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Laws of Physics

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February 2023

Laws of Physics

- It has been a tumultuous few years and the economic cycle has been more volatile than usual. Big highs, deep lows.
- 2022 saw a surge in inflation and interest rates followed.
- Household spending remained sky high, buoyed by strong employment and accumulated savings.
- 2023 will see the inevitable follow on from these factors:
  - lower inflation
  - slower economic growth
  - weaker consumption
  - deflating labour market
  - eventually, the RBA starts easing, just not soon.

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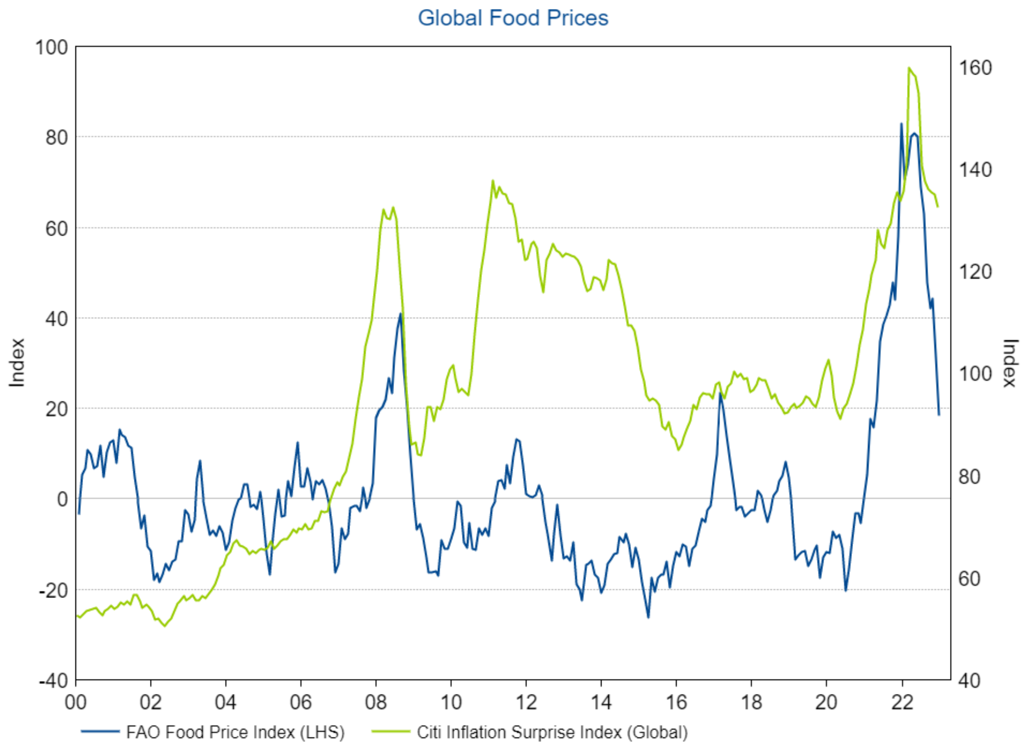
Global inflation is abating

- Global inflation is moderating as the supply side impacts of Covid and war abate.
- The combined impact of prior interest rate tightening also reduced demand, and slowed inflation.
- Sticky inflation risks remain, but are lessening. Most aim for 2%yoy inflation, so still a way to go yet.



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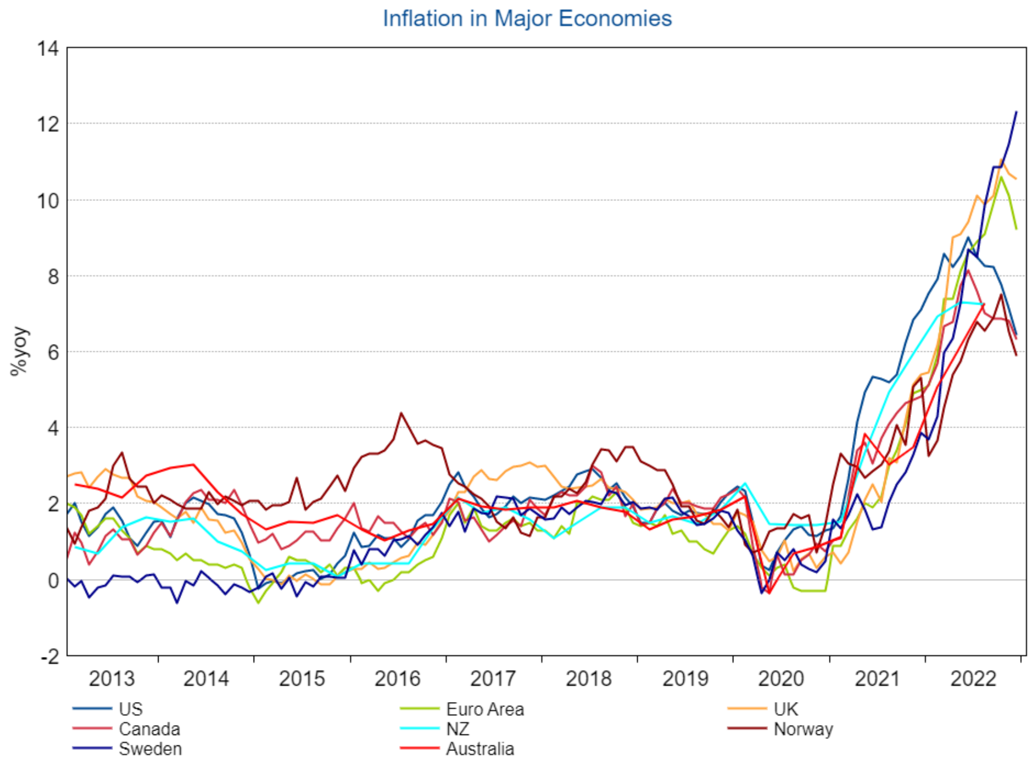

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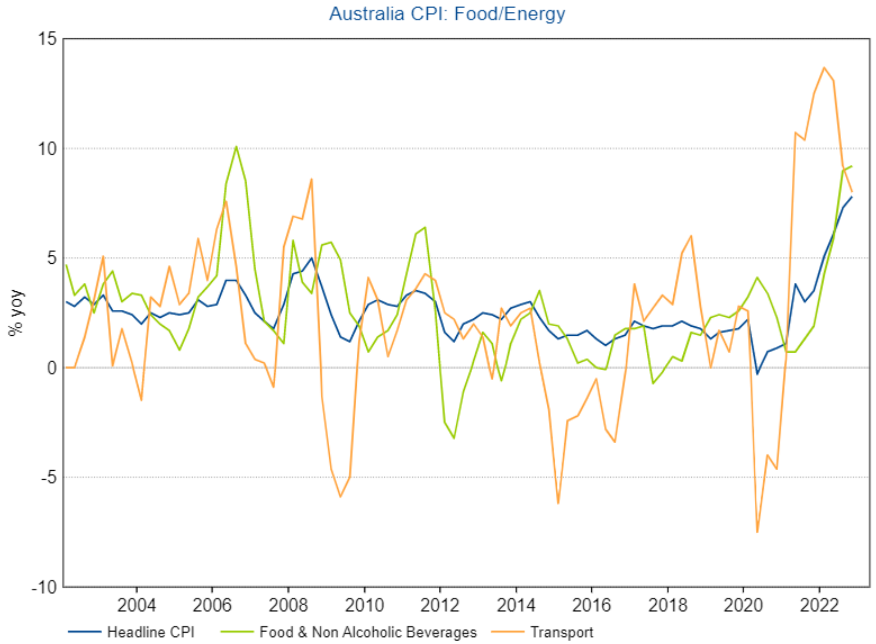
Australian inflation

- Australia's CPI likely peaked at 7.8%yoy and should moderate through 2023, but remain higher than target (2.5%)
- Fuel prices are moderating, but electricity gains were high. These should ease over time.
- Goods prices are peaking, but services prices are moving higher and may be harder to contain.
- Wages growth will continue to feed into inflation over time and takes headline CPI to just 4.7% by end 2023.

Source: Refinitiv Datastream, TCV



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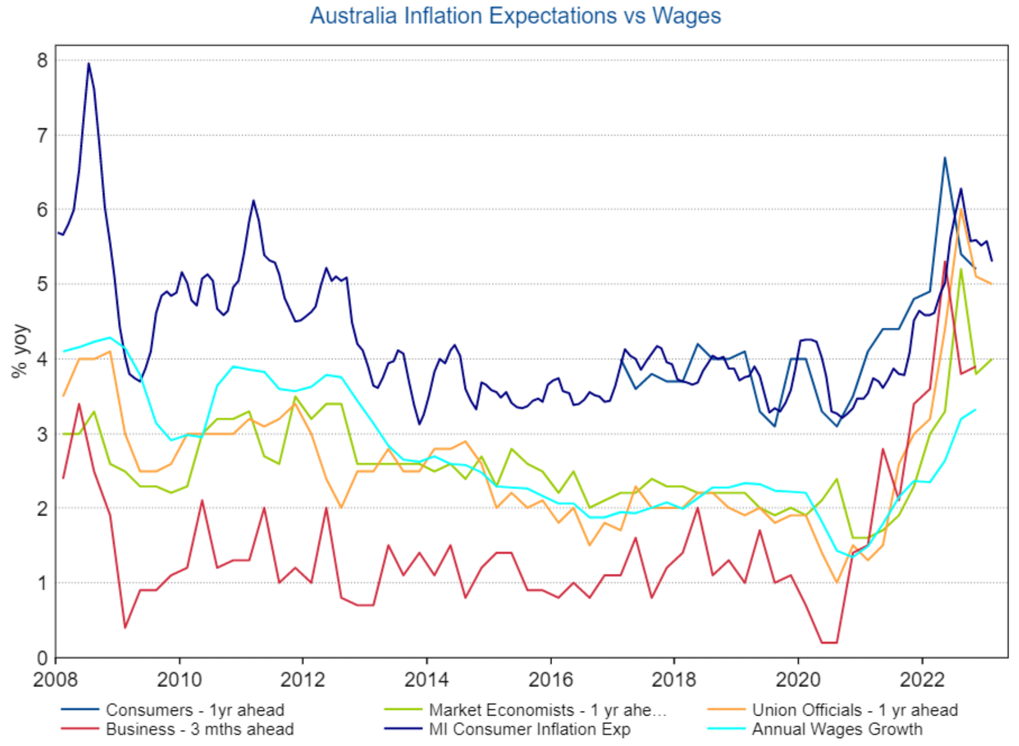
Australian inflation Expectations

- Inflation expectations are a key indicator of future expectations – if you think it will go up, it can.
- We feel inflation all around us, and as we hear more about it, we want to do something about it, like ask for higher wages.
- Australian surveyed inflation expectations are high, but coming down from their highs. Not uncontrolled.
- Market inflation expectations are higher, but again, not at alarming levels.



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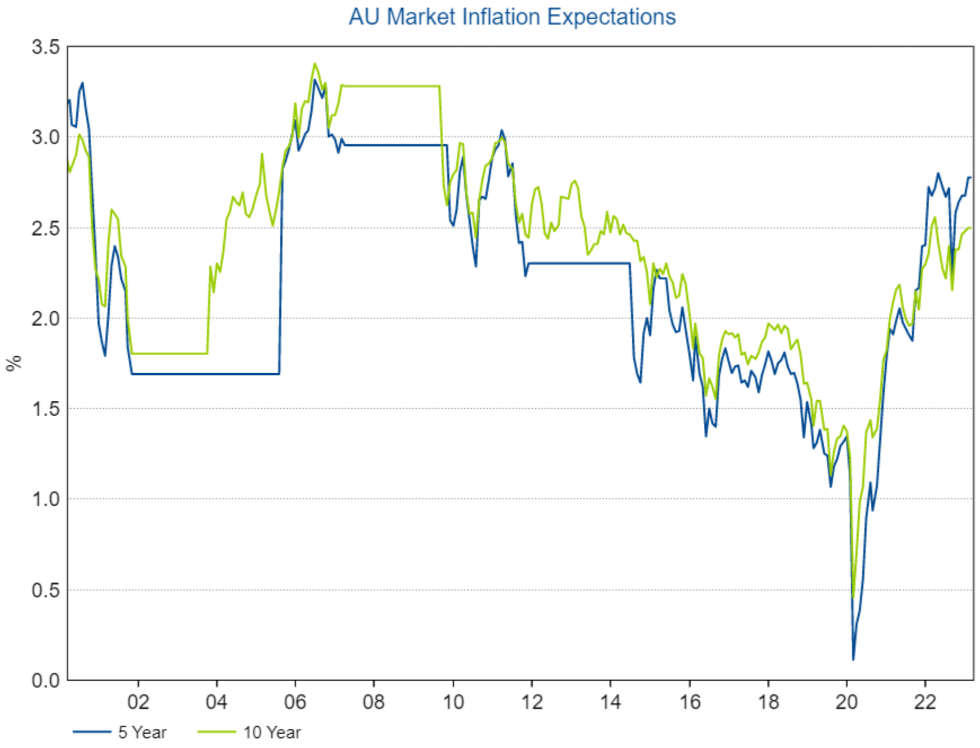

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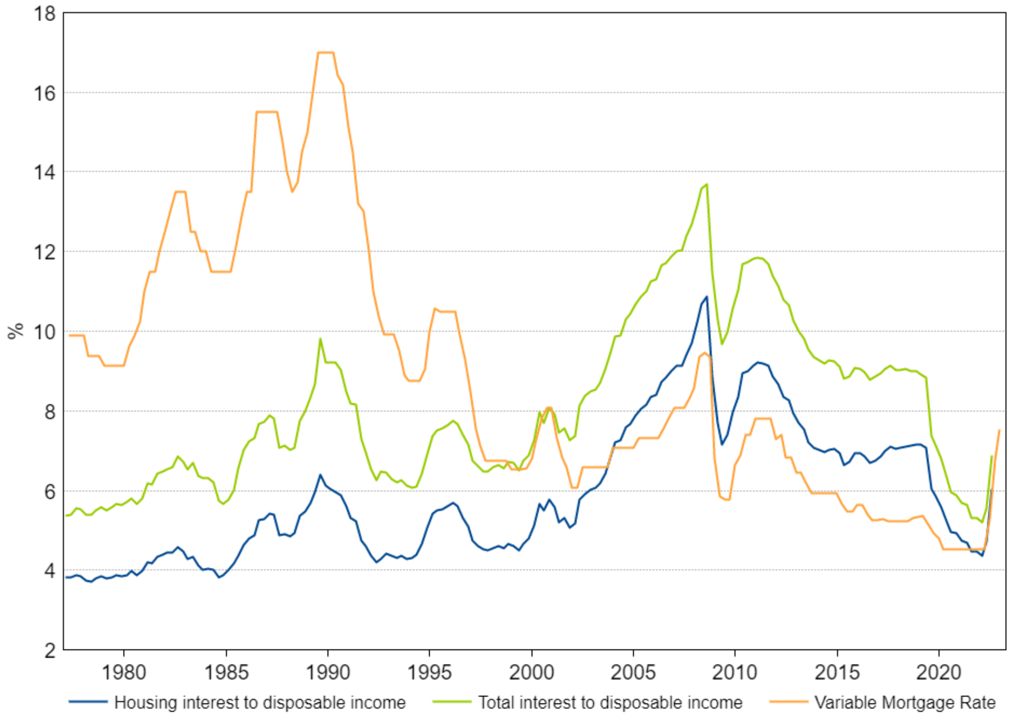
Mortgage payments a heavy cloud

- Interest rates are rising but it is taking time to flow through, longer than usual. Even so, payments are up.
- We aren't yet at the peak in payments seen in 2010, but risk getting there through mid to late 2023.
- Higher levels of household debt mean payments rise faster in response to rate rises, high savings delay this.
- Higher than usual levels of fixed mortgages delay the rise in repayments, the shock 'should' be anticipated.

Household Interest Payments to Disposable Income



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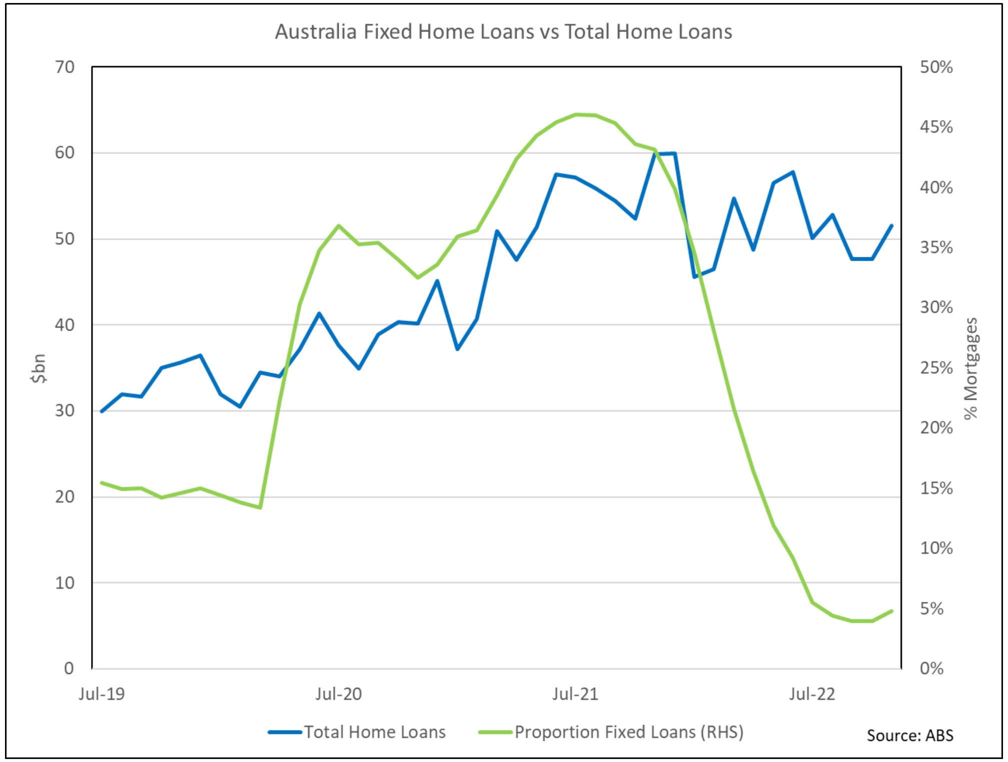

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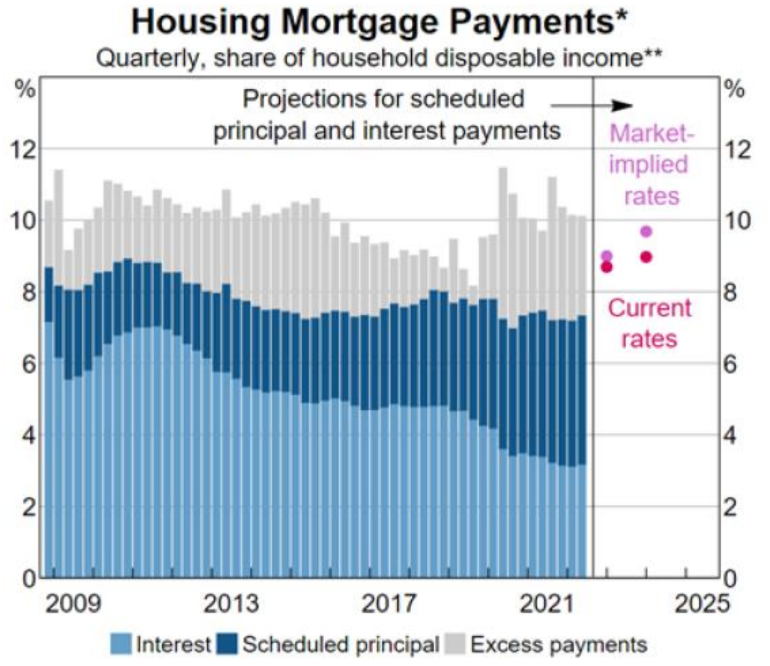
Household's Ability to Pay

- RBA warn mortgage payments are projected to reach highest level on record (as % household disposable income).
- "Average" mortgage cost to rise from 19% average wage to over 26%, more for those on downside of average.
- RBA reports 1/3rd households with variable mortgages are TWO year's ahead with payments, >50% One year ahead.
- 10% have NO spare cash post mortgage and living expenses, and low buffers. Low incomes, high non-discretionary spend.



Scenario	2021	2022	2023
Principle	$ 300,000	$ 300,000	$ 300,000
Mortgage Rate	2.90%	5.90%	6.65%
Cash Rate	0.10%	3.10%	3.85%
Term	25	25	25
Annual	$17,036.96	$23,245.49	$24,936.76
Month	$ 1,419.75	$ 1,937.12	$ 2,078.06
Per Week	$ 327.63	$ 447.03	$ 479.55
Av Wage	$ 1,736.17	$ 1,769.80	$ 1,814.05
% Wage	18.9%	25.3%	26.4%

Source: TCV, RBA, ABS

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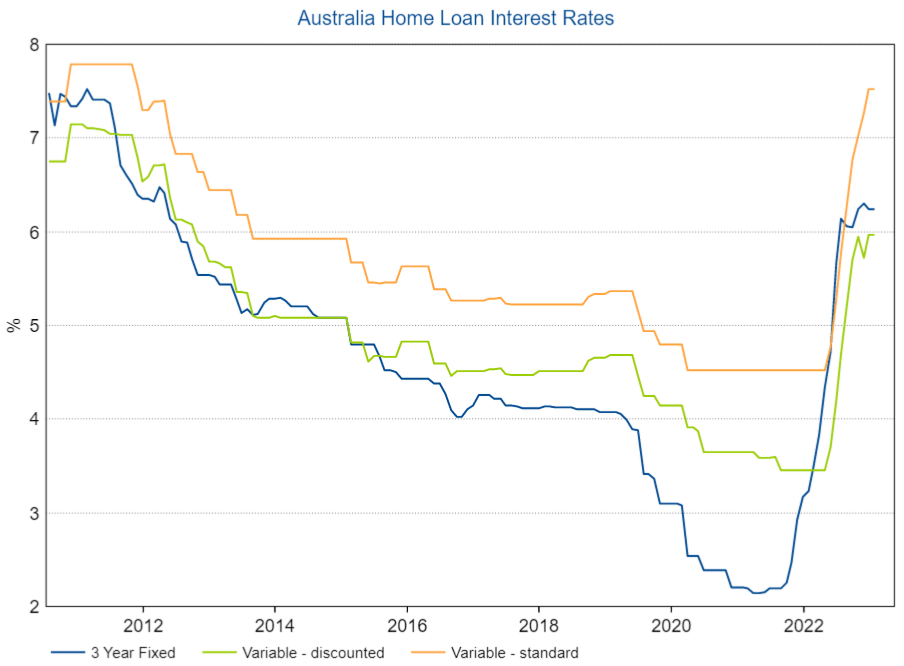
Default Risk Low

- RBA Research shows risks of default depend on:
  - ability to pay – unemployment rate and payments as % disposable income
  - negative equity – house prices
  - RBA's Jones: < 0.5% currently in negative equity
  - If house prices fall 10% more, it increases to 1%, another 20%, it increases to 4%



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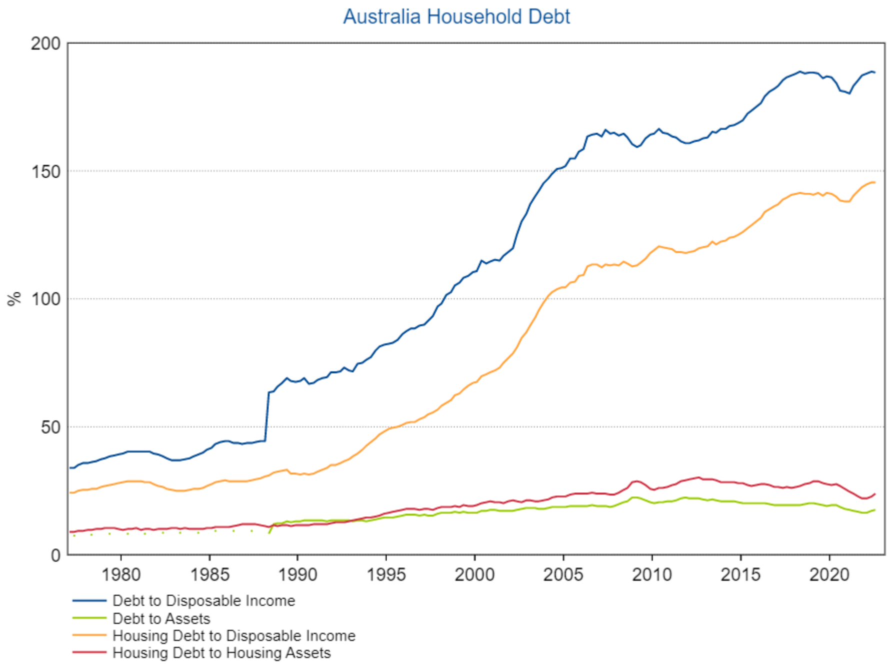

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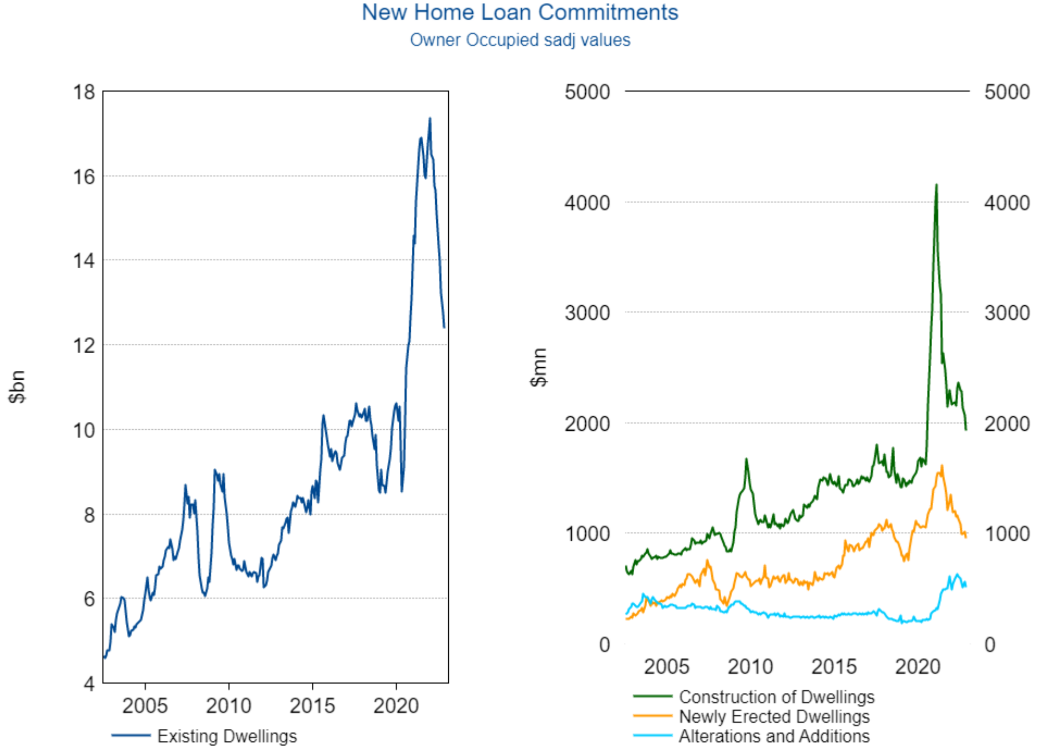
Housing impact

- Home loans have fallen sharply from their lofty levels. But they remain elevated. Turnover is still occurring.
- The impact is flowing through to construction, but completions are well behind approvals.
- The lag should see construction continue at modest levels through 2023.
- Population increase, via net migration, then stabilises demand for new housing by year end.



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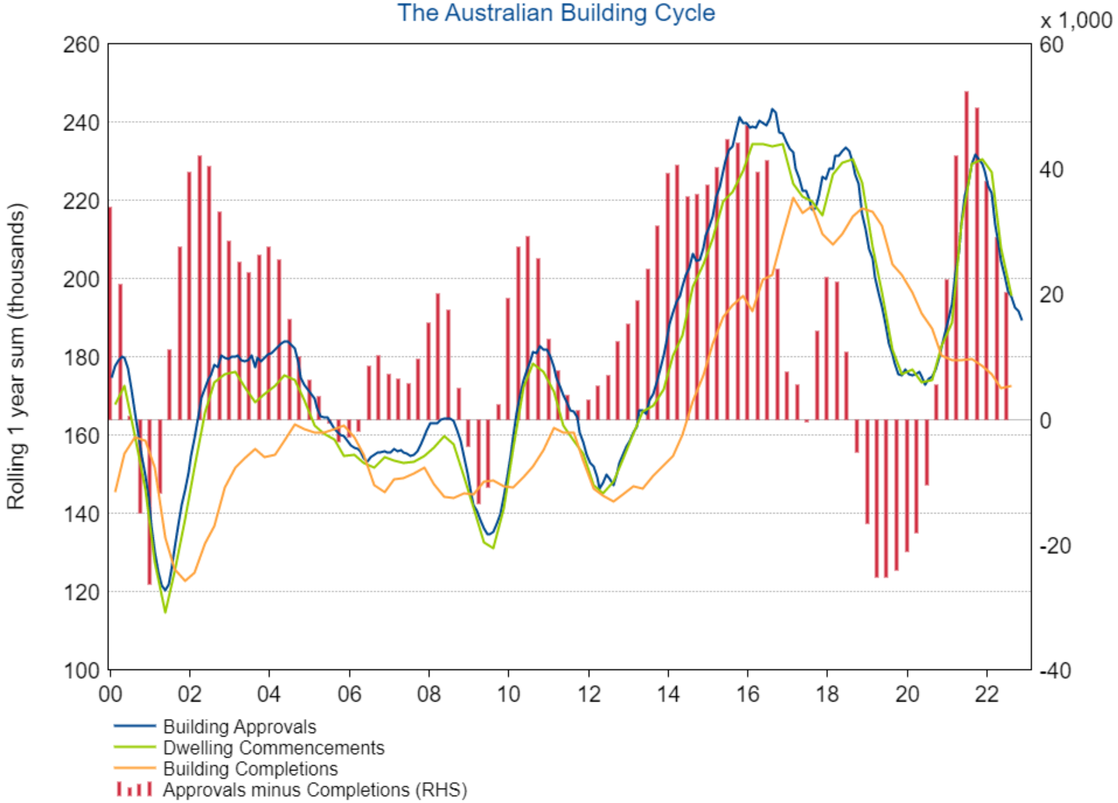

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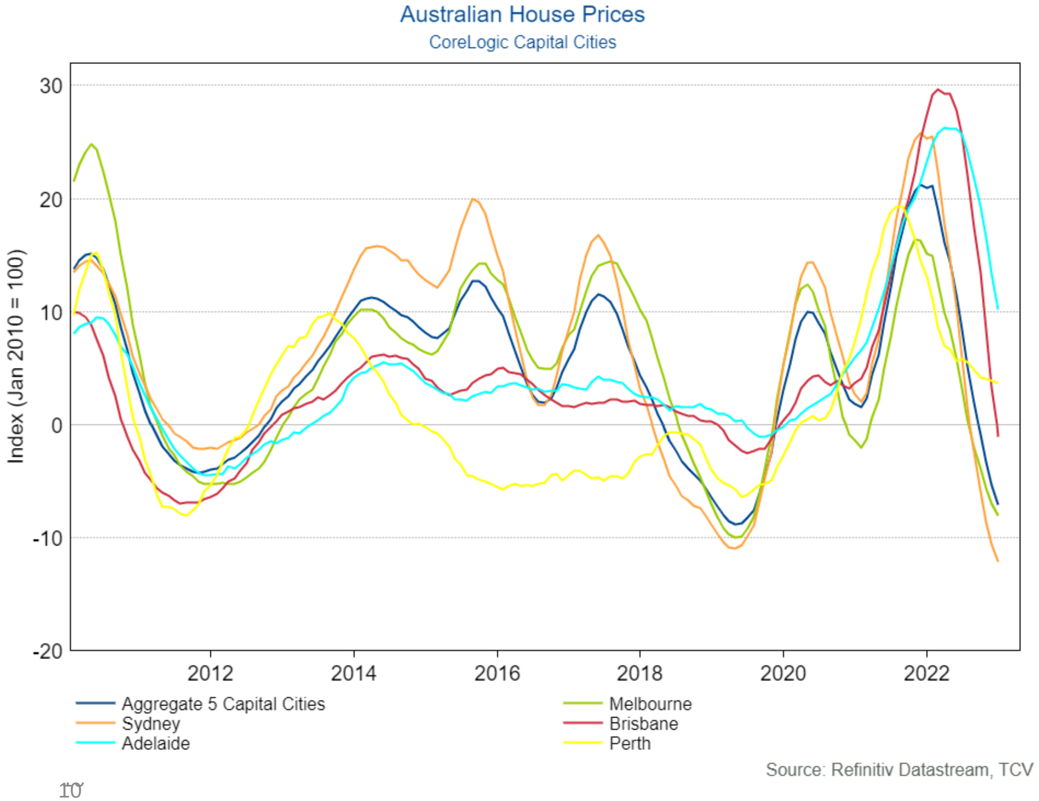
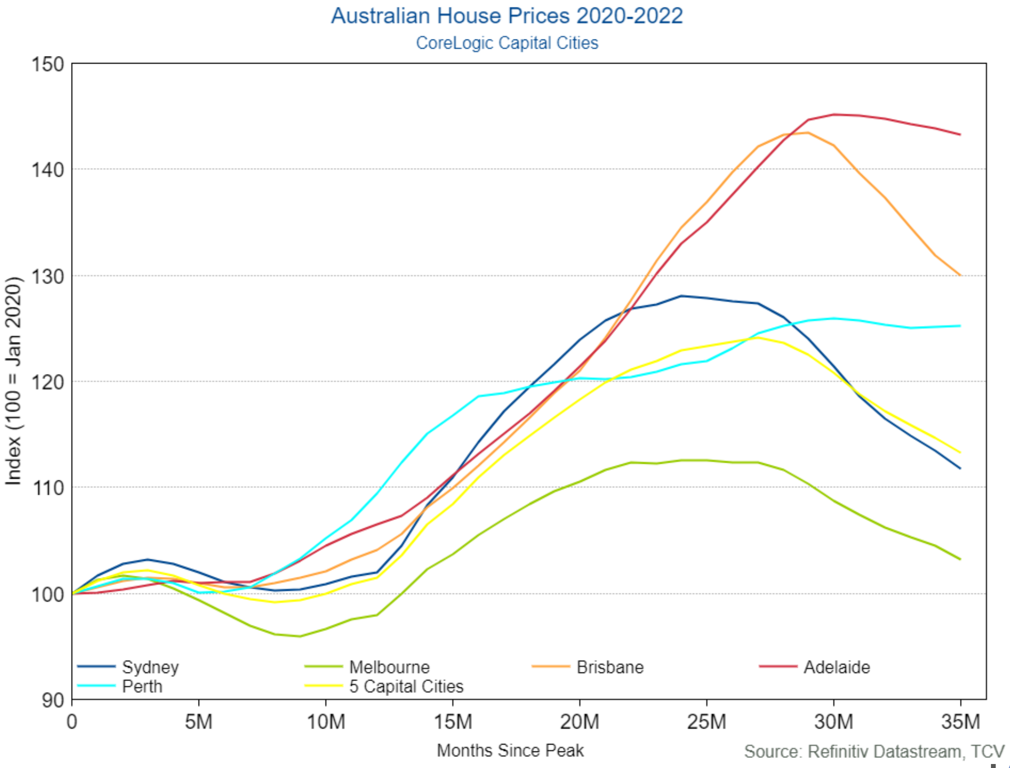
House prices falling, but still above 2020 levels

- House prices in capital cities have now fallen in the last nine months. From the peak, down 10% for five Capitals.
- The falls look dramatic, and they are. But the peak was even more spectacular.
- All capital cities are above the levels before the pandemic hit.
- We expect more price declines over time as they unwind the 2020 gains, this will impact wealth effects.





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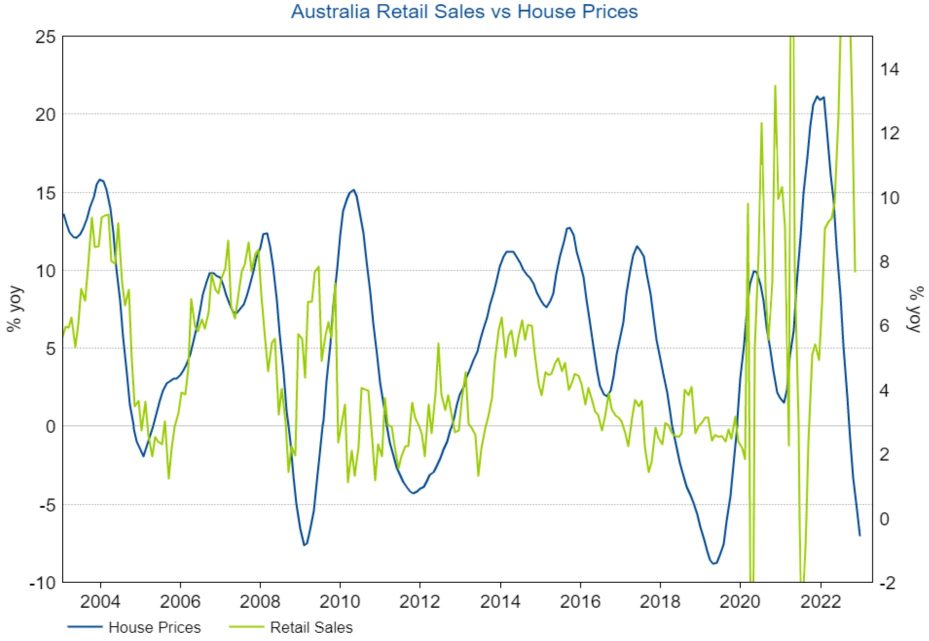
Retail spending feeling gravity

- Retail sales follow house prices, but have been slow to respond this time around.
- High levels of accumulated savings and full employment have kept the momentum going, until now.
- December saw a sharp fall in retail sales and Q4 real spending has also fallen.
- Weak consumer confidence, high cost of living and a slowing labour market are likely to keep household consumption soft.



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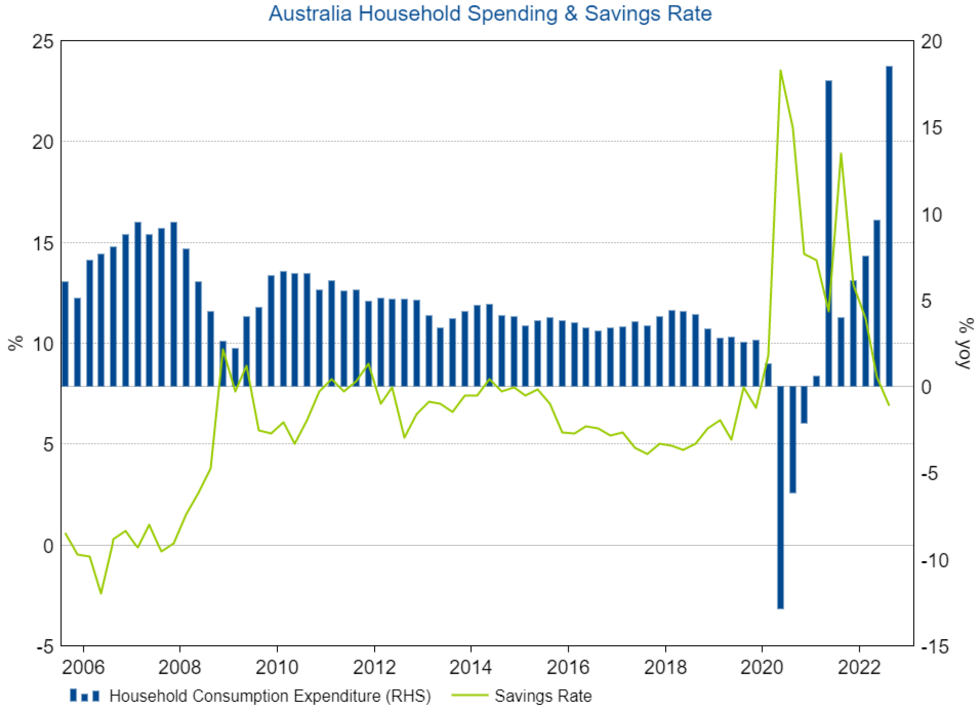

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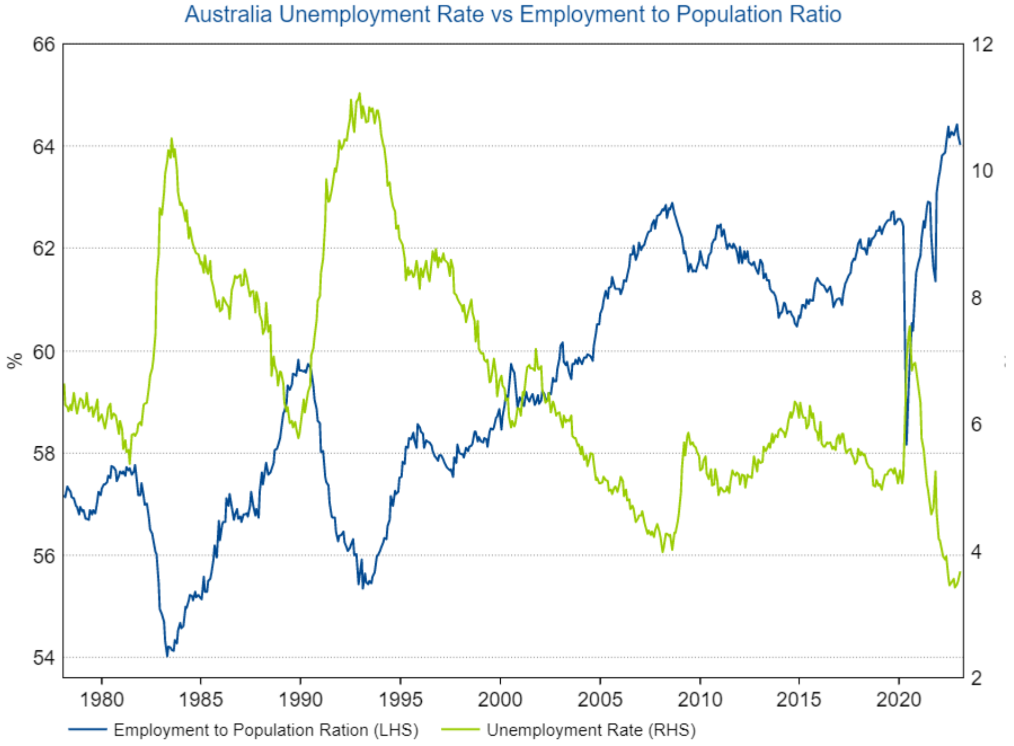
Labour market on the edge

- Employment has remained very strong and the unemployment rate is near historic lows (3.7%)
- Forward indicators such as job ads, NAB business survey show moderation from highs.
- Supply starting to return as the borders re-open, tourists, students and permanent migrants are coming in.
- Wages lag the cycle and there is still momentum. This holds household income up and counters some slowing forces.



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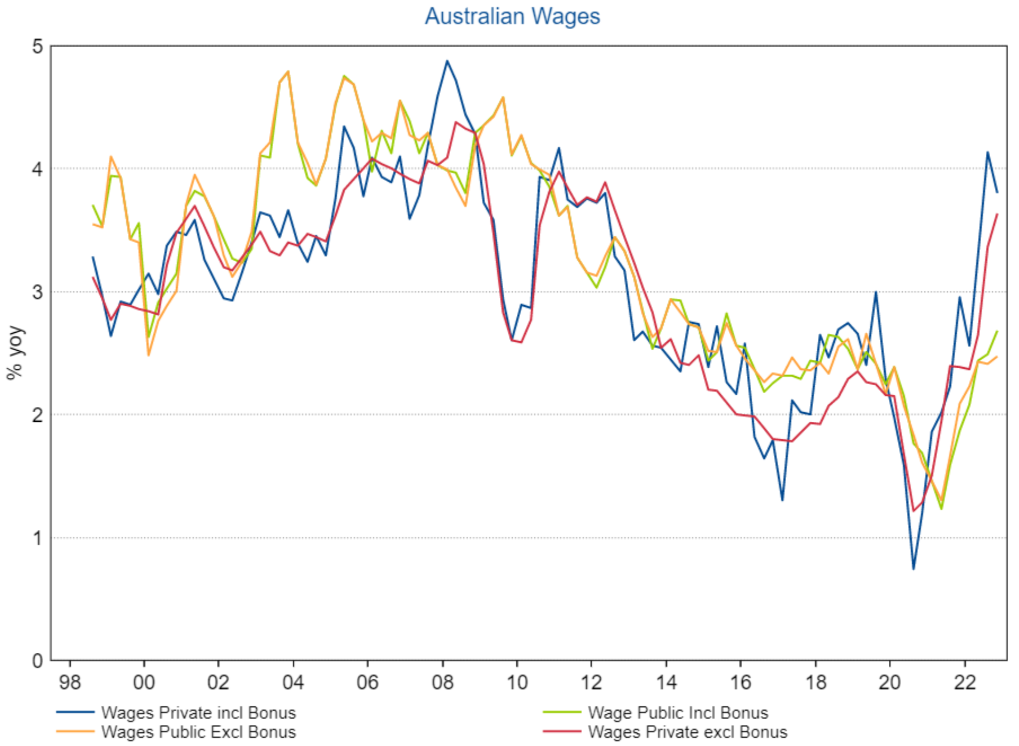

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How Monetary Policy Works

- The RBA's *<u>ONLY</u>* job is to manage stable inflation and full employment in the economy.
  - The rest is up to Government.
- They are independent because raising interest rates is unpopular, but is in the best interest of everyone to have stable prices.
- Faced with higher inflation, the RBA will raise cash rates and thus making financing more expensive for everyone.
- This alters investment decisions, slows the economy, reduces demand and eventually reduces inflation.
- It is definitively a blunt tool, and takes a long time to work – typically 9-12 months.
- It is best done in conjunction with fiscal policy- ie government spending.

- Things to note about inflation
  - It does not come down by itself. Momentum plays a part in determining future inflation.
  - Inflation expectations are also a strong factor in future inflation.
  - Monetary policy does not work on supply side inflation, ie higher prices due to reduced demand from war.
  - But it does work to combat demand led inflation and inflation expectations.

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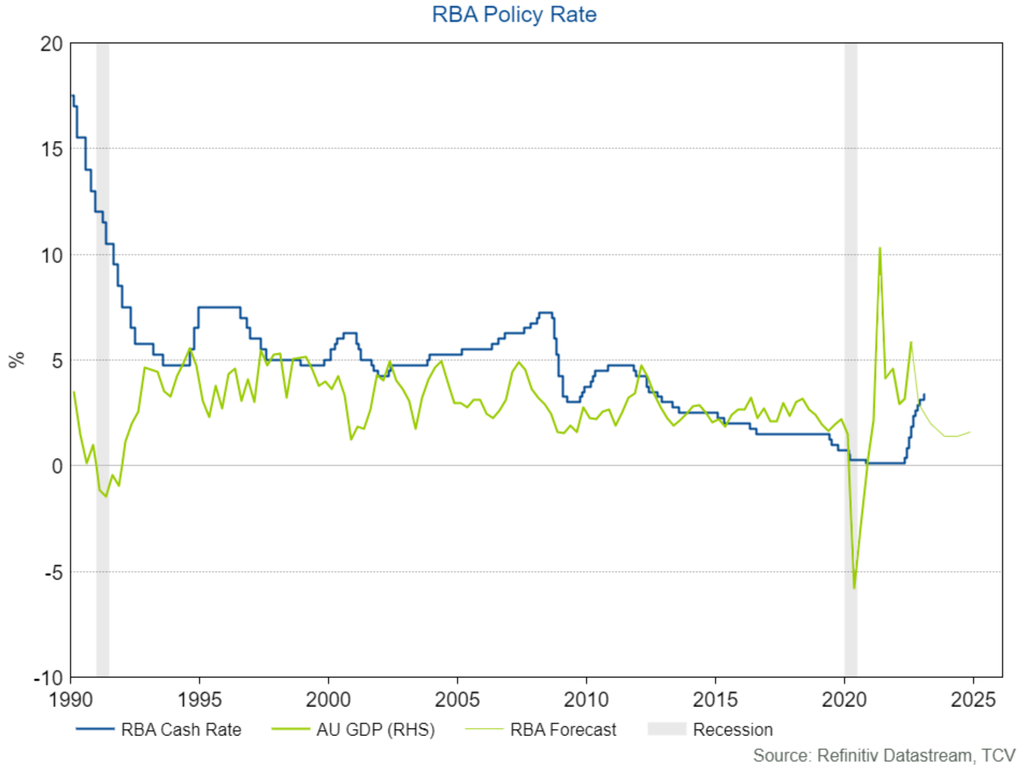
Going up – hiking cycles

- The RBA's tightening cycle has been the most aggressive in the inflation targeting era, at 325bps and counting.
- A typical cycle is around 219bps, lasting 10 months (outside the 2002 epically long cycle).
- This cycle will be higher, but from a lower starting point. This cycle returns some normalcy to rates, but will still be low.
- Interest rates are usually held for 12 months, 6-19 range. The slowing economy will be the determinant.



	Cycle Length	Cycle Amount	Peak Rate	Months at Peak
	Months	bps	%	Months
31/08/1994	5	275	7.50	19
30/11/1999	10	150	7.00	6
31/05/2002	71	275	7.25	6
30/10/2009	14	175	4.75	12
31/05/2022	12	350	3.85	
Average	25	219	6.63	11
ex 2002	10	200	6	12

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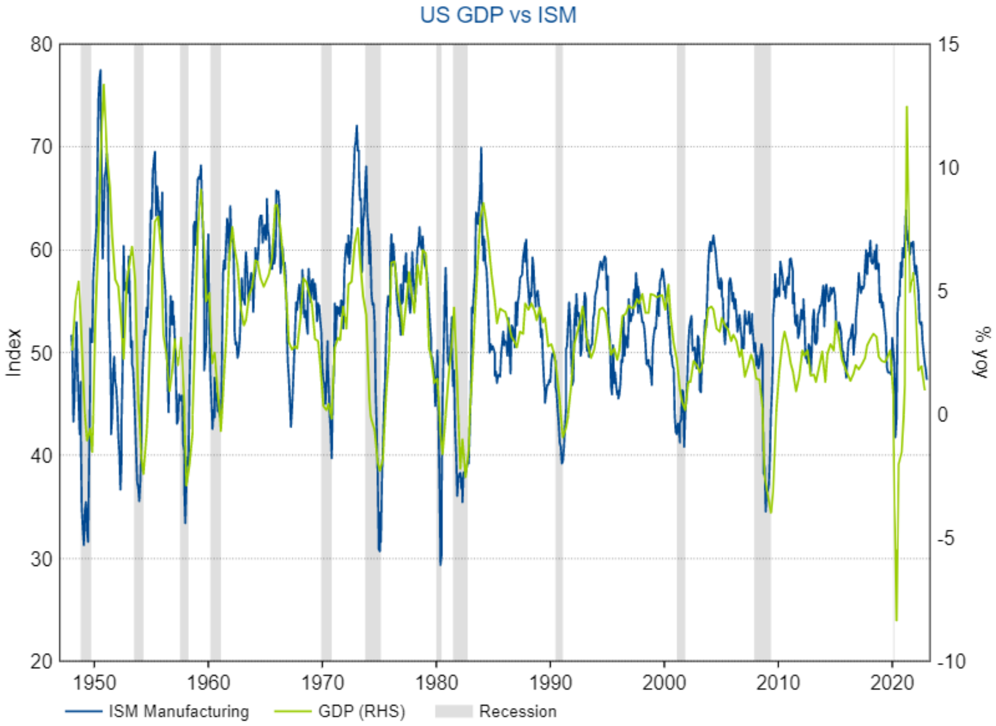
Tightening often brings recessions

- The large amount of tightening brings with it concerns of recession. The big question is just how bad this will be?
- The IMF see greater weaking in developed countries, compared to emerging markets. It sees a relatively ‘soft’ decline.
- US ISM is forecasting a US recession, with the index below 50. Developed market S&P PMIs are universally below 50.
- The US yield curve (2-10’s) is inverted, signalling recession.



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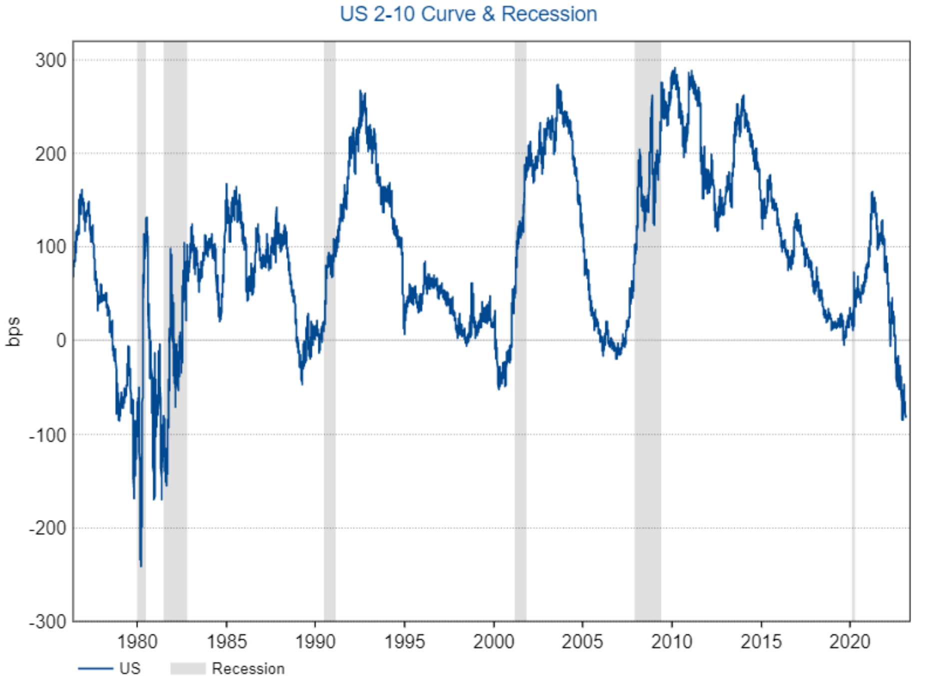

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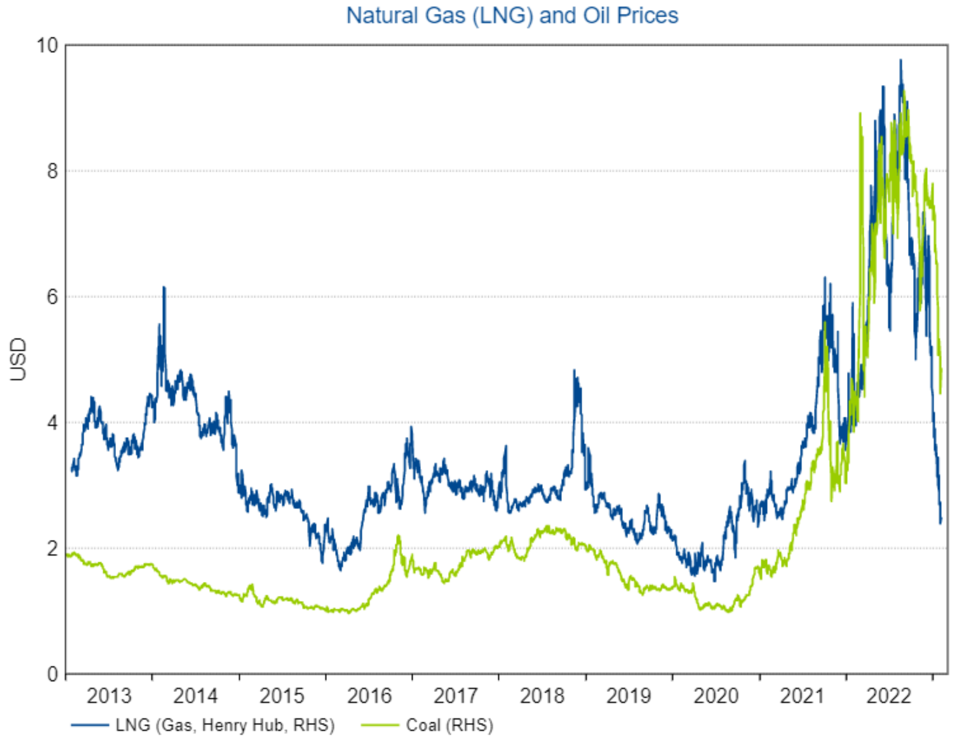
Offsetting factors

- CB's talk about a 'narrow path' for a 'soft landing'. Recession isn't inevitable, but a high risk.
- Lower global energy prices, assuming they continue, will be a significant release valve for the global economy.
- China exiting its covid zero policy, raising its demand for global goods and services.



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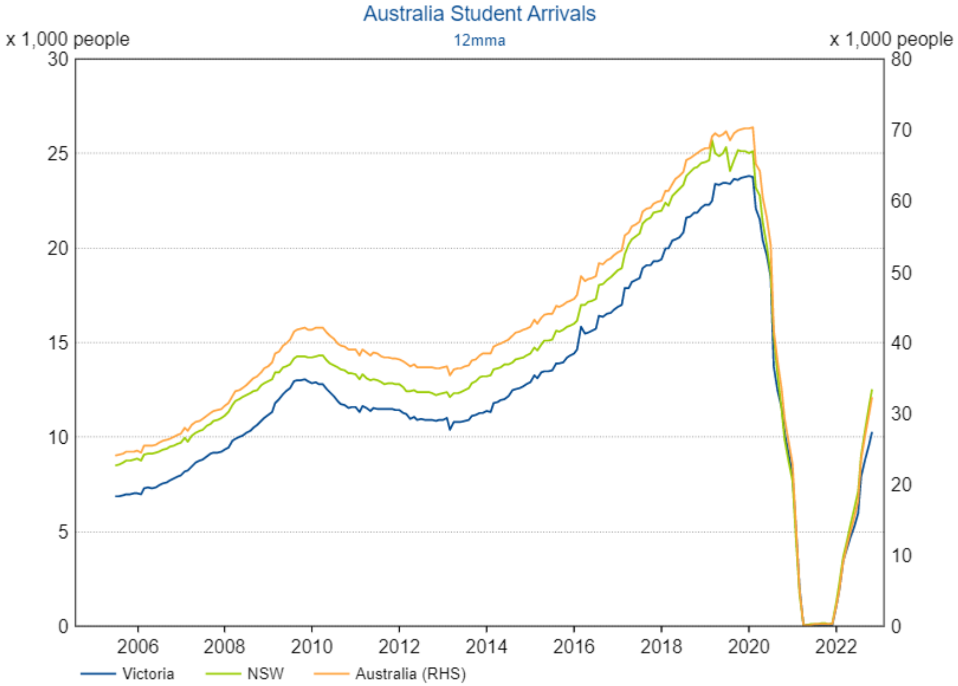

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Forecasts

		Current	Mar-23	Jun-23	Sep-23	Dec-23
Australia	Cash	3.35	3.60	3.85	3.85	3.85
	90 Day Bank Bills	3.47	3.75	3.65	3.35	3.20
	3 year CGL bonds	3.42	3.50	3.45	3.40	3.20
	10 year CGL bonds	3.71	3.90	3.90	3.85	3.75
Victoria	3 year TCV bond	3.77	3.90	3.85	3.75	3.50
	10 year TCV bond	4.43	4.60	4.60	4.50	4.35
United States	Cash	4.75	5.00	5.25	5.25	5.00
	US 10 year T notes	3.73	3.90	3.80	3.75	3.65
	AU-US 10 year spread	-3	0	10	10	10

Forecasts

- RBA moves to 3.85%
- Fed raises to 5.25%
- Markets price slowdown
- 10’s fall faster than 3’s
- Start to normalise year end
- TCV spread remains high
- Volatility remains high due to greater economic uncertainty

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