Outlook Q1 2024 & Quarterly review

BlackRock

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Economic Outlook Q1

The RBA increased the cash rate to 4.35% in Q423 in line with our view that monetary policy was not restrictive enough to dampen “homegrown” domestic demand pressures stoking persistent services inflation. We are now well past the peak in headline inflation and expect further moderation in 2024. However, the key drivers of services inflation (wages, rents and energy prices) will prove a challenge to bring down as we move through the year. The need for the RBA to balance the employment and growth outlook is obvious, but we think the focus on inflation will remain front and centre. Therefore, the Q124 CPI data (released late January) will be critical in determining whether or not the RBA hike again.

Achieving the RBA’s stated 2.5% ‘midpoint’ inflation target over the forecast horizon leaves very little margin for error under current policy settings. We know that the RBA’s current forecasts are predicated on two rate increases, one of which has been delivered. With an inflation forecast of 2.9% by the end of 2025 any near-term thoughts about the RBA becoming dovish in their communication would seem overly optimistic to us. Given Governor Bullock’s hawkish views about domestic inflation we’d expect some push back against rate cuts in market pricing signaling that rates will be kept higher for longer. The second-half of 2024 will become interesting from an RBA messaging standpoint with the new Monetary Policy Board kicking off from 1 July.

GDP growth is expected to be below trend over the year ahead. We saw signs of this in Q323 data where household spending was flat, even as the household savings ratio declined further to 1.1%, its lowest level since 2007. Subdued growth in household consumption is from cost-of-living pressures, higher interest rates and higher taxes weighing on disposable income. The continued roll off of fixed mortgages will hit consumption further. Public and business investment remains strong, supported by a large pipeline of construction and public infrastructure work.

We expect a further gradual easing in the labour market. However, increases in the participation rate will push the unemployment higher regardless of any employment gains. Survey measures of business confidence continue to fall as do business conditions.

While the RBA will closely watch the data unfold through Q1 the AUD rates market has already bought into the theme of rate cuts sooner rather than later. Central banks will attempt to soft-land their economies. The lagged effects of past tightening will coincide with a reduction in the pace of economic activity and consumption, inflation easing further, and rising unemployment rates. It’s instructive to note the RBA has learnt some lessons from the current tightening cycle, namely, “incorporating more signal from overseas developments, expanding the suite of alternative timely indicators, and increasing the use of scenario analysis”. The greater reference to offshore developments is important given the moderation in core inflation in the US and Europe.

We expect one more 25bp rate hike at the RBA's February meeting, taking the cash rate to 4.60%. However, we acknowledge the RBA could hold out for a little longer. The likelihood of rate cuts before Q324 seems remote to us.

Credit Outlook Q1

With the prospects for a US economic soft-landing firming both the backdrop and outlook for investment grade credit remains positive in Q124. Bond yields have already started to fall in anticipation of Fed cuts, which is typical before cuts are eventually delivered. To be sure, investment grade credit spreads are already quite tight, and we expect limited compression from current levels. Timing the exact turn in the credit cycle is difficult even in the best of times. Therefore, we are mindful that after the most rapid hiking cycle since the 1980’s the risks to credit spread widening are growing.

Given these increasing risks investors should be looking to moderate exposure to the most expensive segments of the credit market. For example, BBB spreads, are offering investors questionable compensation for the cyclical risks likely to emerge through 2024. Shorter maturity credit offers better carry and roll potential vs long duration credit. On a positive note, the technicals continue to look good for local investment grade credit with non-financial supply remaining light. Investor demand remains firm given high absolute yields on offer which investors are aiming to lock-in. The clear risk to the outlook is a hard landing in the US.

Currency Outlook Q1

The AUD was well supported around US$0.65 cents in Q424 with bouts of strength coinciding with higher levels of market conviction that the US Federal Reserve might be finished raising rates. Recent weaker US economic data on the back of restrictive monetary policy continues to chip away at US dollar strength. With the Fed closing the door to further rate hikes risk currencies like the AUD will benefit. With market pricing in the US pointing to rate cuts commencing in early 2024, the prospect of a narrowing AU/US cash rate differential will support the AUD. The Fed will be cutting the Fed Funds rate well before the RBA is in a position to consider rate cuts.

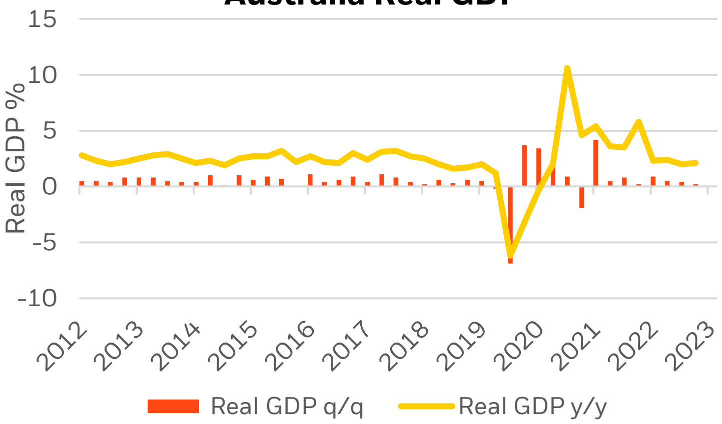
Helping to underpin the AUD are relatively high commodity prices, including iron ore. China’s growth outlook has steadied but challenges in the property market remain. If we see strong Chinese policy support delivered by an expansionary fiscal stance to boost investment in infrastructure and property, iron ore prices should remain high. Australia continues to record current account and budget surpluses in contrast to the US. The risk to the AUD is as sharp deterioration in global growth and risk sentiment given the AUD is a bellwether risk-proxy.

GDP – Q3 2023

▲ QoQ GDP **grew 0.2%**. This was **0.3% below** expectations.
▲ YoY GDP increased from **2.0%** to **2.1%**.

Despite the overall slowdown to GDP over 2023, the increase in growth marked the eighth straight rise in quarterly GDP. Government spending on infrastructure and capital investment were the main drivers of GDP growth this quarter. While the quarterly miss was sizable, the annual growth rate beat estimates of a +1.9%. The quarterly miss (+0.5% expected) was largely because of less contribution coming from inventories, and weaker than expected real household consumption. The strong labour market is helping households remain resilient, but it is clear spending power is being eroded by higher rates, a rising tax burden and inflation. Excess savings have helped but falling productivity and high inflation could result in further rate rises.

Australia Real GDP



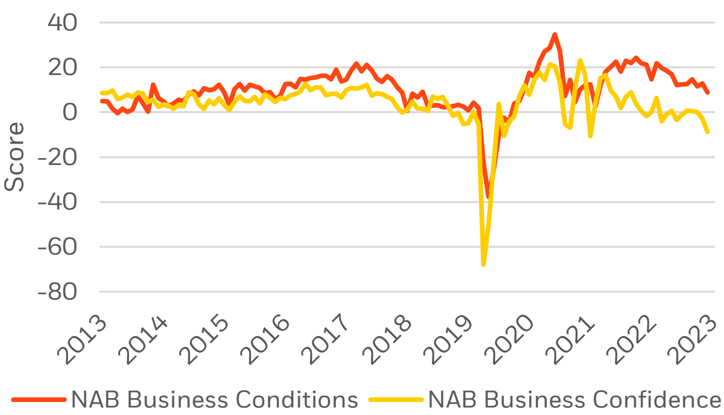
Source: ABS, Bloomberg, BlackRock as of 5/01/2024

Business Conditions – Nov 2023

▼ **Conditions fell by 4pts** from +13 pts (Oct) to +9 pts (Nov)
▼ **Confidence fell by 6pts** from -3 pts (Oct) to -9 pts (Nov)

The November NAB business survey showed a decline in both the economic outlook and activity, with the easing visible across most states and industries. After a second consecutive decline, business confidence is now at its lowest level since 2012 (outside of the COVID period). The additional increase in the cash rate saw confidence fall in the key consumer-facing sectors such as retail, recreation and personal services. Business conditions also fell and while still above average, are now at their lowest level since early 2022. Conditions continue to be supported by strong employment with both trading and profitability close to their long-run averages. However, the results indicate that growth in Q4 is unlikely to improve much from Q3.

NAB Business Survey



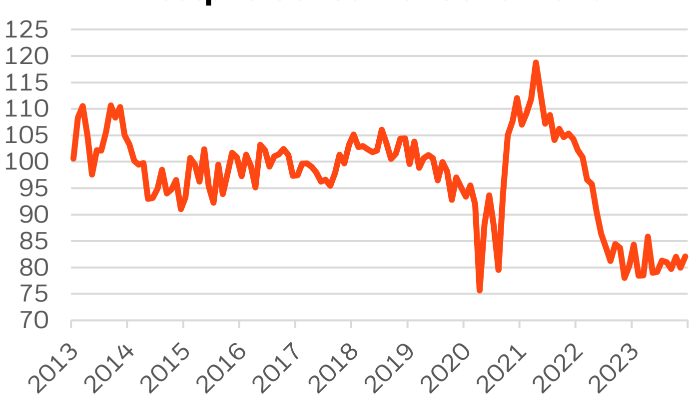
Source: NAB, Bloomberg, BlackRock as of 5/01/2024

Consumer Sentiment – Dec 2023

▲ The Westpac-M.I. Index of Consumer Sentiment **increased by 2.7%** from 79.9 in November to **82.1 in December**.

Consumer sentiment improved slightly with the RBA deciding to leave rates on hold at its December meeting, easing concerns that further rate hikes are imminent. However, consumers are still wary of the potential for more rate rises with 60% of those surveyed after the decision still expecting mortgage rates to move higher over 2024. Inflation remains the most prominent topic for consumers with over 55% citing news on this issue. This explains why declining purchasing power rather than interest rate moves remains the dominant driver of buyer sentiment. The 'time to buy a major household item' sub-index delivered another weak read of just 78.2. However, consumers remain relatively comfortable about the outlook for jobs which has been positive for the 'time to buy a dwelling' index, up 1.6% to 74.3.

Westpac Consumer Sentiment



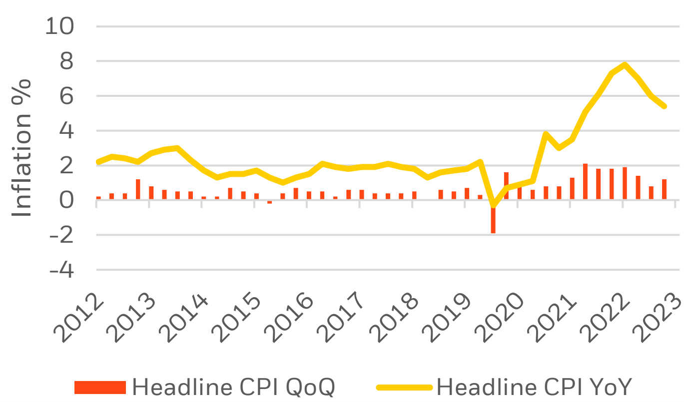
Source: Westpac, Bloomberg, BlackRock as of 5/01/2024

Inflation – Q3 2023

▲ Headline CPI **increased by 1.2%** QoQ. This was **0.1% Higher** than market consensus.
▼ Annual inflation **fell 0.6%** from to 6.0% to **5.4% YoY**.

Australian Q3 CPI for both headline and core inflation came in on the high side, both rising 1.2%. The annual pace of inflation still fell but printed slightly above where markets at 5.4% (expected, +5.3%). This marked the third quarter in a row of lower annual inflation, down from the peak of 7.8% in December 2022. The most significant contributors to the rise in the quarter were automotive fuel (+7.2%), rents (+2.2%) and electricity (+4.2%). Annually it was a similar story with automotive fuel (+7.9%), rents(+7.6%) and electricity (14.5%) all the leading contributors. Offsetting the rises this quarter, we saw declines in vegetables and domestic holiday travel & accommodation, while childcare and energy subsides also offset rises.

Headline CPI



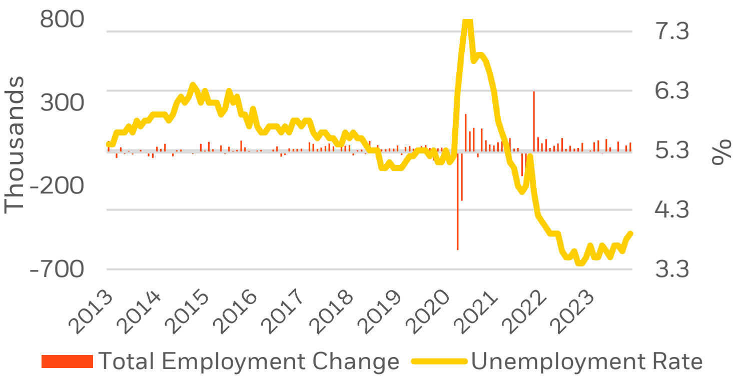
Source: ABS, Bloomberg, BlackRock as of 5/01/2024

Labour Market – Nov 2023

- ▲ Employment data saw 61,500 **new jobs gained**. This was **50,000 more** than market consensus.
- ▲ The unemployment rate **rose 0.2% to 3.7%**.

Australian employment surged in November, surprising again to the upside with 61,500 new jobs added. The majority came in full-time work (+57,000), with part-time adding just 4,500. Despite the large gains, the unemployment rate rose indicating the supply of labour is now greater than the demand. The employment-to-population ratio returned to a record high of 64.6%, while the participation rate reached a new high of 67.2%. Strong migration has added to those looking for work, but there are also signs that household income stress is another driver behind the increase in labour supply with more people looking for additional income to offset the higher costs of living.

Monthly Employment Change & Unemployment Rate



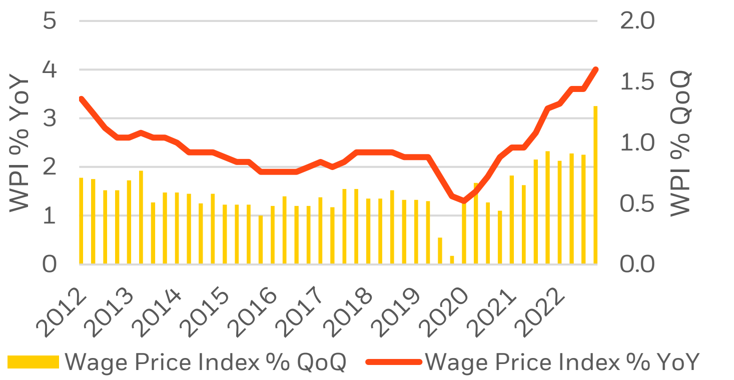
Source: ABS, Bloomberg, BlackRock as of 5/01/2024

Wage Price Index – Q3 2023

- ▲ Wages **increased by 1.3%** over Q3. This was **in line** market consensus.
- ▼ Annual wage growth **rose 0.4%** to **4.0%**

As expected, Wage growth accelerated by 1.3% in the September quarter, lifting annual growth to 4.0%. This was the highest quarterly growth rate in the 26-year history of the WPI, while the annual growth rate is the highest it's been since the March quarter of 2009. The growth was driven primarily by jobs covered by individual arrangements in the private sector, with increases to enterprise arrangements also increasing strongly, making a larger contribution over the quarter compared to the prior year. Award wages also contributed to the record increase with the Fair Work Commission lifting wages in excess of 4% across 8 out of 19 industries, while the national minimum wage increase was set at 5.75%.

Wage Price Index



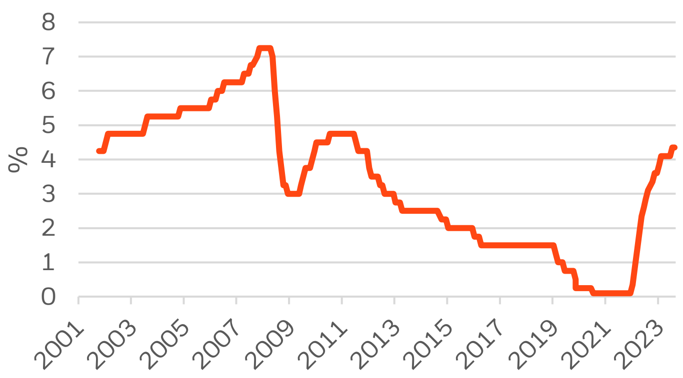
Source: ABS, Bloomberg, BlackRock as of 5/01/2024

RBA Policy Rate – Dec 2023

- ▲ The RBA increased the cash rate by 0.25% to 4.35% during the quarter.

With new RBA Governor Michelle Bullock taking over the Bank raised the cash rate once during the quarter, increasing it by 0.25% at their November meeting. Governor Bullock cited inflation "proving more persistent than expected a few months ago" and that "progress looks to be slower than earlier expected" as the reason for raising rates. The higher-than-expected Q3 CPI print clearly influenced their decision and unless improvement is made relatively quickly, we expect to see another rate hike. The Bank's Statement on Monetary Policy (SoMP) indicates they are navigating a fine line in reaching their CPI target of below 3% by December 2025 especially given the RBA minutes stated, "the board has a low tolerance for a slower return of inflation to target than currently expected".

RBA Cash Rate Target



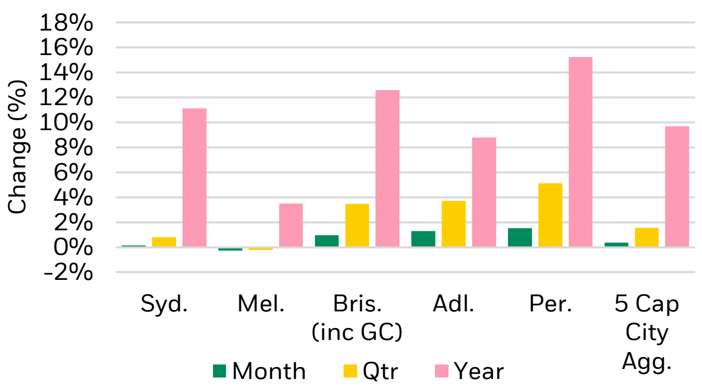
Source: RBA, Bloomberg, BlackRock as of 5/01/2024

House Prices – Q4 2023

- ▲ The CoreLogic national HVI **rose 1.6% in Q4**
- ▲ The CoreLogic national HVI **increased 9.7% over the year**

House prices continued to rise over Q4, albeit at a lightly slower pace than earlier in the year. After monthly growth peaked in May, RBA rate hikes in June and November, combined with higher cost of living pressures took the heat out of the market over the second half of the year. These trends suggest softer growth should be expected in the early part of 2024 with the trajectory of interest rates shaping property prices over the year. Another notable trend to observe was the increased supply across Sydney and Melbourne saw their monthly growth rate slow to below 1%, with Melbourne even experiencing a decline in prices over November and December. Conversely consistent supply levels and less affordability challenges allowed monthly gains across Perth, Adelaide, and Brisbane to remain above 1%.

Core Logic Australian Home Value Index



Source: CoreLogic, Bloomberg, BlackRock as of 5/01/2024

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