17 January 2024

ECONOMIC UPDATE

Three issues to watch in Twenty-Twenty Four

Key Points

- **The economy will be a tale of two halves;**
- **The second half of the year activity should pick up, the global economy is the big risk;**
- **Inflation is declining, and there is more to come. But from here it will be down by the stairs not the elevator;**
- **Geo-political risk is on the rise, with the US election to get many of the headlines.**

There are always questions as to what a new year will bring. Sometimes the right questions are asked. The slowdown of the economy and inflation went broadly as expected. Other times the question is not asked (a pandemic, Russia-Ukraine War, and their implications). Below I touch on what I think will be three of the key questions for 2024:

- How well will the economy perform?
- How much will inflation slow?
- Will geo-political issues have a significant impact?

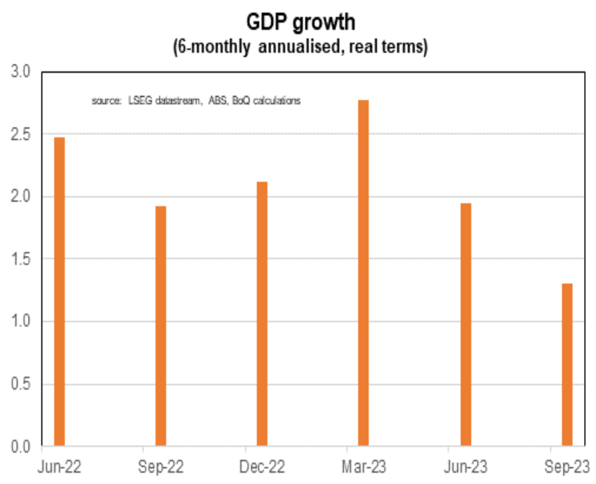
The economy in 2024 – a tale of two halves

The economy in the second half of 2023 ran at a sub-trend pace. Quarterly GDP growth averaged around half its 'normal' speed (which I estimate to be 0.5-0.7%). The underutilisation rate picked up by around half percentage point, job vacancies declined. Order books grew at a below average pace, spending in restaurants was flat. The reports have been that outside of 'Black-Friday'-related purchases, retail spending was soft over the festive season with discounting evident.

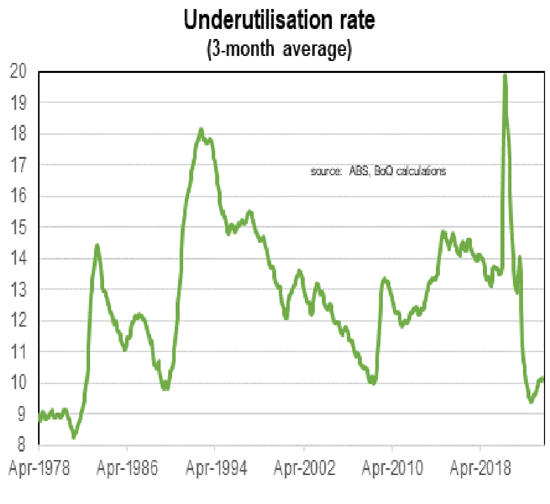
Higher interest rates played an important part in slowing the economy. The end of COVID revenge spending had a role. The most significant factor though was the weakness of 'real' household disposable incomes (ie, after allowing for the impact of inflation).

All of those factors are still prevalent entering 2024. In addition, population growth will almost certainly be lower this year (although whether it declines as much as expected is a different question). The global economy looks like it is taking a (modest) step down entering the new year. Residential construction activity could be lower as builders reduce their backlog of jobs outstanding but high costs reduce incentives for new construction. All of this means that it is hard to see how economic growth can improve substantially in the first half of the year.

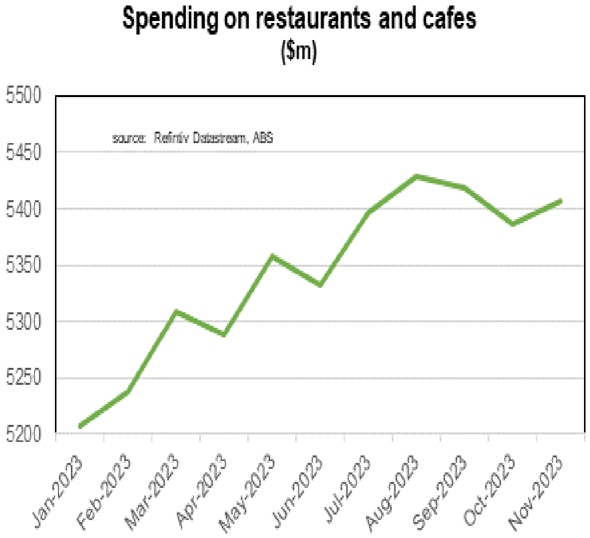
GDP growth took a step-down in the second half of last year.



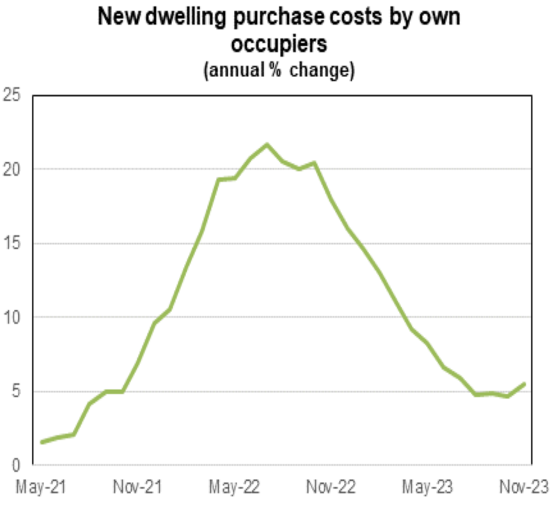
The underutilization rate picked up.



Eating out has become less popular.



Building cost inflation has slowed significantly. But it has not declined.



The economy should be kicking with the wind in H2

It is hard to get too negative about the economic outlook. Indeed, the economy is likely to end the year in a better state than it started.

- Budget data indicates that fiscal policy will be more supportive this financial year (and even more so in 2024-25). And news reports suggest that the federal government may provide further cost-of-living assistance in the upcoming budget.
- Several global central banks have suggested that the next move of interest rates is down. Financial markets are currently pricing the developed economy rate cut cycle to begin in the second quarter, with the cash rate expected to fall by 1-1.5% by year-end in peer countries. The Chinese Government is likely to provide fiscal and monetary support to its economy.
- Moderating inflation and tax cuts should see real household disposable income growth turn positive in the second half of this year. The current very low household saving rate suggests that at least some of this additional cash flow will be saved. But rising household wealth should mean that at least some will be spent.
- The underlying demand for housing is still high although construction work might be lower this year reflecting high costs. But there is a large amount of building and engineering work elsewhere still in the pipeline (roads, rail, mines, infrastructure, green transition). High capacity utilization puts a floor under business capex spending. El Nino has not been as bad as feared (although partly offset by the severe flooding in some regions).

A notable feature of most developed economies (including Australia) is that despite sub-trend economic growth the unemployment rate is still near their cyclical low. Over the past couple of years there has been a big mismatch between very strong demand for workers and a lack of supply. That gap is narrowing although it may take another 6-18 months for it to return back to its pre-COVID level. By that time the economy may be on an upswing. So there is the potential for the unemployment rate to rise only modestly in this economic cycle (ie, by one percentage point, or less).

What are the risks

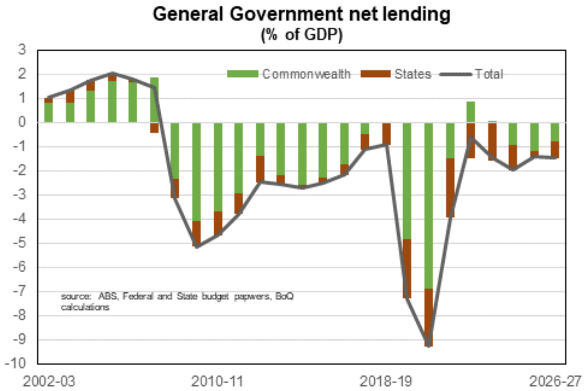
The tale of two halves for the Australian economy (weak first half, stronger second) is very much a consensus call. The key question is what are the risks to that view.

My economic growth forecasts are on the weak side of consensus for the second half of the year. The main reason is that I think that households will want to save a fair chunk of their increased cash flow following a period of very low saving. Some increase in the household saving rate is certain. But it is possible that increased wealth (from higher house prices and improved equity markets), a still strong jobs market and catch-up spending following the cost-of-living squeeze could see consumer spending (and therefore the economy) be in a better state than what I (and most other forecasters) are projecting. This would be even more likely if interest rates were cut earlier or fiscal policy is more supportive than expected.

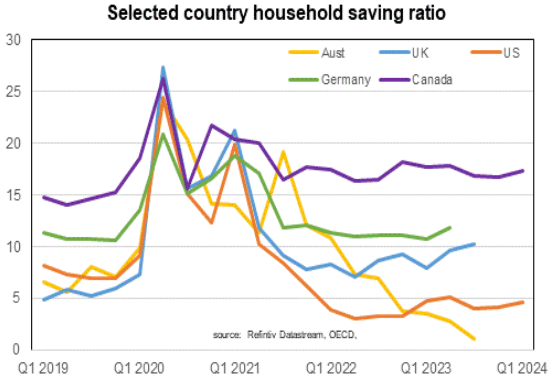
The big negative risk to the Australian economy is the outlook for the global economy. The European economy is verging on recession and has yet to feel the full impact of the rate rises of the preceding 18 months. The US economy has done better although the recent weakness in the services sector points to a consumer starting to feel the pinch. And while the Chinese Government will supply added economic support this year it also did that in 2023 without any notable pickup in the rate of economic activity.

Perhaps the biggest risk is if fiscal and monetary policy support is more limited than expected this year. The most likely reason would be the second big question for 2024: the inflation outlook.

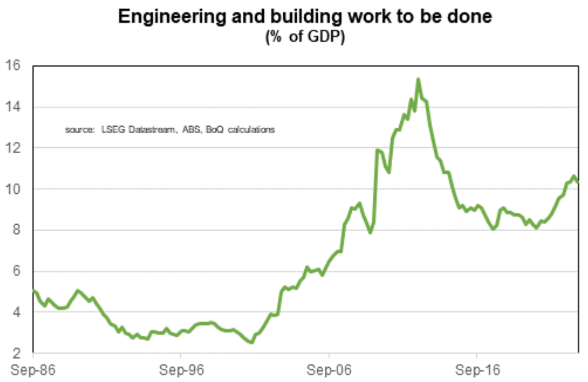
Fiscal policy is projected to be modestly more supportive over the next couple of years.



The household saving rate is low by peer country standards.



There is a large amount of construction work still in the pipeline.



The mismatch between the demand and supply of workers has been reduced but still is high.

Inflation progress will now be by the stairs

Inflation declined sharply in 2023 for the reasons widely expected. Demand slowed in line with the crunch to household disposable incomes and the end of revenge spending. Supply has risen reflecting improved worker availability and the end to global supply-chain snarls (despite the recent problems in the Red Sea).

These factors will still provide a downward push to inflation in 2024. Lower oil and gas prices will help and it looks like that there will be no big rise in electricity prices this year. A stronger AUD will reduce the price of imported goods and services. Rents have been a big contributor to higher inflation. But increasing affordability worries will probably result in lower rent growth this year.

The major concern for the inflation outlook this year is that wages growth is unlikely to decline much. This will reduce the ability for inflation to decline in some parts of the economy (notably in the services sector). It is this concern that has led to many central banks to worry that the last mile of the journey back to central banks' inflation targets might be the hardest.

There have been signs of inflation 'stickiness'. Much of the reporting on inflation concentrates on the annual inflation rate. But that measure is influenced by inflation developments one year ago. More 'real-time' benchmarks (such as a rolling 6-month average) points to a headline inflation rate that has been stuck between 3.5-4.5% for the past six months. Similar inflation 'stickiness' is evident in the US and Canadian CPI's.

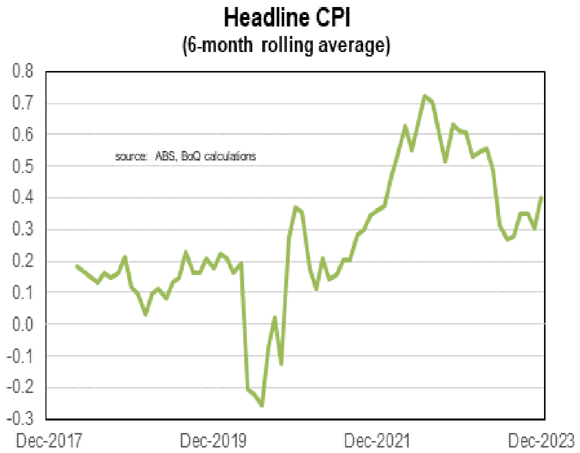
I think this 'stickiness' is delaying, not stopping, the moderation of inflation. The one proviso is that interest rates are not cut too quickly or fiscal policy support becomes too generous. Firms are indicating that while purchase costs are elevated they have declined back down to levels seen on a couple of occasions in the 2000's. Firms also indicate that the prices they are receiving are still above their long-term average but are now not unusually high. That feedback is consistent with the producer price data.

Another concern for central banks is that the extended period of higher inflation might have made firms more comfortable in raising prices (and consumers more ready to pay those higher prices). But surveys of consumer inflation expectations indicate that they have fallen back to near their long-term average. Worries about rising inflation expectations are also inconsistent with reports of widespread discounting.

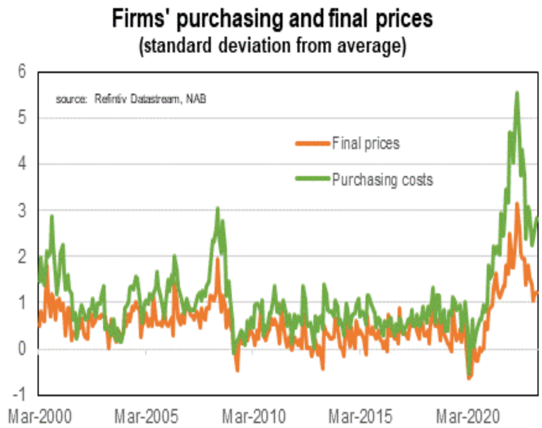
A financial market measure of inflation expectations is at its highest level in over a decade. But financial markets were (at the time of writing) also pricing rate cuts before year-end. That suggests to me that while financial markets are predicting inflation to decline back towards the RBA's target they are less confident about their inflation forecasts than they used to be. That increased uncertainty likely reflects a premium being added because of the higher-inflation experience of recent years.

In summary, inflation over the past year has come down via the elevator reflecting big changes in supply and demand. The elevator ride though is near its end. From here the downward path of inflation will be by the stairs.

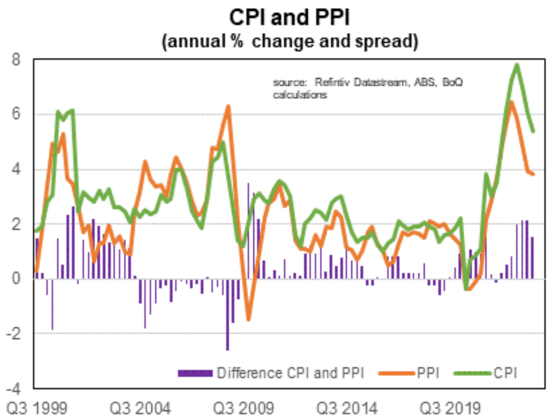
The decline of inflation has moderated in recent months.



Firms pricing pressures have declined substantially albeit well above their historical average.



The survey data on prices is consistent with the message from the producer price data.



Consumer inflation expectations have returns to be close to their long-term average.

Geo-political risks

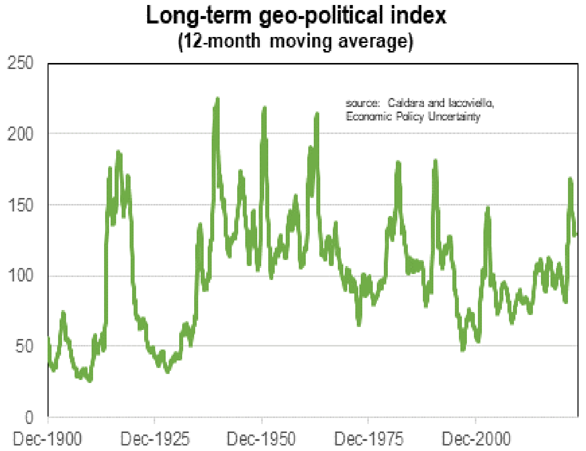
Ever since I started in financial markets geo-political risks (risks coming from other countries) has been nominated as a critical issue. Sometimes that risk has been important (the Russia-Ukraine War and its impact upon inflation). More often the impact on financial markets and the global economy has been fleeting. Some geo-political events do have important long-term consequences (the impact of the second Iraq War on the politics of the Middle East or rising US-China tensions). Those consequences only become clear over the long-term. The forecasting of geo-political events is typically poor.

The relationship between geo-political risk and the economy is mixed. Geo-political tensions were a lot higher in the 1950s and 60s than they have been over the past couple of decades (at least until recently). But that was also a period when economic growth was substantially stronger. How big an impact geo-political events have on the economy depends upon which countries are involved and how serious and long-lasting is the event.

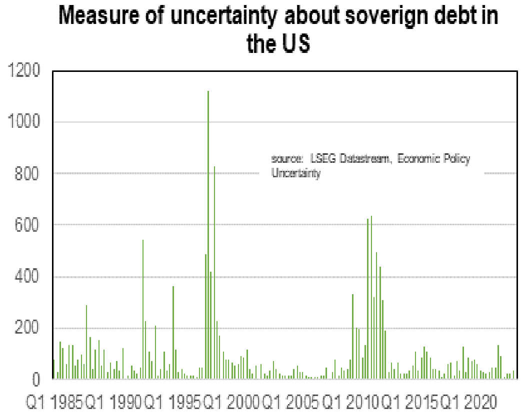
I have no strong view on how important geo-politics will be this year. The current problems in the Red Sea (and the Panama Canal) are leading to higher freight costs and creating some supply chain problems. But those problems are of a far smaller magnitude than those faced through the pandemic. And they matter less given that global demand for goods and services is lower.

Other global issues may become important. But I will keep my comments to two of the issues that are currently front of mind.

Geo-politics has been less important until recently.



Concern about government debt (in the US) is currently low.



US-China tensions

The most significant geo-political issue over the past five years has been the increase in tensions between the US and China. The almost certainty that the Chinese economy will become bigger than the US economy (and the impact that this will have on trade, global political positioning and defence spending) within the next decade will mean tensions are likely to remain elevated for years' to come.

But it is not in either country's interest to currently ramp up tensions. The Chinese Government has been struggling to get its economy back up to full speed, something that would become harder if relations with the world's largest economy became more intense. The US economy has been struggling to get inflation down, something that would become more difficult to achieve without access to the largest and most efficient manufacturer in the world.

The consensus view is that the breakdown of economic relations between the US and China is a negative for the global economy. The global supply chains of the future are unlikely to be as efficient and there will be reduced knowledge transfer between countries. But the experience of the past decade has been that the focus on maximizing efficiency of supply chains has come at the cost of increased vulnerability. The rush to boost domestic manufacturing capacity does provide an immediate stimulus to the economy (albeit at the cost of reducing long-term economic efficiency and increasing Government debt).

US election

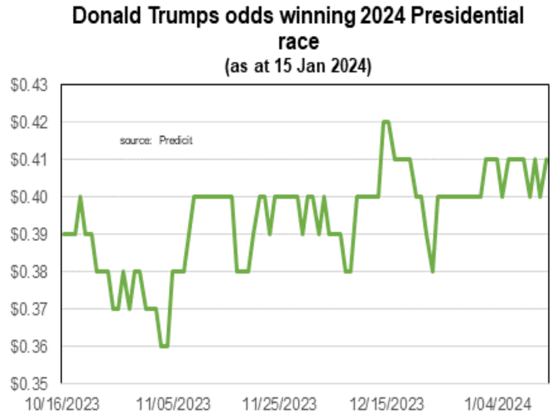
The geo-political issue that will get the most coverage this year will almost certainly be the US election. At this early stage Joe Biden is the strong favourite to be the Democrat nominee and Donald Trump the Republican. At the time of writing Trump was modestly ahead of Biden in the nationwide voting although the more critical measure is the state-by-state voting patterns (and particularly 'swing' states such as Georgia and Wisconsin). There is still plenty of time for movement in the polls although both candidates are very well known. The possibility of other candidates being on the ballot complicates the analysis (eg, if Robert Kennedy Junior runs it will likely reduce the chances of a Biden victory).

Regardless of who wins the Presidential vote fiscal policy will probably remain supportive for the economy (a President Biden win means higher spending, a President Trump lower taxes) albeit probably less supportive than it has been over recent years. This will also mean ongoing increases in US Government debt, an issue that one day could be significant but unlikely to be so over the next 3-5 years. A Trump election win could lead to big changes in defence and trade policy, as well as making it more difficult to get global agreement on issues such as climate change. The policy platforms of the remaining Republican candidates are less well known although they almost certainly will have different defence and climate-related views to President Biden.

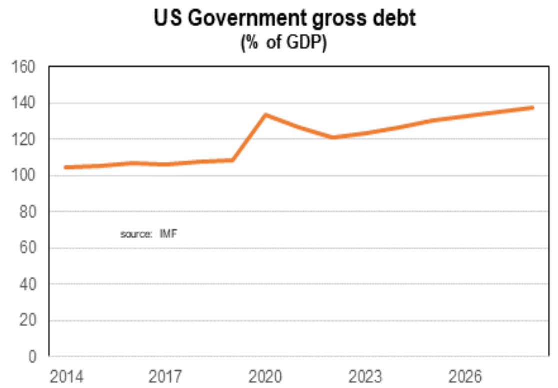
Federal Reserve Chairman Powell's term ends in May 2026 and he would unlikely be reappointed by a President Trump. His replacement could have major financial market implications although any candidate would need to be confirmed by the Senate.

A President Trump's ability to make big changes will be dependent upon how well the Republicans do in Congressional elections (and state elections). At the time of writing the Republicans are modestly favoured to win both the House of Representatives and the Senate. If Trump did win the constitution allows him to be in power for one term (including having to face a Congressional election after two). His power to make big changes is also constrained by an independent legal system, as well as the constitutional power that resides with the states (as currently seen by the actions of the Florida and Texas Governors).

Donald Trump polling has recently improved.



US Government debt is high and forecast to go higher.



We really do live in interesting times.

Regards

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