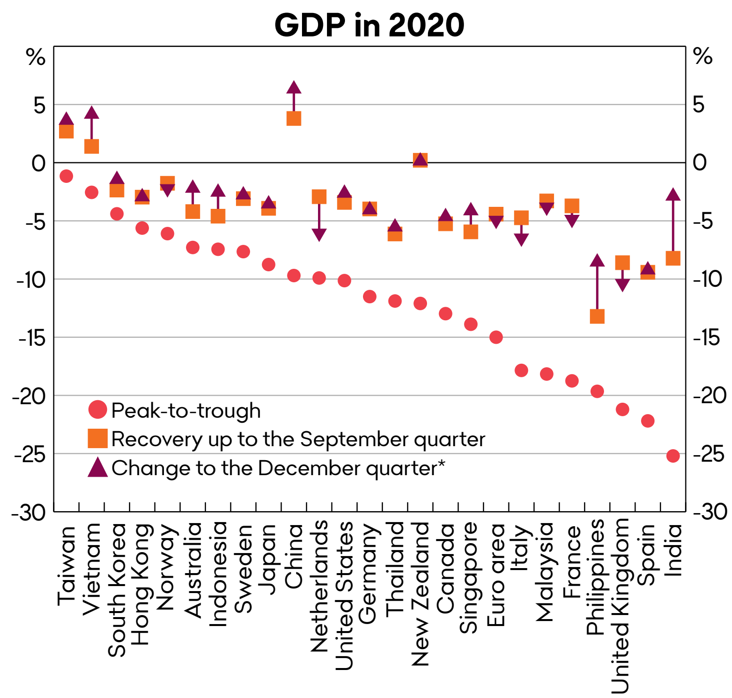
February
2021

Economic and market update

Economic Overview – as of 18th February 2021

Global markets

The ongoing strength in stock markets coinciding with rising bond yields is an unusual combination, but 2020 was an unusual year to say the least. Equally unique has been the fiscal and monetary policy response from governments and central banks around the world, delivering stimulus that remains in place. The chart below ranks countries by the depth of their 2020 recessions, but also shows the rebound in Q3 and Q4 thanks to these policy responses. How this recovery continues in 2021 will be largely dependent on the success of vaccine programmes and health policies, however the ‘reflation trade’ is in full swing with the markets pinning their hopes on a post pandemic boom.



* Forecasts used where December quarter GDP has not yet been reported

Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv

The US ranked mid-field in the depth of their recession (refer chart), and the recovery has been constrained by persistently high COVID-19 cases, so Q4 progress was limited after the strong Q3 bounce. The outlook for 2021 is dependent initially on further stimulus, with the Biden administration still trying to get their US$1.9 trillion support package through Congress, but for the medium term the vaccine rollout will be crucial. Thus far the US vaccination rate is ahead of much of the rest of the world per capita only trailing Israel, the UK and UAE. The US ten-year bond rate has risen to 1.3 per cent, its highest level in a year. This suggests confidence in the medium-term recovery is building, although the US Federal Open Market Committee stated that “it was likely to take some time for substantial further progress to be achieved.”

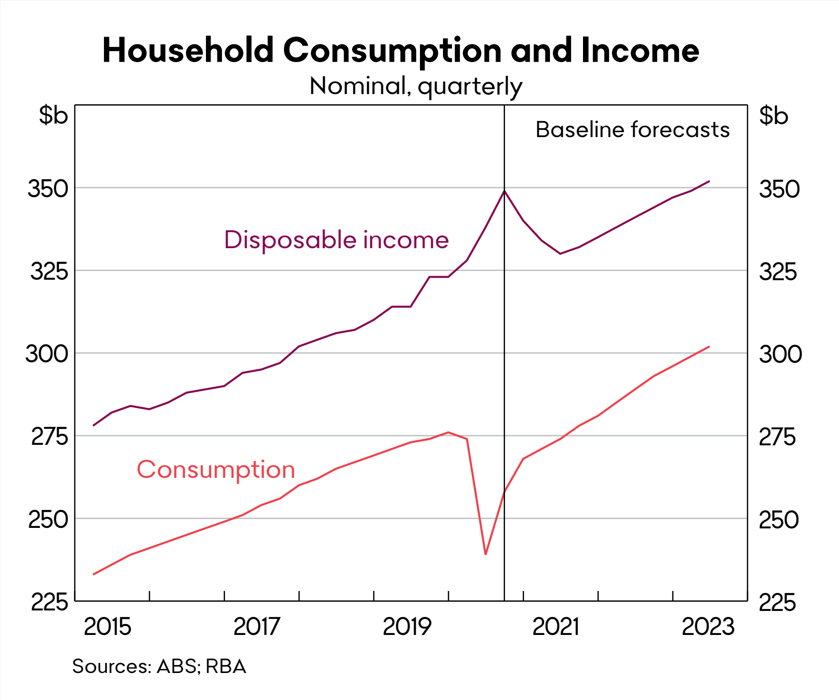
The countries leading the way in the economic recovery from the pandemic are primarily located in Asia and Oceania. China, Taiwan, Vietnam and New Zealand are among those achieving an expansion in 2020. The Chinese recovery is showing little sign of decelerating. Its vaccination programme is expected to accelerate in the weeks ahead, and ahead of Lunar New Year all parts of the Chinese economy were running ahead of pre-pandemic levels. The growth in Chinese exports and trade more broadly is evidence of the recovery in the region. The Yuan strengthening 10 per cent since May to 6.45 against the US dollar also points to relative economic outperformance. Japan's recovery has also run well ahead of forecasts in Q4 with exports and domestic demand accelerating strongly. Despite this, the Japanese economy still contracted 4.8 per cent last year. A dip in this quarter is likely with the current (second) state of emergency for 10 prefectures, but (once again with vaccine progress) the consensus forecast for 2021 is above three per cent including from the IMF.

The outlook for Europe is mixed with Eurozone Q4 GDP contracting 0.7 per cent. The larger economies of France and Germany are likely to continue to outperform the south, although under Mario Draghi as new prime minister there has been a welcome rush for Italian debt and a rally in bonds. Meanwhile the UK had its largest decline in annual GDP since the Great Frost of 1709, but its vaccination programme appears to be progressing well with a very high participation rate thus far.

Domestic economy

Australia's economic recovery continues to be driven by the success of fiscal, monetary and health policies through the pandemic. It is also helped by our links to the rebound in Asia. Despite evidence of this recovery building in January our dependence on the vaccine rollout is critical for the outlook. Assuming the vaccine programmes are successfully deployed, the recently updated RBA forecasts (refer appendix) will be upgraded further. Nevertheless, the further gains in property, jobs and sentiment hasn't been sufficient to convince the RBA that inflation (and wages growth) will follow suit.

The February RBA Statement on Monetary Policy was far more upbeat than last year's editions. However its primary concerns were pandemic related such as the risks of further outbreaks, and uncertainty on 'how households and businesses respond to the tapering of fiscal and other temporary support measures.' The latest Melbourne outbreak was good evidence of these risks, although if the lockdown is limited to five days then the focus returns to vaccine efficacy. The end of JobKeeper is becoming more imminent, but as the chart below shows fiscal support thus far has been saved rather than spent, and this accrued stimulus, plus the fall in workers reliant on JobKeeper, is most helpful.



Data has run further ahead of expectations since the release of the latest RBA forecasts, including the latest jobs data. This positive trend may plateau through Q2 as stimulus tapers off. Nevertheless, in January:

- Employment rose 29,000 to 12.94 million (only 60,000 behind its February peak)
- Unemployment fell to 6.4 per cent (with each state between 5.9 per cent and 7.1 per cent)
- Underemployment fell to 8.1 per cent (0.4 per cent lower than a year ago)
- Youth unemployment was steady at 13.9 per cent (up 1.8 per cent on a year ago)

The RBA's forecast for just six per cent unemployment by year end thus appears very cautious, although their baseline for GDP growth is 3.5 per cent which is more ambitious. The forecasts for wages growth and inflation are modest at 1.5 per cent this year and barely improving in 2022, so this may be the best explanation as to why our central bank appears so comfortable about the rise in house prices. Consensus for residential property prices over the next two years is gains of around seven to eight per cent. Regional property is expected to outperform larger capitals and high-rise appears most at risk. Rising asset prices, mainly real estate and stocks, are driving an improvement in household wealth, so assuming the jobs market keeps improving this should help the recovery, even in the absence of wages growth. The government will need quick wins in structural reform to drive productivity and wages, but their lack of progress with industrial relations suggests it is a long road ahead.

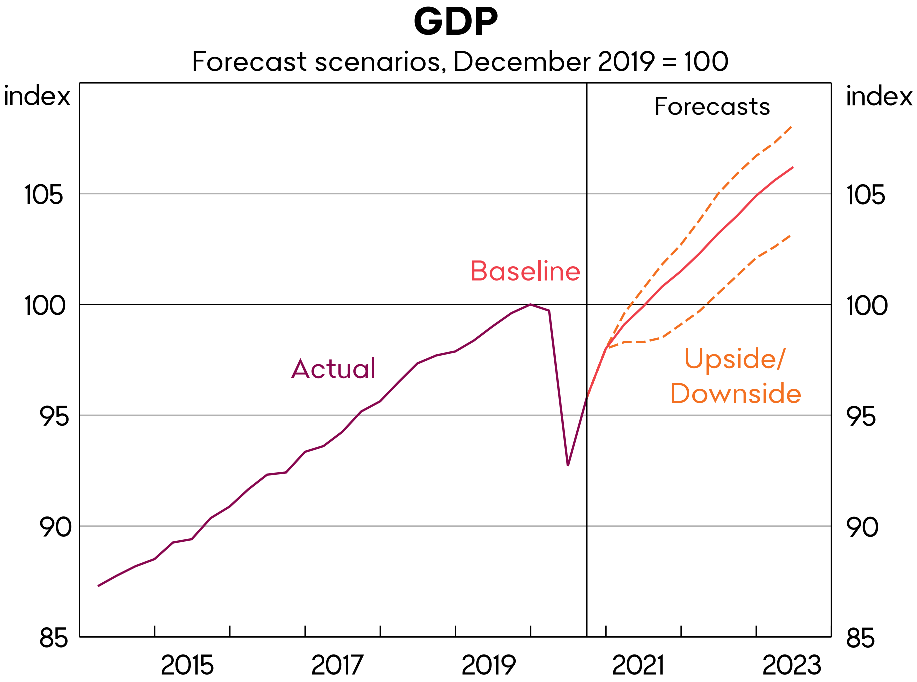
The Aussie dollar remains firm (as are other 'commodity currencies') but would be much higher had the RBA not extended its quantitative easing (QE) bond buying programme- which happily is also keeping the interest bill on government and private sector debt at bay. Despite the trade tensions with China international merchandise trade is near record levels, albeit mainly due to iron ore. The iron ore price is US$165 per tonne compared to the federal budget assumption of average US$55. The fall in service exports will not recover until international travel recovers but it is worth noting that in 2019 11.3 million Australians travelled overseas, while 9.5 million international tourists came here. So the outlook on balance is an increasingly optimistic one, but very much linked to the success of vaccines.

Interest Rate Outlook

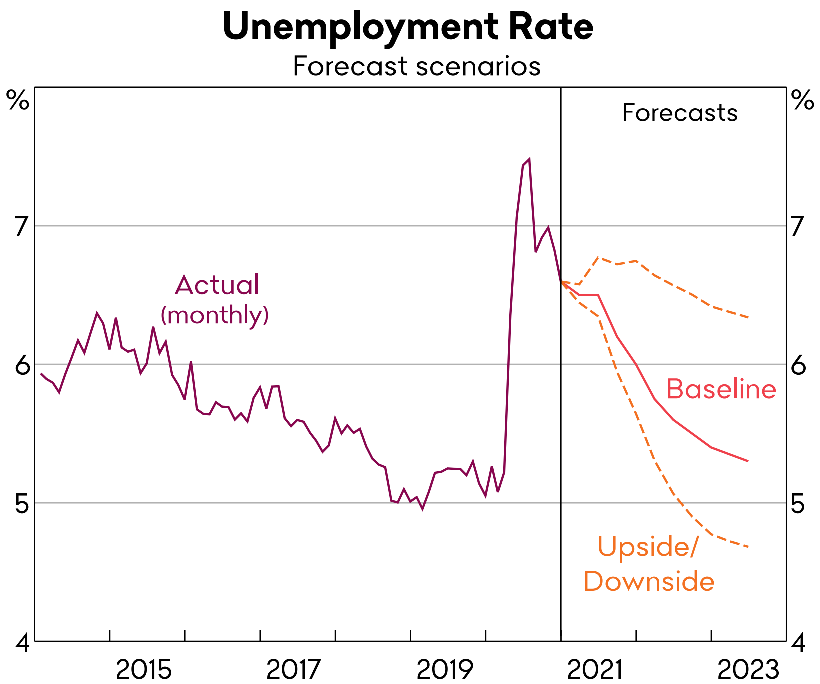
The RBA rate cut in November to 0.10 per cent for the cash rate, the targeted yield on three-year bonds and new drawings of the Term Funding Facility is very likely to be the low point for these targets. If needed any further monetary stimulus would come in the form of ongoing QE. The steepening in yield curves here and around the world suggests global reflation is a risk, but the pace and timing of this event is the subject of much debate. The commitment of the RBA not to tighten monetary policy until inflation is sustainably above two per cent suggests they are not expecting a sharp rebound in inflation for some years.

	31 / 12 / 19	31 / 12 / 20	31 / 01 / 21	18 / 02 / 2021
90-day bills	0.89 %	0.02 %	0.01 %	0.01 %
3-year swap	0.95 %	0.14 %	0.15 %	0.18 %
5-year swap	1.18 %	0.39 %	0.43 %	0.58 %
AUD/USD	.7015	.7690	.7625	.7755
ASX 200	6 684	6 587	6 607	6 902
Credit Index (iTraxx- 5 yr)	46.7	57.3	62.8	57.7

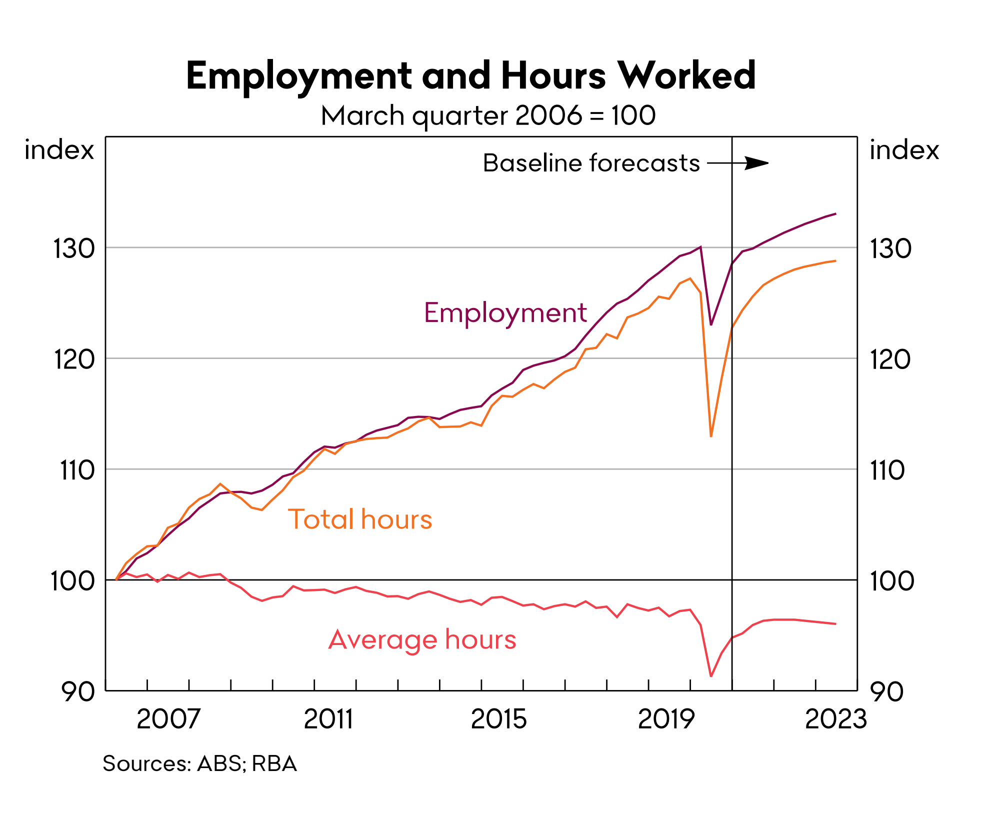
Appendix - RBA forecasts (February Statement on Monetary Policy)

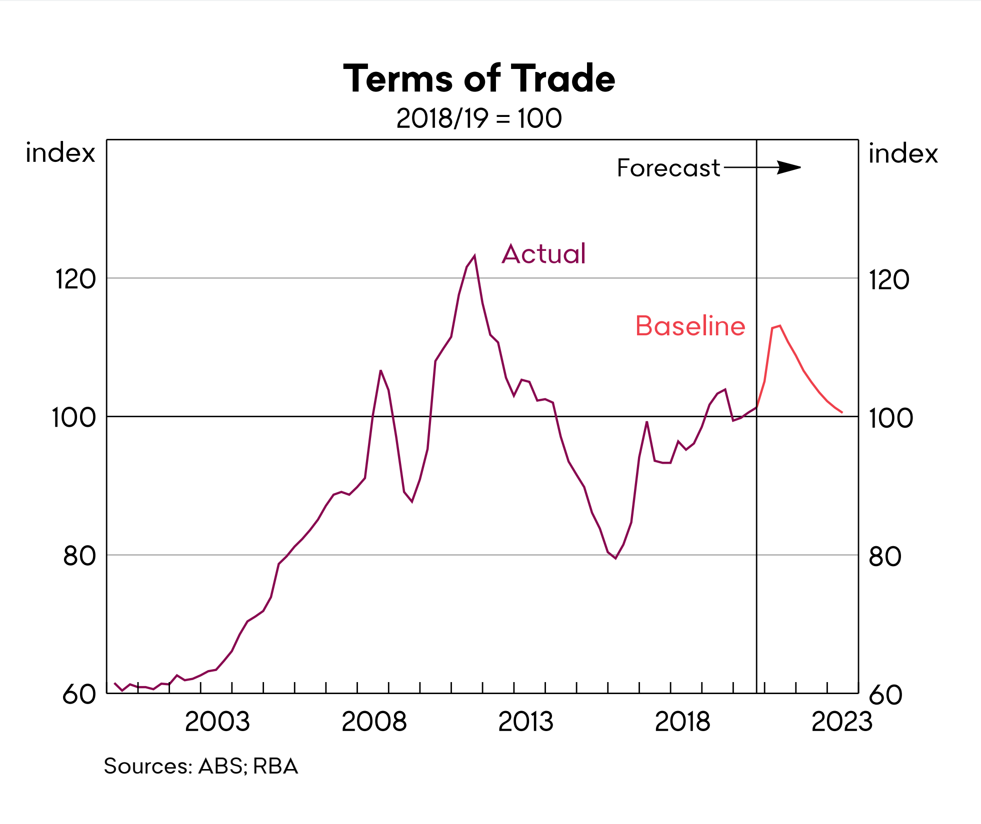


Sources: ABS; RBA



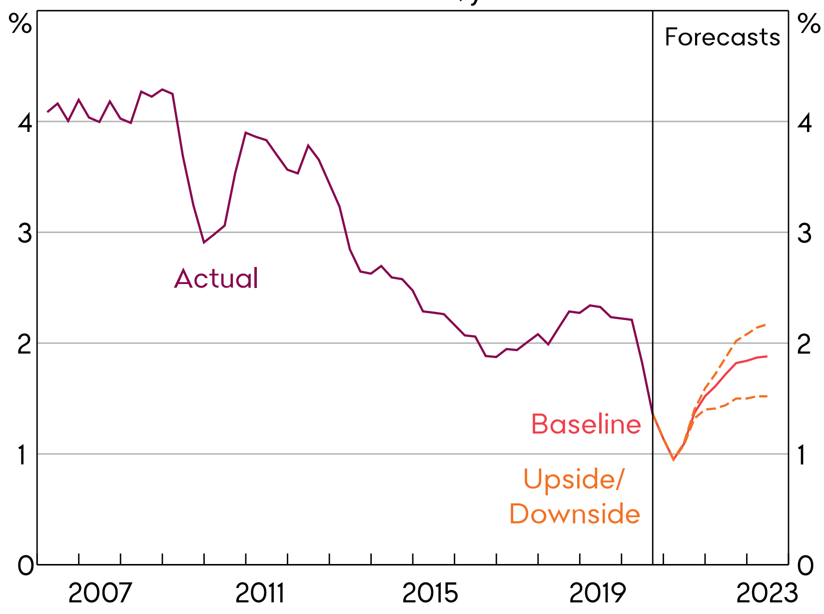
Sources: ABS; RBA


Employment and Hours Worked
March quarter 2006 = 100
index
Baseline forecasts
Employment
Total hours
Average hours
130
120
110
100
90
2007
2011
2015
2019
2023
Sources: ABS; RBA


Terms of Trade
2018/19 = 100
index
Forecast
Actual
Baseline
120
100
80
60
2003
2008
2013
2018
2023
Sources: ABS; RBA

Wage Price Index Growth

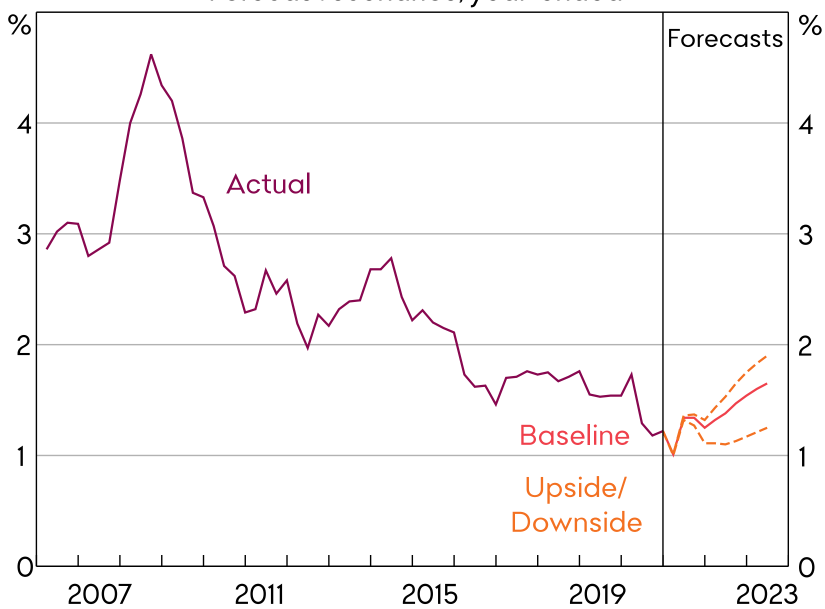
Forecast scenarios, year-ended



Sources: ABS; RBA

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

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