ECONOMIC & FINANCIAL MARKET UPDATE

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Summary:

- A further big fiscal stimulus is needed;
- But a further (modest) reduction in interest rates wouldn't hurt;
- The USD and Yuan were the strong currencies in September;
- My fair value model for the $A is still around 75c.

The Budget announcement on 6th October is very important. If the rumours are right the budget deficit for this year could be the largest ever in peacetime. The budget strategy will be to boost economic growth for the next 1-3 years and then (hopefully) step back to allow the private sector to take over the growth baton.

Given the already extremely low level of interest rates fiscal policy must lead the way. But monetary policy will likely also have to do more. The RBA has made it clear there is some room (0.15%) to further reduce the 'target' cash rate. Some analysts thought that a rate cut could be as soon as October. More recently investors' have (rightly) backed away from that view.

When the rate cut happens the RBA is also likely to reduce its yield curve target for 3-year interest rates on Government debt (from 0.25% to 0.1%) as well as further reducing bank funding costs. This will ensure lower interest rates are passed to the wider economy.

The dominant foreign exchange theme over the past month has been the strength of the $US. The US economic data has been generally stronger than expected. As a result US GDP forecasts have been revised up. At the same time a renewed virus wave has hit Europe. Concerns about the sustainability of global growth has hit commodity and emerging market currencies. The exception to the strong USD theme has been the rise of the Yuan and the Japanese yen.

I still think the $A has not hit its peak in this cycle. The $A continues to get strong support from a current account surplus and high iron ore prices. My 'simple' fair value model currently has the $A at 75c. Providing the global economy has a decent final quarter I think the $A can hit the models' value by year-end.

Interest rates

The Australian economy improved in the September quarter. Victoria has been through a very tough patch but the rest of Australia has done better. The economy in the fourth quarter should also do Ok. The benefits of Victoria opening up and the massive amount of household and business saving should offset the reduction in the size of the Government income support programs. Importantly, China is doing well and there has generally been better signs in the economic data out of the US and Europe.

All of this is good news. But the outlook for 2021 remains uncertain. And the 'underlying' momentum of the economy remains too slow. Although down from its high, the underutilisation rate is currently at the peak level reached during the 1990s recession. Consumer inflation expectations are falling and are below the level consistent with the RBA's 2-3% inflation target. Globally, second waves of the virus are hitting Europe and the north east of the US.

So the economy is off the floor and moving around. But it is not yet moving well enough and so still needs a helping hand. The uncertain outlook means that households and businesses don't feel in the right shape to help out. But the Government does have the required muscle to help.

This makes the Budget announcement on 6th October very important. All the signs are that the Government will step up to the plate. If the rumours are right the budget deficit for this year could be the largest ever in peacetime. The budget strategy will be to boost economic growth for the next 1-3 years and then (hopefully) step back to allow the private sector to take over the growth baton. It looks likely that infrastructure spending and tax cuts will be bought forward and the investment allowance maintained. There could be more spending on labour market programs. And it has been mooted that JobKeeper might be extended for a few more months.

The Government is also looking to implement a number of reforms to help boost long-term potential growth. Mooted reforms include changes to lending practices, bankruptcy laws, industrial relations, the energy market, as well as more investment into the broadband and education. All reasonable ideas. Let's see what the Budget brings.

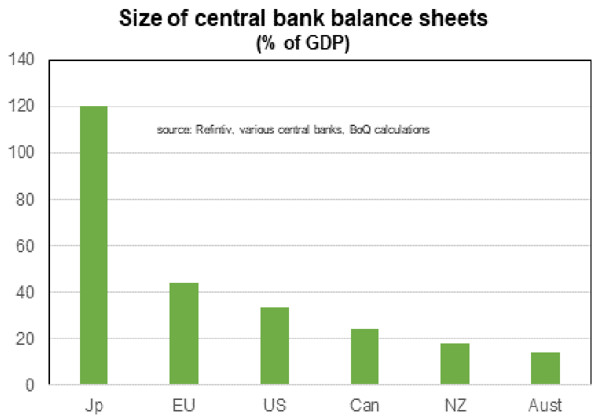
Given the already extremely low level of interest rates fiscal policy must lead the way. But the economic outlook means that monetary policy will also likely have to do more. The RBA has made it clear there is some room (0.15%) to further reduce the 'target' cash rate. Some analysts thought that a rate cut could be as soon as October, providing a '1-2' punch with fiscal policy to get the economy moving. But more recently investors' have (rightly) backed away from that view. The thinking now is that the RBA is more likely to wait and at least see the shape of the budget. Waiting also means that the RBA will get to see the Q3 CPI numbers (released 28th October).

A further modest reduction in the cash rate is likely. And when it happens the RBA is also likely to reduce its yield curve target for 3-year interest rates on Government debt (from 0.25% to 0.1%) as well as further reducing bank funding costs to ensure lower interest rates are passed to the wider economy.

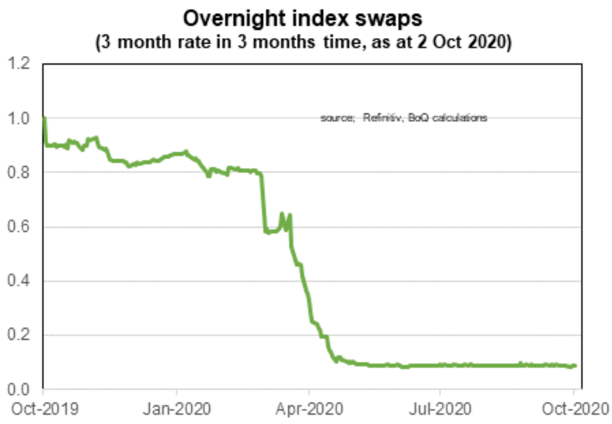
Providing cheap lending to banks increases the size of the RBA's balance sheet. The balance sheet would also increase if the RBA had to buy bonds to maintain the yield curve target. By historical standards the RBA balance sheet is big. But not by the standards of other central banks. That does not mean that the RBA is not doing its job. The massive size of the Japanese and European central banks reflects the length of time that economic growth and inflation has been too low. The greater size of the US Federal Reserve balance sheet is because of the greater importance of financial markets for funding in the US (and the legacy of the greater impact of the GFC on the US economy).

The RBA may yet have to increase the size of its balance sheet further to help the economy. Federal and state government budgets will be providing plenty of support to the economy over the next couple of years. This will also mean plenty of debt. It is possible that this could that lead to higher interest rates on government debt. In that event, RBA buying might become necessary to lower government borrowing costs particularly if the economic signs weren't good.

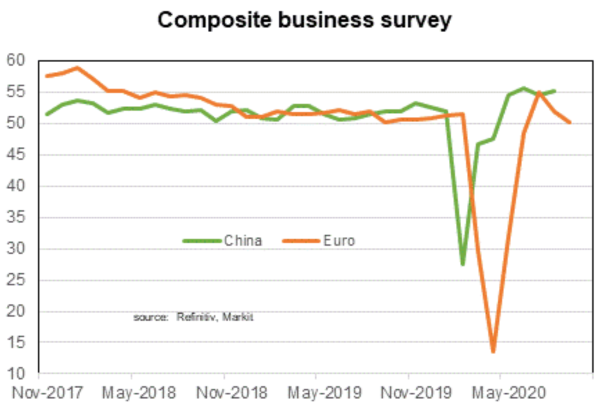
The RBA's balance sheet is smaller than comparable central banks.



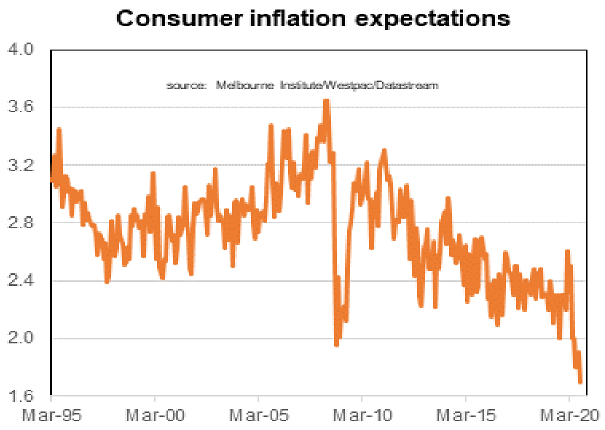
Financial markets having been pricing in a low 'actual' cash rate for some time.



Europe is becoming worried about a '2nd wave', China is powering ahead.



Consumer inflation expectations continues to fall.



Exchange rate

The dominant foreign exchange theme over the past month has been the strength of the $US. Despite the renewed outbreak of COVID cases in the north east, US economic data has been generally stronger than expected. As a result US GDP forecasts have been revised up. A new fiscal package in the US is still likely, although the better tone of the economic data has removed the political urgency of getting a fiscal deal done (particularly given the closeness of the election and the politically-charged issue of a Supreme Court nominee).

For a while financial markets had been speculating that a Federal Reserve monetary policy easing would be just around the corner. But the better data has given the Federal Reserve time to sit back and assess. It has also provided the Fed with the opportunity to put the spotlight back on the need for more fiscal support. But the lack of imminent Fed easing has also resulted in a stronger USD.

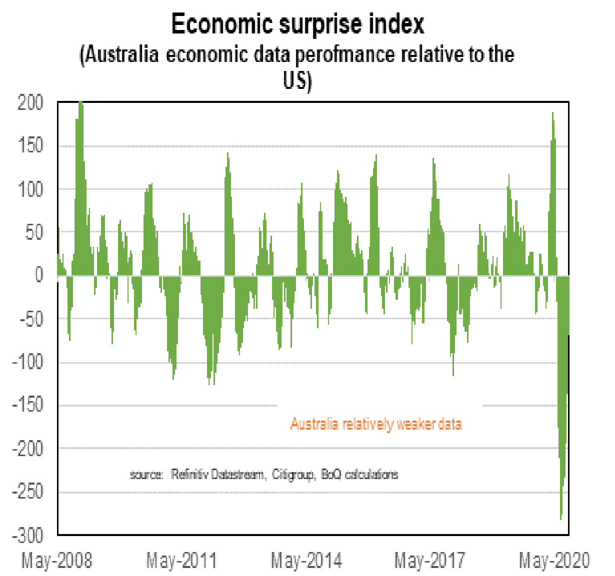
At the same time a renewed virus wave has hit Europe leading to talk of a return to shutdowns (albeit not as stringent as earlier in the year). Concern about the sustainability of global growth has hit commodity (such as New Zealand and Canadian dollars) and emerging market currencies.

The exception to the strong USD theme has been the rise of the Yuan as a result of the (relative) strength of the Chinese economy. The Japanese yen also had a decent month. It typically does during periods of heightened financial market volatility. And financial markets expect that volatility to rise further over the next month. Not only are there worries surrounding the US election, but concerns around the progress of COVID as well as the generally heightened level of economic uncertainty.

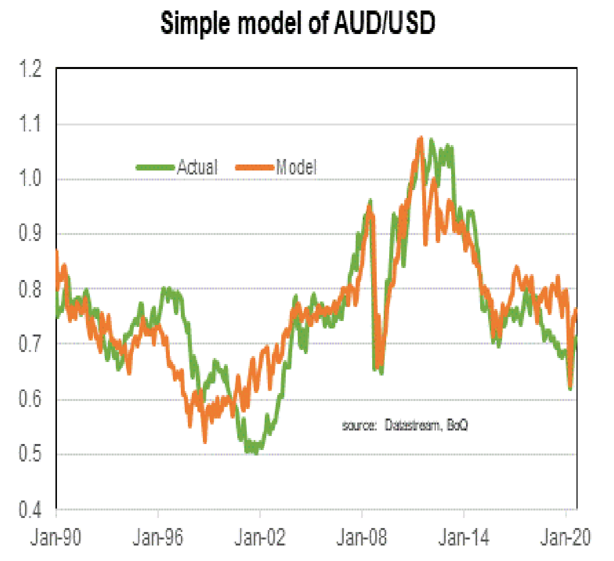
This elevated financial market volatility (and the associated weakness of equity markets) has hit the $A over the past month. Expectations about an imminent (small) rate cut has also told against the Aussie. The recent push back in the expectations of when the RBA will reduce rates has coincided with some strengthening in the $A.

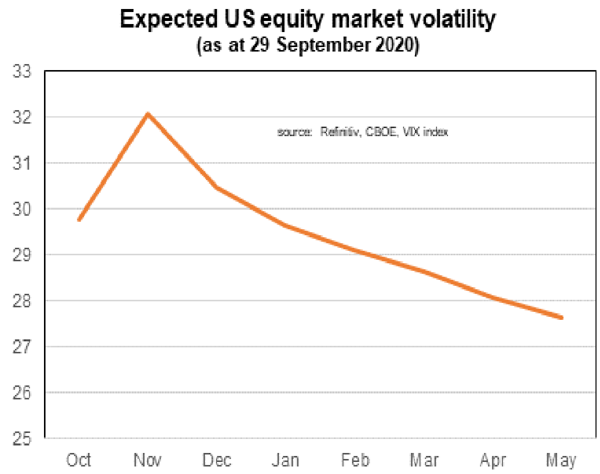
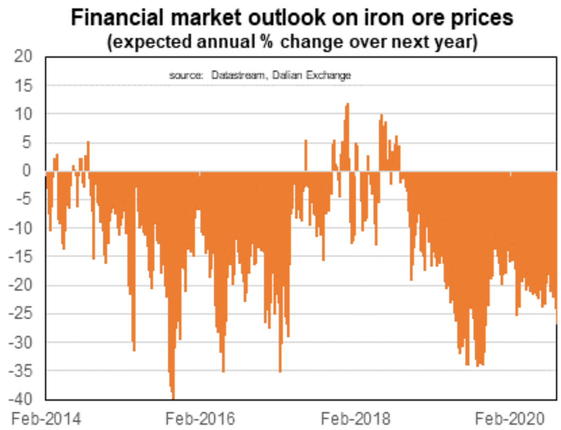
I still think the $A has not hit its peak in this cycle. The $A continues to get strong support from a current account surplus. Iron ore prices are expected to decline as Brazilian iron ore comes back on stream. But expectations for lower iron ore prices have been around for a while. And for now they remain at a high level. My 'simple' fair value model currently has the $A at 75c. Providing the global economy has a decent final quarter I think the $A can hit the model's value by year-end.

Relative Australian economic underperformance has reduced in recent weeks.



The simple model indicates fair value for the $A is 75c.



Financial markets are expecting increased volatility around the US election.	**A substantial decline in iron ore prices is expected over the next year.**
	

At first glance a view of lower interest rates and a higher $A appears inconsistent. But short-term interest rates are already so low and are expected to stay there for some time that they are not driving the currency market. And Australian longer-term interest rates are relatively high by global standards. The fiscal stimulus in Australia has been large by global standards. And all the signs are that it will get bigger. High iron ore prices and a current account surplus means there remains good underlying demand for the $A.

The Australian economy is getting better. But it is still some distance from full health. A little helping of monetary policy would be positive. A bigger fiscal injection would be better. And it looks to be on the way.

We live in interesting times.

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