PAYTON

PAYTON CAPITAL ECONOMIC UPDATE

September 2022

CONFIDENCE IS KEY

Households sit at the centre of Australia's economic narrative. They are the engine room driving three-quarters of the spending in the Australian economy.

With the 2022-23 financial year underway, households again find themselves affected by extraordinary forces. On the one hand, interest rates are rising at record pace, house prices are falling and consumer prices are rising, driving down purchasing power. On the other hand, accumulated savings are strong; the savings rate remains high; and the labour market is very strong: unemployment is at lows most workers have not seen in their lifetimes.

The balance of these forces will determine the fate of the economy, but estimating their net effect has never been more challenging.

Aggressive rate hikes are designed to cool the household sector, and the RBA expects unemployment to rise from its current lows as rate hikes bite. But the strong wage growth expected as a result of a tight labour market has not yet arrived, meaning the inflationary impulse of a labour price spiral is not locked in.

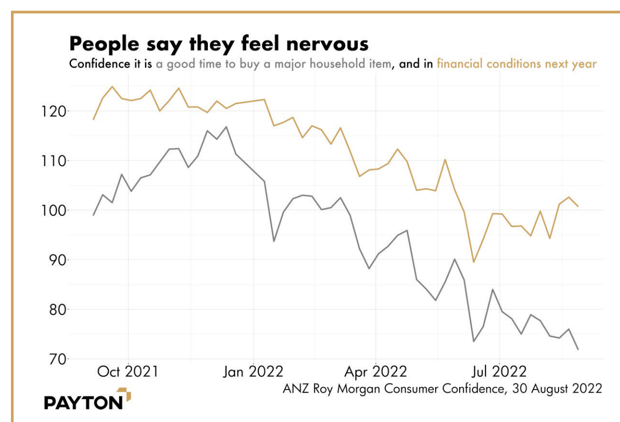
With evidence that the housing market is already cooling, market expectations of peak interest rates are falling. It is certainly possible a shorter-than-anticipated rate-hiking cycle will be required to reduce inflationary pressures, bringing with it less collateral damage to labour markets and a faster return to normal.

WHAT HAVE WE SEEN?

CONSUMERS

The RBA sharply downgraded its household consumption forecasts in August, just as it lifted the inflation forecast and downgraded forecast GDP growth. It expects consumers enthusiasm to fade away, but how do consumers feel right now?

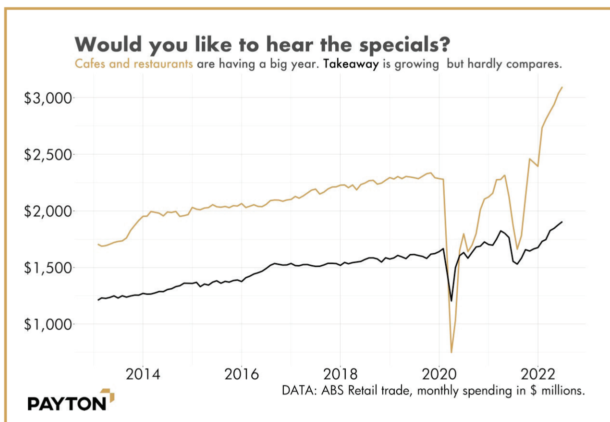
Consumer confidence is at a dramatically low level. Consumers told ANZ-Roy Morgan Australian Consumer Confidence researchers that it resolutely was "not a good time to buy a major household item", and reported their confidence in "future financial conditions" was at levels similar to those seen in the early stages of the pandemic.



Sounds bleak. Actions speak louder than words however, and when it comes to spending we observe action aplenty.

Retail trade figures are in an upswing - and not just because prices are higher. Retailers are moving higher volumes of goods - up 1.4 per cent in the last quarter, and consumer spending is not just on the basics - it extends to the discretionary realm.

For example, spending on cafes, restaurants and takeaway food was up 1.8 per cent in July alone (seasonally adjusted). As the next chart shows Australians have headed back to the restaurant table with gusto.



This hints at an Australian consumer with rather more confidence than they are letting on. But can it last? The upcoming federal budget, wage growth, house prices, headlines from the US and Europe, the war in Ukraine, and possible mutations in SARS-CoV-2 will all affect household spending and the prospects of the Australian economy.

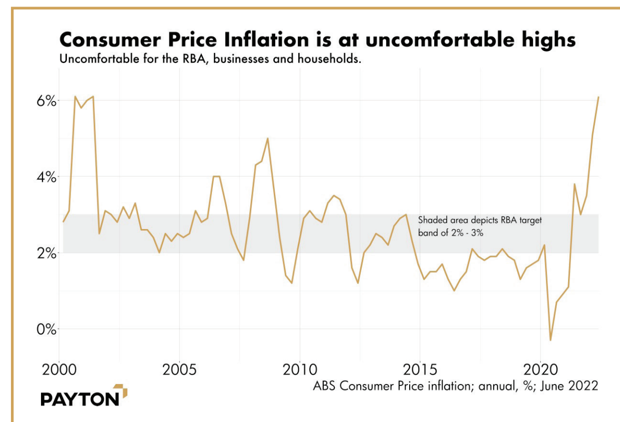
However, the biggest challenge of all is the dance between central banks and inflation.

INFLATION

In the latest US data, we saw a shred of hope with inflation falling from 9.1 per cent in June to 8.5 per cent in July. Is it happening? Is inflation reversing? Is the Fed winning? Could inflation have been transitory all along?

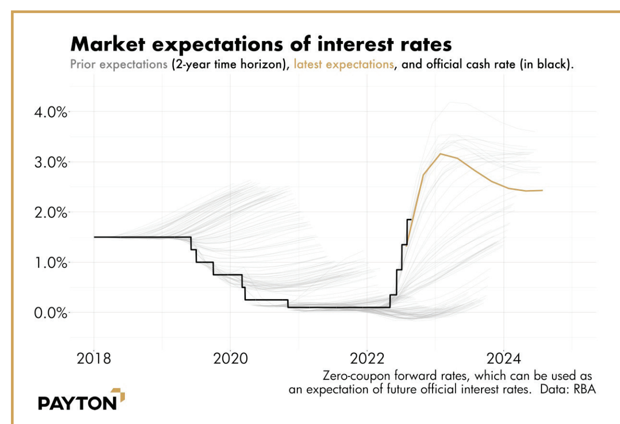
Anyone hoping a single good data point might slow the monetary policy juggernaut would have been disappointed when, at the Jackson Hole Economic Policy Symposium in late August, US Fed Chairman Powell said fixing inflation would "take some time," and would "bring some pain to households and businesses."

Australia gets our inflation data points quarterly and that means each one packs a punch. The latest report was something of a knockout, with annual CPI rising 6.1 per cent, the highest rate since the introduction of the GST over two decades ago, as the next chart shows.



The RBA noted that "[g]lobal factors explain much of the increase in inflation", but still reacted strongly, lifting interest rates by 50 basis points.

After an initial pause the RBA has certainly been aggressive in lifting interest rates. As the next chart shows, they raced well ahead of market expectations with a series of 50 basis point rises.



That "front-loading" has been enough that the market is now predicting an overshoot, with official interest rates expected to fall in 2023 before settling just under 2.5 per cent. The gold line on the above chart is the most recent iteration of the faded grey lines; like them it shows the market expectations of rate rises for two years.

THE PATH

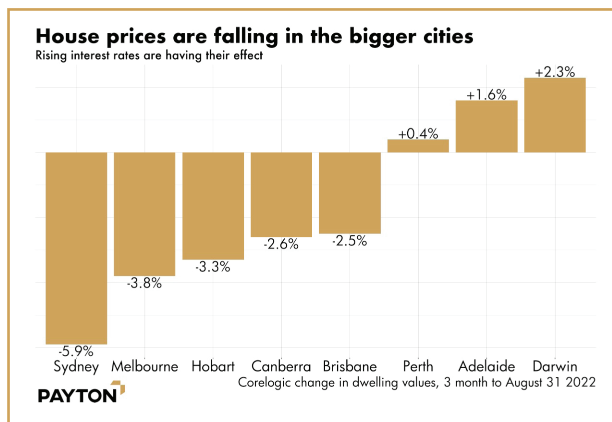
During the pandemic the RBA Governor liked to use a metaphorical "bridge" that would lead us to the other side. Having now reached the far side, his metaphor has changed to "a narrow path", "clouded in uncertainty". What he doesn't say aloud is what happens if the RBA sets a foot off that path.

To stumble in one direction allows inflation to run amok without taming it, lifting inflation expectations in a way that locks in an inflation spiral. A fall in the other direction squeezes economic growth too vigorously, causing an economic contraction and a labour market collapse that lifts unemployment.

What complicates the RBA's journey is an inability to confirm it is on the right path before taking each step. Interest rate hikes take time to work. If fiscal policy is like sugar in your diet, monetary policy is like iron. The rate hikes that have been delivered in 2022 will be absorbed slowly by the economy and their effects will show up in activity during 2023 and even 2024. If the RBA has in fact erred incorrectly, it could be too late.

HOUSE PRICES

Falling house prices began in Sydney and Melbourne several months ago, moving from the inner suburbs outward. They have also spread to other capital cities. This pattern was seen in the last house price fall, during 2017-18. Back then a combination of tighter macroprudential policy and wavering confidence caused a slide in house prices. This time the reason for falling house prices is plainer: It is about monetary policy.



A tight cluster of house price forecasts has been issued from the major banks:

- Commonwealth Bank expects a fall in house prices of 15 per cent by mid-2023;
- ANZ says a fall of 15 to 20 per cent by end 2023;
- Westpac says a 16 per cent fall, and a recovery in 2024;
- NAB says a fall of18% by end-2023.

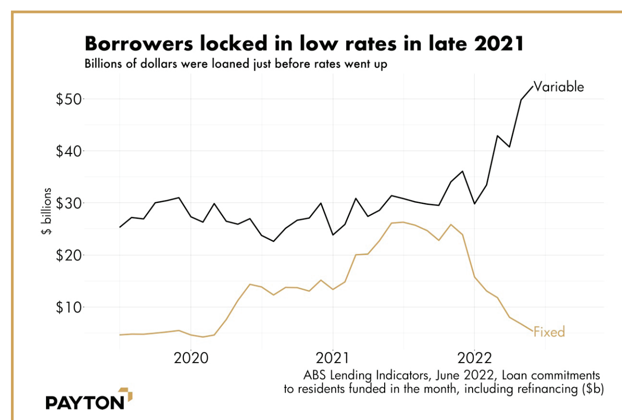
But what will this do to the economy? And to inflation? Interest rates rises are designed to crimp the economy by reducing cashflows and wealth. Home-owning households are the surface on which interest rates grip.

THE CASH-FLOW CHANNEL

Official interest rates have risen 1.75 percentage points, adding an estimated $540 per month to the average new variable rate owner-occupier loan of $600,000. Can borrowers afford it?

The RBA thinks yes. Australian households appear to have been extremely frugal during the pandemic, increasing mortgage pre-payments from a median of 10 months of prepayments to 21 months. That means being nearly two years ahead on the home loan.

Higher repayments are not hitting all households, not yet. Australian borrowers made a shift during the pandemic, adopting fixed-rate borrowing with enthusiasm. So instead of getting immediate traction in those household budgets, the RBA must wait for the fixed period to expire. And with many not expiring until the second half of 2023, the RBA might have to go hard and early to make any impact with rate rises.



Higher repayments are the obvious way in which higher interest rates dampen the economy, but they are not the only way. When house prices fall strongly, the wealth effect becomes even more significant.

Aussies who feel their house is worth less are much less likely to go and drop money on a new Porsche.

House prices are the single largest contributor to household wealth, especially for older Australians. For a given fall in house prices, the wealth effect would strip twice as much consumption from households aged 55-64 compared to those with a 25-34 year old household. And that's in proportional terms, not dollar terms.

Given the ageing population of Australia and the rise in housing wealth in recent years, wealth effects of interest rate hikes are likely to be an even more important source of monetary policy transmission than during the last hiking cycle.

WHERE ARE WE NOW?

Petrol prices will jump at the end of September with the expiry of the 22.1 cent per litre excise tax cut. The new Government has promised that cut will not be extended in the October Budget. Without more general falls in the price level, a jump in petrol prices could be expected to temper consumer enthusiasm.

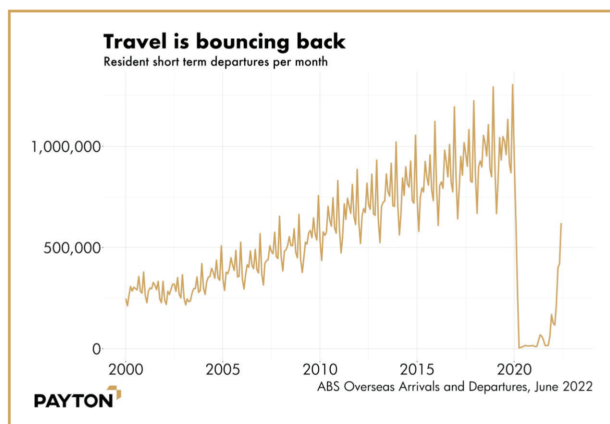
At time of writing, oil price futures have returned to early 2022 levels, but that may not be sufficient to energise consumers. Global oil prices prevailing in early 2022 caused prices at Australian pumps that were, at the time, historically high. A more complete normalisation of global energy markets would help bring petrol prices back to levels Australians are used to, but that seems unlikely.

CONSUMPTION, BUT IN THE WRONG PLACES

There is one way in which a resurgent Australian consumer can be a net negative for Australian consumption. That is if their department store spending is in Harrods and Bloomingdale's and their restaurant spending is in Soho and Midtown.

Australians stuck spending in Australia provided the invisible fiscal stimulus of the pandemic. Now Australians are taking off overseas again, that functions for GDP like an import. The loss of that spending in Australia may well be noticed by local restaurateurs, retailers etc.

As the next chart shows, Australians are getting back into travel as though they want to make up for lost time. The rise in the chart is almost as steep as the fall was.



Whether outbound travel will be reciprocated by incoming foreign tourists remains to be seen - Australia's tourism is like our exports of iron ore: mostly about China. While Chinese (and Japanese) tourists are still confined to their countries, our chances of seeing much tourism on the export side of the ledger are uncertain.

GROWTH

Australia's growth prospects are tied to the prospects of the global economy. Global growth amid rising interest rates is far from certain. Indeed, a US or European recession represent CBA's "base case" for those economies.

Meanwhile China is not growing like it was. So long as China pursues a zero-covid strategy, it cannot be relied on to perform as the growth engine it has been. Retail sales in that country are down as its citizens navigate rolling lockdowns that would seem harsh even to Victorians.

Without US, Chinese and European growth impulses, the chances of strong Australian economic growth in late 2022 or early 2023 is reduced. But the chance of strong inflation and the need for the RBA to act would also be reduced.

WHAT DO WE SEE?

BUDGET

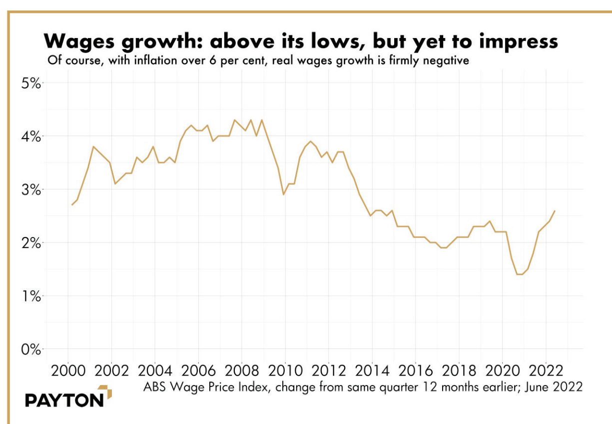
The upcoming federal budget is unlikely to be an especially happy one for households. New Treasurer Jim Chalmers has promised to combat inflation and reduce the deficit. That means reducing spending. The political imperative is the same. At this point in the electoral cycle - the ink is still drying on stories about the government's first 100 days, so a budget stuffed full of sweeteners is unlikely.

Of course, Chalmers doesn't want to preside over a recession either. Managing the level of fiscal stimulus to keep the economy humming should be at the forefront of budget planning. Like the RBA Governor, he walks a narrow path, and nowhere is this more evident than in trying to sustain a strong labour market without generating excess inflation.

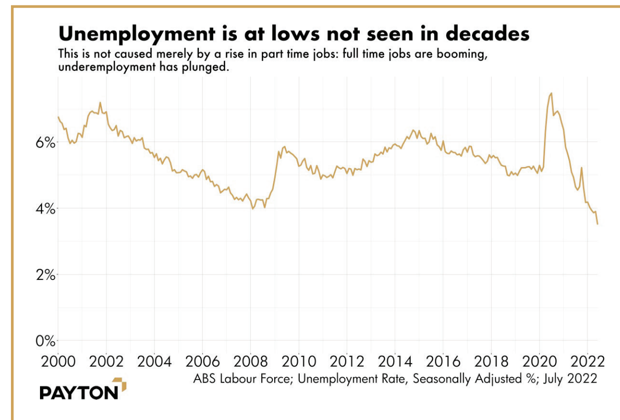
WAGES

The new Treasurer says "stagnant [wages] have been the defining problem in the economy now for the best part of a decade". It is true. Wage growth has struggled to stay above 2 per cent recently - the bottom the of RBA's target band for inflation - let alone above 3 per cent.

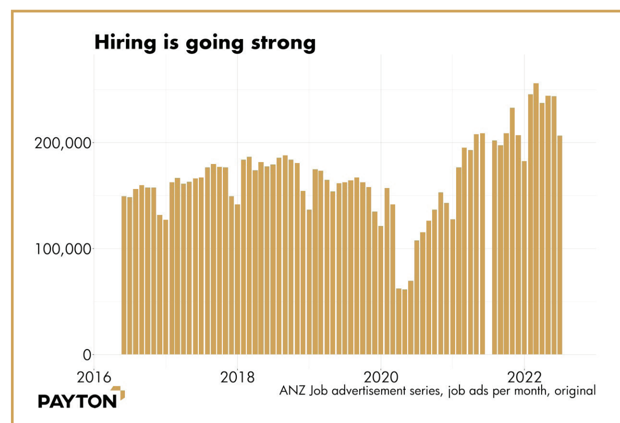
Chalmers hopes that by lifting productivity and changing wage-bargaining arrangements, higher wage growth can be locked in (preferably only after inflation is brought down as raising wages too soon might contribute to inflation).



The economy that delivered us roaring inflation has also ushered in an unemployment rate that would be unfamiliar to most Australians: one starting with a three, as the next chart shows. That is the greatest real reason to hope that wage growth could turn around and start to climb once again.



But Treasury forecasts unemployment to rise to 4 per cent by 2023-24. That seems to imply that Australia's current abundant job vacancies will be filled and job advertisements dry up, leaving people unable to find work. It is not clear whether wage growth will arrive in those circumstances.



Is it the level of the unemployment rate that matters to household confidence - below 4 per cent is still good! - or is it the direction in which the labour market is moving that sways household spending? If the labour market is shedding jobs and wage growth starts to look further away, does confidence dry up and spending ebb?

This may be the turning point for Australian economic policy-making entities. Because if households stop spending in a weakening labour market, the engine room of the economy begins to stutter and stall. And then - to the extent that inflation is domestically generated - low inflation will be in sight and rate rises can come to their natural conclusion.