December
2020

Economic and market update

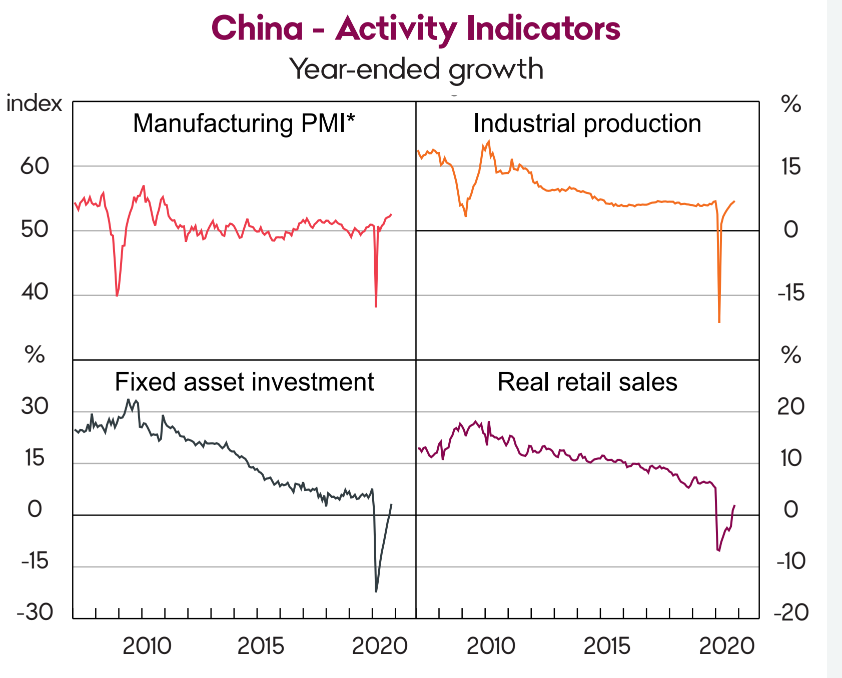
Economic Overview – as of 14th December 2020

Global markets

In a year of unique and surreal events, including the largest global recession in around 90 years, the unique nature of the recovery (especially for the markets) has been almost as surprising as the initial onset of the pandemic. While the economic recovery will lag the full recovery for stock markets, the MSCI World Index is back at a record high, up 12 per cent year on year. Although recovery will be most uneven by location and by sector, progress with vaccines should make it much more sustainable and broad-based. The appendix shows further context for stocks with a record short bear market - so all of a sudden the concern isn't how deep the fall in asset prices might be in the global recession, but how over-inflated prices are becoming due to limitless fiscal and monetary support. This is undoubtedly a better problem to have, and may take years to play out, but 'reflation' now has much greater risks, if and when it occurs.

The Chinese economy has led the recovery and their trade data shows promise that this rebound is occurring elsewhere in Asia. China is one of the few countries in the world with higher GDP and activity levels than pre-pandemic. The stimulus measures in China in response to COVID-19 focussed on infrastructure investment, which has flowed through to firmer commodity prices, especially iron ore (up at US$150/tn). Beyond price increases, the volume of exports is also being driven by strong demand across China's key trading partners, despite trade tensions with the US and more recently with Australia.

In November China's exports to Australia grew 22 per cent year on year, while imports rose nine per cent year on year.



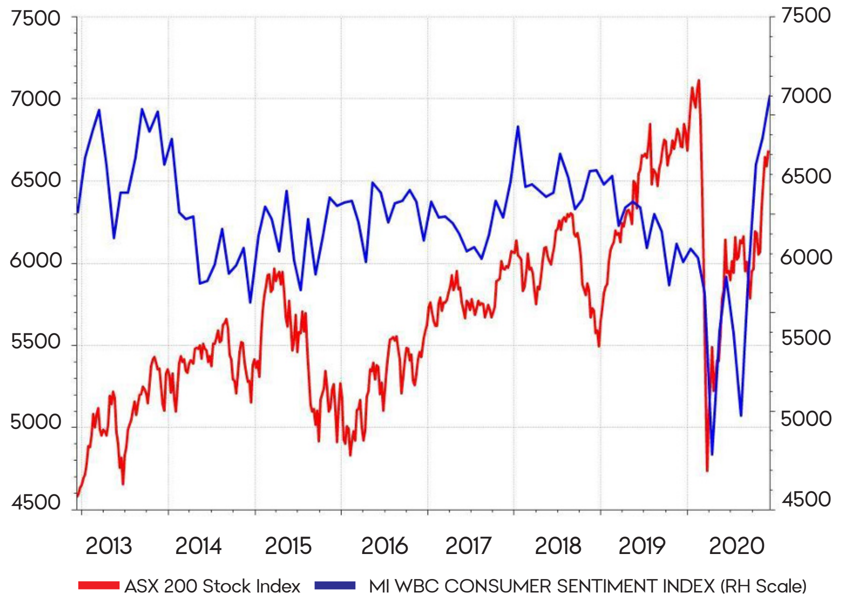
*Diffusion index; average of the official Caixin
Sources: CEIC Data; Markit Economics; RBA

In contrast to China, the economic recovery in the US has lost momentum mainly due to the lack of progress on another stimulus package, and increasing numbers of new COVID infections. The latter are around 200 thousand people per day so the vaccine can't come soon enough. The US unemployment rate is back down to 6.9 per cent however the rebound has faded, evidenced by the rise in weekly jobless claims and consumer spending. President elect Biden will inherit an economy that had shown promising improvement in Q3 but will need to play catch up thanks to the lack of fiscal support progress in Congress, and some of the highest per capita rates of COVID-19 new cases in the world. Spending and urgent fiscal action appear to be the only solution beyond the vaccine roll out, hence the sharply weaker US dollar.

Elsewhere the outlook at a high level is promising for Asia and Oceania but mixed in Europe, as the European Central Bank again scales up its emergency quantitative easing (QE) program and ultra-cheap lending facilities for EU banks.

Negative interest rates on bonds are again on the rise, so while the depth and length of the global recession has been much less than first feared, the structural changes that the pandemic has created will be lasting, and the path of unwinding the policy responses full of hazards.

Domestic economy



Source: Refinitiv Datastream

The domestic economic data has consistently beaten forecasts over the last month and together with the promising vaccine news has resulted in further upgrades for Australian GDP and employment in 2021. This makes the 'fiscal cliff' after JobKeeper and JobSeeker taper off far less worrying, when considering that the number of workers supported by JobKeeper has fallen from around 3.6m to under 1.5m since October, well ahead of the Federal Budget forecasts. That NSW and Victoria both lost their Standard & Poor's AAA rating is a reminder that fiscal support does have consequences. However the RBA QE program means that bond yields remain incredibly low, so funding costs are still very affordable. Our sovereign AAA rating remains intact, and the latest Federal Government Treasury Note auction actually saw a negative yield on some of the three-month notes.

Consumer and business confidence has moved further into positive territory with the latest consumer sentiment reading at a ten year high (refer chart). Similarly, business confidence and conditions are back up at a three-year high.

The Q3 GDP data revealed a much stronger rebound than forecast at 3.3 per cent, and Q4 is now likely to see a further two per cent rise. The latter is helped by Victoria reopening and all state borders opening up. The GDP data did show that household saving remains very high at 19 per cent, however this spending potential is likely to be unleashed as confidence builds. Most forecasts now point to GDP reclaiming pre-pandemic levels by mid-2021.

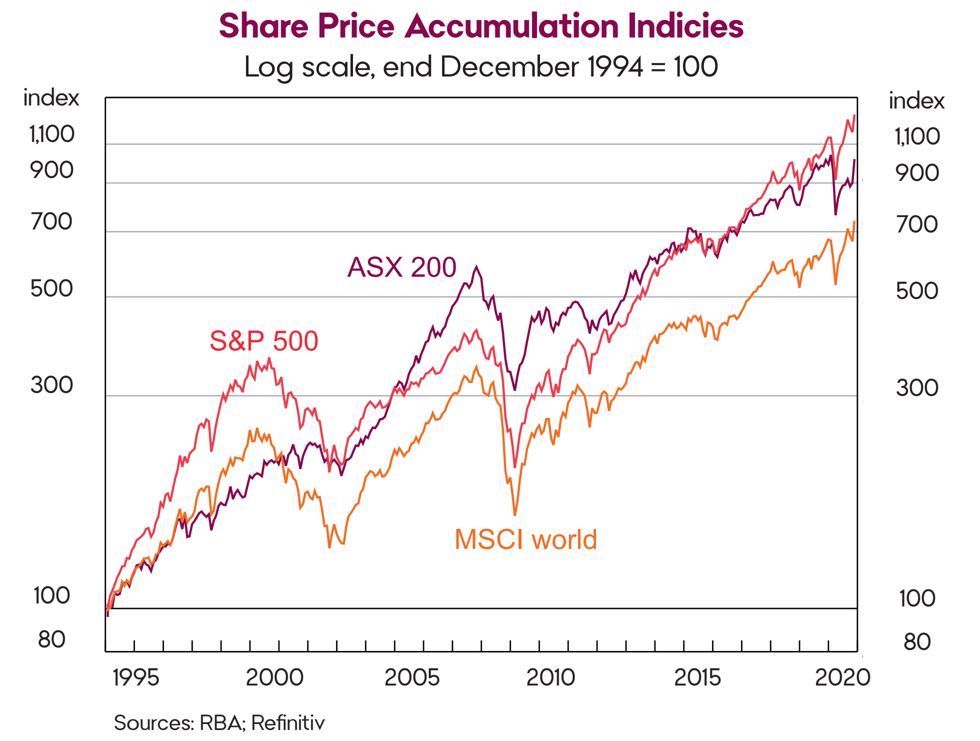
The residential property market is also beating forecasts with all capital cities and state regional dwelling values (on average) growing over the month. The RBA commitment to keep the cash rate at 0.1 per cent for three years and not to increase it until 'full employment' creates wages growth (and thereby lifts inflation) may create a tricky monetary policy environment in the next year or two. This is further complicated by the firm Aussie dollar, which is still relatively low on a trade weighted basis (refer appendix) but is up at a two and a half year high against the greenback.

Interest Rate Outlook

The RBA rate cut to 0.10 per cent for the cash rate, the targeted yield on three-year bonds and new drawings of the Term Funding Facility is likely to be the low point for these targets. Any further monetary stimulus is likely to come in the form of increased QE rather than entering the world of negative interest rates. The RBA has stated it expects the OCR to remain at its current level for at least three years, although faster progress in achieving full employment and inflation above two per cent is not out of the question.

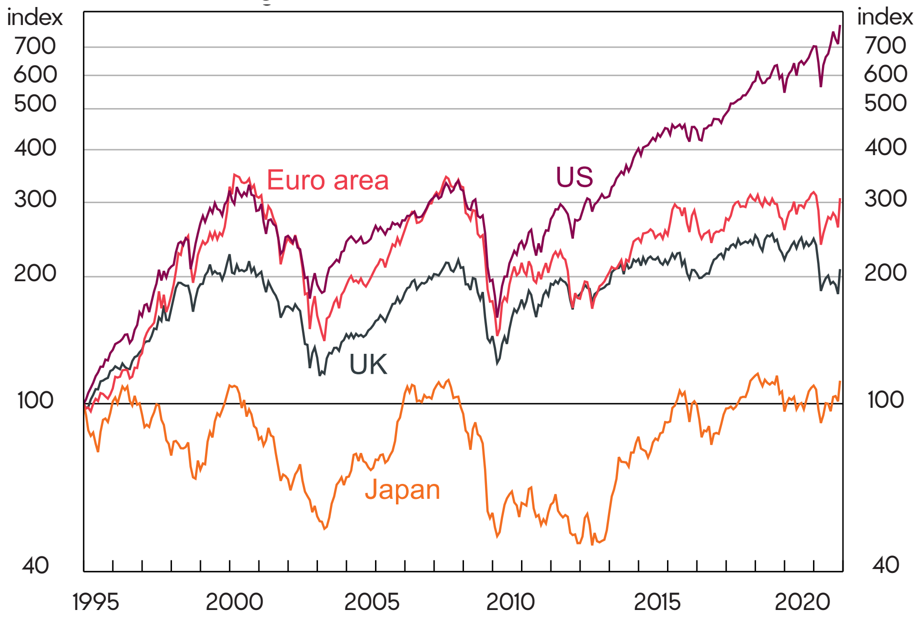
	31 / 10 / 19	30 / 10 / 20	30 / 11 / 20	14 / 12 / 2020
90-day bills	0.93 %	0.06 %	0.02 %	0.02 %
3-year swap	0.83 %	0.08 %	0.13 %	0.14 %
5-year swap	1.05 %	0.29 %	0.36 %	0.37 %
AUD/USD	.6905	.7020	.7340	.7535
ASX 200	6 690	5 928	6 518	6 680
Credit Index (iTraxx- 5 yr)	60	69	59.4	58.3

Appendix - assorted financial market charts:



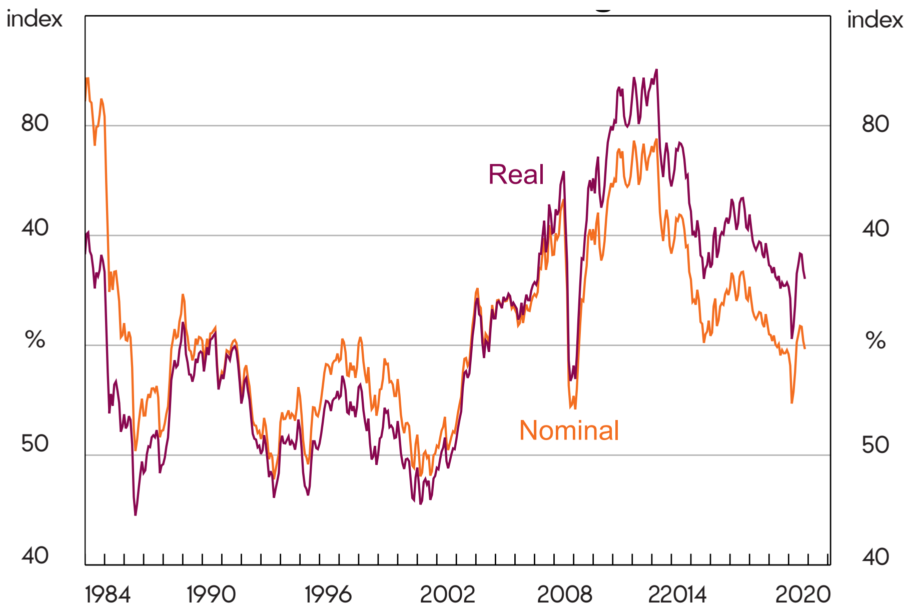
Advanced Economies' Share Price Indicies

Log scale, end December 1994 = 100



Sources: Bloomberg; RBA

Advanced Dollar trade-weighted Index*



*May1970 = 100 for nominal; real indexed to equate post-float averages; latest observations for real TWI are estimates

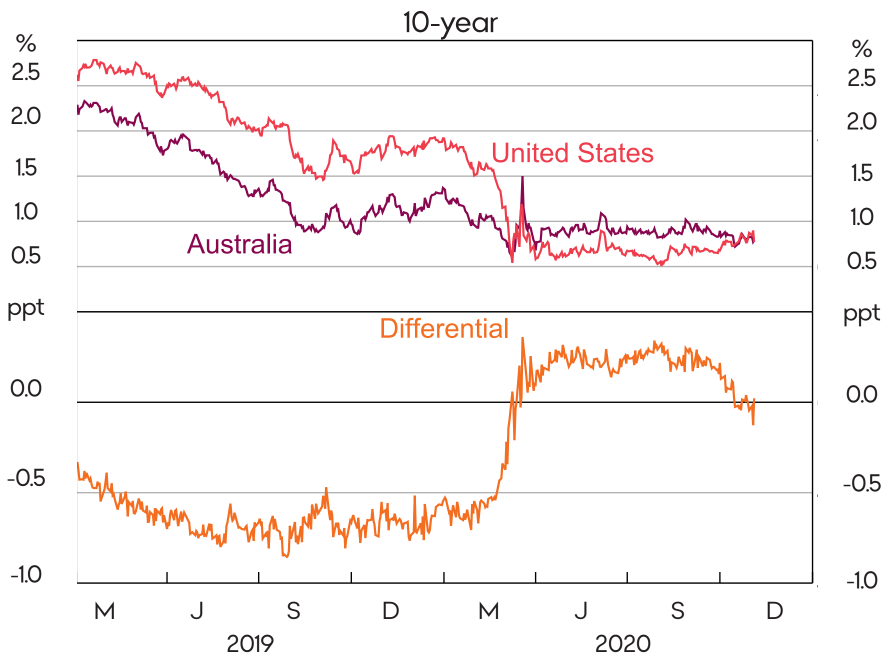
Sources; ABS; RBA; Refinitiv; WM/Reuters

Australian Government Bond Yields

*3-year yield target bond is the April 2023 Treasury bond until 20 October 2020, and the April 2024 Treasury bond thereafter
Sources; RBA; Yieldbroker

Government Bond Yields

10-year



Sources: Bloomberg; RBA; Yieldbroker