Royston Capital
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Economic Update

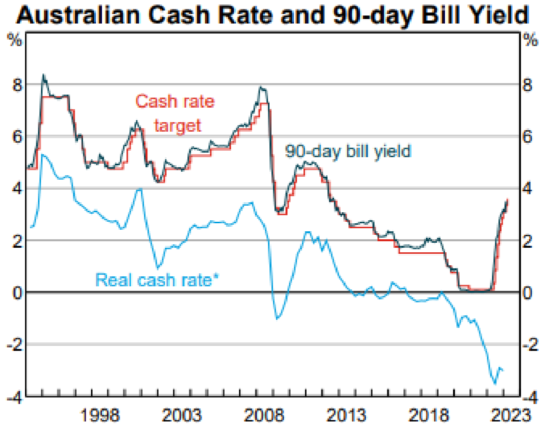
Time to Pause

April 2023 edition, By Chris Boag

As the month of March commenced, a crisis was emerging within US regional banks that threatened to spiral out of control. US regulators were quick to step in and did so in decisive manner. It was not enough to stop markets testing other banks that have showed some weakness and this resulted in the swift downfall of Credit Suisse. Much of the issues in the banking sector seem to have been quelled for now. The RBA may have taken some of the US regional banking issues on board when setting interest rate policy for the month when it decided to pause after 10 consecutive interest rate increases. This decision was probably made easier by OPEC+'s decision to cut production by over 1m barrels per day from 1 May. The outlook indicates inflation is falling and that GDP growth will slow throughout the year with some economies likely to have a harder landing than others.

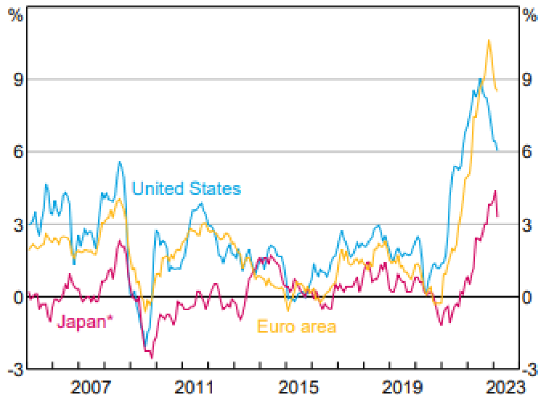
The RBA decision to pause interest rates was widely tipped by bond markets and economists alike. I was tipping that the RBA would be more likely to pause at its April meeting, and/or after the US had paused, to maintain a higher AUD$. I certainly have egg on my face! Bond markets have proven to be a very reliable indicator of interest rates.

Australian Cash Rate and 90-day Bill Yield



* Calculated using average of year-ended weighted median inflation and year-ended trimmed mean inflation.
Sources: ABS; AFMA; ASX; RBA

Inflation – Advanced Economies
Year-ended



* Excludes the effects of the consumption tax increase in 2014.
Sources: RBA; Refinitiv

The RBA does have good reason to pause. The fixed rate mortgage cliff is upon us, there is significant uncertainty surrounding the US regional banks and the likelihood of tighter credit conditions, Credit Suisse has just collapsed and been folded into UBS, and economic activity is expected to slow after 10 consecutive rate increases. They noted that the decision to pause provides "additional time to assess the impact of the increase in interest rates to date and the economic outlook". This is despite global inflation remining very high and well above target. In Australia, CPI has fallen from circa 7.8% to 6.8% recently.

There were a couple of items of note in the RBA minutes. Wages growth is increasing in response to continued tight labour markets and inflation. In aggregate this is consistent with the inflation target if productivity growth lifts. This seems unlikely at present. Households had built up savings buffers during COVID however its seems that only some now have substantial buffers while others are now experiencing a painful squeeze on their finances (those with big mortgages we presume). The overall savings rate is now back below pre-pandemic levels.

This may have contributed to the RBA making a small but meaningful change to guidance. Lowe softened his comments from March "further tightening of monetary policy **will** be needed" to April's

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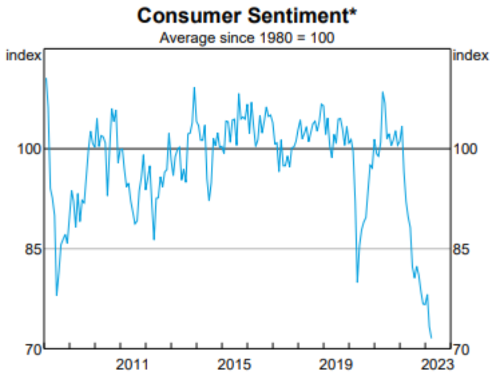
"further tightening of monetary policy **may well** be needed". I note that the US Fed Chairman, Jerome Powell has also made a similar change to their wording and may have been the signal the RBA needed to pause without too much damage to the AUD$.

Lag effects are frustrating for policy makers with consumption remaining a key source of uncertainty. Consumer sentiment is falling rapidly and will eventually manifest into lower spending. It's only a matter of time, combined with lower savings, before spending drops and demand for goods and services falls more materially. The tightening cycle is close to its end, but the economic consequences are yet to be fully realised.



* Average of the ANZ-Roy Morgan and Westpac-Melbourne Institute consumer sentiment measure of respondents' perceptions of their personal finances relative to the previous year; ANZ-Roy Morgan index rescaled to have the same average as the Westpac-Melbourne Institute index since 1996.
Sources: ANZ-Roy Morgan; RBA; Westpac and Melbourne Institute

In the US this reality has been notable with several lightly regulated US regional banks encountering trouble triggered by rapidly rising interest rates. Much has been said in the news and I note that despite the potential for a much larger issue to emerge, regulators have acted swiftly and decisively to put out spot fires. Credit Suisse threatened to be a significant issue too, owing to poor management and decision making over a number of years, it would seem the forced sale to UBS is a timely end to the 167 year old organisation.

Positively, the US Personal Consumption Expenditures (PCE) price index for February was modestly better than expected and trending lower. Headline readings have risen month-on-month, but the annual rate is easing from 4.7% to 4.6%. While the trend is encouraging, the readings are still too high and comfortably above the target 2-3% range. There is still more work to do, and markets are pricing in a 58% chance of the Fed lifting rates by 25bpts on the 3rd of May.

Recent releases from the US Census Bureau and the US Bureau of Economic analysis indicate that real personal consumption expenditures growth, real gross private domestic investment growth, and real government spending all decreased, resulting in a meaningful reduction to overall real GDP growth forecasts. Several leading indicators also suggest a slowing US economy. These included ISM Manufacturing index, new orders, employment, and prices surveys all recording numbers below 50 indicating slowdowns. Manufacturing is now technically in a contraction and is a clear sign recessionary pressures are mounting. The knock-on effect is lower corporate profits.

China, whose economy remained shut for longer, is recovering fast. They are clearly on the same pandemic trajectory that other economies are on, just a long way behind. China is loosening credit conditions, and this is likely to lead to improved consumer confidence and more confidence in the property sector. This is positive for Australian miners and US manufacturing.

The US regional banking crisis, while under control, will lead to tighter credit conditions in the US. The impact will be felt by the Australian banks by way of higher funding costs, not through any crisis in confidence for the quality of our banks. Interest rate increases look to largely be done now in the US and Australia. With high migration in Australia, we are not likely to see any sort of hard landing. In fact, we may see a housing led recovery.

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Sources: Royston Capital, Morningstar, CBA Global Economics, MST Marquee, RBA.