July 2021

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

COVID-19 remains the most significant risk to our global outlook. Much of the emerging world remains vulnerable to the pandemic due to low vaccination rates and this is unlikely to be resolved before late 2022 at the earliest. There is growing concern that newer COVID-19 variants are more easily transmitted – potentially requiring higher than previously thought rates of vaccination to achieve herd immunity. Financial conditions indices remain accommodative reflecting stimulatory policy settings. Despite current inflationary pressures, we expect major central banks to keep policy rates low for now, with initial adjustments to policy settings to be in the form of asset purchase tapering. Relatively strong global business survey readings are skewed towards the opening-up advanced economies. In contrast, surveys for EMs have softened.

- At a high level, global **financial conditions** remain broadly easy, with loose monetary policy settings supporting economies as they recover from the impact of COVID-19. Bloomberg's Financial Conditions Indices for the US and EU-27 have steadily trended higher (indicating supportive conditions) since late 2020. Equity market trends have been somewhat mixed in recent times. The US MSCI index has continued to push higher, setting fresh record highs in early July. In contrast, while non-US advanced economies and EM equity markets have generally trended higher since March, prices in early July were off their early-to-mid June highs – with EM markets still well below peaks in February.
- **Commodity price** indices continue to trend higher. The Refinitiv CoreCommodity CRB Index rose through June, with the index in early July at its highest level since June 2015. That said, non-energy commodities were off their recent peaks, but crude oil has pushed above US$70 a barrel following the failure of OPEC+ to negotiate an increase in production. More generally, **inflationary pressures** continue to grow due to the rise in commodity prices, supply shortages and selected labour shortages. Consumer price inflation has also been rising – our measure of global CPI increased by 3.9% yoy in May (up from 3.3% in April). The US is a standout among advanced economies – with the CPI up 5.4% yoy in June.
- Despite the inflationary pressures, we continue to anticipate that **major central banks'** policy rates will remain on hold for an extended time. As recoveries progress to more advanced levels, the adjustment to policy settings will initially occur via tapering of asset purchase programs (QE). The Bank of Canada has already started 'tapering' and we expect the US Fed will announce later this year that QE tapering will start in late 2021 or, more likely, early 2022. Meanwhile, the ECB's Pandemic Emergency Purchase Program is scheduled to run until March 2022 (although the pace of purchases is likely to be reduced before this time).
- Among the major **advanced economies**, re-opening in the US and, more recently, the UK, has led to a strong pick-up in activity. In the US an additional boost has come from fiscal policy. Canadian GDP declined in April and looks to have done so in May due to COVID-19 related restrictions. However, these are now easing, and economic indicators are showing improvement. In contrast, Japan is lagging and Tokyo again returned to a state of emergency on 12 July. Manufacturing sector PMIs remain elevated but industrial production data have been patchy, probably reflecting to supply constraints although this should only temporarily hold back growth. Our assumption is that the vaccines will be effective in limiting the health consequences of the virus, ending the cycle of off-on COVID-19 restrictions and enabling a strong recovery over the rest of the year. This assumption is again being tested with cases rising in the US, UK, Euro-zone and Japan.
- Business surveys point to a softening in **emerging market** (EM) conditions in June, albeit they remain in expansionary territory. China's GDP growth was 7.9% y/y (1.3% q/q) in Q2 which was broadly in line with market (and our own) expectations; we continue to expect growth in 2021 of 9.5% although there is some downside risk. The impact of fresh COVID-19 outbreaks is evident in mobility data for a range of countries, particularly in East Asia. EMs have suffered from poor access to vaccines; in some cases this has meant tougher restrictions to manage infections. Indicators for Taiwan, Malaysia and Vietnam have notably deteriorated over the past few months, while India continues to gradually recover from the impact of past restrictions.
- At the **global** level, our forecasts for 2021 through 2023 are unchanged this month – with growth of 6.3% in 2021, subsequent strong growth of 4.6% in 2022 (reflecting delays to the full recovery from COVID-19) before slowing to the long term trend of 3.5% in 2023. That said, we have made significant revisions to our individual country forecasts. These include a downgrade to our forecast for Japan in 2021 (and a subsequent upgrade to 2022), and a downgrade to forecasts for Other East Asia (excluding China) for both 2021 and 2022. In contrast, we have revised our 2021 growth forecast for Latin America slightly higher.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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The current virus outbreak in NSW and associated lockdowns/border closures highlights the significant uncertainty around economic forecasting at present. We have made a modest tweak to our forecasts for GDP based on current developments but there is some downside risk depending on the ultimate duration of the Sydney (already extended since the forecasts were prepared) and Victorian lockdowns. At this stage we do not see the recovery as having been derailed, given the significant momentum heading into the current disruptions. We see GDP growth of 5.0% in 2021, 2.5% in 2022 and 2.2% in 2023. The unemployment rate is forecast to continue declining but we don't expect it to reach a level consistent with full employment (a rate in the low 4's) until towards the end of 2023. Nonetheless, we do expect wage growth to pick-up from here – tracking by around 3% at end 2023. Following the RBA meeting last week, we have affirmed our view that the cash rate will remain on hold until early 2024, although there is a risk it could come sooner (end 2023) if there are further upward surprises to activity and the labour market, or the RBA reverts to being forward-looking. On QE we expect the RBA to continue to taper gradually with total purchases after September of around $100bn.

- We continue to expect **the cash rate target will be unchanged until early 2024**, even as the RBA in July pulled back slightly on its unconventional instruments. The Yield Curve Control target has now been pegged at the Apr-24 bond and the weekly rate of QE purchases was also tapered to $4bn per week when the current program ends in early September. In total, we. expect there to be a further $100bn of QE purchases from September, with the weekly rate of purchases tapered gradually before the program ends in mid-to-late 2022. With the RBA wanting inflation to be sustainably within the target band, and allowing some time to make this assessment, we see some risk of a rate rise in late 2023 but it is more likely to occur in 2024. The first hike is likely to be a larger than typical 40pb (taking the target to 0.5%) to allow normalisation of the ES corridor. Following this, we see increases of around 25 points per quarter.
- **The labour market recovery continues at a faster-than-expected pace**. The unemployment rate declined again in June to 4.9%, its lowest level in over 10 years while resident employment is 1.2% above it pre-COVID-19 level. Victoria, which was in lockdown at the time of the survey, also saw a fall in the unemployment rate (by 0.4ppts to 4.4%) but reflected a fall in the number of people looking for work as there was a small fall in employment; moreover, the fall in hours worked of 8% (+0.5% for the rest of Australia) highlights the lockdown impact. Other indicators point to strong labour demand - job vacancies are around 60% above pre-COVID levels and the NAB Business Survey employment measure is also high. We expect unemployment to fall to 4.2% by end 2023, which should lead to a rise in wage growth over time.
- **Lockdowns are likely to weigh on household consumption at least in the short-term.** Retail sales growth eased to 0.4% m/m in May, possibly impacted by the lockdown that started late in the month in Victoria. The lockdown will also have weighed on June activity even with an easing in restrictions over the month. Parts of NSW, Queensland, WA, SA and NT also imposed COVID-19 related restrictions or lockdowns towards the end of June. Most were short, but the Sydney lockdown is still underway (and a five-day Victorian one has just started) which will prove to be a major headwind for July activity at least. Once the lockdown is over, however, experience indicates activity can bounce back quickly.
- **NAB Business Survey business confidence and conditions took a hit in June** from the lockdowns but remained elevated. In the past there has been a rapid rebound following short lockdowns and with forward orders, capacity utilisation and capex still elevated we expect to see ongoing strength in business investment over the next two quarters, before growth eases into 2022. **The trade balance remains large** and widened further in May. However, we see net exports contribution to future growth being soft for some time with service imports beginning to recover. The international border is expected to remain largely closed until mid-next year.
- **Housing markets remain strong although construction indicators appear to have peaked**. Dwelling price growth was again robust in June, with the CoreLogic 8-capital city dwelling price index rising 1.9% m/m, within the range it has been in since February (also true of Melbourne, despite its lockdown). New housing finance again rose strongly in May, pointing to strong growth in sales although lockdowns may mean some sales activity is deferred. New residential construction loans and building approvals fell in May, likely reflecting the lagged impact of the end of the Government's HomeBuilder programme, Nevertheless, approvals remain at high levels and there is a substantial pipeline of work so we expect to see robust growth in dwelling investment over much of 2021, but for it to ease into 2022.
- The AUD/USD traded lower over the last month but remains around 5% higher than October/November last year. We continue to expect the Aussie to trade up to around $US83c by end 2021 before pulling back to around $US80c by end 2022. While the US Federal reserve looks to be moving towards a tapering in asset purchases – the strength in commodity prices warrants a higher value for the AUD.
- Current events demonstrate that the risk of lockdowns will remain a key risk – particularly if they are lengthy – at least until vaccinations reach a sufficiently high level. How long the Sydney and Victorian lockdowns run for is the immediate concern given the risk they are extended beyond their scheduled end. Other risks relate to low population growth and the uncertain path of net migration even when the border re-opens, the possibility of a larger than anticipated impact from the end to Homebuilder, and the potential for macroprudential policy measures (such as debt-to-income limits) to be introduced, affecting the housing market.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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