October 2021

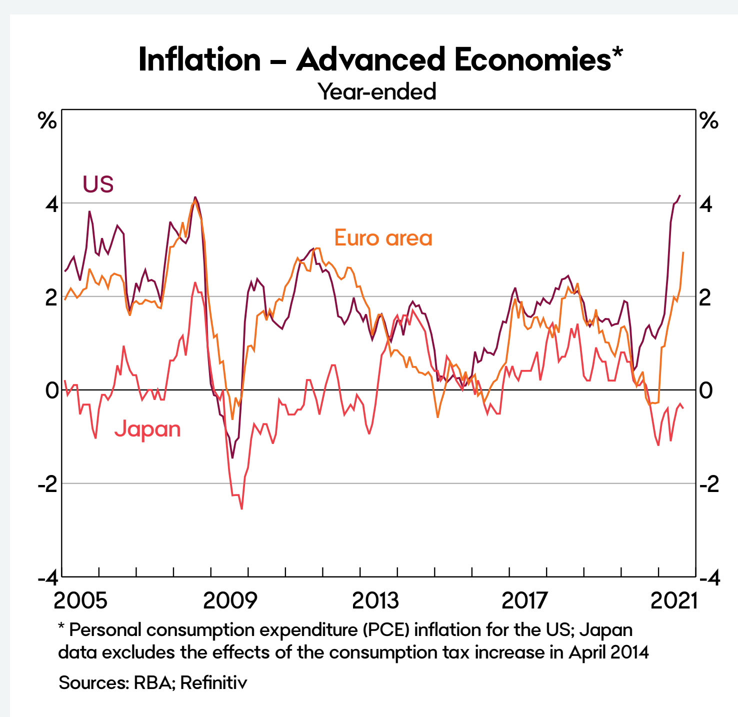
Economic and market update

Economic Overview – as at 21st October 2021

Global markets

The recent sharp rise in expectations for higher and more permanent inflation, together with downgrades to growth forecasts for 2022, sounds a lot like stagflation, especially when the main cause of this change in sentiment is higher energy prices. Fortunately, the subtext is much more positive than this worst-case scenario. The markets are continuing to price in strong jobs growth through the year, despite inflation being a lot higher than previously expected, and more likely to be persistent. As a result, economic growth (while pared back from earlier predictions due to the Delta variant) is still expected to be well ahead of trend, given the anticipated widespread resumption of tourism via higher vaccination rates.

The challenge for central banks (except for the Bank of Japan, see the chart below) is how quickly to increase official interest rates to manage inflationary risks, without derailing the recovery from COVID-19 induced recessions. They'll also need to differentiate between temporary inflation versus more lasting factors.



* Personal consumption expenditure (PCE) inflation for the US; Japan data excludes the effects of the consumption tax increase in April 2014

Sources: RBA; Refinitiv

In the US a range of inflation measures (CPI, PPI and PCE inflation) are all at multi-decade highs, driven by a perfect storm of supply chain bottlenecks, rising energy prices and tight labour markets. This has built market expectations of not just a tapering in quantitative easing by year-end, but also increases to the Fed Funds target interest rate by mid next year.

Equity markets are suddenly back near record highs despite the prospect of higher US inflation and interest rates. This is hard to reconcile when labour shortages (while appearing to be a good sign in terms of job openings) are consistent with a stagnant participation rate, and not yet driving the rise in employment that had been hoped for. Wages pressure is growing via demand but supply is yet to respond.

In Europe and the UK inflation is also the hot topic, with sharply higher gas prices driven by a surge in demand coinciding with supply constraints. This will see inflation approach 4% for the euro-zone in coming months, while UK CPI in September remained above 3%, as petrol prices hit their highest level in eight years. The Bank of England are expected to increase official interest rates as early as next month, with a hike to 0.25% almost completely priced into markets. It's anticipated however that the European Central Bank will be far more cautious in exiting negative interest rates.

The outlook for China's economy is even more complicated. High energy prices are causing power shortages and impacting industrial activity, at the same time as the Chinese economy is decelerating and stress in real estate markets remains elevated. The economic slowdown and challenges for property construction have been driven partly by policy reforms that have 'common prosperity' and environmental themes, including the 'three red lines' policy which exposed the extremely leveraged position of property developer Evergrande. Bond yields for other developers are understandably sky high.

The slowdown in China needs context when considering GDP growth having fallen to 5% year-on-year, from a pace of 8% just a few months ago (refer appendix for a range of data, and associated commodity prices that are impacted by these events). This pace of growth is likely to slow further, with reform prioritised over expansion, but the Evergrande default may well see a policy response that briefly puts further reform measures on hold. In many respects the real estate issues are symptomatic of a broader slowdown, and therefore less import demand from China may be ahead. However, the recent recovery in the price of iron ore suggests this transition should be orderly.

On balance, the global outlook is complicated by the pick-up in inflation, and how central banks deal with the risks this poses as the shortage in traded goods impacts industry. Underlying demand, however, is likely to be very strong as countries emerge from lockdowns. The experience of Singapore is a helpful case study given their high vaccination rates and the strong recovery in their economy, with their Monetary Authority tightening policy last week. So despite rising COVID-19 case numbers as economies reopen, the largest cause for economic optimism is the high effectiveness of vaccines which reduces hospitalisation risks. Higher interest rates are coming, but hopefully with brisk growth, not just with inflation.

Domestic economy

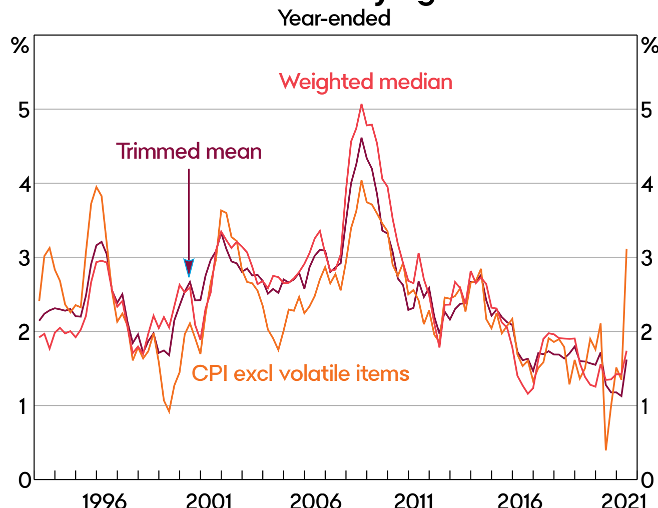
The Reserve Bank of New Zealand's rate hike this month, and its latest inflation report (with CPI up 4.9% year-on-year, and even core inflation running at 4.8%), might suggest the RBA should reconsider the stated timelines from its October monetary policy meeting. At this meeting it said it "will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The central scenario for the economy is that this condition will not be met before 2024." However, the market is increasingly convinced that inflation will be above two percent by mid next year, making a late 2022 rate hike quite plausible.

The next read for the Consumer Price Index and 'core measures' of inflation is Wednesday 27 October and economists have been busy increasing their forecasts for this in the wake of the New Zealand experience. The 'trimmed mean' core measure is now expected to be up 0.5% for Q3, and around 1.9% year on year. This may still only translate to a 2023 RBA rate hike (although November 2022 is fully priced in by the market), however the yield curve has steepened markedly since the NZ rate hike and similar central bank hints from Canada, the US and UK. The RBA is at the back of the rate hike queue, but the queue is now moving along with some momentum.

The RBA may be right in its assertion that Australia will lag on wages growth and on 'non-tradeable' inflation. They could also be correct that some of the rise in tradeable inflation could be temporary, but the resilience in our labour markets (even through NSW, ACT and Victorian lockdowns) should see unemployment fall to near 4% next year, perhaps lower. Like the global outlook, this all comes back to the increase in vaccine rates, with 70% of our adult population now fully vaccinated.

The HomeBuilder incentive scheme and other state government grants have artificially lowered the cost of a new dwelling, but this component (with housing making up almost a quarter of the CPI) should be sharply higher in the months ahead, at least while the property boom continues.

The reopening of the NSW, ACT and Victorian economies is expected to drive a sharp increase in consumer activity, complimenting the healthy retail sales data seen in the rest of Australia. Household wealth has (on balance) been supported by sharply higher residential property prices, strong gains for financial assets and ultra-low interest rates. So, when combined with high levels of savings, household balance sheets are, on average, well stocked up leading into the end of the year.



The immediate unknowns (prior to the medium-term consequences of rate hikes in 2023) include consumer hesitancy about 'living with the virus'; how quickly we can reopen state borders (and international borders); and how well businesses can bounce back from COVID-19 lockdowns. Part of the challenge for businesses (particularly in hospitality) will be access to labour, as well as dealing with supply chain issues, especially for imported goods. A sharp rebound in demand appears imminent, although how effectively businesses can flex up to this demand is harder to anticipate. In Q3, GDP probably contracted around 3.5%, but Q4 should rebound around 1.5% and consensus for 2022 is around 5% growth.

The challenges with China's slowing economy (as detailed in the Global Markets section) add to diversification imperatives for exporters, but this need has been in place for some time. The diplomatic standoff actually gave exporters a heads-up to actively seek alternative markets, with coal an instructive case study (refer chart below). The Aussie Dollar had dipped as these tensions were playing out, but from here it may simply follow commodities higher and the reopening spending trends.

Interest Rate Outlook

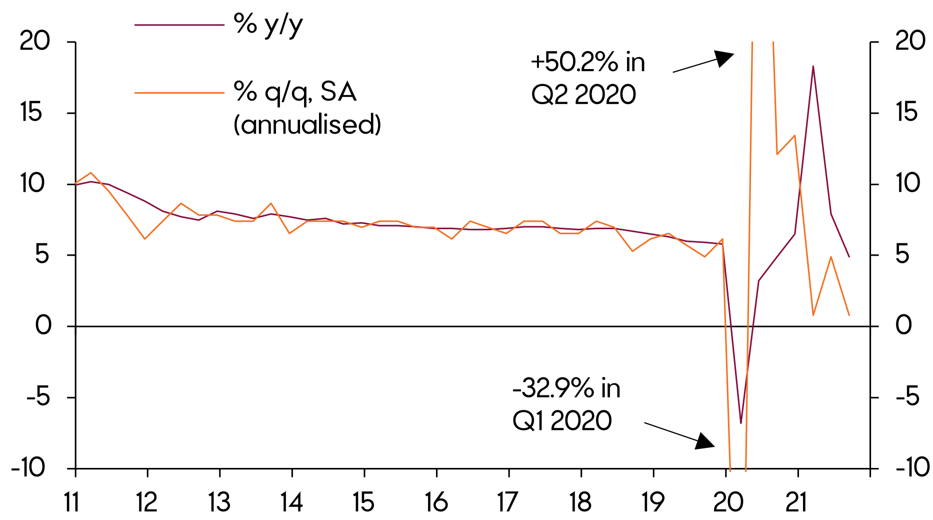
The RBA has reiterated its commitment to supporting the path to 'full employment' and hitting inflation targets, stating it does not expect conditions for any increase to the official rates to be met until 2024.

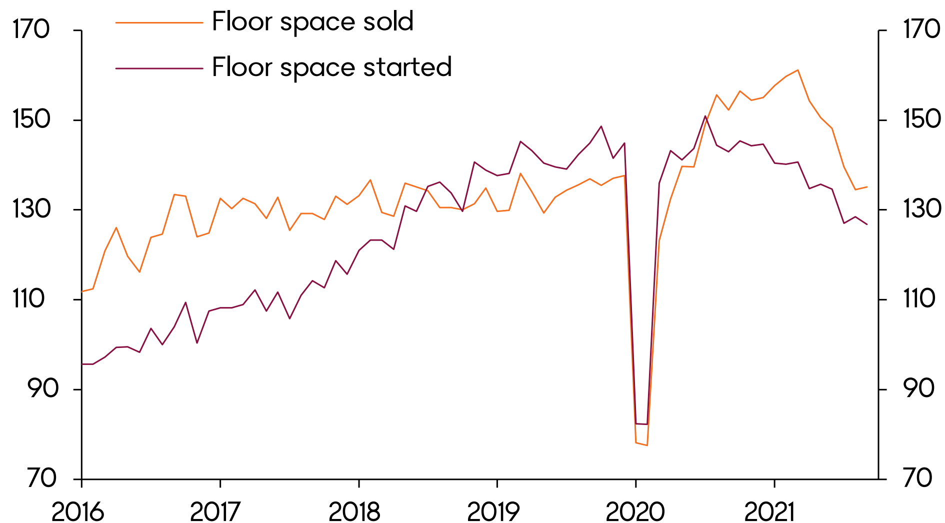
This guidance is based on expectations of slow progress for wages growth, but global trends of rising inflation amid supply chain disruptions and elevated energy prices put this timeline at risk.

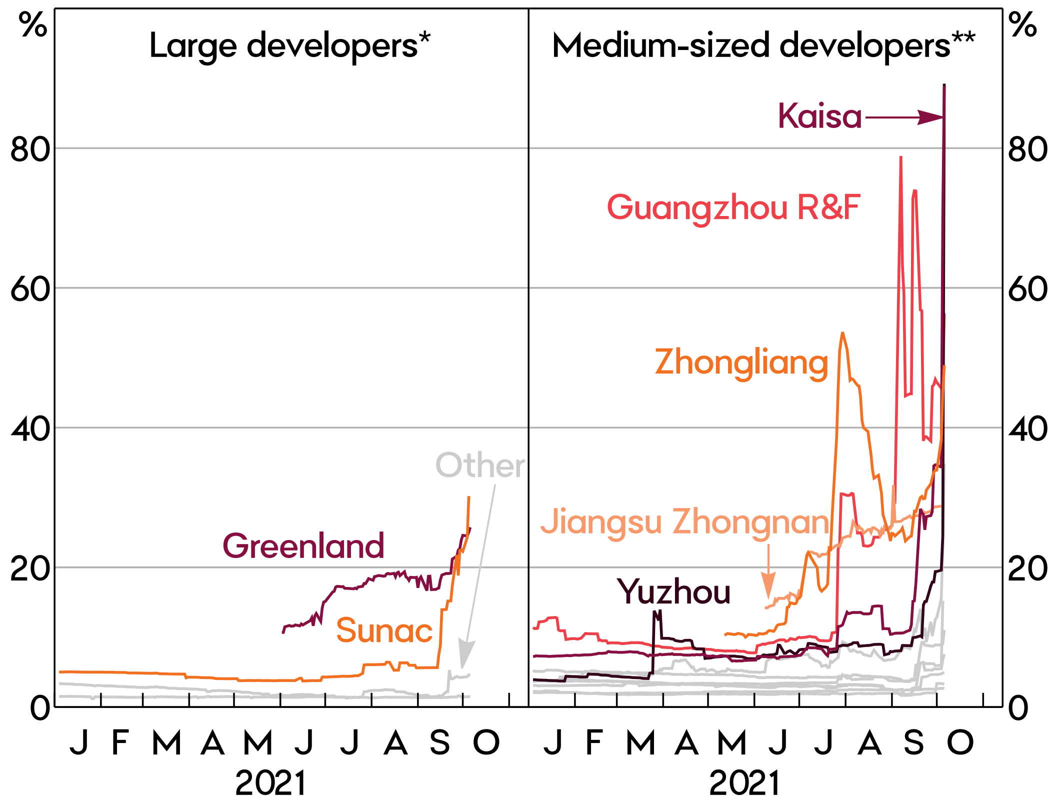
Faster progress for wages growth and/or inflation is increasingly likely, so 2023 hikes should not be ruled out purely as a result of the Reserve Bank's guidance, and late 2022 is also a plausible date.

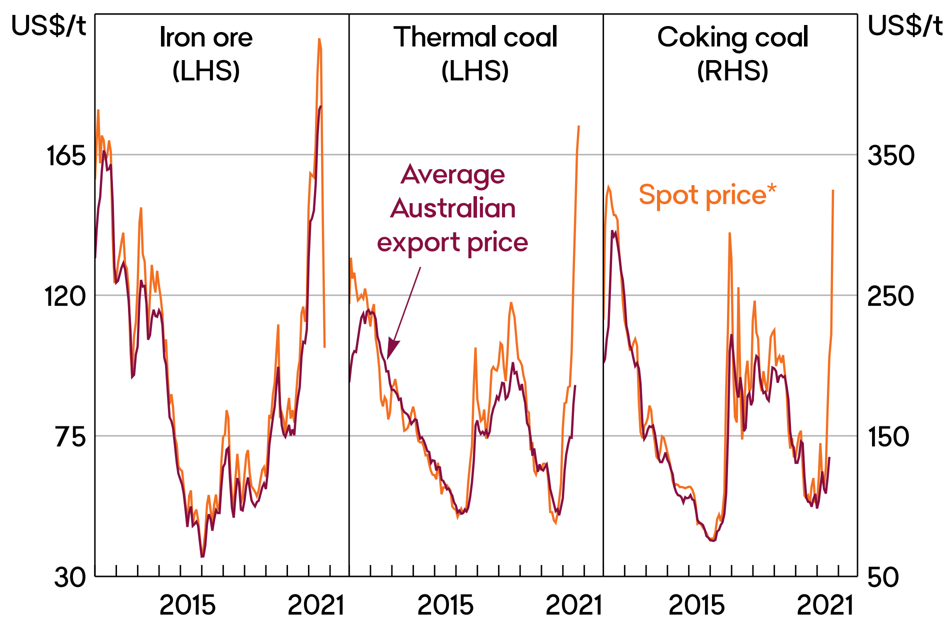
	31 / 08 / 20	31 / 08 / 21	30 / 09 / 21	21 / 10 / 2021
90-day bills	0.09 %	0.01 %	0.02 %	0.04 %
3-year swap	0.19 %	0.43 %	0.55 %	0.92 %
5-year swap	0.42 %	0.79 %	1.03 %	1.39 %
AUD/USD	0.7375	0.7310	0.7225	0.7530
ASX 200	6 061	7 535	7 332	7 430
Credit Index (iTraxx- 5 yr)	65	58.5	66.8	68.0

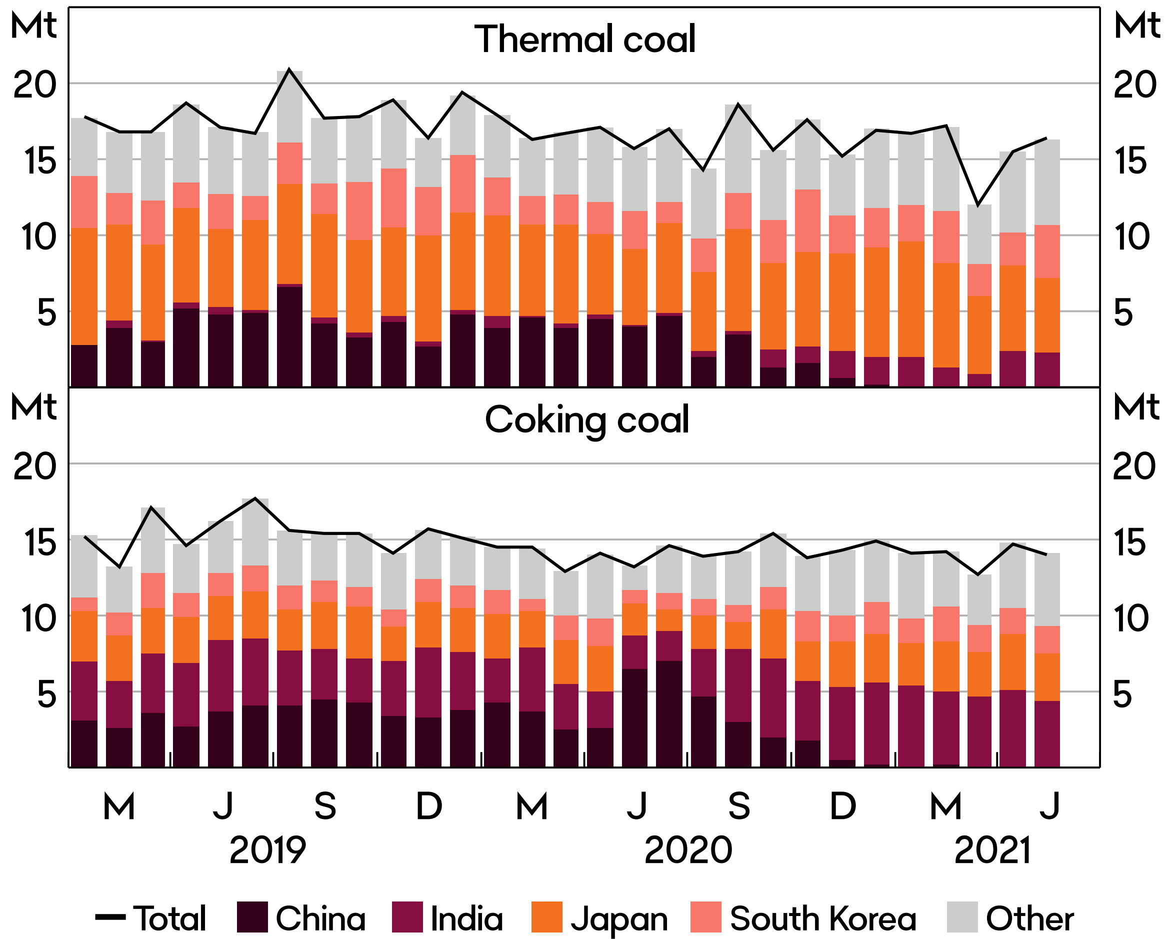
Appendix - Chinese economic data, related commodity prices






Chinese Developer Bond Yields
USD 2022 bonds by developer total liabilites
%
Large developers*
Medium-sized developers**
Kaisa
Guangzhou R&F
Zhongliang
Other
Jiangsu Zhongnan
Greenland
Yuzhou
Sunac
80
60
40
20
0
J F M A M J J A S O
2021
*Developers with liabilities more than CNY 500 billion
**Developers with liabilities of CNY 100-500 billion
Sources: Bloomberg; RBA


Bulk Commodity Prices
Free on board basis
US$/t
Iron ore
(LHS)
Thermal coal
(LHS)
Coking coal
(RHS)
Average
Australian
export price
Spot price*
165
120
75
30
350
250
150
50
2015
2021
*Iron ore 62% Fe Fines Index; Newcastle thermal coal and premium hard coking coal
Sources: ABS; Bloomberg; IHS Markit; RBA



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