Outlook Q1 2023 & Quarterly review

BlackRock

Produced by BlackRock Australia Fixed Income

Economic Outlook Q1

With 300bps of rate hikes delivered by the RBA in 2022*, the bulk of the tightening is now behind us. The outlook for monetary policy in 2023 will chiefly be about finessing the peak in the cash rate, assessing how long it remains there, and importantly when the inevitable 'pivot' to easing starts. An assessment of the RBA at the present time suggests they have moved towards a 'slower but higher for longer' cash rate path. Actions by the US Federal Reserve in H1 23 will shape global bond markets. We note that market pricing is for a peak in the Fed Funds rate of around 5% by mid-23 with rate cuts commencing in Q3.

We expect the RBA to stick to its gradualist 25bp hike approach, otherwise known as "business-as-usual". This is despite the recent favourable Q3 22 CPI beat. The hurdle for returning to 50bp hikes remains very high in our view. Should the economic data continue to come in strong, the RBA will hike for longer rather than switch back to larger hikes. Our central case is for an RBA terminal cash rate of 3.85% by mid-23 and we would not rule out a 'pause' sometime in Q1. A more "data dependent" RBA will see them become more reactionary as opposed to last year's program of rapid-fire hikes.

We expect GDP growth to slow through 2023 with the major drag likely to be slower household consumption. RBA Governor Lowe has mentioned several times that the monetary policy transmission mechanism is likely to be longer, and that the full effect of the increase in mortgage payments has yet to be felt. Consumer prices are more likely to be driven by service-side factors. We expect both headline and core inflation to remain elevated over 2023, as does the RBA. They expect headline CPI to hit 8% (Dec. 2022) and still be slightly above the 2-3% target by the end of 2024.

The key difference in inflation between the US and Australia remains the divergence in wages growth, with a wage-price spiral yet to materialise here. Wage/price-setting behaviour is something the RBA is watching very closely. We have also seen a quicker impact within the housing market and expect some further weakness in this sector. The unemployment rate remains the key metric the RBA is focused on in the labour market and they expect a small rise to 3.75% (currently 3.4%) by December 2023.

We expect central bankers to continue to talk tough on inflation in an effort to keep financial conditions tight. Restrictive monetary policy is necessary if they hope to achieve this objective. Markets will naturally look ahead anticipating a broad economic slowdown. The risk to bond markets at the moment is that activity does not moderate and more policy tightening is required. The reluctance to tighten fiscal policy by most governments is arguably making the central bank's task harder.

Credit Outlook Q1

With bond yields correcting sharply and investment grade credit spreads nearly doubling since the beginning of 2022, the renewed interest to allocate to credit is growing. The yields now on offer are attractive both on an outright basis and relative to equities. When combined with lower expected volatility, the investment case is compelling for long term investors.

However, there are risks worth bearing in mind as we head into 2023. Credit spreads have tightened over the past few months in anticipation of the mooted final Fed rate hike sometime in Q1 '23. Typically, such gains can be unwound by the time of a final hike – and then gradually widen ahead of a recession. The key risks for credit are the possibility of a global and US economic slowdown, a prolonged high interest rate environment and persistent inflation. Any combination of these could lead to increased default risk. We prefer investment grade credit over high yield because of the quality aspect , as well as valuations being attractive. There is a good chance of further spread compression between "BBB" and "A" rated credit in the near term as investor appetite improves. High-quality shorter-dated bonds offer good protection against market volatility.

Currency Outlook Q1

The AUD ended the quarter roughly unchanged at US$0.68 cents. However, it was notable how quickly support for the currency can dissipate and when global risk-off factors come to the fore as we saw mid-way through Q4 22. As we noted last quarter, the AUD at current levels is trading below longer-term "fair value" estimates given commodity prices, terms of trade and relative interest rates. We think the AUD has some room to rally into the low US$0.70's with the RBA still needing to hike the cash rate in H1 '23 and the tailwind from a China re-opening.

The broad direction of the USD remains one of the two key drivers of AUD in 2023. A less aggressive Fed should see interest rate differentials narrow leading to a weaker USD. The USD remains overstretched after the extended rally in 2022. China's economy will be the other key driver and a staged rollout of Covid policy relaxation is now set to take place in 2023. The re-opening of China and their commitment to a strong economy in 2023 is a positive signal the focus is shifting outwards again. Downside risks for the AUD will stem from a combination of global recession fears, falling commodity prices and heightened geopolitical tensions.

*Source: RBA, December 2022

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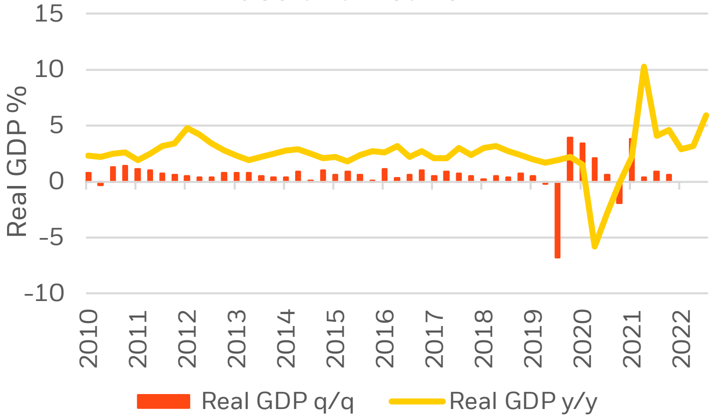
GDP – Q3 2022

▲ QoQ GDP **grew 0.6%**. This was **0.1% lower** than expected.
▲ YoY GDP is now **2.7% higher** at **5.9%**.

The Australian economy performed well in Q3, with GDP growing by 0.6% over the quarter. This is the fourth consecutive quarter of economic growth and saw annual GDP increase to 5.9%. The composition of growth with activity in the quarter underpinned by household spending (+1.1%), non-dwelling construction (+8.6%), business investment (+1.6%) and small contribution from inventories (+0.2ppc). Yearly GDP growth was 5.9%, under the 6.3% consensus. However, this growth rate is misleading as it reflects the fall in GDP from Q3 last year. In annualised terms, GDP growth was 2.6%, which is a better reflection of current underlying economic activity and close to potential growth in the economy of around 2.5%.

Australia Real GDP



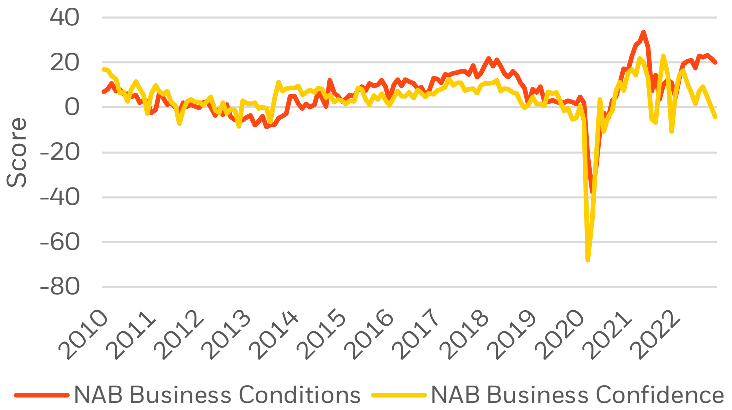
Source: ABS, Bloomberg, BlackRock as of 31/12/2022

Business Conditions – Nov. 2022

▼ **Conditions fell by 2pts** from +22 pts (Oct) to +20 pts (Nov)
▼ **Confidence fell by 4pts** from 0 pts (Nov) to -4 pts (Nov)

November saw both business confidence and conditions fall. Business confidence turned negative, falling below zero for the first time since Dec. 2021. The fall in confidence was led by falls in manufacturing, construction and retail. Confidence fell across all states apart from S.A., entering negative territory apart except for S.A. and Tas. Business conditions on the other hand remain elevated. Despite all three subcomponents easing by 2 index points, trading (+28), profitability (+20) and employment (+13), all remain quite strong. Overall, the survey is pointing to a growing concern that the economy's strength over 2022 is set to come to an end as inflation, higher rates and the slow down in global growth weighs on consumers.

NAB Business Survey



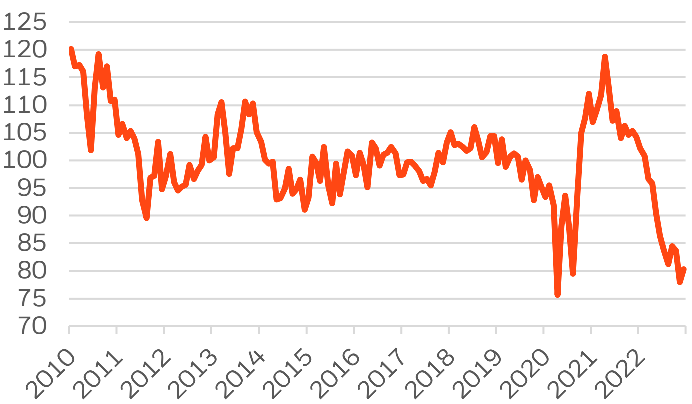
Source: NAB, Bloomberg, BlackRock as of 31/12/2022

Consumer Sentiment – Dec. 2022

▲ The Westpac-M.I. Index of Consumer Sentiment **increased 3.0% from 78.0** in November **to 80.3** in December.

Consumer sentiment in December improved slightly, with a 3% increase following a 6.9% drop in November. Concerns about inflation and the economy remain high, with 58% of respondents recalling news about inflation and 35% recalling news about economic conditions. Interest rates are viewed as slightly less negative, possibly due to the belief that the bulk of the interest rate tightening cycle is over. Confidence among mortgage holders increased by 11.3%, with house price expectations increasing by 28%, and the outlook for the economy over the next 5 years improving by 5.2%. Sentiment about the labor market has stabilized, and the outlook for household finances also improved. However, cost of living pressures remain a concern for vulnerable consumers.

Westpac Consumer Confidence



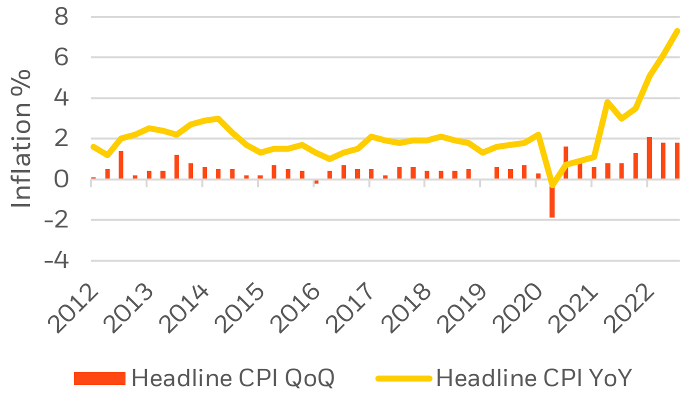
Source: Westpac, Bloomberg, BlackRock as of 31/12/2022

Inflation – Q3 2022

▲ Headline CPI **increased by 1.8%** QoQ.
This was **0.2% higher** than market consensus.
▲ Annual inflation **rose 1.2%** from to 6.1% to **7.3% YoY**.

Australia's Q3 CPI report was stronger than expected with three-quarters of the rise in the headline CPI coming from higher goods prices, reflecting high freight costs, supply constraints and elevated demand. Yearly headline CPI increased to 7.3%, which is the largest YoY gain since Q1 1990. The momentum in inflation is fairly broad-based with nine of the 11 major groupings in the CPI seeing price rises over the quarter. Inflation is still expected to rise further and while there are conflicting factors ahead, the key uncertainty is when inflation will peak and perhaps even more importantly, how sticky will it be with respect to the extent to which it will ease as we move into 2023.

Headline CPI



Source: ABS, Bloomberg, BlackRock as of 31/12/2022

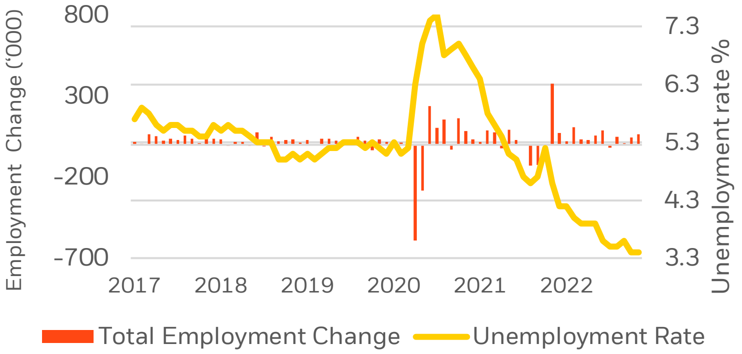
Labour Market – Nov 2022

▲ Employment data saw 64,000 **new jobs gained**. This was **45,000 more** than market consensus.

▶ The **unemployment rate** remained at 3.4%.

Australia's November employment numbers came in stronger than expected with 64,000 new jobs added. This consisted of 34,200 full-time jobs and 29,800 part-time jobs. The unemployment rate held steady at 3.4%, while the participation rate increased by 0.2% to 66.8%, returning to the previous record high set in June '22. Underemployment fell -0.1% to 5.8%, and underutilisation made a new cycle low of 9.3%. Every state and territory saw employment gains which speaks to the breadth of labour market strength at present. The ABS also noted that the resumption in population flows has been an extra kicker for employment with increases in temporary student visas boosting employment for younger cohorts.

Monthly Employment Change & Unemployment Rate



Source: ABS, Bloomberg, BlackRock as of 31/12/2022

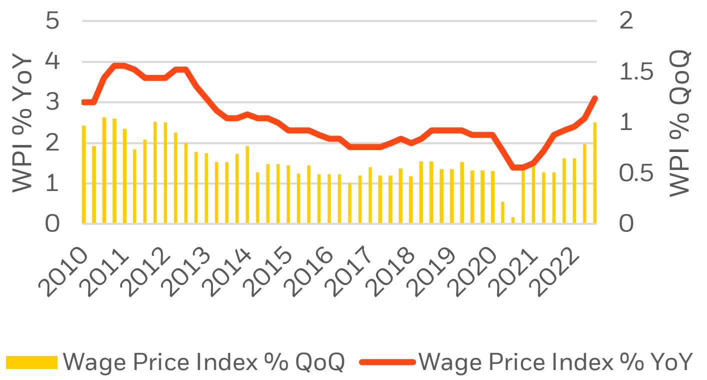
Wage Price Index – Q3 2022

▲ Wages **increased by 1.0%** over Q3. This was **0.1% above** market consensus.

▲ Wage growth over the year **increased by 0.5% to 3.1%**

The Q3 wage price index (WPI) saw its fastest quarterly pace of growth since 2012, rising by 1.0% q/q and 3.1% y/y. Growth in the quarter was driven by the private sector which is more responsive to labour market conditions and continues to widen the gap to public sector wages. Private WPI lifted by 1.2% q/q and 3.4% y/y, with private WPI including bonuses increasing 1.6% q/q and 4.1% y/y which is consistent with the strength of the labour market and multi-decade low unemployment rate. Australia's Fair Work Commission (FWC) increase to the national minimum wage (+5.2% y/y), and the modern award wage (+4.6% y/y) was largely incorporated in this quarter's public sector rise which saw an increase of +0.6% q/q and 2.4% y/y.

Wage Price Index



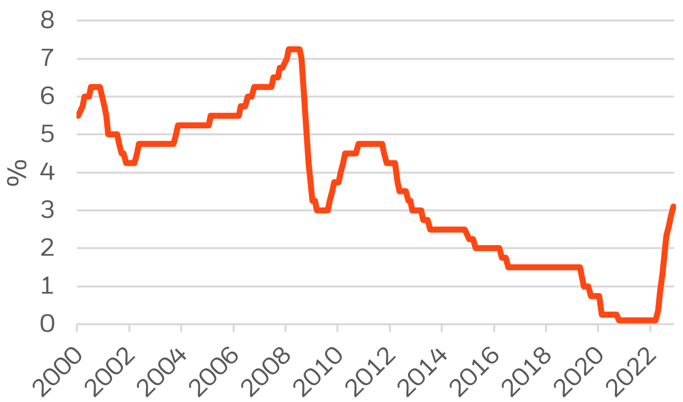
Source: ABS, Bloomberg, BlackRock as of 31/12/2022

RBA Policy Rate – Dec 2022

▲ The RBA increased the cash rate target by 0.75% over the quarter taking the cash rate target to 3.10%.

Over the Q4 the RBA made three 25bps rate rises in an effort to address high inflation, taking the cash rate target to 3.10%. The board expects inflation to peak at around 8% by year end before starting to moderate next year. While the Australian economy continues to grow, the Bank expects this to slow in the coming year due to slower growth in household consumptions caused by the tighter financial conditions. The labour market remains strong and wages are picking up due to the tight market and higher inflation, adding further pressure to the RBA. The Board has stated they plan to continue raising interest rates in order to return inflation to the target range of 2-3%, but this will depend on incoming data and the outlook for inflation and the labour market.

RBA Cash Rate Target



Source: RBA, Bloomberg, BlackRock as of 31/12/2022

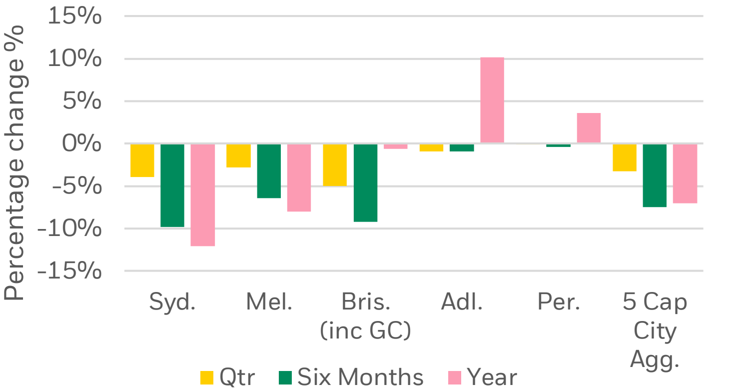
House Prices – Q4 2022

▼ The CoreLogic national home value index **fell 3.3% in Q4**

▼ Over the year, the CoreLogic national home value index **decreased by 7.0%**

Australian house prices continue to decline as large increases to the RBA cash rate have caused a marked downturn. Increases to borrowing costs are placing pressure on mortgage holders which has seen property prices decrease across all capital cities over the quarter. Brisbane saw the largest decline, down 5% in Q4, while Perth fared the best dropping just 0.02%. Nationwide, house prices have been falling since April and are now down 7% y/y in aggregate. The continued softness in house prices should reduce the volume and value of new loans next year. Residential construction indicators have also moved lower over the last 6 months and both of these trends are expected to continue for much of 2023.

Core Logic Australian Home Value Index



Source: CoreLogic, Bloomberg, BlackRock as of 31/12/2022

Want to know more?

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