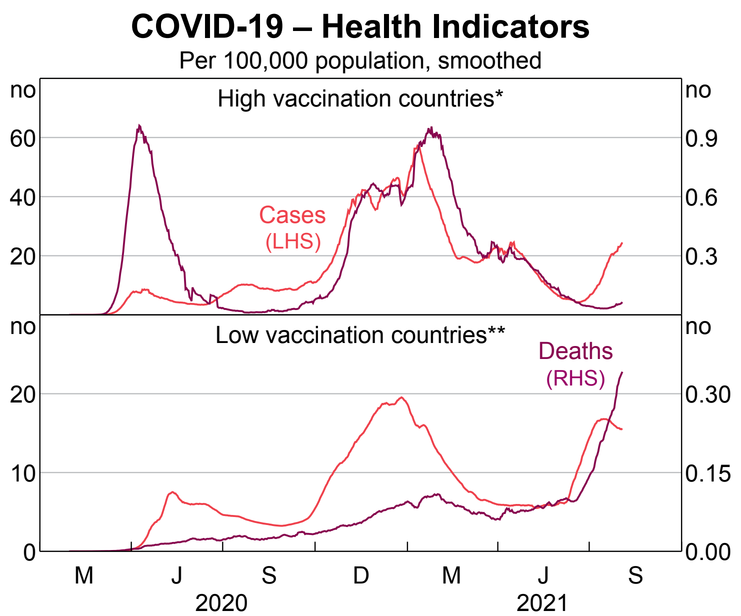
Economic and market update

Economic Overview – as at 19th August 2021

Global markets

The optimistic tone from mid-year has taken a breather as the adverse impacts of the Delta variant on economic progress grow, putting risk appetite back into a defensive mode. Stock markets remain near record highs despite this setback, taking comfort in support packages and still with a view to when the virus will be treated as endemic rather than pandemic. The timing of this critical step for different countries will be heavily dependent on vaccination rates, which will determine the health impact of reopening economies and starting the gradual process of resuming international travel.



* Includes United Kingdom, United States, euro area and Canada
** Includes Russia and parts of Asia
Sources: Our World in Data; RBA

Those countries with higher vaccination rates such as the UK and Singapore are accepting higher case numbers for the virus as they reopen but are maintaining a low mortality rate. As a result, high inoculation rates are expected to be well correlated to economic growth rates through the year.

The US has exceeded 50 percent of its population fully vaccinated although there are significant variances by state, and the Delta variant of COVID-19 has impacted consumer activity with a sharp fall in the latest retail sales and consumer confidence data. The US economy is still expected to grow by around six percent this year and four percent next, but the elevated inflation rate will make the Federal Reserve's job most challenging if inflationary pressures prove to be less transitory than they expect. Interest rate increases will lag the tapering of Quantitative Easing by around a year, but as the minutes from the latest FOMC meeting noted: "it could be appropriate to start reducing the pace of asset purchases this year". Walking the line between policy support, reopening the economy and managing inflation is a herculean task, although the US dollar has strengthened steadily to its highest level in almost a year.

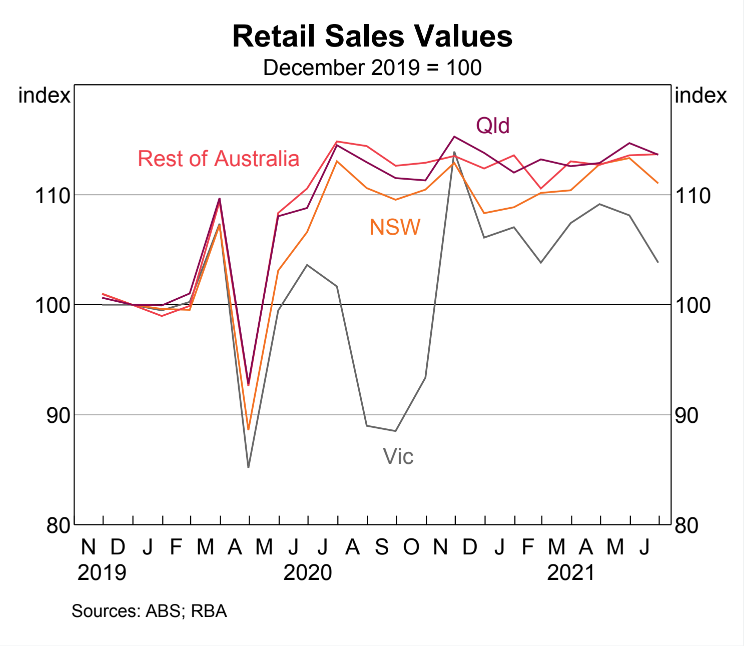
The Chinese economy decelerated further in July as evidenced by a lower growth rate of retail sales, fixed asset investment and industrial production. The official GDP growth rate of 12.7 percent for the first half of 2021 is now expected to be much more sedate in the second half, but still should achieve around eight percent growth overall for the year. Further cuts to the 'required reserve ratio' and policy rates will try to manage the slowdown, as the Chinese administration attempts to manage the pandemic while addressing structural issues and simultaneously cracking down on large tech firms, and data security.

The outlook on balance is for advanced economies to perform relatively strongly through 2022, with policy support intact and rising vaccination rates helping to manage the health crisis, but emerging markets and low-income countries face a much more challenging environment. Further risks exist in the form of new strains of the virus, rising inflation and high levels of government debt. Meanwhile, the geopolitical backdrop remains unpredictable - especially following the Taliban takeover of the Western-backed Afghan government - primarily due to the instability of the middle east and the uncertainty surrounding the US' future role in the region.

Domestic economy

The extent of COVID-19 lockdowns and rising case numbers in New South Wales, the ACT and Melbourne is far more important than economic trends and is placing businesses and households under significant (and cumulative) strain.

The snap lockdowns in Queensland proved to be very effective while WA, SA and Tasmania have all remained free of community transmitted COVID-19 for some time. Consequently and similarly to this time last year, we now expect to see a two-speed economy emerge though this quarter as activity and mobility in the south-east is constrained. However, unlike 2020, more than half of Australia's population is currently in lockdown, while government support measures look very different this time around.



The two-paced economy will soon become clearly visible via retail sales data which we expect to nosedive sharply in NSW and also fall significantly in Victoria. However, today's July jobs report has yet to show the impact of recent events, as the survey was conducted early in the month.

Remarkably, while NSW employment figures fell 37,000 in July - 0.9 percent month-on-month - and 'hours worked' dropped seven percent during the month, the national unemployment rate actually fell to 4.6 percent, its lowest level since December 2008.

The resilience of our labour markets and the momentum they took into this next wave of the pandemic is encouraging, although a temporary rise back above five percent unemployment over the next few months is still the most likely outcome.

Business confidence and consumer sentiment fell sharply in the latest surveys, although some of the measures are still ahead of pre-pandemic levels.

The July NAB business survey revealed a plunge in confidence from +10 to -8, but 'business conditions' was still above trend, at +11. Further losses are certain over the coming months however, - subject to likely increases in policy support and the success of lockdown measures - the rebound in 2022 should be strong. Similarly, consumer sentiment fell in August and further declines are expected, but these will be complicated by regional variances.

Combining the above factors with the slower economic growth rate seen in China and some of our key trade partners, together with commodity prices easing back further from recent highs, it is increasingly likely the fourth quarter will be a less impressive bounce back than the market - and the latest RBA forecasts - had hoped for.

Indeed, having been far too pessimistic in its forecasts since May 2020, our Reserve Bank may have chosen precisely the wrong time to jump ship to an above consensus view in its latest Statement on Monetary Policy.

But, even if the fourth quarter ends up being a period of contraction - and another recession, our second in two years - the W-shaped recovery basically reflects the fundamental problem Australia has faced this year – our glacially paced vaccination roll out.

Assuming we reach a 70 percent adult vaccination rate by November - which appears on track - and 80 percent by early 2022, the robust RBA baseline scenario of 4.25 percent economic growth next year is still achievable, when COVID-19 can be dealt with as an endemic virus and not a pandemic. Despite upbeat growth and jobs forecasts, the RBA remains pessimistic on wages growth and therefore inflation, and the latest wages data would not have changed its minds on that front.

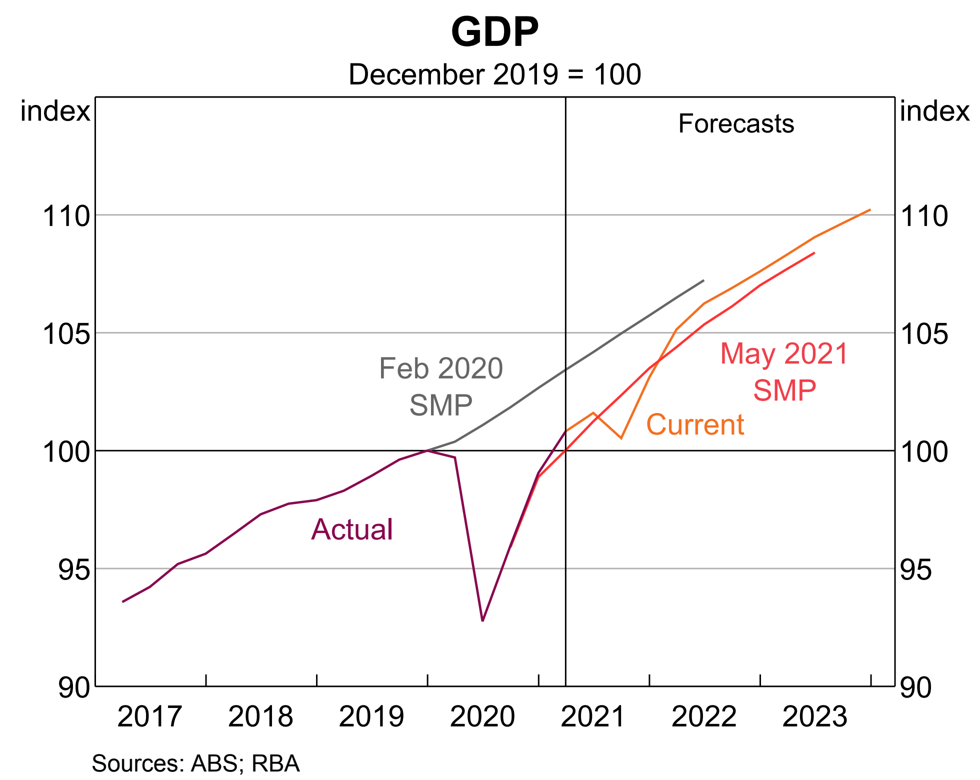
As COVID-19 case numbers continue to grow alarmingly across the country, the Aussie Dollar has just slipped below 72 cents - in line with the weaker outlook for China, the lower price of Iron Ore and a firmer US Dollar. This is good news in many respects and while its benefit in encouraging international tourists is immaterial for now, it does reflect the economic impact of lockdowns. Similarly, the New Zealand dollar is lower after the RBNZ surprised the market by not increasing its official cash rate yesterday due to a sudden level four lockdown, although this is probably just a deferral of the rate hike until October.

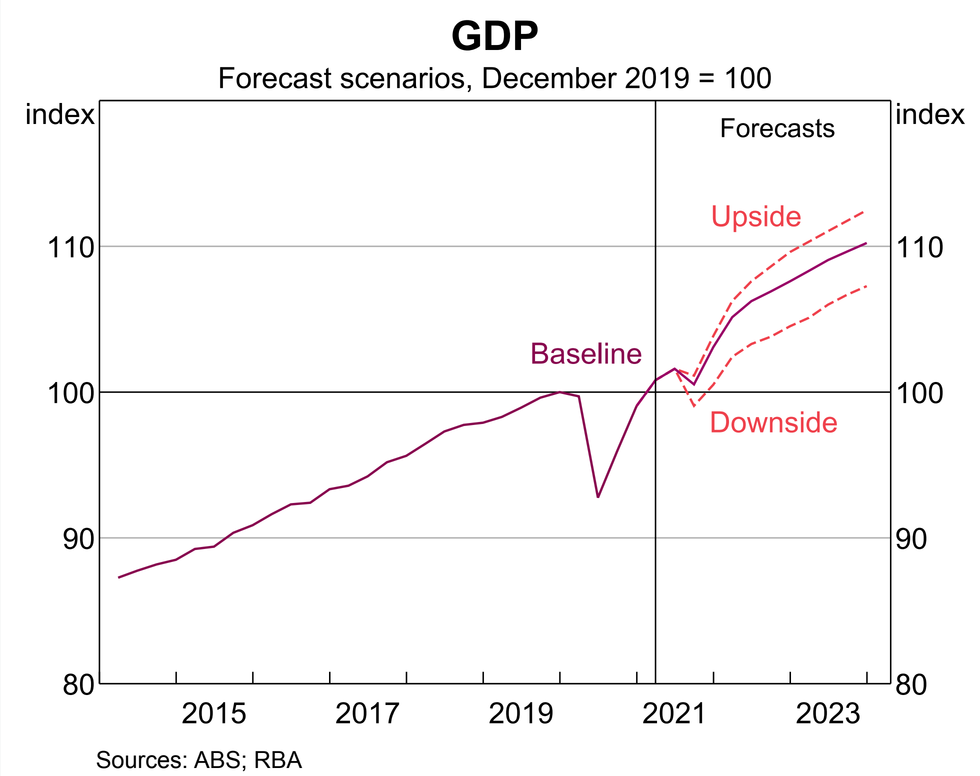
Interest Rate Outlook

The RBA remains committed to maintaining highly supportive monetary policy settings until its goals for employment and inflation are achieved, which they do not expect to occur until 2024. The official cash rate and target for three year Australian Government bond yields is therefore likely to remain at 0.1 percent for another few years. The extent of lockdowns in NSW and Melbourne in August may complicate the path for COVID-19 being able to be treated here as endemic rather than pandemic, and the start of the policy tightening cycle is still dependent on the outlook for wages and inflation. While the market has backed away from late 2022 rate hikes, mid-2023 rises are still quite plausible.

	30/6/20	30/6/2021	30/7/2021	19/8/21
90-day bills	0.10 %	0.03 %	0.02 %	0.01 %
3-year swap	0.23 %	0.48 %	0.36 %	0.37 %
5-year swap	0.45 %	0.95 %	0.71 %	0.70 %
AUD/USD	.6905	.7500	.7350	0.7205
ASX 200	5 898	7 313	7 393	7 462
Credit Index (iTraxx- 5 yr)	89	57.8	62.4	61.2

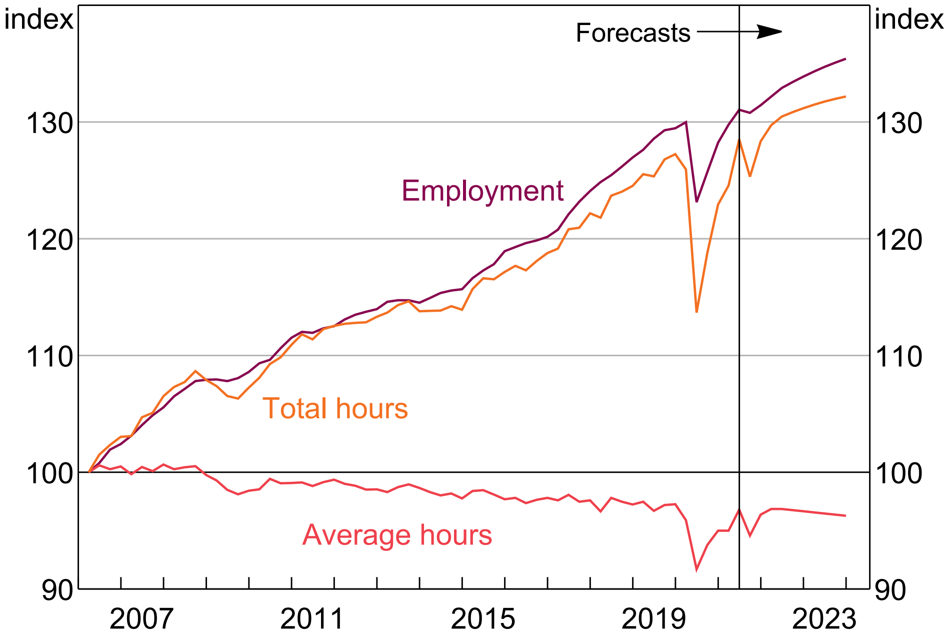
Appendix – Reserve Bank forecasts/ scenarios (August SOMP)





Employment and Hours Worked

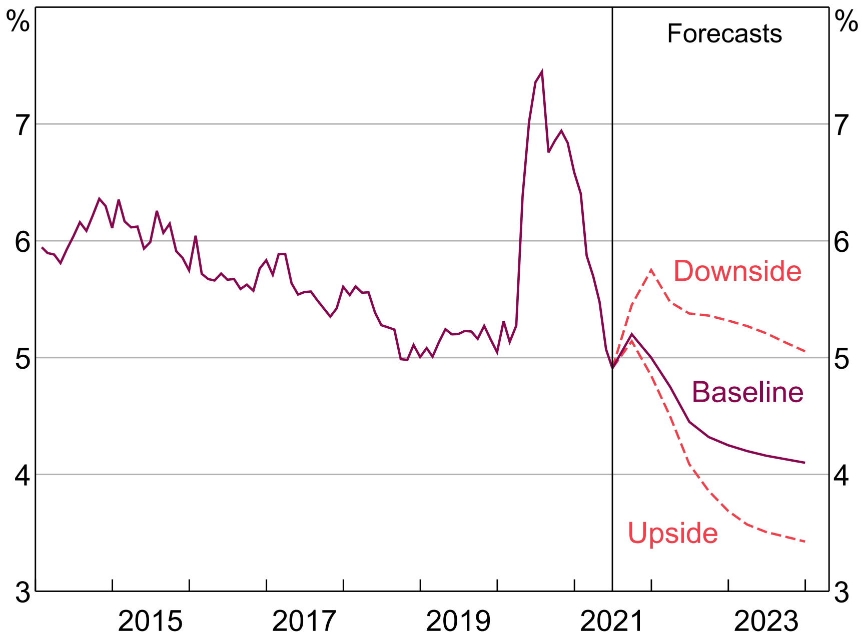
March quarter 2006 = 100



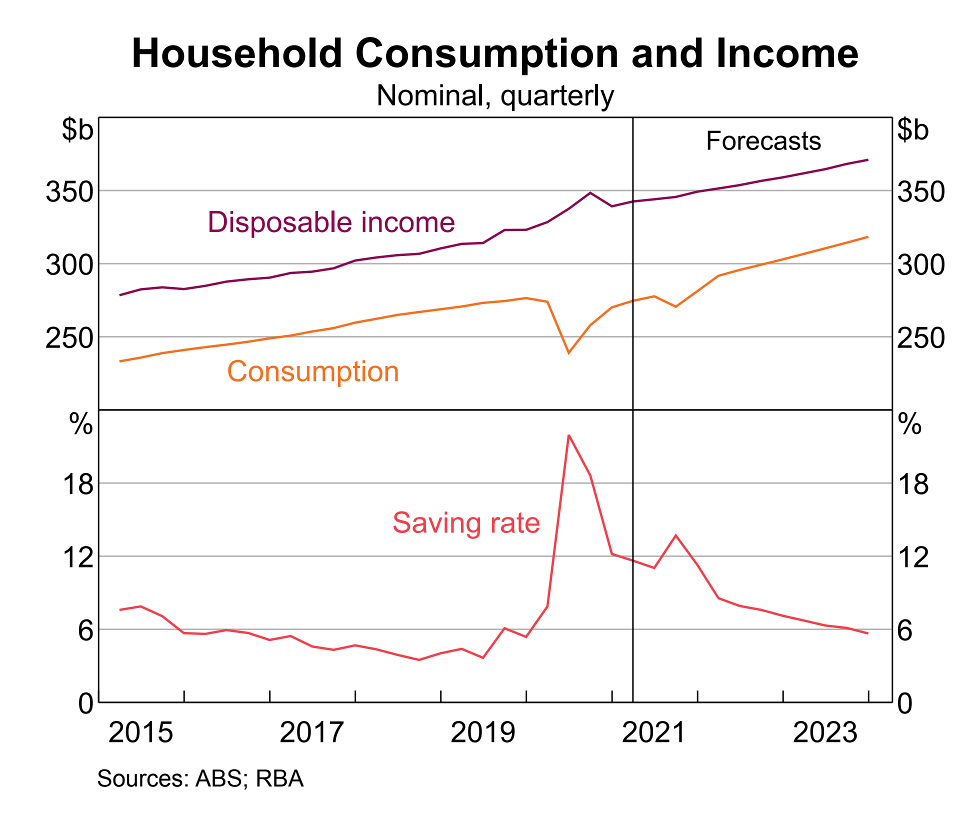
Sources: ABS; RBA

Unemployment Rate

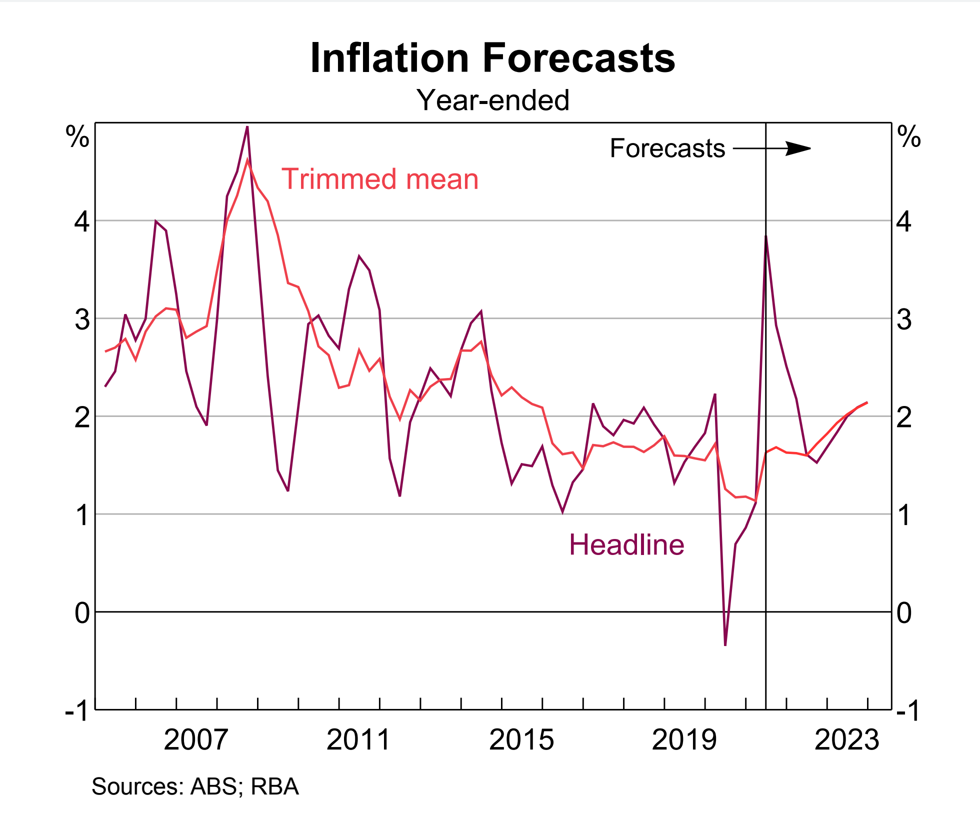
Forecast scenarios



Sources: ABS; RBA



Household Consumption and Income
Nominal, quarterly
$b
350
300
250
Forecasts
Disposable income
Consumption
%
18
12
6
0
Saving rate
2015
2017
2019
2021
2023
Sources: ABS; RBA



Inflation Forecasts
Year-ended
%
4
3
2
1
0
-1
Forecasts
Trimmed mean
Headline
2007
2011
2015
2019
2023
Sources: ABS; RBA