JBWere

The CIO View

Issue date: 12 May 2021

Putting Wealth To Work For Generations

Sally Auld
Chief Investment Officer

The CIO View: Budget 2021-22 – Red is the new black

JBWere View

The 2021-22 Budget reflects the government's new fiscal strategy – no fiscal repair until the unemployment rate is closer to or at levels consistent with full employment. This delivers a relatively rare synchronicity between fiscal and monetary policy settings in Australia, which will be supportive for economic growth. While there are measures in the Budget which support the near-term growth outlook, there are also some significant longer-term spending commitments. These commitments will ensure the Federal budget remains in structural deficit for the foreseeable future.

Key Points

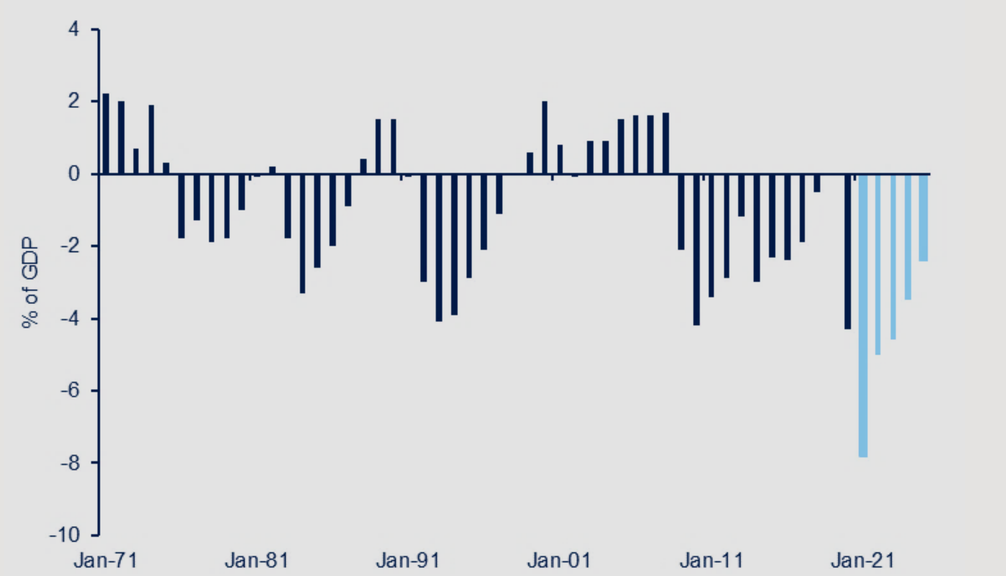
- This week, we devote *The CIO View* to our write up of the Federal Budget. The Budget has been handed down in the context of a very different fiscal strategy – no fiscal repair until the labour market is close or at full employment. Consequently, while the macro-economic context for this year's Budget is vastly improved, the bottom line still remains deficits for the foreseeable future. Net debt is forecast to stabilise at around 40% of GDP by 2024-25. In our view, the broad fiscal strategy adopted by the government reflects an assumption that the growth benefit from the fiscal stimulus will improve the debt dynamics and assist with servicing the debt in the future.
- The new fiscal strategy permits a rare synchronicity between fiscal and monetary policy in Australia. This should be very supportive for economic growth in the near term. From a macro-economic perspective, we believe the Budget is consistent with out-performance of growth assets; indeed, it is possible that current earnings forecasts don't yet reflect the macro-economic environment consistent with an unemployment rate below 5%. At a more granular level, we see the Budget as supportive of our Australian equity portfolio tilts toward exposure the domestic economy. Banking, construction, tourism and education service providers, healthcare and technology are just some of the sectors which we believe should benefit from Budget initiatives.
- We view the Budget as broadly neutral for ACGB yields. The bond supply outlook is largely unchanged relative to the Mid-Year Economic and Fiscal Update, meaning that the RBA should face few constraints if it sees fit to announce a further extension to its QE program in July. For credit, we view the budget as supportive for AUD credit product.
- While fiscal policy is not often thought to be a fundamental driver of AUD, we show that over time, the change in stance of fiscal policy correlates quite well with the directional bias of AUD. In Australia, fiscal policy remains supportive of a stronger AUD.

A rare synchronicity between fiscal and monetary policy

The 2021-22 deficit registered a $37bn improvement relative to the forecast in December

Last night, the Treasurer handed down the 2021-22 Federal Budget. **The deficit for 2020-21 is now forecast at $161bn, an improvement of $36.7bn from the Mid-Year Economic and Fiscal Update** (MYEFO) released in December. A stronger labour market, stronger equity market and higher commodity prices largely account for most of the narrowing in the deficit. Looking further out, there is a very modest improvement to the 2021-22 deficit, and a deterioration in the 2022-23 and 2023-24 deficits relative to MYEFO estimates given large multi-year structural spending announcements. This is a worse outcome than expected by the market consensus. As **Chart 1** illustrates, this outlook leaves the government with a forecast of budget deficits through to June 2025. The last time the government recorded a budget surplus was in 2008 (note the long-run forecasts show the deficit at 1.3% of GDP in June 2032).

Chart 1: Underlying cash balance, % of GDP (light blue bars are Treasury forecasts)



Source: Federal Treasury and JBWere. Past performance is not a reliable indicator of future performance.

But longer term, there is no change to the view that the government will run a deficit for the foreseeable future

The context for Budget 2021-22 is a significant one: in a pre-Budget speech the Treasurer outlined a new fiscal strategy for Australia. Fiscal repair would be conditional on further improvement in labour market conditions. **Specifically, the government will not commence the second stage of its fiscal strategy – consolidation and fiscal repair – until the unemployment rate has reached a level close to or consistent with full employment**. On Treasury's latest estimates, this is likely to be an unemployment rate somewhere between 4.5% and 5.0%.

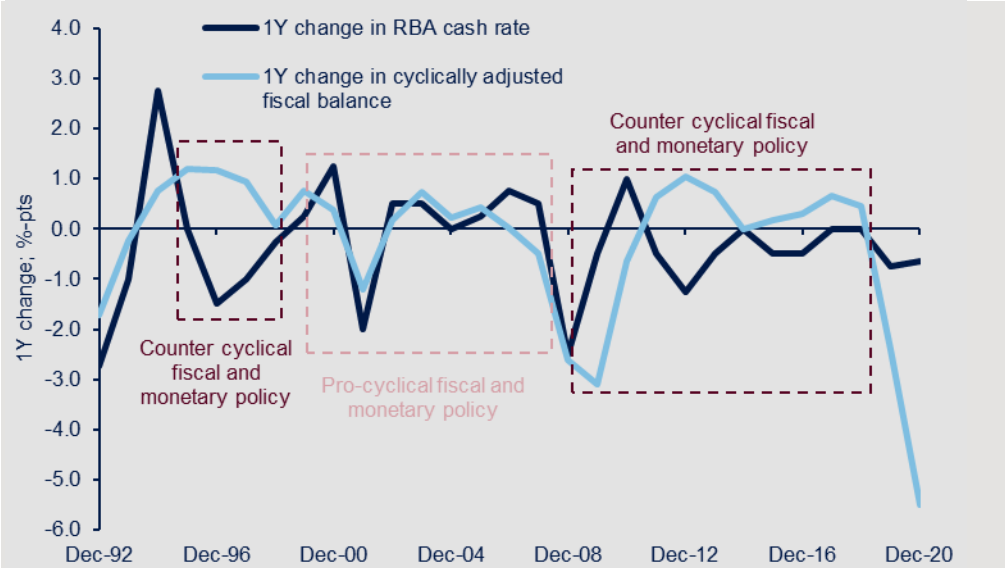
If this sounds familiar, it's because the RBA has articulated a similar strategy. Australia's central bank has stated that it will not start to lift interest rates until inflation is sustainably within the target band. This, in turn, likely requires an unemployment rate in the high 3s or low 4s. Why the focus on this variable? Experience tells us that recessions leave permanent scars on economies, which lower productive capacity (that is, the economy's potential growth rate). Much of this tends to happen via the labour market. Lower potential growth diminishes the capacity of the private and public sector to meet the costs of their respective debt burdens. And for central banks, lower potential growth means lower r*, which further constrains interest rate adjustments in the future (r* is defined as the neutral rate of interest).

So for perhaps the first time in a long time, Australia now has broad synchronicity in its fiscal and monetary policy settings. As **Chart 2** illustrates, the last time this happened was in the period from the late 1990s through to the policy response post financial crisis. After the financial crisis, fiscal and monetary policy have spent most of the decade working at

For the first time in a while, both monetary and fiscal policy are working in the same direction

counter purposes. The RBA cut the cash rate 465bp from 2011 through to 2020, while successive governments pursued modest budget surpluses. With monetary policy already close to its natural limit, the ability to run an overall expansionary stance of policy rests with fiscal policy.

Chart 2: Monetary and fiscal policy have not always worked in the same direction in Australia



Source: Bloomberg, IMF and JBWere. Past performance is not a reliable indicator of future performance.

This is very supportive for the growth outlook in Australia

The bottom line is that the shift in fiscal strategy, together with the RBA's new interpretation of the inflation target, imply that policy settings will be very growth supportive for a while yet. And this is taking place against a backdrop of significant economic momentum in the domestic economy. Already, the consensus forecast expects GDP growth of 4.5% this year, and 3.3% next year. As a benchmark, real GDP growth has averaged 2.1%oya over the past decade. If realised, these growth rates are both well above potential and will go some (if not much of the) way in driving the unemployment rate lower.

While the nature of fiscal stimulus has changed in the past year – away from cash payments to households and businesses and towards sector specific policies (aged care, childcare, infrastructure etc.) – and the magnitude (by definition) will not be as large as delivered in last year's budget, **the broad fiscal strategy adopted by the government reflects an assumption that the growth benefit from the fiscal stimulus will improve the debt dynamics and assist with servicing the debt in the future**. As we saw in the aftermath of the financial crisis, misguided austerity measures in some economies eventually forced the market to question the sustainability of some government's fiscal strategies. Policy makers appear to have taken this lesson to heart in the wake of the COVID recession

A pre-election Budget

Budget 2021-22 should be viewed through the lens of the election cycle

While the Budget has been couched in the context of co-ordinated policy settings aimed at lowering the unemployment rate as quickly as possible, we shouldn't ignore the fact that this Budget has coincided with the pointy end of the electoral cycle.

Were the government to desire a full election (an election for half of the Senate and the full House of Representatives), then the next Federal election will need to be held by 21 May 2022. Even if the government were to hold a late election in 2Q22, it is likely that this will be the last budget prior to voting day. And while the Prime Minister has repeatedly said that he intends to serve a full term and go to the polls in 2022, the calendar (South Australian election, Easter, school holidays etc.) doesn't really suggest this to be practicable.

Realistically, an election in late 2021 can't be ruled out. And while budgets generally should be assessed through an economic lens, we shouldn't forget the role that the electoral cycle can play in influencing budget outcomes too. The fact that the government has upped spending on traditional Labor domains such as aged care, childcare, mental health and the NDIS and extended the tax offset for low- and middle-income earners will make the Budget a centrepiece of the government's re-election strategy.

The major policy announcements

Major multi-year spending initiatives are focussed on childcare, aged care, mental health, the NDIS and infra-structure

Last year, policies supporting households and businesses formed the backbone of the Budget. This year, the focus has shifted; government policy still supports the short term growth outlook by extending the tax offset for low- and middle-income earners and the depreciation allowance for eligible assets but also makes some large social spending commitments which run over a 4-5 year horizon.

While not an exhaustive list, we outline below what we regard to be the key policy announcements contained in the Budget (a number of which were announced prior to the Budget):

- An additional $15.2bn over ten years on **infrastructure** spending;
- $17.7bn for **aged care** over the next five years;
- **Increases to working age payments** (JobSeeker), worth $9.5bn over five years;
- Additional **NDIS** costs of $13.2bn over the next four years;
- Expansion of the **apprenticeship wage subsidy**, worth $2.7bn over four years;
- $2.0bn on **mental health initiatives** over the next four years;
- Increasing **childcare assistance**, costing $1.8bn over the next five years;
- Deductions for the full cost of **eligible depreciable assets** has been extended for a further 12 months through to June 2023; and
- The **low- and middle-income tax offset** has been extended through to June 2022.

The macro-economic assumptions

Budget 2021 contains Federal Treasury's latest set of economic forecasts. Similar to the RBA's forecasts (contained in the May *Statement on Monetary Policy*), the numbers have been subject to significant upward revision. Key details:

- **GDP growth** is expected to be 4.25%oya in mid-22 and 2.5%oya in mid-23. The RBA's forecasts are 4.0%oya and 3.0%oya, respectively.
- Treasury forecasts the **unemployment rate** to reach 4.75% in mid-2023. This is a less optimistic forecast relative to the RBA (4.75% unemployment rate forecast by mid-2022).
- Treasury is forecasting **wages growth** at 2.25% by mid-23, on par with the RBA's forecast, suggesting that Treasury has a higher estimate for NAIRU than the RBA.
- Forecasts for **household consumption** are similar; 5.25% at mid-22 for the RBA, 5.5% for Treasury.

Note that Treasury's forecasts assume a gradual return of temporary and permanent migrants from mid-2022. International students are assumed to start returning in small numbers from late 2021and international travel is expected to remain low through to mid-2022.

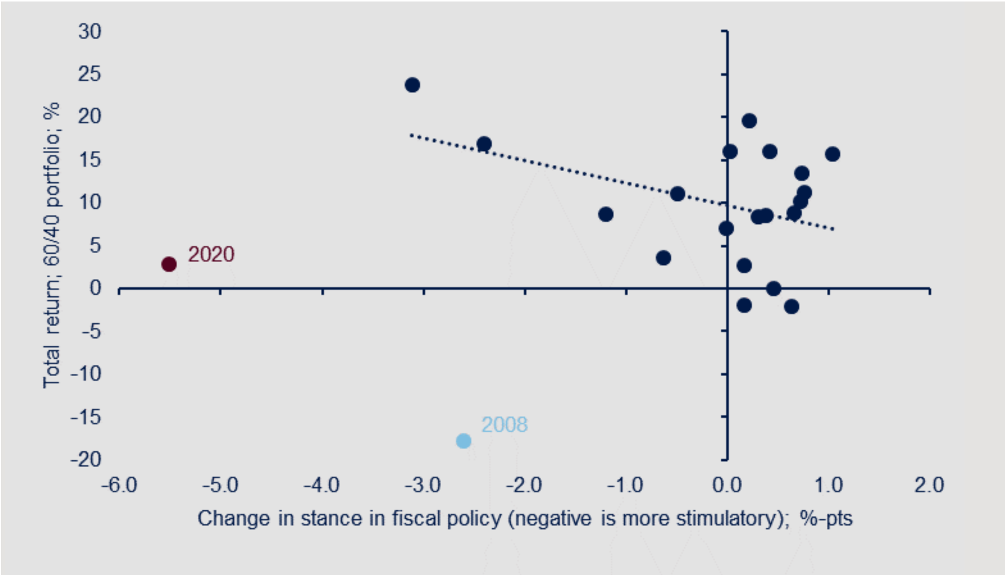
The impact on investment markets

Before we dive into more detail at an asset class level, we think it is important to answer the question as to whether fiscal policy even matters for portfolio returns. In short, **Chart 3** suggests we can answer that question in the affirmative; it shows the returns on a 60/40

Generally speaking, a move towards more stimulatory fiscal policy is good for portfolio returns

portfolio of local assets (60% ASX200, 15% ACGBs and 25% AUD credit) against the change in stance of fiscal policy. Excluding the 2 outlier years (2008 and 2020) when either returns were very poor or fiscal stance changed dramatically, we can see that there is a relationship between the change in fiscal stance and asset class returns. The looser policy becomes relative to the prior year, the better the portfolio returns. The low R-squared in this series tell us that portfolio returns are clearly impacted by more than just the change in fiscal policy stance and so it would be a stretch to say that the stance of fiscal policy is a key driver of investment returns. Still, the slope of the regression line is consistent with what we might believe a priori, which is important.

Chart 3: Returns on a 60/40 equities/fixed income portfolio in AUD and changes in the stance of fiscal policy

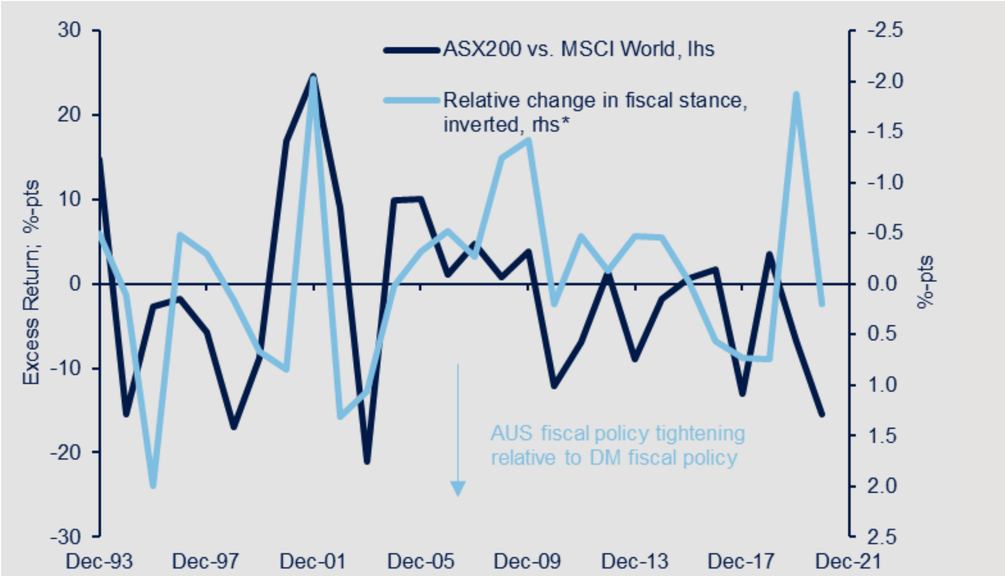


Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance.

Equities – fundamental support from expansionary fiscal policy

At a very simple level, we can start with the premise that if fiscal policy is good for growth, it should be good for the equity market too. Indeed, we can show a simple representation of this by looking at the relative change in stance of fiscal policy between Australia and its developed market peers, and the out-performance (or otherwise) of Australian equities vs. the MSCI World index (**Chart 4**). While the relationship is not strong all the time, there is nonetheless a positive relationship between the two series.

Chart 4: Relative changes in fiscal stance and relative equity market return



Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance

> *It's possible that consensus earnings estimates aren't yet fully priced for an un-employment rate is sub 5%*

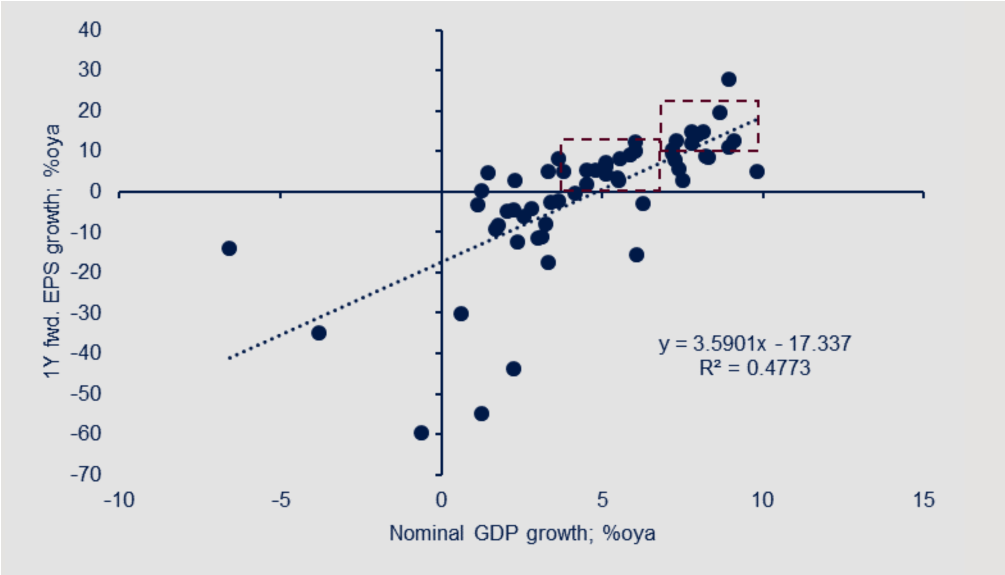
Another way to think about the impact of fiscal policy on equity markets is to think about the ultimate objective of fiscal policy – an unemployment rate ~5% or lower – and earnings expectations. **Chart 5** below shows that gyrations in earnings expectations have a strong cyclical element to them, broadly tracking changes in the momentum of the labour market. Were the government to be successful in driving the unemployment rate to 5% by year end, then the historical relationship between these two series suggests further upside for earnings estimates in the short term.

Chart 5: Further declines in the unemployment rate could force further upgrades to earnings forecasts (dashed line assumes unemployment rate at 5.3% by Sep-21)

Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance.

Over the medium term, if we assume that fiscal policy is supportive for nominal GDP growth, and that nominal GDP growth is good for earnings growth, then it follows that expansionary fiscal policy should be supportive of earnings growth. **Here, the argument relates to whether fiscal policy can achieve a structural uplift in nominal GDP growth**. In **Chart 6**, we observe that nominal GDP growth of around 7-10% tends to deliver earnings growth estimates of around 10-20%oya, while nominal GDP growth of around 4-7% delivers earnings growth estimates of around 2-12%oya.

Chart 6: Nominal GDP growth and earnings forecasts



Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance.

If fiscal policy can achieve a structural uplift in nominal GDP growth, then earnings growth forecasts could shift structurally higher too

Taking this framework and applying it to the measures announce in the Budget, we could say that:

- Additional childcare funding should, all else equal, be positive the female participation rate and hence for labour supply. Over the long run, stronger growth in labour supply should bias potential GDP growth higher;
- Likewise, additional skills training for the labour force should be positive for labour productivity over time, which should also bias potential GDP growth higher;
- Infrastructure spending should expand the productive capacity of the economy over time (in theory), which should be supportive of higher potential growth rates; and
- In the short-term, the extension of the income tax offset for low- and middle-income earners and depreciation allowance should support consumption and investment (and growth).

In summary, from a macro-economic perspective, we think the Federal Budget is consistent with a constructive outlook on growth assets. Whether this is simply a function of stronger short-term growth or a structural upshift in the run rate of nominal GDP growth remains to be seen. Either way, we think it possible that earnings forecasts are not yet fully priced for an economic environment consistent with full employment.

The Budget reinforces our Australian equity portfolio tilts towards exposure to the domestic economy

At a more granular level, the strong fiscal support for the economic supports the existing tilts in our Australian equity portfolios toward exposure to the domestic economy. The banking sector is highly leveraged to the domestic economy, and the recent reporting season for the domestic banks has solidified our view that the major banks remain over provisioned with large amounts of excess capital. We expect this to be returned to shareholders by way of a combination of share buybacks and dividends. Policies which support the consumer and small business reinforce this view.

The construction sector will benefit from the extension of the Homebuilder program which is a net positive for some of the residential property trusts such as Mirvac Group as well as the building material companies such as CSR, James Hardie and Boral. Additionally, the continued support of shovel-ready infrastructure projects should support service providers such as Downer and Seven Group. Higher levels of economic activity will continue to drive demand for commodities and logistics companies (such as Qube) which benefit from the movement of goods around the country.

A key assumption of the Budget is that inbound and outbound international travel is expected to remain low through to mid-2022, after which a gradual recovery in international tourism is assumed to occur. **Support for domestic tourism remains intact**, given discounted airfares, pent up demand and a cashed up domestic consumer. Our preferred exposure to this theme is via Qantas. **We note the plan for small phased programs for international students** will commence in late 2021 and gradually increase from 2022. Our position in IDP Education, the global leader in international education services, with diversity in both source countries for students and education providers across Australia, United Kingdom, Canada and USA, should benefit from this program in our view.

The healthcare and tech sectors may benefit from the Budget's focus on innovation

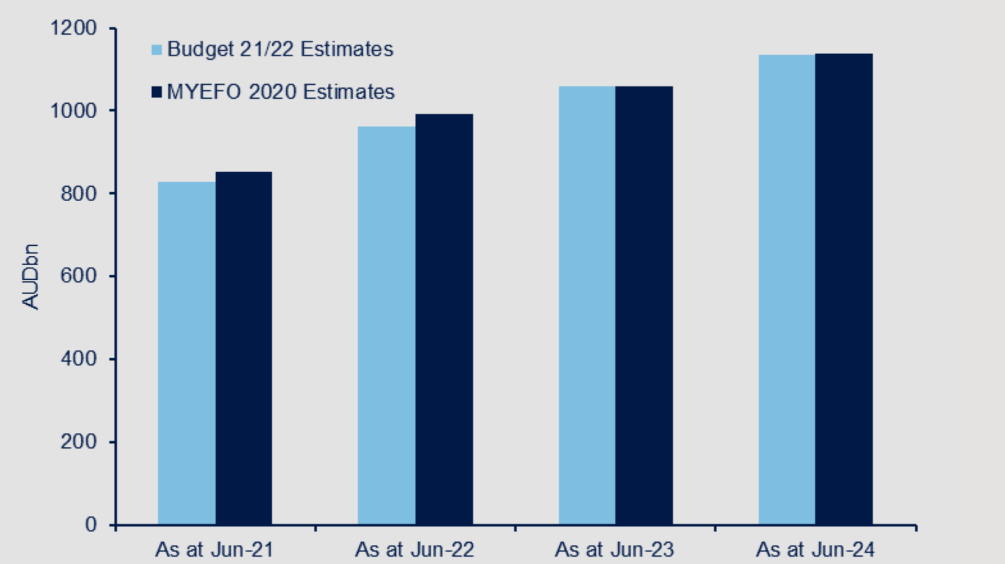
We believe the focus of the Budget on innovation via research and development tax cuts benefits both the healthcare and technology sectors. The former has underperformed the market by ~10% in the last six months. Attracting talent via targeted migration and streamlined visa processes, combined with competitive tax regimes for ESOP programs could see these sectors thrive. **Finally, the government's decision to see gas generators become hydrogen ready is an important decision**. While we have avoided utility companies given their exposure to electricity prices, we have favoured APA given it benefits from gas volume through its network. Now that the role gas will play in Australia's energy future is clearer, we expect greater support for our exposure to APA.[1]

Fixed Income – Budget neutral for ACGB yields, positive for credit spreads

The Australian Office of Financial Management's (AOFM) projections for future issuance later this morning will provide granularity with respect to the government's issuance plans for 2021-22. However, we can infer from the 2021-22 Budget that the amount of Australian Government Securities outstanding is forecast to be little changed relative to the MYEF0 estimates (**Chart 7**). This outcome is likely a disappointment relative to the market consensus, and in large part reflects the fact that meaningful improvement to the budget bottom line is really only evident in the current fiscal year.

The outlook for ACGB issuance is relatively unchanged…

Chart 7: Bonds on Issue – Relative to estimates in the Mid-Year Economic and Fiscal Outlook, the outlook for bond supply is little changed



Source: Federal Treasury and JBWere. Past performance is not a reliable indicator of future performance.

[1] Many thanks to Jacqui Fernley for her assistance with the sectoral and company level implications of the Budget.

...Suggesting that the RBA will face few constraints if it sees fit to announce another $100bn extension to its QE program

As our colleagues outlined in their recent publication titled *Interest rates and asset prices*, higher levels of indebtedness for developed economies do not necessarily result in higher levels of interest rates. On that basis, we do not believe the modestly higher than anticipated government expenditure forecasts in the Budget will exert a material influence on the path of domestic bond yields in the medium term.

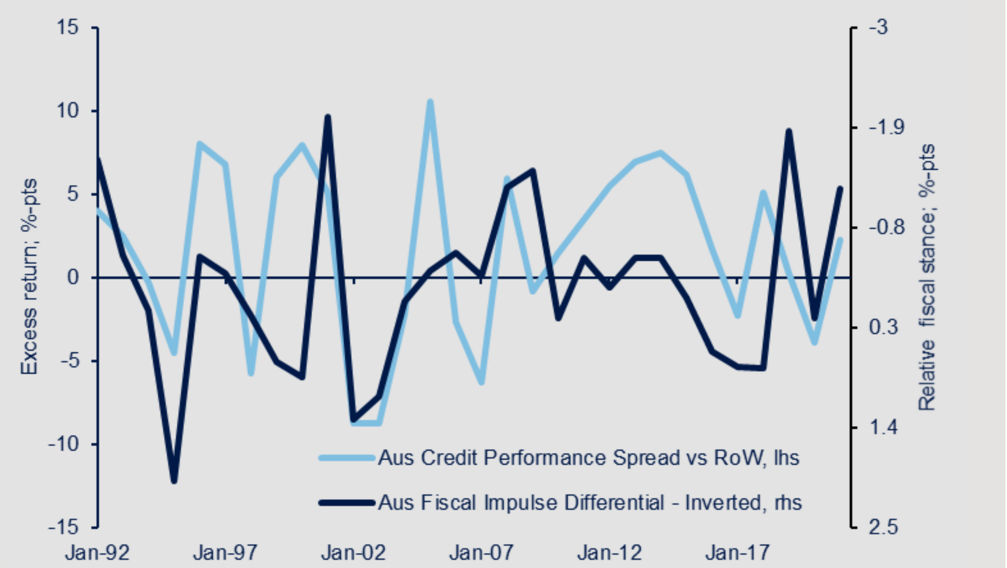
In our view, the higher than anticipated government issuance may be of greater consequence to the RBA and in particular, the next iteration of its QE program. The market had been concerned that lower levels of ACGB issuance in coming years could constrain the RBA's ability to execute another $100bn extension of its QE program. The Budget suggests that the RBA are now unlikely to face any such constraint, should they see QEIII as necessary to achieve macro-economic objectives.

In summary, we see little immediate impact from the Federal on domestic bond yields in the short term and our base case remains for bond yields to drift modestly higher in response to the improving global macroeconomic backdrop.

We view the synchronicity of accommodative fiscal and monetary policy as supportive for the performance of domestic credit. As corporate cash flow generation and balance sheets improve in line with the broader economic outlook, we expect the fundamentals of domestic credit to remain resilient in the current climate.

In comparison to global peers, Australia's relatively successful management of the COVID-19 pandemic in accordance with enacting significant fiscal measures has facilitated favourable conditions for the domestic credit sector. The government's approach to fiscal policy suggests this should continue; as we demonstrate below, a loosening of Australia's fiscal policy relative to its developed market peers has generally resulted in outperformance of domestic credit (**Chart 8**).

Chart 8: Running relatively expansionary fiscal policy in Australia can aid out-performance of domestic credit



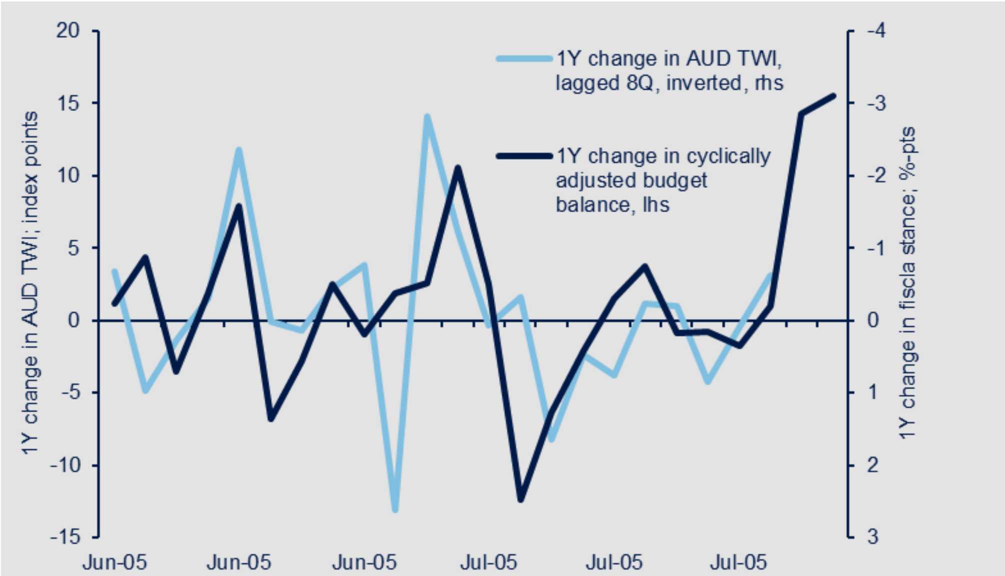
Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance.

AUD – expansionary fiscal policy is supportive of the currency

It might be drawing a long bow to think that fiscal policy has any lasting or material influence on currency markets, but the data tells us otherwise. **Chart 9** shows the 1-year change in the cyclically adjusted fiscal balance (that is, how the underlying stance of fiscal policy changes from one year to the next). Effectively, the chart shows that loosening fiscal policy tends to be supportive of AUD over time, and tightening fiscal policy has the opposite effect. The influence of fiscal policy works with something of a lag (around 2 years in the chart), but intuitively, suggests that the transmission of changes in fiscal policy stance impacts growth, and ultimately, this shift in growth fundamentals is reflected in directional movements in the currency.

A move towards more stimulatory fiscal policy does tend to be associated with a stronger AUD

Chart 9: A shift towards more expansionary fiscal policy tends to be supportive of the AUD



Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance.

While there are clearly other factors which influence the level of the currency and the direction of changes (such as interest rate differentials and commodity prices), the important conclusion is that changes in the stance of fiscal policy do appear to matter for the magnitude and direction of change in the Australian dollar over time. With fiscal policy to remain pro-growth for at least the next year, then the Australian dollar is likely to find another source of medium-term support in addition to commodity prices. At the very least, fiscal policy should work to cap downside for the AUD.

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Prepared by the Investment Strategy Group

JBWere Offices

Melbourne	T (03) 9906 5000
Sydney	T (02) 9325 2600
Brisbane	T (07) 3258 1111
Adelaide	T (08) 8407 1111
Perth	T (08) 9212 7900
Canberra	T (02) 6218 2000

Email Investment.strategy@jbwere.com

Sally Auld Chief Investment Officer
Nick Pryor Senior Analyst

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