ECONOMIC UPDATE

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BOQ GROUP

Summary:

- **The June quarter GDP numbers were the nadir;**
- **The services sector was hit particularly hard;**
- **Government support meant consumer incomes actually rose in the quarter;**
- **Things are improving;**
- **How much they will improve will depend upon business and consumer confidence**
- **And importantly, the extent of fiscal and monetary support.**

We knew it would be bad, and it was. June quarter GDP growth in Australia declined at its fastest ever pace since quarterly records began. And the RBA believes that it was the biggest fall since the 1930s Great Depression. Following on from the decline in GDP that happened in Q1, such weakness would be expected to have a notable impact on the labour market. And it has.

Outside of Government and some utility and mining sectors, very few industries managed to grow. The impact on some sectors was eye-boggling. It is no surprise to see that those are the sectors looking to take an axe to capex budgets this financial year. As would be expected in a very uncertain economic environment, building up saving and cutting unnecessary spending was a theme of the second quarter.

Government income support was also a massive boost for households. Despite GDP growth being down 7% in the quarter, household incomes actually rose. This had nothing to do with the size of pay packets which fell. Many took the opportunity to build their saving that will help provide a buffer if the economic times remain tough.

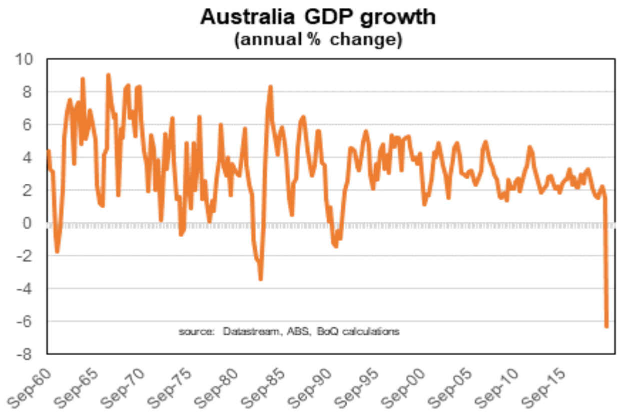
One of the key issues for demand will be the state of business and consumer confidence. In that regard the evidence from the most recent NAB business survey was not good. Business confidence actually improved a little but firms reported that business conditions deteriorated in August. One reason for optimism is that consumer confidence improved notably in September. Ongoing government fiscal support (as well as mortgage payment holidays) are leaving many family budgets in decent shape. There is also good news globally. After being smashed in Q2, many developed countries look to be on track to record impressive growth rates in Q3.

A tough quarter

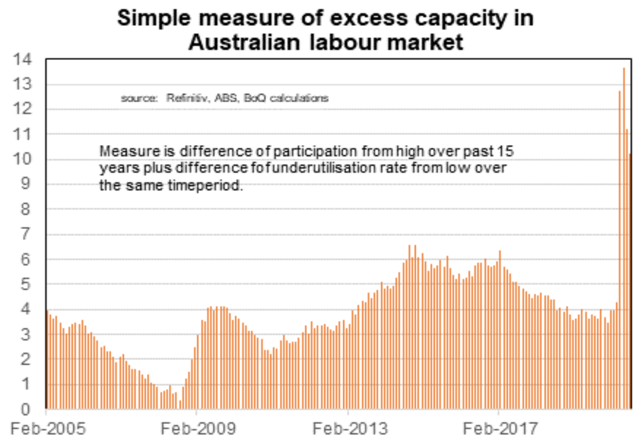
We knew it would be bad, and it was. June quarter GDP growth in Australia declined at its fastest ever pace since quarterly records began. And the RBA believes that it was the biggest fall since the 1930s Great Depression. The outcome was also a lot weaker than expected by most analysts although I am not sure why. Peer OECD countries all suffered a similar shock to their economy, and their GDP declined by between 8-20% in the quarter. Hours worked fell by over 8%.

Following on from the decline in GDP that happened in Q1, such weakness would be expected to have a notable impact on the labour market. And it has. There is over 10% of the workforce not in a full time job relative to a 'strong' jobs market. And that calculation does not include the number of workers who say they have a job but are currently working zero hours.

Since quarterly records began there has never been a plunge in GDP.



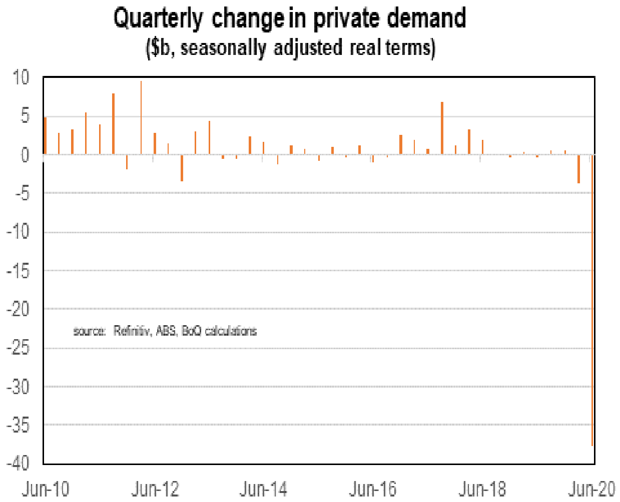
There are lots of workers hoping to find a job.



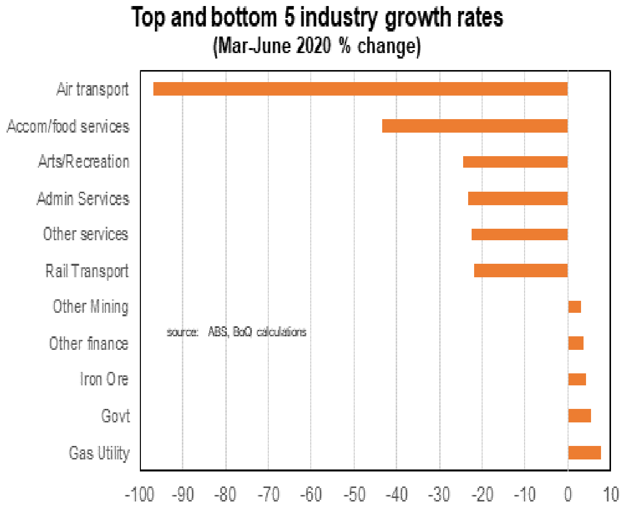
Economic weakness was concentrated overwhelmingly in the private sector. Outside of Government and some utility and mining sectors, very few industries managed to grow. It has been argued that the rise of service sectors was one of the reasons why the volatility of economic growth has declined substantially over recent decades. But service sectors are mostly about people serving people, a problem during a pandemic. Even without Government intervention demand for services would have declined as consumers became more cautious. But Government regulations to limit people movement broadened the economic impact.

The impact on some sectors was eye-boggling. Demand for plane tickets fell 96% in the quarter. The accommodation and food services and recreation industries were hit very hard. It is no surprise to see that those are the sectors looking to take an axe to capex budgets this financial year. Exporters (outside of iron ore miners) had a tough quarter reflecting weak global growth and supply chain disruptions. But imports fell by even more reflecting the massive drop in consumer and capex spending (and supply chain disruptions).

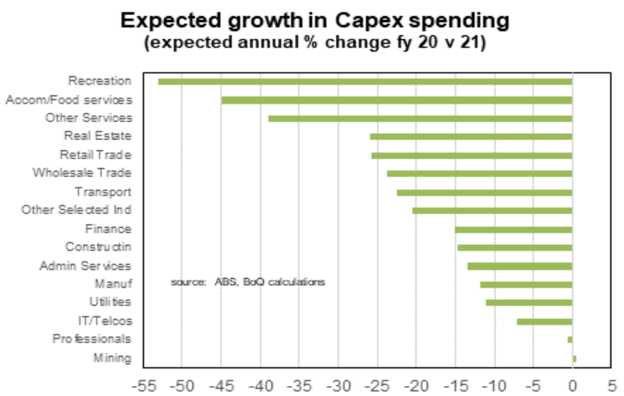
Spending by the private sector cratered in the June quarter.



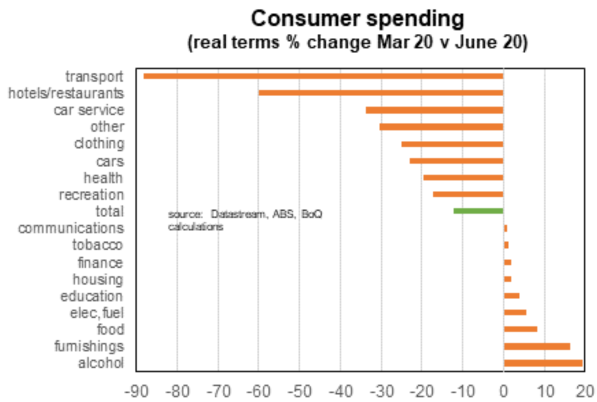
Some sectors grew, far more declined and some by a lot.



Capex budgets for this financial year are being cut across all non-mining sectors.



Household spending rose for most goods but fell for most services.

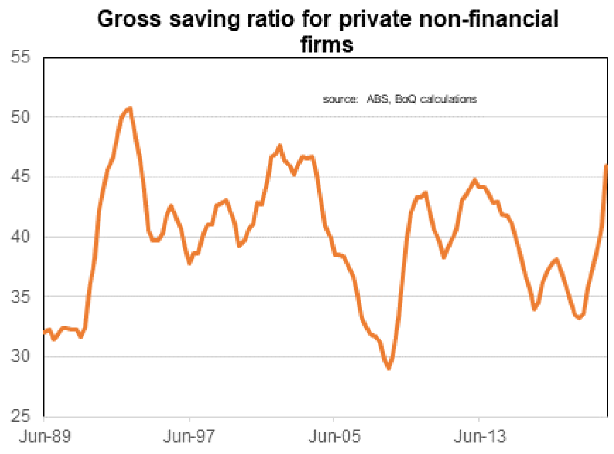


As would be expected in a very uncertain economic environment, building up saving and cutting unnecessary spending was a theme of the second quarter. My calculation of the saving rate by non-financial firms is that it was at its highest level in almost twenty years. To make sure they had enough cash on hand firms not only cut spending and capex, but dividends. They boosted equity. Companies got a kicker from JobKeeper/Seeker programs (which in turn helped to keep jobs).

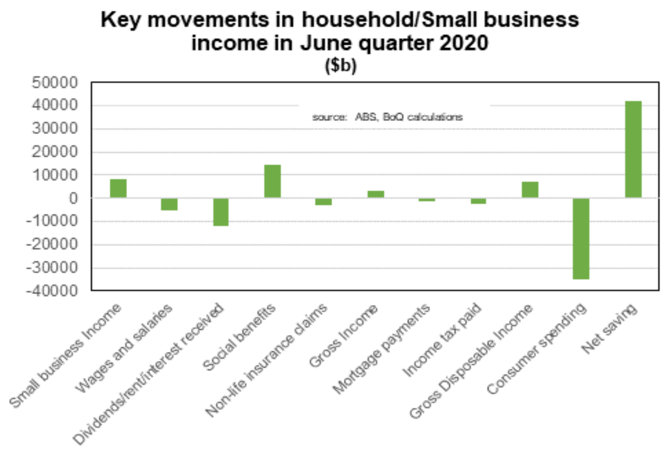
Government income support was also a massive boost for households. Despite GDP growth being down 7% in the quarter, household incomes actually rose. This had nothing to do with the size of pay packets which fell. And households relying on dividend or interest cheques, or are landlords, had a very disappointing quarter. But many benefitted from high social security payments, and small business owners received a hand up from JobKeeper. Disposable incomes were further boosted by lower mortgage and rent payments, reduced income tax payments and early access to super. And when you take into account that household spending fell through the floor (because the shops were shut or heightened consumer caution), there was a massive jump in household saving.

So while spending and production in the economy got smashed in the quarter, massive Government support meant that in aggregate consumer and business incomes were spared (although individual households and firms did it tough). Many took the opportunity to build their saving that will help provide a buffer if the economic times remain tough.

Business saving rocketed up.



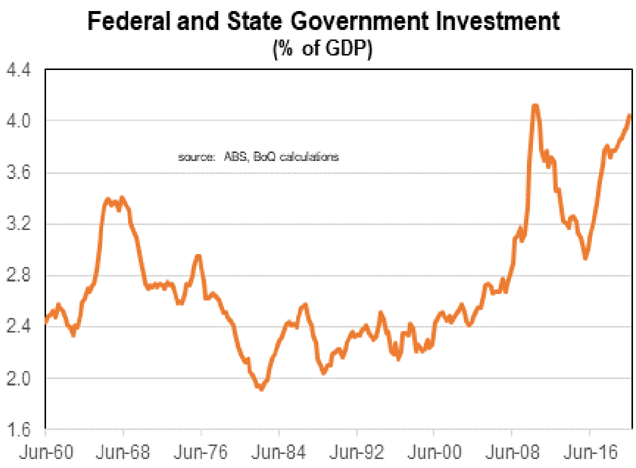
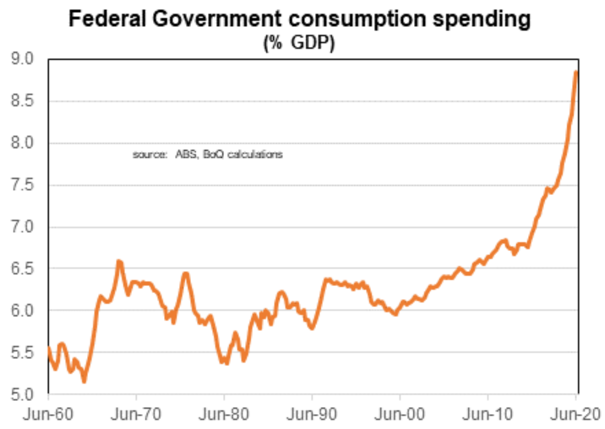
And so did household saving.



But not only was Government income support programs important so was their spending programs. As noted the Government sector was one of the few that grew in the June quarter. Federal Government 'consumption' spending (public servant wages, purchases of computers and pens) has been a strongly growing part of the economy for much of the past decade. More recently that has also been the case for State Government 'consumption' spending. Aggregate Government investment spending (notably on infrastructure) is back to the GFC-stimulus highs.

So Government income and spending support was crucial for the economy in the second quarter. And strong fiscal support will remain crucial for some time to come. Australia has both the economic means (low debt levels, very low interest rates, strong investor support) for an extended period of fiscal pump-priming. And there looks also to be the political will (consensus across the Federal and State Governments that more spending is required).

So the most important domestic economic piece of news for the remainder of the year will be the Federal Budget in October. Analysts will be looking for details of how much more fiscal support is on the way, and it what form (what additional spending, which taxes cut) will be delivered. At least if the tone of the recent political discussion is anything to go by the announcement should be positive one for the economy.

There has been plenty of building of roads and rail.	Government spending more generally has become a bigger part of the economy.
	

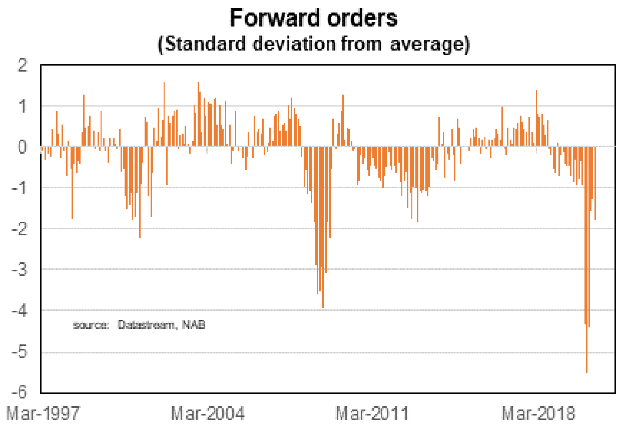
How much more support the Government will need to provide to the economy is of course unknown. We know that the RBA will do whatever it can to help. Recently it announced an extension to its program of providing cheap financing to banks so they can increase lending to firms (particularly SME's). This will help. And the very low interest rates is making debt payments very affordable for most. But neither the cost nor availability of finance is the crucial issue for the economy. It is the lack of demand.

One of the key issues for demand will be the state of business and consumer confidence. If confidence picks up firms and consumers will start spending more. This will lead to greater demand, and will mean businesses will need to create more jobs and do more capex spending. The virtuous economic cycle is then underway.

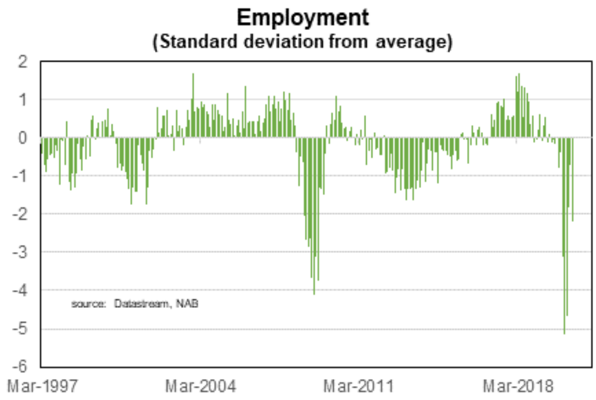
In that regard the evidence from the most recent NAB business survey was not good. Business confidence actually improved a little in August after the shock of the appearance of the second virus wave in July. But the economic impact of the virus was felt with firms reporting that business conditions deteriorated in August (exacerbated when Victoria went into level 4 lockdown). Order books dried up. Business employment plans got put very much on the backburner. Yes, Victorian firms found the going got a lot tougher but confidence dipped across all states (NAB reported that the declines were largest in Queensland, Tasmania and South Australia). Conditions might be weakest in Victoria, but only in WA and Tasmania are firms suggesting that conditions have returned back to pre-COVID times.

One note of optimism is that while firms (in aggregate) are reporting that conditions are bad, they are not (yet at least) saying they are at recessionary levels. Providing conditions don't deteriorate further there is a reasonable chance that business confidence should pickup again in coming months. And that should mean more optimism about job hiring and capex spending plans.

Order books are light.



Which mean hiring in most industries is not on the agenda.

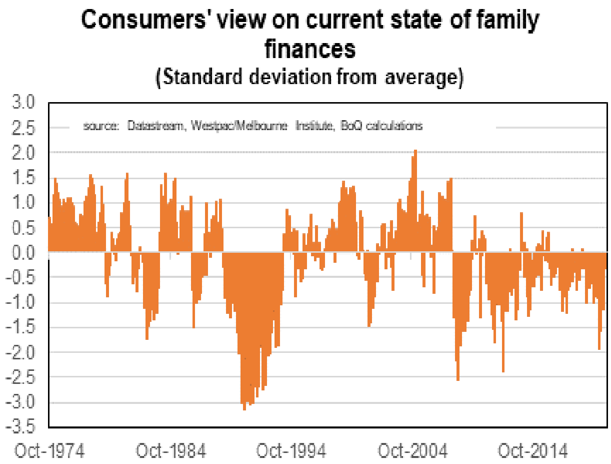


Another reason for optimism is that consumer confidence improved notably in September. One reason is that ongoing government fiscal support (as well as mortgage payment holidays) are leaving many family budgets in decent shape. Rock bottom interest rates helps (unless you are a saver). But while households believe that their budget is in decent shape surveys indicate that many are not in any rush to go on a spending splurge. Indeed, the recent GDP numbers indicated that while spending on necessary items rocketed up (toilet paper, rice, wine), spending on many discretionary items crashed (meals out, holidays).

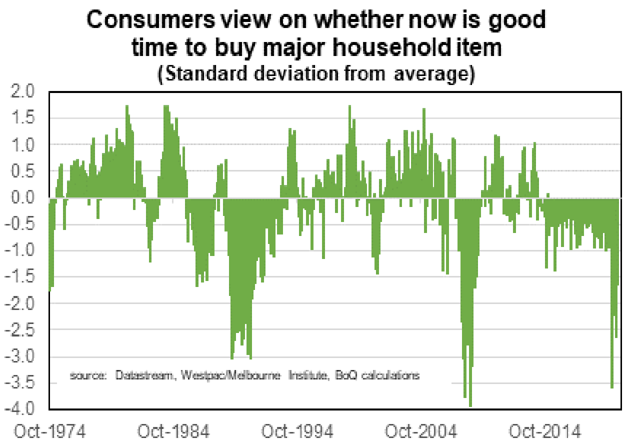
The exception to that pattern was consumer spending on health. In the June quarter that dived mainly because for many weeks only critical health businesses remained open. But consumers caution about visiting their doctor or dentist also played a role. And that consumer caution about visiting their GP has yet to be completely unwound.

Consumer worries about unemployment also fell, although there might be some misplaced optimism. As noted, employer hiring intentions are currently very low. And while job ads have picked up from their nadir in April, they remain well below the levels typically seen over the past couple of decades. It is unsurprising to see that confidence is lower amongst 18-24 year olds, the age group hardest hit in the jobs market (it is also weaker amongst those who are 45 or older likely reflecting health worries associated with the virus).

Households have become more comfortable about their budget.

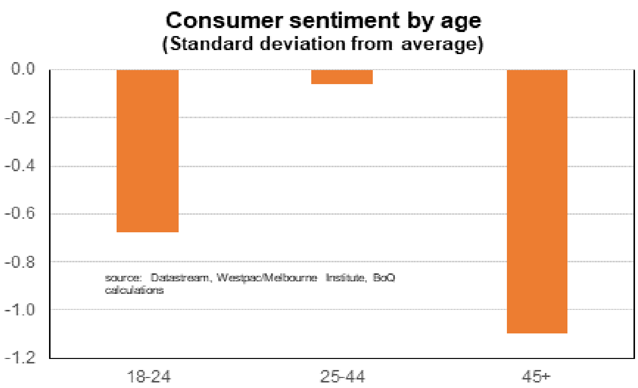


But they are still unlikely to go on a spending splurge.



They became less worried about the jobs market, although that optimism might be misplaced.

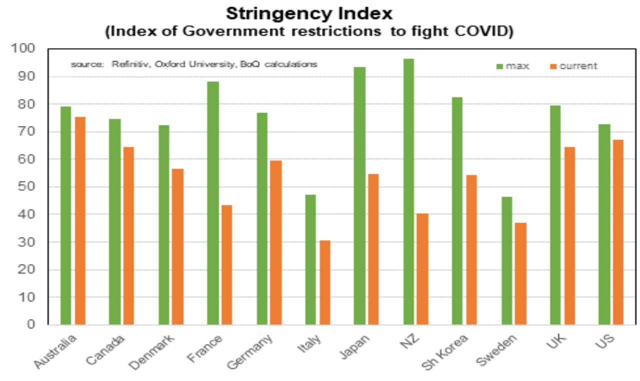
Confidence was lowest amongst the older and younger workers.



There is also good news globally. After being smashed in Q2, many developed countries look to be on track to record impressive growth rates in Q3. China is leading the way, but the US and European economies also appear to be doing alright despite ongoing battles with the virus. In most economies (but particularly the US and the UK) the data has been a lot stronger than expected over the past few months (Australia is an exception). One of the reasons is that the other developed economies suffered a bigger GDP fall in Q2 when their economies were shut to fight. There is a good chance then will enjoy a bigger bounce than Australia in Q3, particularly (according to Oxford University calculations) as they have generally eased more of the restrictions on their economies.

Economic data has been stronger than expected in most major economies over recent months.

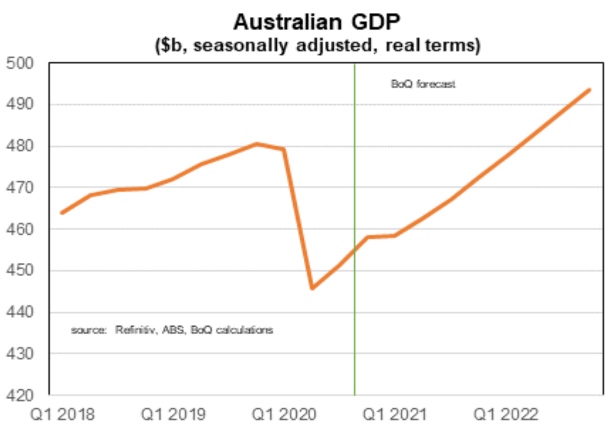
Government restrictions remain tighter in Australia compared with peer economies.



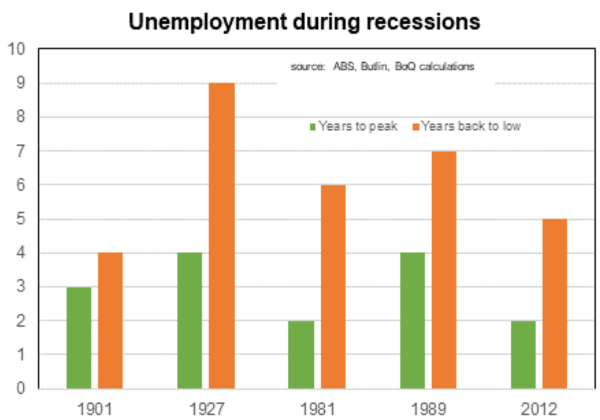
So there are grounds for optimism. How much optimism will depend upon the degree of monetary and fiscal support the economy receives. Most likely a lot, but we shall see. The other is how business and consumer confidence reacts to economic developments.

But even if we purchase a pair of rose-tinted glasses, it is hard to see the economy returning to normal for a while. I am at the optimistic end on how the economy will evolve over the rest of this year (although a little more pessimistic about next year). But even with this optimism I think it won't be until the first half of 2022 that the size of the economy will return back to pre-pandemic levels. And as I noted a few weeks ago, it typically takes twice as long for the unemployment rate to fall back to its lows as it does to rise to its peak. And that suggests that a return back to an unemployment rate in the 'low 5's' (the rate in March) is unlikely to occur until 2023 (at the earliest).

It will take some time for the economy to return to where it was.



The unemployment rate goes up by the elevator but down by the stairs.



At the end of the day this remains a health crisis. While the virus is still circulating consumers and businesses will remain wary. And Governments will think about whether to place restrictions on economic activity. Despite the recent news of a setback to one of the candidates, confidence that a vaccine will be developed and widely available next year remains high. The effectiveness of treatments for COVID has risen significantly over the past few months. Testing and tracing capabilities have also improved significantly. All good news. But until a solution is found to permanently deal with the virus it will be hard for the economy to return to 'normal'.

We live in interesting times.

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