Outlook Q4 2023 & Quarterly review

BlackRock

Produced by BlackRock Australia Fixed Income

Economic Outlook Q4

While we expected the RBA to continue to increase the official cash rate through Q3 they chose to keep it unchanged at 4.10%. The key reasoning behind the RBA's stance is the belief that "members observed that there was a credible path back to the inflation target with the cash rate staying at its present level." We continue to remain somewhat concerned about the prospects of a reassessment by the RBA on the inflation front in the months ahead. There are many services, energy, and wage increases yet to flow through to upcoming inflation data, and so, we see the upside risk to further hikes.

Notwithstanding this, we agree with the RBA that we've now entered the calibration phase of tighter monetary policy. The open question remains… is monetary policy as restrictive as the RBA believes it is. Signs of this will be the pace and sustainability of the slowing in inflation and signs that the economy is cooling as expected. Clearly, some progress has been made on both fronts but there is still a long way to go. The 'higher-for-longer' cash rate theme now adopted by the fixed income market from a pricing standpoint remains the favoured policy trajectory for now.

The list of economic factors the RBA is watching hasn't changed much, relating to household consumption, the global economy, inflation, and the labour market. While Q2 GDP increased 0.4% q/q (2.1% y/y), the annual rate was still above the RBA's assumption at 1.6% y/y. Soft household spending would have given them some comfort looking forward as it reflects traction from high rates. The outlook for consumer sentiment is to remain weak as consumers get squeezed by high inflation and escalating housing costs – both rents and rising mortgage payments.

One area of concern for the RBA remains wages growth. Their year-end forecasts are for 4.1% p.a., so the bar is high for upside surprises. However, these forecasts have been stated as being consistent with inflation returning to the target band only if productivity improves. Productivity growth needs to be around 1.25% p.a. for the wage cost outlook be sustainable. However, productivity growth is well below this and unlikely to improve, thereby lifting unit labour costs which threatens inflationary expectations.

New RBA Governor Michelle Bullock has noted that inflation in Australia remains too high and that her "first priority is to keep very focused on inflation." Decisions on the cash rate are to be made on a month-by-month basis "until next year at least." We expect given the narrow path the RBA are walking that policy communication by them will remain somewhat balanced, with both hawkish and dovish elements.

Australian interest rate markets continue to gain their directional impetus from shifts in global sentiment and momentum. In this respect, we are paying close attention to the recent shift in focus by US Fed officials which suggests the recent tightening in financial conditions due to higher US bond yields could negate the need for more Fed rate hikes. The sharp increase in treasury yields as more term premium is built in by investors likely has its roots in increased bond supply. And that dynamic is unlikely to change over the medium-term.

Credit Outlook Q4

Australian investment grade credit spreads tightened in Q3 driven by higher risk-free yields and tighter swap spreads. This proved to be a return tailwind for investors who remained overweight the asset class. We retain our bullish thesis to owning local investment grade credit as we see the risk of a major widening in spreads for the rest of the year as remote. Indeed, recent investor demand for quality credit names remains strong due to the lack of corporate issuance in 2023.

High quality corporate fixed income offers attractive yields, but with much lower volatility compared to equites. Credit fundamentals remain sound – despite some further weakening in economic conditions. We continue to prefer the shorter end of credit curves to limit duration. Global central banks are nearing the end of their tightening cycles with "higher-for-longer" cash rates becoming accepted wisdom. This will help to stabilise interest rates in Q4, but we think there is still a bit more to play out in regard to rising bond yields.

Currency Outlook Q4

The AUD fell from US$0.666 cents to US$0.644 cents over the quarter and on balance was weaker compared to our Q3 expectation. The combination of a stronger USD, an outperforming US economy, a soft Chinese economic outlook and weaker risk sentiment kept the AUD under pressure. The extended weakness in China's property sector and elsewhere will remain a drag on Australian commodity prices. However, recent efforts by the PBoC to stimulate the economy by cutting loan prime rates has helped improve some negative AUD risk sentiment. Indeed, fears of further Chinese economic stress might be too aggressively priced now.

With our base case view being the RBA are not finished hiking the cash rate yet, the probability of another RBA hike in Q4 is underpriced. While that should help support the AUD the upside remains largely capped by the Fed's "higher-for-longer" Fed funds message. From an external standpoint, Australia's current account surplus remains strong at 1.2% of GDP in 2022-23 and we are a net energy exporter.

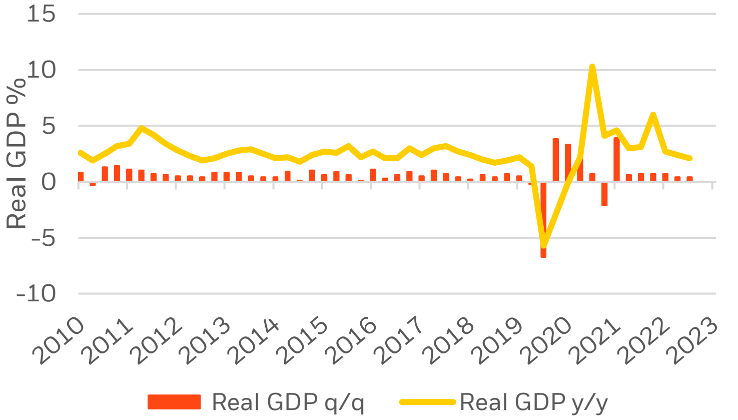
With geopolitical risk firmly back in focus (Russia/Ukraine and the Middle East), having a strong directional view on the AUD is very challenging. However, we would expect it to trade in a range of US$0.60 cents to US$0.65 cents given elevated risk sentiment.

GDP – Q2 2023

▲ QoQ GDP **grew 0.4%**. This was in line market expectations.
▼ YoY GDP fell from **2.4%** to **2.1%**.

Australian GDP growth came in at 0.4% q/q, in line with market consensus. In addition, there was an upward revision to Q1 GDP, as the quarterly growth rate went from 0.2% to 0.4%, and the yearly rate was revised up 0.1% to 2.4%. The key theme we can see from Q2 is that while growth is still positive, it is moderating. This was led by discretionary consumer spending, contracting for a third consecutive quarter, falling –0.5%. This is consistent with the household savings ratio falling to its lowest level since 2008, down 0.4% to 3.2%. On the positive side, the easing in supply chains and the improved weather drove trade in goods with exports up 2.5%. In addition, both public and private investment rose, up 2.4%.

Australia Real GDP



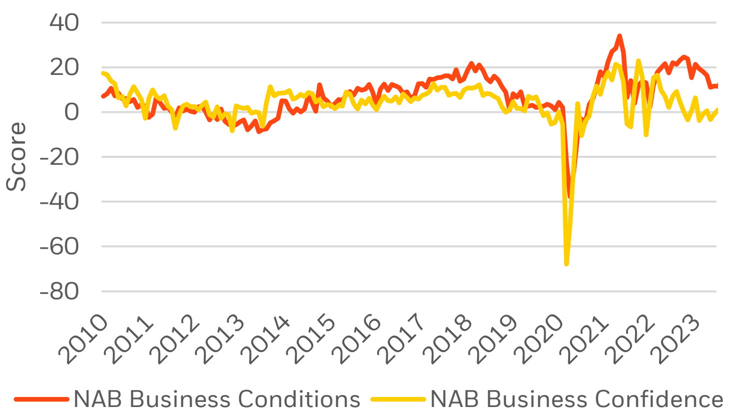
Source: ABS, Bloomberg, BlackRock as of 17/09/2023

Business Conditions – Sep 2023

▼ **Conditions fell by 3pts** from +14 pts (Aug) to +11 pts (Sep)
▼ **Confidence fell by 1pt** from 2 pts (Aug) to 1 pt (Sep)

Overall, the survey continues to show resilience in activity and even though conditions moderated in September, they remain above average at +11. Importantly, capacity utilisation remains high, and we have also seen forward orders gradually improve. Business confidence remained stable and has been broadly neutral for several months now, albeit it at levels still well below average, indicating that enterprises are less apprehensive about the future than they were previously. The survey also revealed some encouraging indicators regarding inflation, including an easing of price rises and cost pressures suggesting the momentum of some key drivers of inflation are in decline. Notably, labour cost growth in quarterly terms fell from 4% to 2%.

NAB Business Survey



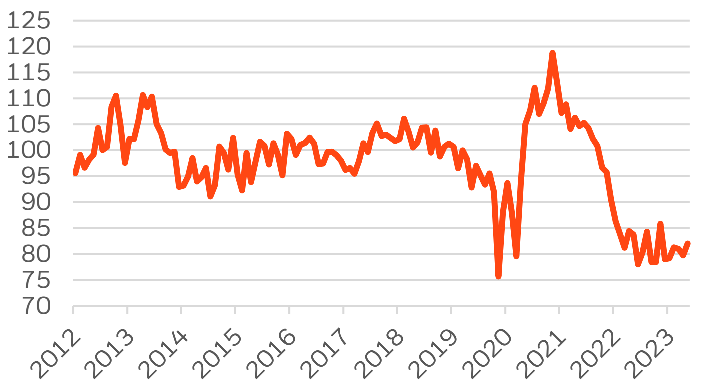
Source: NAB, Bloomberg, BlackRock as of 17/09/2023

Consumer Sentiment – Oct 2023

▲ The Westpac-M.I. Index of Consumer Sentiment **increased by 2.9%** from 79.7 in September to **82.0 in October**.

Consumer sentiment improved slightly, however, there is still a stark shortage of optimism. At 82, the Index is still very negative, which is consistent with the per-capita spending decline that has been going on since late last year. While there are some positive signs around family finances and the outlook for jobs, these are being clouded by the still-high levels of inflation and the possibility of more rises in the months ahead. While consumers are less optimistic about the near-term prospects for the economy, with the 'next 12 months' sub index falling 0.1% to 78.3, the medium-term view has improved with the 'economic outlook over the next five years' sub-index rising 2.1% to 92.4, suggesting consumers are confident the current costs of living problems will eventually abate.

Westpac Consumer Confidence



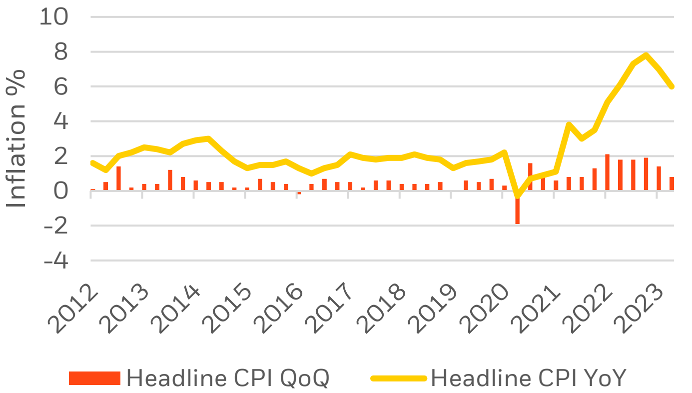
Source: Westpac, Bloomberg, BlackRock as of 17/09/2023

Inflation – Q2 2023

▲ Headline CPI **increased by 0.8%** QoQ. This was **0.2% lower** than market consensus.
▼ Annual inflation **fell 1.0%** from to 7.0% to **6.0% YoY**.

Headline CPI increased less than expected, helping the annual rate of inflation fall a whole 1% lower to 6% y/y. Trimmed mean CPI was also lower than expected rising by 0.9%, vs a forecast of +1.1% over the quarter, and on an annual basis fell from 6.6% in Q1 to 5.9% in Q2. The most significant contributors to Q2 CPI was services inflation (+6.3%), which remains elevated at its highest level since 2001. This included rents (+2.5%), which recorded their strongest quarterly rise since 1988, international holiday travel (+6.2%) and financial services (+2.5%). On the positively side, the more modest than expected price rises in both headline and core measures indicate disinflationary forces are greater than anticipated.

Headline CPI



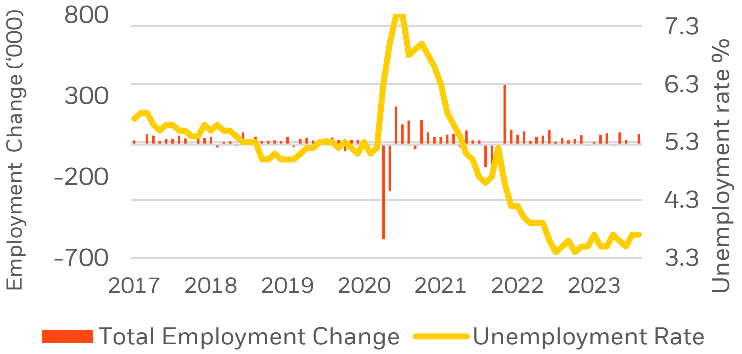
Source: ABS, Bloomberg, BlackRock as of 17/09/2023

Labour Market – Aug 2023

▲ Employment data saw 64,900 **new jobs gained**. This was **39,900 more** than market consensus.
▶ The **unemployment rate was unchanged at 3.7%**.

Employment growth rebounded strongly in August, well above consensus expectations. The unemployment rate held steady at 3.7%, in line with consensus, while the participation rate hit a fresh record high, rising by 0.1% to 67.0%. To boost, the decline in employment in July, previously reported at 15,000, was revised up, to show a minor decline of just 1,000. While the headline figures appear solid, job growth was heavily skewed towards part-time workers (+62,000); with hours worked falling by 0.5% q/q over Q3, and the underemployment rose by 0.2% to 6.6%. Overall, this was a reasonably solid report as the jump in jobs growth likely reflects a rebound from the weaker holiday-impacted reading in July.

Monthly Employment Change & Unemployment Rate



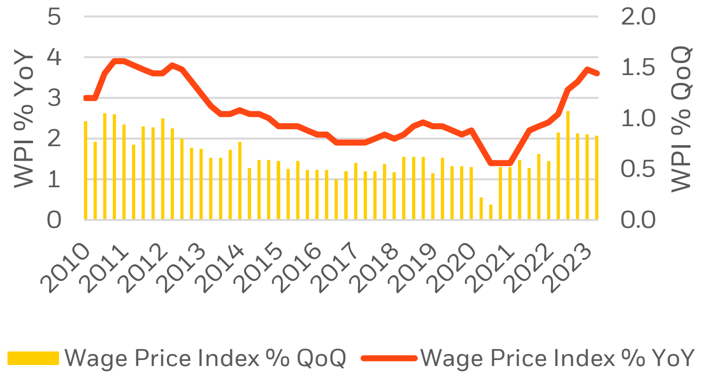
Source: ABS, Bloomberg, BlackRock as of 17/09/2023

Wage Price Index – Q2 2023

▲ Wages **increased by 0.8%** over Q2. This was **0.1% below** market consensus.
▼ Annual wage growth **fell 0.1%** to **3.6%**

The Q2 Wage Price Index (WPI) rose by 0.8% to see the y/y rate edge down slightly to 3.6%. This marked the second quarter in a row that the WPI has surprised to the downside despite the increasingly tight labour market of the last 12 months. Private sector WPI grew by 0.8% q/q with the y/y rate a steady 3.8%, while the public sector WPI lifted slightly less by 0.7% q/q and 3.1% y/y. Even though this quarters WPI outcome Is below the RBA's forecast the annual growth rates in both sectors are now running at the fastest pace since 2012/2013. The Fair Work Commissions 5.75% minimum wage increase for around one fifth of the workforce did not make it into the Q2 data so we should see some further increases ahead in the Q3 print.

Wage Price Index



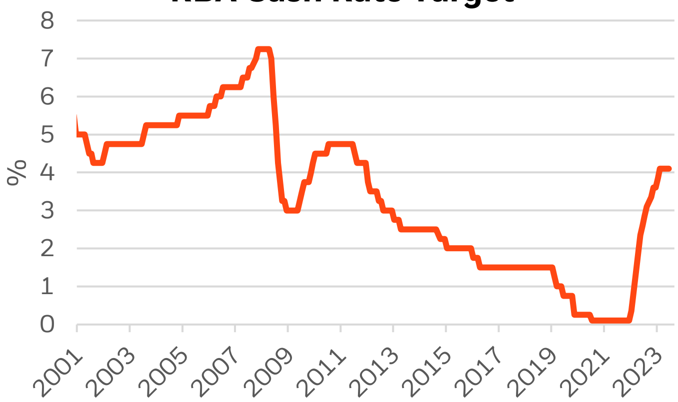
Source: ABS, Bloomberg, BlackRock as of 17/09/2023

RBA Policy Rate – Oct 2023

▶ The RBA has held rates steady since their June meeting, keeping the cash rate target at 4.10%.

The RBA held rates steady over the quarter and into October as economic data, while better than expected, was not quite strong enough to warrant further rate hikes given the bank aims to achieve a soft landing. Clearly, we have entered the fine-tuning phase of setting monetary policy which most likely means longer pauses as the macro data unfolds and the RBA remains "data dependent". The key issues for the RBA will continue to be the unemployment rate being too low and the speed at which the RBA wants inflation to return to the mid-point of its 2-3% band. Currently, the Bank doesn't see inflation falling below 3% until December 2025, but as we noted in the outlook there are still several risks in play that could see the RBA take further action if they wish to achieve this target on time.

RBA Cash Rate Target



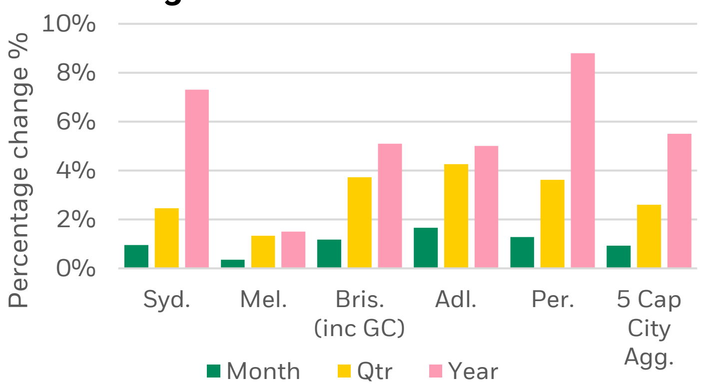
Source: RBA, Bloomberg, BlackRock as of 17/09/2023

House Prices – Q3 2023

▲ The CoreLogic national home value index **rose 2.6% in Q3**
▲ Over the year, the CoreLogic national home value index **increased by 5.5%**

As the median home value reached A$732,886 over the quarter, the residential property market surpassed A$10 Trillion in value for the first time since June 2022. While borrowing costs are materially higher than a year ago, several key factors have supported prices. Namely, strong net overseas migration with a combination of returning overseas arrivals and less departures. People are drawing down savings and using equity from previous home ownership to fund new property purchases. And in addition, supply continues be an issue given it remains historically low. Despite new listing starting to increase September listings were still 23.4% lower than the previous fiver year average.

Core Logic Australian Home Value Index



Source: CoreLogic, Bloomberg, BlackRock as of 17/09/2023

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