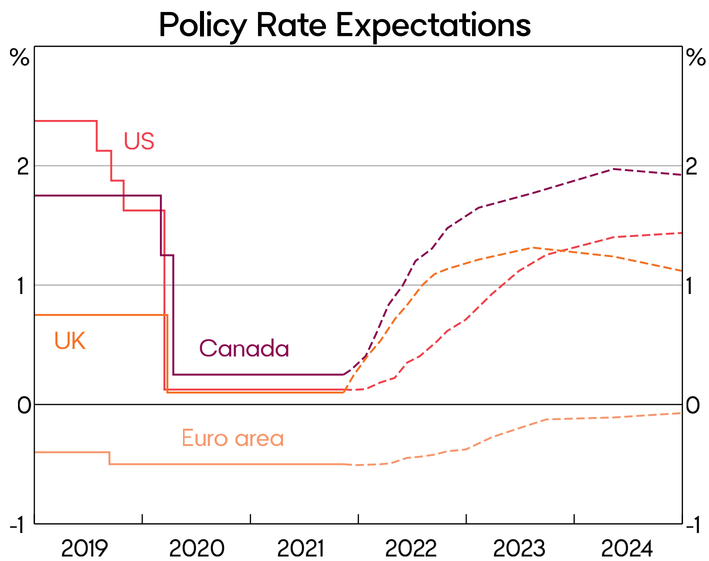
November 2021

Economic and market update

Economic Overview – as of 18th November 2021

Global markets

Inflationary pressures have shown no signs of abating over the last month, and a number of central banks have acknowledged that their previous guidance of 'transitory' rises in inflation are at risk of understating the duration. How rapidly monetary policy stimulus needs to be unwound will vary greatly by location, as will the extent of rate rises to manage inflationary risks. However, it's important to note that rate hikes returning to more neutral interest rates - as global conditions recover from the pandemic - would have occurred even in the absence of inflation outbreaks, as economic activity recovers. Global demand (especially for goods) has rebounded strongly, and in highly vaccinated countries the services sector should also pick up sharply. Price pressures will be uneven, but with supply constraints the dominant theme, as well as a welcome rise in demand, inflation is inevitable.



Sources: Bloomberg; RBA

The US Federal Reserve noted in their latest press release that inflation will now 'moderately exceed 2% for some time', backing away from the transitory message. They also took the opportunity in the FOMC meeting to announce their exit from Quantitative Easing by paring back bond purchases, but tried to uncouple QE tapering from official rate hikes. Since then US inflation data for October has printed even higher, with CPI at 6.2% (its highest annual rate since 1982) and core inflation at 4.6% year-on-year. More positively the manufacturing sector, industrial production and retail sales are all performing well, and President Biden's $1.2 trillion infrastructure package has been signed into law. The missing link for now is more progress on jobs, including an improvement in the participation rate.

China's economy appears to be in a very different position to most advanced economies, as it deals with headwinds from its real estate sector, while authorities work through a reform agenda (broadly themed as 'common prosperity').

The deceleration in China's growth rate was slightly less pronounced in the latest activity data, where industrial growth stabilised, retail sales were stronger than forecast, and energy shortages eased. However, unlike the US, Europe and the UK, Chinese monetary policy can be eased further (their 7-day reverse repo rate is 2.2%), and other stimulus measures are likely to be employed. Inflation is a factor, but may primarily impact the cost of exported goods (where demand remains high). China recorded its largest trade surplus since early 2015 in the latest data.

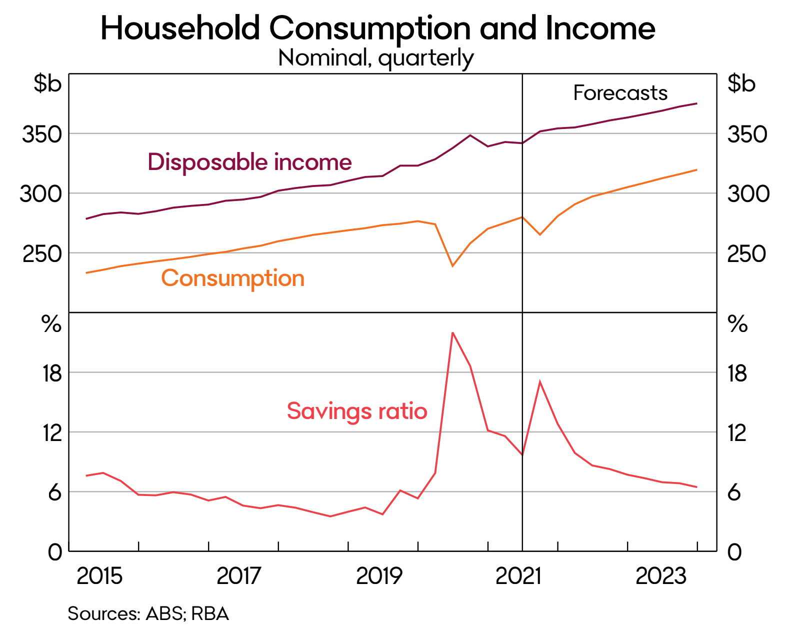
Elsewhere, inflation is the primary concern, overtaking the pandemic and its impact on growth. Canadian CPI was up 4.7% in October from a year earlier, eurozone inflation is 4.1 % year-on-year, and in the UK the CPI rose 4.2%, and core inflation reached 3.4% (its highest level in a decade). The Bank of England appear set to increase their rates next month, although the European Central Bank will move much more slowly. Nevertheless, EU GDP is forecast to grow by around 5% this year and over 4% in 2022, despite vaccination rates in parts of Europe failing to maintain their earlier pace.

Amid these complications and the sharp rise in bond yields in anticipation of higher interest rates, equity markets have continued to march higher. Markets were quick to shake off concerns around the Chinese property sector last month and similarly appear more focussed on the global recovery and the follow through of fiscal stimulus measures (especially infrastructure and green tech) than inflation. Higher energy prices cloud the outlook, but with the exception of iron ore, most commodity prices are firm, tying in with a positive outlook for demand.

Domestic economy

The Reserve Bank of Australia had a healthy list of reasons to radically change its guidance on interest rates this month: the experience of similar economies around the world on inflation (some detailed above), such as New Zealand whose CPI now sits at 4.9%; the rise in our headline CPI to above 3%, but more importantly the increase in core inflation to 2.1% (so back in the target band); and the much improved outlook for our economy in 2022, mainly due to great progress on vaccinations.

Despite these factors - and the RBA upgrading GDP growth for 2022 to 5.5%, with similar upgrades to jobs growth, consumer spending and business investment - the message for interest rates was 'patience'. In a recent speech on inflation, RBA Governor Philip Lowe pushed back on the market's expectations of rate hikes next year, instead saying he wants to see core inflation at the mid-point of the target band (i.e. 2.5%) which he doesn't expect until the end of 2023. On current market pricing, he stated that "the latest data and forecasts do not warrant an increase in the cash rate in 2022". The speech did provide some sound arguments on why Australia may be different to the rest of the world with inflationary trends, but the market remains unconvinced.



Sources: ABS; RBA

Some potential holes in the RBA position (the risk that the assumptions below may not hold) include:

- That rising energy prices will continue to trend lower here, in contrast to other countries
- That higher participation rates in our labour markets may result in lower wages growth
- The recent spike in shipping costs and supplier delivery times is only temporary.

Nevertheless, the RBA makes a sound point that the new year will see a sharp rise in demand for services, although it'll be offset by a fall in spending on goods. Not explored in the speech was the unique aspect of the pandemic era with respect to QE, nor increased money supply and aggressive fiscal policy coinciding with monetary policy. Also absent was the view that an official cash rate of 0.1% was only an emergency setting for the pandemic. If 2022 is all about 'living with the virus' in an endemic rather than pandemic phase, and GDP growth will be close to 6% for the year, do we still need policy settings that were tailored to a recession? The RBA are patient indeed in saying 'yes'.

One of the (many) complications in analysing current data is anticipating the recovery next year, while stripping out the Delta lockdowns impact on NSW, ACT and Victoria in the third quarter. The jobs data for October revealed a rise in the participation rate, but a fall in employment (the survey just preceding the NSW reopening), so unemployment rose to 5.2%. Assuming we replicate job creation as seen last financial year, and in line with record high job vacancies and job advertisements, this should mark the peak in the Delta strain jump in unemployment, with a fall to below 4% quite plausible next year. However, while the two largest states by population are emerging from lockdown, other states face uncertainty around reopening borders (state and international) and possible outbreaks of the virus, even with high vaccination rates. Access to offshore workers is also a major factor.

The case can be made for even stronger economic growth and faster job creation than the already upbeat RBA forecasts. This could occur through high vaccination rates (meaning borders reopened well ahead of year-end), very high household savings rates and disposable income (refer chart above), and the possibility of the lowest unemployment rate since the 1970s, if we dip below 4%. This would be a most welcome outcome given the likelihood of higher inflation, be it temporary (as the RBA argues), or more permanent. Consumer confidence has risen gradually since the worst of the Delta outbreak, while business confidence is suddenly back at +21 in the October survey, close to its April record high.

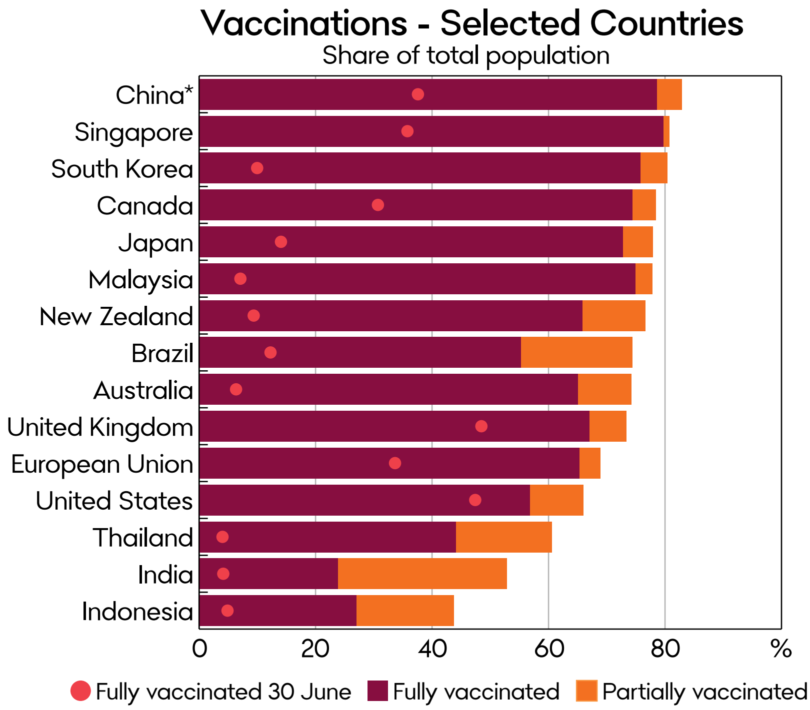
Interest Rate Outlook

The RBA has reiterated its commitment to supporting the path to 'full employment' and hitting inflation targets, and while upgrading its forecast for 2022, is pushing back on rate hikes next year.

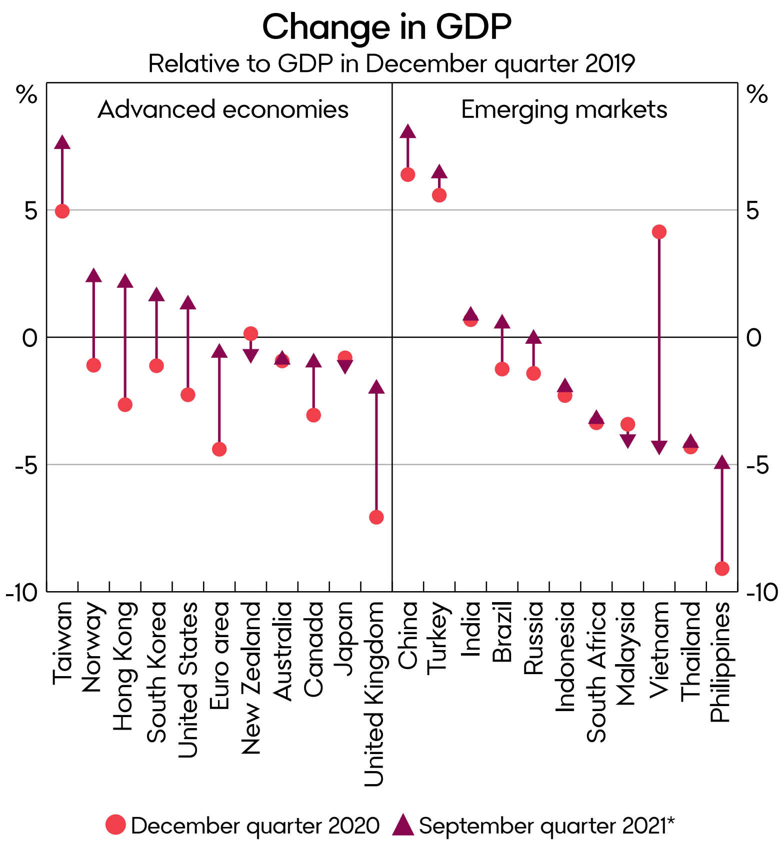
Faster progress for wages growth and rising inflation is increasingly likely, so 2023 hikes are now the mainstream view, with late 2022 also a plausible timeline. The pace of rate hikes will be constrained by household debt levels, and the uneven impact of the pandemic on sectors and locations.

	30 / 09 / 20	30 / 09 / 21	31 / 10 / 21	18 / 11 / 21
90-day bills	0.09 %	0.02 %	0.07 %	0.04 %
3-year swap	0.14 %	0.55 %	1.41 %	1.31 %
5-year swap	0.29 %	1.03 %	1.82 %	1.72 %
AUD/USD	.7175	.7225	.7530	.7275
ASX 200	5 816	7 332	7 430	7 379
Credit Index (iTraxx- 5 yr)	76	66.8	65.4	65.7

Appendix - International comparisons



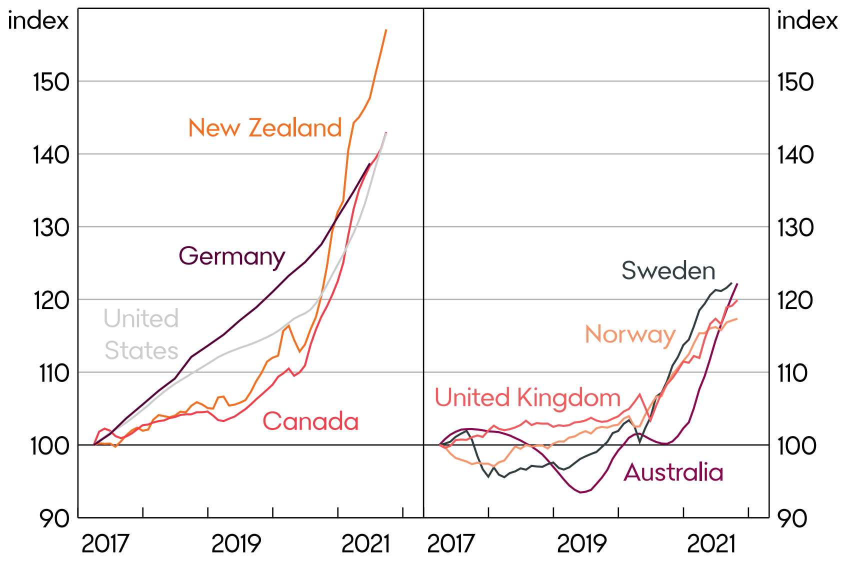
* First and second doses estimated from total vaccinations and recommended delay between doses
Sources: CEIC Data; Our World in Data; RBA



* Forecasts used where September quarter GDP has not yet been reported
Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; RBA; Refinitiv

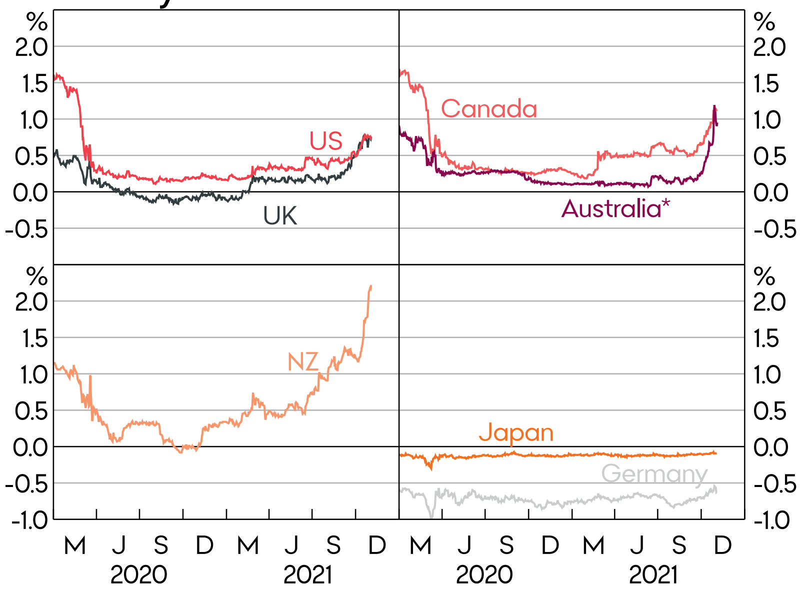
Housing Price Indices

March 2017 = 100



Sources: national sources; RBA; Refinitiv

3-year Government Bond Yields



* The Australian three-year yield is an interpolated value. All other series are the yield on a bench mark bond

Sources: Bloomberg; RBNZ; Yieldbroker