December 2021

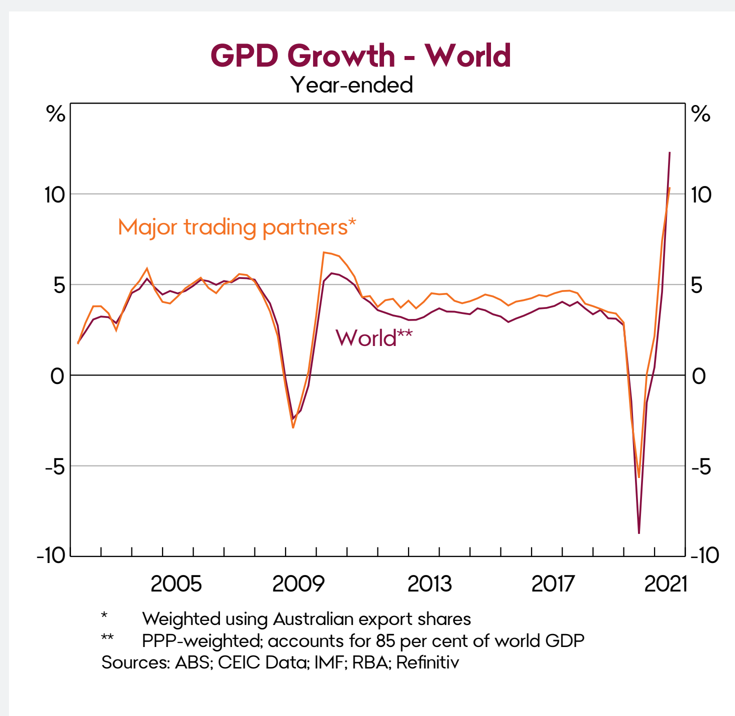
Economic and market update

Economic Overview – as at 14th December 2021

Global markets

The New Year approaches with the promise of an ongoing global rebound in demand, growth, and mobility, but still with increasing concerns on inflation, and with uncertainty around the new Omicron strain of COVID-19. The recovery in GDP is exaggerated in the chart below due to base effects, but is testament to the progress of vaccination programs in larger economies, and the commitment of fiscal and monetary policy through the pandemic.

Equity markets and risk appetite performed strongly in November as the recovery appeared on track for further gains through 2022, however the outlook remains complicated: will inflation be coupled with sustainable growth - a world of higher interest rates but strong real GDP - or will Omicron limit the reopening process, and risk stagflation? Central banks are aiming for a Goldilocks trajectory for demand without overshooting on inflation: it's a big ask.



The US Federal Reserve have formally dropped 'transitory' as its descriptor of inflation, admitting it will not only be higher than previously asserted, but more lasting. This admission was matched by the latest US inflation data: CPI reached 6.8% in November (its highest level in 40 years) and the core inflation rate rose to 4.9% (a 30-year peak). This has added to the market's conviction that there will be three Fed rate hikes next year, although the broader implications of higher interest rates have not (yet) stopped the bull market on Wall Street, with a fresh record close for the S&P 500 set on Friday.

Other central banks on the cusp of increasing official interest rates to address inflation include the Bank of Canada, Bank of England and some Emerging Markets.

However, China is swimming against the tide with a 0.5% cut to its 'required reserve ratio' for local banks, and the likelihood of further policy easing in the weeks ahead. As the comparison table below shows, the Chinese economy is expected to be growing far more sedately in the years ahead, well down from its pre-pandemic pace; so the slowing property sector, amid a wide-ranging reform agenda, means policy settings do need to be more supportive. Fortunately (unlike other large economies), there is ample scope to do so.

GDP (year average growth)	2019	2020	2021 (e)	2022 (f)	2023 (f)
World	3.0 %	-3.2 %	5.6 %	4.5 %	3.2 %
USA	2.3 %	-3.%	5.6 %	3.7 %	2.4 %
Euro-zone	1.6 %	-6.5 %	5.2 %	4.3 %	2.5 %
UK	1.7 %	-9.7 %	6.9 %	4.7 %	2.1 %
Canada	1.9 %	-5.3 %	4.5 %	3.9 %	2.8 %
Japan	0 %	-4.7 %	1.8 %	3.4 %	1.1 %
China	6.0 %	2.4 %	8.1 %	5.1 %	5.1 %
Australia	1.9 %	-2.4 %	3.8 %	4.1 %	3.0 %

Source: Estimates for 2021 and forecasts for '22 and '23 from OECD December 2021

The New Year should be one of ongoing global recovery from the pandemic era as international travel resumes, but the two primary questions now are: how far will interest rates need to rise to address rampant inflation? (refer Appendix); and secondly, for Omicron or any new variants, how effective will existing vaccines be, to avoid the interruptions of further lockdowns and restrictions in the months ahead? The preferable scenario would appear to be that the Omicron strain is more transmissible, but with milder symptoms than Delta, but there is not sufficient evidence yet that this is the case.

Domestic economy

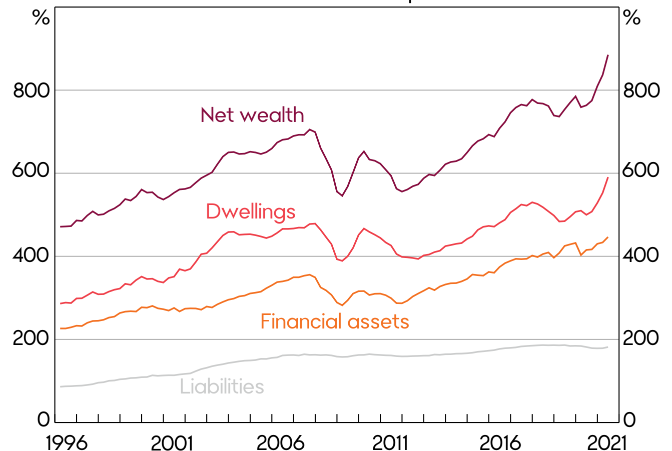
The expectations for domestic GDP and jobs growth in 2022 are very high, and the market is pricing in three to four Reserve Bank rate hikes next year in line with this outlook. Forecasts for GDP growth vary from 4.1% (OECD) to around 6.5%, with consensus near the RBA forecast of 5.5%. However, much like the global outlook, the two candidates for spoilers here are overshooting on inflation (that is, earlier RBA rate hikes) or conversely, adverse consequences from the Omicron strain, delaying the recovery.

Jobs growth is expected to be sustained through next year, based on job vacancy data (with the Seek job ads index 52% above 2019 levels), and by extrapolating the recovery seen last financial year prior to the Delta lockdowns. Unemployment is likely to fall below 5% by year end, and then down to near 4% in 2022, with these tighter labour markets likely to help wages growth towards 3%. The RBA have made it clear that they won't be persuaded that inflation will be sustainably in their 2-3% band until they see wages growth up at this level, so this will be a key metric.

The benefits of substantial fiscal policy (supporting businesses and households through lockdowns), and monetary policy helping to drive a property boom, has created a wealth effect that will shape 2022. The household savings ratio is around 20%, so as the chart below shows the 'average' household balance sheet is in good shape, notwithstanding the unevenness of the impact of the pandemic by industry. In the absence of a hit to consumer sentiment, this should combine favourably with high vaccination rates, reopening of borders and a buoyant jobs market.

GDP contracted 1.9% in the third quarter, its second largest fall on record (only beaten by the 2020 Q2 lockdown recession). This contraction was much less than initially feared from the Delta strain, pointing once again to the resilience of our economy, the effectiveness of policy settings and the confidence in the rebound next year. Business conditions rose to +12 in the November survey, and while business confidence eased from +20 to +12, both are well above the long-run average, and employment (and Capex) intentions are similarly very positive.

Residential property remains in a bull market with the CoreLogic Home Value Index for November up another 1.3%, with regional dwelling values once again outpacing capital cities. This is adding to the wealth effect even with the prospect of higher interest rates next year, and the consensus is for property prices to increase far more slowly next year, before potentially dipping in 2023 and 2024. The reopening of international borders will add to demand next year, and the first home-owner bid is still very strong. However, RBA rate hikes in FY23 should weigh on prices, or at least level off the remarkable price increases.



The Aussie Dollar fell below the crucial 71¾ cent level in late November, setting up a run at 70c, and has remained in that band since. The strong US Dollar (with Fed rate hikes expected next year, as covered in 'Global markets' above), together with the decelerating Chinese economy, have more than offset the normally reliable correlation with commodity prices. So, while commodities are likely to remain firm (refer Appendix), the Australian Dollar faces a long haul back to the 80.1c peak back in February.

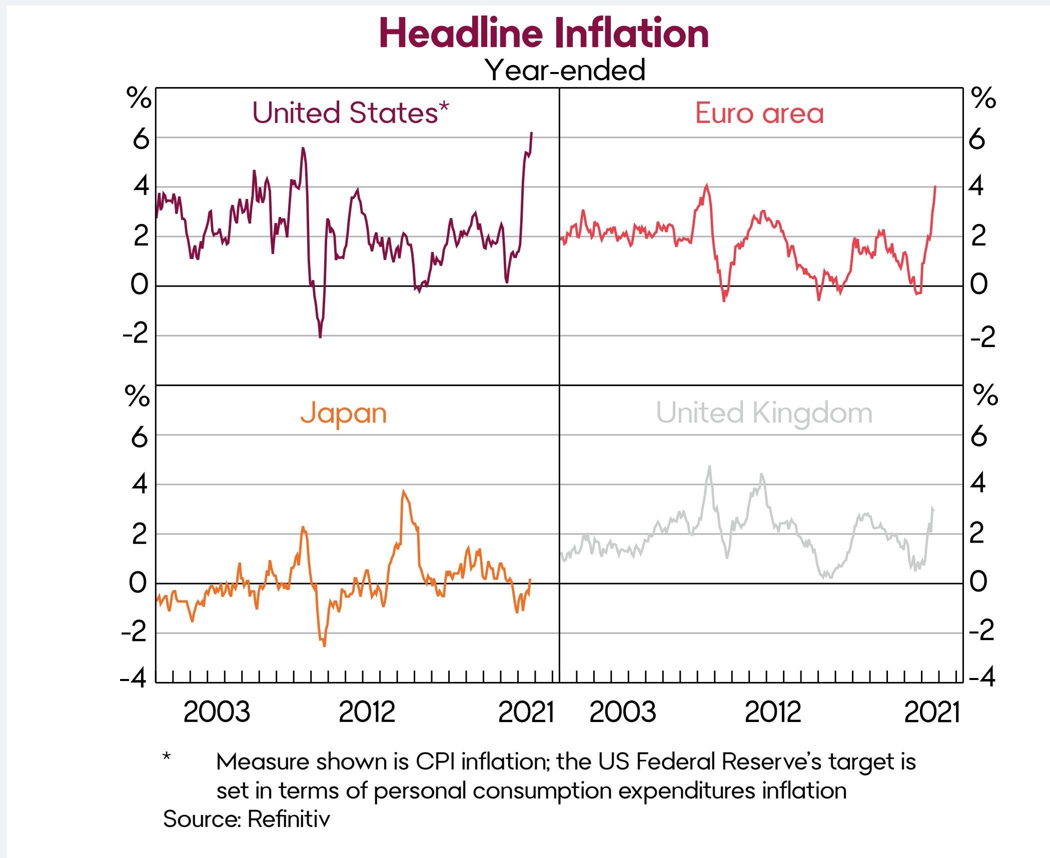
The case for a strong, resilient recovery in 2022 is supported by Australia's high vaccination rates, household balance sheets with accrued stimulus waiting to be deployed, and the impending reopening of borders. The risks to this baseline forecast are very similar to the global risks: inflation (making rate hikes both necessary and impactful due to high debt levels) and new strains of COVID-19. The former makes higher interest rates very likely, while the latter supports the RBA position of 'patience'.

Interest Rate Outlook

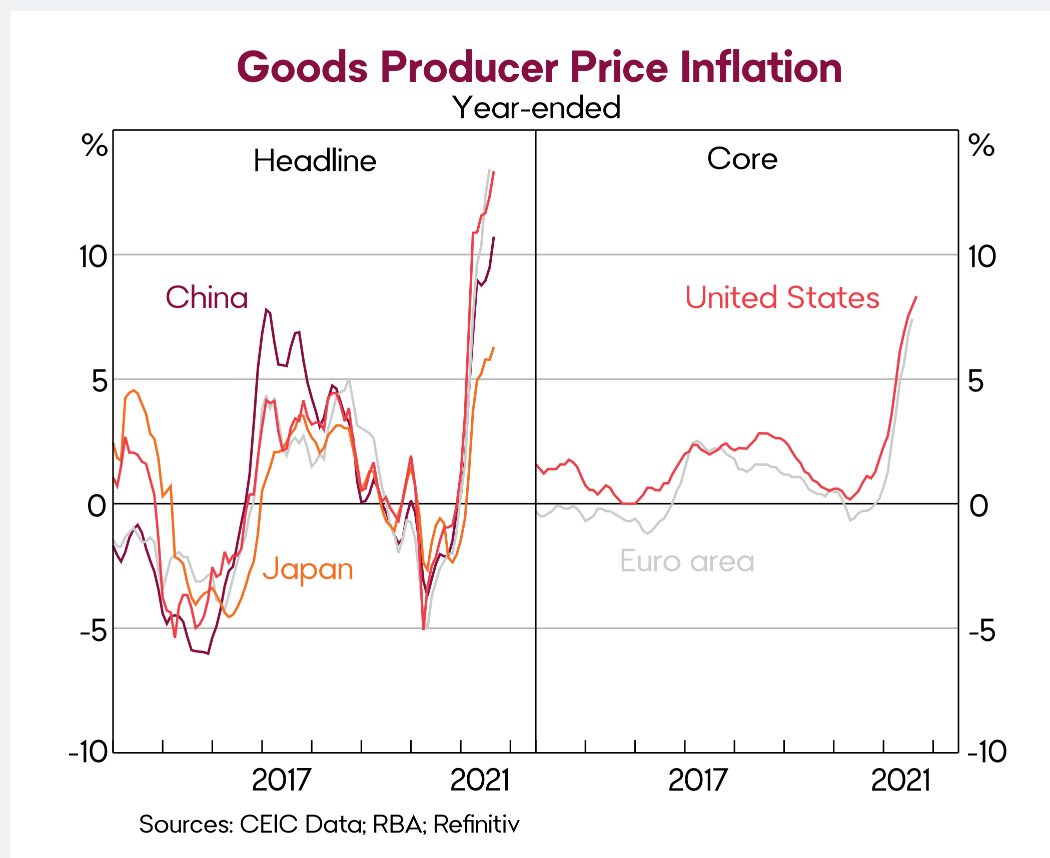
The RBA has paved the way for earlier rate hikes than previously indicated by dropping its reference to 2024 as a timeline, and instead saying it will simply wait until 'a return to full employment in Australia and inflation consistent with the target'. The RBA Board remains patient and will not increase the cash rate until they consider inflation is sustainably near 2.5%, but this outcome appears increasingly likely to be met prior to the end of 2022.

	30 / 10 / 20	31 / 10 / 21	30 / 11 / 21	14 / 12 / 2021
90-day bills	0.09 %	0.07 %	0.05 %	0.06 %
3-year swap	0.12 %	1.41 %	1.29 %	1.23 %
5-year swap	0.29%	1.82 %	1.69 %	1.58 %
AUD/USD	0.7025	0.7520	0.7130	0.7115
ASX 200	5 928	7 324	7 256	7 377
Credit Index (iTraxx- 5 yr)	68.8	65.4	73.5	69.4

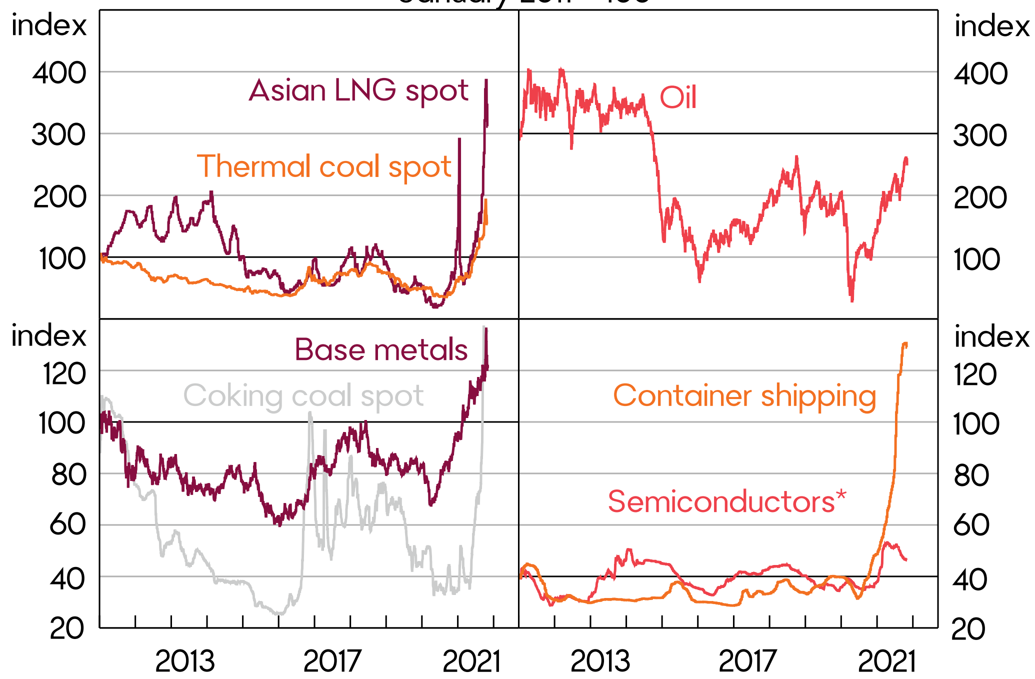
Appendix: Inflation trends

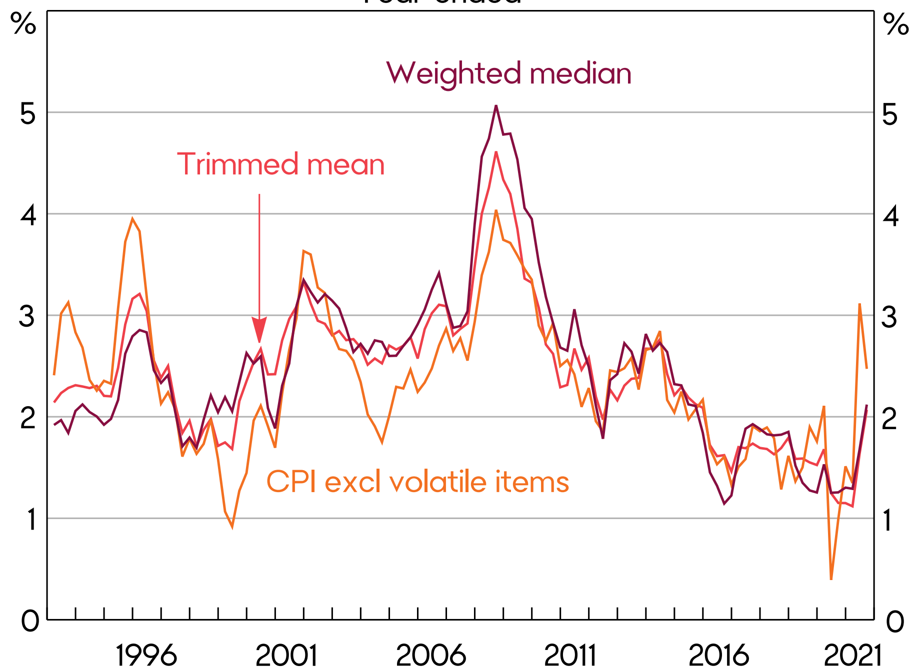


* Measure shown is CPI inflation; the US Federal Reserve's target is set in terms of personal consumption expenditures inflation
Source: Refinitiv



Sources: CEIC Data; RBA; Refinitiv





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