Quarterly review & Outlook Q1 2021

BlackRock

Produced by BlackRock Australia Fixed Income

Economic Outlook Q1

As a COVID-19 vaccine finally enters the realm of reality, Australian economic sentiment shifts to a more optimistic outlook for 2021. The world's first vaccine was administered on December 8th in the UK, and with Australia finalising their vaccination rollout strategy (targeting late February), 2021 is poised to deliver stronger growth and employment underwritten by ultra-low interest rates.

We expect the RBA to continue to work very closely with the Federal Government, utilising fiscal policy and monetary policy to guide Australia through the recovery phase. The RBA expects to keep the official cash rate at 0.10% until 2023 and market pricing supports this stance. Until there is substantial progress made to reduce the unemployment rate and lift the inflation rate, the RBA will be content to let the economy run 'hot'. The first step towards monetary policy normalisation will be a tapering of QE and it is likely, in our view, that additional QE will be required in 2021 to achieve the RBA's key policy objectives.

Household consumption is forecast to improve, based on the government's decision to bring forward tax cuts in the budget. This will be supportive for GDP in H121 assuming a decent portion of the various fiscal support packages are now spent rather than saved. Complicating matters is the ongoing and worsening trade dispute with China which has already cost around 0.3% of GDP. We don't expect to see an improvement in the trade relationship during 2021. Business investment is expected to remain soft through the year.

There are clear risks ahead that need to be carefully managed. For example, the winding down of JobKeeper in late March as well as several other government support programs. As with previous recessions, the unemployment rate is likely to decline much more slowly than it rose. Wage growth is currently at a multi-decade low and that does not bode well for lifting the inflation rate. The speed of the Covid-19 vaccine roll out will also dictate the willingness and ability for countries to re-open their international borders.

For interest rate markets, this means cash and bond yields will remain at very low levels for an extended period. We expect global central banks will be carefully monitoring financial conditions to ensure they remain loose and therefore be ever present buyers in bond markets.

Credit Outlook Q1

Australian credit spreads continued to narrow in Q4, reaching their tightest levels since 2006. The risk on sentiment over the quarter and the delivery of the RBA's cash rate cut to 0.10% was also supportive as investors sought out higher yielding assets. This was especially observable in credit as BBB and A rated corporates significantly outperformed AAA and AA rated names.

We are still relatively constructive on credit as a whole. Credit spreads will remain well very supported and have the potential to tighten a little from current levels given the supportive global central bank policy. The Fed and ECB will remain powerful forces in corporate bond markets ensuring backstop support and ultra-low borrowing costs for issuers. This activity will continue to force investors to look further down the rating curve and take on more credit duration risk in a never ending hunt for incremental yield. Now that the credit beta trade has largely run its course, we expect investors to focus more keenly on more granular sector specific trades.

The main risk to our view on spreads remains the roll-out and the pending success of the vaccine to help stabilize the global economy, allowing for a proper recovery to take place. There is no prospect of monetary or fiscal stimulus being withdrawn anytime soon.

Currency Outlook Q1

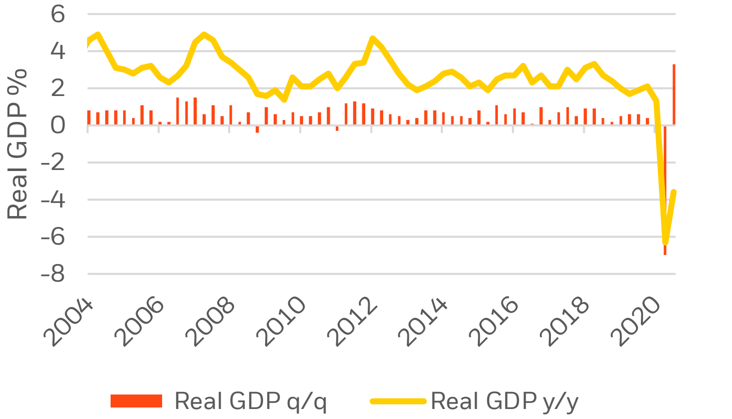
Over Q4, the AUD rallied from US 0.72c to US 0.77c by year end. US dollar weakness has been a big contributor to the rapid AUD rise, as well as the general 'risk on' market sentiment. Locally, the recent surge in the iron ore price which is up by almost 30% since the start of December, has also been a significant factor in the rally of the AUD. The fundamentals for the AUD look relatively positive with a strong terms of trade outlook and the potential for further US dollar weakness in 2021. Obviously, commodity price weakness and relative global interest rate attractiveness could pressure the AUD lower. As mentioned, we are not overly optimistic on an improvement in China trade relations as the key risk is supply restrictions being expanded to include iron ore. We expect the AUD to trade to US 0.80c during H121 with further upside potential to the mid-80c level assuming 'risk on' and 'reflation' remain the dominant market themes.

GDP – Q3 2020

▲ **QoQ GDP expanded by 3.3%**. This was **0.8% higher than consensus,** taking Australia out of recession.
▲ **YoY GDP improved 2.5%** from **-6.3%** to **-3.8%.**

The 2020 recession ended with stronger than expected growth, as GDP rose by 3.3% in Q3, following a historic 7% fall in Q2. The improvement in growth came from continued fiscal support with ~A$63 billion delivered to businesses and households in Q3. The majority of this came from JobKeeper (A$36bn). This contributed strongly to household consumption, up 7.9%q/q (from -12.5% in Q2) and accounted for the majority of the upside surprise. Importantly the savings rate remained elevated (+18.9%) in Q3, providing households with the scope to draw down further on savings to support spending over the next year.

Australia Real GDP



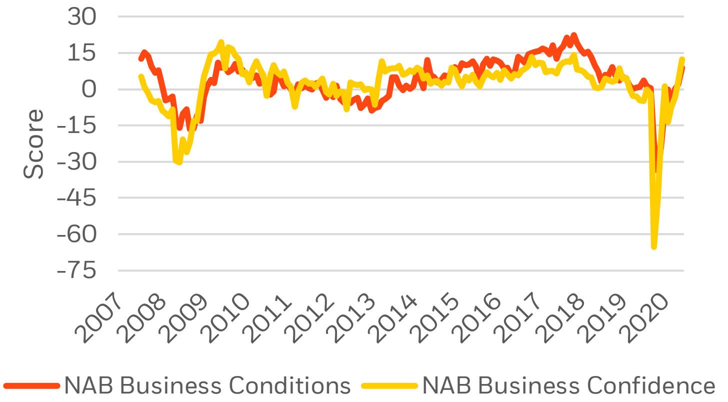
Source: ABS, Bloomberg, BlackRock as of 12/01/2021

Business Conditions – Nov. 2020

▲ **Conditions jumped 7pts** from +2 (October) to +9 index points, the **highest reading since March 2019.**
▲ **Confidence improved by 9pts** from +3 (October) to +12 index points, its **fourth consecutive monthly gain.**

Business conditions and confidence continue to improve, as both are now above average and have returned to levels greater than pre-COVID. The boost in conditions was driven by trading (+17pts) and profitability (+15pts), both up 10pts and well above average levels. The employment index edged higher but remains negative (-5pts). Confidence rose as settings normalised with the easing of government restrictions and were further boosted by positive vaccine news. All industries except construction and mining saw gains, with the largest gains coming in retail and wholesale.

NAB Business Survey



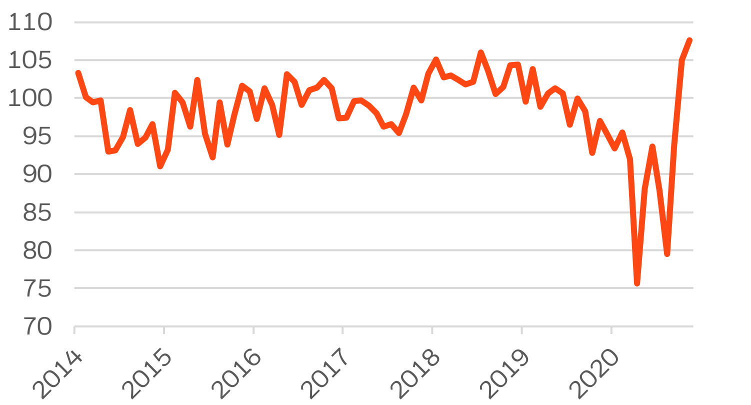
Source: NAB, BlackRock as of 12/01/2021

Consumer Confidence – Dec.2020

▲ The Westpac-Melbourne Institute Index of Consumer Sentiment **lifted 4.1% from 105 to 112** in December.

The surge in consumer confidence continues with the index now 48% above the low in April – marking a 10-year high - with the index at its highest level since October 2010. Within only eight months, the evidence seems clear that sentiment has fully recovered from the COVID-19 recession as the reading is a solid 10.6pts above the long-run average level of 101.4 and 16.5pts higher than the pre-pandemic level of 97.8. Households are clearly not worried about events overseas, but are instead focusing on the stronger than expected Australian economic recovery, as nearly half of the respondents viewed news on the economy as favourable, compared to less than one-fifth last quarter.

Westpac Consumer Confidence



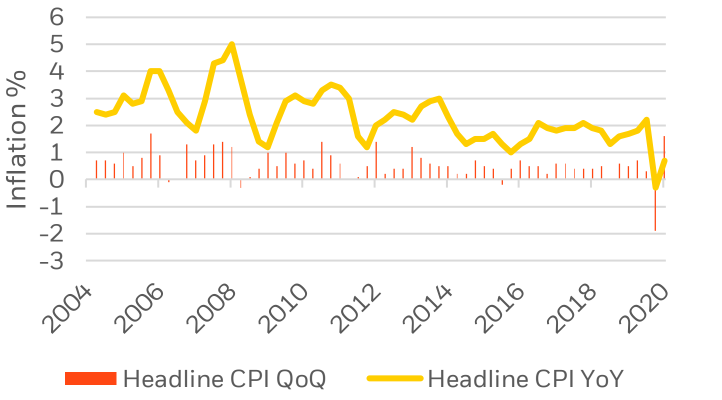
Source: Westpac, BlackRock as of 12/01/2021

Inflation – Q3 2020

▲ Headline **CPI increased** by 1.6% QoQ. This was 0.1% better than market consensus.
▲ Annual inflation **rose 1%** from to -0.3% to **0.7% YoY**.

The September quarter CPI rebounded +1.6%, the largest rise since 2006, yet only partially offset Q2's -1.9% fall. The jump came due to the ending of free child care in all states, except Victoria, adding 0.9% to CPI. However, this left child care still 26% below the pre–COVID level, meaning it will be contributing to a further rise in in Q4 CPI. Importantly, the volatility of the change in inflation overstates the reality of the 'true' inflation impulse as the most significant driver of the fall and the rise was the Government's policy decision to provide free child care during the first wave of the COVID-19 pandemic.

Headline CPI



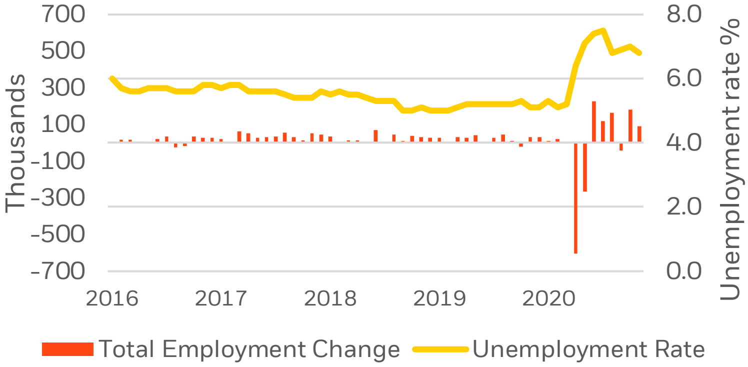
Source: ABS, BlackRock as of 12/01/2021

Labour Market – November 2020

- ▲ The employment change saw **90,000 jobs created**. This was 50,000 more than forecasted.
- ▼ The **unemployment rate** fell from 7% to **6.8%.**

Australia's November labour force survey was strong, with 90,000 new jobs created and the unemployment rate falling 0.2% to 6.8%. The participation rate also climbed, moving 0.2% higher at 66.1% and is higher than the 2019 average indicating labour supply is now tracking above pre-COVID levels (excluding for population growth changes). The easing of restrictions in Victoria was the primary catalyst behind the strong numbers gaining +74,000 jobs, well ahead of the other states and territories. The underemployment rate also improved, falling a further 1% to 9.4%, and is now 4.4% below April's peak.

Monthly Employment Change & Unemployment Rate



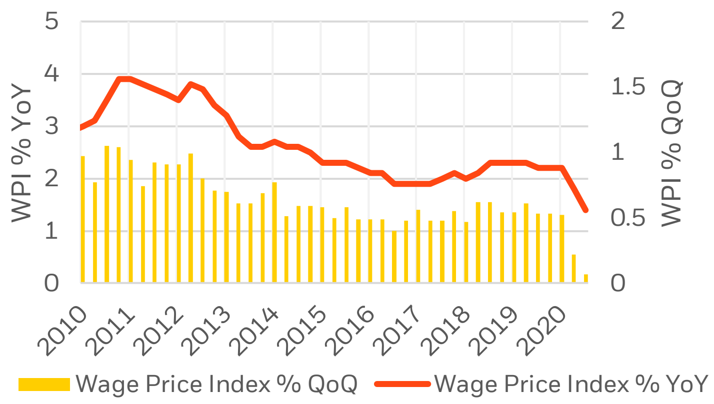
Source: ABS, Bloomberg, BlackRock as of 12/01/2021

Wages Price Index – Q3 2020

- ▲ Wages **increased over Q3 by 0.1%**
- ▲ Wage growth **over the year increased by 1.4%**

The wage gain over the third quarter of the year was 0.1% below expectations at 0.1%. This sent the annual rate down 0.4% to 1.4%. This is now the slowest pace of growth since the series began in 1997. The RBA has stated that to generate CPI inflation within its target band, wages must grow at a 3½-4%y/y. We have not seen wage growth that strong since the height of the mining boom in 2008. Andrew Tomadini, Head of Price Statistics at the ABS said "*The September quarter is generally a quarter of solid wage growth, however, the impacts of the COVID-19 pandemic contributed to a subdued rate of wage growth in September quarter 2020*".

Wage Price Index



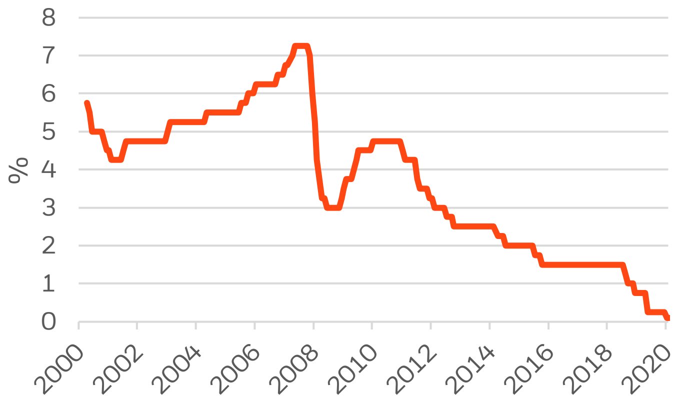
Source: ABS, Bloomberg, BlackRock as of 12/01/2021

RBA Policy Rate

- ▼ The RBA **reduced the cash rate target over the quarter from 0.25% to 0.1%.** The Bank also reduced the yield on the 3-year yield curve control target to 0.10%, and the interest rate on new TFF drawings to 0.10%. In addition, the Bank also reduced the interest rate on Exchange Settlement Balances from 0.1% to 0.0%.

Over the quarter the RBA delivered the largest and most broad ranging monetary stimulus program ever announced by the Bank. In addition to cutting rates across the board, the Bank introduced a A$100bn QE program to purchase Government and Semi-Government bonds targeting maturities of around 5 to 10 years over the next six months. The board has also set the bar materially higher for raising rates and will require gains in wage growth, employment and inflation before considering raising rates.

RBA Cash Rate



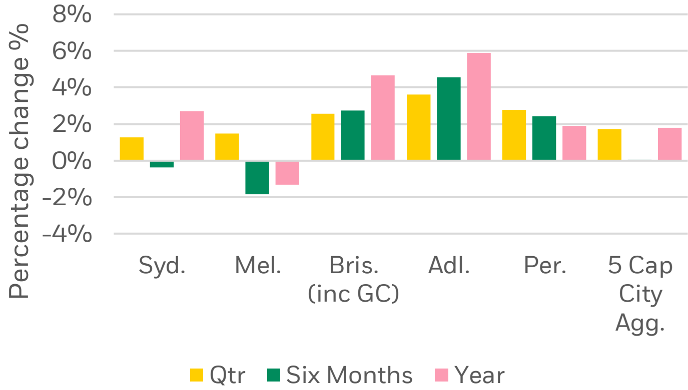
Source: RBA, Bloomberg, BlackRock as of 12/01/2021

House Prices – Q4 2020

- ▲ The CoreLogic home value index **rose 1.8% in Q4**
- ▲ Over the year, the CoreLogic home value index **increased by 2%**

After five consecutive months of price declines, Q4 saw the CoreLogic home value index rise three months in a row with all capital cities seeing growth. Prices have been buoyed by the raft of direct support from the Government (including mortgage deferral, stamp duty and first home owner concessions, HomeBuilder) and indirect assistance (notably JobKeeper, one off payments and access to superannuation). At year end, Darwin house prices performed the best (+11.9%), followed by ACT and Hobart, rising 8.5% and 7.7% respectively. Of the five capital cities, Adelaide performed the best, lifting +5.9%.

Q4 Core Logic - House Price Change



Source: CoreLogic, Bloomberg, BlackRock as of 12/01/2021

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