Weekly economics podcast: Better than expected

By Perpetual Corporate Trust

8 September 2025



By Stephen Roberts

The next cash rate cut by the RBA has become uncertain after the economy grew more strongly than expected in Q2. The Q2 GDP report showing a burst of consumption spending, but no growth in investment spending indicates that improving growth in demand in the

economy could limit the likelihood of the RBA achieving CPI inflation returning sustainably to the middle of the 2-3% target band from late 2026 as detailed in the August Monetary Policy Statement. The RBA now needs evidence of a return to softer growth in demand or weaker labour market conditions before being able to cut the cash rate again. That is becoming a tall order over the next few months making it difficult to cut the cash rate before the end of this year.

Our view has altered from expecting one more 25bps rate cut in November or December this year to a small chance of one more rate cut in this cycle in February next year at earliest.

Essentially, the RBA's August economic forecasts showing soft economic growth ahead, helping to ensure the upward blip in inflation in 2025-26 is temporary, are in trouble given recent data showing stronger than expected growth in Q2 and a bigger than expected blip in inflation early in Q3. Q2 GDP growth was 1.8% y-o-y, higher than 1.6% forecast in RBA's August Monetary Policy Statement for June 2025. The July monthly CPI showed a big jump to 2.8% y-o-y from 1.9% in June with underlying (trimmed mean) inflation lifting to 2.7% y-o-y from 2.1% in June. Underlying inflation is already above the RBA's 2.6% forecast for December this year and the headline CPI looks set to lift in August or September materially above 3.0% - the RBA's forecast for December this year.

Looking first at growth running above the RBA's August forecast, the main reason why the RBA is running off track so early in the piece is that it assumed that households would stay cautious using the substantial rise in household disposable income over the past year to maintain or lift savings rather than lift spending. The RBA forecast that household consumption would be up by 1.5% y-o-y in June 2025. The Q2 GDP report showed household consumption spending up 2.0% y-o-y boosted by a 0.9% q-o-q lift in the June quarter alone.

If quarterly increases in household consumption in Q3 and Q4 2025 come in anywhere near the 0.9% rise recorded in Q2, annual growth in household consumption could top 3.0% y-o-y by the end of 2025. The RBA's August forecast for the end of 2025 is 1.8% y-o-y. Just after the release of the Q2 GDP report, the ABS released July household spending showing a strong 0.5% m-o-m rise, up 5.1% y-o-y. This monthly report is a current price measure, not a real measure, but allowing for inflation it seems that household consumption early in Q3 continues to run well above the RBA's forecast.

Above forecast household consumption spending growth might not matter too much if it was running in tandem with a lift in productive capacity, but that part of the Q2 GDP report still makes relatively dismal reading. Private investment spending in all of its forms was essentially flat in Q2 and public investment spending was down 3.9% q-o-q. Productivity, or GDP per hour worked was up 0.3% q-o-q and only by 0.2% y-o-y.

Apart from the Q2 GDP report and the latest monthly household spending and inflation reports calling the RBA's economic forecasts into question, Q2 wage growth at 3.4% y-o-y was

above the RBA's June 2025 forecast of 3.3% and the latest unemployment rate at 4.2% in July is below the 4.3% the RBA has forecast for December 2025 and the two years beyond to December 2027. The RBA also needs to allow that since it met in August, the Government has announced more housing measures that impact much sooner boosting demand for housing rather than supply, in short pouring more fuel on flaring house prices.

Where the data are tracking currently relating to household spending, economic growth, the labour market and inflation – all tracking stronger and tighter than the RBA's August economic forecasts – provide no room for the RBA to consider a rate cut at its next meeting later this month. Previously high hope for a rate cut at the meeting in November coinciding with revisions to the RBA's economic forecasts are also fast being dashed. To restore hope of a November rate cut It would take at the very least a lift in the unemployment rate to 4.3% in both the August and September labour force reports, near flat growth in household spending in the same two months as well as a Q3 CPI report showing inflation less than was evident in the July CPI report.

This combination of data reports is not impossible, but does require an immediate reversal of the trends developing in these various data reports showing better than expected growth. Much more likely in our view is that the RBA will need to take account of the stronger growth trend when the soft August forecasts are revised in the November Monetary Policy Statement. A stronger set of growth and inflation forecasts means no rate cut in November or December and only a small chance of a rate cut in February 2026 if weaker economic conditions develop late this year.

Australia's unemployment rate averaged 4.0% through 2024 and ended the year at 4.1%, whereas the US unemployment rate averaged 4.1% and ended the year at 4.2%. Judged by unemployment rate, labour market conditions were a touch tighter in Australia than in the US and in both countries were tight enough to make their respective central banks cautious about cutting official interest rates.

Moving into 2025, labour market conditions have become less tight in Australia and are starting to look weak in the US, especially since President Trump's tariff announcement back in April. In the five months April through August average monthly growth in nonfarm payrolls has been only 54,000, less than a third the average monthly growth through 2024. Labour supply has been cut sharply in the US too with the deportation of illegal immigrants. Nevertheless, the unemployment rate has edged up to 4.3% in August.

In Australia, employment growth has slowed too. Over the most recent 5-month period ending July, employment growth has averaged 22,000, around two-thirds the rapid average monthly growth pace recorded through 2024. However, the slowing employment growth pace is much less pronounced than in the US. Supply of labour in Australia is still growing, but at slower

pace than in 2024 with net immigration still running, but not quite as fast, and the labour force participation rate stabilising.

The Australian unemployment rate has lifted only marginally from 4.1% at the end of 2024 to 4.2% in July. Australia's recent labour force experience points to little change in the unemployment rate over coming months, whereas the US labour market data points to risk of a rising unemployment rate. That alone implies greater likelihood of rate cuts from the Federal Reserve than from the RBA, especially as the Fed has held its Funds Rate steady at 4.50% over several meetings whereas the RBA has cut the cash rate three times this year taking the cash rate down from 4.35% to 3.60%.

Of course, the inflation outlook is a key factor determining what each central bank will do with rates. The US CPI inflation rate was 2.9% y-o-y in August, whereas Australia's CPI inflation rate was 2.8% y-o-y in July. Inflation is under upward pressure from tariff changes in the US and is under upward pressure in Australia as government cost-of-living measures end. Whether the Fed and the RBA can look through these near-term 'one-off' inflation pressures depends upon whether demand in the two respective economies is likely to be sufficiently strong in each economy to underpin inflation a year down the track. The answer is moving towards no for the US and yes for Australia in our view.

So, the tale of two labour markets, still tight in Australia but weakening in the US, is adding to factors relating to the inflation outlook in the two countries that make it likely that the US Fed can cut the Funds Rate this week and possibly deliver two or more cuts in meetings beyond, whereas the RBA is running out of room to cut. We see the US Fed funds rate (4.50%) and the RBA's cash rate (3.60%) converging around 3.50% over the next few months.

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