ECONOMIC & FINANCIAL MARKET UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

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BOQ GROUP

Summary:

- **Economic growth in the March quarter fell, but not as much as had been feared;**
- **It is certain there will be a far bigger decline in GDP in Q2;**
- **But the economy is already starting to pick up;**
- **There can be cautious optimism about the future.**

Some years ago I went to a place that had water slides. On the largest slide there was a jump off a ledge landing on a steep slide. My first look down that slope still sticks in the memory (it was fun though once I jumped). And to my mind that sums up the March GDP numbers: the economy on the edge just about to take a steep drop.

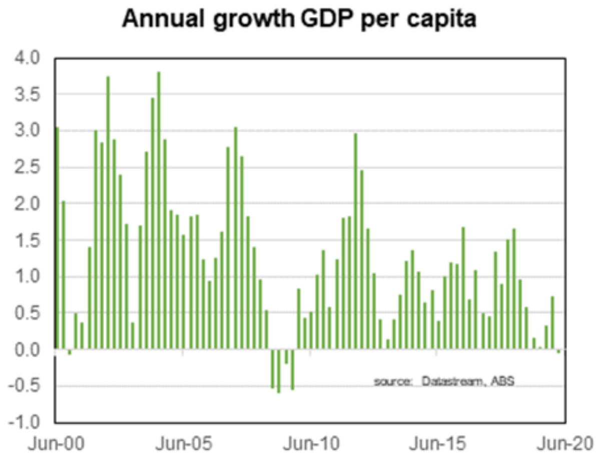
March Quarter

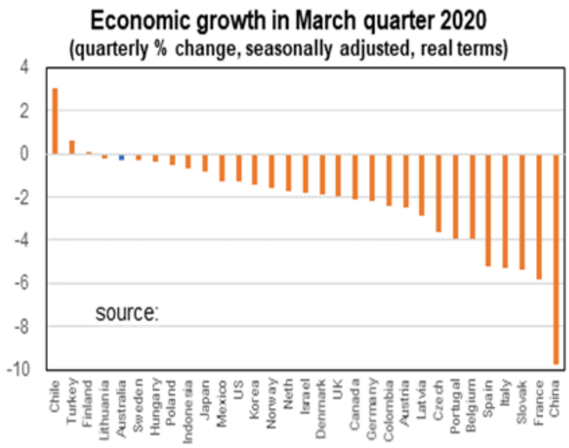
For some time there was a worry about the economy in Q1. There was the Bushfire-impacted January, the China-shutdown in February and a home grown lockdown in the back end of March. All things considered the 0.3% fall in GDP growth in the quarter was pretty good. And by global standards it was top drawer.

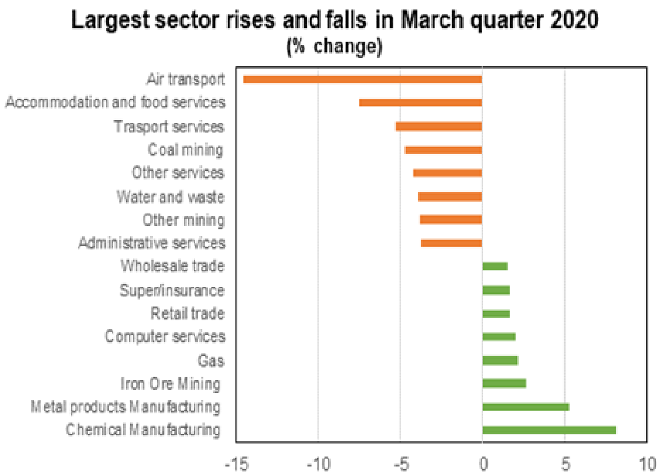
The numbers told the expected story. Consumer spending was down big time (apart from on food, wine, home computers and bikes). The big jump in Government welfare payments started to hit bank accounts but was not all spent (causing a jump in the household saving ratio). Capex spending (particularly outside of mining) took a dive. Residential construction again struggled. The economy was powered by the government (and a massive fall in imports).

Manufacturing (sanitisers, toilet paper) had a good quarter, as did iron ore miners (and super funds were busy meeting redemption requests). Airlines, hotels and restaurants had a very tough time. Activity in the health sector was broadly flat. Busy COVID testers were offset by the stop in elective surgeries and a fall in attendance to doctors and dentists.

Demand in WA was improving (iron ore), but weaker in NSW (slowing population growth, slowing construction activity) and South Australia. Demand in Victoria was broadly flat. In Queensland it fell in line with national GDP growth (-0.3%). National productivity growth rose because the fall in hours in the quarter was more than the decline in output.

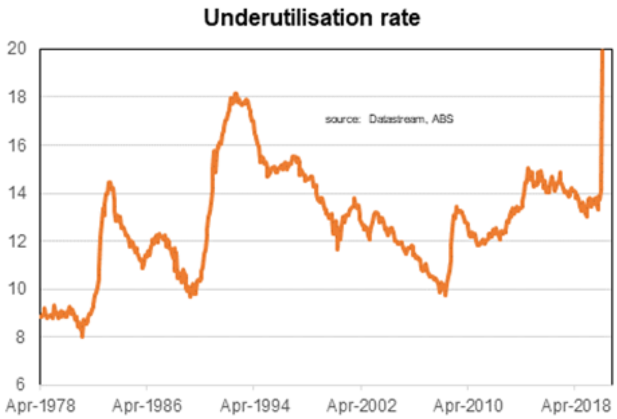






June Quarter

It is certain there will be an even bigger decline in the June quarter (I expect -7.5%, other economists have bigger declines). A significant chunk of the economy was shut for half the quarter (albeit that started in late March). This means consumers couldn't spend even if they wanted and so were forced savers. Weak spending means low profits. In April firms said their forward order book was by far the worst they have seen in the past 20-plus years. The underutilisation rate shot up to a record high (nearly 20%). Hours worked (a decent proxy for economic activity) looks to be down 8-10% in the June quarter.



Second Half Of 2020

But the June quarter will be the nadir. The economy has been opened up a lot quicker than most forecasters had assumed. Consumer confidence starting picking up in mid-April as the number of new cases went down. Credit/debit card data indicates that household spending has been increasing as shops and restaurants have re-opened. The quicker end to social distancing policies and aggressive government response has meant that the fall in GDP will not be as bad as a number of analysts (including the RBA and the Treasury) had feared. And this also means the forecasters are revising up their views about the September quarter. Decent growth is also on the cards for the December quarter as consumers and businesses gain more confidence.

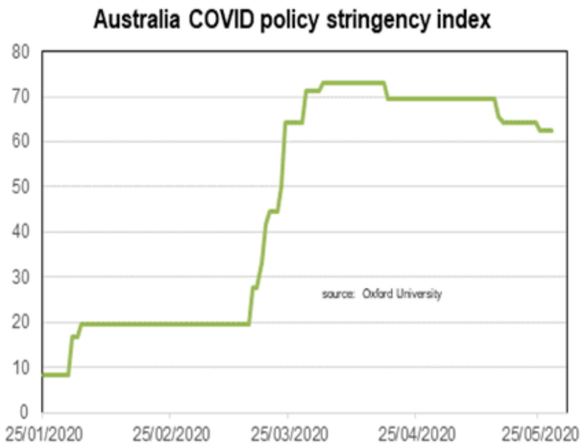
Social Distancing Policies

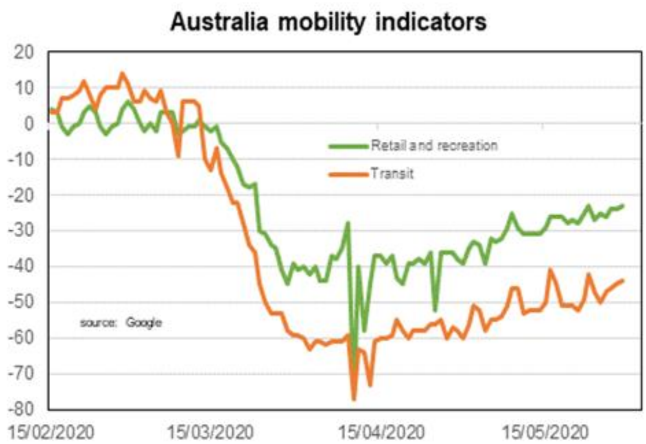
But it will take some time for the level of income in the economy to get back to where it was at the start of this year. The big brake is that some of the (fully justified) social distancing policies will remain in place. According to the Oxford University, Australia's social distancing policies were tough by global standards although others were tougher (such as New Zealand). Although the policies have been eased their stringency remained tighter at the end of May than they had been in mid-March (although things have been eased since then). Confirmation comes from mobility indicators still being well under what would be considered 'normal'.

Further easing of restrictions is likely in coming months. There is talk about travel 'bubbles' with New Zealand (and in time with other countries). Crowds attending sporting events appear to be on the agenda (sell-out attendances are some time away). More people will be allowed into pubs and clubs (and eventually nightclubs). The possibility of re-starting long-term immigration by putting in place a quarantining program is being discussed.

As the economy is opened up there is the real risk of a 'second wave' of COVID cases. This has happened in other countries (outbreaks in nightclubs in Tokyo and Seoul, in some schools in Israel). The number of cases in the community appears to be small (particularly outside of parts of Melbourne) but we can't be certain without a more comprehensive testing program. Our hospital and treatment capacity has been increased. And the testing and tracing capability is now more efficient. All of suggests that in the event of any outbreak it is unlikely to again lead to the shutdown of the entire economy.

But some form of social distancing policies will be in place until an effective vaccine or treatment is found (and that is likely at least 12 months away). This means that activity in some sectors (such as accommodation/food services, air transport, retail, wholesale and recreation) will be constrained for an extended period.





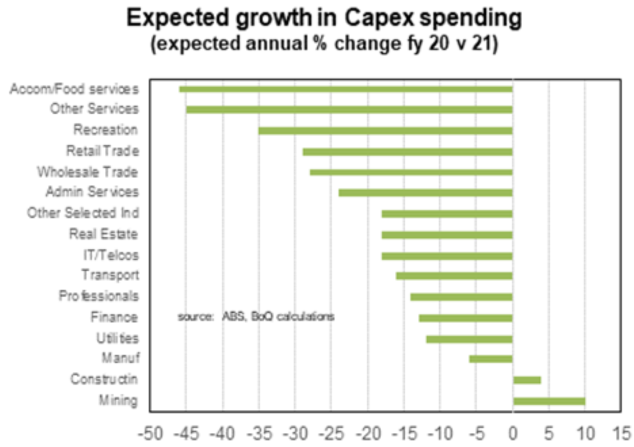
Consumer/Business Confidence

One of the biggest unknowns is how consumers and businesses will react as everything is opened up. Everyone is happy there is now more freedom but it would be surprising if there was not some caution after such a big shock. Surveys suggest that households indicate they feel their budget is under strain. They look for things to improve next year but (probably rightly) don't think they will return to normal any time soon. They are concerned about the jobs market (but interestingly not unduly so). Their bigger worry will be that their pay packet won't be getting any larger for the foreseeable future. And then there is the general uncertainty of what the new world will look like.

Business confidence has also taken a bad knock. At the peak of the lockdown firms reported that new orders were at their lowest than in any time for the past twenty five years. No surprise that firms took a knife to their capex budgets (particularly service industries). Even miners who expect to spend more on capex next year have cut the size of what they expect to do. Many firms indicate that hiring will be kept to a minimum.

Business confidence will improve as more of the economy opens up. But most will remain cautious until there is more certainty about the economy. Most firms will also need to time to re-build their cash reserves after running them down in recent months.

In short, the economy won't return to normal for a while. Sectors still impacted by COVID restrictions will struggle for longer. There will be firms across the economy that are likely to find the going tough and are unlikely to re-open. Other businesses have (or will) cut staff to remain viable.



Construction

One of the sectors that is finding the going hard is construction and this is likely to weigh on the economy over the next year, or so. Residential construction activity has declined for the past five quarters. The construction sector more generally is finding the going tough. The pipeline of work is getting shorter. And the forward indicators (order books, building approvals) are not painting a better story.

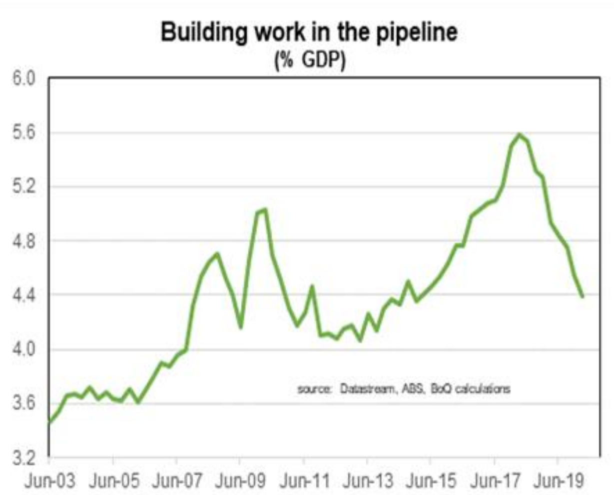
Even before COVID the residential construction industry was slowing. There were clear signs of over-supply (indicated by declining rents). But things have got worse post COVID. Demand is lower because of the big decline in immigration. Supply is higher from an increase of existing housing stock hitting the market as students and long-term visitors returning home. Some renters will also have returned to 'mum and dad'. An uncertain environment makes it tough for consumers to have the confidence to want to make a big investment.

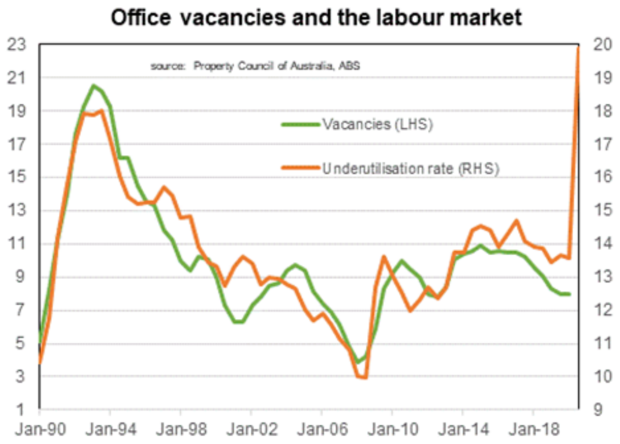
Conditions are different between states and across different segments of the industry. Lower immigration will have a bigger influence on Sydney and Melbourne, the two states that have had the biggest increase in supply of new housing in recent years. Soggy house prices is good for first home buyers, but not for investors. The demand to build new houses is likely to be stronger than for units the next couple of years.

It is not all doom and gloom. The amount of alteration and additions work is rising. This will get a bump from the Government's stimulus package, although how big a bump is a matter for debate.

There will also be a decline in non-residential construction. There is a substantial amount of new office space about to hit the Sydney and Melbourne markets. At the same time the weaker economy means less demand for office space (even once social distancing policies are fully relaxed). Some projects will still go ahead, but the level of building activity will be lower for some time.

One positive of a slowing construction sector is that resources become available to stronger areas of the economy that need similar skills (such as mining or infrastructure projects).





Global Economy

The biggest risk though is the global economy. The European and US are gradually opening up their economies. It will be interesting to see whether they can keep them open given their still high level of new cases (notably in the US and UK). Important for Australia is that a number of our major trading partners (notably China, Korea, Japan and Singapore) have dealt with this crisis well. The US and European Governments have splashed a lot of cash around to support their economies. The Asian Governments are now following.

The economic data is improving. But wherever you look there are worries. In Europe the concern is that a number of governments (such as Italy) don't have the ability to spend enough to pump up their economy. In the US it is that the sky-high unemployment rate won't come back down to earth quick enough. In China it is the rapid buildup of debt.

And the biggest worry is a number of emerging countries (notably in Africa and South America). Some (such as Brazil) have dealt with COVID poorly. Many of the countries have very poor health systems, and are unable to treat, trace or test anywhere near as well as most developed countries. Their Governments' also do not have the same fire power to support their economy. And many of those countries are already vulnerable from having too much debt.

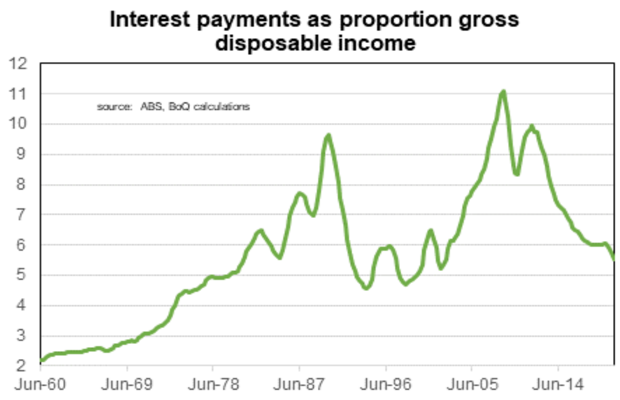
Financial market confidence in the global economy has improved over the past month (a reason for the big bounce in equity markets). Big country central banks have made it clear they will do what is necessary to support economic growth. Some Governments' are also doing their bit. But success in dealing with the health crisis has been mixed. And it is yet far from clear whether all countries will be able to do enough to re-fuel their economy.

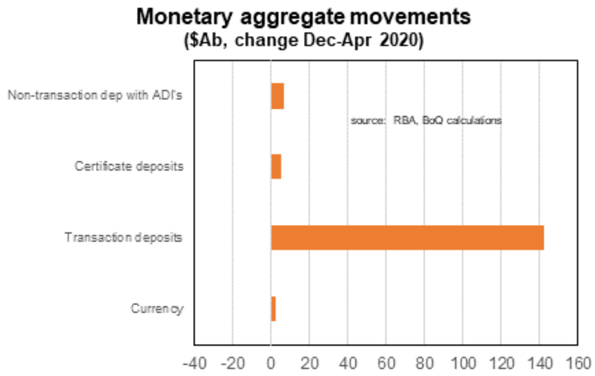
Monetary Policy

But there are reasons for hope. A key factor behind the better than expected economic performance in March was that the RBA quickly cut interest rates and made sure the financial system had plenty of liquidity. The more recent data has convinced the RBA that the economy is doing better than previously thought. Better, but not good enough. This means that the cash rate will need to remain at 0.25% for an extended period. Ditto the three-year part of the (government) yield curve will remain at around 0.25% for some time. It can be taken as a given the RBA will do what is needed to make sure the cheap financing is widely available.

One question I often get is whether interest rates this low adds any extra punch to the economy. Certainly it has not spurred any new borrowing. Monthly credit growth was flat in April. But very low rates is helping households and firms repay debt. Low interest rates has helped keep a lid on the $A. And they are an important reason why house prices have held up (and equity markets have rose). Right now a lot of the extra cash that the RBA (and Government) have pumped into the economy has been saved. But as confidence returns and the economy continues to open up more of that cash will be spent.

There has also been speculation that the RBA is contemplating a move towards a negative cash rate. The RBA themselves are against it (and I agree), thinking that the negatives (weakens the banking system, bad for confidence) outweigh the positives. With the economy currently showing better signs the RBA is more than happy to keep policy where it is. If things do turn bad there are other levers than can be pulled (such as buying bonds to reduce long-term interest rates). The RBA though would face a difficult question if the Federal Reserve (the US central bank) decided it needed a negative cash rate (but is unlikely).





Fiscal Policy

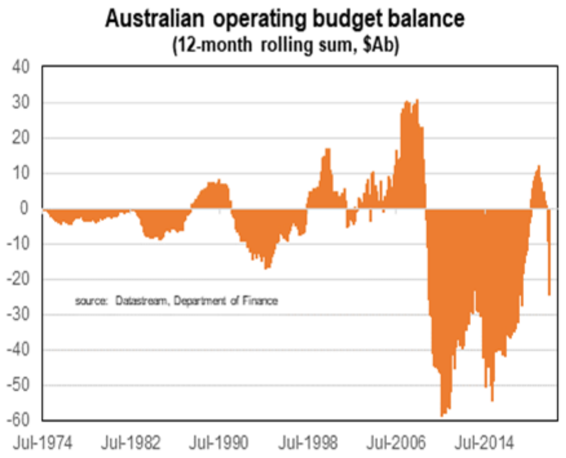
Having very cheap widely available finance has been important. But the level of interest rates is not the crucial issue holding back the economy. Right now it is a lack of income. Towards the end of the year (and into next) it will be a lack of demand. And with these problems only a government can help.

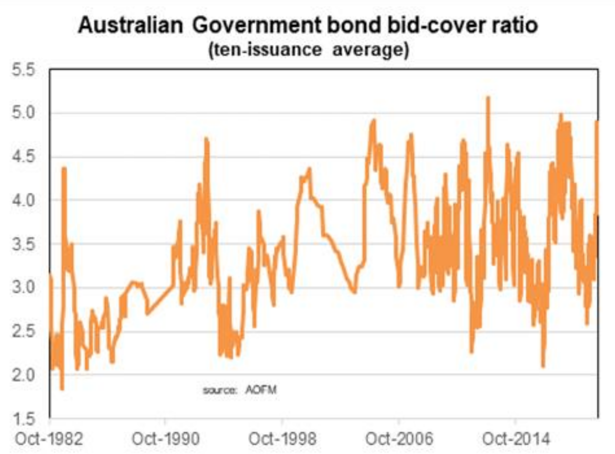
And they are. The amount of money that the Australian (and state) Government(s) are pumping into the economy is towards the top end of the global fiscal spending table. The Government can be so generous because Australia's debt is very low by global standards (we are one of the few AAA rated countries) and interest rates are rock bottom. To date the Government has been easily been able to funds its bigger budget deficits.

There is more Government support to come. In addition to the recently announced construction package there has been more funding for infrastructure. More spending is likely to be required. Ideally it should go towards areas that also help boost the long-term potential of the economy.

There has been discussion about a looming 'income cliff' with the end of the Jobkeeper program at the end of September. This could be a problem. But we don't know how strong the economy will be at the end of September so we have no idea about the size of the 'cliff'. In any event after their aggressive support of the economy so far this year there is very little chance the Government would knowingly let the economy walk off a cliff.

Encouragingly, there is also discussion about other policies that will help the economy. These include tax and industrial relations reform, as well as Commonwealth-State responsibilities (ie, simplifying which government is responsible for doing what things). It is not clear as how much action will come from the talk (although there are some promising signs). But at least there is talk.





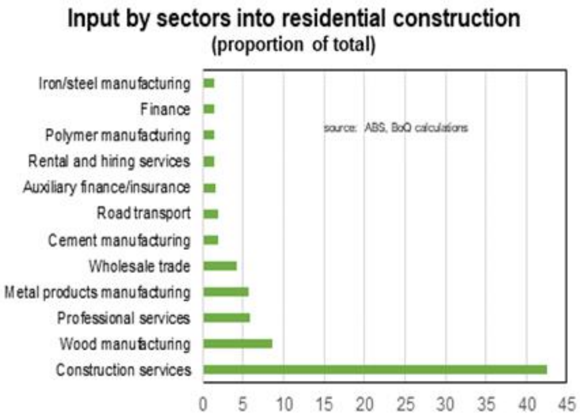
Manufacturing

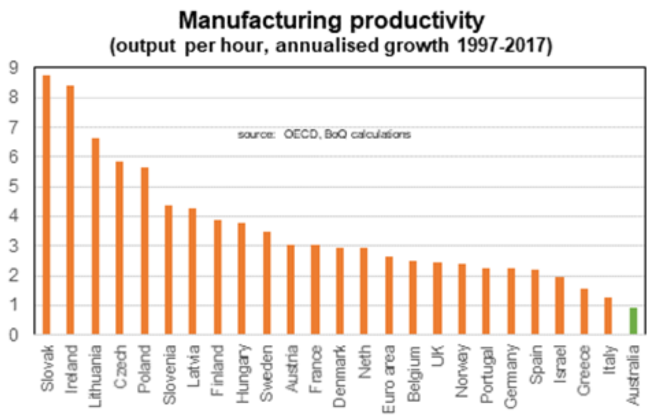
One sector that is being talked about having growth potential is manufacturing. Manufacturer's had a pretty good March quarter, helped by the sudden need to produce sanitisers and face masks. That need won't go away for a while. Manufacturing will get a further boost when a vaccine/treatment is found (Australia does manufacture vaccines). But other manufacturers will be hit by a weaker construction sector.

COVID exposed Australia's vulnerability to problems in the medical supply chain. It is almost certain that the Government will require more medical supplies to be manufactured locally in the future. But there has also been suggestions that Australia should become more self-sufficient in other areas of manufacturing as protection against a future pandemic (or war).

The problem is that Australia has not been competitive in manufacturing for some time. Our productivity in that sector has been at the bottom end for developed countries. A sky-high $A was a problem during the mining boom. More generally the mining boom supercharged incomes in the Australian economy, making it difficult for local manufacturer's to compete. In more recent years the rise of energy prices has made things tough.

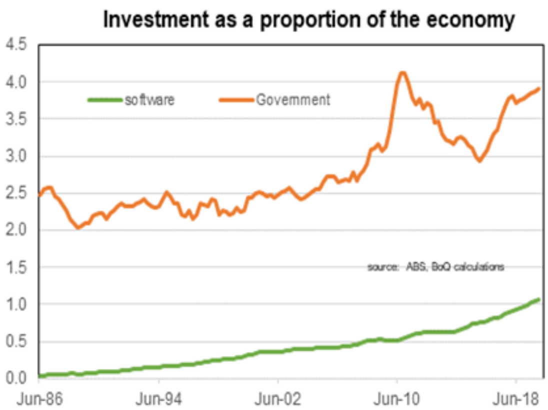
If the Government was to require more manufacturing to be done in Australia that would mean that more production would be done by a relatively inefficient industry. The result would be lower incomes for Australians. But there are reasons to think the sector will become more productive. The weaker $A (if sustained) will help manufacturers. And some of the policy changes the Government is discussing (taxation, industrial relations reform) if implemented would be a big plus. As would anything that could be done to lower energy prices.

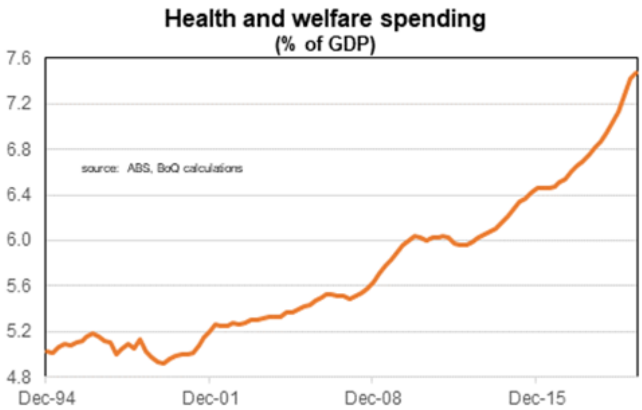




Fast Growing Industries

The COVID crisis has not changed the fact that some fast-growing industries will remain fast-growing industries. Firms will still look to make productivity improvements by investing in technology. An aging population will still require a top-notch health sector. Welfare spending will remain strong, notably programs associated with the NDIS (the occupation with the second largest vacancies in April was psychiatrists). And both Federal and State Government's intend to ramp up their spending on infrastructure.





Like my water-slide jaunt, the economy has found its bottom pretty quickly. After the initial jump my ride was pretty smooth. With the virus still around, the global uncertainties and the state of the jobs market, the domestic economy will have a bumpier ride. But now it is a ride with greater hope, particularly with the Government and RBA standing by to provide a guiding hand.

We live in interesting times.

Peter Munckton
Chief Economist
BOQ Group