ECONOMIC UPDATE

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WEEK ENDING 10TH SEPTEMBER 2021

BOQ GROUP

Key points

- **The RBA has acknowledged the current weakness in the economy;**
- **They remain positive about the outlook for the next couple of years;**
- **Albeit there is more risk to the outlook than they had previously thought;**
- **The RBA would still be comfortable with their view that interest rates will not rise until H1 2024;**
- **The risks are that the cash rate might need to rise a little earlier (H2 2023);**
- **It is hard to prove but QE does help the economy.**

Summary

Heading into the September meeting the economy in Q3 had weakened substantially more than RBA forecasts had predicted in August. The Statement following the meeting rightly highlighted the considerable momentum the economy had entering the September quarter. It also acknowledged that the economy has subsequently weakened significantly. Their central-case view is that the pause in economic growth will only be temporary (in RBA words, the recovery is delayed not derailed). The recent data also provides some comfort about the medium-term. But the risks to the outlook have increased.

The RBA Statement did not say much on the supply-side of the economy. Understandably given the most immediate economic problem is the impact of the Lockdowns. Previously the RBA has said that it thought that any supply problem (supply-chains problems, skilled labour shortages) would be a short-term worry as economies re-open. But the evidence suggests that a return to full re-opening will take longer than had been anticipated. This creates some demand headaches for the economy. But it also means that supply problems may last longer.

Recent developments would have provided some sustenance to the RBA view that the cash rate would not need to change until the first half of 2024. Financial market economists (including me) believe that the RBA will need to move a little earlier, with the consensus expecting a first rate hike in late 2023. That may reflect a little more optimism about the economic outlook than the RBA. But in my case at least it is the thought that the supply problems will last longer. And this means a greater risk of higher inflation and wages growth than the RBA's current view.

At the time of writing, financial markets are pricing the first rate hike by the end of 2022 with a cash rate of about 0.75% by the time the RBA is thinking about first changing the cash rate (H1 2024). This pricing has the RBA moving at around the same time as the Federal Reserve. At face value this looks a little strange.

Prior to the September meeting there was discussion that the sharp contraction in economic activity would lead the RBA to revert back to its previous pace of weekly buying ($5b) but keep the review date (November). In the event the RBA announced that it would keep the pace of buying at $4b but delay the review until February 2022.

The RBA did not explain why it chose to maintain the slower pace of buying. Most probably it was a vote of confidence in an economic pickup next year. There may have been recognition than most other central banks are looking to slow their bond buying programs. It could be that by delaying the time for review until February the amount of bonds that the RBA is buying would be broadly the same under both options.

Right now the most important issue for the economy is the health outlook. If the medium-term economic outlook is worse than expected fiscal policy should (and almost certainly would) step up. By keeping interest rates as low as possible and ensuring that (sustainable) financing is widely accessible the RBA is doing what it can to help the economic recovery. Undertaking QE provides confidence to investors' that the RBA will do what it can to improve the economic outlook. In turn that makes it more likely that an economic recovery will take place.

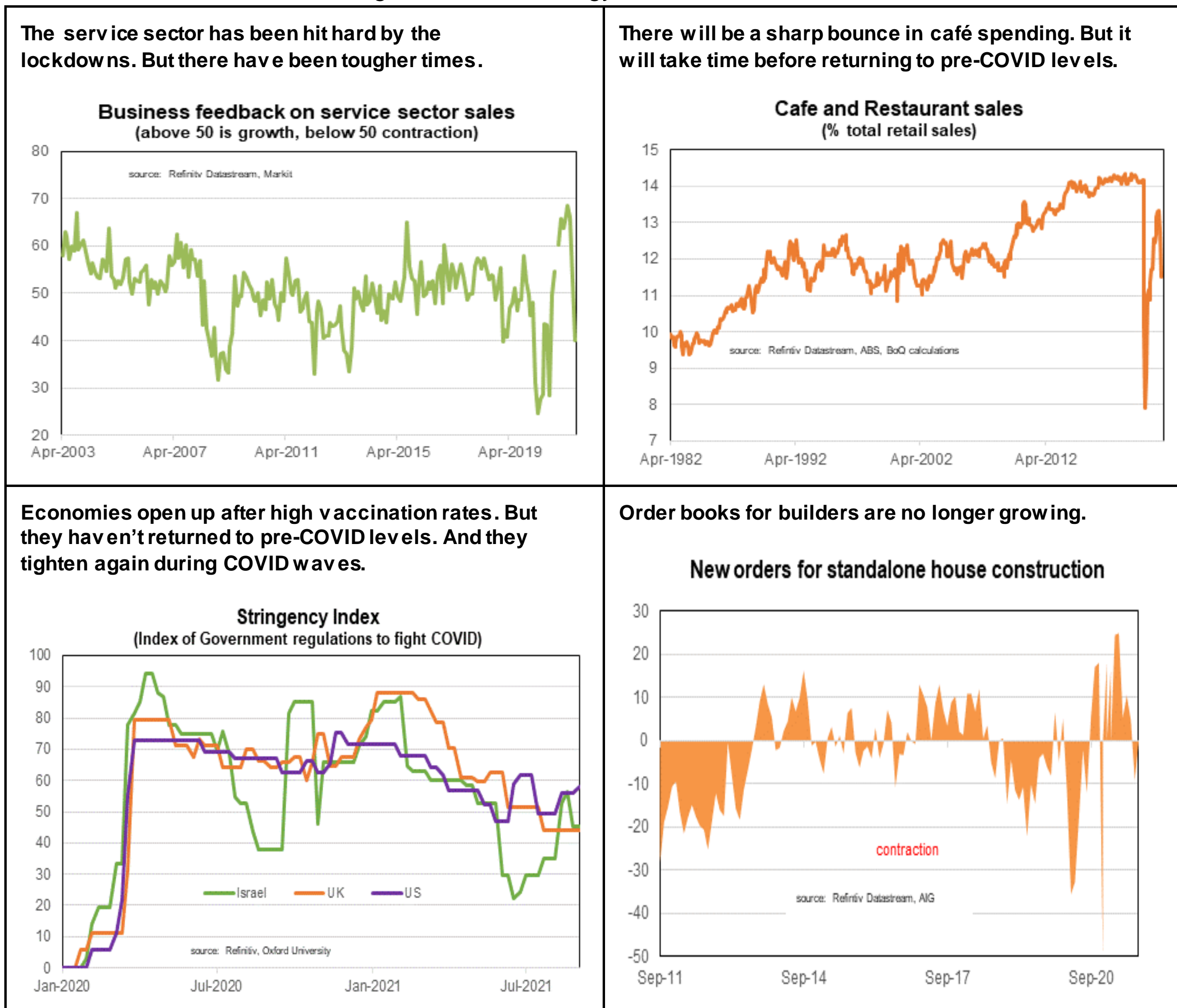
The RBA revised down their near-term economic growth view

A key focus of financial markets is to understand the policies of the central bank (the RBA). One of the main avenues the RBA uses to announce its policies is the statement following their monthly board meeting. More often than not the board meetings are uncontroversial. But not all the time.

Heading into the September meeting financial markets believed that the economy in Q3 had weakened substantially more than RBA forecasts. The Statement following the meeting rightly highlighted the considerable momentum the economy had entering Q3. It also acknowledged the economy has subsequently weakened significantly. Cunningly the RBA did not nominate a number ('GDP is expected to decline materially'). We will probably have to wait until early November with the release of quarterly Statement of Monetary Policy to get their updated forecast. But they did think there would be a rise in the unemployment rate (again no number nominated). And highlighted the divergent economic outcomes (both by region and sector).

Financial market forecasters are not as shy, with expectations ranging from -2% to -4% for Q3 GDP growth. The data released to date does indicate a sharp economic slowing has taken. The national economy is in better shape than Q2 last year as 40% of the economy (the states and territories outside of NSW, Victoria and the ACT) are largely still flying along. Another reason is that parts of the services sector (such as cafes and restaurants) have become better at adapting to working during Lockdowns (better, but conditions are still very difficult).

So the negatives are not as negative. But the positives driving economic growth last year also not as positive. Consumer spending on durables is not as white-hot as last year as households have already stocked up on computer monitors and the set of weights for the home gym.



The service sector has been hit hard by the lockdowns. But there have been tougher times.

There will be a sharp bounce in café spending. But it will take time before returning to pre-COVID levels.

Economies open up after high vaccination rates. But they haven't returned to pre-COVID levels. And they tighten again during COVID waves.

Order books for builders are no longer growing.

Importantly the RBA remains positive on the medium-term outlook

The RBA central-case view is that the pause in economic growth will only be temporary (in their words, the recovery is delayed not derailed). This is in line with much of the domestic and international evidence that a sharp bounce back spending takes place once cases decline and restrictions ease. The biggest beneficiary of an economic re-opening will be the service sector. Surveys point to travel as being high on many households 'to-do' list.

The recent data has also provided some comfort about the medium-term outlook. Firms are still planning on having decent-sized capex budgets this year (notably for purchasing new equipment). While there has been a fall, the level of job ads remains high and consistent with a low unemployment rate. Surveys indicate that consumers' (particularly in NSW, Victoria and the ACT) are worried about the 'here-and-now'. But they are still positive about where the economy will be in a few years' time.

As with most forecasters the RBA is expecting sunnier days ahead for the economy. But with a greater chance of clouds (and possible storms). It is becoming increasingly clear that COVID will be with us for some time. Increasing vaccination rates should mean that the impact on the economy should lessen over time. But after the past 18 months it will take time before society fully adjusts.

In the meantime the overseas evidence is that consumer and business confidence takes a hit when another virus wave hits. In the US less people are going to the movies than they did pre-COVID. The number of people getting on a plane is lower (notably for business travel). And concerns about the virus has seen many Governments' both retain a higher level of restrictions than they did pre-COVID and raise restrictions when the virus wave looks to be getting too high.

A final concern (not highlighted by the RBA) is that the global economy has slowed a little over the past couple of months. Many forecasters have downgraded their World economic forecast for this year. Of most concern is the apparent rapid slowing of activity in China although there have been some loss of momentum in other major economic regions.

The risk of a weaker economy next year has increased. But the RBA is right that the most likely outcome will be stronger growth next year. There are signs that the Chinese Government is looking to stimulate its economy. A lower unemployment rate, rising wages and a big saving buffer should see consumers spending next year. There is plenty of infrastructure spending still to happen. Interest rates will remain low. And a Government facing a tough election will not want to see a soft economy.

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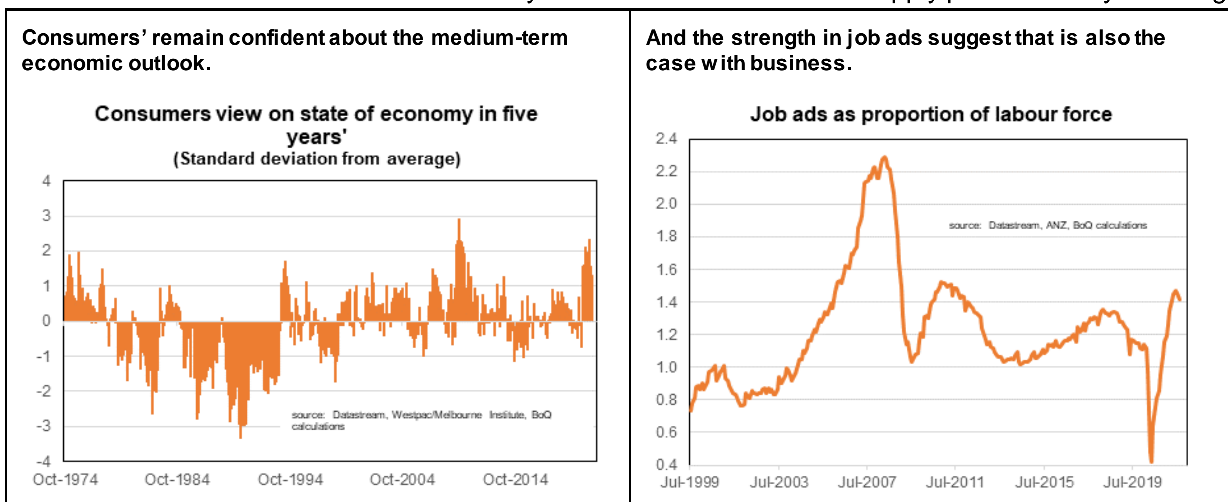
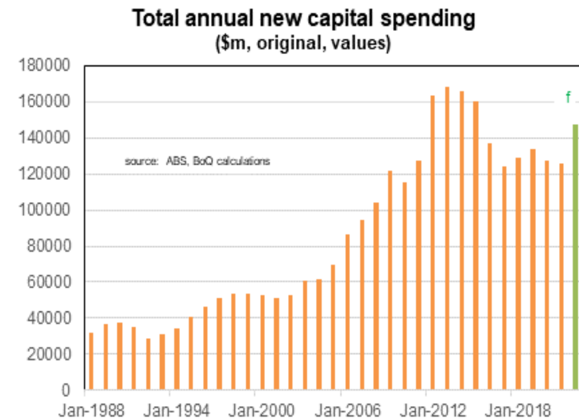


Higher capex also suggest firms have confidence about the outlook.



There has been a notable slowing of the Chinese economy this year.

Impact on cash rate outlook

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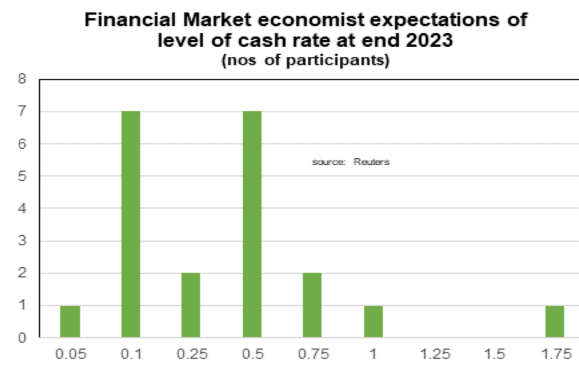
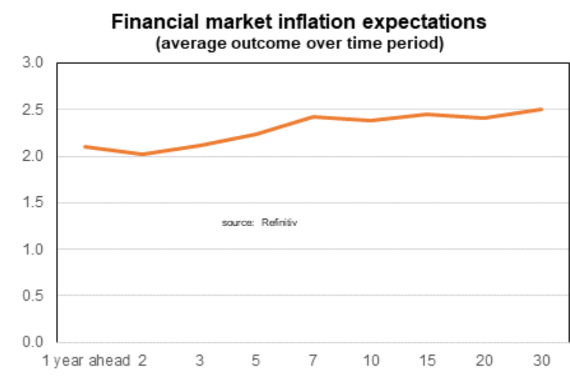
At the time of writing, financial markets are pricing the first rate hike by the end of 2022 with a cash rate of about 0.75% by the time the RBA is thinking about first changing the cash rate (H1 2024). This pricing has the RBA moving at around the same time as the Federal Reserve. At face value this looks a little strange. Higher vaccination rates means the US economy is more open. The Federal Reserve believes that they have already hit their inflation target (although are some distance from hitting their jobs market target). But the Australian economy is months away from being as open as it was back in June. And it has still got some way to go before meeting its labour market target (an unemployment rate of 4%) and inflation (and wage growth) targets.

The RBA included a sentence in their post-meeting statement noting how far inflation and wages growth are from their objectives. The message that sends is that a rate hike is well off into the distance. I don't think that financial markets have quite got the (publically-communicated) RBA reaction function right. My calculations suggest that financial markets expect inflation to be averaging in the 'low 2's' over the next few years. If that is the case I think it unlikely that the RBA would be raising interest rates.

Most economists expect at least one rate hike by end-2023.



Financial Markets are pricing inflation to remain in the 'low 2's'.



The big decision was QE

No one expected the RBA to change their tune about interest rates. Financial markets did expect an update about Quantitative Easing (QE). As a reminder QE is the RBA buying Federal and State Government bonds with an aim to drive down longer-term interest rates (5- to 10-year) to support the economy.

In October 2020 the RBA announced that it would buy $5b of Federal and State Government bonds each week, for a total of $100b. They stated in February 2021 they would buy another $100b of bonds at the same weekly pace. In July the RBA said that they would (modestly) slow the weekly purchases to $4b per week from September, with the pace of buying to be reviewed in November. Importantly, they placed no limit on how many bonds they would be buying. The slower pace of buying was in recognition of the improved economic outlook. And the shift by other global central banks to slow (or stop) their QE programs.

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The RBA did not explain why it chose to maintain the slower pace of buying. Most probably it was a vote of confidence in an economic pickup next year. There would have also been recognition than most other central banks are looking to slow their bond buying programs. Also by delaying the time for review until February the amount of bonds that the RBA would be buying would probably be broadly the same under both options. More light might be shed on this topic in a forthcoming speech by the RBA Governor.

Does QE matter

Does all the fuss in the financial markets about whether the RBA buys $1b more or less matter. Sure, in any market a buyer with a big chequebook often impacts the price. How much of an impact depends upon how large the buying is relative to supply (of bonds). In their research the RBA found that their bond-buying program reduced longer-term interest rates by around 0.3 percentage point (with a slightly bigger fall in state government bond yields).

This is consistent with the evidence that RBA buying has influenced investment flows. In the March quarter 2021 RBA buying was greater than the amount of Federal Government bonds issued. Overseas investors (and banks) were net sellers of federal government bonds, and pension funds slowed the amount they were buying. The lower level of interest rates saw pension funds reduce investments in deposits and short-term debt. Instead, they beefed up their portfolio of loans, domestic and overseas equities and corporate and overseas bonds to achieve higher returns.

But as the great Yoggi Berra said, 'In theory there is no difference between theory and practice. In practice there is'". A lot of people (including the RBA) have noted that when the central bank first announces a QE program the financial market reaction is what you would expect (lower interest rates and a weaker currency). But the reaction is not as strong in in subsequent QE announcements.

This is put down to financial markets being forward looking. Subsequent central banks announcements were 'already in the price' as investors' had been expecting more than one QE announcement. This is a reasonable argument but difficult to prove. There is no transparent price for what financial markets are thinking about future QE buying. Or for that matter the size of expected supply of governments bonds (economist views' are used as a rough proxy).

But the bigger difficulty is that the buying and selling of bonds is only factor that determines the level of interest rates. Investor views about the financial market outlook ('risk appetite) is one driver. Even more important is changing views about the economy. RBA research suggested that the QE announcement in October 2020 led to a narrowing in the Australian-US 10-year interest rate 'spread'. But changes in the spread were also heavily influenced by changes in the tone of Australian and US economic data. Shifts in the Chinese economic data had some impact upon the $A (China heavily influences commodity prices). The aim of the RBA undertaking QE is to

boost confidence in the economic outlook. So if they achieve that aim a QE program could actually result in higher interest rates (and $A).

RBA buying has changed investment flows in financial markets.

Federal Government issuance and buyers in March quarter 2021
($m)

source: ABS

Fed Govt issuance | RBA buy | RoW Buy | Banks Buy | Pension Funds Buy

Low interest rates and more confidence about the economy saw pension funds look for assets providing higher yields.

Selected pension fund investment flows in March quarter 2021
($m)

source: ABS

RoW equity | Non Money Market funds ; | Money market funds ; | Bank equities | Company equities | Loans | RoW Bonds | Bank bonds | Short-term debt | Deposits

Changes in the tone of Chinese economic data have influenced the $A.

Chinese economic surprises and $A TWI

Economic surprise index (LHS)
Aud TWI (RHS)

source: Refinitiv Datastream, Citi, RBA, BoQ calculations

Just as changes in the relative strength of economic data has influenced the difference between Australian and US interest rates.

Australia-US 10-year interest differential and difference in economic data surprises

Data surprises (index, LHS)
AUD-US interest rate diff

source: Refinitiv Datastream, Citi, RBA, BoQ calculations

Right now the most important issue for the economy is the health outlook. Focus will be on speed of the vaccination rates and whether the virus evolves. Also important is the timing of government decisions on when to relax restrictions. As will be Government, consumer and business reactions to any (likely) further virus outbreaks.

If the medium-term outlook is worse than expected then fiscal policy should (and almost certainly would) step up. What the RBA does still matters. By keeping interest rates as low as possible and ensuring that (sustainable) financing is widely accessible the RBA is doing what it can to help the economic recovery. And by providing confidence to investors' that they will do whatever it can improves confidence in the economic outlook. In turn that makes it more likely that an economic recovery will take place.

We live in interesting times.
Regards
Peter Munckton
Chief Economist
Bank of Queensland