ECONOMIC UPDATE

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WEEK ENDING 3RD JUNE 2022

Key points

- **The economy had a pretty solid start to 2022;**
- **Consumer and government spending were the two biggest drivers;**
- **There are good reasons to think the economy will do pretty well over the next 1-2 years;**
- **But there are risks to the outlook.**

GDP numbers

The Australian economy just keeps surprising. First it was the resilience displayed through the pandemic. Now it is the height of the bounce since, as the economy is re-opening. Many overseas economies Q1 GDP numbers surprised with weakness. Not Australia.

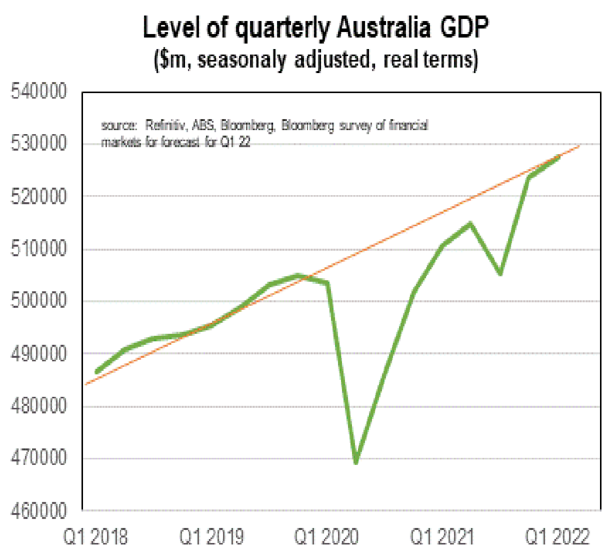
GDP growth rose by 0.8% in the March quarter (above consensus estimates), and 3.3% over the past year. Consumption by both households and governments was the key driver of spending. Public investment remained strong, business investment on plant and equipment and intellectual property (notably IT and mining exploration) were also prominent. Firms re-stocking led to a sharp bounce in imports. High commodity prices was a plus for national income growth. Bad weather and material and worker shortages constrained construction spending.

Despite rising inflation pressure, profit margins in many industries remained decent in the quarter (the exceptions were finance, recreation, utilities and accommodation and food services). But ongoing cost pressures will make things more difficult in coming quarters, particularly for firms unable (or unwilling) to pass cost rises onto customers.

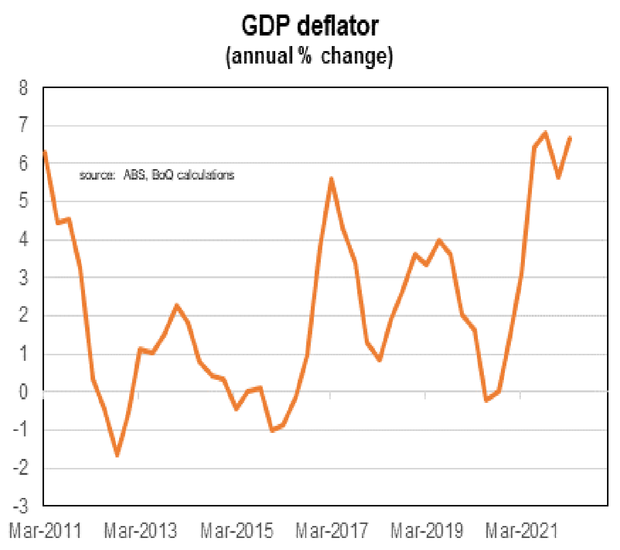
As confirmed by other indicators, wages growth is picking up. The consumer measure of inflation contained within the GDP numbers (private consumption deflator) rose broadly in line with the CPI numbers. Broader measures of inflation in the economy rose even faster.

The household saving ratio declined modestly in the March quarter as more households were both able and willing to spend. The saving ratio though remains high by historical standards. Further reductions in the saving rate are likely in coming quarters as the economy continues to re-open (notably for travel), a desire to spend following two tough years and a need to dip into saving to offset declining real wages growth.

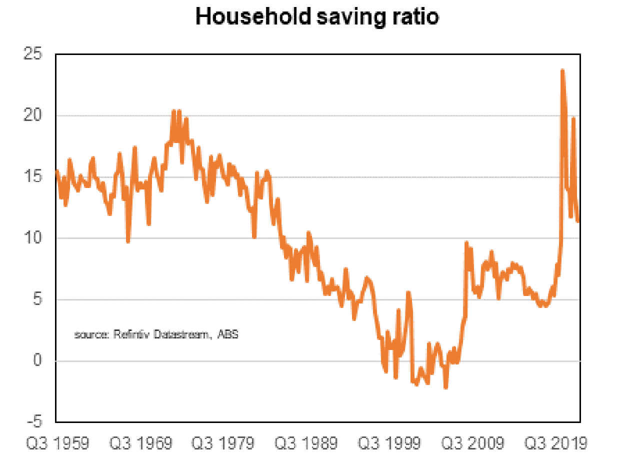
The Australian economy has returned to its pre-pandemic trend.



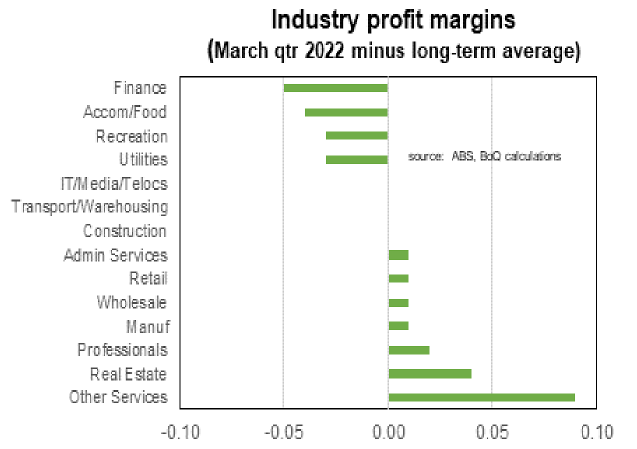
Inflation is high in the wider economy.



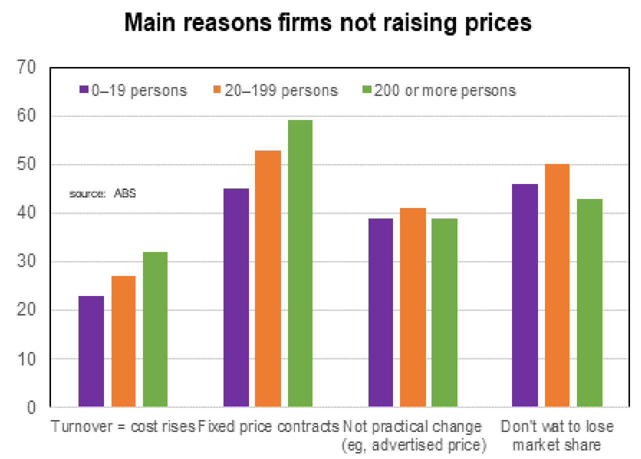
The household saving ratio is declining, albeit from a high level.



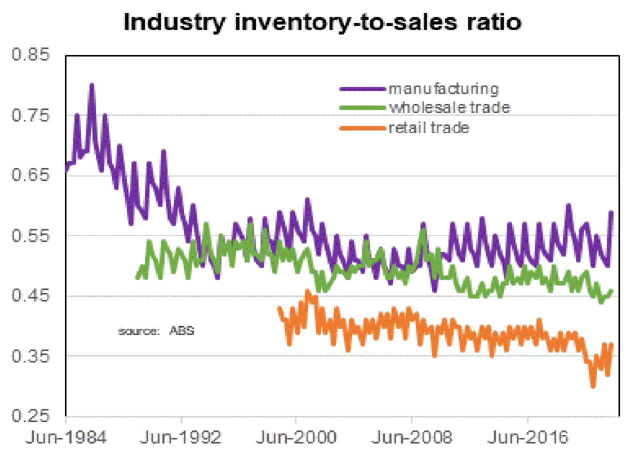
Profit margins are mixed across sectors.



Fixed price contracts and concerns about losing market share are the main reason firms are absorbing higher costs.



The inventory re-build is underway.



How the economy compares to pre-COVID times

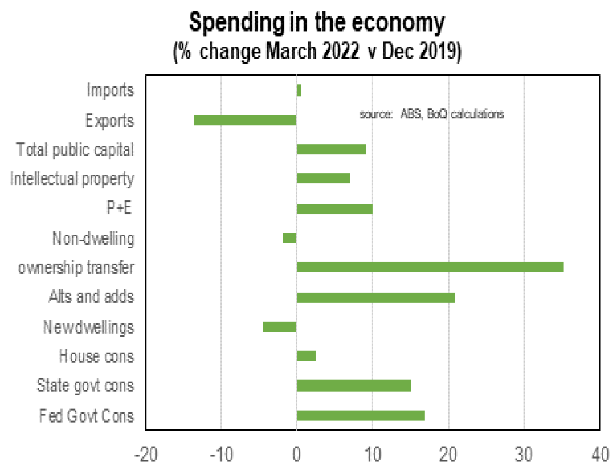
Most areas of spending are now higher than they were pre-pandemic. The exceptions are the volume of exports (held back by various weather events and weak global growth) and construction (weather and material and worker shortages). But even in these areas of weaker spending there are signs of strength. The prices received for exports relative to imports (the terms of trade) is at a record high (Australia has received a significant income boost from the rest of world paying up for our exports). And the pipeline of work to be done (particularly for standalone houses) is at a very high level.

About 70% of sectors are now larger than they were pre-pandemic. The exceptions are transport (notably air and rail due to closed borders and working from home) and some utility sectors. Sectors that have done well over the past couple of years include, agriculture (good growing seasons and strong demand), computer services (increasing investment in digitisation, working from home, online shopping), wholesale and retail trade, government and some areas of manufacturing.

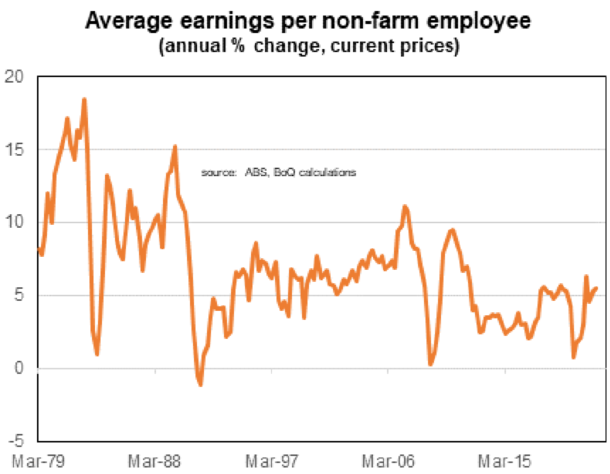
The labour market has substantially strengthened since the end of 2019 although the strength of jobs growth has been mixed between sectors. There are substantially more workers in the health, finance, real estate, retail trade and government sectors. There are currently less workers in the recreation and accommodation and food services sectors.

None of that would shock. But it is more surprising that there are less workers in the manufacturing and wholesale trade industries even though those sectors did quite well through the pandemic. And despite all the talk about worker shortages there are also less workers in construction. Partly the decline of workers may have reflected some immigrants returning home (notably impacting construction). Workers may have also taken the opportunity to switch to industries that may have been less impacted by lockdowns.

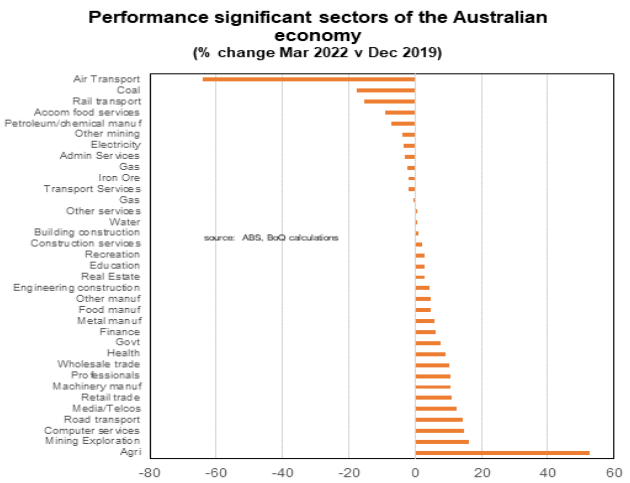
Spending is up across most areas of the economy.



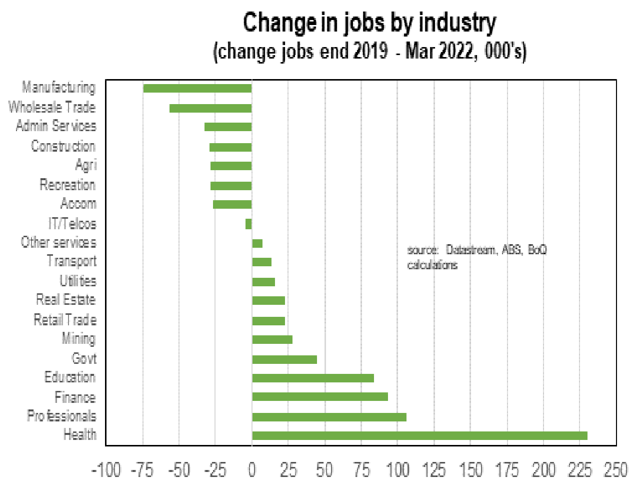
Aggregate wages growth was moderate in the March quarter



A growing number of sectors are now bigger now than they were pre-pandemic.



Jobs growth has risen in most sectors, declined in some.



Outlook

GDP growth will be substantially stronger in Q2 reflecting the bounce-back from the Omicron wave and the floods. I am looking for a figure comfortably north of 1% (1.3%). Substantial worker and material shortages is a significant handbrake. But underlying demand is strong.

The indicators to date show consumers' remain happy to spend. The labour market is strong, wages growth is rising, many households are sitting on a mountain of saving and their wealth has risen substantially over recent years. There is plenty of residential construction work still in the pipeline. Firms have indicated that capex budgets will rise strongly next financial year, and this follows a very strong rise this financial year. And there is so much of infrastructure work still to be done that the NSW Government is looking to delay some projects. While manufacturers' appear to have got their inventories in better balance, further restocking is likely in both the retail and wholesale trade sectors.

Fiscal policy remains supportive for the current state of the economy. High commodity prices is a big income boost to the economy (although further inventory growth will mean higher imports).

But there are risks

The global backdrop is mixed. High inflation and potential energy constraints have led to cuts to GDP growth estimates, particularly for Europe and Japan. Things could get particularly tough if the Russians decide to stop energy exports more widely to Europe. The Chinese economy is struggling as it fights COVID and attempts to reduce debt (particularly in its construction sector). The Chinese Government is increasing both fiscal and monetary support. But there is only so much that can be done if much of the economy re-enters lockdown. The US economy is doing very well although the Federal Reserve is currently embarking on an aggressive monetary tightening cycle.

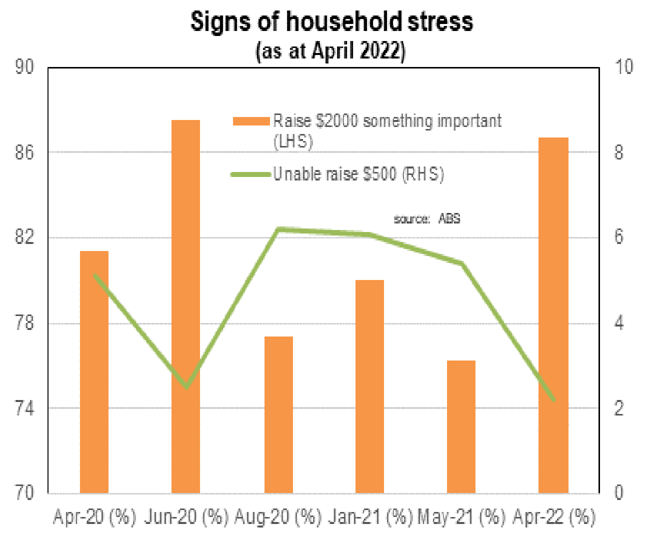
Weaker global growth is a negative for the Australian economy, particularly in China. But the strong level of commodity prices at a time when the $A is relatively low means that Australia is better placed than most countries.

Domestically, a growing issue with be declining real wages growth over the next 12-18 months as it makes things increasingly difficult for some households (particularly lower-income earners). Without assistance this will crimp their consumption although I think it is likely that the Government will provide some further income support to low income earners if real wages growth continues to decline. The end of homebuilder and rising interest rates has led to a sharp slowing in building approvals. In time this will lead weaker residential construction activity although probably not until the second half of next year.

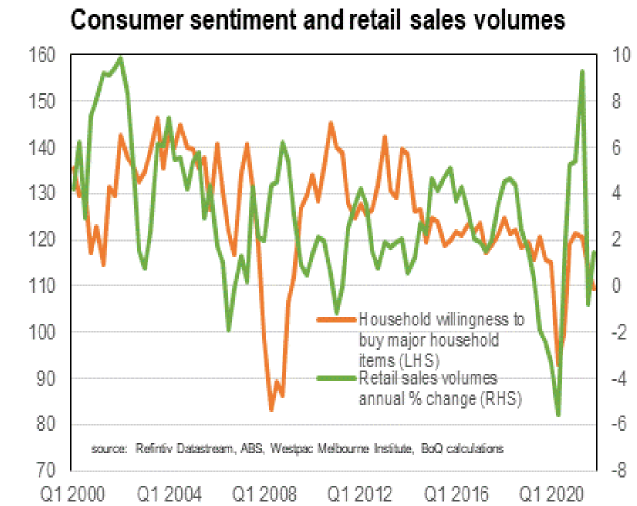
Then there is higher interest rates. We are in an environment where there is a high level of uncertainty as to how long supply-chain problems and worker shortages will last. And how households will react to higher interest rates. The large proportion of fixed rate lending done over the past couple of years will mean that a proportion of new buyers will be initially protected from rate changes.

The fear of higher interest rates is already impacting households through falling share markets. House prices are already declining in some cities (Sydney, Melbourne and Canberra). Further house price declines are likely over the next 1-2 years.

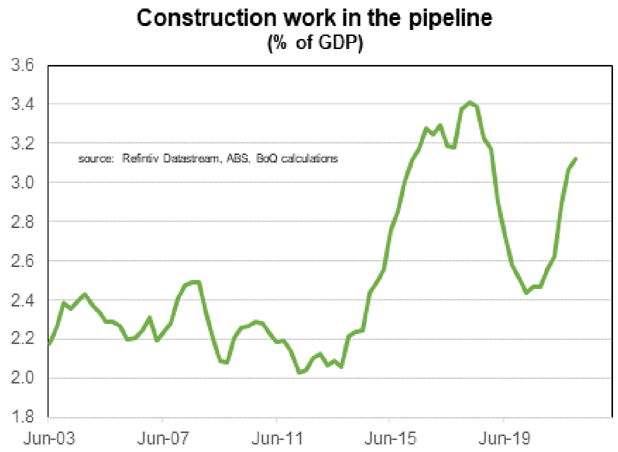
So far there are few signs of widespread household distress.



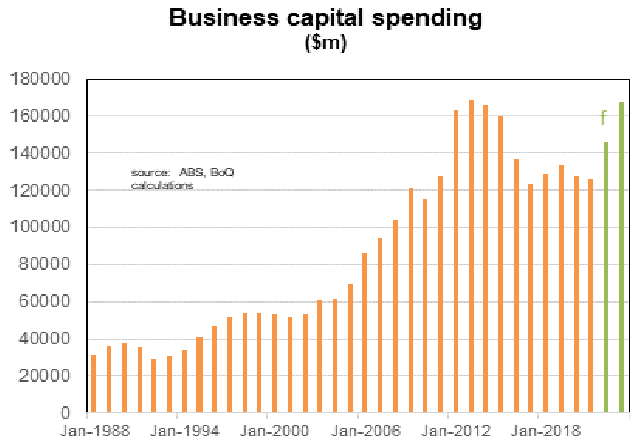
But if weak sentiment is sustained it will likely lead in time to a slowdown in consumer spending.



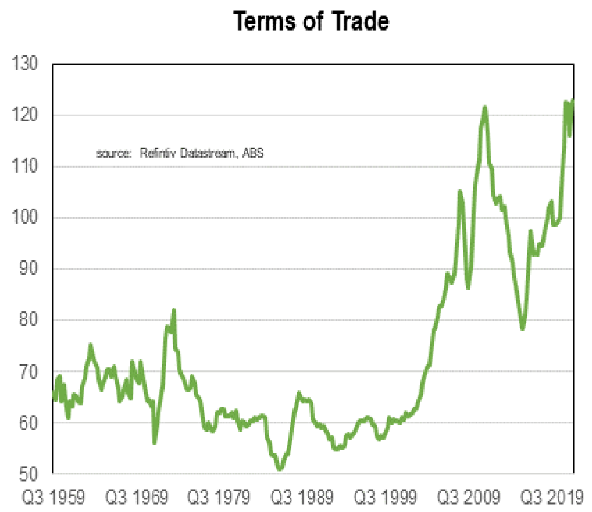
The amount of work in the pipeline in construction remains high.



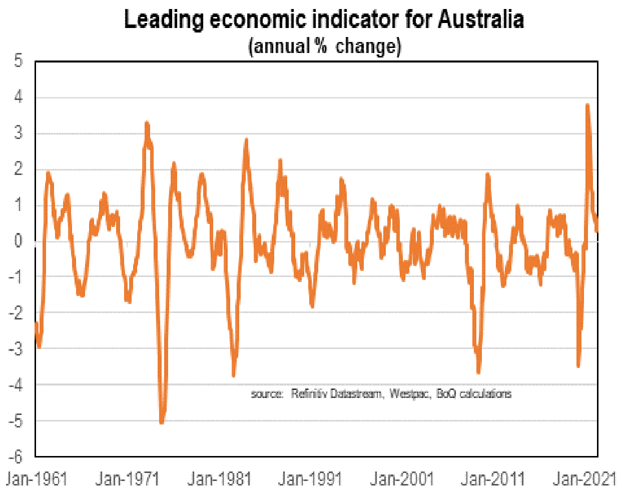
Firms' are indicating bigger capex budget for next financial year.



The terms of trade is at a record high.



The leading economic indicators do suggest some slowing domestic economic growth is on the way.



Outlook

An economy with a 3.9% unemployment rate is one that is doing pretty well. And there are good reasons to think that the economy will remain in reasonable nick, at least for the next 12-18 months. But there are a number of clearly identifiable risks.

Years ago, the Swedish rock band the Hellacopters sang, "it ain't quite what I pictured, it ain't quite what I had in mind." They were singing about life. But that is also the theme of this economic recovery, one that has strong economic growth, a very low unemployment rate but high inflation and low wages growth. Hopefully the economy will turn more 'normal' over the next 1-2 years. But it is possible that the new 'normal' is not the one that most of us have in our mind.

We live in interesting times.

Regards

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