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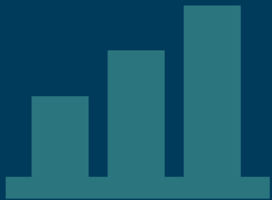
# Economic outlook for FY24

## Perspectives from three experts



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# Key takeaways

## While a mild recession appears likely, investors would be wise to consider positioning their portfolios for resilience

While markets appear to be faring relatively well so far in FY24, compared with the first half of FY23, a major economic downturn for our global economy could have a substantial and negative impact on investment portfolios and income. Helping clients understand the potential investment risks – and opportunities – presented by a recession will likely be an important part of financial advice conversations in the coming year.

This paper offers insights and talking points from three experts on the short-term outlook for the Australian economy. We spoke to three senior economists to explore their views on the most likely outcome for our economy in the current financial year:

Jonathan Kearns, Chief Economist, Challenger Group

Su-Lin Ong, Chief Economist, RBC Capital

Richard Yetsenga, Chief Economist, ANZ Bank

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# Key takeaways

– Overall, our experts were in agreement on the likelihood of a recession occurring in FY24.

– They also shared the view that current data and forecasts for unemployment suggest that a recession would be relatively mild and brief compared with past lows in the economic cycle.

– A strong fiscal position for our government and most households and businesses well placed to service their debt have the ability to cushion the impact from a downturn.

– Our experts qualified their view by highlighting a number of other contributing factors – here in Australia and globally – that could lead to a deeper recession.

– These factors have the potential to drive negative impacts for our local economy, which could, in turn, lead to distress for financial markets.

– With this in mind, it's important for financial advisers and their clients to consider if they need to think about how best to protect their wealth and investment income.

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# Impacts of a decline in economic growth

As FY24 gets underway, businesses and households are feeling the effects of more than a year of higher inflation. Since the Reserve Bank of Australia (RBA) began raising interest rates in May 2022, their policy and actions have been focussed on bringing inflation back to a target of between two and three per cent.

When slower growth is the goal of a central bank it can be difficult to achieve this without putting the economy at risk of entering a recession. While the Australian Bureau of Statistics has yet to report a technical recession – two consecutive quarters of negative economic growth – this isn't to say that Australian households aren't experiencing the effects of rate increases and inflation trends. In Q1 2023, cost-of-living concerns for households rose once again and for the seventh consecutive quarter[1].

**In Q1 2023, cost-of-living concerns for households rose once again and for the seventh consecutive quarter[1].**

1. NAB Consumer Sentiment Survey Q2 2023, 29 June 2023

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# Impacts of a decline in economic growth

**We've had a large spike in inflation and a very dramatic increase in interest rates. We need to make sure wages growth doesn't accelerate so that probably means we will need to have a higher unemployment rate. It's improbable that we can stay on that narrow path that it takes to bring inflation down while avoiding a recession. We can certainly expect to see growth slow down. The question is by how much?"**

**Jonathan Kearns, Chief Economist**
**Challenger Group**

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# Three signs of a softer landing for the economy

**Our experts highlighted three key economic indicators that suggest a relatively mild recession is the more likely outcome in FY24.**

## 1. Unemployment

The state of our labour market is a key economic indicator. Based on data released so far in 2023, we have yet to see a sharp increase in unemployment which would be a clear sign of damage to our economy and a contributor to financial distress for Australian households.

While the slowing of Australia's economy is expected to result in an increase in unemployment during FY24, this is coming from a 50 year low in unemployment, says **Su-Lin Ong, Chief Economist for RBC Capital**. She also highlights other metrics, such as high participation and low underemployment, that also point to the underlying strength of our labour market. *"In true slowdowns and recessions, not only do you get a sharp rise in the unemployment rate, but they stay there for a while,"* says Su-Lin. *"The starting point for the labour market is extraordinarily strong. So we would argue even if you get an increase of a percentage point – which is our base case over the next 12 months – is that going to be recessionary?"*

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# Three signs of a softer landing for the economy

## 2. Household and corporate debt

The chances of the economy withstanding an economic downturn is influenced by the amount and type of debt held by households and businesses. According to **Richard Yetsenga, Chief Economist, for ANZ Bank** Australia has far less troubling leverage in the corporate and household sector than we saw in the lead up to the GFC in 2008, due to lending standards having been more stringent for the last 15 years. *"In aggregate the household sector is in very good shape and the Australian corporate sector's debt as a share of GDP is the lowest since 1998,"* he says. *"We have been through 15 years of gradually tightening prudential standards in Australia. In my view the debt that does exist in the economy is more likely to be with people who can afford it."*

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# Three signs of a softer landing for the economy

## 3. Fiscal strength

The Federal Government announced a $19 billion surplus for FY23 – the first in 15 years. The final figure for tax revenue was more than expected due to receipts from strong commodity prices and a tight labour market. While we shouldn't take this as a sign of a recession being less likely, this fiscal position gives the Federal government potential to provide stimulus if an economic slowdown is deeper or longer than anticipated, says **Jonathan Kearns, Chief Economist for Challenger Group**. *"The fiscal position in Australia is much better than in many other countries,"* he says. *"There is the potential to use fiscal policy as a stimulus to support recovery from a recession to a larger extent than in some other economies."*

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# Factors that could put our economy at risk

Like any country, Australia's own economic position will be impacted by changes in the global economy. While the backdrop demonstrates a higher degree of resilience than we saw in the lead up to the global financial crisis (GFC) in 2008, the impact of recession spillovers or a financial or geopolitical shock could magnify economic stress for Australia. Some significant factors that could heighten the impact of a recession, or hold back recovery, include the stickier elements of inflation and our trading position with China.

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# Reining in inflation

Global inflation has been running high for well over a year. While the surge in energy prices from Russia's invasion of Ukraine contributed to higher inflation, the COVID pandemic brought about significant supply and demand pressures that have triggered the current inflation trend.

– Due to lockdowns introduced by many countries in response to the pandemic, supply chain disruption was widespread. This restricted the supply of goods and services.

– At the same time, strong demand for goods and services was spurred by highly stimulatory monetary and fiscal policy. Interest rates had already been low for a long time. Together with stimulus spending from governments looking to limit harm to their economies, this created conditions for strong demand from consumers for scarce goods and services, driving up prices.

**The COVID pandemic appears to have brought about significant supply and demand pressures.**

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# Reining in inflation

These inflationary pressures are now moderating. This is, in part, due to supply chain normalisation in 2022 and 2023. With central banks in most economies increasing interest rates, tighter monetary policies have so far been successful in bringing some components of inflation under control. In figures announced by the ABS for Australia for the year to July 2023 we see that CPI inflation slowed to 4.9%, from a peak of 8.4% over the year to December 2022. CPI inflation has declined sharply over the first half of the year.[2]

It remains to be seen how far the RBA will raise the cash rate to get inflation back to target. This introduces significant uncertainty as to how interest rates will continue to change over the course of FY24. *"If we become really confident with slaying the inflation dragon, there's a reasonable chance that policies have actually over tightened,"* says Richard. *"So I think we're in for six months or so where we're not quite sure whether policy is tight enough or whether it actually it needs to go further."*

2. Australian Bureau of Statistics, Consumer Price Index Australia, August 2023

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# The stickier elements of inflation: services, energy and rents

Jonathan shared his concerns that 'stickier' elements of inflation could see the RBA continue to hike interest rates to limit long-term damage from persistent inflation and a potential wage/price spiral.

*"While it's relatively easy for inflation to come down from say 7% to 5%, getting it down from 5% to 3% could be more of a challenge with the relative stickiness of certain components of inflation. Services inflation, which is affected to a greater extent by wages, is tending to be more persistent,"* he says. *"The rental market is quite tight right now in Australia and we have a big increase in immigration after the lag we saw due to the border restrictions during the pandemic. We're already seeing significant rent increases and we also have weak levels of housing construction. This points to rental inflation that's likely to be sticky for some time to come."*

*"We need to transition to more green forms of energy and that requires investment,"* he adds *"There is also uncertainty about the life span of our existing electricity producing assets. That uncertainty could mean less investment in those assets leading to a potential supply shortage. If we don't get our renewable energy supply in place quickly and at an effective cost, there is a risk that electricity price inflation will continue to trend upwards over the long-term."*

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# The global economy has been tested in FY23

It's typical to have recessions occurring in a number of countries at the same time – we saw this with the GFC and simultaneous recessions across the world in the 1980s and 1990s. Recessions that have a global impact are generally caused either by a common shock or spillovers from one country to another.

The US is the biggest economy in the world and when they go into a recession, exports and trade and investment flows are affected as is business and consumer confidence. We saw this impact during the GFC and this was magnified by weaknesses in the financial system at the time. Recent events suggest that financial markets and institutions are now more resilient, reducing the risk of this potential tailwind effect on a global economic slowdown.

*"The Silicon Valley Bank crisis and the Russia-Ukraine conflict are examples of shocks which at the time looked like they could be quite damaging,"* says Richard. *"The impact has, in fact, ended up being fairly limited. It highlights the underlying resilience we currently have here in Australia, and in most advanced economies, following 15 years of balance sheet repair and much tighter bank regulation."*

*"We are closer to the Goldilocks outcome than I thought would be possible,"* he adds. *"Certainly it seems like inflation in the US is, at least in headline terms, coming back to target and there's enough evidence that suggests even core inflation is heading in that direction. And all of this is occurring without substantial job losses, business bankruptcies or financial market stress."*

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# Australia's exposure to China heightens 'spillover' risk

When the global recession of 2008 occurred, triggered by the GFC, Australia was quite protected by having China as our major trading partner and their relative economic strength at the time. When we look at China's economy today, it is in a much less robust position, entering a period of deflation well ahead of other large economies. This could see Australia more exposed to the impacts of a recession spillover from China's economic position and performance.

*"In the GFC. China was the strong link in the chain as the advanced economies faced tremendous problems,"* says Richard. *"No cove was totally sheltered but Australia was in about the best cove you could find. Whereas China now is in a much less strong position."*

**Australia more exposed to the impacts of a recession spillover from China's economic position.**

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# Australia’s exposure to China heightens ‘spillover’ risk

*“During the global financial crisis, Australia avoided true recession and much of the slowdown,”* says Su-Lin. *“This was, in part, because China deployed the largest stimulus globally and Australia was a key beneficiary of that response. This time round China’s authorities seem reluctant to lend as much support as they have done in the past, particularly through the fiscal channels. They’re also likely to be constrained on the monetary side because of the build-up of debt levels and a desire not to add to that. With a much weaker China you have an additional risk for Australia’s own economy.”*

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# Market snapshot reflects optimism but will expectations be met?

Financial markets can be sensitive to economic indicators such as inflation figures, interest and exchange rates as well as changes in GDP and unemployment. At the time of writing, financial markets continue to be buoyant, in spite of GDP data and forecasts that suggest an economic slowdown is imminent.

*"There seems to be a disconnect between some of the economic data which is suggesting the greater likelihood of a recession and financial market prices which are more buoyant,"* says Jonathan. *"In particular, we see that equity markets have been relatively strong despite the recession risk."*

*"I think markets seem to be pricing in this soft landing scenario. but the question is will this actually be the case?"* says Su-Lin. *"Is there a lag in the weakening of labour markets because of COVID and changes in labour practices? If the cycle does turn more substantially next year, with growth surprising to the downside and a big pickup in unemployment, we can expect to see rate cuts as central banks come to the rescue. In this hard landing scenario, it's fixed income that will outperform."*

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# A resilient approach can protect clients' wealth and income

This optimism in financial markets can seem reassuring. But it's important to keep in mind the complex range of factors that can – together and separately – have a major impact on market movements and portfolio performance.

In this paper, we have discussed just some of the factors expected to influence economic outcomes in the current financial year. While our three experts and investor sentiment both suggest that an economic downturn will be modest and relatively brief, there may be surprises in store which could put markets at greater risk of increased volatility. Even a mild recession could trigger a sell-off in some assets, creating potential for substantial investment losses.

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# A resilient approach can protect clients' wealth and income

As always, investors should consider their options for protecting their wealth and investment income from the effects of market volatility and drawdowns. With the prospect of a recession on the horizon, taking a resilient approach to portfolio construction can help advisers and their clients prepare for a range of potential outcomes – for our economy and financial markets – in FY24 and beyond.


**Taking a resilient approach to portfolio construction can help advisers and their clients prepare for a range of potential outcomes.**

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