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The Forward View: Australia July-2023

A slow second half, but persistent inflation

NAB Group Economics

Overview

- Our growth and labour market forecasts are broadly unchanged this month, though we have revised up our near-term expectations for the CPI slightly as we have refined our "bottom-up" forecasts ahead of the Q2 CPI release.
- On inflation, we have nudged up our expectations for trimmed mean in Q2 (released next week) and Q3. We see headline inflation printing at 0.9% q/q and trimmed-mean printing at 1.1% in both Q2 and Q3.
- We still expect quarterly GDP growth to be flat over the next three quarters, with growth of just 0.5% over 2023 – the slowest pace of growth outside of the pandemic since the 1990s – and 0.9% in 2024. Both would be well below trend.
- The labour market is also expected to weaken through the second half, with the unemployment rate rising from the near 50-year low of 3.6%. The sharp slowing in growth will see unemployment reach 5% by end 2024. This is a significant turnaround from the outcomes seen over the past year or so, but broadly around pre-pandemic levels.
- That said, wage pressures are expected to continue to build – reaching around 4% y/y before the easing in the labour market sees some of the wage pressures abate.
- Though the RBA remained on hold, we still see two further hikes – pencilling in August and September. There is increasing evidence that rates are working to slow demand, though inflation remains high and services inflation will pressure the RBA in the near term.
- We have raised our dwelling price forecast given the considerable resilience in the market, and now see a 4.5% increase over 2023. However, uncertainty is high.
- In terms of activity, building commencements rose in Q1 after falling in recent quarters. There appears to have been some easing in supply and cost constraints in the construction sector. That said, they remain low relative to recent standards. The pipeline of work outstanding is still very elevated with around 6 quarters of work outstanding. However, the recent run of weaker dwelling approvals should see this normalise over the next year.

Table of Contents

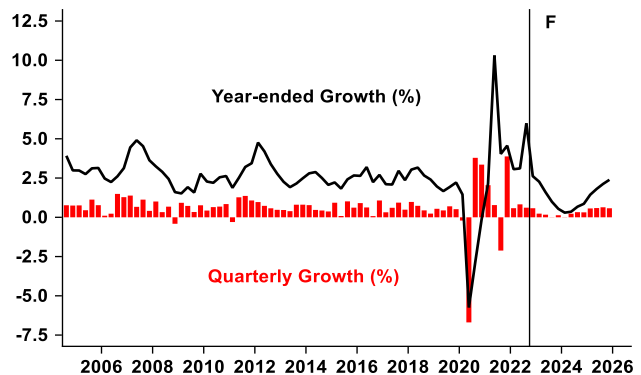
Overview 1
Labour Market, Wages & Consumption 2
Housing and Construction 3
Business and Trade 4
Monetary Policy, Inflation and FX 5
Theme of the Month: Building Activity Data for Q1 6
Key Domestic Forecasts: 7

Key Economic Forecasts

	2022-F	2023-F	2024-F	2025-F
Domestic Demand (a)	4.9	1.2	0.1	1.9
Real GDP (annual average)	**3.7**	**1.3**	**0.5**	**1.9**
Real GDP (year-ended to Dec)	**2.6**	**0.5**	**0.9**	**2.4**
Terms of Trade (a)	6.1	-2.0	-2.8	-1.1
Employment (a)	4.2	2.6	0.3	1.1
Unemployment Rate (b)	3.5	4.2	5.0	4.8
Headline CPI (b)	7.8	4.6	3.1	2.7
Core CPI (b)	6.2	4.4	3.2	2.7
RBA Cash Rate (b)	3.10	4.60	3.10	3.10
$A/US cents (b)	0.68	0.72	0.73	0.78

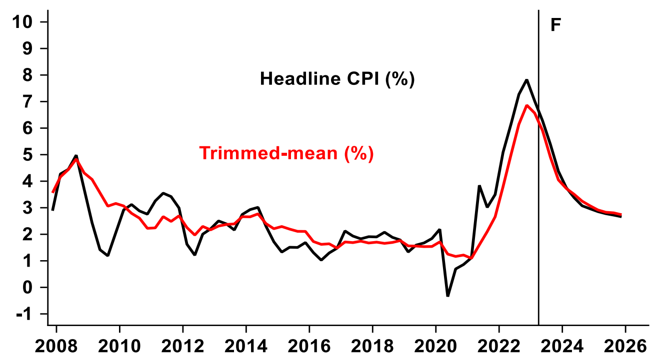
(a) annual average growth, (b) end-period, (c) through the year inflation

Chart 1: GDP forecasts



Source: Macrobond, NAB Economics

Chart 2: CPI forecasts



Source: Macrobond, NAB Economics

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Labour Market, Wages & Consumption

The labour market remains very tight with only incremental easing in job vacancies over the past year, and wage growth should continue to strengthen as a result before the slowing economy sees unemployment begin to rise.

The most recent labour force data showed strong employment growth continued through May and the unemployment rate remained at historic lows at 3.6%. More recent payroll data showed the number of jobs increased 0.3% to mid-June, suggesting the pace of employment growth may have eased slightly but nonetheless continued through the month.

More significantly, the release of job vacancies data for Q2 showed a fall of just 2% to 432k. That leaves the number of vacancies down 10% from their mid-2022 peak but still almost double their pre-COVID level, with the number of vacancies per unemployed at around 0.8.

In terms of the outlook, we continue to expect the rate of employment growth to slow (and vacancies to fall) over the second half of the year and through 2024 as the economy weakens, enough to see the unemployment rate rise to around 5% by end-2024. This would be a considerable rise but, importantly, would still leave unemployment around its pre-COVID level.

Wage growth should continue to strengthen in the near term as the current labour market tightness and elevated inflation drive bargaining negotiations, alongside the very large minimum and award wage rise taking effect in Q3. We see wage growth lifting to 4% by the end of the year before stabilising as the labour market softens and inflation eases.

There are increasing signs that consumption is slowing and it remains our expectation that real household consumption growth will be flat or negative for much of the coming year as the impact of higher rates continues to flow through to households.

Nominal retail trade data for May showed a pickup, with spending rising 0.5% m/m after a flat April result. NAB's transaction data, published in last week's *Data Insights* report, showed overall spending eased back again in June, including in retail. On net, that suggests Q2 spending was only marginally positive in nominal terms and given the ongoing strength of inflation, suggests reasonably flat real consumption growth for the quarter.

Further out, we expect real consumption growth to decline slightly over the coming year, weighing on GDP growth overall. However, the outlook for consumption remains a major source of uncertainty with scope for households to draw down on savings to maintain their consumption even as inflation and interest rates weigh.

Chart 3: Unemployment rate will likely rise to around 5% as the economy slows

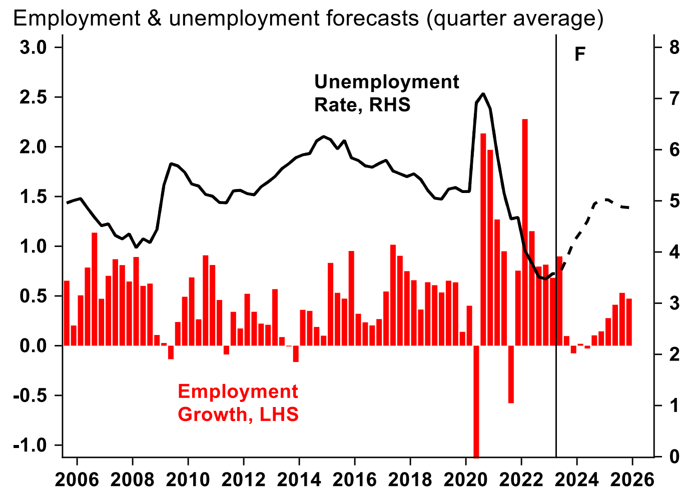


Chart 4: Job vacancies remained high in Q2, only around 10% lower than their mid-2022 peak

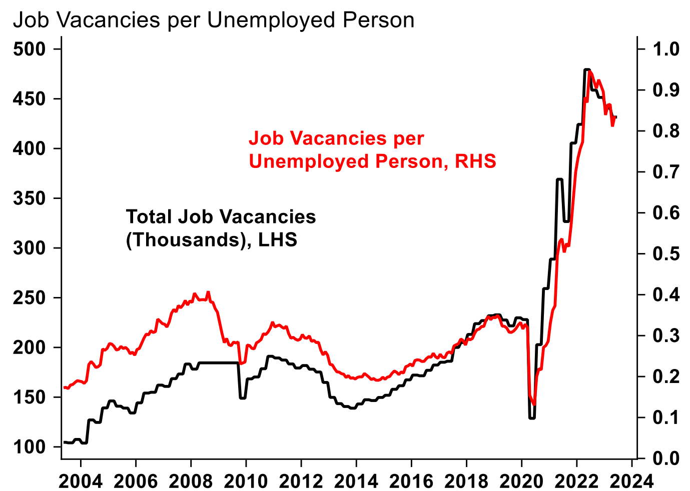
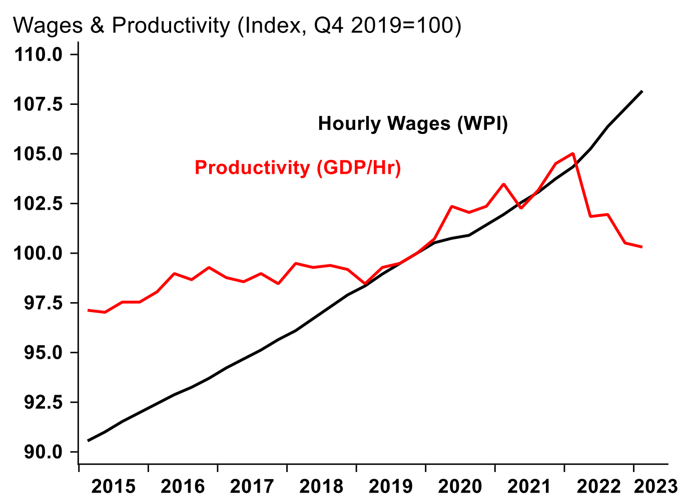


Chart 5: Real household consumption is expected to be flat or negative over the coming year



Housing and Construction

We have upped our end of year expectation for house prices although uncertainty is high.

House prices continued to rise across almost all capital cities in June except for Hobart where prices continue to buck the national trend. Across the 8 capital cities, house prices rose 1.2% in the month and are now 4.1% higher than February 2023. Sydney continues to lead the increase, rising by a further 1.6% in the month, to be 6.4% higher since troughing in February.

That said, Brisbane, Melbourne and Perth have also made solid gains rising by 2-3% since early 2023. Dwelling prices are now just 6% below their peak in early 2022 (after falling as much as 9.7% to early 2023). Recent data show the pace of increase has slowed but remains solid.

The pace of rents growth slowed slightly in monthly terms, up 0.7% nationwide in June. The pace of growth eased in both Sydney and Melbourne, edged lower in Perth and edged up in Brisbane. Hobart recorded a second monthly fall. Nonetheless, rents growth remains strong and the rental market tight.

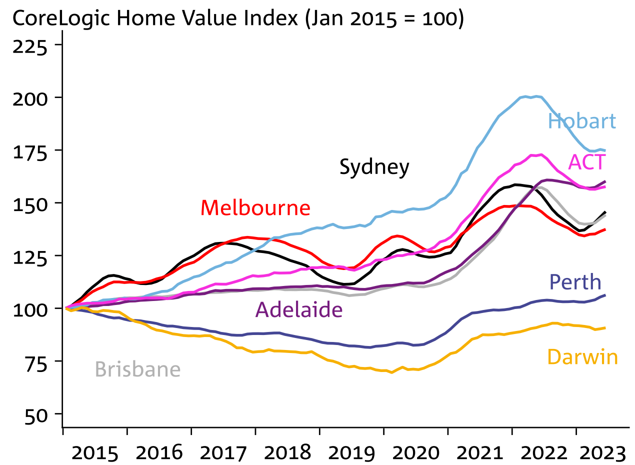
The rental vacancy rate edged up further in June reaching 1.3% based on the SQM measure. The increase was driven by rises in Sydney, Melbourne and Hobart while the other capitals saw flatter outcomes. Though they have edged up in recent months, rental vacancy rates remain low across the capitals which will likely see ongoing pressure on rents in the near term.

We have revised up our outlook for house prices in 2023, now expecting prices to end the year up around 4.5% (from -6.4%). House prices have remained very resilient to the rapid increase in interest rates and associated decline in affordability and borrowing power. The rebound in population growth and a tight rental market alongside a weaker supply side appear to be key offsetting factors and the labour market has remained very healthy.

In terms of activity, both building and finance approvals rose in May after weakness through early 2023. Building approvals rose 20% driven by a rise in the volatile "high-density" component (up 60%), though approvals for detached houses also increased 0.9%. Despite the rise in the month, building approvals remain 10% lower over the year and in trend terms, approvals for detached housing continue to fall.

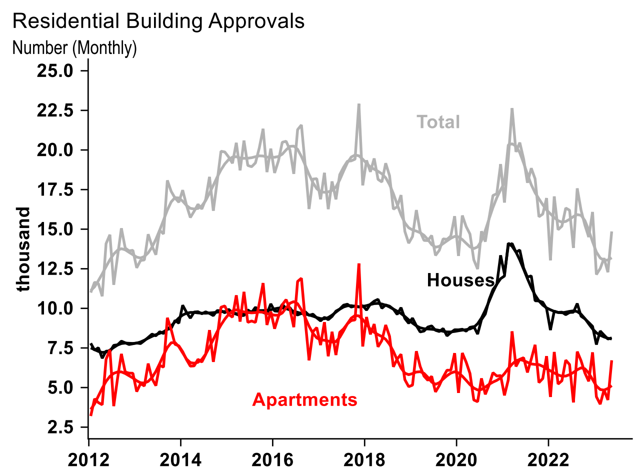
Finance approvals rose 5% in May but remain 21% lower over the year. The increase was driven by both owner-occupiers and investors in the month. With the full impact of rates continuing to flow through and the RBA likely to hike further in the near term there may be some ongoing pressure on both approvals and credit growth.

Chart 6: House price have shown signs of stabilisation



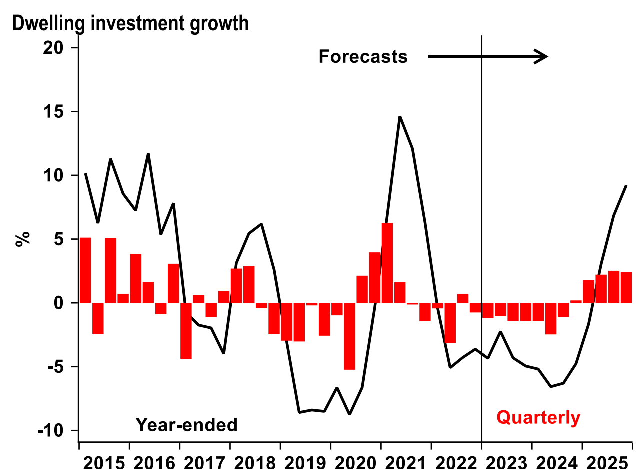
Source: National Australia Bank, CoreLogic, Macrobond

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 have softened in recent months but were steady in June at an above average level. However, forward looking indicators remain soft and business credit growth has slowed.

Business conditions in the NAB Monthly Business Survey were steady at +9 index points in June, still above the long-run average. Retail conditions fell in the month, in line with other measures of retail spending softening, but construction conditions improved.

Forward indicators in the survey remain soft with confidence sitting at 0 index points (up slightly from May), reflecting that there is an equal number of pessimistic and optimistic firms. Forward orders also remained negative in June at -2 index points, another sign that conditions may weaken further in the period ahead.

The weakness in the outlook, alongside elevated interest rates, does appear to be weighing on firms' borrowing with business credit growth slowing to 0.5% m/m in May. Total business credit remains 9.7% higher y/y – a very elevated rate of growth – but the run rate over recent months has been much slower. Together, weak confidence and reduced borrowing likely signal weaker growth in business investment over the period ahead.

The nominal trade surplus lifted to $11.8b in May (from $11.2b in April), with exports boosted by non-monetary gold. In terms of underlying volumes, we continue to expect weak demand to weigh on imports over the period ahead.

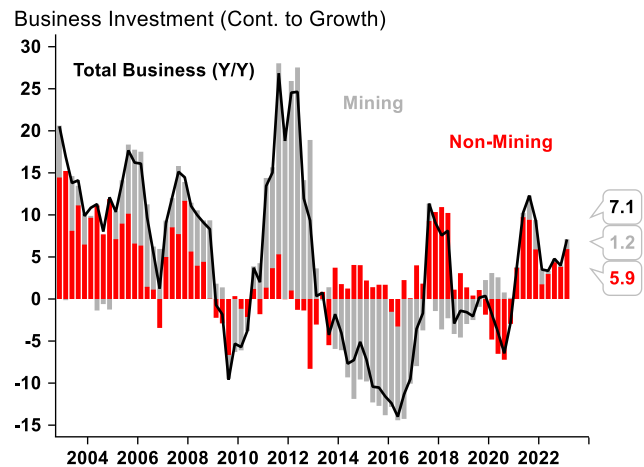
Goods exports rose 5% in May, boosted by a 77.1% m/m increase in non-monetary gold exports. Volumes for iron ore and coal appear to have lifted but there have been offsetting declines in prices.

Goods imports also rose in the month, up 3.1%, led by non-industrial transport equipment – possibly reflecting the clearing of order backlogs as well as delivery ahead of 30 June to take advantage of the expiring instant asset write-off.

In terms of services, the ongoing recovery in tourism exports has seen Australia return to a small surplus in services trade. Under the surface, however, elevated freight services costs through the recent period of supply chain disruption have been boosting services imports. When these are stripped out, services trade would have been in surplus for much of the pandemic period. The normalisation of freight services costs is now weighing on services imports growth. The recovery in outbound tourism has also slowed.

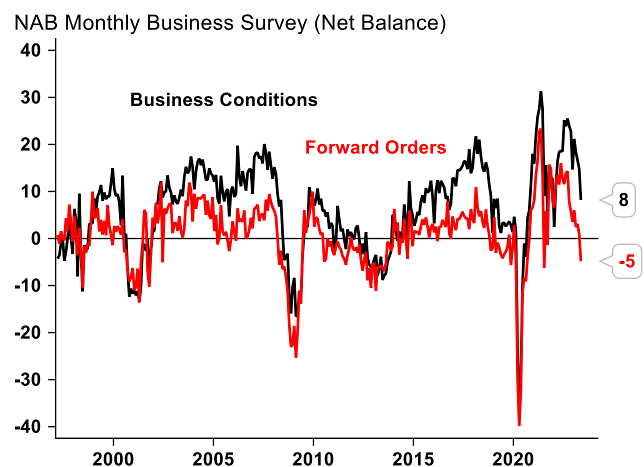
Looking ahead, we continue to expect weak demand to weigh on imports more broadly over the period ahead, while the continued normalisation of global trade should support export volumes.

Chart 9: Business conditions remain above average but forward orders are still below average



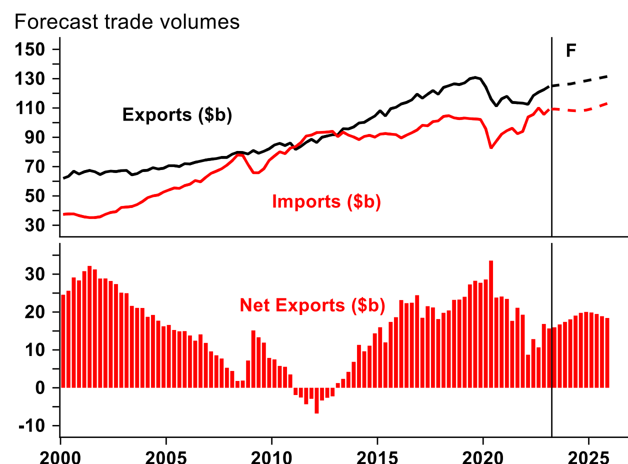
Source: Macrobond, NAB Economics

Chart 10: Business credit growth has slowed from very elevated rates



Source: Macrobond, NAB Economics

Chart 11: Services trade is now in surplus alongside a large goods trade surplus



Source: Macrobond, NAB Economics

Monetary Policy, Inflation and FX

Though the RBA remained on hold in July, we still expect two further cash rate increases to 4.6%.

For now, we have pencilled in back-to-back increases in August and September. Like the pause in April, we see the RBA as waiting for the full quarterly CPI and an updated set of staff forecasts (to be released in the August SMP) before taking rates higher.

With the pace of hikes slowing, the RBA Board clearly feels that rates are close to being restrictive enough, and there is a chance they remain on pause at 4.1%. Indeed, the post meeting statement highlighted the increasing evidence that rates are working to slow demand as well as the elevated uncertainty around growth – including globally.

That said, the statement (and Governor's subsequent speech) continued to reiterate the importance of returning inflation to target within a reasonable timeframe and risks to the upside on inflation remain, which in our view will ultimately push them to raise rates slightly further.

We expect the Q2 CPI to print at 0.9% q/q and the trimmed mean measure at 1.1% q/q.

In underlying terms, this outcome would see little improvement in the quarterly pace of inflation (1.2% prior) and the outlook for Q3 suggests little further gains with a range of services side pressures – such as insurance services and rents - continuing to support growth as well as the risk of second round energy and wage impacts.

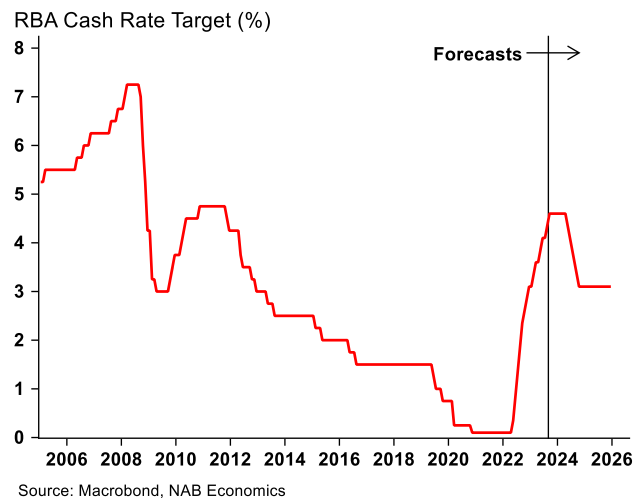
Globally, upstream pressures continue to ease with demand growth moderating alongside the improvement in supply - shipping costs having recovered, and supply chains have normalised. Locally, farm gate prices for meat have fallen while the impacts of flooding and other weather disruptions have faded. There is the possibility that goods deflation is able to offset some of the strength in services inflation but how and when any easing in upstream pressures is passed through remains to be seen.

The balance of supply and demand in the domestic economy remains key, and our Monthly Business Survey suggests that capacity utilisation remains high and conditions above average despite easing significantly this year. Alongside this, the survey's price measures appear to have stabilised at a high level in recent months though they have come off their peaks of mid-2022. This supports our expectation that further easing in inflation will only be incremental in the near term.

The AUD has strengthened recently, trading in the high 68c range after falling as low as the low $66c in late June.

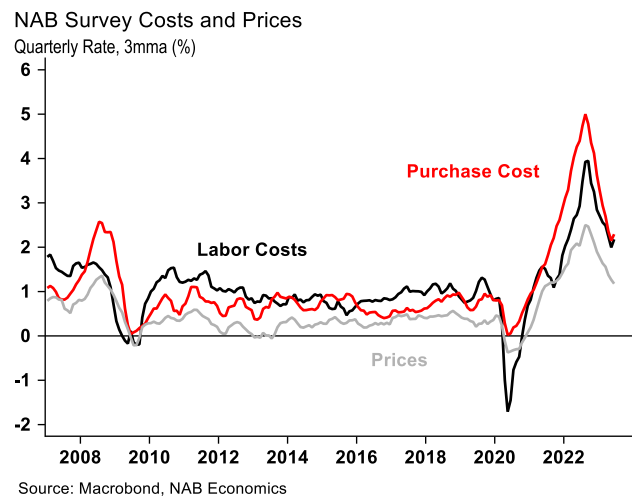
Our outlook for the AUD is unchanged, ending the year around US72c before still drifting up to US73c by the end of 2024.

Chart 12: The cash rate is still expected to peak at 4.6%.



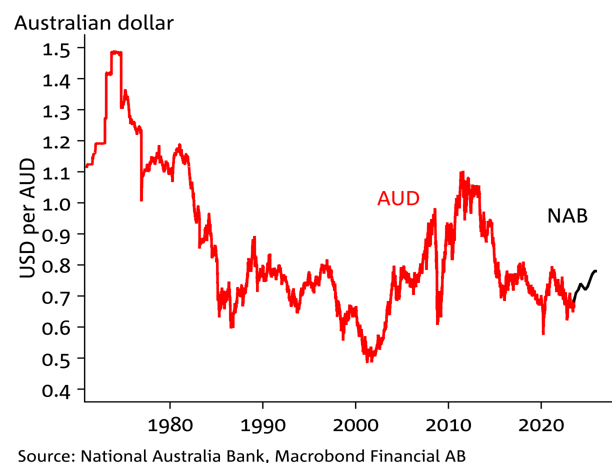
Source: Macrobond, NAB Economics

Chart 13: The NAB Monthly Business Survey shows price pressures remain elevated



Source: Macrobond, NAB Economics

Chart 14: AUD/USD to drift higher over coming years, reaching US78c by end 2024



Source: National Australia Bank, Macrobond Financial AB

Theme of the Month: Building Activity Data

With housing supply a major focus, the release of the Q1 ABS Building Activity Survey provides a belated insight into the dynamics unfolding on the development and supply of new dwellings.

Commencements rose 14% in Q1, driven by a rebound in NSW (+14%), Vic (+24%) and QLD (+19%) and a smaller gain in SA (+3%). Despite the solid increase in the quarter (noting the series can be volatile) commencements are still 7% lower than a year ago and 30% down on their recent peak in Q2 2021. The starkest decline has occurred in QLD where commencements of new dwellings are around 40% of their peak with NSW also down 33% and Vic is 17% off their peaks in mid-2021. The smaller states and territories, which are prone to more volatility (and construction cycles), have also seen declines.

Completions have also declined significantly from pre-pandemic levels, currently tracking at around 175k on a rolling annual basis compared with 200k+ in 2018.

The fall in completions has come despite an elevated pipeline of work under way. Supply chain and labour constraints have likely delayed the start and completions of some dwellings while very strong price growth for key construction inputs has also likely contributed to uncertainty. As of Q1 there were 250K dwellings under construction or about to be commenced. At current rates of work done there are around 6 quarters of work outstanding, compared with the usual 4 quarter pipeline.

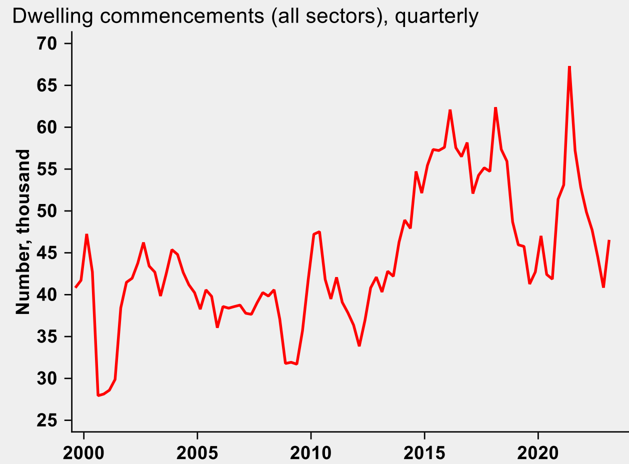
Notwithstanding the spike in May, building approvals have weakened over the past year, tracking at their lowest level since 2012. Current rates equate to ~120k annually, which would see a further step down in completions (and ultimately supply) once the current pipeline is worked through.

On the demand side, population growth has rebounded more strongly than expected, while demand for increased floor space during the pandemic will likely take some time to unwind (if at all) pointing to ongoing pressures in housing supply.

The construction sector reported an improvement in conditions in the NAB Monthly Business Survey for May suggesting that supply constraints and price pressures may be easing.

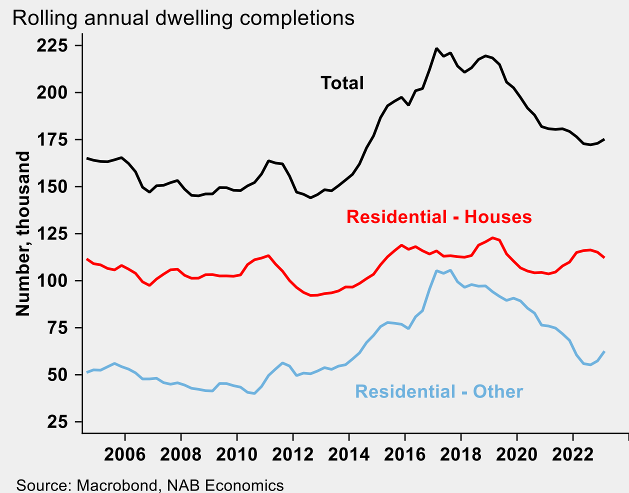
These factors suggest that a tight housing market and upward pressure on both rents and prices will continue in the near term without a more material increase in completion rates, but due to the interest sensitive nature of the sector, but with a rise in approvals will likely only occur further out.

Chart 15: Commencements picked up in Q1, after falling sharply in 2022.



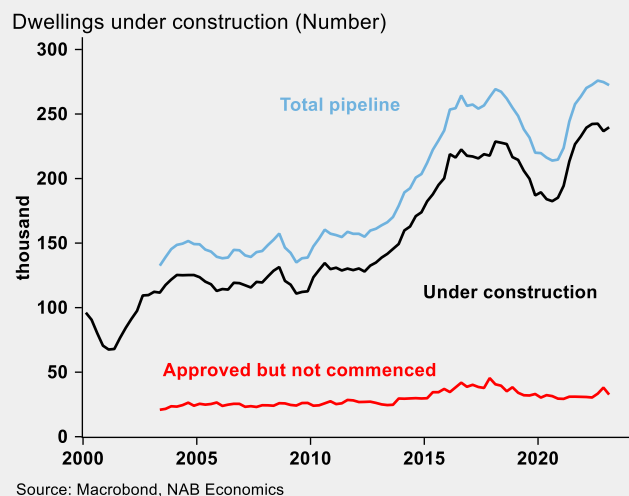
Source: Macrobond, NAB Economics

Chart 16: Dwelling completions appear to be stabilising.



Source: Macrobond, NAB Economics

Chart 17: The Pipeline of work remains elevated despite the recent weak run of new approvals.



Source: Macrobond, NAB Economics

Key Domestic Forecasts:

	% Growth q/q				% Growth y/y			
	Q1-23	Q2-23 (f)	Q3-23 (f)	Q4-23 (f)	2022	2023 (f)	2024 (f)	2025 (f)
GDP and Components								
Private Consumption	0.2	0.1	-0.2	-0.1	5.2	0.1	0.0	2.1
Dwelling Investment	-1.2	-1.0	-1.4	-1.4	-3.6	-5.0	-4.8	9.2
Underlying Business Investment	3.5	1.2	-0.4	-0.2	4.6	4.1	-1.4	3.3
Underlying Public Final Demand	0.6	0.0	0.5	0.5	2.3	1.7	2.0	2.0
Domestic Demand	**0.6**	**0.2**	**0.0**	**0.0**	**3.3**	**0.7**	**0.4**	**2.7**
Stocks (Cont. to GDP)	0.3	-0.2	-0.1	0.0	0.5	-0.5	-0.1	0.1
Gross National Expenditure	**0.6**	**-0.1**	**-0.2**	**0.0**	**3.4**	**0.3**	**0.4**	**2.8**
Exports	1.8	0.4	0.4	0.3	8.1	3.0	1.9	2.3
Imports	3.2	0.2	-0.3	-0.2	12.4	2.8	-0.2	4.2
Net Export (Cont. to GDP)	-0.2	0.1	0.1	0.1	-0.5	0.1	0.5	-0.3
Real GDP	**0.2**	**0.2**	**0.0**	**0.1**	**2.6**	**0.5**	**0.9**	**2.4**
Nominal GDP	2.1	0.9	0.4	0.5	12.0	4.0	3.9	4.4
External Account								
Current Account Balance ($b)	34.8	33.8	41.6	34.4	27.1	34.4	29.0	25.1
Current Account Balance (% of GDP)	1.4	1.3	1.6	1.3	1.1	1.3	1.1	0.9
Terms of Trade	2.8	-0.8	-2.8	-2.1	6.9	-3.0	1.0	-2.5
Labour Market								
Employment	0.7	0.9	0.1	-0.1	5.1	1.6	0.3	1.7
Unemployment Rate (End of Period)	3.6	3.6	3.9	4.2	3.5	4.2	5.0	4.8
Ave. Earnings (Nat. Accts. Basis)	2.3	0.9	1.1	1.0	4.0	5.4	3.6	3.2
Wage Price Index (WPI)	0.8	0.9	1.1	1.0	3.4	3.9	3.6	3.2
Prices and Rates (end of period)	**Year-ended**							
Headline CPI	7.0	6.1	5.4	4.6	7.8	4.6	3.1	2.7
Trimmed-mean CPI	6.6	6.0	5.2	4.4	6.9	4.4	3.2	2.7
RBA Cash Rate	3.60	4.10	4.60	4.60	3.10	4.60	3.10	3.10
10 Year Govt. Bonds	3.31	4.00	3.90	3.90	4.04	3.90	3.55	3.65
$A/US cents	0.67	0.66	0.71	0.72	0.68	0.72	0.73	0.78

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

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