# Economic Update

## Smooth Sailing Through to Christmas

*November 2023 edition, By Chris Boag*

Last night (14 Nov) may have been the moment that investment markets finally became satisfied that the US Federal Reserve had managed to control inflation. US CPI came in at the bottom end of expectations and YoY Core CPI is rising by 4.0%. This is the slowest pace of increase since Sep 21. Weaker inflation comes despite the stronger economic backdrop, remember domestic demand grew by an annualised 4.8% in 3Q23 and set to grow by an annualised 2.5% in 4Q23 (according to the Atlanta Fed nowcast). All this suggests the decline in inflation has been more of a function of supply side issues being resolved. From here our US team (Julia Coranado of MacroPolicy Perspectives) forecast inflation to fall further and are expecting Core CPI to reach 2.5% by 2Q24.

The FOMC kept rates on hold at its November meeting at a range of 5.25% to 5.5%. The Fed Funds Target rate is at the highest level since 2001. Powell made clear the FOMC is trying to answer two questions. First, what is the right interest rate to get inflation down to 2%? Second, how long should rates be at this level? On the first question it appears Powell thinks we are there. His discussion on the real fed funds rate, using year ahead inflation expectations, suggests the FOMC governor has raised rates enough. He also noted that the latest dot-plots in September, which indicate another hike before year-end, reflect the view of the FOMC at a certain period of time. FOMC member individual forecasts have been updated since then.

On the second question Powell revealed less but on several occasions in the Q&A session he did point to the strong economic growth in 3Q and is possibly the reason he has not adopted a more dovish stance. Powell did talk about some of the differences this cycle including the increase in the productive capacity of the economy via a rise in the participation rate and boost from migration (Australia is benefiting from the same forces). However, it seems he would like to see further evidence that this is genuine supply side benefit and will not feed into higher inflation.

Powell believes QT has only had a small effect on bond yields. He also noted the Fed is not looking at ending QT yet and suggests the level of Fed reserves remains high. Powell also highlighted the obvious difference between the conflict in Ukraine and the middle east has been the effect on the oil price. The war in the Ukraine resulted in a material increase in oil prices (and future inflation) while the current middle east war has yet to be a material driver of oil prices, just yet.

The increase in bond yields has been driven by several factors but now we see reason why they should be range bound around 4.5% to 5%. We think the upside is capped because of slower economic growth, falling inflation and the end of the hiking cycle. Also, we think the downside in bond yields is capped as economic growth will remain solid (if not slower) and bond issuance will remain strong courtesy of the Treasuries 5-6% fiscal deficit. It suggests the direction of the equity market will be more driven by profits than discount rates. While the US 3Q23 earnings season was weak with EPS forecasts for both calendar 2023 and 2024 coming down by more than 1%, the direction of profits is higher and supported by a relatively buoyant economic backdrop. In Australia the profits backdrop is stronger with EPS momentum inflecting higher more recently. We think broad equity indices have adjusted to higher bond yields, but more valuation adjustment may need to occur.

US inflation is no longer a major concern for investors……….*but* it doesn't mean a bond rally is about to begin. Falling inflation helps to confirm the cap in bond yields this cycle is around 5%. However, we can't get too bullish on bonds given the still solid growth backdrop, large level of bond issuance courtesy of the 5-6% US fiscal deficit and, continuation of QT. The bond market will remain rangebound with the bottom for the US 10-year yield around 4.5%, close to where they are now. This is a reason why we are not chasing the bond sensitive stocks like the REITs, infrastructure, and high PE stocks. They will rally today (15 Nov), but this outperformance will not continue without falling bond yields.

The major debate with investors still revolves around the risk of a hard landing. Rapidly falling inflation diminishes the need for a too-hawkish-for-too-long central bank. MacroPolicy Perspective forecast the Fed to start cutting

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rates in 2Q24. By this time the real funds rates (nominal rate less core inflation) would have been around 3% for a couple of months. Still not high enough, for long enough, to deliver a hard landing, in their view. Lower rates next year (and we're thinking the RBA will start cutting rate in 2H24) should help stimulate a more forceful recovery in corporate profits and stock indices.

In Australia we saw the RBA raise interest rates. We felt that Michele Bullock (RBA Governor) really had no choice but to hike. The RBA has raised its trimmed mean inflation forecast by 60 basis points for Dec 23 and 20 basis points for Dec 24. Inflation is forecast to now be 4.5% and 3.3% respectively. In creating these forecasts, the RBA assumes the cash rate peaks out at '*…around 4.5% before declining to around 3½ per cent by the end of 2025.*' The cash rate is currently at 4.35%. The higher inflation forecast imply the hurdle rate for another hike has also been pushed higher.

The RBA has also lowered its forecast of the unemployment rate and wage inflation (note there will be a one-off spike this quarter). This appears to be because of a further increase in its assumption for migration and population growth. The RBA now expects population growth to have peaked during the September quarter at 2.5% and then it is expected to decline back down to a pre-pandemic average of 1.5% (no time-frame given). Previously the RBA forecast population growth to have peaked at around 2% and then expected it to decline to its pre-pandemic average of 1.5%. By lowering both the unemployment rate and forecast of wage inflation suggests the RBA acknowledges growth can come without inflation.

We've entered a wait-and-see period for markets. Investors are waiting to see the impact of the tightening cycle so far which would colour their outlook for interest rates and profits. Our view is that policy is still not tight enough to deliver a hard landing in domestic demand. Also, this cycle is different as it has come with several sources of resilience including (1) a still high level of savings, (2) strong migration and (3) strong business investment (RBA raised their forecasts here too). We think the Aussie profits outlook is in the process of bottoming out, the tightening cycle is over (for both the RBA and the Fed) and bond yields are range bound. Aussie equities can push higher but investors should avoid or be cautious with leveraged stocks and business models which will continue to struggle with higher-for-longer interest rates.

The economic recovery in China is finally here. It is late, it is not very sharp, it is not terribly broad either. Real GDP grew by more than 1% in the September quarter vs June and the acceleration made up for the weakness in the June quarter. The Chinese economy is on track to achieve the central government's 5% growth target for 2023. This follows 3% growth in 2022. The recent acceleration in GDP has been driven by a pick-up in consumption and continued strength in public infrastructure investment. Household consumption has improved partly because balance sheets have adjusted following a period of balance sheet stress during COVID. Back then jobs were lost, pay was cut, the social safety net weakened, and savings were depleted. Retail sales grew 5-6% in September. Auto purchases are growing by 10% YoY. Also, domestic tourism revenue during Golden Week (early October) has finally pushed above pe-pandemic levels.

To help ensure Chinese economic momentum continues will be the recent RMB 1 trillion stimulus announcement by the central government. It is worth around 0.8% of GDP but the impact on the economy is set to be larger given the multipliers. The money will be raised via the issuance of special treasury bonds and used to fund local government spending on disaster relief and prevention in 4Q23 and 1Q24. The Ministry of Finance said the money can be used for: disaster recovery; construction of reservoirs, dikes, urban drainage and other flood management projects; disaster response and management facilities; projects that prevent soil erosion and develop 'high-standard' farmland in the northeast of the country. The support by the central government differs from the framework used in the past. Typically, Beijing pushes local governments to bear the fiscal burden of infrastructure investments. As these are local-level decisions to benefit the local economy, it should be local governments which wear the cost. However, by focussing on disaster relief the central government has found a way to justify borrowing on behalf of the already indebted local authorities. We could see more of this in the future.

Early signs of economic momentum in China are encouraging and we believe the efforts so far should help generate an acceleration into the first half of 2024. However, the efforts so far may not be enough to generate solid growth

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into the second half of 2024. To help ensure solid economic momentum through all of 2024 we need to see a combination of: Boost to the fiscal impulse in 2024, Improvement in private investment, Stabilisation of the property market.

Aussie commodity producers have held up well this year despite the weakness in the broad equity market and the Chinese economy. The prospect of further stimulus in China has been a support here.

With the risk of hard landing diminishing, investors should gain more confidence about the medium-term outlook for cyclical company profits. Valuation multiples here appear cheap, especially when compared to more defensive stocks. There is a 10 PE point spread between Woolworths and Bluescope. While this is lower than levels a few years ago, still too high in a historical context and as the risks of a hard landing dimmish.  With the inflation dragon now slayed, it could mean smother sailing into Christmas for equity markets.

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