Is Australia off course?
...Delta delays the growth recovery

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After a sharp rebound during H1 2021, Australia's near-term economic outlook has worsened significantly. The COVID-19 Delta outbreak has extended across the eastern seaboard, with much of the population under severe mobility restrictions. This suggests Australia's growth in H2 2021 will take a significant hit.

However, a rapidly accelerating inoculation path (as vaccine supplies have arrived) suggests targets for eased restrictions and re-opening will be met during the final quarter of 2021. While Australia's recovery has been pushed off course in H2 2021, we expect a strong growth rebound to resume in H1 2022.

"We have to break this cycle. The national plan is the way to cut through and for us to emerge from that. This Groundhog Day has to end, and it will end when we start getting to 70% and 80% [vaccinations]".

SCOTT MORRISON, PRIME MINISTER
AUGUST 2021

Australia's growth trajectory...weak H2 2021, rebound 2022

Australia's growth data, which was released on 1 September, showed that the annual pace of growth was 9.6% to June. During this year, retail sales posted sustained double-digit gains and unemployment fell from a lockdown-induced peak of 7.5% to just 4.6%, its lowest in 12 years.

However, while Australia's strong recovery has matched that in many major economies (with 12% for the US, 14% for Europe and 18% for China), a low level of vaccination mid-year, relative to other countries, has seen Australia's growth recovery pushed off course amid the global Delta COVID-19 outbreak. Like other low-vaccinated countries, including New Zealand and emerging markets (ex-China), this is likely to delay the recovery in growth into 2022.

Over the past month, signs of the impact of the lockdowns have grown. CBA credit card data shows spending growth relative to 2019 has halved from around 17% in H1 2021 to 8% mid-August. Business conditions have retraced from a record high (chart on following page), and weekly jobs data has collapsed by 3.7% in July (chart page 3), suggesting a renewed rise in unemployment ahead.

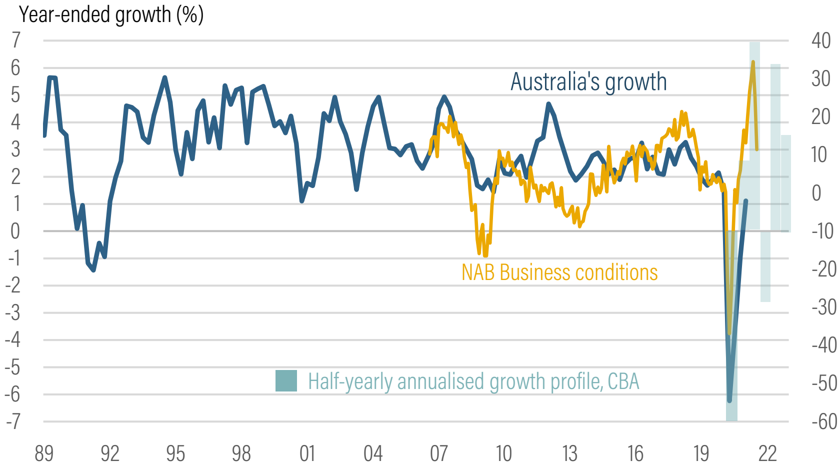
We expect a weak pace of growth in H2 2021 to give way to a renewed strong recovery in 2022.

With restrictions likely to extend into Q4, expectations are for a significant pull-back in growth, with CBA forecasting a near-3% drop in Q3. However, as shown in the following chart, we expect a weak pace of growth in H2 2021 to give way to a renewed strong recovery in 2022. Indeed, after a 2-3% fall in annualised growth in H2 2021, we expect a return to 5-6% growth in H1 2022, similar to the pace seen during the first half of this year.

Australia is now vaccinating at a rate exceeding 1% (one of the fastest paces in the world, at any time)...

... putting us on track for 70-80% vaccination during Q4 this year.

Australia's growth should rebound in H1 2022, as vaccine targets reached



Source: ABS, NAB, CBA, Crestone.

Key drivers of a growth rebound in H1 2022

The accelerating pace of vaccination—As recently as May, plagued by a lack of supply of the 'consensus' vaccine, Australia was vaccinating 0.2% of the population on average per day. At that time, the US, UK and Europe were vaccinating at three times that pace, at around 0.6-0.7%. However, as shown in chart on the next page, we are now vaccinating at a rate exceeding 1% (one of the fastest paces in the world—at any time), putting us on track for 70-80% vaccination during Q4 this year. This should lead to the easing (and eventual removal) of mobility restrictions as 2022 gets underway.

Consumer spending will rebound as the economy re-opens—As seen post prior lockdowns, consumer demand (supported by a rebound in employment growth) accelerates as restrictions are eased (see chart on page 3). Moreover, Australia's household saving rate was 12% in Q1 2021, three times its average of 4% in 2018. A combination of eased restrictions and 'ability to spend' should see a strong lift in consumer activity.

"While the exact timing of the bounce-back is difficult to predict, it is likely to start well before the end of the year".

DR PHILIP LOWE
GOVERNOR OF THE RESERVE BANK
OF AUSTRALIA
AUGUST 2021

Global growth backdrop remains strong—Even as major economies pass their peak in H2 2021, global growth is likely to normalise at a very healthy level in 2022. The International Monetary Fund (IMF) forecasts 5% (after 6% in 2021), a still relatively fast pace of global growth. As a cyclical economy, exporting two thirds of our goods and services to Asia and with large financial, property and resources sectors, Australia should be well-supported by a strong global backdrop in 2022.

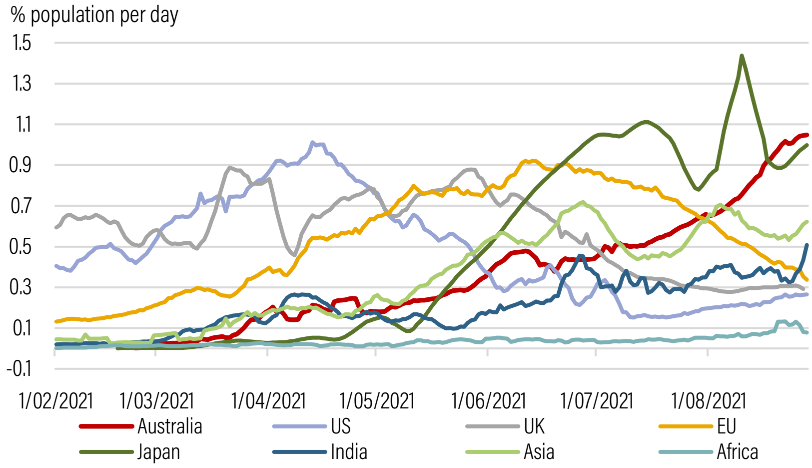
Policy will remain very supportive—While the fading of fiscal support in 2022 will present somewhat of a headwind for growth, this is expected to be mitigated by high levels of consumer saving and a long tail of public capex projects. The Reserve Bank of Australia (RBA), while expected to reduce its stimulus via bond buying in the quarters ahead, appears unlikely to lift interest rates from near-zero until well into 2023.

Reflecting these factors, we expect a reasonably robust rebound in domestic activity as we enter 2022. We would, however, note that:

- The worsening 'stay-at-home' trends (see chart on next page) suggest the economic data will deteriorate noticeably over coming months before a recovery path is restored in early 2022; and
- as recently noted by CBA, there remains some likelihood that the pace of that recovery may not be as swift as it was after the first lockdown. This reflects the likelihood that households, while not subject to as many restrictions, may be less buoyant, or experience behavioural changes associated with 'living with the virus' as case numbers surge for the first time. This could weigh on some sectors, such as travel and entertainment, and slow the 'return to offices' in central business districts.

If restrictions ease as we approach Christmas, we anticipate a solid uplift in consumer activity (though not to the quantum seen last year), which should accelerate strongly in H1 2022.

Australia's vaccination rate has accelerated sharply



Source: Our World in Data as at 28 July 2021, Crestone.

The outlook for Australia's key sectors

Consumer spending will rebound in the lead-up to Christmas

Trends in consumer spending will largely be governed by vaccination rates and when lockdowns are eased. Prime Minister Morrison appears committed to the agreement with his state counterparts that restrictions are to be eased when 70% of adults are inoculated, then removed at 80%. These targets should be met during the last quarter of this year.

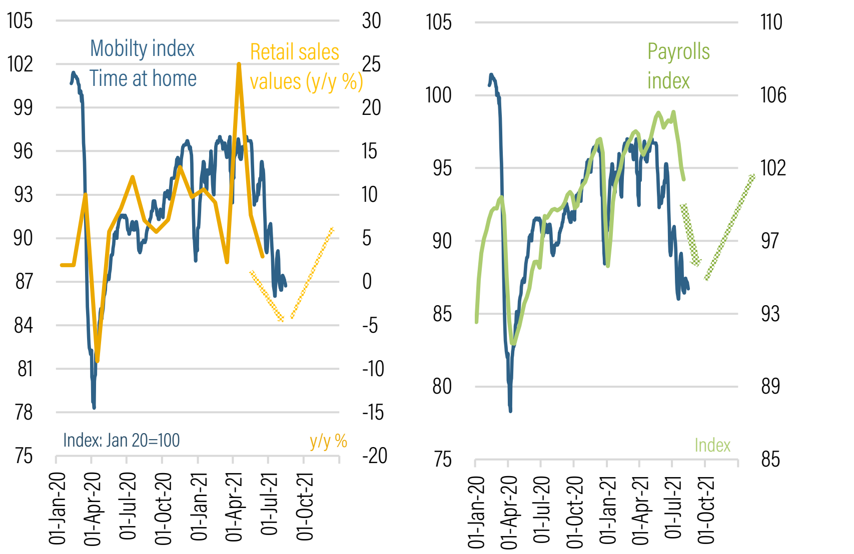
The impact of this year's stimulus measures will fade through 2022…

… but the backlog of activity should underpin a material uplift in residential activity over the coming year.

This suggests near-term consumer trends (particularly in the current quarter) will be very weak, with a renewed pick-up in on-line purchases (and logistics) unlikely to offset the weakness in in-store spending across Melbourne and Sydney. We would expect to see similar trends evident across most COVID-19 sector losers, such as childcare, travel, accommodation and gaming.

However, if restrictions are eased as we approach Christmas, we anticipate a solid uplift in consumer activity (though not to the quantum seen last year), which should accelerate strongly in H1 2022. This will be supported by elevated saving rates, above average consumer sentiment and current strong hiring intentions. After real growth of 5% in 2021 (including a H2 slowdown), UBS is forecasting 3% consumption growth on average in 2022, well above the 1.9% average across 2018 and 2019.

Retail spending and jobs should rebound when restrictions ease



Source: Google trends, Our World in Data, ABS, Crestone.

The latest official business capex survey points to a significant recovery over the next few years, buoyed by the current high level of business profitability, as well as signs of relatively tight capacity utilisation.

Housing activity will pick up in 2022 as price growth ebbs

The impact of this year's first home buyer stimulus packages from state governments and home builder grants from the federal government will fade through 2022. But the backlog of activity should underpin a material uplift in residential activity over the coming year. This will have the usual flow-on to associated sectors, including manufacturing and household goods retailing.

Building commencements are currently annualising at 207,000, about 20% higher than a year ago. This is being driven particularly by houses (not multi-dwellings), where starts are 50% higher than a year earlier. Even as current trends in new approvals have pulled back in recent months, they are consistent with new starts rising further to over 220,000 (another 6%).

A key driver of whether this high level of activity leads to an oversupply of dwellings in 2023 will depend on when borders open and immigration returns. Vacancy rates have recently risen to around their highest level (3.5%) since the early 2000s and could rise further through 2022.

Home prices have risen 16% over the past year, their fastest pace since 2004. While price growth may ebb toward mid-to-high single digits in the year ahead, price growth is likely to continue to be supported by ongoing demand (reflected in high auction clearance rates) and record low borrowing rates.

Business capex intentions suggest strong 2022 growth ahead

Over the past decade, business investment, as a share of national output, has fallen to a record low, almost halving from 18% to around 10%. The latest official business investment surveys point to a significant recovery over the next few years, buoyed by the current high level of business profitability, as well as signs of relatively tight capacity utilisation.

UBS is currently forecasting business capex growth of 4% in 2022, compared with relative flat investment growth across 2018 and 2019. Economy-wide activity and employment is also likely to be supported by an elevated pipeline of public infrastructure projects, some announced during the pandemic, worth around 2% of national output over the coming couple of years.

As a high dividend market, ongoing low interest rates and more moderate market returns should support the domestic market in the period ahead…

… Australia's earnings yield/bond yield gap is also supportive relative to other regions.

Staying overweight domestic equities despite growth hit

While the risk of extended lockdowns and a delayed recovery will continue until Australia has a higher vaccination rate, we continue to hold a modest overweight allocation to domestic equities within our regional equity tilts.

Given the strength of the economy's rebound over the past year, we continue to expect **ongoing positive net earnings per share (EPS) revisions** near term. The ASX 300 has now seen 11 months of positive EPS surprises through to the end of July. As the current domestic equity market reporting season draws to a close, beats have been concentrated in earnings (50%), followed by dividends (30%) and then cash flow (20%). Interestingly, the market has rewarded companies beating on revenue more than other types of 'beats'.

However, given the hit to the growth cycle in H2 2021, the EPS upgrade cycle is likely nearing its peak. This suggests a **greater emphasis on style and sector rotation**, and likely greater volatility (with positive, but more moderate, returns). Banks have been upgraded significantly. Telecoms and staples retail have also seen more upgrades. Consumer services has the weakest earnings, not surprising as it includes travel stocks impacted by the NSW lockdown.

As a **high dividend/income market**, ongoing low interest rates and more moderate returns are also likely to support the market ahead. During July, high dividend yielders (3.5% for the market) had among the highest returns, suggesting strong demand for income as bond yields and term deposit rates remain depressed. The need for longer-term income also underlies the recent takeover offers for infrastructure assets. Quality as a style should also continue to perform well as cyclical momentum slows in the economy near term.

Australia's **earnings yield/bond yield** (EY-BY) gap is also supportive relative to other regions. An elevated EY-BY supports an ongoing bond-for-equity switch and provides a favourable backdrop for continued acquisitions activity. As the table below shows, while most regions' EY-BY is elevated, only Australia's is at a premium to its five-year average.

Lastly, the market appears to be looking beyond the current hit to growth to the economy's re-opening in 2022. We expect this to continue as inoculation rates rise. A likely **H1 2022 re-opening of the economy will support key sectors**. We continue to believe investors should overweight COVID-19 losers, as their earnings recovery ought to outpace the market. In the US, some of the strongest post-result returns have come from re-opening sectors (such as restaurants and hospitals). Strategically, we remain positive on healthcare, given it tends to outperform in slowdowns, and, in time, will also be a post-pandemic beneficiary. Healthcare also had the strongest returns during the 2013 taper tantrum, a rising bond yield environment.

Australia's EY-BY gap is still above the five-year average

COUNTRY	INDEX	EARNINGS YIELD (EY)	BOND YIELD (BY)	EY-BY GAP	5-YEAR AVERAGE	+/- TO AVERAGE
Australia	**S&P/ASX 200**	**5.6%**	**1.2%**	**4.4%**	**4.3%**	**8bps**
US	S&P 500	4.9%	1.3%	3.5%	3.9%	-39bps
UK	FTSE 200	6.0%	0.6%	5.4%	6.3%	-93bps
Japan	Nikkei 225	6.2%	0.03%	6.2%	6.3%	-8bps
China	CSI 300	7.7%	2.9%	4.8%	5.3%	-49bps
Eurozone	Stoxx Europe 600	6.3%	-0.4%	6.7%	7.1%	-41bps

Source: Bloomberg, Crestone.