21 December 2022

Leading Index signals weak growth outlook

- **Growth rate falls to -0.92% from -0.84% in October.**
- **Fourth consecutive month of negative growth rate.**
- **Consistent with below trend growth well into 2023.**
- **Drivers of weakness are the cash rate and commodity prices.**

The six-month annualised growth rate in the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic activity relative to trend three to nine months into the future, fell from –0.84% in October to –0.92% in November.

The growth rate of the Leading Index continues to hold in negative territory. November is the fourth consecutive month that the growth rate has been negative. That first negative signal in August was consistent with a below trend growth pace in late 2022 and well into 2023. The persistence of these negative prints confirms the sustained below trend outlook for the Australian economy in 2023.

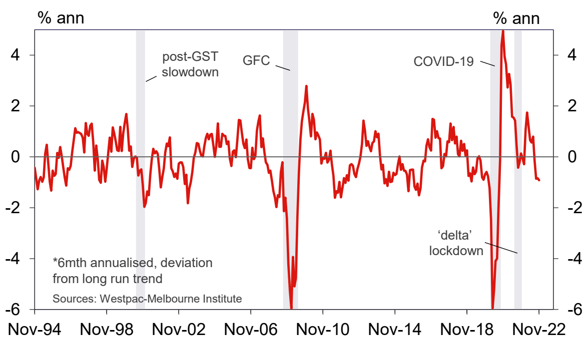
That profile is consistent with Westpac's own growth forecasts for 2023. We expect growth of only 1% over the year with growth at zero in the second half of 2023 – a half-year of stagnation for the Australian economy.

The accumulated impact of the Reserve Bank's tightening cycle, which began in May this year and is expected to extend out to May 2023, will be the main source of the economic headwinds although persistent declines in real wages; an ongoing deterioration in the residential housing market; uncertain asset markets; and a difficult year for the global economy will all play their parts.

Direct impacts from monetary policy and the weakening global environment are apparent in the components of the Index that are explaining most of the weakness in the last six months. The indirect effects of the sharply inverting yield curve and falling commodity prices can be expected to feed back through other components of the Index as we move into 2023.

The Leading Index growth rate has seen a sharp turnaround over the last six months, going from running 0.66% above trend in May to 0.92% below trend in November. Two components account for the 1.57ppt swing: the yield spread, which has seen a sharp narrowing as policy tightening has driven up short term rates (–0.86ppts); and commodity prices, which have seen a significant reversal in AUD terms (–0.74ppts).

Westpac-MI Leading Index



Other components have had no net effect on the index growth rate since May. Modest additional drags from US industrial production, the Westpac Unemployment Expectations Index and monthly hours worked (–0.24ppts on a combined basis) have been offset by a reduced drags from the Westpac Consumers Expectation Index, dwelling approvals and the S&P/ASX200 (+0.28ppts on a combined basis).

The Reserve Bank Board next meets on February 7. Without a Board meeting over the holiday period the Board can take time to further assess the impact of the 300bps of rate increases since May this year.

In the minutes to the December meeting the Board noted that it considered three options: pause; 25bp increase; and 50bp increase. The case for a pause was weak given that in November the Bank had forecast that even with further rate increases inflation would not move into the target range before 2025. By December there had not been any developments that would change that outlook, pointing to the need to continue down the tightening path.

The case for the increase of 25bps had been made in both October and November and mainly rested on the need to assess the impact of previous moves given the long lags in the impact of monetary policy. Consistency was also seen to be a major benefit of this approach.

We were surprised to see that a 50bp rise was still on the table. Sensibly, the risk of a faster than anticipated wages blow out in response to very tight labour markets was discussed as the key trigger to embedding damaging high inflationary psychology in the Australian economy and the need for more decisive policy action.

We expect the Board will opt for a further 25bp increase at the February meeting given the outlook for wages; inflation and economic growth. We also expect that the wages and inflation challenges will persist through the early months of 2023 requiring further increases of 25bps in both March and May.

The slowing economy; prospects of easing conditions in the labour market; lower inflation; and weak global growth will lay the foundation for an extended pause for the remainder of 2023.

Bill Evans, Chief Economist

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