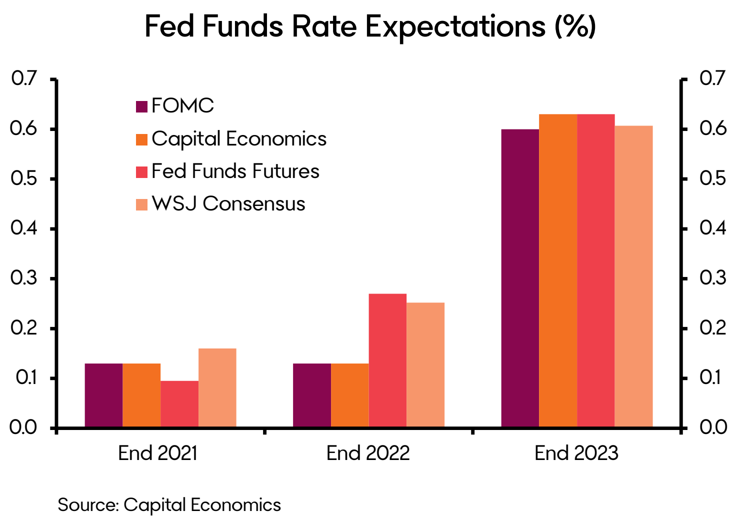
June
2021

Economic and market update

Economic Overview – as of 17th June 2021

Global markets

The path to a post-pandemic world appears to be on track based on risk sentiment and fresh record highs for stock markets around the world, although the trade-off between a stronger outlook and the implications for inflation, interest rates and high debt levels is now the primary concern. Vaccination programmes are still running promisingly in many regions, with 21 percent of the world's population having received at least one dose, although that ratio is less than one percent in low-income countries. The improved outlook in a range of countries means a growing number of major central banks are bringing forward their guidance of policy tightening, including the USA - see 'Fed Funds' rate chart below.



The June Federal Open Market Committee (FOMC) meeting revealed upgraded forecasts for US economic growth (up to seven percent for 2021), jobs growth (unemployment heading below four percent next year) and inflation (core inflation expected to be three percent in Q4, up from the 2.2 percent previously forecasted).

The upbeat FOMC assessment of the economic outlook was matched by median projections of two interest rate hikes in 2023, but later tempered by Federal Reserve Chair Powell's assertion that rising inflation will be 'transitory'. This remains a critical assumption - especially considering May's US core inflation data showed the largest monthly rise in 30 years - although there are clearly some one-off factors. Despite these developments and a sharp rise in the US Dollar, the impact on stock markets was minimal and bond yields only rose around 10 basis points. Chinese economic data was again a little less aggressive in May than earlier in the year, but still up sharply in year-on-year terms. This suggests the recovery is entirely intact and likely to continue, with Q2 GDP probably heading for at least eight percent annualised growth. However, gradual policy tightening is underway.

Retail sales accelerated in May, up 12.4 percent year-on-year, while industrial production and investment were slower (but still grew, just at a slower pace). China has similar issues with inflation to other economies - producer prices rose at their fastest pace since 2008 - however, core inflation is much lower, and likely to only rise 1.5 percent this year. Chinese exports growth eased back to 28 percent year-on-year, but its trade surplus remains strong despite a rise in imports. Iron Ore volumes increased three percent year-on-year in May, although over time, carbon neutrality policies will start to reduce this demand.

Meanwhile, the outlook in Europe is also brighter as virus risks recede amid higher vaccination rates. The European Central Bank is expected to gradually taper its 'emergency asset purchases' in coming months, despite being yet to reduce overall bond purchase QE measures.

Bond yields remain negative in much of Europe, but it will be interesting to see the impact of US trends (post FOMC) in the coming weeks. Euro-zone first quarter GDP was revised up from -0.6 percent to -0.3 percent, but the consensus is for the EU to reclaim post-pandemic GDP by early 2022.

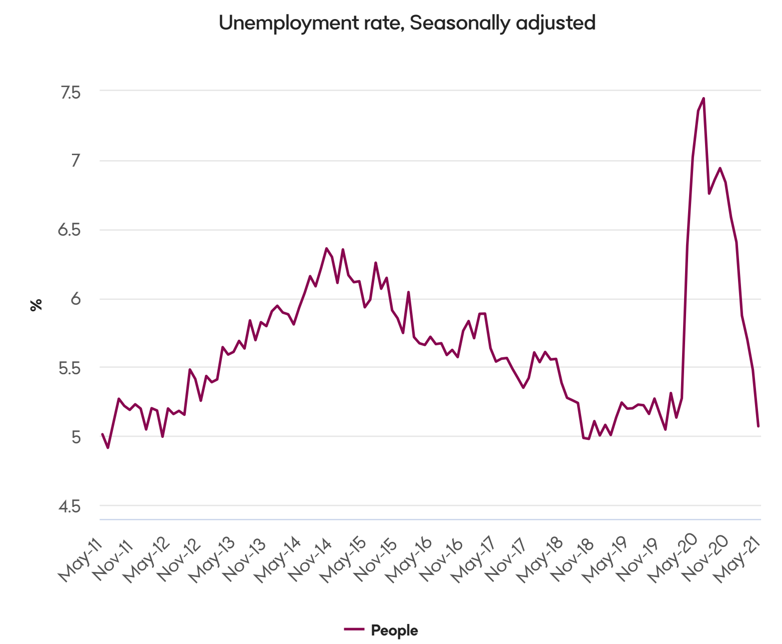
Moreover, the improved outlook for the UK - thanks to high vaccination rates and massive government support - has the markets mulling over 2023 interest rate hikes. The Bank of England raised its forecast for growth this year to 7.25 percent, but off a very low base.

Domestic economy

The relentless run of economic data running ahead of forecasts was again on display in the first half of June with GDP, business conditions, house prices and labour force all beating consensus.

These numbers illustrated the strength of the Australian economy in May and while consumer sentiment indicators for June appear to have moved back a gear - due to the fourth Victorian lockdown - even they are ahead of long run averages.

However, the latest virus outbreak in Sydney is a timely reminder of just how fragile confidence remains in this COVID-safe phase, ahead of the arrival of a vaccine sponsored, post-pandemic world.



Source: Australian Bureau of Statistics, Labour Force, Australia May 2021

The GDP data for Q1 revealed another 1.8 percent rise in output (on top of the upwardly revised 3.5 percent and 3.2 percent gains in the second half of 2020) which leaves our economy 0.8 percent ahead of December quarter 2019 levels.

Some further information on this data is outlined in the appendix, but one of the most pleasing aspects of the national accounts was the contribution from business investment. This has been one of the missing links for the Australian economy for some years - when will businesses increase their investment to support future growth - and the data showed that elevated levels of business confidence is combining positively with the range of Government incentives.

Machinery and equipment investment recorded its strongest quarterly rise in over a decade. Dwelling investment and household spending also increased strongly, as did 'Farm GDP', and while the contribution from the public sector was lower, the large pipeline of future infrastructure projects suggests broad-based growth ahead.

The jobs data for May (refer chart above) was ahead of forecasts on almost every measure, taking the unemployment rate down to 5.1 percent (below the March 2020 pre-pandemic baseline of 5.3 percent). Other details included:

- A rise of employment of 115,000, 97,500 full-time and 18,000 part-time
- Total employment is now 13.125 million, versus 13 million in March 2020
- Underemployment fell 0.3 percent to 7.4 percent (lowest level since January 2014)
- Youth unemployment rose 0.1 percent to 10.7 percent (with April its lowest level since January 2009)

Some of these figures are influenced by the lack of available workers from overseas and don't fully reflect the unevenness in the supply and demand for labour. However, they do suggest the RBA's definition of 'full employment' and resulting wages growth may be achieved well before the RBA timeline of 'not until 2024 at the earliest'. As a result, the markets (and an increasing number of forecasters) are leaning towards possible RBA interest rate hikes in 2023, which appears more consistent with this data.

The Reserve Bank hasn't adjusted its language yet with respect to inflation risks and the implications for monetary policy, and in a speech today Philip Lowe reiterated "inflation pressures remain subdued and are likely to remain so" beyond one-off factors.

This insistence that wages growth will not emerge for some years does seem at odds with the jobs data but setting aside the timing of increases to the RBA cash rate, some changes to Quantitative Easing and Yield Curve Control (YCC) are imminent.

We will hear the specific details via next month's policy announcement (with a press conference already booked), but at this stage the expectation is the RBA will outline:

- The tapering off of QE measures following September's completion of 'QE2'
- The composition of 'QE3' which may mean a smaller amount than the $100 billion in the previous tranche, or perhaps a weekly $5 billion rolling commitment
- The likely end of the YCC (the 0.1 percent target for the yield on three-year government bonds) with the April 2024 bond, instead of rolling it to November 2024

Arguably, this tapering is reflective of the improved outlook, albeit at a very conservative pace and without any admission inflation risks may be higher than the RBA is suggesting. As the last chart in the appendix shows, labour markets have recovered much faster from this recession than any other in the last 50 years, so this unique environment will no doubt require agile adjustments to policy support.

Interest Rate Outlook

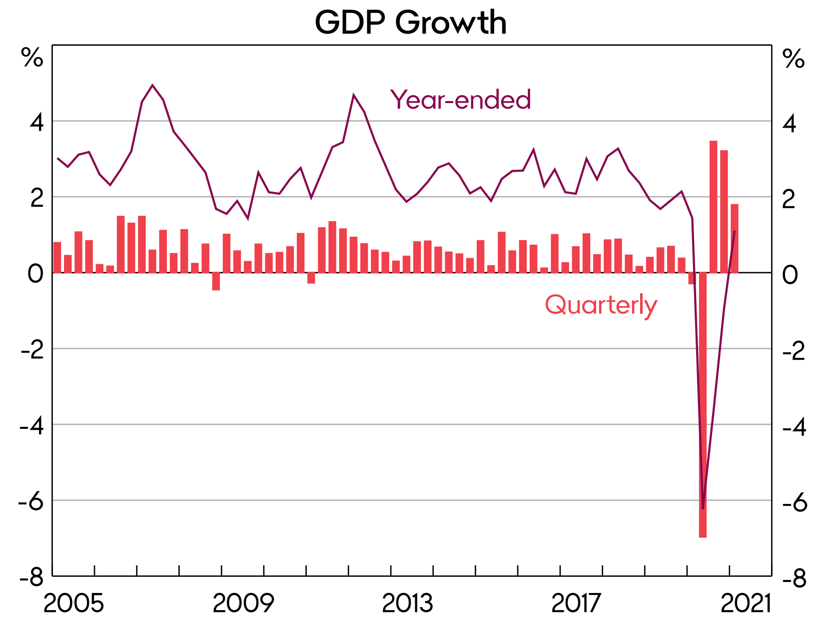
The RBA remains committed to maintaining highly supportive monetary policy settings until its goals for employment and inflation are achieved, which it suggests is unlikely to occur until 2024.

Therefore, the official cash rate and target for the yield on three-year Australian Government bonds is likely to remain at 0.1 percent for another few years. However, there is a strong chance the progress to 'full employment' will be faster and as a result, will require an increase in the cash rate in 2023.

With much to address regarding the future of QE and the YCC, all eyes will be fixed on the outcome of the RBA's 6 July Board meeting.

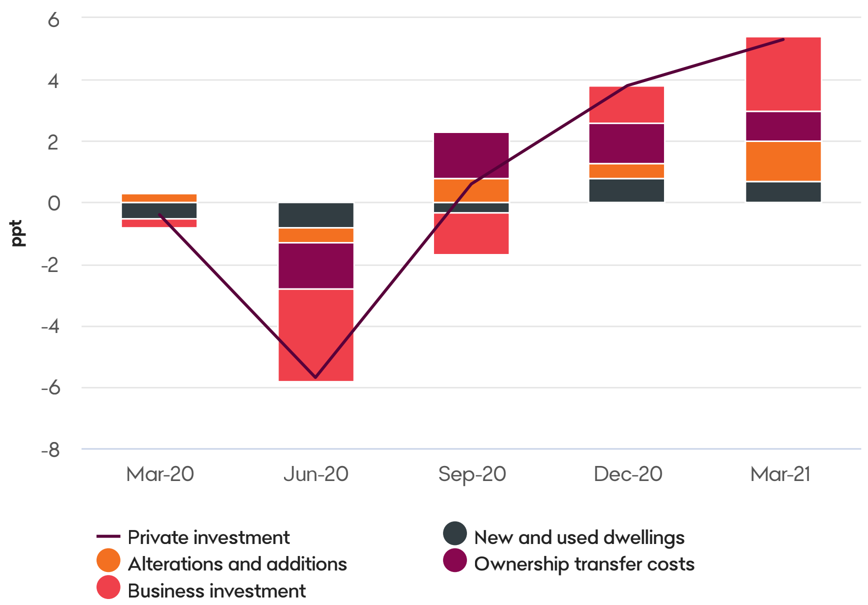
	30 / 04 / 20	30 / 04 / 21	31 / 05 / 21	17 / 06 / 21
90-day bills	0.11 %	0.04 %	0.04 %	0.02 %
3-year swap	0.32 %	0.32 %	0.37 %	0.40 %
5-year swap	0.51 %	0.89 %	0.91 %	0.89 %
AUD/USD	.6510	.7715	.7730	.7635
ASX 200	5 552	7 026	7 162	7 365
Credit Index (iTraxx- 5 yr)	120	61.7	59.5	57.9

Appendix - Australian GDP data (Q1 2021)



Source: ABS

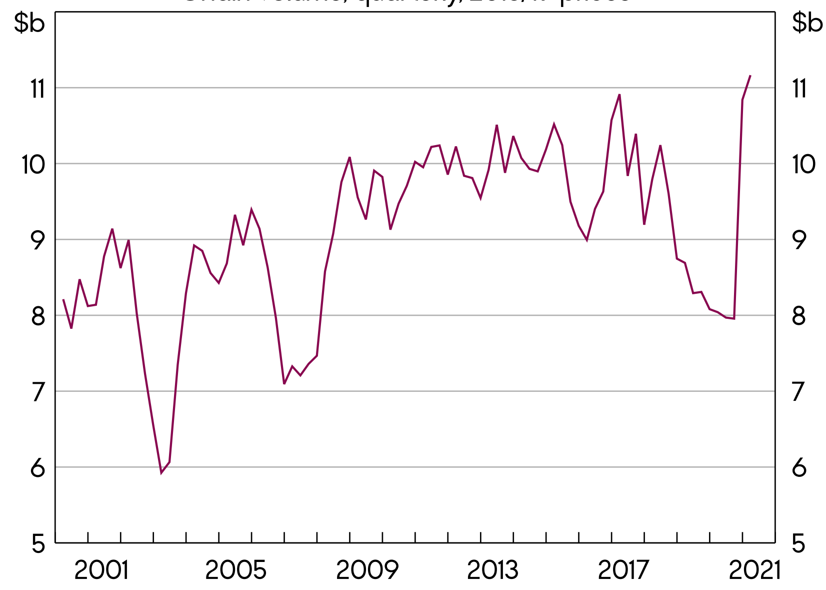
Contributions to quarterly growth in private investment, chain volume measures, seasonally adjusted



Source: Australian Bureau of Statistics, Australian National Accounts: National Income, Expenditure and Product March 2021

Farm GDP

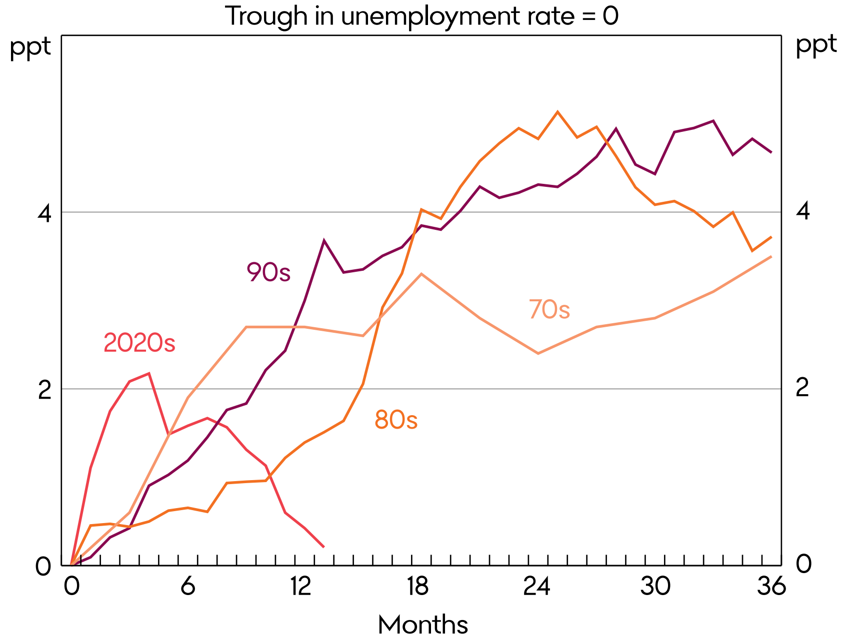
Chain volume, quarterly, 2018/19 prices



Source: ABS

Change in Unemployment Rate During and After Recessions

Trough in unemployment rate = 0



Sources: ABS; OECD; RBA