ECONOMIC UPDATE

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WEEK ENDING 4TH JUNE 2021

Summary

- The economy was doing a lot better than anyone had envisaged in the March quarter;
- And further good news is on the way;
- But not all regions and sectors have done well;
- COVID remains the key short-term risk to the economy.

For the third quarter in a row the Australian economy busted all expectations. The leading indicators look good. The third Melbourne lockdown is a negative (particularly for Melbournians). There will be an impact on the economy. But the history of the past six months suggests that the impact may not be big (providing the lockdown doesn't extend much past two weeks). While the aggregate economy is now bigger, that is not the case for all industries. A number of sectors are smaller in size than they were pre-COVID.

As is typical in the early stages of an economic recovery, consumption is leading the way. The main driver has been stronger consumption spending by the state and (particularly) the federal government. The pattern of household spending is starting to return to 'normal' (spending more on services).

In recent months firms have started to splurge on capex. Plant and equipment investment has notably risen, although the surveys suggest non-residential investment could also rise strongly over the next year. Government investment has been a growing positive for the economy. But actual government spending has not been as much as what they had planned on in last year's budgets.

Residential investment has also picked up strongly, for similar reasons as the rise in business investment. The contribution to the economy from the building of new standalone homes may rise further in coming quarters. The other big plus for economic growth in the March quarter was a significant rise of inventories. Inventory levels still looks low when compared to sales, particularly for retailors. This suggests that stock rebuilding may still be a positive for economic growth in coming quarters.

One of the reasons that households are happy to spend more is that their disposable incomes are growing (despite the fall in social benefit payments). The reason is that more workers are in jobs (although their wages growth has been modest). There are few signs that the end of JobKeeper at the end of March will have a significant economic impact. Intriguingly, household saving rates remain elevated. Declines in the household saving ratio are very likely over the next 1-2 years.

Not all states are enjoying the same economic momentum. The mining states have done best. By contrast, the lockdowns have hurt the Victorian economy. And the lack of students and international travellers has been a negative for the two largest states. But all states need to do better. All states unemployment rate remain well above the 4.5% level that Treasury has suggested is 'full employment'.

What are the key implications from the release of the GDP numbers. First, the economy is doing a lot better than what anyone had thought. And the forward indicators suggest that there are further good times ahead. Second, there is very strong demand. The question is whether supply constraints that are struggling to meet the strong demand are short- or long-term. The answer to that question will determine the outlook for inflation. And the outlook for interest rates.

Third, the numbers are a reminder that although the outlook for the Australian economy is good there are areas of the economy not doing well. Finally, events over the past couple of weeks is a reminder that while Australia has largely handled the virus well COVID remains the biggest short-term risk to the outlook.

A stronger, but mixed, economy

For the third quarter in a row the Australian economy busted all expectations. Indeed, the economic outcome was almost twice what was expected. And it was the strongest three consecutive quarters of growth since at least 1959 (when quarterly records started).

The leading indicators look good. Business sentiment in April was the best it had been in at least twenty-plus years. Consumer confidence is strong. There are plenty of job ads. Capex budgets have got a lot bigger. There is still plenty of fiscal stimulus hitting the economy. And low interest rates will be with us for some time to come.

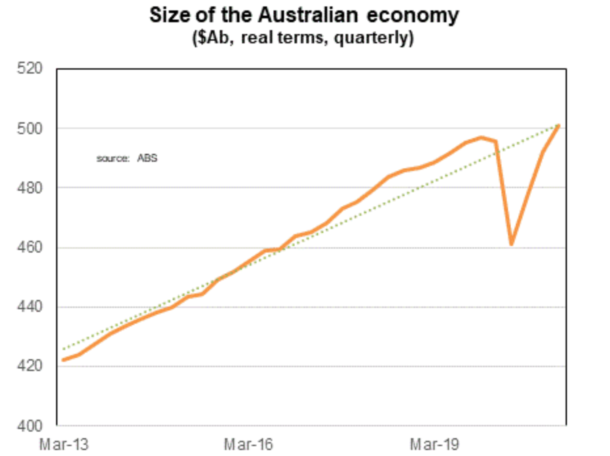
Of course the third Melbourne lockdown is a negative (particularly for Melbournians). There will be an impact on the economy. But the history of the past six months suggests that the impact may not be big (providing the lockdown doesn't extend much past two weeks). There is talk that the Federal Government might provide support to the Victorian economy. And we have got a lot better at keeping more parts of the economy going during a lockdown.

The economy is now bigger than it was pre-COVID. Not many economies around the world can say that. And the momentum of the economy suggests that there are still better times ahead.

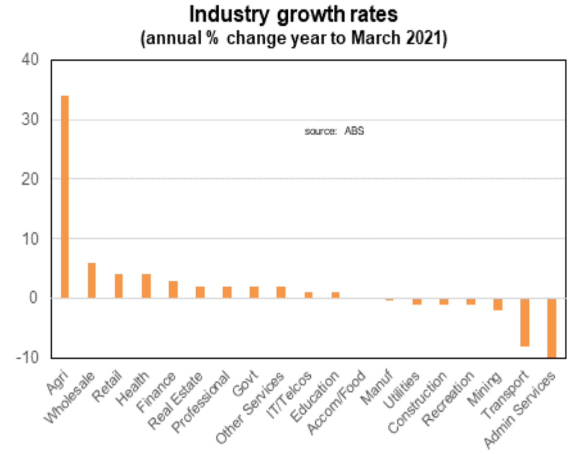
While the aggregate economy is now bigger, that is not the case for all industries. Many farmers have had a bumper year (helped by more rain). All the extra spending by consumers on goods has seen many retailers and wholesalers enjoy a good time. The health industry also had a decent year (albeit not as stellar as many other years).

But a number of sectors are smaller in size than they were pre-COVID. The transport sector has not only been hurt by less people boarding a plane, but the substantial reduced use of public transport to get to work. While the footy is back on, the sport and art sectors are still not back to where they were pre-COVID. The mining sector has been hurt by weather-related shutdowns.

The economy is now bigger than it was pre-COVID



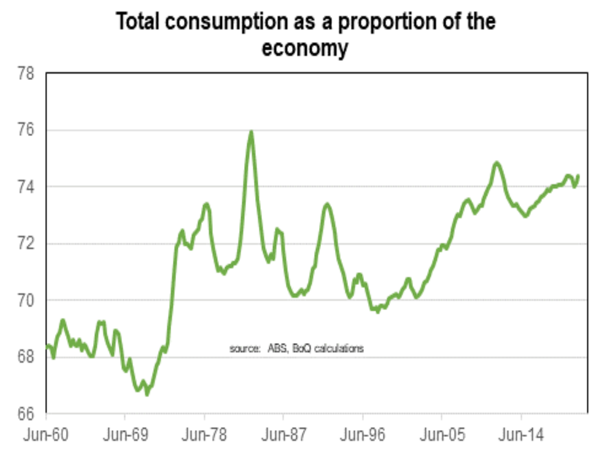
Agriculture has been the standout performer. Transport and Admin Services have struggled.



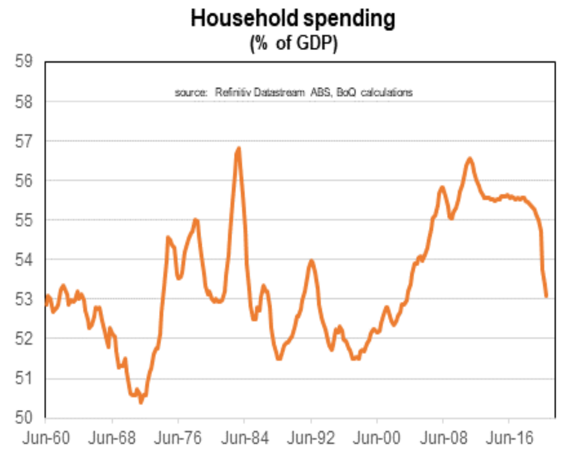
As is typical in the early stages of an economic recovery, consumption is leading the way. Firms are unlikely to invest big time if they don't know what the economic future looks like. Household spending has picked up in recent months. But right now its contribution to the economy is at its lowest in almost twenty years. The main driver has been stronger consumption spending by the state and (particularly) the federal government. More Government spending during economic tough times is what should happen. But Federal consumption spending (such as NDIS) was becoming a bigger part of the Australian economy even before COVID.

Household spending patterns are starting to return to 'normal'. It is getting harder to get a seat at a decent restaurant. And it is a lot easier to get a computer monitor (or a packet of toilet rolls!).

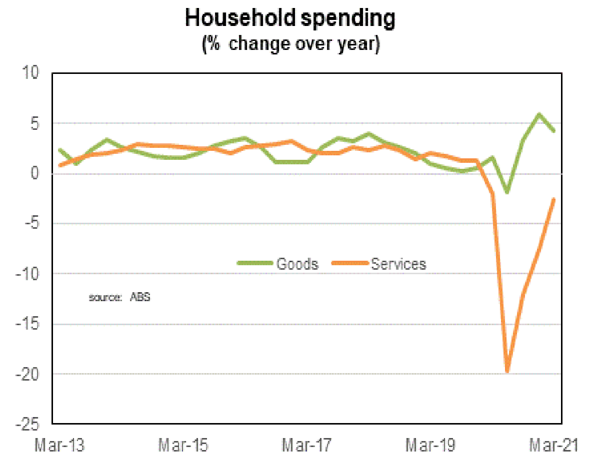
Consumption is currently a big driver of economic growth.



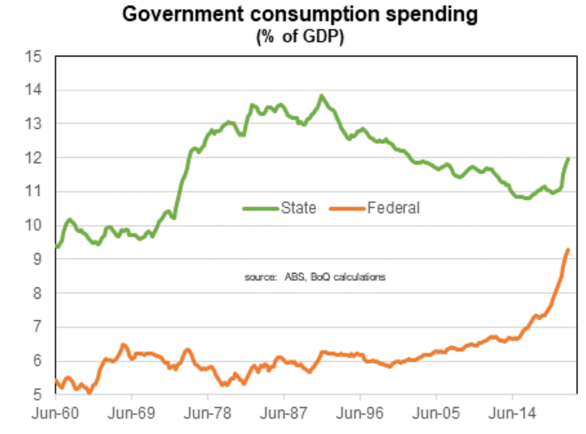
But spending by households has been less important.



Consumers are spending more on services.



Federal Government consumption has become a bigger part of the economy.



And this is leading to more business investment

In the long run for the economy to sustain strong economic growth it requires high levels of investment. Firms cut back capex spending big time during the depths of economic worries last year. But in recent months they have splurged, a result of the stronger economy, extremely low interest rates and government incentives. Plant and equipment investment has notably risen, although the surveys suggest non-residential investment could also rise strongly over the next year.

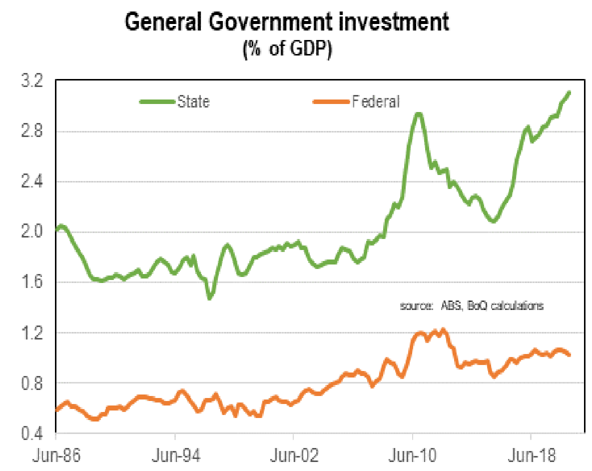
Government investment has been a growing positive for the economy. This is particularly the case for state governments, who are spending up big on transport projects (road and rail), as well as improving electricity networks. But actual government spending has not been as much as what they had planned on in last year's budgets. Partly this reflected issues that often occur with big projects. But problems associated with COVID has not helped.

Residential investment has also picked up strongly, for similar reasons as the rise in business investment. There was been a notable rise in alterations and additions, although this comes off a very low base (and households deciding they may as well do up the house if they can't travel). The contribution to the economy from the building of new standalone homes may rise further in coming quarters. This will be partially offset by a reduction in the building of units.

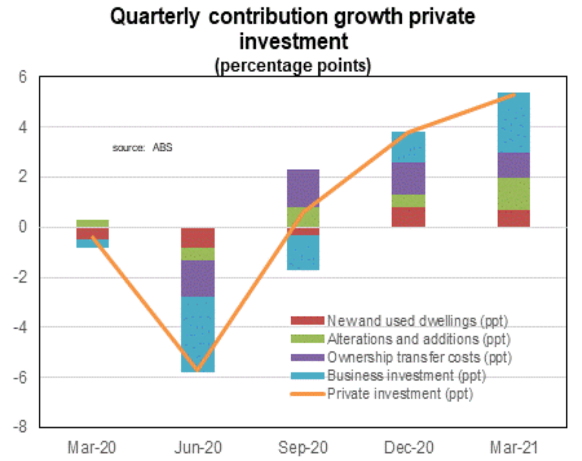
The other big plus for economic growth in the March quarter was a significant rise of inventories. At the height of concerns about the economy last year firms significantly cut the size of their inventories to reduce costs. It turned out though that the demand for goods (such as cars) actually rose strongly reflecting disposable income growth. And people redirected spending from what they would have spent on services (such as travel or going to the footy).

In the March quarter wholesalers and (particularly) retailors substantially rebuilt their inventory levels was a big plus for the economy. Inventory levels still looks low when compared to sales, particularly for retailors. This suggests that stock rebuilding may still be a positive for economic growth in coming quarters.

Infrastructure spending by states is very strong.

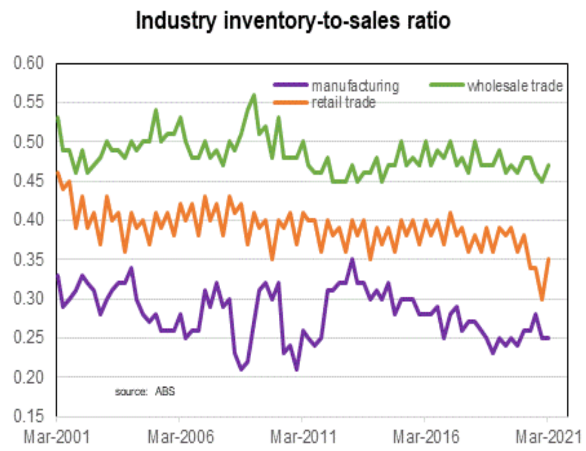


And business investment has picked up strongly in recent months.



Residential construction will also help boost the economy.

Retailors will likely need to boost their stock levels further.



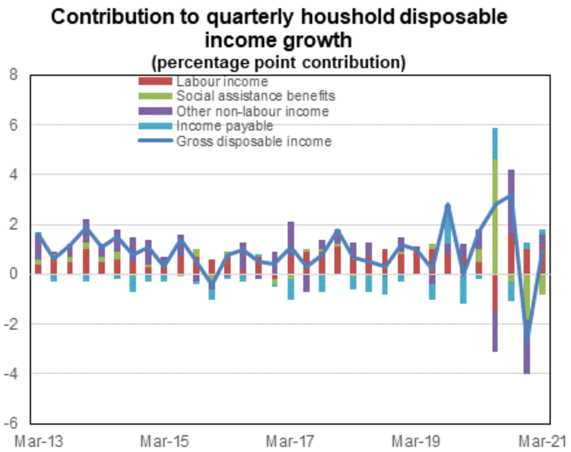
The household saving rate is still high

One of the reasons that households are happy to spend more is that their disposable incomes are growing (despite the fall in social benefit payments). The reason is that more workers are in jobs (although their earnings growth has been modest). Non-labour income are also rising again (companies are again paying dividends, rent freezes have ended). There are few signs that the end of JobKeeper at the end of March will have a significant economic impact.

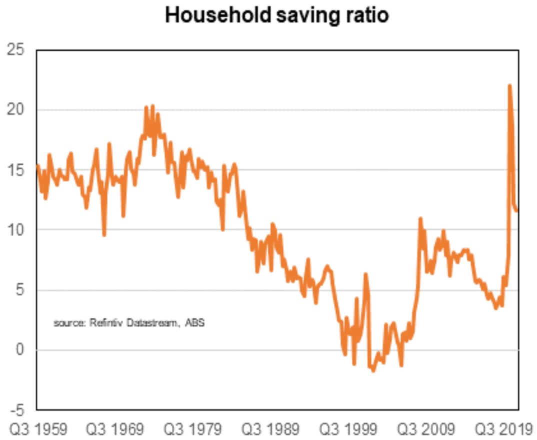
Intriguingly, household saving rates remain elevated. Partly that would be because consumer spending remains constrained on some services (notably travel). That might also be because of caution. Very low interest rates might actually also be encouraging households to pay off debt (because other investments are not offering strong returns). Declines in the household saving ratio are very likely over the next 1-2 years.

Corporate income growth has also been strong. The profit share has declined a little over recent quarters, although remains near record highs. Strong income growth has allowed firms to build up substantial saving buffers. It also is a reason why business credit growth is low despite the strong rise in capex and inventory investment. Firms can meet their greater funding needs from cash in the bank.

Stronger jobs growth is now the biggest driver of consumer disposable incomes.

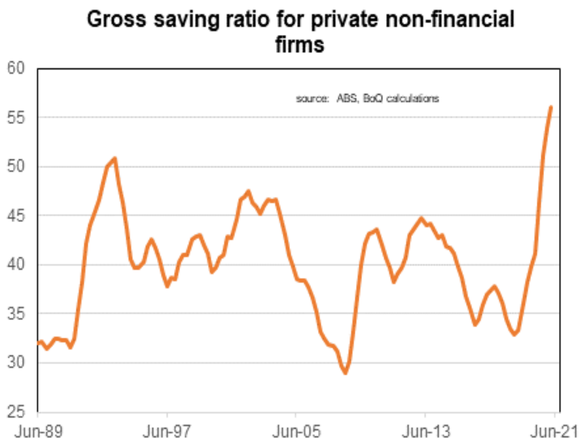


But the household saving ratio remains elevated.



The profit share remains near a record high.

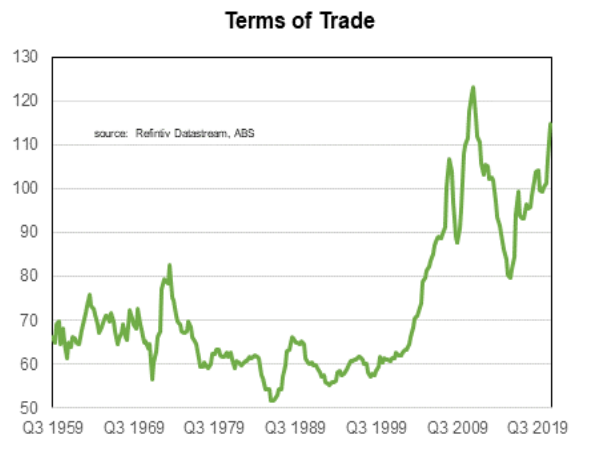
Strong income growth has boosted corporate saving.



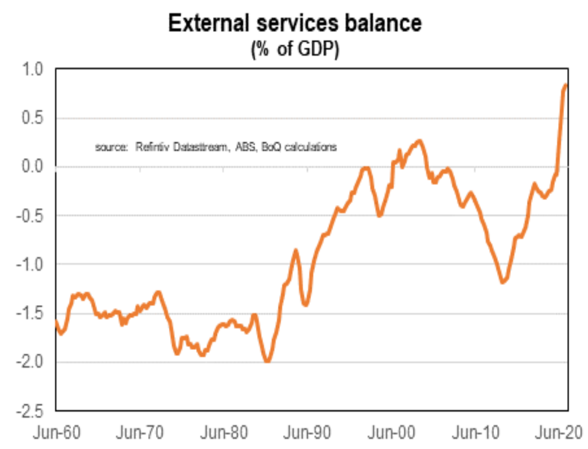
Clearly the Government (and the RBA) has played a big role in powering up the economy. But also very important has been a significant rise in the terms of trade (ie, export prices rising more than import prices). This is mainly a result of very high iron ore prices (but plenty of commodity prices have been heading north). This means domestic incomes have been boosted by the rest of the world happy to pay us higher prices for our exports. The impact on the economy has been seen through higher tax revenue for the government (which the Federal Government has been happy to spend), higher dividend payments and increased wages for miners.

The other big plus for our economy is that the shutting of the borders has meant that Australian traveller dollars have been kept local. Australian tourists typically spend a lot more overseas than international travellers spend here. Some of those extra funds have boosted our local tourism industry. Some of that money has been spent on other goods and services (cars). Or saved.

Our economy has been boosted by the high prices paid for our exports.



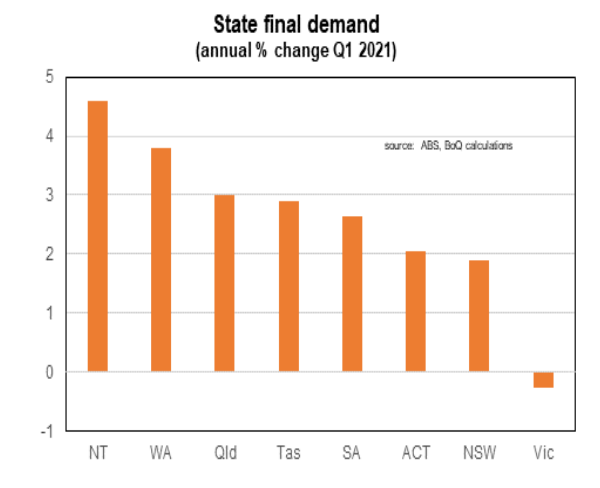
Australians not travelling overseas has kept the money in the local economy.



Not all states are enjoying the same economic momentum. The mining states have done best. They were also the states that entered COVID in the worst state. They have done well because of high commodity prices. There was also more upside to their construction sector following a period of extended weakness. Queensland also benefits from the focus on domestic tourism. By contrast, the lockdowns have hurt the Victorian economy. And the lack of students and international travellers has been a negative for the two largest states. Those states also constructed plenty of inner-city units pre-COVID that are currently vacant. There was also plenty of Office construction activity in the two largest states that is unlikely to be replicated for some years.

But all states need to do better. The new unemployment rate benchmark set by the government is 4.5%. And all states remain well above that level.

The mining stats have done best.



The unemployment rate needs to decline further across all regions.

Implications

So what are the key implications from the release of the GDP numbers. First, the economy is doing a lot better than what anyone had thought. And the forward indicators suggest that there are further good times ahead. Particularly with more fiscal stimulus and the RBA still in a generous mood (we will find out more about the extent of the RBA's generosity next month).

Second, today's numbers confirm there is very strong demand. The question is whether supply constraints that are struggling to meet the strong demand are short- or long-term. The answer to that question will determine the outlook for inflation. And the outlook for interest rates.

Third, the numbers are a reminder that although the outlook for the Australian economy is good there are areas of the economy not doing well. Notably, transport, admin services, recreation sectors. And the Melbourne CBD is doing it very tough.

Finally, events over the past couple of weeks is a reminder that while Australia has largely handled the virus well, COVID remains the biggest short-term risk to the outlook.

We live in interesting times.

Regards

Peter Munckton
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