Hedge Clippings: Risks & Issues in 2025 – Part 2

13 December, 2024

Part 2 of Risks & Issues in 2025 considers the implications of the global backdrop discussed in Part 1 for Australia - as well as some home-grown influences.

The global backdrop and associated risks will feed into the Australian economic story.

Like all countries, the implications of a second Trump Presidency are being debated in Australia. And prudent policy makers have been war-gaming likely outcomes.

We know that the Commonwealth Treasury have been hard at work – the Treasurer has told us so. But we have only a broad overview of their work – because that is all the Treasurer will tell us!

What Treasurer Chalmers has told us is to "expect a small reduction in our output and additional price pressures". Tariffs cut demand for Australian exports – which slows growth. They also mean a weaker AUD – so higher import prices and a boost to inflation.

We do have some protection in this new global backdrop. Australia is one of the few major economies that runs a trade *deficit* with the US (Chart 21). That deficit is running at around $30bn (or over 1% of Australian GDP) at present. We should not be at the front of any tariff firing line.

The broader global growth backdrop is a relatively neutral one when it comes to commodity prices (Chart 22). It would probably take a major Chinese stimulus package, with a construction focus, to produce much upside for Australian commodities.

Interest rates are falling in many countries. But Australia is reluctant to join the rate cut party.

RBA Governor Bullock persistently hoses down rate cut expectations. And even occasionally suggests a rate *rise* is still a possibility.

The Governor's argument why Australia shouldn't be cutting rates has a number of parts:

- The slowing in Australian inflation rates is *less* than in other countries (Chart 23 shows an Australia-US comparison). And part of that slowing has been purchased by temporary government subsidies on dwelling rent and electricity.
- Unemployment increased by more in other countries than in Australia.

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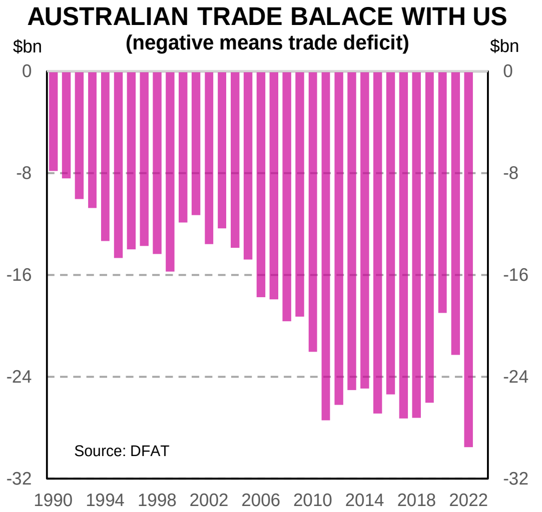

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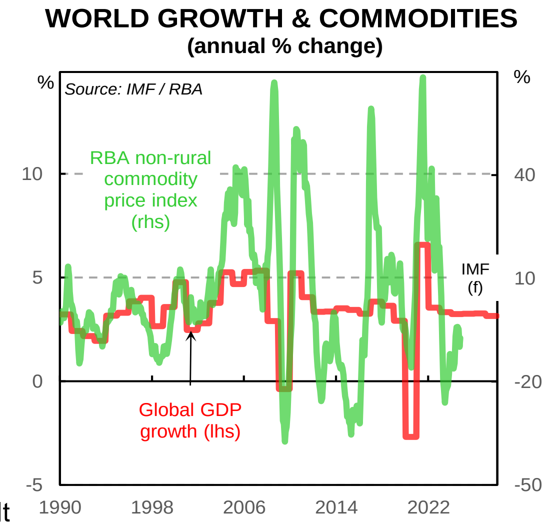

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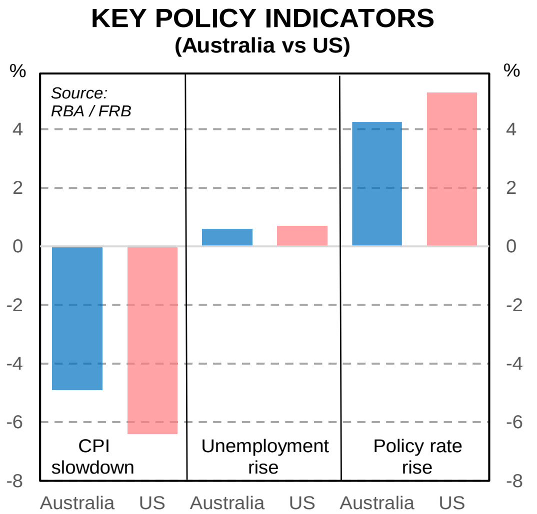

- Policy rates were increased by more in other countries than in Australia. The peak policy rate in the US, for example, was 5¼-5½%. The peak in Australia was only 4.35%.

Getting inflation just over the line and into the target band of 2-3% (by end 2025 on the RBA's forecasts) is not enough. The Governor has stated that she wants to get back to the <u>middle</u> of the band (not reached until end 2026 on the RBA's forecasts).

The RBA is facing the classic policy problem. It is easy to make big inroads into inflation initially. But progress then becomes more difficult. Squeezing the last 1% of inflation out of the system is typically the hardest to achieve.

The current disinflation cycle is the <u>slowest</u> of those in the modern (post 1990) monetary policy era (Chart 24). Inflation stickiness is concentrated in the *services* side of the equation (Chart 25). Services prices are closely correlated with labour costs (Chart 26). So the RBA will take some comfort from the recent slowing in wages growth that their inflation forecasts are on track.

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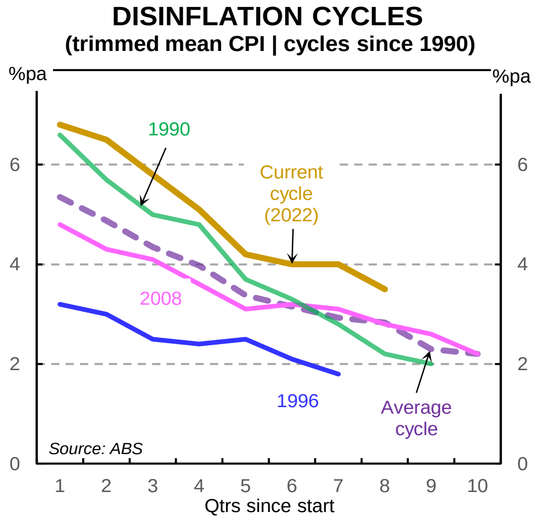

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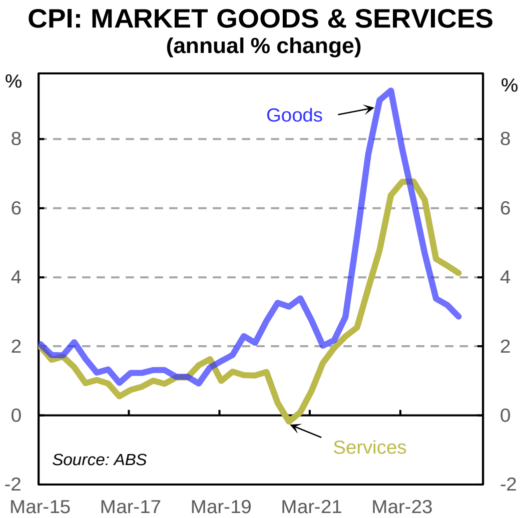

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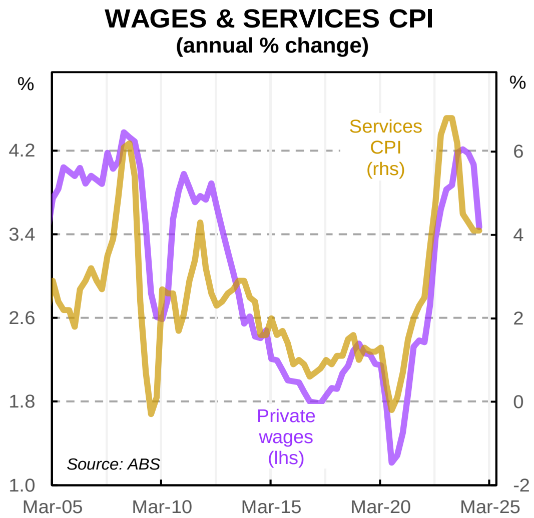

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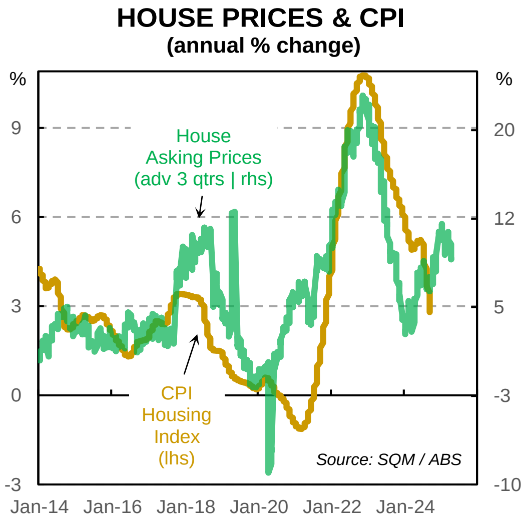

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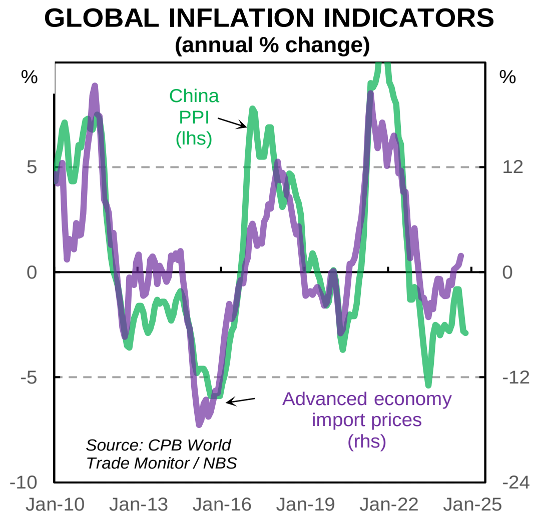

Below the surface, much of the services inflation comes from housing. Housing has the largest weight across the main CPI categories (22% of the overall CPI). And housing CPI growth is strongly correlated with dwelling prices (Chart 27). So the RBA will also take comfort that dwelling price growth is easing back (for now).

In a similar vein, the RBA will note that Chinese producer prices are still falling (Chart 28). This deflation will provide some comfort to the RBA that any acceleration in *goods* prices is unlikely.

At the end of the year we have a central bank confident that its inflation forecasts are on track. But disappointed at the length of time taken to get there. So don't look for a rate cut any time soon.

A word of caution: back in 2021 then RBA Governor Lowe assured all and sundry that interest rate *rises* were unlikely before 2024. The first rate rise was in May 2022!

The RBA may be reluctant to join the rate cut party. But they will have to put in an appearance eventually.

In the end interest rates are only one of the transmission channels for monetary policy. Another key channel is the Aussie dollar.

The interest rate differential between Australia and the rest of the world is widening as other central banks cut policy rates. Global capital flows notice this and money flows to the place of best return. The AUD should strengthen as a result.

A Monetary Conditions Index (MCI) combines interest rates and the exchange rate into an indicator of financial conditions (Chart 29). So a stronger currency will tighten Australian financial conditions further. The RBA will have to offset this tightening by cutting interest rates.

Bottom line: rate cuts are coming – but seem unlikely before Q2 2025 (Chart 30).

Once a rate-cut cycle is under way, most of the action occurs in the first 12 months (Chart 31). The "typical" reduction in the cash rate during Year 1 sits in a 1-2% range. More aggressive easings are associated with major shocks, like the GFC in 2008.

When the RBA starts the process, standard practice is to get policy rates back to a "neutral" setting. Interest rates are not exerting a positive or negative influence on the economy at that point.

Current RBA estimates of neutral lie in a 2¼-3¾% band. A band of that size may reflect the uncertainties.

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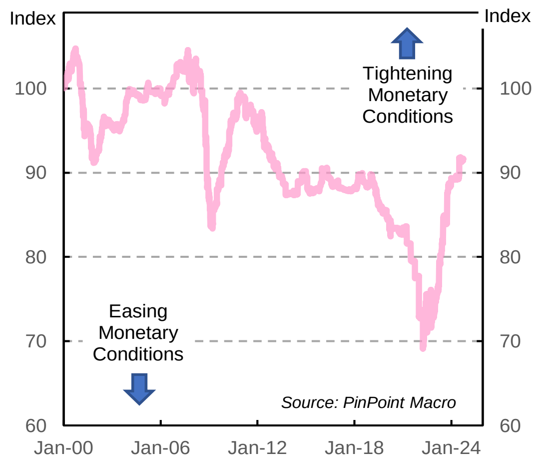
PINPOINT REAL MCI



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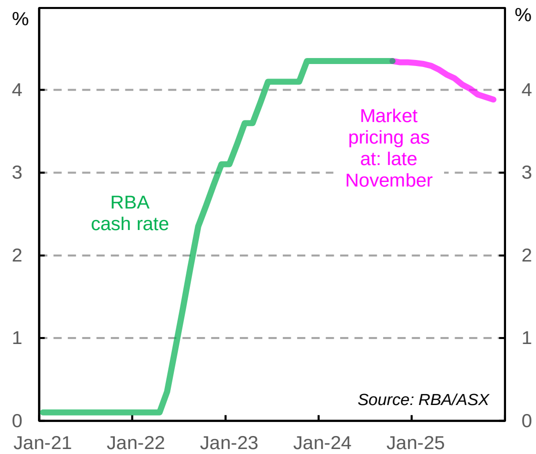
RBA CASH RATE PRICING
(30 Day Interbank Cash Rate Futures)



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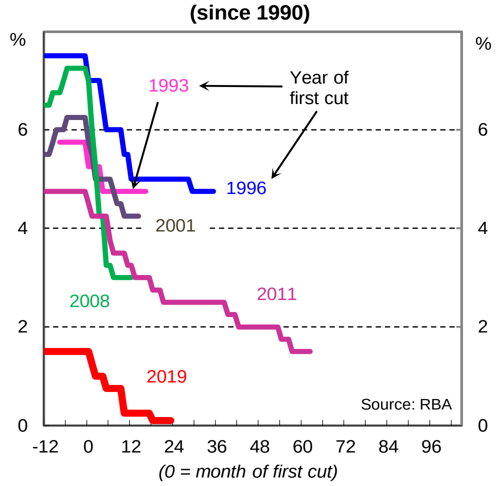
RATE CUT CYCLES
(since 1990)



But it is not particularly useful. The consensus among private economists puts the neutral rate at 3½%. 32

Global fiscal trends may have disappointed. But those for Australia have surprised:

- the Commonwealth Budget lurched into surplus in 2022/23 and repeated that performance in 2023/24;
- the government debt trajectory is lower as a result (Chart 32); and
- the fiscal path is not far off that required to stabilise debt:GDP ratios.

Less positively, budget deficits are expected to return from the current financial year and persist all the way out to 2034/35. And fiscal settings are currently expansionary (Chart 33).

This fiscal stimulus is helpful for economic growth and employment. But it complicates the monetary policy task for the RBA. 33

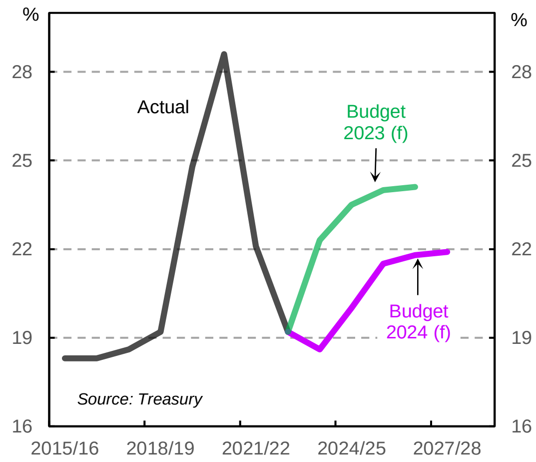
Beyond the inflation and monetary/fiscal backdrop, expectations for economic activity are for some improvement during 2025.

RBA projections, for example, typically set the baseline for the private sector consensus (Table 2). These projections have the Australian economy turning in a better performance in 2025. But a performance that remains sub trend. And one dependent on some significant shifts in growth drivers.

The main points are:

- GDP growth is expected to run at around 2¼% during 2025. This projection represents a significant step *up* from the 1½%pa pace of the past year. But it remains below what was seen as "normal" in the pre-COVID period (2¾%pa). And below most estimates of potential GDP growth (2½%pa).
- Faster GDP growth and slower population growth means the "per-capita recession" should end in 2025.
- GDP growth at this sort of pace is sufficient to drive further jobs growth. But not strong enough to prevent a small lift in the unemployment rate.
- The lift in unemployment is enough to see some step down in wages growth and assist the slowing in the underlying inflation rate.
- The main driver contributing to the growth pick up is a *tripling* in household spending growth.

NET DEBT
(% of GDP)



FISCAL STIMULUS
(% of GDP | structural & temporary measures)

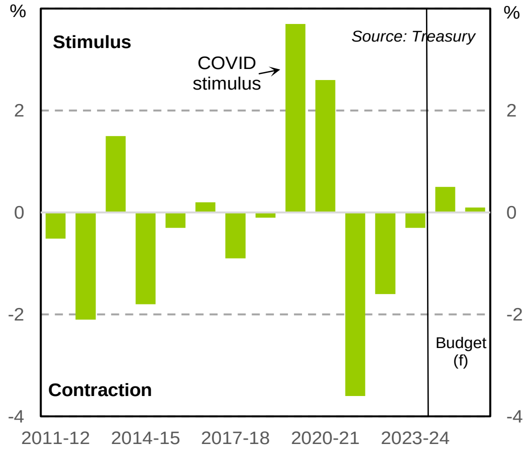


Table 2: Australia: Key Forecasts (%pa)

	End 2023 *(a)*	End 2024 *(f)*	End 2025 *(f)*
GDP	**1.6**	**1.5**	**2.3**
H/hold spending	0.8	1.0	2.9
Dwelling capex	-2.9	-0.7	0.5
Business capex	9.3	0.0	1.7
Public spending	4.6	4.0	3.7
Employment	3.0	2.6	1.4
Unemployment	3.9	4.3	4.5
CPI	4.1	2.6	3.7
Underlying CPI	4.2	3.4	2.8
Wages	4.2	3.4	3.2
Terms of trade	-3.9	-5.7	-0.7

Source: ABS / RBA/PinPoint/Consensus

PinPoint MACRO ANALYTICS

- Public spending continues to grow and business capital spending holds at high levels after a number of years of growth.
- Import growth outpaces exports so some of the lift in spending "leaks" overseas.
- A small decline in the terms-of-trade implies a drag on business profits, government revenue and export receipts. The current account surplus should narrow.

The expected growth scenario depends on consumers opening their wallets again.

The one certainty at the end of 2024 is that consumers are miserable.

Households are dealing with the ongoing cost-of-living crisis. Overlaying that, we have a housing affordability crisis and a rental crisis. Low construction activity means we have a housing supply crisis and high mortgage rates means we have a household debt crisis. Rising constructions costs have contributed to insolvency and corporate failures. Housing issues have depressed consumer confidence. And worries about the housing have-and-have-nots is a key input into a perceived crisis of intergenerational equity.

Consumers have been miserable before. The stagflation of the 1970s was a painful experience for many. Economist Arthur Okun developed the Misery Index at that time as a way of measuring the pain. The index adds inflation and unemployment rates to derive a measure of economic misery (Chart 34).

The current cost-of-living crisis needs a new measure of misery. We need to:

- add on debt servicing to capture the pain from higher interest rates; and
- add on rents to capture the pain from the affordable housing shortage.

The resultant Enhanced Misery Index is at the high end of the range of the past 30 years!

Clearly "misery" needs to subside before consumer spending can lift. Prospects for a decline in misery look favourable:

- an ongoing (slow) reduction in inflation will offset the expected (small) lift in the unemployment rate;
- RBA rate cuts will reduce mortgage rates and lower the household debt service ratio; and
- leading indicators like asking rents point to some slowdown in dwelling rents growth (Chart 35).

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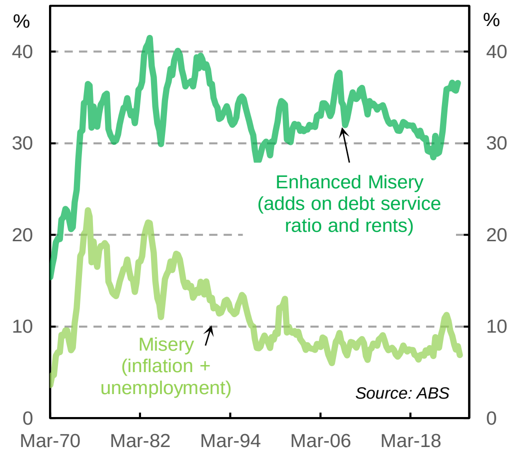
MEASURES OF MISERY
(based on CPI | unemployment | debt | rents)



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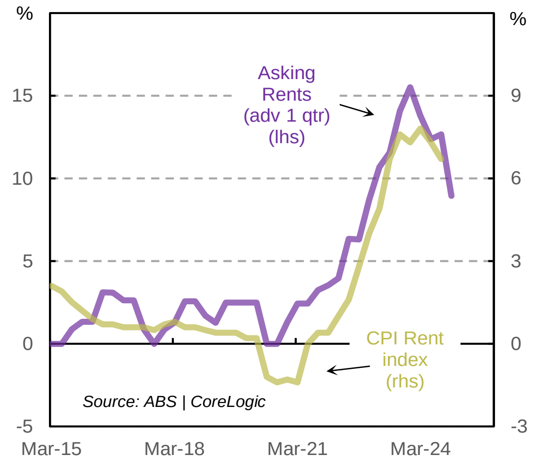
CPI & RENTS
(annual % change)



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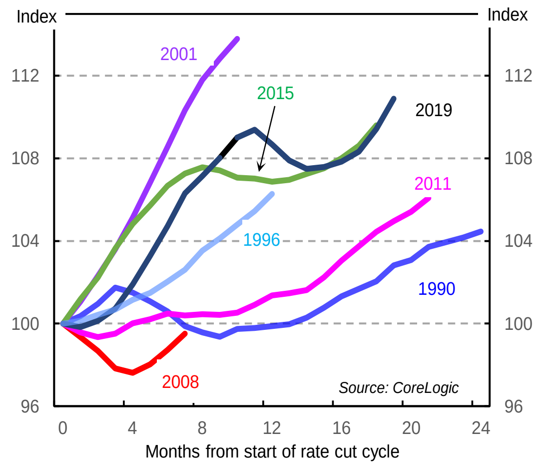
DWELLING PRICES & RBA RATE CUTS
(rate cut cycle starts in month 0 | start=1000



Other factors will help as well. Consumer sentiment has lifted. The labour market remains tight. The employment:population ratio, for example, is at a record high. It seems that we don't so much have a shortage of jobs (i.e. unemployment) but rather a shortage of workers to fill those jobs! Job security fears have eased as a result. The Stage 3 tax cuts are filtering through. And RBA rate cuts will activate the wealth monetary policy transmission channel.

Policy makers have long known how to fire up the housing market. Cut interest rates and stand clear!

The potential impact of lower mortgage rates is set to be magnified by:

- the strength of housing *demand* given strong population growth – the Australian population rose by an extraordinary 615,000 over the past year;
- the weakness in housing *supply* as new construction falls;
- the *pent-up demand* overhanging the housing market from the last few years of underbuilding;
- the ever-present *fear of missing out* (or FOMO) – consumer sentiment surveys show more than half of respondents expect dwelling prices to <u>rise</u> over the next year; and
- the increase in borrowing capacity that lower mortgage rates will allow.

The historical experience over the past 30-plus years is that dwelling prices rise as the RBA cuts interest rates (Chart 36). The lags between the first rate cut and an acceleration in price growth is variable. But, apart from the short-lived easing cycle during the GFC in 2008, prices have always increased.

The consensus among the major banks is that dwelling prices will grow at a reasonable pace over 2025 (Table 3).

Housing is our biggest asset (and our biggest liability). Rising dwelling prices mean the household wealth will lift (Chart 37). And rising wealth generally flows through to stronger consumer spending.

This same mix of drivers - interest rates, wealth, population – feed into the residential construction story as well. Falling dwelling investment has been a drag on economic activity since 2022.

The demand demographics are unambiguously strong. As noted, population growth accelerated strongly after the pandemic-induced closure of Australia's international borders.

Table 3: Dwelling Price Forecasts (end year | %pa)

	2023 *(a)*	2024 *(f)*	2025 *(f)*
Sydney	11.3	5	4
Melbourne	4.2	-1	4
Brisbane	13.6	13	6
Adelaide	8.9	14	7
Perth	16.2	23	8
Hobart	-1.7	1	2
Darwin	0.1	2	2
Canberra	0.4	3	4
Australia	**8.5**	**7**	**5**

Source: CBA / NAB / WBC / ANZ / CoreLogic

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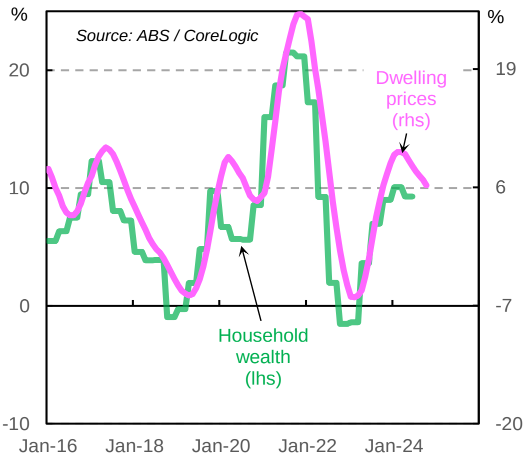
WEALTH & CONSUMER SPENDING
(annual % change)



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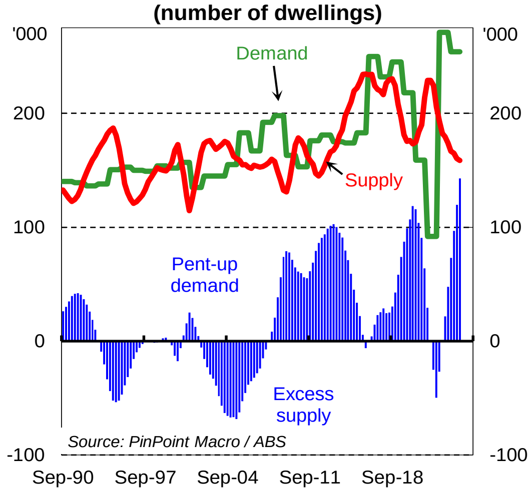
HOUSING DEMAND & SUPPLY
(number of dwellings)



There are roughly 2.4 inhabitants per dwelling. So, the 615,000 jump in the population has lifted the underlying demand for housing from “normal” levels of 185,000 dwellings per annum to 256,000 (Chart 38).

Current construction activity is running at only 159,000 dwellings per annum.

Population growth should ease back to more normal levels. But there is little evidence of any slowing in the data for 2024 to date. The May 2024 Commonwealth Budget assumes that population growth runs ahead of normal until 2026/27. The risk is that housing demand remains strong.

One underappreciated part of the demand story is that any unsatisfied demand from earlier years does not disappear. It gets carried over into future years. There is a sizeable pent-up demand for housing as a result (Chart 38).

A turn in the interest rate story as the RBA begins cutting interest rates will help on the supply side of the equation. With a short lag, a reduction in interest rates is usually accompanied by a lift in building approvals (Chart 39).

Residential construction should shift from a drag to a support for overall economic activity in 2025.

Despite a lift in residential construction activity, the Federal and State governments plan to build 1.2m dwellings over the next 5 years remains out of reach. (Chart 40).

The forecasts showing a pick-up in GDP growth and a step-down in employment growth imply a better productivity outcome in 2025. Any improvement is welcome. But much remains to be done to close the productivity shortfall that emerged over the past decade. Productivity growth ground to a halt before the pandemic hit. And there is an endless debate on how to get it moving again.

The debate is generally framed around the 3 P’s. The 3-P’s are Population, Participation and Productivity.

Trends in the 3 P’s ultimately drive economic activity, jobs and incomes. They create the wealth needed to fund Australia’s longer-run objectives and deal with the longer-run challenges. But population growth is set to slow. Participation is already at record highs. Which leads us back to the pressing need to boost productivity growth again.

Some thoughts on asset and financial markets

The RBA is set to shift course towards policy rate cuts by Q2 2025.

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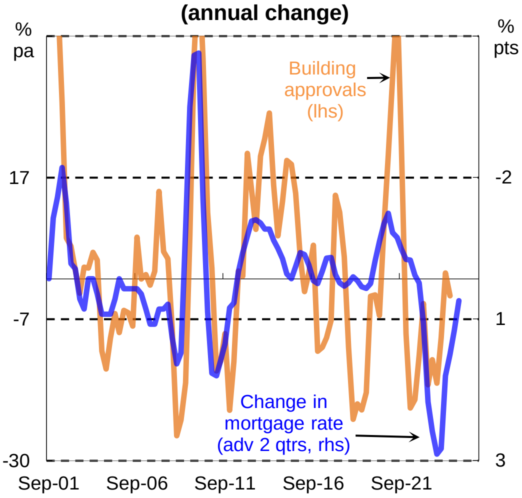
BUILDING APPROVALS & RATES
(annual change)



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DWELLING COMPLETIONS
(rolling 5-year sum)

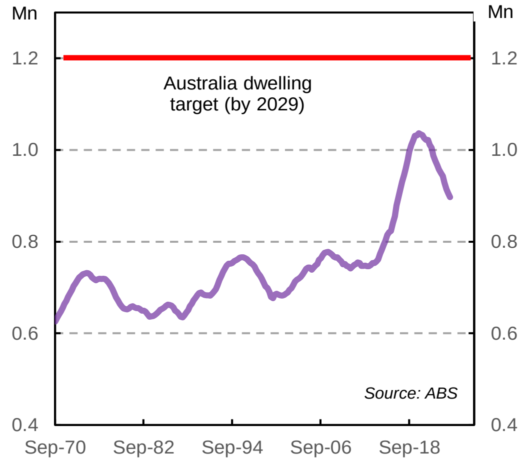

Table 4: Illustrative Financial Forecasts

	End ‘24	Mid’25	End’25
US Fed funds (upper)	4.50	3.75	3.75
RBA cash rate	4.35	4.10	3.50
Australia			
3-yr bonds	4.0	3.6	3.4
10-yr bonds	4.4	4.1	4.0
Curve slope	40bpts	50bpts	60bpts
Aus-US 10-yr spread	0bpts	15bpts	10bpts
AUD/USD	0.65	0.70	0.72

Source: RBA / Author’s calcs

Changes in the RBA cash rate influence the short end of the yield curve. Rates further out are more reflective of market forces and interest rate expectations. So, the typical experience during a rate cut cycle is 1-3 year bond yields fall. But longer-term rates tend to move earlier. Since short rates usually fall by more than long rates, the yield curve steepens.

Some of the key AUD influences, like the terms-of-trade and current account balance, are set for a muted impact in the year ahead. That leaves the widening interest rate differential in the driver's seat. The implication is a stronger currency.

The risk of lower commodity prices and the potential for some squeeze on profits as nominal GDP growth slows imply a negative lead for Australian equity markets in 2025.

Beyond financial markets, and as discussed earlier, residential real estate prices are expected to rise a little faster than the inflation rate.

Commercial real estate expectations are little changed in recent years (Chart 41). The consensus among industry experts remains:

- Industrial expected to outperform in terms of rental growth and capital expectations.
- Office and Retail expected to remain exposed to falling rents and lower capital values (albeit at a slower pace).

There are some risks to this consensus.

A return to working in the office is underway. Office occupancy rates exceed 75% in all main cities except Melbourne. Government and business are pushing for more. There may be some upside for the Office segment.

The upward trend in the share of online in retail spending has stalled. And prospects are brighter for consumer spending overall. There may be some downside for Industrial and upside for Retail segments.

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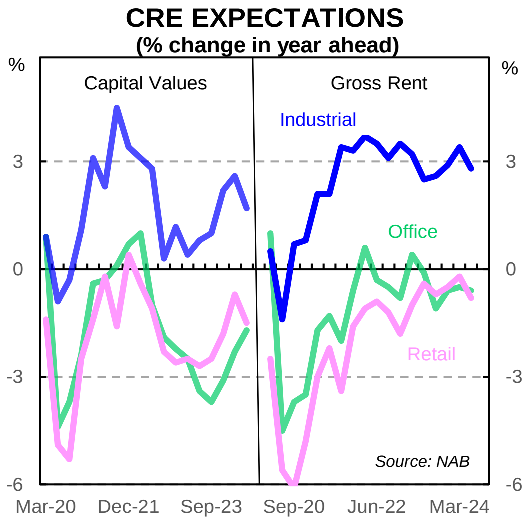

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