CIBC

In Focus

November 18, 2020

ECONOMICS

Australia Outlook: Things Are Starting to Look Up, Down Under

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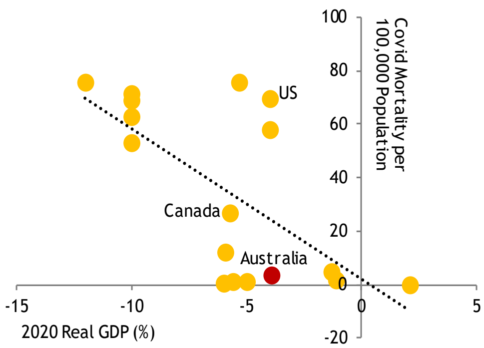
Australia has faced greater hardship than most over the past twelve months, with the global pandemic following on from the worst wildfires in living memory. However, with the Covid-19 case numbers now under far better control than the rest of the developed world as Australia heads toward its summer months, and with the state of Victoria reopening after more than four months of lockdown, economic fortunes are looking brighter in the near-term.

The Here and Now

Since the start of the pandemic, Australia has had greater success in keeping Covid-19 cases and deaths low relative to other developed economies. That has also helped to restrict the amount of economic damage, certainly relative to countries in Europe, although the contraction in 2020 GDP appears to be on par with the US and a little worse than some other Asia-Pacific nations (Chart 1).

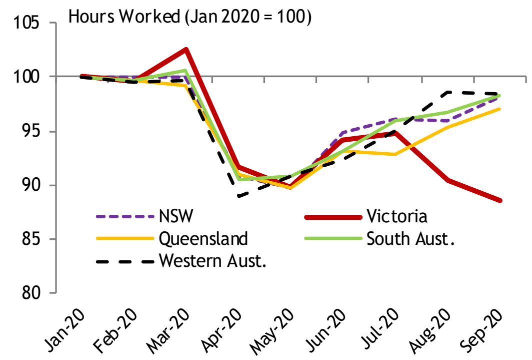
Looking forward, the success in getting case numbers under control will hopefully mean that more of the country's economy can be opened, and then kept open, towards the end of this year and into 2021. That is particularly true as the state of Victoria reopens following a strict four-month lockdown. Since July, hours worked in Victoria slumped to around 12% below their pre-pandemic level, while other states were able to get to within 2-3% of that prior level (Chart 2). If Victoria were able to get to within 5% of its pre-pandemic level, the aggregate shortfall for Australia as a whole would shrink from more than 4% to less than 3% (Chart 3). The fact that we're approaching summer in the southern

Chart 1
Where Australia Stands in Covid Cases vs Economic Impact



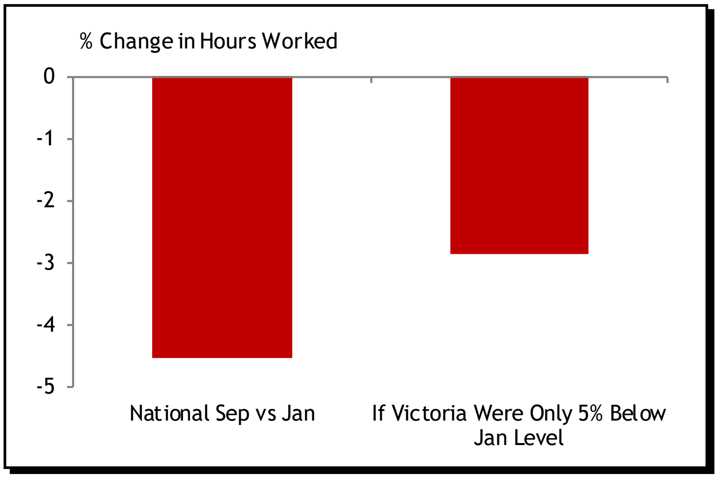
Source: Bloomberg, John Hopkins University, CIBC

Chart 2
Victoria Has Seen Big Decline in Working Hours During Lockdown



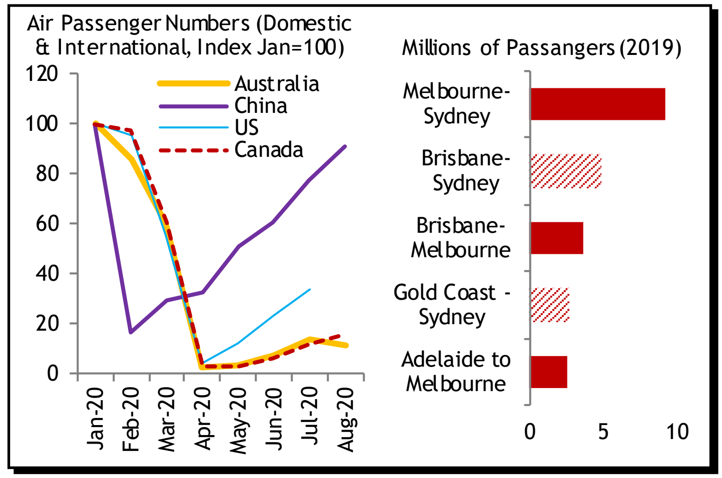
Source: ABS, CIBC

Chart 3
Victoria Weighing on National Total



Source: ABS, CIBC

Chart 5
Air Travel Flying Very Low Still (L); Top Air Routes Show Melbourne, Victoria, a Key Hub (R)



Source: Bloomberg, Statista, CIBC

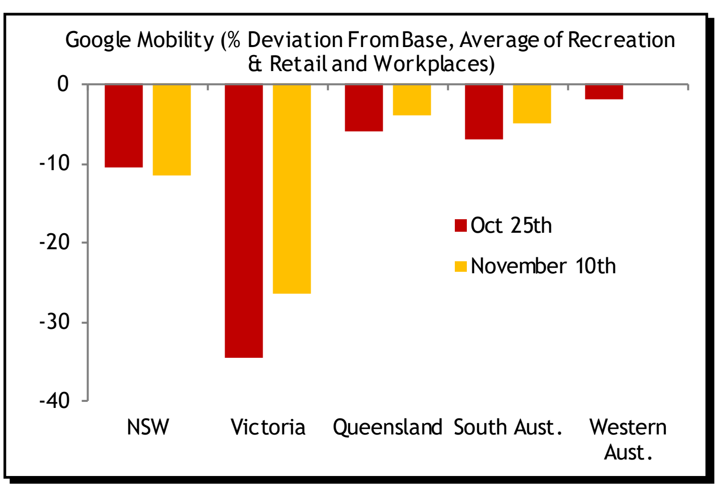
hemisphere should also help, by shifting more activity outdoors.

Thus far, the reopening is continuing, albeit with some protestors wanting it to advance at a faster pace. Judging by mobility figures from Google, and specifically those related to workplaces and retail/recreation establishments, the reopening is already slowly drawing people back to work and bolstering economic activity (Chart 4).

The reopening in Victoria would also benefit other areas of the country, by potentially, eventually, allowing domestic travel to resume. Even though Australia has had fewer Covid cases, relative to its population, than many other areas of the world, stricter distancing measures and the lockdown in Victoria have meant that air travel is on a lower flight path than even Canada and the US (Chart 5). While caution will likely continue, some pick-up in domestic travel, and maybe even travel to Asian countries with low Covid cases, could be seen even before a vaccine is widely distributed.

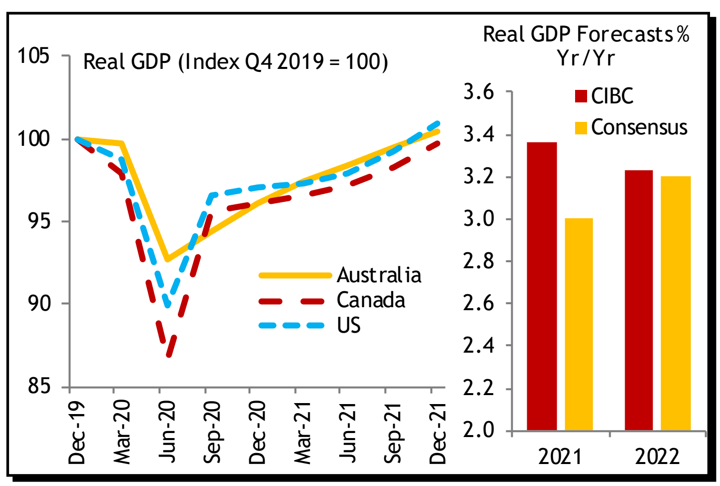
As such, the Australian economy should be poised for strong growth in Q4 this year and the first quarter of next year, which would put it ahead of other developed countries, such as Canada and the US, in terms of the recovery versus levels of activity seen in 2019 (Chart 6, left). We also expect that Australia will outpace the

Chart 4
Mobility Data Already Shows a Rebound as Lockdown Eased



Source: Google, CIBC

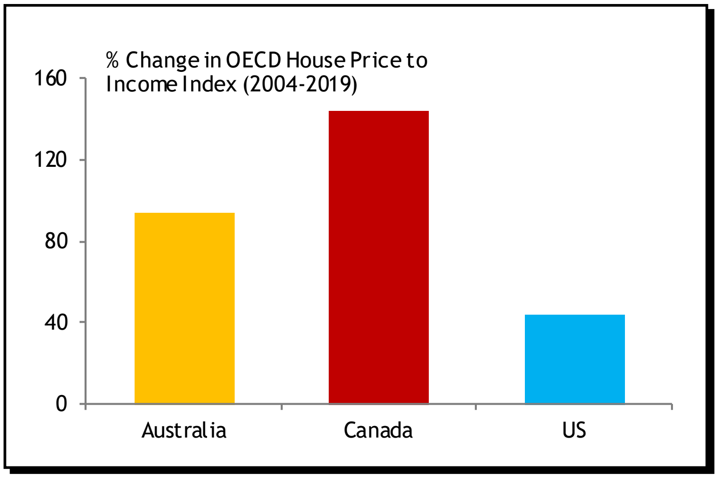
Chart 6
Australia Recovery to Briefly Overtake US (L) and Beat Consensus (R)



Source: Statistics Canada, CIBC

Chart 7

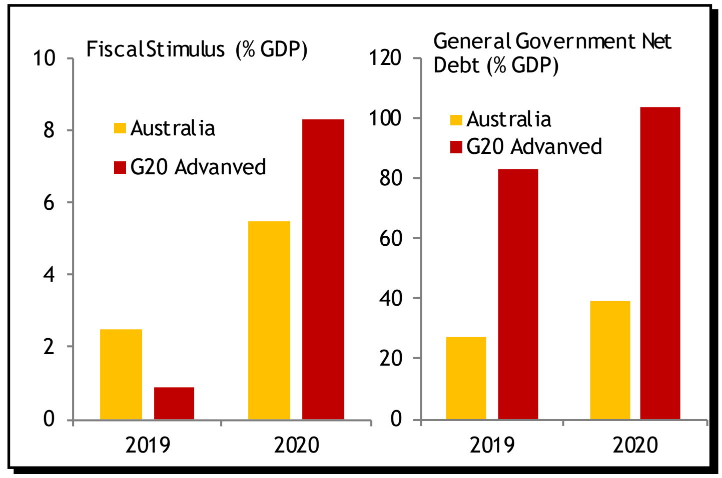
House Price Growth Hasn't Exceeded Incomes by as Much as in Canada



Source: OECD, CIBC

Chart 8

Australia Has More Room to use Fiscal Policy



Source: IMF, CIBC

current consensus view (chart 6, right), although there of course is a greater deal of uncertainty than normal over these forecasts as they rely on how successfully Covid-19 cases can be kept down. An earlier return to more "normal" levels of economic activity in the near term would also limit the extent of further growth in the past-vaccine period of the recovery.

Challenges and Opportunities

Some longer-term challenges remain for the Australia economy, however. China isn't stimulating its economy as much or in the same way as it did following the global financial crisis or its 2014 slowdown, when spending in China had a big impact on Australia's exports and economic growth in general.

There's also been concern for a number of years over escalating house prices and the potential for a correction in the market at some point. While that is clearly a risk to monitor, as house prices have indeed escalated greatly in the past couple of decades, that rise hasn't seemed as out of sync versus incomes as it has in Canada (Chart 7). That is in part because the market had already been cooling somewhat before the global pandemic struck.

Indeed, the Australian economy as a whole was slowing already in 2019, well ahead of this pandemic, and the government was using fiscal stimulus to support growth (Chart 8, left). And that is one advantage that Australia has over many other developed countries—greater room to use fiscal stimulus thanks to the much lower starting point for net debt (Chart 8, right).

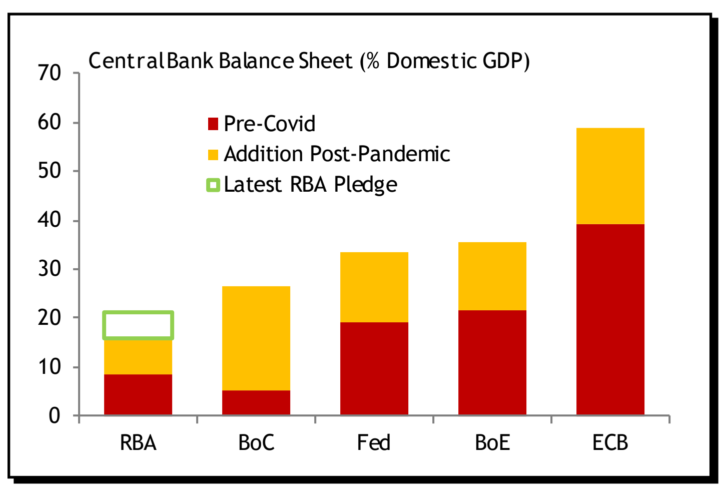
Moreover, if the rebound from Covid-19 does falter and/or virus numbers start to rise again, the Reserve Bank of Australia (RBA) also has room to act. Yes, it has already recently committed more towards its bond buying program, and unlike the US and Canada is already undertaking yield curve control. However, even adding on the additional A$100bn in asset purchases it committed to earlier this month, the size of the RBA balance sheet would remain lower relative to the size of the economy than other major central banks (Chart 9).

FX and Interest Rate Implications

The Australian dollar (AUD) has been a roughly mid-range performer relative to other major currencies this year, falling initially and sharply in response to Covid-19 fears, before recovering solidly, and extending toward the

Chart 9

RBA Also Has Room to Act



Source: Bloomberg, CIBC

year's highs in recent weeks. Headwinds for the currency, including RBA easing and China tensions, are worthy of caution, though recent indications are that those are well-priced and are thus fading in influence.

Over the medium to longer-term, assuming any further Covid outbreaks can be tamped down without a major economic disruption now that community case counts are low, we are constructive on prospects for outperformance of the AUD, against the USD and on crosses including versus CAD and JPY.

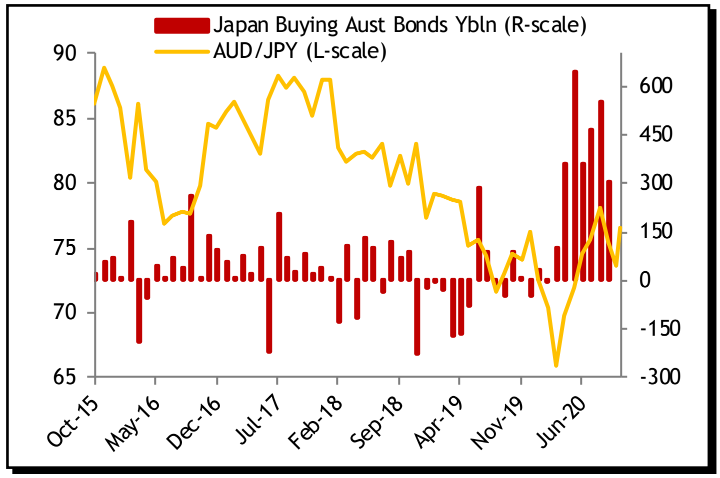
The stance of RBA monetary policy is often seen as instructive to the currency's movement. For Australia, the application of Yield Curve Control (YCC) from March, which initially targeted capping the 3-year yield at 25bps, meant Australia bought significantly fewer bonds than other major economies—both in outright and relative terms.

Also, yields further out on the curve continued to be the most generous in the G10 (Chart 10), something RBA Governor Lowe identified as attracting foreign investor inflow and keeping the currency stronger than it might otherwise have been. Japanese portfolio investors have bought record amounts of Australian bonds this year (Chart 11).

The RBA has looked to address the high yields with further easing. Earlier this month the central bank cut the cash target rate, the rate on the term funding facility (TFF), and the 3-year YCC target, all to 10bps, from previous 25bps. The bank also announced purchases of A$100bln of 5- to 10-year bonds over the next 6-months. Bond yields did shift slightly lower but will continue to trade with linkage to global yields. The spread to US bonds is presently around 3bps in the 10-year sector.

Chart 11

Japanese Purchases of Australian Bonds



Source: Bloomberg, CIBC

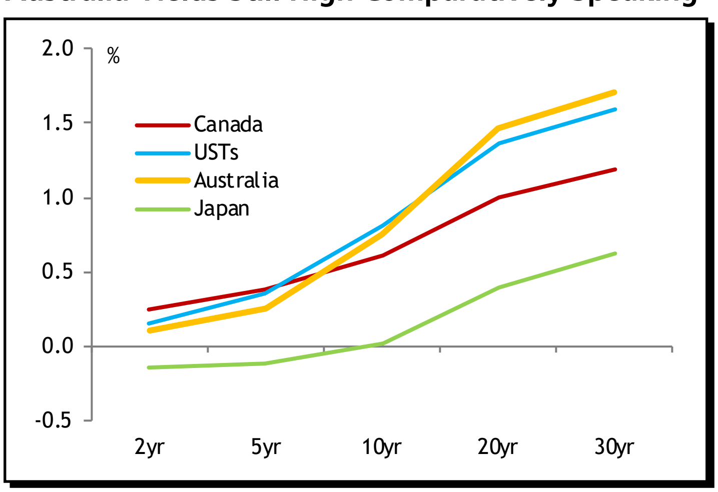
We now see the RBA on-hold for an extended period, although the initial A$100bn of bond purchases may be increased in future periods, and as discussed above the RBA has ample room to do so.

The short statement that accompanied the latest RBA decision detailed; "The combination of the RBA's bond purchases and lower interest rates across the yield curve will assist the recovery by: lowering financing costs for borrowers; contributing to a lower exchange rate than otherwise; and supporting asset prices and balance sheets."

However, in supporting the economy and assets, the attraction of the AUD to investors will be little diminished. Moreover, with the currency already still looking cheap relative to terms-of-trade (Chart 12), and unlike Canada with Australia now running a current account surplus

Chart 10

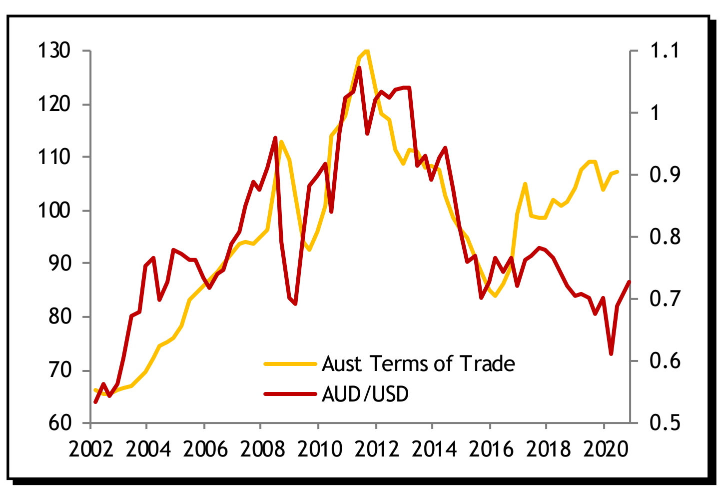
Australia Yields Still High Comparatively Speaking



Source: Bloomberg, CIBC

Chart 12

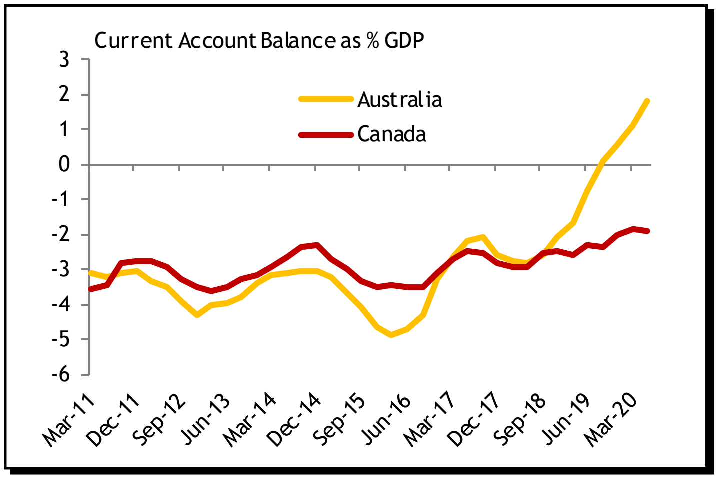
Terms-of-trade and AUD



Source: Bloomberg, CIBC

Chart 13

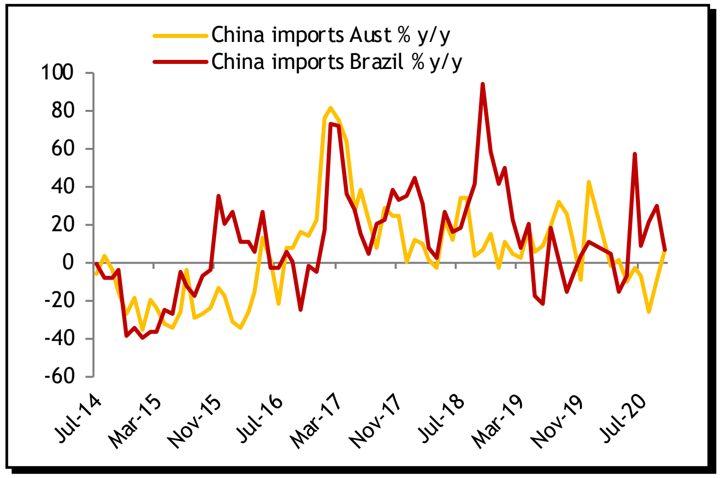
Australia Current Account Has Moved to Surplus



Source: Bloomberg, CIBC

Chart 14

China imports From Australia and Brazil



Source: IMF, CIBC

(Chart 13), resisting further strength from present levels will be difficult.

Amongst challenges for the AUD, a deterioration in trade and political tension with China is the most concerning. Chinese economic activity, including trade, has rebounded strongly, but trade with Australia has not (Chart 14). While Chinese imports from Australia did recover on a year-over-year basis in October, they are still 6.1% lower year-to-date than in the same period of 2019.

A change in the US administration may benefit Australian trade to some degree, as some of the weakness seen in recent months appears to be the result of substitution of agricultural products to satisfy the phase one trade deal. For now, Australia's trade surplus is healthy, and the lack of inward tourism or education spending is being neutralized by a lack of outbound travel. Still, this is an area of some caution and bears ongoing attention.

Looking Up, Down Under

Overall, there are reasons to be optimistic regarding the Australian economy and AUD over the medium term. Low Covid-19 case numbers relative to North America and Europe should mean an earlier rebound in economic activity. Meanwhile, strengthening global risk sentiment as vaccines begin to be rolled out, a yield advantage over other developed countries even after recent RBA action, and a modest current account surplus are reasons to be optimistic on the AUD. While some risks remain, including relations with China, the housing market and environmental concerns, for now things appear to be looking up, down under.

Table 1

FX Forecast

	Curr	4Q 2020	2Q 2021	4Q 2021	2Q 2022	4Q 2022
AUD/USD	0.73	0.75	0.77	0.78	0.79	0.81
Aust OCR	0.1	0.1	0.1	0.1	0.1	0.1
Aust 10yr	0.91	0.8	0.85	0.95	1.1	1.2

Source: CIBC

Table 2

Global Growth

Real GDP Growth, Y/Y % Change

	2017A	2018A	2019A	2020F	2021F	2022F
World*	3.8	3.5	2.8	-3.4	5.1	4.6
US	2.3	3.0	2.2	-3.7	3.4	4.3
Canada	3.2	2.0	1.7	-5.5	4.1	4.8
Euroland	2.4	1.9	1.3	-7.0	4.5	3.5
UK	1.7	1.3	1.3	-10.7	6.1	5.5
Australia	2.4	2.8	1.8	-3.5	3.4	3.2
Japan	2.2	0.3	0.7	-5.5	3.1	2.2
China	6.9	6.7	6.1	1.6	8.8	5.9

Source: CIBC