ECONOMIC & FINANCIAL MARKET UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

15 JUNE 2020

BOQ GROUP

Key Points

- **Both business and consumer confidence is heading higher;**
- **Consumers appear more confident than firms, particularly about the jobs outlook;**
- **Cash flow concerns will keep a lid on business Capex, exporters worry about the global economy;**
- **Households are looking to invest in bank deposits and equities, but in housing.**

Summary

May saw a notable jump in business confidence. But it also meant that confidence had improved from a truly shocking level to a merely terrible one. Forward order books remained dire (albeit not as bad as April). Both business conditions (and orders) should improve in June.

Not all industries are feeling the economic pain equally. Iron ore miners are doing Ok. As are food, electronic and a number of recreation stores. There is lots of money being spent on gambling! And manufacturing has done better than the wider economy. Parts of manufacturing are being hurt by the slowdown in the construction industry. Social distancing policies have hit the service sector the hardest.

The bounce back in consumer confidence has been more pronounced. Confidence is mixed between age groups. Consumers report that their family budget is not in great shape. Households' fear about unemployment is not unusually high. Their biggest issue is the lack of income growth. Despite the current gloom households are more optimistic than usual about the medium-term.

Low confidence is impacting the way consumers save. Households want easy access to a chunk of their saving. So putting money into a bank has been popular. The desire to invest in housing is at historically low levels despite the rock-bottom level of interest rates. The discussion about falling house prices means there are some (potential) buyers.

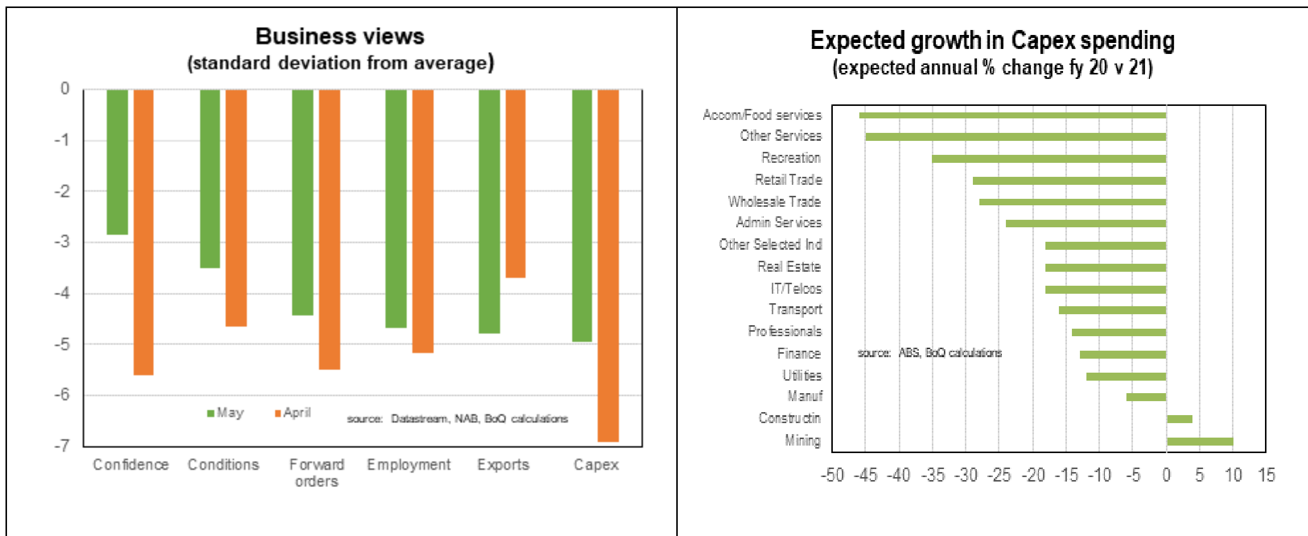
Sell in May and go away

That is the old share market saying in the US (May being before the start of US summer when the economy enters a seasonal slow period). What might be true for the US equity market (although September always seems to be the month when serious things happen) was certainly not true for Australian firms this year. With the infamous 'curve' almost flattened and government re-opening announcements popping up by the week, May saw a notable jump in business confidence. But confidence improved from a truly shocking level in April to a merely terrible one in May. A further improvement in confidence is virtually certain in June given the further reductions of social distancing.

Confidence is important. But it is different from the conditions that firms actually face. Businesses say that conditions did improve in May but remained worse than in any other time for at least the past twenty five years (the history of the survey). Forward order books remained dire albeit not as bad as in April. Both business conditions (and order books) should improve in June.

While there has been a lift in confidence firms remained concerned about their cash flow. This means capex budgets are expected to be meagre in coming months (particularly for service sector firms). And firms' appetite to boost payrolls also is low (although most existing staff will be re-hired). Job ads are at a very low level (there are also signs of improvement).

A big worry for firms was the export outlook (firms say it worsened in May). The problem will be reduced as the global economy (slowly) re-opens. But many countries (including the US and the UK) have not got on top of the health crisis. The situation is even direr in many Emerging Economies, with worse health systems and less scope for governments to pump up their economy. The economic outlook for most countries is worse than for Australia.



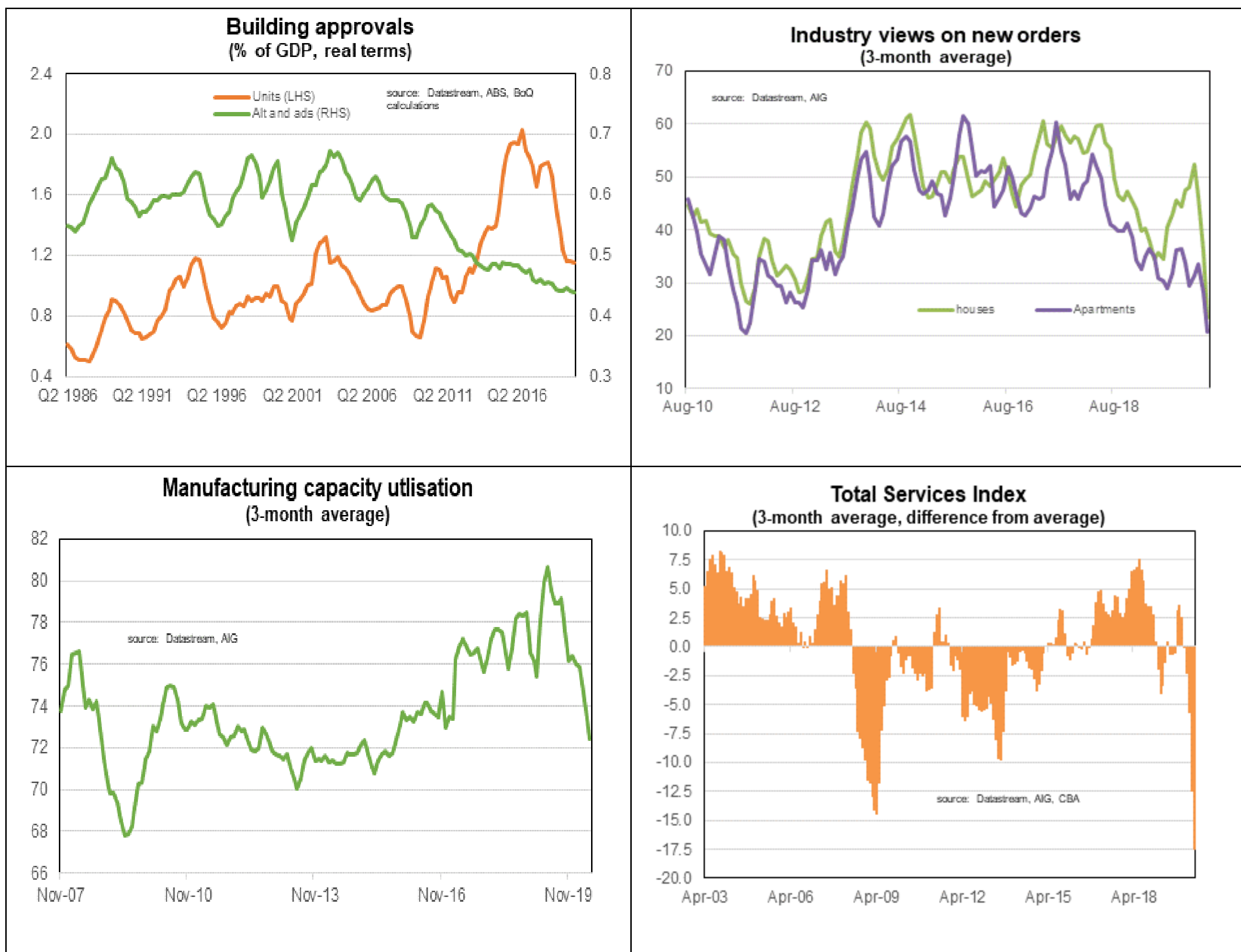
Not all industries are feeling the economic pain equally. Iron ore miners are doing Ok. As are food, electronic and a number of recreation stores (bike shops). There is lots of money being spent on gambling! And (as is the case in most countries) manufacturing has done better than the wider economy. In the year before COVID manufacturing was doing fine, with companies reporting rising capacity use. Subsequently, manufacturers have had to meet rising demand for a number of goods (toilet paper, canned fruit, sanitisers, ventilators).

COVID has resulted in some manufacturers being busy while others are not. Many firms in the industry are exporters (or import vital components). They are vulnerable to the chill winds that have hit the global economy (and supply chains).

Others parts of manufacturing are being hurt by the slowdown in the construction industry (activity has fallen for the past five quarters). Residential construction in particular has been suffering, with a very sharp slowing of new orders for both units and dwellings. The Federal Government package is about getting more alterations and additions work done over the next year. Builders have noted a jump of inquiries. How much this translates into actual work done has been a matter for debate.

Rising supply and the weaker economy will hit commercial building (notably for Offices). Approvals for new hotels are also likely to fall over the next couple of years. Building for segments of industrials (logistics and data storage centres) is likely to be stronger.

Social distancing policies have hit the service sector the hardest. And a number of these sectors will be the last bits of the economy to return to 'normal' (transport, food and accommodation services). Service sector companies are making the most savage cuts to capex budgets. They are also the areas of the economy where jobs growth might be the slowest.



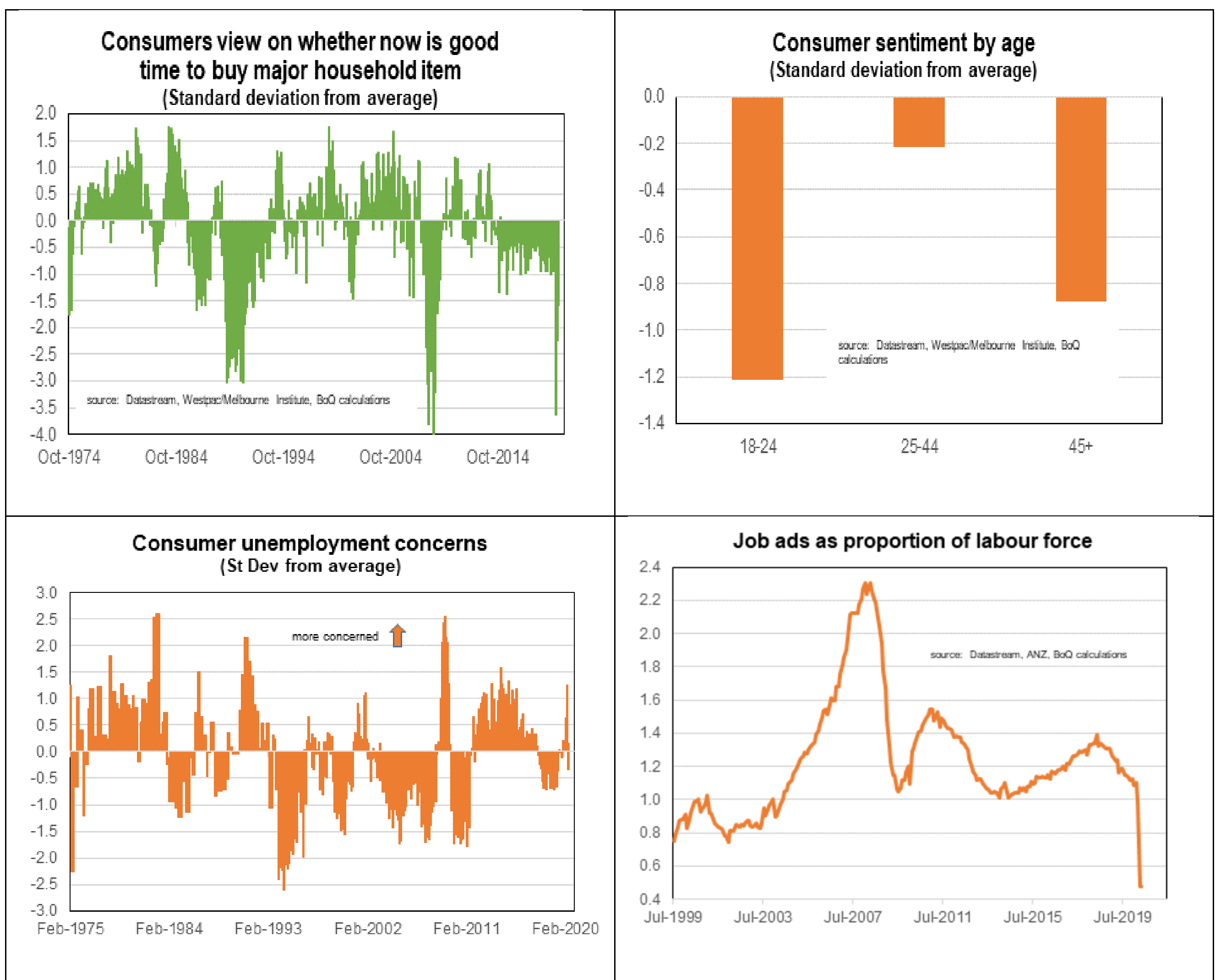
The bounce back in consumer confidence has been more pronounced (albeit still at weak levels). Confidence is mixed between age groups, lower amongst the very young and more experienced workers. These are the age groups most affected by the weaker jobs market. Many older workers have also had the experience of a recession and might be more fearful about the implications.

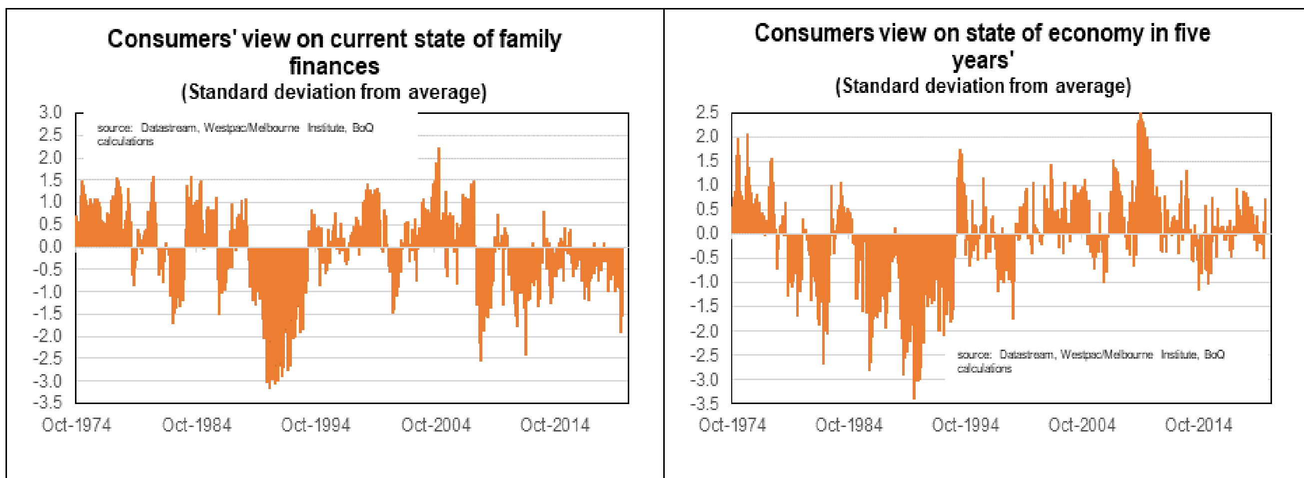
Consumers report that their family budget is not in great shape. Government support has been a big help to (many) households. Consumers report that they are unlikely to make big purchases (cars). But they can still spend. Transaction data from the Major Banks indicates spending has been rose across a number of categories in May.

Households' fear about unemployment is not unusually high. And this is despite the underutilisation rate hitting a record in April (almost 20%). This lack of concern probably reflects many workers view that they will get their old job back once their business re-opens. In many cases that will be right. Other workers may not be worried because the JobKeeper payments are currently providing a decent level of support. But job ads and employer hiring intentions are at a very low level. Unless they pickup in coming months the level of unemployment could be higher than households' expectations. This could lead to a renewed hit to confidence.

The biggest issue for households over recent years has been a lack of income growth. This will remain the case over the next couple of years with a soft labour market and low national income growth. The closure of many shops has meant that consumers have been 'forced savers'. Being able to draw on this saving will help consumption in the coming couple of quarters. But consumers are unlikely to be able to carry the economy unless there is sustained growth of disposable incomes. This argues for the next stage of the income tax cuts to be bought forward.

Despite the current gloom households are currently more optimistic than usual about the medium-term economic outlook. Their optimism probably reflects the success that governments have had (to date) in battling the health crisis. Hopefully they have the same success with the economics.





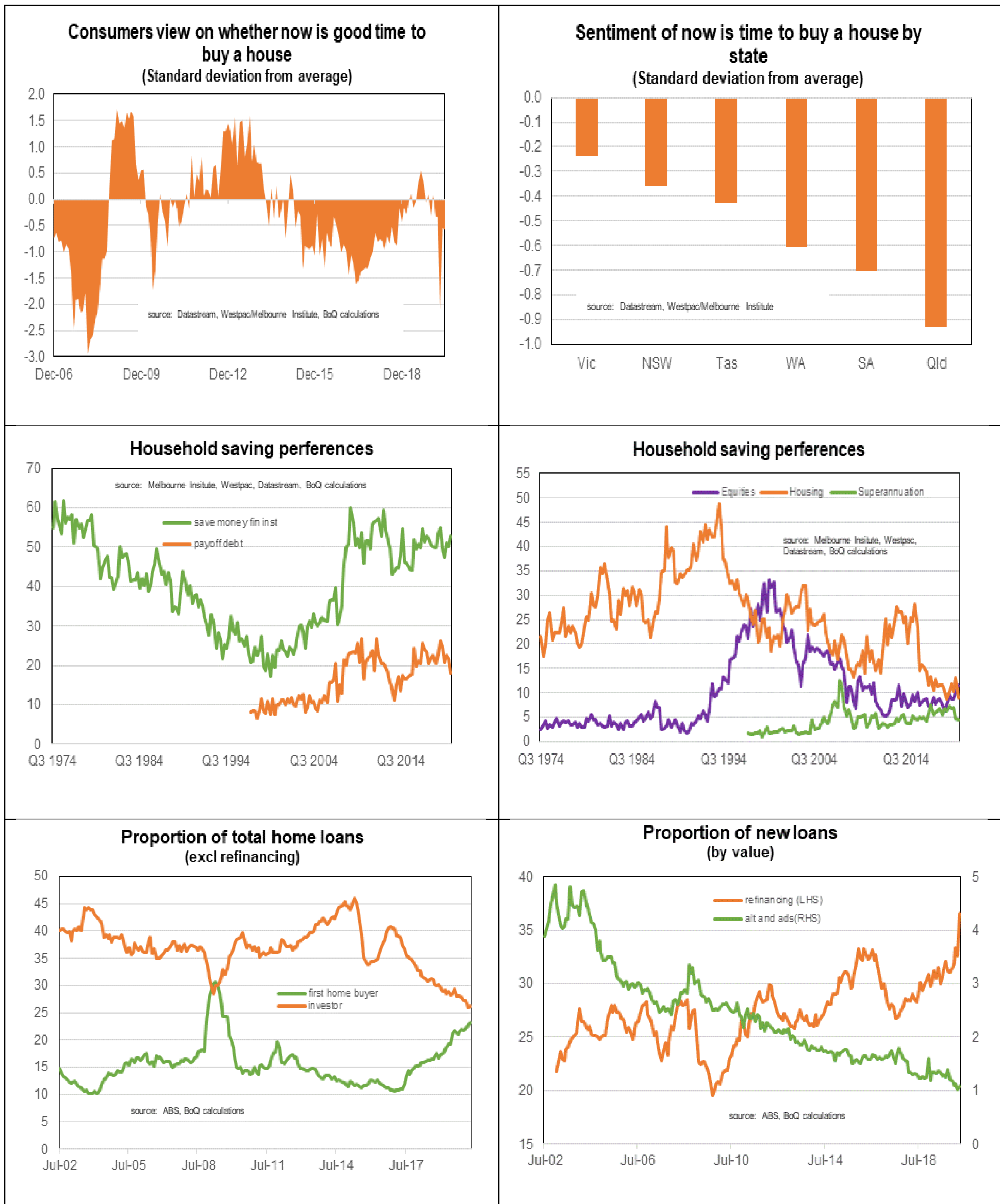
Low confidence is also impacting the way consumers save. Understandably in these uncertain times households want easy access to a chunk of their saving. So putting money into a bank has been popular (as seen by the big jump in transaction deposits). Households are also looking more closely at cash management trusts and (even) bonds (also because they provide a slightly better return right now than deposits). More people are investing in equities (households like the potential return although it is unclear whether all of them understand the associated risks).

By contrast the desire to invest in super has fallen with many households wanting access to their money. The desire to maximise cash on hand has also reduced the attractiveness of paying back debt (although the preference of reducing debt remains well above the level seen in the 1990s).

The desire to invest in housing is at historically low levels despite the rock-bottom level of interest rates. House prices look like falling (and most places aren't cheap). And there has been a big increase in rental listings resulting in falling rents and rising vacancies.

The discussion about falling house prices means there are some (potential) buyers (notably in Victoria and NSW). But they need to see value. The value of home loans fell 5% in April, with the decline broadly even across owner occupiers and investors. The decline of loans to first home buyers (owner occupiers) was less dramatic, the buyers most attracted by improved housing affordability.

BOQ GROUP



So business and consumers both reported that the slow unfreezing of the economy is leading to rising signs of life. Where the economy was in May/June is not where it needs to be. It will certainly get better in coming

months. Whether that will be good enough is the key question. Hopefully for the Australian economy the new motto will be 'Started selling in May and here to stay'.

We live in interesting times.

Regards,

Peter Munckton
Chief Economist
Bank of Queensland