction) to remain elevated through 2022. The pipeline of work yet to be done remains elevated on the back of the HomeBuilder program and other state-specific policies which provided support through the pandemic, while supply constraints and the availability of labour have also delayed some of this work. As a result, work done will remain high in the near term as the pipeline is worked through, but ongoing delays and disruptions may see some further volatility on a quarterly basis.

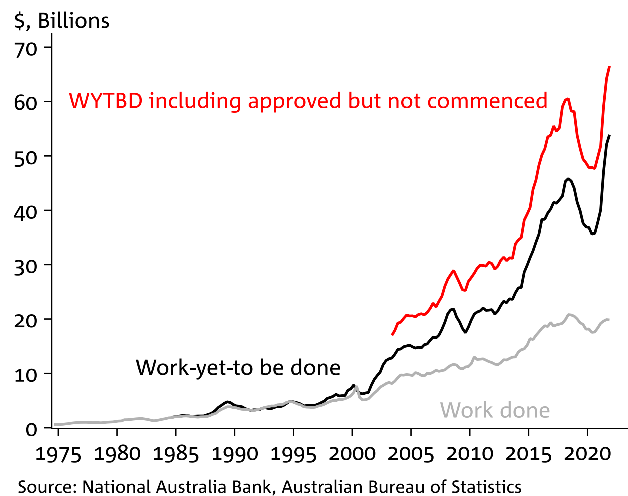
On the financing side the impact of higher rates and eventually softening prices will likely see a slowing in credit growth. Indeed, housing loan commitments have come off their record high reached in January (down 2%), notwithstanding a small pickup in March. That said, for now approvals have broadly held at high levels with the strength over the last year coming from gains in the investor segment.

## DWELLING PRICE GROWTH HAS DIVERGED



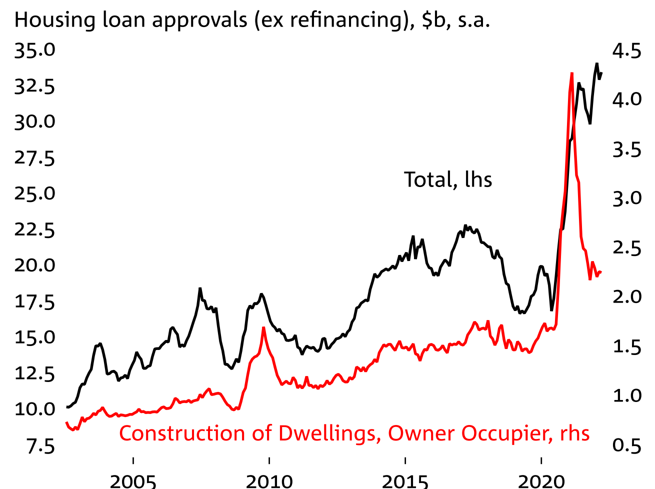

Source: CoreLogic, National Australia Bank, Macrobond

## THE PIPELINE OF RESIDENTIAL BUILDING WORK IS ELEVATED




Source: National Australia Bank, Australian Bureau of Statistics

## LOAN APPROVALS ARE STILL HIGH BUT ARE EXPECTED TO EASE AS RATES RISE



# BUSINESS AND TRADE

**Business conditions have continued to strengthen over recent months, setting the stage for a likely pickup in business investment.**

Yesterday's NAB Business Survey release showed conditions continued to strengthen to +20 index points in April, and while confidence eased, both conditions and confidence are well above their long-run averages. Importantly, the strength is broad based across most industries and states.

Trading conditions and profitability continue to drive the improvement in overall conditions, pointing to strong underlying demand, and capacity utilisation also continues to rise. The results suggest businesses are well placed despite supply disruptions, rising input costs and a very tight labour market.

The strength in conditions should support business investment, with the survey's capex index picking up above its long-run average over the past few months (albeit not yet at the highs seen in early 2021). The next ABS capex survey, due out later in May, will shed more light on investment intentions.

We expect solid growth in underlying business investment across Q1 and Q2 – around 4% q/q in each – normalising through the second half of the year.

**The nominal trade balance rebounded somewhat in March after a large fall in February, but in real terms looks set to subtract substantially from GDP in Q1.**

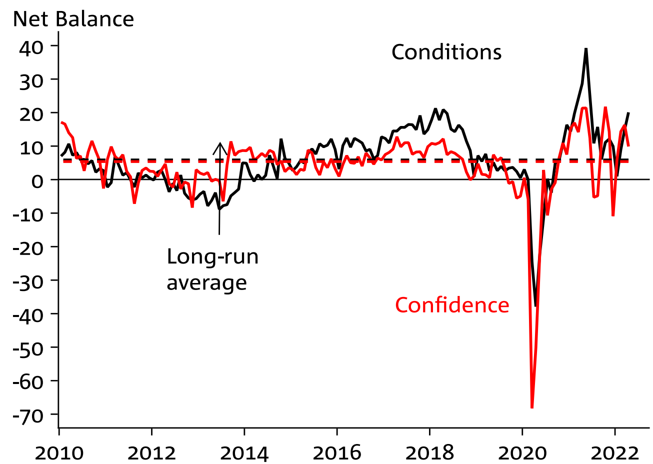
Import values fell 5% in the month, largely driven by a fall in consumption goods imports, but this only went part of the way to unwinding the 13% surge in February. Export values were little changed, leaving the nominal trade balance at $29.2bn (up from $27.9bn). Services trade remains subdued.

Export trade prices were up 18% in the quarter, while import trade prices rose 5%. With such large swings in prices and uncertainty about the effects of supply bottlenecks, a clear read on the volume of trade is difficult to obtain.

However, it seems evident that import volumes have lifted over the quarter while export volumes have fallen, driving a large contraction in the volume of net exports which will subtract from GDP in Q1. At this stage we expect a subtraction of around 1.5-2ppts, somewhat offset by consumption.

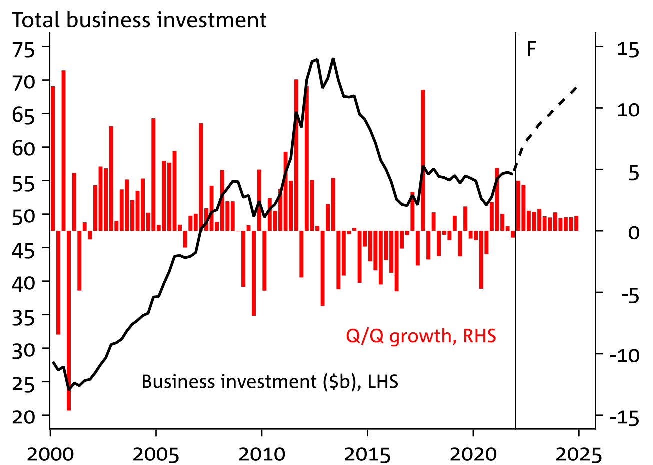
Further ahead, we expect a gradual recovery in services trade as imports (outbound tourists etc) and exports (education and inbound tourists) begin to recover. We forecast services imports to rise more rapidly as tourism leads education trade, though this should transform into a tailwind as education exports eventually recover. Still, a small subtraction from net exports it likely to be the norm for some time.

## CONFIDENCE AND CONDITIONS ARE ABOVE THEIR LONG-RUN AVERAGES



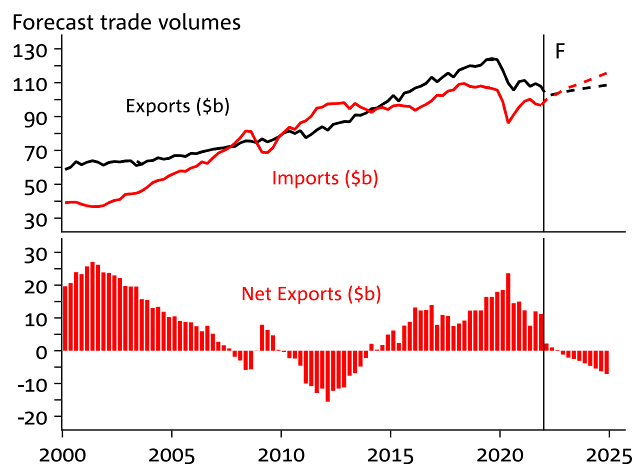

Source: National Australia Bank, National Australia Bank

## BUSINESS INVESTMENT FORECAST TO PICK UP OVER 2022




Source: Macrobond, NAB Economics

## NET EXPORTS ARE EXPECTED TO SUBTRACT FROM GDP IN Q1




Source: Macrobond, NAB Economics

# MONETARY POLICY, INFLATION AND FX

**The RBA lifted the cash rate target by 25bps to 0.35% in May. As expected, it also announced that holdings of maturing bonds will not be reinvested.**

The board "judged that now was the right time to begin removing extraordinary stimulus" against a backdrop of higher-than-expected inflation, a tight labour market and growing evidence that wage growth is strengthening.

The start of a new hiking phase came alongside a significantly upgraded set of staff inflation forecasts in the May SMP. Trimmed mean inflation is now expected to end 2022 at around 4.75% (from 2.75%). The RBA sees some resolution to supply side/commodity price disruptions, which sees inflation easing back to around 3% by mid-2024 – though in an underlying sense stronger wage growth is expected to offset some of this pullback. The RBA remains optimistic on growth (4.6% in 2022, and 2.5% in 2023) and after feeding in the previous forecast miss, now sees unemployment at around 3.5% by end 2022.

**We have revised up our expected profile for the cash rate by 10bps in the near-term and included an additional hike in 2024. That sees the cash rate at 1.35% by end 2022, 2.10% by end 2023 and 2.60% in 2024.**

Our forecasts for inflation are broadly similar to the RBA where we expect some resolution of supply chain issues, and for wages to pick up gradually over the next couple years. We have slightly increased our inflation forecast in the near term – now expecting stronger prints in Q2 and Q3 – which sees underlying inflation peak at around 4.6% in September.

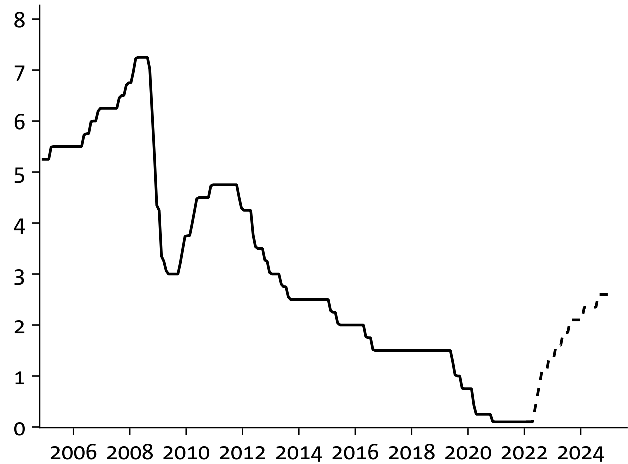
With the cash rate well below 'neutral' the RBA will need a steady series of increases to the normalise the cash rate. We continue to see a series of further 25bp hikes in June, July and August with a follow up in November before the cadence is slowed in 2023. It is possible that the RBA could make larger moves in June if upcoming wage data show a larger than expected pickup in response to the tighter labour market, or if inflation surprises further to the upside.

We expect the pace of increases to slow in 2023 as the RBA assesses how the economy evolves and observes the impact of higher rates. Further out, the question of how far the RBA will go depends on both where the neutral cash rate is – we think around 2.5% or slightly higher – and whether the stance of policy needs to become restrictive – for now we don't expect this to be the case.

**The AUD/USD has fallen over the past month despite strengthening monetary policy expectations – as concerns on global growth have weighed.**

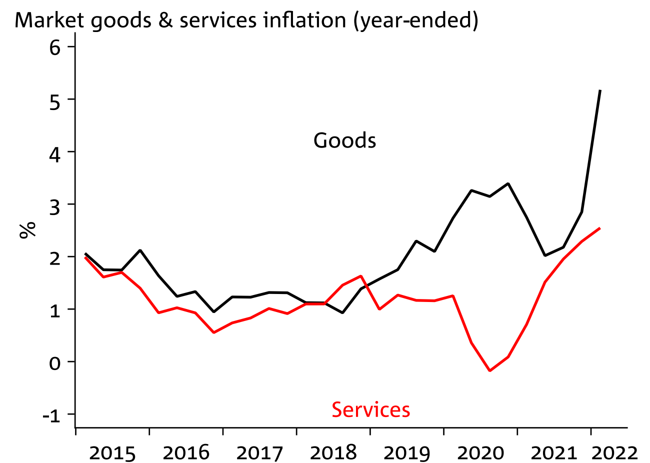
The Aussie is currently trading around US70c after trading up to 2.5c higher during the month. We have revised down our forecasts – now expecting the AUD to end 2022 at US72c and 2023 at US76c.

**RBA TO CONTINUE NORMALISING RATES AT A FAIRLY STEADY PACE**



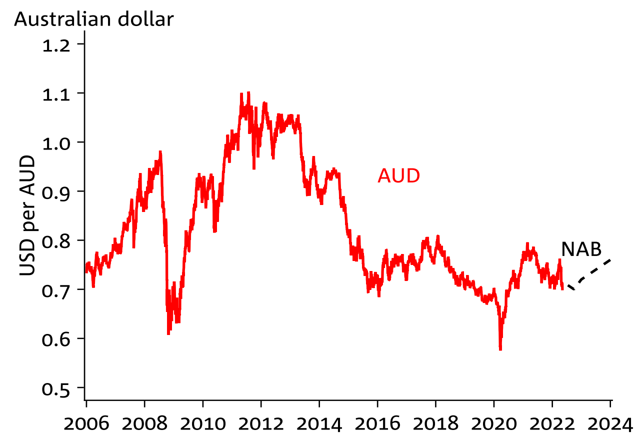

Source: Macrobond, NAB Economics

**BOTH GOODS AND SERVICES INFLATION ACCELERATED IN Q1**




Source: National Australia Bank, Australian Bureau of Statistics

**AUD/USD TO APPRECIATE IN THE NEAR TERM**




Source: National Australia Bank, Macrobond Financial AB

# THEME OF THE MONTH: THE IMPACT OF RISING RATES

**Rates are expected to continue to rise over the next few years following the RBA's first post-pandemic hike in May. Higher interest rates will flow through a number of channels to impact the real economy.**

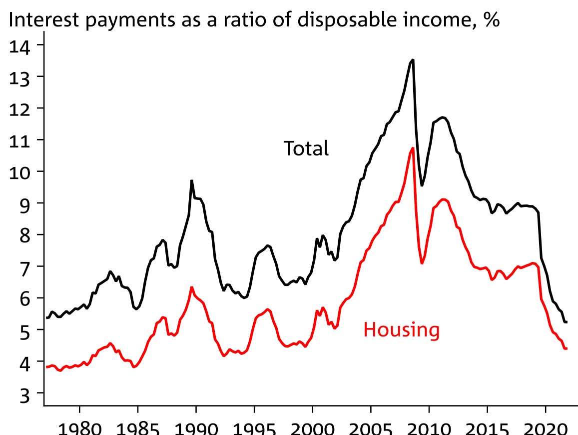
The most immediate impact will come through the effect on households' cash-flow. Higher rates will lift mortgage servicing costs and some households will likely need to reduce spending as a result. With debt to income at high levels, the interest burden may rise more quickly than in previous cycles. However, it is important to note that households are starting with an elevated savings rate (in part due to lower interest rates) and an accumulated stock of savings built up over the pandemic. Recent reporting also suggests that only around 10% of borrowers take the maximum loan available to them, and many have built up large buffers, leaving most with significant room to spare in their budgets.

Higher rates will also weigh on asset prices – both housing and financial – and this impact on household wealth will weigh on consumption in turn. House prices rose 23% through the pandemic and equity markets rose 7%, and this has supported elevated household goods demand with little adjustment back to pre-pandemic levels as we have come out of lockdowns. Higher rates will likely reverse some of the boost to consumption from wealth effects (indeed, asset prices have already declined over recent months as rate expectations have strengthened). We see house prices declining by around 10-15% over the next 18 months or so, coinciding with some normalisation in spending patterns by households.

More broadly, savings and investment decisions by both households and businesses will be affected by rate rises. Higher rates will encourage greater saving by households (albeit savings rates are still likely to decline from pandemic-period highs) while also discouraging investment by those businesses that rely on debt funding for new expansions. However, the extent to which this plays out will depend on the investment opportunities (and rates of return) available to businesses. For now, investment intentions remain strong. Similarly, higher rates should weigh on housing credit and investment.

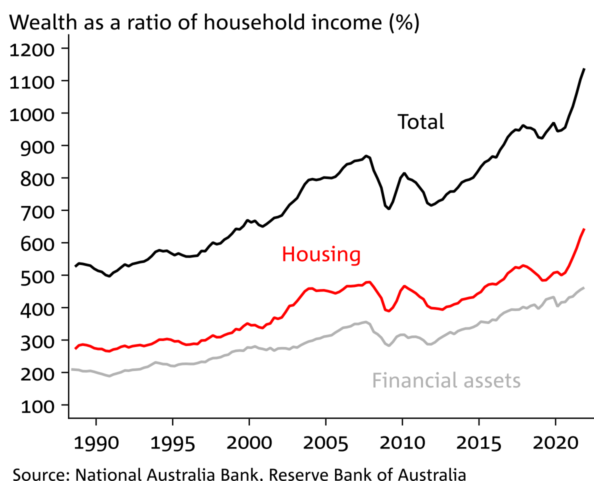
The exchange rate channel also plays a relatively important role in Australia given the significant share of the economy made up by imports and exports. All else equal, higher rates tend to attract foreign capital, putting upward pressure on the currency. While the lingering effects of the pandemic continue to disrupt trade (particularly for services which remain 30% lower on the imports side and 36% lower on the exports side) a stronger outlook for the AUD than otherwise will weigh on exports and increase the domestic competitiveness of imported goods – ultimately slowing domestic activity.

## THE INTEREST BURDEN HAS FALLEN TO VERY LOW LEVELS AS RATES FELL TO RECORD LOWS



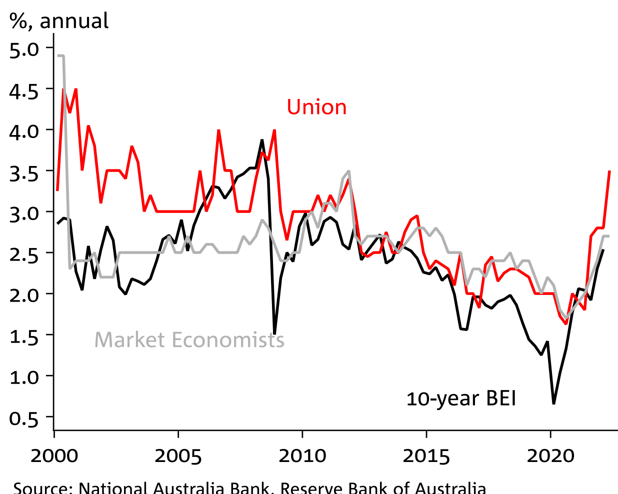

Source: National Australia Bank, Reserve Bank of Australia

## WEALTH HAS INCREASED SHARPLY – AS HOUSE PRICES INCREASED




Source: National Australia Bank, Reserve Bank of Australia

## INFLATION EXPECTATIONS WILL BE AN IMPORTANT CHANNEL AMID SIGNIFICANT SUPPLY SHOCKS




Source: National Australia Bank, Reserve Bank of Australia

Together, these channels mean that higher rates will begin to remove some of the stimulus provided to domestic demand and consequently labour demand (as well as wages). Softer demand will mean less pressure on prices, easing the rate of inflation.

In addition to these activity channels, the impact of the RBA's actions on inflation expectations will be important. Inflation expectations had softened prior to the pandemic alongside a relative long period of inflation tracking below the RBA's target band – with strong competition weighing on prices and excess capacity in the labour market. The current context of significant supply shocks and spikes in commodity prices is now causing inflation expectations to rise, particularly among union officials and in the bond market. Higher inflation expectation can feed into the wage bargaining process with significant implications for inflation.

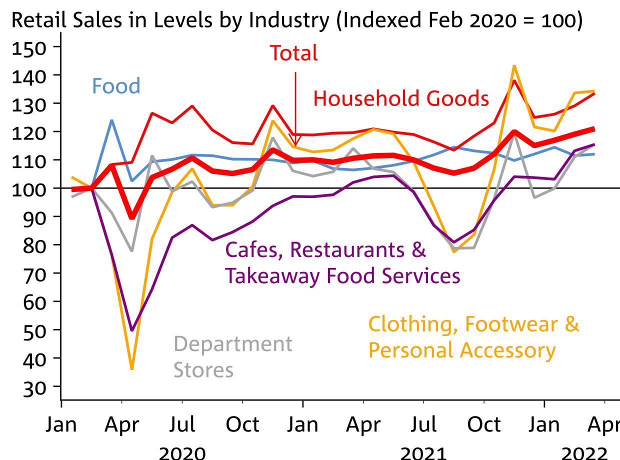
Raising interest rates – and clear signaling by the central bank that it is committed to keeping inflation at target – play a key role in keeping inflation expectations in check. So far, expectations remain consistent with inflation tracking within the RBAs target band. However, should these expectations become de-anchored the RBA may need to do more on policy to bring expectations back down to 2-3% over time.

By sector, the housing market is most likely to show the most sensitivity to rate rises in the near term. Higher rates will weigh on prices through reduced borrowing power and also flow through to activity (in terms of new construction). Indeed, the housing market has already slowed (not withstanding still solid price growth in the smaller capitals) as rate expectations have strengthened and fixed rates have repriced.

The retail and recreation & personal services sectors will also likely feel the impact of higher rates on household consumption in the near term. Already high prices have the potential to slow growth in consumption but higher rates are likely to weigh most significantly on discretionary areas of retail and household services as households adjust to higher rates.

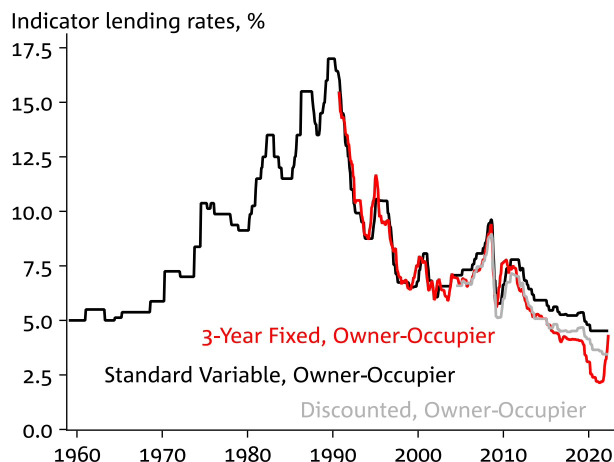
While higher rates will work to slow the economy, it is important to note that we do not expect the RBA's policy stance will become restrictive in the near-term. Rather we see the upcoming series of rate increases as removing the exceptional degree of support provided by historically low rates through the pandemic period.

## RETAIL SALES HAVE RISEN STRONGLY IN THE PANDEMIC, BUT DISCRETIONARY SPENDING WILL LIKELY PULL BACK AS RATES RISE




Source: National Australia Bank, Australian Bureau of Statistics

## EXCEPTIONALLY LOW MORTAGAGE RATES HAVE BEEN A KEY SUPPORT TO THE HOUSING MARKET BUT ARE EXPECTED TO RISE




Source: National Australia Bank, Reserve Bank of Australia

# FORECAST TABLES

| | Fiscal Year | | | | Calendar Year | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **2020-21** | **2021-22 F** | **2022-23 F** | **2023-24 F** | **2020** | **2021** | **2022-F** | **2023-F** | **2024-F** |
| Private Consumption | 1.0 | 3.6 | 6.9 | 2.6 | -5.8 | 4.8 | 6.9 | 3.7 | 2.5 |
| Dwelling Investment | 3.2 | 3.3 | -1.8 | -0.2 | -5.7 | 9.2 | -1.3 | -1.8 | 2.0 |
| Underlying Business Investment | -2.4 | 5.7 | 8.7 | 4.3 | -5.6 | 4.6 | 7.6 | 6.0 | 3.7 |
| Underlying Public Final Demand | 5.9 | 5.8 | 2.5 | 2.1 | 6.0 | 6.0 | 3.8 | 2.5 | 2.0 |
| **Domestic Demand** | **2.5** | **4.8** | **5.4** | **2.7** | **-2.5** | **5.9** | **5.7** | **3.5** | **2.7** |
| Stocks (b) | 0.8 | -0.4 | 0.0 | -0.1 | 0.0 | 0.5 | -0.1 | -0.2 | 0.0 |
| **GNE** | **3.3** | **4.3** | **5.4** | **2.6** | **-2.5** | **6.5** | **5.5** | **3.3** | **2.7** |
| Exports | -8.3 | -3.0 | -0.9 | 2.1 | -9.8 | -1.6 | -5.3 | 2.5 | 1.9 |
| Imports | -2.8 | 2.6 | 7.2 | 4.8 | -13.0 | 5.8 | 4.5 | 5.9 | 4.6 |
| **GDP** | **1.5** | **3.4** | **4.0** | **2.1** | **-2.2** | **4.7** | **3.8** | **2.6** | **2.2** |
| Nominal GDP | 4.4 | 9.3 | 7.9 | 3.1 | -1.4 | 10.5 | 8.8 | 4.7 | 3.5 |
| Current Account Balance ($b) | -69 | -58 | -39 | 19 | 51 | 77 | 47 | 11 | -37 |
| (%) of GDP | -3.4 | -2.6 | -1.6 | 0.8 | 2.6 | 3.5 | 2.0 | 0.4 | -1.4 |
| Employment | 1.1 | 3.2 | 3.9 | 1.5 | -1.7 | 3.4 | 4.2 | 2.3 | 1.1 |
| Terms of Trade | 10.3 | 9.5 | 1.7 | -7.7 | -0.2 | 17.7 | 3.7 | -3.9 | -5.9 |
| Average Earnings (Nat. Accts. Basis) | 2.6 | 3.3 | 3.4 | 3.4 | 3.6 | 1.9 | 4.0 | 3.3 | 3.3 |
| **End of Period** | | | | | | | | | |
| Total CPI | 3.8 | 5.4 | 3.3 | 2.7 | 0.9 | 3.5 | 5.3 | 2.7 | 2.6 |
| Core CPI | 1.6 | 4.3 | 3.4 | 2.8 | 1.3 | 2.6 | 4.5 | 2.9 | 2.7 |
| Unemployment Rate | 5.1 | 3.7 | 3.5 | 3.6 | 6.8 | 4.7 | 3.5 | 3.5 | 3.8 |
| RBA Cash Rate | 0.10 | 0.60 | 1.85 | 2.35 | 0.10 | 0.10 | 1.35 | 2.10 | 2.60 |
| 10 Year Govt. Bonds | 1.51 | 3.00 | 3.25 | – | 0.98 | 1.68 | 3.25 | 3.25 | – |
| $A/US cents : | 0.75 | 0.71 | 0.74 | – | 0.77 | 0.73 | 0.72 | 0.76 | – |

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

# Group Economics

Alan Oster
Group Chief Economist
+(61 0) 414 444 652

Jacqui Brand
Executive Assistant
+(61 0) 477 716 540

Dean Pearson
Head of Behavioural & Industry Economics
+(61 0) 457 517 342

## Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0) 436 606 175

Brody Viney
Senior Economist
+(61 0) 452 673 400

Phin Ziebell
Senior Economist
+(61 0) 475 940 662

## Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 0) 477 723 769

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 0) 455 052 520

Steven Wu
Economist – Behavioural & Industry Economics
+(61 0) 472 808 952

## International Economics

Tony Kelly
Senior Economist
+(61 0) 477 746 237

Gerard Burg
Senior Economist – International
+(61 0) 477 723 768

# Global Markets Research

Ivan Colhoun
Global Head of Research
+(61 2) 9293 7168

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