FINANCIAL MARKET UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEKD ENDING 29TH JANUARY 2021

BOQ GROUP

Summary:

- **The Australian economy will be stronger at the end of this year than it started;**
- **But there remains ample spare capacity in the economy**
- **The RBA will be wary about reducing monetary support too early;**
- **I doubt we have seen the peak of the $A in this cycle;**
- **My 'simple' model had 'fair value' for the AUD at 80c at the end of last year.**

Last year the RBA indicated that both a notable reduction in the unemployment rate and inflation moving sustainably above 2% would be important milestones for any monetary policy change. Wage rises of at least 2.5-3% might be another sign that the unemployment rate has fallen to a low enough level.

The other key test is inflation. The bottom line is that aggregate inflation is very low, meaning the economy will have to grow very strongly for some time before the CPI will (sustainably) return to the RBA's 2-3% target.

I think that the RBA will look to increase interest rates when the unemployment rate is closer to 5.5%, wages growth is at least 2.5-3% and (underlying) inflation of 2% (or above) for two consecutive quarters. At the time of writing financial markets were pricing in a good chance of a quarter percentage point rate hike some time in 2023. I think that timing might be a bit early. Mostly that is because as Deputy Governor Guy Debelle pointed out one of the lessons from the GFC is be careful of removing stimulus too early.

Exchange rate movements in the year to date have (mostly) been limited. The lack of significant currency movement reflects that most economies are being driven by similar factors. Another reason for the more limited moves is that the $US has moved from being very over valued in the first half of last year to modestly over valued by year-end.

The $A has been mainly trading in a 77-78c range so far this year, although it had dipped below that range at the time of writing. By the end of last year my simple model of the $A suggested that 'fair value' was around 80c. The recent move below 77c though is a sign that the Aussie does not want to head higher right now.

But I doubt that we have seen the high of the $A in this cycle. The combination of lockdowns and the vaccine rollout will likely see the major economies get on top of the virus by mid-year. In that event providing commodity prices stay high and financial market volatility low a break of 78c is possible, and would see the $A hit 80c (and maybe as high as 81c).

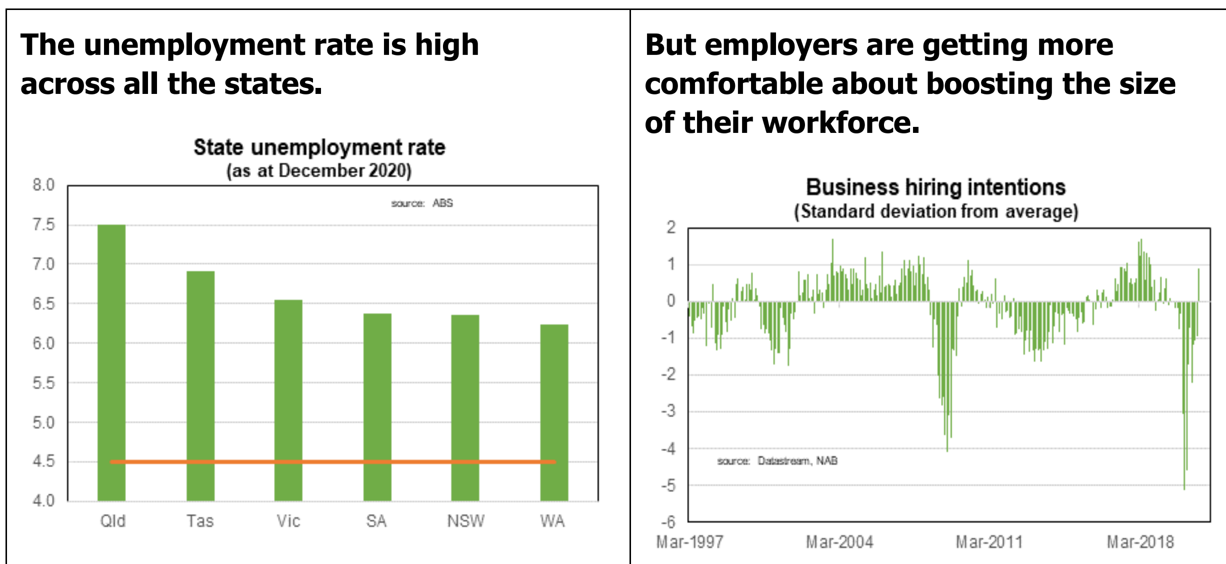
The economy is improving, but much more improvement is needed

The theme for the past few months has been surprising economic strength. A fair bit of that can be put down to activity bouncing back from its COVID-driven shutdown following the Melbourne outbreak. But very supportive fiscal and monetary policies are playing their role. The result has been upward revisions to expected GDP outcomes for both 2020 and 2021.

Given the growing confidence about the economic outlook discussion has recently shifted to when the RBA may start to turn down the monetary policy spigot. Last year the RBA indicated that both a notable reduction in the unemployment rate and inflation moving sustainably above 2% would

be important milestones for any change. An obvious question to ask is what is a sustainable reduction in the unemployment rate? There is a growing possibility that the unemployment rate may have already peaked in this cycle. And a number of the forward-looking indicators (job ads, vacancies, employment intentions) suggest continued strength in the jobs market for at least the first few months.

The Federal Treasury has suggested a benchmark of the unemployment rate falling comfortably below 6%. As at the end of last year no state or territory was below 6% (Queensland was well above 7%).



The unemployment rate is not the only measure of how the jobs market is performing. Arguably a better indicator is the underutilization rate as it also takes into account the proportion of employees that cannot work the hours they want because they can't find full-time employment. That measure has declined from over 20% in April/May to a bit over 15% by December. But that year-end figure is still comfortably above its historical average (12.8%).

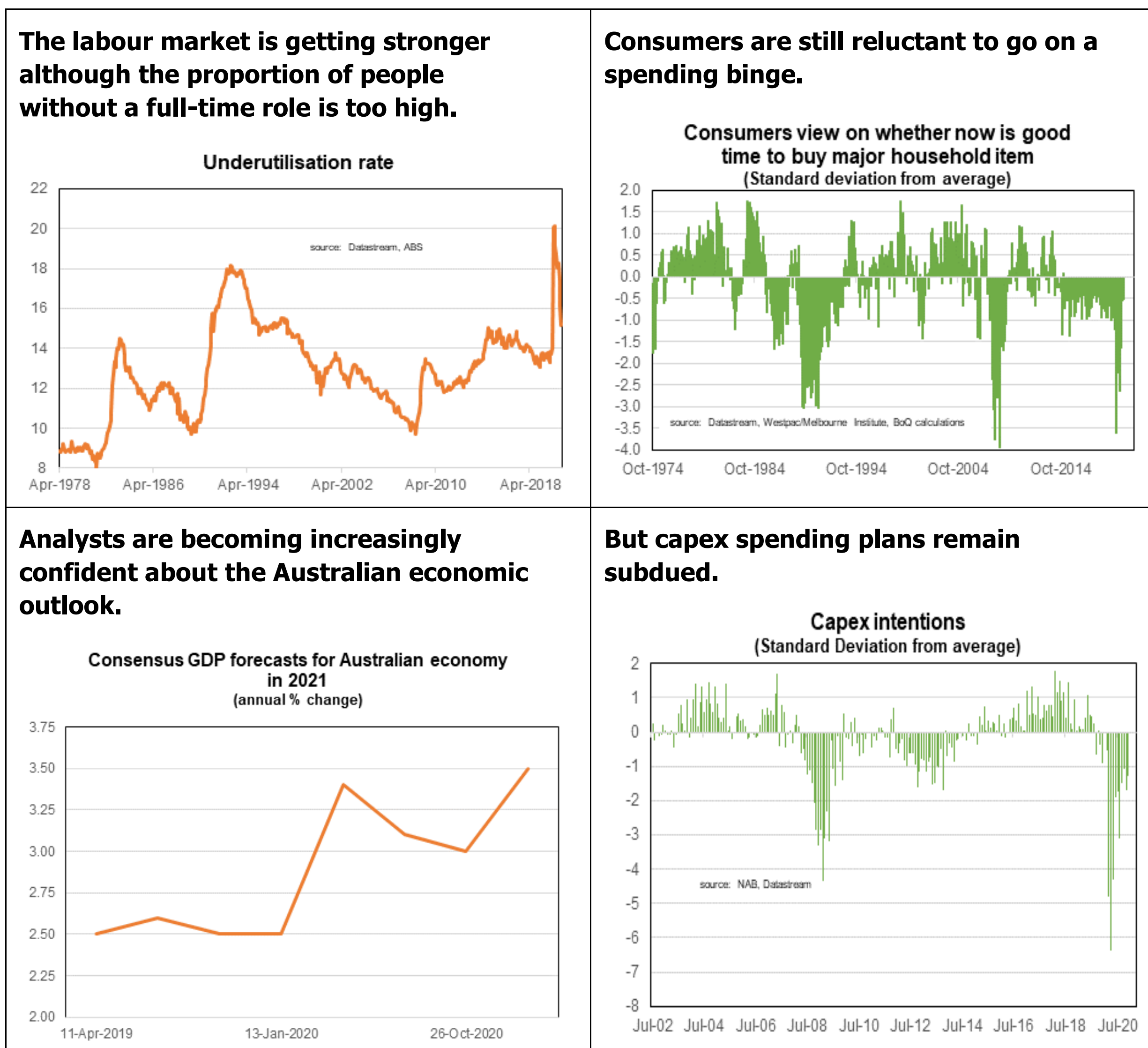
A falling unemployment rate is important in its own right. A key feature of any well-functioning economy is that it provides enough full-time work for those that want it. But the level of the unemployment rate is also a signal of how much spare capacity there is in the jobs market, a sign of when inflation (and wages growth) might rise. The experience of the past decade was that the unemployment rate needed to decline well under 5% before there would be a significant rise of wages growth.

It is possible that number may have changed. The evolving nature of the economy (more technology-driven) is changing the demand for the type of skills needed from workers. The lack of capex spending will reduce worker productivity. Border closures has meant that it has been harder to source workers. Wage rises of at least 2.5-3% might be the sign that the unemployment rate has fallen to a low enough level.

The other issue confronting the RBA is what the famous economist John Maynard Keynes called 'animal spirits', or the confidence of consumers and business to spend. Last year Governments'

were very good at supporting household and company incomes. This has allowed them to significantly boost their saving and could be a massive positive for the economy if a fair chunk of it is spent. But the more that consumers and businesses want to save the harder it will be to nurse the economy back towards full health.

Surveys indicate that both consumers and businesses think that current economic conditions are a bit above average. Despite that those same surveys indicate that household saving intentions are still quite high. And firms' capex intentions quite low. There is a risk that this caution could continue. COVID followed a period when consumers experienced an extended run of low wages growth, as well as a growing debt burden. Businesses have grown increasingly fearful of the impact that competition was having on profit margins.



The other key RBA test is inflation, a story I will examine in more detail next week. But the bottom line is that aggregate inflation is very low, meaning the economy will have to grow very strongly for a sustained period before the CPI will (sustainably) return to the RBA's 2-3% target.

The CPI numbers were higher than expected a reflection of the strong bounce in the economy. There are notable areas of price growth, particularly in housing sparked by Government incentives. Consumer, business and financial market inflation expectations have also risen.

The RBA might be in for a quiet year

What does all of this mean for the interest rate outlook? I think that the RBA will look to increase interest rates when the unemployment rate is closer to 5.5%, wages growth is at least 2.5-3% and (underlying) inflation of 2% (or above) for two consecutive quarters.

At the time of writing financial markets were pricing in a good chance of a quarter percentage point rate hike some time in 2023. This might reflect views of when the economic outcomes nominated above are achieved. But I think financial markets might be a bit early in their current thinking as they could be underestimating how long the RBA will be willing to accept stronger economic growth. The RBA has changed how it thinks about monetary policy. Going forward it will be the actual inflation outcomes that will matter setting for interest rates not their forecast for inflation.

But in this cycle interest rates is not the only tool the RBA has been using to fix the economy. There has also been yield curve control (setting the interest rate for 3-year government bond yields), quantitative easing (or QE, the buying of government bonds to help keep longer-term interest rates low) and access to cheaper financing for banks. Those policies would likely end before the RBA changes interest rates. There has been speculation that this process could even begin in the first half of this year.

Nothing will be done soon. As at the end of January the RBA was only about half way through its bond-buying program. And there remains significant uncertainty about the economic outlook. If the economy keeps powering ahead in the next few months there is a higher chance that the RBA might end its QE and bank financing programs by mid this year. But at this stage I doubt it. Mostly that is because as Deputy Governor Guy Debelle has pointed out one of the lessons from the GFC is be careful of removing stimulus too early.

Another reason why the bond buying program could be extended is the $A. All of the major developed economic regions (US, UK, Japan, UK) will undertake substantial central bank purchases of government bonds this year. The risk is that if the RBA did not extend its program the result could be a higher exchange rate, dampening both the inflation and economic growth outlook.

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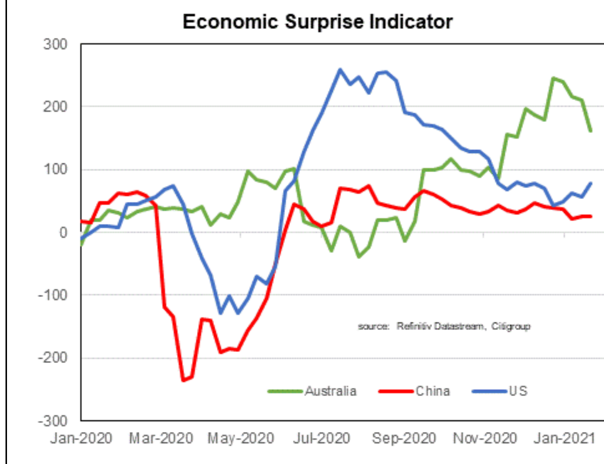
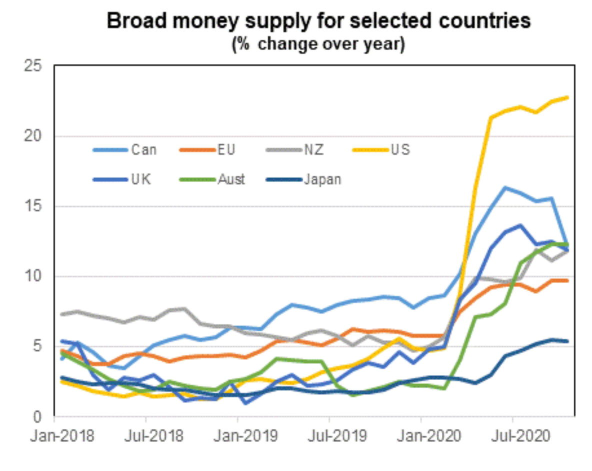
The Australian economy has provided the biggest economic surprise over the past couple of months.	**Aggressive bond buying significantly increased the money supply in the US, helping the $US to fall.**
	

The $A upward journey has not yet finished

Exchange rate movements in the year to date have (mostly) been limited. The Yuan has been the strongest currency boosted by the strength of the Chinese economy. The lack of significant currency movement reflects that most economies are being driven by similar factors (the rollout of the vaccine, the state of the economy, how much fiscal and monetary help is being provided). Another reason for the more limited moves is that the $US has moved from being very over valued in the first half of last year to modestly over valued by year-end.

The $A has been mainly trading in a 77-78c range so far this year although it had dipped below that range at the time of writing. The main reason for the $A strength over the past few months has been the size of the current account surplus (powered by high commodity prices, most notably iron ore) and expectations of an improving global economy (making investors more comfortable about investing funds into small markets such as Australia).

By the end of last year my 'simple' model of the $A suggested that 'fair value' was around 80c. This was up from estimates in the preceding few months, a reflection of the rise of commodity prices and the decline of financial market uncertainty (proxied by the VIX index, a measure of US equity market volatility).

The recent move below 77c is a sign that the Aussie does not want to head higher right now. The impact of COVID on the global economy, delays in the global vaccine rollout and the uncertainty about the size of any fiscal stimulus in the US (and the problems about spending the stimulus in Europe) are taking their toll. Some central banks (notably the ECB) have become worried about the strength of their currency.

But I doubt that we have seen the high of the $A in this cycle. Delays in the vaccine rollout are only short term. There is plenty of fiscal help still in the pipeline, and interest rates will remain low for some time yet (supporting strong global growth and therefore currencies such as the $A). China is forecasting higher steel production this year. Sure it will be met by a pickup in Brazilian

iron ore supply. But financial markets have been predicting (big) falls in the iron ore price for much of the past two years but the price has gone nothing but up! Providing financial market volatility remains low a break of 78c is possible in coming months, and the possibility that the $A could hit 80c (and maybe as high as 81c).

Currency movements have mostly been modest in the year to date.

Currency movements against USD
(% change 1 Jan - 27 Jan 21)

source: Datastream, BoQ calculations

The $A is pretty close to fair value against major trading partners.

AUD real exchange rate
(standard deviation from average)

source: BIS, BoQ calculations

A current account surplus has been a $A positive.

Basic Balance of Payments
(Current Account balance + Foreign Direct Investment as % GDP)

source: Refinitiv Datastream, ABS, BoQ calculations

This has meant the $A has not needed interest rate support.

Real cash rate
(cash rate deflated by annual % change underlying CPI)

source: Refinitiv Datastream, BoQ calculations

An expectation of an extended period of a low cash rate and a stronger $A have been two notable financial market trends over the past few months. I think both those trends still have some way to run. Further significant falls in the unemployment rate and rise of inflation (both domestically and globally) will be necessary before the interest rate and currency trends change.

We live in interesting times.

Peter Munckton
Chief Economist
BOQ Group