ECONOMIC UPDATE

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WEEK ENDING 17TH SEPTEMBER 2021

Key points

- **The September quarter will be a tough one for the economy;**
- **But it may not be as bad as some fear;**
- **There are good reasons for optimism about next year;**
- **This assumes better outcomes on the health front;**
- **Rising vaccination rates makes this better outcome more likely.**

Summary

It is no surprise that with all the dismal news business confidence was very weak in August. Firms indicated that conditions were above average in August. The weakness of business confidence is impacting firms' decisions. Capex plans are lower than what they were expected in June (although budgets are at a reasonable level). There was a drop in employment intentions (although they are still high). Pricing pressures remain elevated.

Conditions differ between regions and sectors. NSW and Victorian firms are finding the going toughest. Those in WA, SA and Tasmania are having a better time. Firms that have business models that involve a large number of people (transport, recreation and accommodation and food services) are more negatively influenced by COVID. Mining is less impacted and is helped by the high level of commodity prices.

Consumers agree with firms that conditions worsened in Q3. Concern about the state of the economy is one reason they are saying they are not spending (another is that they can't spend given that most shops in Sydney and Melbourne are shut). But when you ask households about the state of their own finances they are more optimistic. And like firms households remain optimistic about the future. One reason for the ongoing optimism of households is how they are feeling about the labour market. Unemployment concerns are below average across all states.

One thing that households have got more pessimistic about is buying a house. This reflects rising affordability concerns due to the sharp rise in house prices over the past year. Affordability worries is the reason why there is a declining share of home loans taken out by first-home buyers. But the rise in house prices (and an increase in rents) has attracted investors back to the residential market. This coincides with an uptick in the proportion of households nominating housing as a good investment.

The August employment data was weak. There was a big fall in the number of jobs, a rise in the underutilisation rate, a substantial decline in hours worked and a large drop in the participation rate. In short, there was a lot less work done in August.

But the month of August was almost certainly the low point in economic activity. The pace of vaccination means that NSW is on track to re-opening parts of the economy in early- to mid-October. The ACT will also likely reduce restrictions in that month. Victoria will take longer but should be re-opening by December. This means that GDP growth could be up in the order of +2% in Q4. This could prove optimistic if rising case numbers following re-opening (which has happened in other countries) leads to renewed government restrictions or an increase in consumer and business risk aversion.

The bottom line is that Q3 has been a difficult for one for society and the economy (notably in NSW, Victoria and the ACT). Economic growth will decline in the September quarter. But maybe not as much as some fear. Business and consumer optimism about the economy in 2022 and beyond remains generally positive. With interest rates set to remain at rock-bottom levels and fiscal policy supportive there are good reasons to believe that the economy will end 2022 in a better state than it will be at the end of this year. Obviously luck with the health outcomes will be required. But a dramatically improved vaccination effort means there should be more optimism on that front.

Bad, but not that bad

At the start of the month the prevailing commentary on the Australian economy was pessimism. Sentiment about the Australian economy has since improved. The Q2 GDP number was above consensus. And would have been even stronger without supply-chain constraints or skilled labour shortages. The NSW Government announced roadmap means that the Sydney population will face less restrictions in Q4 (how much less will depend upon the number of new cases). And while the new virus numbers from Melbourne have been on the rise in recent weeks, rising vaccination rates and reduced mobility should see restrictions eased before year-end. The bounce-back in activity when restrictions end will make it virtually impossible for there to be negative GDP growth in Q4.

There is no doubt that the data released to date points to a substantial fall of GDP in Q3. But the decline may not be as sharp as some of the more pessimistic forecasts (ie, -4% or worse). This view was supported by the data released over the past week.

Business Confidence

It is no surprise that with all the dismal news business confidence was very weak in August. Confidence is higher than it was during the depths of last year (and during the GFC). There was even some improvement in August! But confidence is not necessarily the same thing as business activity. Indeed, firms indicated that not only were conditions above average in August but they actually had improved a little from July. One of the reasons was that they experienced a jump in new orders in August. This helped boost profitability.

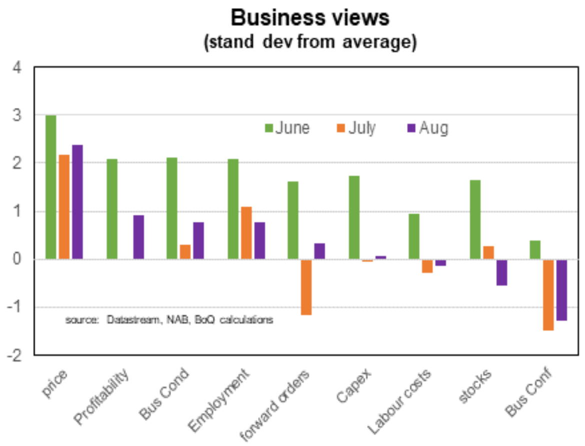
The weakness of business confidence is impacting business decisions. Firms indicated they want to reduce investment in stock despite a low inventory-to-sales ratio in a number of sectors. Capex plans are lower than what they were expected to be in June although capex budgets remain at a reasonable level. And while there was a drop in employment intentions they are still high. This is consistent with the job ads and vacancy numbers.

One of the things that has not changed is that pricing pressures remain elevated. In places such as WA this might partly reflect strong demand. But in the main it is a result of the substantial supply-chain problems that are evident both domestically and globally. These supply-chain constraints are likely to be around until the global economy is fully re-opened. That is likely to be at least 6-18 months away.

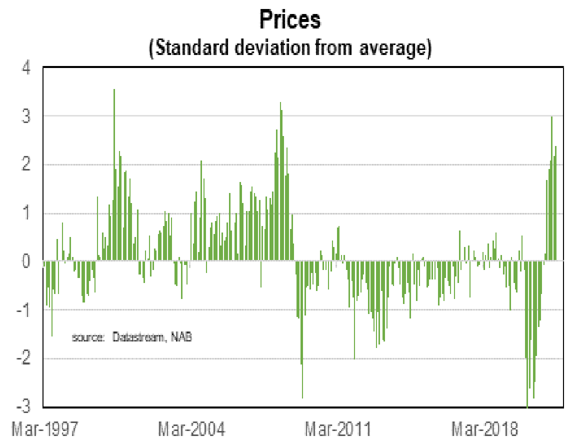
Understandably, conditions differ between regions and sectors. NSW and Victorian firms are finding the going toughest. Those in WA, SA and Tasmania are having a better time. Firms that have business models involving large number of people (transport, recreation and accommodation and food services) are more negatively influenced by COVID. Mining is less impacted, and is helped by the high level of commodity prices. Retail is not doing as well as last year when consumers purchased a large number of durable items. The shutdown in Sydney and capacity limits have impacted the construction sector.

In summary, August was a tough month for many firms. WA miners are doing well, Sydney CBD gyms (and the airlines) are not. But firms did report above average conditions and profitability in August. And that employment intentions and capex spending are both still at decent levels indicates that firms' still have confidence about the outlook for 2022.

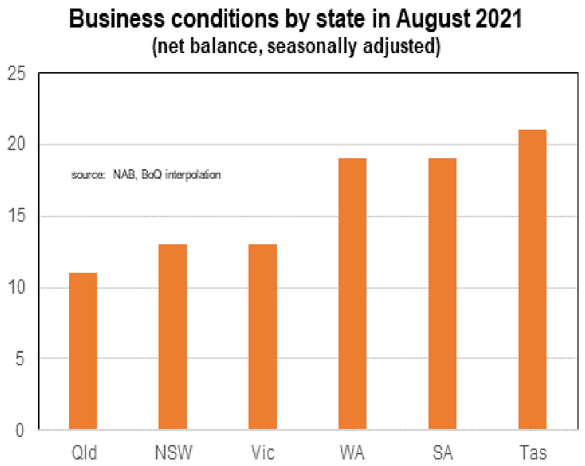
Firms' confidence is currently low. But they report that conditions are Ok. And they are still investing for the future.



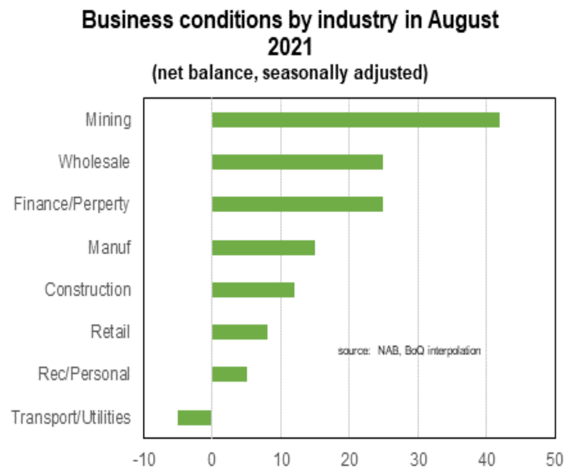
There is plenty of pricing pressure still in the pipeline.



Firms report the weakest conditions are in the three Eastern States.



Mining is doing fine. But Recreation and Transport sectors are having a tougher time.



Consumer confidence

Consumers agree with firms that conditions worsened in Q3. Concern about the state of the economy is one reason they are saying they are not spending. Another is that they can't spend given that most shops in Sydney and Melbourne are shut.

But when you ask households about the state of their own finances they are more optimistic (and increasingly so since June). This probably reflects the impact of government income support programs. And like firms households remain optimistic about the future. Sure they have (modestly) marked down their view of the economy next year (and with some justification). But they remain very bullish about where the economy will be in five years' time. And that optimism about the medium term has not changed over the course of the current lockdowns.

One reason for the ongoing optimism of households is how they are feeling about the labour market. Unemployment concerns are below average across all states. And they have substantially reduced in NSW, Qld and Tasmania. Optimism of households about getting a job is consistent with the very strong level of job ads and the hiring intentions of firms.

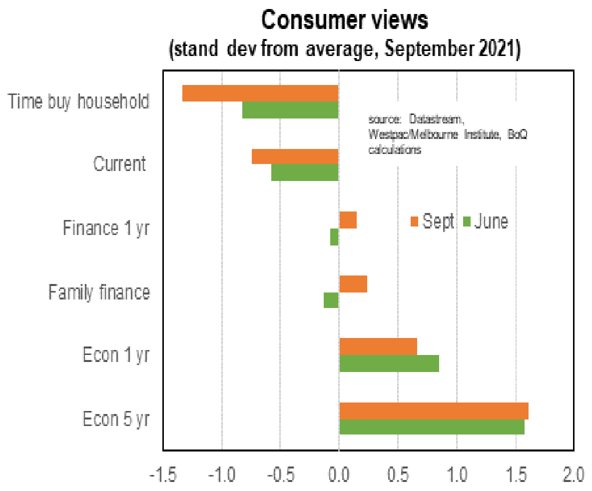
Sentiment is strongest amongst households in the 25-44 age bracket, although only about average in younger and older households. Younger households are more likely to be directly impacted by lockdowns (they are more likely to work in sectors most impacted by lockdowns, there is no in-person teaching at universities, clubs and pubs are largely shut in Sydney and Melbourne). Older households' face higher health risks from COVID.

One thing that households have got more pessimistic about is buying a house. This reflects rising affordability concerns due to the sharp rise in house prices over the past year. This concern is prevalent across all states, albeit less so in SA and WA. Affordability worries is the reason why there is a declining share of home loans taken out by first-home buyers.

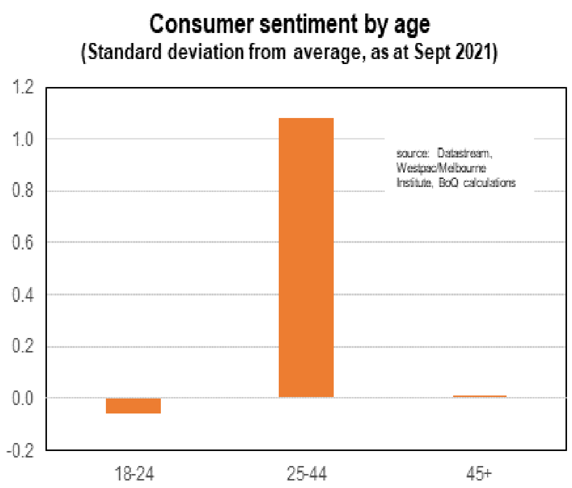
But the rise in house prices (and an increase in rents) has attracted investors back to the residential market. This coincides with an uptick in the proportion of households nominating housing as a good investment. That proportion is low by the standard of the past forty years.

Low interest rates has seen more households attracted to equities and Super (and a growing interest in bonds). The low level of interest rates has seen the proportion of households nominating deposits or paying off debt to be a bit below the average level of the past fifteen years.

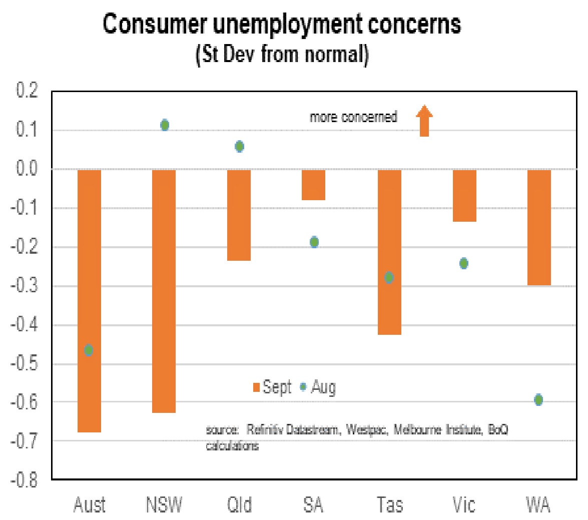
Consumers are worried about current conditions. But their own finances are Ok. And they are optimistic about the future.



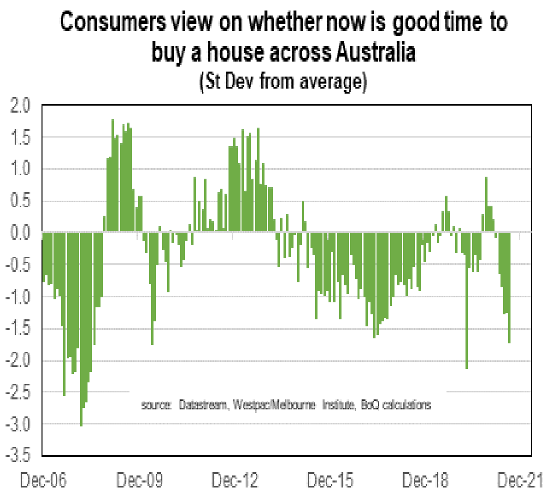
Younger and older households are less likely to see the glass-half full.



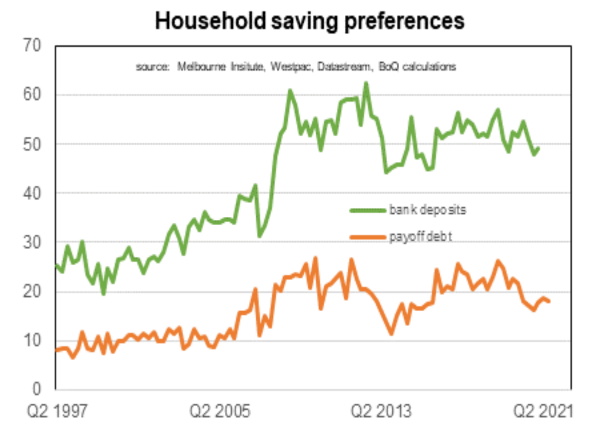
Households across all states think that the jobs market is in good shape.



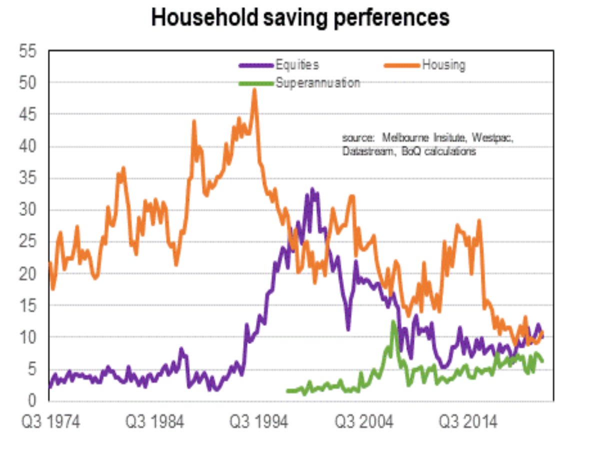
But households report greater caution about buying a house.



Very low interest rates has meant less households are putting their money into the bank or paying off debt.



It has seen more saving flow into equities and Super.



Employment

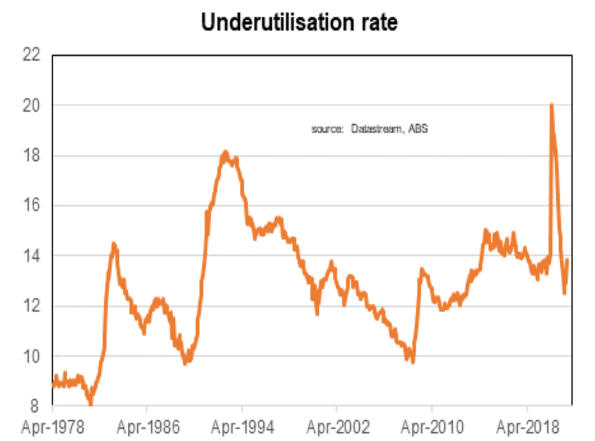
And then we come to the August employment data. In my view it was a weak number. The 'good' news was the unemployment rate fell. But that was completely misleading. There was a big fall in the number of jobs (over 140,000), a rise in the underutilisation rate (because more people were working fewer hours than they wanted), a substantial decline in hours worked (notably in NSW) and a large drop in the participation rate. In short, there was a lot less work done in August.

But the month of August was almost certainly the low point in economic activity. At some stage in August, all of NSW, Victoria, South East Queensland and the ACT were in lockdown. Only Sydney was in lockdown for much of July. Queensland will (hopefully) be open for all of September, as will parts of regional NSW and Victoria. So assuming the current outbreaks don't spread outside of NSW, Victoria and the ACT (admittedly a big assumption) there should be a rise in hours worked in September.

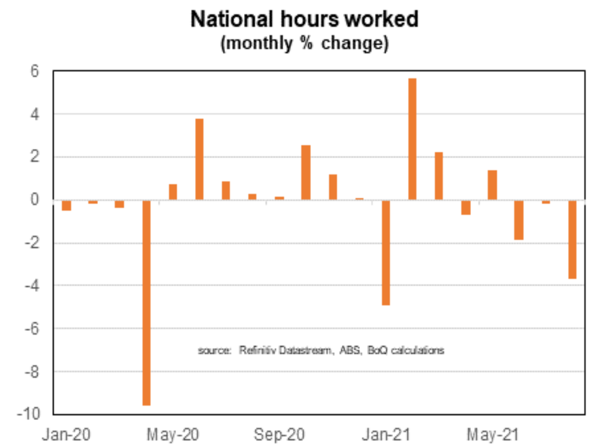
And things should only get better from there. The pace of vaccination means that NSW is on track to re-opening parts of the economy in early- to mid-October. The ACT will also likely reduce restrictions in that month. Victoria will take longer but should be re-opening by December. This means that GDP growth could be in the order of +2% in Q4. This could prove optimistic if rising case numbers following re-opening (which has happened in other countries) leads to either renewed government restrictions or an increase in consumer and business risk aversion.

A lot of people that lost a job in August left the labour force.

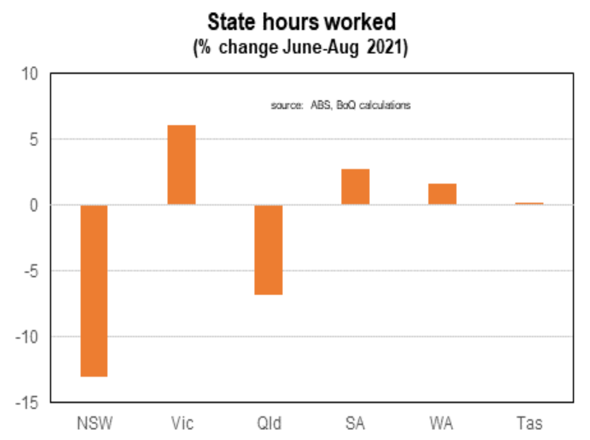
There was also a substantial rise in the proportion of employees working less hours than they want.



This meant that there was a big drop in the amount of work done in August.



The fall in hours worked has been dramatic in NSW and Qld. Hours worked in Victoria fell in Aug.



The bottom line is that Q3 has been a difficult for one for society and the economy (notably in NSW, Victoria and the ACT). Economic growth will decline in the September quarter but maybe not as much as some fear. Business and consumer optimism about the economy in 2022 and beyond remains generally positive. With interest rates set to remain at rock-bottom levels and fiscal policy supportive there are good reasons to believe that the economy will end 2022 in a better state than it will at the end of this year. Obviously luck with the health outcomes will be required. But a dramatically improved vaccination effort means there is also optimism on that front.

We live in interesting times.

Regards

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