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The Forward View: Australia May-2023

Rates to pass 4% with economy to slow in response

NAB Group Economics

Overview

- Our outlook for the economy is broadly unchanged over the past month – though we have reverted to our previous expected rate call of a peak of around 4.1%. Overall, the pattern of our forecasts is similar to the updated forecasts recently released by both the RBA and Treasury, albeit we are marginally more pessimistic in the near term.
- For both 2023 and 2024 we expect growth to be well below trend at 0.7% and 1.2%. That represents the slowest annual growth since the early 1990s, outside of the covid impacted period in 2020. Consumption dynamics remain the key force at play, with pressures on households to weigh through H2 2023 and early 2024.
- Our expectations for the labour market are largely unchanged – with weaker employment growth unable to fully absorb population growth – and unemployment is expected to rise to 4.7% by end 2024. That is a relatively large increase but comes off an exceptionally low starting point.
- We see inflation moderating broadly in line with the RBA's profile – reaching 4% by end 2023 and 3% by end 2024. Large uncertainty remains around the adjustment in goods prices – how quickly and far they fall – while globally services inflation has proved to be sticky. For Australia, wage growth will be important but for now remains consistent with inflation returning to the RBAs target band.
- We have reverted to our earlier expectation that rates will peak at 4.1% and see a material risk that the RBA peaks at 4.35% in the near term. We continue to expect cuts back towards neutral in 2024 as the economy slows and unemployment rises.
- Following the release of the May SoMP and the 2022/23 Budget we have compared our forecasts to those of the "official family". Generally, there is an expectation that GDP growth will slow to below trend over the next two years, though both the RBA and Treasury are marginally more optimistic in the near term. Consequently, we see a larger increase in the unemployment rate and a slightly faster moderation in inflation.

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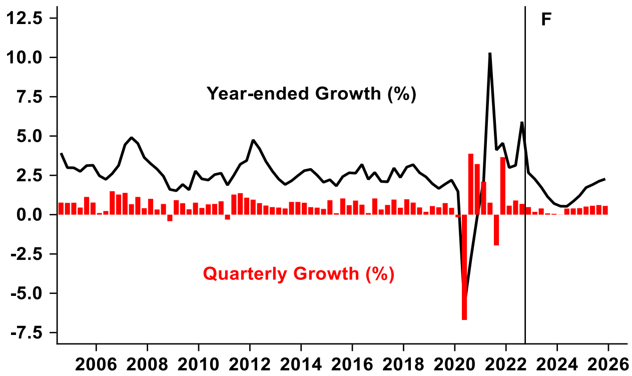
Key Economic Forecasts

	2022-F	2023-F	2024-F	2025-F
Domestic Demand (a)	4.9	1.5	0.7	2.0
Real GDP (annual average)	**3.7**	**1.5**	**0.8**	**2.0**
Real GDP (year-ended to Dec)	**2.7**	**0.7**	**1.2**	**2.3**
Terms of Trade (a)	6.0	-0.7	-2.8	-1.1
Employment (a)	4.1	2.3	0.8	1.6
Unemployment Rate (b)	3.5	4.0	4.7	4.5
Headline CPI (b)	7.8	4.4	3.0	2.7
Core CPI (b)	6.2	4.1	3.1	2.7
RBA Cash Rate (b)	3.10	4.10	3.10	3.10
$A/US cents (b)	0.68	0.74	0.73	0.78

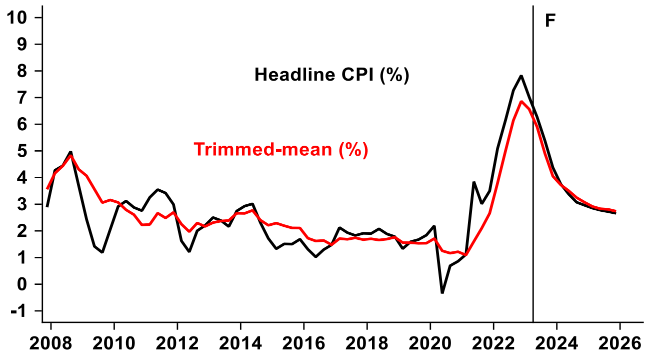
(a) annual average growth, (b) end-period, (c) through the year inflation

Chart 1: GDP forecasts



Source: Macrobond, NAB Economics

Chart 2: CPI forecasts



Source: Macrobond, NAB Economics

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

Labour Market, Wages and Consumption

Unemployment remains very low at 3.5%, and the focus is now squarely on how wages are responding with Q1 hourly wage growth due to be released this week alongside April employment figures.

Strong employment growth in February and March has left the labour market very tight and job vacancies have eased only slightly from their peak in 2022.

The tightness in the labour market comes despite surging population growth on the back of a very strong migration rebound. Treasury figures released in the Budget estimated net overseas migration would total 400,000 in 2022-23 and 315,000 in 2023-24 before normalising at around 235,000 over subsequent years.

We continue to expect unemployment to gradually begin to rise this year as the economy slows and labour demand softens enough to be outpaced by population growth, leaving the unemployment rate at 4% by end-2023 and 4.7% by end-2024. This is slightly higher than both the Treasury and RBA's latest estimates, reflecting slower forecasts for economic growth.

We continue to see the tightness in the labour market translating into stronger wage growth in the near term. The Q1 WPI result this week should see hourly wage growth lift to around 3.6% y/y, and further support is likely to come from the next minimum wage decision and changes to public sector wage policy. Wage growth should peak at around 4% this year, which would still be consistent with a return to at-target inflation but at the upper end of what the RBA is likely to tolerate.

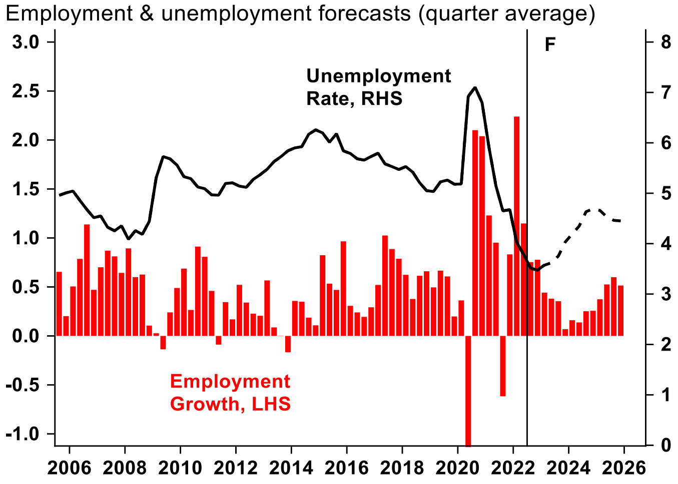
Real retail sales declined in Q1, flagging a likely soft quarter for real consumption growth ahead of a slowdown later in the year.

Despite positive nominal growth over the three months to March, the ABS's latest data confirmed the underlying volume of retail sales declined 0.6% in Q1. In a sign of the ongoing rebalancing from goods to services, cafes & restaurants saw a 1% increase in volumes in the quarter, while goods-related retail (ex food and cafes) saw a 1.4% fall. Food – an essential - was flat.

The result signals a likely soft Q1 result for overall consumption, with the now well-advanced services recovery needing to continue to make up for declining goods consumption. We expect consumption growth around 0.2-0.3%.

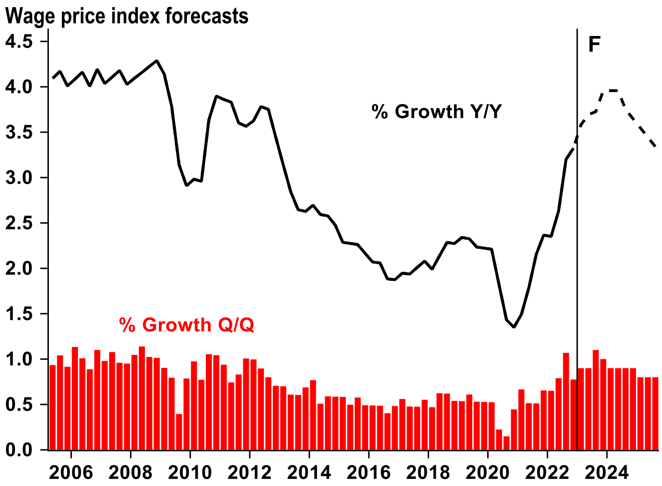
Further ahead, we continue to see high inflation and higher interest rates weighing increasingly heavily on household budgets, causing real consumption to decline slightly through late 2023 and into 2024. This is a slightly more pessimistic outlook that that presented in the recent forecasts of the RBA and the Treasury, and there is considerable uncertainty about how this will play out – but some softening is unavoidable.

Chart 3: Unemployment rate expected to gradually rise as population growth exceeds employment growth



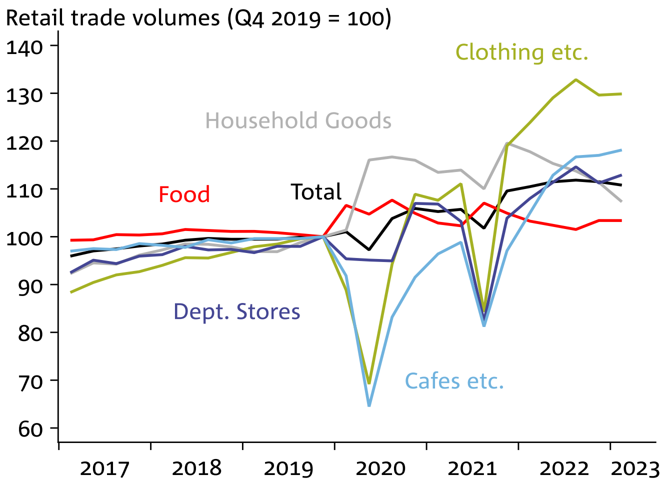
Source: Macrobond, NAB Economics

Chart 4: Hourly wage growth is likely to peak around 4% before declining somewhat as unemployment rises



Source: National Australia Bank, Australian Bureau of Statistics

Chart 5: Real retail trade declined slightly in Q1, although cafes & restaurants grew



Source: National Australia Bank, Australian Bureau of Statistics

Housing and Construction

House prices have recorded further gains over the past month, despite a further increase in rates and the potential for more.

Both the CoreLogic and PropTrack house price measures showed further gains in April, rising by 0.7% and 0.2% respectively. Both measures show Sydney leading the way, following a larger decline through 2022 than other capitals. Higher frequency CoreLogic daily data suggests prices increased further in early May, even as the RBA surprised with another rate increase. The stabilisation is apparent across the states with only Hobart showing signs of ongoing weakness.

The earlier than expected stabilisation in prices comes as some surprise given the sheer reduction in borrowing power over the past year. However, the rapid rise in rents, rebound in population growth and growing expectations that rates may be near the top are all key offsets.

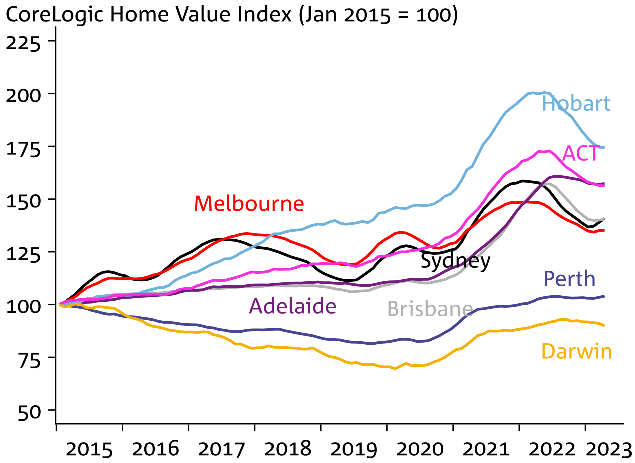
Indeed, in the established market, clearance rates have recovered to relatively healthy levels in the major cities in recent months, though volumes remain relatively low. New house sales also continue to decline.

The rental market is expected to remain tight in the near term, with vacancy rates to stay low. CoreLogic's measure of new rents continues to grow at a rapid rate – rising a further 1.1% in April to be up 11.7% y/y. Rents growth is now tracking above 10% in all mainland capitals, led by Sydney and Perth which are up over 13% y/y, followed by Melbourne and Brisbane at around 12% y/y. Hobart has tracked at a much slower 4% y/y.

A key factor for both rental and property prices over coming years will be the extent of the ongoing mismatch between supply and demand. Dwelling completions have fallen notably (albeit from very high levels) over the past year, and new building approvals continue to decline – and are now at levels last seen in 2012. So while the pipeline of work to be done remains elevated construction activity is likely to fall as the pipeline is eroded. This will put further pressure on housing supply amidst a recovery in demand.

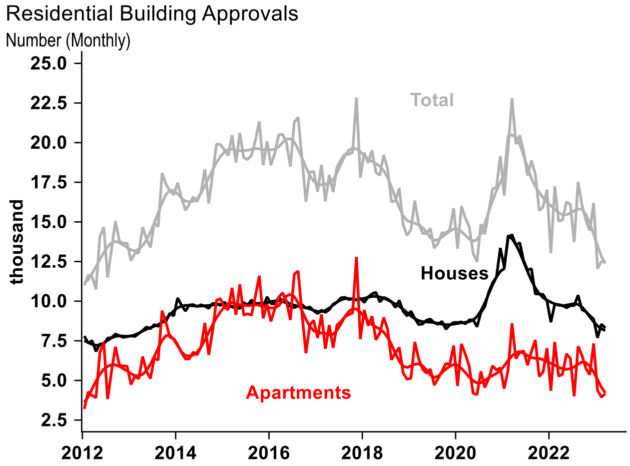
The ongoing impact of higher rates and lower turnover remains evident on the financing side. New loan approvals (ex-refinancing) rose 5.5% in March but remain down around 25% y/y. Financing for the construction or purchase of new dwellings also rose in the month but are also down around 27% over the year. More broadly, growth in the stock of outstanding housing credit has slowed over recent months but is still up 3.3% y/y.

Chart 6: House price have shown signs of stabilisation



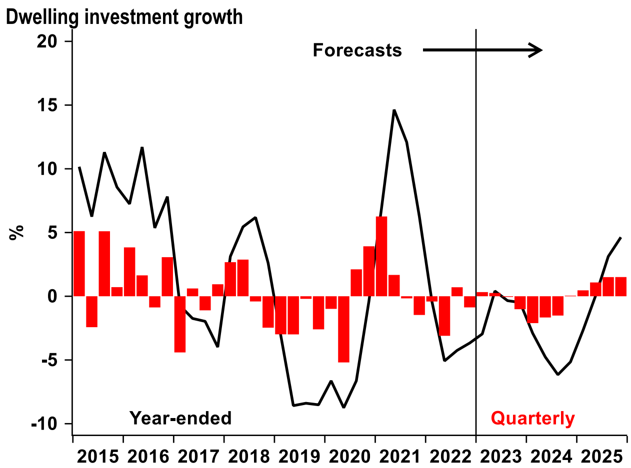
Source: National Australia Bank, CoreLogic, Macrobond

Chart 7: Building approvals have fallen sharply



Source: Macrobond, NAB Economics

Chart 8: Dwelling investment is likely to fall as the pipeline of outstanding work is completed



Source: ABS, National Australia Bank

Business and Trade

Business conditions continued to gradually ease in April but remain well above average and confidence has stabilised, albeit at a lower level.

Business conditions in the NAB Monthly Business Survey eased 2pts in April to +14 index points, still well above average. Elevated trading conditions continue to suggest demand is strong and the employment index also ticked higher in the month, reflecting the strength of the labour market. Confidence rose slightly and has now somewhat stabilized around 0 index points after falling for a number of months.

Cost growth remained a challenge, with purchase cost growth picking back up after easing in recent months and labour cost growth still high. Nonetheless, price growth measures continued to gradually moderate with overall price growth running at 1.1% in quarterly terms and retail prices at 1.4% (down from 1.7%). This may signal further gradual easing in inflation in the early part of Q2 after the most recent CPI release showed some easing in Q1, albeit inflation remains very elevated.

With confidence low and the economy expected to slow, we continue to expect business investment to be subdued over the coming year.

Rising exports outstripped the rebound in imports in March, seeing the trade surplus grow to $15.3b. However, we expect a substantial detraction from real GDP from net exports for Q1 overall.

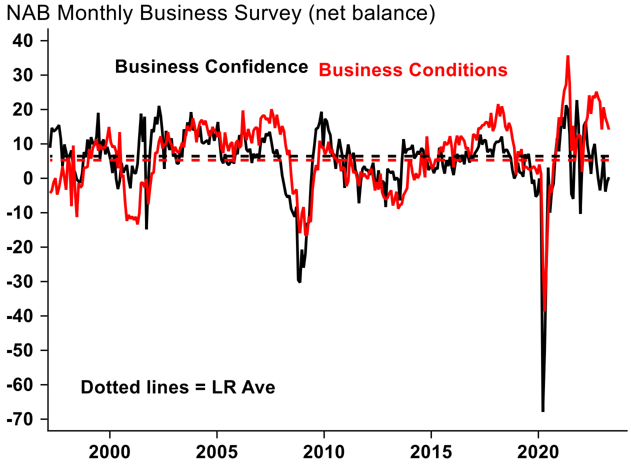
Growth in iron ore exports of 11.6% in March, driven by a lift in volumes, contributed to the strong monthly result alongside a 10.9% increase in rural goods exports, with exports increasing by 3.8% overall. Imports also rose, up 2.5% after a fall in February, driven by a sharp rise in imports of consumption goods.

Recent months have also seen services trade return broadly to a position of balance with services exports continuing to gradually recover – albeit they remain below pre-COVID levels – and services imports receding slightly from their elevated levels over the summer.

The nominal trade surplus totalled $40.3b for Q1 2023, up from $38.2b in Q4. However, we expect net exports to subtract considerably from real GDP growth in the quarter. Price indicators suggest much of the increase in exports has been price rather than volume related, while import prices for goods have declined. The subtraction could be as large as 1ppt of GDP growth, although the scale of price movements makes this uncertain.

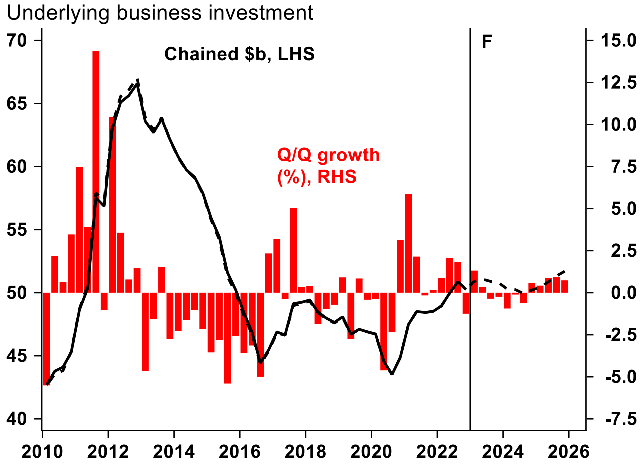
Despite the likely subtraction in the near term, we expect a positive contribution from exports through the forecast period as trade normalises further and consumption softens, weighing on imports.

Chart 9: Business conditions remain strong and confidence has stabilised



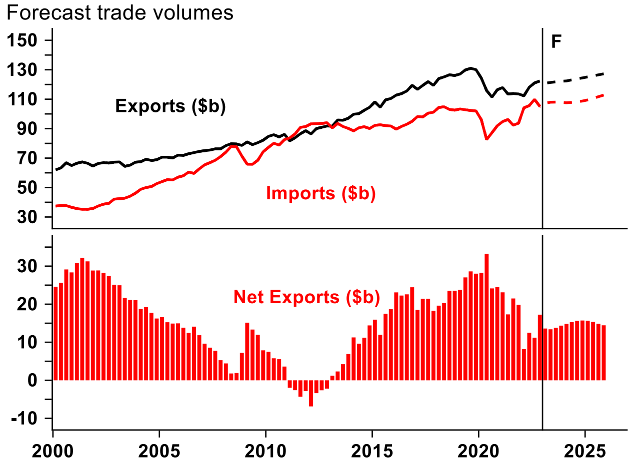
Source: Macrobond, NAB Economics

Chart 10: We expect business investment to remain subdued over the coming year



Source: Macrobond, NAB Economics

Chart 11: Net exports are likely to subtract from GDP growth in Q1



Source: Macrobond, NAB Economics

Monetary Policy, Inflation and FX

The Q1 CPI showed headline inflation fell to 7.0% in Q1 after peaking at 7.8% in Q4 2022.

Trimmed-mean inflation slowed to 6.6% y/y after peaking at 6.9% y/y in Q4 (and in quarterly terms peaked in Q3 at 1.9% q/q).

We see a further easing in inflation in Q2 with goods prices inflation continuing to moderate (driven by outright declines in some components) and the impact of the run-up in building costs fading. However, market services inflation rose and rents growth, in particular, is strengthening significantly. We see a further easing in the rate of quarterly inflation in Q2 but expect further improvements beyond that to be more gradual.

Upstream indicators continue to suggest an easing in price pressure and the exchange rate which is encouraging for goods prices. The pass-through and interaction with other costs as well as the strength in demand will be important for how the easing in costs is passed through. Our business survey for example shows that cost and price growth has eased substantially over the past 9 months or so, but that remains elevated.

We see trimmed-mean inflation easing to 4.0% y/y by end 2023 and 3% y/y by end 2024. Key to this outlook is that wage growth remains consistent with “at-target” inflation.

We have reverted to our previous rate call, expecting rates to peak at 4.1% in July, with the strong risk that the RBA could take rates to 4.35% if incoming wage and inflation data challenge their outlook.

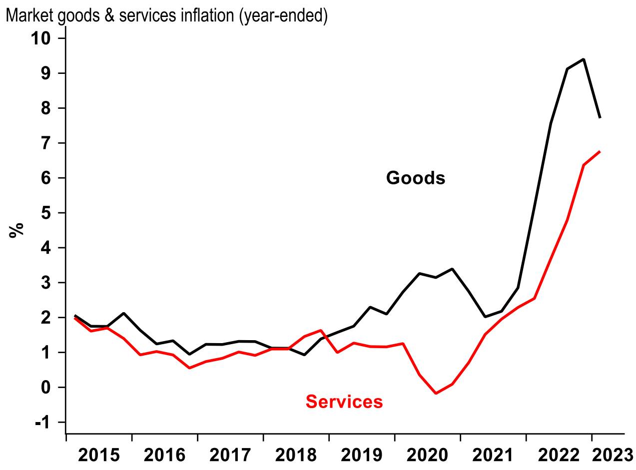
The RBA surprised markets but lifting rates a further 25bps in May after just a one month pause. Following the May meeting the RBA released a full set of updated staff forecasts which were slightly softer on unemployment and wage growth than February. Importantly, the RBA continues to see inflation moderating but remaining above the target band until 2025.

We judge this to be at the very limit of the “reasonable timeframe” the board will tolerate for a return to target and see at least one more rate increase in the coming months, with the possibility of another, taking the cash rate to 4.35%.

The AUD has traded between US66-68c over the past month and we see the AUD/USD strengthening through H2 2023 on the back if a weaker USD.

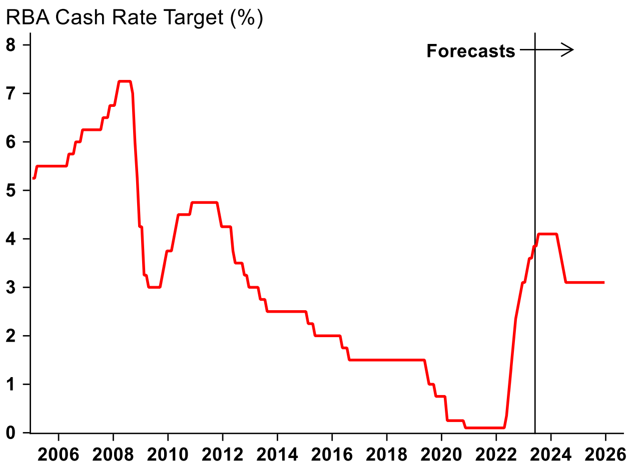
We see the Aussie rising to US74c by end 2023, before tracking in the US70-74c range over 2024 and ultimately strengthening to around US78c as the global economy recovers in 2025. We expect the material appreciation in H2 2023 to come from a weaker USD as certainty of a Fed peak is materialised and cuts become likely if the US enters a recession.

Chart 12: Goods inflation is clearly moderating, while services is a growing concern.



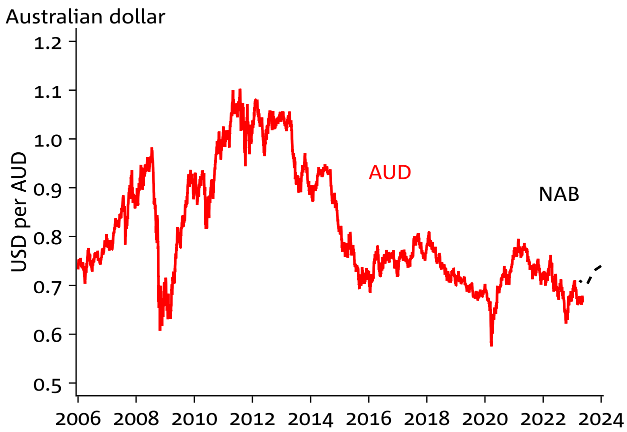
Source: Macrobond, NAB Economics

Chart 13: Cash rate expected to rise to 4.1% by July and stay there through H2 2023



Source: Macrobond, NAB Economics

Chart 14: AUD/USD to drift higher over coming years, reaching US80c by end 2024



Source: National Australia Bank, Macrobond Financial AB

Theme of the Month: Lining up NAB and Official Forecasts

There is broad agreement on the path ahead for the economy, with GDP and employment growth expected to slow, leading to a rise in unemployment and continued fall in inflation, although NAB's forecasts for growth (and the labour market) are somewhat more pessimistic than that of the RBA and Federal Government.

The official family – the RBA and Federal Government – have both released forecast updates this month via the May Statement of Monetary Policy and 2023-24 Commonwealth Budget ('the Budget') respectively. Different views over the outlook can have implications for policy decisions in the here and now, so this month we compare how our forecasts align to those of the RBA and the Budget.

There is a common expectation that GDP growth will slow. This reflects a slowdown in consumption growth and a fall in dwelling investment. We expect there to be modest falls in business investment, while the RBA and the Budget see it continuing to rise albeit at a slower rate.

While the path for annual household consumption growth is similar in direction (slower growth than in 2022), there is a notable difference in the projected growth rates from the second half of 2023. Our forecasts allow for flat to slightly negative consumption in the back half of 2023 and into 2024. Over the year to June 2024, we expect household consumption growth of only 0.2% y/y, while the RBA projects 1.8%. In year average terms, our forecast for 2023-24 is 0.6% compared the Budget's 1.5%.

With household consumption the single largest component of GDP (on an expenditure basis), NAB's GDP growth forecast is also weaker than that of the RBA/Treasury, reinforced by a less sanguine view for business investment. That said, all three forecasts expect to GDP growth to slow to a level clearly below its trend.

Unsurprisingly, the slowdown in growth is expected to see employment growth also slow to modest levels. NAB's forecast is for somewhat weaker employment growth over 2023/2024, consistent with a lower GDP growth forecast.

It is a similar story for the unemployment rate. While total employment is expected to rise (albeit at a slower rate), it is unlikely to match population growth given the strong rebound in net overseas migration that is underway. Again, consistent with our softer GDP forecast than the RBA/the Budget, we see a higher peak for the unemployment rate, although all three forecasts see it rising by at least 1ppt (i.e. to at least 4.5%).

Chart 15: GDP growth to be below trend, though RBA and Treasury see more resilience

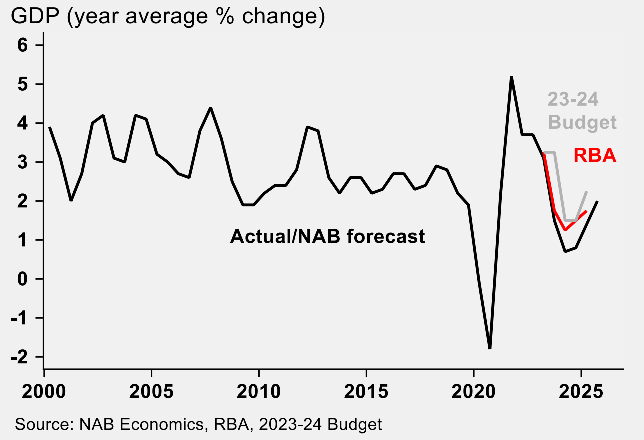


Chart 16: Lower GDP growth also sees lower employment growth

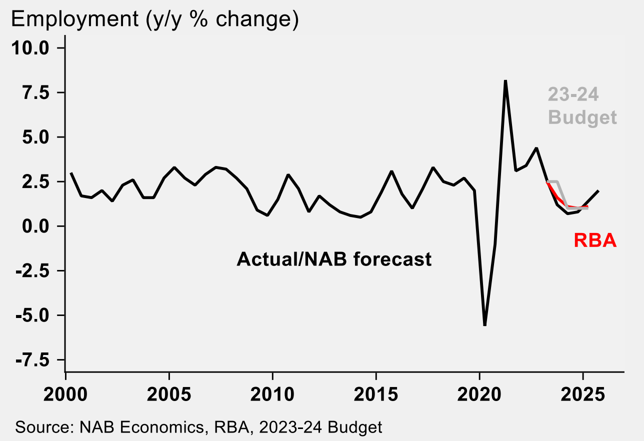
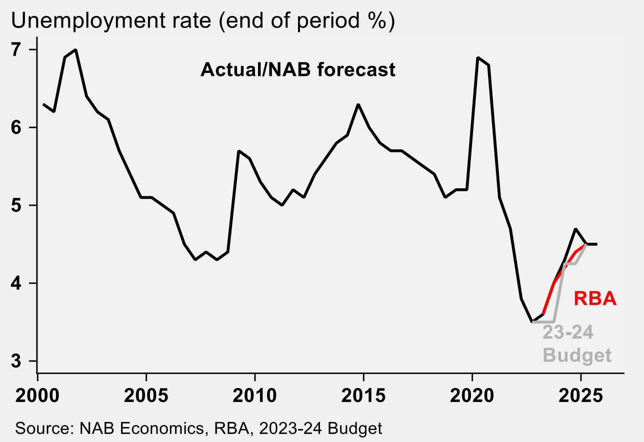


Chart 17: Unemployment rate expected to rise by at least 1ppt



Note: data are half yearly except 2023-24 Commonwealth Budget which are yearly (base on June financial years)

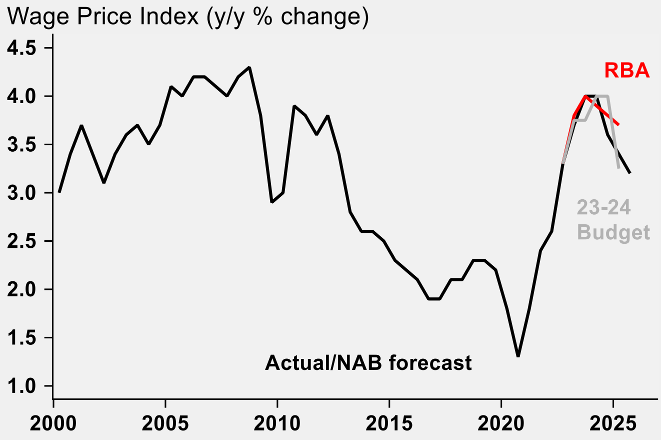
While a rise in the unemployment rate is expected, currently it is at very low level. The very tight labour market, along with elevated inflation, is leading to a strengthening in wage growth. There is agreement across the NAB/Budget/RBA forecasts that the wage price index will peak at 4% y/y. There is some disagreement at what level wage growth will remain as the labour market starts to soften. The RBA expects wage growth to ease more slowly than NAB/Budget. However, the RBA's projected level of wage growth is not inconsistent with its inflation target.

More directly relevant for the outlook for interest rates is inflation. All three sets of forecasts allow for headline (annual) inflation to keep falling over the forecast horizon. The NAB and the Budget forecasts see inflation moving to below 3% y/y in H1 2025.

The RBA sees inflation remaining slightly higher, at 3% y/y by June 2025, right at the top its inflation target range. In terms of a forecast a couple of years out, this is not a significant difference, particularly given the RBA expects trimmed mean inflation (a measure of underlying inflation) to fall below 3% in H1 2025.

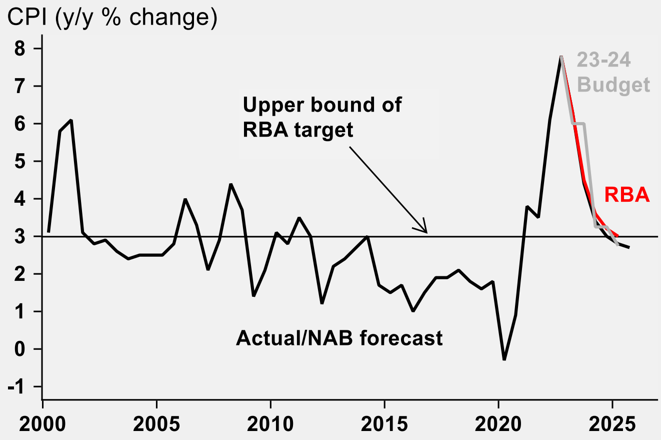
However, the RBA has indicated that is committed to getting inflation back to target "within a reasonable timeframe". Inflation above target for a further two years is likely to be the very limit of what the Board would consider a reasonable timeframe. Indeed, given the recent RBA Review recommended the RBA Board focus on achieving the mid-point of the target (2.5%), it may be that reaching only 3% by the end of the forecast period is outside what is reasonable. Given this, even small differences in the inflation outlook over the next two years may have implications for how far rates go in this tightening cycle.

Chart 18: Consensus that wage price growth will climb to 4% - less agreement on how quickly it will decelerate



Source: NAB Economics, RBA, 2023-24 Budget

Chart 19: Annual inflation has peaked and expected to decelerate – RBA more cautious on picking when it will move below upper bound of inflation target



Source: NAB Economics, RBA, 2023-24 Budget

Key Domestic Forecasts:

	% Growth q/q				% Growth y/y			
	Q1-23 (f)	Q2-23 (f)	Q3-23 (f)	Q4-23 (f)	2022	2023 (f)	2024 (f)	2025 (f)
GDP and Components								
Private Consumption	0.4	0.4	0.0	-0.1	5.4	0.7	1.1	2.2
Dwelling Investment	0.3	0.3	-0.1	-1.0	-3.7	-0.5	-5.2	4.6
Underlying Business Investment	1.3	0.3	-0.4	-0.2	3.5	1.1	-1.1	3.0
Underlying Public Final Demand	0.7	0.5	0.5	0.5	2.5	2.2	2.0	2.0
Domestic Demand	**0.6**	**0.4**	**0.1**	**0.0**	**3.3**	**1.1**	**1.0**	**2.5**
Stocks (Cont. to GDP)	0.3	0.0	-0.1	-0.1	0.4	-0.1	-0.1	0.1
Gross National Expenditure	**0.9**	**0.4**	**0.0**	**-0.1**	**3.2**	**1.3**	**1.0**	**2.6**
Exports	-1.2	0.4	0.4	0.3	7.7	-0.2	1.9	2.2
Imports	2.0	0.6	0.1	-0.2	12.1	2.6	0.9	3.7
Net Export (Cont. to GDP)	-0.7	0.0	0.1	0.1	-0.5	-0.5	0.2	-0.2
Real GDP	**0.2**	**0.4**	**0.1**	**0.1**	**2.7**	**0.7**	**1.2**	**2.3**
Nominal GDP	1.8	1.1	0.3	0.4	12.0	3.7	4.2	4.3
External Account								
Current Account Balance ($b)	39.2	39.1	45.4	35.7	29.4	35.7	24.7	19.4
Current Account Balance (% of GDP)	1.6	1.5	1.8	1.4	1.2	1.4	0.9	0.7
Terms of Trade	3.4	-0.8	-2.8	-2.1	7.2	-2.4	1.0	-2.5
Labour Market								
Employment	0.4	0.4	0.4	0.1	5.0	1.3	0.8	2.0
Unemployment Rate (End of Period)	3.6	3.6	3.8	4.0	3.5	4.0	4.7	4.5
Ave. Earnings (Nat. Accts. Basis)	0.9	0.9	1.1	1.0	4.4	4.0	3.6	3.2
Wage Price Index (WPI)	0.9	0.9	1.1	1.0	3.3	4.0	3.6	3.2
Prices and Rates (end of period)	**Year-ended**							
Headline CPI	7.0	6.3	5.4	4.4	7.8	4.4	3.0	2.7
Trimmed-mean CPI	6.6	5.9	4.9	4.1	6.9	4.1	3.1	2.7
RBA Cash Rate	3.60	3.85	4.10	4.10	3.10	4.10	3.10	3.10
10 Year Govt. Bonds	3.31	3.85	3.85	3.65	4.04	3.65	3.50	3.55
$A/US cents	0.67	0.70	0.73	0.74	0.68	0.74	0.73	0.78

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

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Important notice