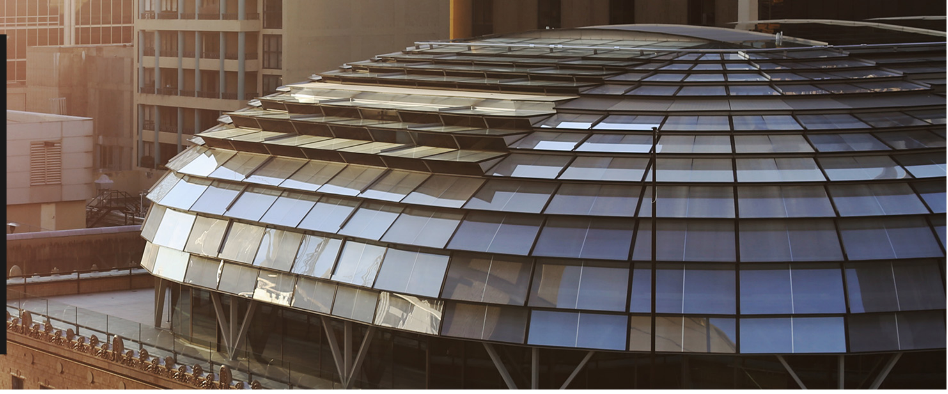
Research

20 December 2021

MACQUARIE



Investment Strategy Update #81

Australian Economic Outlook: Bouncing Back

- The Australian economy has been a constant source of positive surprise throughout the global pandemic. Shutdowns have not been as bad as feared, while recovery periods have been much stronger than expected. Macquarie forecast economic growth to bounce back strongly through 2022 with the economy expected to expand by a little over 5%.

- Consumer spending is expected to remain robust and support overall growth with government tax breaks to incentivise a strong recovery in business investment. Dwelling investment will contribute to growth over the next few quarters, but thereafter residential construction activity is set to decline.

- Both arms of macro policy are providing strong support to growth. With a federal election due by May 2022, it seems unlikely that fiscal consolidation is on the radar. Fiscal policy is likely to recycle revenue surprises, driven by higher-than expected commodity prices and property transfer revenue, while monetary conditions will remain ultra-accommodative with the RBA likely on hold until 4Q22 when we expect it to raise rates by 25bps.

- Australians have accumulated A$200bn in ‘excess’ saving and this will provide some support to consumption through 2022. However, we can expect to see a rebalancing of spending patterns with services picking up strongly. Macquarie estimate that households have foregone ~A$120b in travel related spending during COVID which will therefore play catch-up as borders reopen. However, slower housing price growth and fewer home sales poses a downside risk to retail and discretionary spending.

- Macquarie expect inflation to surprise on the upside through 2022 due to a combination of strong demand growth and supply constraints, including labour supply and supply chain frictions, which generate higher wages growth (but still below 3%). They have a slightly faster decline in unemployment to 4.0% while population growth will pick up to around 0.9% - still well below pre COVID averages but up significantly from the current rate of 0.3%.

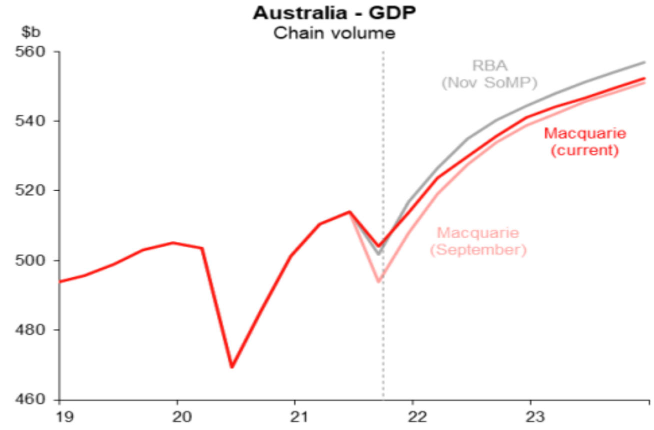
- Many factors could alter Australia’s course through 2022 including further COVID outbreaks (which are resistant to current vaccines), a more rapid slowdown in Chinese growth due to recent property sector dislocations and/or inflation risks which prove more persistent and drive a faster than expected rise in interest rates.

For a more detailed analysis please see: 2022 Australian Macro Outlook - Bouncing Back.

The Australian economy has bounced back from lockdowns…

The Australian economy contracted by much less than expected during the recent lockdowns and is quickly bouncing back. Despite more than half of the population being under government stay-at-home orders in Q3, the economy contracted by ‘just’ 1.9% q/q. The major surprise was the resilience of consumer spending which fell by a little under 5% q/q. Clearly, government income support for both households and businesses played a big role (again) in cushioning the effect of lockdowns on the economy.

The Australian economy is forecast to grow strongly over 2022…



Source: ABS, RBA, Macquarie Macro Strategy, December 2021

…setting a strong platform for growth in 2022…

We expect most of the decline in GDP in Q3 to be recovered in Q4 and for the economy to grow a strong 5¼% over 2022. This would leave the economy around 7% larger than in Q4 2019 and equate to average growth of 2.3% per annum over those three years. While that would hardly be stellar growth, very weak population growth means that GDP per capita over the coming year would be noticeably above the counterfactual if trend growth over 2012-19 had continued.

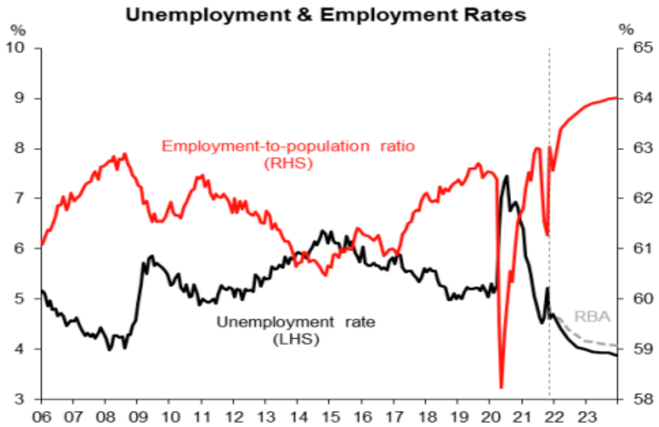
We remain comfortable forecasting such an outcome because that previous period was one of relatively sluggish growth as the economy adjusted to lower commodity prices and mining investment. With a federal election due by May 2022, it seems unlikely that fiscal consolidation is on the radar. In fact, the Government’s mid-year budget update showed that nearly all of the expected upside surprise to government revenue over the next four years is expected to be spent. Treasury estimates that the structural budget deficit will increase over 2021-22 and 2022-23 and remain firmly in deficit over the outlook period.

Households and businesses are also sitting on considerably higher savings because of both fiscal support during COVID and reduced spending opportunities. Monetary policy remains supportive of growth even though the initial sugar hit from policy easing has passed.

…and a further tightening in labour market conditions

Employment had already returned to pre-lockdown levels in November despite some catch-up still required in NSW, Victoria and the ACT. Alongside a noticeable increase in the share of the working age population with attachment to a job, this bodes well for further strong jobs growth in coming months. While we aren't quite as optimistic as the RBA on the outlook for GDP growth, we see more scope for the labour market to tighten. We forecast the unemployment rate to fall to around 4% by the end of 2022 and the risks appear skewed to a faster-than-expected decline in the jobless rate in the near-term.

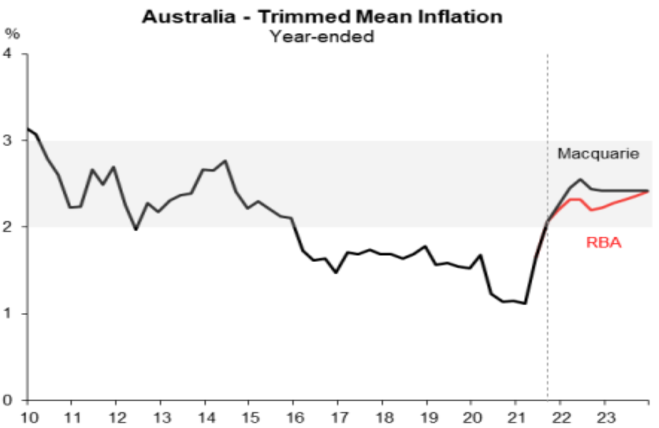
We see scope for the unemployment rate to fall further than the RBA's central forecast



Source: ABS, RBA, Macquarie Macro Strategy, December 2021

While the re-opening of Australia's international borders should eventually allow some businesses to tap the global pool of workers, the movement of people and workers across borders is likely to remain well below pre-COVID norms for a while yet. There has been a net outflow of people from Australia during COVID and population growth has been the weakest since WWI. While population growth has edged higher already, it remained very low at just 0.3% y/y in Q3. Our forecasts assume population growth picks up slowly to 0.9% y/y over 2022 and 1.2% over 2023.

We expect a stronger pick-up in underlying inflation in coming quarters than the RBA's latest forecasts



Source: ABS, RBA, Macquarie Macro Strategy, December 2021

Inflation is expected to surprise to the upside

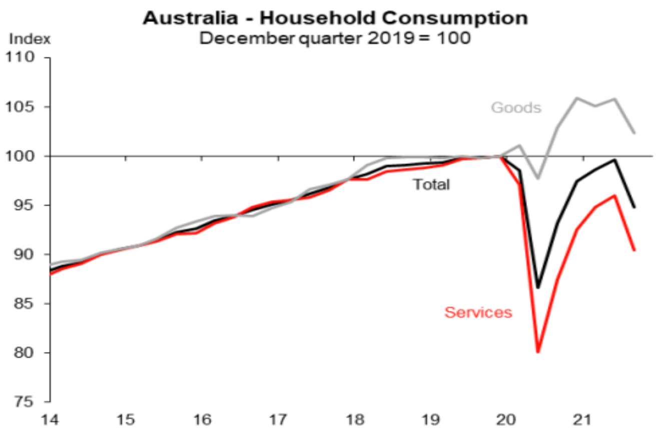
The combination of expected strong demand growth and supply constraints, including in terms of labour supply and supply chain frictions, should generate higher wages growth and inflation over 2022. Reduced spare capacity in the labour market combined with higher inflation expectations, if sustained, should support a further increase in wages growth. We forecast growth in the wage price index of 2.6% over 2022 and 3% over 2023.

How far and fast consumer spending recovers is a key uncertainty

Growth in household disposable income has been solid and supported by a large decline in interest-servicing costs and the absence of income tax "bracket creep". Nonetheless, spending opportunities are still fewer than before COVID and some hesitancy remains to mix with large numbers of people. The key downside risk to consumer spending remains the virus and related uncertainties about its evolution.

Like elsewhere, Australian consumers have substituted towards spending on goods and away from services. The closure of both international and some domestic borders has severely dampened consumer spending on travel. In 2018-19, Australian households spent $142.3b on tourism and travel ($59.7b on outbound travel and $82.7b on domestic travel). By 2020-21 it had fallen to $69b, almost all of which was for domestic tourism and travel ($67.7b), but this had also fallen sharply from pre-COVID levels.

While goods consumption has fared better than services spending but it hasn't been super strong



Source: ABS, RBA, Macquarie Macro Strategy, December 2021

Our central scenario assumes the household saving ratio declines back towards the pre-COVID level over the next couple of years. While a faster reduction may occur, we expect outbound travel and tourism to remain significantly lower than pre-COVID levels well into 2023 at least. Uncertainty around domestic borders is also likely to weigh on domestic travel into at least the near-term even though there is clear evidence (e.g., flight data) that domestic tourism is picking up sharply.

Weaker housing price growth poses a risk to retail sales and discretionary spending

Household spending on goods has not only been supported by COVID-related demand and substitution effects due to restrictions on services spending. Strong housing price growth and activity is also likely to have provided a fillip to non-food retail sales and particularly spending on household goods.

Early signs are emerging of a sharp slowing in housing price growth, particularly in Sydney, Melbourne and Perth. While the volume of sales remains high, we expect sales to moderate over the next year as the heat comes out of established housing markets. History suggests that this will be a headwind to growth in non-food retailing, including sales of household goods.

Strong demand growth will incentivise business investment

Government tax incentives have already been supporting investment in machinery and equipment and those incentives are currently available until mid-2023. More broadly, however, our strong outlook for business investment was supported by the fact that growth in business investment has historically been more volatile than broader demand growth. As broader demand growth strengthens, business investment typically picks up even more quickly.

The outlook for government-backed infrastructure investment, with work carried out by the private sector, also remains strong based on mid-year budget updates. Investment related to the transition to renewable energy sources and to reduce emissions is also expected to support business investment over the medium-term.

Exports will provide modest support to growth

Our team's expectation for above-average global GDP growth next year should support solid growth in Australia's exports. Resource export volumes are expected to recover gradually after declining over the past year or two. Favourable weather should support ongoing strength in rural export volumes in the near-term. Services exports are forecast to strengthen as inbound travel (and international students) pick-up amid the reopening of Australia's borders. Nonetheless, Australians will also travel more overseas, booting services imports. Our commodity team's latest forecasts imply a decline in the prices of Australia's key resource exports over the next couple of years. While this is expected to drag Australia's terms of trade lower, we aren't as bearish as the RBA.

Interest rate outlook: RBA to begin winding back policy support

Our base case is that the RBA tapers its bond purchases in February from $4b/week to potentially less than $2b/week and ends it in May. On the outlook for the cash rate, we think market pricing for RBA rate hikes is too aggressive and can't fathom why markets expect more policy rate tightening by the RBA than the Fed over 2022. Our central scenario is that the Bank will start to increase the cash rate in late 2022 as inflation proves more persistent around the mid-point of their 2-3% target than currently forecast. We expect the Bank's narrative to move on from an overemphasis on wages growth to placing more importance on actual and forecast inflation outcomes.

At the longer end of the yield curve, the Australian 10-year government bond yield has recently been sitting above the US equivalent. As outlined in our 2022 Global Economic & Markets Outlook, the US 10-year yield is forecast to rise to 2% by the end of 2022. We have pencilled in a similar increase for the Aussie 10-year yield.

Quarterly economic forecasts

		Quarterly										Annual*			
		Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	2020	2021	2022	2023
GDP	q/q	(1.9)	2.0	1.9	1.1	1.1	1.0	0.5	0.5	0.5	0.5				
	y/y	3.9	2.6	2.7	3.1	6.3	5.2	3.8	3.1	2.5	2.1	(2.2)	4.2	4.3	2.9
CPI	y/y	3.0	3.0	3.0	2.8	2.7	2.4	2.4	2.4	2.4	2.4	0.8	2.7	2.7	2.4
Core CPI**	q/q	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6				
	y/y	2.1	2.2	2.5	2.6	2.4	2.4	2.4	2.4	2.4	2.4	1.3	1.8	2.5	2.4
A$/US$		0.72	0.72	0.73	0.74	0.75	0.76	0.76	0.76	0.76	0.77	0.77	0.72	0.76	0.77
Policy rate	%	0.10	0.10	0.10	0.10	0.10	0.25	0.50	0.50	0.75	1.00	0.10	0.10	0.25	1.00
3-yr yield	%	0.31	0.95	1.00	1.10	1.20	1.40	1.50	1.55	1.60	1.70	0.11	0.95	1.40	1.70
10-yr yield	%	1.49	1.70	1.80	1.85	1.90	2.00	2.00	2.00	2.05	2.10	0.97	1.70	2.00	2.10

Source: ABS, Bloomberg, RBA, Macquarie Macro Strategy, December 2021

Macquarie WM Investment Strategy Team

The report was finalised on 20 December 2021.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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