Economic Update: Secular and cyclical forces shaping our economy

May 2024

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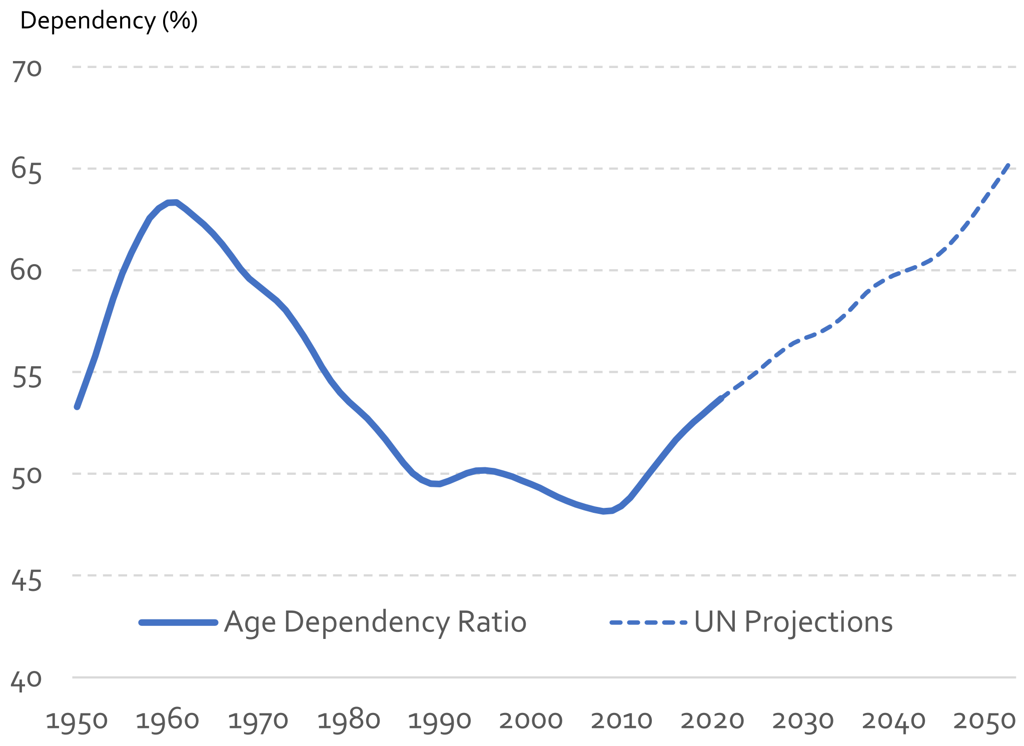
Secular Challenges for our Economy.

It will be an investment led economy for the decade ahead.

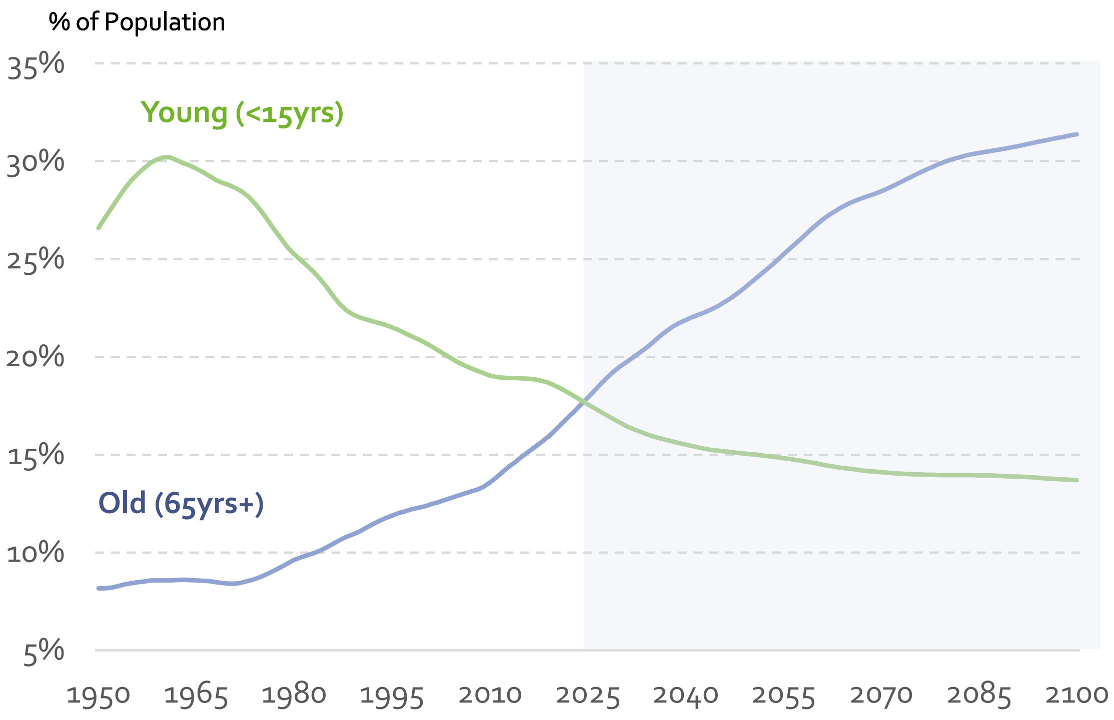
Rising dependency will reshape our economy

- The population over 65 years of age is expected to rise by around a third over the next 15 years
- Unlike the elevated dependency ratio of the 1950s and 1960s, the current rising trend is driven by old age dependency

Australia's Dependency ratio



Dependency ratio: Australia (Old and Young)



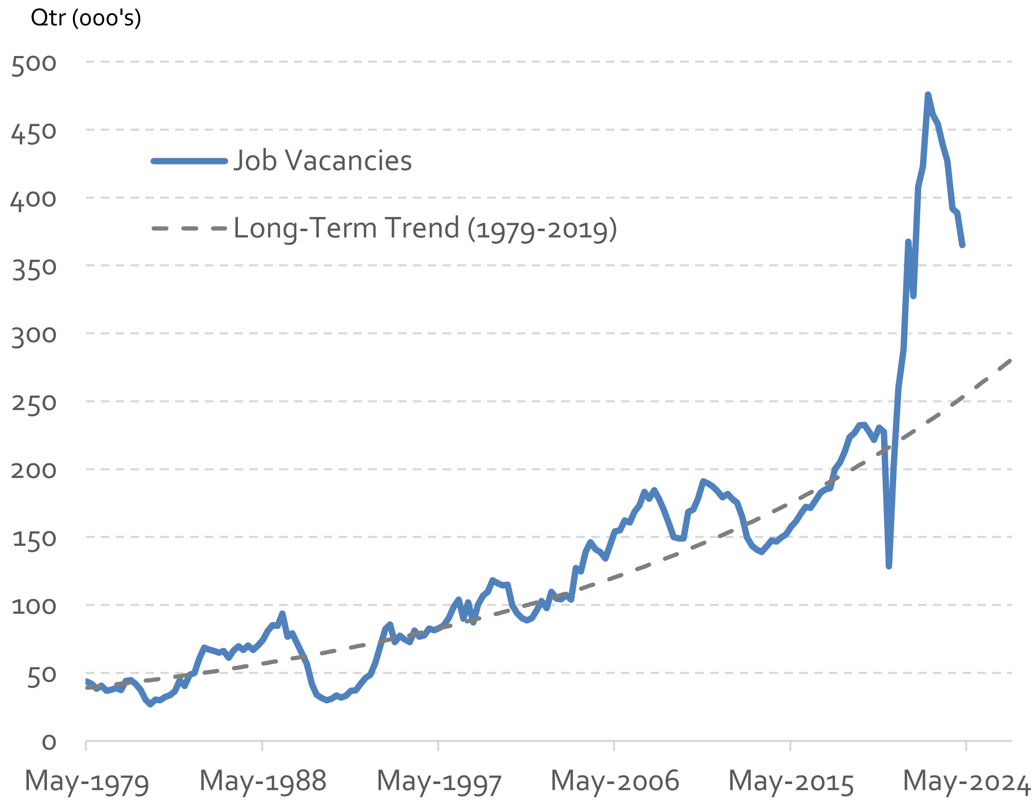
Source: United Nations, EQ Economics

Economic implications of rising dependency.

- Excess demand for labour will put upward pressure on real wages and unit labour costs (and inflation).
- Business can address labour shortages with two broad strategies:
  1. Accessing new pools of labour,
  2. Investing in labour saving technology.
- Business can access non-working age population and overseas labour pools via outward FDI, offshoring of components of operations and immigration
- 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

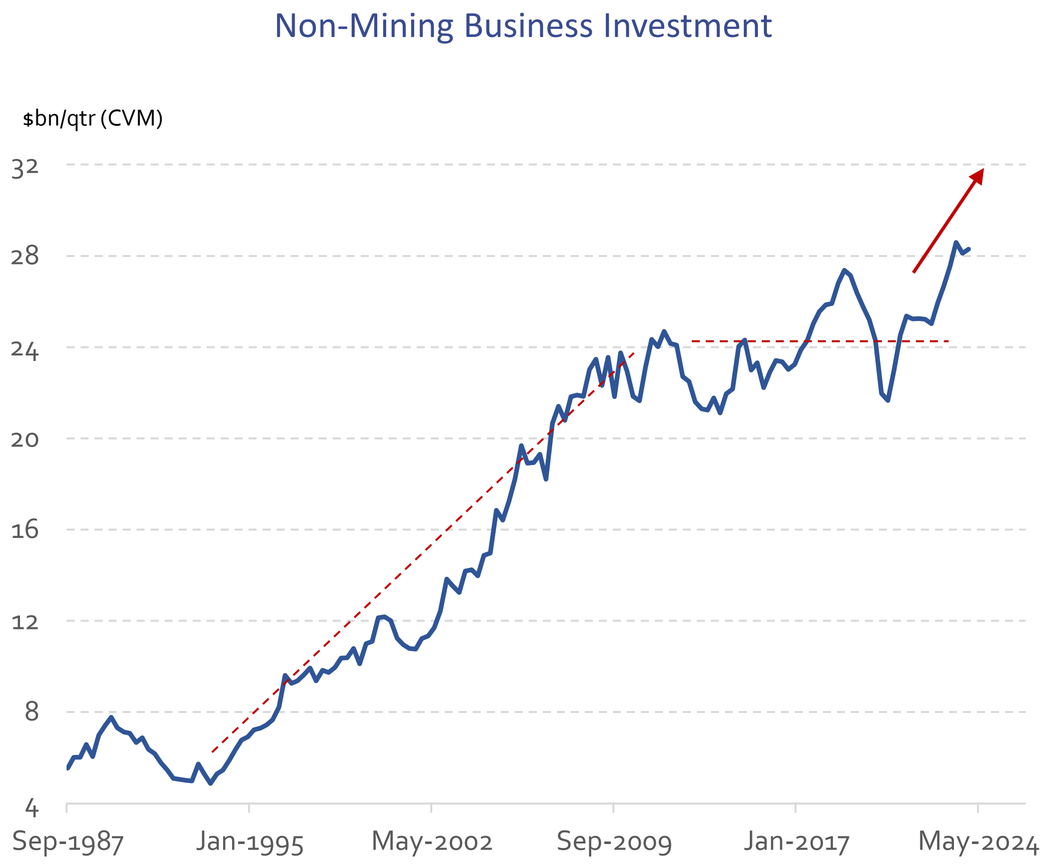
Labour shortages are already an acute problem in our economy



Source: ABS, EQ Economics

Supply Side Transformation.

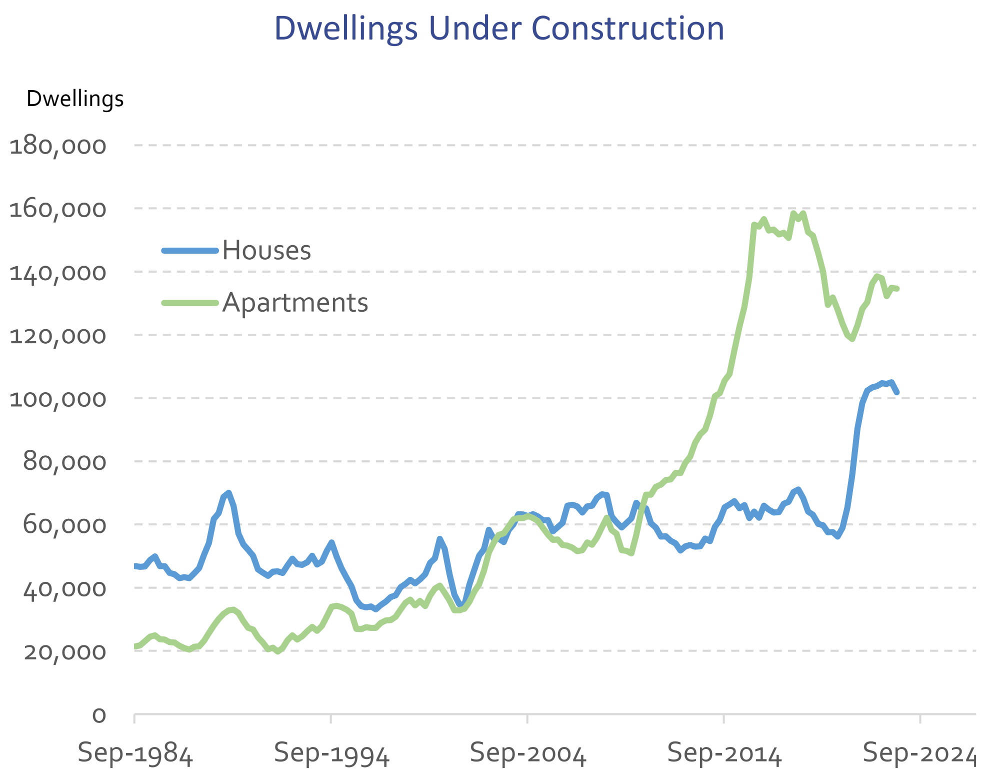
- **A business investment led economy?** Labour shortages, rising insolvencies, the energy transition and new technology are all factors expected to drive a sustained lift in business investment.
- **Consumer consolidation:** The era of sustained household debt accumulation appears to have run its course 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.
- **Energy Transition:** Every business will have to focus on energy efficiency and reporting which should spur a wave of investment in new technology and processes.

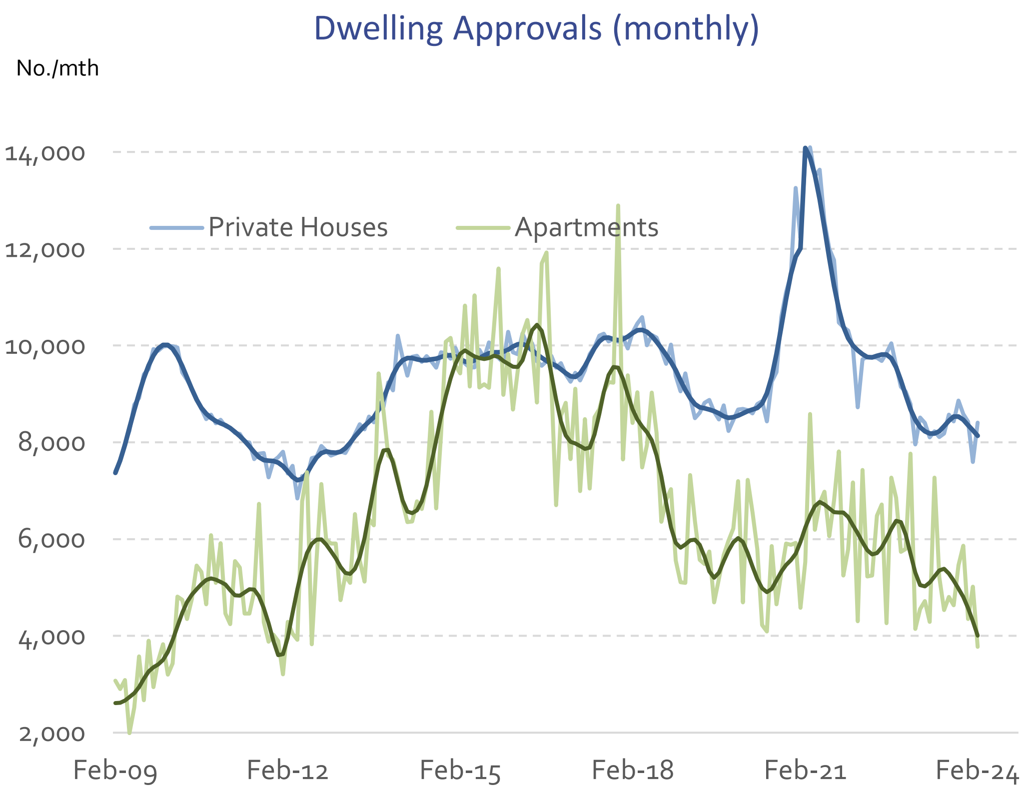


Source: ABS, EQ Economics

Australia's dwelling shortages will get worse

- There are presently about 225k dwellings under construction, not far from the record high of 245k in 2022.
- Strong population growth and a slump in dwelling approvals suggest housing shortages will get worse before they get better.
- We need to increase the supply of new dwellings by reducing the cost of producing those dwellings – labour costs are a major issue





Source: ABS, Judo Bank

Budget 2024–25: Turning surplus into deficit.

Pre-election spending weakens Government financial position

Issues impacting business.

Cashflow Measures

1. Instant Asset Write-Off extension to June 2025 (<$10m turnover)

Energy Measures

1. Energy Bill Relief of $325 for small business (1m)

Falling Net Overseas Migration (NoM)

1. After more than 900k NoM over the last two years, target reduced to 260k in 2024/25 and 250k in 2025/26
2. Takes pressure off housing but may worsen skills shortages.

Stage Three Tax Cuts

1. Counters ‘bracket creep’ in 2024/25
2. Average taxpayers gets $1888 (support consumer spending).

Future Made In Australia

1. Projected $22.7bn of subsidies and tax incentives for green energy supply chain and advanced manufacturing over 10yrs.
2. No critical industries strategy (food and grocery) beyond medium to long term energy price moderation.
3. May hurt other industries trying to attract capital and labour?

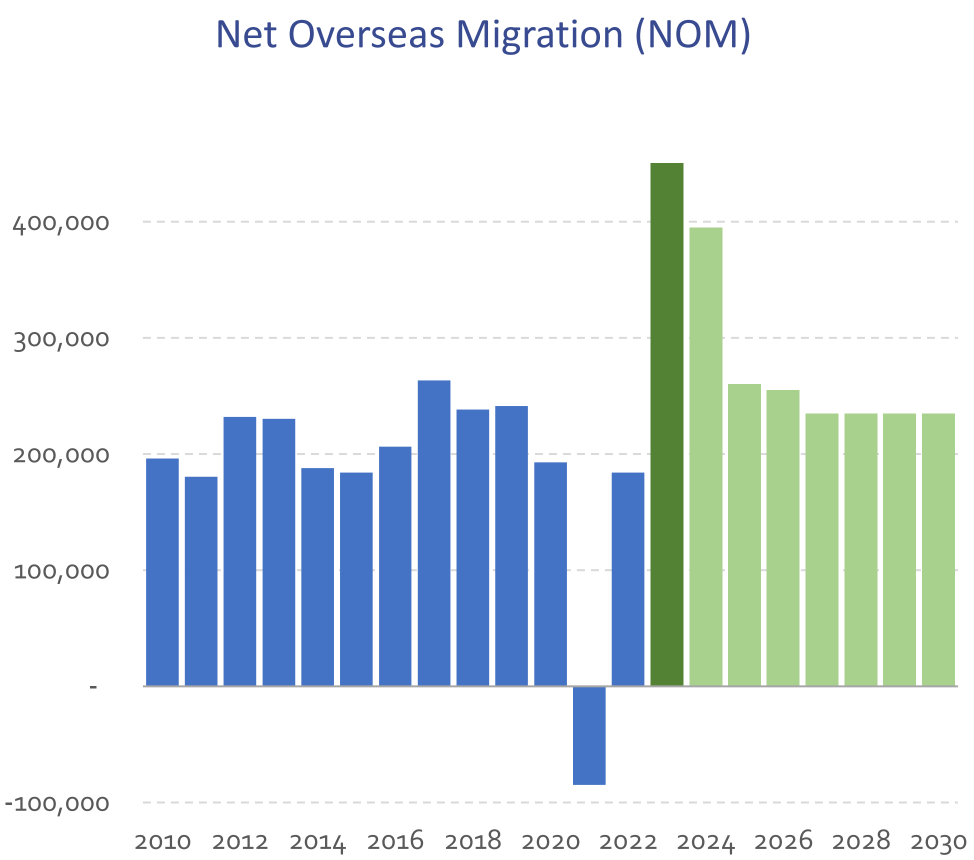
Recovery for the Economy

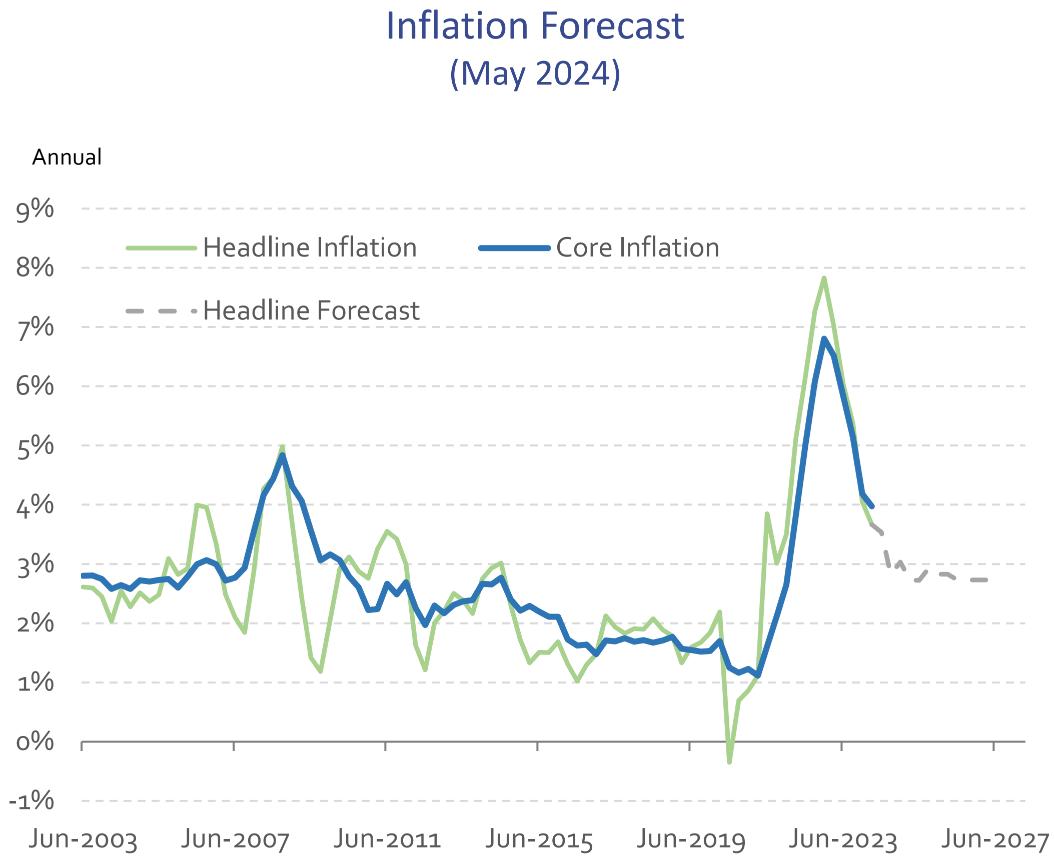
1. Government expects inflation below 3% by December 2024
2. Raises hopes of rate cuts in 2024/25.
3. Economic recovery in 2024/25 although growth remains modest over the next two years.
4. Consumption improves in 2024/25 although business investment weaker.

Source: Treasury, EQ Economics

Inflation expected to remain at top of target band into 2025/26.

- A quick fall to 3% but inflation remains at top of target band (2.75%) over the next two years – unlikely to trigger rate cuts.
- The pandemic saw Net Overseas Migration (NoM) fall by 400k compared to trend with the recent surge adding 600k



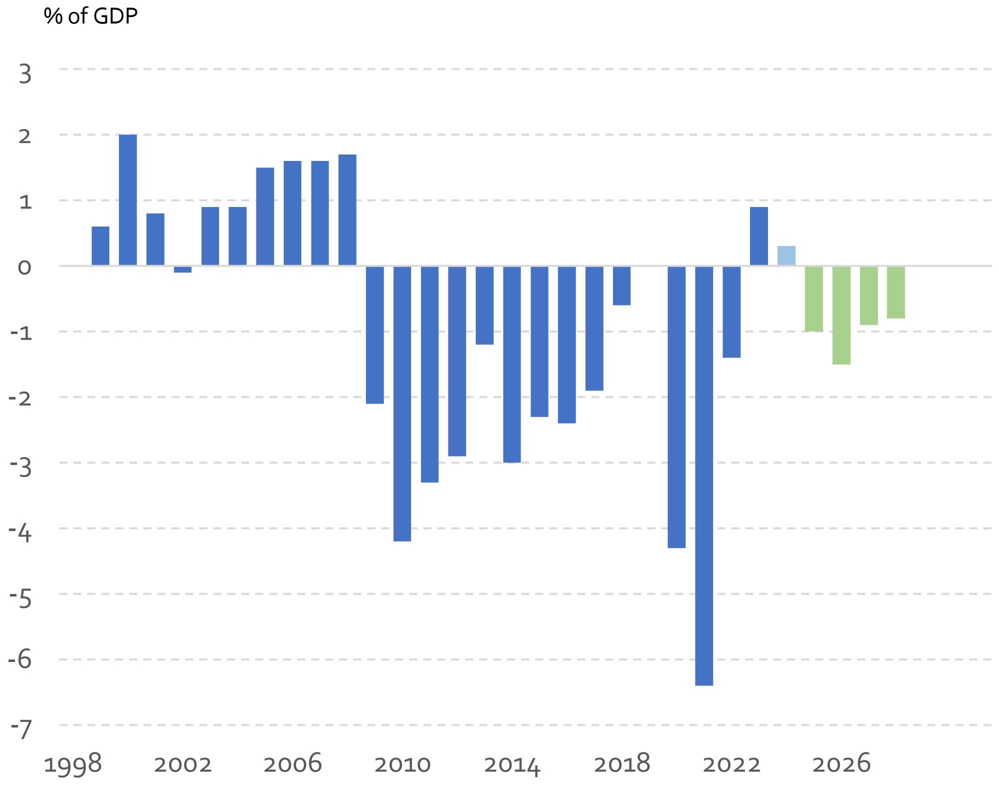


Source: Treasury, EQ Economics

Budget 2024-25 snapshot.

- A strong economy, high inflation and elevated commodity prices have delivered back-to-back surpluses.
- New spending measures and the loss of economic tailwinds (inflation, employment growth, commodity prices) means that deficits stretch well into the future.
- A $37bn deterioration in the Budget position in 2024/25 leaves a deficit of $28bn. Deficits remain around 1% of GDP well into the future - $122bn over four years.
- New spending initiatives are the big driver of the new Budget projections. There are $9.5bn of new measures in 2024/25 and a total of $24bn over the forward projections.
- ‘Off balance sheet’ borrowing adds $80bn to underlying deficits over the next 4 years taking total borrowing to $200bn.

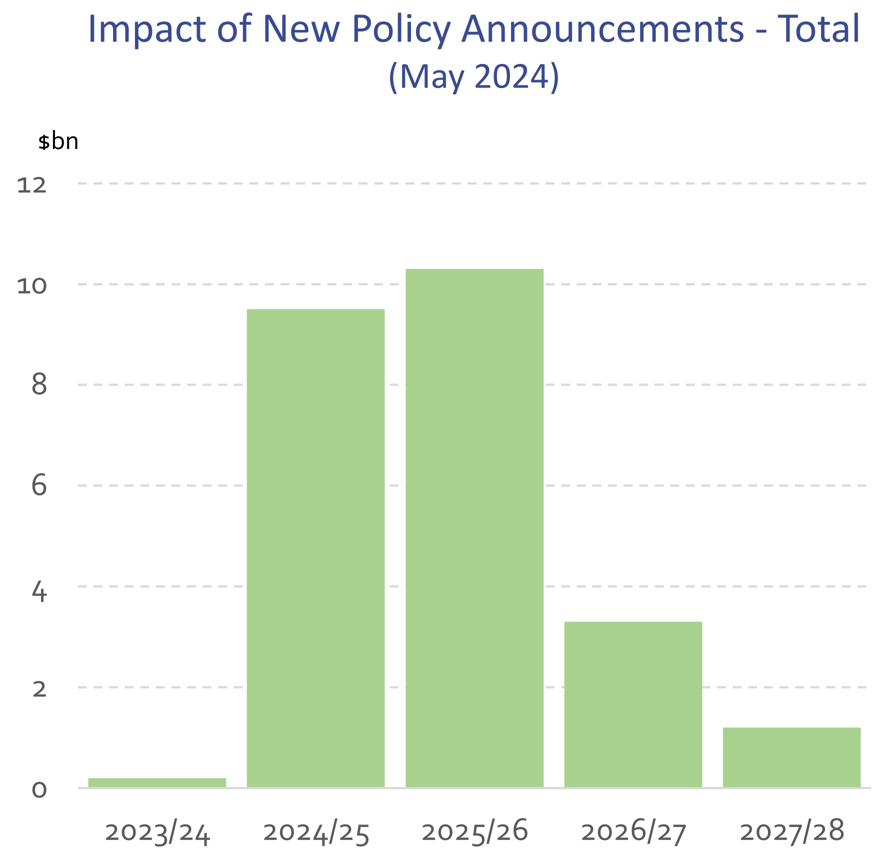
Australia’s Budget Balance (% of GDP)
(May 2024)

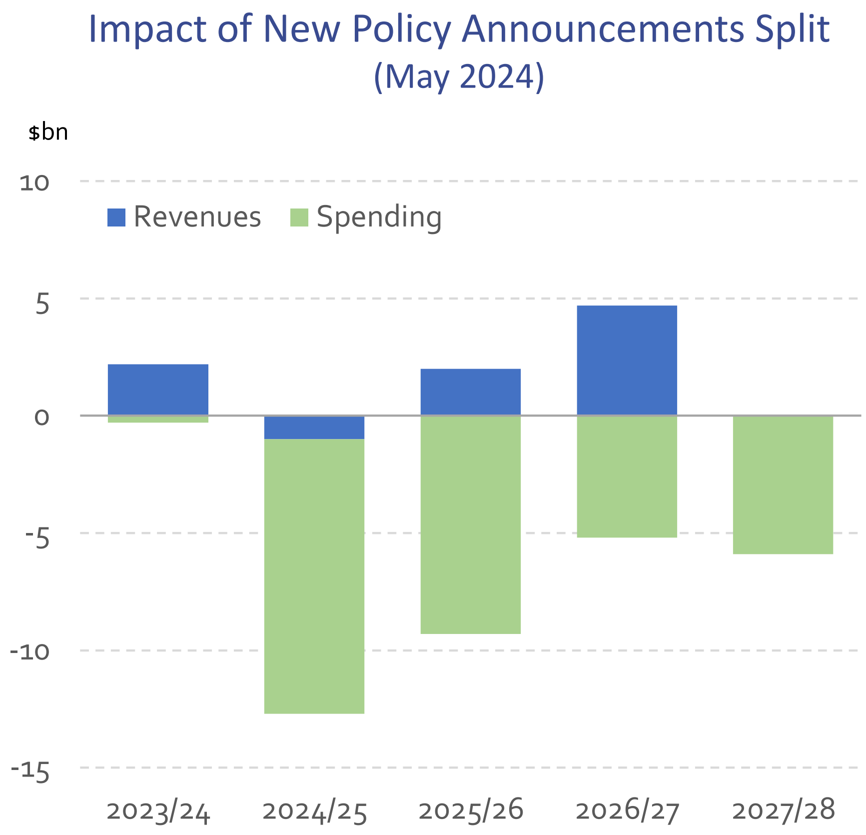


Source: Treasury, EQ Economics

Budget impact from new policies.

- New policy announcements will take about $20bn out of the Budget over the next 2 years.
- Policy changes are mainly new spending initiatives and all funded by bigger deficits.



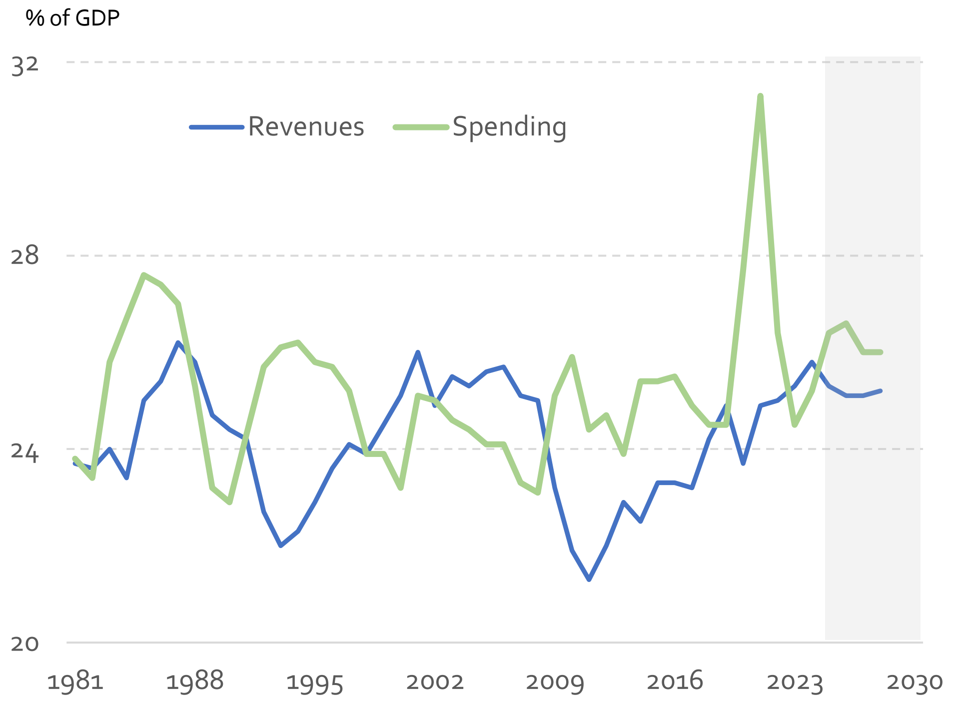


Source: Treasury, EQ Economics

The structural Budget deficit.

- The structural budget deficit is around 1-2% of GDP which equates to about $40bn a year in 2024/25.
- This deficit can be closed by a combination of lower spending and higher taxes.
- If we are to raise taxes, the question is how? New sources of revenue will be required.
- Cutting back on Government spending is a genuine option that this government doesn't seem to want to contemplate.
- Higher taxes would lock in the highest share of government spending and taxation in 40 years.

Australia's Budget Position: Revenues and Spending
(May 2024)



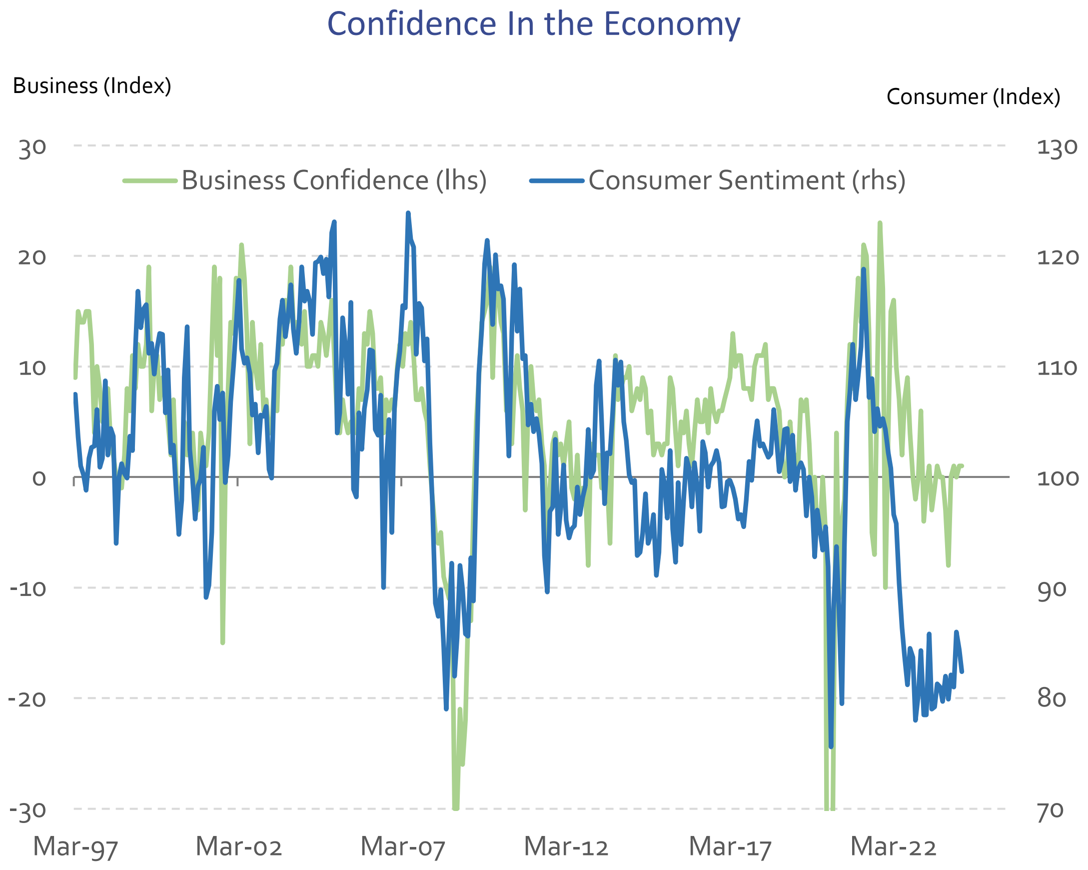
Source: Treasury, EQ Economics

The Economic Outlook.

Will Australia remain on the ‘narrow path’?

Confidence divergence.

- Business confidence is at ‘neutral’ levels according to the NAB’s April Business Survey.
- Consumer Sentiment in contrast is ‘stuck’ at recession levels, where it has been since inflation emerged in 2022.
- It is historically unusual for such as sustained divergence between consumer and business confidence although it did happen for 6 years in the last decade (2013-18).
- High levels of household debt and weak real incomes are a feature of the Australian economy over the past decade.

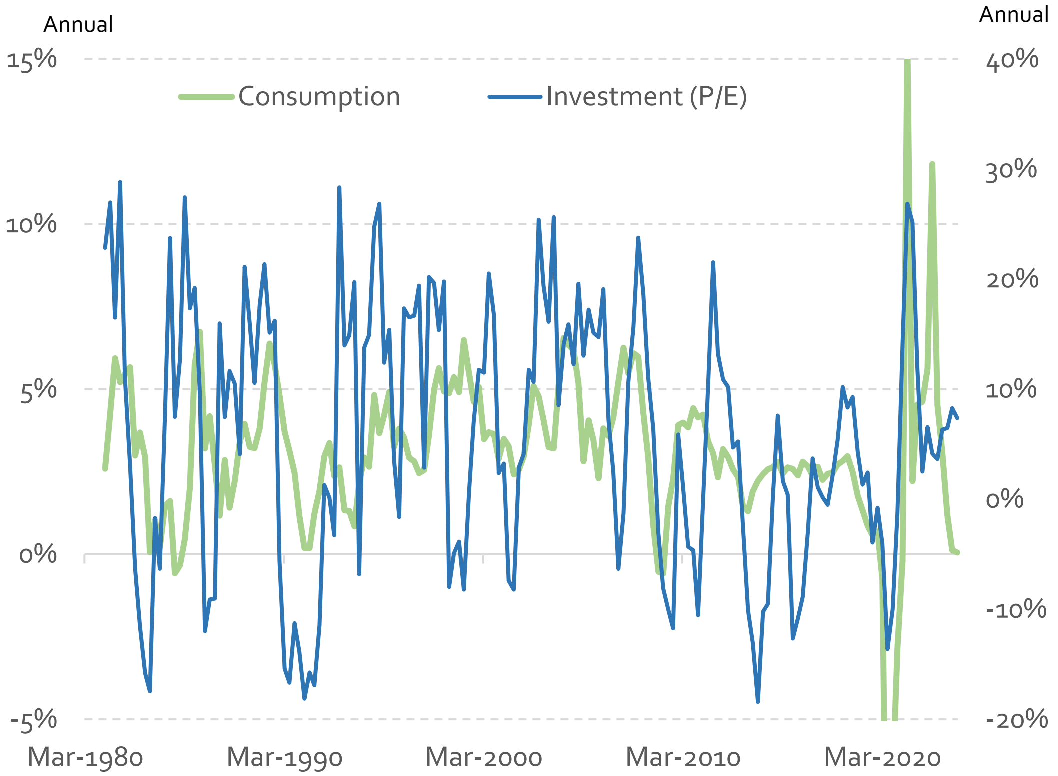


Source: NAB, Westpac – Melbourne Institute, ABS, EQ Economics

Not a normal cycle.

- Consumption growth has all but stalled, growing just 0.1% in 2023.
- This is only the fifth occasion in the past 40 years when consumption growth has ‘stalled’ in this way.
- What stands out on this occasion is that the business sector is still expanding.
- Plant, Equipment and Machinery investment, a good cyclical indicator of business investment, rose 7.4% in 2023.
- Business spending is more volatile than consumer spending (chart). This cycle is not normal with the main driver of economic weakness coming from consumer belt tightening while businesses continue to hire and invest.

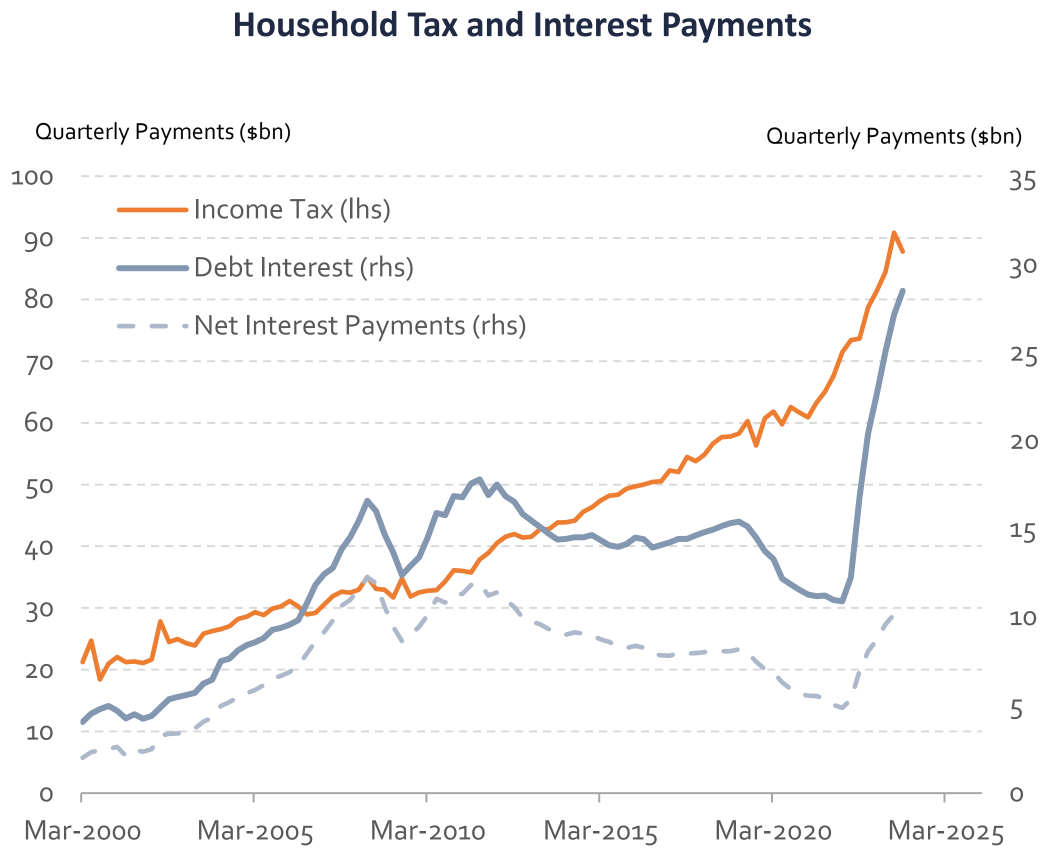
Consumption and Investment Over the Cycle

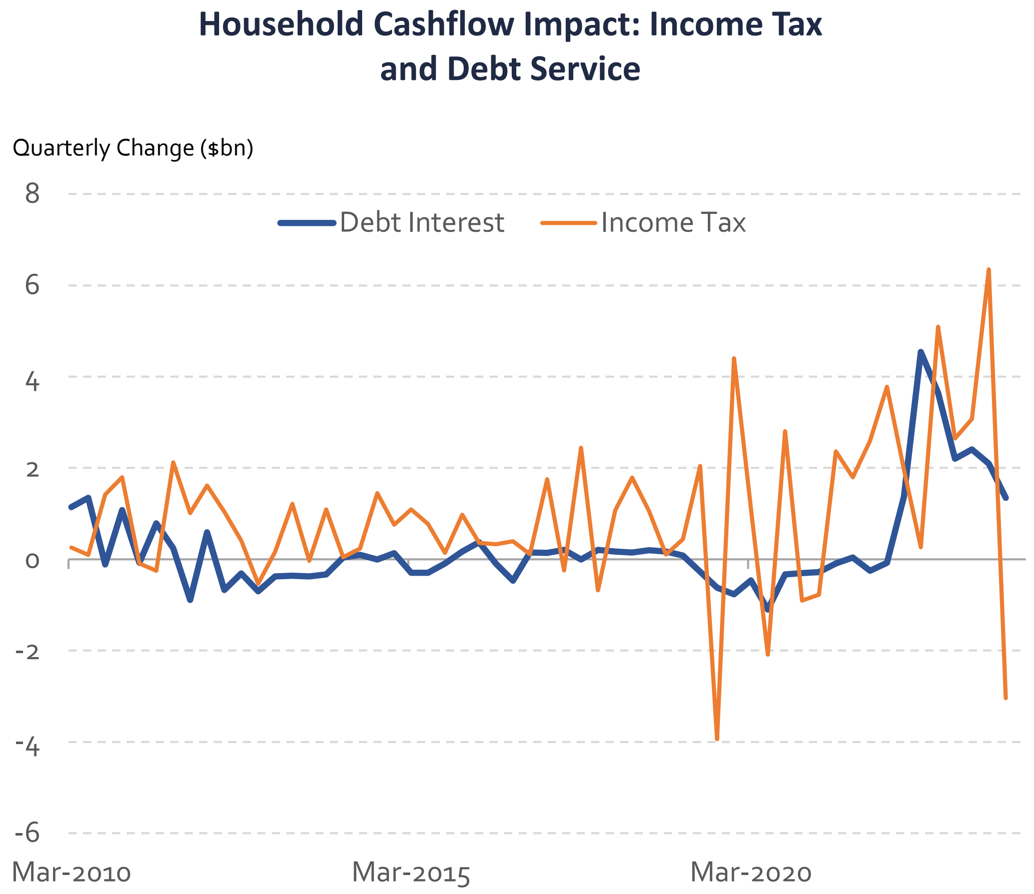


Source: ABS, EQ Economics

Some first signs of an easing of household pressures in Q4

- Over the past 2 years income tax payment have increased 50% (+$30bn/quarter) while debt service is up 3x (+$18bn/quarter)
- There has been some relief in the December quarter



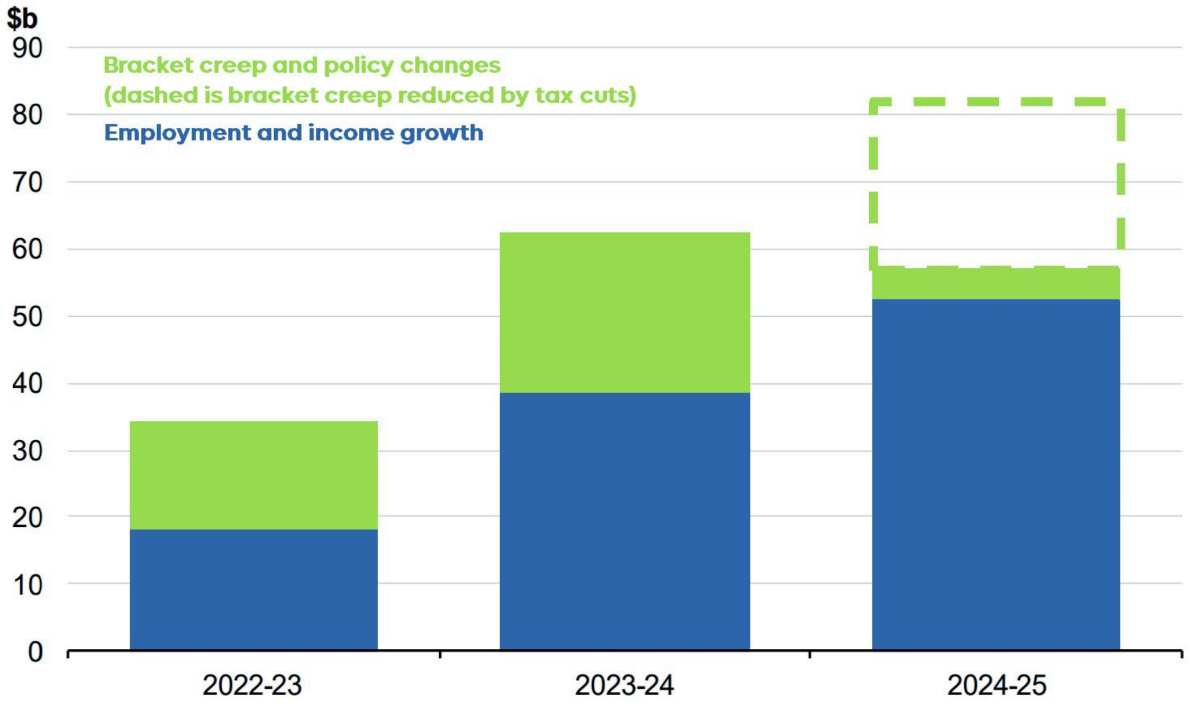


Source: ABS, EQ Economics

Bracket creep has been significant.

- Treasury estimates have bracket creep taking $17bn out of household income in 2022/23. This was 50% of the increase in the income tax take that year.
- In 2023/24 bracket creep is estimated to be $25bn, about 40% of the increase in the total tax take.
- Bracket creep has played a big role in squeezing household budgets over the last two years, potentially a bigger impact than interest rate rises.
- Tax cuts reduce bracket creep to $6bn over the year ahead.
- A major factor than has been restraining economic activity via weaker household income growth and consumer spending will be lifted this year.
- This could be the equivalent to 3 rate cuts

Bracket Creep Estimates

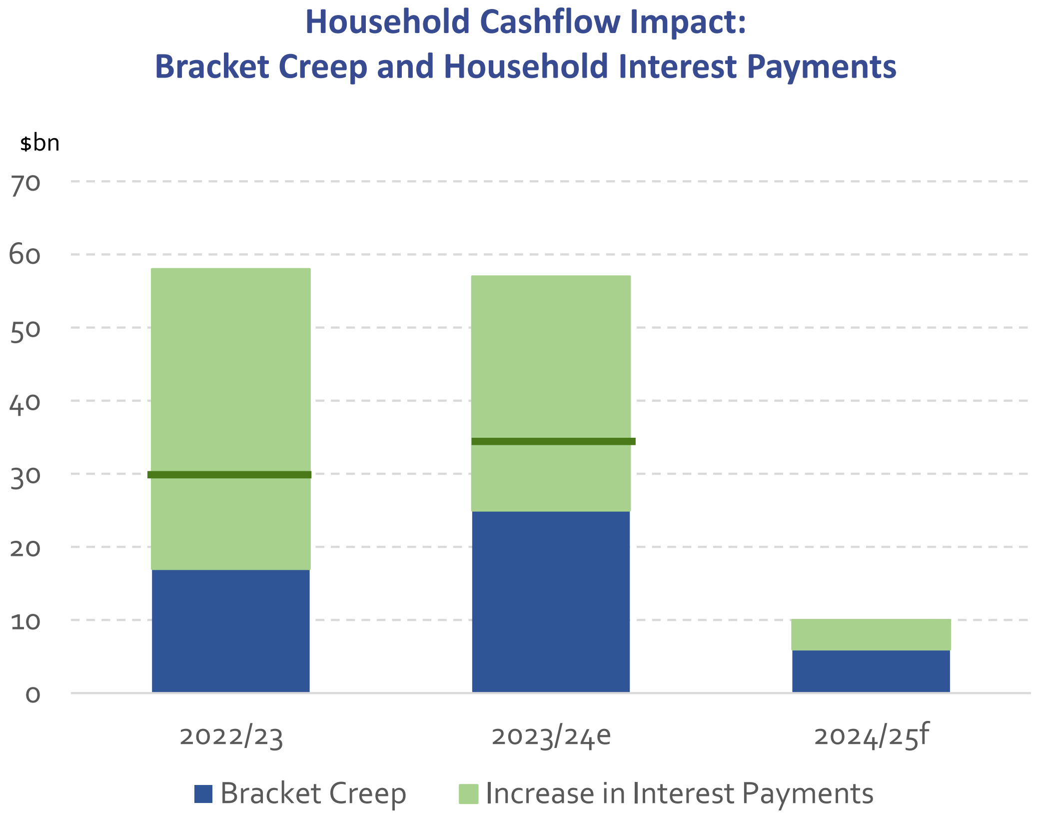


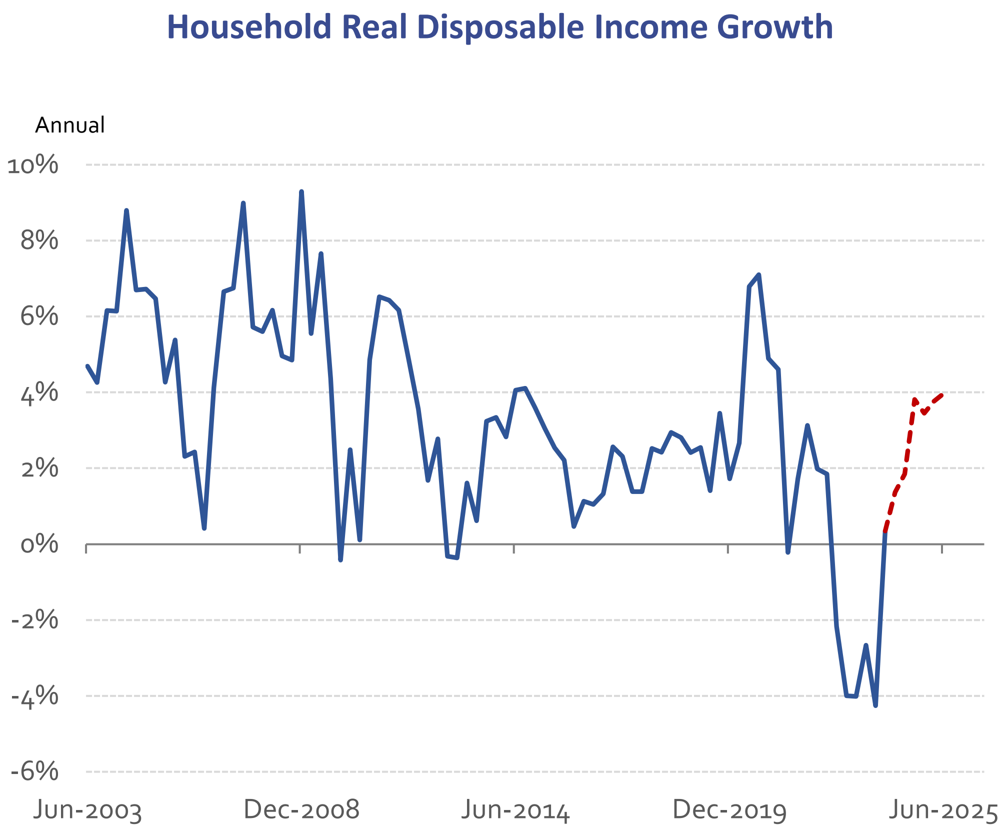
Source: Treasury, EQ Economics

Household income growth is expected to recover in 2024/25

judobank

- The increase in mortgage interest payments and bracket creep have had a big impact on household incomes over the last two years
- Both these factors will ease back considerably (even without rate cuts) in the coming financial year



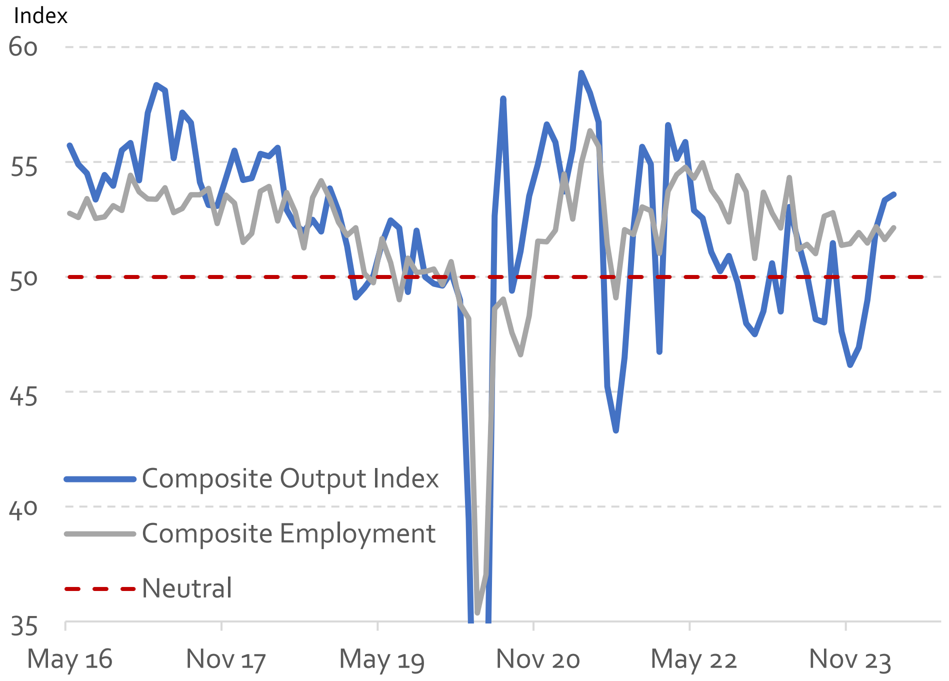


Source: ABS, Treasury, EQ Economics

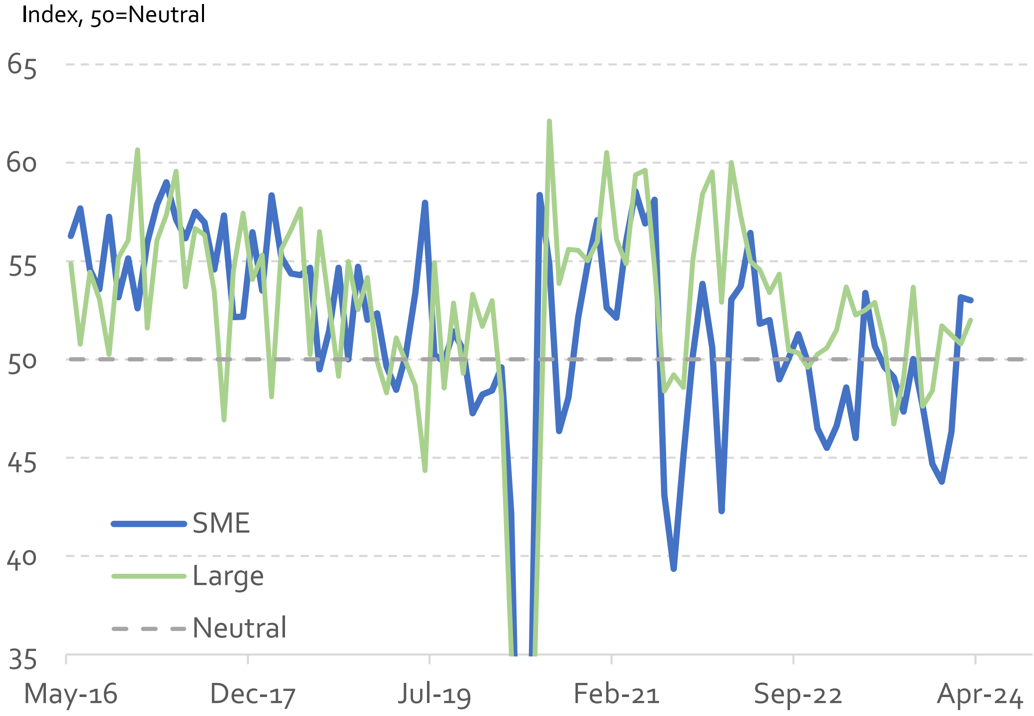
Business activity has moved higher in 2024

- The output index has increased five months in a row from a cyclical low point in November 2023 to a 2 year high in April 2024
- SME activity has led the way in 2024 after a difficult 2023.

Judo Bank PMI: Output and Employment



Judo Bank PMI Output: SME vs Large

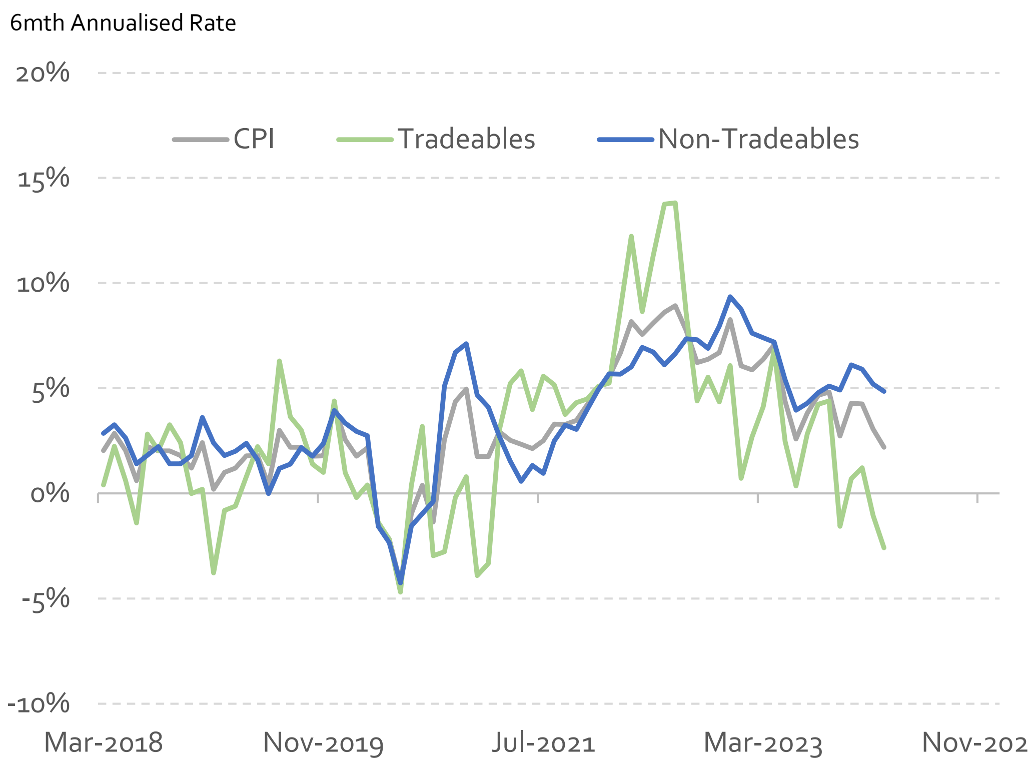


Source: ABS, EQ Economics

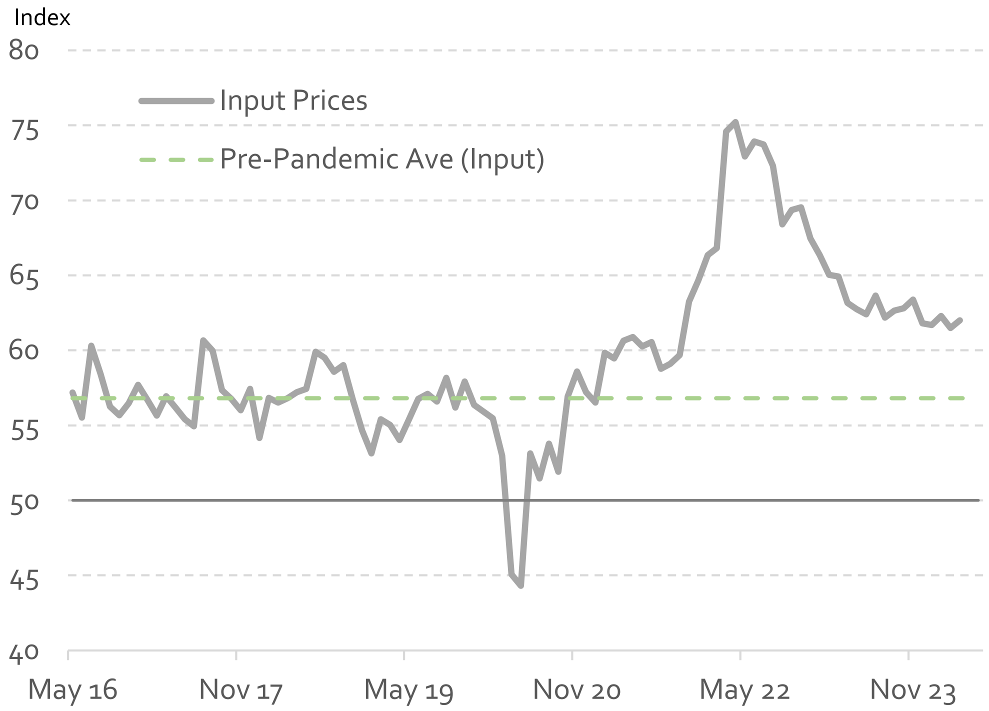
Inflation pressures easing – but how quickly?

- Global disinflation has been the main driver of lower inflation in Australia over the last 6 months
- Domestic inflation indicators have come down but remain above 4% (annualised) over the second half of 2023

Domestic vs Global Inflation
Monthly CPI (Feb)



Judo Bank PMI Input Prices

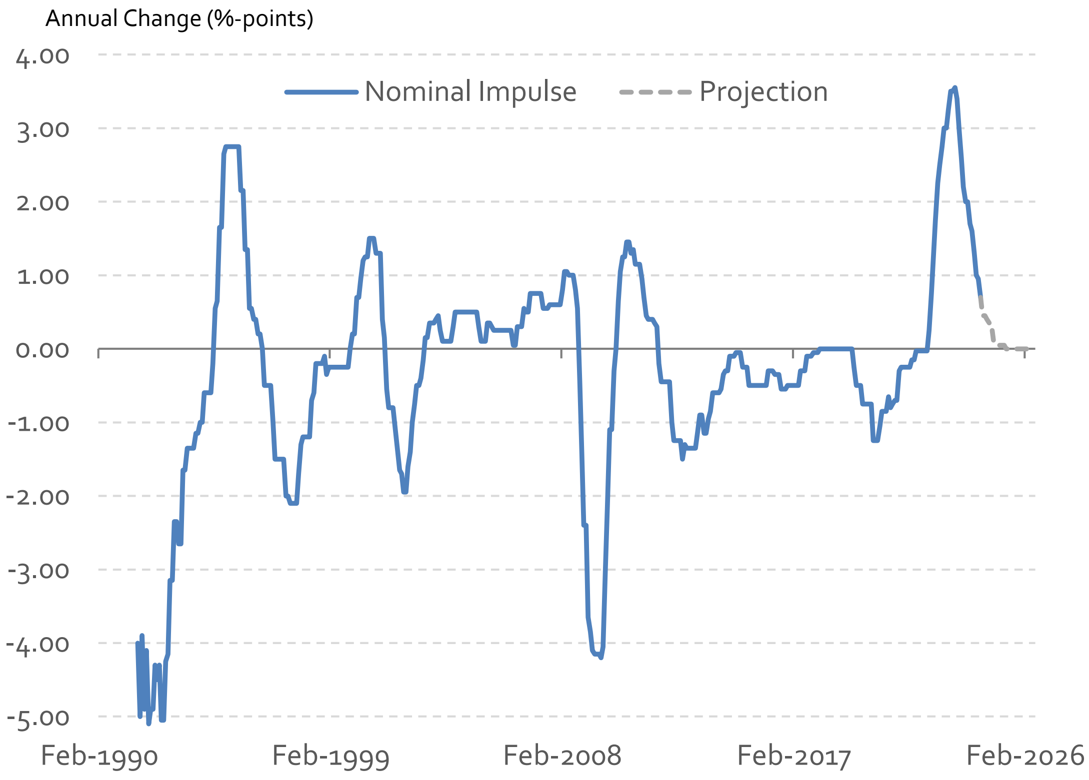


Source: ABS, EQ Economics

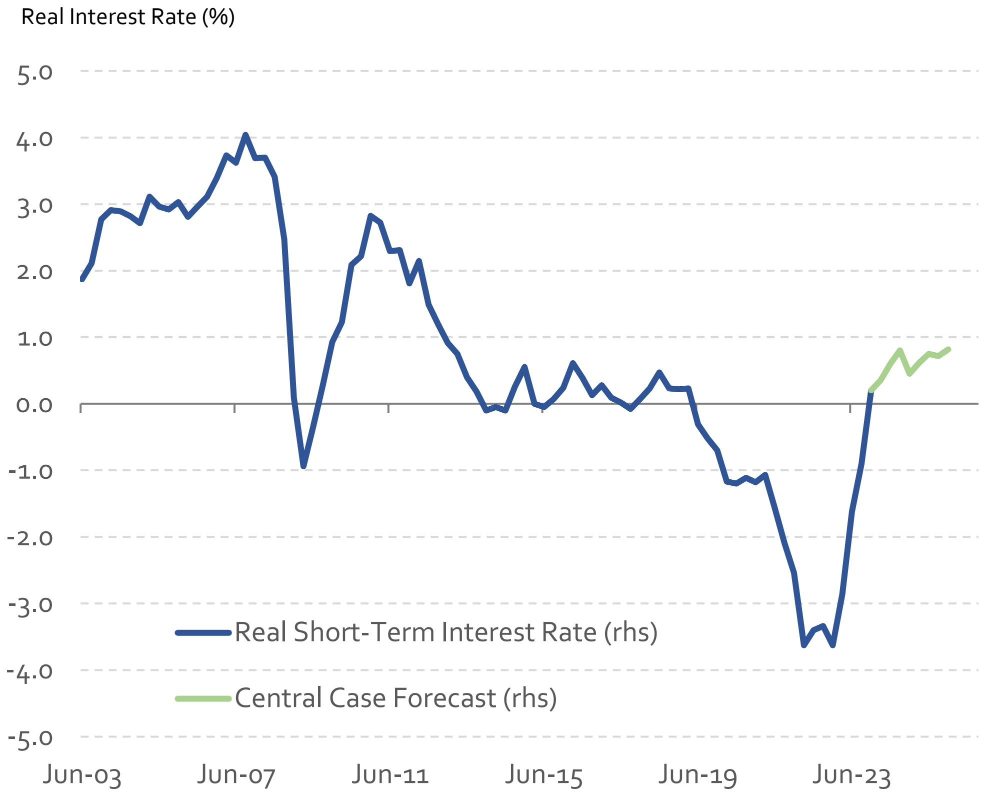
Monetary policy and the economy.

- 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



Source: RBA, ABS, EQ Economics

Restoring stability.

- **The primary short-term objective of policymakers should be to restore price stability:** The combination of secular change, pandemic stimulus and political intervention is making the normalisation of monetary policy and the return to price stability difficult.

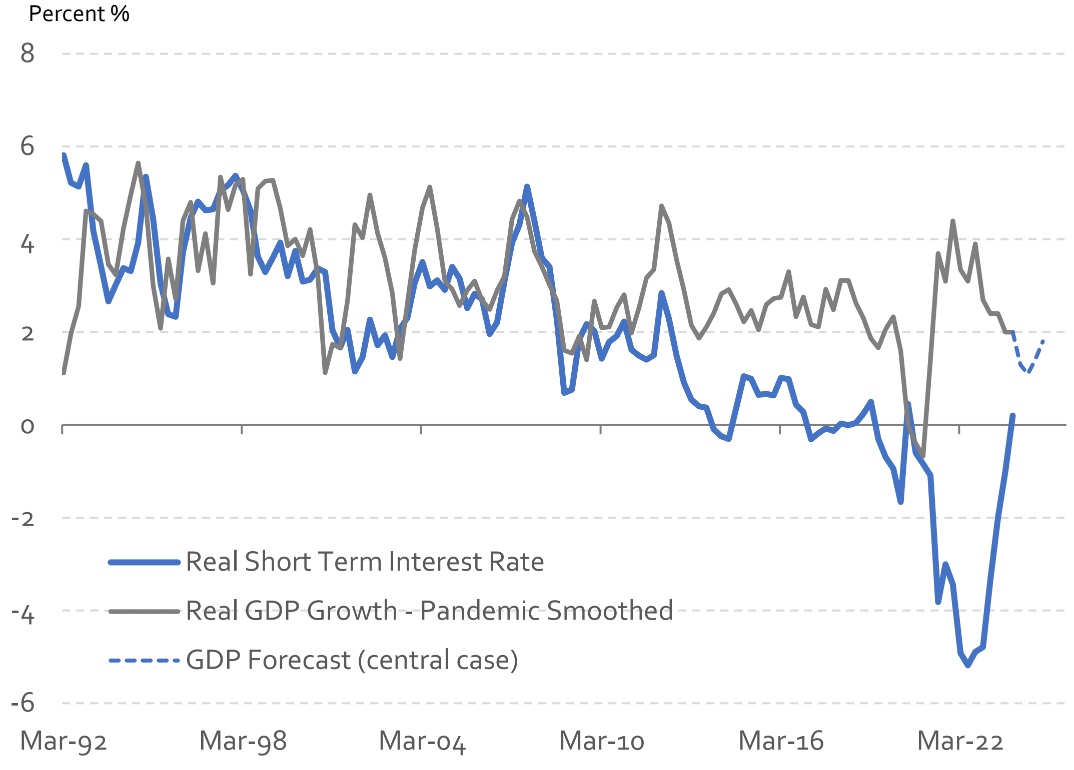
- **Financial distress is rising:** The nominal adjustment to interest rates will inevitably generate financial distress within the financial system and across households and business.

- **Interest rate adjustment path matters:** Taking real interest rates back to historically normal levels will likely induce financial distress. Central banks are navigating a tricky (narrow) path back to equilibrium.

- **Full employment:** Concepts of full employment (NAIRU) are proving illusive given demographic change, uncertainty around participation, high rates of immigration and rapid industrial structural change.

Real Interest Rates and Real Economic Growth

An important indication of economic stability



Source: ABS, RBA, Judo Bank