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The Forward View: Australia Oct-2022

Near term resilience but a slowing ahead

NAB Group Economics

Overview

- Our outlook for the economy is broadly unchanged this month, though we have upped our expectation for consumption growth in Q3 based on the resilience of our high frequency data, ABS retail sales and ongoing strength in trading conditions in our business survey.
- That said, we see this as a small tweak and continue to expect consumption growth to slow as the impact of higher rates continues to flow through to households in addition to significant price pressures already at play. However, while we expect growth to track at below-trend rates in 2023 and 2024, we do not see a major downturn in the economy.
- For GDP the revision to Q3 consumption sees a print of 1.3% q/q and 0.9% for overall GDP growth. In year-ended terms this points to growth of 2.8% in 2022 (reflecting the rebound from 2021 and ongoing healthy growth), before slowing to well below 2% over each of the next two years.
- The labour market is expected to stay exceptionally tight in the near term. We expect unemployment to trough around 3.5% before drifting up to 4.3% over the next two years. With unemployment at or below a level consistent with 'full-employment', we see wage growth continuing to accelerate to around 3.5 y/y by end 2023.
- Inflation is expected to peak in Q4 at 7.5% y/y in headline terms, and 6.3% for the trimmed-mean measure. For Q3 we have pencilled in 1.3% in headline terms and 1.6% for underlying inflation.
- We have tweaked our monetary policy view, but still expect a peak of 3.1% - with 25bp increases in both November and December. That sees the cash rate reach its highest level since early 2013 in just a 7-month period. We expect the impact of these hikes on consumption to become more evident through Q4 and into 2023.
- Our rates view, and outlook for growth is contingent on an easing in global inflation and an expectation that wage growth only rises to a level consistent with target inflation. Should wages growth accelerate more quickly - reaching more than 4% - or inflation expectations show signs of de-anchoring, rates may need to rise further and more quickly. Consequently, this would see a sharper slowing in growth and bigger deterioration in the unemployment rate.

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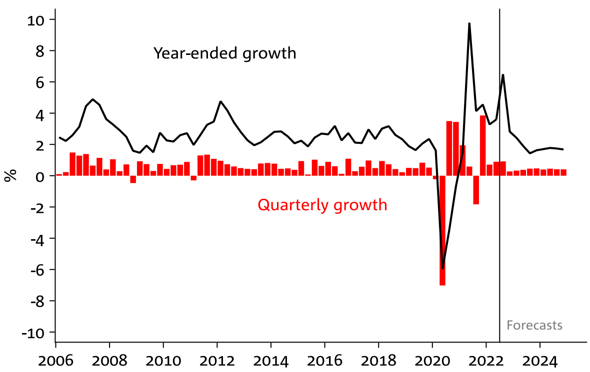
Key Economic Forecasts

	2021	2022-F	2023-F	2024-F
Domestic Demand (a)	6.1	5.5	2.2	1.9
Real GDP (annual average)	**4.9**	**4.0**	**1.8**	**1.7**
Real GDP (year-ended to Dec)	**4.5**	**2.8**	**1.6**	**1.7**
Terms of Trade (a)	17.6	7.4	-4.6	-2.9
Employment (a)	3.5	3.7	2.0	1.1
Unemployment Rate (b)	4.7	3.4	3.9	4.2
Headline CPI (b)	3.5	7.5	3.0	2.4
Core CPI (b)	2.5	6.0	3.2	2.9
RBA Cash Rate (b)	0.10	2.85	3.10	3.10
$A/US cents (b)	0.73	0.65	0.72	0.74

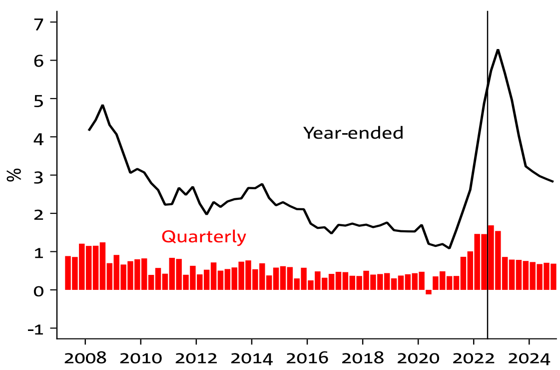
(a) annual average growth, (b) end-period, (c) through the year inflation

Chart 1: GDP forecasts



Source: National Australia Bank, Australian Bureau of Statistics

Chart 2: Trimmed-mean CPI forecasts



Source: National Australia Bank

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

Labour Market, Wages, and Consumption

Unemployment ticked up to 3.5% in August but remains low, while employment and labour force participation also remain robust.

Employment increased 34k in the month while the participation rate rose to 66.6%, largely reversing the falls seen in July. Sample volatility continues to be a factor with unemployment edging higher – but regardless the labour market remains very strong having been at or around 3.5% since June.

We expect the labour market to remain tight across the rest of the year before gradually rising to around 4% in 2023 and 4.2% in 2024 as the economy slows. There are already some early signs that labour demand may be easing, with job vacancies edging lower in August – albeit they remain near record highs with one vacancy per unemployed person.

The responsiveness of wage growth to such a tight labour market remains a key question for the forecasts. We continue to expect wage growth to strengthen further in the second half of the year on the back of minimum award wage changes and the effect of very low unemployment. We see wage growth around 3.2% y/y by Q4 and 3.5% in 2023.

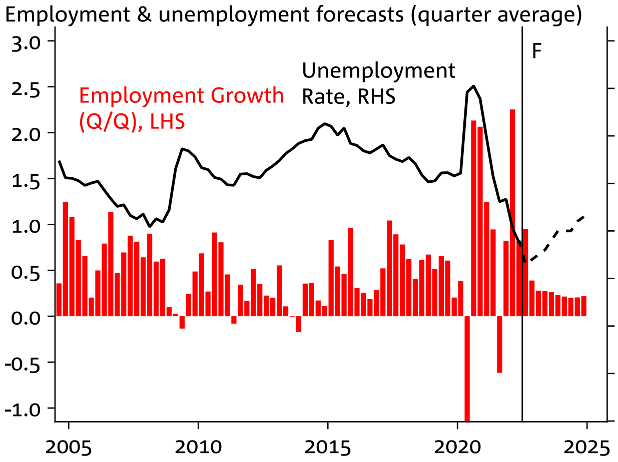
High-frequency indicators point to resilience in consumption, and we have revised up our Q3 consumption forecasts as a result. Still, we expect consumption growth to slow as interest rate rises begin to flow to mortgage payments.

Nominal retail sales data for August showed an increase of 0.6%, following a very strong 1.3% increase in July. Household goods and department stores were particularly strong in the month, up 2.6% and 2.8% respectively, and food and hospitality sales were also up although clothing and other retail fell. Strong inflation is clearly a factor, but it is likely that retail sales have still grown in volume terms over the first two months of Q3.

NAB's consumer spending data for September, released in today's *NAB Monthly Data Insights* report, shows another strong month of spending in nominal terms across both retail and other spending categories. Spending on services continues to rebound, with the travel and recreation industries still recovering. As a result, we have revised up our Q3 consumption growth forecast to 1.3% q/q.

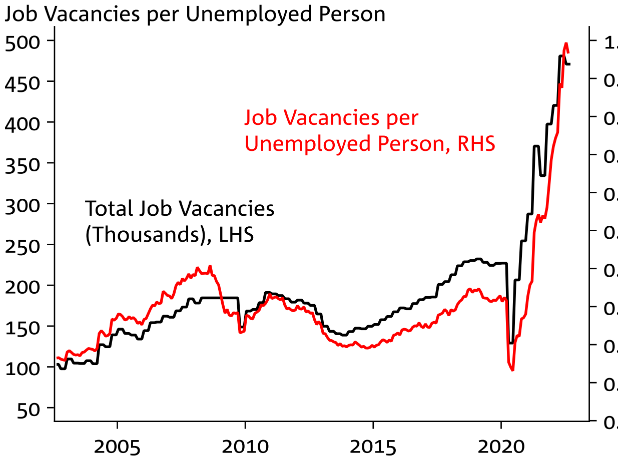
Despite this upward revision, we remain of the view that consumption growth will slow considerably as rebound effects wane, inflation weighs on real incomes and recent interest rate rises begin to flow through to mortgage payments. Low unemployment and wage growth will provide support as well as savings buffers, but as the impact of lockdown induced pent-up demand fades and household budgets are stretched, the pace of growth in consumption seen over the past year will become unsustainable.

Chart 3: Unemployment rate remaining around 3.5% over the rest of 2022 before edging higher



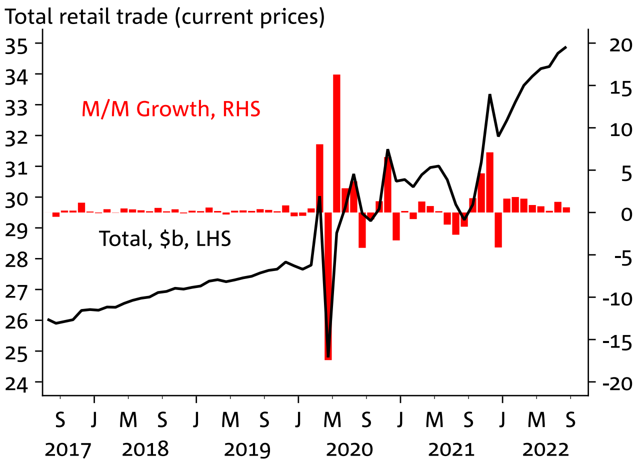
Source: National Australia Bank, Australian Bureau of Statistics

Chart 4: Job vacancies edged down in August but remain at record high levels



Source: Macrobond, NAB Economics

Chart 5: Retail sales continued to grow strongly in July and August, supported by inflation



Source: National Australia Bank, Australian Bureau of Statistics

Housing and Construction

As the most interest rate sensitive sector, the housing market continues to adjust to higher rates but is being supported by a strong labour market.

The pace of decline in capital city dwelling prices slowed in September but continued to decline at a solid pace. The CoreLogic 8-capital city and PropTrack Capital city indexes showed declines of 1.4% and 0.2% restrictively.

Declines continue to be concentrated in the larger capitals, with Brisbane, Sydney and Melbourne well outpacing the declines in Adelaide and Perth. Regional areas also recorded a solid decline. Dwelling prices have now declined by around 5% from their peak in early-to-mid 2022.

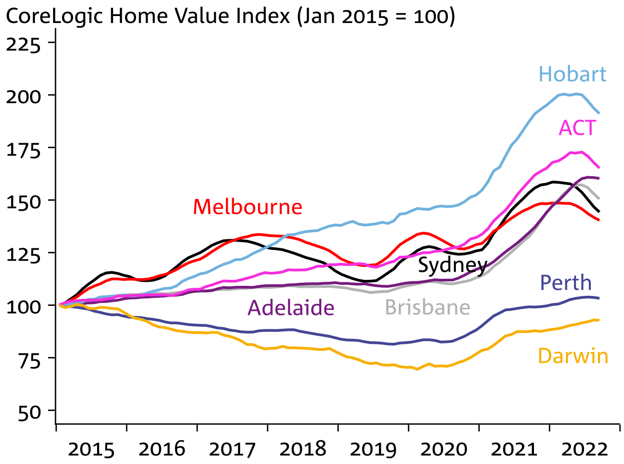
We continue to expect an overall decline in dwelling prices of around 20% - led by areas where affordability is most constraining, but for all capitals to decline by at least 15%. The key driver in our view will be declining borrowing power as interest rates rise, rather than a fundamental oversupply of housing. Indeed, the rental market has tightened significantly while recovering population growth and a strong labour market are also supporting the housing market.

Rental vacancy rates have fallen to low levels across all cities and are below 1% in Brisbane, Adelaide and Perth. However, Sydney and Melbourne have also declined relatively sharply this year and now sit at around 1.5%. Unsurprisingly, new rents growth according to the CoreLogic indicator has accelerated strongly and is now tracking at around 13% y/y in Brisbane and Adelaide, while Sydney and Perth are tracking a little more slowly, but still a brisk 10%. Melbourne is tracking at around 5% but will likely accelerate as the market tightens further.

On the construction side, we expect dwelling investment to remain at a high share of GDP over the next year or so. However, work done will likely remain volatile as supply chain disruptions continue to recover and weather impacts. The pipeline of work remains elevated. Building approvals have trended lower over the past year and broadly are now around pre-COVID levels though appear to be stabilising with detached housing approvals rising 4.1% in August and the volatile high density component rebounding following a large fall in July.

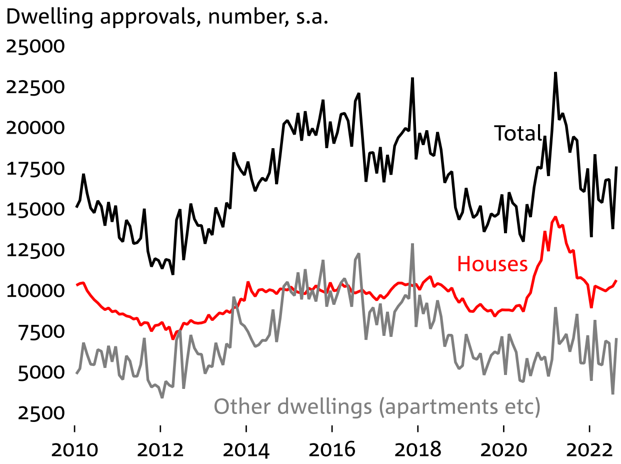
In terms of financing activity, new loan approvals (ex-refinancing) continue to decline, falling 3.6% to be 12.5% lower than over the year. nonetheless, they remain elevated after reaching very high levels during the pandemic.

Chart 6: House prices are expected to fall further



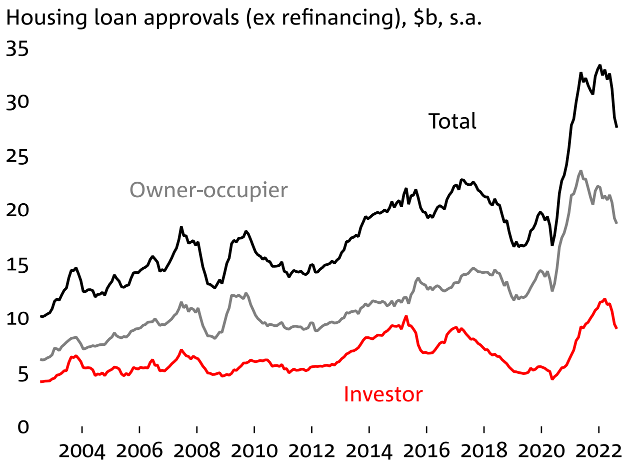
Source: National Australia Bank, CoreLogic, Macrobond

Chart 7: Building approvals have fallen but appear to be stabilising



Source: Macrobond, National Australia Bank

Chart 8: Loan approvals are falling sharply



Source: Macrobond, National Australia Bank

Business and Trade

Business conditions remain very strong, rising to +25 index points in September, while there are early signs that some cost pressures may be easing.

Business conditions in the NAB Monthly Business Survey are now higher than their pre-COVID peak with the current level of +25 index points only surpassed during the pre-Delta rebound in early 2021. Confidence is less strong, at +5 index points, but still around the long-run average.

Importantly, cost growth measures in the survey have eased somewhat over the past two months, likely reflecting an easing in some of the sources of global inflation, although labour costs clearly spiked in July when the minimum wage decision took effect. Still, the price measures in the survey indicate another very strong quarter of inflation in Q3 when data is released later in the month.

We continue to expect further modest investment growth in Q3 and beyond, supported by strong conditions and a tight labour market. However, the weakening global outlook is likely to weigh on businesses' plans somewhat and higher interest rates will also have an effect.

The trade surplus fell again in August, to $8.3b, with a pickup in exports more than outweighed by an increase in imports. That leaves the Q3 trade volumes outlook uncertain with a broadly flat impact on GDP likely.

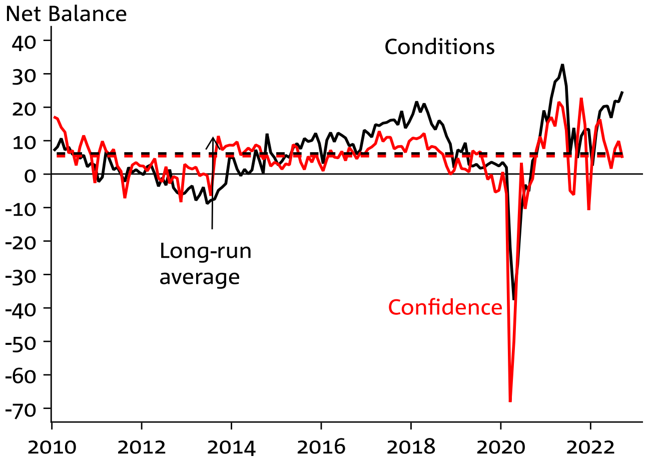
Exports rose 2.6% m/m, with good exports up 2.9%. The increase was largely driven by coal with a strong rebound in coal volumes in the month exceeding the impact of lower prices. Support also came from rural goods exports, which increased 6.8% in the month.

The gains in goods exports were more than offset, however, by a strong 4.8% increase in goods imports, including a 7.1% lift in consumption goods and a 6.6% increase in intermediate and other merchandise goods. The significant run up in goods imports over recent months suggests that supply chain issues may be unwinding, alongside ongoing resilience in consumer demand.

In terms of services, a negative trade balance persisted with service exports only edging up 0.4% while service imports rose 2.9%. Tourism-related imports continued to rebound strongly, while tourism-related exports were steady in the month.

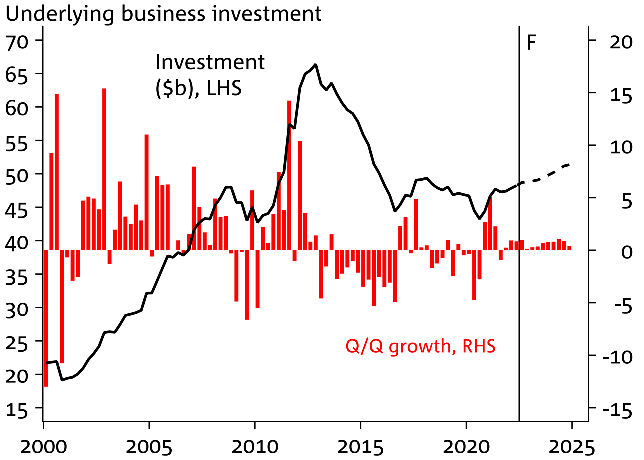
We expect these dynamics to continue to play out, with the recovery in services trade as well as commodities shaping the broader trade outlook. The large price movements in global markets continue to make it difficult to draw strong conclusions about volumes, but for now we continue to expect trade to deliver a flat to a small detraction from GDP in Q3.

Chart 9: Business Conditions are Strong



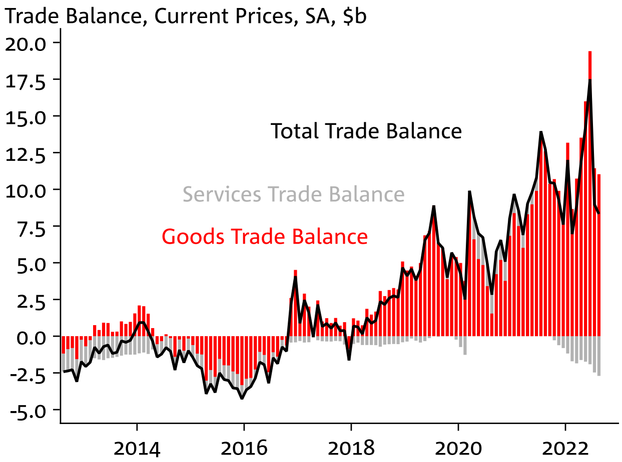
Source: National Australia Bank, National Australia Bank

Chart 10: Conditions should support further modest investment growth



Source: Macrobond, NAB Economics

Chart 11: Australia's trade surplus has declined from record highs earlier in the year



Source: Macrobond, NAB Economics

Monetary Policy, Inflation and FX

The RBA increased the cash rate by 25bps in October, ending its run of 50bp increments. The cash rate has now risen 2.5ppt over 7 months and is at its highest level since Dec 2013.

The step down in pace is in line with our view that the RBA would eventually need to slow the pace of hikes as it assessed the impact of prior rate hikes which are yet to fully flow through the economy – though we had expected this step down to come in November.

The post meeting statement echoed this view highlighting that there has been a rapid tightening in policy, and that 'the full impact was yet to be fully reflected in mortgage rates'. The RBA will likely be more cautious in future increases - with the cash rate now broadly around neutral - and heavily dependent on how the data plays out, as well as the risks for global inflation and growth.

We have tweaked our rates view but still expect the cash rate to end the year at 3.1% following increases in November and December.

We see the risks around this view as evenly balanced. It is contingent on wage growth continuing to pick-up, but not accelerating to a point that is inconsistent with at target inflation. it is also contingent on a fairly solid easing in global inflationary pressure over the next year. Upside risks to this would be a stronger wage response to a tight labour market. Key downside risks include a larger than expected slowing in global growth or a larger than expected response from households to higher rates.

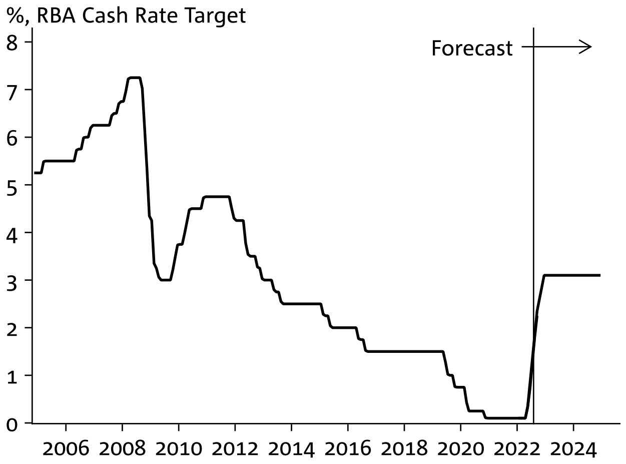
On inflation we continue to expect the peak to occur in Q4 at around 7.5% in headline terms, and over 6% for the trimmed mean. We then expect inflation to soften over 2023 falling back to around 3.2%. Global indicators of supply side pressures are easing, while flood impacted fruit and vegetable prices have also begun to normalise. The housing costs component of the CPI will likely be mixed. New building costs should level off or even decline, while strong growth in new rents is expected to begin feeding through to the CPI rents measure more fully.

If global inflationary pressures ease as expected, wages will become the important factor in whether inflation moves back to target. Wage growth is a key, domestic, source of inflation and is expected to peak at around 3.5 y/y a level that is likely consistent 2-3% inflation.

The AUD/USD is around 6% lower than a month ago, after trading in a 5 cent range over the month.

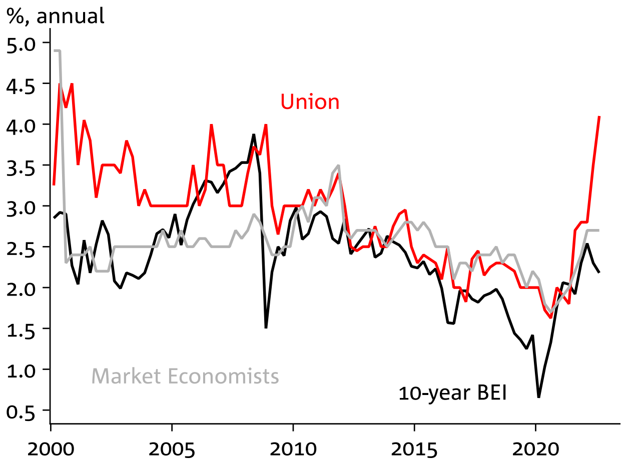
USD strength continues to be the driver of a weaker Aussie, though the TWI has also weakened over the past couple of months. We have slightly lowered our forecasts in the near term, expecting the Aussie to end the year around US65c before it strengthens to US72c by end 2023 and US74c by end 2024.

Chart 12: Cash rate expected to rise to 3.1% by December



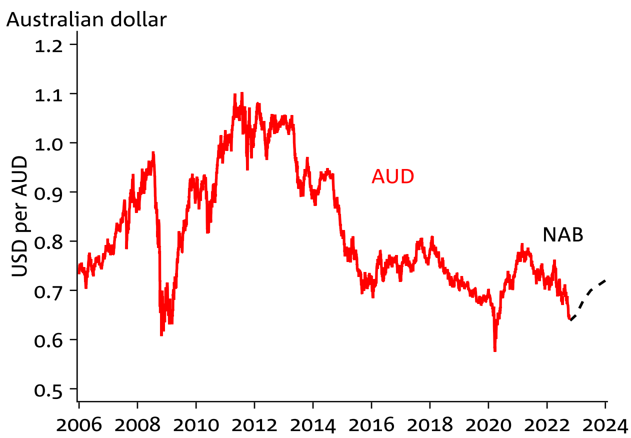
Source: Macrobond, NAB Economics

Chart 13: Inflation expectations remain anchored but are a risk



Source: National Australia Bank, Reserve Bank of Australia

Chart 14: AUD/USD to trade below below US65c in the near term



Source: National Australia Bank, Macrobond Financial AB

Theme of the Month: Forecast uncertainty is high

Forecast uncertainty remains high reflecting global developments – such as in the labour market – outside recent experience. How wages respond to the very tight labour market is a key variable to watch, and will be a key determinant for the RBA's peak cash rate.

There are myriad risks around the outlook for the Australian economy. These include the highly uncertain outlook for the world economy given elevated inflation, the risk that this may de-anchor inflation expectations, rapid monetary policy tightening, the energy supply disruptions from the Ukraine/Russia war, and China's Zero-COVID policy as well as problems in its housing sector. This is occurring in the context of fading (but still not fully resolved) supply chain disruptions, and high levels of savings accumulated by households during the pandemic which may act as a buffer against declining real incomes and rising mortgage costs.

The result is uncertainty over how much central banks will need to tighten policy, what impact any given monetary policy action will have on economies and, because of this, the risk that the major central banks will overshoot what is required, leading to an even greater downturn in the major advanced economies than we expect.

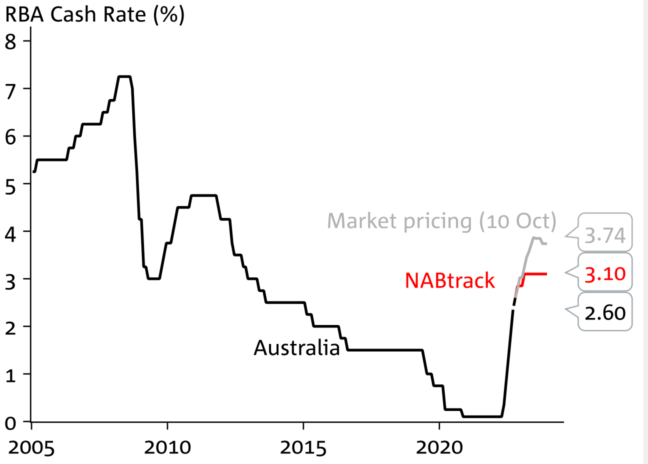
For Australia, a major downside risk is that the RBA tightens policy significantly more than we expect; this will be highly dependent on future inflation/wage outcomes.

The risks are not one sided. The easing in global supply chain disruptions and rebuilding of inventories, raises the prospect of a faster than expected fall in inflation. Freight rates have substantially unwound, supplier delivery times and order backlogs are normalising and press reports suggest some retailers, faced with excessive stock, are now moving to discount prices. Whether this will see a rapid decline in inflation back to target or only partially offset now broad-based inflation is an open question. For the US we expect inflation to only gradually fall back to the Fed's target because the labour market is tight and wage growth is running at a high level.

Australia's labour market is also extremely tight with the unemployment rate at around a five-decade low, and job vacancies relative to unemployment also very high.

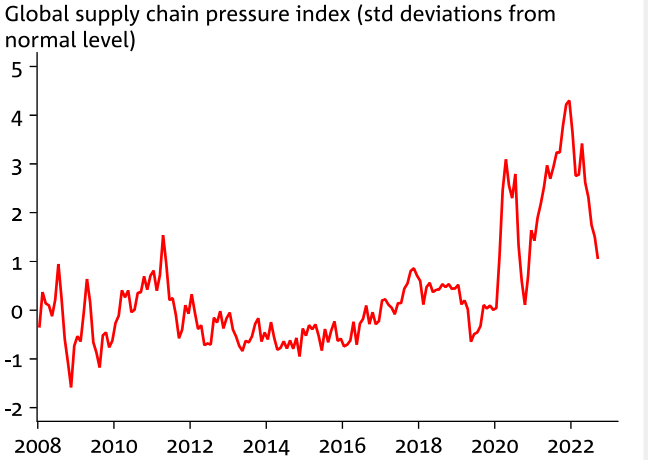
However, at this stage an important difference between Australia and some other countries, is that wages growth has not picked up to the same extent. Importantly, it remains at a level still broadly consistent with the RBA's inflation target. Our view is that wages growth will accelerate from here, but not rapidly, and we expect wage price index growth of 3½% in 2023. Inflation expectations generally remain well-anchored (see p5), although the greatest lift has occurred amongst union officials, a key part of the wage bargaining system.

Chart 15: Market pricing suggests some upside risk to our RBA cash rate projections



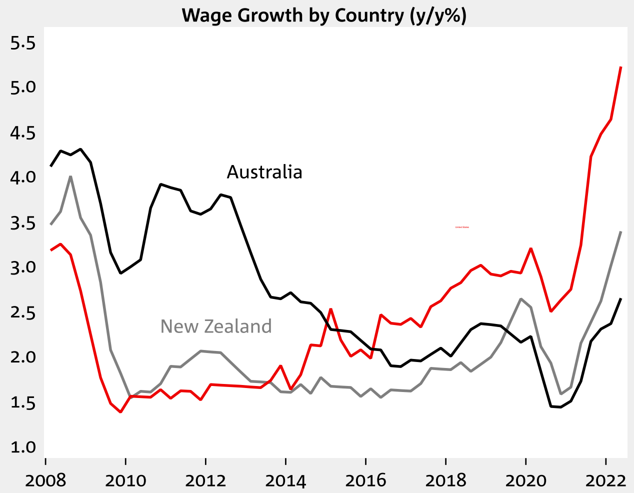
Source: National Australia Bank, Reserve Bank of Australia

Chart 16: An easing in supply chain disruptions a positive for future imported goods inflation



Source: Macrobond, Federal Reserve Bank of New York

Chart 17: Will Australia wage growth continue to buck the experience of other economies?



Key Domestic Forecasts

	% Growth q/q				% Growth y/y			
	Q1-22	Q2-22	Q3-22 (f)	Q4-22 (f)	2021	2022 (f)	2023 (f)	2024 (f)
GDP and Components								
Private Consumption	2.2	2.2	1.3	0.7	3.7	6.5	1.7	1.5
Dwelling Investment	-0.5	-2.9	2.1	-0.8	5.8	-2.1	0.3	2.1
Underlying Business Investment	0.9	0.8	1.5	-0.2	6.7	3.1	2.5	3.3
Underlying Public Final Demand	2.5	0.5	0.4	0.7	5.6	4.1	2.1	2.0
Domestic Demand	**1.9**	**1.0**	**1.0**	**0.5**	**5.2**	**4.5**	**1.8**	**1.9**
Stocks (Cont. to GDP)	0.7	-1.1	0.0	-0.1	0.6	0.2	-0.4	0.0
Gross National Expenditure	**2.9**	**-0.2**	**1.1**	**0.4**	**5.6**	**4.3**	**1.8**	**1.9**
Exports	-0.8	5.5	1.5	0.7	-2.6	6.9	2.6	2.1
Imports	11.3	0.7	1.8	0.9	2.7	15.1	3.2	3.0
Net Export (Cont. to GDP)	-2.3	1.0	-0.1	0.0	-1.1	-1.4	-0.1	-0.2
Real GDP	**0.7**	**0.9**	**0.9**	**0.3**	**4.5**	**2.8**	**1.6**	**1.7**
Nominal GDP	4.1	4.3	1.8	1.1	10.4	11.7	3.1	4.5
External Account								
Current Account Balance ($b)	51.8	50.0	46.4	50.5	68.4	50.5	30.3	7.0
Current Account Balance (% of GDP)	2.3	2.2	2.0	2.1	3.1	2.1	1.2	0.3
Terms of Trade	7.5	4.6	-2.3	-1.6	10.1	8.2	-6.6	1.0
Labour Market								
Employment	2.0	0.9	0.5	0.8	2.4	4.2	1.4	1.1
Unemployment Rate (End of Period)	4.1	3.8	3.4	3.4	4.7	3.4	3.9	4.2
Ave. Earnings (Nat. Accts. Basis)	-0.2	1.4	0.9	0.9	2.9	3.1	3.4	3.3
Wage Price Index (WPI)	0.7	0.7	0.9	0.9	2.3	3.2	3.4	3.3
Prices and Rates (end of period)	**Year-ended Growth (%)**							
Headline CPI	5.1	6.1	6.7	7.5	3.5	7.5	3.0	2.4
Trimmed-mean CPI	3.7	4.9	5.7	6.3	2.5	6.0	3.2	2.9
RBA Cash Rate	0.10	0.85	2.35	2.85	0.10	2.85	3.10	3.10
10 Year Govt. Bonds	2.79	3.69	3.96	4.10	1.68	4.10	3.70	3.55
$A/US cents	0.75	0.69	0.65	0.65	0.73	0.65	0.72	0.74

Data are percentage growth rates over the quarter or year as noted, except where specified otherwise.

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Important notice