ECONOMIC UPDATE

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BOQ GROUP

Summary:

- **Australian GDP growth will be strong in H2 2020;**
- **But there is greater uncertainty about the first half of next year;**
- **This suggests that more fiscal stimulus may yet be required;**
- **And a further increase in bond buying by the RBA;**
- **I look for the $A to head towards 75c in coming months;**
- **And then perhaps to 77-78c sometime next year.**

I have thought for some time the second half of this year would be strong. First as Australia ex-Victoria opened up much of their economy (Q3), and then Victoria (Q4). I have been more cautious though about the first half of next year. Partly that reflects uncertainty about the path of the virus. But the economy is getting plenty of help. There are now realistic scenarios where GDP growth could be very strong over the next couple of years (and a factor behind the recent strength of the equity markets and the $A).

The biggest unknown is whether consumer and businesses spend. Households are saying it is not yet time to spend up big in the shops. Firms have boosted the size of their capex budget. But investment plans are still well down on last financial year's spend.

The central case economic forecasts for the next two years is still not good enough. Current projections have fiscal policy support being sharply reduced in the next financial year (although the total government budget deficit will be still be wide). This suggests that most Governments (particularly the Feds) may have to do a little more than currently projected next year. It also means that the RBA may have to further increase the size of its bond-buying program.

There is no doubt that the past month has seen positive factors line up for the $A. Iron ore prices (after adjusting for inflation) are near historically high levels. This has helped Australia record a significant current account surplus. Right now my simple model for the $A says 'fair value' is about 75c. This view is consistent with the level of the real exchange rate. Views on the economic outlook remain critical for the outlook for the $A. I look for the $A to head towards 75c in coming months, and perhaps then on to 77-78c sometime next year. The path of COVID over the next six months will play a big part in that story.

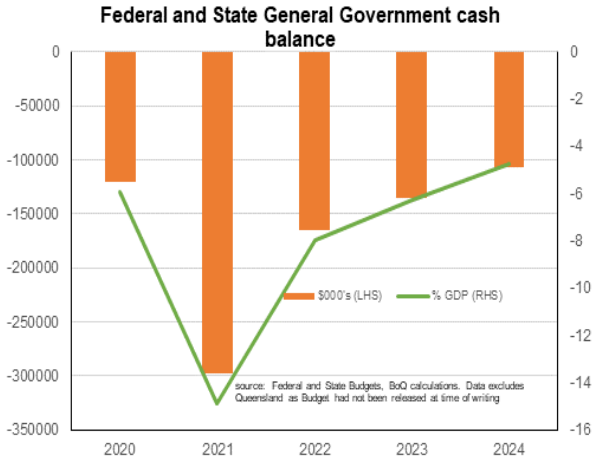
Interest Rates

As we have found out in 2020, a lot can happen in one year. But a lot can happen in just one month. In November we had the most controversial US election in at least twenty years. There has been positive news on not one but three potential COVID vaccines. The vaccine news (and a better run of data) has led to many analysts revising up their economic forecasts. I have thought for some time the second half of this year would be strong. First as Australia ex-Victoria opened up much of their economy (Q3), and then Victoria (Q4).

I have been more cautious though about the first half of next year. Partly that reflects uncertainty about the path of the virus. Certainly the vaccine news means that it is now almost certain that the domestic economy will be fully open by the end of next year (international restrictions are likely to remain in place longer). But as current events in Europe are highlighting until widespread immunity is achieved COVID retains the potential to dramatically hurt economic growth. Further, the New Year will see the reactivation of the insolvency regime. And at the end of March the JobKeeper and interest rate payment holidays come to an end. Finally, while the economy is benefitting from the opening up effect the underlying momentum remains sub-par.

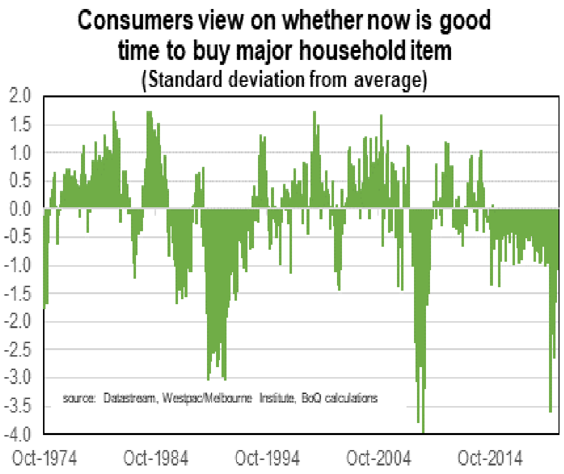
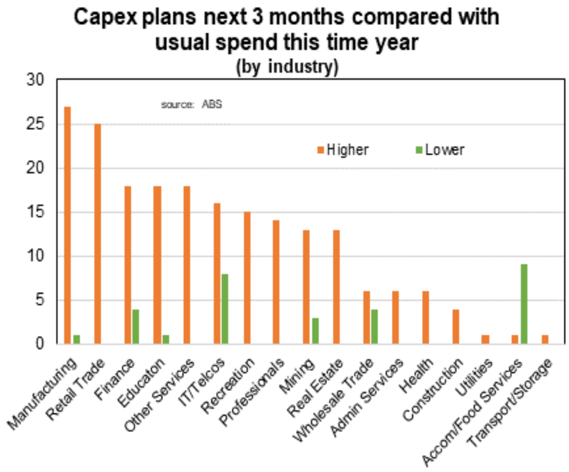
For those reasons I have been expecting that economic growth in the first half of next year would be just average. But the economy is getting plenty of help. After the Federal Government made headlines with an eye-popping Budget in October, the states that have released their budgets (Queensland had not at the time of writing) have joined the fiscal pump-priming party (most notably Victoria). This means there are now realistic scenarios where GDP growth could be very strong over the next couple of years (and a factor behind the recent strength of the equity markets and the $A).

There is plenty of Government support hitting the economy this year. But the fiscal taps get turned down next year.



Financial market inflation expectations have risen over recent months. But they remain below the pre-2019 levels.

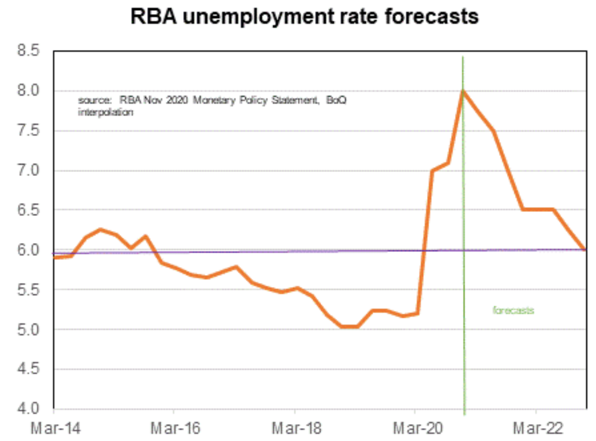
The biggest unknown is whether consumers and businesses spend the money that the RBA and Governments are letting slosh around the economy. While households have become more confident about buying a house (although not investors') they are also saying it is not yet time to spend up big in the shops. The improvement in the economic outlook in recent months has seen firms boosting the size of their capex budget. But investment plans are still well down on last financial year's spend (particularly in industries such as Accommodation and Food Services).

Households are still not keen about going in a spending binge.	**Firms have bumped up the size of their Capex Budget. But they remains small relative to last year.**
	

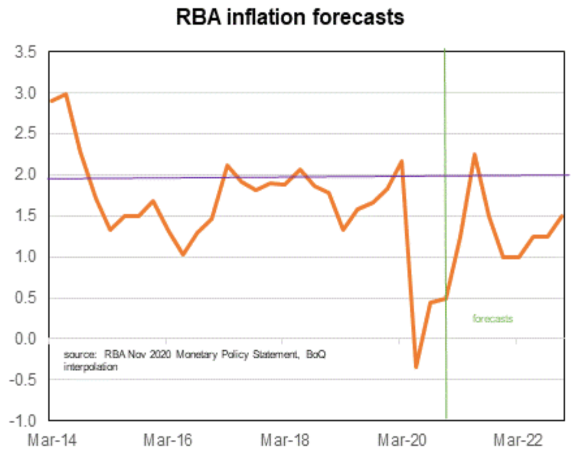
For the RBA the better news means they can more confidently forecast that the unemployment rate will go down and the inflation rate will rise. But their latest projections do not have the unemployment rate declining below 6% any time over the next couple of years. And the inflation rate is not expected to get close to 2% in that time. Over recent months Financial Market expectations about the inflation outlook has increased. But it remains well below the level typically seen pre-2019. And it is below the 2.5% mark that is the mid-point of the RBA's inflation target.

Arguments are starting to be made that Governments and the RBA might be providing too much stimulus. But the central case economic forecasts for the next two years are still not good enough. One reason is that the underlying economic momentum is not fast enough. And with some COVID-related restrictions likely for the next 1-2 years the economy will likely require some further help. Current projections have fiscal policy support being sharply reduced in the next financial year (although total government budget deficit will be still be wide). This suggests that most Governments (particularly the Feds) may have to do a little more than currently projected next year. It also means that the RBA may have to further increase the size of its bond-buying program (to help Governments afford the big budget deficits).

The RBA does not expect the unemployment rate to get under 6% for at least the next two years.



Nor the inflation rate to get above 2%.



Exchange rates

Keep it simple is a common piece of advice that is often not followed. Including by me last month. In October I thought there would be a pullback in the $A as a result of a period of $US strength. An important factor driving my reasoning was that the Euro looked vulnerable given the emerging weakness of the European economy because of rising COVID cases. And if the Euro was to go down the $US would benefit as it is the only market big enough to absorb sizeable capital flows out of Europe. I thought this would result in the $A spending some time trading under 70c.

All that happened. For about one day. The positive sentiment about the vaccines meant that equity markets went higher, as did commodities. The positive vibe helped emerging market currencies. Commodity currencies (such as the $A) have also benefitted from the strong Chinese economy.

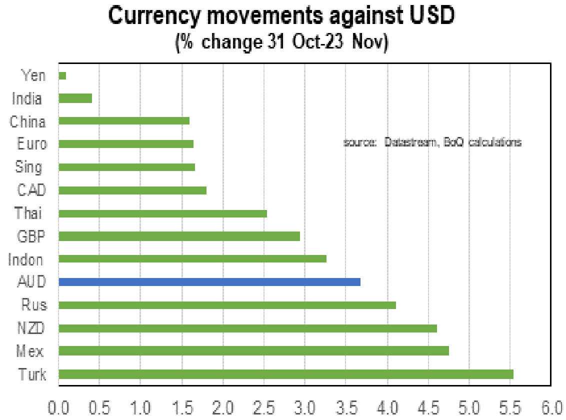
There is no doubt that the past month has seen positive factors line up for the $A. Iron ore prices (after adjusting for inflation) are near historically high levels. This has helped Australia record a significant current account surplus. That means that Australia does not need to offer higher interest rates to attract capital. Indeed one of the reasons behind the RBA's move to Quantitative Easing was to try and drive down the structure of interest rates, and therefore get a lower $A.

Right now my simple model for the $A says 'fair value' is about 75c. This view is consistent with the level of the real exchange rate (the $A adjusted for inflation differences with major trading partners) trading around its historic average. Views on the economic outlook remain critical for the outlook of the $A. The combination of improving sentiment about global growth and interest rates remaining low for an extended period would typically be positive for smaller markets (such as Australia). I look for the $A to head up towards 75c in coming months, and perhaps then on to 77-78c sometime next year. The path of COVID over the next six months will play a big part in that story.

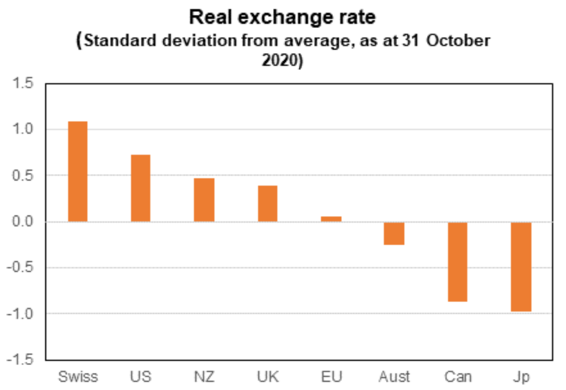
Over the medium-term a number of cross winds will hit the $A. One is that the $US is overvalued, putting upward pressure on the $A. Another is that Australia's net income deficit (the amount of interest payments and dividends we make overseas minus the amount that we receive) is nearest its lowest level in over 35 years. This suggests that the current account deficit will be structurally lower in coming years than it has been for the past forty. In turn this means that our interest rate structure relative to international peers may not need to be as high to attract funds. Or it could mean that the average range of the $A in coming years will be higher than it has been previously (particularly in the years prior to the mining boom).

Those are the medium-term positives for the $A. Before we get there it is likely that the iron price will have declined, and our goods and service surplus narrowed (or turned into a deficit). Financial markets are pricing in about a 20% fall in the price of iron ore over the next year. Given its historically high level, a drop of such a magnitude does not seem unreasonable. But financial markets have been pricing in that sort of decline for the past six months. And over that time the iron price has actually risen by that order of magnitude.

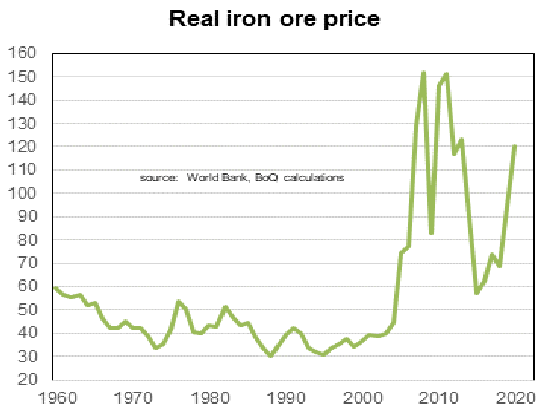
The $US has underperformed over the past month.



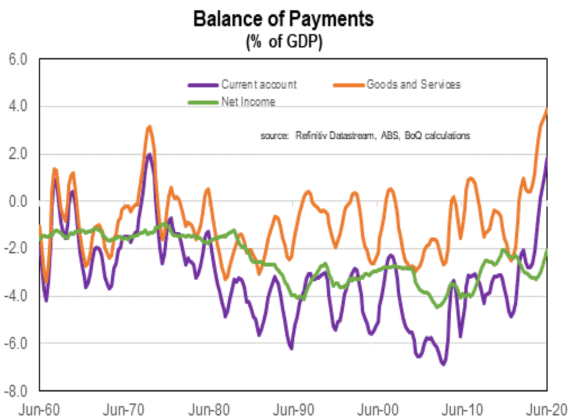
The $A and Euro looks close to fair value. The $US (and Swiss Franc) look over valued, the yen undervalued.



Iron ore prices are high by historical standards.



The current account deficit might be structurally lower in the future.



There are good reasons to be optimistic about a stronger economic outlook. But a stronger economic outlook does not mean strong enough. And optimism is not certainty. This suggests that interest rates should be kept at rock bottom levels for some time to come. More fiscal help next year is likely to be required. And the RBA may well need to expand its bond buying program. And with a background of greater optimism about global growth because of the rollout of vaccines, a higher $A.

We have had an unusual month in an unusual year. The coming couple of months are unlikely to be as newsworthy. But hopefully what news that does come continues to be good.

We live in interesting times.

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