BULLETIN

16 December 2022

The market themes for 2023 and 2024

The Reserve Bank Board lifted the cash rate by 0.25% at its December meeting.

Markets were convinced that the Governor would soften his guidance with a weaker tightening bias. In the event he maintained the guidance used in the last two meetings, that "the Board expects to increase rates further in the period ahead" although adding "but is not on a pre-set course." That term has been used in previous communications and does not detract from the interpretation that the statement carries a strong tightening bias.

Central banks to remain resolute on inflation fight in 2023
Despite market pricing now only anticipating around a 50% chance that the cash rate will reach our target of 3.85% from the current 3.1% by May we confirm that forecast.

Forces we expect will require that higher rate by May include evidence of very high inflation prints for both the December and March quarters. Our current forecasts are: 7.5% for the December quarter (6.7% underlying) and 6.6% for the March quarter (6.5% underlying).

While these numbers indicate that inflation is slowing, mainly because of easing supply side pressures, the Board will be cautious given that wage increases will be intensifying in the first half of 2023 and some components of inflation – particularly services – will remain a challenge while the need to anchor inflationary expectations in the face of such high inflation prints will be ongoing.

Convincing evidence that wages are lifting quickly will also be apparent by the May meeting with wages growth on the way to a 4.5% peak by the June quarter. Only the December quarter Wage Price Index report will be available by the May meeting – and is expected to show a forecast 3.6%yr gain up from 3.1%yr in September – but this will be enough to unnerve authorities given anecdotal evidence of ongoing pressures and still historically low unemployment.

Meanwhile the Australian economy is likely to be showing only a modest slowing. There will be some initial resilience for consumers – spending growth is expected to run at a 2% annualised pace in the first half of the year, down from 4% annualised in the second half of 2022 but still running at a reasonable pace. The unemployment rate is forecast to still be holding near 50-year lows by March. We have also been surprised by the strong recent recovery in population growth and the surge in jobs growth in October and November which will provide some added growth support.

So the May Board meeting will see the Board confronted with inflation in the 6–7% range; an unemployment rate near 50-year lows; clear evidence of rising wage pressures and a degree of uncertainty about how long restrictive policy will be required in the US and other major developed markets.

The situation will turn more decisively from mid-year. Consumer spending is expected to stagnate in the second half of 2023; the unemployment rate will edge higher; and inflation pressures will continue to ease, providing RBA with some comfort that the inflation rate can eventually return to the target band.

This scenario is consistent with the RBA going on hold through the second half while making it clear that rates are unlikely to be eased in 2023.

Markets are currently flirting with around a 50% chance of a further rate hike in the second half of 2023 to be followed by a rate cut later in 2023 – in our view both prospects, which imply a very skittish approach to policy, appear to be unlikely.

Sustained policy easing in 2024
As we move into 2024, ongoing evidence of a stalling economy and rising unemployment, coupled with a slowdown in wage pressures and the inflation rate edging back towards 3%, will allow the RBA to begin to cut the cash rate back towards the 'neutral zone' which we believe is 2.5–3.0%.

We anticipate around 100bps of cuts in 2024 from the March quarter pushing the cash rate to 2.85% by year's end.

Central banks will be tentative in running policy on the basis of forecasts given their recent disappointing forecasting records. But we believe that by 2024 even the RBA will feel sufficiently confident to move away from the clear contractionary stance of policy. It will still be dealing with inflation rates running above the 2–3% band (3.9% headline; 3.6% underlying by end 2023) but a move into the band will be more clearly within sight, particularly with unemployment rising and wages growth easing.

The policy objective will shift from fighting inflation towards providing relief for a stagnating economy in the context of existing restrictive policy.

That profile for the RBA will be close to that of the FOMC – we expect the fed funds to be lifted in January and March 2023, before going on hold for the remainder of 2023 despite nearly two years of an economy that is near stall speed.

That policy will be seen to be needed to ensure that the decline in inflation is sustained into 2024. With this achieved, the Fed is expected to also pivot to responding to the stalled economy, providing extensive rate cuts in 2024. Note that the latest FOMC forecast 'dots' show 100bp of rate cuts in 2024 despite the inflation target (PCE inflation) only slowing to 3.1% by end 2023.

We are anticipating an even lower inflation rate by end 2023 and lower outcomes in 2024 that allow for more extensive rate cuts during that year – in the order of 200bps.

Key risk is inflation stickiness around wages and services
But there may be some stickiness in inflation in both economies initially, presenting a clear risk to market pricing, which is currently anticipating FOMC and RBA rate cuts in the second half of 2023.

If inflation is slower to fall the FOMC, in particular with a more ambitious inflation target, will need to signal its strong commitment to lowering inflation permanently, delaying rate relief – the task of bringing inflation below 3% might prove much tougher than moving it from 8% to 4%.

That task will be closely aligned with the progress in slowing wages growth. While there is evidence of slowing inflation for goods prices and even shelter costs, it is apparent that stubbornly high wages growth is holding up inflation in the core services sector. The risks are that the challenge of reining in wage-driven service sector inflation may be much more difficult than we are anticipating.

In our view the issue for both RBA and FOMC in this inflation fight is around wages and the direct link to services inflation. Goods inflation pressures are easing as supply chains are being restored and demand is slowing. But wages growth is increasing in Australia and remains elevated in the US due to record labour shortages. Even though Australia does not have a labour participation problem like the US, COVID disruptions and restricted immigration are affecting labour supply in both countries.

Greater momentum in wages growth than we currently envisage that would stem from rising inflationary expectations represents the dominant risk to our central cases.

Markets again pre-empting shifts
The key theme which we promoted through most of 2022 was that 2023 was going to be the year when bond rates would fall and the appetite for the USD would wane. We had thought US 10 year Treasuries would fall towards 3.2% by end 2023 from the 4% starting point by end 2022, while the AUD would lift from USD0.65 to USD0.72 in 2023.

We did not sufficiently count on the propensity for markets to be pre-emptive. Once the headline inflation rate in the US appeared to peak markets factored in a lower terminal federal funds rate – a rational response to the sustained expected weakness in the US economy – and this move spread to Australia.

Those anticipated falls in bond rates and increased aversion to the USD, including support for the AUD, were partially brought forward to the final quarter of 2022.

We have only made a slight reduction in the end 2023 target rate for US 10 year bonds, from 3.2% to 3.1%, with the fall from 4% + occurring more in late 2022 than 2023.

With the AUD now expected to finish the year at USD0.68 rather than USD0.65 we have revised up our end 2023 forecast from USD0.72 to USD0.74.

Conclusion
The risks to these scenarios are evenly balanced. The supply side drag on inflation could overwhelm the lingering demand side, mainly represented by rising wages and bold pricing policies from businesses, to yield a much faster slowdown in inflation in both the US and Australia than we are factoring in. That would open up the possibility of earlier rate cuts in both markets than we currently envisage.

On the other hand, the supply side drag may prove to be unsustained while demand pressures build and inflationary expectations become entrenched. That would raise the unsavoury prospect of an extended round of rate hikes in both economies during the stagnation in the second half of 2023.

That fear of stagflation should motivate both the FOMC and the RBA to err on the side of higher rates in the near term and to remain resolute in keeping rates on hold in 2023.

In summary, we see 2023 as a year when inflation falls; economies stall; central banks continue to tighten decisively in the first half; are on hold by mid year; and remain resolute through the remainder of the year.

That will lay the platform for an extension of the falling inflation in 2024 and the conditions for sustained policy easing.

Compared to our central scenario, markets are too dovish on the RBA in the first half of 2023; too ambitious around the timing of rate cuts both by the RBA and FOMC later in 2023; and too cautious around the extent of rate cuts in 2024.

Bill Evans, Chief Economist

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