2020 FEDERAL BUDGET

Comment

As expected this is one of the most stimulatory budgets we have ever seen.

Broadly it is largely as expected. A key decision has been to backdate the Phase 2 tax cuts (worth $17.8bn over four years). The back dating of Phase 2 cuts is important as it helps fill the gap to consumers incomes from the reduction of JobKeeper and JobSeeker payments. It has also led us to revise up our near-term GDP forecasts and reduce the level of unemployment at the same horizon.

The biggest item in the budget was the instant asset write off for firms with turnover of less than $5bn (covering around 99% of businesses) – worth $26.7bn. It is very much aimed at encouraging business investment. Further in keeping with the tone of moving from "support to survival" extra money has been given by way of pay incentives to employ people, especially for under 35 year olds who were previously unemployed ($4bn). Also announced were wage subsidies for new apprentices ($1.2bn).

A surprise was not bringing forward the timing of "Stage 3" tax cuts (which the Opposition opposes) or permanently increasing the JobSeeker payment.

The expenditure items include bringing forward infrastructure spending by providing extra money to the States ($6.7bn) along with Commonwealth road infrastructure of $2bn. There was also a carry back tax provision (of around $4.9bn). There was extra money for manufacturing support ($1.5bn) and higher education ($0.9bn). Further, as previously announced, the laws on Responsible lending have been scrapped in an attempt to boost credit for SMEs.

The size of the total fiscal package can be seen from our analysis of the Structural Budget impulse using OECD methodology. That suggests a policy stimulus this year of around 7% of GDP. The implied fiscal tightening that follows as JobKeeper drops out sees the Budget position improving by around $100bn – or a tightening of nearly 5%. At a time when the economy is expected to grow by 4.8%. That in our view is a big stretch – either for the pace of Budget repair and growth.

In looking at the near-term deterioration in the Budget nearly all the work is done on the expense side – as is the subsequent repair process. Albeit, the structural Budget deficit is – even on these charitable assumptions still likely to be around 6% in deficit. Therefore, repairing the budget will be a protracted process, taking well over 5 years.

Overall, we have no problem with the focus on getting the economy going using fiscal stimulus. Structural reform would have also been useful but has not really been attempted apart from the tax cuts. We agree the issue of future debt is of little near term concern. The economy needs all the help it can get from fiscal policy. While the RBA may fractionally lower rates, that would have marginal impacts at present. The cost of credit is not the issue – rather it is the lack of demand for credit.

Fiscal Outcome

The underlying cash balance for 2020/21 is estimated at $214bn (or around 11% of GDP) after a deficit of $85bn in 2019/20. The deficit is expected to start to narrow from 2021-22 onwards, but is expected to remain well in deficit right through the forward estimates period and beyond.

Economic Outlook

Fundamentally we are much more worried about the outlook than the forecasts published by the Treasury. We see GDP falling by around -2.1% in 2020/21 (while the Treasury is at -1.5%). For 2021/22 we have around 3.8% but the Treasury has 4.7%. While we both see unemployment peaking at around 8% (Treasury in December 2020, NAB March 2021) the Treasury has unemployment falling to around 6½% in 2021/22 while NAB is nearer 7%. We both have unemployment of around 6% in 2022/23.Generally, we are weaker across all private sector components, while we are stronger on the outlook for government spending. We also expect a slower bounce back in exports.

Financial Markets

There was little to no market impact as the bottom line was close to expectations. S&P has confirmed its negative outlook on Australia's AAA rating, the AAA rating is contingent on deficits narrowing from fiscal 2022 onwards. Moody's and Fitch have reserved judgment for now.

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The Key Metrics

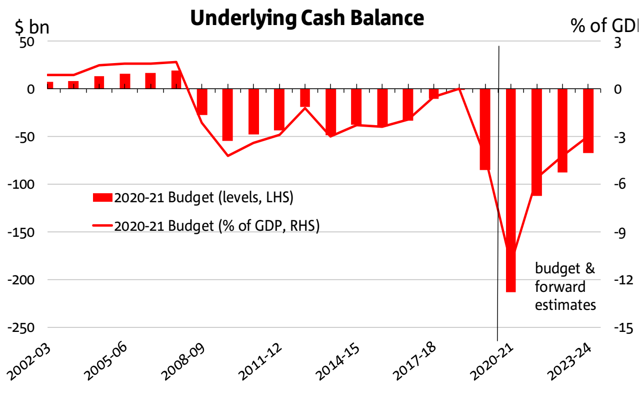
	Estimates								Projections		
	2019-20			2020-21(e)			2021-22(e)		2022-23(p)		2023-24(p)
	MYEFO	EFU	Budget	MYEFO	EFU	Budget	MYEFO	Budget	MYEFO	Budget	Budget
Underlying cash balance, $bn	5.0	-85.8	-85.3	6.1	-184.5	-213.7	8.4	-112.0	4.0	-87.9	-66.9
% of GDP	0.3	-4.3	-4.3	0.3	-9.7	-11.0	0.4	-5.6	0.2	-4.2	-3.0
Net operating balance	8.0	n.a.	-93.5	12.1	n.a.	-197.9	17.8	-103.4	11.6	-83.5	-58.5
% of GDP	0.4	n.a.	-4.7	0.6	n.a.	-10.2	0.8	-5.1	0.5	-4.0	-2.7
Net capital investment	4.2	n.a.	4.0	6.3	n.a.	7.8	8.2	9.6	8.7	11.0	10.8
% of GDP	0.2	n.a.	0.2	0.3	n.a.	0.4	0.4	0.5	0.4	0.5	0.5
Fiscal balance, $bn	3.8	n.a.	-97.5	5.8	n.a.	-205.7	9.7	-113.3	2.9	-94.5	-69.3
% of GDP	0.2	n.a.	-4.9	0.3	n.a.	-10.6	0.4	-5.6	0.1	-4.5	-3.1
Net debt, $bn	392.3	488.2	491.2	379.2	677.1	703.2	364.5	812.1	360.8	899.8	966.2
% of GDP	19.5	24.6	24.8	18.4	35.7	36.1	16.9	40.4	16.0	42.8	43.8

Source: Commonwealth Treasury

This year's federal budget simply reinforces what was already known – there has been a rapid and sharp deterioration in the Government's budget position. At the end of last year (in its 2019-20 Mid-Year Economic and Fiscal Outlook) the government was projecting small cash surpluses, but this has turned into large deficits right through the projection period.

This is due to the impact of COVID-19 on the economy and the fiscal measures put in place by the Government to support the economy. The forward estimates highlight that returning the budget position to where it was pre-COVID is going to be difficult; indeed the strategy of aiming for cash surpluses has been abandoned and replaced with a medium term goal of stabilising the debt level.

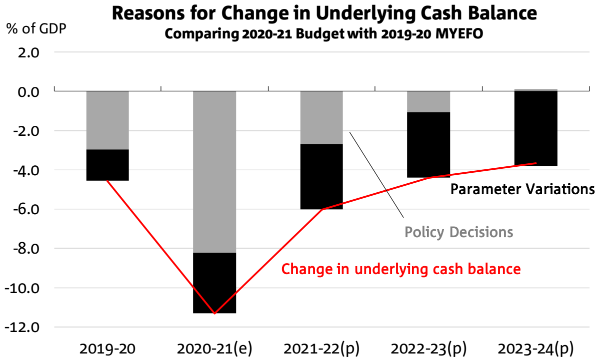
As a per cent of GDP, the underlying cash deficit is expected to peak in 2020-21 at 11% of GDP ($213.7b). The budget deficit is then expected to start to decline but to remain in deficit right through the forward estimates period.



Source: Commonwealth Treasury

The deterioration in the underlying cash balance reflects both policy decisions and the impact of the economic downturn. Reduced economic activity weighs on the tax revenue and spending also rises as more people become eligible for government support. The size of these 'automatic stabilisers' can be seen in the changes in the budget position due to 'parameter variations', predominately on the revenue side.

Policy decisions have significantly added to the support coming from these automatic stabilisers. In contrast, initially they were mainly focussed on the spending side, although in 2021-22 the emphasis switches to the revenue side with the bringing forward of scheduled income tax cuts.



Source: Commonwealth Treasury, NAB calculations

Budget Reconciliation

Underlying cash balance estimates

	2019-20	2020-21(e)	2021-22(p)	2022-23(p)	2023-24(p)
Budget 20-21	**-85,272**	**-213,654**	**-112,003**	**-87,883**	**-66,926**
% of GDP	-4.3	-11.0	-5.6	-4.2	-3.0
Policy Decisions					
Receipts	-373	-11,830	-32,815	-10,867	11,514
Payments	58,026	147,952	21,045	11,324	8,866
Total	-58,399	-159,782	-53,860	-22,191	2,648
% of GDP	-2.9	-8.2	-2.7	-1.1	0.1
Parameter Variations					
Receipts*	-32,602	-41,004	-54,512	-31,329	-76,012
Payments	-44	18,922	11,981	8,407	8,475
Other	745				
Total	-31,901	-59,926	-66,493	-69,736	-84,486
% of GDP	-1.6	-3.1	-3.3	-3.3	-3.8
MYEFO 19-20	**5,028**	**6,054**	**8,351**	**4,044**	**14,912**
Budget 2019-20	**7,054**	**11,004**	**17,792**	**9,165**	

Source: Budget Papers, NAB calculations. 2019-20 reconcilliation based on July Economic and Fiscal Update

The impact of the policy decisions made this year starts to unwind from 2021-22 and by 2023-24 they are negligible. However, the persistence of 'parameter variations' underscores the long-run fall out from the downturn on the budget outlook.

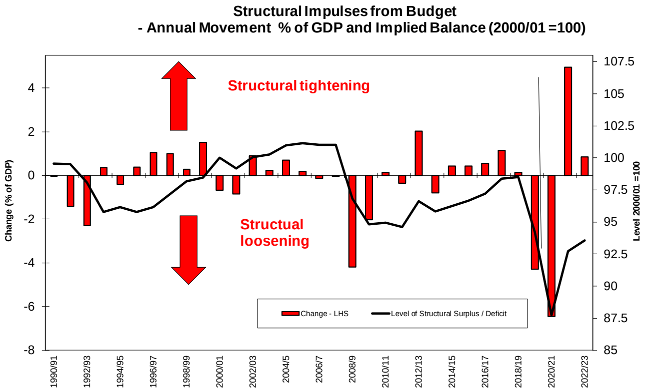
Alternative measures of the budget position - the operating balance and fiscal balance (operating balance but with net capital investment included) - show a similar story. Namely a big blow-out in the budget position followed by partial repair.

Fiscal Stimulus

Normally we use this section to comment on the medium term Budget outlook and the sustainability of the return to surplus. That however is not really relevant in these very special circumstances where the fiscal settings are very much aimed at getting the economy over the damage inflicted by the virus shut downs.

Instead we have turned to trying to give a better handle on the size of the stimulus involved. To do that we again turn to using an OECD methodology which attempts to show the structural changes of Budget measures by excluding cyclical factors. That is, what the Budget is doing to the economy and excluding what the economy is doing to the Budget

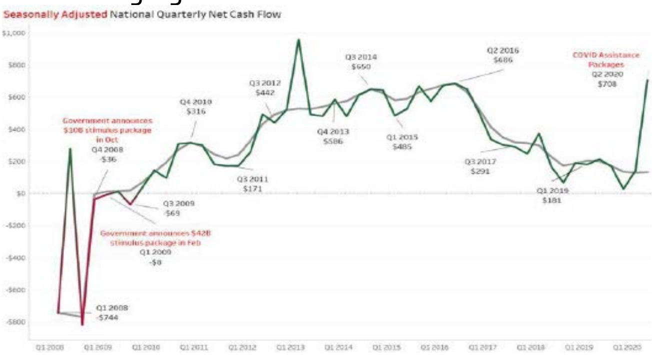
The chart below indicates the Budget in 2019/20 added around 4.2% of stimulus to the economy. While the Budget deficit was much larger last year than during the peak spend of the GFC (Budget of 2008/09) the impact as a percent of GDP was much the same – basically because the economy didn't fall as much in the GFC and hence the methodology gave more weight to a structural impact.



The impact in 2020/21 however was a much larger -7.2% of GDP (despite a massive fall in GDP in that fiscal year of around -2%). Again, this highlights the massive stimulus let loose by the Government.

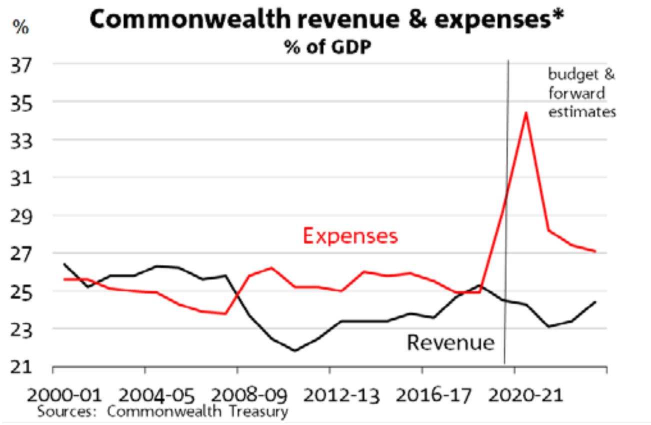
What is more interesting is the implied fiscal tightening in 2021/22 if we believe our forecasts and the Governments fiscal calculations (using the Governments own forecasts do not change the story much). Clearly this raises a lot of doubts about the outlook.

Another way to look at the issue of the extent of the Governments near term support is to look at household cash flows over a 10 year period – again going back to the GFC. As shown by the following chart Consumer Cashflow increased massively on the back of Government hand- outs (eg JobKeeper et al), early withdrawal of superannuation (both in April and July) and deferment of interest payments. The chart also shows why Government support such as backdating Phase 2 tax cuts are needed to help fill in the hole of reduced JobKeeper payments and the inability to double dip into super again this year. It is also sobering to realize that by August cash flows had again turned negative. That is lower income receipts were largely used up by consumer spending. It also highlights why we fear Q4 GDP will be challenging.



Going back to the OECD chart it is also clear that the Structural Budget deficit goes as low as -12% of GDP (the black line) but as noted previously repairs to around a 6% deficit by around 2022/23.

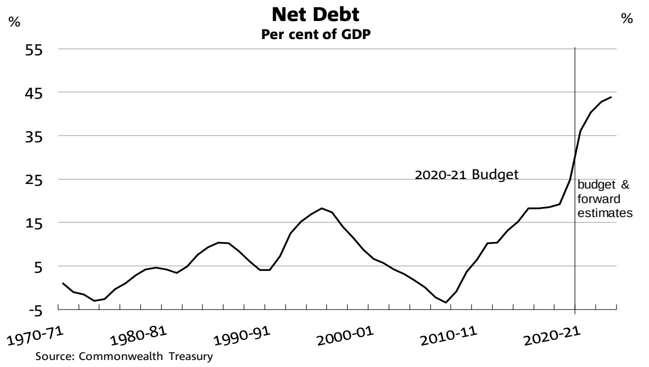
Finally we look at the Governments "jaws" – that is their revenues v their expenses. As can be seen it is clear that much of deficit has come from the expenses line as has its subsequent repair.



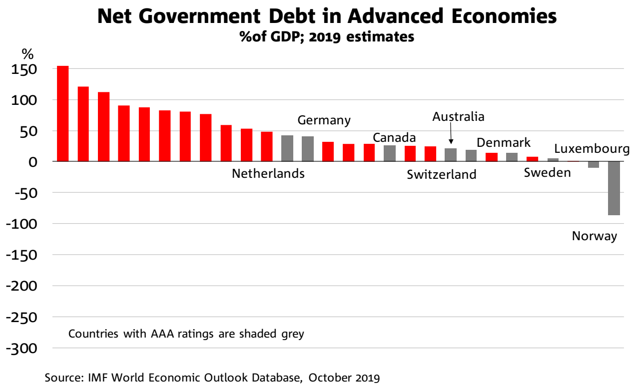
As noted earlier, the size of the stimulus is unprecedented and while necessary will see the country in deficit for probably another 6-10 years.

Government Debt

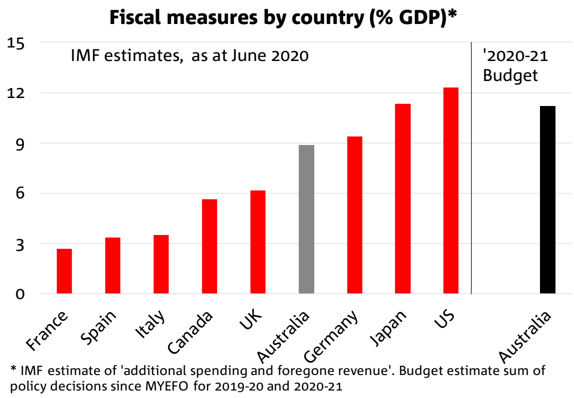
The blowout in the budget position means that net debt is expected to rise sharply over the forward estimates period, and to move to a level well above anything seen since the 1970s (as a % of GDP). By the end of the forward estimates (2023-24) net debt is expected to be 43.8% of GDP. According to medium term estimates published in the budget papers this is expected to be the peak for net debt, but only with a modest improvement expected beyond this date.



Pre-COVID-19, Australian net government debt to GDP was low by international standards and around the middle of the pack of AAA rated countries (see chart below). Many other countries have enacted large scale fiscal support, particularly other advanced economies, to address COVID-19 fall out.



The chart below illustrates IMF estimates (prepared in June), of fiscal measures related to COVID-19 put in place by other countries. Moreover, with other countries rolling out further fiscal support since June, it is unclear to what extent Australia's *relative* debt ranking will change even with the rapid projected increase in net debt.



Implications for the Bond Market

The 2020-21 Budget says that CGS on issue will grow to $872bn by the end of the fiscal year. This is about $20bn more than the July Economic and Fiscal Update projected and implies $233bn of gross issuance in the current fiscal year.

The AOFM's most recent comment on their issuance program was in a speech by CEO Rob Nicholl in July, where he said the AOFM is targeting $190bn net or $240bn of gross nominal bond issuance for the year. Overall, assuming zero net inflation-linked issuance, year-end T-note outstandings of $70bn (up about $6bn from the time of that speech) and $190bn net nominal issuance, this pointed to total AGS on issue of $885bn at the end of the fiscal year. This was well ahead of the $852bn in the EFU and it is still slightly ahead of the $872bn projected in the Budget.

Nevertheless, we do not expect the AOFM to announce a material change to the current pace of issuance. The AOFM said in July that as well as front-loading the issuance task they aim to increase cash balances to cover four weeks of market disruption. We estimate this to be about $16-20bn based on the current issuance pace. Making allowance for that cash buildup over the $233bn funding program implied in the budget could see a total AOFM issuance target of $250-260bn, but the current weekly run rate ($4-5bn of nominal tenders) would still easily achieve that.

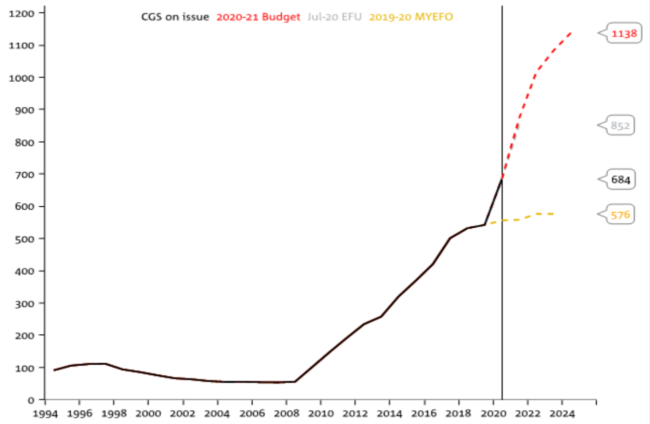
Four of the five new bond lines discussed in the July speech have now been issued, with a 2032 maturity syndication still remaining. Announcement of further syndicated lines is a possibility, and the AOFM discussed in July the possibility of introducing a third maturity into a calendar year. If the RBA increases its buying activity (either for YCC, QE or market functioning) then the introduction of a third line may be a useful tool for maintaining free float in the shorter futures baskets, as well as smoothing the AOFM's cashflow profile.

Looking forward the gross issuance program is expected to approach $170bn in 2021-22 and exceed $150bn in 2022-23 off a net funding need of $144bn and $67bn respectively. Obviously, there is even greater uncertainty to those projections than usual, so the AOFM is unlikely to shy away from continuing to front load.

We expect a formal issuance update from the AOFM tomorrow, 7 October.

Bond Supply Projections

2020-21 Budget	2019-20	2020-21	2021-22	2022-23	2023-24
Year End Face Value ($bn)	684.3	872	1016	1083	1138
Implied Net Issuance ($bn)		187.7	144	67	55
Maturities ($bn)		46	23	85	61
Gross Issuance ($bn)		**233.3**	**167.2**	**152.5**	**115.9**



Source: National Australia Bank, Macrobond

New Budget Measures – In Brief

Key budget policy measures	Cost ($b)	Detail
Investment allowance	26.7	Eligible assets bought and used before the end of FY22 will be fully deductable for businesses with turnover under $5bn
Earlier income tax cuts	17.8	Bringing forward stage 2 income tax cuts by increasing the bottom of the: 19% bracket to $45k from $37k and the 32.5% bracket to $120k from $90k
JobKeeper extension	15.6	Already announced after the introduction of stage 4 lockdown in Melbourne. Easing eligibility for JobKeeper.
Infrastructure spending	10.7	$6.7bn in grants to the states, $3bn for roads and community infrastructure and $1bn for water infrastructure
Business loss carry-backs	4.9	Businesses with a turnover under $5bn can use tax losses FY20 to FY22 income years to offset profits taxed in the previous financial year.
JobMaker hiring credit	4.0	Businesses will get $200 per week for 12m for every person aged 16-29 they hire and $100/week for every person aged 30-35. The new employees need to have previously received unemployment benefits or youth allowance in the past 3m. Until the end of FY23.
Extending apprentice subsidy	1.2	Businesses of any size (not just SMEs) can now claim a subsidy for hiring apprentices, worth 50% of an apprentice or trainee's wage, up to $7000 per quarter. Until 30 Sep 2021.
Undoing cuts to R&D incentives	2.0	
Manufacturing grants	1.5	Manufacturing grants for priority areas: resources; food & beverages; medical products; recycling & clean energy; defence; and space.
Other measures	27.0	
Total	**111.4**	

Source: Treasury

Most significant budget measures had been announced/leaked prior to the release of the budget. Unsurprisingly, a number of these measures are very large – with the intent of providing significant support to the economy. However, it is important to note that both the JobSeeker and JobKeeper measures have not been extended beyond existing arrangements and have instead been replaced by the JobMaker program.

Tax Measures

Tax cuts/breaks are the clear centerpiece of the budget. The single most significant measure included in the budget is an upsized investment allowance. Until June 2022, businesses with up to $5bn of revenue (around 99% of companies) will be able to write off the full value of asset purchases as an expense for tax purposes.

Business loss carry backs have also been introduced on a temporary basis, allowing companies to claim losses against previous year's tax payments, which sees instant access to the cash flows rather than waiting to offset future profits.

As was widely foreshadowed on the household side, the government has brought forward the "stage 2" tax cuts and backdated this to 1 July 2020. This sees the lowest tax bracket lifted to $45k while the bottom of the 32.5% tax bracket has been lifted from $90k to $120k. This is a structural change to the budget, with the "stage 3" cuts still legislated according to the original schedule.

The last major tax measure includes a reversal of the cuts to R&D tax breaks worth around $2bn.

New spending measures:

Also included is around $10..7bn of infrastructure spending, with around $2bn of direct spending on roads and a use-it-or-lose it allowance of around $6.7bn for state infrastructure spending on shovel ready projects.

The government has left the expiry dates of the JobSeeker and JobKeeper payments unchanged but has introduced a new JobMaker payment. This tiered wage subsidy will be available to firms who hire a new employee aged 16-35 for at least 20 hours a week, that had received an unemployment benefit for at least month over the previous quarter.

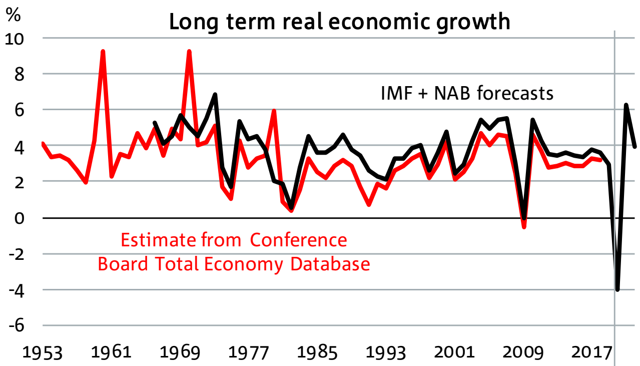
Alongside this subsidy the government has expanded the 50% apprentice wage subsidy to all businesses (previously only SMEs) up to $7000 per quarter until the end of Q3 2021.

A Modern Manufacturing Initiative including manufacturing grants of $1.5bn have also been included. This is targeted towards the resources technology and critical minerals processing, food and beverage, medical products, recycling and clean energy, defence, and space industries – which have been deemed a national priority.

A range of other new expenditure measures have also been included worth around $20bn largely focusing on industry/community specific issues.

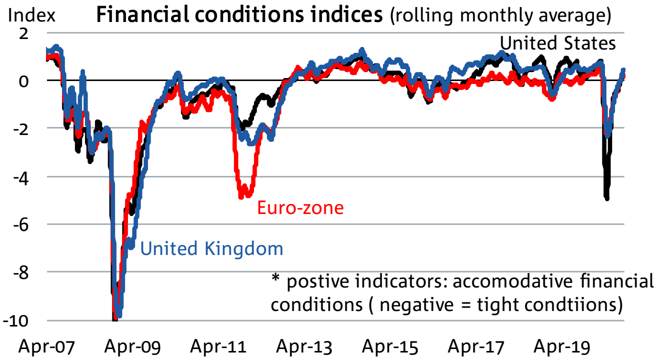
Global Economic Outlook

Global economic conditions deteriorated sharply across the second quarter of 2020, as a wide range of countermeasures implemented to control the spread of COVID-19 severely restricted activity. Although a broad recovery commenced in Q3, the overwhelming scale of the earlier downturn means that 2020 will record the largest economic decline since at least the early 1950s, and most likely the Great Depression.



Source: Refinitiv, The Conference Board, NAB Economics

Authorities responded to the global downturn by reducing policy rates along with a range of other measures, including bank funding programs, asset purchases and loan guarantees to support the flow of credit. This has supported a rapid recovery in financial markets from April onwards, although there is a risk that a tightening in lending standards (already evident in the United States and Canada) could constrain the pace of recovery.



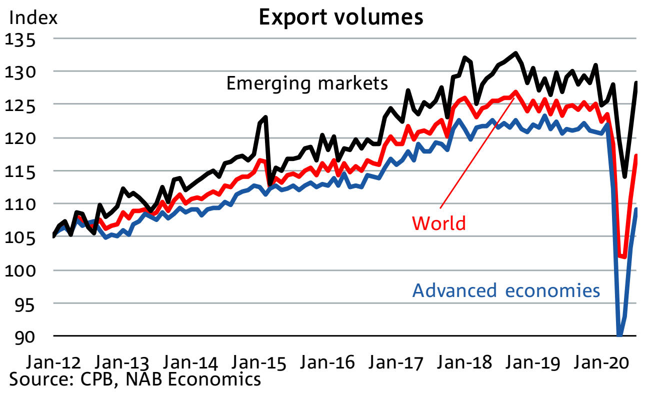
Source: Bloomberg, NAB Economics

In addition, governments have introduced a broad range of fiscal programs to support businesses and households impacted by COVID-19 countermeasures. Although higher public sector debt (as a result of these programs) will increase risks over the medium to longer term, premature unwinding of these programs could undermine the recovery, as resulting business closures and unemployment constrain growth.

High frequency activity indicators point to a substantial (but incomplete) recovery in advanced economies in Q3. However, these measures suggest that momentum may have eased across the quarter. Many countries have experienced fresh outbreaks of COVID-19 – which have resulted in the reintroduction of some restrictions or more cautious behaviour by consumers. In addition, it is possible that pent-up demand from the initial period of restrictions has been satisfied.

Trends in emerging markets have differed considerably. China's economy recovered in the second quarter, in stark contrast to steep contractions in India and Latin America – with the latter hit particularly hard by COVID-19 outbreaks that remain largely out of control. It is worth noting that China's recovery has largely been driven by the industrial sector – supported by investment in infrastructure and housing construction – while growth in household consumption has remained historically weak.

Growth in emerging markets is more trade dependent than in advanced economies. Global trade volumes contracted sharply in response to COVID-19 countermeasures and despite strong month-on-month increases in June and July, volumes as of July remained well below its pre-COVID-19 levels. Advanced economy export volumes remain notably weaker.



Source: CPB, NAB Economics

Prior to COVID-19, global trade activity was significantly impacted by the US-China trade war – with volumes peaking in October 2018. Although the two countries signed a partial trade deal in January 2020, tensions have risen more recently, with US actions against Chinese firms and doubts that China can meet the import requirements specified in the agreement.

A further uncertainty is the outcome of the US Presidential Election in November. Current polling suggests a change in leadership, however a range of factors – including COVID-19 outbreaks – could influence voter turnout and the ultimate winner.

Monetary policy expectations remain subdued in the near term – with the US Federal Reserve moving to average inflation targeting in late August. Given that inflation has been below target for some time, this is likely to keep US rates unchanged over our forecast horizon, with similar trends for most other major central banks.

These trends and risks highlight that a full recovery in the global economy will take some time.

The table below compares NAB's global economic forecasts with that of the Commonwealth Treasury. Overall, we expect the global economy to contract by 4.1% in 2020, before subsequently growing by 6.3% in 2021 and 3.9% in 2022. Generally Treasury appear to be somewhat more pessimistic in its outlook – with a larger downturn in 2020, followed by a more modest recovery across 2021 and 2022. In particular, Treasury see weaker growth in the next two years for China and India – respectively the largest and third largest economies in the world (on a purchasing power parity basis). It also forecasts considerably weaker growth in the US and Euro-zone in 2021.

Comparison of Treasury Budget Forecasts and NAB Forecasts

	2020		2021		2022	
	Treasury	NAB	Treasury	NAB	Treasury	NAB
US	-5.5	-4.1	2.3	3.4	3.0	2.7
Euro-zone	-9.0	-6.9	3.5	5.7	3.0	2.3
Japan	-5.8	-5.7	2.5	2.7	1.8	1.4
China	1.8	1.5	8.0	9.5	5.3	5.8
India	-9.0	-8.8	9.0	13.3	4.8	6.0
Other East Asia	-3.8	-3.5	4.0	5.3	3.5	5.1
World	-4.5	-4.1	5.0	6.3	3.5	3.9
Major trading partners	-3.0	-2.5	5.8	6.8	3.8	4.5

There remain significant risks around the global outlook. COVID-19 outbreaks remain uncontrolled in a number of countries, and there remains the risk of additional waves of outbreak – which could impact household demand and business activity, regardless of whether governments reintroduce countermeasures.

In addition, further deterioration in the relationship between the United States and China threatens a resumption of the economically damaging trade war. Other geopolitical risks include uncertainty around the EU and UK relationship post the current transition period, tensions between Hong Kong and mainland China, and uncertainty around the Middle East and the South China Sea.

Australian Outlook

As a result of the budget we have adjusted up our forecasts for GDP in the near-term, while we also see the unemployment rate peaking slightly lower (in around March 2021). That said, the Australian economy has undergone the largest peace time contraction since the 1930's. While we have likely passed the trough in GDP – which was in Q2 as output fell 7% fall following on from a smaller decline in Q1 – we expect the recovery will be gradual. That said there will likely be an initial bounce in activity in Q3, with most states having eased restrictions internally after the virus-related lockdowns in Q2. Victoria will weigh somewhat on the overall result – with the more stringent second round of lockdowns impacting both Q3 and Q4 activity data.

Assuming the fall in COVID-19 cases in Victoria continues and the second wave of the virus is brought under control by the end of the year, we see activity lifting within states, and a relaxation of border restrictions across states by the end of the year. This should see a gradual recovery in the level of activity, that sees the quarterly level of GDP fully recovered by mid-2022.

In growth terms, that sees a fall in activity of 2.1% in 2020/2021 and growth of 3.8% in 2021/22. Overall, this fall in output and then recovery is driven by a large swing in household consumption (particularly services). The rest of the private sector is also expected to follow this pattern, with business investment expected to fall sharply in the near term, before beginning to recover from late 2021. Dwelling investment which had already seen weakness pre-COVID is expected to fall further.

The recovery in activity is likely to be uneven across industries. Household services are expected to rebound relatively quickly, as restrictions on trade are removed, but goods retailing is likely to moderate from the levels seen in recent months – as the wage support given to households fades.

Domestic tourism (both within and between states) is likely to recover, though sectors impacted by international tourism will likely see ongoing impacts until borders are opened to free movement. There is some opportunity to capture at least some of the spend Australian tourists would have used overseas however.

The education sector will likely see ongoing impacts in the near-term while borders remain closed and there is a sharp decline in international students. In the medium term much will depend on when the international border opens (or an effective program is set in place to bring students into the country while meeting quarantine requirements). Outside of these direct impacts, there are further risks with a global recovery, from the recession earlier in the year, likely to take some time, impacting on global incomes while the exchange rate remains relatively strong – putting Australia at a cost disadvantage at a time where potential international student incomes have been reduced.

Construction and related manufacturing, may see some impacts from the weaker demand for housing as population growth slows and the existing pipeline of supply comes online.

The outlook for commercial property is mixed. CBD hotels, retails and office space are at risk from ongoing work from home while industrial space and retail in suburban areas are likely to benefit. To the extent that at least some part of current working arrangements becomes permanent, there may be ongoing structural risks to commercial property.

Engineering construction on the other hand may benefit from a bring forward of infrastructure spending as well incentives provided to the states under the scheme announced in the budget.

Unsurprisingly, the hit to activity has seen a large deterioration in the labour market. Between March and May, employment fell by 872k while hours worked fell by a massive 10.4%. The unemployment rate rose sharply to 7.5% (but has since fallen). The rise in unemployment rate was smaller than initially feared because of two factors. Firstly, the interaction of the definition on unemployment and the removal of the requirement for dole recipients to be 'actively' searching for work saw a large fall in participation, which muted the rise in the unemployment rate. Secondly, the effect of the JobKeeper subsidy has seen measured employment hold up better than expected as workers are still counted as having a job, despite working no hours.

Broader measures of unemployment, including the underemployment rate (those seeking more hours) or the underutilization rate (the sum of unemployed and those looking for more hours) provide a more accurate reflection of the true labour market impact. The underemployment rate rose to 13.8% in April, while the underutilisation rate spiked to 20.2% in May. Since then, these measures have eased slightly but remain elevated.

From here we expect the unemployment rate to rise further as workers re-enter the labour force and participation increases. We expect the unemployment rate to peak at around 8.2% by early next year, before a gradual (but not complete) recovery to around 7.0% by end 2021 and 6.0% by the end of 2022.

The large degree of spare capacity in the labour market will see very weak outcomes for wage growth over the next couple of years. We expect wage growth to fall to around 1% y/y by end 2021, before lifting to around 2% at the end of 2022. With wages already tracking at the lowest pace since the WPI began – real incomes will remain very weak.

Consequently, we expect very weak inflation over the next couple of years. In addition to weak wage pressure domestically, soft demand and strong competition will see restraint on price increases. Tradables inflation will also likely remain weak with the dollar expected to strengthen and global inflation to remain low.

Business Sector

The outlook for the business sector remains highly uncertain. Confidence saw the largest and fasted hit in the history of the NAB Business Survey to a low of -66 index points in March. Unsurprisingly business conditions also saw a very large deterioration – with particularly large hits to the services sectors.

Both confidence and conditions have since seen a significant recovery. However, the recovery in capacity utilisation has been much more modest. This suggests that while there has been some improvement in recent months there is still some way to go before a full recovery will occur.

Further, forward orders remain weak, and suggest at face value that the pipeline of work continues to shrink. Therefore, it is unlikely that capacity utilization will rise in the near term.

With capacity utilisation remaining low, it is likely that confidence will remain fragile. Our expectation is that business investment will fall sharply over the next year.

The August release of the ABS Capex Survey largely confirmed this – with investment expected to fall by 10% (in nominal terms) in the next financial year – with the declines concentrated in the non-mining sector.

Housing

The hit to house prices has been significantly less severe than initially expected – especially given the large deterioration in the labour market that has occurred. Part of the reason for this is the very significant support the government has provided to households through the upsized JobSeeker payment as well as the JobKeeper wage subsidies. In addition, the deferral of mortgage payments as well the support of the banking system to restructure loans where suitable to enable ongoing payments has helped.

Overall, prices have declined by 2.8% since peaking in April, after rising very rapidly in the preceding 12 months. The decline in prices has been led by weakness in Melbourne (down 5.2%), though Sydney (down 2.9%) and Perth (down 2%) have also seen declines. Brisbane had edged lower, while Adelaide and Hobart have risen by over 1%. More recently, prices appear to have levelled off – though volumes remain low.

We still see further weakness in prices from here, with a deterioration in household income growth, high unemployment and a very sharp slowing in population growth weighing on demand. In the near term there is also a still significant pipeline of new dwellings to come online. Supports to the housing market will come from very low interest rates and a sharp fall in the pipeline of work, with approvals at relatively low levels. However, government support through the HomeBuilder program (previously announced) will provide some support to the activity side of the market while support for first home buyers which was extended in the budget via the First Home Loan Deposit Scheme will continue.

Monetary Policy

We expect monetary policy to remain highly accommodative for an extended period. Indeed, we do not see any increase in the cash rate (as signalled by the RBA) for the next 3 years. With inflation posing no constraint to policy (and having undershot the target for an extended period) the focus will remain firmly on pushing economic activity towards potential and eventually driving down the unemployment rate to a level consistent will full employment. Only then will then will the outlook for inflation point to a sustainable return to the target band.

In the near-term we expect that there will be some tweaks to the package of policy measures introduced in mid-March. We see the bank cutting the cash rate target (which will have little impact on where cash is currently trading) alongside a cut to the 3-year AGS yield target – both by 15bps to 0.1%. We also think that the RBA will move to a more formal QE program - buying bonds further along the curve to ensure yields remain low.

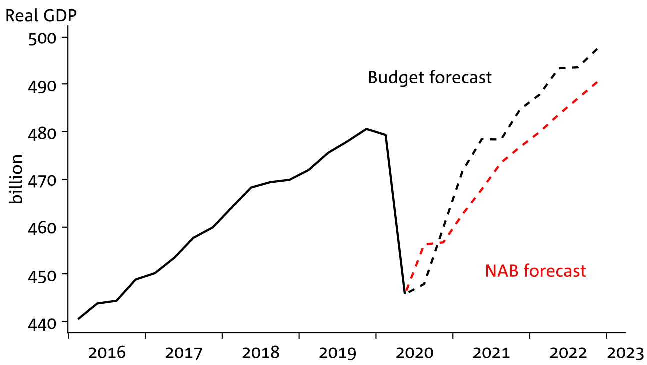
In addition, we expect the RBA will cut the rate on existing and future drawings of the term funding facility (TFF) to 0.1%. All of these actions will continue to ensure the price of credit remains extremely low by historical standards, with bond yields as well as household and business interest rates at low levels.

The focus of the RBA from here will likely be to ensure that the flow of credit continues where it is needed. This may mean expanding the TFF as required and upping bond purchases should there be any upward pressure on yields (or digestion issues with a large amount of supply entering the bond market).

NAB Forecasts v Budget Outlook

Overall, the budget allows for GDP falling by 1½% (NAB: -2.1%) in 2020/21 before increasing by 4¾% (NAB: 3.8%) in 2021/22. We see the budget containing a set of forecasts more optimistic than ours and may be somewhat courageous given the implied magnitude of the subtraction fiscal policy will make in the 2nd year of the forward estimates as the underlying cash deficit shrinks. The fall in GDP this year is smaller, while the rebound in the next financial year is substantially larger. The difference is consistent across each of the expenditure components, with our forecasts including larger falls across dwelling investment, business investment as well as consumption. On public spending Treasury sees slightly less growth than what we have included in our overall forecast but the magnitude will likely be swamped by the moves across the other components.

GDP FORECASTS



Source: National Australia Bank, Australian Bureau of Statistics, Treasury

We see similar falls in both imports and exports but have a more gradual improvement in exports in the second year of the forward estimates.

That said, we do not see a materially different path for unemployment to the assumptions included in the budget albeit our initial recovery in the unemployment rate is a slightly slower. They see unemployment peaking at 8% by Q4 2020 (NAB: March 2021 peak of 8.2%), before falling to 7¼% (NAB: 8%) at end 2020/21 and 6½% (NAB: 6.4%) at end 2021/22.

With a broadly similar outlook for unemployment, the budget forecasts for wage growth at 1.25% in the year to 2020/21 and 1.5% in the year to 2021/22 are broadly similar to our own.

On the other hand, Treasury appears to have taken a conservative approach to forecasts of nominal GDP with a weaker outlook for the terms of trade. Treasury expects a fall in nominal GDP 1.75% in 2020/21 (NAB: -0.7%) before growth of 3¼% in 2021/22 (NAB: 5.6%). Correspondingly the outlook for the terms of trade is significantly weaker than ours.

The assumptions underlying the budget forecasts are broadly similar to ours. They see the economy gradually opening up from here, with the virus coming under control in Victoria and any further outbreaks elsewhere being contained. State borders are expected to open up late this year and early next year, before international borders begin to open up in H2 2021. At this time the government expects an effective vaccine to be available. We do not fundamentally disagree with this outlook, though obviously much uncertainty rests on this outlook – particularly the wide-spread availability of a vaccine in that timeframe and the ability to see international students return to Australia. Crucially, the speed and the strength of the recovery in activity is contingent on a rapid recovery in business and consumer confidence. Our own business survey shows that confidence has indeed recovered significantly from the lows reached in H1 2020, but capacity utilization is yet to fully recovery and forward orders remains very weak. Further, confidence was relatively weak prior to the onset of the pandemic and we would likely need to see a further increase from here before we would expect a notable pickup in hiring and investment.

Budget economic forecasts table

	2020-21 (f)		2021-22 (f)		2022-23 (f)	2023-24 (f)
Annual % Change	**Budget**	**NAB**	**Budget**	**NAB**		
Private Consumption	-1 1/2	-5.3	7	7.2		
Private Investment – Dwelling	-11	-15.8	7	2.2		
Underlying Business Investment	-9 1/2	-14.1	6	0.1		
Underlying Public Final Demand	5 3/4	8.5	2 1/2	4.8		
Domestic Demand	n.a	**-3.2**	n.a	**5.6**		
Stocks – Contribution to GDP	0	0.6	1/4	0.0		
GNE	-1	**-2.6**	6	**5.6**		
Exports	-9	-9.6	2	-5.6		
Imports	-9 1/2	-10.7	8 1/2	3.8		
Real GDP	-1 1/2	**-2.1**	4 3/4	**3.8**	2 3/4	3
- Non-Farm GDP	n.a	-2.1	n.a	3.8		
- Farm GDP	n.a	-1.9	n.a	2.0		
Nominal GDP	-1 3/4	**-0.7**	3 1/4	**5.6**		
Federal Budget Balance (fiscal balance, $bn)	**-213.7**		**-112.0**		-87.90	-66.90
Current Account Deficit: % of GDP (-%)	2	2.9	-1 1/2	1.3		
Terms of Trade	-1 1/2	2.9	-10 3/4	1.6		
World GDP (b)	5	6.3	3 1/2	3.9		
End Period						
Wage Price Index	1 1/4	1.0	1 1/2	1.5	2	2 1/4
Employment	2 3/4	4.9	1 3/4	2.7	1	1 3/4
Unemployment rate	7 1/4	8.0	6 1/2	6.4	6	5 1/2
Underlying CPI	n.a	1.8	n.a	1.4		
Official Cash Rate (%) (c)	n.a.	0.1	n.a.	0.1		
10 Year Govt. Bond Yield	n.a.	1.0	n.a.	1.2		
US cents/$A		0.77		0.80		
Trade Weighted Index (d)		62.8		64.3		

(a) Percentage change on previous year, unless otherwise indicated (b) Calendar year forecast (c) Budget assumes profile similar to market pricing (d) End of period (f) Forecast

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