Outlook

Economic Backdrop and Interest Rates

26 September 2024

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Everything’s changed.

Labour shortages and the new economy

Demographic Change.

- Population growth is **slowing**, largely the result of declining fertility rates. Population is **ageing** driven by rising life expectancy and the retirement of the 'Baby Boomers'.

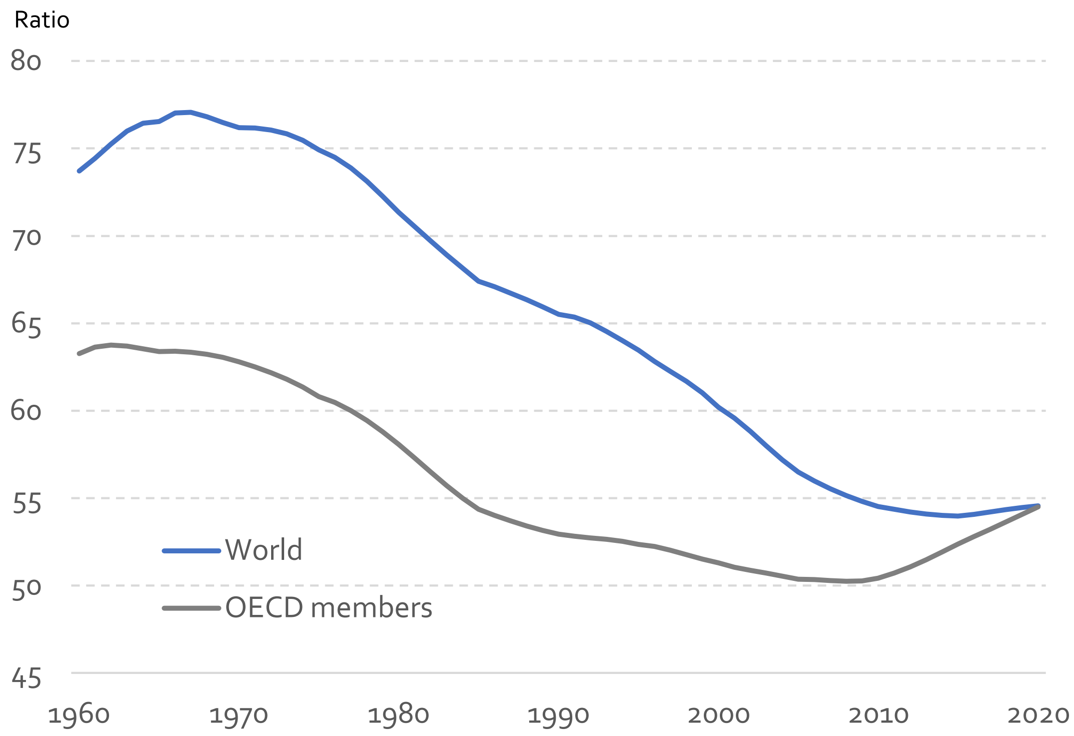
- These demographic processes are well understood – but it is dependency that is most important for the economy.

- **Dependency** is rising in most parts of the world reversing a 50 year trend. This is the ratio of non-working age (young and old) to total population. This fundamentally changes the relativities between supply (workers) and demand (total population).

- The economic impact of rising dependency is not well understood but it will lead to a structural rise in the cost of labour (wages) and capital (interest rates).

Global Dependency Ratio

After four decades of declining dependency, just about all high-income countries are now experiencing a rise in the dependency ratio

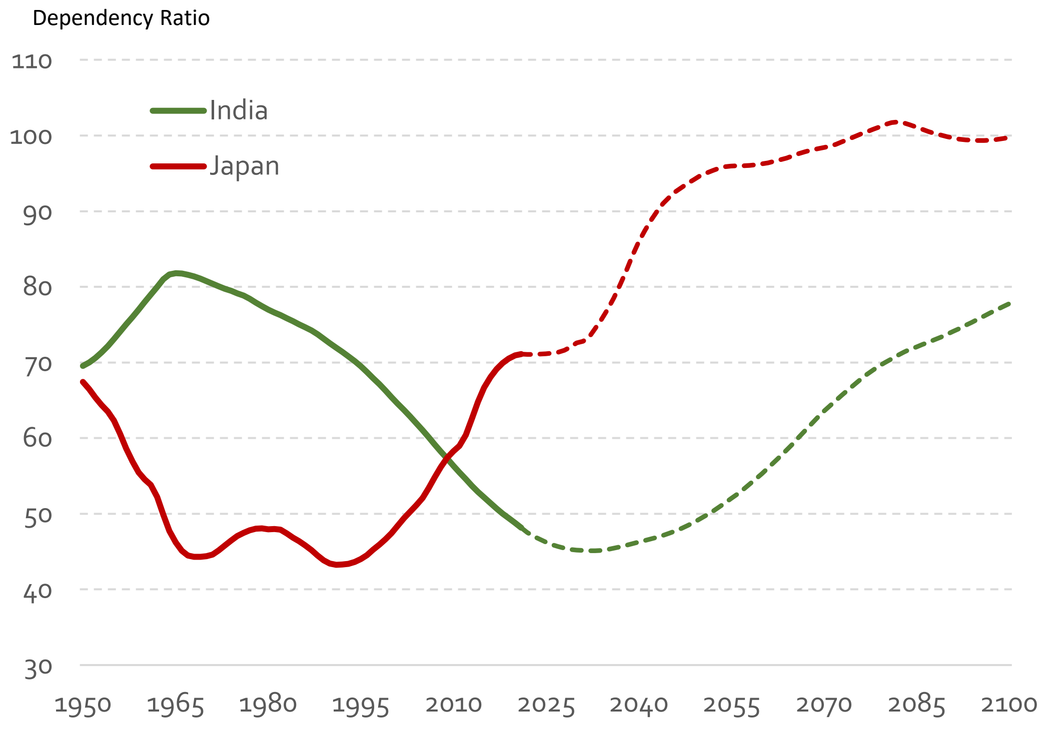


Source: UN, IMF, EQ Economics

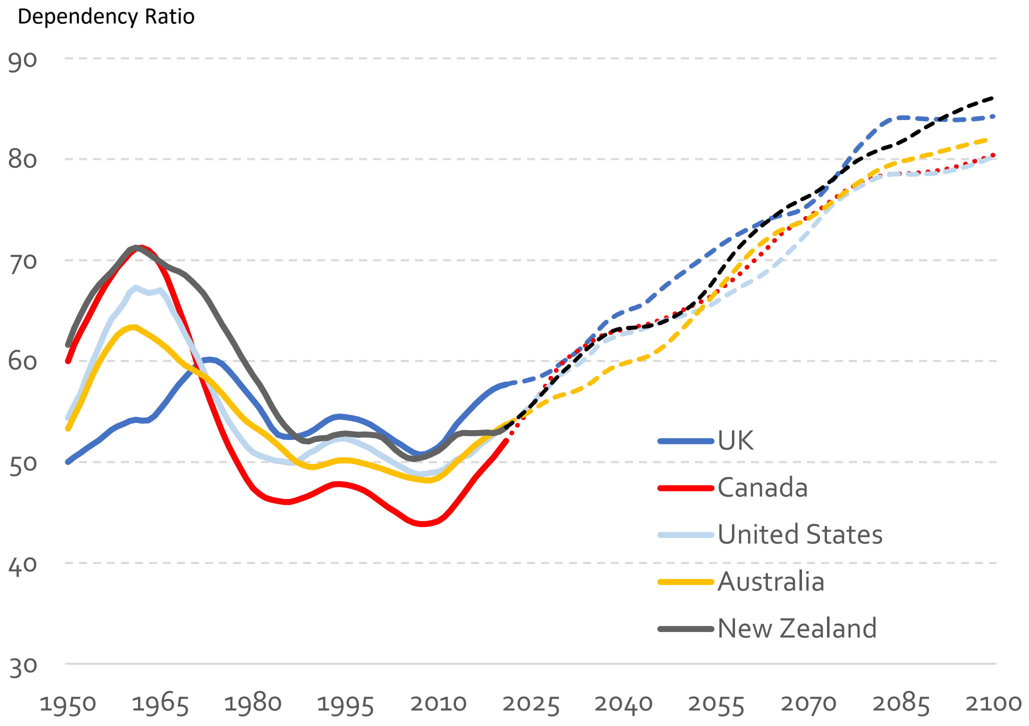
Dependency: international comparison

- India and Japan define the extremes of the global dependency cycle for the world's major economies – even India is 'bottoming out'
- The 'Anglo' countries have remarkably similar dependency patterns reflecting similar population dynamics and policies

Extremes: Asia



Anglosphere

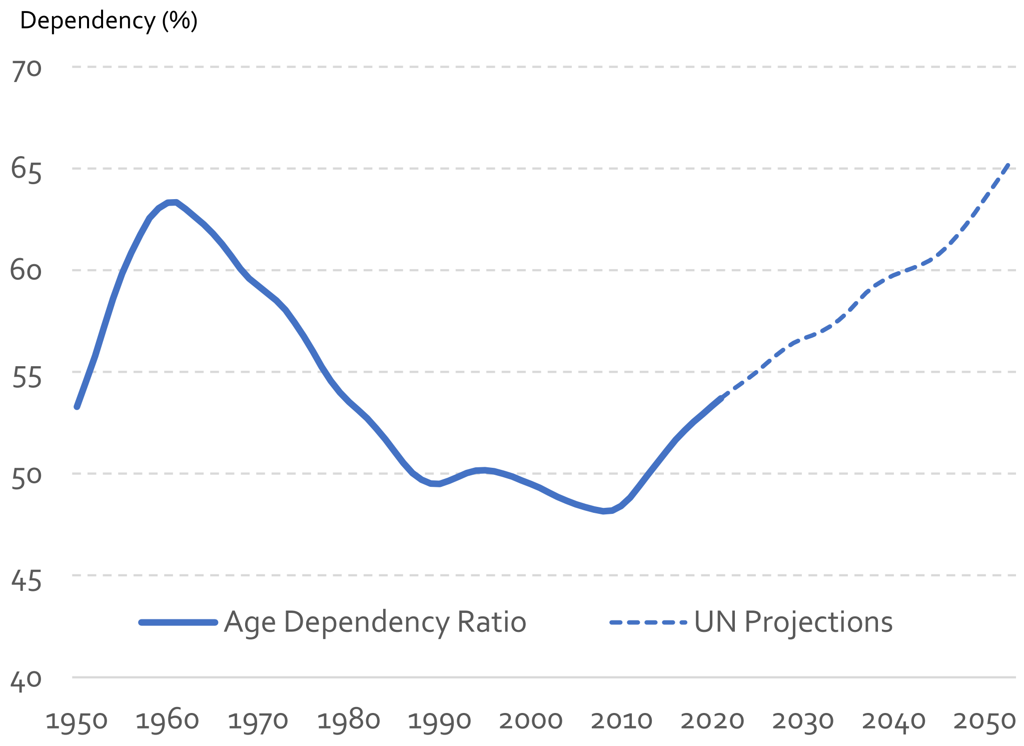


Source: UN, EQ Economics

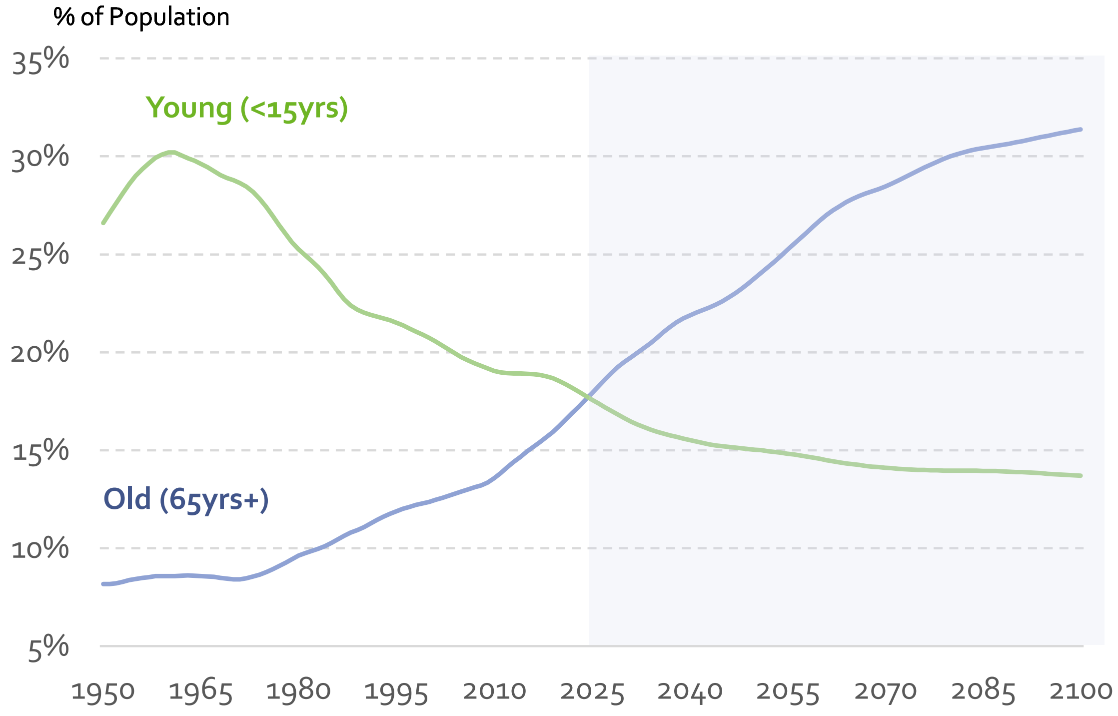
Rising dependency will reshape our economy

- We have passed through the turning point in a 50-year demographic (dependency) cycle which will transform our economy
- We have gone from labour abundance (unemployment as the problem) to labour scarcity (excess demand and inflation as the problem)

Australia's Dependency Ratio



Dependency Ratio: Australia (Old and Young)



Source: United Nations, EQ Economics

Economic implications of rising dependency.

- Excess demand for labour will put upward pressure on real wages and inflation.

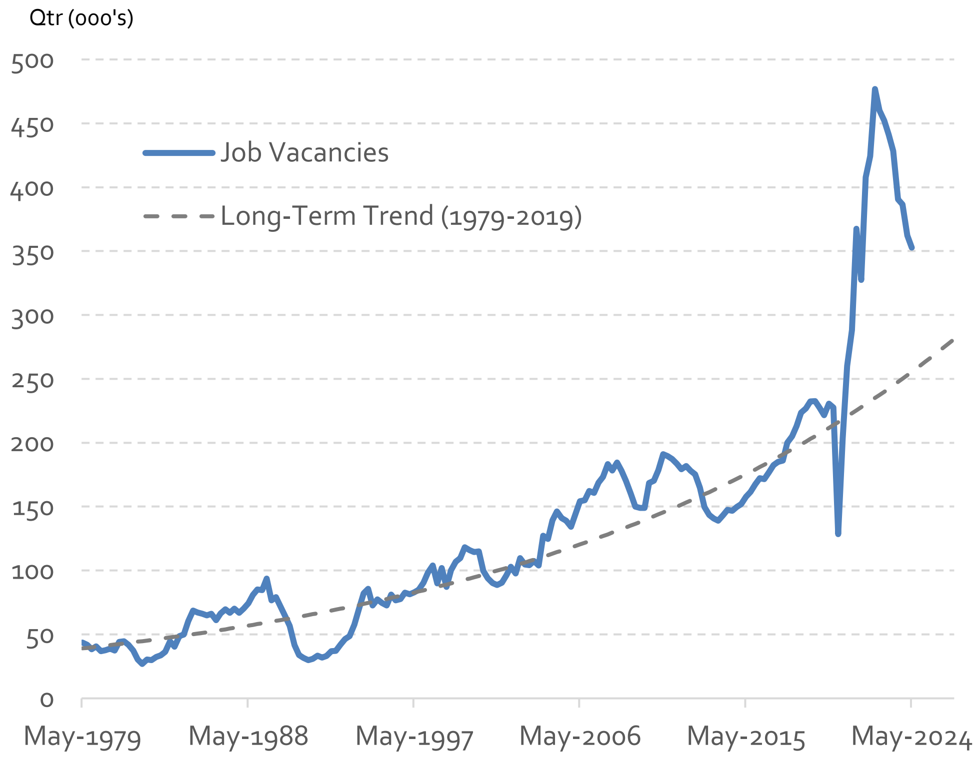
- Business can address labour shortages with two broad strategies:

  1. Accessing new pools of labour (outside workforce and overseas),
  2. Investing in labour saving technology.

- The turn in the demographic cycle (dependency) will shift the balance between saving and investment putting upward pressure on real interest rates.

Australian Job Vacancies

Labour shortages are already an acute problem in our economy



Source: ABS, EQ Economics

Supply Side Transformation.

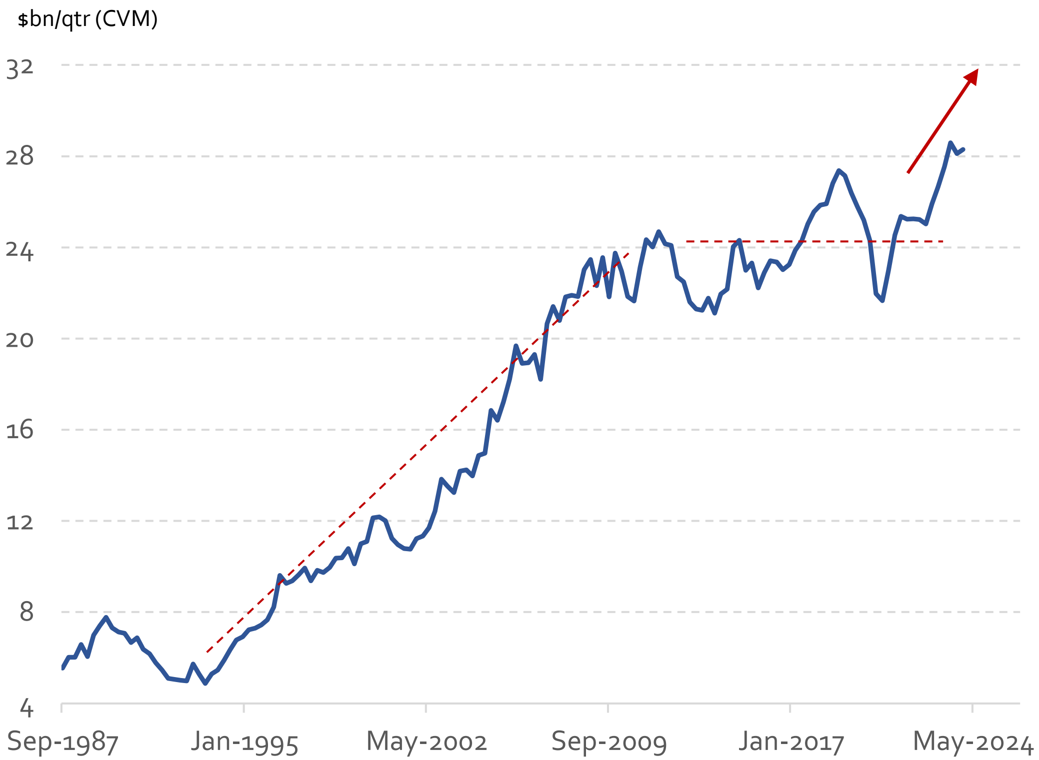
- **A business investment led economy?** Labour shortages, rising insolvencies, the energy transition and new technology, specifically AI, are all factors expected to drive a sustained lift in business investment.

- **Consumer consolidation:** The era of sustained household debt accumulation appears to have run its course in most advanced economies.

- **Rising business insolvencies:** Far from the economic disaster that a wave of business failures implies, removing 'zombie' companies from our economy will free up labour and create market space for stronger businesses which will then be more inclined to invest.

- **Deglobalisation:** or at least a pause in the process of globalisation will change investment flows and supply chains as international tensions introduce more uncertainty into a highly connected global economy.

Non-Mining Business Investment



Source: ABS, EQ Economics

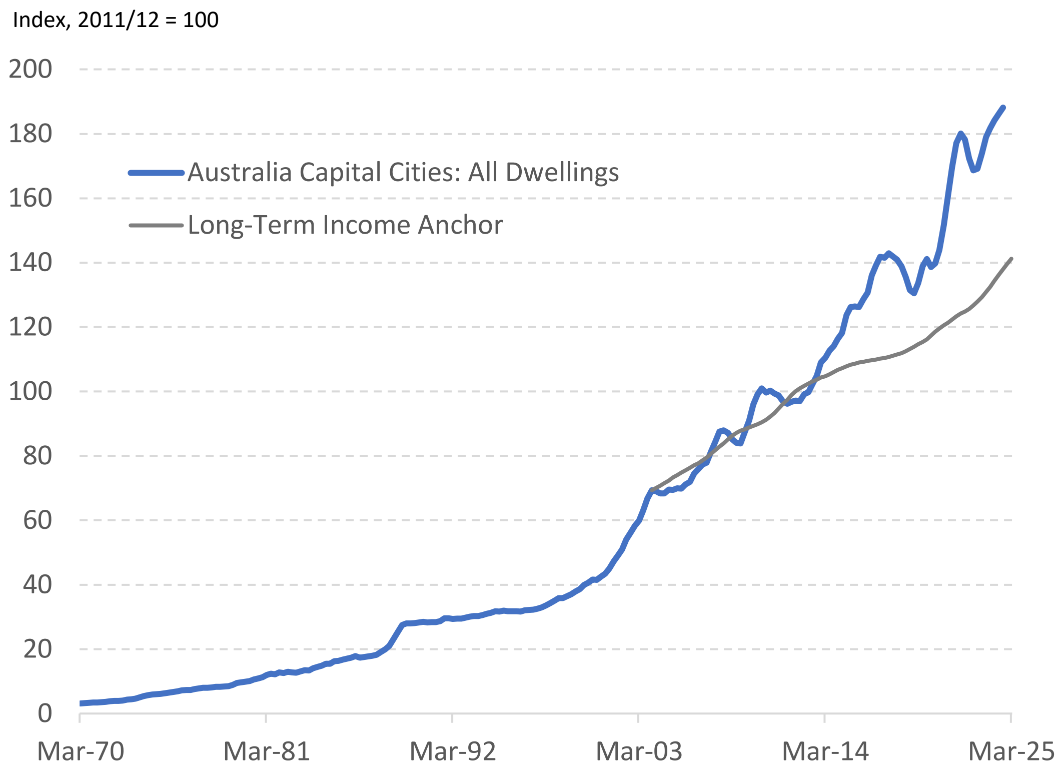
Australia's economic challenges.

Dwelling shortages, big government and productivity

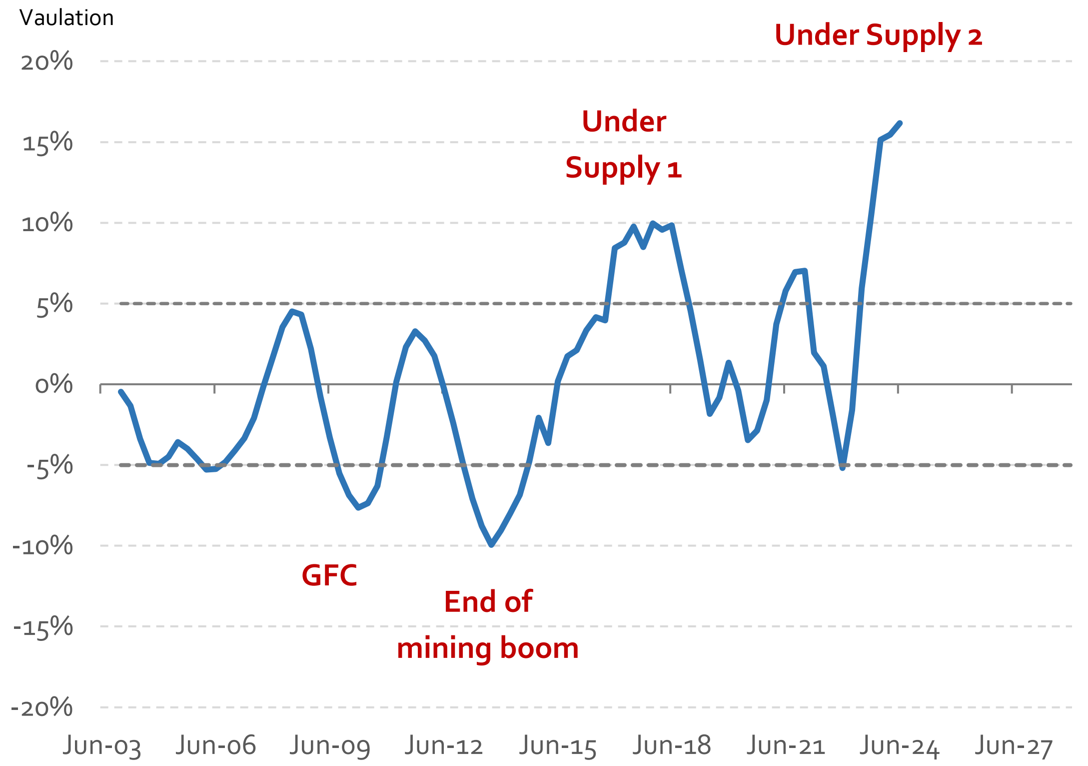
Housing has become extremely unaffordable

- Australian capital city dwelling prices were 26% ‘expensive’ to income in June 2024 (high of 32% in 2021)
- Factoring in the impact of interest rates reveals the impact of ‘undersupply’ in 2024 (and 2016-18)

House Prices vs Household Income



House Price Macro Valuation

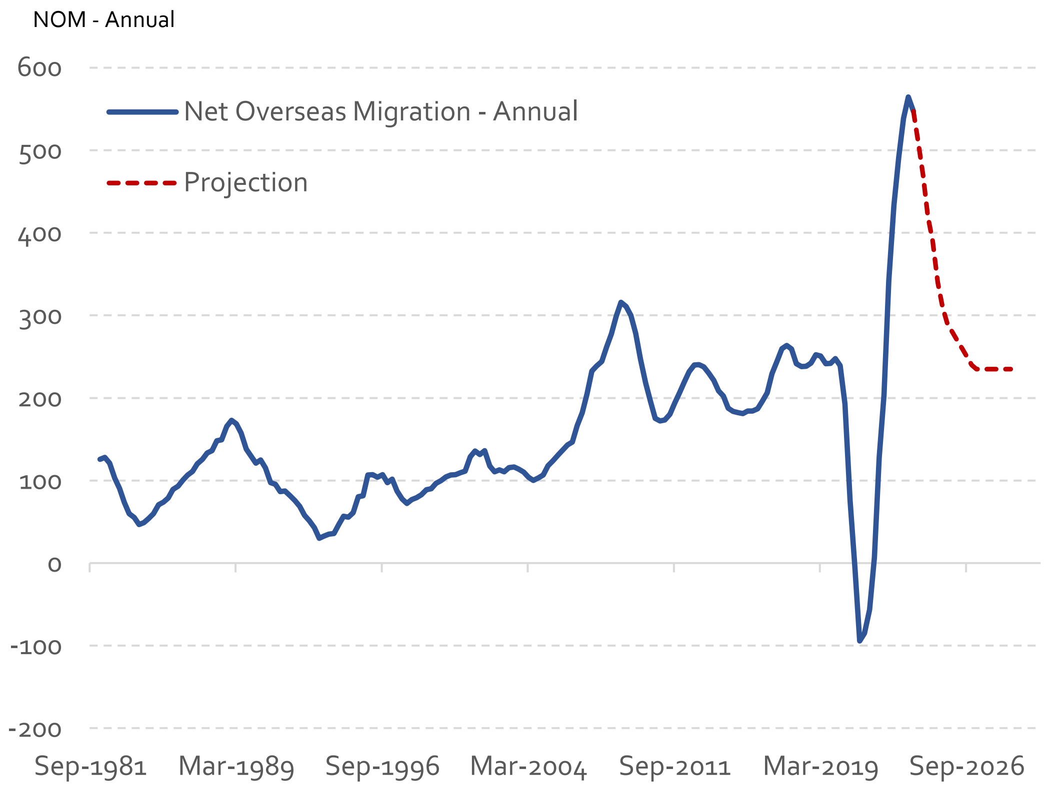


Source: ABS, EQ Economics

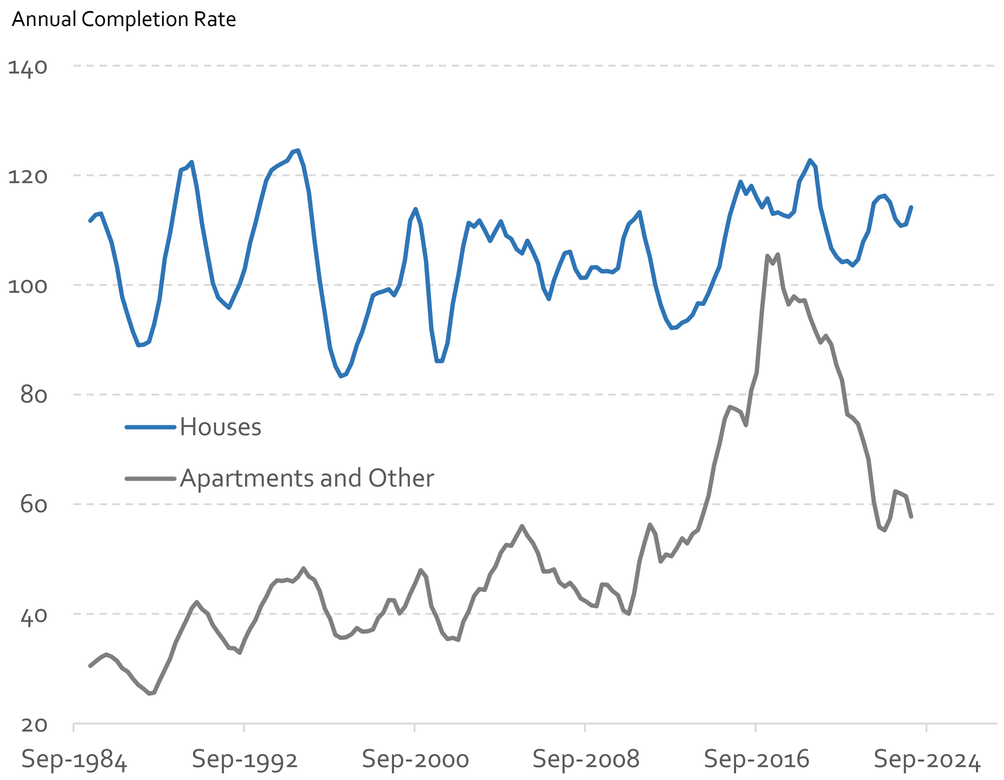
Australia experienced a shift up in population growth in 2006

- The Howard Government lifted Net Overseas Migration targets pushing up population growth by 120k a year from 2006
- Australia's construction industry responded with an east coast apartment building boom in the middle of the last decade

Net Overseas Migration (NoM)



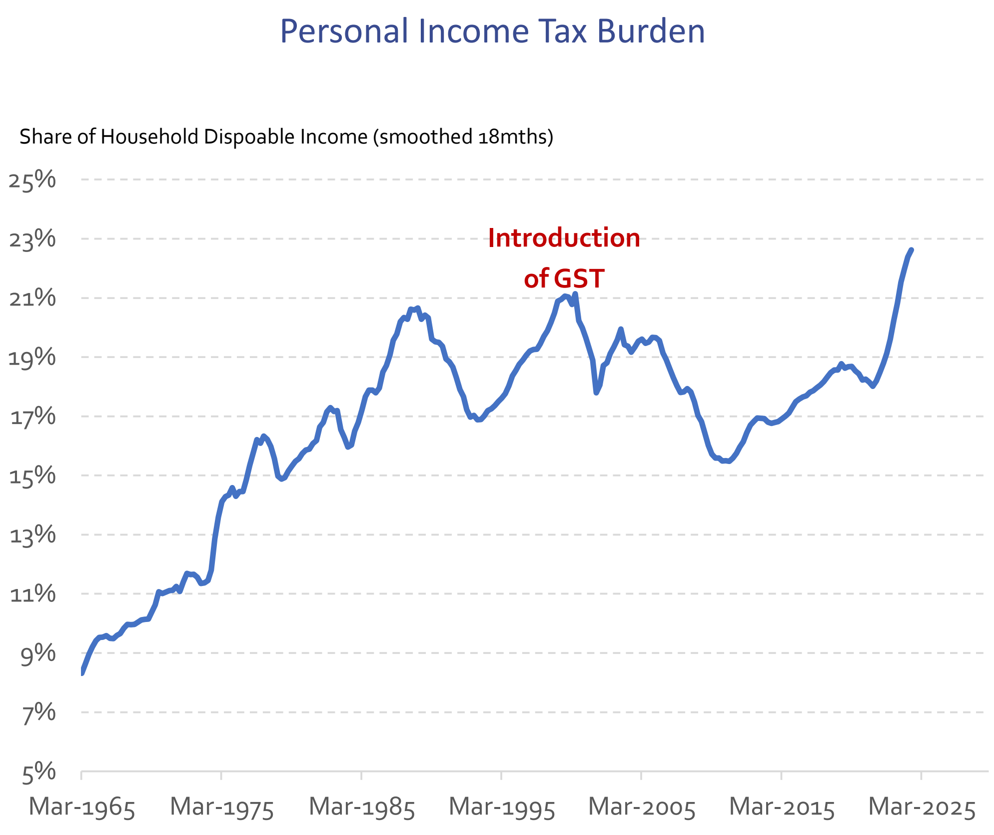
Dwelling Completions (Annual Rate)

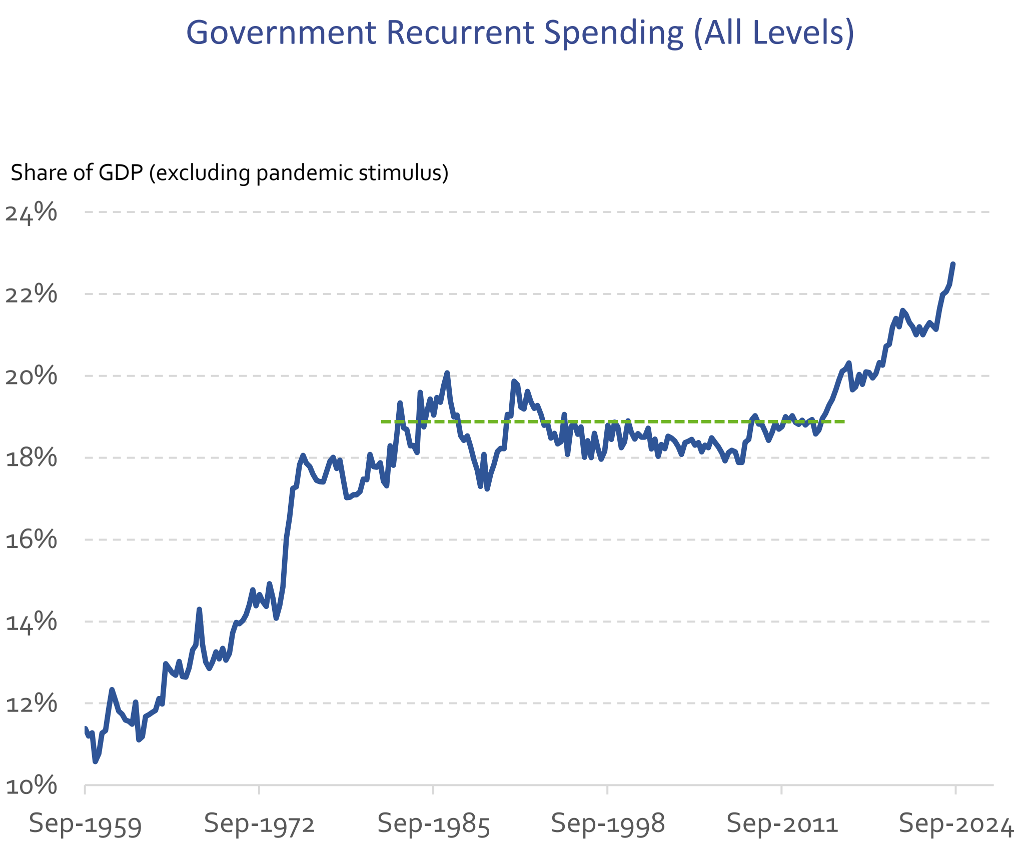


Source: ABS, Judo Bank

Bracket creep has driven the income tax burden to record highs

- The income tax burden is higher than when the GST was introduced in 2000 – with more money comes more spending
- Government spending as a % of GDP has jumped 3 percentage points in less than a decade to the highest level (excluding the pandemic) on record.



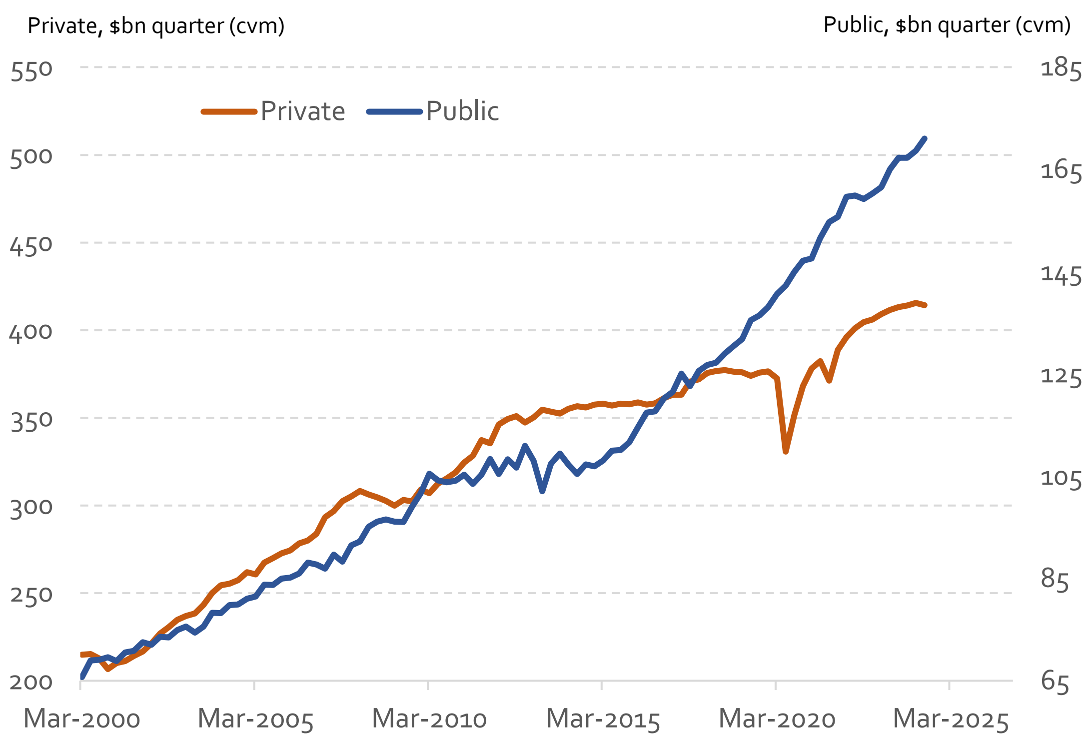


Source: ABS, Treasury, EQ Economics

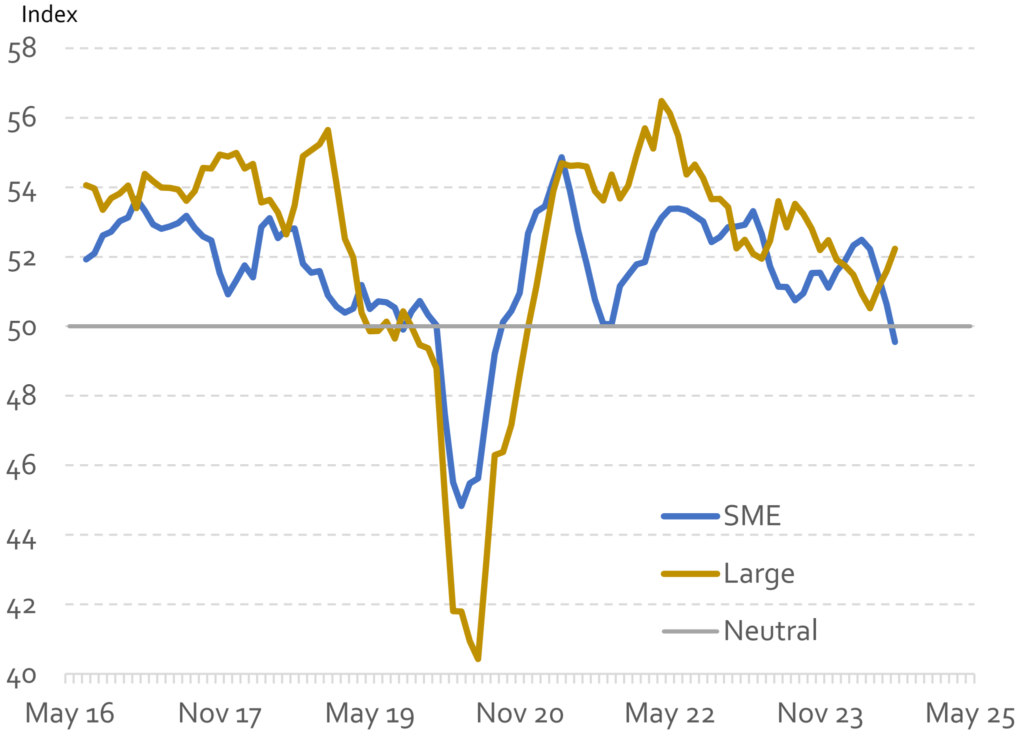
Public and quasi-public sector jobs dominate hiring

- Since 2015 public demand is up almost 60% while private demand is up just 16% - are we at risk of crowding out the private sector from labour markets?
- SME labour demand appears to have slowed over the winter months – in contrast to large business which is picking-up.

Employment Growth: Public versus Market Sector



SME & Large Business: Employment Index

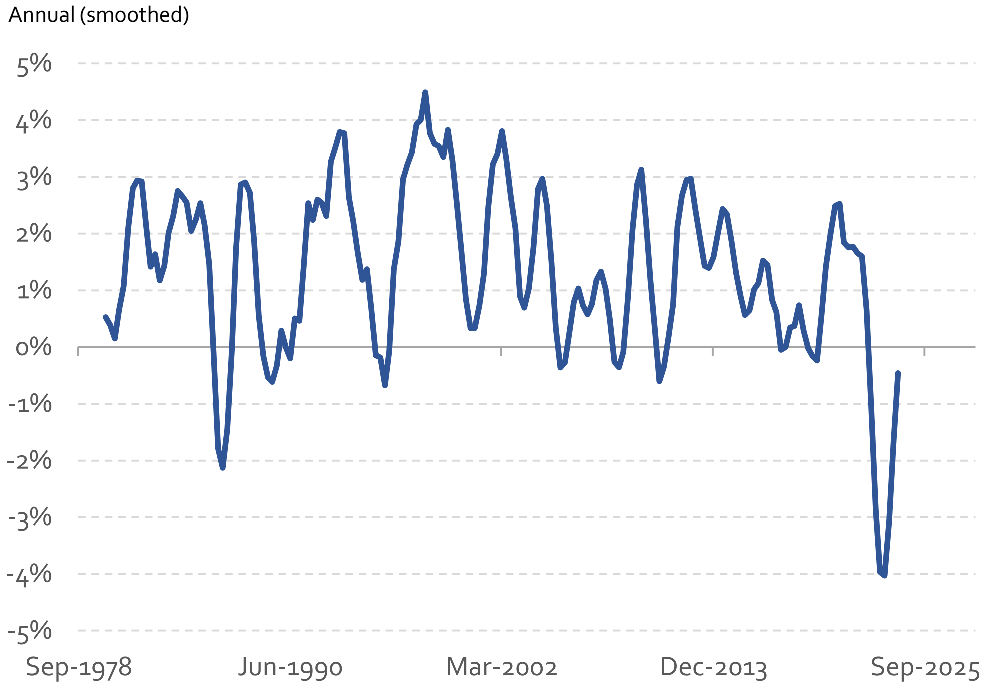


Source: ABS, RBA, Treasury, EQ Economics

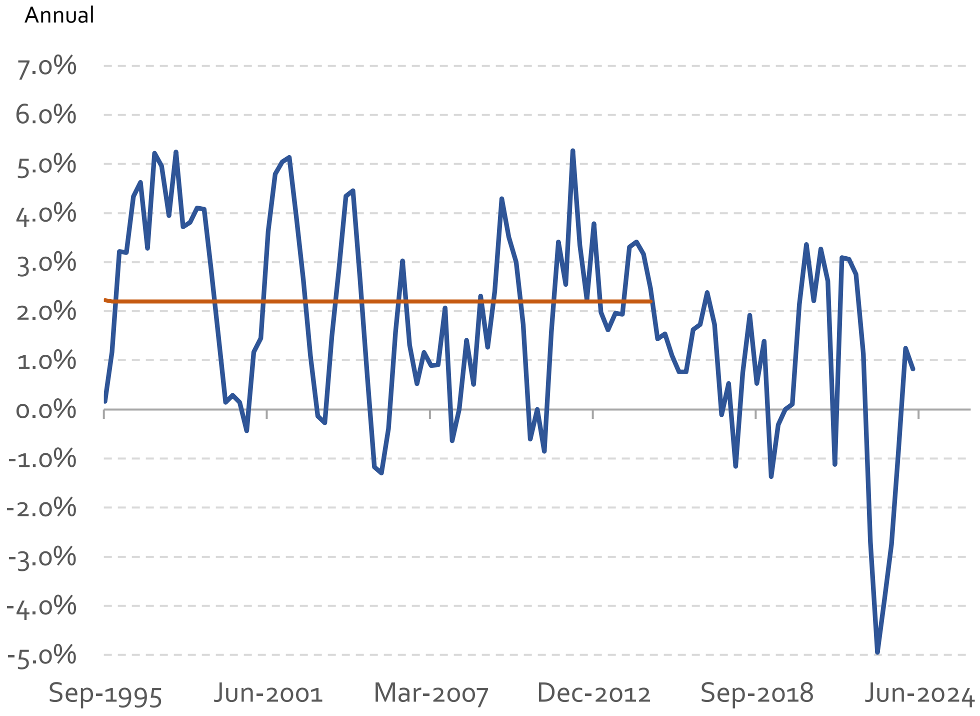
Productivity growth has collapsed over the past 2 years

- Weak productivity growth can cause inflation, particularly when cost pressures are elevated
- Over the longer term we need productivity growth to drive real incomes higher (for both wage earners and investors/profits)

Economy Wide Productivity Growth
(since 1978)



Market (private) Sector Productivity Growth
(since 1995)

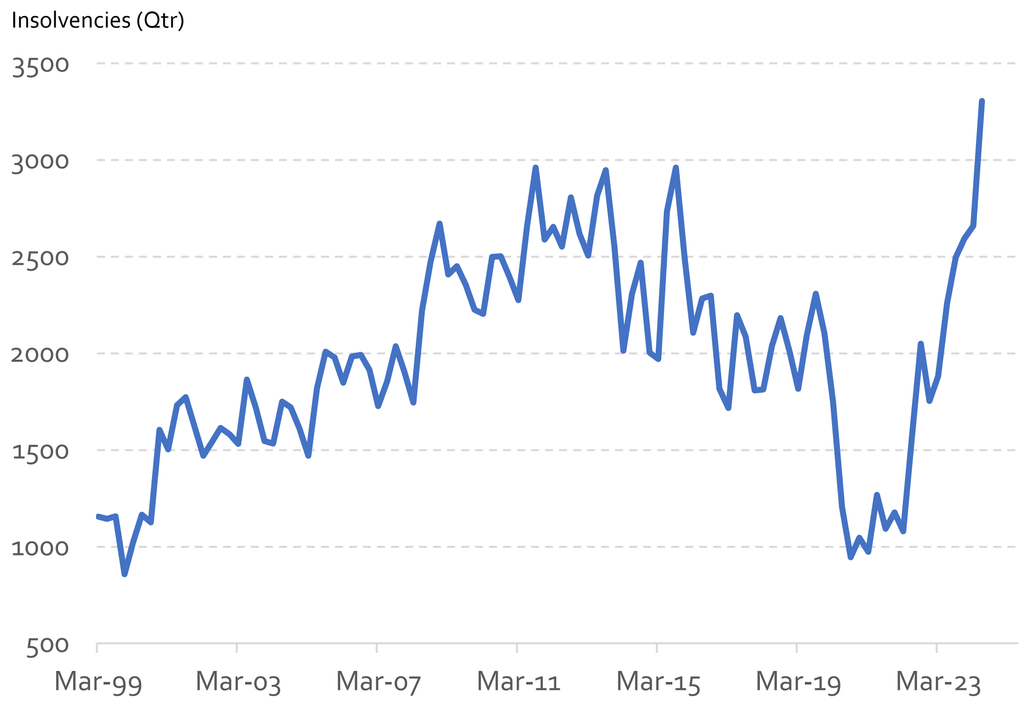


Source: ABS, EQ Economics

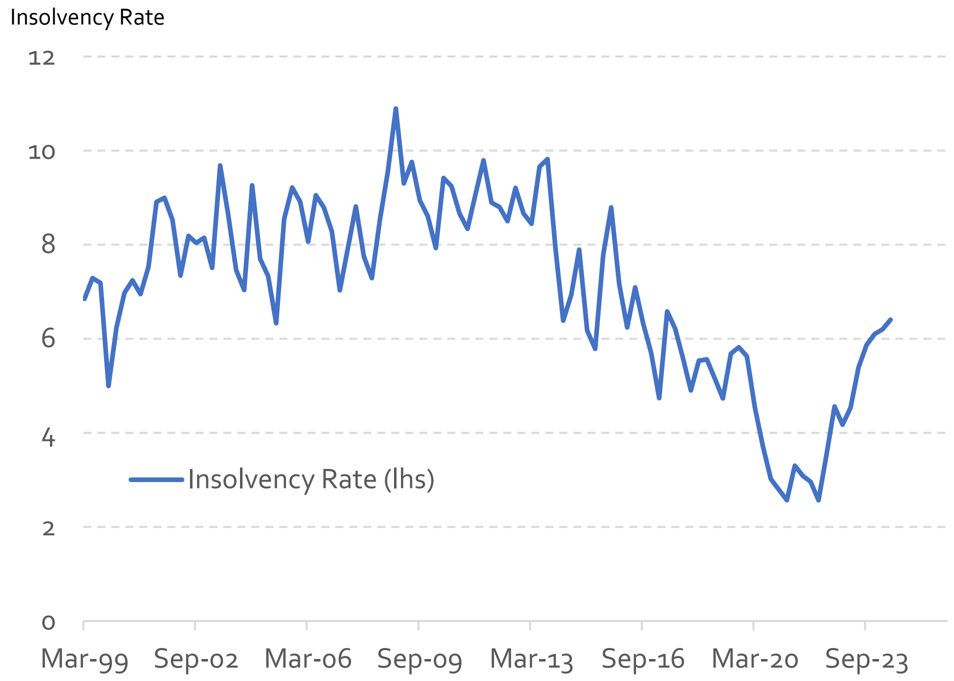
Insolvencies are normalising after being suppressed for a decade

- The ASIC first time insolvencies statistics look alarming with the June Quarter numbers rising to new highs
- But when adjusted for number of businesses in the economy the 'insolvency rate' is still well below previous highs

1st Time Insolvency (Quarter)



Insolvency Rate



Source: ASIC, EQ Economics

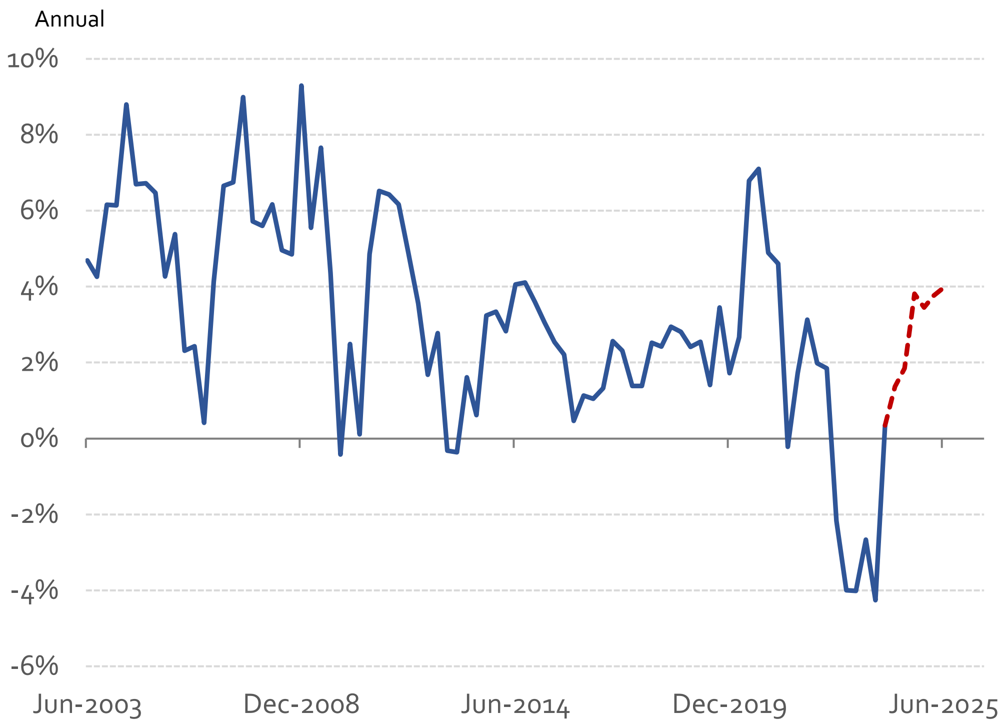
Economic Outlook.

Australia is ‘out of whack’ with the rest of the world

Not a normal cycle.

- The economic slowdown of the past two years has been driven by a squeeze on household incomes – mainly due to inflation (70%), bracket creep (15%) and higher interest rates (15%).
- Consumption growth has slowed to a standstill over the past year- only the 5th time in the last 40 years.
- On each of the past 4 occasions when consumption growth has stalled (1982, 1991, 2009, 2020), business investment has, on average contracted by 16%.
- Households and consumption were a casualty of something else happening in the economy – not this time. Business investment is growing, and employment is booming.
- This is a very different cycle that reflects big secular changes in the economy as well as Australia adopting a very different macro policy stance to the rest of the world.

Household Real Disposable Income

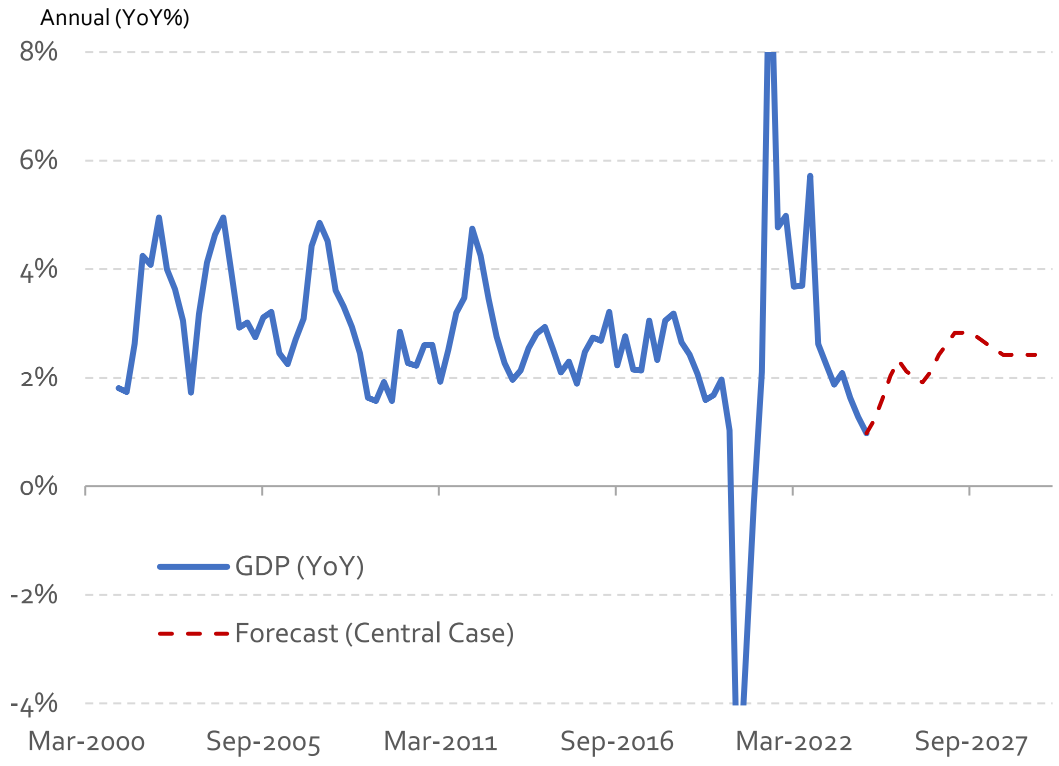


Source: RBA, EQ Economics

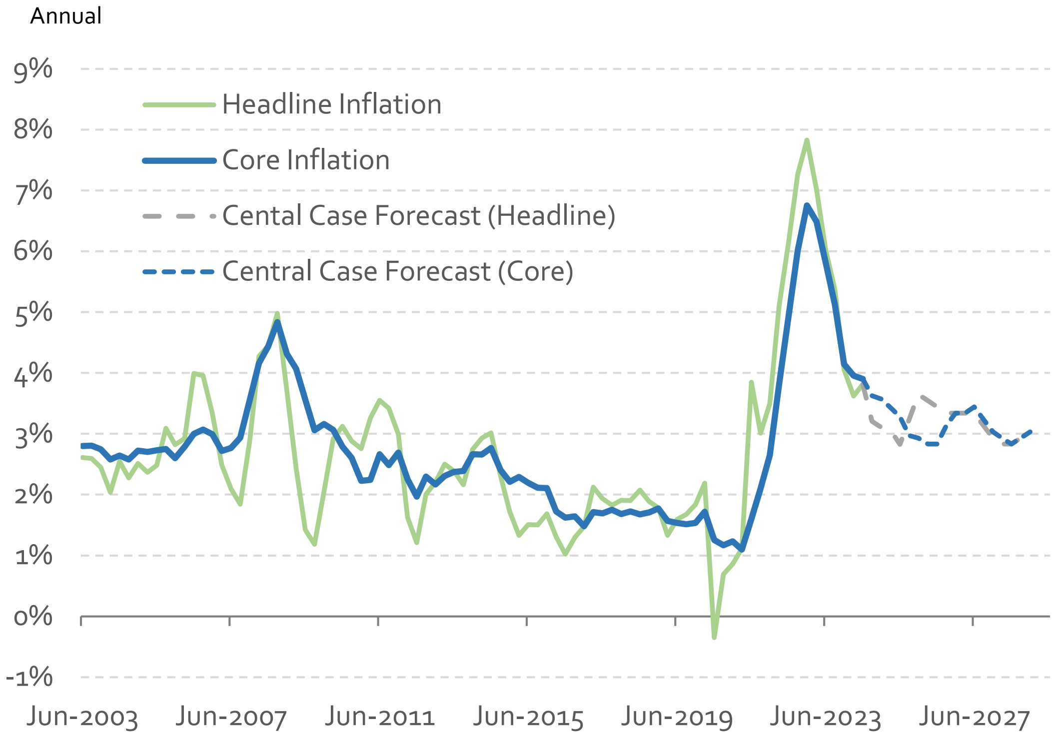
Central Case: Narrow Path

- Higher consumption and GDP growth could take the economy further away from a sustainable path necessitating further rate hikes.
- Government policies artificially reduce the CPI in the short-term, only to boost measured inflation later - focus on 'core' inflation

The Business Cycle: Central Case (GDP, YoY%)



Inflation Forecast (CPI and Trimmed Mean)

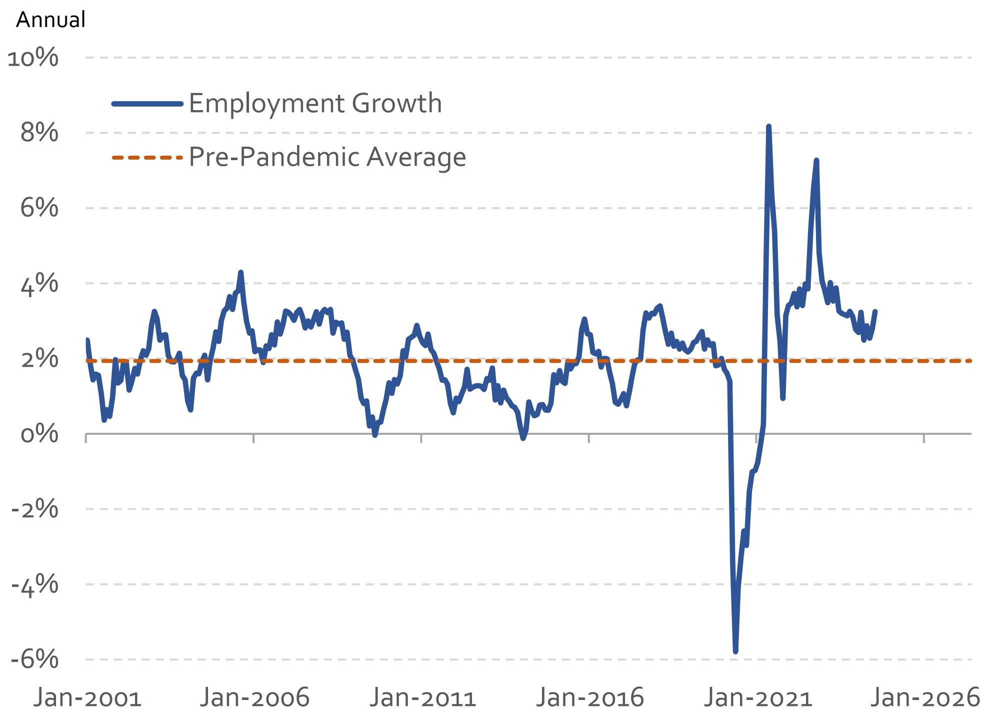


Source: ABS, RBA, Treasury, EQ Economics

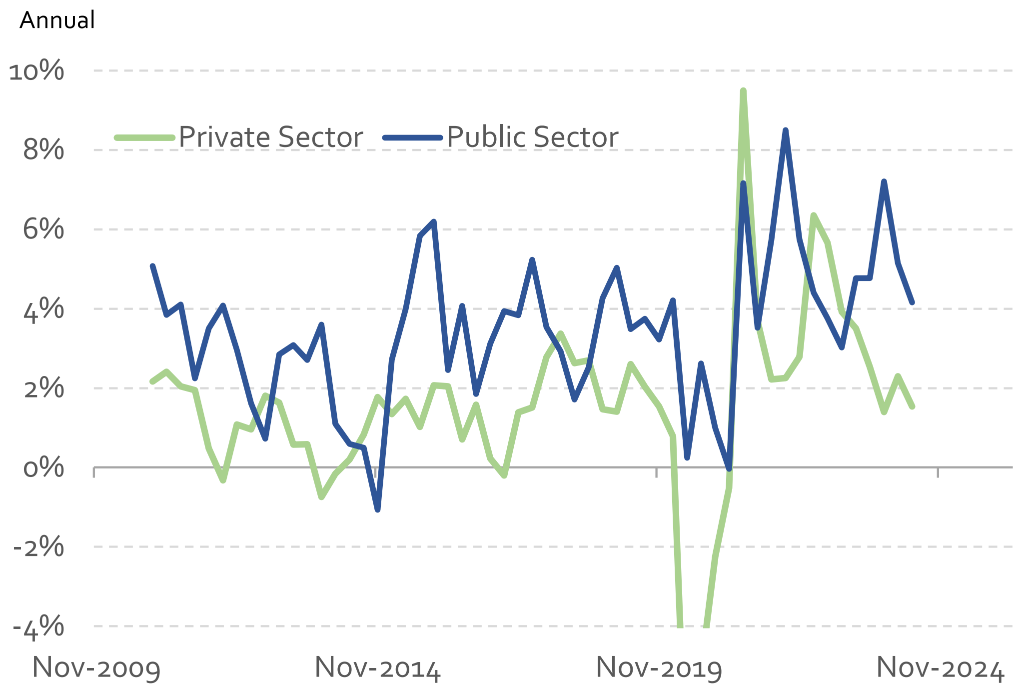
Employment growth is being driven by government

- Total employment growth has picked up in 2024 with annual growth of 2.7%, above the long-run average of around 2%
- Breaking down employment between market (private) sector jobs versus public and quasi-public sector jobs reveals a stark contrast.

Employment Growth



Employment Growth – Market Sector vs Public



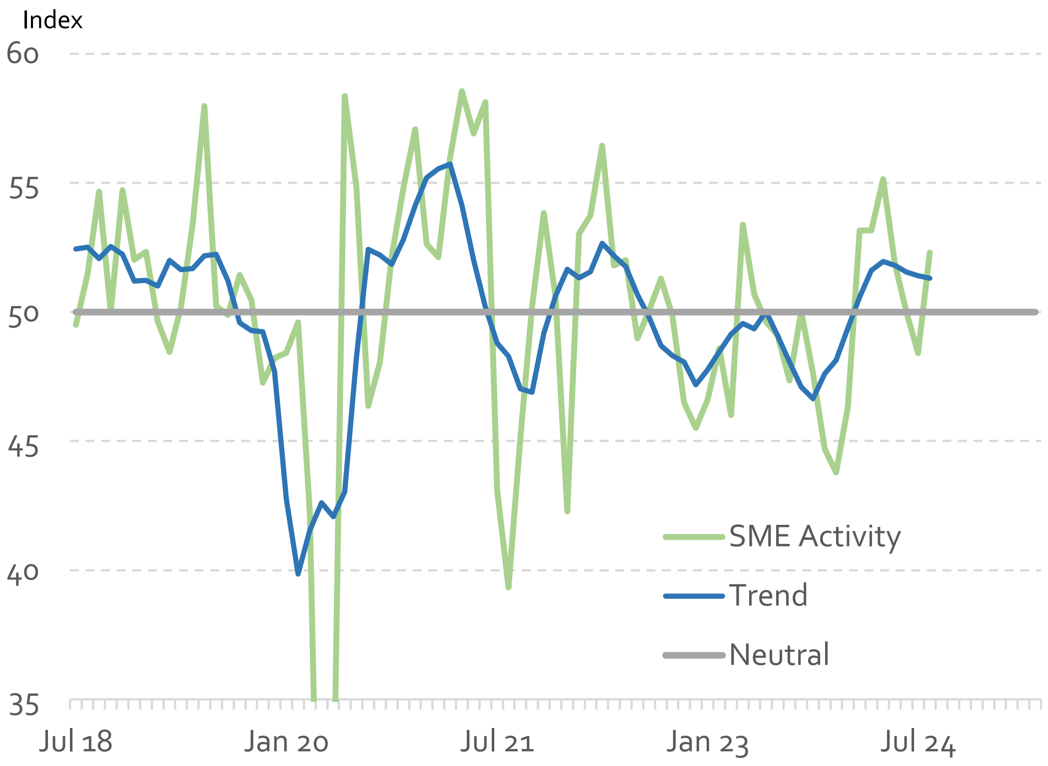
Source: ABS, RBA, Treasury, EQ Economics

Despite all the challenges business remain optimistic

- The Judo Bank Australian PMI highlights the improvement in business conditions (service sector) in 2024 although September was soft
- SME's have been an important part of the 2024 recovery story – and continue to see expanding activity in August

Australian PMI: Service Industries Activity Index

Australian PMI: SME Activity Index

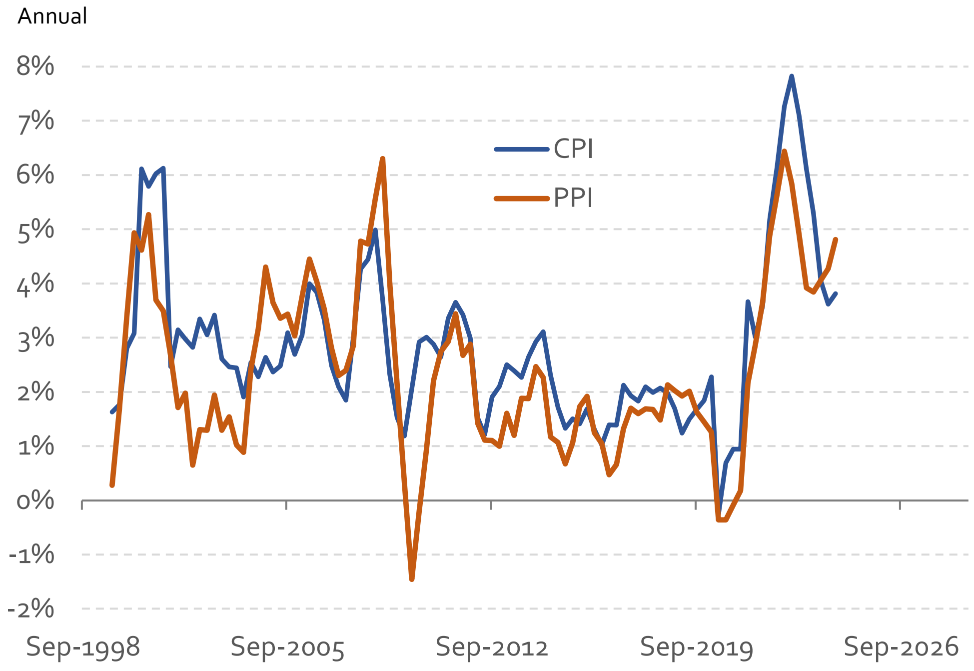


Source: Judo Bank, S&P Global

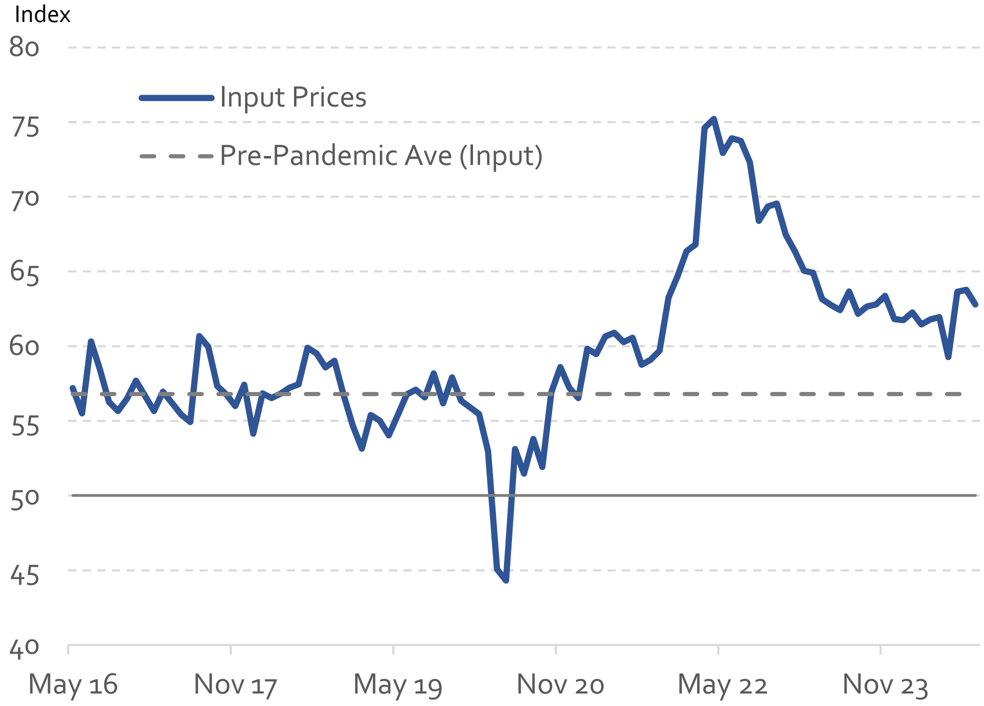
Pipeline inflation pressures have not eased in Q3.

- The Producer Price Index (PPI) is picking up again in Q2 – inconsistent with falling inflation (CPI)
- PMI input price index points to a pick-up in business cost pressures in September quarter

PPI and CPI



Input Price Index - Services

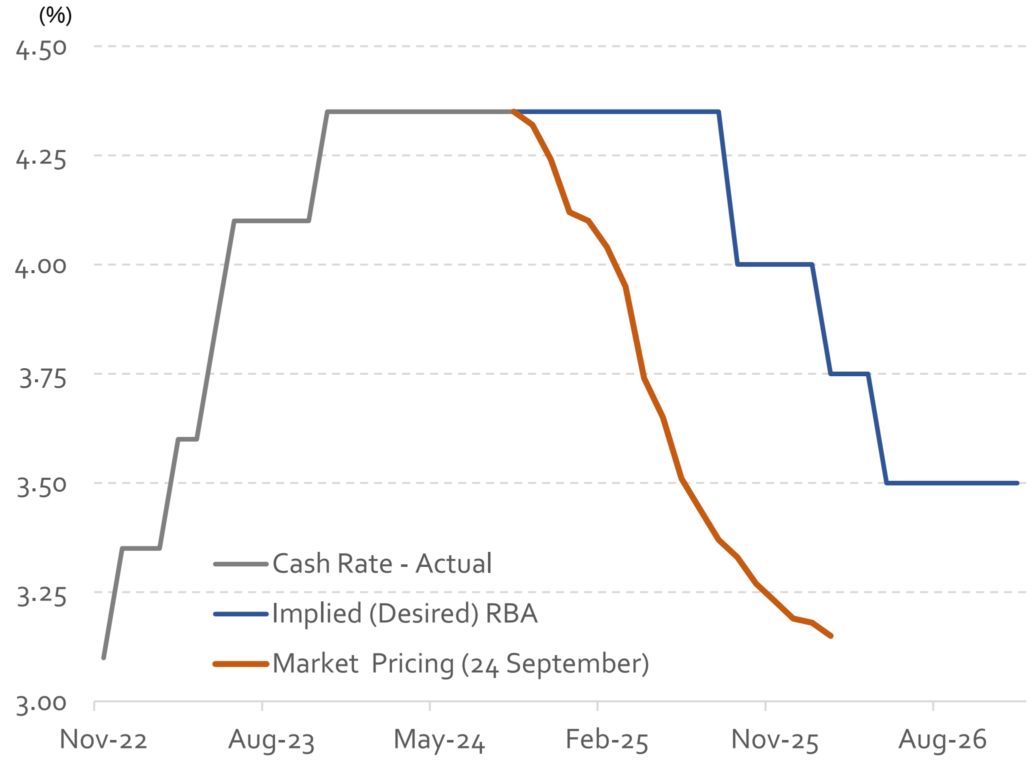


Source: RBA, ABS, EQ Economics

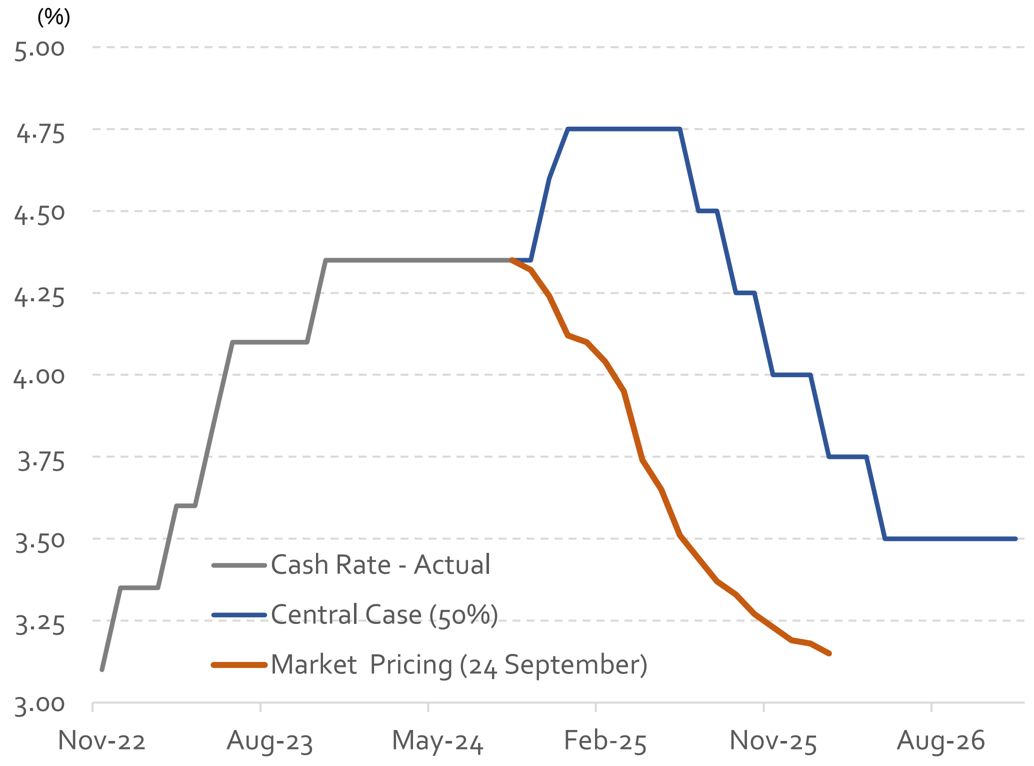
Markets expect the next move to be a rate cut

- Markets are pricing a rate cut in early 2025 and have factored in a 3% cash rate as the low point in the cycle (late 2025).
- RBA is hoping they don't have to hike, and can then start to bring rates down from mid next year

Market Pricing for the RBA Cash Rate (September 2024)



Judo Central Case and Market Pricing

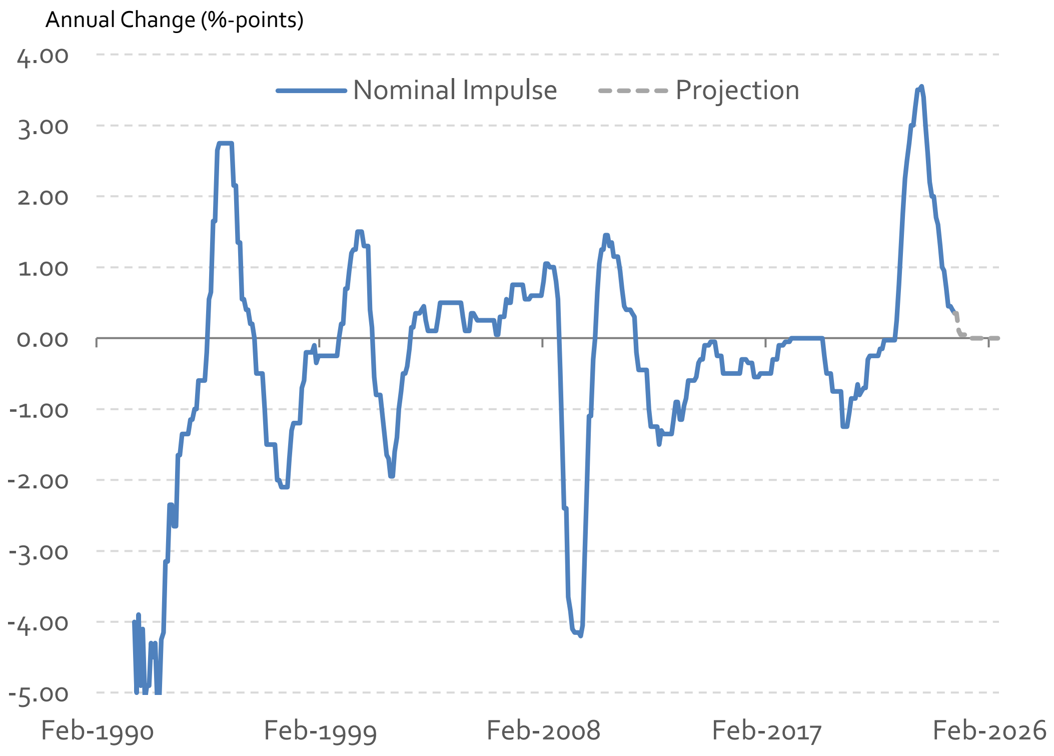


Source: ABS, RBA, Treasury, EQ Economics

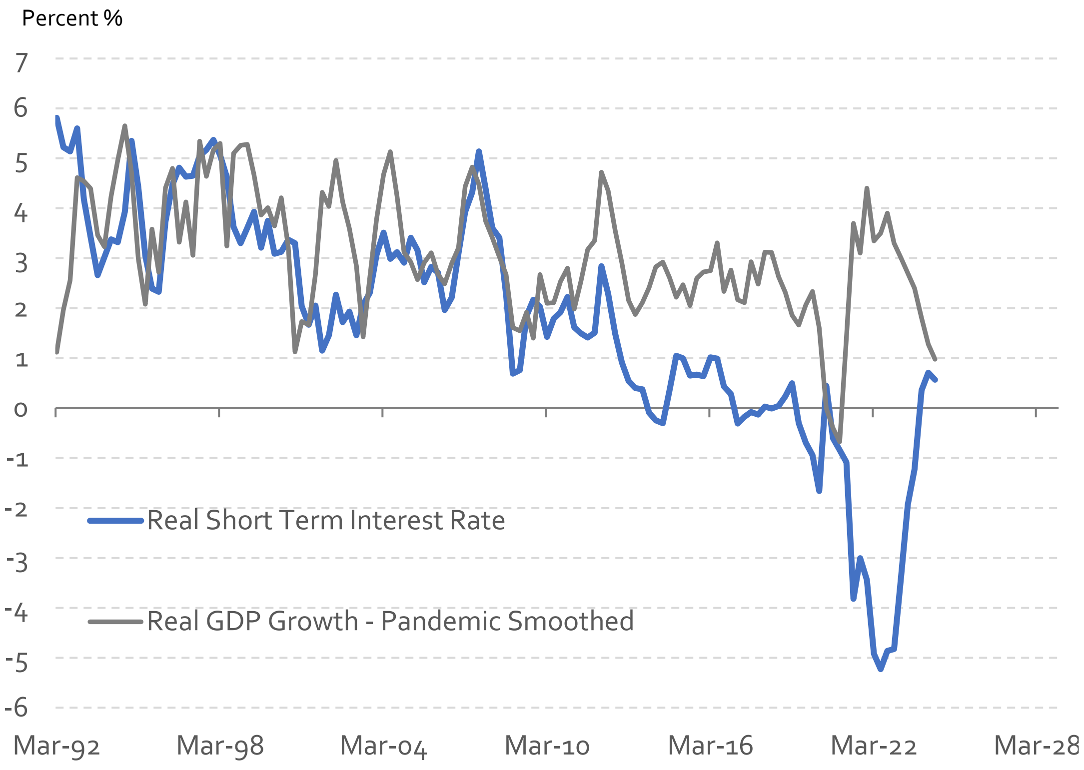
Monetary policy and the economy.

- The nominal channel of monetary policy (change in cash rate) is fading while real interest rates remain historically low
- Ultimately it is the level of the real (nominal interest rate minus inflation) that determines the 'stance' of monetary policy

Change in Nominal Cash Rate



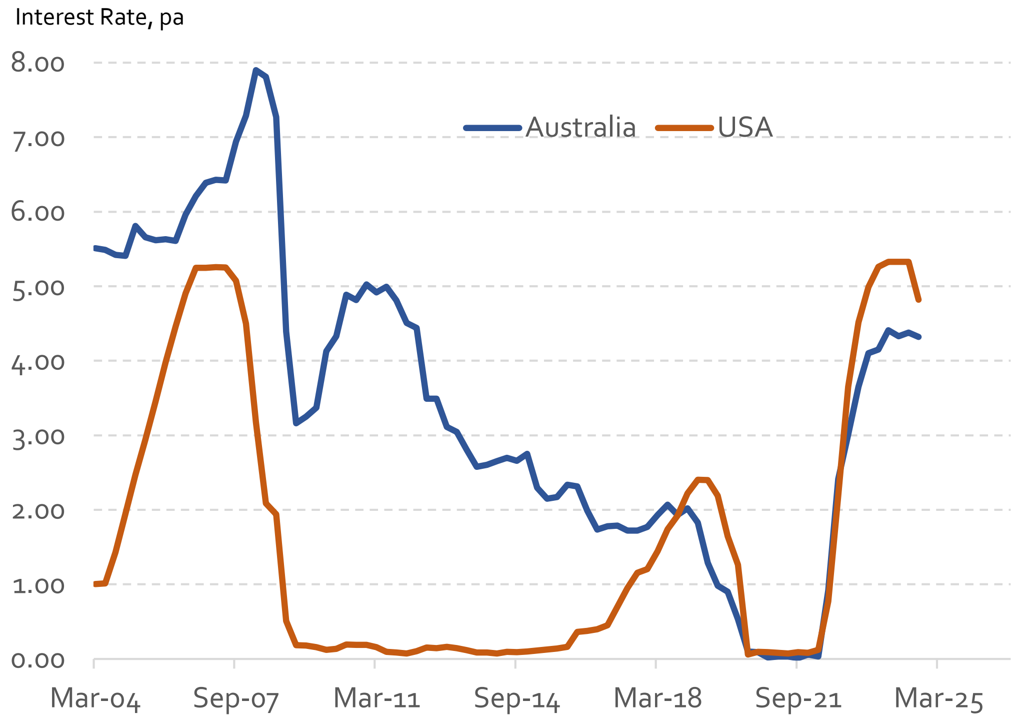
The 'Real' Short-Term Interest Rate and Real Economic Growth



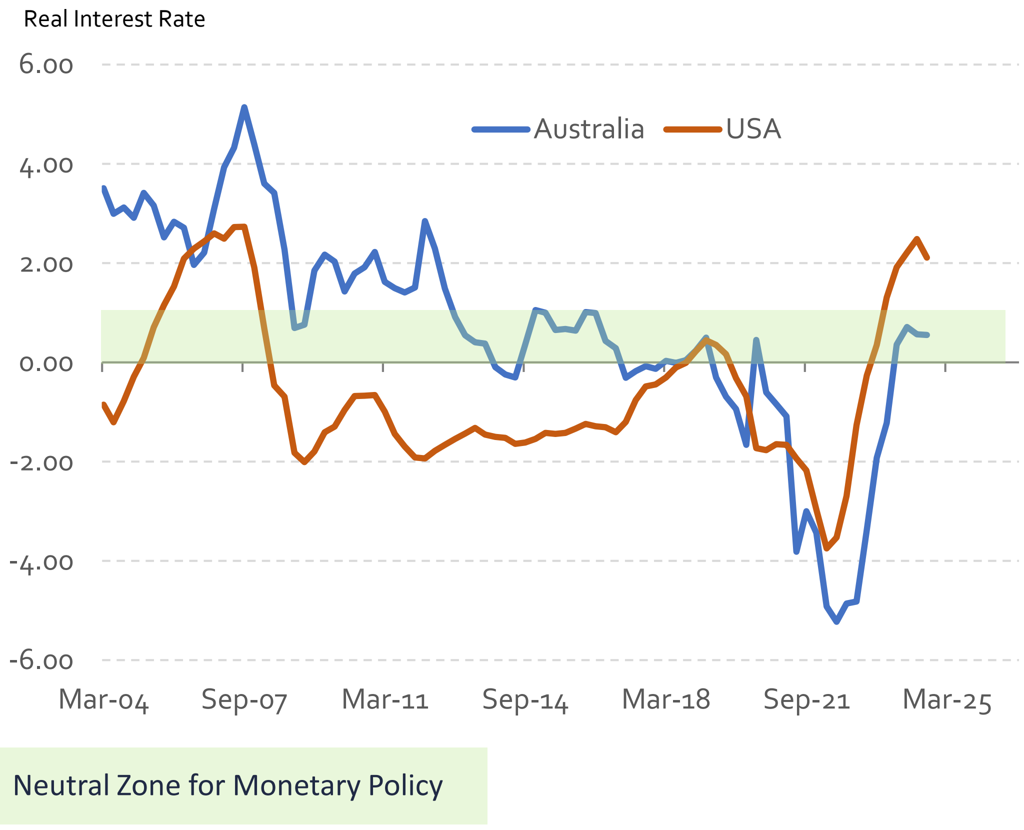
Australian rates are still higher than Australia's

- The 50bp cut to the Fed funds rate means that the US rate is still 50bp above our cash rate
- When adjusting for inflation (real interest rate) the contrast is even greater – with the level of the real rate in Australia still in neutral territory

RBA Cash Rate versus Fed Funds Rate



Real Interest Rate: Australia versus US

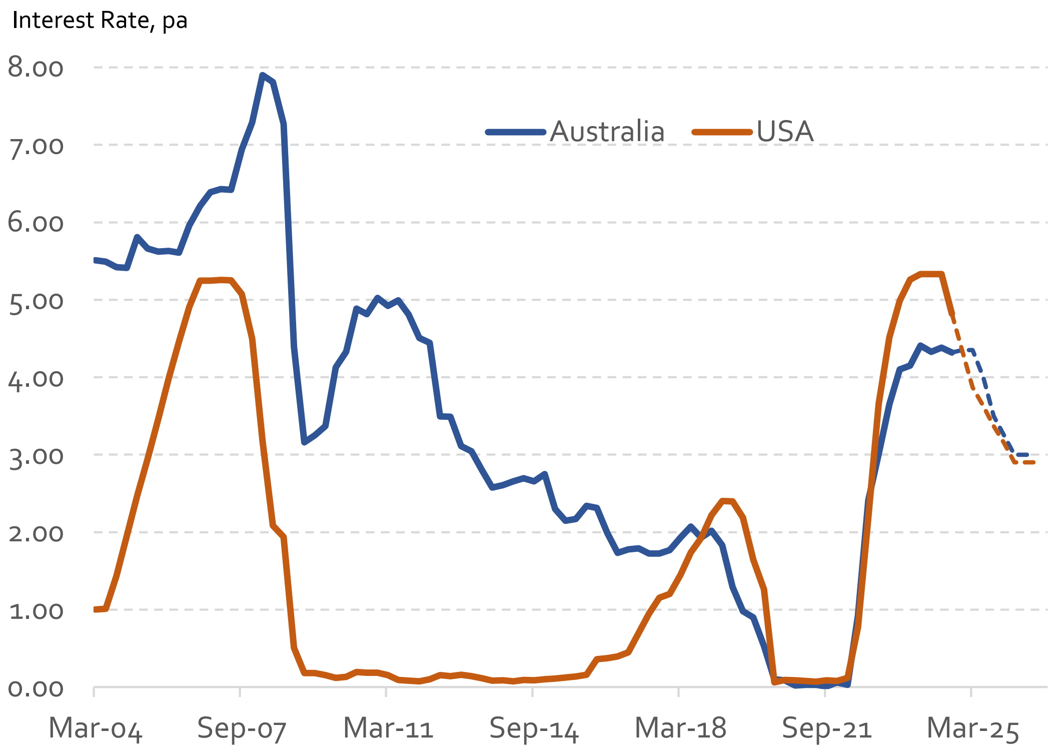


Source: ABS, RBA, Treasury, EQ Economics

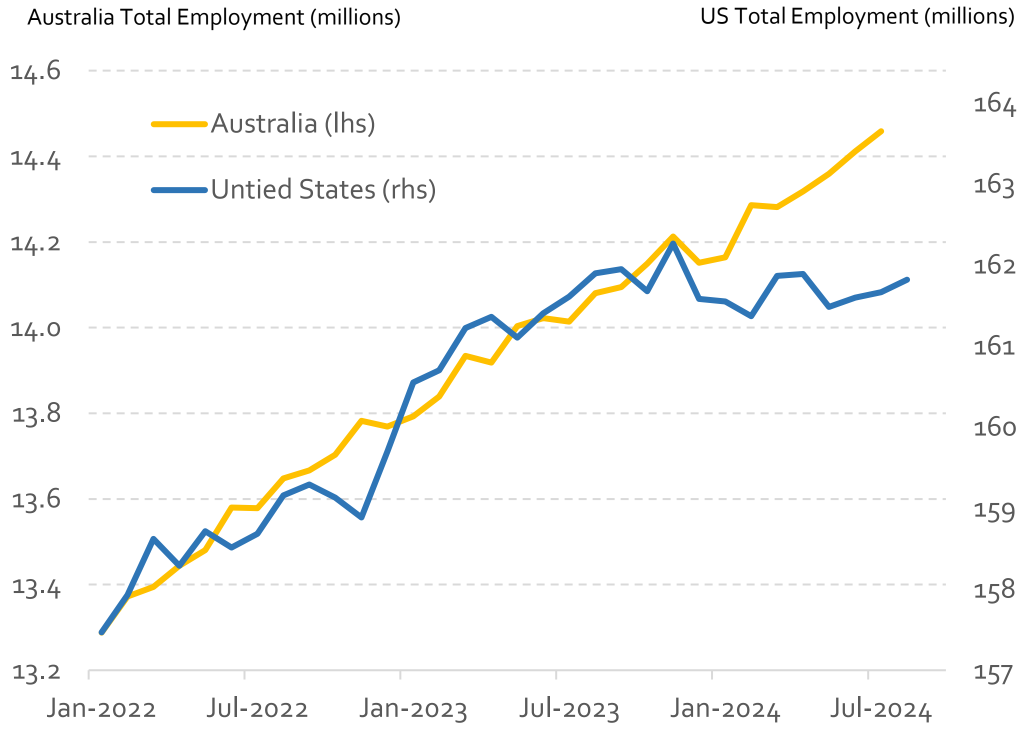
The RBA won't simply follow the Fed

- Australian and US interest rates could 'crossover' in the next 6 months before realigning in late 2025
- Even though the US economy is slowing (as desired), Australia is in a very different position according to employment trends in 2024

US and Australian Policy Rates and Projections



US and Australian Employment



Source: US Federal Reserve, US Bureau of Labor Statistics, ABS, EQ Economics

Thank You.

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