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Leading Index improved but mixed

- **Leading Index growth +0.01%.**
- **Second positive read after fifteen consecutive negatives.**
- **But much of the gain is due to a commodity price rally that may not last.**
- **Broad picture still looks to be a stabilisation rather than a cycle upturn.**

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, eased back to +0.01% in December from +0.18% in November.

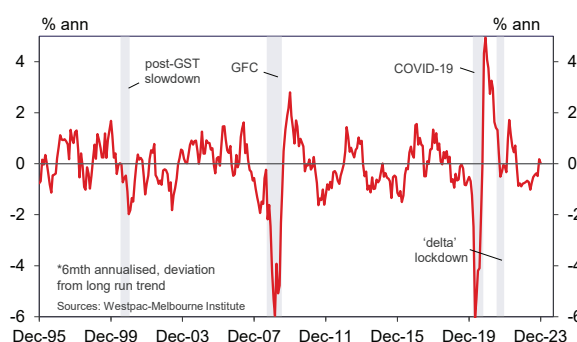
Despite the dip back into year-end, the Leading Index growth continues to show a clear improvement. December is the second consecutive month that the Index growth rate has been around or slightly above the zero 'gain line'. That follows fifteen consecutive months of negative, below trend reads, mostly in the -0.5-1% range.

However, the broad picture still looks to be of, at best, a stabilisation rather than the beginning of a cyclical upturn. Much of the lift is coming from a recovery in commodity prices since mid-2023, a rally that may not last. Meanwhile momentum excluding this component still looks to be weak.

The Index growth rate has improved from -0.76% in June last year to +0.01% currently. Over two thirds of that lift is coming from higher commodity prices, which rallied 9.5% in AUD terms over the second half of 2023, having declined 17% in the first half of the year. Iron ore prices alone rallied from around US\$112/t to a peak of over US\$135/t around year-end. The December update could prove to be a temporary high-water mark for prices. The contribution from commodity prices could also reverse if the AUD appreciates.

Meanwhile, other Leading Index components are much more mixed. The second half of 2023 saw some positives from financial market components as the central bank tightening cycle showed signs of nearing a peak. The reduced drag from rising yield spreads added +0.31ppts to the headline index growth rate while a related modest rally in the S&P/ASX200 added a further +0.06ppts. Stabilising consumer sentiment has also helped at the margin, especially around labour market expectations (adding +0.25ppts to headline growth).

Westpac-MI Leading Index



However, other components continue to show residual weakness. In particular, a deterioration in hours worked has taken 0.29ppts off the headline Index growth rate since mid-2023. Soft reads on dwelling approvals and US industrial production shaved the pace back a further 0.10ppts.

The Reserve Bank Board next meets on February 5-6. Recent economic data has continued to point to slow, below trend growth in Australia. While Leading Index reads have been showing some improvement, the signal is not convincing. Prospects still looks mixed at best.

For the RBA, high inflation remains the primary concern. As such the quarterly CPI release on January 31 will still be critical to its policy decision in February. On balance, we expect the RBA to leave rates unchanged in February, and to be unlikely to raise rates further from here. However, a material upside surprise on inflation would make for a more finely balanced decision.

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