Embargoed until 11:30am AEST, 15 August 2023

The Forward View: Australia Aug 2023

Flat consumption in Q2 with one more rate rise left

NAB Group Economics

Overview

- With inflation moderating more than expected in Q2 and further evidence of activity slowing, we now see only one more rise in the cash rate, taking the peak to 4.35% – most likely in November.
- Our forecasts for GDP growth have strengthened marginally, reflecting stronger Q2 exports, but we nonetheless continue to expect growth to be well below trend at 0.7% y/y in 2023 and 0.9% y/y in 2024.
- High inflation and the ongoing pass through of rate rises continues to weigh on households. Real consumption was most likely flat in Q2 and we see small falls in H2 2023. Importantly, consumption growth should improve in 2024 as inflation moderates and rates begin to normalise. We see the RBA beginning to cut in August 2024, returning the cash rate to around 3% by early 2025.
- The labour market has remained very tight with the unemployment rate still at 3.5% in June. This should continue to support wage growth in the near term, and we expect a strong WPI print for Q3 with growth around 4.2% y/y by end-2023.
- As the economy slows, however, softening labour demand should see the unemployment rate rise back to 4% by end-2023 and around 5% by end-2024. We expect this easing to be enough to bring wages growth back to around 3.8% in 2024.
- With the economy slowing and global supply chain issues largely resolved, inflation has started to moderate, falling to 6% y/y in Q2. We still see significant pressures on the services side with Q3 CPI likely to show a re-acceleration before further gradual easing to around 3% in headline terms by end-2024. The easing in the labour market and wage growth will play a part in this but profit margins will also be squeezed as firms face into an environment of much softer demand.
- House prices have continued to rise and have now regained around half of the fall seen between mid-2022 and early 2023. Rents are also still rising strongly though vacancy rates have started to edge back up. Building activity is still set to ease further although approvals have started to stabilise after falling early in the year.

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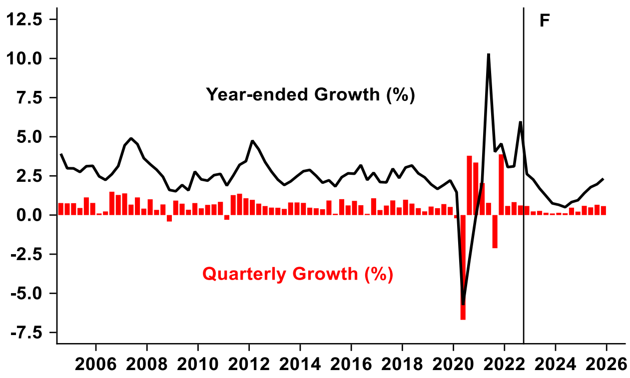
Key Economic Forecasts

	2022-F	2023-F	2024-F	2025-F
Domestic Demand (a)	4.9	1.1	0.2	2.0
Real GDP (annual average)	**3.7**	**1.5**	**0.7**	**1.9**
Real GDP (year-ended to Dec)	**2.6**	**0.7**	**0.9**	**2.3**
Terms of Trade (a)	6.1	-1.4	-2.4	-3.5
Employment (a)	4.2	2.8	0.4	1.2
Unemployment Rate (b)	3.5	4.0	4.9	4.6
Headline CPI (b)	7.8	4.4	3.0	2.7
Core CPI (b)	6.3	4.3	3.1	2.8
RBA Cash Rate (b)	3.10	4.35	3.35	3.10
$A/US cents (b)	0.68	0.72	0.73	0.78

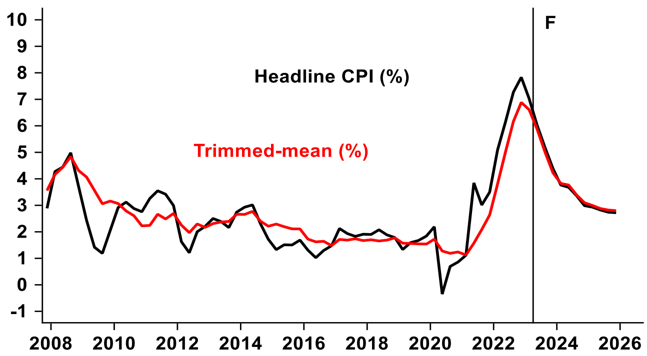
(a) annual average growth, (b) end-period

Chart 1: GDP forecasts



Source: Macrobond, NAB Economics

Chart 2: CPI forecasts



Source: Macrobond, NAB Economics

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Labour Market, Wages & Consumption

Wage growth is set to strengthen in the second half of 2023 as the labour market continues to show few signs of easing – though we still expect unemployment to rise eventually as the economy slows.

The unemployment rate was steady in June at 3.5% (with the May result revised down from 3.6%). Employment rose 33k in the month, continuing a run of strength that has kept the employment-to-population ratio at a historic high of 64.5%. There are now more than one million more people employed than in March 2020.

We continue to see the unemployment rate beginning to rise later in the year as the economy slows and labour demand softens, reaching around 4% by end-2023 and 5% by end-2024.

Wage growth is now a key focus with the Q2 Wage Price Index (WPI) out today likely to show growth remaining around 3.7% y/y. Further ahead, we expect a strong rise in Q3 as minimum and award wage increases take effect and other wage adjustments occur in the context of a very tight labour market. There is also some evidence that the share of wages adjusting in July is rising, contributing to a larger than usual seasonal effect.

Labour cost growth in the NAB Business Survey rose sharply in July, from 23% to 3.7% in quarterly terms, likely reflecting a combination of these factors (though labour cost growth also captures employment growth). In terms of hourly wage growth (as measured by the WPI), we expect to see growth of around 4.2% y/y for 2023 as a whole, easing slightly to around 3.8% y/y for 2024.

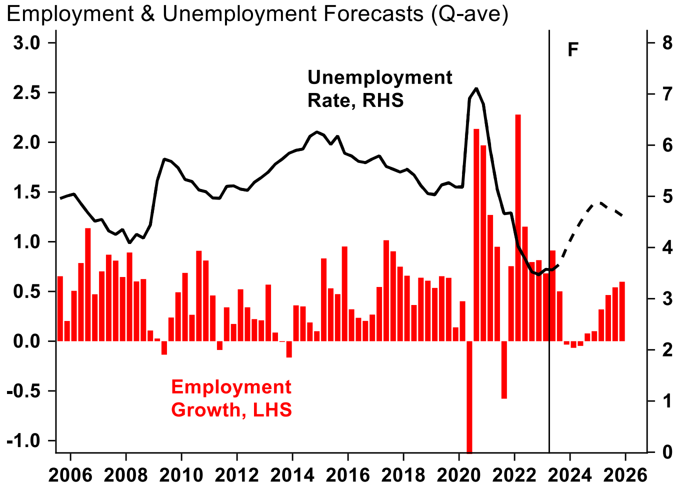
Real retail turnover fell in Q2, foreshadowing a soft quarter of consumption growth with further weakness likely to follow.

Retail trade declined by 0.5% in volume terms in Q2, marking the third consecutive quarterly decline. Falls in retail volumes have been rare outside of major downturns, but the decline since late 2022 partly reflects the ongoing rebalancing from elevated goods consumption towards services consumption.

Nonetheless, there was a small 0.1% decline in cafes & restaurants in Q2, the first fall in this component since lockdowns ended and a possible sign the recovery in services consumption has run its course. Components such as health and rents should still rise, but we expect a flat quarter for consumption growth overall.

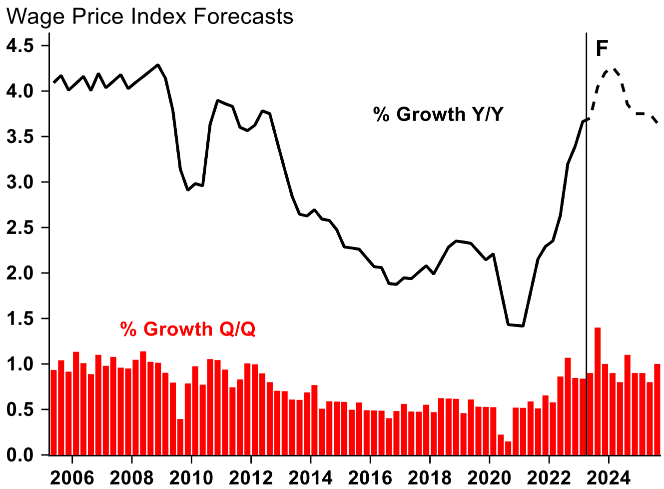
Going forward, we expect the effects of inflation and interest rates to dominate over coming quarters, seeing real consumption declining slightly despite underlying population growth. Consumption should begin to recover from the second half of 2024 as rates begin to normalise and real wage growth recovers.

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



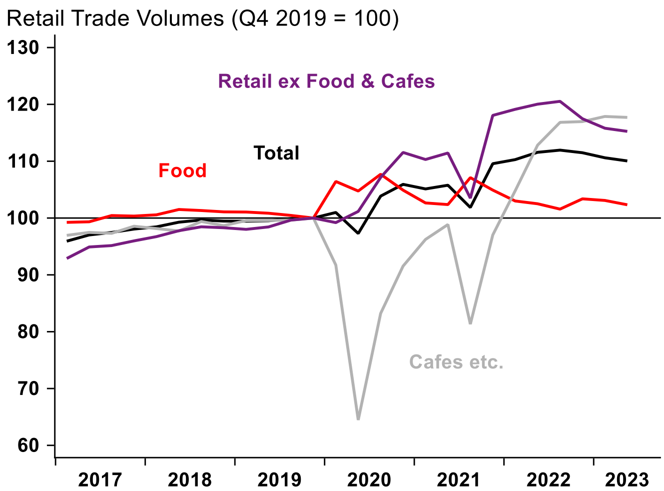
Source: Macrobond, NAB Economics

Chart 4: Wage growth is expected to be particularly strong in Q3, pushing annual growth over 4%



Source: Macrobond, NAB Economics

Chart 5: The volume of retail trade has fallen for three consecutive quarters



Source: Macrobond, NAB Economics

Housing and Construction

House prices and rents continued to grow solidly in July although the pace may have moderated. Housing finance and (tentatively) building approvals have stabilised of late and there are signs that construction supply constraints are abating.

House prices again increased in July but at a slower pace than prior months. The Core Logic Capital City Home Value Index increased 0.8% m/m - down from 1.4% in May – while the PropTrack measure rose only 0.2% (with its recent high of 0.8% also being in May). Over the last five months capital city prices rose 5.0% (Core Logic), reversing about half the fall seen between mid-2022 and early 2023. Dwelling prices grew by 1% m/m or more in July in Brisbane, Adelaide and Perth and with no clear softening from prior months, while they fell in Canberra and were flat in Hobart.

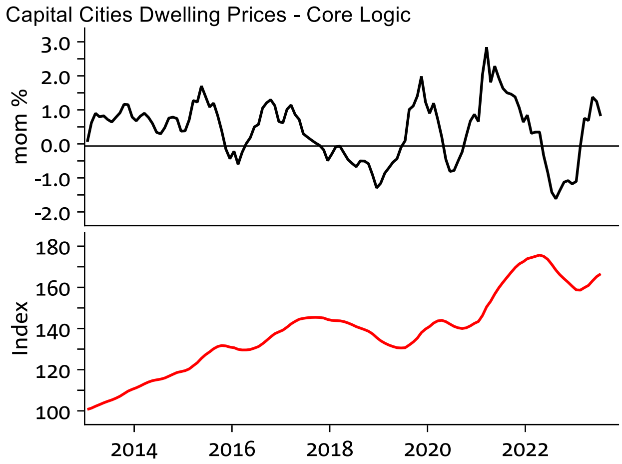
Capital city rents also grew by 0.8% m/m in July (Core Logic hedonic measure). The growth rate has eased from a few months ago, but it is too early to identify any clear downwards trend as the series has been somewhat volatile. That said, vacancy rates have started to edge back up although they remain at a very low level.

Housing finance approvals fell slightly in June (-1.0% m/m) and are 18% lower than a year ago. That said, they broadly appear to have stabilised (up over 7% over the last four months). The number of loans to owner-occupiers for new home construction increased in June (up 6%), but remains very low by past standards. Similarly, in trend terms, dwelling approvals have levelled off for now (the 7.7% fall in June followed a larger rise in May) although this improvement is driven by the volatile other (non-house) dwelling category so it is a tentative conclusion.

We still expect to see further falls in residential investment even as we near the peak for interest rates in this cycle. Residential investment has fallen in six of the last seven quarters (to Q1 2023) and is forecast to continue falling through the rest of this year and into 2024. It should be a relatively gradual decline as there is still a large pipeline of work.

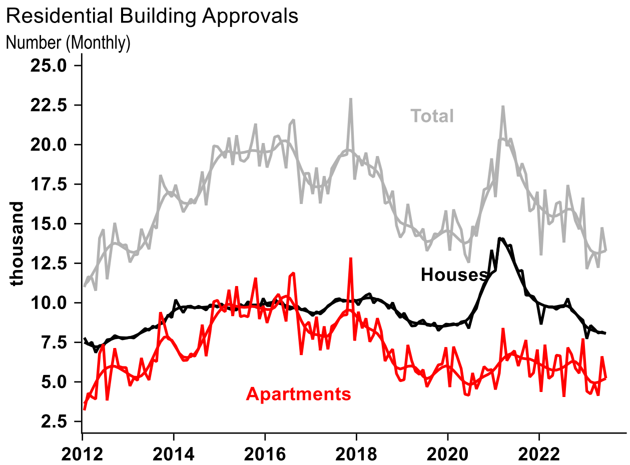
Supply disruptions and labour shortages meant that in recent years work done has been well below what would be expected given approvals. There are signs that this is now turning around. Construction sector respondents to NAB's Quarterly business survey suggest labour constraints have become less significant (even though they remain an issue) while material constraints have also eased. Housing cost construction inflation is now running at 1% q/q or below depending on the measure used - well down on the 4-6% q/q pace seen in 2022. This still leaves the level of housing costs well above their pre-COVID level (over 30%) which, together with the lift in interest rates, will be an impediment to investment for a time to come.

Chart 6: Recent upwards turn in house prices continues



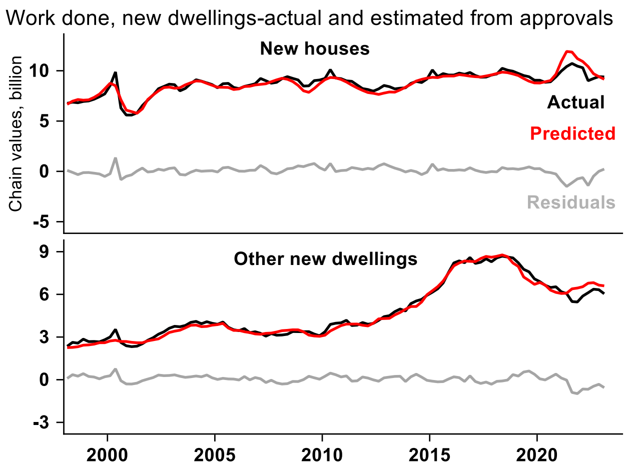
Source: National Australia Bank, CoreLogic

Chart 7: Building approvals – trend has flattened out, but at a low level



Source: Macrobond, NAB Economics

Chart 8: Shortfall in work done, given level of approvals, narrowing – a sign of supply side improvement



Source: Macrobond, NAB Economics

Business and Trade

Business conditions have remained resilient despite weakness in forward indicators, and capacity utilisation remains elevated.

Business conditions in the NAB Monthly Business Survey were broadly steady at +10 index points in July with the trading, profit and employment sub-components all steady. Retail conditions strengthened, reversing a fall in June, and remain above average despite the weakness in recent retail trade data. Overall capacity utilisation also rose in July, back to 84.6% to remain well above average.

The resilience of the survey's conditions measures continues to contrast with soft leading indicators with business confidence still low (+2 index points) and forward orders still negative (-1 index point).

Higher rates and low confidence levels continue to cloud the outlook for investment. Total business credit growth slowed further in June, to 0.3% m/m (from 0.5% in May). We continue to see softer growth in business investment over the period ahead as a result.

The nominal trade surplus rose to $11.3b in June (from a revised-down $10.5b in May). Net exports likely made another strong contribution to real GDP growth in Q2, and should continue to support growth as weak consumption weighs on imports.

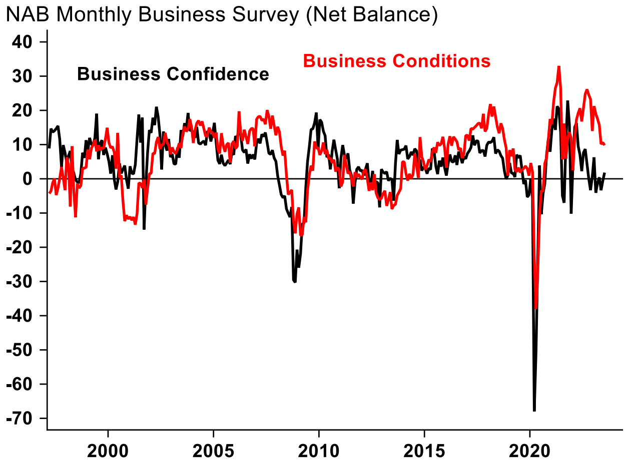
Exports declined 1.7% in the month, largely driven by coal and oil and gas as prices fell. However, the decline in exports was more than offset by a 3.9% fall in imports, driven by a large fall in consumption goods (down 12.4%). This was largely the result of a sharp fall in non-industry transport equipment imports which have been volatile as backlogs have cleared and the 30 June end of the instant asset write-off scheme has approached.

For services, there was a further pickup in both exports and imports in the month with services trade now roughly balanced. Freight services – which surged during the supply chain crisis – have continued to normalise, now down to 4.1% of the total value of goods imports.

For Q2 as a whole, nominal exports declined but this was more than explained by price movements with large falls across key commodities. As such, the underlying volume of exports likely increased by around 4%, while import volumes are expected to have been broadly flat. As a result, net exports likely contributed 0.5-0.7ppts to GDP growth in the quarter.

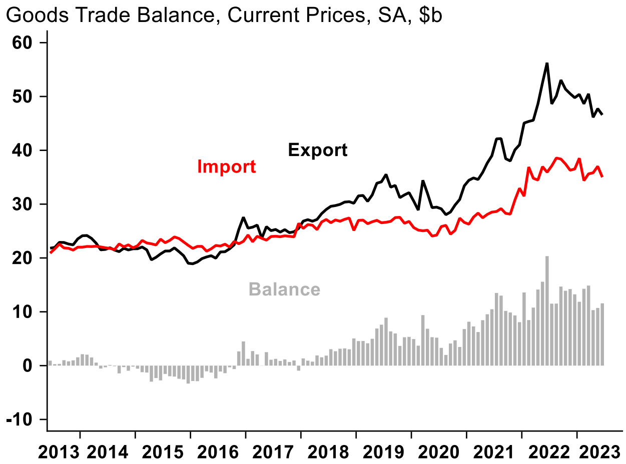
Further ahead, we continue to expect weak demand to weigh on imports more broadly over coming quarters, while the continued normalisation of global trade should support export volumes.

Chart 9: Business conditions remain above average despite low business confidence



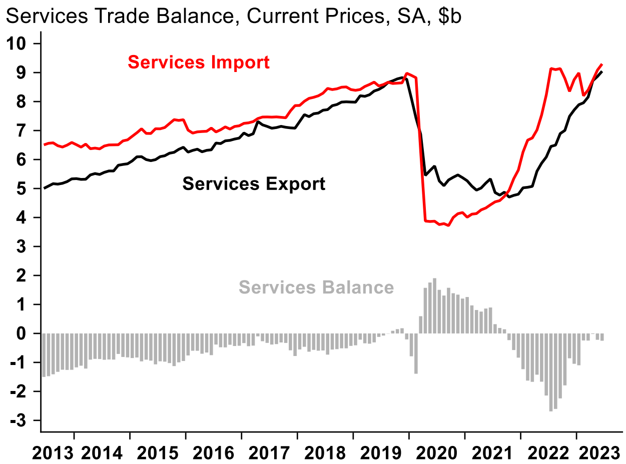
Source: Macrobond, NAB Economics

Chart 10: Goods trade remains in strong surplus as goods imports soften



Source: Macrobond, NAB Economics

Chart 11: Services trade is now roughly balanced as freight services imports normalise



Source: Macrobond, NAB Economics

Monetary Policy, Inflation and FX

The Q2 CPI showed some further progress on inflation but significant pressures remain – particularly in Q3.

Headline CPI in Q2 rose 0.8% q/q (6% y/y) and the trimmed mean grew at 0.9% q/q (5.9% y/y), marking significant progress from the very elevated rates seen in 2022. In the detail, there was improvement across both goods (0.9% q/q, down from 1.2% in Q1) and services (0.8% from 1.7%). However, market sector measures, which better reflects general supply and demand pressures, accelerated slightly.

Food price growth remained elevated at 7.5% y/y and while new dwelling prices are moderating (7.8% y/y from a peak of over 20% in 2022) rent inflation reached 6.7% y/y to be the highest since 2009. There was also a large rise in insurance prices in the quarter.

Further improvement in goods prices is expected but progress on services inflation is likely to be slower with pressure coming from higher wage growth, energy prices, and the ongoing pass through of elevated market rents.

These challenges were evident in the NAB Monthly Business Survey in July. As noted above, labour cost growth jumped from 2.3% to 3.7% in quarterly terms, and purchase cost growth also rose from 2.2% to 2.6%. Businesses appeared to pass some of these pressures directly to consumers with product price growth up from 1% to 2%. Price growth in the retail sector rose to 2.6%, while in recreation and personal services it was 2.9%.

On balance we see a strong Q3 inflation print as likely before inflation gradually moderates to around 4.5% by end-2023 and 3% by end-2024.

With inflation moderating, the RBA kept rates on hold again in August, and we now see scope for only one further rise to a peak of 4.35% (previously 4.6%).

The Board viewed the risks around inflation as "broadly balanced" and appear willing to wait to be pushed to raise rates further. The longer they wait, the more we expect the economy to slow, limiting the need for further increases.

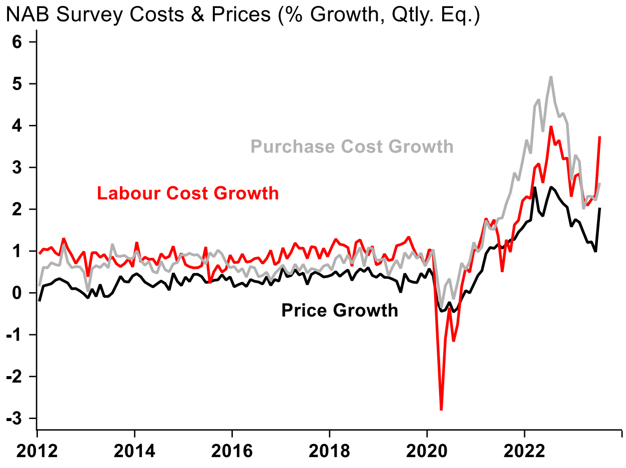
However, we expect the strength of inflation through Q3 will push the Board to take out additional insurance against inflation remaining above target. In fact, the updated RBA staff forecasts published post-meeting showed the crucial mid-2025 inflation forecast has crept higher, to 3.2% - with an assumed rate path including one further rise.

We see a rise in the cash rate to 4.35% in November as most likely, after the release of the full Q3 CPI, and rates should remain at that level until the second half of 2024.

The AUD has weakened since mid-July, back to the low US65c range after almost reaching US69c.

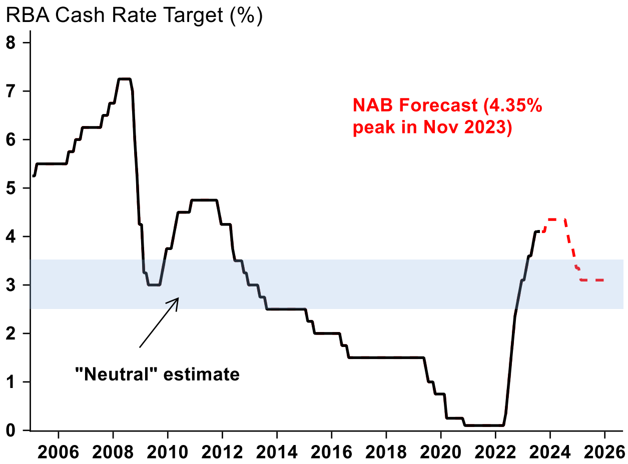
Rising US yields and weak China growth are weighing but we still see the AUD returning to US72c by December.

Chart 12: Cost pressures in the NAB Monthly Business Survey rose sharply in July



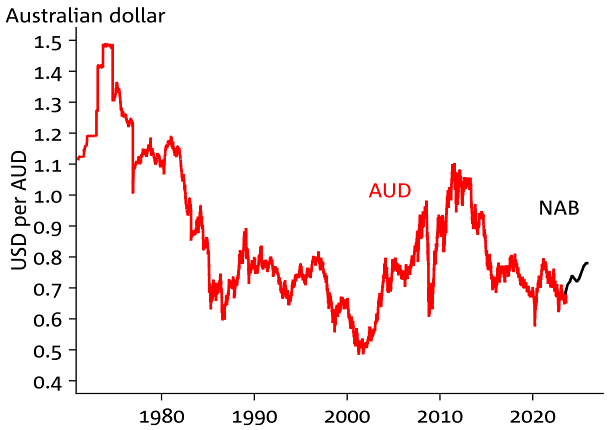
Source: Macrobond, NAB Economics

Chart 13: We expect one further increase in the cash rate, to a peak of 4.35%



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: Household Disposable Income

With interest rates rising more than 400bps in a year and signs that consumption is slowing, household disposable income is a critical factor shaping the outlook. However, the forces acting on household incomes are varied.

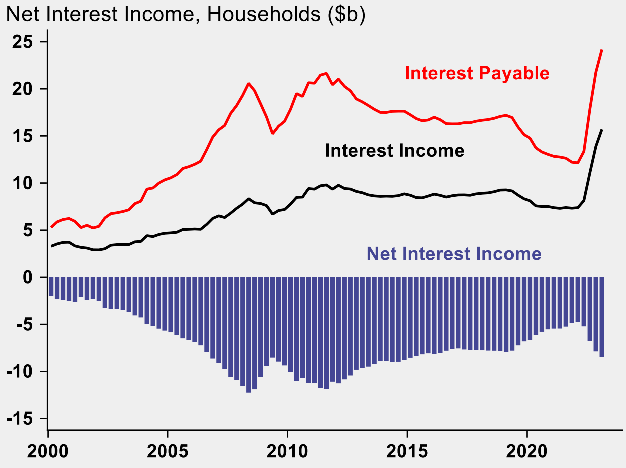
In aggregate, interest payments by households have increased sharply to be around $12b per quarter higher in Q1 2023 (relative to Q1 2021), but interest income has also increased, with the net interest cost to the household sector per quarter increasing only around $4b. Both interest payable and income likely rose further in Q2.

The distribution of interest income and payments is likely to be highly uneven across households, and not all interest income is available to support cashflow (for example, earnings within superannuation accounts). Nonetheless, the two-sided impact of higher rates is an important feature shaping disposable income.

Importantly, the shifts in interest rates are relatively small when compared to the shifts in wage income and taxes. The strength of the labour market has meant that wages income has grown rapidly, to be around $53b per quarter higher than pre-COVID. There has also been a corresponding rise in income taxes paid, which are around $19b higher per quarter, while transfer payments have normalised as pandemic payments have ended.

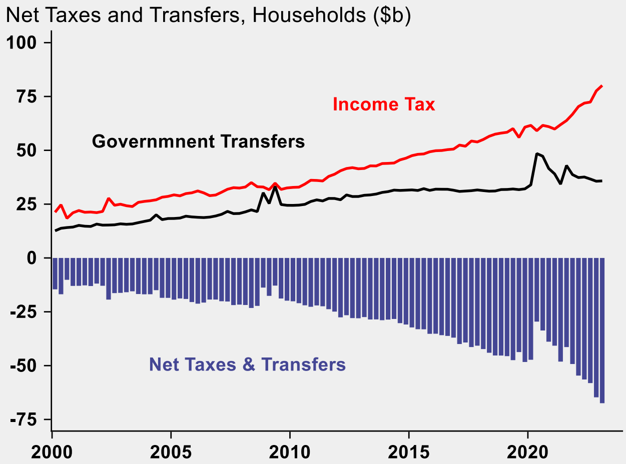
All of these effects have been swamped by the impact of inflation. Adjusting disposable income for change prices (using the consumption deflator), real disposable income grew during the pandemic period as government support flowed to households, but has declined steadily since Q3 2021 as prices have rapidly increased. In per capita terms, this represents an even more dramatic correction, underlining the significant pressures facing households.

Chart 15: Both household interest payments and interest income have increased sharply



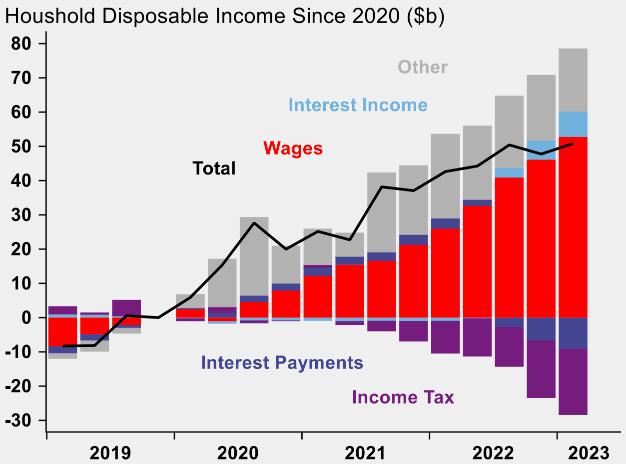
Source: Macrobond, NAB Economics

Chart 16: There has been a steep rise in income tax paid as employment and wages have risen



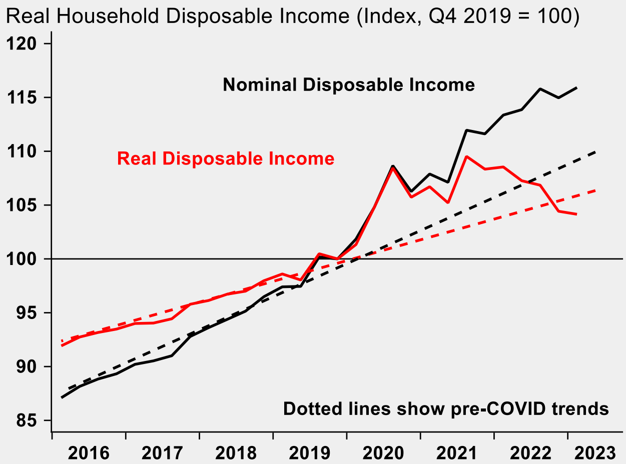
Source: Macrobond, NAB Economics

Chart 17: Wage growth has been the main driver of higher disposable income since 2020



Source: Macrobond, NAB Economics

Chart 18: Real disposable income has declined but is only just below trend



Source: Macrobond, NAB Economics

Table of Economic 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	0.0	-0.1	-0.2	5.2	-0.1	0.6	2.2
Dwelling Investment	-1.2	-1.0	-1.4	-1.4	-3.6	-4.9	-4.8	9.1
Underlying Business Investment	3.5	0.2	0.5	-0.3	4.6	4.0	-2.1	2.3
Underlying Public Final Demand	0.6	0.0	0.5	0.5	2.3	1.7	2.0	2.0
Domestic Demand	**0.6**	**0.0**	**0.1**	**0.0**	**3.3**	**0.6**	**0.7**	**2.6**
Stocks (Cont. to GDP)	0.3	-0.3	0.0	-0.1	0.5	-0.5	-0.1	0.1
Gross National Expenditure	**0.6**	**-0.3**	**0.1**	**-0.1**	**3.4**	**0.2**	**0.7**	**2.7**
Exports	1.8	3.5	0.8	0.6	8.1	6.8	1.5	2.2
Imports	3.2	1.6	0.7	-0.3	12.4	5.3	0.3	4.1
Net Export (Cont. to GDP)	-0.2	0.5	0.0	0.2	-0.5	0.5	0.3	-0.3
Real GDP	**0.2**	**0.3**	**0.1**	**0.1**	**2.6**	**0.7**	**0.9**	**2.3**
Nominal GDP	2.1	0.9	0.7	0.7	12.0	4.5	3.6	4.1
External Account								
Current Account Balance ($b)	34.8	37.2	48.6	46.9	27.1	46.9	44.6	20.3
Current Account Balance (% of GDP)	1.4	1.5	1.9	1.8	1.1	1.8	1.7	0.7
Terms of Trade	2.8	-0.8	-2.1	-1.1	6.9	-1.3	-1.0	-4.5
Labour Market								
Employment	0.7	0.9	0.5	0.0	5.1	2.1	0.1	1.9
Unemployment Rate (End of Period)	3.6	3.6	3.7	4.0	3.5	4.0	4.9	4.6
Ave. Earnings (Nat. Accts. Basis)	2.3	0.9	1.4	1.0	4.0	5.7	3.8	3.6
Wage Price Index (WPI)	0.8	0.9	1.4	1.0	3.4	4.2	3.8	3.6
Prices and Rates (end of period)	**Year-ended**							
Headline CPI	7.0	6.0	5.2	4.4	7.8	4.4	3.0	2.7
Trimmed-mean CPI	6.6	5.9	5.0	4.2	6.9	4.2	3.1	2.8
RBA Cash Rate	3.60	4.10	4.10	4.35	3.10	4.35	3.35	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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Important notice