BULLETIN

16 February 2022

Leading Index now signalling above trend growth

The six-month annualised growth rate in the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic activity relative to trend three to nine months into the future, rose from –0.1% in December to +0.4% in January.

This is the first positive, above trend, read on the Index growth rate since the 'Delta' lockdowns impacted in August last year. With the growth rate now in positive territory the Index is signalling that the growth outlook has improved with above trend growth over the next three to nine months likely.

While Westpac expects that the contraction in spending in January due to the Omicron variant will see zero growth in GDP in the March quarter, the economy is likely to bounce back strongly over the remainder of 2022 registering a solid 5.5% growth rate for the year overall.

Strong balance sheets and rising incomes will support both consumer spending and business investment while the unemployment rate is likely to fall to 3.75% – the lowest we have seen since the 1970s.

The Australian housing market is likely to maintain momentum until near mid-year when the reality of rising interest rates in the second half of 2022 will impact confidence.

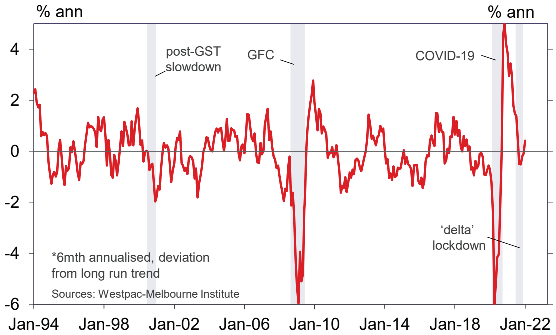
As we have started to see with the Westpac Melbourne Institute Index of Consumer Sentiment, confidence is already being dented by prospects of rising inflation and higher interest rates.

Although 2023 and 2024 are beyond the scope of the Leading Index we do expect material slowdowns in both years as higher interest rates take their toll.

Notably, at 0.4% the Index growth rate is unchanged from August last year. Exactly half of the eight components have registered improvements, but this has been balanced by deteriorations across the other half.

The strongest positives have come from: a sharp rebound in aggregate hours worked (adding +0.6ppts to the headline growth rate since August); an associated improvement in the Westpac-Melbourne Institute Unemployment Expectations Index (+0.4ppts); and a widening yield spread (+0.3ppts) – although in the current context the latter may be saying more about the rising inflation challenge than growth prospects.

Westpac-MI Leading Index



These gains have been neutralised by a softer signal from commodity prices (measured in AUD terms, –0.4ppts); slower growth in US industrial production (–0.4ppts) and the sell-off in equity markets, the S&P/ASX200 down 6.4% in January, taking another –0.4ppts off the index growth rate.

It is quite relevant that the latest lift in the Index growth rate between December and January, from -0.1% to 0.4%, is largely explained by the improving conditions in the labour market.

The Reserve Bank Board next meets on March 1. No interest rate change is expected until the meeting on August 2.

This week we saw the Minutes from the February meeting. The Board has continued to emphasise its patient approach to raising rates. We believe that it has progressed from the need to see an annual growth rate of 3%+ in the Wage Price Index before it could feel that the inflation rate can be sustained within the target zone.

We were also encouraged by the Governor's observation in his testimony to the House of Representatives Standing Committee on Economics that he would need to see a couple more CPI prints before moving on rates. This supports our view that the August 2 meeting is the likely timing for the first rate increase.

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