Market Outlook

September 2021

Recently, we've received a lot of questions from clients on a range of hot-button topics including COVID-19 and lockdowns, inflation and interest rates, and the equity and property markets. In this month's *Market Outlook*, we answer some of these questions.

Commonwealth Private

COVID-19

Questions:

When will this disruption to the economy end?

Why is Australia locking down with a relatively small number of infections when other countries like the US are opening up while they still have tens of thousands of infections per day?

Will the current outbreak and lockdowns have a short- or longer-term impact on business confidence?

What modelling has been done on the impact of future variants?

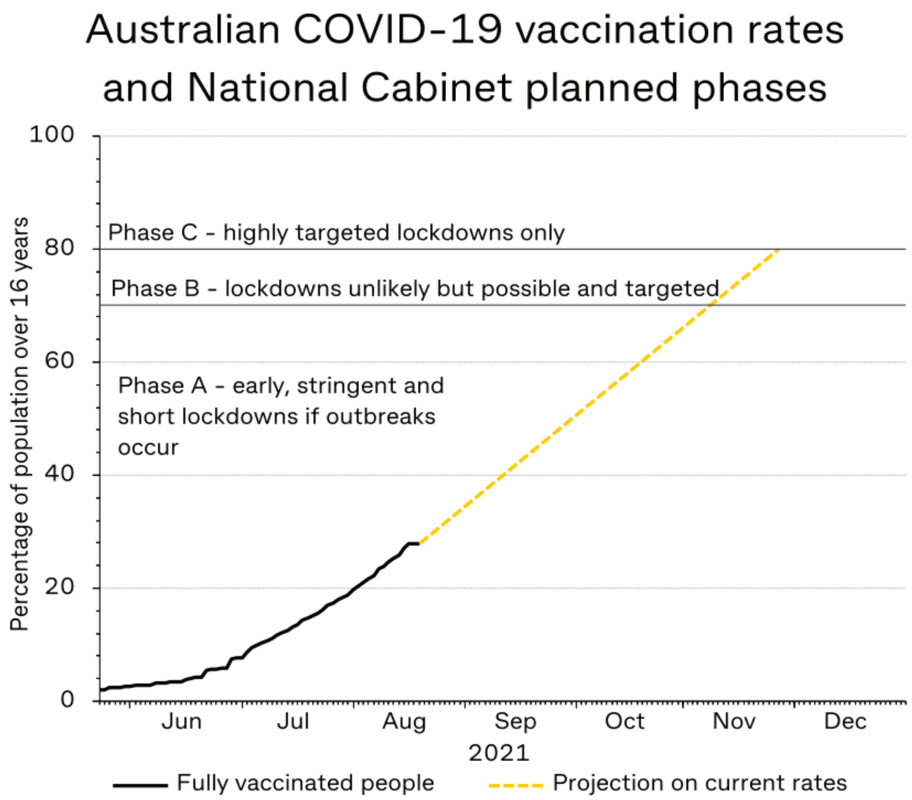
Will comprehensive vaccination help us avoid lockdowns in the future?

Although Australia was very successful in eliminating earlier variants of COVID-19, the higher transmissibility of the Delta strain suggests we may never fully eliminate community transmission. This means widespread vaccination is our best hope for protecting us against the virus.

Other countries such as the United States, the United Kingdom and Israel opened up once they'd reached high levels of vaccination coverage. The initial evidence suggests that, even with daily cases in the tens of thousands, vaccination is helping to prevent severe illness and deaths.

Australia's National Cabinet has outlined a four-stage plan, based on the Doherty Institute's modelling of the virus, vaccinations and lockdowns. The modelling considered various scenarios, including where current vaccines were 50% less effective against future variants. It confirmed that in such a scenario, high vaccination rates would still be largely effective.

Under the National Cabinet plan, widespread lockdowns will no longer be used once 80% of the population aged over 16 is fully vaccinated. Based on current vaccination rates, we should achieve this level of coverage by the end of 2021. But until we reach that point, it appears that state governments will continue to use lockdowns, causing further disruptions to the economy and confidence.



Source: Refinitiv Datastream 19/08/2021

Unsurprisingly, both business and consumer confidence in Australia have dropped in the last month. However, we've seen from previous lockdowns that confidence can rebound quickly once economies reopen.

That's why we expect this fall in confidence to be short term, with a recovery later in the year as lockdowns become less frequent. But it's yet to be seen if there will be any long-term 'scarring' to business confidence from repeated lockdowns – particularly in services sectors like tourism and hospitality.

While our outlook assumes Australia's economy will recover later this year once we reach 80% vaccination coverage, there are risks to this view. For example, we may never reach this threshold because of vaccine hesitancy. It's also possible that some states will continue to impose border restrictions and targeted lockdowns even with 80% vaccination coverage, rather than tolerating a rise in cases.

There is a further risk that a future variant of the virus will become completely vaccine resistant. The Doherty Institute discussed this scenario, but provided no modelling for it.

Inflation, interest rates and term deposit rates

Questions:

Will COVID-19 influence the inflation outlook and, if so, what are the implications for investments?

Do current reported inflation rates truly reflect reality?

Can the RBA really wait until 2024 to raise interest rates or must it follow the market's expectations?

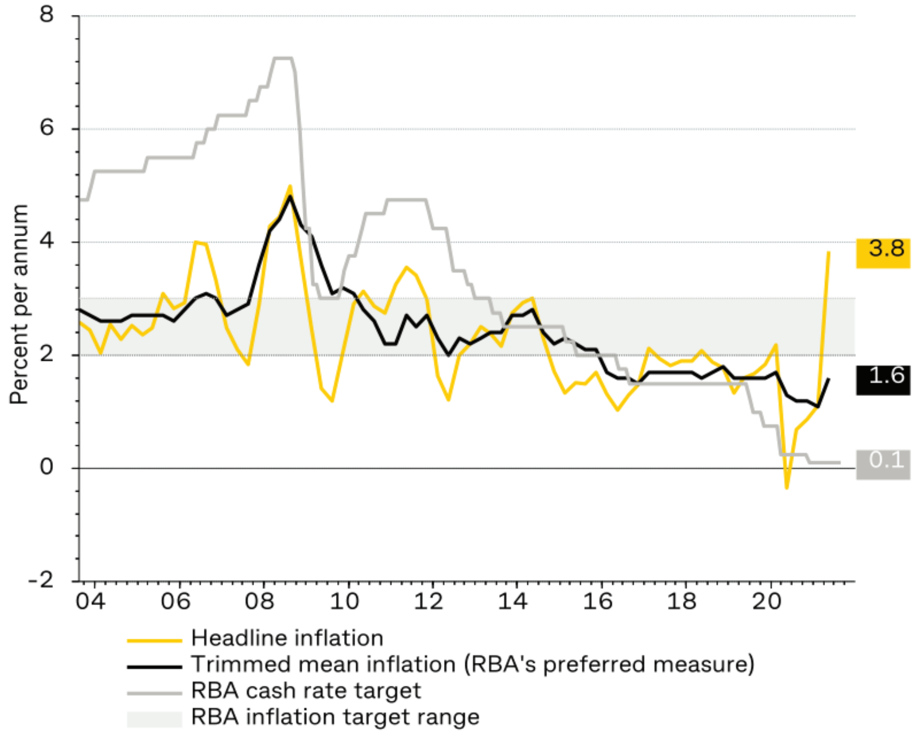
When will interest rates on term deposits be raised?

In our May 2021 *Market Outlook*, we wrote that COVID-19 was having a temporary impact on inflation. However, there are risks that an overheating economy could lead to sustained higher inflation.

If this causes interest rates to rise faster than expected, it could impact investments that are sensitive to interest rates, like fixed income. Other asset classes, such as equities and property, can still generate positive returns in a rising inflation environment – as long as company earnings and rents are growing faster than inflation.

In our opinion, the most important measure of inflation is the trimmed mean, which is the focus for the RBA. This measure smooths out large price swings, creating a lower rate than the current headline inflation rate. Studies have shown that consumers tend to notice price rises more than price falls, leading to a perception that inflation is higher than its actual rate.

Australian inflation and official interest rates



Source: Refinitiv Datastream 17/08/2021

Our current outlook for the Australian economy assumes a recovery later this year and into 2022. Based on this outlook, official interest rates are likely to rise modestly in mid-2023 – about six months earlier than the RBA's current forecast.

Term deposit rates, particularly for longer-maturity deposits, may rise sooner than 2023, reflecting expected interest rate rises. However, term deposit rates are also impacted by bank demand for deposits. Currently, banks are awash with excess funds after borrowing $188 billion at 0.1% per annum through the RBA's Term Funding Facility. This funding is due to mature in mid-2024.

Conclusion

In our opinion, markets and clients alike are clearly concerned about rising COVID-19 cases and lockdowns, and what they mean for inflation and interest rates. We're closely monitoring the current situation for potential risks, as well as any potential opportunities for investment portfolios. For now, we remain comfortable with a largely neutral position in growth assets and a higher exposure to cash.