



Australian recession Q&A - Why the worry? What's the risk? And what would it mean for investors?

Key points

- ▶ The risk of recession globally and in Australia has increased with ongoing central bank rate hikes.
- ▶ Signs of faster wages growth has seen the RBA turn more hawkish. The risk of recession here is now around 50%.
- ▶ Recession would mean higher unemployment, less job security & a likely further leg down in shares & home prices.
- ▶ By Feb we may need a Taylor Swift lift to help "shake it off"!
- ▶ Share market volatility is bad news but the best approach for most investors is to stick to a long-term strategy.

Introduction

The past few weeks have seen lots of talk again about a recession - particularly in Australia. This has been a recurring theme over the last year or so but has intensified lately. But what's driving it? How serious is the risk of recession? And what would it mean for Australians and investors?

But first what is a recession?

A recession is generally defined as a contraction in the level of economic activity. In some countries it's technically defined as two or more quarters in a row of falling economic activity as measured by GDP but this measure can have its failings, e.g. if GDP falls 1% in one quarter, rises 0.1% the next next and then falls 1% it wouldn't meet the technical definition of a recession but most would agree that it is. So, some like the US adopt a wider definition based around a period of contraction as measured by GDP and a range of other economic indicators including industrial production, income and employment.

Because Australia has strong population growth there been a focus on "per capita recession" which is where the economy still grows but at a lower rate than the population so GDP per person goes backwards. This is arguably more relevant for individual living standards. GDP per capita has already contracted in the March quarter and most, including the RBA and the Government, are forecasting at least a per capita recession.

Why the concern now?

The concern about recession has been rising with central bank interest rate hikes. The rise in interest rates is aimed at slowing inflation by slowing demand and hence economic activity. It does this by:

- increasing debt servicing costs for households (particularly those with mortgages) and businesses with debt, which reduces spending power;
- raising the cost of future borrowing which slows down home building and business investment;
- lowering asset values – for say shares and property – which results in less spending as people feel poorer via the "wealth effect"; and

- by pushing the currency higher than otherwise making it cheaper to bring in imports and reducing demand for exports.

Because central banks never know when they have raised interest rates enough to control inflation they often go too far – pushing the economy into recession. This was the case prior to recessions in Australia in the early 1980s and 1990s and in the US in the early 2000s and 2008.

We have been off the view that easing global inflationary pressures – as evident in improving supply and falling price pressures in various business surveys, etc – would have enabled central banks to have stopped raising interest rates by now. But central banks have gone further than we thought and remain hawkish. This includes the RBA which following signs of increasing upside risks to wages growth – particularly the higher than expected increase in minimum and award wages at a time of low productivity growth – appears to have become more hawkish and be giving less weight to keeping the economy on an "even keel".

Why all the fuss about faster wages growth?

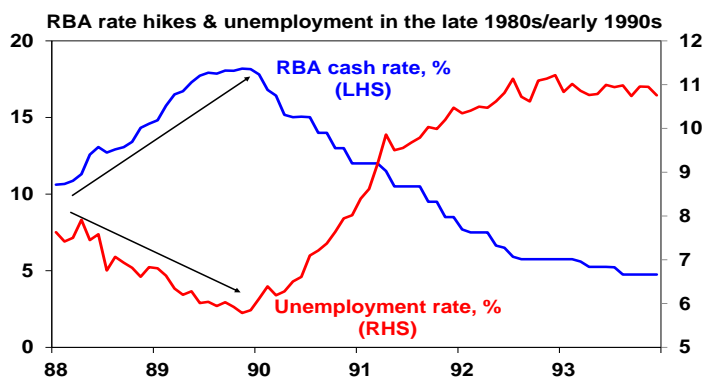
Everyone wants to see their wages grow faster than inflation. But when wages are simply chasing inflation higher as we saw in the 1970s it can lead to a wage price spiral which perpetuates high inflation as companies raise prices to maintain profits in response to stronger wages. As a result the second round response to the initial spike in inflation of catch up wage growth risks entrenching high inflation. Hence the more aggressive approach by central banks to guard against this. The Bank of England has gone down this path & the RBA appears to be doing the same.

But unemployment is low & shares are up 10% plus from 2022 lows so how can there be a recession?

It's true the Australian economy has been remarkably resilient despite a 4%, or 400 basis points, rise in the official cash rate and a doubling or more in mortgage rates. The economy is still growing, the roads are congested, restaurants seem full, travel has surged and unemployment is just 3.6%. However, this provides little comfort.

- Interest rate hikes normally impact with a lag of up to 12 months as it takes time for rate hikes to be passed through to borrowers, for borrowers to cut spending and for companies to cut their workforces.
- This time around the lag is likely longer thanks to massive pandemic fiscal stimulus which left many households with much higher than normal savings balances, the release of pent-up demand with reopening, 40% of home borrowers at record low fixed mortgage rates (compared to a norm of 15%) and a highly competitive mortgage market that has blunted the flow through of rate hikes.

This lag was evident in the late 1980s and early 1990s. Despite the RBA progressively hiking rates to 18% over 1988 and 1989 the unemployment rate kept falling prompting many to argue the economy was impervious. But then in late 1989 and early 1990 the lagged impact of rate hikes hit and the economy went into deep recession with the RBA having to rapidly reverse course. It was a classic case of the economy being ok until it's not!



Source: AMP, ABS

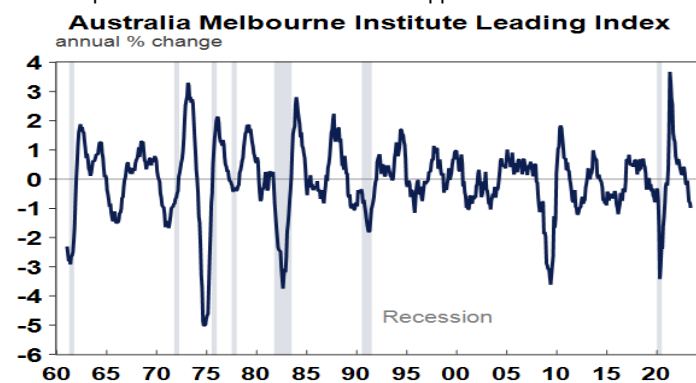
Of course, things were different back then with household debt to income ratios being one third current levels and very high inflation expectations resulting in much higher interest rates - but the lags are still relevant.

The protection provided households by fixed rates is now ending with borrowers seeing rates reset to levels two or three times what they were and at some point the saving buffers and the reopening boost will have been exhausted. And we are now seeing increasing evidence rate hikes are biting with falling real retail sales, falling building approvals, slowing business investment, slowing GDP growth, more negative corporate commentary, rising insolvencies and indications of a slowing jobs market.

So what's the risk of recession?

We have already revised our Australian GDP growth forecast down to just 0.7% for this financial year (compared to the RBA's forecast for growth of 1.4%). But as a result of ongoing rate hikes, we see the risk of recession starting around late this year as now very high at about 50%. Consumer spending is almost certain to start going backwards later this year as the 4% plus cash rate will push debt servicing costs into record territory as a share of household income and on the RBA's analysis 15% of households with a variable rate mortgage (about 1 million people) will be cash flow negative by year end at a 3.75% cash rate & we are now well beyond this.

The US Leading Index - which is comprised of economic indicators like building approvals that normally lead the economic cycle - has already fallen to levels normally associated with recession. In Australia though the Westpac/Melbourne Institute's Leading Index has fallen but is not yet decisively at levels associated with recession. Which partly explains why we have put the risk of recession at 50% as opposed to more.



Source: Macrobond, AMP

What will recession mean for Australians?

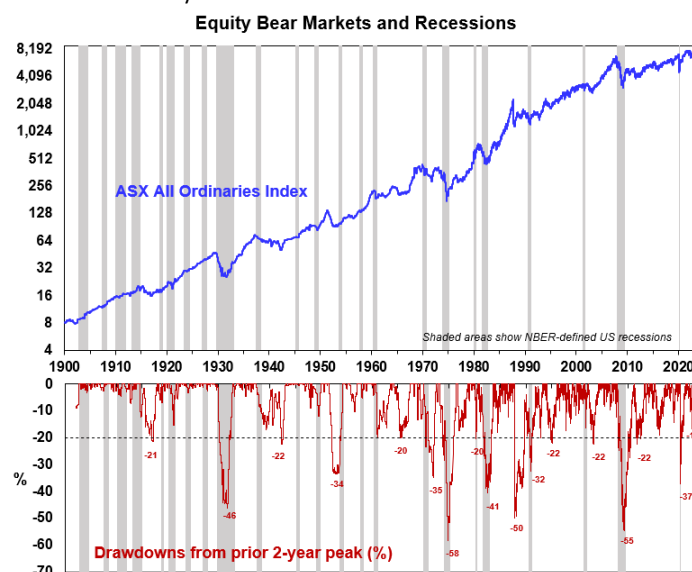
Many Australians have had no experience of recession as the last real recession ended over 30 years ago. The pandemic slump in 2020 was due to a mandated shutdown and incomes were protected by programs like Job Keeper so it's not much guide to any future recession. A recession normally sees higher unemployment – the early 1980s and 1990s

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recessions saw a roughly 5 percentage point increase, less job security, a contraction in living standards and low levels of confidence. Most will still keep their jobs but they would experience less job security and wages bargaining power and lower levels of confidence. However, recessions eventually also mean lower inflation which would help alleviate cost of living pressures. Recessions often also lead to lower levels of immigration and less household formation which could take pressure off rents and home prices although declining home building won't help.

What would be the impact on shares?

Historically recessions in Australia and the US have tended to be associated with bear markets in shares, ie, 20% or more falls, as recessions drive a slump in company profits. The next chart shows the Australian share market and falls in it against US recessions. A modifying factor is that share markets are still 8% or so down from their 2021/early 2022 highs so the risk of recession is arguably partly still factored into markets which may limit the extent of falls if a recession does eventuate.



Source: ASX, Bloomberg, AMP

What would be the impact on residential property?

Australian home prices have rebounded from their lows as a severe supply shortfall has dominated rising rates. However, a recession could drive another leg down in home prices as buyers back of, higher rates and higher unemployment push up distressed selling and recession drives reduced household formation. CoreLogic data shows a 9% fall in capital city property prices in the early 1980s recession with a 25% fall in Sydney, and a 6% fall in the early 1990s recession with a 10% fall in Sydney.

What about interest rates?

Recessions invariably drive sharp falls in interest rates as the RBA will cut rates in response to falling inflation and rising unemployment. While we are allowing for two more 0.25% rate hikes from the RBA in the next few months, we expect it to cut rates four times next year.

Implications for investors

While times like these can be stressful, for superannuation members and most investors the best approach is to stick to an appropriate long term investment strategy to take advantage of the rising long-term trend in share markets given the difficulty in trying to time short term swings.

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