
## HIGHLIGHTS

- Containment measures continue to be rolled back and the data suggests that the worst is now behind us.
- Australia's early success in containing the virus is slowly coming undone as community transitions in Victoria start to spread.
- The RBA remains committed to doing all it can to support the economy and ensure that the price and availability of credit will support any recovery.
- However, with little room left to have a meaningful impact and its measures still under-utilised, pressure is mounting on the government to steer the economy through the crisis.
- With the spread of the virus gaining pace and crossing into NSW and Queensland, the outlook for the economy is at the crossroads and the next few weeks will be crucial.

## RATES RECAP

- The RBA left the cash rate and its yield curve target unchanged once again in July and reiterated that *"The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band."*
- While the cash rate target is 0.25%, the actual cash rate remained largely unchanged at 0.13% driven by the ongoing excess of liquidity currently in the system.
- BBSW also remained largely unchanged over the month with the 3 months rate still sitting at 0.10% and the 6 month at 0.17%.
- The curve flattened over the month with the 3 year swap down 5bp while the 5 year was down 9bp.
- Credit spreads continue to drift lower as investors chase yield further out the curve. With issuers reluctant to issue significant volumes in

**Key Market Moves**

| | Latest | 1 Month Ago | Change |
|---|---|---|---|
| Cash Rate Target | 0.25 | 0.25 | 0.00 |
| Cash Rate | 0.13 | 0.14 | -0.01 |
| 3M BBSW | 0.10 | 0.10 | 0.00 |
| 6M BBSW | 0.17 | 0.17 | 0.00 |
| 1 Year Swap | 0.14 | 0.16 | -0.02 |
| 3 Year Swap | 0.21 | 0.26 | -0.05 |
| 5 Year Swap | 0.40 | 0.48 | -0.09 |
| 3 Year Futures | 0.31 | 0.27 | 0.04 |
| 10 Year Futures | 0.91 | 0.90 | 0.01 |
| AUD | 0.69 | 0.69 | 0.00 |
| ASX 200 | 5938 | 5848 | 91 |
| US 2 year | 0.15 | 0.19 | -0.04 |
| US 10 year | 0.62 | 0.70 | -0.09 |
| US 30 year | 1.30 | 1.46 | -0.15 |
| USD Index | 96.54 | 97.32 | -0.78 |
| Dow Jones | 26086 | 25606 | 480 |

the short end, long end spreads are expected to continue to decline as excess liquidity is absorbed.

- The AUD has remained very volatile within a tight range again in June but failed to break through the 70 US cent barrier. The RBA has omitted any comment on the AUD from recent remarks an interesting change from its usual commentary.

## Second Wave Threatens Outlook

The Australian economy was just starting to pick itself up off the canvas after lockdowns around the country hit the economy hard at the start of the quarter. As those lockdowns were being wound back, activity was slowly coming back to life & the clouds hanging over the outlook were starting to dissipate. Meanwhile overseas in places like the US, India & South America, the spread of the virus was accelerating.

Hopes that Australia has seen the back of the virus were quickly dashed as Victoria started to see small pockets of infections start to re-emerge. Fast forward and a second wave of the virus is now well and truly underway in VIC and it threatens to spread quickly to other states, especially NSW.

This second wave is far more potent than the first. When the Covid-19 first made its way to our shores, it was mainly through Australians and visitors arriving from offshore. This was much easier to curtail and with our boarders quickly shut, the spread of the virus slowed dramatically. The second time around it is community transmissions that are the driving the spread and this is more difficult to contain.

Slowly, with the virus now largely under control within our As a result of the second wave, much of VIC has had to return to lockdown measures in a bid to get the spread of the virus under control. Borders have been shut but it may already be too late. A spot fire of cases in NSW is already starting to get quickly out of control and it feels like it is only a matter of time until the easing of restrictions are rolled back community movements and gatherings are reduced.

Even if the second wave is limited to Victoria and NSW, it will be enough to derail the economy and set the recovery back significantly. The two states account for a large chunk of economic activity in Australia. Confidence is sure to be hit, even if widespread lockdowns don't ensue.

The setback means that the bridge to the other side of the crisis now needs to be extended. APRA & the Banking Institutions have already announced that mortgage payment deferrals will be extended out to March next year or 10 months, whichever comes first. This buys homeowners & investors some time but is won't solve the situation for many. High level executives of the banks have already sounded warnings that some mortgagees will need to make tough decisions and it might be in their best interests to act sooner rather than later.

With the RBA having little room to provide more support, pressure will be building on the government ahead of their scheduled budget announcement on July 23. The government has already confirmed that many current measures will end as planned but will be replaced with new, more sustainable measures. It will likely be a fluid situation for the government as what they will be required to deliver will be changing by the day as the second wave of the virus continues to spread.

How the situation evolves over the next few weeks will be critical for the longer-term outlook. If the spread of the virus can be brought under control, the damage that it does to the outlook may well be minimal with the recovery only suffering a minor setback. If it continues to spread & restrictions are re-introduced it could have significant ramifications for the outlook.

One very public example of what might happen can be seen with the situation Qantas has found itself in. With a recovery in international travel some way off, they could no longer rely on temporary measures to solve a problem, reduced activity, that was no longer temporary. Subsequently the first round of restructuring took place.

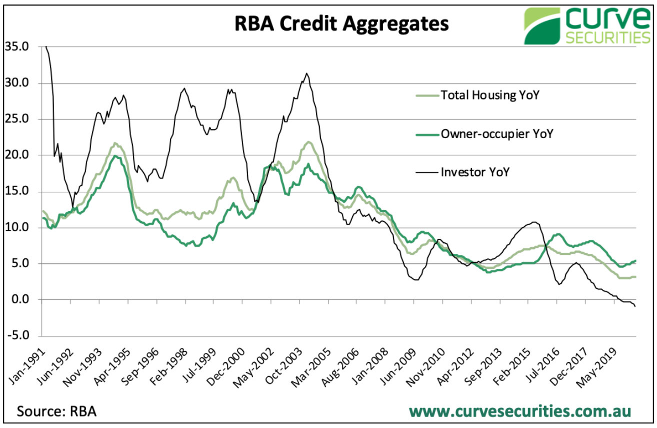
Many businesses and employees have been waiting for life to get back to normal. However, this second wave of infections means that normal may be some way off. For many businesses normal will never return & their operating environment will permanently change. The longer it takes this second wave to be brought under control, the more businesses that will be forced to make tough decisions. Temporary layoff in some cases will become permanent. Some businesses won't be able to make it to the other side & may close all together.

Australia's economic recovery is at the crossroads & the outlook hinges on what happens in the next few weeks.

## Outlook for interest rates

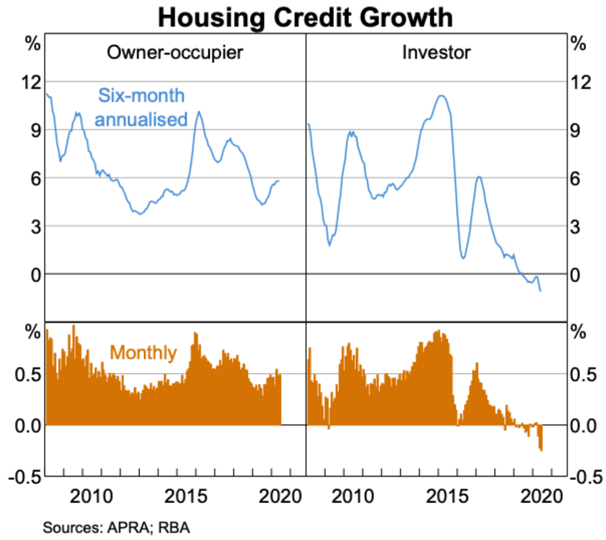
For some time now the RBA has been steadfast in their positioning of monetary policy. In their late June speeches and July meeting they reaffirmed their stance on multiple occasions. Their monthly meetings have evolved whereby the centrepiece for the market is not the movement or lack thereof in the cash rate but more of an insight into their view of the uncertainly before us.

Governor Lowe outlined well before this current period what unconventional tools they have available to them and they are certainly using these. Whilst they have all but ruled out negative interest rates for now, the use of extended liquidity operations, currently in the form of the RBA's Term Funding Facility, asset purchase programs and most importantly forward guidance are central to the RBA's current policy settings.



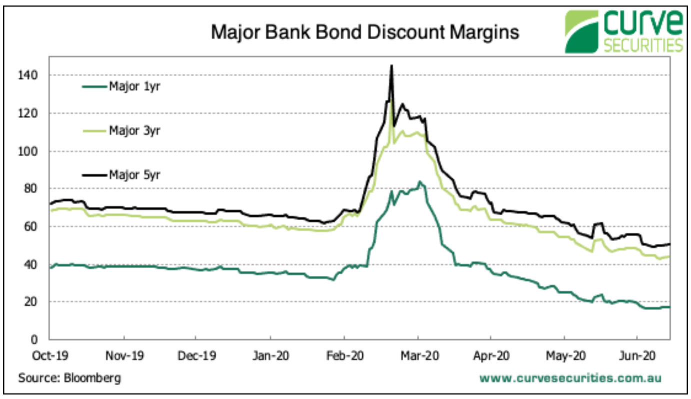

The challenge the RBA currently face is that whilst some elements in their unconventional policy tools have capacity for further action, their traditional toolkit is simply running out of road. An example of this is the RBA have ample capacity to purchase more government securities from the market, they simply do not currently need to. Their forward guidance to the market that they will purchase securities in any volume to maintain a 3yr government bond yield at 0.25% simply removes the need to physically transact.

*"The Bank is prepared to scale-up its bond purchases again and will do whatever is necessary to ensure bond markets remain functional and to achieve the yield target for 3-year AGS. The yield target will remain in place until progress is being made towards the goals for full employment and inflation."*



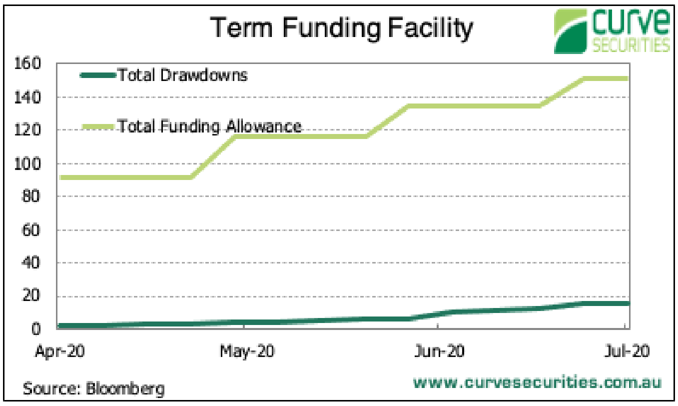

Similarly, there remains a significant proportion of their Term Funding Facility yet to be drawn, some $70 billion of the initial allocation to the banks remains untouched. Whilst the RBA is doing everything, they can to facilitate the recovery, they cannot create jobs or solve a health crisis.

A further challenge evolves in that the steps they are taking do also have negative side effects. The liquidity they have provided to the system is facilitating cheap credit but the effect on deposit and savings rates is significant. As ADI's tapped into their TFF allocations at the same time as credit aggregates fell, their demand for new deposit funding went to near zero. This also had a side-effect in that yield on ADI securities are under significant downward pressure as traditional money market participants term out their deposit allocation into ADI paper.



The outlook for the economy over the long term is also uncertain with so much reliant on the health and employment effects of Covid-19. The outlook for interest rates at least in the short to medium term is less uncertain,

*"The Board is committed to do what it can to support jobs, incomes and businesses and to make sure that Australia is well placed for the recovery. Its actions are keeping funding costs low and supporting the supply of credit to households and businesses. This accommodative approach will be maintained as long as it is required. The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band."*



## Australian Economic Highlights

- Growth for the first quarter dipped into negative territory, falling by 0.3% with the economy slowing as Covid-19 containment measures ramped up. It means with the second quarter expected to be deeply negative, the Australian economy is in the midst of its first technical recession in almost 30 years.
- Inflation was largely in line with expectations in Q1. Headline inflation rose 0.3% taking the annual rate to 2.2% while the trimmed mean was up 0.5% with the annual rate edging up to 1.8%. Prices are expected to fall in Q2; however, core inflation is expected to remain positive.
- Employment data for May saw the unemployment rate rise to 7.1% from 6.2% and the participation rate fall from 63.5% to 62.9%. The numbers understate the impact on employment from the pandemic, as the JobKeeper wage subsidies define people as being employed despite not working. If those on JobKeeper were classified as unemployed the unemployment rate would be 11.3%.
- The ANZ Job ads report saw new job ads increase 42% in June. This coincided with the unwinding of lockdown measures across the country. The large increase leaves job ads still well below pre-pandemic levels.
- Business confidence continued to recover from April lows, with the index back in positive territory at 1. Business conditions remain negative, at -7, but are a big improvement on the previous month's -24. These figures though are liable to fall once more as lockdown measures are reimposed across the country.
- Consumer confidence is now only 2% below the 6-month average before March. The index rose two months in a row, to be at 93.7 after slumping to 75.6 in April. The dichotomy between the perception of the next 12 months and 5 years remains, with the index for family finances and economic conditions for the next 12 months still below 80. Whereas the indices for the next 5 years are both above 100, showing individuals are optimistic about the next 5 years.
- In a positive note for the economy, retail sales rose 16.9% in May, albeit this followed a 17.7% fall in April. As JobKeeper, JobSeeker and early super withdrawals have sustained incomes despite rising unemployment, spending has been sustained. After panic buying in March and the May data, total retail spending for the past 12 months is 5.8% higher than the prior 12 months.
- Stalling credit growth continued in May, with new housing finance approvals down 11.6%. This was much worse than the market expectation for a 5.5% fall and follows a 4.6% drop in April. As new loans have slowed, refinancing has increased more than 45% over May and June.
- Australia's trade surplus increased slightly from a revised $7.8 billion in May to $8 billion in June. This was on the back of a 6% fall in imports and 4% fall in exports, which shows our overall trade activity is and was being heavily impacted by the pandemic.
- Building approvals fell 16.4% in May after a 2.1% fall in April. As housing has many flow on effects to economic activity, the sharp fall is concerning for activity over the medium term.