APRIL 2020 INSIGHTS

Slower for Longer

HIGHLIGHTS

- The outlook for the economy continues to develop as the fight to contain Covid-19 remains the focal point.
- At their emergency meeting the RBA cut the cash rate to the lower bound of 0.25% and commenced quantitative easing to support the economy.
- Volatility across markets has continued with the focus on the health fight, not the longer-term implications for the economy.
- While the near-term outcomes will be determined by the health crisis, longer term implications are starting to emerge.

RATES RECAP

- The RBA lowered the Cash Rate by 25bps at their emergency meeting taking it to the RBA's professed lower bound of 0.25%
- While the cash rate target is 0.25%, the actual cash rate is currently sitting at 0.17%, driven to an extent by the excess of liquidity currently in the system.
- BBSW fell a further 30bps across the curve and now sits below the cash rate target out to 4 months.
- Similar falls were seen across the curve out to three years, in line with the RBA's approach to yield curve control. However, the longer end of the curve has moved a little higher leaving the yield curve steeper.
- The AUD has remained very volatile. After hitting a new cycle low of 0.55, it has since jumped back above 0.63 due to the weakness of the USD as the Fed and US Government have pursued aggressive stimulus policy measures and the Fed has re-opened USD swap lines that haven't been used since the GFC.expected impact on the outlook.

Key Market Moves

	Latest	1 Month Ago	Change
Cash Rate	0.25	0.50	-0.25
3M BBSW	0.21	0.55	-0.35
6M BBSW	0.33	0.61	-0.29
1 Year Swap	0.27	0.59	-0.32
3 Year Swap	0.39	0.62	-0.23
5 Year Swap	0.62	0.94	-0.32
3 Year Futures	0.28	0.48	-0.21
10 Year Futures	0.92	0.79	0.14
AUD	0.63	0.62	0.01
ASX 200	5387	5940	-552
US 2 year	0.22	0.49	-0.27
US 10 year	0.72	0.96	-0.24
US 30 year	1.34	1.53	-0.19
USD Index	99.53	98.75	0.78
Dow Jones	23719	25018	-1299

Slower for Longer

The unfolding series of events we are currently witnessing, many of us from the confines of our own home, are reshaping not only the medium term outlook but the future as we know it. What started out as a localised health crisis is now a global pandemic. Some countries have been much harder hit than others with countless variables impacting the severity of outbreaks.

With containment measures across the world gaining traction, there are signs that the peak of the epidemic is now in sight at the global level. The spread is slowing thanks to social distancing and shutdown measures that vary in their application from jurisdiction to jurisdiction. While the peak pace of spread of the virus could soon be behind us, Covid-19 will still shape our lives for some time yet.

In the absence of a vaccine for the virus, Australia and the globe are going to be subject to some form of containment and social distancing measures. This will be the case even if herd immunity were to be pursued, to contain the pace of the growth so that it doesn't overwhelm health systems as we have seen in hot spots such as Italy, the UK and in the US, particularly in the US.

As long as the containment measures are pursued, the impact will be restricted from operating at full capacity. The longer the containment measures are in place, the deeper and the broader the impact on the economy will become. That is why we so often hear of the battle being on two fronts. One to stop the virus and one to protect the economy.

One way or another the virus will pass, eventually. The question is what will the economy and growth look like on the other side?

We are likely to see a rebound on the other side in the initial stages of the unwinding of containment measures. There will be pent up demand in some areas in the economy while in others what has been foregone will never be replaced. It is what comes after the initial rebound in activity that will be of a more pressing concern.

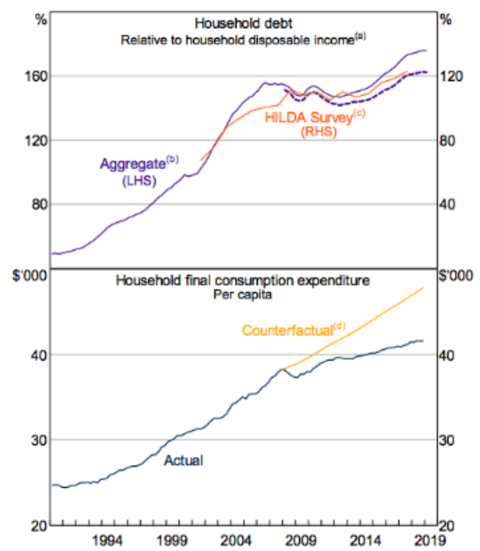
If we learnt anything from the previous crisis over a decade ago, the legacy of such large scale events can be long lasting. The impact of the Covid-19 battle and ensuing economic woes are likely to leave a much longer and substantial legacy than the aftermath of the GFC.

While the hard economic data so far during this crisis is yet to emerge, there are some things that we already know. Coming into this crisis, debt levels were already higher amongst households and governments. The unemployment rate was 5.1% compared to a pre-GFC rate of 4.0%. Wage growth was 2.2% compared to a pre-GFC rate of 4.3%. GDP for the previous decade averaged 2.9% compared to a pre-GFC rate of 3.3%. Retail sales averaged 3.4% the previous decade compared to a pre-GFC rate of 6.2%.

Based on the metrics above, the situation we were in prior to the GFC is very different to the one we were in entering this crisis. That leaves us with a much weaker starting point before we start to assess what the economy will look like on the other side of this crisis.

Given we don't know exactly how this will play out, what we can do is look at what we have seen so far and what some of the impacts will be.

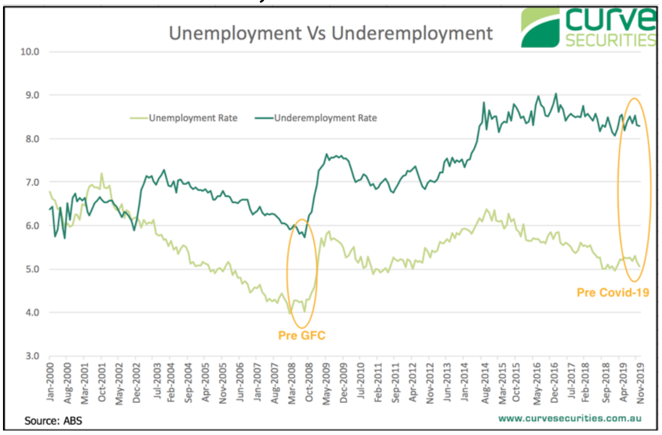
Debt will be higher - For businesses and households debt levels will be even higher on the other side of this crisis. Many of the measures to support the economy are either in the form of cheap debt or deferment. Both leave a bigger problem for another day. Government debt will also be higher as they must fund stimulus measures used to support the economy.



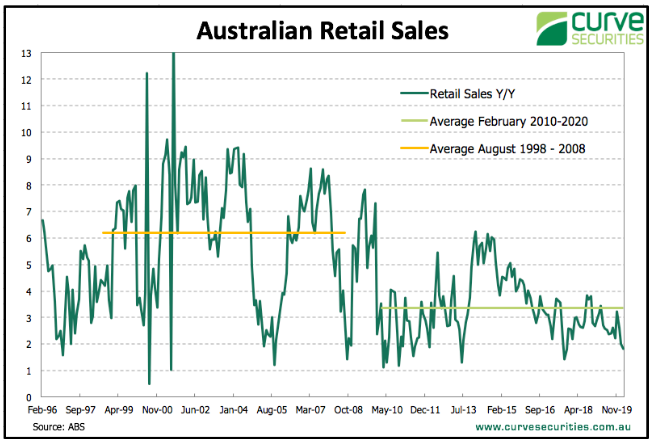
Notes: (a) Excludes unincorporated enterprises and income is before interest payments
(b) Dashed line excludes offset account balances
(c) Owner-occupier housing debt
(d) Assumes household consumption grows at the 1960–2007 average of 0.9 per cent per quarter from March 2008 onwards
Sources: ABS; Authors' calculations; HILDA Survey Release 17.0; RBA

Unemployment will be higher - while we don't have much up to date data locally, jobs data offshore have been truly remarkable. In the US, 16 million people have filed for jobless claims in the past 3 weeks, while in Canada over 1 million jobs were lost in March. To put the Canadian numbers in perspective, monthly jobs growth in the lead up to the crisis was 19,000 per month. Over the past decade, Australia has averaged 17,600.

They are the known knowns. We know that those things are happening and are a reality that we will have to deal with on the other side of the crisis. We then have a series of known unknowns. Things we know will be effected but by how much and in what way is still unclear.

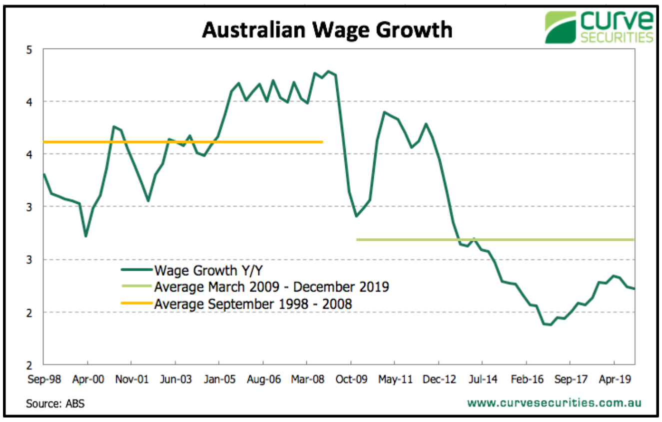


Consumption will be weaker - What we know from the GFC is that household consumption per capita fell during the crisis. When it recovered, the pace of growth was slower than the average for the 47 years that preceded it. With higher debt levels and higher unemployment, we are likely to see the same pattern again, only this time the trend growth on the other side could be even weaker.

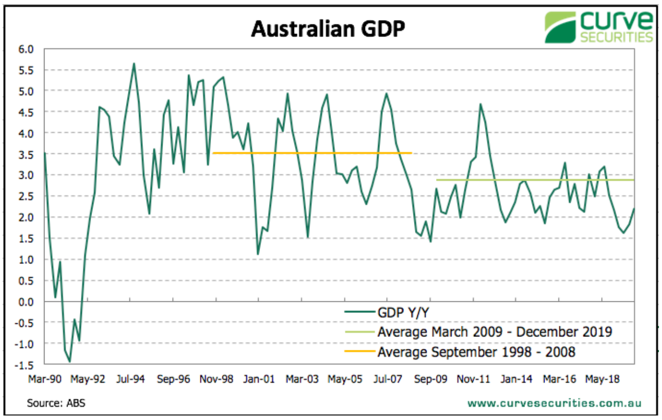


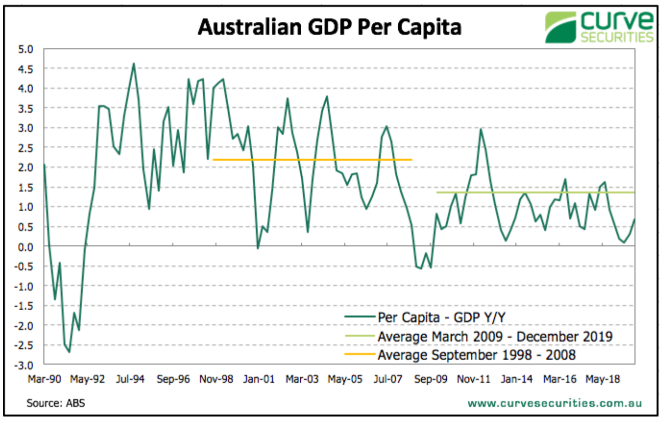
Wage growth will remain weak - A higher unemployment rate will leave significantly more slack in the labour force. This will mean even less pressure on wage growth post crisis. Also, what this experience is showing businesses is how lean they can run and still continue to operate efficiently. So even if activity were to recover to pre-crisis levels, the same level of employment may not.

There is also the negative wealth effect from falling asset prices as well as the continuation of demographic changes.



Trend growth will remain lower - consumption is still the biggest component of growth. With debt levels higher, unemployment higher, consumption lower and wage growth weak, Australia's biggest growth engine will remain under pressure. Other sectors could see lasting impacts too. Tourism will be impacted for some time, especially if our boarders remain closed. With the shutdown forcing many things online, such as education, visiting international student numbers to our universities could also be permanently impacted. Lower global growth could also impact demand for our natural resources.





Less monetary and fiscal support - With the cash rate at the RBA's professed lower bound, Quantitative Easing under way and explicit forward guidance adopted, there is little room for monetary policy to provide further support. We are also witnessing the limitations of fiscal support as the government keeps one eye on future budgets in every announcement of further stimulus measures. There is a clear reluctance to adopt a 'whatever it takes' approach so as not to rack up a monster debt burden for future generations. That means that further support on the other side of the crisis will be limited.

Shifting global supply chains - This crisis has exposed the risk of being over reliant on global supply chains. This is especially important for critical items such as food and medical supplies. This creates opportunities and risks. An unwinding of the globalising of supply chains can create opportunities at a national level but it comes at a cost. Supply chains were globalised to reduce costs which means on-shoring them will have implications for inflation. Talk of on-shoring is already happening but we will see how willing companies and economies will be to absorb the costs once the dust settles on the other side.

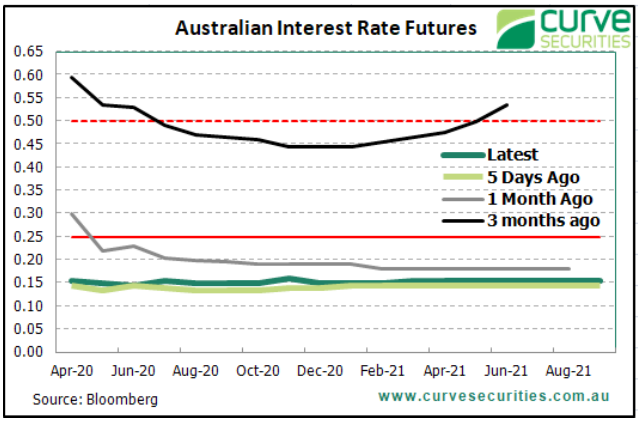
The list of known unknowns isn't limited to those above. On top of the known unknowns that will become clearer as we move to the other side of the crisis, there are also the unknown unknowns. That is to say that there will be developments or events that unfold during this crisis and afterwards that we don't yet know about.

However, what we do know, is that the economy is more likely to be slower for longer once this crisis is over.

Outlook for interest rates

Over the past month, we have had two meetings of the RBA Board. An emergency meeting on the 18th of March and their subsequent scheduled meeting on the 7th of April. The changes made to the calibration of monetary policy at their emergency meeting and the post meeting minutes have made the outlook for the official setting of monetary policy for the foreseeable future clear.

At their emergency meeting, the RBA lowered the cash rate to 0.25% as was widely expected. It was also expected that this would be the lower bound for the cash rate in Australia. The RBA confirmed this was the case in the minutes from the meeting which stated that *"Members also agreed that the cash rate was now at its effective lower bound."* The minutes even went one step further, adding that *"Members had no appetite for negative interest rates in Australia."*

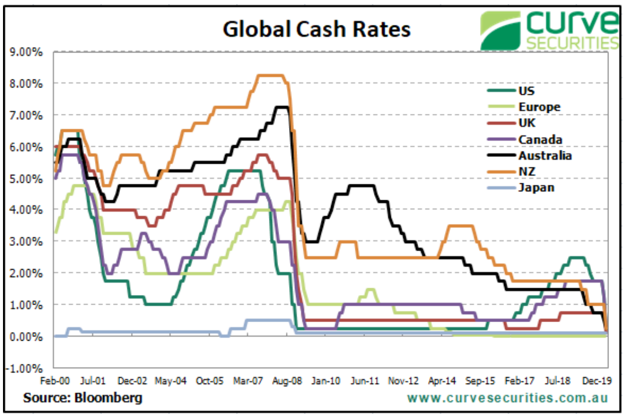


With the cash rate reaching its lower bound, in order to provide further support, the RBA announced that it would commence quantitative easing. Rather than following the US and Europe into announcing an amount of government bonds that they would purchase, they opted the Bank of Japan's recent approach of targeting the yield of government bonds. The RBA's minutes stated that:

"The specific proposal was to target the rate at the three-year mark, given its importance as a benchmark rate in financial markets and its role in funding across much of the Australian economy."

In addition to the cash rate being taking to the lower bound and quantitative easing commencing, the RBA also gave more explicit forward guidance. They indicated that:

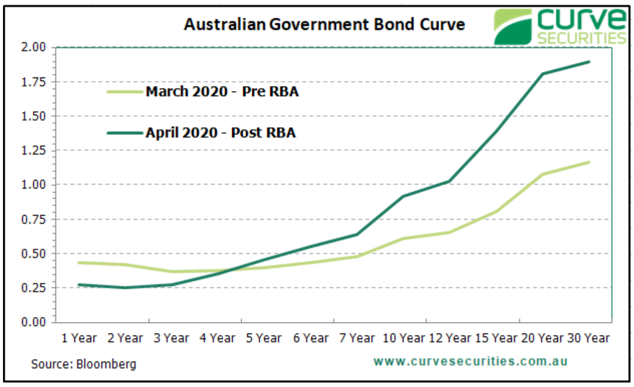
- the cash rate would remain at a very low level for an extended period;
- the target for three-year yields would be maintained until progress was made towards the Bank's goals of full employment and the inflation target;
- that it would be appropriate to remove the yield target before the cash rate itself was raised.



Considering the outlook for unemployment and the prospects for achieving full employment, we are likely to see the cash rate remained unchanged and the yield curve target in place for many years.

The general outlook for inflation is that it should remain weak from a demand side perspective. However, we can't rule out supply side inflation should we see globalisation start to unwind and with supply chain on-shoring occurring over the years ahead. We will explore this further as the situation develops.

So as far as the official interest rate outlook goes, the cash rate is expected to remain unchanged and risk free rates, government bond yields, to remain anchored at 0.25% at the three year part of the curve for some time to come. That doesn't mean we won't see other market interest rates move to a larger degree over the coming months and years.



Australian Economic Highlights

- Growth ticked up slightly in Q4 for 2019 printing at 0.5% for the quarter bringing the annualised rate to 2.2%. Despite an indication that growth may be at a gentle turning point recent events could see large changes when Q1 data arrives.
- Inflation pressures rose slightly in Q4, with both headline and core inflation printing in line with expectations. The headline index was up 0.7% which saw the annual rate edge up to 1.8%, while the trimmed mean was up 0.4%, leaving the annual rate unchanged at 1.6%. Both were in line with the RBA's forecasts.
- Employment data for February, which pre-dated the slowdown saw total employment grow 26,700 which saw the unemployment rate fall to 5.1%. Due to the timing of the March survey it is unlikely to capture the full effect of the shutdowns meaning we are unlikely to know the true impact until the April data is available in mid May.
- ANZ Job ads collapsed 10.3% in March as the economy was shuttered to fight the spread of Covid-19. More up to date data from private sources such as Seek and Indeed suggest that job ads are currently down over 60% from the corresponding month a year ago. The falls across different categories range from -29.7% in mining and energy which is the smallest fall to -97.7% in sports and recreation job ads.
- Business confidence fell heavily in February, losing 3 points to post at -4 for the month. Business conditions also fell at 0 points for the month. The crucial Employment index gained 1 point to post at 2 points for the month.
- Consumer confidence fell in March with the index down 3.8% to 91.9. We are likely to see a more substantial fall in the April survey when it is released this week. The weekly ANZ-Roy Morgan survey suggests the index will breech its GFC lows.
- Retail sales held up ok at the headline level in February thanks to a surge in food sales leading into partial shutdowns of the economy. Food sales jumped 0.8% over the month driven by grocery sales which were up 1.1%. Given the widespread shutdown, sales will be significantly lower over the months ahead.
- Housing finance has slowed materially during the first two months of 2020 after ending 2019 at a solid growth rate. January's initial solid increase was largely revised away while February saw large declines for the value of both owner occupier and investor loans.
- Australia trade surpluses fell in February but not by as much as had been expected. The surplus printed at $4.4bln against expectations of $3.8bln. However the headline number masked the deterioration in trade flows which saw exports fall 8% over the month while imports were down 4%.
- Building approvals posted an unexpected jump in approvals in February after January's sharp falls. Approvals were up 19.9% in February, driven by apartment approvals in Victoria after January's 15.1% fall.