NAB Economic Update 5 May 2025

Economic and financial market update

NAB Economics

Key points

- Markets have rebounded on the hope of further rollback of Liberation Day tariffs. We remain more concerned about the damage to business and household sentiment and consequently, have downgraded our global growth outlook in recent weeks.
- Locally, forecast revisions have been relatively modest. In part, this is due to an expectation of monetary easing, starting later this month. We expect the RBA to cut by 50bps in May, followed by 25bps in July, August, November and February.
- The Federal Election outcome saw the ALP returned with a larger than expected majority. The government is likely to take the election result as a strong mandate and we would expect that the government's share of economic activity in Australia to increase over the next 3 years.
- We see a multi-year bear market in place for the USD and have lifted our year-end target for AUD/USD to 0.70. Our colleagues in the CIO Office at NAB Private Wealth & JBWere remain defensively positioned in multi-asset portfolios. In fixed income markets, ACGB out-performance should sustain as the trading range for the AUS-US 10Y spread shifts lower.

Focus on the consistent narrative on trade and tariffs

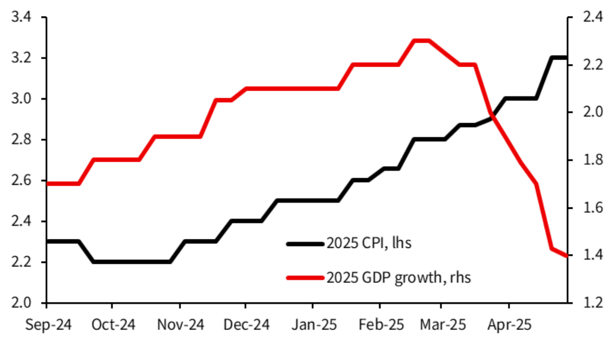
International developments continue to keep financial markets on high alert. In reality, it is difficult to forecast much with certainty at present and we should be humble about the utility of our efforts to anticipate the likely path for economic and financial variables in coming quarters. A shock of the nature and magnitude that shifts in US trade policy have imposed is unprecedented in the working lives of most people, let alone economists or others who indulge in the forecasting process.

Still**, it helps to anchor to some "known knowns". One such anchor is the US President's belief in tariffs**. This belief has been consistently articulated by Trump for many years. It should tell us that while there remains great uncertainty about the details of the final tariff regime in the US, we can nonetheless be certain that tariffs will be higher than they were the start of the year.

Indeed, **despite the headline noise and at times chaotic nature of policy announcements, there has been an underlying consistency to the broader narrative that has emanated from the Administration both pre- and post-election**. There is a desire to make supply chains more secure via onshoring, to shrink the US trade deficit, to deter unfair trade practices and to reinvigorate the industrial base in the US. We should keep these ambitions front of mind when thinking about the longer-term trajectory of US economic policy, particularly those parts of policy which can be implemented via executive orders.

While the precision of point forecasts is undoubtedly highly limited at present, the broad direction of travel is clearer and more widely understood. In the US, growth will be lower this year and inflation will be higher. The chart below shows the change in the consensus forecasts for US economic growth and inflation in 2025. Growth in Europe, Japan, China and the UK is also expected to be lower this year relative to forecasts in place at the start of the year. Policy support (both fiscal and monetary) is expected to offset some, but not all, of the shock to global growth.

Consensus US 2025 GDP & CPI forecast (%)



Source: Bloomberg and NAB.

Incrementally, the news on tariffs and trade has been less hawkish lately. This dynamic has combined with evidence of a solid US economy through 1Q to provide considerable support to equity markets recently; the AX200 is now up 1% year-to-date, while the S&P500 is down a little over 3%. However, we do not expect a meaningful nor fast rollback of Liberation Day tariffs and hence are more concerned about the bearish signal from survey-based measures of business and consumer sentiment in recent weeks.

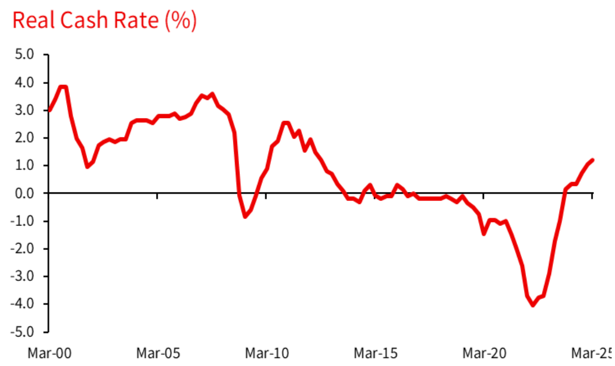
Australian economic update

In Australia, we have also made some forecast changes but these are modest in magnitude. We cut our 2025 GDP forecast by 25bp to 2% and lifted the forecast peak in the unemployment rate from 4.2% to 4.4%. If we can realise outcomes close to these forecasts then policy makers will have done a good job navigating what is a difficult global backdrop. Our limited export basket to the US (less than 5% of total exports) means that we are relatively sheltered from the direct impact of tariffs.

Locally, domestic activity data suggest that the economy likely recorded another respectable quarter of growth in the first three months of the year. However, recent retail sales data cast some shadow on this expectation; in volume terms, retail sales were flat for the first three months of 2025 and highlight the risk that the consumer has been unable to sustain the robust momentum witnessed in spending in 4Q 2024.

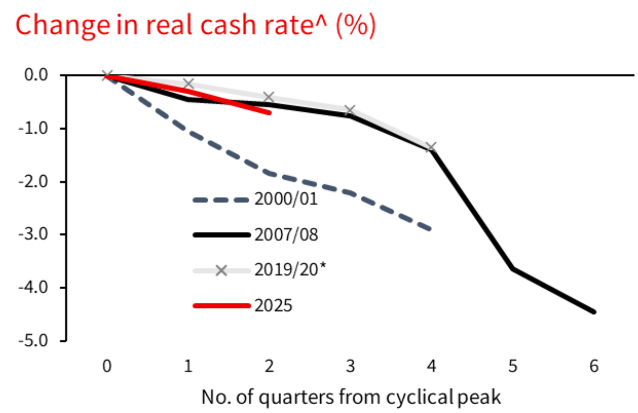
Price data for 1Q 2025 show both headline and core inflation in the RBA's 2-3% target band, and importantly, ongoing disinflation in the market services portion of the CPI basket. This should ease any lingering concerns the RBA has about the inflationary impact of current labour market dynamics.

With the current setting of monetary policy restrictive in both a nominal and real context (see chart) and recent developments shifting the distribution of risks around domestic growth and the labour market to the downside, **we think the RBA will see a need to take policy to a more neutral stance relatively quickly**. If the RBA knew on 1 April what it knows today, it is likely that the Board would have decided to lower the cash rate by 25bp at the last meeting and followed up that easing up with a 25bp rate cut in May. There is thus some catch up required to align policy settings with recent developments.



Source: Bloomberg and NAB.

We forecast 100bp of easing by August 2025, beginning with 50bp rate cut in May. Indeed, the RBA has historically shown a willingness to respond quickly to offshore shocks. As the chart below illustrates, this easing cycle as per our forecasts would look very similar to those which responded to the GFC, and the COVID-19 pandemic.



Source: Bloomberg and NAB. ^Measures change from cyclical peak in cash rate. *COVID-19 cycle is truncated on chart.

However, we acknowledge that our call requires the RBA to shift its thinking on a couple of fronts. **First**, an acknowledgement that risks to inflation are no longer balanced, but rather, biased to the downside as a consequence of trade diversion and weaker global growth. **Second**, a shift in mindset towards a less cautious approach to their policy strategy; that is, a willingness to act quickly and boldly.

The latter may be more of a constraint to our call than the former, given elevated uncertainty is always a reason to act with caution. Nonetheless, even if the RBA only cuts by 25bp in May, we would still expect a 100bp of easing to be the first order of business. This would see the cash rate of 3.1% (NAB estimate of neutral) reached at the end of Q3 rather than the middle of Q3 as we currently forecast.

Federal Election outcome

Australian voters have returned the ALP government with a larger than expected majority in the House of Representatives. In the very near term, the change since markets closed on Friday is simply that the ALP's position as the party of government is now more secure, and its ability to execute on its agenda will be easier. This provides financial markets with more certainty and predictability.

The government is likely to take the election result as a strong mandate and we would expect that the government's share of economic activity in Australia will likely increase over the next 3 years. However, we expect the government's agenda to proceed largely as it has in the first term; that is, relatively cautiously and adhering to a 'no surprises' policy.

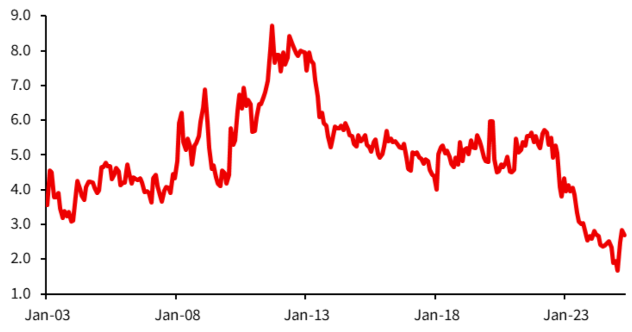
This dynamic towards bigger government is consistent with the notion of regime change, where we have transitioned from a multi-decade economic and political regime based on free trade and free markets to one where the role of government is bigger and broader than was the case in the prior regime. The Public sector debt burden will continue to rise.

Relatedly, fiscal spending will remain high, and the RBA will take the government's announced spending plans as the base case for fiscal policy in Australia going forward. All else equal, fiscal policy will continue to be supportive for economic growth.

Financial markets update

Realised volatility across financial markets has fallen in recent weeks, as markets have responded positively to incrementally less hawkish news on US trade policy. However, earnings estimates still look too high in the US for 2025 relative to the modal forecast for economic growth, and the equity risk premium looks low relative to long run averages; see chart below. **Our colleagues in the CIO Office at NAB Private Wealth & JBWere hence remain cautious on growth assets and are defensively positioned across their multi-asset portfolios**.

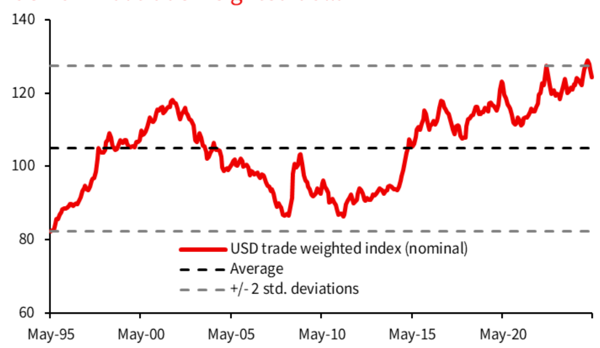
US equity risk premium (%-pt)



Source: Bloomberg and NAB (for S&P500).

The Fed's measure of the trade-weighted US dollar exchange rate continues to sit at elevated levels relative to its multi-decade average, despite falling sharply in recent weeks; see chart. **We see scope for a multi-year bear market in the US dollar, as the era of US exceptionalism comes to an end** and investors re-allocate capital to alternative destinations. In the short term, it is likely that real rate spreads will work against the USD too. Our FX strategy team released updated FX forecasts on Friday (see *here*), with new forecasts reflecting a broad bias to USD weakness. **Year-end targets for key cross rates are AUD/USD to 0.70, USD/JPY to 125 and EUR/USD to 1.23**.

US nominal trade weighted dollar



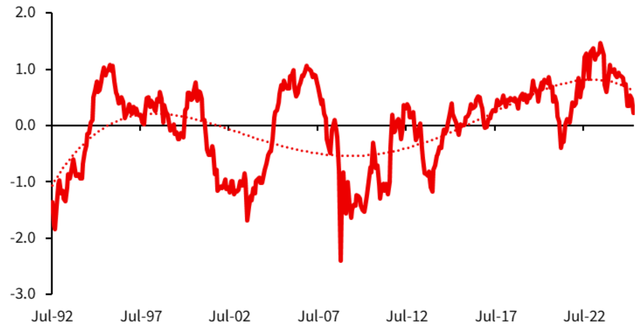
Source: Bloomberg and NAB.

The weaker USD backdrop will favour AUD/USD higher, although out-performance on the crosses is unlikely to be part of the story for AUD given the alternate safe haven status of EUR and JPY. **One notable upside risk to our AUD forecast lies with the behaviour of superannuation funds and their hedging strategy**. Hedging behaviour has been predicated on a positive correlation between the performance of US equities and the AUD; when US equities fall, AUD has typically fallen too. But we are likely facing into a period – possibly a regime change – where the correlation between US equity market performance and AUD/USD reverses. If this prompts a shift in hedging strategy and / or allocation into USD assets by local superannuation funds, then AUD may out-perform against a broader basket of currencies.

In US fixed income markets, credit spreads have narrowed and sovereign yields have fallen as some softer data and incrementally better news on trade have delivered a more constructive trading environment. In the short run, we continue to believe that investors will distinguish between markets with less constrained central banks – where risks are biased towards lower growth *and* lower inflation – and those markets where central banks are facing a more uncomfortable set of forecast revisions, such as lower growth and higher inflation. The US is one such market, but shorter-run issues may also be compounded by longer-term worries about fiscal sustainability and institutional credibility.

In our view, Australian sovereign bonds should be a beneficiary of investors' discernment; all else being equal, we would expect the -30bp to +30bp trading range for the AUS-US 10Y bond spread that has been sustained since late 2022 to move lower over time. It is possible that we have reached a long-run turning point in the relative pricing of term premium in Australia vs. the US (see chart); this should favour longer-term out-performance of AUS bonds, particularly in higher duration tenors.

AUS less US 10Y term premium (%-pt)



Source: Bloomberg and NAB.

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