EL&C Baillieu Strategy Research
20 March 2020

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Australian Strategy Insight

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Investment Strategy

RBA firing blanks and out of bullets; Treasury the cavalry

The Reserve Bank of Australia's (RBA) March 2020 50bps of rate cuts and 0.25% target yield for the 3-year Commonwealth bond has been overshadowed by rate cuts of 65-150bps and quantitative easing (QE) programs of 3.3-8.5% of GDP by the world's major central banks.

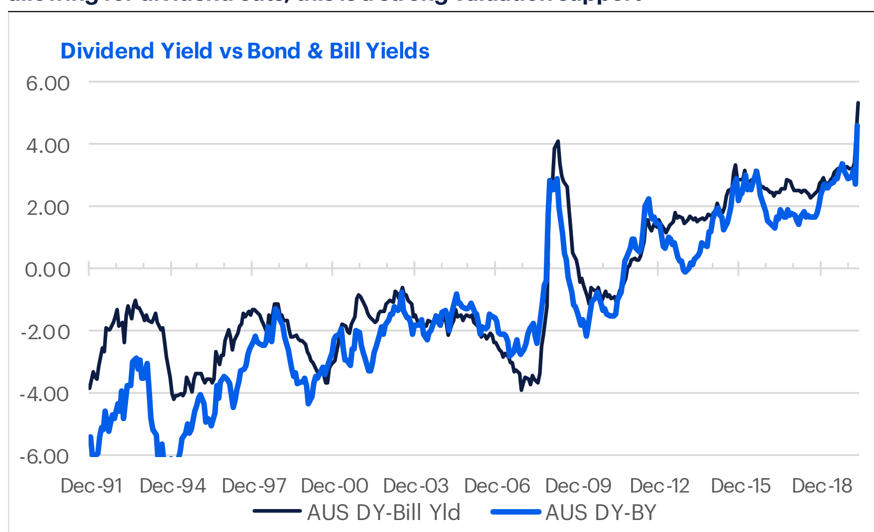
This new easing by the RBA follows a 75bps easing cycle in June-October 2019, which was supported by both an easing of standards by APRA and the Federal Government's tax rebate. That stimulus has proven ineffective even before the COVID-19 shock, with seven of nine key indicators weak and private domestic demand flat year-on-year.

We see little prospect for this new monetary easing to be more effective, and so see the burden of policy now firmly on fiscal support and stimulus. In our view, an effective counterattack in the war on COVID-19 entails five factors:

i) **containment measures** limiting the economic impact of COVID-19 to 15-20% of GDP for 2-3 months, or 3-4% of annual GDP;
ii) **monetary support and stimulus** – in the RBA's case this should primarily be support, ensuring liquidity for markets and small businesses;
iii) **fiscal support** offsetting most of the 3-4% hit to GDP from COVID-19, minimising job losses and business collapses;
iv) **fiscal stimulus** of 1-2% of GDP as the economy stabilises – this should help unleash pent-up demand; and
v) **the oil price windfall** of ~1% of GDP.

Market implications: In the short term, we are watching for a slowdown in new cases in the West to turn positive on equity markets. Vaccine or treatment breakthroughs are other possible catalysts. For longer-term investors who can look beyond current volatility, the gross dividend yield-interest rate gap of 4-5% p.a., even assuming a 25% dividend cut, extreme policy support and an eventual recovery, offers material upside. Well-positioned businesses with strong balance sheets should emerge from this shock in strong shape.

Fig.1: Australia's dividend yield-interest rate gap is a record 4.6-5.3% - even allowing for dividend cuts, this is a strong valuation support



Source: Datastream, EL&C Baillieu

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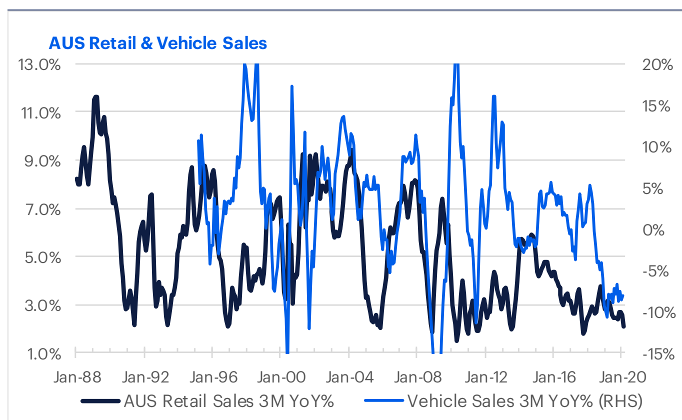
- The RBA's March 3rd 25bp emergency rate cut was quickly overshadowed by 50-150bps of rate cuts and vastly expanded QE programs by the world's major central banks. In that context it was hoped that yesterday's (Thursday March 19th) inter-meeting announcement would mean the RBA had, to paraphrase its own words, 'gone early, gone hard'. Instead, the RBA announced a further 25bp rate cut to the 0.25% lower bound previously identified by Governor Philip Lowe and a target 0.25% yield for the 3-year Government bond; deciding against a QE program, let alone the purchase of private assets. In this note, we analyse the tepid impact of the RBA's 75bps easing cycle of June-to-October-2019, the likely failure of this new easing cycle and the necessity of substantial fiscal support and stimulus.

RBA firing blanks: The 75bps easing cycle to 0.75% in June-October 2019

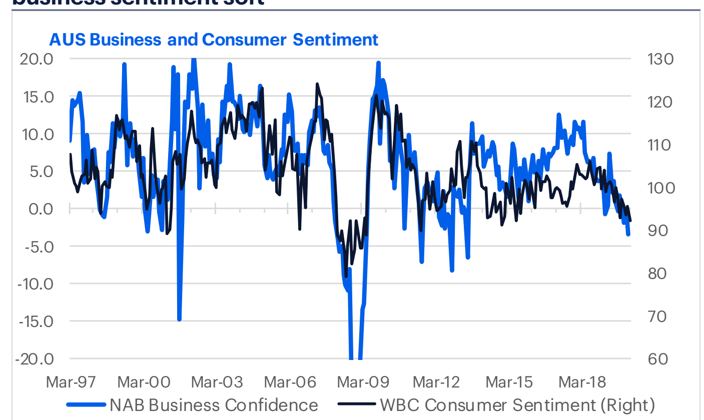
- To recap, the RBA resumed its easing cycle after a three-year hiatus immediately after the May 2019 federal election. At the same time, APRA eased some of its prudential lending controls and the Federal Government legislated passage of its low and middle income tax offset (LMITO).
- The immediate impact of this co-ordinated stimulus was a bounce in business confidence (which proved temporary), a decline in consumer confidence and a turn in the established property market (which has so far continued).
- Since then, however, most lead indicators of the economy have failed to improve, with seven of our nine "canary" indicators continuing to deteriorate or moving sideways, and just two improving. Consumer-oriented indicators remain broadly soft:
- **Vehicle sales:** down 8.2% YoY (Feb) and down 8.1% YoY on a three-month moving average trend basis (Figure 2);
- **Retail sales:** up 0.4% MoM and just 1.7% YoY (Feb), and up a modest 2.0% YoY on a trend basis (Figure 2). February sales felt some impact from COVID-19.
- **Consumer confidence:** up 2.3% MoM as the bushfires abated in February, but down 8.0% YoY and down 7.7% YoY on a trend basis (Figure 3). Confidence fell 3.8% MoM and 7.0% YoY in March, as the impact of COVID-19 began to be felt.
- **Tourist arrivals and returns:** down 2.0% YoY and up 1.5% YoY respectively in January, with trend growth a little better at 0.8% and 3.0% YoY respectively (Figure 4). 2019 arrivals growth (2.6% YoY) was an eight-year low and returns growth (2.5% YoY) a 16-year low.
- **ANZ Job Ads:** down 10.2% YoY in February and down 13.7% YoY on a trend basis, consistent with the slowdown in hours worked to 1.2% YoY (Figure 5).

Fig.2: Vehicle sales -8.1% YoY and retail sales up just 2.0% YoY



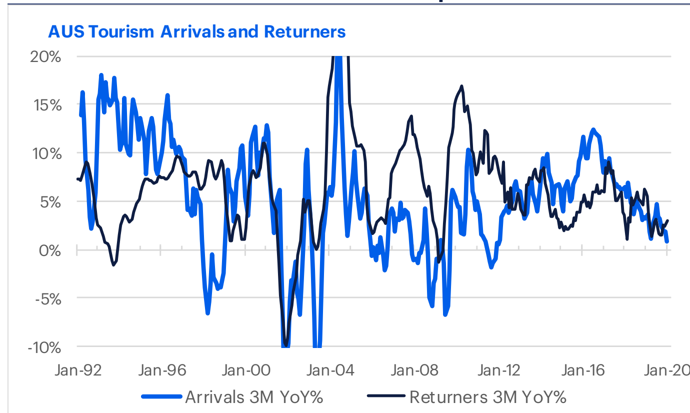
Source: ABS, Datastream, EL&C Baillieu

Fig.3: Consumer confidence is weak, down 7.7% YoY, and business sentiment soft



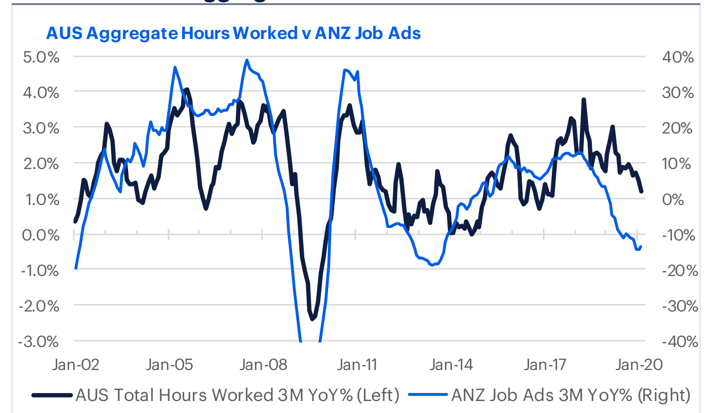
Source: Datastream, EL&C Baillieu

Fig.4: Tourist arrivals have already slowed to 0.8% YoY and returns to 3.0% YoY – both will now collapse



Source: Datastream, EL&C Baillieu

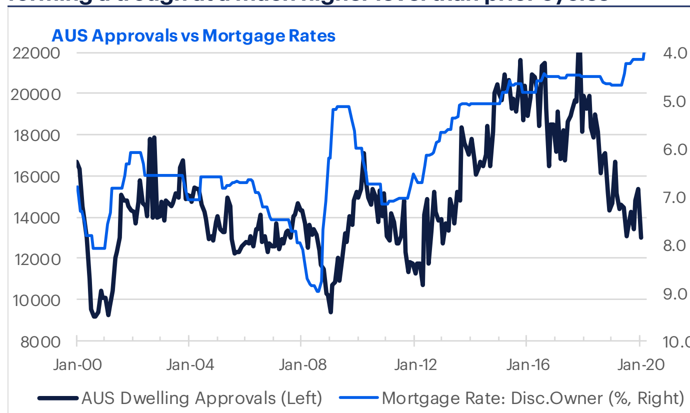
Fig.5: ANZ Job Ads are trending down 13.7% YoY, consistent with the slowdown in aggregate hours to 1.2% YoY



Source: Datastream, EIA, EL&C Baillieu

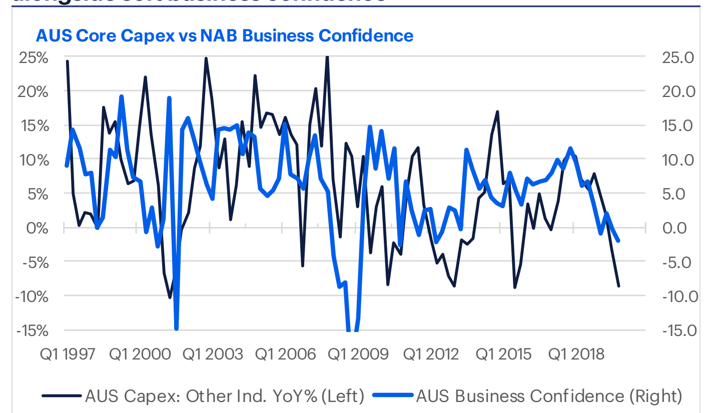
- Housing-related indicators have been more positive, though the picture is mixed:
  - **Dwelling approvals:** notoriously volatile, these fell to a new cycle low in January, down 11.3% YoY. The more accurate picture is an easing rate of trend decline of just 2.3% YoY, an improvement from the dramatic declines of mid-2019 (Figure 6).
  - **Home prices (CoreLogic):** up 1.2% MoM and 7.2% YoY in February, and up 5.3% YoY on a trend basis. Asset prices have been where the RBA's easing has been most effective, assisted by APRA's easing of macro-prudential controls and the Coalition's election victory protecting negative gearing.
  - **Housing finance** has improved along with home prices.
- **Business indicators, after an initial positive reaction to the stimulus, have deteriorated:**
  - **NAB Business Confidence:** down to -4, a 7-year low, 1.3 standard deviations below the long-term average +6 (Figure 3). Other business activity measures are weak – 0.6-1.0 standard deviations below average.
  - **Capital spending:** quarterly private capex survey fell 2.8% QoQ and 5.8% YoY in 4Q19 (Figure 7). Whilst capex plans point to an improvement, the NAB Business Confidence is a far better indicator and, consistent with that, capital goods imports fell 12.5% YoY in January and 4.4% YoY on a trend basis.

Fig.6: Dwelling approvals, down just 2.3% YoY, appear to be forming a trough at a much higher level than prior cycles



Source: Datastream, EL&C Baillieu

Fig.7: Private capex, down 5.8% YoY in 4Q19, has weakened alongside soft business confidence



Source: Datastream, EIA, EL&C Baillieu

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- Overall, the RBA, APRA and Treasury policy stimulus has had little effect on weak lead indicators, which have not improved since mid-2019. In line with this, real private domestic demand rose just 0.1% in 2H19 and 0.1% YoY!

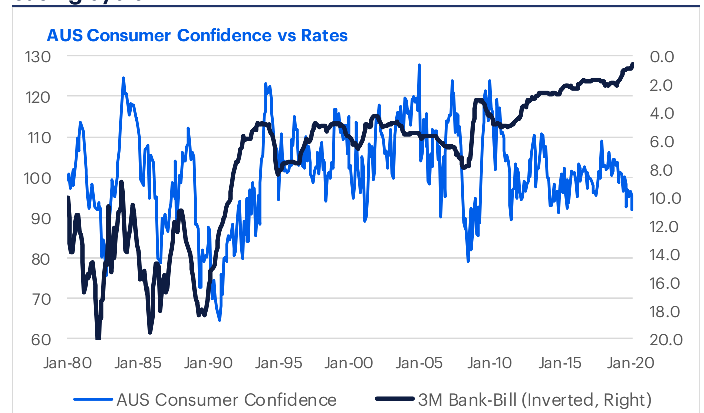
Why have RBA rate cuts and the broader stimulus proven ineffective?

- The lack of policy traction is attributable to four factors:
  - **Timing – monetary policy works with long and variable lags:** the RBA has referred to this explanation for the weak response, but, in our view, the unprecedented declines in consumer and business confidence in reaction to the rate cuts suggest this is far more than a timing problem (Figure 9).
  - **A lack of firepower:** RBA easing cycles in the past 25 years have ranged from 200-425bps in size (Figure 8). So, at 75bps (now 125bps), with ~57bps passed on to mortgagees (now ~82bps), this easing cycle has been by far the smallest.
  - **Poor consumer fundamentals:** the household sector is under unusual pressure from six headwinds: i) low wage growth – sluggish wages growth of 2.2% YoY, or 0.4% YoY in real terms; ii) record debt at 189% of disposable income, with RBA rate cuts now exhausted; iii) rising debt burden with the ongoing shift from interest-only to principal and interest mortgages; iv) falling mixed and interest income, reflecting the housing decline on tradesmen incomes, the drought on farm incomes and record low rates; v) tax bracket creep, given no adjustment to tax brackets for a decade, despite the LMITO a one-off relief; and vi) a low saving rate of ~3%, providing no cushion against an uncertain outlook.
  - **Mixed signals:** the RBA has been consistently optimistic on Australia's growth outlook, with projections of 2.8%-3.5% YoY growth, far above 2019's 1.8% YoY. Rate cuts to emergency levels seemed at odds with this rhetoric, inducing a record negative response to the RBA's rate cuts by consumers and businesses (Figure 9).

Fig.8: This RBA easing cycle – 75bps and now 125bps – is far smaller than the 200-425bps range of the past 25 years

Source: Datastream, EL&C Baillieu

Fig.9: Consumer confidence has fallen a record 9.2% in this RBA easing cycle



Source: Datastream, EIA, EL&C Baillieu

With the RBA firing its last bullets in March 2020, we expect this easing to also be ineffective

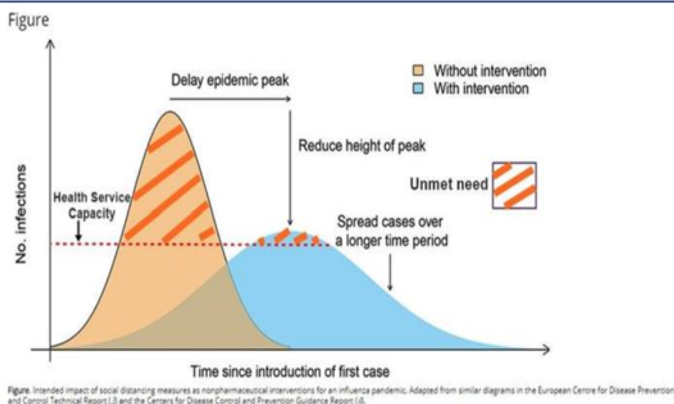
- With this backdrop, we wonder why the RBA would expect another round of underwhelming policy stimulus to be more effective. Nonetheless, in response to COVID-19 the RBA's March 2020 easing has provided 50bps of rate cuts and a three-year yield curve control measure. Whilst the first 25bp rate cut by the RBA was fully passed on by the banks, none of the second cut has been passed on to variable mortgage rates by the Commonwealth Bank of Australia (CBA).

- With confidence already weak (Figure 9) and COVID-19-related panic buying, we again expect this very modest 25bps cut in mortgage rates to be saved (despite efforts to reduce repayments by CBA).
- Moreover, the situation for many on fixed income has deteriorated rapidly. The yield on a $1 million portfolio distributed evenly between cash, bonds and equities has fallen from almost 5% a decade ago and 3% two years ago to less than 2% currently, a record low. So, a $48,000 income on this nest egg has fallen progressively to ~$19,000, a decline of 60%. If these consumers are forced to economise, the net impact of this easing cycle may be negative!
- We are also sceptical of the effectiveness of any Australian yield curve control. The cash rate, which drives most borrowing, is at effective zero. The yield curve is not unusually steep, with the 10-year-3-month bill yield curve just 10bps below average at 0.6%. It is difficult to see this going materially lower. At the same time Australia has announced this tepid measure, the Federal Reserve, European Central Bank and Bank of England have announced QE programs encompassing government bonds and private assets of 3.3-8.5% of GDP.
- With the RBA out of bullets, we may see a negative reaction from asset markets. We would not be surprised to see a belated QE program from the RBA to help weaken the Australian dollar, in response to these more aggressive actions by other central banks.
- Finally, we do not expect a 25bps change to mortgage rates to materially impact the housing outlook. With approvals trending at a ~172k annual rate – less than 5% below our estimate of underlying demand, after a period of six years above this level – we see little pent-up demand, particularly back at record bubble prices (Figure 8).

Is Treasury the cavalry?

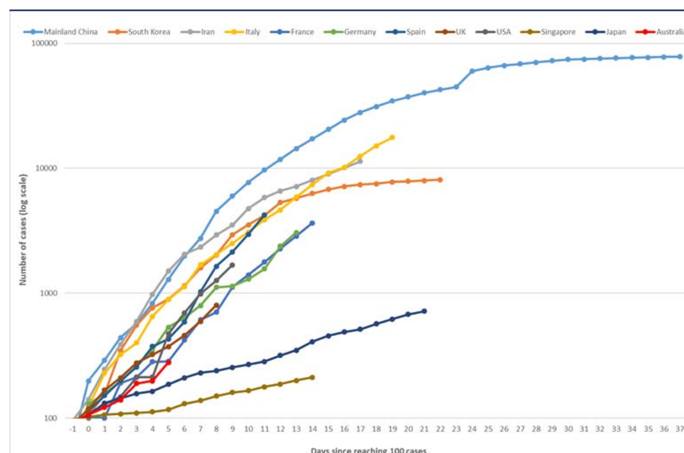
- The virtual exhaustion of RBA policy capacity leaves the burden for policy support on fiscal policy. The dimension of the needed fiscal stimulus will be determined by the duration and severity of measures to control COVID-19. The Federal Government appears to be pursuing a containment strategy to flatten the peak, rather than the aggressive lockdown policies adopted in East Asia (Figure 10). Unfortunately, at this point Australia's containment strategy seems to be following the path of Western Europe, suggesting a far higher level of cases and deaths before eventually imposing an East Asia-style lockdown, as now seen in Italy, Spain and France (Figure 11).

Fig.10: Australia's COVID-19 containment strategy seeks to flatten the peak of new cases



Source: Commonwealth of Australia

Fig.11: COVID-19 case development by country- Australia appears to be tracking Western Europe



Source: ECDC, EL&C Baillieu

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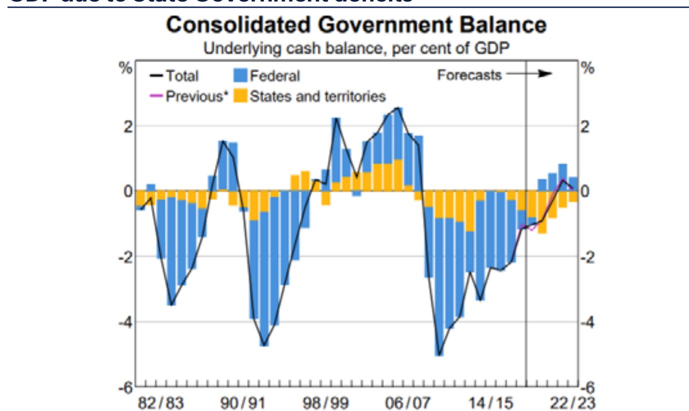
- If we assume most of March, all of April and part of May become "lost" months, as containment measures, panic consumer behaviour and business cutbacks drive a sharp downturn, at a minimum, Federal and Reserve Bank policy will be needed for 2-3 months to minimise business collapses and job losses. We assume about 15-20% of GDP is "lost" per month – large parts to almost all of retail, tourism, transport, international education, recreation, manufacturing and some deferred construction and professional services. This amounts to about 1.2% of annual GDP per month, or about $25 billion. So, the containment package needs to offset the risk of widespread layoffs and business collapses in these sectors through a combination of income and business support, tax and fee deferrals and suspensions of debt repayments. This would mean a 2 to 3-month downturn requires fiscal support of ~3-4% of annual GDP.
- Beyond that, fiscal policy needs to provide stimulus for a recovery. Given the above analysis and somewhat similar structures of Western economies, we are not surprised with Canada's fiscal stimulus of ~4% of GDP, New Zealand's 4% of GDP or the US' proposed US$1 trillion package, or about 5% of GDP. For Australia, this would amount to about A$80-100 billion (4-5% of GDP), far more than the current $17.6-$20.6 billion, or 0.9-1.0% of GDP. A low-cost option for the Federal Government would be to provide a ~six-month holiday on employer super-guarantee contributions, equivalent to ~A$45-50 billion, or 2.25-2.5% of GDP. The Federal Government's forthcoming fiscal response needs to be measured against these international benchmarks.
- As we noted in our recent piece on the oil price collapse, the lower oil price windfall should assist, adding a further 1% or so to real spending power.

What does this mean for the Budget?

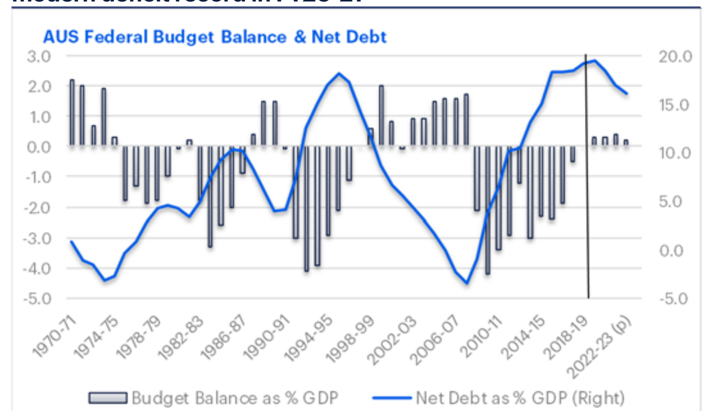
- Of course, these actions have significant implications for Australia's budget deficit. Even before COVID-19, Australia's sluggish economy was imperilling the forecast return to surplus, with the Federal budget balance over the year to January a small deficit of about $5 billion, tracking below the mid-year update target surplus of $5 billion. This somewhat understates Australia's deficit starting point, with record government infrastructure spending by State Governments partly funded by debt. An RBA Monetary Policy Statement puts the consolidated deficit at ~1-2% of GDP, before the recent fiscal slippage (Figure 12).
- So the economic downturn, plus a fiscal support package of 3-4% of GDP and a fiscal stimulus package of ~1-2% of GDP could easily see Australia's federal deficit jump to ~5-7% of GDP, larger than the 4-5% deficits of the GFC and the 1990-91 recession (Figure 13).

Fig.12: The Budget balance starting point is a deficit of ~1-2% of GDP due to State Government deficits



Source: Reserve Bank of Australia

Fig.13: Federal Budget likely to move from balance in FY19 to modern deficit record in FY20-21



Source: Australia Treasury, EL&C Baillieu

Investment Implications

- In our view, an effective response to COVID-19 probably entails five factors:
  - i) successful quarantine and lockdowns to contain the spread of the virus and allow resumption of normal activities;
  - ii) monetary stimulus and support, easing pressure on borrowers and ensuring system liquidity;
  - iii) fiscal support to minimise second-round effects on exposed businesses and households;
  - iv) fiscal stimulus to add impetus to the recovery and help unleash pent-up demand; and
  - iv) the windfall benefit of much lower oil prices.
- So if the economic hit from COVID-19 can be contained to 2-3 months and, say, 3-4% of GDP, then pent-up demand following ~2 months of isolation, monetary stimulus of ~0.25-0.5% of GDP, fiscal support of ~3-4% of GDP, fiscal stimulus of 1-2% of GDP and windfall lower oil prices of 1% of GDP should drive a strong recovery.
- Of course, this scenario first requires a successful containment program, enabling markets to look through the trough to a recovery. We remain of the view that a credible slowdown in the number of new COVID-19 cases is a key indicator of this shift.

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