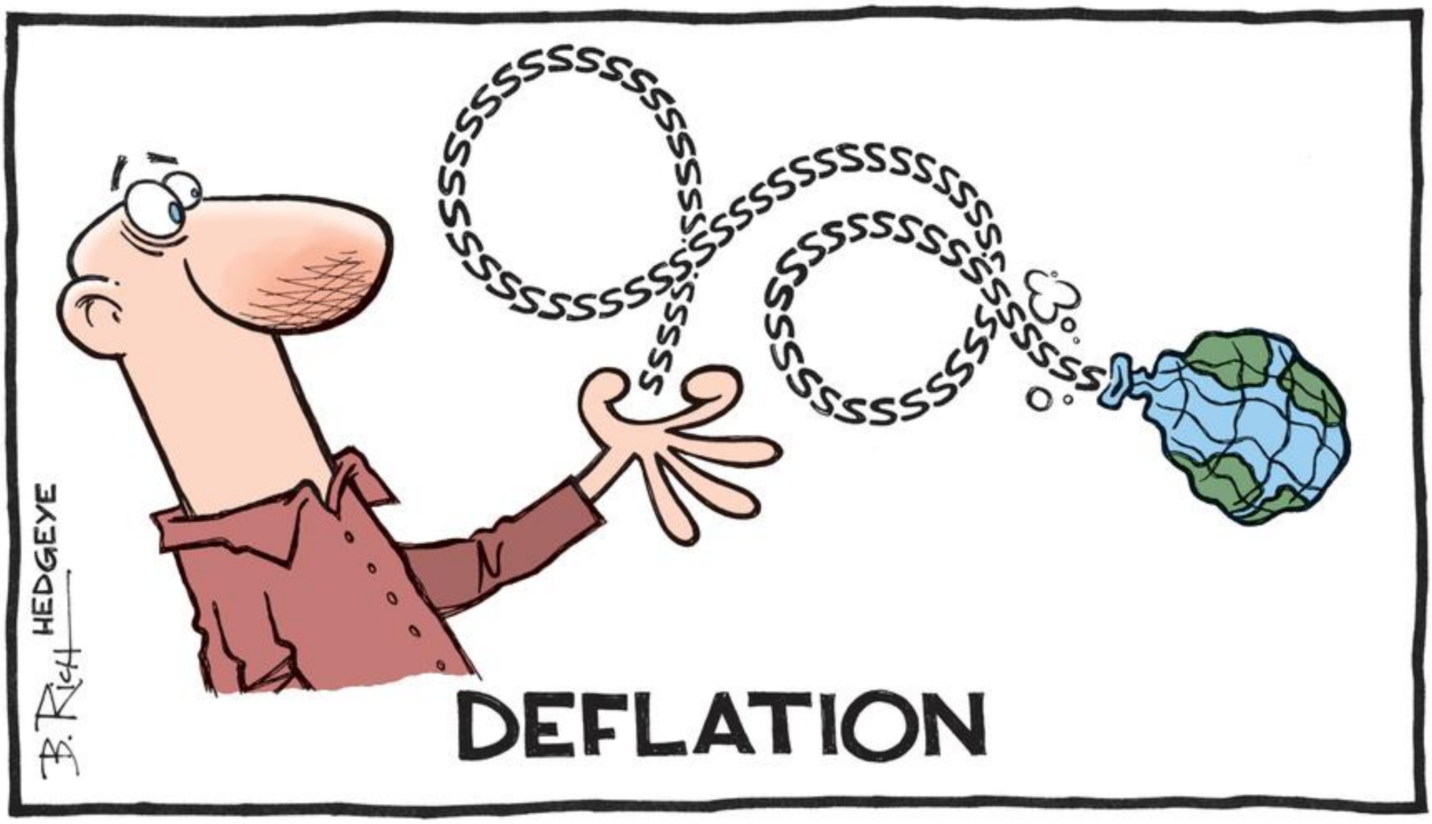
Economic Outlook 2023

Inflation, Interest Rates, Growth and Property



ECONOMIC OUTLOOK 2023

BY PAUL MIRON

As the dust settles from our post-Australia Day celebrations, we ease into the New Year refreshed and invigorated with our resolutions and plans in motion. We begin to reflect on and update our personal and financial goals for the year and ponder the new year challenges for all of us.

The New Year brings a significant concern for businesses, mortgage holders and consumers. It brings much speculation and uncertainty regarding whether further interest increases will work to stabilise inflation or ultimately tip the Australian economy into a recession. Mortgage holders and business owners remain hopeful that the Reserve Bank will take a momentary pause before considering increasing the official interest rates again. We hold our breath and wait for the anticipated confirmation that the most aggressive period of interest rate increases we have seen in Australia are working to tame inflation.

Below is a summary of the main economic updates over the past three months and an analysis on how this may shape the 2023 economic environment.

Inflation

The single most significant economic metric monitored at the moment is the rapid rise of inflation. Inflation will determine interest rates which in turn will influence asset prices, employment, as well as economic and social stability.

On January 25th, the annual inflation rate for Q4 2022 reached 7.8%, the highest since the early 1990s.

The above graph shows quarterly headline inflation figures from January 2020. This graph can be quite distressing to readers as it demonstrates that inflation figures have accelerated over the last year…without any signs of abating. Even economists are unsure how many more interest rate increases may be required. The predominant view is for further increases of between 0.25% to 1.00% over 2023. Indeed, Phil O'Donaghoe from Deutsche Bank predicts the official cash rate to increase to 4.10% during 2023.

However, what is most concerning is the uniqueness of our current economic environment. Due to the extreme volatility of energy and food prices, COVID-19 lockdowns and supply chain problems, we believe excess money supply is behind the current inflation story. As a result, central banks and economists alike cannot rely upon inflation trajectory data confidently and need to move beyond the headline inflation rate. Consequently, they are more likely to be hawkish and to overshoot the official cash rate in the short term.

This brings us to a specific measure of inflation that the RBA and other economists are observing today – *trimmed inflation*. Trimmed inflation is a statistical method used to measure inflation by excluding the highest and lowest values in a data set. This approach is used to remove extreme outliers (or 'anomalies') in the data set that could significantly impact the overall calculation of inflation. This method is considered to provide a more robust and accurate measure of inflation compared to the traditional method of calculating the average of all the data points.

One may indeed look at the latest headline inflation figure of 7.8%, which has maintained an upward trend during the last quarter. However, *core inflation* is actually in decline. This is because core inflation is a measure of inflation that observes the change in the prices of goods and services with the exclusion of volatile industries, such as food and energy. With this bit of information, can we slowly breathe a sigh of relief…or are there further problems associated with an inflation *decline* as well?

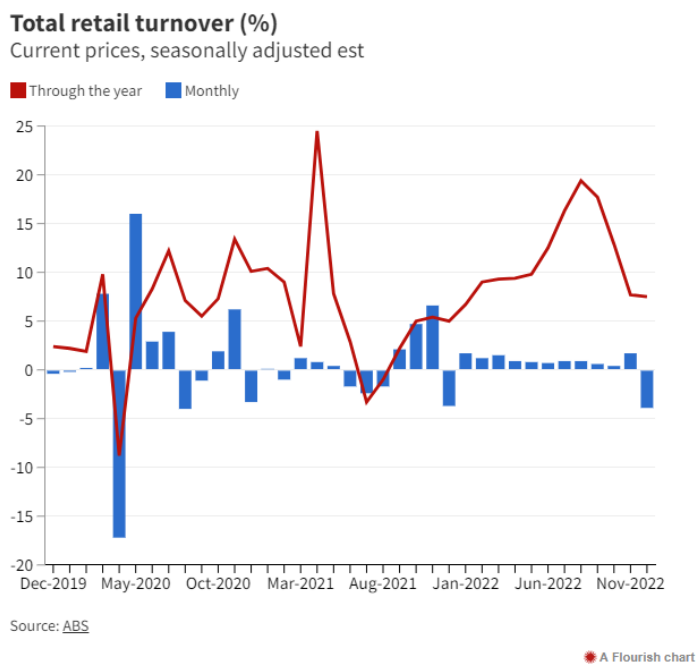
"Trimmed Mean" Inflation	
Year to December 31	6.90%
Year to September 30	6.10%
Quarterly	
Mar-22	1.57%
Jun-22	1.58%
Sep-22	1.87%
Dec-22	1.66%

Now, what about the rest of the world? 25 of the 38 OECD countries recorded global inflation *declines* between the months of October and November 2022. We are likely to follow the international trend, giving confidence to politicians and economists that the worst is truly behind us.

Retail Spending

With the average mortgage repayment increasing by 35% over the 2022 calendar year, it has certainly been a surprise that retail spending in November has increased by 1.4% from the previous month. This indicates that the interest rate increases' full impact has not filtered into everyday spending habits in November.[9]

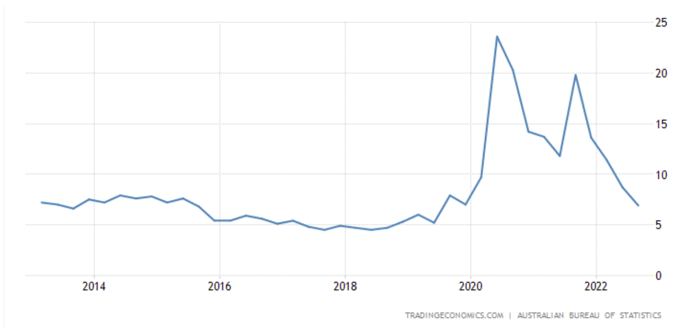
Indeed just this week, the latest retail figures for December plunged 3.9%. As alarming as this figure is, it is important to keep in mind that this is off a strong base and that current spending is on aggregate higher than pre-pandemic levels, as shown in the graph below.



[9] https://www.reuters.com/markets/australia-retail-sales-jump-surprisingly-strong-14-nov-2023-01-11/

Our view is that retail spending will continue to trend downwards sharply as higher interest rates and the higher cost of living for households begin to impact households' cash flow. Additionally, the excess cash reserves accumulated throughout the pandemic will begin to deplete, with the household savings ratio returning to pre-COVID levels.

Household Savings Ratio



Geopolitical Environment

There have been several ever-changing geopolitical events over the past few months.

However, the most noteworthy for Australians is the thawing diplomatic relationship with China and their stance towards COVID-19 policy from 'Zero Tolerance' to 'Zero Care'.

We must wait and see what inflationary impact China's anticipated post-COVID lockdown economic recovery will have on global resources. The pent-up demand for travel and other services will likely have global implications. Importantly, there is a possibility that the Chinese trading bans on Australian goods will soon be eased as the demand for these products is now high during the post-COVID lockdown period.

This can be seen as a positive impact on many Australian businesses, such as farmers and miners, and off-plan property purchases.

Unemployment

December's figures have surprised many economists. Unemployment rose from 3.4% to 3.5%, with approximately 14,000 jobs being shed, clearly indicating that we have crossed the inflexion point. We believe this trend will continue rapidly as spending eases and labour capacity expands as more skilled migrants enter the country. We will see an increase in unemployment, reducing further inflationary pressure on the economy. It is likely unemployment will trend towards 4.5% over the next 12 months, taking further pressure off inflation.

Australian Property

According to CoreLogic, Australian property has experienced an 8.9% decline nationwide from its peak in April 2022.[12]

This was widely anticipated, given the increase in the official cash rate from 0.10% to 3.10%,[13] which has had a material impact on borrowers' ability to afford higher mortgage repayments. That being said, there is undoubtedly a lag between interest rates and property prices. The property market is currently falling between 0.50% to 1.20% each month. However, once the RBA signals that they are unlikely to increase rates further, we will see prices slowly stabilise. Until then the negative price trajectory will continue. We believe the rate of decline will start decreasing despite further interest increases.

It is important to note that, besides interest rates, the fundamentals of property are highly positive, with rental growth staying strong and the supply of new properties reducing due to the cost of building and net migration being restored to historical levels of 185,000 p.a. It is likely that in 2023, net migration will peak at 300,000,[14] further placing upward pressure on property prices and cushioning it from the dramatic falls as many have predicted.

As a result, we believe that property prices will have a further 8% decline throughout 2023 if we have another 0.5% of interest rate increase, as is anticipated. We believe property prices will stabilise as soon as the RBA signals that there will be no further interest rate increases.

Even if interest rates remain the at their current level, there will be some property appreciation in certain segments, such as apartments and affordable housing, due to a lack of supply and exacerbated rental pressures.

Furthermore, there will likely be considerable upward inflationary pressure placed on the economy due to the lack of housing construction work and supply. This is due to higher interest rates

[12] https://www.corelogic.com.au/news-research/news/2023/corelogic-home-value-index-rate-of-decline-eases-despite-1.0-fall-in-january

[13] https://www.corelogic.com.au/news-research/news/2023/australian-home-values-officially-record-the-largest-decline-on-record

[14] https://infinitewealth.com.au/industry-news/300000-migrants-expected-in-2023/

and also allowing enough time for construction costs to normalise, as developers are waiting for the feasibility of many construction projects to be restored. This will only add fuel to the current rental crisis and the lack of supply in the property market.

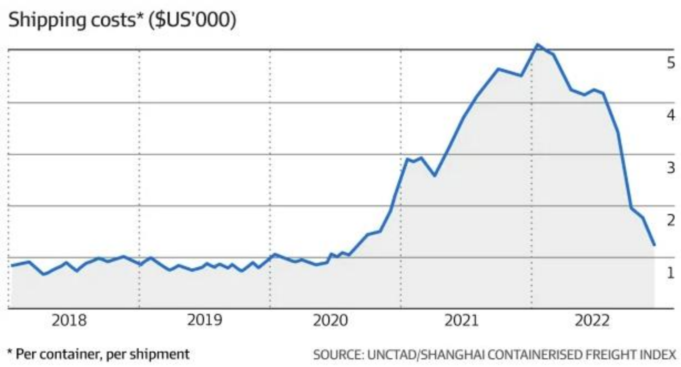
What Does Msquared Believe?

Here at Msquared Capital, we strongly believe that the full impact of the interest rate rises has not filtered and factored into the economy. We see retail spending contracting and unemployment increasing as households adjust discretionary spending in line with international trends.

With China slowly showing interest in kickstarting its economy, we will likely see an increase in global demand for energy, fuel prices and mining. We will likely experience some deflationary pressure for many goods and services, especially those produced by China, such as building materials, white goods, and car parts with uninterrupted production capacity.

One need only look at the second-hand car market, which has fallen over 12% in the last quarter as new cars are now flowing off the production line more smoothly due to the supply chain issues being resolved.[15]

In addition, the graph below shows that international freight prices have fallen more than 380% in the last 12 months.



Furthermore, the full impacts of immigration will start to ease wage pressure, with skilled labour and many students being able to work more freely as work restrictions are being eased within their visa requirements.

Another aspect to point out is that in our modern economic history, we have not witnessed deflation, whereas the price of goods may become cheaper.

[15] https://premium.goauto.com.au/moodys-confirms-slide-in-used-car-values/

In fact, in the past 73 years, we have only experienced this briefly on four occasions, 1953, 1984, 1997 and June 2020.

It is plausible that in the second half of 2023, we may see a sharp price contraction as economic conditions normalise to pre-COVID levels. The negative aspect of this could be a decrease in economic activity, higher unemployment, and reduced business investment. It would not come as a surprise to us if the RBA sees this as a quick justification for decreasing interest rates to boost activity.

As per my previous article, the neutral cash rate in Australia as stated by the RBA is 2.5% for the monetary stance not to be expansionary or contractionary. Therefore, I believe the official cash should lie somewhere between 2.75% and 3.00% once inflation is no longer a threat. This will form the basis and justification for indeed decreasing interest rates. Once this is done, we may see an approximate 10% appreciation in property prices, with the demand for credit bouncing back quickly.

As for Msquared, we see lending opportunities throughout the economic cycle. Private credit performs well through volatility, with asset preservation being a key component as all our debt is secured by the property itself.

Msquared Capital is a private credit provider with investment opportunities backed by quality property along the Eastern Seaboard; we ensure that all investment opportunities are based on risk-to-reward as our core offering and performance. Mortgage funds perform well during volatile times, and the preservation of capital is regular, with reliable monthly income that gives our investors peace of mind.

If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office with the following details:

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