Economic Update

Shifting Gears

November 2021 edition, By Chris Boag

Equity markets extended the recovery from the September 2021 sell-off with US equity markets setting new highs and the Australian equity market closing in on the previous peak. Calendar year 2022 looks set to be a year of ongoing recovery from the setbacks of the COVID-19 pandemic. Australia (and New Zealand) is in the early stages of removal of pandemic restrictions and businesses are looking forward to improved trading conditions. As we have spoken about over the course of the year, inflation remains a key uncertainty. Other issues that we have spoken about include a new mutation of the virus, and the removal of generous levels of fiscal and monetary policy support. Global fund managers are adjusting strategies to include more hedges against inflation and reassessing sectors that may be negatively impacted by rising interest rates.

The recovery in global equity markets is reflective of the global economy's emergence from pandemic induced setbacks. Most global industries have been showing increasing output with the only major exception being the car industry which is impacted by supply chain interruptions unrelated to the pandemic. The world economy is expected to bounce back by 5.7% this year and follow-up with a solid 4.5% in calendar year 2022. China could prove to be the biggest downside risk to this view. Emerging markets with less vaccine coverage are likely to lag however could provide support to global GDP in 2023 and beyond as vaccine rollouts continue and other major economies normalise.

The OECD has noted that "The distribution of risks is not better balanced than a year ago, but significant uncertainty remains." However, faster vaccination rollout could produce a better year ahead, but central banks would need to keep markets calm: "Clear guidance by the monetary authorities that the additional inflation pressures were only temporary would help to anchor inflation expectations and limit financial market repricing." The major downside risk to this otherwise positive outlook is some further mutation of the virus. "In such circumstances, stricter containment measures might need to be used again, confidence and private sector spending would be weaker than in the base line, and some capital would be scrapped. In such a scenario, output would remain weaker than the precrisis path for an extended period. World GDP growth could drop to under 3% in 2022."

The International Monetary Fund, in the forecast update for its annual meeting in October, also sees ongoing global growth and has very similar numbers in mind. The IMF also agreed with the OECD that, while the baseline scenario is positive, uncertainty remains high: "The balance of risks suggests that growth outcomes—over both the near and medium terms—are more likely to disappoint than to register positive surprises." It pointed to much the same menu as the OECD: the emergence of more transmissible and deadlier virus variants and, if inflation remains high (because of supply chain issues or otherwise), the risk of "a faster-than-anticipated monetary normalization in advanced economies." In current market conditions, that would not go down well: "Compressed volatility and elevated equity price valuations point to the possibility of rapid repricing of financial assets in the event of a reassessment of the outlook."

According to Morningstar, global fund managers in the October Bank of America Merrill Lynch (BAML) survey also buy the ongoing growth story: a net 50% remain overweight to global equities. But they also feel that the peak period of GDP and profit growth is behind us, and they are particularly keen to be well positioned if inflation remains high, which is by far the biggest risk on their horizon (the top choice for 48%). The survey found that allocations to inflation-linked assets such as commodities, energy, and banks,

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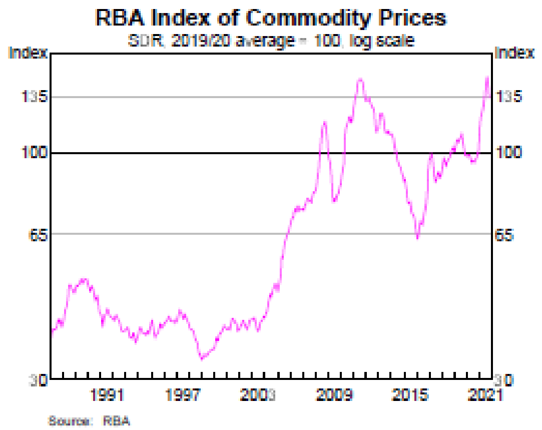

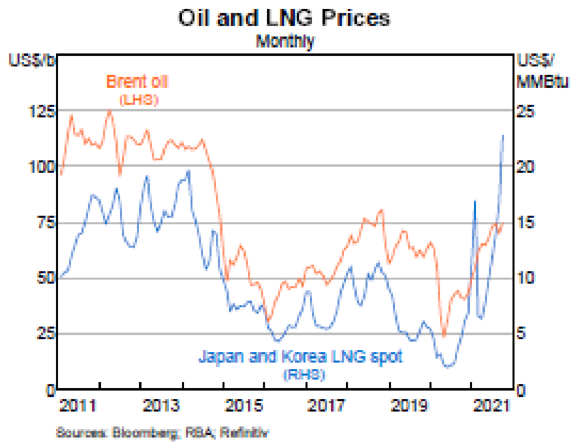

were at historically very high levels. The other main risks they mentioned were the ramifications of a slowdown in China (the knock-on impact of Evergrande may also have been in that basket, picked by 23%), the existence of asset bubbles (9%), and the impact of any Fed taper (less support for bond yields, also 9%). Oddly, given the thinking of the likes of the OECD and the IMF, the risk of COVID mutating was way down the list (picked by only 3%). It would be nice if the fund managers were proved right.

In the US the Federal Open Market Committee (FOMC) has announced it will taper its asset purchases by $15b per month starting this November. This is not a tightening of monetary policy. The taper can be adjusted according to the economic outlook but otherwise would stop buying assets by June 2022 based on the trajectory of tapering. An increase to the Fed Funds rate was not considered and they are keen to avoid a repeat of the 2013 'taper tantrum'. FOMC still considers the current elevated inflationary levels as transitionary due to supply chain bottlenecks.

It appears the FOMC is adopting a cautious rather than a dismissive stance about inflation. Much hinges the definition of full employment in a post-pandemic environment. The current participation rate of 61.6% is below the long-term average of 62.9 from 1948–2021. If this is a permanent change, then perhaps full employment will be reached sooner, and the dual mandate settings would indicate rate increases will closely follow the completion of the taper. This would suggest increases starting in the September quarter of 2022.

In Australia the race that stops a nation was not the Melbourne Cup (it's decidedly on the nose with ESG concerns from the public) but was the 3yr bond yield race. On the Friday before the Cup, the nation (of investment professionals) was eagerly awaiting news at approximately 11am to find out if the RBA had stepped into the bond market to purchase more bonds and squash the rampant bond market rout to enforce it's 0.10% 3yr bond yield target rate. The RBA did not step in, and this set the scene for the RBA Board meeting on Cup Day. The 0.10% yield curve target on the April 2024 maturity was an integral part of the former commitment to not raise the official cash rate until "at least 2024". Lowe elegantly explained "its effectiveness as a monetary policy tool declined as expectations about future interest rates shifted due to a run of data and forecast progress towards our goals."

The 2024 line in the sand for raising interest rates has moved forward into 2023. The bond market continues to price in rate hikes in 2022, but the governor is still struggling "with the scenario that rates would need to be raised next year." While giving some ground by abandoning yield curve control, Lowe believes, based on the RBA's forecasts it is "entirely plausible" the first increase in the cash rate will not be before the April 2024 maturity. Though on Australia's biggest gambling day, he had an each-way bet "but it is now also plausible that a lift in the cash rate could be appropriate in 2023."

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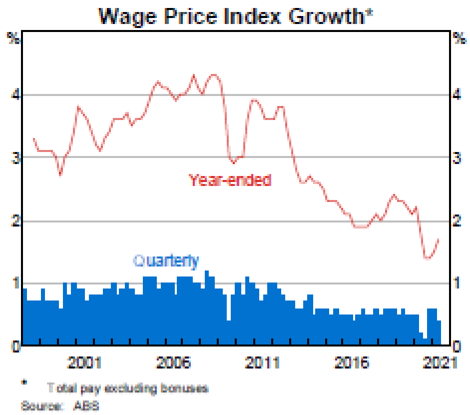

Despite bullish economic growth forecasts for 2022 and 2023 and elevated asset price inflation, one must be wondering why the RBA is so convinced interest rates should not rise until late 2023? One theory is that it is because companies are reluctant to lift a large portion of their fixed costs (wages) as international borders are about to reopen and foreign workers can return.

Lowe suggested Australia is different to other countries with falls in the participation rate seen offshore not yet evident here. Australia's participation rate is down from 66% in January to 64.5% in September. It has been falling from June's 66.2% print for three consecutive months. (Nothing in comparison to the 'Great Resignation' being experienced in the US).

Another factor could be China and our significant economic ties. China's latest official Purchasing Managers Index (PMI) for October's reading of 49.2 was down from 49.6 in September, the second consecutive contraction in factory activity and below expectations of 49.7. The production and new orders subindices contracted to 48.4 and 48.8, respectively while the subindex for outprices soared to 61.1, the highest since 2016. This reflects rising inflationary pressures while economic activity and output slows. This is not an attractive combination and does point to a potentially low growth quarter to farewell 2022.

Central banks in major economies are moving to taper their bond purchases and shifting gears for an eventual move to increase interest rates. In most countries, the expectation for rate increases is being brought forward by the current inflationary spike that is anticipated to be transitionary, however should it linger longer than expected could cause more permanent inflationary pressures which bond markets and global fund managers are anticipating. China's economic growth will need to be watched carefully both pre and post the Winter Olympics to see how it will fair. China could abandon its zero tolerance COVID policy post the Olympics and free up the economic recovery. Emerging markets will continue to drag on global growth but could swing to support if they are provided with greater access to quality vaccines. This, along with open international boarders (Australia!), could reduce supply chain bottlenecks, inflationary pressures, and wages growth.

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Sources: CommBank Global Markets Research, RBA, Morningstar