WILSONS

The Australian Economy: Room to Grow

Our weekly view on Asset Allocation.

15 March 2021

A New Growth Cycle Emerges

Australia's superior handling of the COVID-19 pandemic allowed the local economy to outperform most of its developed peers in 2020. GDP fell by just over 2% in 2020 compared to a 4% decline in the US and 7% in Europe.

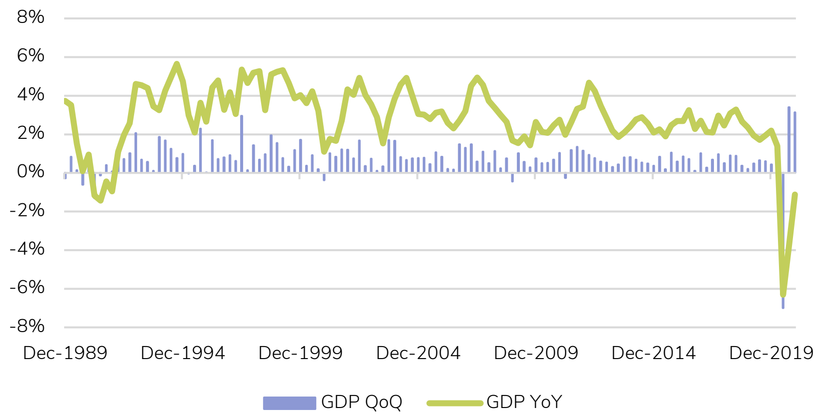
While Australia's relative resilience was impressive, economic activity and the labour market still took a big hit, ending a golden run of 30 years without a recession.

Australian Labour Market - Good progress on the long road back

Australia's GDP is still below pre- COVID levels despite the strong rebound in the second half of 2020. Total employment has recovered to sit less than 1% lower than a year ago (60,000 jobs). In contrast, US employment levels are 6% lower, or almost 10 million jobs. Australia's official unemployment rate is 6.4% compared to 5.1% pre- COVID and an official peak of 7.5% last year.

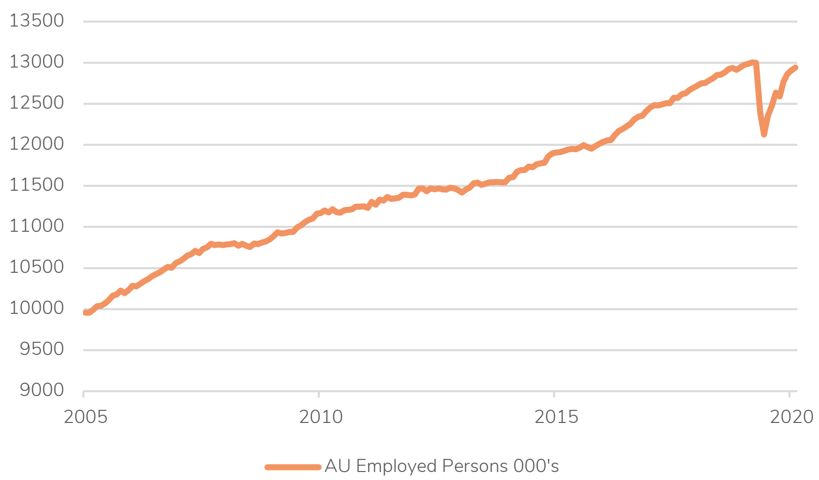
There is still a high level of underemployment, as indicated by hours worked being 5.7% lower than a year ago. Jobkeeper is set to end on March 31, with around 1 million workers still being supported by the payment (the peak was 3.5m). However, there are now only 100,000 workers reporting that they are "employed but working zero hours", so any uptick in the unemployment rate will be moderate. We expect unemployment to trend down toward 5% over the next 18 months as the economy revives.

Exhibit 1: The economy has quickly rebounded after the first recession in 30 years



Source: Refinitiv

Exhibit 2: The labour market has staged an impressive recovery.



Source: Refinitiv.

Budget in "Relatively" Good Shape

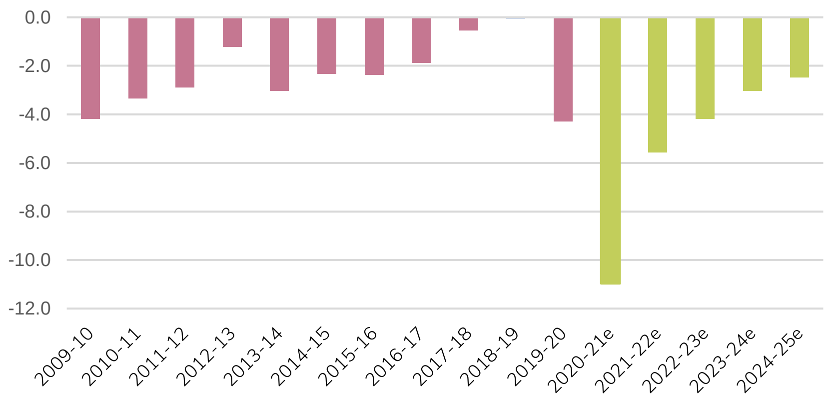
The Federal Budget also deteriorated at an unprecedented pace as huge fiscal support mechanisms were enacted last year. The budget deficit is forecast to be 11% of GDP (FY21) relative to a post-GFC high of just over 4% (in comparison, the US deficit will be close to 20% in CY21). A better than feared economy and surging commodity prices suggest a better than forecast FY21 budget result will be announced in May.

Excess Savings to Support Consumption Rebalancing

A still depressed activity base and plenty of labour market slack suggest ample scope for a growth recovery this year. The growth bounce is unlikely to be as dramatic as in the US and Europe, but real GDP should grow by close to 5% this year (the RBA's forecast looks conservative at 3.5%) which should be very supportive for corporate profits.

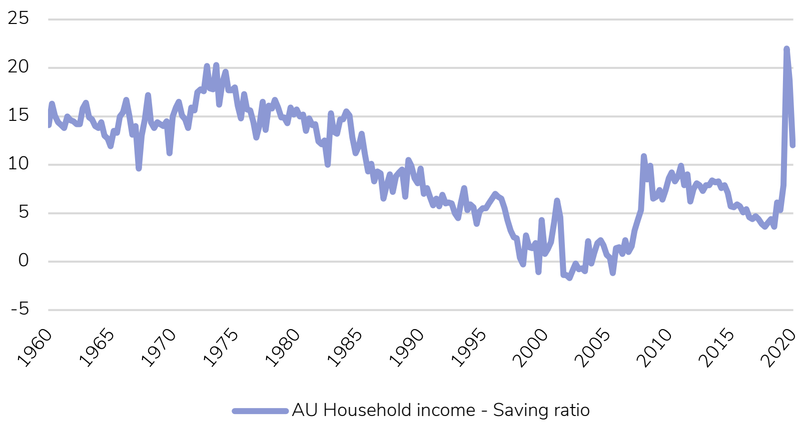
Australia's high domestic savings ratio provides plenty of consumer firepower. This savings drawdown and targeted incremental support measures will offset the March 31 expiry of emergency support measures such as the Jobseeker supplements and Jobkeeper payments. Retail sales experienced a boom in 2020, though overall consumption (retail sales are only one-third of total consumption) was weak. We expect a rebound in services spending over the coming year to drive strong growth in total consumer spending. This services recovery will assist the labour market repair as we move through the year.

Exhibit 3: Deficit spending much larger than post GFC (Deficit to GDP%)



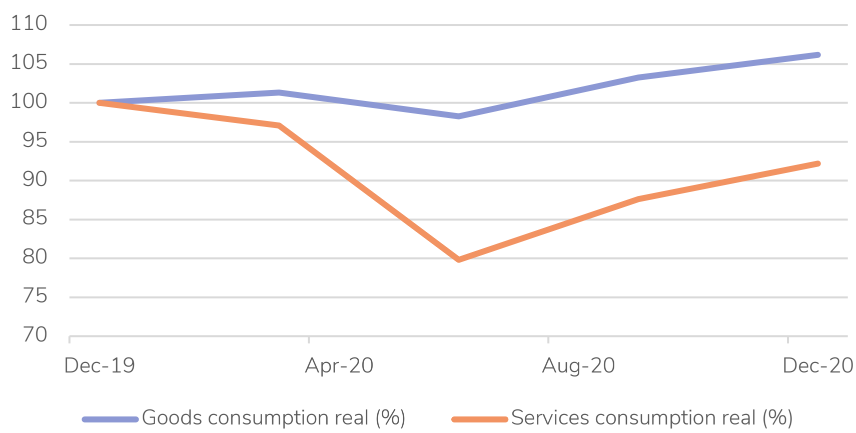
Source: Refinitiv

Exhibit 4: Household Savings Ratio Hit Record Levels last year and has scope to Fall Further



Source: Refinitiv

Exhibit 5: Goods consumption has boomed but services spending remains depressed



Source: Refinitiv

Business Investment Showing Signs of Life After a Long Hibernation.

Recently released private real capex was significantly stronger than expected, rebounding in Q4-20 by 3.0% q/q, after 5 quarterly declines in a row. Business capex intentions were also stronger, implying strong growth of ~+15% – driven by mining (24%). However, non-mining was also strong (12%). The rebound in capex intentions is a positive development and would be welcome news for the RBA and the Government, suggesting the policy stimulus in place is proving effective.

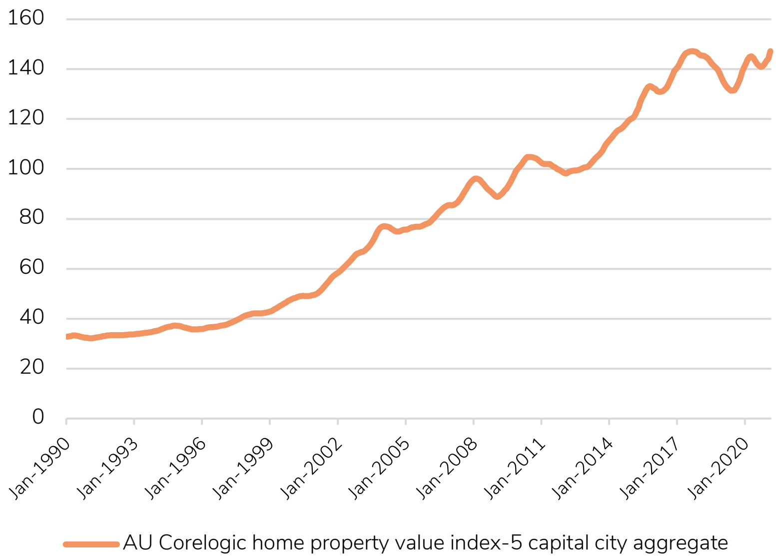
Housing: Fueling the Great Australian Dream

Dwelling investment has also begun to revive again due to low interest rates and a surge in optimism around future house prices. 2021 should be a strong year for residential construction, particularly detached houses. This is interesting in the context of virtually zero net migration in 2020 and 2021. We expect immigration will revive again in 2022. This will likely be needed to absorb the growing stock of dwellings.

The RBA has tried its best to sound relaxed around the recent revival in house prices, though it has flagged the potential return to using "macro-prudential tools" to control the quantity and quality of lending. It remains resolute in its aim to anchor the cash rate at 10 basis points until 2024. The RBA Governor has recently remarked that the recent pick-up in credit growth is still relatively mild, but they are watching developments closely.

Governor Lowe: "There are various tools, other than higher interest rates, to address (housing) concerns, leaving monetary policy to maintain its strong focus on the recovery in the economy, jobs and wages. As part of this focus, we are continuing to pay close attention to lending standards, especially given the combination of low interest rates and rising housing prices. Looser standards would increase medium-term risks and add to the upward pressure on prices, so would be of concern. Reflecting this, the Council of Financial Regulators has indicated that it would consider possible responses should lending standards deteriorate and financial risks increase. We are not at this point, but we are watching carefully."

Exhibit 6: National House Prices Exceeded The Previous 2017 Peak in February



Source: Refinitiv

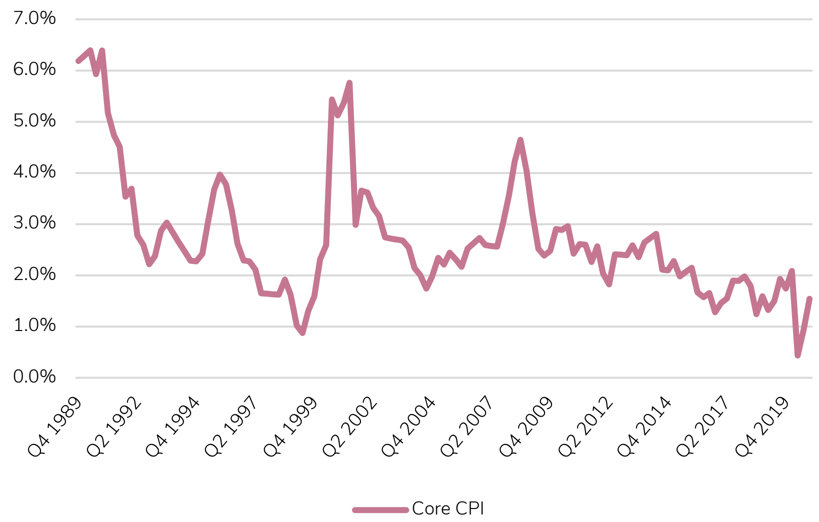
CPI and Wages Inflation Benign

In terms of inflation, the picture still looks benign, and the RBA appears relaxed. Core CPI is a very benign 1.5 %. Wages are also very tame at 1.4% yoy, and the ample slack in the labour market suggests the risk of near term acceleration is low. Like the US Fed, the RBA wants a little more CPI and wage inflation in the mix (ideally backed by improved productivity growth). Indeed the RBA policy mindset has shifted much like the Fed to an explicit dual mandate of 2-3% inflation and full employment, as echoed by Governor Lowe's comments just a few days ago.

"I also want to emphasise that the monetary stimulus is not just about achieving an inflation rate of 2 point something. It is just as much about achieving the maximum possible sustainable level of employment in Australia. Unemployment is a major economic and social problem and the Board places a high priority on a return to full employment. ..There is, inevitably, some uncertainty about exactly what constitutes full employment in our modern economy. Over the past decade, the estimates of the unemployment rate associated with full employment have been repeatedly lowered both here and overseas. But based on this experience, it is certainly possible that Australia can achieve and sustain an unemployment rate in the low 4s, although only time will tell. As we progress towards full employment, we will be relying on the wages and prices data to provide a signal as to how close we are. The current signal is that we are still a long way away from full employment."

- Governor Lowe

Exhibit 7: Inflation remains well below the RBA 2-3% target



Source: Refinitiv

Exhibit 8: Wage growth remains low with plenty of labour market slack

Source: Refinitiv

The RBA's Great Balancing Challenge

These comments reinforce the high threshold for the RBA to move the cash rate. Of course, the other motivation in keeping the cash rate anchored, and a large part of the motivation for introducing Quantitative Easing (QE), is the path of the A$.

The A$ is up 20% over the past 12 months, although it has eased back slightly in recent weeks. The A$ appreciation has eased inflationary pressure though the RBA commented recently that it would likely be "a little lower". Since announcing QE, the A$ has actually risen from 72c to 78c, though the counterfactual is where the A$ might be in the absence of QE given the strength of commodity prices.

Our A$ model suggests the A$ is moderately undervalued based on current commodity prices and interest rate differentials. We still think the A$ has at least moderate upside. We retain an 80c year-end target with an upside risk skew due to our expectation that global growth surprises on the upside and the sheer weight of the US twin deficits weighs on the US$. Upside pressure on the A$ will likely encourage the RBA to extend QE once again and keep talking a dovish story regarding cash rate guidance.

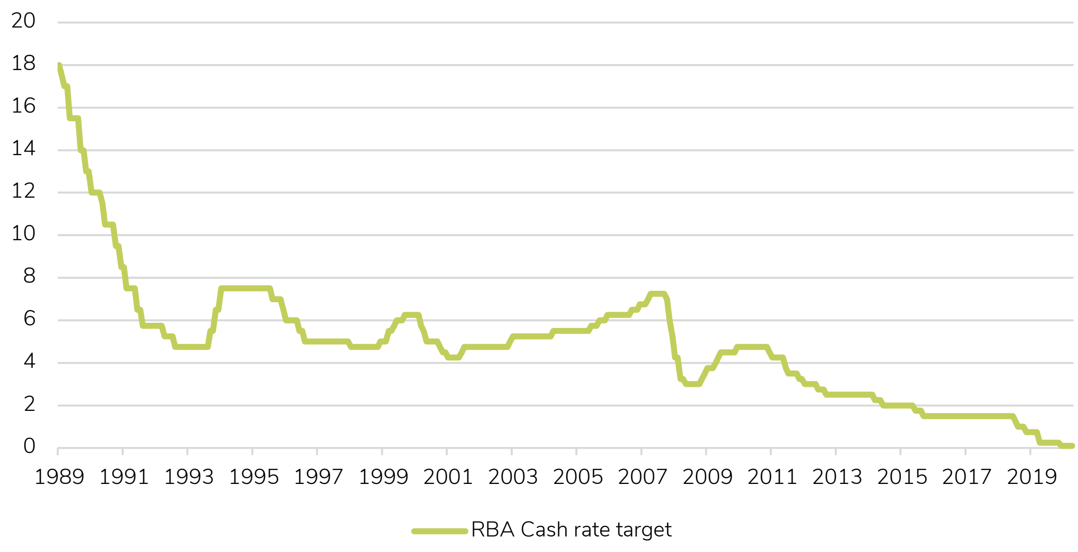
Strong Growth and Zero Rates – Goldilocks Moves to Australia?

In conclusion, the Australian economy has experienced less economic scarring than other economies. It is well placed to accelerate this year, albeit the rebound may not be as spectacular as in some of the deeply depressed economies overseas.

The rolling off of Jobkeeper may cause a blip in the unemployment cycle, but the release of excess household savings into the services sector should push unemployment lower. The apparent revival in business investment is also encouraging. With policy so accommodative, overheating is a long term risk. Still it is likely to be felt first in asset markets (particularly housing) rather than in the real economy, given substantial labour market slack.

The RBA has a difficult balancing act, but its mindset has clearly shifted to pursuing full employment by facilitating a sustained period of strong growth. A strongly growing economy and a near-zero cash rate will likely be Australia's unusual macro backdrop for some time.

Exhibit 9: RBA Continues to Guide to Near Zero Cash rate until 2024



Source: Refinitiv

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