FINANCIAL MARKET CONDITIONS
February 2023

Local Government Finance Authority

After a positive start to 2023, the month of February witnessed a reversal of risk sentiment and considerable volatility in financial markets. The turnaround in risk sentiment was driven by a more resilient growth outlook in many parts of the world. Whilst this would normally mean good news, however, the threat of continuing high inflation fueled markets to define strong economic data as a signal that interest rates would remain elevated for longer. After gains of approximately 6% in January global equities dropped by 1-5% over the past month. The fine balance between a soft landing and recession, or a bounce back in economic activity threatening the risk of higher inflation is a reality that central banks are facing in developed nations, globally.

After many months of central bank tightening, a number of central banks are facing the decision to continue to raise rates, or to pause and review the impact on consecutive rate rises. The Bank of Canada kept interest rates on hold in February, and the Reserve Bank of New Zealand raised rates by 0.50% in March, maintaining a projection of a peak in coming months.

In the US, after the Federal Reserve raised rates by 0.25% in February, markets continue to expect a further hike of 0.25% in March. US economic data continued to support the potential of a soft landing, with an easing inflation pressure and a moderate bounce back in some key data readings. Manufacturing services data printed the largest monthly advance since mid-2020. US GDP grew at 2.7% in the December quarter. Whilst home sales have continued to weaken, – US homebuilder sentiment rose in February by the most since mid-2020. Whilst US CPI rose by 0.5%, Annual growth eased from 6.5% to 6.4% in January, the lowest level since 2021. However, employment data is still very strong with the unemployment rate dropping further to 3.4%.

In Europe, inflation appears to also be easing. Whilst varied across Europe, inflation is 5.6% and appears to be moderating. GDP growth was softer than expected, weakening to be flat compared to 0.1% the previous quarter, raising the prospect of a technical recession. In the UK, Q4 GDP was also flat, averting the expected contraction. In addition, inflation in the UK eased from 10.5% in December to 10.1% in January. After the Bank of England's 0.50% rise in February, markets expect that there is a chance for a pause in coming months.

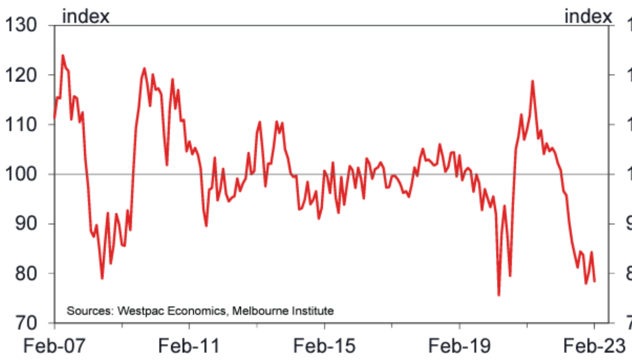
The Chinese economy is performing well after reopening and the abandonment of their zero COVID policy. The government has set a modest economic growth target for 2023 of 'around 5%'. Export activity, trade data and loan growth and financing figures were strong, supporting the potential growth target. Chinese inflation data remains low by global standards, rising to 2.1%.

Locally, the Reserve Bank of Australia raised rates in March by 0.25% as expected. Data throughout February broadly illustrated negative effects of rising rates. Consumer confidence continued to weaken, with cost-of-living pressures and interest rate rises weighing heavily. Construction work fell in Q4, housing lending declined (making 12 consecutive monthly declines) and building approvals continued to fall, currently at their lowest monthly level since July 2012. The housing price decline that started in May 2022 continued, with prices now down 9.7% from the peak. The monthly CPI indicator eased to 7.4% from 8.4%, and whilst the indicator only gives partial coverage of CPI, it is further evidence that inflation is moving in the right direction. Further pleasing for the RBA was the weaker employment data suggesting a cooling in the labour market, with the unemployment rate rising to 3.7%. Key data that should additionally provide comfort to the RBA was the wage price index data, whilst 3.7% higher, the data indicates that wages are growing but there is no evidence of a wage price spiral in Australia, putting further pressure on inflation.

Despite broadly weaker data, business conditions picked up after three months of easing in 2022, suggesting that the economy has remained resilient to headwinds from inflation and higher interest rates. Australia's current account surplus widened to $14bn, the 15th consecutive quarter of surplus, the longest run in the history of the series. Key in the strong trade position was a lift in export volumes and a further reduction in imports.

Whilst the Reserve Bank's statement acknowledged the expectation of further tightening of monetary policy, Governor Lowe also recognised that recent lifts in the cash rate has pushed rates into restrictive territory, and that "we are closer to the point where it will be appropriate to pause interest rate increases to allow more time to assess the state of the economy". Major banks expect that the RBA have 1-2 rate hikes to go, with a potential pause in April.

Consumer Sentiment Index



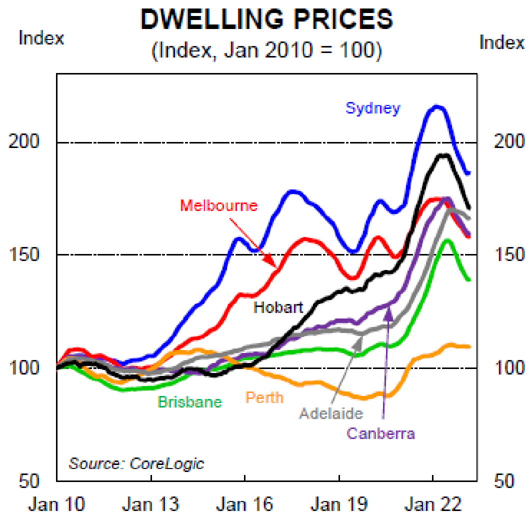
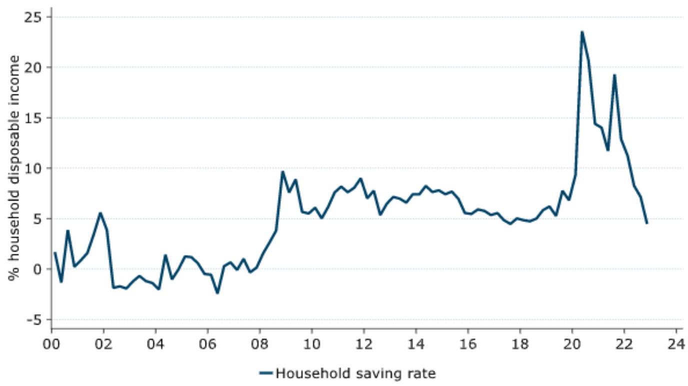


Figure 8. The household saving rate fell back to pre-pandemic levels



Source: ABS, Macrobond, ANZ Research