June 2020

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

There was a massive plunge in activity across many countries in March/April, with the notable exception of China where the fall in activity occurred earlier (February). High frequency indicators point to a subsequent upturn in activity in May and early June. Business surveys have also shown some improvement but they remain very weak. As a result, extremely large falls in Q2 GDP for many advanced and emerging economies are likely, although with activity now strengthening, there may be a (partial) bounce-back in Q3. We continue to expect that a full recovery will take a long time. Our forecast is for the global economy to contract by 3.7% in 2020 (previously 3.8%), before increasing by 6.2% (previously 6.5%) in 2021. While there is a higher degree of uncertainty around forecasts in the current environment, the extent of the declines already seen to-date combined with our expectation of a protracted recovery, points to 2020 having the largest fall in annual growth since at least the 1950s, and most likely since the Great Depression.

- **Financial and commodity markets** continue to recover from the impact of the COVID-19 pandemic and the associated economic impact of containment measures. However, markets have not fully recovered and there remains a degree of stress. Equity markets fell sharply between mid-February and mid-March, but trended higher from April to early June; our composite indicator of AE stock market indices, has gone from being over 30% below its February peak to 'only' around 10% lower by early June. Stock market volatility has also declined substantially but remains elevated. Commodity prices are well down from their pre-COVID-19 levels, particularly in energy markets, despite a partial recovery (for some commodities, such as oil, this partly reflects supply cuts).
- Due to significant restrictions on activity to bring COVID-19 under control there was a large fall in activity across the major **advanced economies** (AEs) in March and April. All the major AEs saw significant falls in Q1 GDP and even larger falls are expected for Q2. Between February and April, retail sales declined by 21% in the Euro-zone, 23% in the US, 14% in Japan and 22% in the UK. In May, high frequency indicators point to activity recovering while auto sales in the US, and auto production in Germany, rose sharply. Further, the number of jobs in the US increased 2.5m in May. However, most indicators remain substantially below their pre-virus levels (the number of US jobs is still down around 20m), so the average level of activity across Q2 will likely be substantially below that in Q1. Over the last month Japan and Germany have announced further fiscal packages, and the EU is aiming to set up a Recovery Fund.
- Widespread countermeasures to the spread of COVID-19 have had a significant negative impact on **emerging market** (EM) economies, constricting domestic demand while exporters face a deeply depressed global trade environment. The aggregate EM Manufacturing PMI edged up in May, but is at a level that indicates manufacturing conditions are very weak, particularly outside China. Capital outflows are an issue for Brazil – with investors alarmed by the handling of the COVID-19 outbreak and policy response of authorities. More generally, capital flows for EMs could remain volatile in the near term – as investors weigh the higher returns available in EM debt and equity markets against the perceived risks to these investments.
- How governments manage the expiration of their COVID **fiscal** measures over time – some due to happen in coming months – looms as a key issue and a major source of uncertainty. In contrast, **central bank** policy is likely to remain highly supportive. AE central banks had limited room to ease policy rates (with the US Fed the main exception, although it too has now reached what it considers the lower bound for the fed funds rate). AE central bank policy has been focussed on supporting financial market functioning and credit flow to businesses and households. Over the last month, the ECB has expanded its pandemic asset purchase programme, the BoJ introduced a funding programme to support SME lending, while the Fed launched its Main Street Lending facility. EM central banks have been able to reduce their policy rates, despite concerns that stress on EM financial markets would force their central banks to tighten policy.
- Global activity in 2020 is expected to record the biggest contraction since at least the early 1950s and most likely since the Great Depression. The global economy is forecast to contract by 3.7% in 2020, before increasing by 6.2% in 2021. There are a range of risks around these forecasts – including the potential for a second wave of COVID-19 infections that could result in additional countermeasures, ongoing supply chain disruptions and the risk of escalating US-China trade tensions. On the upside, it is possible that the initial bounce in activity as restrictions are eased with be greater than we are factoring in. That said, we continue to expect that a full recovery will take a long time – this is because of continued social distancing, the balance sheet damage done to many businesses/individuals, permanent business closures and long lasting structural impacts.
- For more detail on the global outlook, please see the [Forward View – Global], released yesterday.

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Australia: The pattern of growth in our forecasts is broadly similar to last month, following the integration of the Q1 national accounts and an extension of our forecast horizon to the end of 2022. We expect a large fall of around 8.5% in Q2, following the 0.3% decline in Q1. The accounts suggest that the early stage of COVID-19 impacts may have been larger than we anticipated with a significant fall in services consumption, given the significant lockdowns on activity only occurred in the last two weeks of the quarter. We expect a rebound in activity in H2 2020 and continued above trend growth in 2021. We see growth returning to around trend of 2.8% in 2022. While we see a rebound in growth from Q3, pre-COVID levels of activity are not fully recovered until 2022 and therefore we see unemployment still above 6% at end 2022 after peaking at around 8½% in the next few months. Given this protracted recovery we expect the RBA to remain on hold for an extended period with the cash rate unchanged over the forecast period and the target for 3-year yields to remain in place. We also see a role for ongoing fiscal support as existing measures wind back. We will continue to monitor business confidence which has taken a huge hit in recent months, as ongoing depressed confidence will put the recovery at risk – with investment spending and hiring intentions likely to remain weak.

- As expected the **RBA left rates unchanged** at 0.25% in June and maintained its yield curve target of 0.25% at the 3-year horizon. Bond purchases slowed further in the month reflecting a return of market functioning and that the 3-year yield continues to trade at the RBAs target. We expect rates to remain on hold for an extended period, with the RBA stating it will not remove the yield curve target, which is a precursor to lifting the cash rate until conditions in the labour market suggest a return to full-employment, and inflation is sustainably back within the 2-3% target band. On our forecasts, these conditions will not be met for at least the next 2½ years.
- We have revised down our forecasts for the **unemployment rate** and now expect a peak of 8.5% (instead of 11.7) but only a gradual improvement over the following 2 years. Despite the revision we still see this as a substantial labour market downturn – and the ABS estimates that in the absence of the eligibility changes to Jobseeker payments, the unemployment rate would have risen to 9.6% in April. The true impact is better reflected in hours worked which fell 9% in the month and labour market underutilisation which rose to 19.9%. Nonetheless, it appears that the rate of job shedding has slowed with ABS payrolls levelling off in recent weeks.
- Household **consumption** fell by 1.1% in Q1, driven by a sharp fall in services consumption which was partially offset by an increase in spending on goods. We expect a larger fall in consumption in Q2 with the full-impact of COVID-19 containment measures being felt for the first 2 months of the quarter and a pullback in spending on goods – already evident in the monthly retail sales figures where spending fell 17.7% in April- more than reversing the large 8.5% increase in March. The NAB Cashless retail sales index points to a 5.5% increase in May which would only see a partial recovery in the middle of the quarter. Internal transactions data points to a levelling off in spending suggesting that the easing in restrictions has seen a halt to the plunge in sales. As restrictions are eased further we expect consumption to rebound, but see risks further out in the forecast period should the labour market turn out as forecast.
- The **NAB monthly business survey** for May saw an improvement in both business confidence and conditions, which was fairly broad-based. Nonetheless, both measures remain significantly negative with reads below zero index points in all industries and states. Capacity utilisation rose after falling sharply last month but remains low by historical standards. Accordingly, capex and the employment index saw marginal improvements but are unlikely to turn positive until capacity utilisation is restored. With forward orders still at historical lows this doesn't appear to be likely in the near term.
- **House prices** recorded their first monthly fall in May since the trough in prices mid last year. The declines were led by Melbourne and Sydney, though prices in Perth and Brisbane also fell. Hobart and Adelaide saw gains in the month. The Q2 national accounts showed a 1.7% decline in dwelling investment for the quarter. A 2.9% fall in construction of new dwellings was offset by a 0.4% rise in alterations and additions. We expect dwelling investment to fall further from here before reaching a trough in mid-2021. Softer demand alongside falling prices and uncertainty over levels of migration are expected to weigh. Indeed, building approvals remain around 30% below their peak in late 2015 – despite rising 4.5% since the trough in dwelling prices mid last year. The pipeline of work will be rapidly eroded without a significant pickup in approvals from here.
- **Net exports** made another large contribution to growth in Q1 (0.5ppts) with the fall in exports offset by a larger fall in imports. There remains considerable uncertainty around passenger movements and international travel suggesting service exports (including tourism and education) will remain weak for some time. Offsetting some of this impact will be softer outbound tourism – resulting in weakness in service imports.
- **Commodity markets** were mixed in May. Iron ore prices rose on supply concerns with the fallout of the virus in Brazil likely to weigh on production there. Hard coking coal prices eased in the month, while thermal coal prices have stabilised. Oil prices continued to recover in the month after the sharp falls seen earlier in the year. The LNG sector continues to see ongoing impacts of coronavirus with demand forecast to soften this year.
- We have revised up our expectations for the **exchange rate** to $US72c at end 2020 and US75c by end 2022. Currently the UD/USD has traded around US70c after trading as low as US55c in mid-April.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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