JBWere

The CIO View

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Putting Wealth To Work For Generations

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Budget 2024: Today's moment is tomorrow's memory

JBWere View

The combination of strong commodity prices, robust employment growth and higher wages growth will likely see the Government achieve a modest Budget surplus in FY23. But looking ahead, the mix of low productivity growth and the rising cost of the National Disability Insurance Scheme (NDIS), health and aged care expenditures means that fiscal sustainability remains elusive. The Government has taken some small steps to address these issues in the Budget, but we believe bolder measures will be required if Australia is to achieve sustainable fiscal outcomes.

Key Points

- The combination of elevated commodity prices, strong employment growth and higher wages growth will likely see the Government record a budget surplus of $4.2bn for the current fiscal year. And while the Government will undoubtedly take some pleasure in this outcome, it is also willing to acknowledge that the real work on achieving sustainable fiscal outcomes has only just begun. Budget 2024 takes some small steps to address some big challenges, but tougher decisions will be required to finish the job.
- The centrepiece of the Budget was a meaningful cost-of-living package, as well as some considerable uplift to social security spending (JobSeeker, Rental Assistance, Single Parenting Payment) and award wage increases for aged care workers. These initiatives speak to the Government's desire to reduce "entrenched disadvantage".
- The Government followed through on some well flagged taxation initiatives – modest changes to the Petroleum Resource Rent Tax (PRRT), an increase in the tobacco excise and the increase in taxation of earnings for superannuation balances above $3m (effective mid-25). Together with some initial changes to NDIS and Medicare spending, these changes begin the process to put Australia's fiscal outcomes on a sustainable footing.
- From a markets perspective, we observe a couple of key points. **First**, we regard the Budget as supportive of the ACGB market, given relatively favourable net supply outcomes this fiscal year and next. **Second**, we note that it is likely Australia's fiscal policy will tighten relative to offshore peers. All else equal this will act as a modest headwind to AUD/USD and to the performance of the local equity market relative to offshore markets. **Finally**, the Treasury's forecasts for nominal GDP growth in coming years may suggest some downside risk to ASX200 consensus earnings estimates.

Federal Budget 2024: Today's moment is tomorrow's memory

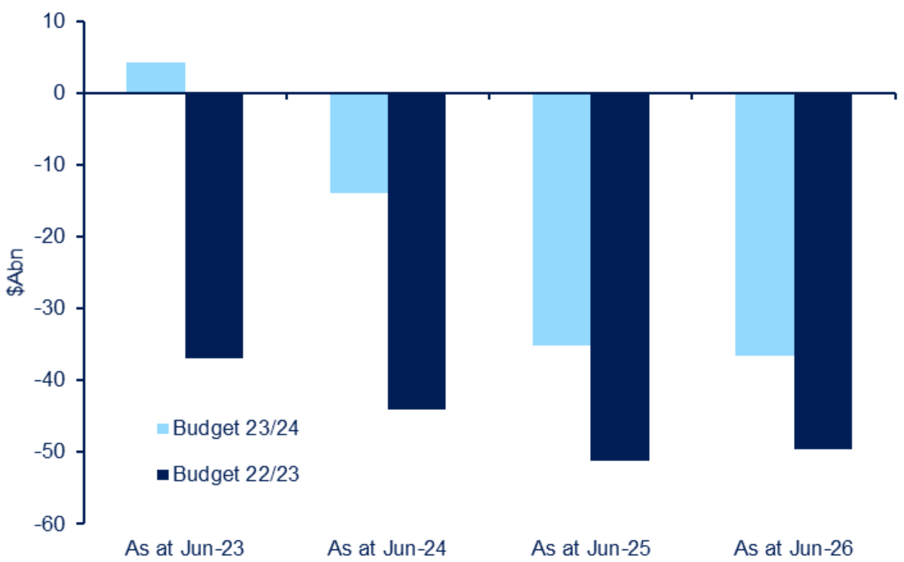
A brief overview of the budget

It is only a little more than six months on from the Treasurer's first Budget (delivered in October 2022) and already a lot has changed. The combination of high commodity prices, strong employment growth and higher wages growth have delivered a significant revenue uplift to Australia's finances. **The 2022/2023 Budget is forecast to record a very modest surplus of $4.2bn**.

Unfortunately, we believe the story loses some of its lustre once we look forward, rather than back. While the forecast surplus for the 2022-23 fiscal year represents a $41bn improvement compared to the October 2022 estimate, **the forward estimates show a continuum of deficits, albeit smaller than forecast in October last year** (**Chart 1**). Fiscal outcomes in the forward years continue to be compromised by a difficult combination of low productivity growth and growing expenditure on the usual suspects – NDIS, aged care and health.

High commodity prices, strong employment growth and higher wages growth will likely deliver the first surplus in 15 years

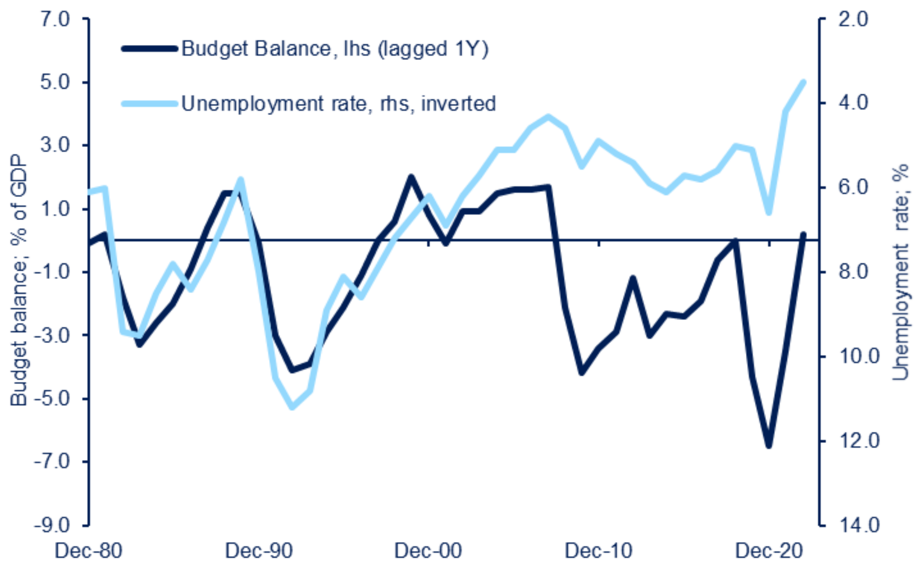
Chart 1: Forecasts for the budget balance have improved by a cumulative $A100bn through to June 2026 since the October 2022 Budget



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

These structural headwinds are not new, but the strong cyclical impulse to revenues in the past year – and the Government's decision to bank just over 80% of the upside revenue surprise in FY23 – now means that **the budget balance (as a % of GDP) looks a little more in line with economic fundamentals** than has been the case for a number of years (**Chart 2**). The improvements to Budget balances in the forward estimates also mean that gross debt peaks at 36.5% of GDP in FY26, five years earlier and just over 10%-pts lower than expected in the October Budget.

Chart 2: Unemployment rate and Budget balance



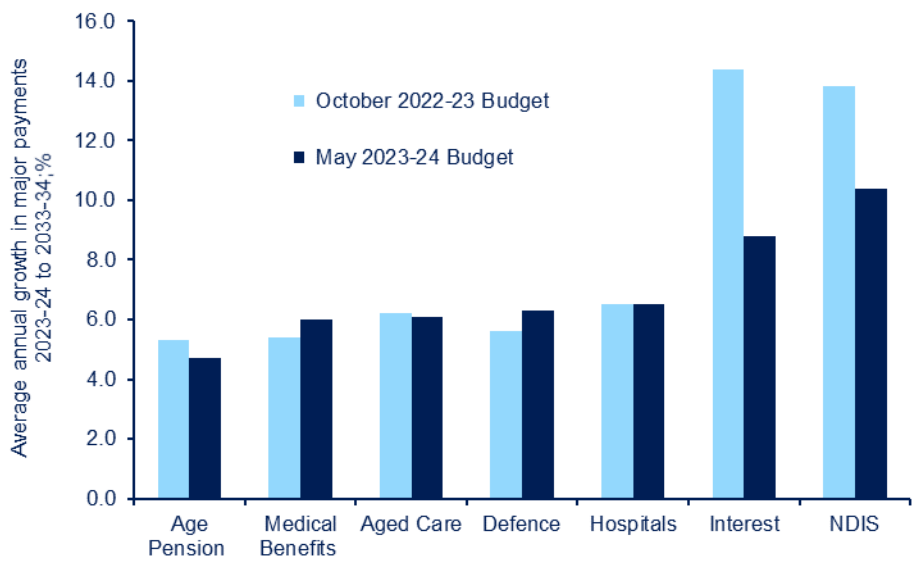
Source: Commonwealth Treasury, ABS and JBWere. Past performance is not a reliable indicator of future performance.

Interestingly, **the primary budget balance – which adjusts the underlying cash balance by excluding interest payments and interest receipts – is forecast to be in surplus** by ~$17bn in 2022-23 and balanced in 2023-24. This is quite a contrast to the primary budget balances in a number of other developed market economies.

Expected spending cuts on the NDIS and lower interest payments help with medium term Budget improvement

Over the medium term, the improvement in Budget balances is driven by banking higher-than-expected tax receipts, constraining real spending growth, the flow-on impact of lower interest payments and a meaningful decline in the average growth rate of NDIS costs (**Chart 3**).

Chart 3: Interest payments and NDIS spending cuts drive most of the improvement in the Budget's longer-term spending trajectory



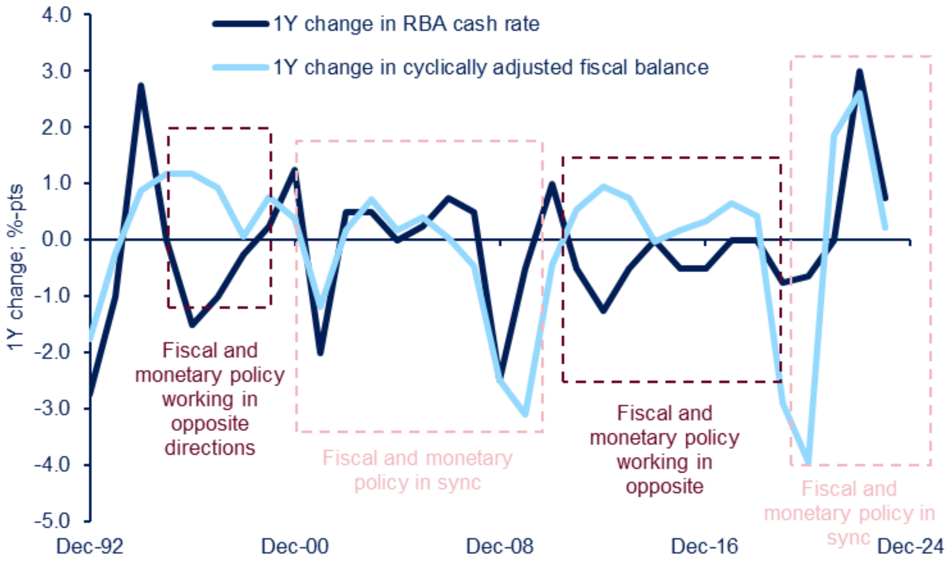
Source: Commonwealth Treasury and JBWere. Past performance is not a reliable indicator of future performance

Fiscal policy and its impact on short- and long-term economic challenges

Broadly speaking, monetary and fiscal policies are working in the same direction at present

The economic context for the budget, both in the short- and long-term, is a difficult one. In the short term, economic growth is forecast to slow, and inflation remains uncomfortably high. Thus policy initiatives should be judged by their ability to assist with broader macro-economic management and the extent to which they do not exacerbate existing macro-economic challenges. At a top-down level, we at least have alignment between fiscal and monetary policy at present (**Chart 4**), something which has not always been the case.

Chart 4: The broad settings of fiscal and monetary policy are currently aligned in Australia, which has not always been the case



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

The Treasurer has argued that the cost-of-living relief package will not be inflationary; indeed, the arithmetic of inflation calculations will mean that the form of energy bill assistance provided by the budget will lower energy prices in the short-term, thus contributing some modest disinflationary impulse to the CPI. But other welfare payment increases – targeted at lower income households with a higher propensity to consume – will place additional income into the economy, adding to aggregate demand at a time when the RBA is trying to do otherwise.

The Budget takes some small steps on big challenges like emissions reduction, productivity growth and tax reform

In the longer-term, the challenges relate to fiscal sustainability, de-carbonisation, productivity growth and the impact of Artificial Intelligence and Big Data on the Australian economy. In this regard, policies to enhance productivity growth and opportunistic management of Australia's decarbonisation are perhaps the most important longer-term challenges. On these fronts, the Budget notes improvement in labour market participation rates due to the favourable demographics of the additional migrant population as well as stronger population growth. These factors have delivered a small upgrade to Treasury's estimate of trend GDP near term. Further out, the estimate of trend economic growth remains unchanged at 2.5%. Other policies around access to child care and paid parental leave (enhancing workforce attachment) are forecast to improve labour supply via higher participation rates. On decarbonisation, the establishment of the Net Zero Authority to co-ordinate Australia's emission reduction targets and investments in renewable energy and hydrogen production are a step in the right direction. Likewise, modest changes to some taxation arrangements (tobacco excise, PRRT and superannuation) represent a modest, if not meek, start to rethinking the sustainability of the current taxation system.

The major policy announcements

Last year, government initiatives focused on shorter-term measures to shore up household incomes, and longer-term measures focused on infrastructure, defense, cyber capability and training and skills (new). This year, the focus is on cost-of-living relief, making a start on sustainable frameworks for Medicare and the NDIS, some modest taxation changes and supporting Australia's decarbonisation, industrial and defence efforts.

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):

- Energy bill relief to low-income households and small businesses
- Expanded eligibility for the single parenting payment
- Increasing the base rate for JobKeeper
- Increasing rent assistance
- 15% pay rise on award wages for aged care workers
- Reducing out-of-pocket health costs via changes to bulk billing and maximum dispensing quantity for some medicines
- Encouraging investments in build-to-rent projects, expanding eligibility for the First Home Guarantee Scheme, and further investment in social and affordable housing
- Changes to the paid parental leave scheme and lower childcare costs for some
- Investment in renewable energy and hydrogen production
- $20k instant asset write-off for small businesses
- Investments in defence and Australia's industrial base
- An additional 300,000 TAFE and vocational education training places to become fee-free, for courses in "critical and emerging industries" such as care, clean energy and digital sectors
- Tax changes – tobacco excise, PRRT and superannuation

The economic assumptions

The economic forecasts under-pinning the budget look reasonable, and are broadly consistent with the RBA's most recent forecasts

Budget 2023-24 contains Federal Treasury's latest set of economic forecasts. Similar to the RBA's latest set of forecasts (contained in the May *Statement on Monetary Policy*), the numbers have been subject to some revisions. While there are small differences, the forecasts across the "official family" broadly align. Key details:

- Treasury expects **GDP growth** to slow to 1.5% on year ago (oya) by mid-24. GDP growth is expected to be 2.25% by mid-25. In contrast, the RBA's forecasts are 1.4%oya by mid-24 and 2.1% by mid-25, respectively.
- Treasury forecasts the **unemployment rate** to remain at 3.5% through to mid-23, gradually rising to 4.5% by mid-25. This is similar to the RBA's forecast, which sees the unemployment rate rising gradually towards 4.5% by mid-25.
- Treasury is forecasting **wages growth** at 3.75%oya by mid-23, before rising to 4.0%oya by mid-24. The RBA is forecasting wages growth to peak at 4.0% at the end of 2023, before declining towards 3.7% by mid-25. Treasury is more optimistic on wages growth further out, forecasting a decline to 3.25% by mid-25.
- Both Treasury and the RBA forecast **real wages** to turn positive by the end of the 2023-24 fiscal year.

- **Population growth** estimates have been upgraded: 2.0% in FY23 and 1.7% in FY24 (vs. prior forecasts of 1.4% for both years). Net migration is forecast to return to "normal" levels (260k per fiscal year) in 2025-26 and 2026-27.
- **Long-term commodity prices** have been revised higher by a small amount, with a longer adjustment period back towards the long-run price level underpinning Budget forecasts.

The budget and investment markets

The Budget has been handed down after a reasonable performance from most asset classes this year

The 2023-24 budget has been handed down at an interesting time for investors. The narrative around US recession, banking system stresses, cost-of-living issues and the transmission lags of an aggressive monetary policy tightening cycle belies what has generally been a strong start for markets in 2023. Indeed, at least in $A terms, all asset classes (as defined by JBWere's Strategic Asset Allocation) have registered year-to-date gains.

It can be difficult to make too many strong calls about what one Budget might mean for the investment outlook, but our top level observations on the Budget and investment markets are as follows:

- The government is forecasting a sharp slowing in nominal GDP growth in the coming year, which may represent some modest downside risk to consensus earnings estimates for the ASX200;
- The stance of Australian fiscal policy relative to developed market peers looks – at least on IMF forecasts – to be relatively less supportive of the domestic equity market relative to peers and relatively less supportive of AUD/USD;
- At an individual stock level, cost-of-living relief and increased social security payments should be a modest positive for consumer discretionary stocks, all else equal;
- Likewise, strong population growth, changes to eligibility for the first home buyers scheme and additional investment in the National Housing Finance and Investment Corporation should aid stocks with exposure to housing;
- We don't believe there is any significant implication for energy stocks from changes to the PRRT given changes were likely less severe than expected and remove the uncertainty overhang; and
- We see the Budget as supportive of the ACGB market given favourable net supply outcomes in FY23 and FY24.

Equity markets – budget is neutral at best

It might be a long bow to draw implications for the equity market from the Budget, but there are a couple of frameworks which at least historically, have proven informative. The first relates to the strong relationship between earnings growth and nominal GDP. 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 and their assessment of medium term earnings growth. Indeed, a simple regression shows that since 2010, nominal GDP growth can explain around 80% of the variation in 1Y ahead EPS estimates. **Chart 5** shows a line graph of these two series.

Treasury's nominal GDP forecasts suggest some modest downside for ASX200 earnings estimates

Chart 5: 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. Dashed lines are Commonwealth Government forecasts (nominal GDP) and Bloomberg consensus forecasts (EPS).

If we take the government's economic forecasts for nominal GDP growth over the next few years, we can assume that this forces a meaningful slowdown in aggregate earnings growth in the listed sector. Relative to market expectations, the government's forecasts for nominal GDP growth suggest that consensus estimates for earnings growth are perhaps a little elevated. If the historical correlation between the two series in the chart above persists and the Government's forecasts are realised, then the 2024 Budget outlook may suggest some modest scope for earnings growth downgrades.

But some budget measures will support growth near-term, all else equal

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 (cost-of-living relief, increased social security payments). All else equal, this could support short-term earnings growth estimates in those sectors with exposure to household discretionary spending. The **second** is that measures to support higher trend GDP growth, such as measures to increase productivity, participation or population growth do feature in part in the budget. We know that population growth will be running at higher rates of growth relative to the estimates in the October budget; this will be compounded by upgrades to participation rates over the forward estimates and results in a modest upgrade to near term trend GDP estimates.

We also note that there does appear to be a reasonable directional relationship between relative fiscal policy and equity market out-performance (**Chart 6**). 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. The chart shows that *if* current IMF forecasts are realised, Australian fiscal policy is likely to tighten by relatively more than DM peers. All else equal, this suggests scope for some mean reversion in relative equity market performance, after some significant out-performance by the ASX200 in 2022.

The relative fiscal stance of Australia vs. DM peers suggests scope for some under-performance of the local equity market vs. offshore

Chart 6: 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.

What does the budget mean for individual stocks? On a more granular level, the increase in social security payments and cost-of-living relief should provide some modest short-term support for consumer discretionary spending, potentially benefiting companies like **Coles, Woolworths, Wesfarmers, Endeavour Group** and **Aristocrat Leisure,** in our view.

Housing and consumer related stocks are the two sectors that may see some modest upside post Budget

The higher forecasts for population growth (driven in large part by foreign students) should continue to benefit **IDP Education.** This dynamic will drive ongoing demand for housing, assisting companies such as **Mirvac, James Hardie** and **REA**. Broadened eligibility criteria for the first home buyer program and an additional $2bn for the National Housing Finance and Investment Corporation should aid this sector too.

On the **PRRT changes**, our view is that the announcement was well received by the market as it removed the uncertainty overhang for the industry. One of the key changes was the introduction of a deduction cap of 90% for PRRT calculations, enabling the bring forward of cash taxes. Interestingly there was no change to the existing gas transfer price methodology, despite some speculation that the Budget might bring change on this front. In summary, we believe the deductions cap brings higher cash taxes for the Government without discouraging investments in new projects; a reasonable compromise. **Woodside** remains our preferred pick in the energy sector.

Interest rate markets – the Budget is supportive, all else equal

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 modestly positive for government bonds, given favourable net supply dynamics

We have already noted the possibility that the Budget may add to aggregate demand in the short-term, given cost-of-living measures. All else equal, this could pressure front-end yields higher, at the margin, given the market is currently reluctant to price in the chance of further rate hikes from the RBA.

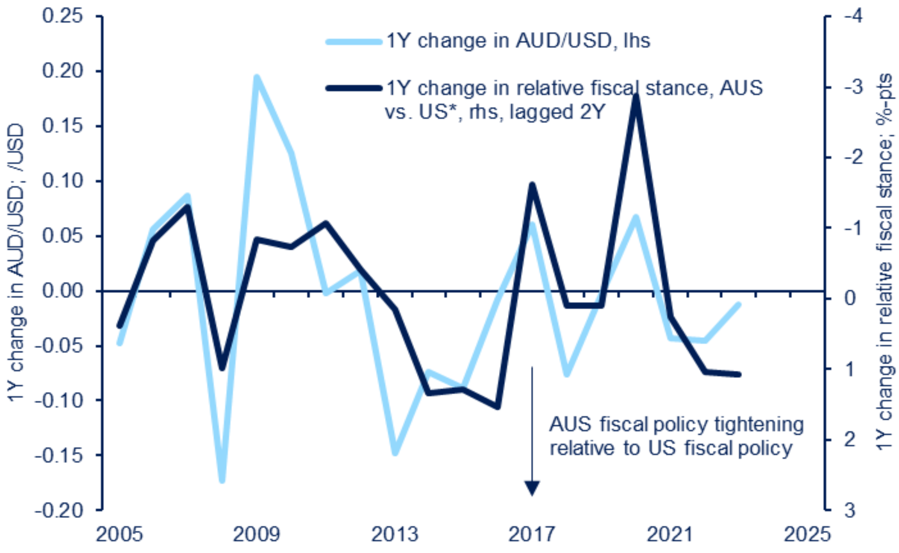
From a supply perspective, we note that the government is forecasting bonds on issue to be $144bn lower by June 2026 than was the case in the October Budget. Most of this improvement is due to better tax receipts. Looking at **net issuance**, we note that improved fiscal outcomes led the AOFM to lower FY23 gross issuance to $85bn, down from an initial estimate of $125bn. With bond maturities in FY23 around $85bn, this implies zero net issuance of ACGBs this fiscal year. Looking ahead, ACGB maturities are significantly lower in the coming fiscal year (~$36bn), which suggests a modest increase in net bond supply in FY24, assuming gross issuance of around $50bn. These modest numbers (~$15bn of net supply over two years) should be broadly supportive of ACGBs both on a cross market and absolute basis.

FX – not much support from fiscal policy at the moment

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, both the private and public sectors are net savers, meaning that Australia is a net exporter of capital. All things equal, this supports the $A in a relative sense. **Second**, to the extent that fiscal policy can influence trend rates of GDP growth over the long-term and growth in the short-term, and hence the term structure of interest rates, it can potentially impact longer run fair value estimates for the currency.

On net, we don't expect the AUD to receive much support from the Budget

Chart 7: Relative fiscal stance might be a modest drag on AUD/USD



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

Interestingly, we do observe a reasonable directional relationship between 1Y changes in AUD/USD and shifts in the relative stance of Australian fiscal policy vs. the stance of fiscal policy in the US (Chart 7). When Australian fiscal policy tightens relative to that in the US (as is currently the case), this tends to drag on the AUD/USD in subsequent years. Intuitively, this makes sense – a more contractionary setting of fiscal policy tends to be a headwind to growth, in the short-run, which all else equal should cap AUD/USD. So on net, we suspect fiscal policy might act as a cap on the AUD/USD, at least while Australian fiscal policy seeks to reflect a more responsible budget outcome relative to the US. The caveat to this is that the analysis only holds for as long as the market is happy for the USD to remain a reserve currency in the face of increasingly unsustainable US budgetary outcomes.

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