

EUROPEAN ECONOMIC UPDATE

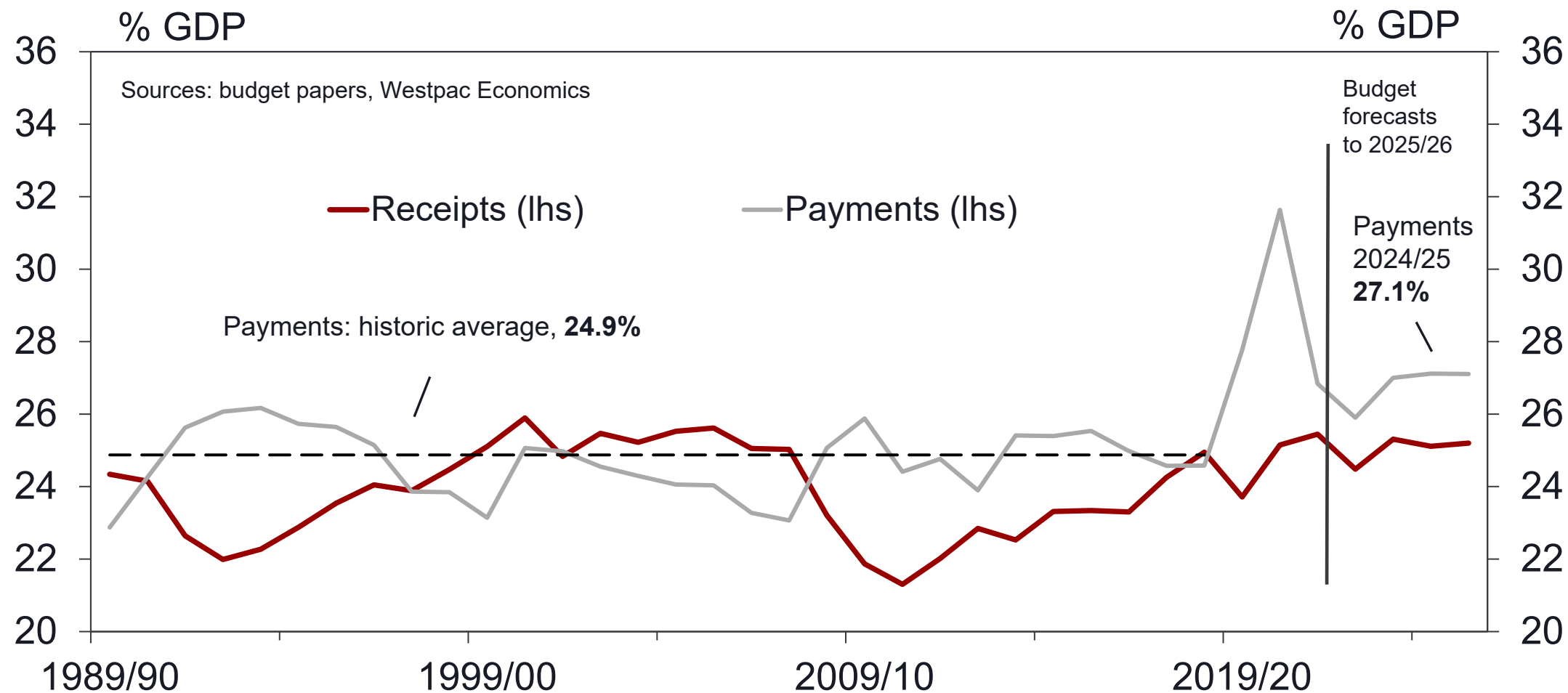
Presented by Westpac Chief Economist, Bill Evans

Westpac Institutional Bank

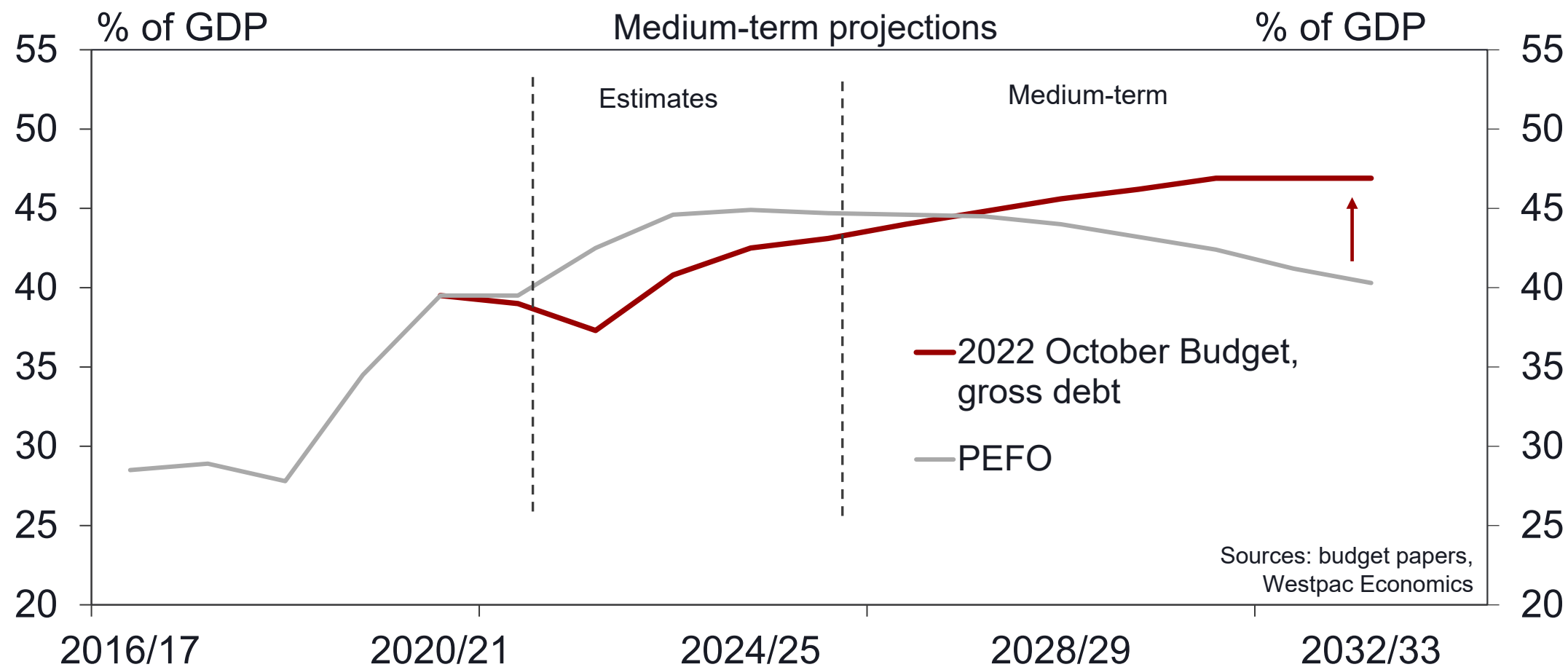
November 2022



Federal Budget: receipts and payments

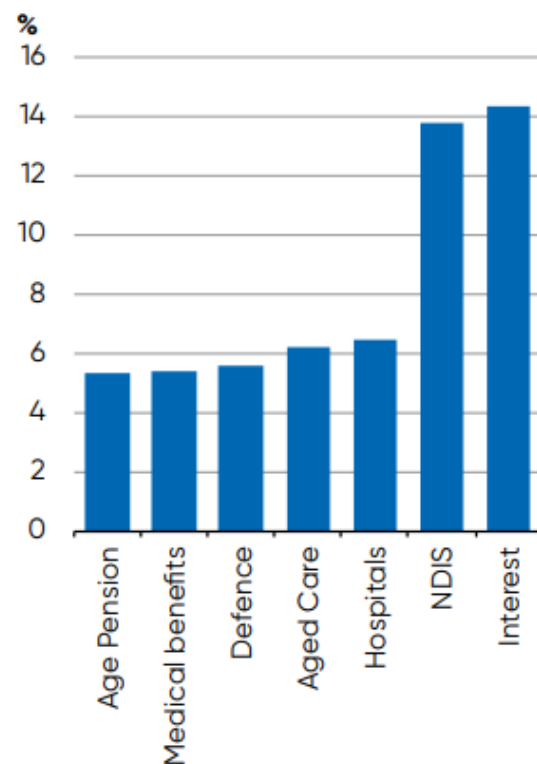


Public gross debt projections



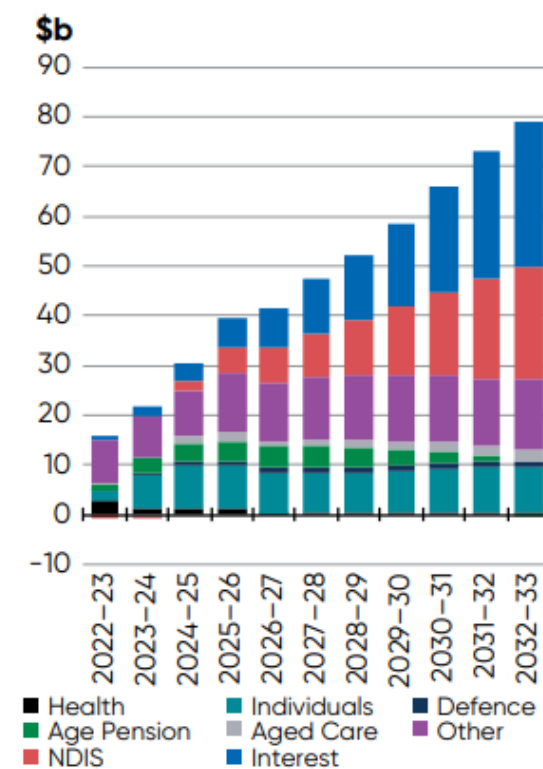
Structural pressures on the Budget

Average annual growth in major payments, 2022-23 to 2032-33



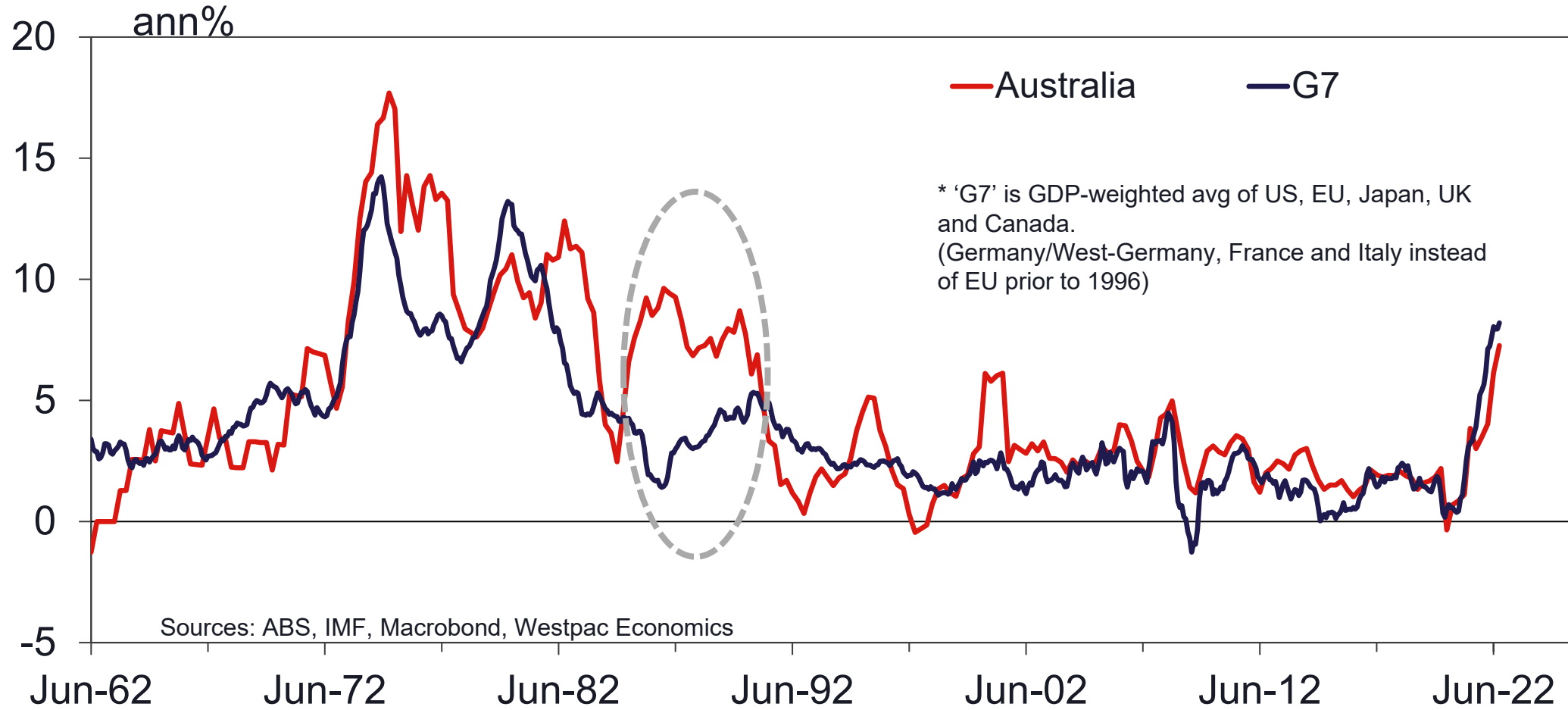
Source: Treasury

Revisions to major payments since pre-election estimates, 2022-23 to 2032-33



Source: Treasury

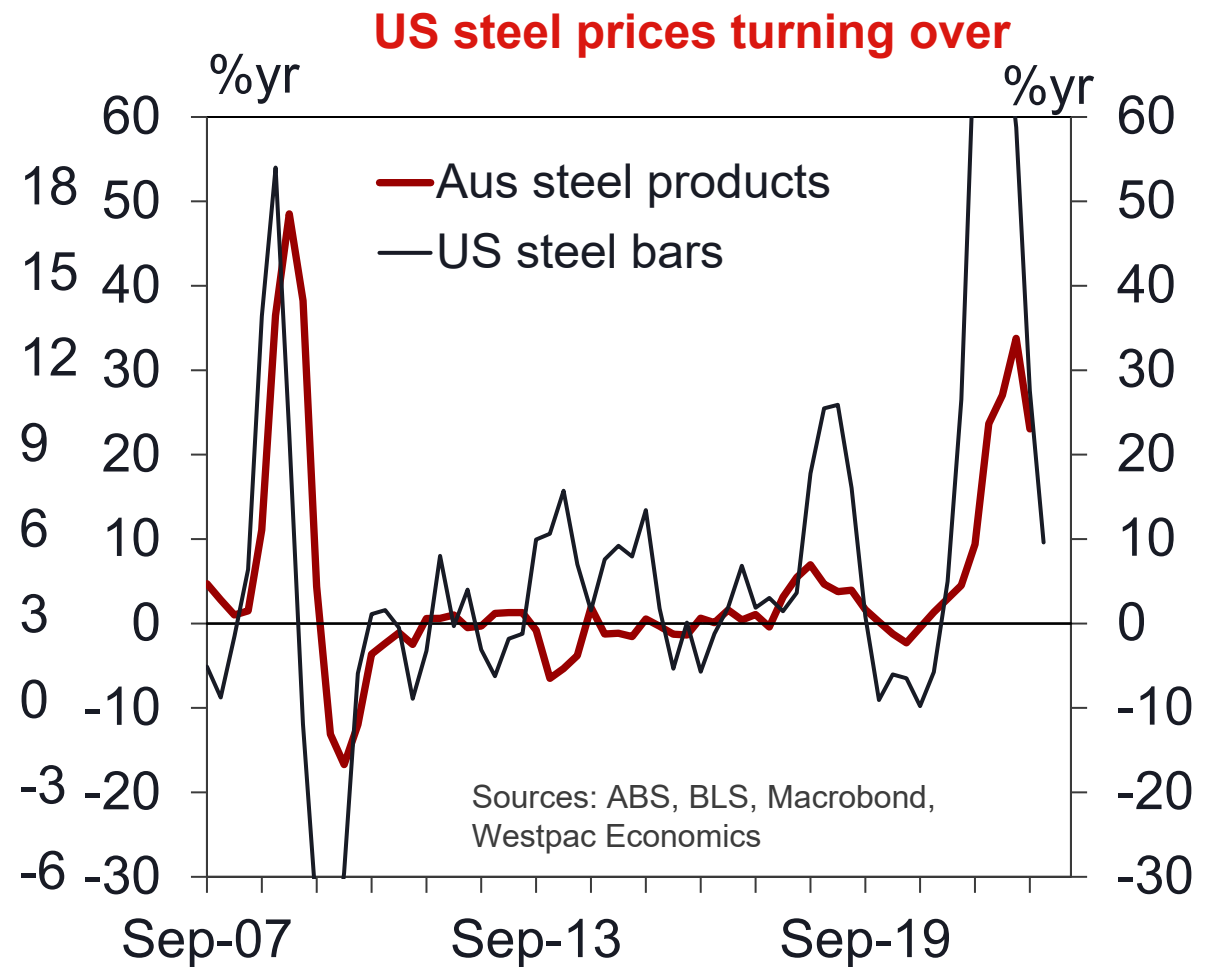
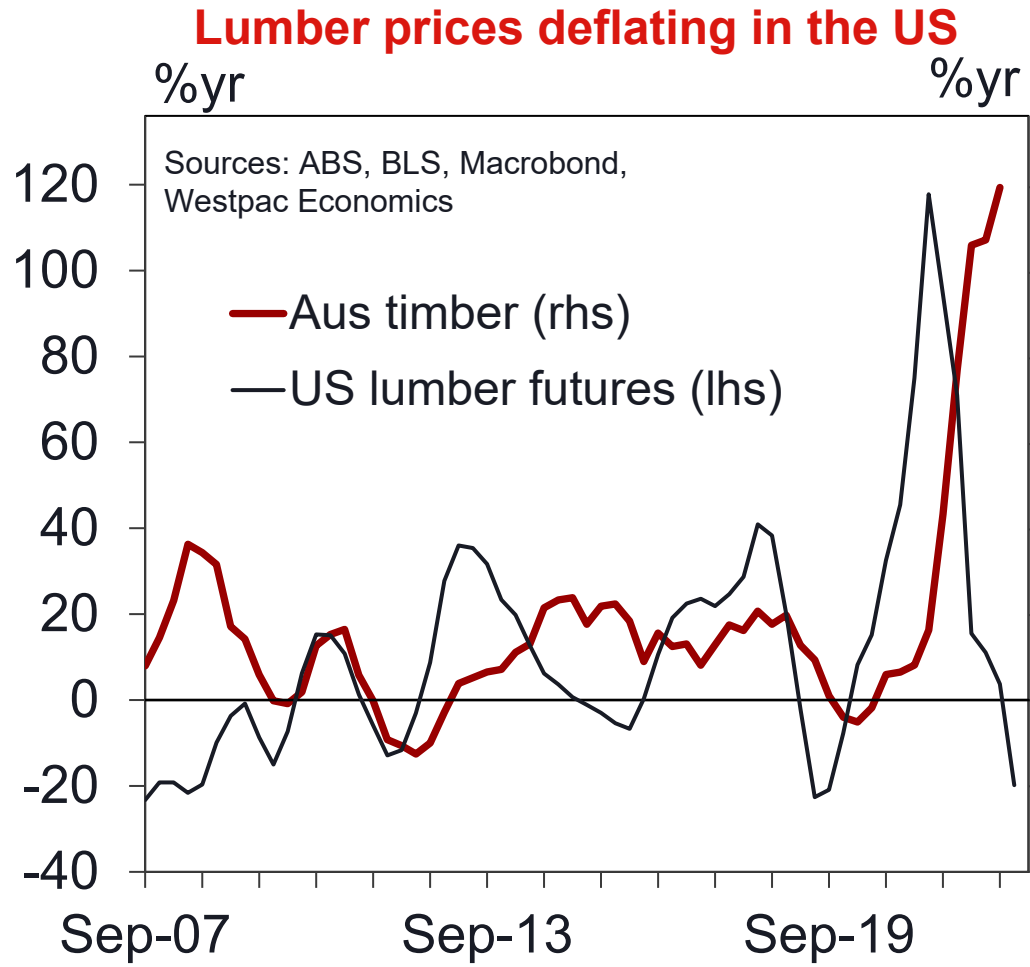
Inflation: long history: G7 challenge



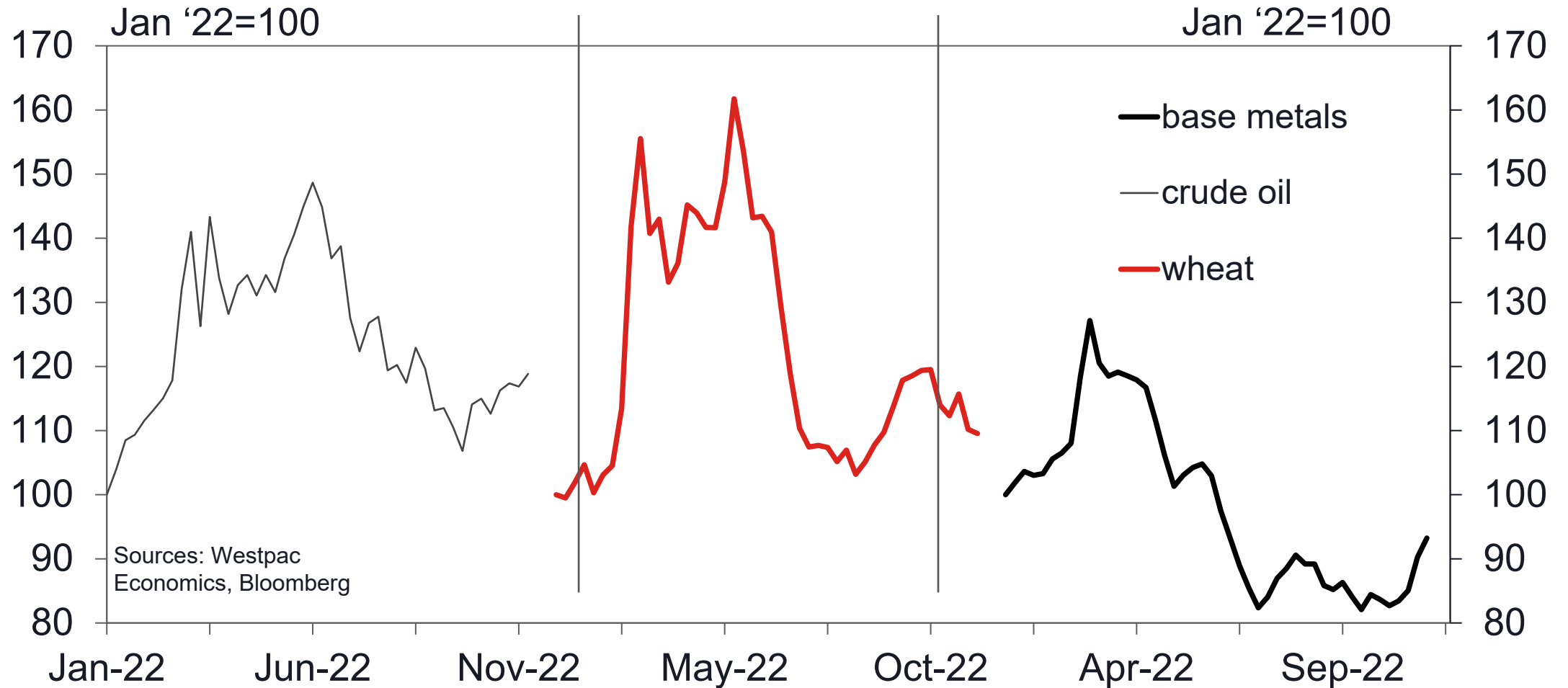
Global supply chain disruptions – clearing



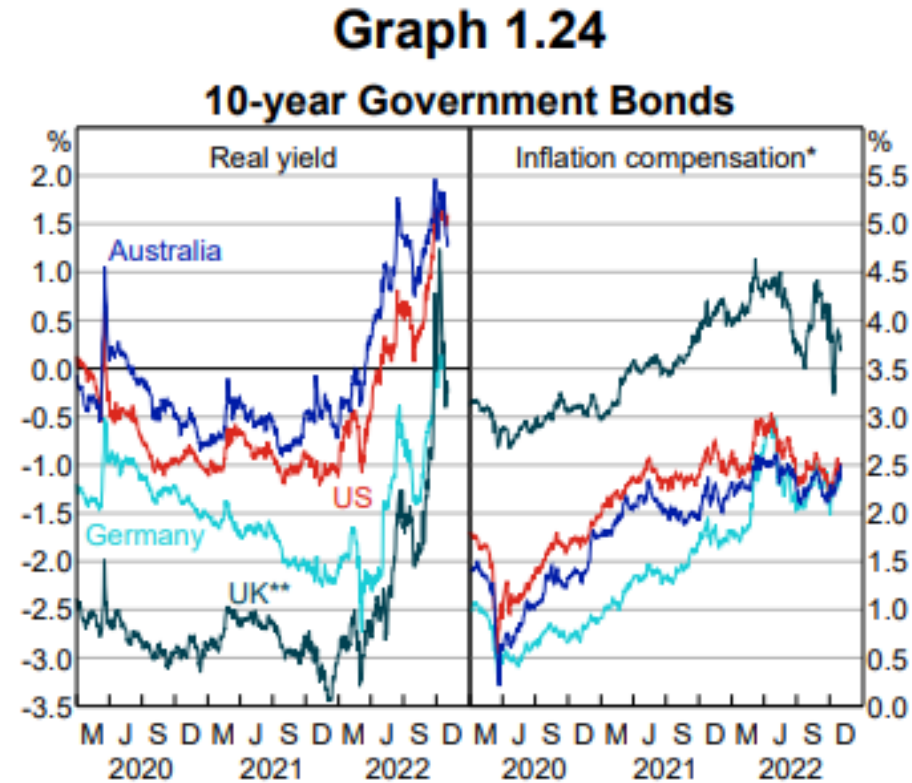
International construction cost inflation has peaked



Commodities; Ukraine spike has passed



10-year Government bonds

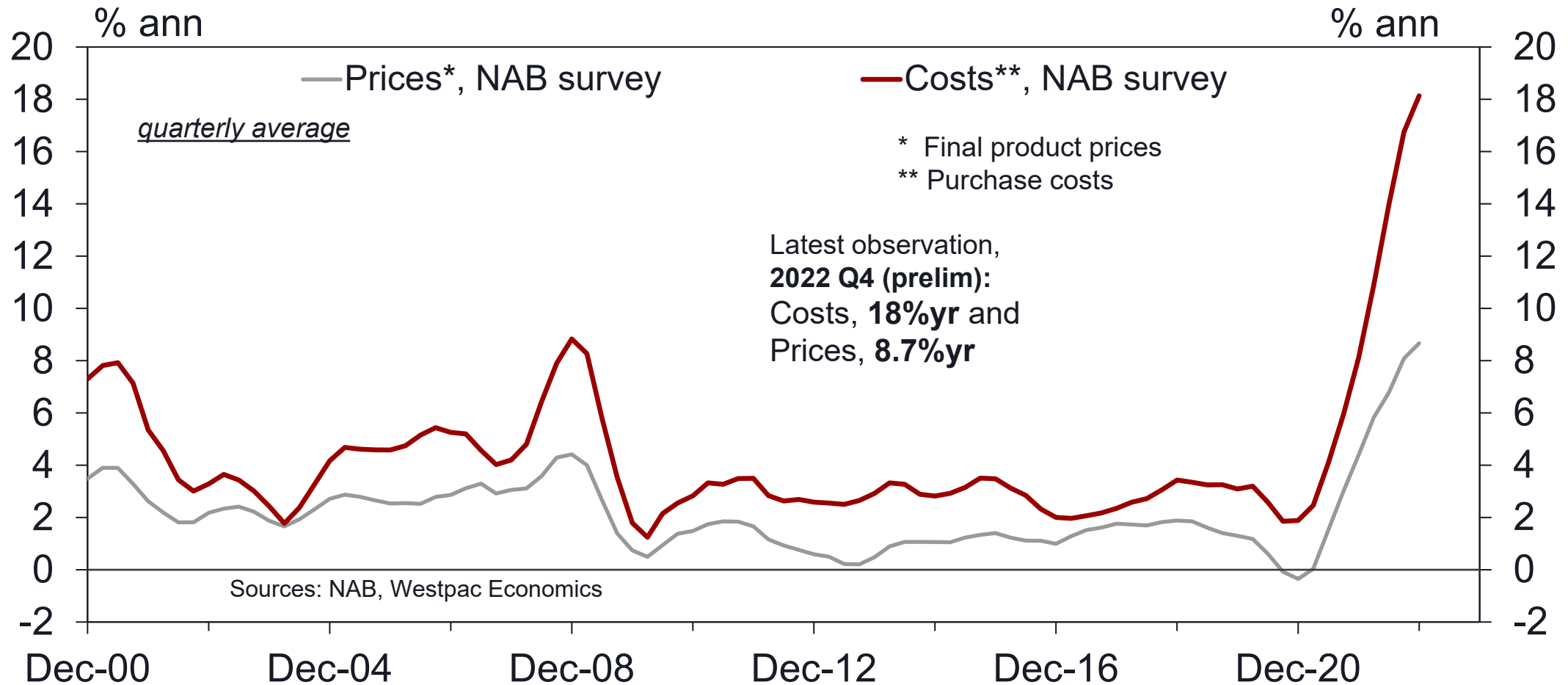


* Spread between yields on nominal and inflation-linked bonds.

** UK inflation-indexed bonds are linked to Retail Prices Index (RPI) inflation, which is currently 2.5 percentage points higher than CPI inflation. RPI inflation is typically higher than CPI inflation because of differences in their calculation method and the inclusion of owner-occupied housing costs in the RPI.

Sources: Bloomberg; RBA; Yieldbroker

Spiralling costs leading to price pressures

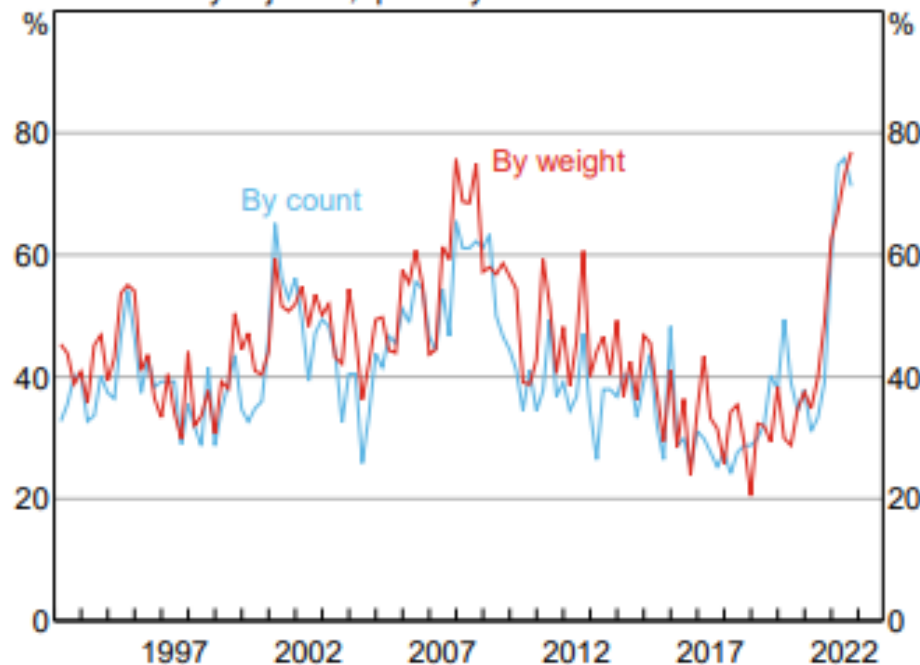


CPI items rising by more than 3 per cent*

Graph 4.3

CPI Items Rising by More than 3 Per Cent*

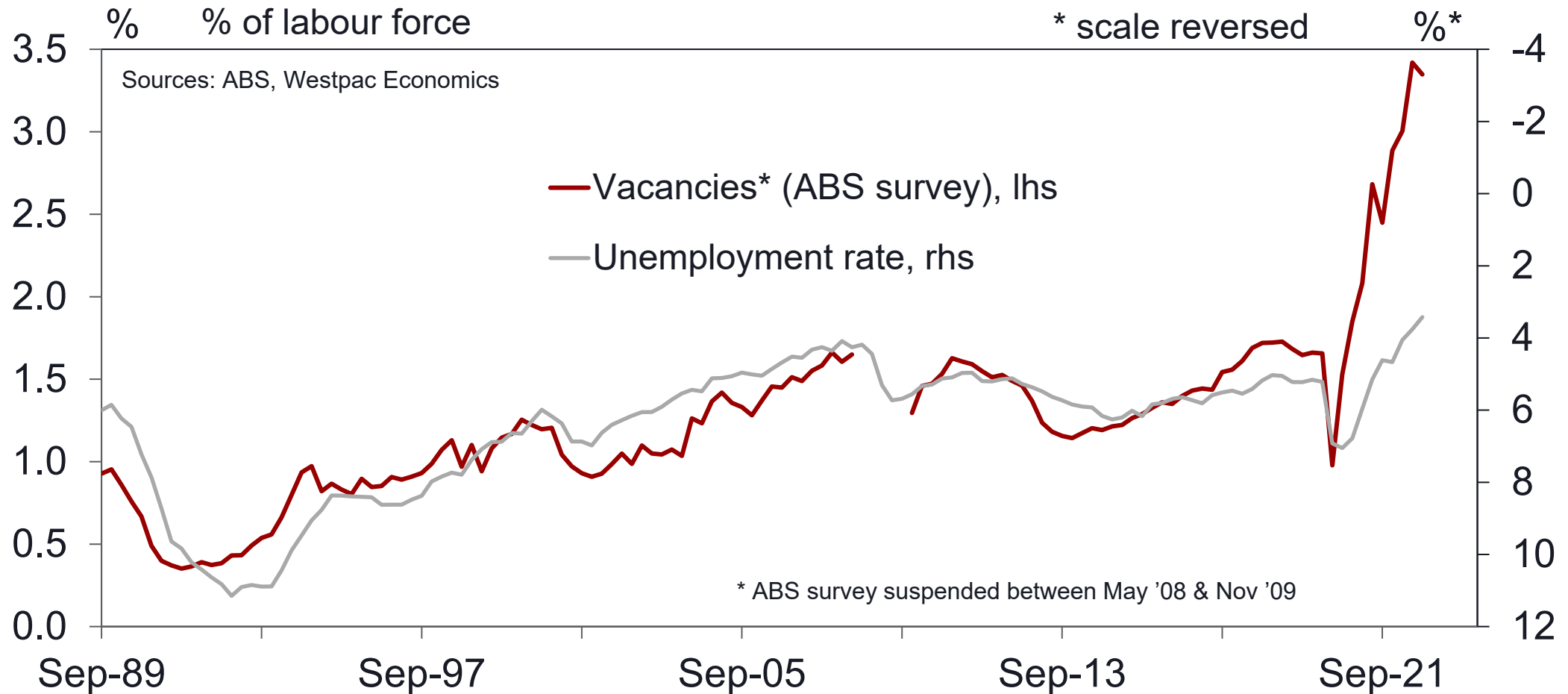
Seasonally adjusted, quarterly increase at annualised rate



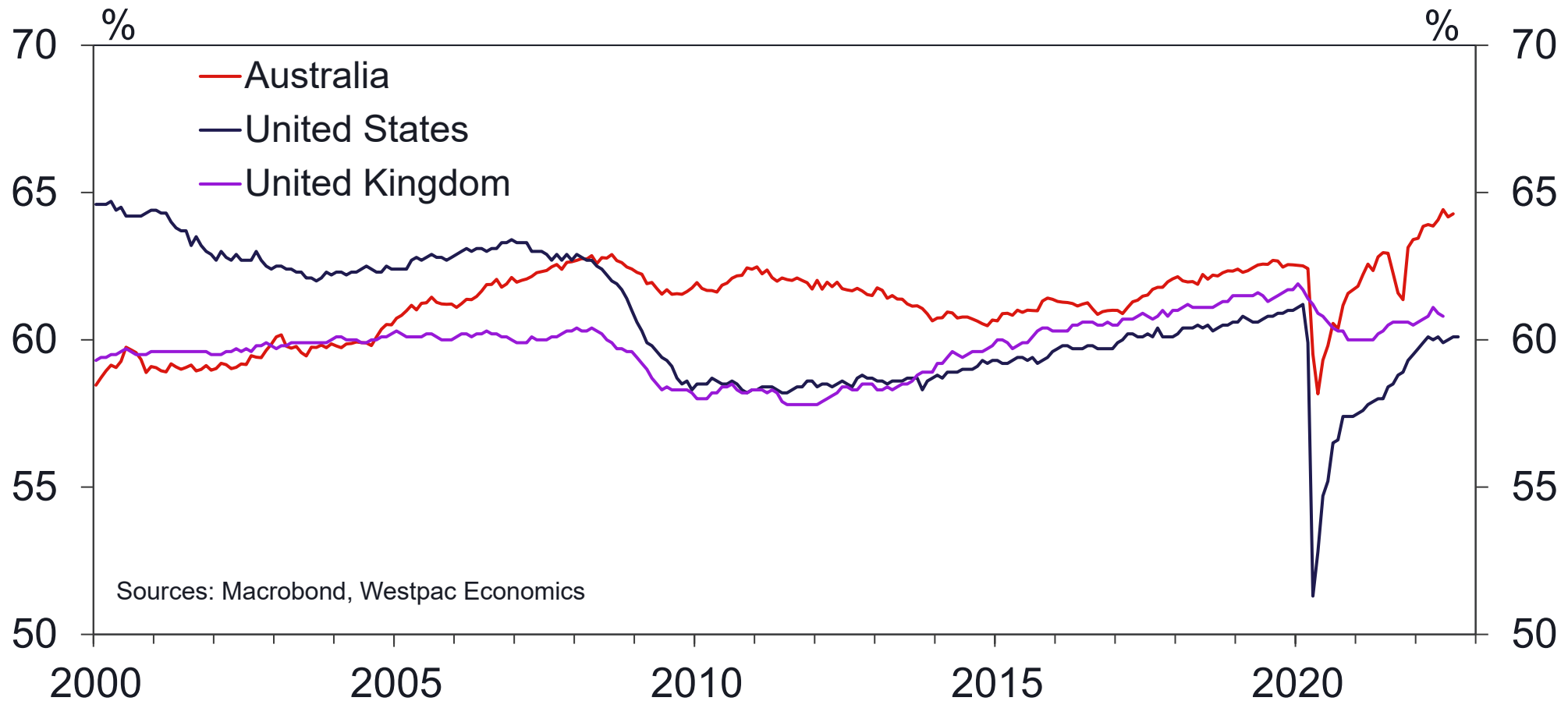
* Adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

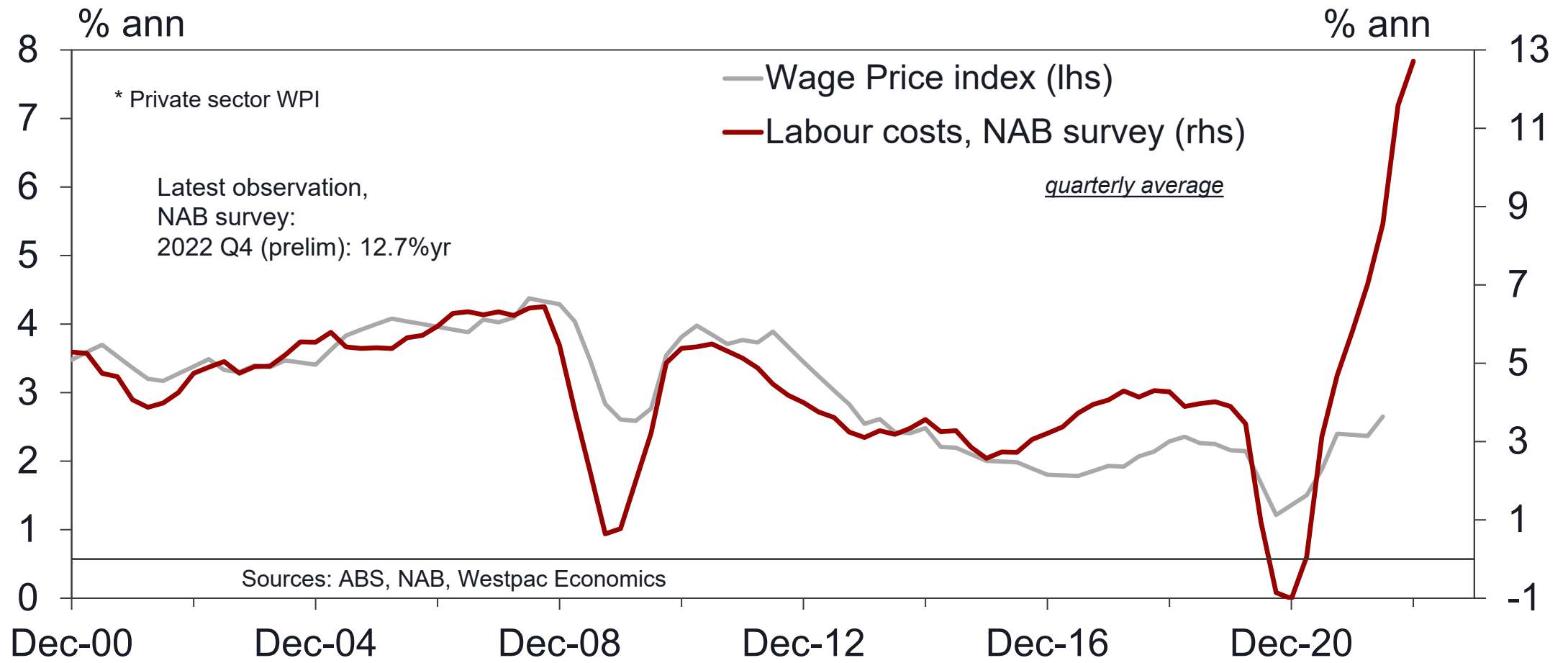
Job vacancies – impacted by net migration/strong demand



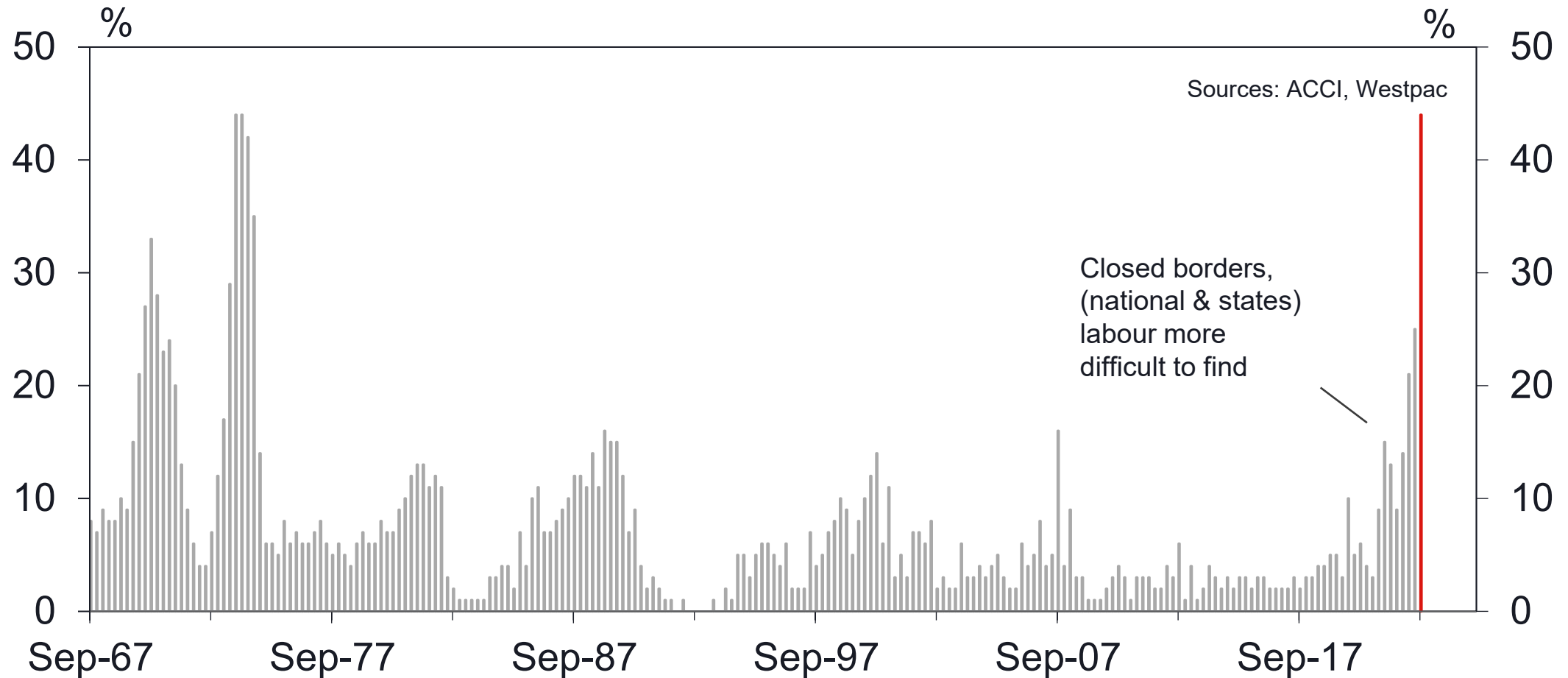
Employment to population ratio: US/UK participation weak



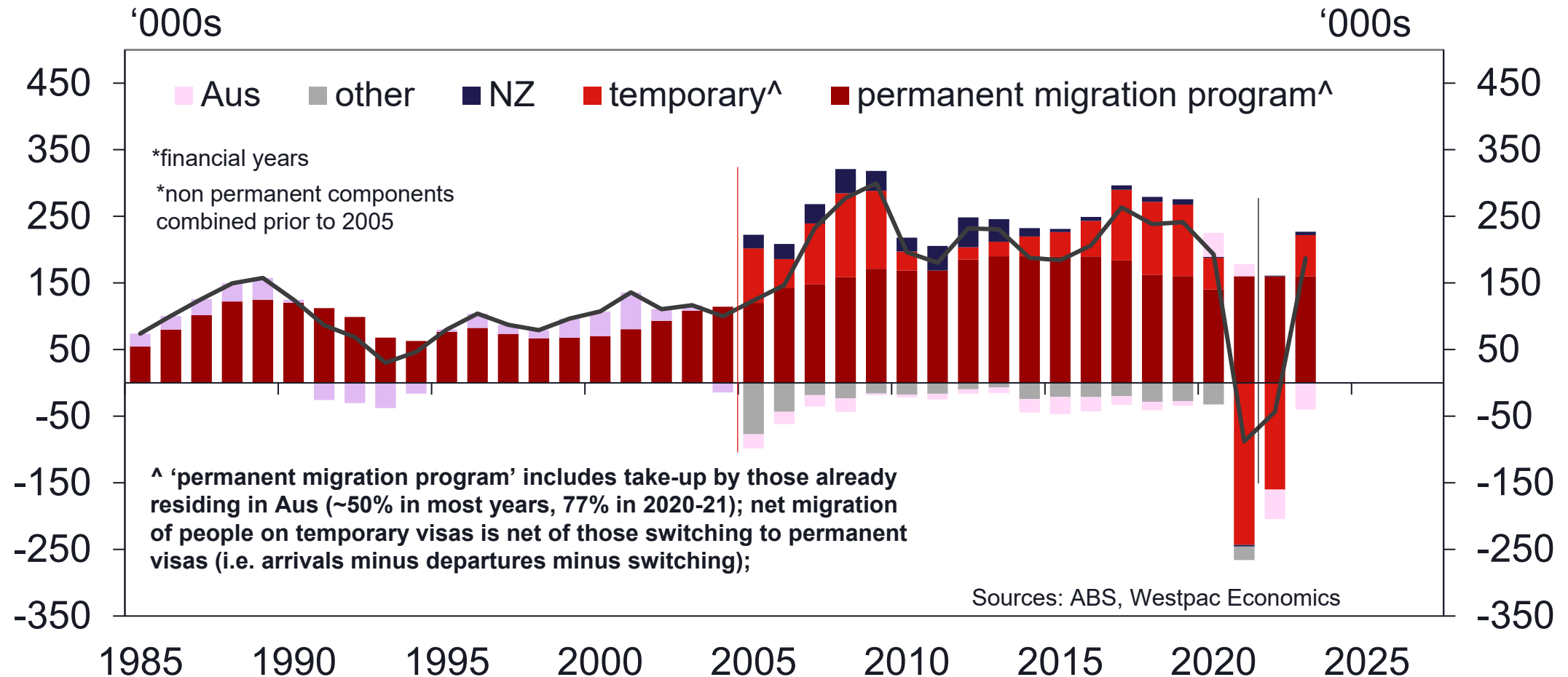
Labour costs: significant pressures



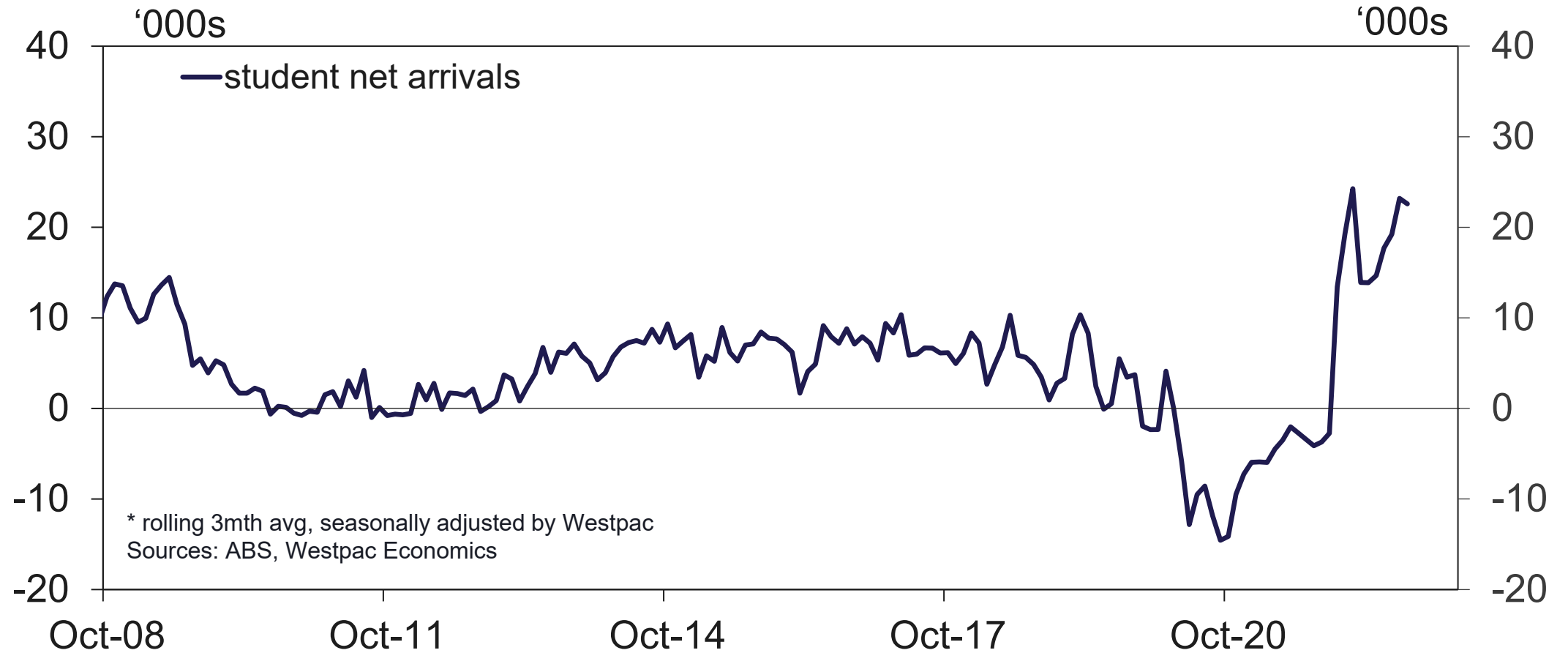
Labour: “single factor” most limiting production



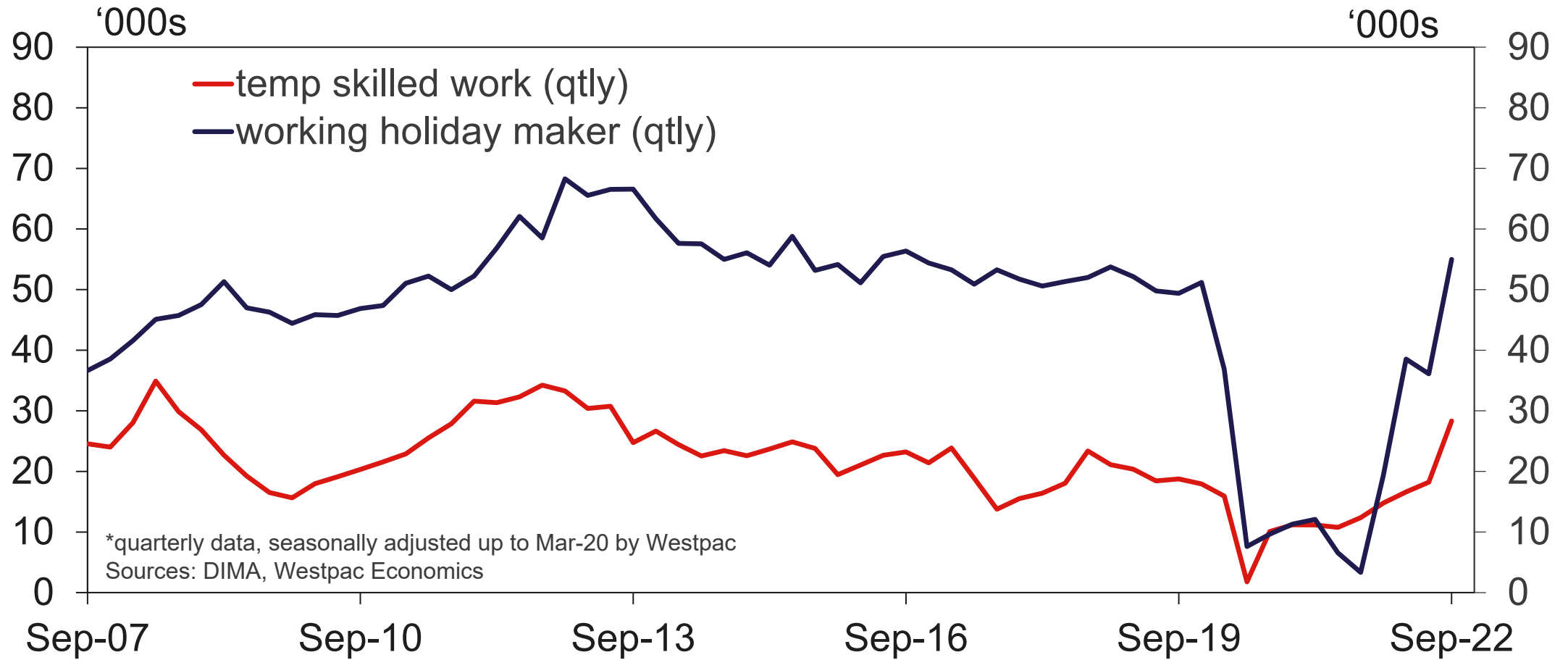
Net migration: 240,000 (2019) to -130,000 (2021 and 2022)



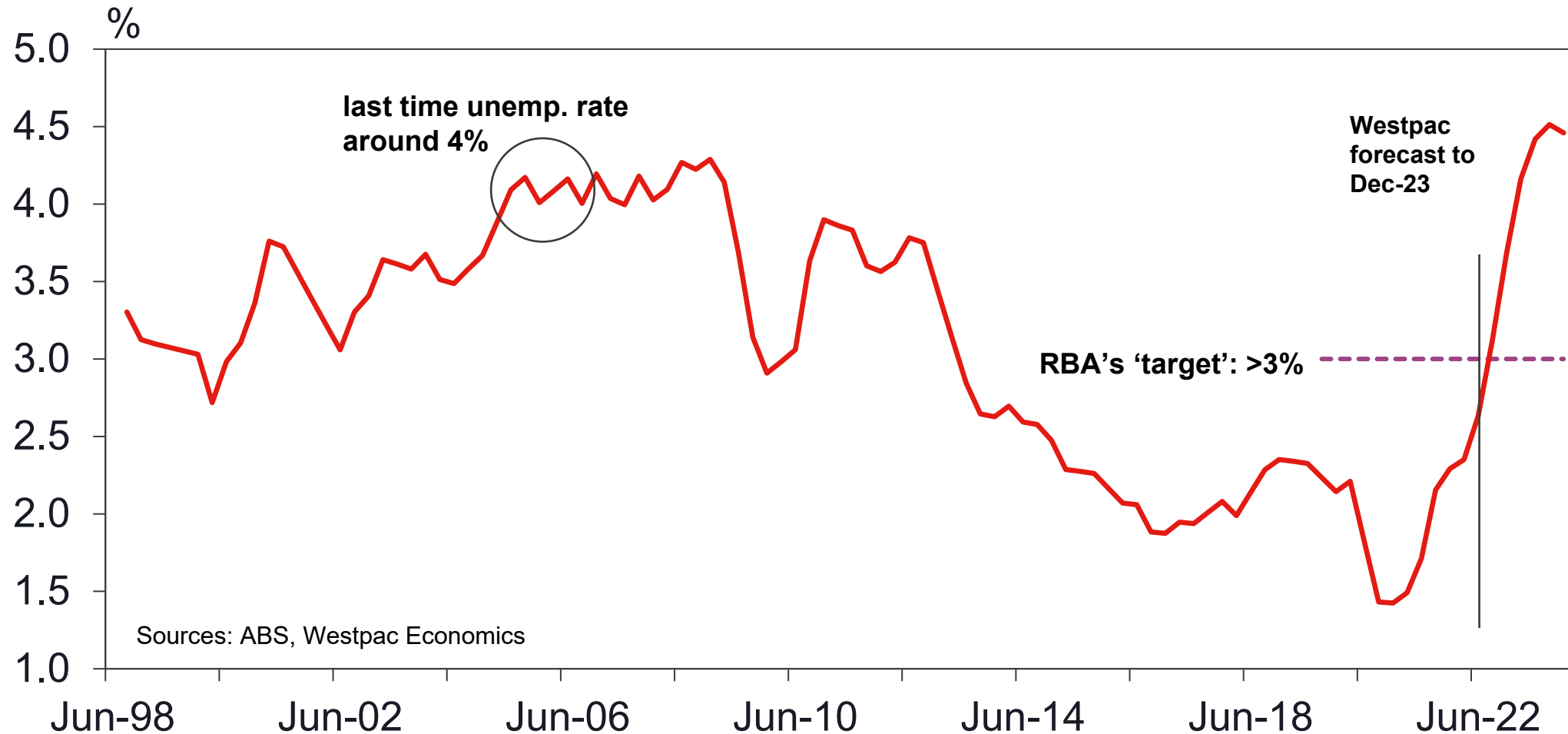
Net arrivals: student visas



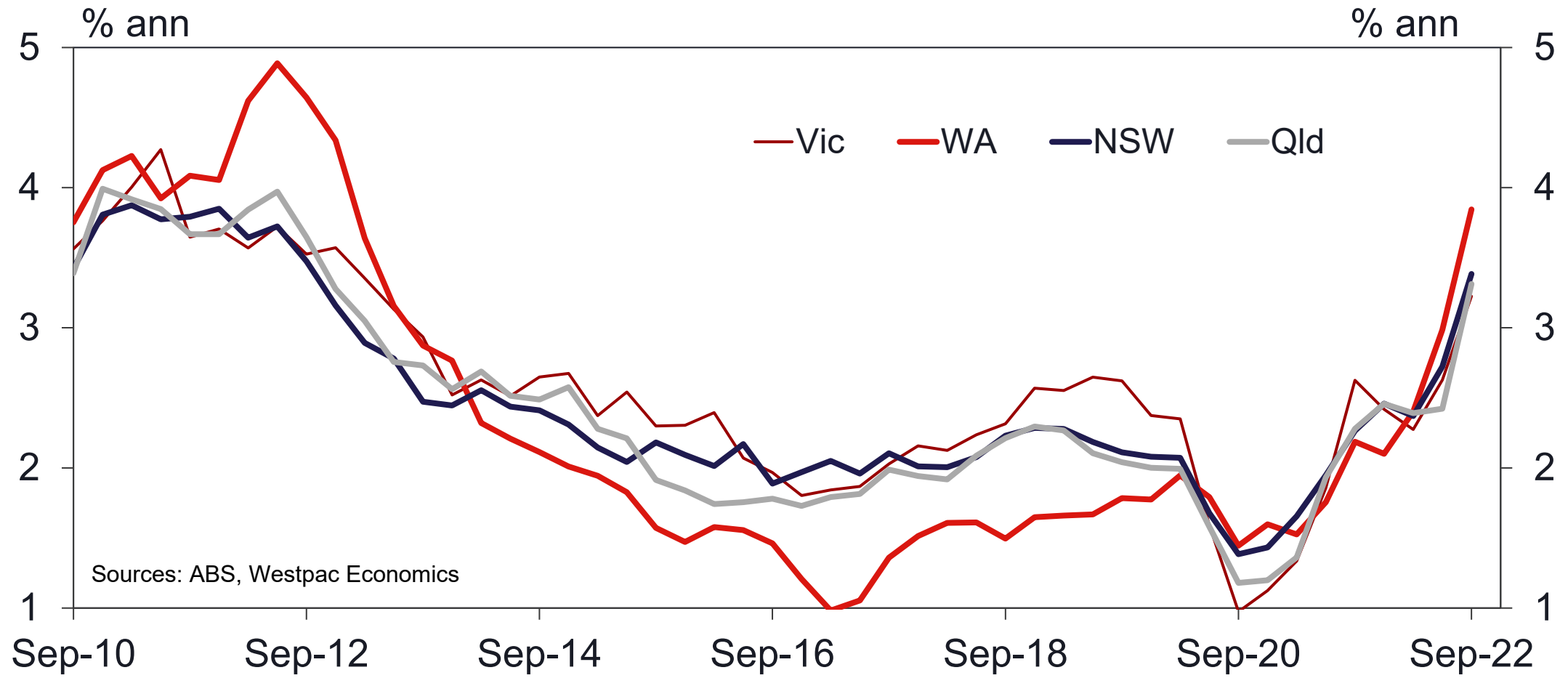
Temp work visas: grants



Wages growth: key to RBA outlook – 4.5% peak, at least



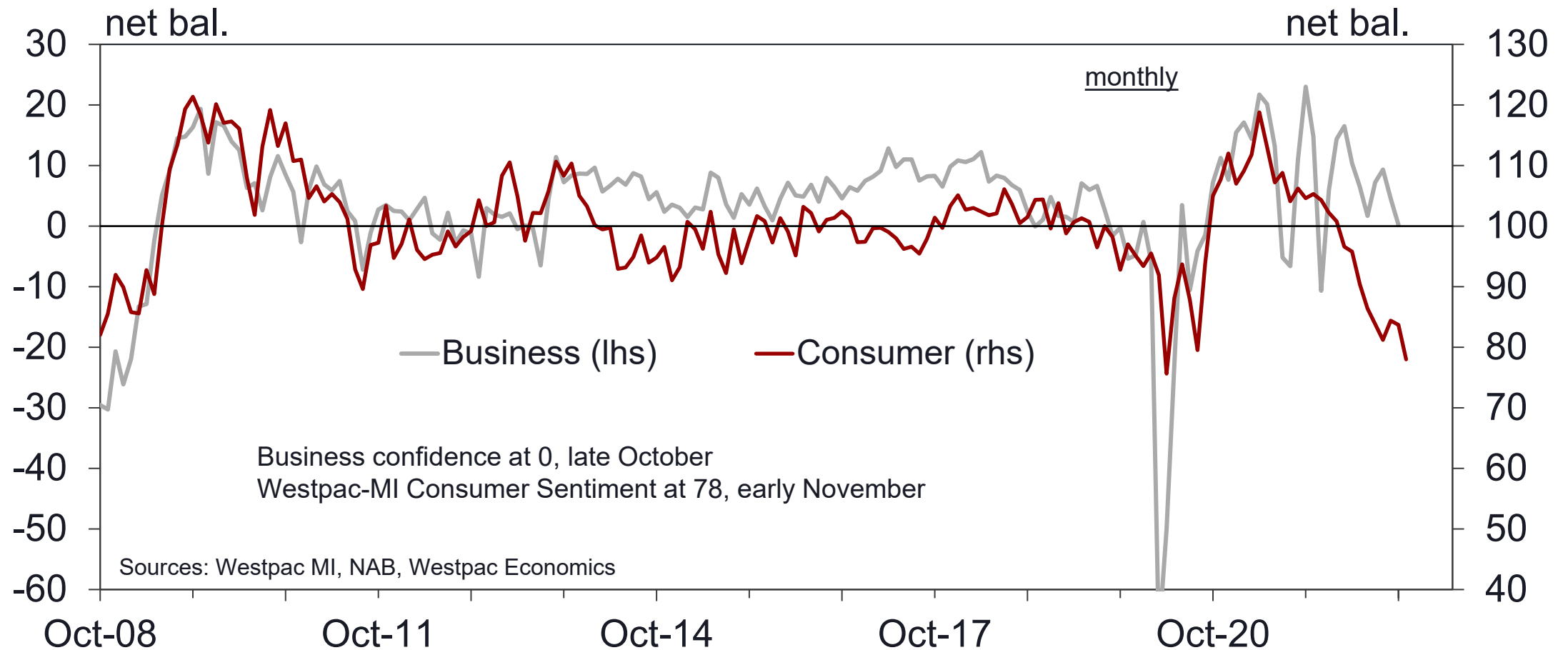
Private sector wages: pressures building in NSW



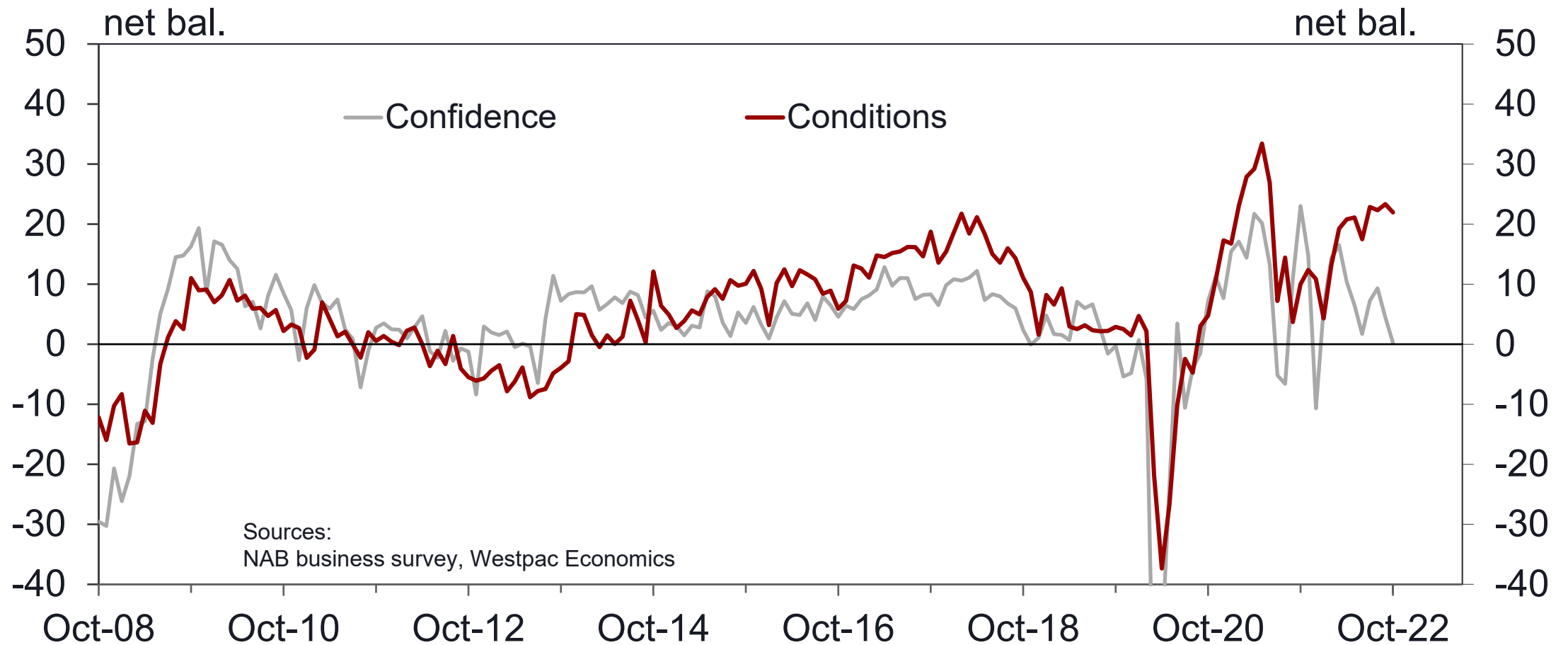
Australian wages lagging US wages – but outlook is strong



Confidence: consumers and businesses



Business conditions and confidence



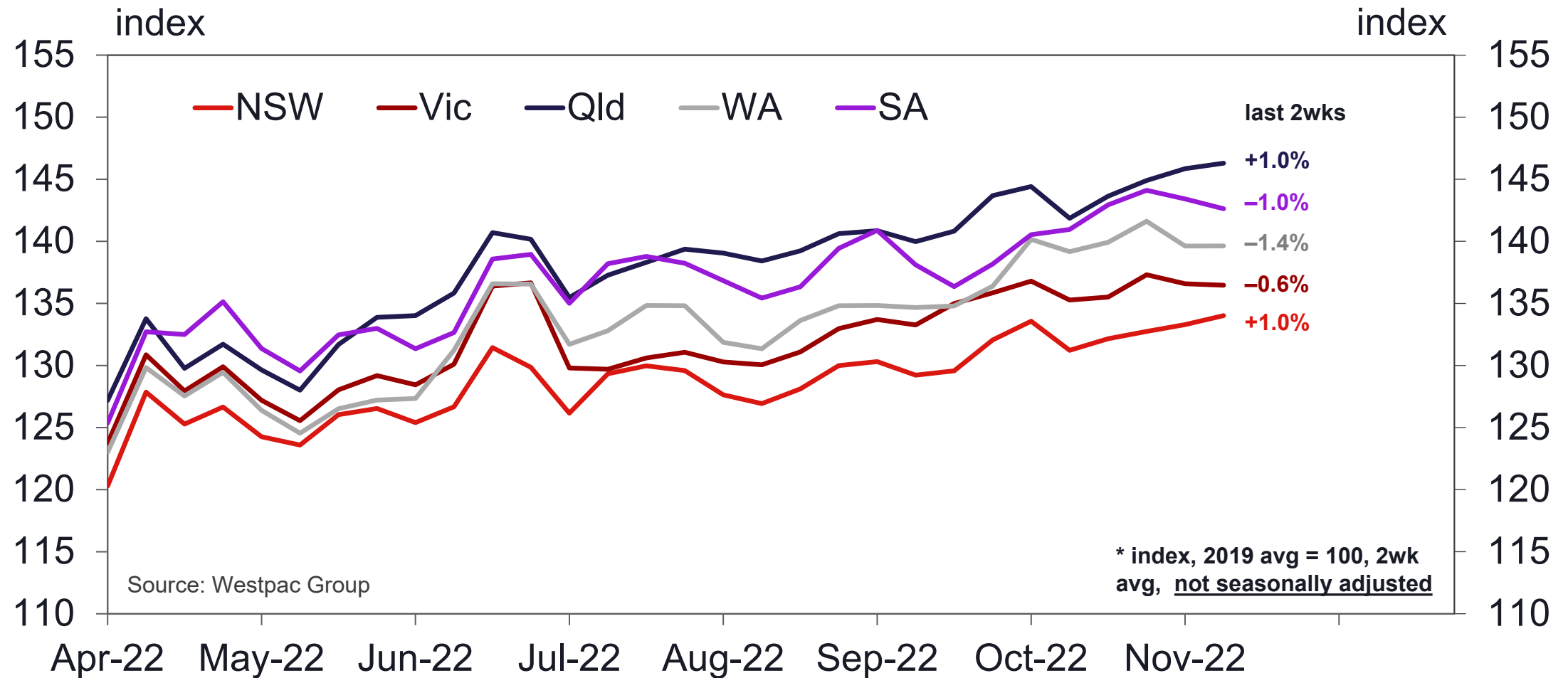
Consumers: Sentiment & Unemployment ' expectations – differ



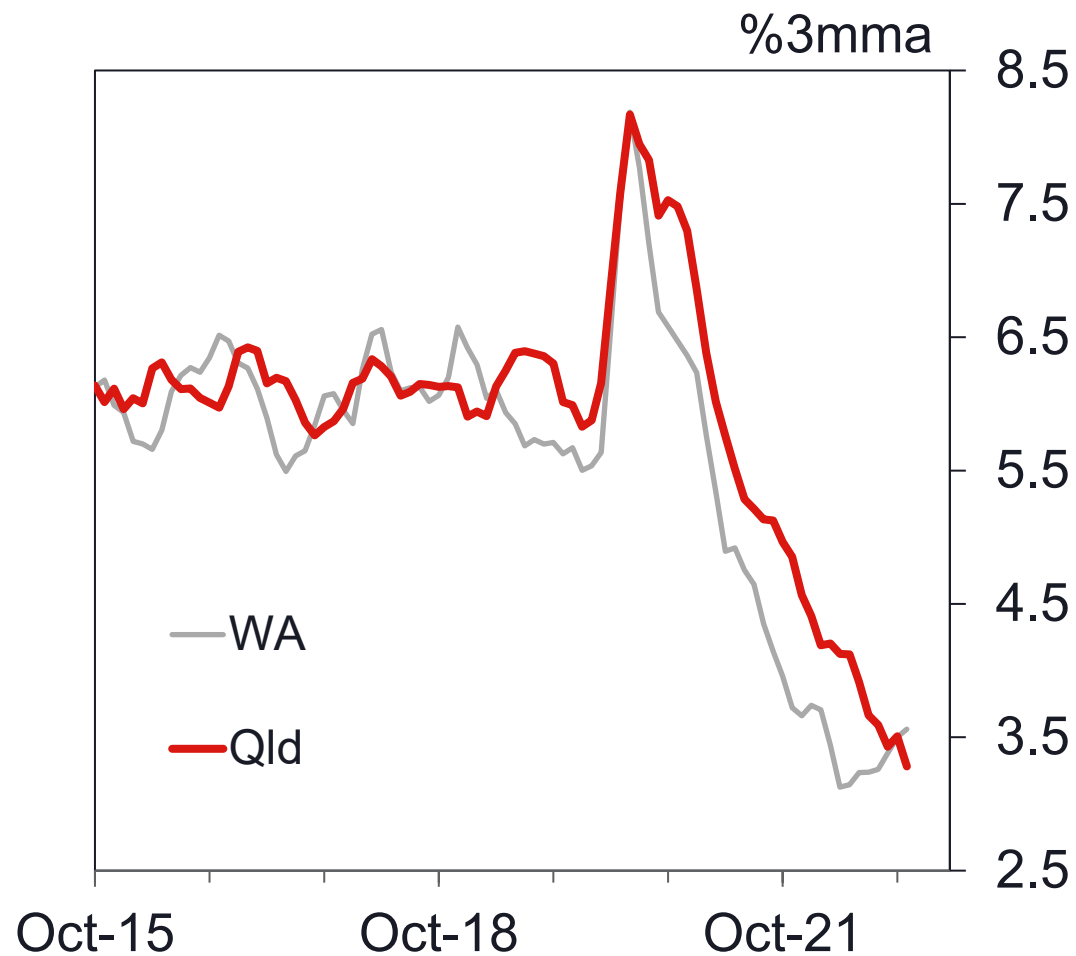
Savings ratio – boosted spend by \$7 bn ; \$260 bn in savings



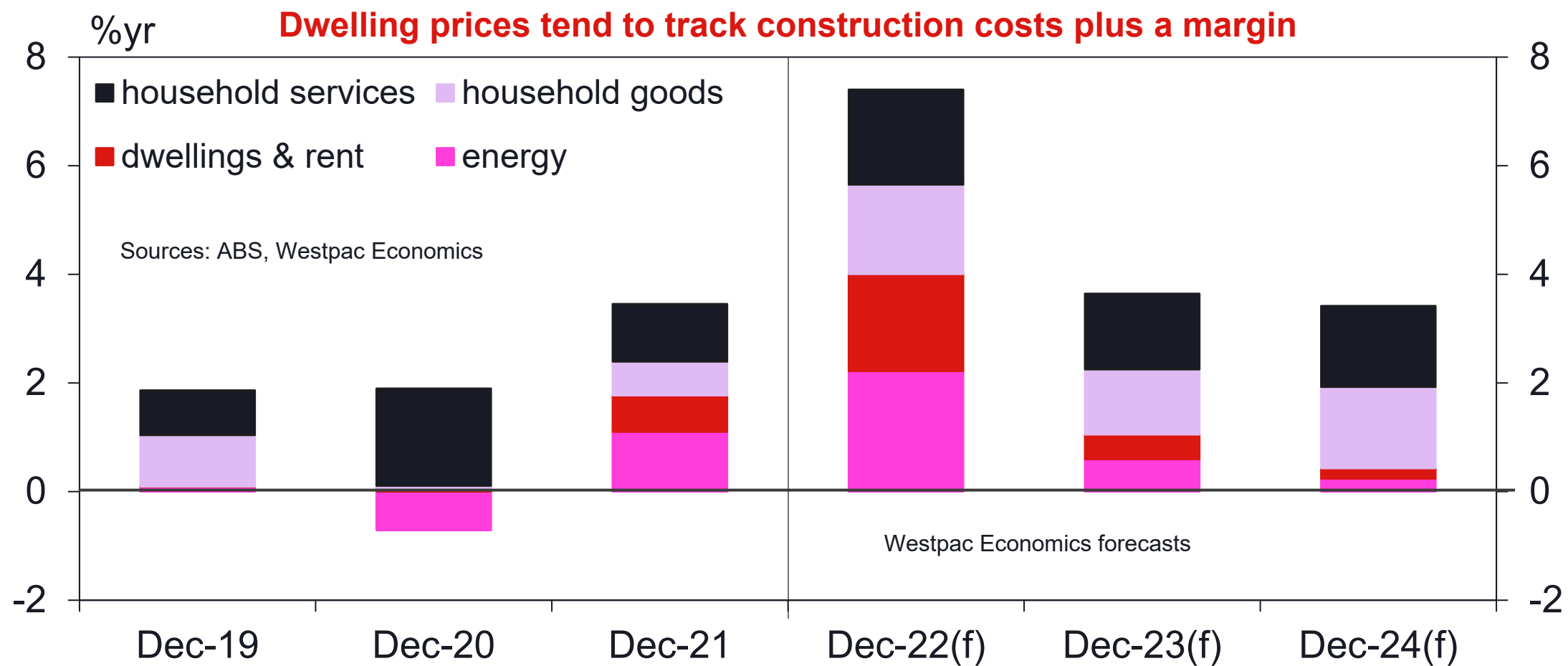
Card activity by state: level – reopening still building!



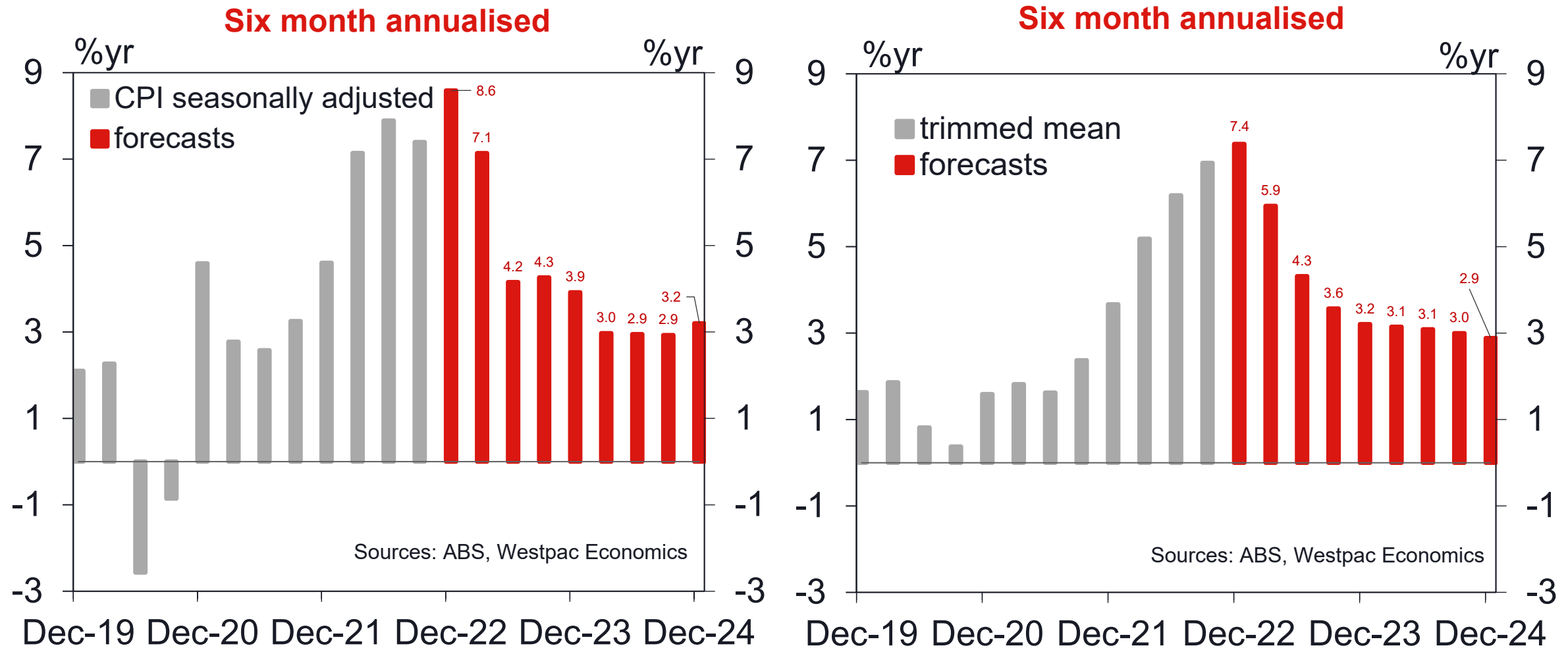
Unemployment by state – NSW lowest in Australia



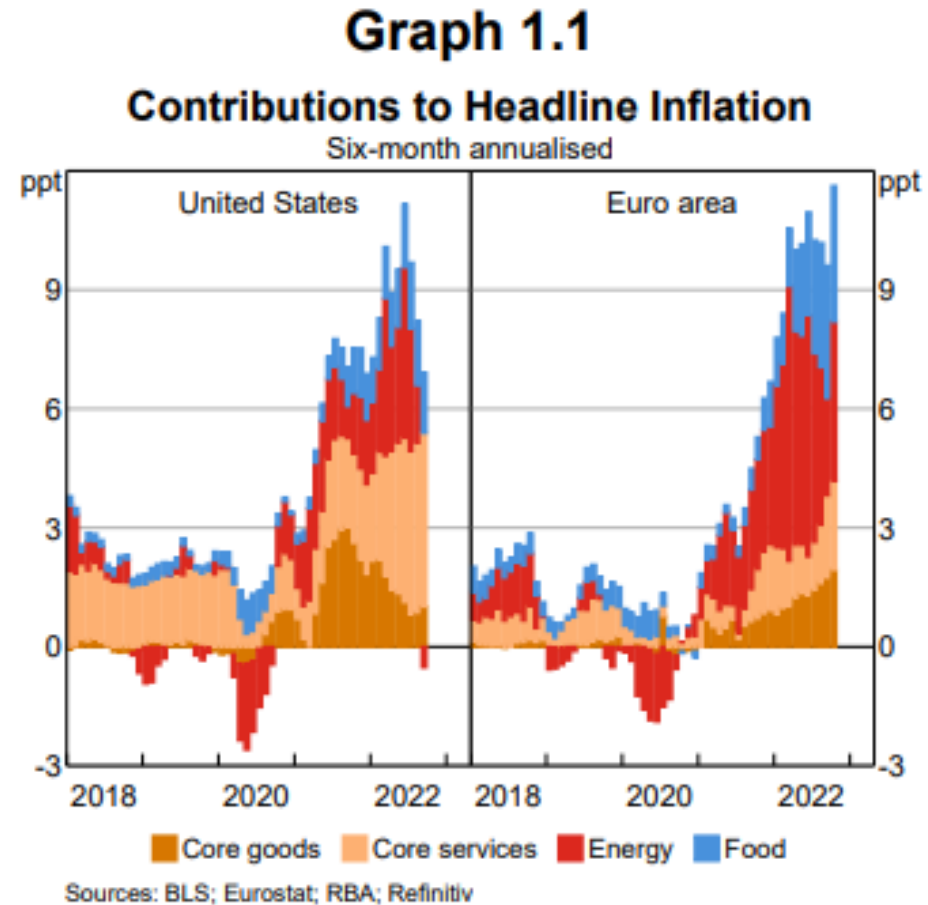
Inflation: dwelling & energy prices key to 2023 slowdown



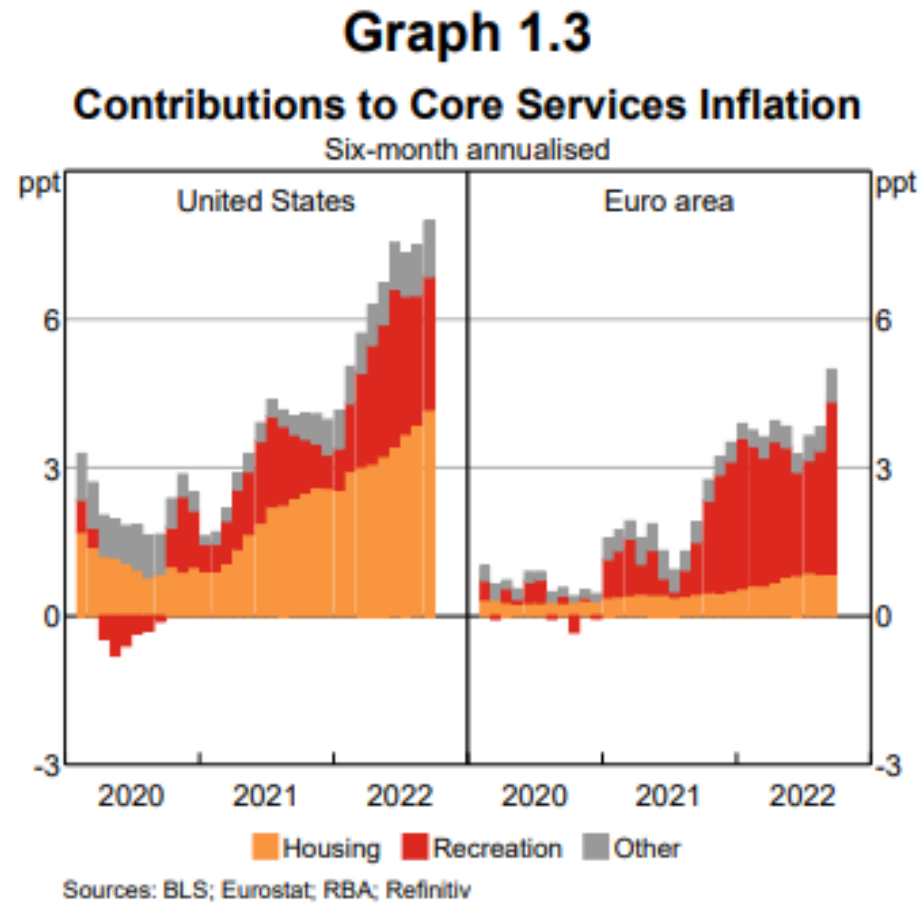
The pace of inflation moderates though 2023



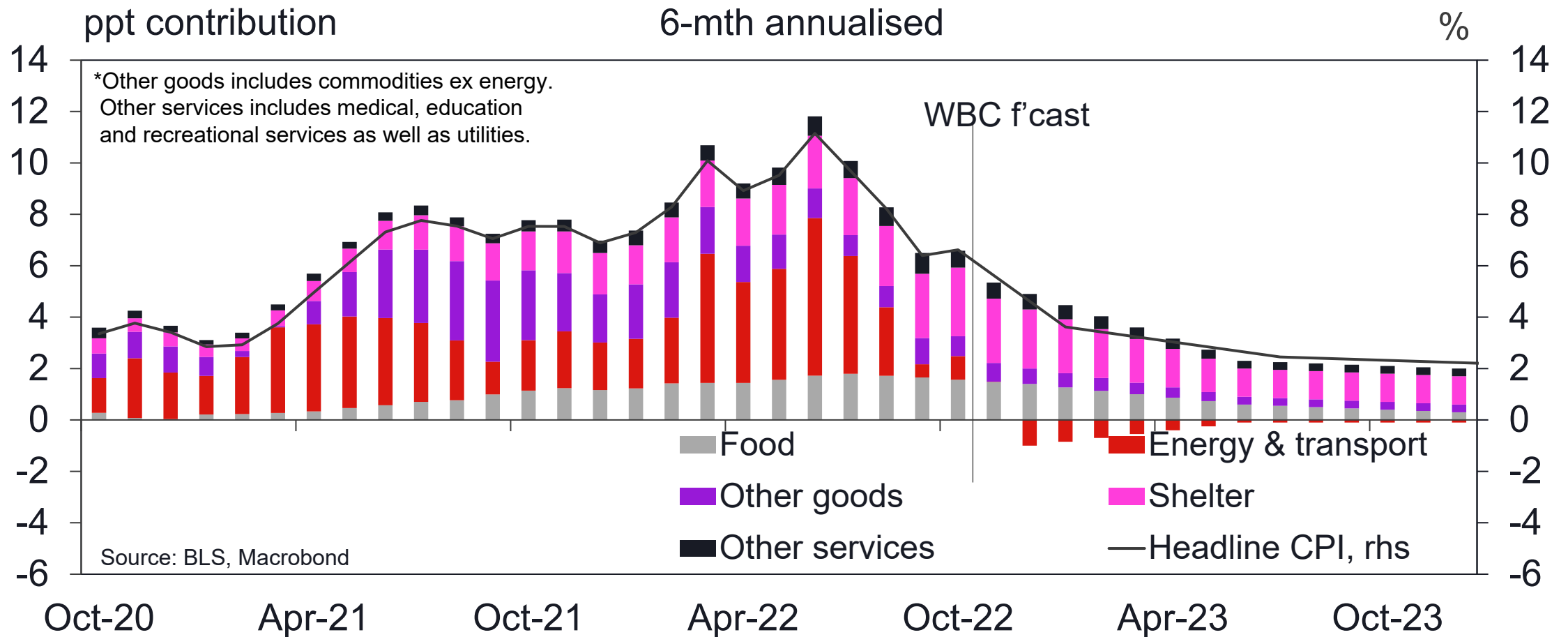
Contributions to headline inflation – Europe's Energy Problem



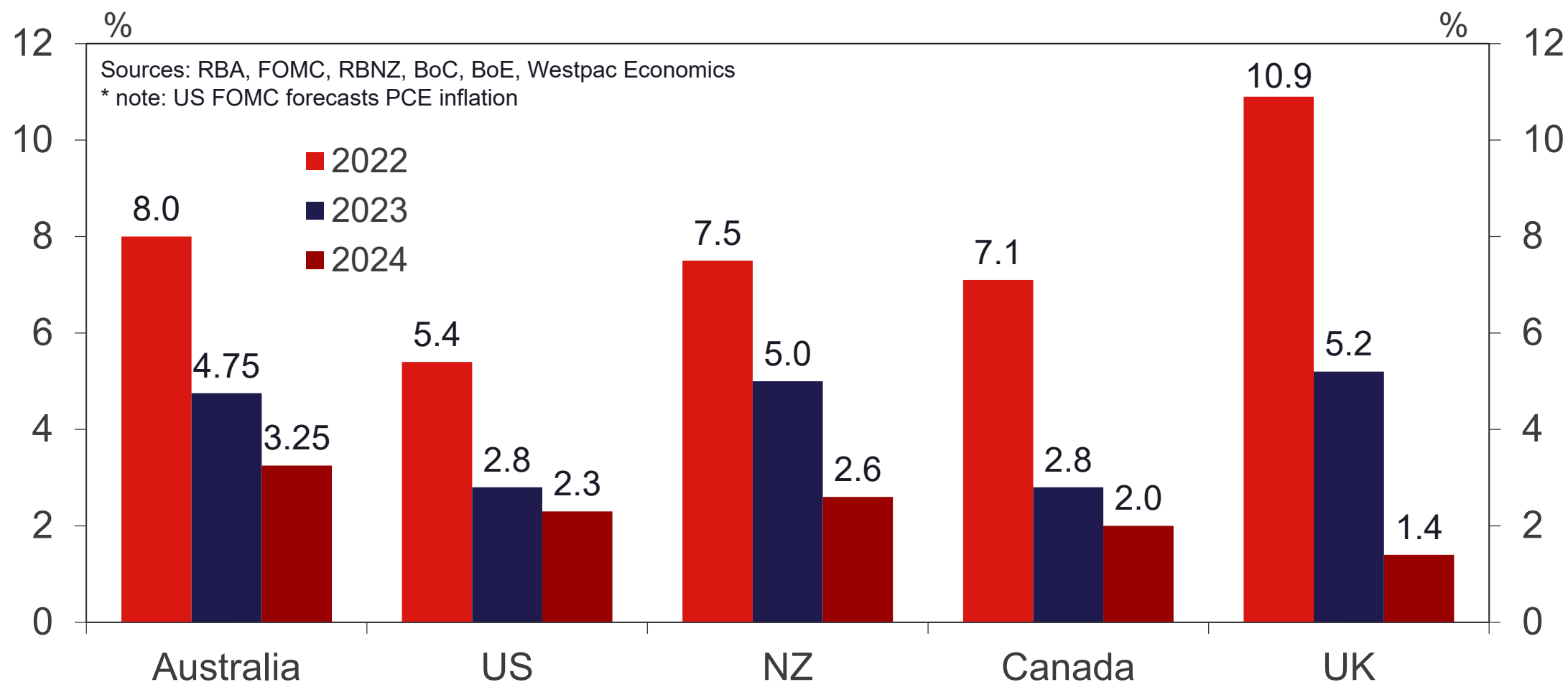
Contributions to core services inflation – US has a rental problem



US CPI inflation peaks; low energy costs are the key



Central bank inflation forecasts – RBA; 3 years outside target band



Financial and Economic Forecasts

	End-2022	2023	2024
GDP (%pa)	3.4	1.0	2.0
Unemployment rate (%)	3.3	4.5	5.2
Inflation (%pa)	7.9	4.1	3.0
Dwelling prices (%pa)	-6.0	-8.0	2.0
Wages growth (%pa)	3.25	4.5	3.6
Cash rate (%)	3.10	3.85	2.85

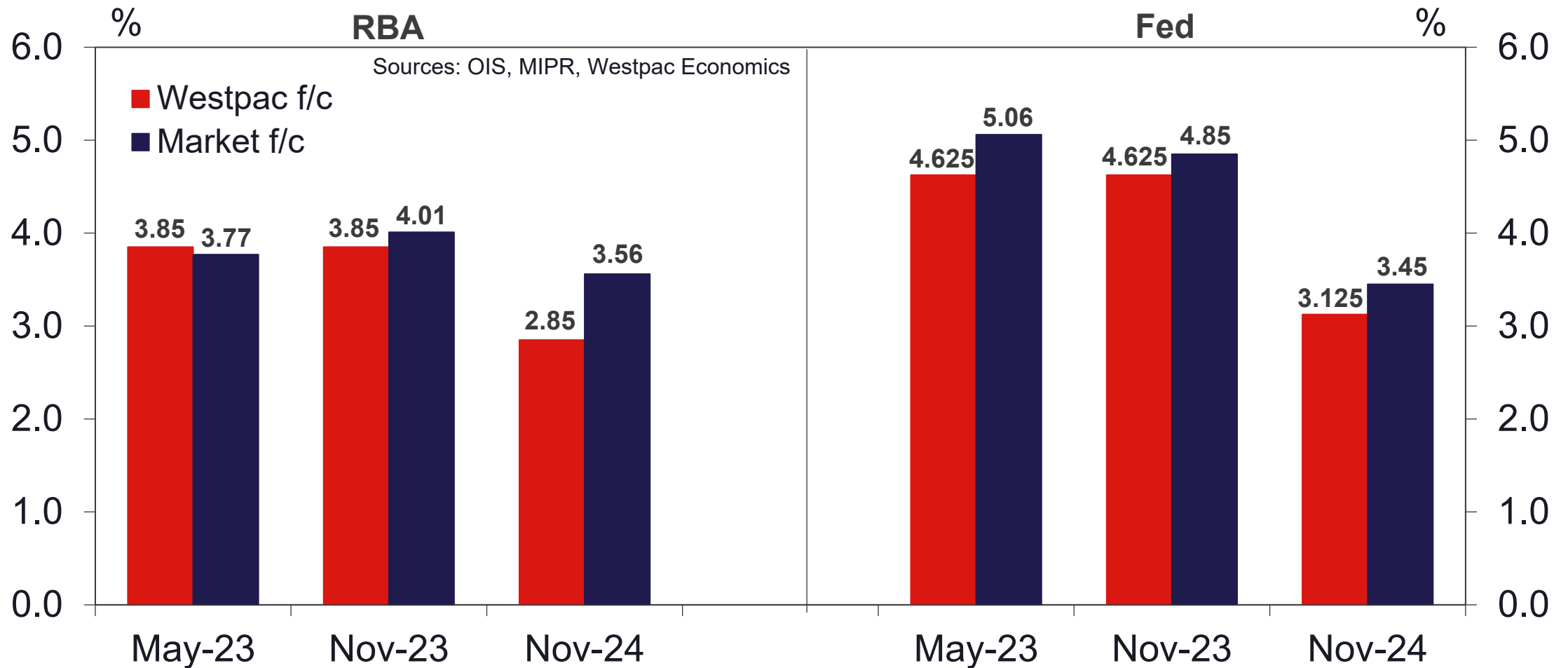
Sources: Westpac Economics

Detailed Forecasts – bond rates lower in 2023 and 2024

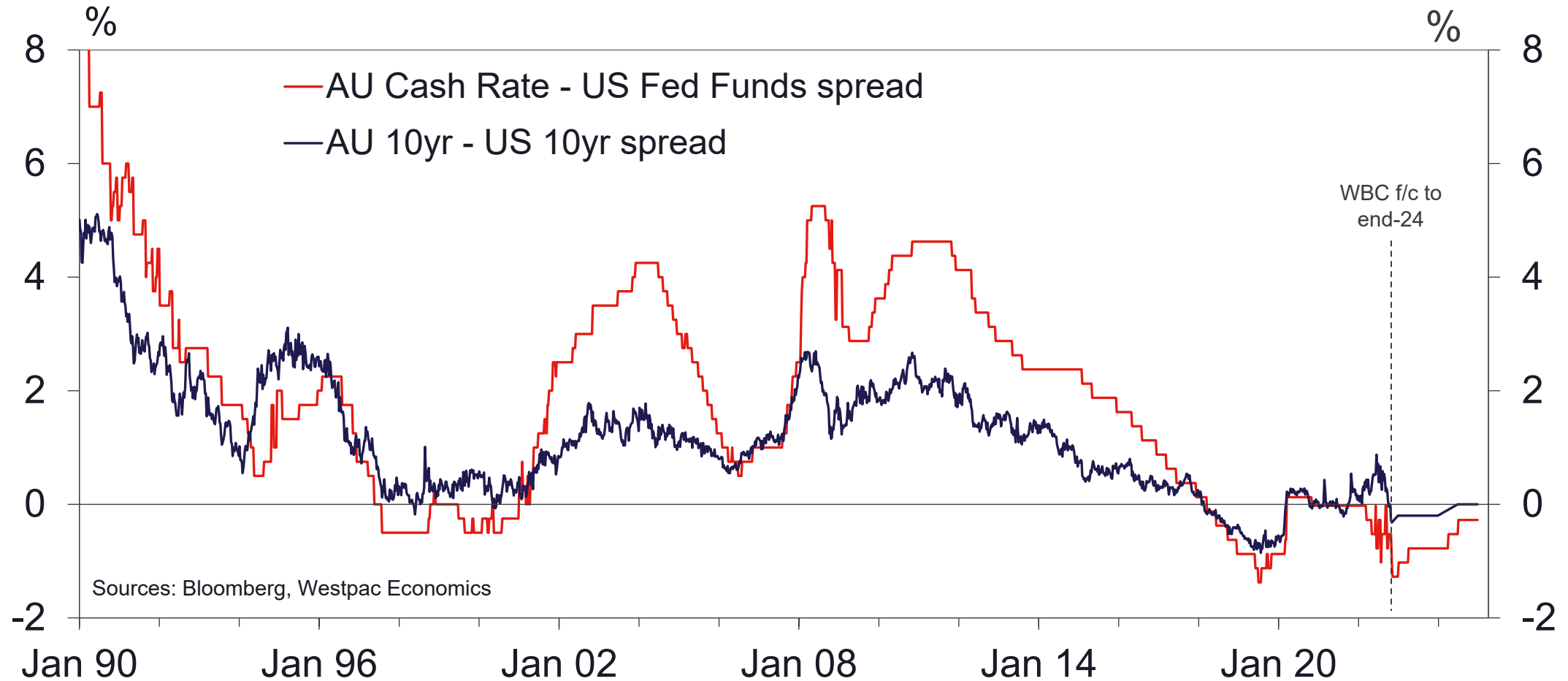
	Latest (28/11)	Dec-22	Jun-23	Dec-23	Dec-24
RBA Cash	2.85	3.10	3.85	3.85	2.85
3yr swap rate	3.83	3.90	3.85	3.60	3.40
AU10yr bond	3.62	3.80	3.60	3.20	2.50
Fed Funds	3.875	4.375	4.625	4.625	3.125
US 10yr bond	3.68	4.00	3.80	3.40	2.50
AUD/USD	0.67	0.68	0.70	0.74	0.77

Sources: Bloomberg, Westpac Economics

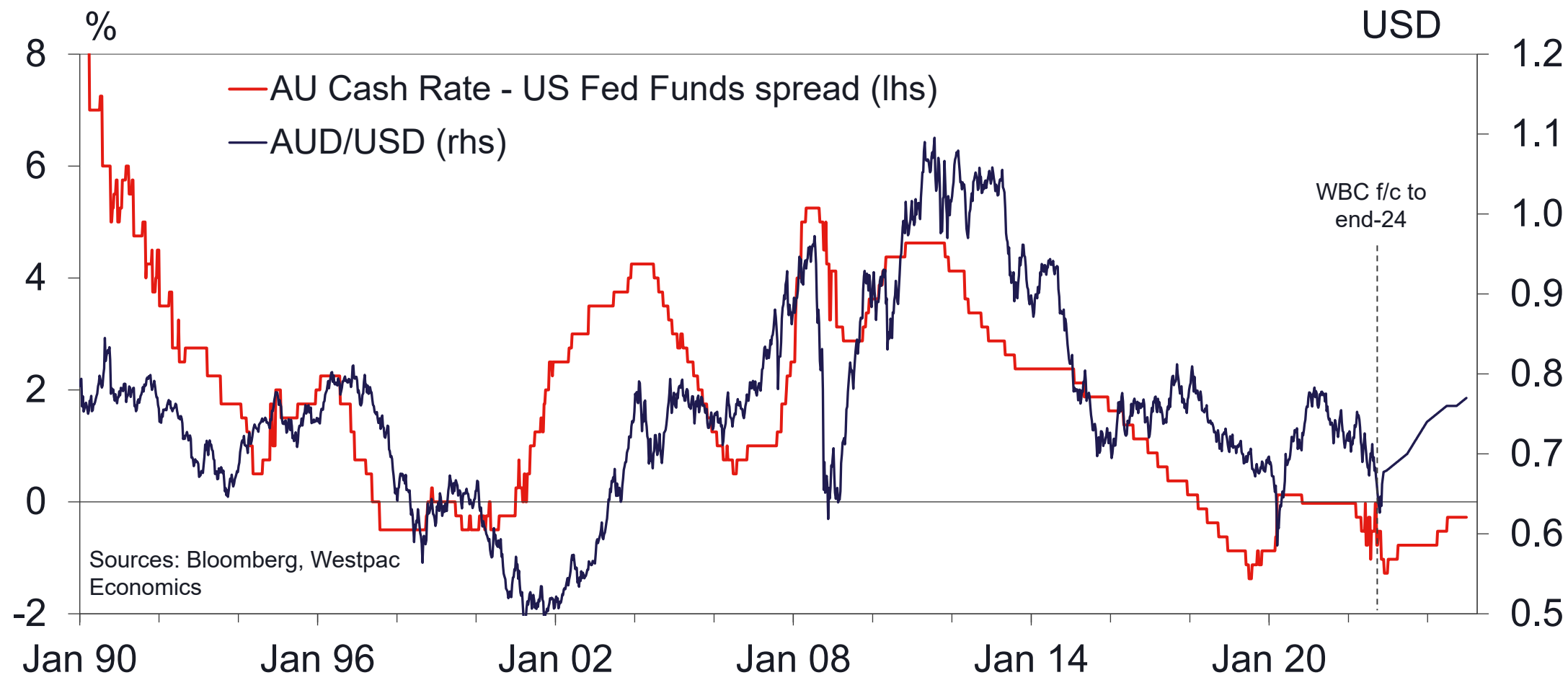
Market Expectations for RBA & US Fed – November 28



Short-end and long-end spreads



AUD/USD and RBA / FFR differential

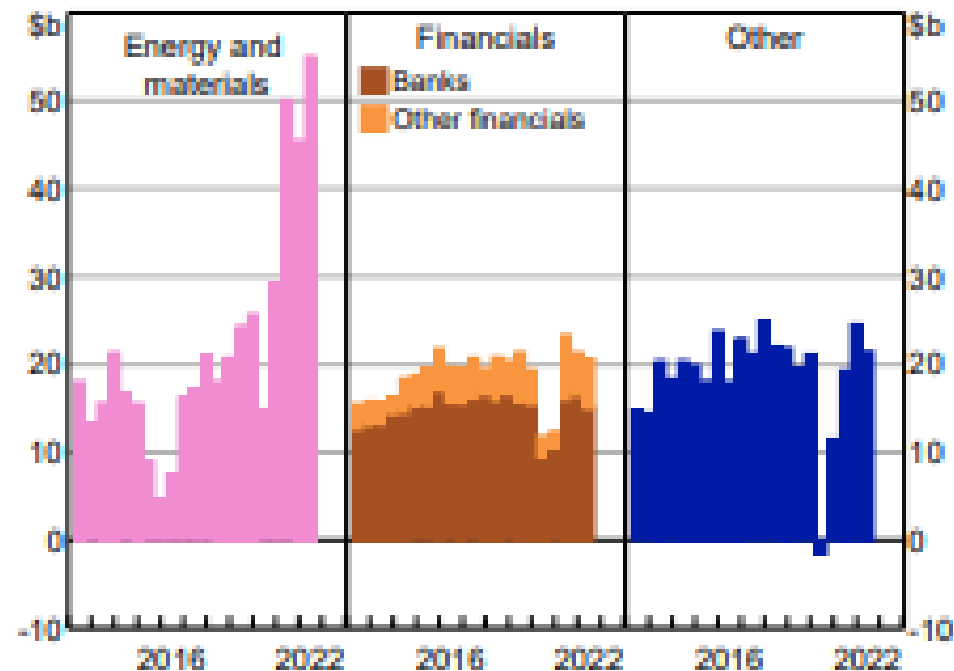


ASX 200 underlying profits*

Graph 3.30

ASX 200 Underlying Profits*

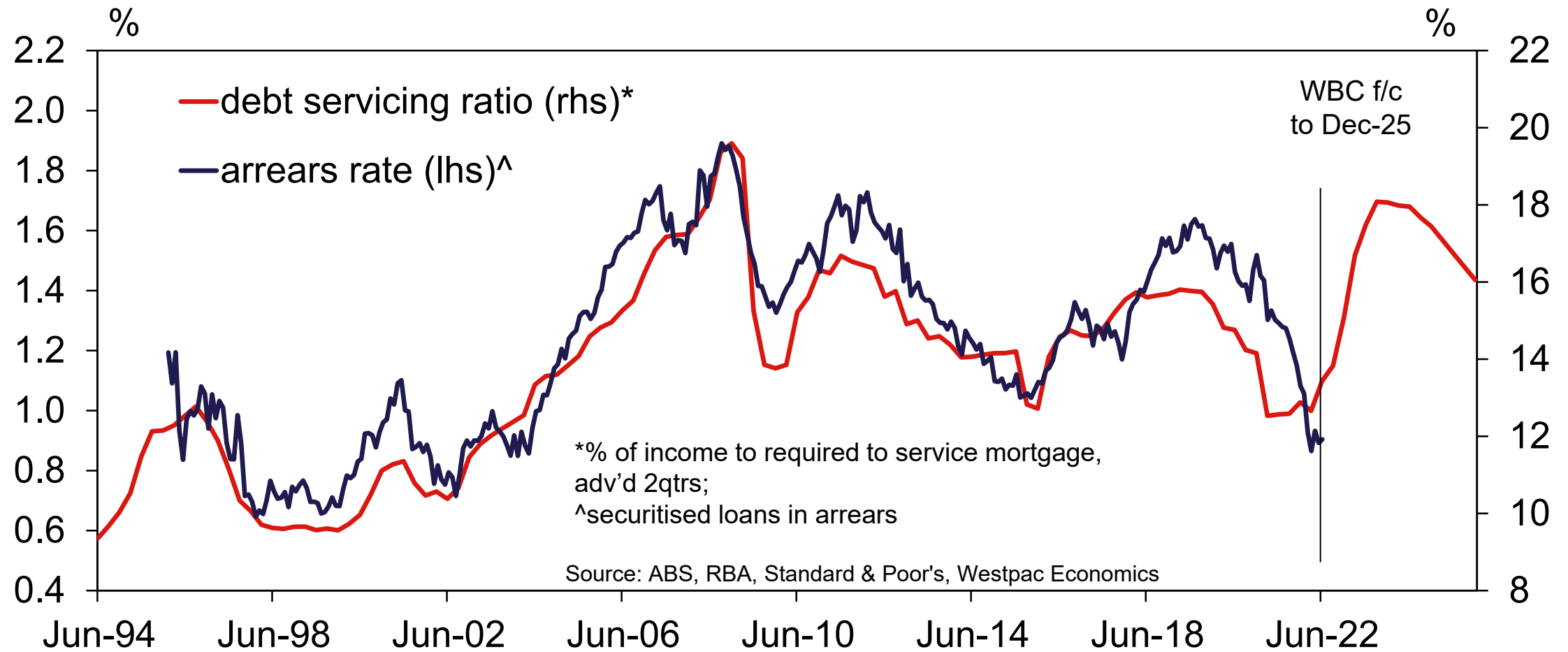
Semi-annual



* Underlying results adjust for one-off items such as asset revaluations.

Sources: Bloomberg; company reports; Morningstar; RBA

Household debt servicing ratio vs arrears

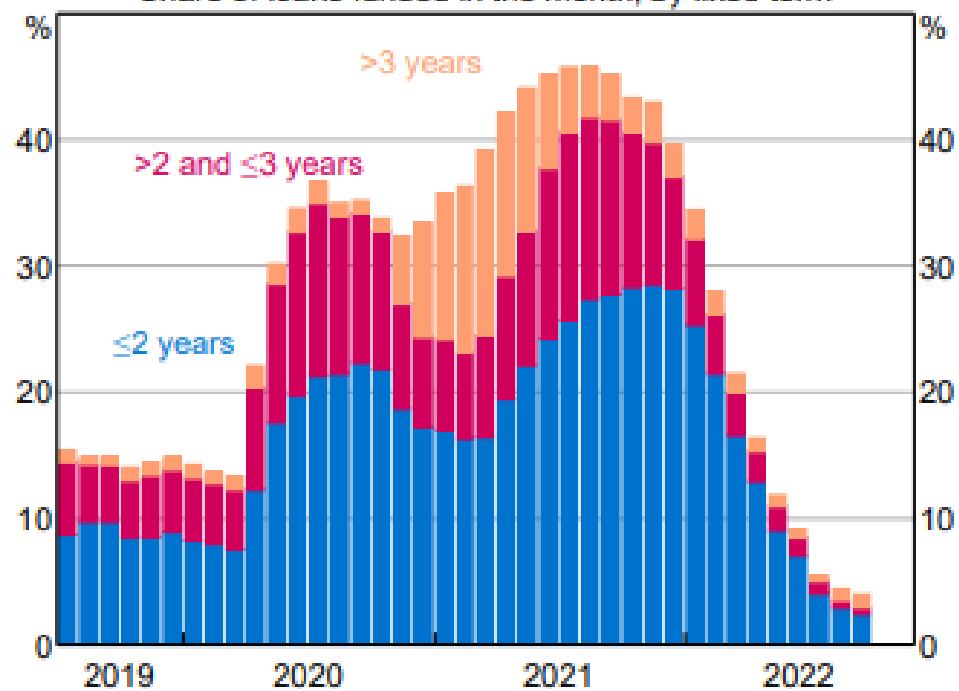


Fixed-rate housing loans- refinancing headwind in 2023

Graph 3.22

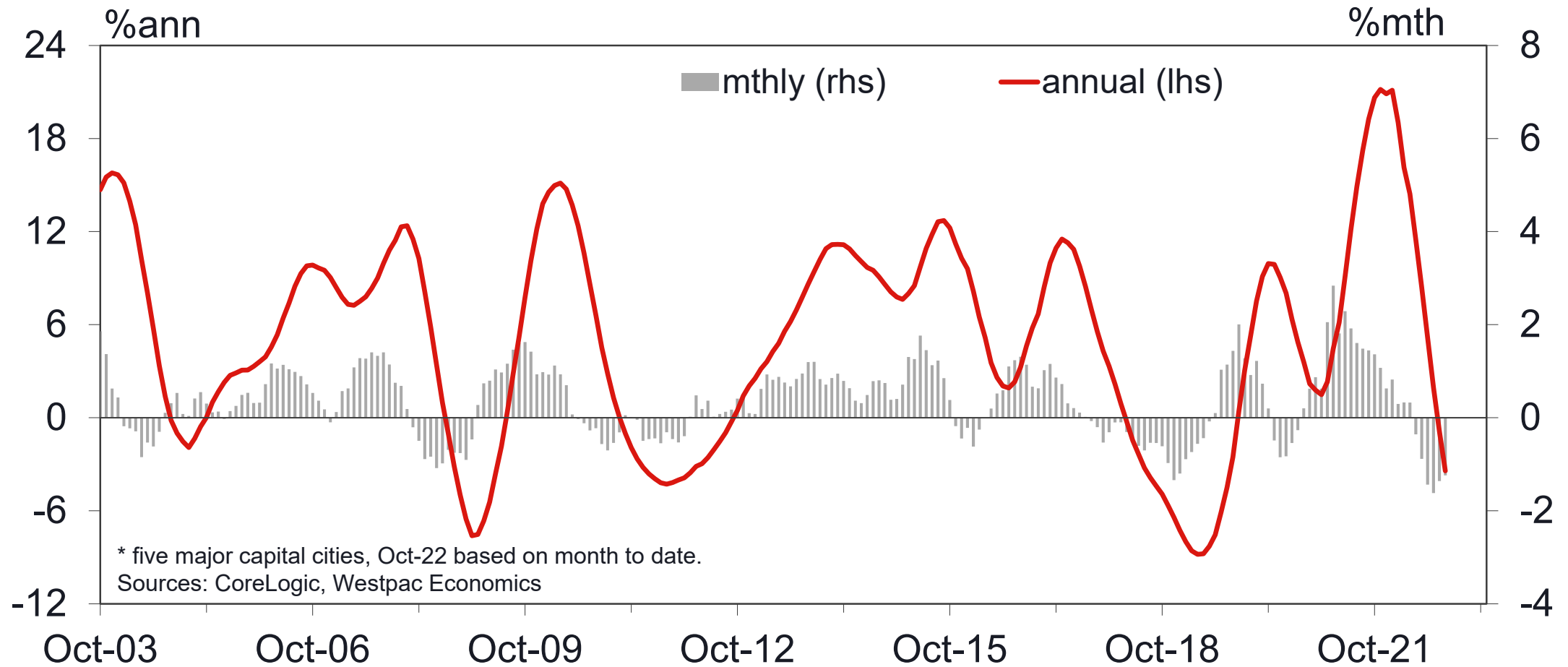
Fixed-rate Housing Loans

Share of loans funded in the month; by fixed term

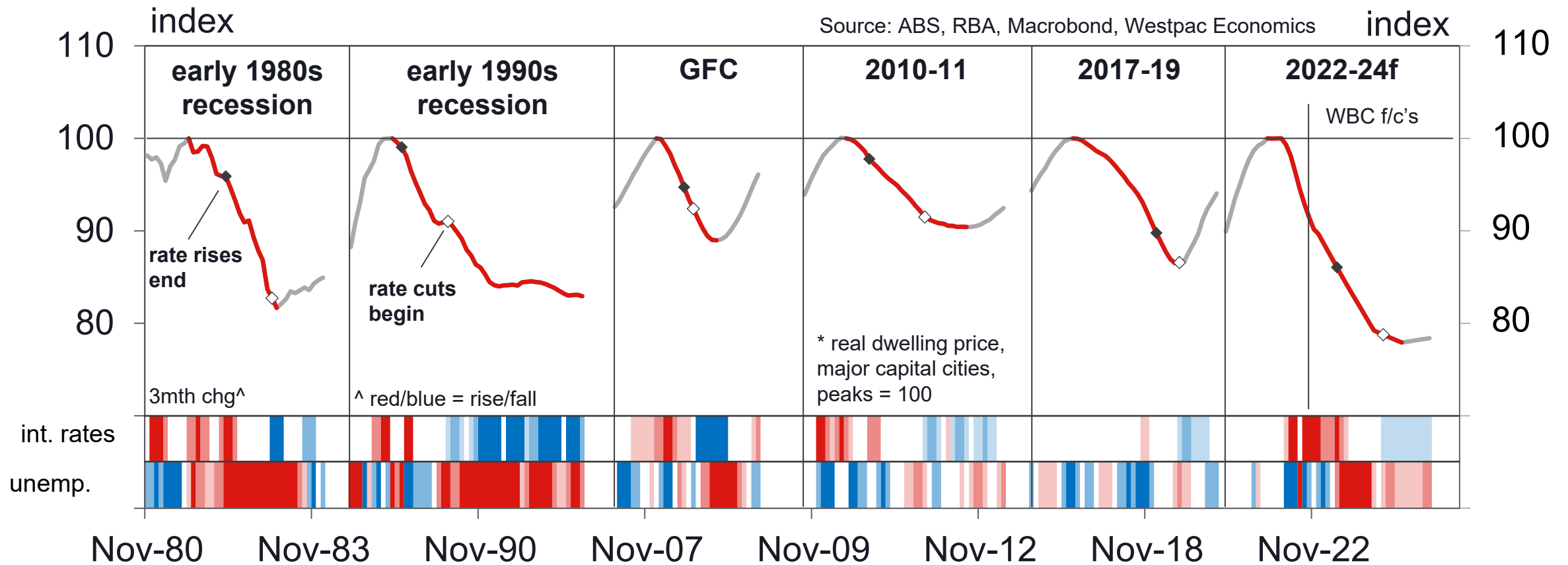


Sources: APRA; RBA

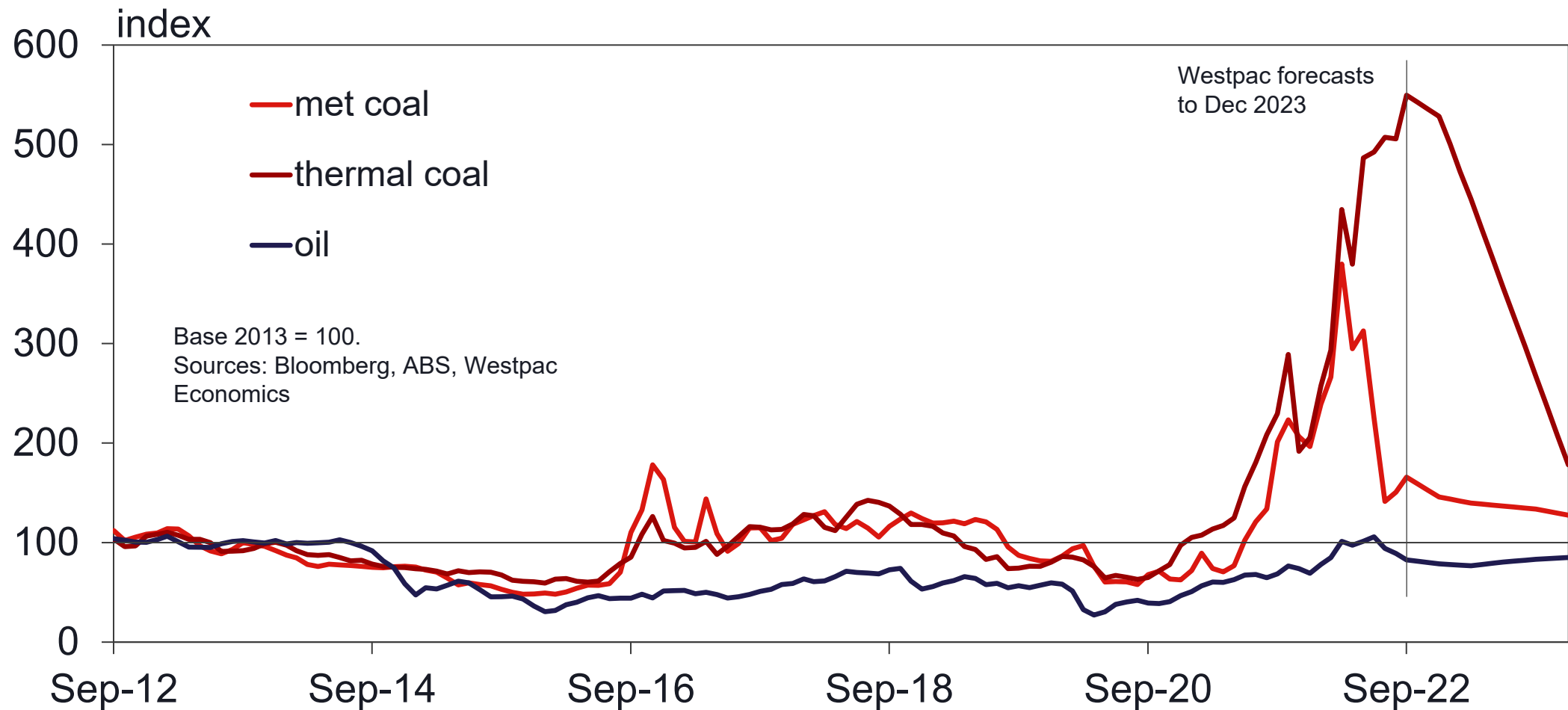
Australian dwelling prices – falling year on year; -16% fall forecast



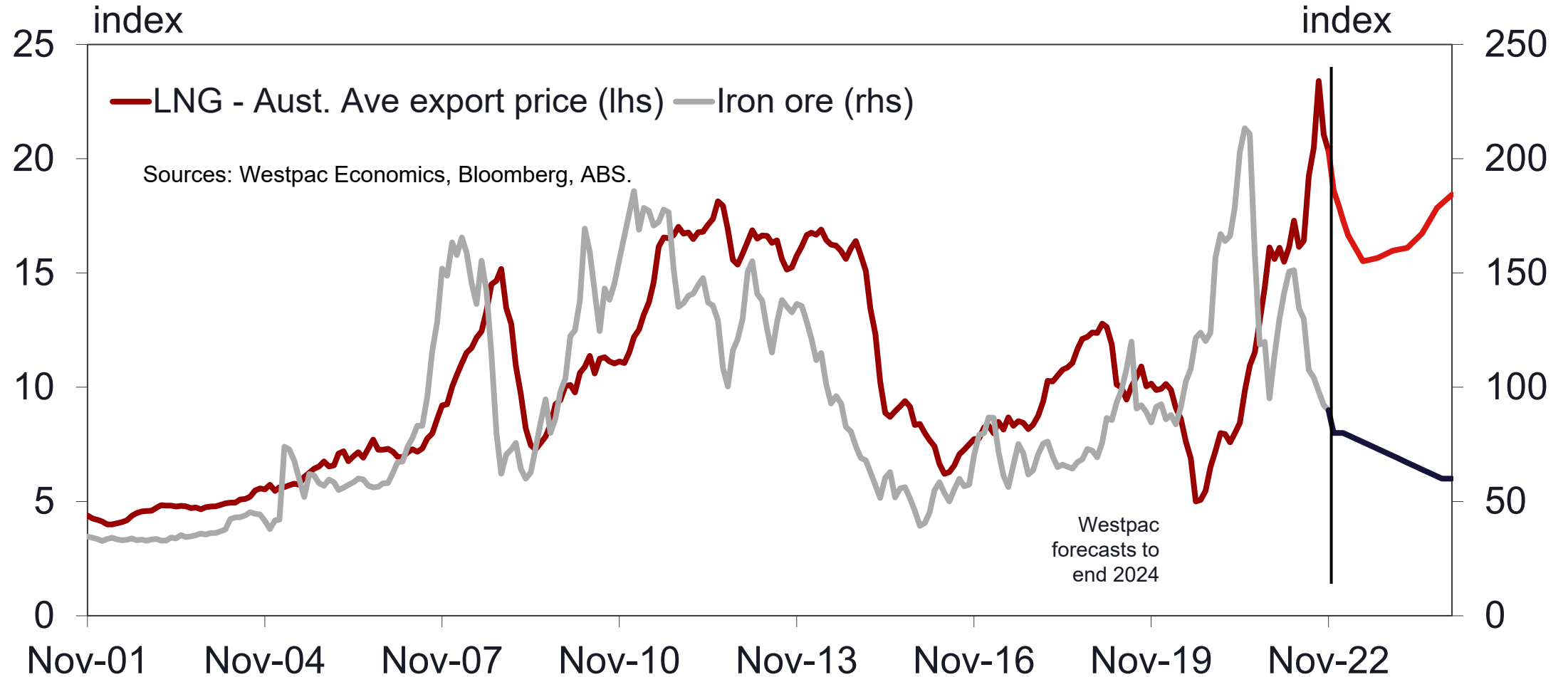
Australia: dwelling price corrections – need rate cuts



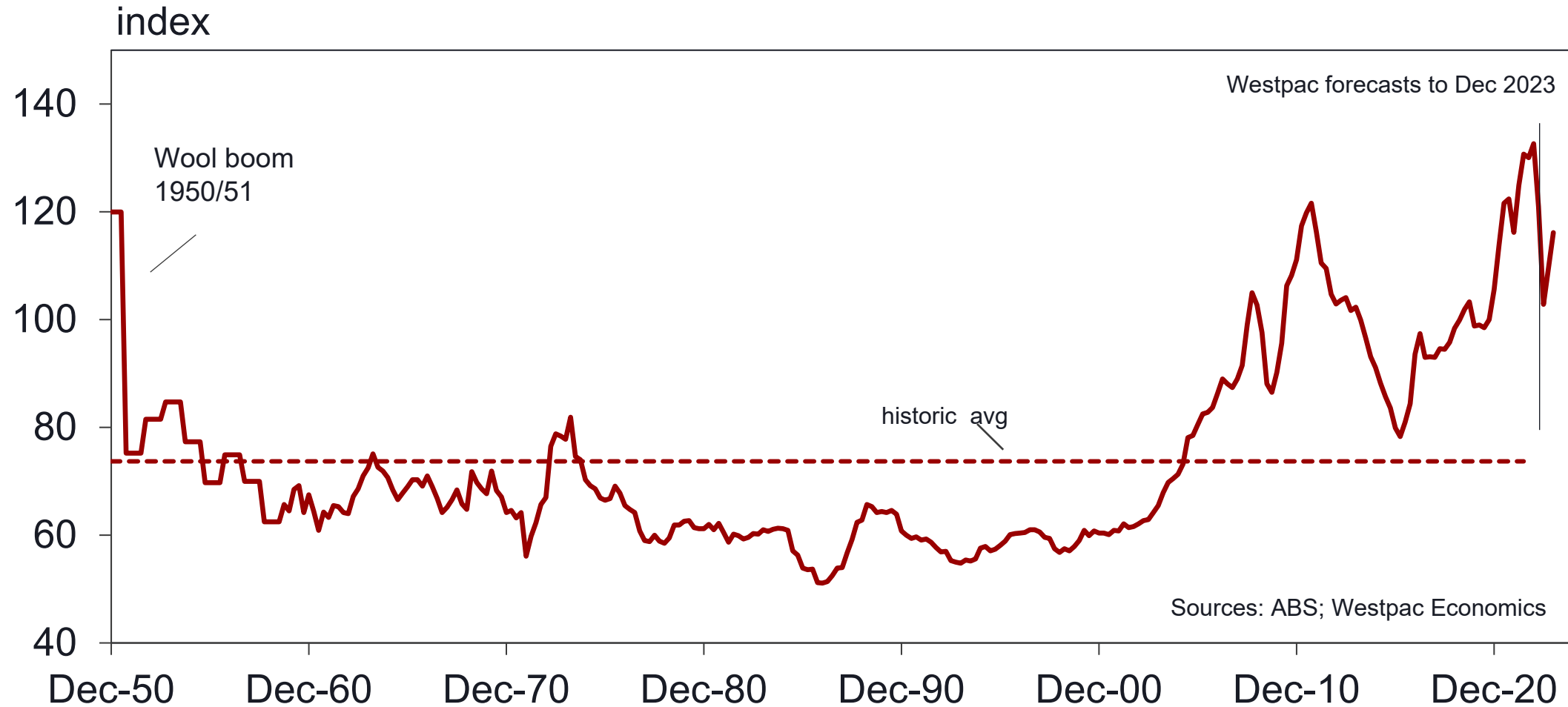
Australian commodity prices – coal boom



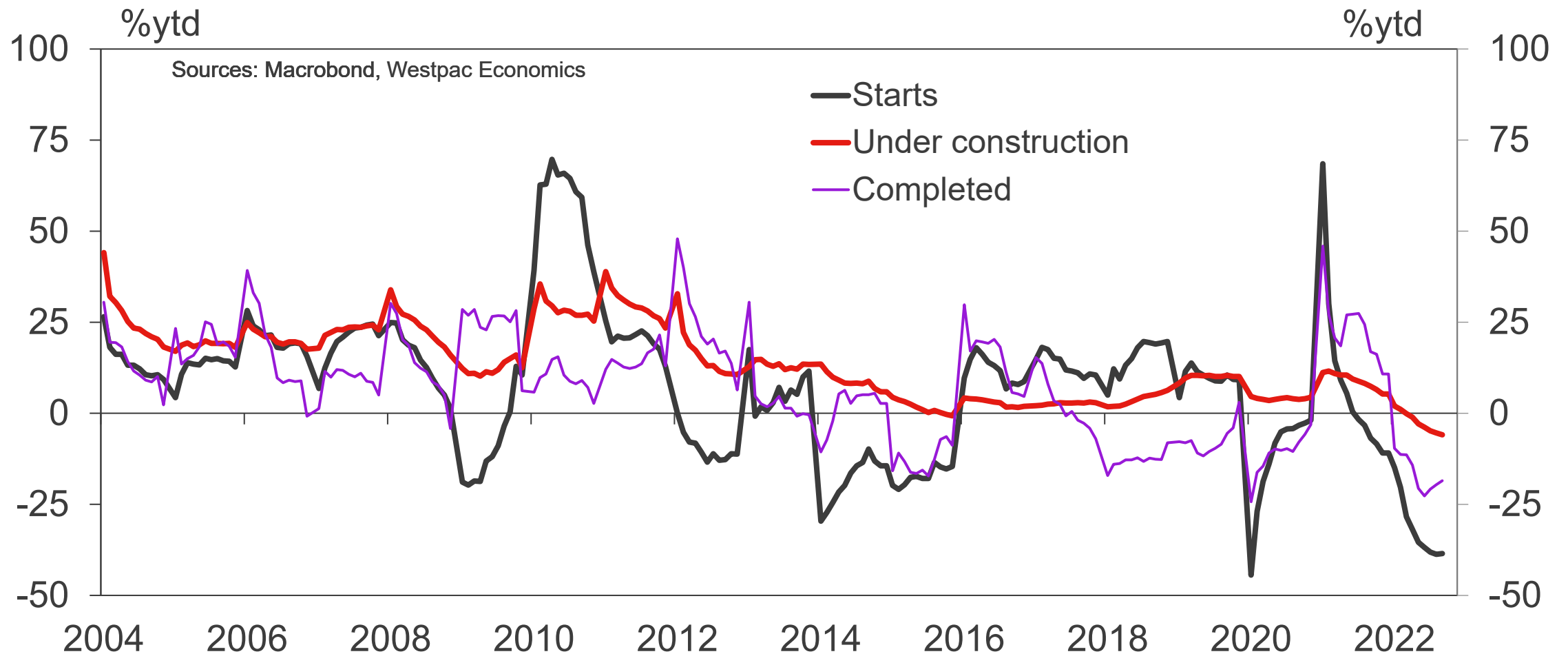
Commodity prices – US\$; iron ore to trend down



Terms of trade: riding high (77% above long-term average)



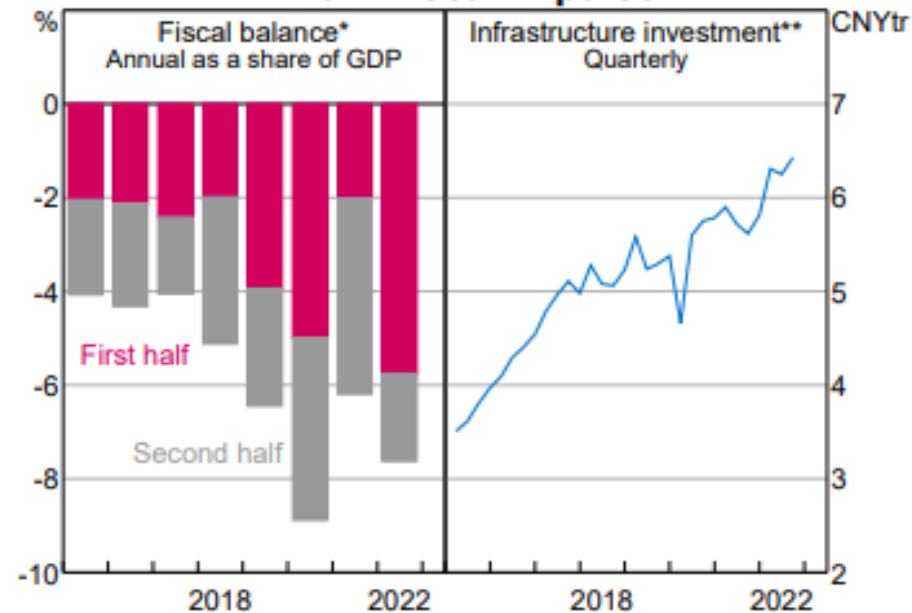
Supply of completed dwellings constrained



China – fiscal impulse

Graph 1.17

China – Fiscal Impulse



* Consolidated measure that includes central government, local government and government funds; as a share of previous year nominal GDP.

** Includes social infrastructure such as health, education, and cultural and sporting facilities.

Sources: CEIC Data; RBA

Conclusion

- Three stages of Great Inflation: supply; war; inflation psychology takes hold.
- Material and labour shortages at extreme levels – not seen since 70's; labour should ease by 2024; demand and supply shock slowdown key to easing in inflation.
- RBA cash rate to rise quickly in 2022 – 3.10% by year's end; peak at 3.85% by May.
- High household debt will limit rate increases but offset by high savings – higher peak Debt Servicing Ratio than previous two peaks.
- With tight labour market (unemployment rate falls to 3.3%), inflation control relies on slowing interest sensitive sectors.
- Bond rates to fall in 2023 – as FOMC and RBA go on hold and markets look to cuts.
- Risk to economy is wage/price spiral; firms also identify scope; RBA should be nervous.
- Falling house prices in 2022 and 2023 – national; down 16% – SYD/MEL 18%.
- Border opening unlikely to see replacement of Covid losses in workforce.
- Central banks have erred with money printing during Covid – government support enough.

Conclusion

- Inflation must ease globally in 2023 to take pressure off central banks and avoid wage/price spiral.
- US inflation structure and cycle conducive to earlier falls in inflation.
- Bond rates volatile but near peak; but progress towards much lower yields will be bumpy.
- Biggest risk to outlook is if inflation is much stickier than currently expected particularly precluding FOMC from cutting rates when US consumer flat lines in 2024 and RBA from easing rates in 2024 (RBA forecast of 4.7% inflation in 2023 and 3.2% in 2024 is risky).
- 2023 will mark the weakest consumer spending growth in US since GFC.
- China's prospects are still uncertain, current conditions in property markets are parlous – stimulatory policy (credit boost; lower rates); easing of restrictions on property and technology; zero Covid still cause for considerable caution as virus still spreads.
- AUD to benefit from easing of “risk aversion” in 2023 as inflation falls.

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