IMAP Independent Thought Podcast
Episode 19: Is the Economy Headed For a Repeat of Past Policy Mistakes AMP

Dr Shane Oliver - Head of Investment Strategy and Economics and Chief Economist, AMP Investments discusses:

- High inflation and its aftermath, how it affects expectations and the challenge of getting interest rates back down, along with lags in monetary policy impacts.
- Whether the RBA and other central banks have done enough is a judgement call. Upcoming retail sales and jobs data are critical in this.

Moderated by David McDonald, CFA IMAP

IMAP Disclaimer (00:01):

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David McDonald - IMAP (00:17):

Welcome to this podcast in the IMAP Independence Thought series.

Today I'm joined by Shane Oliver, Head of Investment Strategy and Chief Economist at AMP

Welcome, Shane.

Shane Oliver - AMP (00:30):

Thanks, David. Great to be here.

David McDonald - IMAP (00:33):

So obviously a lot is happening both domestically and globally. We've got inflation, interest rates, and recession for years in the headlines at the moment, so I think there is plenty to talk about.

Perhaps just to start, I thought it was very interesting that you published a note recently that looked at the lessons from the seventies, eighties, I think even nineties, and compared to where we are now.

I'm not sure if I'm allowed to mention that we both worked together in the eighties long ago, <laugh>. So would you like to share some of the findings from that forest?

Particularly are we headed for a similar period and what should we do to avoid it if we are?

Shane Oliver - AMP (01:15):

Yes sure and yes, we did work together way back then which was I guess in the midst of it still, you know we are still recovering from the high inflation of the seventies and we didn't really get inflation down fully until the 1990s. But I mean that period is worth thinking about.

And many people wonder why now the Reserve Bank is going so tough?

Why do we have to worry about a little bit of inflation?

You know, didn't we always want inflation to be higher?

Prior to the pandemic, the concern was inflation was too low. But it is worth looking at that period because inflation started off mainly due to supply side factors. Not solely, but partly a big factor in there. Central banks let it sort of gradually get out of control. They realised they had a problem and then started putting their brakes on, but then as soon as things slowed down, they took the brakes off too early.

Shane Oliver - AMP (02:08):

And then of course the inflation problem would reappear and come back worse than ever. And we had this period of "stop … go" monetary policy through the seventies.

We finally got rid of it in the USA with very aggressive monetary policy by Paul Volcker Jr, the Federal Reserve chairperson at the time. And that led to a double set of recessions in the early 1980s.

And for Australia, we didn't really get rid of it till the early 1990s, but there is a bunch of key lessons from it. I mean, some things don't work, price freezes don't work. Just getting everyone to have a wage rise to catch up to inflation just locks in the high inflation. And getting rid of central bank governors doesn't work. The USA tried that with replacing Martin with Arthur Burns in the early 1970s, which ultimately just perpetuated the inflation problem.

Shane Oliver - AMP (03:08):

Getting the government to do things might sound fine in theory, but governments tend to lack the political will to do things to inflict the pain, to slow things down. So you have really got to rely on the Reserve Bank.

But I think the key two key lessons from that period are firstly you've got to try and nip it in the bud fairly early because the longer it persists, the more inflation is built into people's expectations. They behave in ways via wage setting, price setting, and so on, that becomes accepting of high inflation, and then it's very hard to get rid of. And that of course explains why we had to have severe recessions to get rid of inflation.

I guess the other lesson from the latter part of the period or the early nineties in fact, was that there are these monetary policy lags.

Shane Oliver - AMP (03:52):

So there is a risk of, (as the Reserve Bank governor says), not doing enough to control inflation, letting it get out of hand, the other risk is doing too much. And I suspect that that is probably a greater risk, although the Reserve Bank at the moment disagrees.

And the reason I say there's a risk of doing too much is that we saw through the late eighties the central bank raised rates aggressively and Australia kept going. Unemployment kept falling. Problem was that it doesn't work. And then suddenly it did work in nearly 1990s and they'd gone too far. And by then it was too late. We plunged into the recession. We didn't have to.

So it is an instructive period to look at. There's no simple answers to this, but ultimately it does come back to central banks.

David McDonald - IMAP (04:32):

Okay, the Reserve Bank I think seemed to be suggesting late last year that maybe there wasn't much more to go, or certainly that's what the market thought and even a couple of people suggesting they might even have a pause. And then I think the February meeting seemed to shock markets and they came out and said, no, there's actually a lot more to go. So I guess that's one of the findings from your study that they should do a lot more to make sure it gets under control.

Shane Oliver - AMP (05:03):

Well, yes but I think you could argue that, that the study argues for being quite aggressive, and then of course that is what they've done. But there's a counter to that where if you don't allow for the lag, you end up going too far. So it's a bit of a balancing act. And I must admit, I'm not going to claim that I was misled by the Reserve Bank. I think we all have.

Yes well I had a degree of optimism that inflation was close to peaking. I still think it is. And then we got the December quarter numbers, which showed the underlying measures of inflation, what they call the “trim mean” was higher than they expected, 6.9% rather than 6.5%. And that seems to explain, seems to largely explain why they're so much more I guess hawkish compared to where they were in December 2022.

Shane Oliver - AMP (05:59):

But at the end of last year, I thought we were getting pretty close to the top if not already at it Then the inflation numbers seemed to blow that out of the water. Then the Reserve Bank's reaction to that was a lot more hawkish than I would've thought would be justified.

And we are where we are now, and they're now signaling that they might have to do several more hikes, at least two more hikes. But I worry that they're just driving the car with a rear view mirror, and therefore we'll end up going from one extreme to the other, and find ourselves in recession. Fingers crossed, we won't land in “base case”, but it's a risk,

David McDonald - IMAP (06:35):

Maybe we'll talk perhaps about recession risks and, and so on here and globally in a little while. But I mean we are not headed back for 17% mortgages again, thankfully. But how many more hikes do you think we'll see now?

Shane Oliver - AMP (06:50):

Well, our base case is just one more, even though the RBA is saying a couple more, and we see we will get a run of strong, and softer data, which will enable the Reserve Bank, well, they're probably going to almost certainly hike in the next week and then pause after that, probably still signaling they've got to do more, but ultimately, the softer data will dissuade them from doing that.

So that's, that's our base case. But I'm also conscious that other economists out there are factoring in many more. Yes many are talking about 4.1% as the peak and the money market has now moved up to about 4.3, 4.4% for the peak.

So that's certainly where the risks are skewed. They're still skewed on the upside. And there's always this debate, economists have about what they should do <laugh>, what they should do is have a pause now and take it a bit easy for a while and what they will do. And of course you know, they determine what they will do, but ultimately time will tell whether that's the right thing or not.

David McDonald - IMAP (07:48):

Yes. Now you mentioned just one of the other things from the history lessons was that putting wages up to match inflation is not the answer. And we've certainly seen a lot of that, particularly it seems from people like nurses and teachers that are probably not paid that well in the first place, saying, well, why are we getting the 2 ½ , 3% wage rise when inflation is 6%, 7%, 8%? You don't think that's a risk locally, then you don't see wage just breaking out too much.

Shane Oliver - AMP (08:22):

Well, it's certainly a risk, and that's what the Reserve bank keeps worrying about. And the logic is simple, yes, inflation's 8% and I should get salary rise to compensate for that. And the labor market is very tight.

So worker bargaining power is higher than normal or higher than it's been for the last 30 or 40 years. So that obviously adds the risk. But so far there's not a lot of evidence of that. T

he enterprise bargaining agreements, which should count for something like 15% of wages is running around 3%. It's mainly individual contracts, individual agreements where the faster increases are coming through.

There was a survey by the Melbourne Institute survey of consumers, and they're talking about wages growth running at pretty moderate levels, you know, around 3%. And of course, the most recent wages data from the ABS showed, again, wage inflation running around 3.3%.

So the risk is there, but I lean to the view that yes, we may see it in certain pockets, but I don't think it's going to be a generalised thing. But obviously it is a risk, it's logical for people to ask for a higher wage rise given the level of inflation.

But of course, if we all do that costs go up and we get another round of strong price rises and we end up chasing our tails.

David McDonald - IMAP (09:43):

Yeah, indeed. Maybe one last thing on the 70’s and so on, Shane, before we move on to today a bit more. And the 1970s particularly was a decade where both bonds and equities had very poor returns. Do you see low returns in the next 5 - 10 years because of where we are now?

Is that a thing in terms of your outlook for markets? Do you think the 8% - 10% super fund returns we've seen in the last decade of not going to be repeated?

Shane Oliver - AMP (10:19):

Well on our numbers, they won't be. We sort of look at current investment yields and reasonable nominal capital growth assumptions, and we don't get numbers that high.

We get numbers quite a bit lower than that. So yeah, more like six and a half percent. I think we have to allow, and this certainly benefits us earlier in our careers or our superannuation, that that period into the early 80’s which particularly started with very high bond yields, low PEs on shares high inflation as we moved from very high inflation to very low inflation that enabled bond yields, interest rates to come down and growth assets like shares and property and infrastructure and so on to be revalued upwards.

And so that provided a fantastic tailwind for investment returns. And at various points there, superannuation funds were typically providing double digit returns.

Shane Oliver - AMP (11:13):

Not every year though as there was the 87 crash, but on average in a run of 10 years, they're well into double digits. That period is now behind us. The tailwind from falling inflation is probably over.

We've come into a more inflation prone world. Globalization is in reverse. You can see that all around us <laugh>, you know, with attempts to bring supply chains back on shore. Issues with trading with China and so on had been a big government reversal of the supply side reforms of the 80's and 90's more regulation and so on.

All of those things make the world more inflation prone. So I think a more realistic assumption is yes, that inflation does come back down, but doesn't get quite as low as it was pre pandemic. And you know a reasonable expectation for superannuation returns is more like six and half percent or thereabouts.

David McDonald - IMAP (12:09):

Right. Okay. Thanks. Now we talked briefly earlier about outlook and potential recessions and so on. And I gathered you are not too concerned about Australia, but what about the rest of the world?

Do you see a recession definitely happening in the US and probably Europe as well?

Shane Oliver - AMP (12:30):

Look, I think it's high risk. I mean, if you'd asked me this question late last year, I'd say the risk was higher than it is right now. Recent business surveys have shown some improvement, some resilience. I mean the basic argument for recession is that monetary policy has been tightened significantly. The yield curves, which is a standard tool that economists look at to see whether economic conditions are expansionary or contractionary, they've inverted.

So 10 year bond yields have fallen below short term interest rates because short term interest rates have gone up. And historically that provides a disincentive to borrow and lend long or invest. And historically in the us there's about a 12 to18 month lag from a yield curve, inversing short rates above long rates to a recession the yield curve that I prefer inverted late last year, so that it suggests a risk of recession later this year, early 2024.

Shane Oliver - AMP (13:30):

So that's certainly a risk. I think in the US it's, it's probably 50 / 50 as to whether we get there or not. Some other indicators aren't quite as bad. In Europe,

I thought the risk there was almost certain recession, but they've done a good job of getting their gas prices down and their gas reserves under control… helped buy a bit of good luck with the mild winter in Europe. So that's reduced the risk there. \

The other factor that's come along, of course, is that China has reopened and they're seeing sort of rebounded economic growth that we were seeing, you know, a year or so ago. So that's going to provide an offset to weakness in the Europe and in the US and therefore on average globally, I don't think we're going to see recession even though there is a high risk in the US and Europe or both.

David McDonald - IMAP (14:21):

Okay, thanks. Now you mentioned China, obviously it's probably more important for Australia than what happens in the US and Europe, particularly from an export point of view.

How do you see China now post reopening? There's a lot of talk about a much lower growth outlook there. Do you think that's fair?

Shane Oliver - AMP (14:42):

I think it probably is. You know, look, China will see a cyclical rebound much like other countries have after they reopen from Covid and there's pent up demand there, and that will be unleashed. And growth this year will probably be 6% after 3% last year.

But I wouldn't confuse that with the longer term trend, which is to watch slower growth in China.

Go back 15 years ago, it was quite normal to think of Chinese growth potential and longer term growth running around 9, 8, 10% but this has been stepping down in recent times down towards the 5 ½ %, 6% pace, obviously weaker last year for covid related reasons.

I think in the years ahead, it's probably going to be stepping down again over the next decade, probably down towards 3 ½%.

Shane Oliver - AMP (15:31):

And there's a bunch of factors involved in that their population is now falling, so they're not getting a tailwind growth from an expanding workforce. And their productivity growth, you know, is still solid, but it's going to slow down, because once you start intervening in the economy and directing it more like the Chinese government is doing recently, that entrepreneurial spirit is dampen a little bit which adversely affects economic growth.

And some of the levers that they've pulled over the years to spur growth have sort of run their course. You know they've had the export surge, they're not as competitive as they used to be.

They've had the investment surge, they've had the property burn, they're sort of now a bit spent. So I think Chinese growth will trend down towards, or sustainable growth will trend down towards 3%, 3 ½% over the next decade.

I guess the next question is that a big problem for Australia? I think if it occurs over time, then we'll gradually move on to other countries just as we did as China, as Japanese growth slowed down. We'll find other countries and India is an obvious example of one that provides opportunities on a longer term basis.

David McDonald - IMAP (16:34):

Right. I guess one thing that was always raised with the India / China comparison was that India's probably a bit more commodity endowed than China.

And given our export tilt to that area, that might be a problem in terms of making up for what might be lost in China.

Shane Oliver - AMP (16:54):

Yes It won't fill the gap to the same extent. It will help in some areas. But not all of them, they don't have a lot of coal. Any problem there is that coal is going out of fashion globally. In other areas they have more. But then there's still a lot of other countries - Vietnam for one – and back to our near neighbors, Indonesia and so on.

So I think one of the benefits of Australia's resource endowment is that we seem to be able to find other countries as time goes by. The other that will help over the next decade is decarbonisation, which will mean more demand for metals. Obviously in time it'll be less demand for gas and coal, particularly coal. But that retooling of the world economy to make it less carbon intensive will mean more demand for metals going into electric cars and so on.

David McDonald - IMAP (17:52):

And I guess even places like India are still sending a lot of students to Australia, and that's another big export for us these days.

Shane Oliver - AMP (18:00):

That's right. The focus is shifting towards services, and away from some of the commodities.

David McDonald - IMAP (18:07):

Can we talk just a little bit more, Shane, about the local consumer and spending still seems to be quite strong. I think I saw in your note you talked about revenge spending, at least that's a post covid thing.

And I've seen articles talking about revenge travel, everyone overseas cause they couldn't go for the last so many years. But then, you know, we hear about the mortgage cliff coming and as fixed rates go off and how that'll impact people.

And I've seen weaker results the last week or so from people like JB HiFi, Harvey Norman and so on, suggesting things might be slowing that.

Where do you see the consumer locally? Do you think it is starting to ease off?

Shane Oliver - AMP (18:52):

Yes I think it's starting to ease off. And it's amazing the transformation perceptions that has occurred in the last six weeks when JB Hi-fi first put out an update in January. It seemed very upbeat. Consumerism wasn't slowing, but then as the profit reporting says it came along and they reported their formal profit results, it looked like things had actually slowed down through the second half of last year, particularly in December quarter.

And the start of the year was just so-so and other retailers have said something similar, it's not universal, but you did get this impression that the combination of higher interest rates, which are taking a lot away from groups or households, which normally drive a lot of spending people who have a big mortgage and are usually 25 to 40 or something like that group tends to change their spending a lot more than people like you and me whose families have grown up and the mortgage mortgages are under control.

Shane Oliver - AMP (19:51):

And spending patterns don't change that dramatically in response to changes in our free cash flow. So there will be a big impact coming through. It's starting to become apparent in some of the anecdotes from companies, not all of them, but it's starting to become more apparent. And when you look at the retail sales figures which came out just today for January 2023, it showed that retail sales rebounded in January, but over the whole period since September, they've actually gone sideways. Which means in real terms they've fallen, right? And over the last year, in fact they're just flat, they're up 7 ½% and inflation is about 7.8% or thereabouts. And that means over last year they're not, cause they've not gone anywhere and recently they've gone down in real terms.

So it looks to me like the falling consumer confidence, the hit from higher interest rates, the cost of living cost issues are impacting.

Shane Oliver - AMP (20:52):

And you mentioned the fixed mortgage step I know we've been talking about that one for such a long time and as we get closer to it, we start thinking, well, maybe it's not going to have any impact, but it must have some impact.

You know when you double people's mortgage payments and their debt cost debt servicing bill, you must have some impact. It's a bit hard to believe that it's not going to have any impact. I mean, you go to a website like Rate City and do the mortgage calculator for someone on a $500,000 loan, they're paying around $12,000 extra p.a. in payments than they were back in April last year before the rate hike started. That must have some negative impact. So I think yes, we have to get used to the idea we are going to see a softer consumer, particularly as the, the reopening rush slows down.

People were really happy to get out over Christmas and spend and go to restaurants because they couldn't do it the year before or the two years before. Now I think that's largely run its course and then as that fades then you'll see a much weaker consumer demand.

David McDonald - IMAP (22:01):

Yes fair enough. And I mean the $12,000 you quoted a big impact on a lot of people. But then we've also seen huge jumps in electricity, gas, insurance, things like that, which are basically necessities for everyone. I mean I've recently had a re insurance renewal and it was 35% higher than a year ago. That's not just 7% inflation.

Shane Oliver - AMP (22:26):

Yeah. That crazy. And I've had a few bills like that particularly insurance is a key one. Sometimes if you ring up they might get it down a little bit, but you often have to reduce your level of cover to have any meaningful impact. And, those sorts of things are quite onerous.

Like I & my family had a holiday over January in Tasmania, it costed $400 a day to rent a car and you sort of think, oh well I haven't been on a holiday for a while, <laugh>, I'll pay the 400. But then after a while you realise, well that was a bit of a rip-off. And I'm not going to do that again. You know, if that's, that's why I'm going to have to pay and the air flights were exorbitant as well, then I'm not going to do it. I've had the holiday I'll opt for something a lot cheaper next time, drive myself there and stay in a motel.

So people's behavior will adjust to this. Yes. And I'm not someone who's under a lot of pressure. I'll admit, I've saved a bit over the years and in reasonable financial shape. But people who are don't have the buffers, don't have free cash flow. They going to start cutting back.

David McDonald - IMAP (23:36):

Yeah. I'm just wondering how you fitted the four of you in a Ferrari

David McDonald - IMAP (24:00):

That's one last topic we haven't touched on Shane, is the Aussie dollar you know, I mean commodity prices have stayed high, not just energy, but as you mentioned, you know, there's going to be continued demand for things like metals with the move to a low carbon economy and so on. Where do you see the Aussie dollar going short term, and longer term?

Shane Oliver - AMP (24:24):

Well, short term is always hard to predict. It had a good runup over the Christmas period, like markets did. Obviously a bit of optimism there that things were subtly on the mend globally on the inflation run.

And then now there's been a bit of a setback in the last few weeks. And the Aussie has fallen back to around 67 cents. Short term could still have some more downside, but I think ultimately it will head higher. You know we saw a record or near record 14 billion current account surplus in the December quarter in previous times. You know, the current account deficit was a major problem and that impacted on the Aussie dollar. Now we're running a surplus and that I think is underpinned by high commodity prices and ultimately underpin a stronger Aussie dollar. So I think it's going higher from here. And by the end of the year, I think we're probably pushing up well above 70, probably pushing towards 75 US cents

David McDonald - IMAP (25:27):

Do you have a sort of fair value where you think the Aussie dollar should be?

Shane Oliver - AMP (25:33):

Well my preferred model of fair value (because I can never get the other ones to work), is just purchasing power parity. And it only works every 10 years.

That's the currency to swing from one extreme to the other around it. And right now it's around 73 US cents and we're below that at just above 67 US cents. As we're speaking today we're below that. So there's upside there to get to fair value.

And then I think we'll go a bit beyond that. Normally if the terms trade was this high and the current account was in surplus and the trade balance was in this surplus, you'd probably be looking at something towards parity. But it's been partly offset by the Fed raising rates more than the RBA has. And also there's a bit of a risk premium in there because of uncertainty about issues around China. Obviously the trading relationship and also Australia's dependence on China. So those two things have dampened it relative to what you might normally have seen if the fundamentals were this strong.

David McDonald - IMAP (26:35):

Right. Thank you. We have covered a lot of topics today, and it's been fascinating. So, think if I can summarise Shane's relatively optimistic view, we are probably not heading for a recession in Australia, possibly only one more rate hike, but we are betting that it needs to stay the course because we don't want to head back to the 70's.

It just remains for me to say thank you very much to Shane Oliver from AMP for taking part in our podcast today.

And lastly, a reminder that the IMAP Portfolio Management Conferences is on in Sydney (after a successful conference in Melbourne).

These conferences will bring you the latest thinking from leading investment managers and help you to guide you in managing your clients' portfolios in what has been quite tough market circumstances, more details, including the agendas and the speaker at the conferences are on the IMAP website.

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