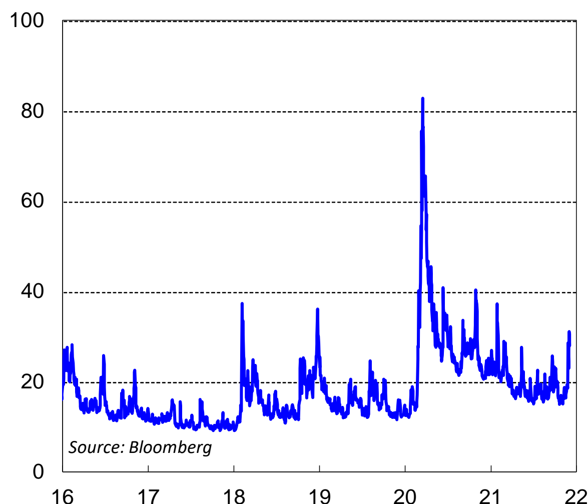
Monday, 6 December 2021

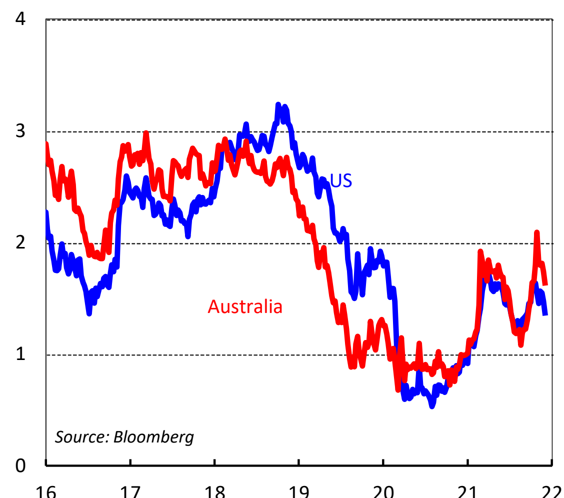
Why We Expect a Bumper 2022

Omicron has landed in Australia. NSW has recorded 25 cases as of today and there have also been cases in the NT and the ACT. State governments have tightened travel restrictions. For example, NSW has reintroduced mandatory 14-day hotel quarantine for arrivals from parts of Africa.

Fears over the Omicron variant continued to roil financial markets over the past week. While we will learn more about the variant in the coming weeks, it is still too early to assess the economic implications.

The market reaction reflects a rise in risk aversion as the new variant has elevated uncertainty over the global economic outlook. The VIX index – a volatility measure which gauges risk sentiment – rose to a 13-month high of 30.7 on Friday. The benchmark US S&P 500 index is down more than 3% from its level on 24 November, before news of the variant hit financial markets. The US 10-year bond yield fell around 25 basis points to 1.38% over the same period. The Australian 10-year yield closed at 1.61% on Friday, down around 30 basis points relative to its pre-Omicron level. Plus, the AUD/USD broke to a 13-month low of 0.6993 on Friday night. We will likely see more volatility in the weeks ahead as more news about Omicron emerges.





That said, the Australian economy has been remarkably resilient in the face of the pandemic. And we look set for a bumper year ahead.

Last week, GDP data for the September quarter showed the Delta lockdowns did less damage than was feared. Economic activity shrunk 1.9% in the quarter. This is the third largest quarterly decline on record, but it was lower than the 2.7% decline projected by consensus forecasts, and much lower than the record 6.8% plunge in the June quarter of 2020.

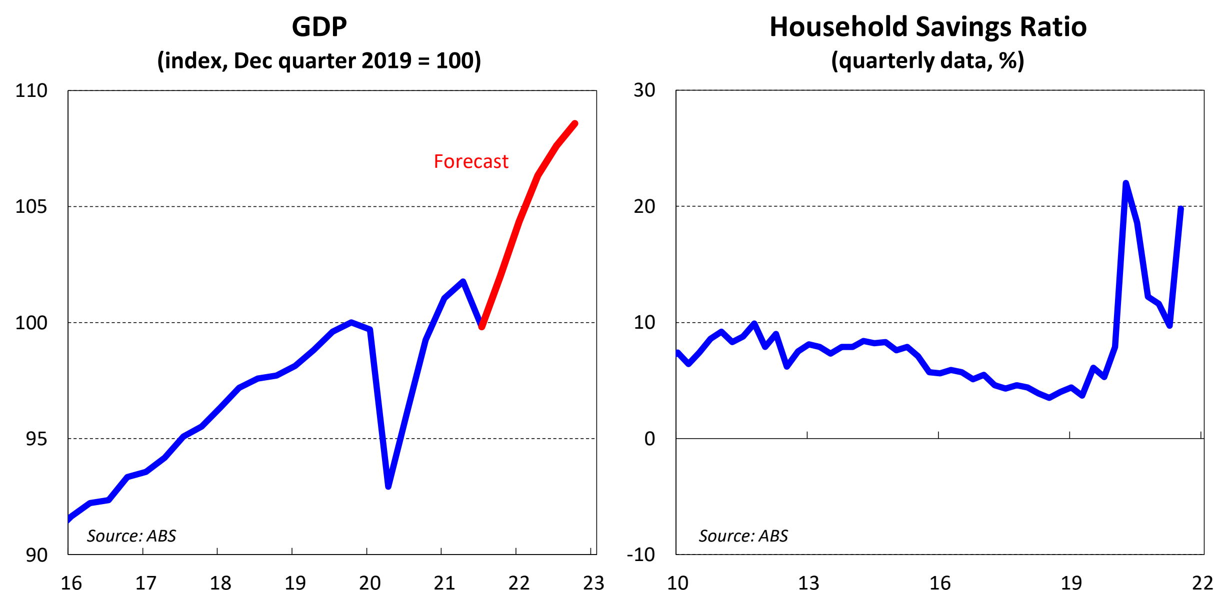
Off the back of this better-than-expected data print, and early signs of a strong rebound in the

December quarter, we have lifted our near-term forecast for GDP growth.

We now expect 2.2% growth in the December quarter (previously 1.6%). In turn, we expect 2.8% GDP growth over 2021 (previously 0.0%).

In 2022, we expect a whopping 6.4% GDP growth. This is lower than our previous forecast of 7.4% because we now expect a stronger recovery in 2021, and because the contraction driven by the Delta lockdowns was smaller than anticipated.

On this basis, GDP would be around 8.5% above its pre-COVID level at the end of 2022. This would put growth well above the 10-year average annual rate of 2.3%.



So how is the economy set for such a strong performance despite a once-in-a-century pandemic?

Much of it comes down to the extraordinary support provided by governments and the Reserve Bank. Government support payments and record low interest rates have cushioned the blow to households and businesses.

In turn, households have accumulated huge saving buffers. This is because government support has bolstered household incomes. And at the same time, people have spent less money with shops and restaurants closed, and international travel off the cards. The savings rate reached 23.6% in the June quarter of 2020 and has remained elevated since, touching 19.8% in the September quarter. Prior to the pandemic, the savings rate was hovering around 5.0%.

The savings war chest will support spending as restrictions as ease. In fact, the extent to which households drawdown these savings will be a critical determinant of GDP growth in 2022.

Another important factor supporting the recovery is the strong housing market. Dwelling prices were up a whopping 22.2% in the year to November, and they have further to run. Higher dwelling prices support household spending via the ‘wealth effect’. Effectively, homeowners feel richer when their home increases in value, and so are more willing to spend.

The outlook for business investment is also robust. There was an uplift in business spending underway ahead of the Delta lockdowns, underpinned by generous tax incentives and improving business confidence. Businesses paused investment plans during lockdown. But with restrictions lifting and government incentives in play until mid 2023, we expect the pickup in investment to resume.

But the year ahead is not without challenges.

Supply disruptions are driving material shortages and point to rising inflationary pressures. Meanwhile, restrictions on international and domestic travel mean many businesses are having difficulty sourcing labour. It will still be sometime before supply bottlenecks are resolved.

We expect the positive forces outlined above will outweigh the impact of supply challenges on GDP growth.

Of course, the pandemic continues to cloud the outlook. We cannot rule out the possibility of further lockdowns, if, for example, the Omicron variant proves resistant to current vaccines and leads to an increase in hospitalisations. It is too early to bake in any such assumptions to our forecasts, but this scenario is a clear downside risk.

Separately, the Reserve Bank (RBA) Board meets tomorrow in the last meeting until February next year. No change is expected to policy settings after the significant changes announced last month. The RBA abandoned its yield curve target and dumped forward guidance that rates would not be raised until 2024. We continue to expect that first rate hike will come in early 2023.

Now the focus has shifted to the future of quantitative easing. The Governor has flagged the bond-buying program will be reviewed in February. We expect the rate of weekly purchases will be reduced from the current pace of $4 billion in February, and that the program will conclude before the middle of 2022. Whilst our core view is that the rate of purchases will be lowered in February, we would not rule the program being scrapped entirely at this point.

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Forecasts

		2022				2023	
End Period:	**Close (3 Dec)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.10	0.10	0.25	0.50
90 Day BBSW, %	0.05	0.10	0.15	0.20	0.40	0.65	0.70
3 Year Swap, %	1.42	1.30	1.25	1.20	1.20	1.30	1.40
10 Year Bond, %	1.86	2.15	2.30	2.30	2.30	2.30	2.25
US Interest Rates:							
Fed Funds Rate, %	0.125	0.125	0.375	0.625	0.875	0.875	1.125
US 10 Year Bond, %	1.63	2.00	2.20	2.30	2.30	2.30	2.25
USD Exchange Rates:							
AUD-USD	0.7070	0.71	0.70	0.71	0.73	0.75	0.76
USD-JPY	113.15	116	116	117	117	118	118
EUR-USD	1.1294	1.10	1.08	1.09	1.10	1.11	1.12
GBP-USD	1.3285	1.36	1.37	1.38	1.38	1.37	1.37
NZD-USD	0.6790	0.67	0.66	0.67	0.69	0.70	0.71
AUD Exchange Rates:							
AUD-USD	0.7070	0.71	0.70	0.71	0.73	0.75	0.76
AUD-EUR	0.6260	0.65	0.65	0.65	0.66	0.68	0.68
AUD-JPY	79.997	82.4	81.2	83.1	85.4	88.5	89.7
AUD-GBP	0.5322	0.52	0.51	0.51	0.53	0.55	0.55
AUD-NZD	1.0412	1.06	1.06	1.06	1.06	1.07	1.07

	2019	**2020**	**2021 (f)**	**2022 (f)**
GDP, %	2.3	-0.8	2.8	6.4
CPI (Headline), %	1.8	0.9	3.0	2.5
CPI (Trimmed mean), %	1.5	1.1	2.3	2.8
Unemployment Rate, %	5.2	6.8	5.3	3.8
Wages Growth, %	2.2	1.4	2.2	2.8

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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