ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

6TH NOVEMBER 2020

BOQ GROUP

Summary:

- **The September quarter was a decent one for the Australian economy;**
- **It looks like October was better still.**
- **And there are reasons to be optimistic about the remainder of the year;**
- **But it is not yet clear that the 'underlying' economic momentum is strong enough;**
- **It may be that further support from the RBA and Federal and state Government's will be needed;**
- **The good news is that will do more if they need to do more.**

The RBA cut rates at its November meeting. They also announced a quantitative easing (QE) program (buying $100b of Government bonds). The aim of the program is to reduce financing costs in the economy. The RBA would also be hopeful of a lower $A.

The RBA expects the unemployment rate will peak at 8% around the end of this year, before declining to about 6% by end-2022. I think the risks are that the unemployment rate will be higher than those forecasts. The RBA also think 'underlying' inflation won't reach 2% over the next couple of years. Certainly right now household, business and financial markets expect inflation to stay low.

The RBA will be hoping that the economy will recover enough such that it will not have to do more than the $100b program. In any event interest rates are already rock bottom. What the economy needs is more spending. And if the private sector is not doing enough then it is down to Governments to get things moving. The Federal Government Budget was a plus. In coming weeks we will get a look at state government budgets.

A bounce in Q3 growth is consistent with feedback from firms. Companies said that conditions in the September quarter improved although remained some distance from 'normal'. Order books were getting fuller. The export outlook was better albeit still tough. Firm are giving thought about adding a few more staff although they are some distance from going on a hiring binge. Margins remain tight. One positive for some firms was pricing.

The Budget and talk of lower interest rates looks to have helped things in October. The existence of the Homebuilder program means that the short-term outlook for the construction sector has improved. The pickup in construction has had a positive flow-on to manufacturers. The opening up of the economy has seen service sector firms become more confident.

The opening up of the Victorian economy should see the economy get a further boost through November and December. It is not yet clear though that the 'underlying' economic momentum is strong enough. In six months' time if the economic outlook doesn't improve then the RBA will have to extend its QE program. But even more certainly Government(s) will need to provide even more fiscal support.

 Bank of Queensland Limited ABN 32 009 656 740 (BOQ).

BOQ GROUP

Monetary Policy

Following its November meeting the RBA announced further rate cut support for the economy. In particular

- The cash rate was cut from 0.25% to 0.1%
- The 3-year Australian Government bond target was also reduced to 0.1%, as was the lending rate charged to banks (the so-called Term Funding Facility)

These changes were widely anticipated. Much of the financial market focus was on whether a Quantitative Easing (QE) policy would also be implemented (where the RBA buys bonds in the financial markets with an aim to reduce longer-term interest rates). It was. There will be a $100b program (the size was in line with consensus) buying Federal and state Government bonds with a maturity of between 5 and 10 years. It will be spent over 6 months (the consensus was over 2021). The RBA says that equates to around $5b per week (I can't make that maths work but presumably that was said to provide themselves with some flexibility).

As the pace of spending was quicker than had been anticipated longer-term interest rates fell following the announcement. There was only a small downward movement in the $A (and that was more than fully reversed in the subsequent hours). That would have been something of a disappointment to the RBA given that a lower $A was an explicit outcome they hope to achieve from the monetary easing. But of course they have yet to begin their buying program.

The RBA's view on how the economy will evolve over the next couple of years looks about right to me. They think GDP growth will be about 6% over the year to June 2021 (I think it will be a little lower), and 4% to June 2022 (I agree).

The RBA's are targeting two key economic outcomes: inflation returning sustainably above 2% and an unemployment rate dropping back towards 'normal' (under 6%). The RBA has revised down its view on the unemployment rate, now expecting a peak of 8% around the end of this year then falling to 6% by end 2022 (the unemployment rate is currently about 7%). But this drastically understates the weakness of the labour market. It is widely thought that the 'real' unemployment rate is somewhere between 9-10%. And the underutilisation rate is above the highs of the 1990s recessions.

I think the risks are that the unemployment rate will be higher than what the RBA is currently thinking. The end of both JobKeeper and the temporary pause on insolvencies is likely to result in an increase in firms going bankrupt over the next 6-12 months. And the forward labour market indicators (such as jobs ads and employer hiring intentions) are suggesting only a modest rise in jobs growth.

The RBA believe that 'underlying' inflation will not reach 2% any time over the next couple of years. A high underutilisation rate will mean wages growth will be subdued for the next couple of years (a big reason why inflation is likely to be low). I have no strong view about the RBA inflation forecasts. But it is worth keeping an eye on how household, business and financial market inflation expectations evolve over coming months (they have recently picked up but remain below the level consistent with

sustained 2%-plus inflation outcomes). The RBA has said it will not be raising the cash rate for at least the next 3 years. That statement is consistent with their economic outlook.

At a press conference the RBA Governor noted that the size of the program ($100b) was chosen at it was about 5% of GDP, the amount that overseas experience suggested leads to a notable reduction in 5-10 year interest rates. The immediate beneficiaries are borrowers that issue such long-term debt. In Australia that is mainly governments and large corporates. But if the RBA buys that debt then other investors' will have to buy other assets, helping to drive down interest rates down for other borrowers. Lower interest rates should also help underpin house prices and equities (the power of low rates is one of the factors why house prices has not declined by as much as had been feared).

But should reduce interest rates is not the same as will. For shorter term interest rates the RBA can explicitly set the level of the cash (and 3-year) interest rate. But RBA buying of debt is only one factor that drives the level of longer-term interest rates. Other factors include investors' outlook for economic growth and inflation, investor risk sentiment and the size of government budget deficits.

This is even more the case with currency markets. One aim of QE is to lower the $A. But the foreign exchange market is how one currency moves against another currency. By itself the RBA doing QE (and therefore putting more money in the economy) would be expected to lead to a weaker $A. But most other peer country central banks already have a QE program (and some such as the Bank of England and the European Central Bank are boosting the size of their programs). The RBA always has the option to sell $A (and buy foreign assets) to help drive the currency lower. But the RBA does not think this policy would succeed if the $A is close to its 'fair value'. And given Australia is running a current account surplus and is enjoying the benefit of high iron ore prices, the currency is currently close to fair value (which my 'simple' model says is about 74c).

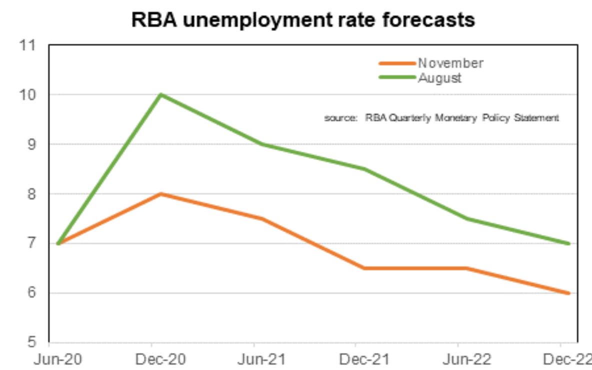
When the RBA has finished all its buying they believe they will own around 15% of the Government bond market (assuming they don't need to purchase much to support their yield curve control policy). This compares with about 20% of the US bond market owned by their central bank, 30% in Europe, 40% in New Zealand and about 50% in Japan.

One of the other objectives of the RBA is to maintain a normal functioning bond market (ie, you can easily buy and sell bonds). There has been concerns that is becoming a problem in Japan, a consequence of the Bank of Japan owning such a large proportion of the bond market. And the New Zealand central bank (RBNZ) is buying swaps partly in recognition of these concerns about its market. To me that suggests that the RBA could buy potentially another 20-25% of GDP ($400-500b) of bonds if they believed the economy needed additional support without seriously impacting market functioning (although the amount will also depend upon how much debt Government's actually issue).

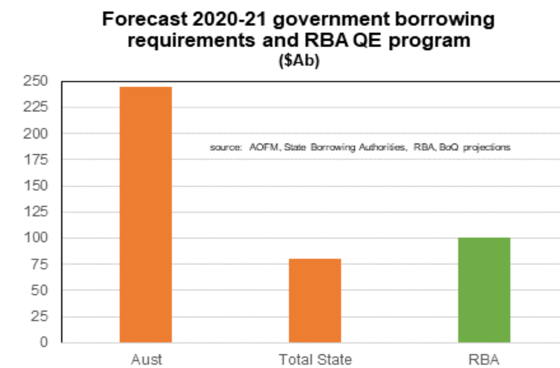
Above this level the RBA might have to think about what other assets they could buy. Other central banks have already been buying corporate debt, residential mortgage backed securities and equities (domestically the AOFM have already been purchasing mortgage-backed debt).

Of course, the RBA will be hoping that the economy will recover enough such that it will not have to do more than the $100b program. But even if they do the economic impact will only be modest. Interest rates are already rock bottom. What the economy needs is more spending. And if the private sector is not doing enough then it is down to Governments to get things moving. The recently announced Federal Government Budget was a plus. In coming weeks we will see how much of their shoulder the state governments will put to the economic wheel. In six months' time if the economic outlook doesn't improve then the RBA will have to extend its QE program. But even more certainly Government(s) will need to provide even more fiscal support.

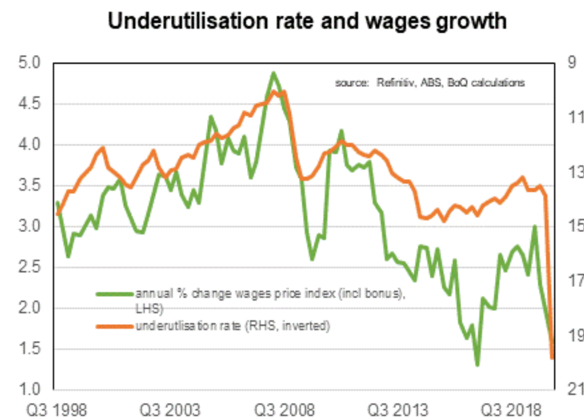
RBA have revised down their unemployment rate view.



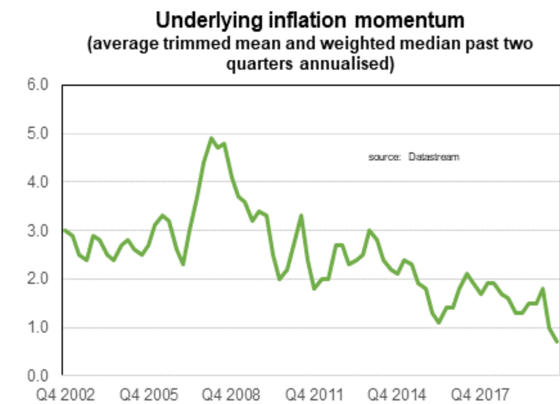
The RBA buying program is equivalent to a fair chunk of projected Government debt issuance.



A weak labour market means low wages growth.



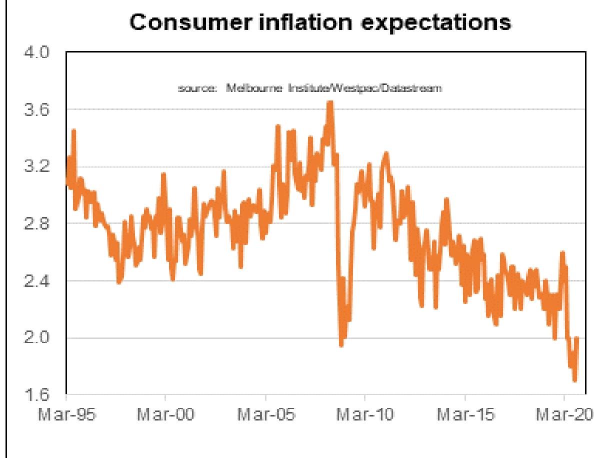
And that means it will take a while for inflation to get back over 2%.



 Bank of Queensland Limited ABN 32 009 656 740 (BOQ).

BOQ GROUP

Consumers' expect inflation of about 2%.



Which is also the financial market view.

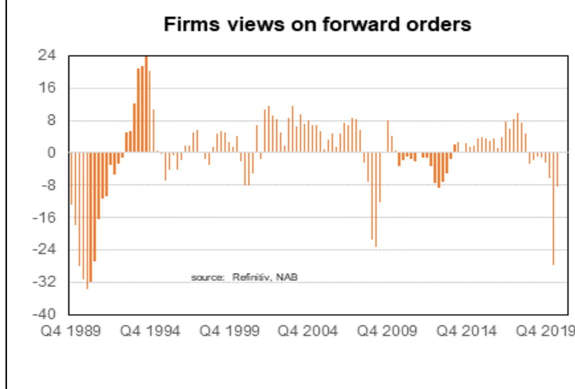
September quarter economic performance

One of the reasons that the RBA revised down its unemployment rate forecast was that the economy has done better than it what it was expecting. The maths said the economy had to have had a decent Q3. Three quarters of the Australian economy were able to go out and buy a coffee again. I look for September quarter GDP growth to grow stronger than the current consensus (2-3%).

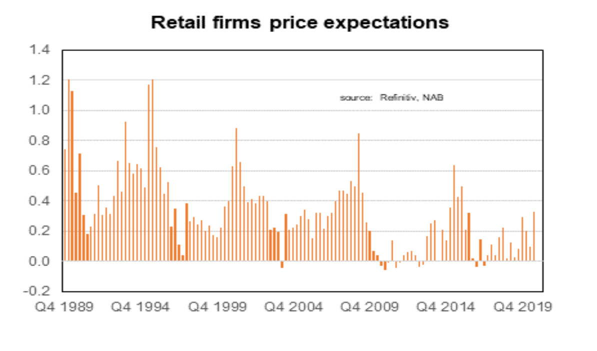
Such a bounce in growth was consistent with the feedback from firms. Companies said that conditions in the September quarter improved although remained some distance from 'normal'. Order books were getting fuller but were still relatively light. The export outlook was better albeit tough. Firm are giving thought about adding a few more staff although they are some distance from going on a hiring binge. Margins remain tight.

One positive for some firms was pricing. Shortages of some stock and household switching from buying services to goods has meant that retailors have not had to offer as many discounts. Pricing power in other parts of the economy though remains weak.

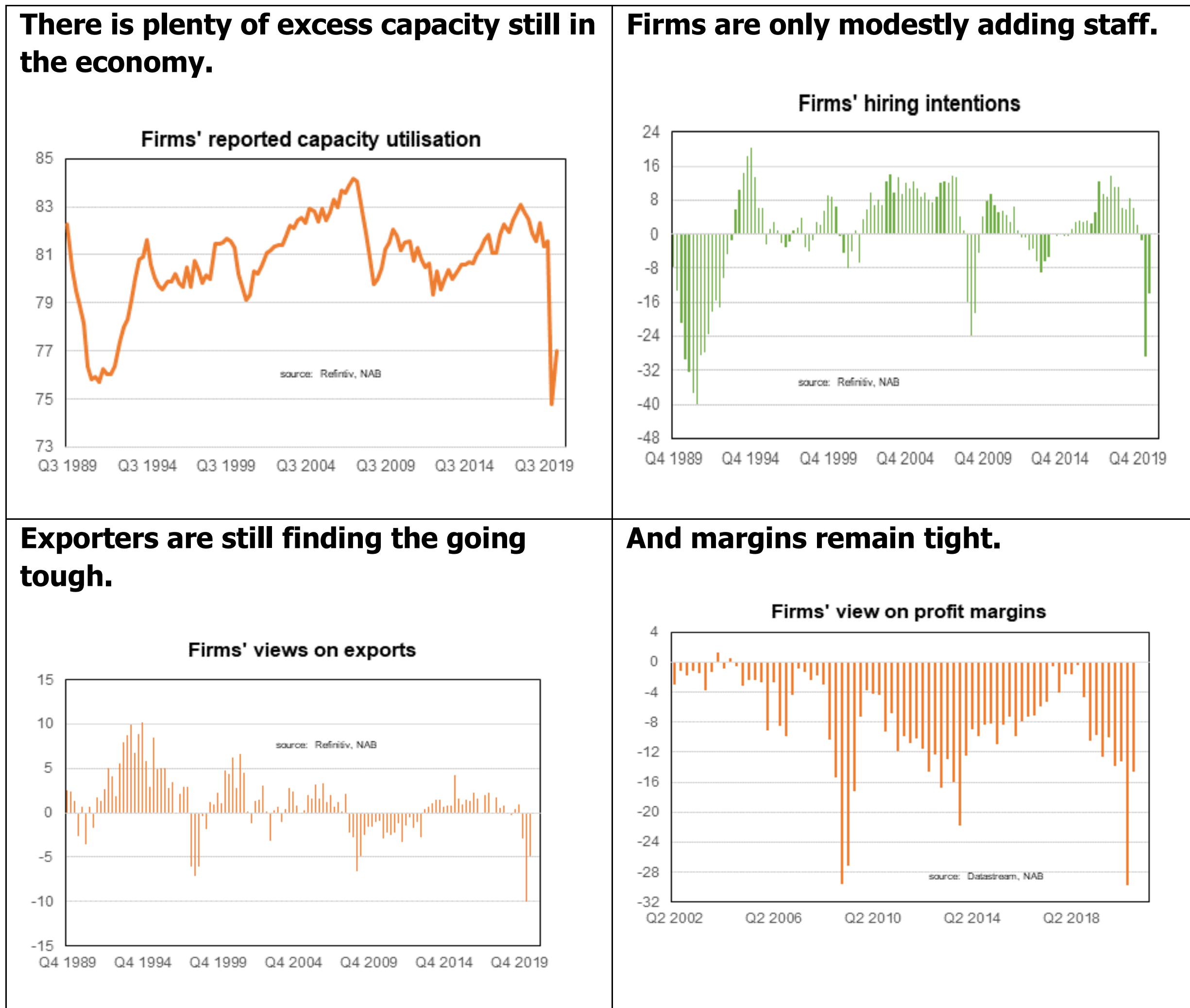
Firms are still saying order books are light.



Retailors have had some pricing power this year. Less so in the rest of the economy.



 Bank of Queensland Limited ABN 32 009 656 740 (BOQ).



Understandably firms indicated that a lack of orders was their biggest problem. Order books will get fuller in coming months. Whether they get full enough is the key question. Interestingly, despite the elevated unemployment rate a number of firms are indicating that it is difficult to find skilled labour. Anecdotally this has been a particular issue in WA, notably in the mining sector.

Some firms also say that supply chain disruptions were an issue. Certainly some stores have complained of not having enough stock on the shelf. This should become less of a problem in coming months as more internal borders are opened (although the rising wave of cases in Europe and the US might create a problem for firms reliant upon international trade).

Firms in WA and Tasmania thought conditions were the most favourable in Q3, Victorian and NSW firms the toughest. Firms in the smaller-population states actually suggested that conditions were better in Q3 of this year than for the same time last year. This is hard to reconcile with the other data.

Business confidence by sector was essentially the mirror image of what it was the same time last year. Retail and the wholesale industries were most confident, recreation the least. Construction

firms were getting pessimistic, not helped by thinning order books and forecasts of drastically slowing population growth. Mining firms were also a little worried, although iron ore miners would have seen the glass half full.

October and the outlook

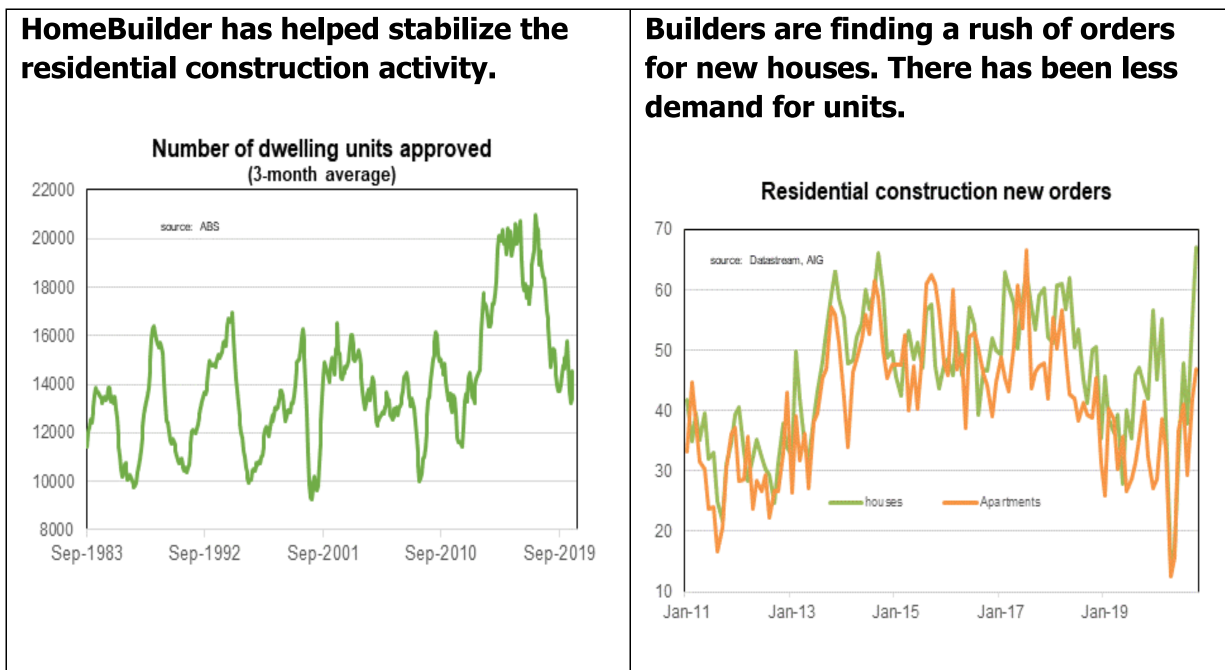
So growth bounced back in the September quarter. And it looks like things improved further in October. The Budget announcement would have helped. Construction has benefited from a souped-up HomeBuilder program. The JobKeeper and JobSeeker income support programs are still around (albeit less generous). The RBA gave clear signals in October that interest rates would be cut further.

One sign of improved optimism has been the better-than-expected performance of house prices. There were many forecasts back in March/April about potential large declines. But the power of very low (or declining) rates has historically always provided a firm floor for house prices. And despite

the deepest peacetime recession since the Great Depression the existence of mortgage payment holidays meant there were few forced home sales. The result has been that even in Melbourne prices are only down a cumulative 6% since March (according to my calculations based on CoreLogic data). And they are up in Adelaide and Brisbane. If anything the housing-buying mood is brightest in Perth.

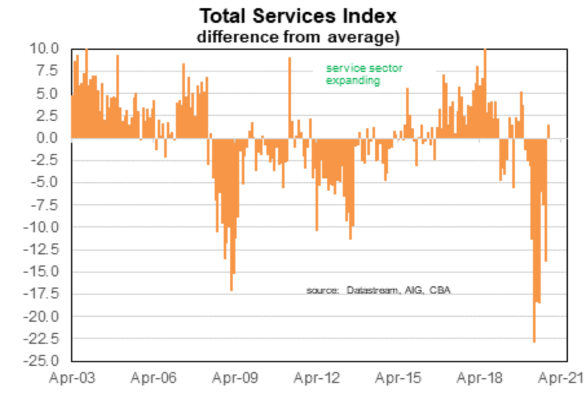
The existence of the Homebuilder program also means that the short-term outlook for the construction sector has improved. There has been a rise in building approvals and new orders to build houses. The outlook for units though is less optimistic. There has been a rise in mortgage financing, notably for owner occupiers and first-home buyers.

The pickup in the construction sector has had a positive flow-on to manufacturers. Manufacturing has also benefited from stronger consumer spending on goods. The opening up of the economy has seen service sectors become more confident. But as has been the case globally, confidence of service sector firms lags that of manufacturer's and retailors.



Manufacturer's order books picked up in October.

And many service sector firms also saw some rays of sunshine.

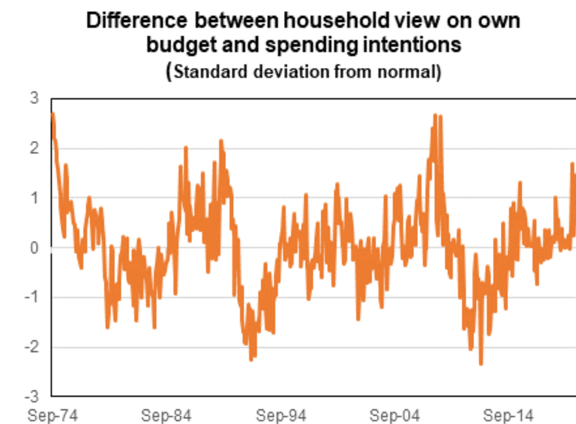


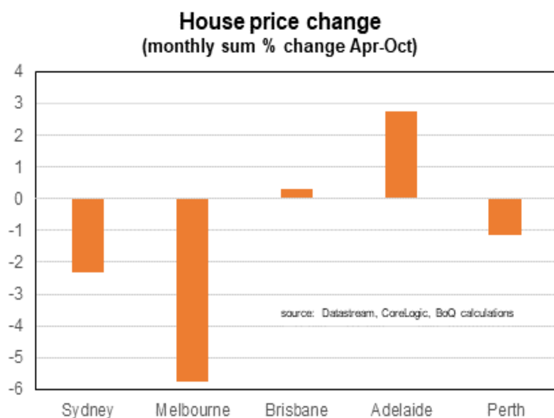
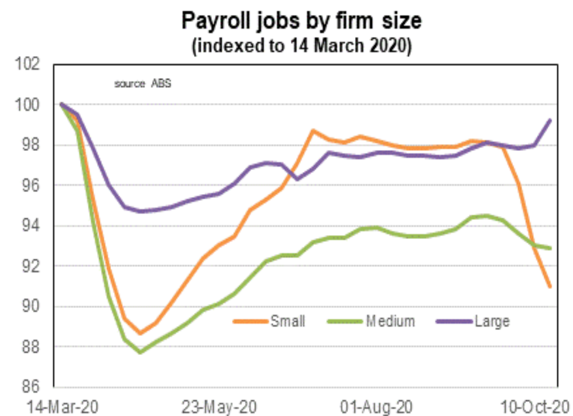
The key issue for sustainable growth will be how much of the money sitting in household and business bank accounts will be spent. Right now the signs are that consumers are happy to keep a healthy bank balance. Households report that their own finances are in reasonable nick (helped by JobKeeper and tax cuts). But surveys also suggest that they remain reluctant to spend much of that extra booty. Bank deposit growth remains very strong.

The key issue on whether consumers spend is their view on whether they will have a job. The jobs market is not as tough as it was at the peak of COVID cases. But job ads remains well below the level of recent years. Firms don't look like they are about to go on a hiring spree. And the number of workers on payrolls has fallen over the past couple of months (particularly for small firms).

There are more job ads, but not as many as in the pre-Covid days.

Households are still looking to build up a nest egg.



Even in Melbourne and Sydney there has recently been better signs on house prices.	**Small firms have found the going tougher than big.**
	

All up, the signs are that the economy improved in the September quarter. And the Budget and talk of lower interest rates looks to have helped things in October. The opening up of the Victorian economy should see the economy get a further boost through November and December.

But it is far from clear that underlying economic momentum is enough to create the number of full-time jobs necessary to take a big chunk out of the underutilisation rate. Or to get the inflation rate back above 2%. The RBA and the Government have done a lot. They still may have to do more. The good news is that judging by their actions in the year to date they will.

We live in interesting times.

Peter Munckton
Chief Economist
BOQ Group