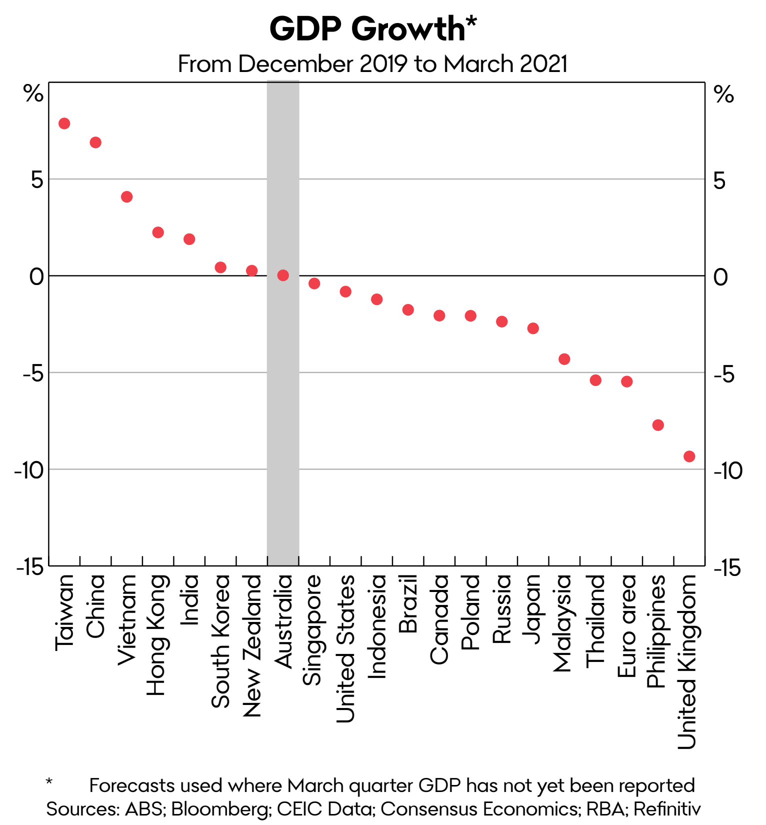
May
2021

Economic and market update

Economic Overview – as of 20th May 2021

Global markets



Similar themes to the first quarter of 2021 have continued in Q2, with markets and risk appetite generally implying strong post-pandemic conditions ahead. However the implications of this, especially for interest rates, complicate the outlook. The economic recovery in many countries has built on earlier progress, supported by relentless fiscal and monetary policy and progress with vaccines. Nevertheless, recent COVID-19 related lockdowns in India, Japan and parts of Europe highlight the inconsistency and uncertainty of growth profiles ahead, consistent with last year.

The United States economy has made further progress evidenced by manufacturing surveys, jobs data and consumer spending. However the latest inflation numbers pointed to one consequence of a sharp recovery- a sharp rise in prices. Core Consumer Price Index (CPI) rose 0.9 per cent month-on-month in April (triple the market forecast) to be three per cent higher than a year ago. The US Federal Reserve is insistent that this is “transitory” while the markets are less convinced. Headline CPI may now rise to close to five per cent which will test the patience of investors. However there are genuine reasons to expect inflation to fall back to two per cent, with shortages in materials, labour and supply chain issues likely to be temporary. The US economy is forecast to grow more than six per cent in 2021, but the Fed is yet to indicate when monetary policy will start to tighten.

The Chinese economic recovery leads the world with output back to its pre-pandemic trendline. The focus is now turning to a slightly lower trajectory of economic growth while authorities attempt to constrain credit. Gross Domestic Product (GDP) is likely to rebalance from industrial production and investment to services and household consumption. Year-on-year data for April looked impressive thanks to base effects, but the easing back in policy support will see monthly trends soften for activity and investment. Nevertheless, tighter labour markets, given surveyed unemployment is down to 5.1 per cent, support a stronger outlook for the second half of 2021. Consensus for Chinese GDP growth this year is still around eight per cent. More broadly through Asia trade volumes have rebounded strongly, and commodity prices reflect growing demand especially for iron ore, base metals and oil, as well as supply issues. The region is likely to outperform North America and Europe, despite lower vaccination rates thus far.

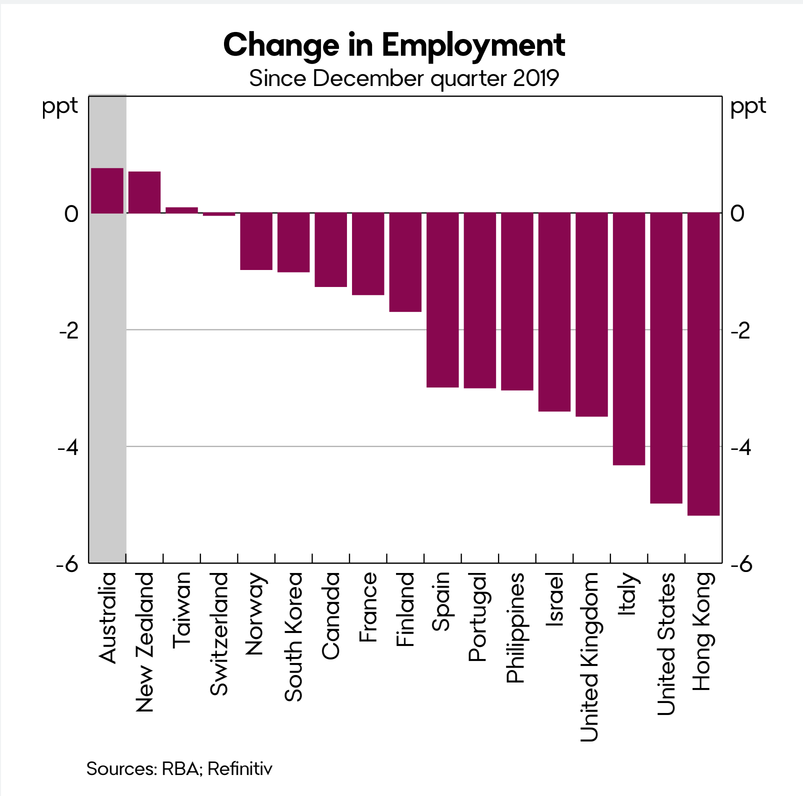
In Europe the acceleration of vaccine programmes has encouraged further upgrades to European Union growth forecasts, but off a lower base than its peers. Tourism will be an important part of the recovery, so border reopening timelines are crucial- however virus variations and the logistics of international travel complicate the path ahead. EU GDP fell 0.6 per cent in Q1, but a four per cent expansion for 2021 is still expected.

Domestic economy

The steady stream of better than forecast data has shown no sign of letting up, once again pointing to policy effectiveness and the resilience of Australia's economy. The Reserve Bank outlook as detailed in the May 'Statement on Monetary Policy' was upgraded sharply, with unemployment now forecast to fall to five per cent by year end and 4.5 per cent by the end of 2022. Previous forecasts were six per cent and 5.5 per cent respectively. The success of JobKeeper compared to equivalent policies elsewhere is clear from the chart below.

The April jobs data saw unemployment fall further to 5.5 per cent despite seasonally adjusted employment falling by 30,000. Overall the details were impressive given this was the first read after the end of JobKeeper:

- Underemployment fell to 7.8 per cent, its lowest level since May 2014
- Youth unemployment fell to 10.6 per cent, its lowest level since 2009
- Full time employment rose by 33,800 in April, so is 25,000 ahead of pre-pandemic levels.



The implications for interest rates from this well-defined trend for jobs depend on how quickly tighter labour markets will drive sustainable wages growth. The Q1 wages data (refer appendix for details) was slightly better than forecast with wages up 0.6 per cent for the quarter, to be 1.5 per cent higher year-on-year. The latest RBA forecast is for wages growth to only reach two per cent by mid-next year, consistent with core inflation only rising to 1.5 per cent by then. However overlaying recent jobs growth with the record high for business confidence, elevated levels for consumer sentiment and housing values, plus the recent Budget announcements all suggest upside risks to inflation.

The Federal Budget added further stimulus with deficits out to 2025. While the improved revenue position, thanks to record iron ore prices and the sharp recovery in employment, has delivered an improved debt profile, the deficit for FY22 is still over $100 bn. This continuation of fiscal support, avoiding the temptation to return to budget repair is a welcome alignment of fiscal policy to monetary policy, both aiming to deliver full employment as quickly as possible. Net debt to GDP is now forecast to rise to 40.9 per cent by 2025, but this ratio compares very favourably by international standards and our AAA credit rating remains intact. The Budget focus was on aged care ($17.7 bn over the forward estimates), NDIS ($13.2 bn), infrastructure ($15 bn) and the extension of the low- and middle-income tax offset for another year ($7.8 bn). For businesses the extension of instant asset write off will add further incentives for business investment, which is hoped to trend higher following the recent record high for surveyed business conditions.

The economic outlook remains very promising based on all the data we have seen since October and thanks to the Budget's further commitment to fiscal support. However the risks from vaccine hesitancy and delayed timelines to reopening borders cannot be dismissed. Trade tensions with China are not helpful and have tempered the rise in the Aussie dollar, but our international trade surplus remains resilient.

Interest Rate Outlook

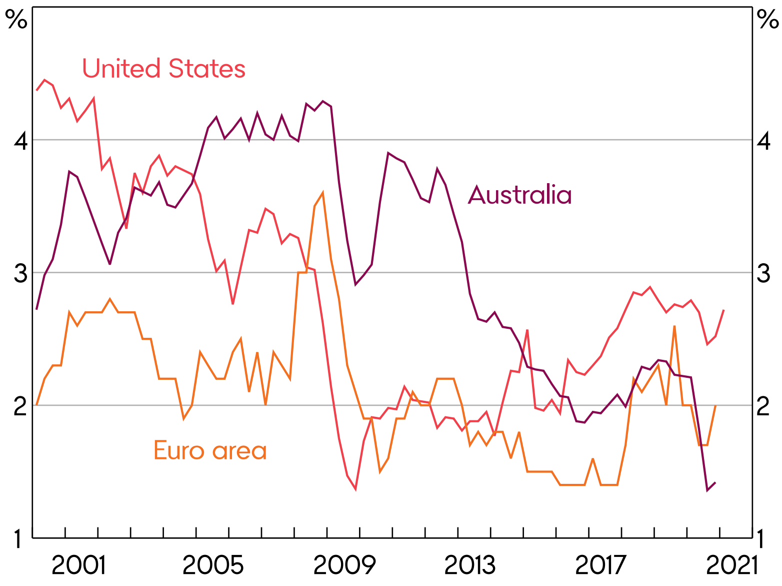
The RBA rate cut last November to 0.10 per cent for the cash rate (and the targeted yield on three-year bonds) is very likely to be the low point for these targets. If needed, any incremental monetary stimulus is likely to come in the form of ongoing Quantitative Easing (QE). The steepening in yield curves here and around the world suggests global reflation is a material risk. Despite consistently strong domestic economic data the RBA continues to insist that it doesn't expect inflation (via wages growth) to reach its target band until 2024 at the earliest. However, the market is increasingly factoring in higher rates through 2023, and the tapering of QE later this year would be consistent with economic progress.

	31 / 03 / 20	31 / 03 / 21	30 / 04 / 21	20 / 05 / 21
90-day bills	0.37 %	0.035 %	0.04 %	0.04 %
3-year swap	0.38 %	0.35 %	0.32 %	0.33 %
5-year swap	0.60 %	0.91 %	0.89 %	0.86 %
AUD/USD	.6140	.7595	.7715	.7745
ASX 200	5 077	6 791	7 026	7 020
Credit Index (iTraxx- 5 yr)	176	61.2	61.7	60.5

Appendix - Wages data

Wages Growth*

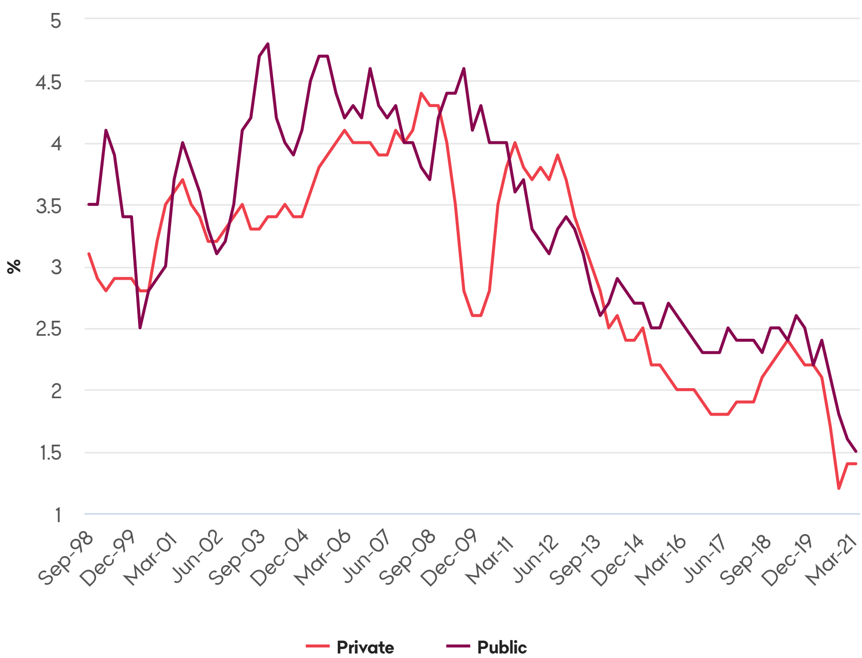
Year-ended



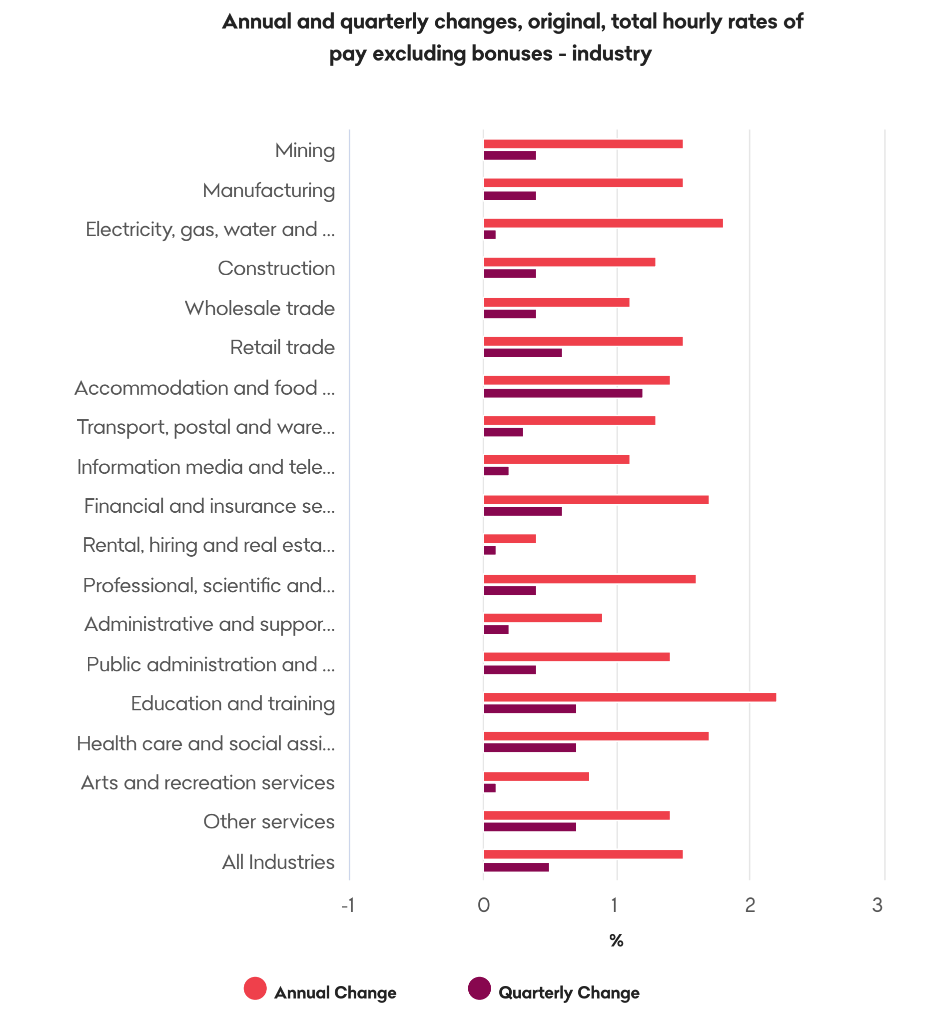
*	Wages Price Index for Australia; Employment Cost Index for the United States; indicator of negotiated wages for the euro area

Sources: RBA; Refinitiv

Annual changes, seasonally adjusted, 1997 to 2021

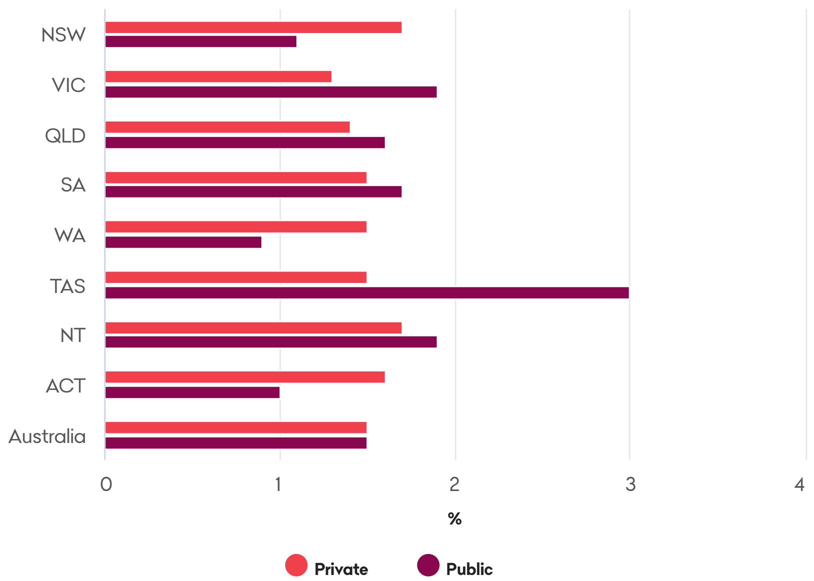


Source: Australian Bureau of Statistics, Wage Price Index, Australia March 2021



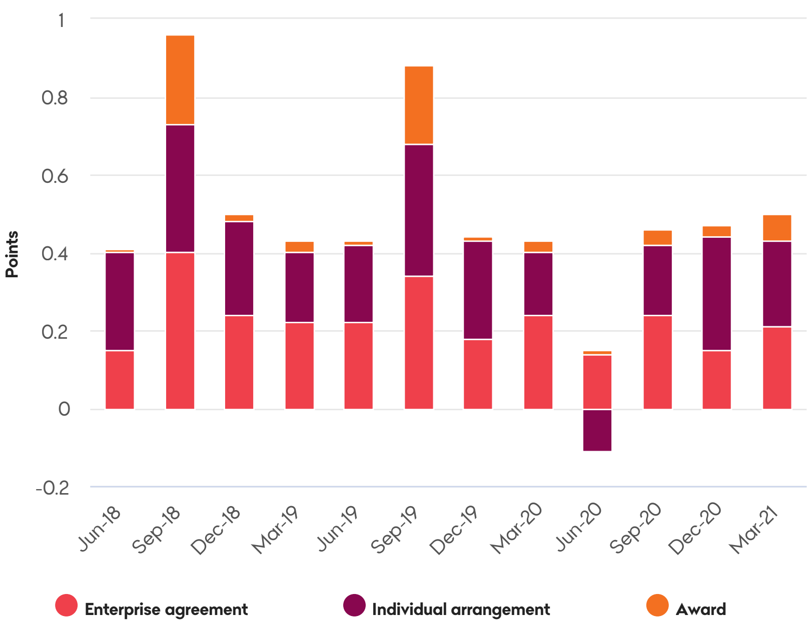
Source: Australian Bureau of Statistics, Wage Price Index, Australia March 2021

Annual change, original, total hourly rates of pay excluding bonuses - states and territories



Source: Australian Bureau of Statistics, Wage Price Index, Australia March 2021

Contributions to wage price index, by method of setting pay



Source: Australian Bureau of Statistics, Wage Price Index, Australia March 2021