JBWere

The CIO View

Issue date: 29 March 2022

Putting Wealth To Work For Generations

Sally Auld
Chief Investment Officer

Budget 2022/23: A pre-election budget for the times

JBWere View

The Treasurer has handed down a budget that reflects a shift in fiscal strategy but also responds to near term political imperatives. Spending is targeted at short term measures designed to offer temporary relief to cost of living pressures, but also includes longer term infrastructure, cyber capability and defence initiatives. All up, this is a pre-election budget for the times; it sets the government up for the forthcoming election campaign, but also shows a willingness to respond to a changing world order while keeping faithful to the fiscal strategy framework.

Executive Summary

- **The Treasurer has handed down a budget that shows the budget deficit for 2022-23 at $A78bn, a $A21bn improvement since the release of the *Mid-Year Economic and Fiscal Outlook* (MYEFO)** in December. Most of this improvement is due to more favourable economic parameters. Some of this windfall has been spent on near-term measures aimed at offsetting “cost-of-living” concerns. These measures speak mostly to the political context for the 2022-23 budget (a pre-election budget).
- **The budget also reflects a shift in fiscal strategy**. Now that the labour market is close to full employment and the economic recovery has been entrenched, focus turns to stabilising Australia’s debt to GDP ratio. In part, this is reflected in the government’s decision to bank much of the windfall delivered by more favourable economic conditions over the forecast horizon. For example, over the four years through to mid-26, policy decisions since MYEFO (that is, new spending initiatives) are worth $A30.4bn. In contrast, parameter and other variations (that is, the impact of a stronger economy) have improved the underlying cash balance by $A114.6bn over same period.
- **The budget does however reflect some conflict between the economic and political cycles**. To the extent that the labour market is tight and core inflation already elevated, economic theory would usually advise against expansionary fiscal measures. However, the political imperatives for a government trailing in the polls and finding itself with a better fiscal starting position probably argue the opposite. As such, we believe markets will continue to price in an earlier start to the tightening cycle than currently suggested by RBA officials.

- **Where did the money go?** Last year, budget initiatives were designed to support the short-term growth outlook and also made some large social spending commitments which ran over a 4–5-year horizon. This year, government initiatives have focused upon shorter-term measures to shore up household incomes, and longer-term measures focused on infrastructure (again), defence (new), cyber capabilities (new) and training and skills (new).
- **The economic forecasts underpinning the budget look reasonable**, but we would argue that the risk bias to the forecasts is somewhat asymmetric (to the downside). Growth is expected to remain above trend for the next few years and the unemployment rate is forecast to remain below NAIRU for an extended period.
- **From a financial markets perspective, we see the budget as modestly supportive for the local equity market**. By supporting household incomes, we believe companies exposed to discretionary spending should see some support. The expansion of the First Home Guarantee and continuation of the Family Home Guarantee should help prop-up demand for housing and benefit building material companies. With almost $A18bn earmarked for infrastructure projects, support service providers should continue to benefit at the margin. Companies exposed to a strong labour market should also benefit.
- **For fixed income and FX, we see the budget as broadly neutral**. Better fiscal outcomes imply less net issuance of government bonds, which is timely given the RBA has already concluded its quantitative easing program. We don't believe the market will struggle to absorb what appears to be a reasonable net supply of government bonds in coming quarters, meaning that offshore influences will likely be the dominant force for $A government bond yields. For FX, the prospect of smaller deficits in coming years will continue to reinforce Australia's position as a net exporter of capital. We believe this should be modestly positive for AUD, all else equal.

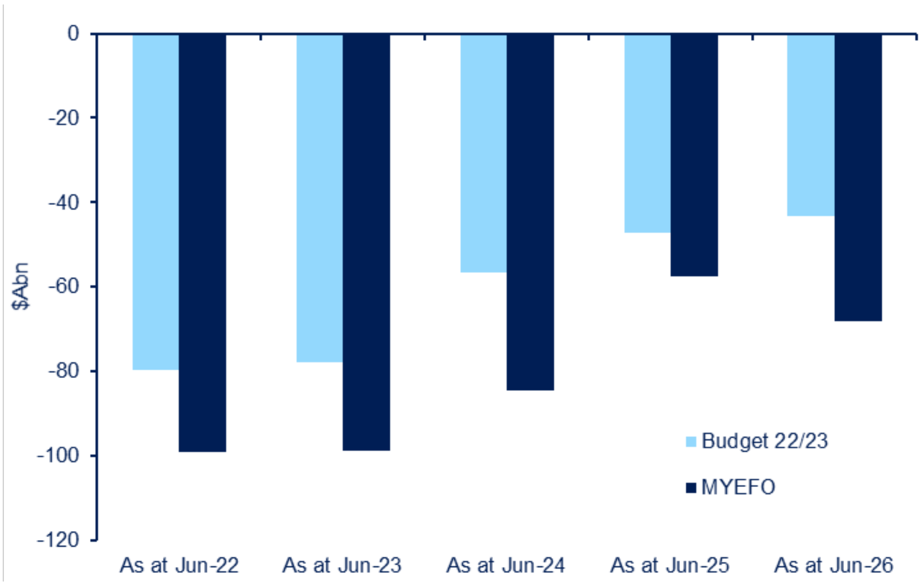
In summary, this is a pre-election budget for the times. The government has walked a fine between using the benefits of incumbency and a better fiscal starting position to boost its electoral prospects and delivering a budget that stays faithful to the second phase of fiscal strategy.

An overview of the budget

The Treasurer has handed down a budget which we think is best described as a pre-election budget for the times. After a period in which fiscal policy was eased dramatically to support the economy through the pandemic, the government can argue that it has started the long process of fiscal repair now that the economy is on a solid footing. Over the forecast horizon, budget deficits are now $A103.6bn lower than was expected in December's *Mid-Year Economic and Fiscal Outlook* (MYEFO); see **Chart 1**. While most of this improvement comes from stronger economic outcomes, the political benefits of fiscal improvement shortly before an election will be duly noted by the government.

Deficits over the forecast horizon are smaller relative to prior estimates

Chart 1: Forecasts for the budget balance have improved by a cumulative $A103.6bn since MYEFO



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

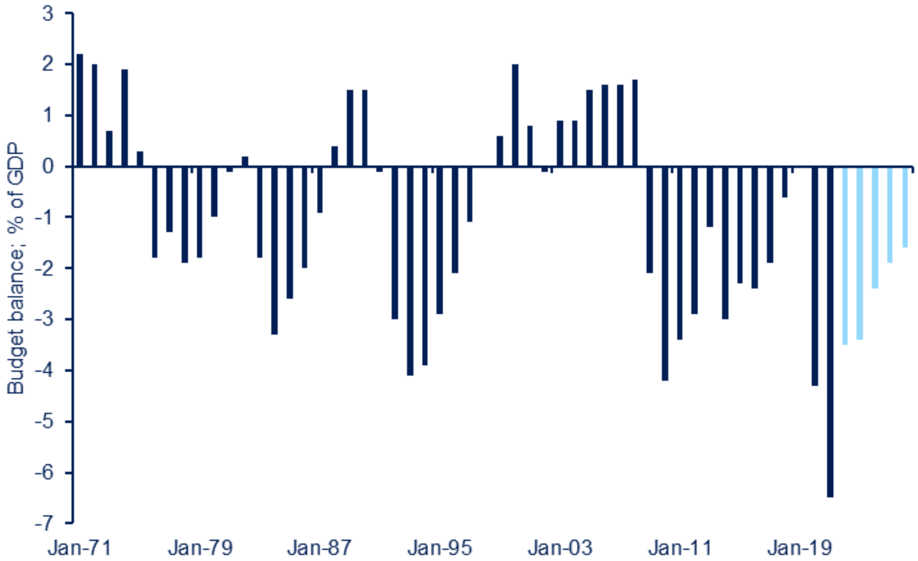
This is largely due to the impact of improved economic parameters on the budget bottom line

Taking a shorter-term focus, the deficit for the current fiscal year ended June-2022 is expected to be $A79.8bn, a $A19.4bn improvement from the estimate provided in MYEFO, just over three months ago. As noted above, a stronger economy and higher commodity prices than forecast are largely responsible for the improved outcome as they bolster both income and corporate tax revenue. For the coming fiscal year, the deficit is expected to be $A78.0bn by June-2023. Over the four years through to 2025-26, policy decisions since MYEFO (that is, new spending initiatives) are worth $A30.4bn. In contrast, parameter and other variations (that is, the impact of a stronger economy) have improved the underlying cash balance by $A114.6bn over the four years to 2025-26. So the government has banked much of the additional revenue increase over the next four years.

Long-run forecasts show Australia's fiscal outlook to be one of modest deficits for the foreseeable future; see Chart 2. This reflects a deliberate choice not to pursue aggressive spending cuts in order to entrench economic recovery so far, as well as the longer-term challenges associated with funding the NDIS, aged care and health budgets over the next decade. At the moment, ratings agencies don't view this outcome as threatening Australia's AAA sovereign rating outlook given the improvement in our external sector (Australia is now a capital exporter, given a current account surplus).

Budget surpluses still remain elusive…

Chart 2: But longer term, there are deficits for the foreseeable future (light blue shaded bars are Treasury forecast)



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

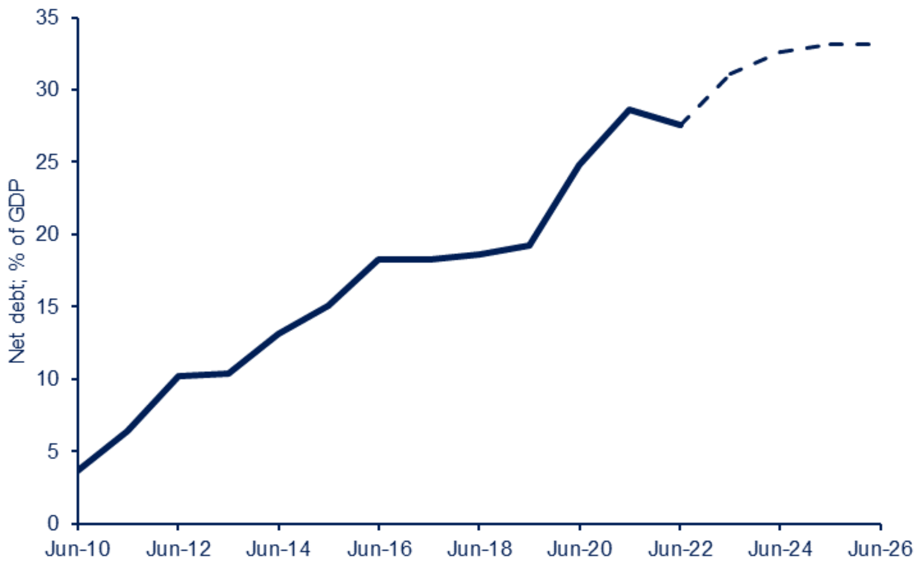
The budget in context

There are three lens through which we can look at the 2022-23 Budget. These are **1)** the political cycle; **2)** the government's approach to fiscal strategy; and **3)** overall economic policy settings. **Turning to the political context, our view is that the Treasurer has handed down a pre-election budget for the times**. This budget is a pre-election budget, which means it contains measures designed to boost the government's standing in the short-term. The temporary reduction in the fuel excise tax, cash handouts and uplift to the low- and middle-income tax offset (LMITO) are three such measures, designed to soothe concerns around "cost-of-living" challenges. These will be couched as temporary and responsible, thus appropriate for the times. Indeed, LMITO will be discontinued from 1 July 2022, which will add $A8bn per year to budget revenues. Additionally, the optics of fiscal consolidation (smaller deficits over the forecast horizon) will allow the government to highlight its credentials as a superior economic manager. And we should note that the Budget provides for $A2.4bn of "decisions taken but not yet announced" likely to come in the election campaign.

…but we are now at least in the second stage of the fiscal repair process

In terms of fiscal strategy, we note that the government has now moved into the second stage of the fiscal repair process. The first stage of the fiscal strategy was to run expansionary fiscal policy until the economic recovery was secure and the labour market was close to full employment. These conditions have both been satisfied. The second stage of the fiscal strategy is targeting a budget position that stabilises the government debt to GDP ratio, then reduces it. As **Chart 3** shows, *net* debt relative to the economy is expected to rise in coming years before stabilising around 33.1% of GDP. *Gross* debt as a share of GDP is expected to peak at 44.9% per cent in Jun-25, before falling to 40.3% of GDP by the end of the medium term (2032).

Chart 3: The second stage of the government's fiscal strategy aims to stabilise the debt to GDP ratio (dashed line is Treasury forecast)



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

At present, the success of this strategy hinges on a growth rate of nominal GDP that is greater than the nominal interest rate paid on the debt. However, this requires confidence in **1)** trend or better growth in the Australian economy; and **2)** the absence of a sustained lift in global interest rates. Governments may have some control over the former but have little or no control over the latter.

More broadly, there is a desire to support only a gradual pace of fiscal consolidation. As **Chart 2** shows, the government is forecasting the budget to remain in deficit for a number of years yet. The lessons learnt post financial crisis in a number of economies appear to be central to the government's strategy – rushing fiscal consolidation can be counter-productive and can undermine economic recovery, risking future fiscal improvement.

It could be argued there is some conflict between the political and economic cycles at present

The economic context for the budget is interesting; to the extent that this budget is mildly expansionary in the near-term, it reflects some near-term conflict between the economic and political cycles. With the government indicating the unemployment rate forecast to be 3.75% by September 2022 and the RBA forecasting core inflation to be in the top half of the RBA's target band for the next 18 months, there is little economic justification for an expansionary fiscal policy, particularly that which adds $A8bn into the economy in just six months. But for an incumbent government that is already behind in the polls on a 2-party preferred measure but is the beneficiary of an already improved fiscal situation, political imperatives make additional spending an easy decision. At the margin, we believe it's probably fair that the budget will be perceived as increasing pressure on the RBA to commence the rate normalisation process. What fiscal policy gives with one hand, monetary policy may take with another.

The major policy announcements

Last year, budget initiatives were designed to support the short-term growth outlook and also made some large social spending commitments which ran over a 4–5-year horizon. This year, government initiatives have focused upon shorter-term measures to shore up household incomes, and longer-term measures focused on infrastructure (again), defense (new), cyber capability (new) and training and skills (new).

Defence, cyber capabilities and infra-structure account for the lion's share of new spending initiatives

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 immediate cut to fuel excise from 44.2c/l to 22.1c/l, lasting six months;
- Cash payments of A$250 to pensioners and other income support recipients;
- An increase in LMITO of A$420 for the current fiscal year;
- A further $A18bn of infrastructure spend (mostly road and rail projects);
- $A2.8bn to increase the take up and completion rates of apprentices, with additional payments for new apprentices and employers who take on new apprentices;
- Tax deductions for small businesses for training employees and for investmenting in technology;
- Funding for the manufacture of mRNA vaccines in Australia;
- $A1.3bn to end violence against women and children;
- Measures to enhance the use of paid parental leave;
- Doubling the Home Guarantee Scheme;
- A $10bn investment in offensive and defensive cyber capabilities; and
- $A15bn for defence projects (east coast submarine base, upgrades to WA naval shipyard).

The economic assumptions

The economic forecasts under-pinning the budget look reasonable

Budget 2022-23 contains Federal Treasury's latest set of economic forecasts. Similar to the RBA's latest set of forecasts (contained in the February *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 3.5%oya in mid-23. The government forecasts the economy to reach trend real GDP growth of 2.5% by mid-24. The RBA's forecasts are 5.0%oya by mid-22, 2.5%oya by mid-23 and 2.0% by mid-24, respectively.
- Treasury forecasts the **unemployment rate** to reach 3.75% in the September quarter of 2022 and remain there until 2024-25. This is similar to the RBA's forecast.
- Treasury is forecasting **wages growth** at 3.25% by mid-23, slightly higher than the RBA's forecast of 3.0%. This may suggest Treasury has a higher estimate for NAIRU (4.25%) than the RBA.
- Forecasts for **household consumption** differ notably; 4.5% at mid-23 for RBA, 5.75% for Treasury.

The budget and investment markets

The 2022-23 budget has been handed down at a difficult time for investors. So far this year, US and Australian equity markets, credit markets, government bond markets and real assets have all registered declines. While we don't think the budget will make much (if any) difference to the difficult trading environment in 2022, we thought it worthwhile to outline our thoughts on how the budget might impact local equity, currency and debt markets.

Equity markets

From a macro-economic perspective, earnings growth tends to track nominal GDP. This makes intuitive sense. To the extent fiscal policy can influence nominal GDP growth in the short-run (cyclical decisions) and in the long run (structural decisions designed to boost trend GDP), then it matters for equity investors. Indeed, a simple regression shows that since 2010, nominal GDP growth can explain around three quarters of the variation in 1Y ahead EPS estimates. **Chart 4** shows a line graph of these two series.

Chart 4: To the extent that fiscal policy matters for both short-run and longer-run growth rates of nominal GDP, it matters for earnings growth too

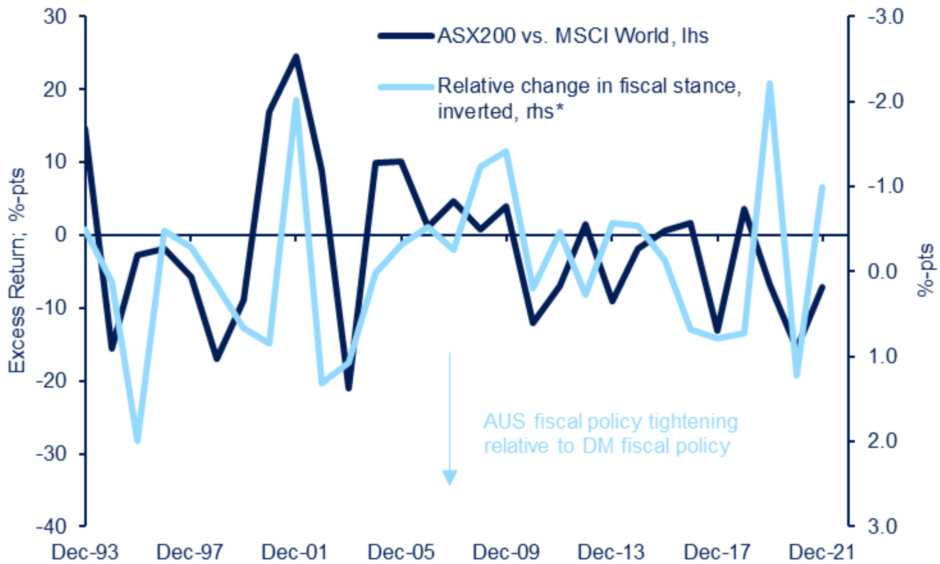
Source: Bloomberg, ABS and JBWere. Past performance is not a reliable indicator of future performance.

We view the budget as modestly supportive for the local equity market

On this point, we would make 2 observations. **First**, there are clearly measures in the budget designed to provide support to GDP in the near term (cash handouts, temporary excise cut). All else equal, this should support earnings growth estimates in those sectors with exposure to household discretionary spending. The **second** is that measures to support higher trend GDP, such as measures to increase productivity, participation or population growth do feature in part in the budget. Measures to boost apprentice take up and completion rates and more flexibility with paid parental leave are positive on this front, at the margin. But it is hard to argue there are longer term measures that will materially boost trend nominal GDP growth, and by extension, trend earnings growth.

We also note that there does appear to be a reasonable directional relationship between relative fiscal policy and equity market out-performance (**Chart 5**). If Australian fiscal policy tightens by less than that of Developed Market (DM) peers, it supports the notion of out-performance of the Australian equity market relative to equity market performance of DM peers.

Chart 5: Relative fiscal settings appear to have some correlation with relative equity market performance



Source: IMF, Bloomberg and JBWere. Past performance is not a reliable indicator of future performance. *This measures the 1Y change in the cyclically adjusted budget balance of Australia vs. that of other Advanced Economies.

$A8bn worth of short-term measures designed to bolster household incomes should be supportive for the consumer discretionary sector

What does the budget mean for individual stocks? On a more granular level, the temporary cut to the fuel excise, cash handouts and the extension and increase in LMITO should help to ease some of the pain at the pump and provide support for continued discretionary spending, potentially benefiting companies like **Breville** and **Aristocrat Leisure** in our view. Other potential beneficiaries of the temporary cut in fuel excise include **Transurban** and **Bapcor** as commuters eschew public transport in favour of private transportation.

We believe the expansion of the First Home Guarantee and continuation of the Family Home Guarantee should help prop-up demand for housing and benefit building material companies such as **CSR**, **James Hardie**, and **Boral**. With almost $A18bn earmarked for infrastructure projects, we believe support service providers such as **Downer** and **Seven Group** should continue to benefit at the margin although infrastructure spending typically occurs over several years.

While we believe house prices have likely peaked this cycle, the **four major banks** will benefit from higher rates that lead to an expansion of net interest margins. Additionally, business banking remains a significant source of growth. NAB's recent business survey indicates that capital expenditure plans remain very strong. Finally, the major banks should benefit through their support of infrastructure projects in our view.

The reopening of Australia's international borders should see a gradual improvement in tourism which we believe will benefit **Qantas,** though this is likely offset in the short-term through higher oil prices. The return of international students would benefit **IDP Education** in our view**,** while an increase in net migration could see renewed demand for housing, assisting companies such as **Mirvac** and **REA**. Finally, a still tight labour market, falling unemployment rate and rising wages growth should benefit those companies with exposure to strong labour market dynamics, such as **SEEK**, in our view.[1]

[1] With thanks to Aidan Kerr and Lincoln Valentine for their input on the impact of the budget at a stock level.

Interest rate markets

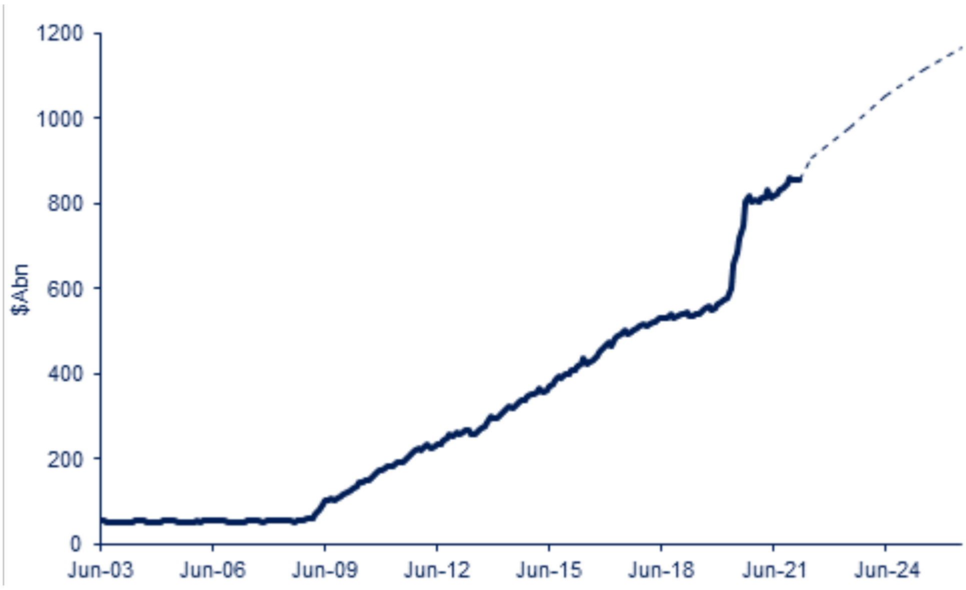
The two arms of economic policy, monetary and fiscal, are both important for the level and change in interest rates. Monetary policy sets the overnight cash rate, which tends to anchor the level of front-end yields. And with the introduction of quantitative easing (QE) into the RBA's toolkit in recent years, it can be argued that monetary policy also exerts influence over longer-end yields too, at times. Fiscal policy plays a part in this process through a couple of channels: **1)** influencing the overall level of aggregate demand in the economy, which is relevant to the outlook for front-end yields; and **2)** influencing the gross supply of ACGBs (Australian Commonwealth Government Bonds), by virtue of the size of the government deficit that is funded in public markets.

We see the budget as broadly neutral for government bond yields…

We have already talked about the possibility that the Budget may add to aggregate demand in the short-term, given cash handouts and the temporary reduction in the fuel excise. All else equal, this could pressure front-end yields higher, at the margin.

From a supply perspective, we note that the government is forecasting bonds on issue to reach $1169bn by the middle of 2026 (**Chart 6**).

Chart 6: Australian Commonwealth Government Bonds on Issue (dotted line is Treasury forecast)



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

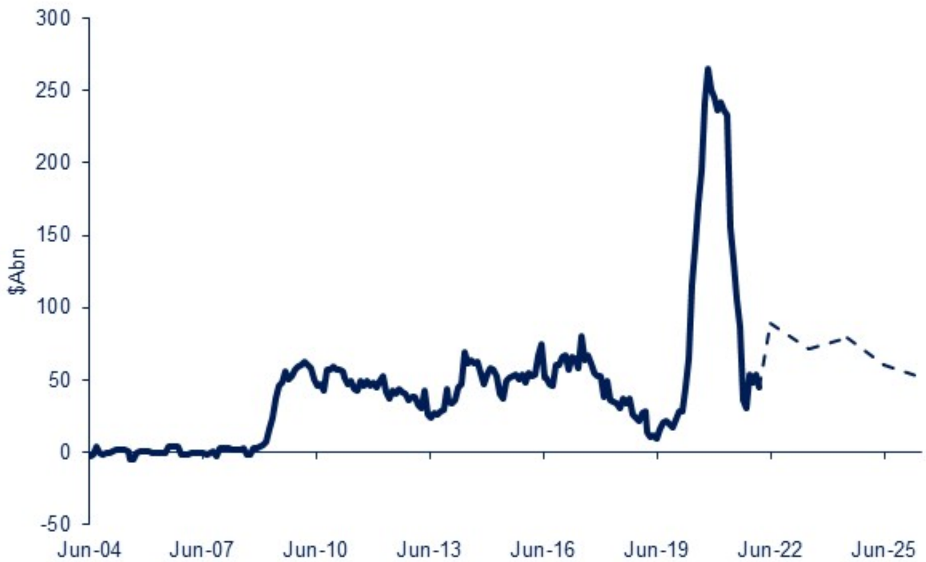
…and see offshore influences as likely key for the direction of local yields

Interestingly, annual net issuance has now returned to levels that are broadly in line with the post-GFC and pre-pandemic era; that is, net supply of ACGBs is forecast to oscillate around $A50-90bn over any given 12-month period in coming years; see **Chart 7**.

With the RBA having ceased its QE program but unlikely to be an active seller of ACGBs on its balance sheet anytime soon, we don't think that net supply in the range of $A4-7bn per month is going to be difficult for the market to absorb. This is especially the case at present, where FX hedged yield pick-ups on 10Y ACGBs to USTs (for US investors) and JGBs (for Japanese investors) are meaningful. **So in our view, this backdrop suggests domestic influences on ACGB yields (such as the RBA and the Federal budget) will likely be a minor driver of yields relative to offshore influences**. We therefore view the Federal budget as neutral for longer-end ACGB yields.

Net bond supply should settle at more reasonable levels in coming years

Chart 7: Annual change in ACGBS outstanding (dotted line is Treasury forecast)



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

For $A credit markets, we would view the Budget as broadly supportive. To the extent that fiscal policy is providing near term support to the economy, this helps to protect corporate cash flows and balance sheets. Our sense is that developments offshore will likely be more influential on the path of credit spreads, and so for that reason, we think the actions of the Federal Reserve and the path of the US economy will be more consequential for $A credit.

From a sectoral perspective, it is hard to tease out too many implications largely because issuance in the Australian credit market is heavily biased towards the financials sector. To the extent that Budget measures and the broader markets backdrop are supportive for financials, we would argue that remains the case for credit overall.

FX

The trajectory of smaller deficits should reinforce Australia's position as a net exporter of capital, all else equal

It might be drawing a long bow to think that fiscal policy has much enduring influence on the level of the AUD. But there are some channels through which fiscal policy can influence FX. **First**, to the extent that the government contributes to the overall net savings / investment imbalance in Australia, it can thus impact the balance of payments. At the moment, the private sector is a net saver, and the net savings of this sector more than compensate for the public sector's dissaving. This means currently, Australia is a net exporter of capital, which all things equal, supports the $A in a relative sense. Given that the government's forecasts are for deficits to reduce over the forecast horizon, it could be argued that this is a modest positive for AUD, all else equal. **Second**, to the extent that fiscal policy can influence trend rates of GDP growth, and hence the term structure of interest rates, it can potentially impact longer run fair value estimates for the currency. **Third**, to the extent that short term fiscal measures can be relevant for monetary policy, the budget could give AUD a boost if it forces an earlier start to the RBA tightening cycle. However, with the market already pricing ~32bp of rate hikes by the June RBA Board meeting, we don't think there is much in the budget that will materially alter this pricing. In conclusion, we see the budget as broadly neutral for AUD/USD.

Any advice in this report has been prepared without taking into account your objectives, financial situation or needs. You should consider the appropriateness of the advice in light of your own financial circumstances. Where relevant, offers of units in any of the investment vehicles referenced in this document are made under a product disclosure statement which is available from your JBWere adviser. We recommend that you consider the product disclosure statement in deciding whether to acquire units in relation to any particular product mentioned in this report.

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

Disclaimers and general disclosures

Important Notice

This report has been prepared by JBWere Limited (JBWere) and comprises general advice only. In preparing it, JBWere did not take into account your investment objectives, financial situation or particular needs. Before acting on any advice contained in this report, you should consider whether the advice is appropriate in light of your financial circumstances or contact your adviser. JBWere recommends that you consider the relevant Product Disclosure Statement or other disclosure document, where relevant, before making investment decisions in relation to any particular product mentioned in this report.

JBWere's advisers and other professionals may provide oral or written market commentary or trading strategies to clients that reflect opinions that are contrary to the opinions expressed in this report, and they may make investment recommendations that are inconsistent with the recommendations or views expressed in this report.

Ownership and Material Conflicts of Interest

JBWere requires all research personnel to disclose to JBWere any material investment position or financial interest in issuers that they review. Research personnel are paid in part based on the profitability of the National Australia Bank Limited group (**NAB Group**), which includes JBWere.

No business units within the NAB Group which provide corporate advisory services, including JBWere's markets division (which provides capital raising services) have any input into determining the budget decisions, bonuses or allocations of resources for any business units within JBWere which produce research. The revenue and results of JBWere's markets division are not taken into account when determining JBWere's research budgets or expenses.

In the last twelve months, JBWere has played a role in transactions for certain entities which may be referred to in this report. For details, go to ***Deal Flow Participation***.

JBWere's research analysts may from time to time hold financial products that are the subject of a JBWere research report. The ***Managing Conflicts of Interest and Maintaining the Integrity of Research Policy*** sets out how JBWere manages these conflicts. Please refer to the ***list of financial products currently held by JBWere's research analysts***.

The NAB Group and associates, may have provided, provides or seeks to provide investment banking, capital markets and / or other services, to the issuers and their associates mentioned in this report.

Our research process

Further information about the methodology applied by JBWere in preparing research reports is available on the JBWere website.

General Disclosures

This report is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The information contained in this report is subject to change without notice. The price and value of the investments referred to in this report and the income from them may fluctuate. Past performance is not a guide to future performance. Future returns are not guaranteed and a loss of original capital may occur.

Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors.

In producing research reports, members of JBWere's Investment Strategy Group may attend site visits and other meetings hosted by the entities mentioned in those reports. In some instances the costs of such site visits or meetings may be met in part or in whole by the issuers concerned if JBWere considers it is appropriate and reasonable in the specific circumstances relating to the site visit or meeting.

JBWere's research is disseminated primarily electronically, and, in some cases, in printed form. Electronic research is generally made available simultaneously to all clients.

General Disclaimer

So far as laws and regulatory requirements permit, JBWere, its related companies, associated entities and any officer, employee, agent, adviser or contractor thereof (**JBWere Group**) does not warrant or represent that the information, recommendations, opinions or conclusions contained in this report (**Information**) is accurate, reliable, complete or current and it should not be relied on as such. The Information is indicative and prepared for information purposes only and does not purport to contain all matters relevant to any particular investment or financial instrument. Subject to any terms implied by law and which cannot be excluded, the JBWere Group shall not be liable for any errors, omissions, defects or misrepresentations in this report (including by reasons of negligence, negligent misstatement or otherwise) or for any loss or damage (whether direct or indirect) suffered by persons who use or rely on the Information. If any law prohibits the exclusion of such liability, the JBWere Group limits its liability to the re-supply of the Information, provided that such limitation is permitted by law and is fair and reasonable.

Research Analyst Disclaimer

The Information accurately reflects the personal views of the author(s) about the securities, issuers and other subject matters discussed, and is based upon sources reasonably believed to be reliable and accurate. The views of the author(s) do not necessarily reflect the views of JBWere. No part of the compensation of the author(s) was, is, or will be, directly or indirectly, related to any specific recommendations or views expressed in this report.

Other Research Providers

This report may contain a restatement, summary or extract of a report prepared by UBS Securities Australia Limited (**UBS**) or a related body corporate (**UBS Report**). Please contact your JBWere adviser if you would like a copy of the UBS Report. For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research, please visit ***www.ubs.com/disclosures.***

This report has been prepared for distribution only to clients of JBWere (and potentially to clients of other financial advisers). It may not be reproduced or distributed without the consent of JBWere. Please refer to the full details of the important disclosures, available in the ***Disclosures section of the JBWere Limited website.***

Issued by JBWere Ltd ABN 68 137 978 360 AFSL 341162.