15 December 2023

ECONOMIC UPDATE

2023 in review and a 2024 preview

BOQ GROUP

Key Points

- **The path of economic growth, unemployment and inflation rates have gone broadly as expected;**
- **But both the cash rate level and house price growth has been higher;**
- **Next year the economic tale will be one of two halves;**
- **We have likely hit peak cash rate. The first decline though may need to wait until 2025.**

'*Forecasting is very difficult, especially when it involves the future*"
Yogi Berra

The ex-New York Yankees baseball manager was always good for a quote. My favourite Yogi-sim is "In theory there is no difference between practice and theory. In practice there is" although there is debate as to whether he made that statement.

There is more than a semblance of truth about what Berra said about forecasting, particularly in the field of economics. For all the progress made, the economy is getting bigger, more complex and more varied. The data needed is still incomplete and, in many cases, released with a lag. But it must be done.

Below I list my major forecasts for the past year, and where I think the economy will be going in the next one. I leave the reader to decide how good the forecasting has been.

The tale of two halves

The profile of **economic growth** over the past couple of years has developed broadly in line with my expectations. From the middle of last year, it became obvious that the economy would benefit from a snapback in demand following the COVID lockdowns and strong fiscal and monetary support. Growth would then slow due to a combination of rising interest rates and high inflation crimping consumer spending. There was very strong GDP growth in the first half of last year followed by a still strong second half. There was decent GDP growth in the first half of this year but sub-trend in the second half.

This pattern of growth has become more obvious since upward revisions to the GDP numbers in the first half of this year and the second half of 2022. There may still be other revisions to come. Other economy-wide indicators (such as surveys of new orders, job ads and the underutilisation rate) tell a similar story as the revised GDP data.

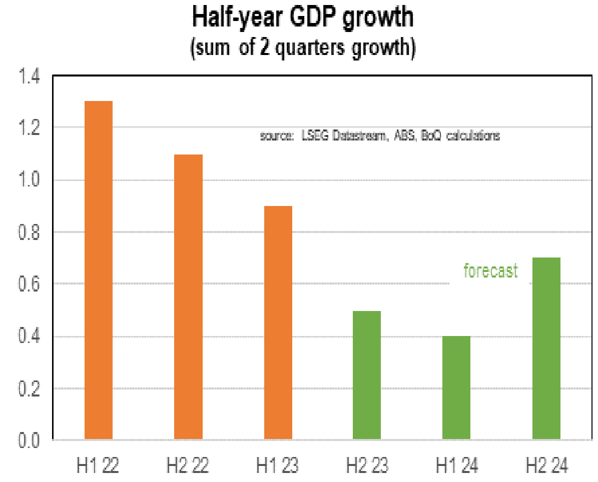
I think we will see another (small) leg down in GDP growth in the first half of next year with a better economic performance in the second half.

The weakness of real disposable income growth has been the key driver of slow consumer spending. That growth will still be negative in the first half of next year (although less so than this year). That is one reason why I expect another step down in GDP growth. Weaker global economic growth, a decline in residential construction and less business investment into inventory will also be negatives.

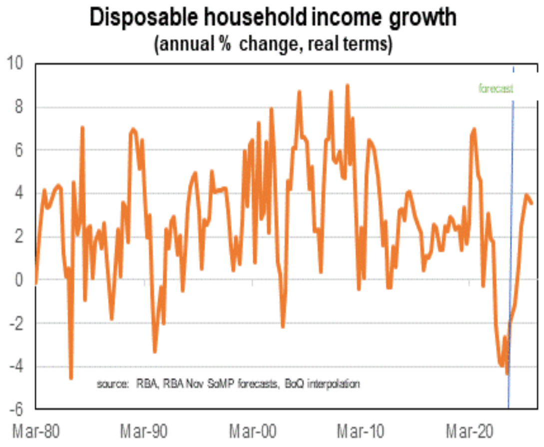
In the second half of next year things will start to turn brighter. Real household disposable income growth will become positive, as wages growth likely exceeds inflation and the (probable) delivery of income tax cuts (offset by slower jobs growth). Much of the impact of the increase in the cash rate should be in the rear-view mirror. Financial markets are pricing in rate cuts next year in peer economies, and if delivered should mean better things for the global outlook.

An important factor determining how much stronger the economy will grow will be how much households decide to save from their additional cash flow. There could be some catch-up spending as high inflation has capped the volume of goods and services households could purchase over the past 12-18 months. But the current household saving rate is well below its pre-pandemic level. Higher interest rates are attracting households to put more money into deposits or repay debt. I think a decent number of households will want to boost their saving rate again and this will cap how much the economy will improve.

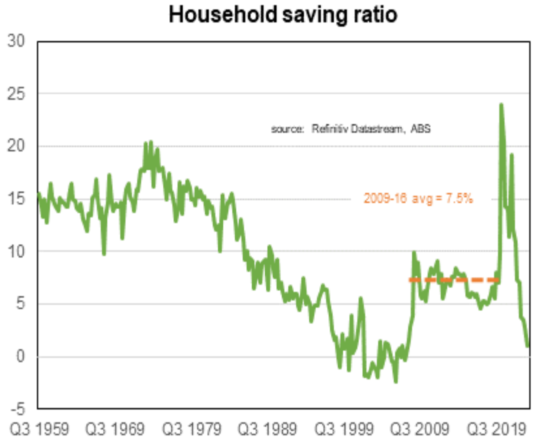
GDP growth has stepped down.



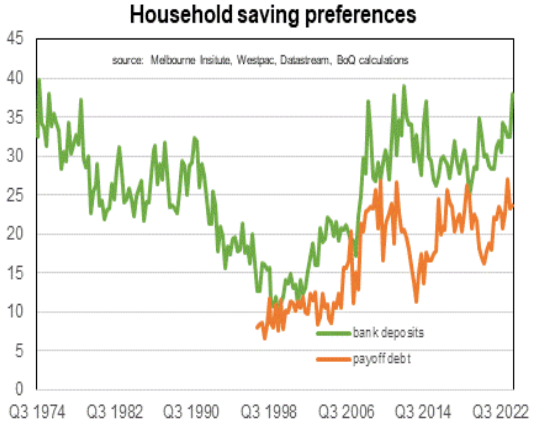
Real disposable income growth is improving but won't turn positive until the second half.



The household saving ratio is at its lowest level in over 15 years.



Households are looking to repay debt and stash more money into the bank.

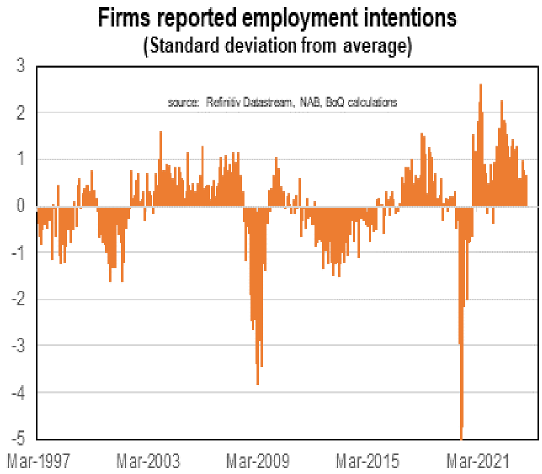


At the end of 2022 firms biggest concern was a lack of available workers. As the economy has slowed this year there has been less demand for employees. There has been a big jump in the number of available workers due to the (surprisingly) big increase in immigration. So, some of the worry about worker shortages has abated. But not by enough to lead to any significant change in the **unemployment rate.**

I think the unemployment rate will only rise a little in the first half of next year given the current excess demand for workers (from 3.8% to 4%). A bigger pickup in the unemployment rate in the second half of the year is on the cards as economic growth remains sub-par (to 4.5%). The projected rise in this cycle will still leave the unemployment rate low by our historical standards.

The jobs market ended the year on a strong note. But it wasn't as strong as it was end-2022.

An imminent rise in the unemployment rate is unlikely given hiring intentions are elevated.

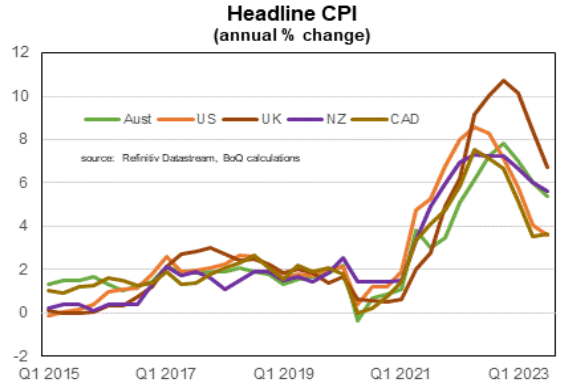


The path of **inflation** has broadly stayed on its expected path. While there was some noise around particular numbers (the CPI data was a bit lower than expected in Q2, a bit higher in Q3) the end point of inflation declining towards the 'mid 4's' by end-2023 is pretty much where it had been expected. Forecasts of lower inflation was based on the view that most of the rise that had taken place in goods inflation was down to supply-chain problems, many of which have now been fixed. The fall in commodity prices has helped.

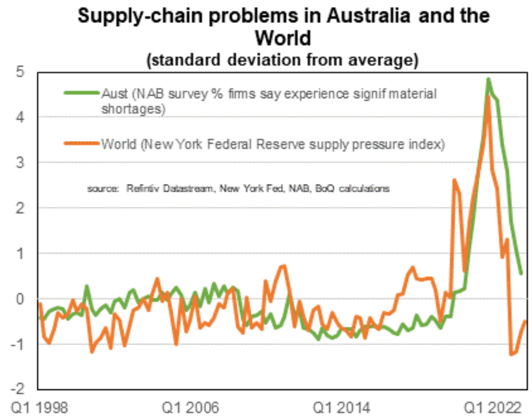
Similar economic shocks have hit Australia and most overseas developed economies. The data to date shows that CPI has fallen by more in most peer economies. Principally that is because Australia re-opened its borders post COVID later than most other economies. Developments in those economies suggest that there is further moderation in Australian CPI growth to come.

I think that the inflation run rate is currently 3-4%. The overseas experience has been that the 'last mile' of inflation reduction is likely to be a harder journey than the first part of the trip. 'Underlying' CPI in the US has been stuck at around 3% for the past few months. The overseas inflation experience is why I don't expect that inflation clearly will head below 3% until early 2025 (and therefore why I expect the first rate cut not to happen until that time).

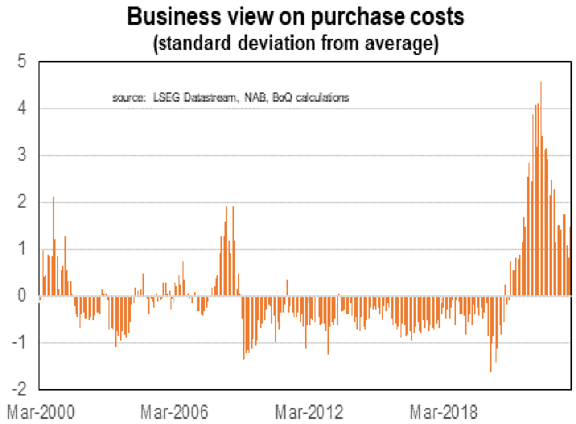
There has been a similar pattern of inflation across developed economies.



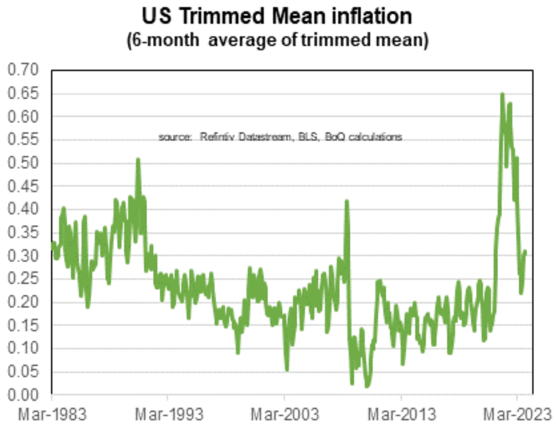
Supply-chain problems are largely resolved.



Firms' input costs remain elevated.



The final step-down of US inflation is proving problematic.



At the start of 2023 I thought the **cash rate** would end-2023 at 3.6%. It ended the year three quarters of a percentage point higher.

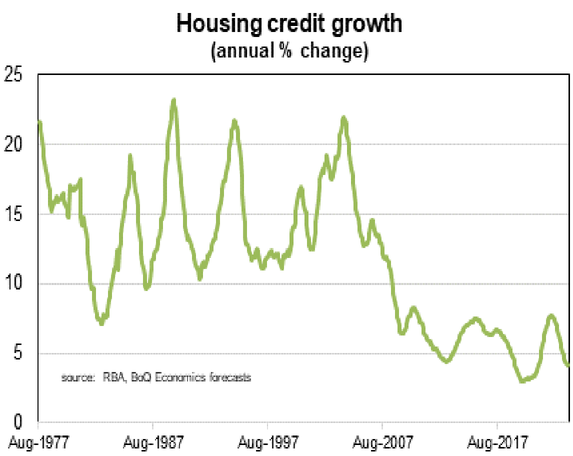
Why did the cash rate end the year so much higher than I had projected? I thought that the cash rate couldn't go higher than 3.6% without severely impacting households and creating major economic problems. Even at 3.6% it would be the most aggressive rate hike cycle in thirty years, this at a time when the household debt to income ratio was near a record high. And followed a decade of a very low, and falling, cash rate.

In part the economic resilience has reflected the extremely strong jobs market. Stronger population growth has played a role. Some analysts point to the benefits of the 'saving mountain' built up through the pandemic. Unarguably that has helped some households pay their mortgage. And for those with large deposit balances, higher interest rates have boosted their disposable incomes. But for other households, the rise in new saving (the increase that took place in the household saving ratio) offset the reduction in the value of existing saving (mainly a result of fall in equity markets).

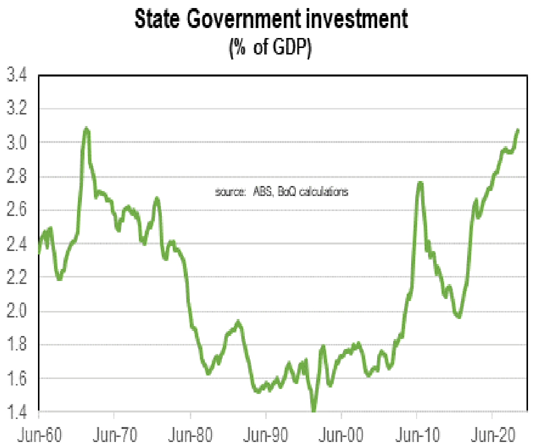
Underestimating the impact of fiscal policy (particularly from the states) was another reason why the cash rate ended the year higher than I expected. The $A was also lower than I had anticipated, and prices of our key commodity exports higher. Finally, I knew that infrastructure spending would be strong. But I thought that business investment would not be as decent as it turned out to be given concerns about the consumer.

With an inflation rate around 5% (as at October) and an unemployment rate in the 3's, if there is to be any change in the cash rate in early 2024 it must be up. Most of my fellow financial market economists, the financial markets and myself think that we have likely seen the peak in the cash rate in this cycle. The difference is that I think the first rate cut may not take place until (early) 2025. Most of my peers and current financial market pricing expect the first cut sometime in the second half of next year.

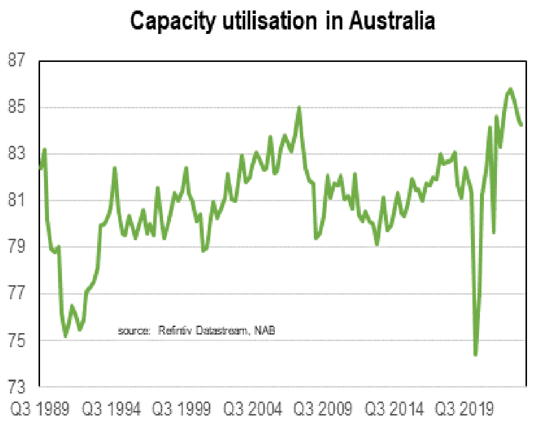
Higher interest rates are slowing the economy, partly through lower credit growth.



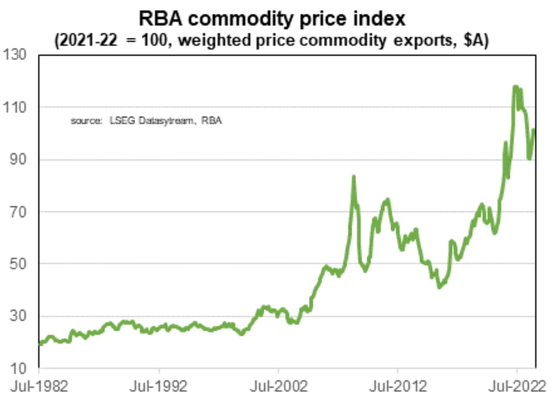
State infrastructure spending is near a record high.



Firms' capacity utilisation was also at a record high.



High commodity prices provided extra income to the economy.



Recently RBA Governor Bullock said that the biggest surprise to her this year has been the rise in **house prices**. That was also my biggest forecasting error. The reason I (and others) expected lower house prices at the start of the year was that we expected further increases in the cash rate. Higher interest rates have typically never been a good thing for the housing market. It is after all one of the ways that monetary policy has historically impacted the economy. And if I knew that the cash rate would rise by more than I had expected my confidence in my house price forecast would have been even higher.

Why then did I get it so wrong? Partly it was because I was using the wrong benchmark. Price adjustments are done in 'real' terms (i.e., how house prices change after considering inflation). From peak-to-trough real house prices declined by around 14% (higher inflation having a significant influence on that outcome). That was still a bit better than my forecast made at the start of the year for an actual dwelling price decline of about a 15-20% fall.

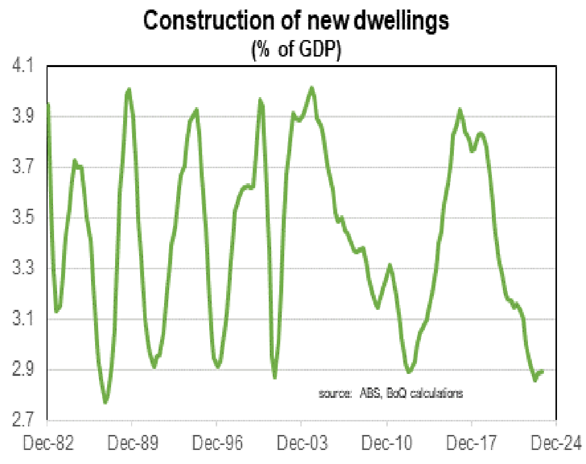
Higher interest rates partly works by reducing the demand for housing. Slowing mortgage credit growth suggests that has happened. But population growth was a lot stronger than anticipated. And the importance of the RBA's observation of the big increase in demand for housing from the WFH shift was underestimated.

The supply of housing also didn't rise as much as expected. There has been a lot of attention paid to the structural problems of getting local government approvals to build additional new housing. But the new element in this cycle has been the extreme lack of materials and workers to build new homes. It is unusual to see that we are currently at the low of the residential building cycle given the strong demand for housing and the previous very low level of interest rates. Strong employment growth (and maybe the heightened level of saving) has meant that there has been less forced selling in this cycle.

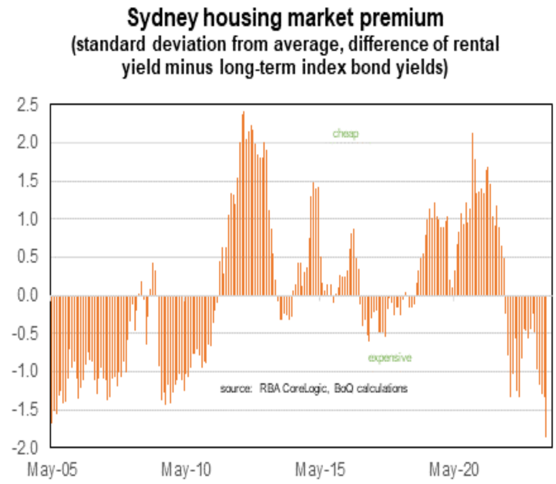
The result has been that demand for housing has been stronger than anticipated and supply less. This has led to a rise this year in both house prices and rents. This has meant that the rise in house prices for much of this year can be explained by the 'fundamentals'. But towards the end of 2023, valuations were looking stretched in most of the major capital cities.

A higher level of interest rates and house prices has reduced affordability. Higher rents are reducing demand for housing, leading to a renewed rise in the number of people per household. This slowing in demand against a backdrop of still constrained supply should lead to lower (but still positive) house price growth across Australia next year. The cities that are least affordable (Sydney) are likely to see the slowest house price growth. The most affordable (Perth) the highest.

Residential construction activity is very low despite the strong demand for housing.



House prices at the end of 2023 were starting to look stretched, notably in Sydney.



Overall, next year looks like it will be a tale of two halves for the Australian economy. The first half of the year will feel similar to the last half of 2023. The second half will be better, but how much better will be the critical question. I think only modestly better as households take the opportunity to rebuild their saving. I also think it will take until 2025 to get inflation back down under 3%. Which is also what drives the timing of my expectations for the timing of the first rate cut.

This will be my last note for the year. May you all have a fantastic break and be refreshed for the new year that (hopefully) will end up being a better one for the economy.

We really do live in interesting times.

Regards

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