ECONOMIC UPDATE
PETER MUNCKTON – CHIEF ECONOMIST
WEEK ENDING 22ND OCTOBER 2021

BOQ GROUP

Key points

- **The September quarter was tough for firms;**
- **Although COVID will be with us for a while yet there are good reasons to think that 2022 will be a better one for the economy;**
- **An increasing number of firms are nominating supply chains and worker shortages as problems;**
- **Supply-chain problems are likely to be an issue for the next 6-12 months. Worker shortages potentially longer.**

Summary

The September quarter was a tough one for firms. Business (and consumer) confidence was down. But it did not sink to the lows of 2020. Order books filled up in line with firms' expectations despite the lockdowns. The bigger issue was trying to fill customer orders. The most significant constraint was government restrictions. But supply-chain problems (materials) and skill shortages (labour) were key problems. The supply-chain problems created higher input prices and provided headaches for firms to meet deadlines. The tight jobs market led to more firms reporting rising unit labour costs.

The strong level of orders during a tough economic period bodes well for a decent economic bounce-back. Order books are only likely to get bigger with Sydney, Melbourne and Canberra opening up. Capex budgets look likely to grow.

Many areas of construction should feel confident about next year. In the residential sector, there have been a huge amount of orders for standalone homes. Confidence about sales of apartments is OK, in line with industry feedback that orders for unit developments is rising. Government incentives, time spent at home and plenty of saving has meant that households are making a few alterations and additions to their family home. The industry reports strong sales of engineering projects (mining, infrastructure, renewable energy).

Like in many industries the big increase in demand for residential construction has come at the same time as there has been supply-chain problems and a lack of skilled workers. This means higher prices. But it also means that the time to complete many building projects will be delayed.

The services sector has been hardest hit by the pandemic. There was a sharp decline in orders as lockdowns hit Melbourne (in June and then July) and Sydney (in July). There is evidence of a snapback in spending as restrictions have been eased. Firms' confidence about the future can be gauged by their employment intentions remaining positive throughout the tough September quarter. The other positive is that many firms have been able to pass on some of the rise in costs onto consumers.

Consumers' have started to note the rise in prices. Household inflation expectations are at their highest level in over seven years. Most likely they think these price rises will be temporary. The longer the price rises remain high the more likely that consumers' (and businesses) will expect them to remain high.

Rising vaccination rates will mean lockdowns will become less of a risk going forward. But some government restrictions will likely be in place for some time yet. And consumer confidence will depend upon the path of the virus. Despite the weaker economy firms' remain very concerned about supply chains. That is likely to remain an issue for the next 6-12 months until the global economy fully re-opens. The lack of skilled workers is likely to be a constraint for longer, at least until the immigration program returns to its previous strength.

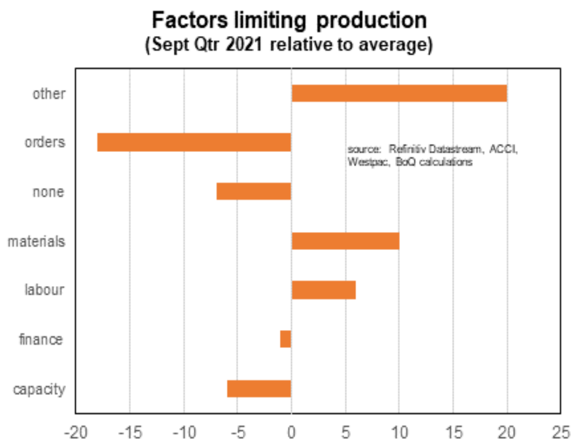
September quarter was tough for many firms

The September quarter was a tough one for business, notably those that have most of their customers and employees in Sydney, Melbourne or Canberra. We won't get the 'official' read of how the economy went in Q3 until early December. But surveys provide us with a pretty good steer on what the ABS numbers will say.

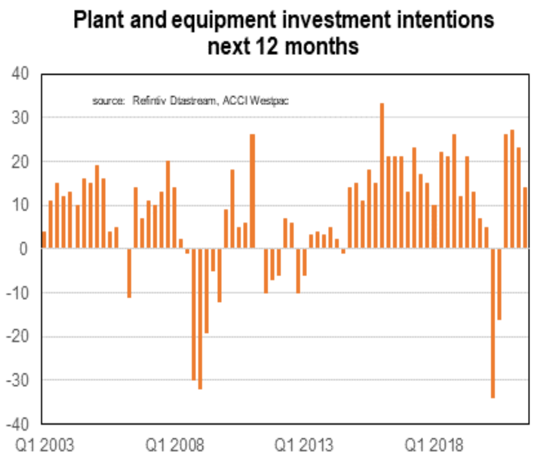
Business and consumer confidence was down. But it did not sink to the lows of 2020. Part of the reason is that more is now known about COVID, there is less fear of the unknown. It also reflected confidence in the strong health outcomes that have been achieved in Australia. The economy also performed pretty decently. The ACCI/Westpac survey business survey (respondents are mainly manufacturers) indicated that order books filled up in line with firms' expectations despite the lockdowns. The proportion of firms nominating a lack of orders as a major drawback was comfortably below average.

The bigger issues for many manufacturers was trying to fill customer orders. The most significant constraint was 'other' (government restrictions associated with COVID). But supply-chain problems (materials) and skill shortages (labour) were also key problems. The supply-chain problems created higher input prices and provided headaches for firms to meeting deadlines. The tight jobs market led to more firms reporting rising unit labour costs (labour costs after adjusting for inflation).

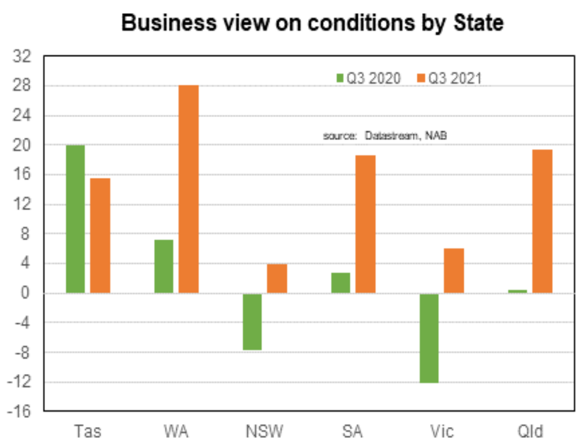
Government restrictions, materials and labour shortages were firms' biggest worries.



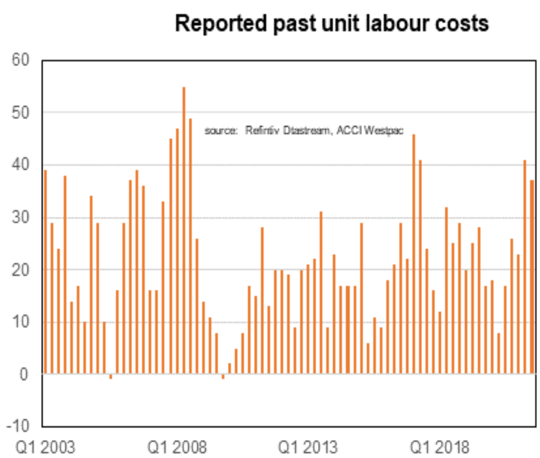
There will be decent-sized Capex budgets this year, particularly for plant and equipment.



Firms in all states say things are better than this time last year. But some states are doing better than others.



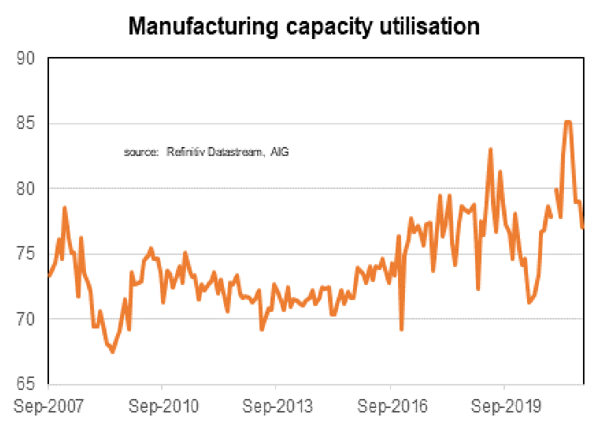
A tight labour market meant higher labour costs.



The strong level of orders during a tough economic period bodes well for a decent economic bounce-back. Order books are only likely to get bigger with Sydney, Melbourne and Canberra opening up. Capex budgets (particularly for plant and equipment) look likely to grow as firms gear up to meet the backlog of orders.

Another good sign for economic activity going forward is that many firms aren't sitting on a large pile of stock. Stocks were run down more than anticipated in the June quarter reflecting a substantially stronger than expected economy. Stocks did rise by more than anticipated in Q3 reflecting the unexpected length of the Sydney and Melbourne shutdowns. But there already is evidence that spending has bounced back as lockdowns have eased. And the stock-to-sales ratio for a number of industries was well below their historical average in the June quarter.

Capacity utilisation has declined – but that mainly reflects the impact of lockdowns.



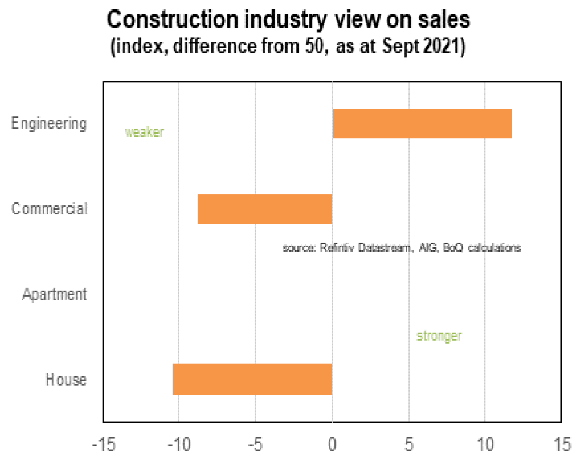
Stock overhangs have been kept to a minimum in recent times.

Better times ahead for construction

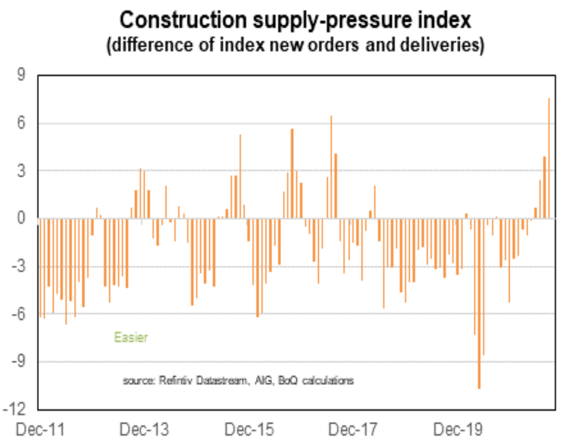
Many areas of construction should feel confident about next year. In the residential sector, there have been a huge amount of orders for new standalone homes. Sales of existing properties remain strong, although perhaps the looming bounce in supply is why industry confidence about new house (and commercial) sales is low. There remains a fair bit of work still to be done on many unit projects. Confidence about sales of apartments is OK, in line with industry feedback that orders for unit developments is rising. In some cities (notably Hobart and Perth) there has not been enough stock on the market to satisfy demand. Government incentives, time spent at home and plenty of saving has meant that households are making a few alterations and additions to their family home. The industry reports strong sales of engineering projects (mining, infrastructure, renewable energy).

Like in many industries the big increase in demand for residential construction has come at the same time as there has been supply-chain problems and a lack of skilled workers. This means higher prices. But it also means that the time to complete many building projects will be delayed.

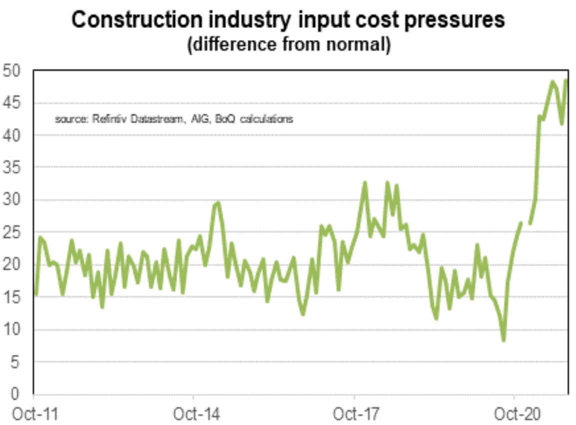
Sentiment in the construction industry is mixed between sectors.



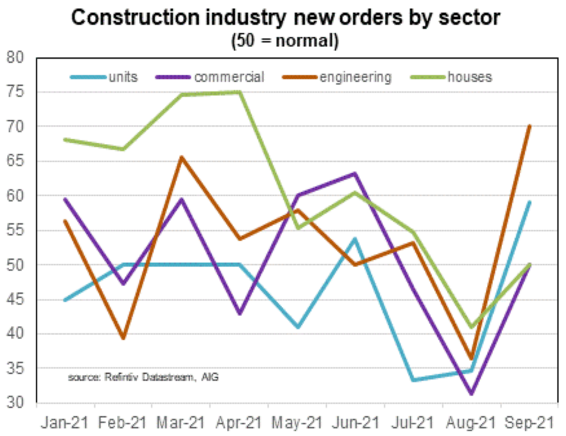
Material and labour shortages is making it hard to deliver projects on time.



And is leading to rising cost pressures.

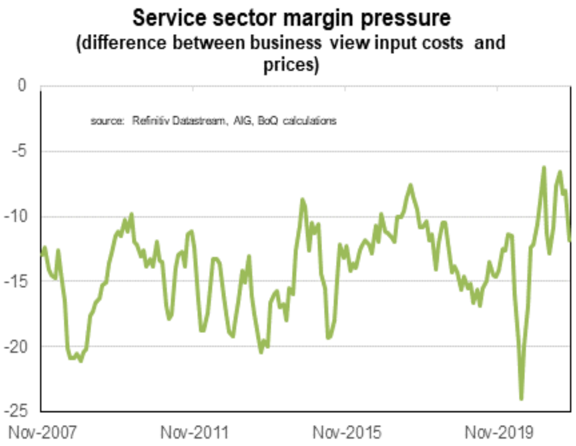


The industry reports a rise in orders for engineering and units.

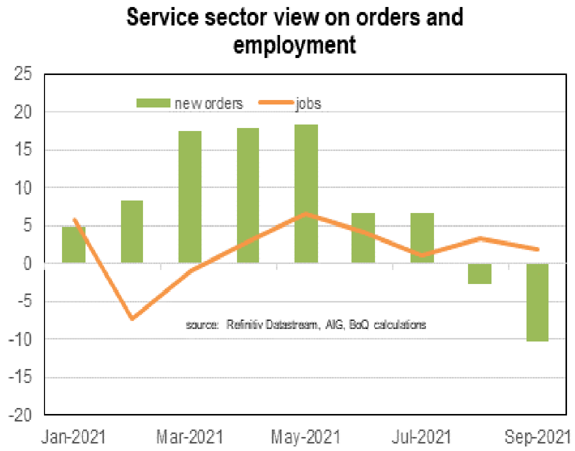


The services sector has been hardest hit by the pandemic. There was a sharp decline in orders as lockdowns hit Melbourne (in June and July) and Sydney (in July). But there is evidence of a snapback in spending as restrictions have been eased. Firms' confidence about the future can be gauged by their employment intentions remaining positive throughout the tough September quarter. The other positive is that many firms have been able to pass on some of the rise in costs onto consumers.

Service sectors firms' are not reporting a squeeze on profits.

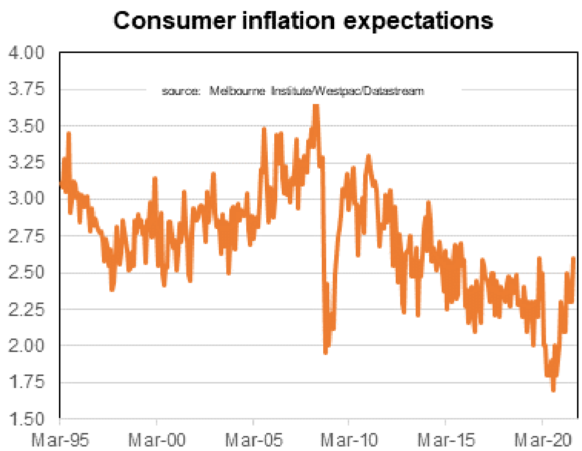


Shutdowns led to a fall in orders. But decent employment intentions suggests confidence about the outlook.

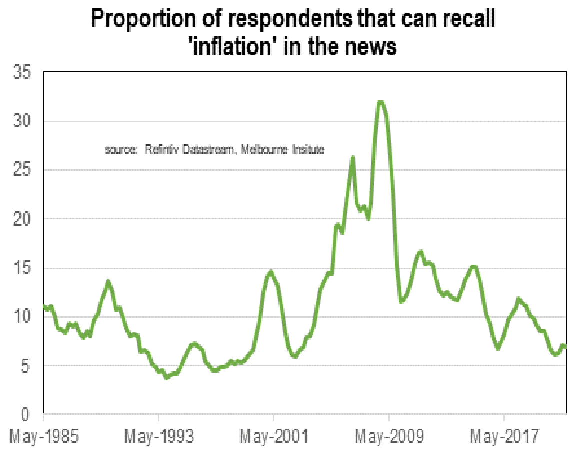


Consumers' have started to note the rise in prices. Household inflation expectations are at their highest level in over seven years. Most likely they think these price rises will be temporary. If that was not the case then more consumers would have noticed the discussion about higher petrol prices and the impact of supply-chain constraints. But the longer the price rises remain high, the more likely that consumers' (and businesses) will expect them to remain high.

Housing prices have outperformed units in the major capital cities over the recent years.



Rising concerns about affordability is weighing on consumer sentiment about housing.



The September quarter was a tough one for firms. Lockdowns in Sydney, Melbourne and Canberra were the main reason. Rising vaccination rates will mean lockdowns will become less of a risk going forward. But some government restrictions will likely be in place for some time yet. And consumer confidence will depend upon the path of the virus.

Despite the weaker economy firms' remained very concerned about supply chains. That is likely to remain an issue for the next 6-12 months until the global economy fully re-opens. The lack of skilled workers is likely to be a constraint for longer, at least until the immigration program returns to its previous strength.

We live in interesting times.

Regards

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