BULLETIN

2 February 2023

RBA to lift rates by 25bps in February; scope for another 25bp move in March

The Reserve Bank Board meets next week on February 7.

We expect it is highly likely that the Board will decide to raise the cash rate by 25 basis points while maintaining the guidance used in December for the next meeting on March 7.

On February 10 the Bank will release its February Statement on Monetary Policy where the interest will be in the Bank's forecasts of inflation, wages and growth.

Consider the wording in the Governor's statement following the December Board decision to raise the cash rate by 25 basis points. "The Board expects to increase interest rates further over the period ahead, but it is not on a pre-set course. It is closely monitoring the global economy, household spending and wage and price behaviour."

Developments since that Statement support a rate increase.

With the unexpectedly rapid reopening of China; a mild European winter with associated lower energy prices; and justifiable expectations that the US Federal Reserve is nearing the end of its tightening cycle and as inflation reports continue to be encouraging (including this week's report showing a further slowing in US wage inflation) there is good cause to be more optimistic about the global economy than at the time of the December Board meeting.

Even the IMF has recognised these developments by raising its forecast growth rate for 2023 from 2.7% to 2.9%.

The latest Retail Trade report showed retail sales fell by 3.9% in December following an upwardly revised 1.7% increase in November.

Note that about half of the retail sales category is food, the rest covering department stores; household goods and clothing. Retail sales also account for only about a third of overall household consumption.

Also note that the survey figures are 'seasonally adjusted'. Unadjusted retail sales still rose in December – by 16% – but not by as much as anticipated by the estimated usual seasonal move: 20%. The challenge here is that the increasing popularity of Black Friday sales in late November is seeing what looks to be a permanent shift in the regular seasonality. This can only be confirmed over time. Until then, seasonal adjustments will tend to overstate 'underlying' strength in November and overstate weakness in December.

It will be instructive to wait for January retail sales estimates to see whether this December effect has been overstated.

It is also important to note that the ABS survey definition of retail sales excludes a wide range of spending, including many segments that might ordinarily be thought of as 'retail'. It does not cover pubs and bars, hotels and accommodation, motor vehicles, fuel, the bulk of market services including recreational services like cinemas, theme park, telecommunications, and travel and other services including health and education.

The December quarter inflation report provided some evidence of demand conditions in the services sector. The domestic travel and accommodation sector saw prices lifted by 13.3% and by 7.6% for international accommodation and travel.

Our Westpac Card Tracker (which covers credit and debit card turnover across the Westpac Group) suggests wider turnover held up reasonably well in December but with some weakening in spending in retail components offset by a strong surge in non-retail components – travel and recreational services in particular. Note that this is over and above regular seasonal increases around the holiday period.

We expect the RBA Board will be cautious around the December retail print. It will not base its decision on one month's data, particularly given the issues noted above. It is likely to instead wait to assess seasonal issues and to get a better assessment of wider consumer spending in the December quarter national accounts, which will be available on March 1 just prior to the March Board meeting.

The key issue for the RBA around the inflation story is the surprise increase in the Trimmed Mean measure of inflation. In November it had forecast that measure to reach 6.5%yr so would be very unsettled by the print of 6.9%yr.

We also noted that annual services inflation had lifted from 3.1% in June to 5.5% in December. Services inflation typically reflects demand and wages growth.

Whereas there is evidence that some supply-side inflation pressures are easing in Australia – along the lines of the US – services inflation is still rising.

While that will partly be about demand, it is also consistent with the idea that Australia's wages cycle is lagging the US: while wage inflation is easing in the US, wage pressure is still building in Australia.

The Minutes of the December Board meeting noted that the Board discussed options of 50 basis points, 25 basis points and on hold.

In the Governor's statement, following the meeting, he did not refer to that detailed discussion, so we will not know whether all options were considered on February 7 until the minutes are released. But from here it seems likely that all options will again be on the table.

If we consider the situation facing the Board at the February meeting compared to December, the stand-out is the higher-than-expected measure for underlying inflation and the associated lift in services inflation that aligns with a stronger domestic demand and wages growth environment.

Accordingly, it seems likely that the Governor will maintain his wording from the December Statement: "The Board expects to increase rates further over the period ahead, but it is not on a pre- set course".

That still provides ample flexibility but makes it clear that the Board is not yet comfortable with its progress in returning inflation to the target range.

The Board will receive updates on wages in the Wage Price Index on February 22 and in the national accounts for the December quarter on March 1.

Westpac expects that after the 25 basis point move in March there will be scope for a pause in April, to await the March quarter inflation report. Another 25 basis point increase in May, in response to a likely 6.5% Trimmed Mean inflation print, will mark the end of the tightening cycle with the cash rate peaking at 3.85%.

As the RBA awaits the June quarter Inflation Report the evidence around inflation; wages; and demand will be sufficient to avoid an August move with rates on hold for the remainder of 2023.

Still Likely to Avoid a Recession in 2023

Despite having a higher trajectory for the cash rate than most other analysts, many of whom also expect a recession, we think the Australian economy will avoid a recession in 2023.

Our central case is for economic stagnation in the second half of the year, although the risks are to the upside.

The key dynamic behind the stagnation is the cumulative impact of a 375 basis point rate increase on the household sector.

But this post-pandemic cycle is different to previous tightening cycles.

Households have accumulated around $270bn in excess savings, around $110bn of which is held in mortgage offset accounts.

The Reserve Bank calculates that the proportion of household disposable income allocated to loan repayments before the tightening cycle will be around the same after the tightening cycle (based on a peak cash rate estimate of 3.6%). That is because higher interest payments will essentially replace the ‘ahead of schedule’ principal repayments households were making a year ago.

In aggregate, the Bank calculates that the median mortgage borrower is currently 20 months ahead on their repayments, although 20% of variable rate borrowers are only 0-3 months ahead.

It will be the vulnerable marginal borrower who has the most difficult period ahead with higher rates.

But note that scheduled principal repayments represent around 50% of total scheduled mortgage repayments. Borrowers and lenders have some flexibility to adjust the principal portion – extending the term of the loan or even moving to interest-only in some instances.

Labour market conditions should also remain broadly supportive. While we expect the unemployment rate to rise during the second half of the year, this is coming from 50-year lows and to a still relatively low level by historical standards. It is also against a backdrop of accelerating wage growth. The bottom line is that most households will be in much better shape to maintain incomes than in previous economic slowdowns, again improving their prospects of meeting mortgage repayments and/or refinancing on better terms.

While these forces will undoubtedly see a significant slowdown in household spending, the legacies of record low unemployment and accumulated excess savings mean the economy is unlikely to lapse into recession.

RBA forecasts in the Statement on Monetary Policy (SoMP)

The most important aspect of the SoMP is the Bank’s revised forecasts, particularly for inflation, growth and the labour market.

These forecasts are based on an interest rate path of the average of market economist forecasts and market pricing.

For the November Statement on Monetary Policy the Bank forecast GDP growth of 1.4% in 2023 compared to Westpac’s forecast of 1%. Both forecasts do not envisage a recession, while anticipating a significant slowdown, and as stated, there are reasons to see upside risks to the Westpac forecast. It seems unlikely that the Bank will make a significant change to the growth profile.

The areas of most interest will be inflation and wages.

The RBA’s November SoMP had wage growth forecast to lift to 3.9% in 2023. Westpac has 4.5%, partly reflecting 3.6% pace at end 2022, which compares to 3.1% for the RBA. The September quarter Wage Price Index printed higher than the RBA had anticipated in November leading to a likely lift in their 2022 forecast.

The wages growth profile for 2023 is likely to be lifted in the SoMP, potentially to around 4.2%.

When we saw the RBA’s 2023 forecast for 4.7% inflation in the November SoMP we were concerned that this showed a lack of urgency about returning inflation to the 2–3% target.

Our own forecast of 3.9% includes a much larger deflationary pulse from supply-side factors in 2023 (including lower fuel prices – the RBA’s convention is to assume flat oil prices in its forecasts). Having observed the encouraging supply-side developments in the US (already affecting fuel, food, energy, goods, and building costs) it is reasonable that RBA will be able to lower its inflation forecast despite lifting the wages profile.

A revision in the headline inflation number to 4.5% in 2023 seems reasonable.

Conclusion

The disturbing inflation report is likely to be the key driver of the decision to raise the cash rate in February.

Wages and Inflation will again drive the March decision and a follow-up in May.

But even at those high rates the economy should avoid recession, thanks in large part to the household sector’s strengthened balance sheets and the low unemployment rate, both of which are legacies of the pandemic.

Bill Evans, Chief Economist (WestpacGroup)

DISCLAIMER

Things you should know.

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary only and is not intended to constitute or be relied upon as personal financial advice. To the extent that this material contains any general advice, it has been prepared without taking into account your objectives, financial situation or needs, and because of this, you should, before acting on it, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs, and, the disclosure documents (including any product disclosure statement) of any financial product you may consider. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a client of Westpac.

For XYLO Foreign Exchange clients: This information is provided to you solely for your own use and is not to be distributed to any third parties. XYLO Foreign Exchange is a division of Westpac Banking Corporation ABN 33 007 457 141 and Australian credit licence 233714. Information is current as at date shown on the publication. This information has been prepared without taking account of your objectives, financial situation or needs. Because of this you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs. XYLO Foreign Exchange's combined Financial Services Guide and Product Disclosure Statement can be obtained by calling XYLO Foreign Exchange on 1300 995 639, or by emailing customercare@XYLO.com.au.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking and Insurance Regulatory Commission (CBIRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Disclaimer continued overleaf

DISCLAIMER

Disclaimer continued

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

I. Chinese Wall/Cell arrangements;

II. physical separation of various Business/Support Units;

III. Strict and well defined wall/cell crossing procedures;

IV. a "need to know" policy;

V. documented and well defined procedures for dealing with conflicts of interest;

VI. reasonable steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.