

Research @ Citi Podcast, Episode 43: Where to Find a Safe Harbor in Turbulent Times

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Transcript:

Josh Williamson (00:00)

65% of our defense procurement in Australia comes from the U.S. We were in negotiations to have our largest-ever defense contract to purchase Virginia-class submarines — which on the one hand would be great for the U.S. administration because they were telling the government here, “We want you to spend more on defense.”

Brent Robinson (00:16)

Welcome, everyone. Welcome to our Research @ Citi podcast. I'm your host, Brent Robinson. I run research across the APAC region based in Hong Kong.

And my two guests today: Josh Williamson, our Chief Economist for Australia and New Zealand, and Faraz Syed, our Senior Economist for Australia and New Zealand as well. Welcome, gentlemen.

Josh Williamson (00:36)

Thank you, Brent. It's good to be here. This is our first podcast with Citi just from Down Under. So, we're quite chuffed to be here with you today.

Faraz Syed (00:43)

Thanks, Brent. Great to join you on this podcast.

Brent Robinson (00:45)

I can't remember any time in my career when the financial markets have not been driven by the global and macro. And in most cases, it's happening on a day-to-day basis, depending on events outside of our control and on a global context.

So, I thought I'd start with a broad question for both of you: In an Australian/New Zealand context, what keeps you up at night? With the backdrop that's so confusing: Whether it's Trump's tariffs or shifting geopolitics, war in Ukraine, Russia, you know, the backdrop is so uncertain. What keeps you two up at night?

Josh Williamson (01:22)

That's a big question, Brent. I think the two things for us, and they're probably not going to come as a surprise. The first is Trump and the administration, and the second is China. And it used to be that China was sort of the thing that kept us up at night. I mean, I've been here at Citi for 16 years, and all throughout that time, in my worry box was China.

And that's because China is Australia's largest trading partner, and so it's always been there. But we're monitoring things more closely now because we want to see how the Chinese administration reacts to Trump, and also how it's managing its maturing growth cycle. That's something that's really important to us as well, because we know that this growth cycle has been going for a long time. And we also know that its growth path actually matters for other economies in the region because its trade linkages are so strong. So that's the first thing.

As I said, Trump is important because obviously we're monitoring what happens with the tariffs. And if you look at when there's been another shock to the global trading regime, I think the only comparison you can make with what's happening now is what happened with Brexit.

And I say that because with Brexit, the UK had left the European Union, but we knew the rules. We knew what the rules were inside the European Union, and we knew what the rules were if you were outside the European Union. What's different this time is that because Trump is president, he can unilaterally change the playing field and change the rule.

And this is what I think is most concerning now: Trump can evolve this situation in a strategic sense to the way he sees it benefiting both the U.S. administration and also U.S. economic policies. So, it's the Trump situation that's probably number one in our mind now, and that's probably relegated China to number two.

Faraz Syed (02:58)

And just to add to that, Brent: Australia and New Zealand, they're both small, open economies, so we tend to be price takers to the rest of the world. So ultimately, when you get these global supply shocks, there's not much monetary policy or fiscal policy can do about it. Or at least there's a lot of uncertainty around what policy can do because we don't necessarily get to control the narrative.

So, we are price takers to the rest of the world. And that's where I think there's a little bit of concern that there are supply-chain issues emerging once again. Obviously, we had that during COVID. If that starts to emerge again, then there's going to be issues here domestically as well. So, I think these are the sort of concerns that are probably keeping us up at night in Australia and New Zealand.

Brent Robinson (03:33)

Yeah, that's a good point. If you stay with China for a second, if you look at obviously the Trump situation and then China's own macro struggles with growth and property downturn and everything, are you seeing a big shift in the import/export coming out of Australia, say, for commodities due to these issues with the U.S. and China?

Josh Williamson (03:54)

No, and this is probably a good thing. Australia's trade relationship with China has remained pretty resilient. And I think this reflects the fact that there is a high degree of demand for Australia's key exports to the Middle Kingdom. And so, for example, if you take iron ore and coal, we are not the high-cost producers in that space. In fact, we're in sort of the second or the lowest quintile for production costs.

So, to the extent that China's demand ebbs and flows for these commodities globally, it's really other countries that tend to export. So, for example, in iron ore, it might be the South Americans that feel it. And in coal, it might be, say, the Indians that feel it. But we generally produce low-cost, high-quality, hard commodity exports to China.

While prices ebb and flow, quantities remain pretty well anchored down. And we've found that on numerous occasions when there have been wobbles within China's growth model.

Brent Robinson (04:47)

That's really interesting. Strangely, China just had a better GDP print the other day. But that's quite interesting that you're not seeing any shift in an Aussie context.

If you then come back to U.S. and Trump, is there any clarity in your mind? I mean, because you are an open economy, both Oz and New Zealand, you have a great relationship with the U.S. historically. Do you see a path for the tariff resolution and how that unfolds?

Josh Williamson (05:13)

Well, unfortunately I don't. And it's not for a lack of trying on the Australian government's behalf. I mean, Australia is not at the head of the tariff negotiating queue. But I think that probably reflects the fact that the U.S. from a trade perspective has more to gain from negotiations with other countries where it has a trade deficit.

You've got to remember that the U.S. has a trade surplus with Australia, and it has had a consistent trade surplus for many years. And the other consideration is the U.S. probably has more to gain from negotiations with other countries with which it wishes to extract strategic or other concessions; fentanyl with China is probably the best example.

So, actually what Australia is doing is it's in the background. We'll continue to try to get U.S. tariffs on Australian goods removed. But what we're also doing is negotiating with other countries.

So, for example, we've been on the front foot as a country with India for an expansion in items covered by our free trade arrangement. And Australia and European negotiators have restarted talks on a free trade agreement that stalled early last year.

But probably in the interim, I think what we're telling ourselves is that the tariffs on Australian goods aren't actually as high as those applied to some other countries. And that what we still sell to the U.S. — particularly I'm thinking aluminium and also iron ore — that's still going to be in demand, despite the fact that there will be some higher prices on those.

(06:34) Faraz Syed

And in terms of the trade relationship with the U.S., what we export to the U.S. is mostly soft commodities. It's stuff like beef, wool, lamb. So, we're not necessarily exporting some of these major manufactured goods and commodities where the administration wants to create more jobs in the U.S., for example.

We do have a trade deficit from an Australian's perspective. The U.S. has a trade surplus with Australia. So we shouldn't be the marginal player that's been hit by these tariffs. So, we'd be surprised to see, for example, tariffs greater than 10% labeled on Australian goods.

Brent Robinson (07:08)

Got it. If you look at Trump, he uses tariffs as an angle for other outcomes. So, could he be angling, say, in an Aussie context, for more military support? Or you talked about fentanyl. Are there other areas that the government has been looking at to, say, please Trump, if that's the right term? To kind of get all this to go away?

Josh Williamson (07:30)

Yeah, well, ostensibly, I'll flip the coin, Australia has a trade deficit with the U.S. That is, obviously, we import more from the U.S. than we export to the U.S., despite the fact that we have that. What seems to avert the administration is we won't take U.S. beef. So, if you pardon the pun, the beef has been with beef, basically.

Now, just to sort of put some facts around this, we do actually take U.S. beef. What we do take is frozen beef. We don't actually take fresh beef, but we don't take fresh beef from any country. So, it's not that we've singled out the U.S. here. We've had a legacy of quarantine restrictions that means that we don't take fresh produce from a number of countries.

So, for example, neither does Australia import bananas. Up until recently, we didn't import apples either because we have a very unique ecosystem and the quarantine

advice has always been, "Do not take fresh produce." And you might know, Brett, that when you come to Australia and you have to come through customs you've got to declare everything. You've got to declare if you've been on a farm, if you've been hiking anywhere, if you've been to a rural area. So, maybe Australia could actually relax its quarantine around beef. But to do that, I think we'd actually need to see some assurances that the supply chain of U.S. beef that does receive the livestock from Canada and Mexico, that needs to be tightened up.

But it's a pretty small thing. It would be a small win for the U.S. because, you know, 65% of our defense procurement in Australia comes from the U.S. We were in negotiations to have our largest-ever defense contract to purchase Virginia-class submarines — which on the one hand would be great for the U.S. administration because they were telling the government here, "We want you to spend more on defense." But that's now at a crossroad because we're seeing another part of the U.S. administration actually put that contract on hold for review.

So, you know, we want to do more. We want to actually trade more. And I'd say that given the fact that we purchase a huge amount of machinery products from the U.S. — technical products, pharmaceutical products, military products, all highly value-add — that we actually directly support many, many jobs in the U.S.

So, it's hard to see what we could be doing more to encourage a free arrangement with the U.S. And let's not forget that for many years, Australia and the U.S. had a free trade agreement that was well functioning and that served both parties well.

Brent Robinson (09:34)

If we shift away, it's quite clear that Australia shouldn't be in the limelight for these tariff issues, right? And there are other ways to work it out.

If you start to shift back towards more domestic policy, I think there's been some confusion around the RBA and how they're adjusting to the new global order. How do you two see it on the ground in an Australian context with the RBA and their future moves?

Faraz Syed (09:58)

So, I mean, the RBA has been quite interesting recently. They surprised the markets, for example, when they held policy rates in July.

But this year, the RBA has got a new board. They have got a new board structure where you've got seven external members and two internal members. So, there's a risk that perhaps the external members may want a policy rate that's slightly different to what the RBA wants. So, these are the sort of things that we're looking at when it comes to the RBA this year.

But one thing that the RBA did during the hiking cycle when we did have high inflation in the past couple of years, was, they came and told everyone that they weren't going to

hike interest rates as much as other global central banks because they wanted to protect the gains in the labor market.

So it was a conscious decision by the central bank that we made a lot of progress on the labor market. The labor market is extremely tight. There's a lot of jobs out there. Most people are employed. We don't need to be hiking policy rates in an environment where inflation was high and driven by supply-chain dynamics. We don't need to be hiking interest rates aggressively in that environment, in order to bring inflation down.

So, they have been, as we market economists call it, more dovish compared to other global peers. So, they didn't hike rates as aggressively. So, on the way down, other inflations come down. There are pockets of the labor market that have started to loosen up a bit. We're seeing the unemployment rate tick up.

You know, we do think the RBA will cut policy rates further. But again, they're not going to be cutting as much as some of our other peers. So, if you look at New Zealand, they had a huge increase in the unemployment rate. Our unemployment rate's only gone up a little bit, whereas the RBNZ has to follow up with more aggressive rate cuts as well. So, the RBNZ has cut a lot more than the RBA, for example. And we expect them to actually cut further as well, going further down this year.

Whereas with the RBA, we're expecting three more cuts. But again, it's of the view that they won't be cutting too aggressively, given that our labor market still remains tight. We still have pockets of inflation that could be a little bit concerning.

But overall, we think it's an environment where you've got this sweet spot where inflation does come down. The labor market remains just about at the right level as well.

Josh Williamson (11:53)

Brent, I might just add to that: There's been some institutional changes at the RBA that people may not be aware of. And what I mean by that is we've had this review into the RBA, and we've also had the situation where the Australian Treasurer has actually employed some people at the RBA from outside the organization.

So, the old structure of, "You stay at the RBA, and you gradually find yourself being promoted?" That hasn't happened. And they've actually lost some senior staff members — we're talking staff members with decades of experience. And these are staff members that develop their economic models, interpret their models. So, there's a lot of intellectual capability that has moved into the private sector from the RBA.

And I think this has occurred at a time, going back to your first question, when we've seen an increased amount of volatility or uncertainty in the global backdrop. So, what's also happened, I think, is the Reserve Bank has probably become, not unsurprisingly, maybe a little less sure of their own forecast. So, they've become more data-dependent than forecast-dependent. So that means your time horizon for sort of any sort of forward

guidance, which the RBA doesn't want to do anyway, but the time horizon of that becomes shorter.

So, this probably explains some of this concern that market participants had about changing policy direction and policy stances between those quarterly statements of monetary policy and even between the six weekly press conferences that we get. So, market participants have had to navigate these institutional changes.

You've actually got other staff members who are more junior coming up the ranks, filling these positions. So, there's probably been a bit of a learning-curve experience here that you wouldn't have had if you'd had these older hands still remaining within the bank.

Brent Robinson (13:20)

I mean, it seems like there's some parallels to the U.S. because there's some criticism in the U.S. that interest rates should be coming down. I think our house view at the moment is two cuts. And I think the markets are pricing in two cuts from the Fed.

And it's pretty well known that Trump's been very critical of Powell. If Powell starts to cut, what happens in Oz with the RBA?

Josh Williamson (13:42)

There's generally been a view, and I think this gets permeated by foreign asset managers and people who sit in hedge funds, that the RBA is potentially another Fed district, or it's an extension of the Fed. And if you actually look at the data over the long run, there really isn't a correlation between what the Fed does and what the RBA does. I think those correlations may be artificially inflated by the fact that you might have both central banks on hold for a period of time for very different reasons.

But there are numerous cases where the banks have gone in different directions. And I think this reflects the fact that ultimately, it's the domestic considerations around your mandates with respect to inflation, employment. The Fed tends to take a bit more of a view of financial conditions via the equity market than the RBA does, whereas the RBA tends to look at financial conditions more through the lens of global financial conditions, through things like yields and exchange rates that tend to explain why they move.

So, I don't necessarily expect this time around for any move in the Fed to be mirrored by the RBA. But we also remember — and Faraz has mentioned this — that the RBA never took its cash rate to the heights that we saw amongst some other developed-market central banks. Their view of restrictive was fairly low compared to certainly the Fed and also the RBNZ.

So, there's a situation where because we didn't tighten as much on the way up, you potentially don't need to do as much on the way down unless there's some huge exogenous shock.

Brent Robinson (15:02)

And staying with the domestic side, the pension program in Australia is well known, one of the best in the world, one of the biggest in the world. How do you see the pension system in Australia dealing with the global environment and where are they asset allocating today?

Faraz Syed (15:20)

Yeah, it's a really interesting question, Brent.

The size of our pension, or what we call here the superannuation industry, it's huge. It's about \$4 trillion Aussie dollars, which is actually larger than the size of our economy. So, in fact, they're projected to continue growing and probably become the second-largest pension system in the world in about five to 10 years' time.

So, if you go back to that asset-allocation perspective, it's just about 50% in equities and about 20% in fixed income. Now, the interesting part is that in recent years, particularly in the last 10 years, there has been an increase in allocation to overseas assets. So roughly around 60 to 70 cents of every new dollar has been deployed overseas. The reason for that is fairly simple. The funds obviously need to diversify away from the Australian market, which is fairly small, relative to the size of the pension industry. So, it's all about managing that concentration risk in the domestic market and of course, diversifying the portfolios as well.

So, what you've seen is there's been a structural flow of these funds going overseas, which has clearly had an impact on our current account. So, it's net-to-net outflows in the capital account, for example, which has put downward pressure on the Australian dollar. So, think of super funds selling Aussie dollars to buy U.S. assets, European assets, or Japanese assets, for example.

So, the ongoing capital outflows actually reduce the demand for Australian dollar assets. So, it's clearly a structure shift where we think Australia will go from being a capital importer to a net capital exporter in the next 10 to 15, maybe even a bit longer period of time. Which is a huge change for us because when you think back since federation, we have mostly imported capital from the world. You think of more recent times as well: We funded the mining boom in the 2000s through importing capital.

Brent Robinson (17:00)

So, when you pull it all together: the domestic unemployment, the economy is quite strong, property is OK, policy obviously on hold for the moment, and your trade situation with the U.S. quite strong. There's a developing view that maybe Australia is a safe haven. Can't take over for the dollar, but a safe-haven destination. Do you think that is cyclical, or do you think there's a structural component to the idea that Australia would be a safe haven for assets?

Faraz Syed (17:28)

Well, we believe it should be. I mean, let's look at the facts. Australia is a AAA-rated sovereign, the lowest gross debt compared to other developed-market peers. We have a strong system of governance, rule of law of course, and an environment where the rest of the world may possibly look to de-risk away from the U.S. dollar assets. Then we think on the margin, perhaps Australian assets could benefit.

Now, going back to the super funds, one interesting question we have been getting is, "Could these Aussie funds look to come back into the Australian market, particularly to sovereign debt?" And we haven't seen that shift just yet. We think it could be coming, but we agree in the sense that Australia does look — relative to the rest of the world, at least, in the next three to four years — like a relatively safer option.

Josh Williamson (18:09)

And I think, Brent, there's already a recognition amongst market participants in a sort of *de facto* sense that we're relatively safe, because despite the fact that we're probably the 12th-largest, soon to become the 11th-largest economy by size, our currency is the sixth-most-traded currency pair.

So punching above its weight, if you like, given our share of global GDP. And the strength in that currency pair is not something that's happened in the last year. I think it's been the last decade that we've seen the strength in global flows in and out of the currency.

Brent Robinson (18:39)

Yeah, quite interesting. We're starting to run out of time, but I wanted to come back to global for a minute. So, I think this has been confusing to everyone.

You look at the U.S. breaking out to all-time highs on the equity side. You look at the Nikkei, the European, DAX, Australia, most markets are either close or almost at their highs. What does this mean from you guys' perspective as economists? Because does this mean global growth is going to pick up? What's your view on how the markets are where they are with the macro backdrop being so difficult?

Josh Williamson (19:14)

Certainly there's a time differential, I think, between what some of financial markets are suggesting in terms of where asset prices are vs. some of the data. And I think that some of the performance you talked about probably reflects the fact that markets have taken a generally rosy view of the deregulation agenda that's been proposed by Trump around companies, but also the agenda for tax cuts more generally. All these things are favorable to company revenue.

And at the same time, we've had Trump announcing policies to cut government expenditure. That might also be seen to cut some of the administrative burden and the expenses associated with companies. So maybe a little bit of top-line performance there. I think markets have definitely run with that. Obviously, we saw this reversal

going into April, but the markets have recovered since then on the fact that the tariff situation doesn't seem to be as bad as expected.

I think the wild card here, Brent, is if we see the aggregate economic data actually start to accelerate because the global economy and the U.S. economy have shown a huge amount of robustness to some of this political uncertainty that we've seen. So maybe the risk is we actually start to see the economic data.

So, we're looking at the big-picture GDP data, for example, actually start to pick up and improve rather than see that moderate down. Because I think the central view here is we do expect the tariff regime to start to bite into real household disposable income and inflation to start to pick up, which also erodes real GDP growth.

So, we could be seeing a situation here where we have the actual macro data perform better than expected — not just in the U.S., but also elsewhere. And that includes Australia.

Brent Robinson (20:56)

So, if the U.S. goes from 1% to 3% growth, what does that mean for Australia and Australian assets and risk?

Josh Williamson (21:03)

Well, I think you'll see a positive halo effect there. In terms of trade exposure, probably not that much, but I think in terms of risk on exposure, it's actually really good because, for example, our currency is seen as high beta. So, if the U.S. growth is looking better, therefore global growth is looking better, you might see an increase in risk preference away from, say, the G3, the G4.

And some of the things we talked about — about Australia being the safe haven, rather than being sort of a backburner — maybe come to the fore and people say, "I'm actually feeling better about investing in Australia where I can have a developed-market-type risk profile, but EM-type yield performance."

Faraz Syed (21:43)

Australian households in general have been a lot more resilient than we thought in the past couple of years. So, we thought during that interest-rate hiking cycle, perhaps households would really slow down consumption growth. They did to a margin, but it wasn't a collapse by any means. We saw an upside surprise to consumption last year, and we're actually expecting household consumption growth to pick up again in the second half of this year as those interest-rate cuts come through.

So, there is still a positive backdrop here at least for households, and a tailwind for households as well from lower interest rates.

Brent Robinson (22:13)

Thank you, Josh. Thank you, Faraz. Very helpful. Thank you for joining us today. Our next Citi Research podcast will feature Jason Gursky, our U.S. Aerospace and Defense Analyst. He'll be discussing his recent Must C report.

Thank you very much, everyone, and have a good day.

Disclaimer (22:31)

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