Economic and market update

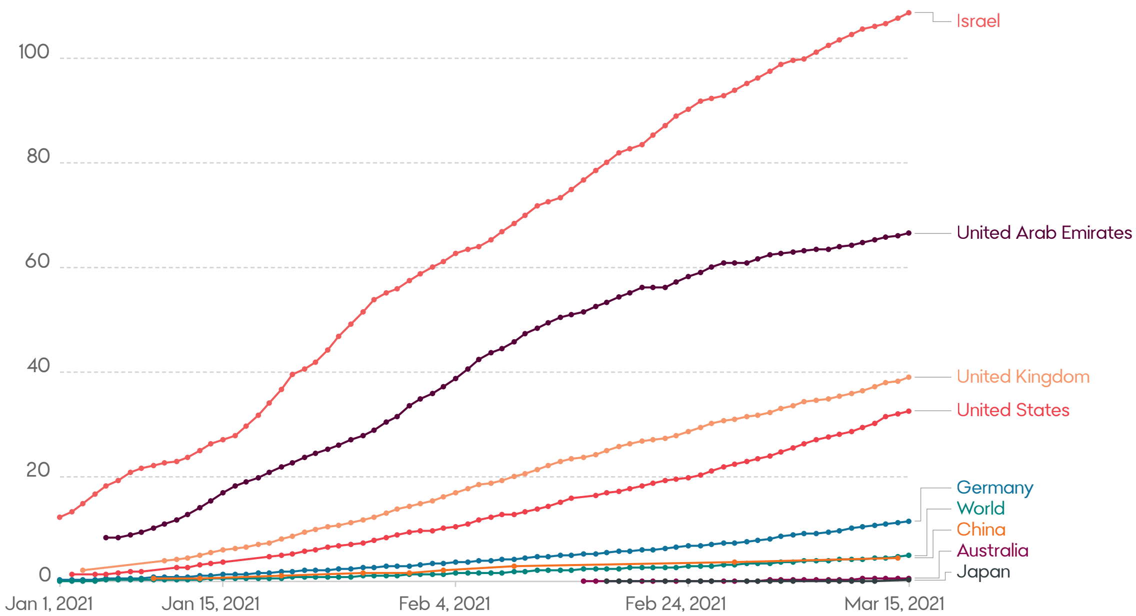
Economic Overview – as of 18th March 2021

Global markets

The global 'reflation trade' remains in full swing as vaccine programmes maintain progress, especially in many countries that had higher case numbers, and as fiscal and monetary policies remain all in. Central banks are not showing any inclination to reduce policy support even as bond yields and inflation expectations continue to rise. This is despite rate hikes now factored into markets in a growing number of countries from late 2022 to mid-2023. Even more important to the global economic recovery than policy support will be the success rate of the vaccination programmes and ensuring that all countries are effective in this vital process.

COVID-19 vaccine doses administered per 100 people

Total number of vaccination doses administered per 100 people in the total population. This is counted as a single dose, and may not equal the total number of people vaccinated, depending on the specific dose regime (e.g. people receive multiple doses).



Source: Official data collated by Our World in Data

The US Federal Reserve held its commitment at its most recent policy meeting to unchanged levels of support. There was no talk of tapering quantitative easing (QE) or even thinking about rate hikes. There was a degree of confidence around the pace of economic growth especially as the vaccine rollout continues (refer chart). Any increase in inflation is expected to be transitory. The relatively new US policy framework of 'average inflation targeting' means the hurdle for lifting rates is much higher than in the past. We are approaching a period where base effects will make year-on-year comparisons less meaningful, given the worst of the economic downturn was a year ago. This means we can discount some of the annualised data ahead including inflation. Nevertheless this somewhat stubborn view that inflationary pressures will only be temporary does come with the risk that central banks, including the US Federal Reserve and the RBA, overshoot the mark. US economic data has picked up over the last month, other than some weather impacted numbers including retail sales and housing starts. This trend is likely to continue now President Biden's $1.9 trillion stimulus bill has finally passed through Congress, so US GDP growth for 2021 is now forecast to exceed 6.5 per cent.

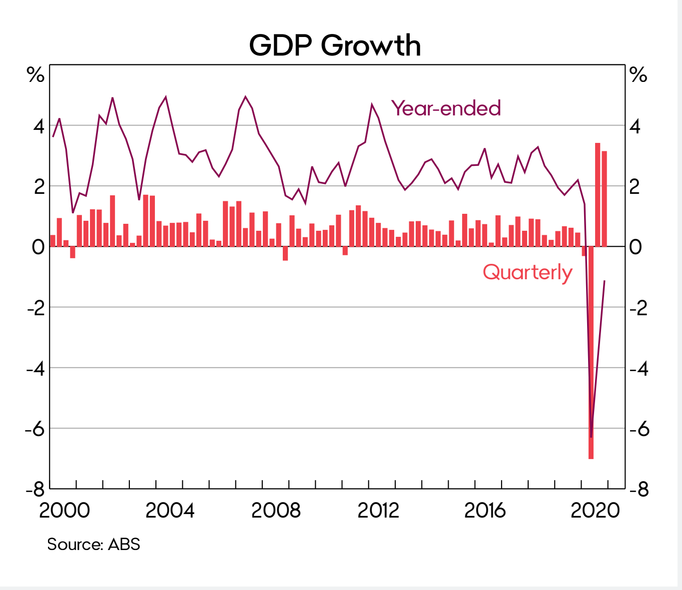
In China the data is even stronger although the base effects are already in play for February's activity data, making month-on-month and quarterly comparisons more insightful than year-on-year. By way of example, the latest figures show fixed asset investment and industrial production both rose 35 per cent compared to a year ago. However the monthly comparisons were more realistically up between one and three per cent. Earlier this month the National People's Congress in Beijing revised the Chinese administration's 'Five-Year Plan'. It no longer has a GDP target, but still has ambitious targets for economic development and standards of living, with a narrative of technology and innovation to drive growth rather than just investment and infrastructure investment. This emphasis on R&D also feeds into environmental aspirations, but delivering on innovation may add further weight to the current trade wars morphing to technology wars. Fiscal support is likely to be superseded by economic reform, and monetary policy is very likely to be tightened in the months ahead, well ahead of advanced economies, given how strongly the Chinese economy appears to be performing.

The outlook for Europe is much less encouraging than in Asia or even compared to North America. The European Central Bank is increasing QE bond purchases amid sluggish growth and slow vaccination rates, especially compared to the UK. Even the stronger parts of the euro-zone are lagging, with German GDP forecast to shrink by around two per cent in the first quarter of 2021. The decision to suspend the AstraZeneca vaccine in many European countries (despite blood clot rates appearing to be consistent with natural rates) may slow down the region's recovery further. Meanwhile the Bank of England governor Andrew Bailey spoke this week of 'upside risks' for the UK economy, albeit with no intention to increase policy settings for the foreseeable future.

Domestic economy

The run of better-than-expected economic data reflecting the V-shaped recovery continues for Australia with more pleasing figures for jobs, housing, business confidence and retail activity. The weak parts of the economy remain those most reliant on international tourism and students but aggregate data is evidence of the success of fiscal and monetary support thus far, and the benefits of having avoided significant COVID-19 lockdowns since October.

GDP data is admittedly a little dated being for the December quarter, but the fact that growth rebounded by over three per cent for consecutive quarters for the first time on record, and that fourth quarter GDP was only 1.1 per cent behind the same period a year earlier completes the full-house of V-shapes for 2020 (refer chart).



How will this evolve in 2021? The trajectory of growth from here does appear sustainable based on the latest jobs data when considering that total employment is now slightly **above** pre-pandemic levels, and when taking in to account elevated job vacancies and business confidence measures. The unemployment rate is back down to 5.8 per cent, which is below the RBA forecast for the **end** of the year, and this strong data was most timely given the JobKeeper subsidy ends in less than a fortnight. Other factors to suggest an extension of the V include the rise in 'hours worked' in the February jobs data (up 0.2 per cent year on year), the ongoing strength in house prices (values rising at their fastest rate in 17 years) and the commitment from the RBA to keep monetary policy supportive for 'as long as is necessary' to drive employment, wages growth and inflation back to target levels. The most obvious potential fly in the ointment for the ongoing economic recovery remains the pandemic itself. One key risk is significant delay in the vaccine rollout, which would not have been helped by the European countries pausing their AstraZeneca rollout. Similar risks exist with our neighbouring countries and their challenges with the pandemic, for example in Papua New Guinea.

Overall, the markets seem to be siding with the optimists if bond yields are any guide. The ten-year rate is back above 1.8 per cent despite the Reserve Bank trying to talk down inflationary expectations and any thought that less monetary policy support is needed. As the charts in the appendix show, the market is now expecting inflation to be back in the RBA's target range next year, in line with rising commodity and energy prices. However the RBA is insistent that wages growth would need to exceed three per cent for inflation to rise, and that it doesn't expect this to happen until 2024 at the earliest. Arguably this misses the point that the jobs data is way ahead of its forecasts, so tighter labour conditions may be far more imminent; and that inflation may rise in the absence of wages growth- but like other central banks, their dovish commentary is unmoved. Trying to cap the Australian dollar's upward trend may be a factor in the RBA's language, over and above its true conviction that inflation simply isn't going to be a problem in the years ahead. Let's hope it is right, especially for the sake of the housing market.

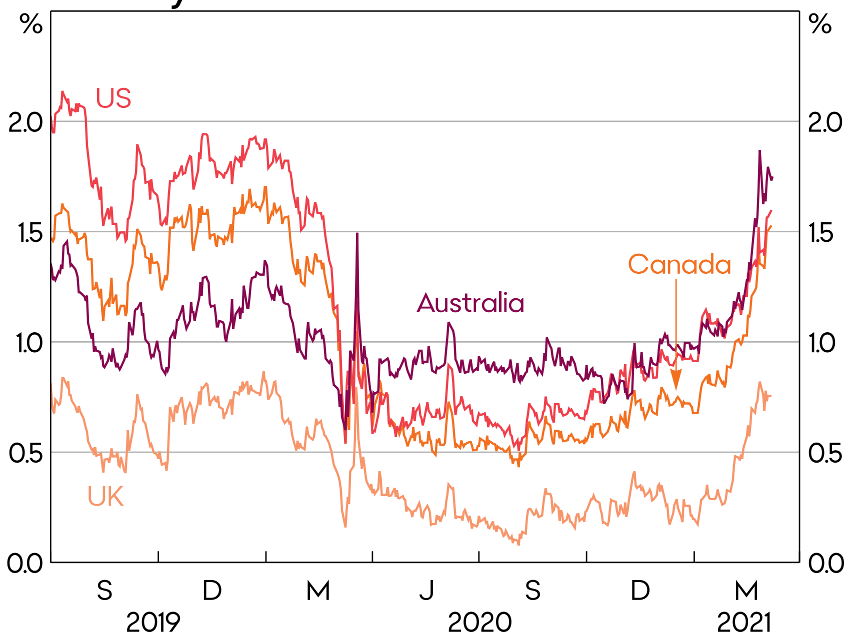
Interest Rate Outlook

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, with any further monetary stimulus if needed to 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 it is not expecting a sharp rebound in inflation for some years.

	31 / 01 / 20	31 / 01 / 21	28 / 02 / 21	18 / 03 / 2021
90-day bills	0.88 %	0.01 %	0.03 %	0.035 %
3-year swap	0.66 %	0.15 %	0.31 %	0.33 %
5-year swap	0.83 %	0.43 %	0.92 %	0.88 %
AUD/USD	.6690	.7625	.7750	.7825
ASX 200	7 017	6 607	6 673	6 760
Credit Index (iTraxx- 5 yr)	52.5	62.8	61.2	60.1

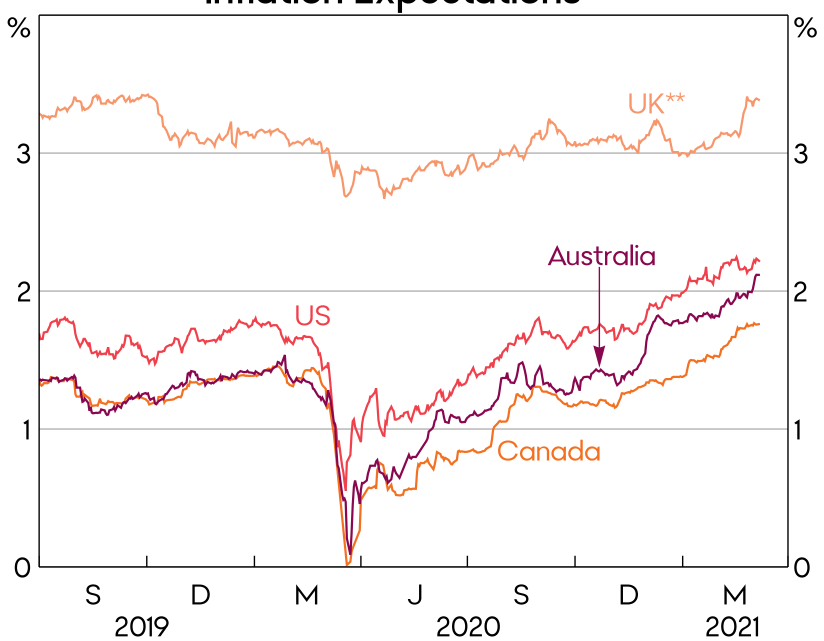
Appendix - Bond yields, inflation expectations and drivers

10-year Government Bond Yields



Sources: Bloomberg; Yieldbroker

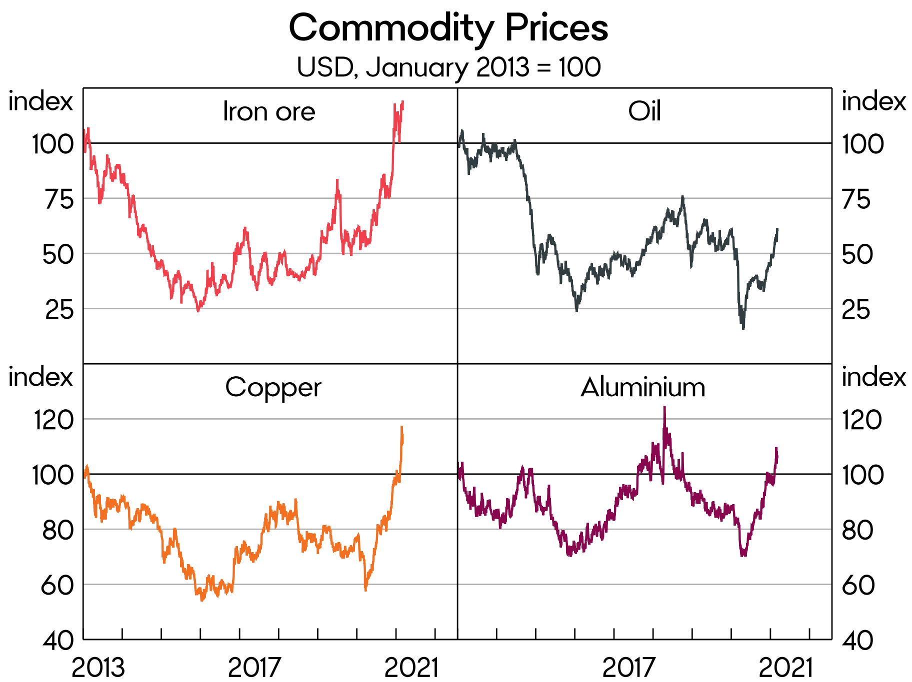
Inflation Expectations*



* Measured as the difference in yields between nominal and inflation-linked 10-year government bonds.

** UK breakeven inflation is structurally higher as it is linked to the UK Retail Prices Index rather than the Consumer Price Index.

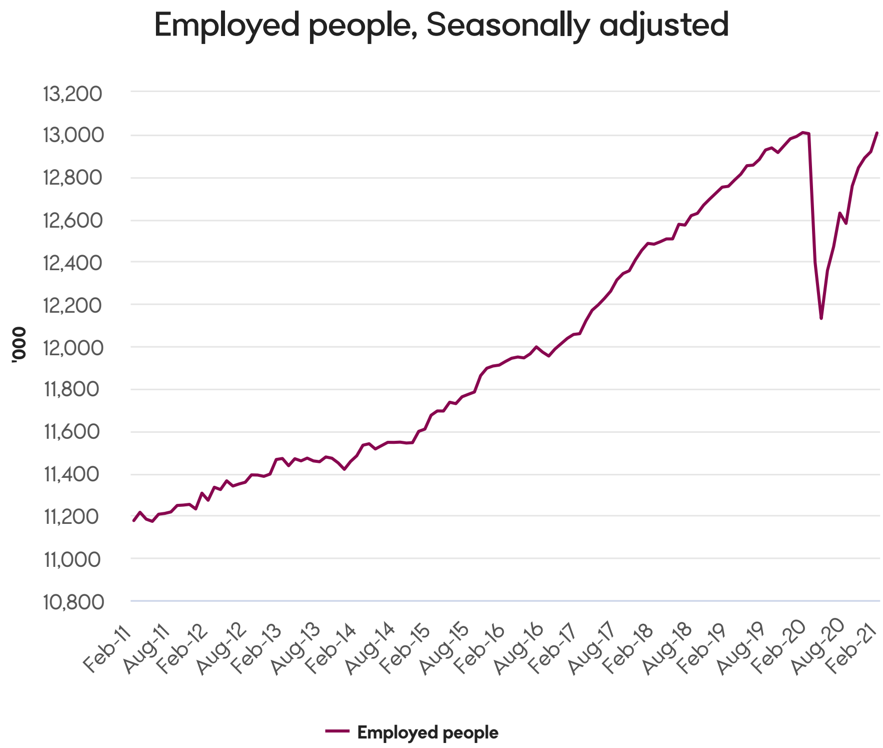
Source: Bloomberg



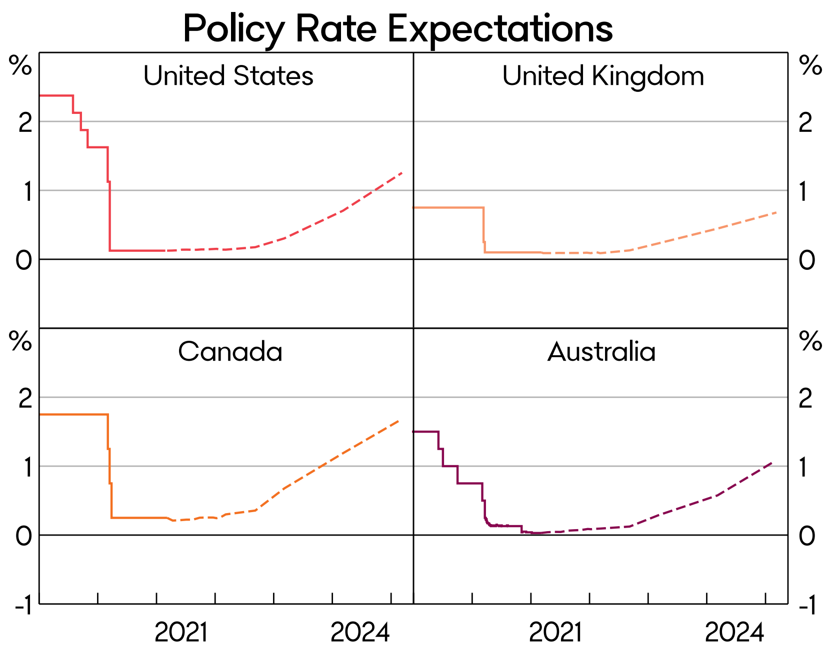
Sources: Bloomberg; RBA

* Excluding bonuses and commissions

Source: ABS



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



Sources: Bloomberg; RBA