July
2021

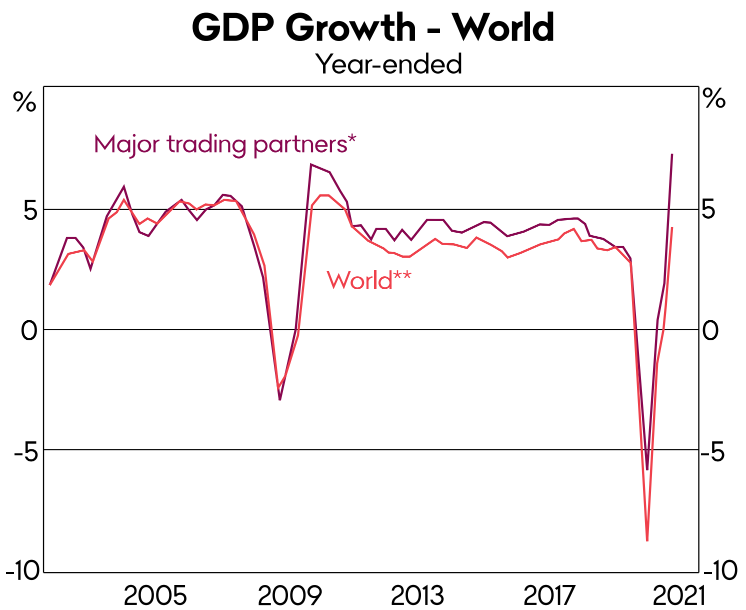
Economic and market update

Economic Overview – as of 15 July 2021

Global markets

The outlook for 2022 has become even more complicated (if that was possible) thanks to a combination of diverging global central bank messaging , a wide spectrum of outcomes for COVID case numbers, fluctuating vaccination rates and different approaches to reopening economies.

A more consistent theme is that policy support is in place in most economies (and if required can flex up to address arising needs), and is something markets continue to take solace from, together with the reality of the rebound in global demand.



* Weighted using Australian export shares
** PPP-weighted; accounts for 85 per cent of world GDP
Sources: ABS; CEIC Data; IMF; RBA; Refinitiv

The delta variant of COVID-19 has clouded the growth outlook to an extent as well as complicating vaccine rollouts and reopening strategies however, opinions are divided on the longer term impacts and risks.

This inconsistency of central bank messaging and its stated timelines for 'policy normalisation', is even evident with close neighbours such as Canada and the USA, and Australia and New Zealand.

The Bank of Canada has just updated its forecasts, with GDP expected to grow six percent this year and an upgraded 4.5 percent in 2022; along with a cut in its Quantitative Easing (QE) bond purchases. But on the same day, US Fed chair Powell pushed back on US QE tapering, stating that meaningful further progress towards its goal of full employment and two percent inflation "is still a ways off".

The sharp rise in US inflation (including yesterday's spike in core PPP up one percent in June) seems at odds with these comments, but the recent surge in prices is being put down to one-off factors. US GDP forecasts have been pared back a fraction (down to around six percent for 2021, but still firm at around four percent over 2022).

Last week's cut in the Chinese Required Reserve Ratio (RRR) was a reminder of the willingness of governments to step in at the hint of any deceleration in growth, or any complication to full economic recovery.

The RRR cut from the People's Bank of China was announced as a liquidity injection to support SMEs amid rising commodity prices - rather than a formal change in monetary policy - but either way it comes as Chinese growth for Q2 has decelerated.

Nevertheless, 2021 growth should still be around nine percent, on top of last year's resilient 2.3 percent growth, and trade data also picked up strongly in June.

Chinese activity data for June released today, showed GDP growth slowed to 7.9 percent for Q2, down from 18.3 percent y/y in Q1, where base effects were more pronounced.

The retail sales and industrial production numbers are best considered month-on-month to strip out base effects, and they held up well, although only rose m/m 0.7 percent and 0.6 percent respectively.
The RRR cut will help to support this trend over the coming months, offsetting high input costs and a rebasing in the export boom growth rate.

Ahead of the Olympic Games, the Japanese economy continues to suffer.

With Tokyo's fourth state of emergency lockdown impacting consumption and hospitality, it leaves the country facing the prospect of footing the bill for the Games but without the chance to offset these costs against tourism benefits.

After the 3.9 percent contraction in the Japanese economy in Q1, consensus is for growth to have picked up 0.5 percent in Q2 and then around four percent in Q3.

The outlook for Europe and the UK is brighter, with the rebound in global demand and vaccination progress encouraging the European Central Bank to upgrade its forecast, and the prospect of UK and euro-zone economies recapturing their prepandemic GDP levels by early to mid-2022.

The UK's 'freedom day' reopening on 19 July (the fourth step in its 'return to normal') coincides with a full adult vaccination rate of around 67 percent, which has been enough to reduce hospitalisation risks, but apparently instead has increased the tolerance for COVID-19 case numbers and with that, the risk of further variants emerging.

Domestic economy

The extended lockdown in Greater Sydney and COVID-19 spot fires around Australia, pose an obvious question: despite all the economic progress over the last year, will these outbreaks derail our recovery?

The answer to this clearly lies in how long the lockdown will last for, and to what degree it spreads - with Melbourne now also dealing with a 'circuit breaker' snap lockdown - but more importantly, it lies in how quickly we can lift vaccination rates, so these responses to clusters do not require lockdowns.

The percentage of fully vaccinated adults needed for the country to progress to 'phase two' of our four stage national COVID-19 exit plan is yet to be formalised or announced. Phase two states that lockdowns would only occur 'in extreme circumstances', which may equate to the requirement for 80 percent of all adults to be fully vaccinated. Depending on vaccine supply and demand, that percentage could be met by early next year.

This scenario of increased vaccination rates would combine very favourably with the reality that policy support (fiscal and monetary) will be in place until after our international borders reopen - hopefully mid-next year.

However, ahead of that, even with increased government support for impacted households and businesses, the Sydney lockdown will have a material impact on Q3 GDP and jobs growth - potentially reducing an expected 0.8 percent growth to flat or even causing a slight contraction.

It will also briefly halt the fall in unemployment and concurrent rise in employment; but here were no signs yet of any U-turn in the June jobs data released today.

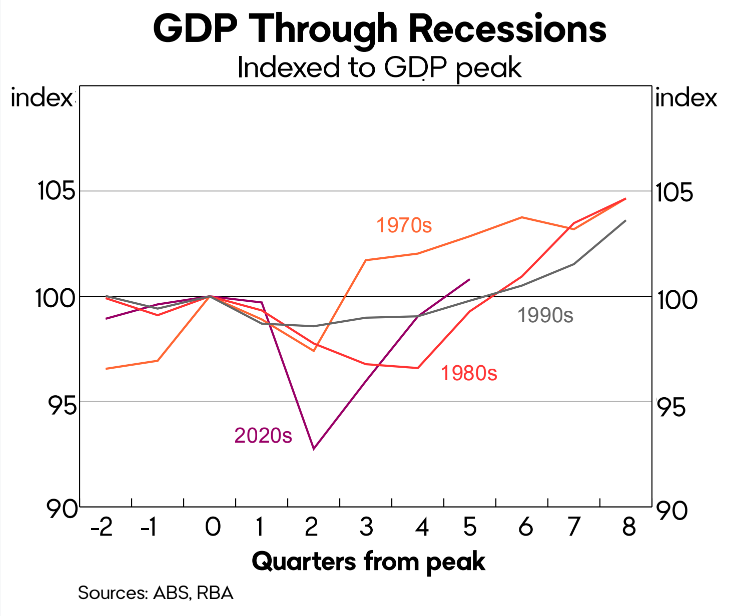
The fall to 4.9 percent unemployment is the lowest rate since June 2011, exactly ten years ago. The rise in employment of 29,000 was actually held back by the survey coinciding with Victoria's fourth lockdown in early June. As a result, the next few reads should see a further improvement but an offsetting fall from NSW. However, for the economy to have dipped below five percent unemployment by mid-2021 is an extraordinary achievement. Afterall, the RBA's forecast in February was for a rate of 6.5 percent!

Much like the disparity outlined in the global markets section above on Canadian vs US Fed policy, the contrasts between the RBA and the Reserve Bank of New Zealand on monetary policy are stark.

The RBNZ has just announced the end of its QE programme with bond purchases to end this month, and an upbeat statement noting inflationary risks (suggesting rate hikes may start as early as next month).

Contrast that with the RBA, which despite making its first steps to policy normalisation in last week's briefing including a tapering of QE, nevertheless is maintaining the same line that it won't increase interest rates until inflation is sustainably above two percent.

It still insists inflation won't reach this level until we reach 'full employment' (around 4.25 percent) and wages growth is above three percent; all of which it doesn't expect to occur until 2024.



The appendix has a number of charts covering inflation, wages and some of the key inputs to these trends, including participation rates and the impact of the absence of temporary migrant workers. Unlike the RBA position, the market is increasingly drawn to the view that falling unemployment and underemployment, together with elevated job vacancies and job ads, will see wages growth emerge far more quickly. A further addition to this argument is the recent ABS survey which reported 27 percent of employers have had difficulty finding suitable staff.

The pandemic recession was much shorter and deeper than those of the 70s, 80s and 90s based on employment and GDP measures, so its unique nature has made economic forecasting challenging to say the least. However, with the new financial year underway, the outlook remains one consistent with ongoing recovery.

Monetary and fiscal policy will remain in place throughout the next 12 months, and despite the current lockdowns which will stunt Q3 growth, the V-shape looks likely to extend through Spring. The outlook after RBA rate hikes (in FY23) is much harder to anticipate and predict.

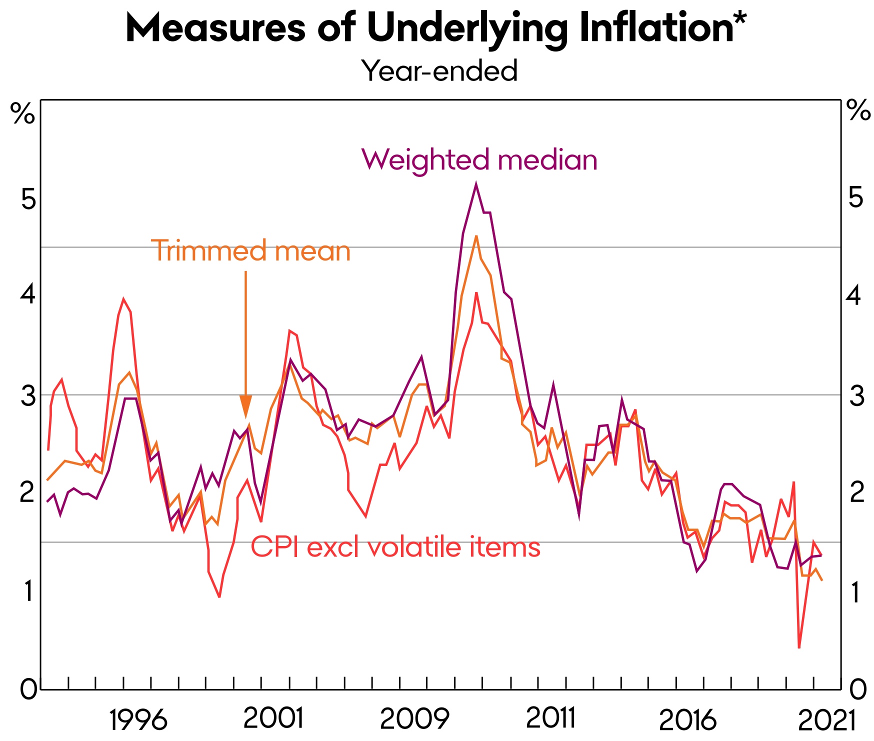
The recent dip in the Aussie dollar down to US 74.1 cents is a measure of the success of the RBA's strategy to talk down potential inflation and position itself at the back of the rate hike queue, but it comes with the risk it is underestimating inflationary risks. Rising oil prices (up to a three-year high) and bulk commodity prices together with supply chain bottlenecks could be temporary, but this combined with limitless fiscal stimulus may make them less transitory than central banks insist

Interest Rate Outlook

The RBA remains committed to maintaining highly supportive monetary policy settings until its goals for employment and inflation are achieved, which it does not expect to occur until 2024. The official cash rate and target for three-year Australian Government bond yields are therefore likely to remain at 0.1 percent for another few years, although it is increasingly likely that progress to 'full employment' will be faster than the RBA 'baseline', so the start of the tightening cycle may occur in FY23.

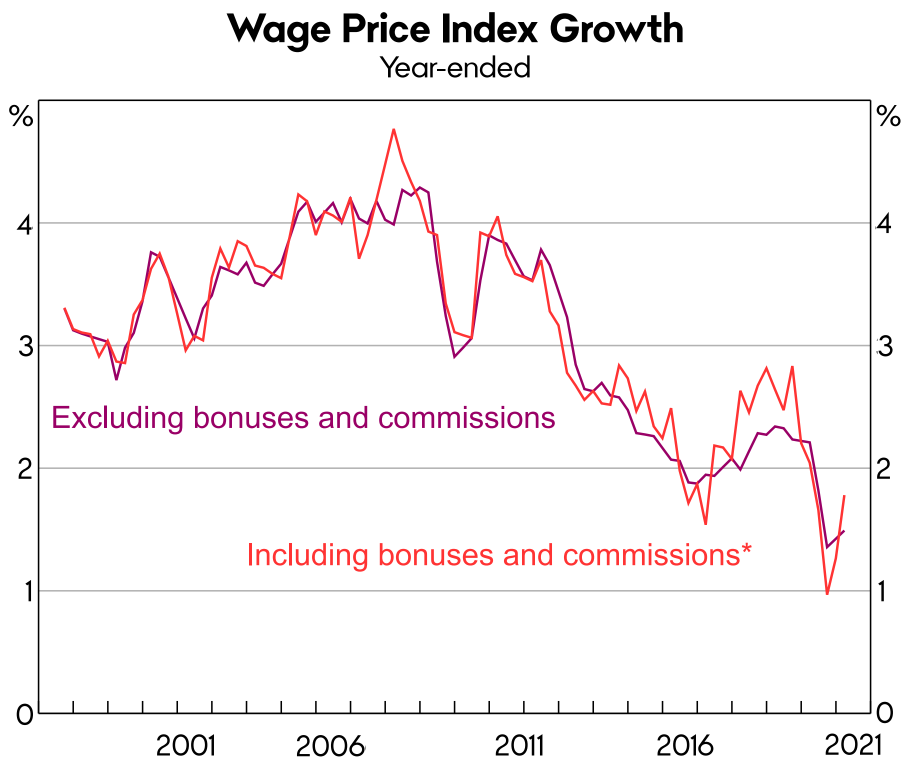
	31/ 5 / 2020	31 / 5 /20 21	30/ 6 / 2021	15/ 7 / 2021
90-day bills	0.10 %	0.04 %	0.03 %	0.025 %
3-year swap	0.29 %	0.37 %	0.48 %	0.41 %
5-year swap	0.49 %	0.91 %	0.95 %	0.81 %
AUD/USD	.6675	.7730	.7500	.7465
ASX 200	5 756	7 161	7 313	7 341
Credit Index (iTraxx- 5 yr)	101	59.5	57.8	59.8

Appendix - Australian inflation and its likely drivers ahead



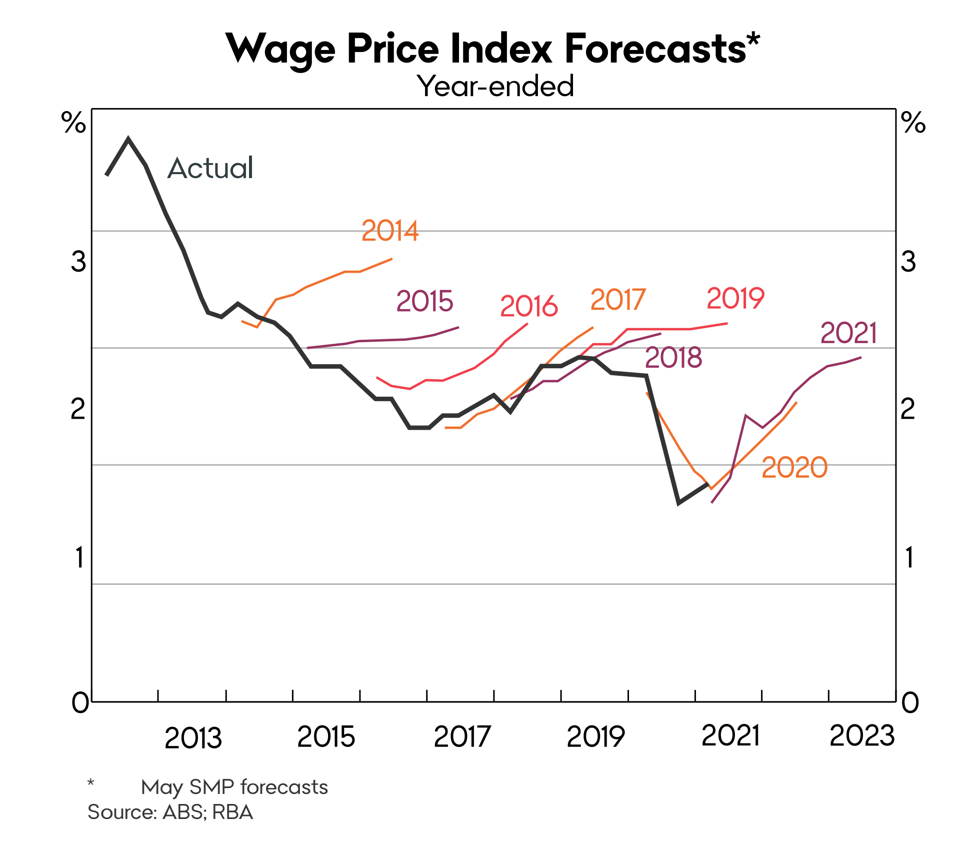
* Excudes interest prior to September 1998 and deposit & loan facilities prior to September 2011; adjusted for 1999-2000 tax changes

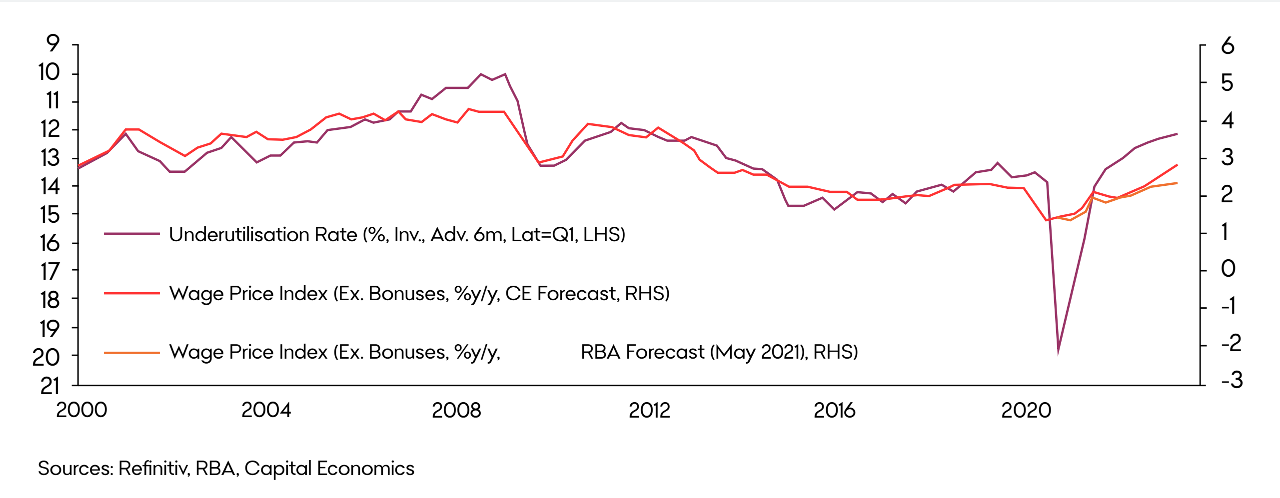
Sources: ABS; RBA



* Not seasonally adjusted

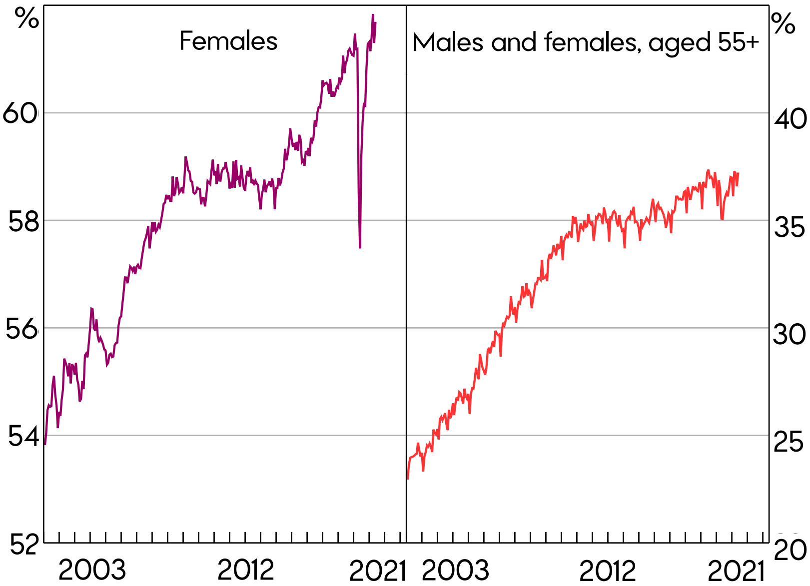
Source: ABS


Wage Price Index Forecasts*
Year-ended
%
Actual
2014
2015
2016
2017
2019
2018
2021
2020
3
2
1
0
2013
2015
2017
2019
2021
2023
*	May SMP forecasts
Source: ABS; RBA


Underutilisation Rate (%, Inv., Adv. 6m, Lat=Q1, LHS)
Wage Price Index (Ex. Bonuses, %y/y, CE Forecast, RHS)
Wage Price Index (Ex. Bonuses, %y/y, RBA Forecast (May 2021), RHS)
9
10
11
12
13
14
15
16
17
18
19
20
21
6
5
4
3
2
1
0
-1
-2
-3
2000
2004
2008
2012
2016
2020
Sources: Refinitiv, RBA, Capital Economics

Participation Rates*

Monthly

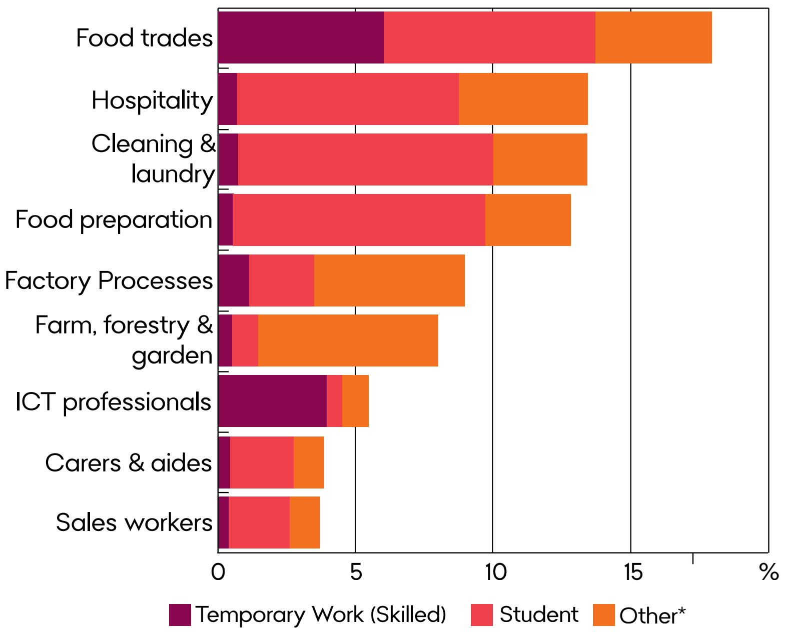


* Female participation rate is seasonally adjusted; males and females, ages 55+ series is non-seasonally adjusted

Source: ABS

Temporary Migrant Employment

Share of employment by occupation and visa type, 2016



* Includes Working Holiday Maker visas, other Temporary visas and Bridging visas

Source: ABS; RBA