

Australia Economic Watch

RBA & GDP preview: Hawkish bells

Trade Idea

Rates on hold for Christmas

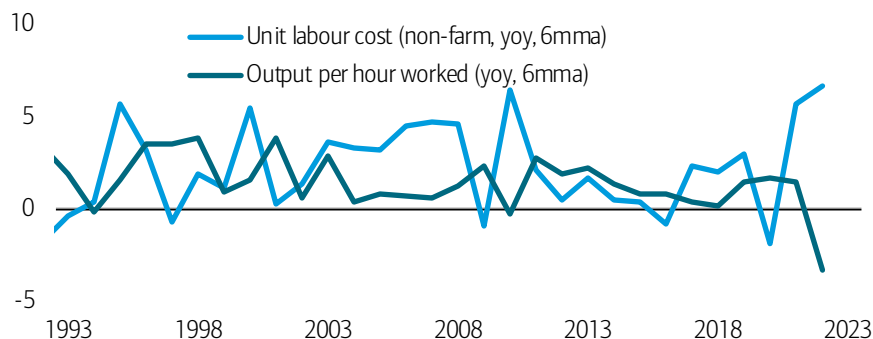
The Reserve Bank of Australia (RBA) meets one last time this year on December 5 and is set to keep the cash rate unchanged at 4.35% following the hike in November. While the Bank Governor recently strengthened her hawkish bias, economic data has been soft since the November hike. Monthly CPI inflation declined to 4.9% yoy in October from 5.6% yoy in September, and retail spending recorded a broad-based fall of 0.2% mom in the month, with all non-foods related industries recording declines.

Soft GDP in 3Q, focus on productivity and spending

GDP data for the September quarter will be released on December 6 just after the RBA board meeting. We forecast a modest 0.3% qoq rise in growth that would push annual GDP down to 1.7% yoy from 2.1% yoy on the back of base effects. While focus will likely be on household spending, which is largely expected to have remained weak, we also watch measures of productivity growth and unit labour cost. Low productivity and higher unit labour cost growth could add to the case for further tightening.

Exhibit 1: Productivity and unit labour costs are the key focus for RBA

In the 3Q GDP data



Source: ABS

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Feb/Mar 2024 OIS steepeners look attractive

Front-end swaps rallied as two economic releases missed expectations. Overnight indexed swaps (OIS) are now pricing just 0.5bps of hikes into December's meeting. Market pricing is also somewhat at odds with the RBA's rhetoric. Governor Bullock has highlighted the risk of persistent inflation. It is also noteworthy that monthly CPI would have been higher without the effect of government subsidies, and collection variability in the monthly series means that only part of the basket was updated.

After such a substantial rally, we see the risk/reward of OIS steepeners as attractive given that the RBA is highly likely to maintain a hawkish bias into the Board's February 2024 meeting. Admittedly, we remain cautious payers of RBA meeting spreads given the backdrop of an aggressive rally in US FOMC pricing. Yet with just Obps priced, Feb/Mar 2024 OIS steepeners look attractive. **We enter the trade at Obps with a target of 15bps and a stop of -7.5bps.** Another US-led rally is the risk to this trade.

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Refer to important disclosures on page 5 to 7. Analyst Certification on page 4. 12632927

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Hawkish RBA but soft growth

At a speech last week, RBA Governor Bullock reinforced her hawkish bias, indicating that “the remaining inflation challenge we are dealing with is increasingly homegrown and demand driven”. In her view, policy response should vary if inflation is rising due to supply factors versus demand. If inflation is the product of global supply disruptions or other price rises that monetary policy has little influence over, such as fuel, electricity or rents, then the monetary policy response should be limited. Conversely, inflation that results from aggregate demand exceeding the economy’s potential to meet that demand should be addressed by more substantial tightening.

The RBA now believes that several signs suggest that Australia’s inflation is largely demand-driven. The breadth of inflation, especially in the services sector, and high rates of labour utilisation are worrying signs for the Bank.

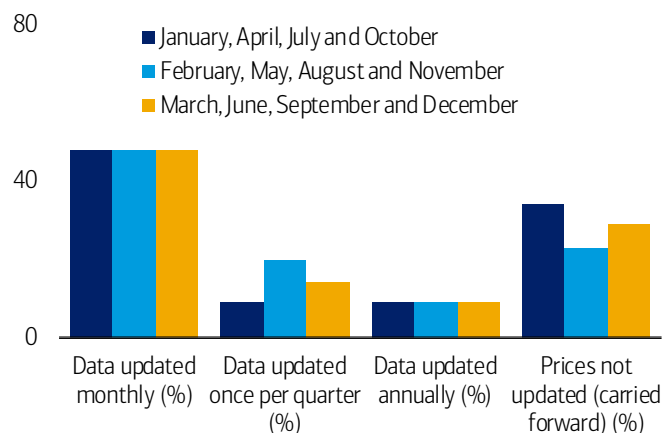
Yet while the RBA remains committed to bring inflation back down to target (by the end of 2025), its willingness to preserve gains in the labour market suggests that scope for further tightening is limited, in our view. As we discussed in our year ahead report, the RBA is likely to remain on hold in 2024 as inflation eases and growth remains below trend (see [Australia Economic Viewpoint: Year Ahead 2024: No landing down under 22 November 2023](#)).

Guidance at the December meeting is likely to remain hawkish ahead of the first Board meeting of 2024 in February. By this meeting, the Bank will have an update on 4Q CPI (our initial estimation is that CPI will have increased by 1% qoq, 4.5% yoy, which is in line with the RBA’s assumption) and further updates on the state of the labour market. Another persistent rise in core inflation in 4Q could trigger further tightening, though this is not our base case.

Since the November hike (see the report, [Australia Economic Watch: RBA review: The reluctant hiker’s last raise? 07 November 2023](#)), unemployment rose to 3.7% despite large employment gains, while retail spending softened, house prices rose and monthly inflation surprised to the downside, falling to 4.9% yoy from 5.6% yoy in October. Notably, collection issues with the monthly series mean that October is one of the months with the least updated items, particularly for services (Exhibit 2). This suggests that the RBA will take these data with a grain of salt. In spite of this, inflation has continued to ease across the main household living costs components (Exhibit 3)

Exhibit 2: October CPI data is not the best reflection of inflation.

As it has the least updated prices

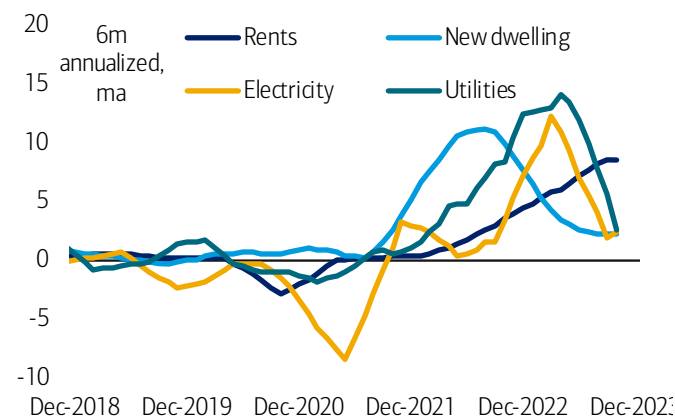


Source: ABS

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Exhibit 3: In annualized terms, inflation is easing

For household-related components



Source: ABS

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The RBA has argued of late that a supply-demand imbalance in the economy continues to boost aggregate demand. GDP data for the September should reflect weak household

spending and soft private investment (see the report, [BofA Australia Household Consumption Tracker: Household spending: Decline, but no cliff 12 October 2023](#)).

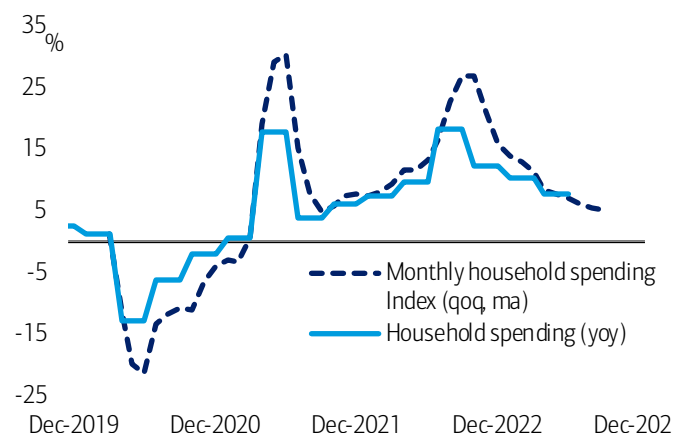
We see a modest 0.3% qoq rise in GDP in September

GDP data for the September quarter is due on December 6, just after the RBA's last meeting of the year. We expect a modest 0.3% qoq rise that takes annual growth down to 1.7% yoy from 2.1% yoy due to base effects. This is well below trend.

Focus will likely be on household spending. Constraints in the household sector have been reflected in our leading Household Consumption Tracker (see above), and we expect household spending to have risen by only 0.1% in the quarter. The ABS monthly series has also weakened (Exhibit 4), and consumers have continued to sharply adjust their discretionary spending given the high cost of living and policy traction (Exhibit 5).

Exhibit 4: The ABS monthly household spending series is soft

Suggesting that household spending softened in 3Q

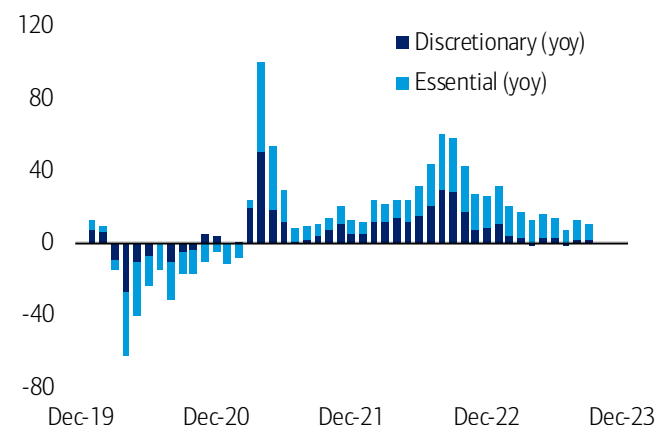


Source: ABS, Macrobond

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Exhibit 5: 3Q is the quarter of essential spending

A modest rise in consumption is expected in 4Q on the back of sales



Source: ABS, Macrobond

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As for the rest of the components, partial data has been mixed. Construction work done recorded a larger-than-expected increase. The value of total construction work done rose 1.3%, driven by engineering work, which rose 2.6% in the quarter and is 14.9% higher than the same time last year. Building work done rose 0.2% and is 3.4% higher than the same time last year.

Meanwhile, private new capital expenditure (capex) rose 0.6% in the quarter 2023, to 10.7% higher than a year ago. The mining industry was the main driver behind the growth in total new capital expenditure, increasing by 5.6% in the quarter. This was offset by a fall in non-mining industries, down 1.3% after large rises in the previous four quarters.

Capex was up 0.5% for new equipment and machinery, which feeds into private investment in the national accounts. Additional partials for business inventories, public spending and net exports are yet to be released next week, but we expect a modest 0.2ppt contribution to quarterly GDP from the public sector, a 3% rise in business profits following a sharp decline in 2Q and a flat contribution from net exports, driven by a rise in both exports and imports.

Ongoing easing of supply chain issues should be reflected in this quarter's data as well as some decline in the price deflators. We also watch the household's savings ratio, which remains positive despite large increases in cost of living and mortgage rates. We think that the new information in this release will be the measures of GDP production. Low sustained productivity growth, combined with high unit labour cost, could argue for higher interest rates, while a decline in unit labour costs could reflect some progress in pushing inflation back to target.

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