The road to recovery

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frontier

About

Frontier has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $400b in assets across the superannuation, charity, public sector and higher education sectors.

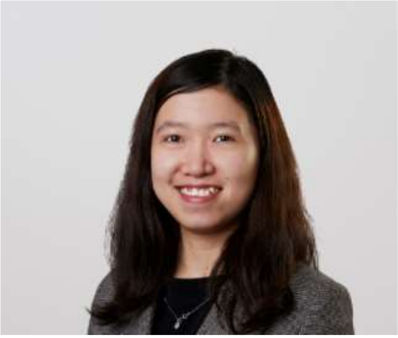
Author

Philip Naylor, CFA

Principal Consultant

Philip Naylor is a Principal Consultant and senior member of the Capital Markets and Asset Allocation Team, having joined the firm in 2018. Philip has over a decade of senior experience, much of that in currency and fixed income trading roles with the Reserve Bank of Australia (RBA) in both Sydney and New York, and as the RBA's representative on the G20 Investment and Infrastructure Working Group. Philip has also worked as a consultant to the World Bank in Washington DC and as an Economist at Macquarie Bank. Immediately prior to joining Frontier, Philip was the Economic Advisor to the Treasurer of the Northern Territory. Philip holds a Bachelor of Business (Honours) in Economics and Finance from RMIT University along with a Master of Public Administration (MPA) in Economic Policy Management from Columbia University in New York. He is also a CFA Charterholder.

Author



Ann Tran, Phd

Associate

Ann Tran joined Frontier as an Associate in July 2019. She is a member of Capital Markets and Asset Allocation team and is responsible for applying econometric modelling to contribute to the preparation of Frontier's analytical reports and undertaking relevant economic and financial market research. Prior to joining Frontier, Ann worked as a lecturer and tutor for Economics and Finance courses at RMIT University. She has also published academic journal articles on Empirical Economics and Journal of Policy Modelling. Ann holds a PhD in Economics from RMIT, majoring in Applied Macroeconomics and Time Series Econometrics. She also holds a Master of Economics from University of Leeds (United Kingdom).

Summary

The road to recovery: insights from our economic modelling.

In March, we released two papers titled *Navigating the new macro environment* which outlined our initial thinking on the macroeconomic impacts of COVID-19. This included econometric modelling using the RBA's MARTIN model to forecast how big the downturn could be, as well as what the policy response would look like and what impact it could have.

In this paper, we focus on the economic recovery. In particular, this paper provides insight on:

- how well the economic modelling did at explaining the downturn
- what the modelling can tell us about the recovery
- the outlook for policy.

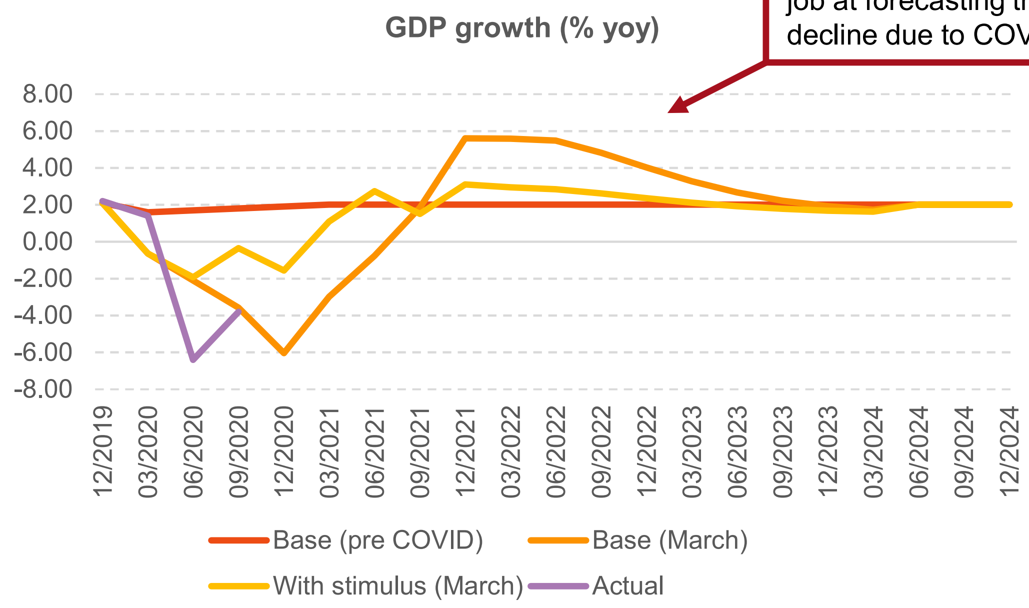
Key take-aways

- No model is perfect, but our economic modelling has done a fairly good job at explaining the economic downturn due to COVID-19 to date.
- In this paper we update our modelling assumptions to consider a range of possible paths the economic recovery could take. In particular, we consider how escalating tensions with China could impact a 'downside' case for the recovery.
- The modelling shows that very accommodative policy could support a continued 'V'-shaped recovery. However, a trade war with China would cause a double-dip recession for Australia's economy and the unemployment rate could rise to over 8% next year.
- Spill-overs from policy have impacts across the economy. For example, our modelling results show that house prices could rise strongly (up to 20%) over next 12 to 18 months.
- Although policy may continue to support a sharp economic recovery, the implications for investment returns is less clear cut. In particular, the *growth* in stimulus may be fading. We think this is an important aspect that is not fully appreciated by markets at this point. It may be possible that a continued economic recovery does not translate into continued very strong equity returns.

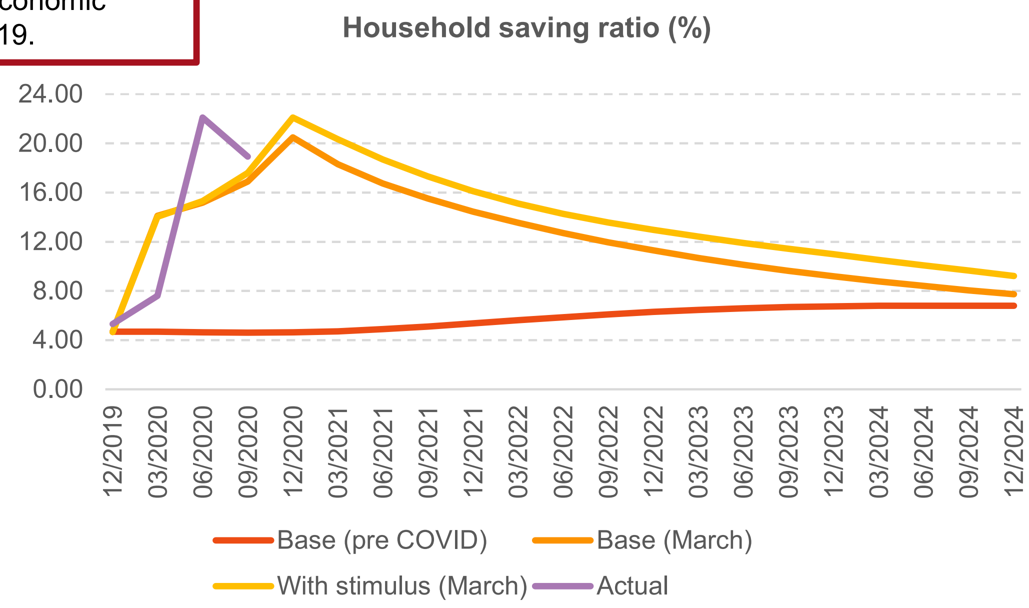
Predicting the economic downturn through our modelling

Econometric modelling is not perfect, but it has provided fairly accurate forecasts on the downturn to date.

Our modeling has done a fairly good job at forecasting the economic decline due to COVID-19.



Source: Frontier, Datastream



Source: Frontier, Datastream

Twelve months ago, no forecaster on the planet could have forecasted the economic downturn we have witnessed in 2020. While the risks of a pandemic had been flagged in the past, it is extremely hard to predict the timing and extent of any pandemic.

Although no one could have predicted COVID-19, econometric forecasting has been a useful tool since the pandemic in forecasting the potential size of the hit to the economy and the type of economic reactions that were possible. For example, our modelling published in March has been fairly accurate in explaining the size of the potential hit to GDP we have witnessed so far. However, the forecasts in March highlighted the modelling uncertainty in trying to take into account the impacts of such a large policy response. Beyond key macro indictors like GDP, the modelling has also given insights into other economic impacts, like the spike in the household savings rate that we have seen due to both a large fall in consumption and a rise in incomes as a result of policy stimulus.

What the modelling says about recovery

We consider three alternative paths, including escalating China-Australia tensions.

Our modelling is based on a range of key assumptions across key economic variables. Full details of on these variables can be found in the Appendix. We updated economic shocks from March version based on actual economic outcomes we have seen this year due to COVID-19.

Downside

This scenario specifically considers the potential effect of an escalation in China-Australia trade tensions. We assume ‘’sudden stops’ in commodity and service exports to China.

Base-case

The base-case implies a moderate recovery from now on. We assume it would take around 3-4 years for major economic activities (consumption, investment, etc) to catch up to the pre-COVID growing trend.

Upside

The economic recovery were to occur at a rapid pace and fiscal stimulus would be extended. We assume it would take 1-2 years for major economic activities (consumption, investment, etc) to catch up to the pre-COVID growing trend.

China tensions are considered in our downside modelling case

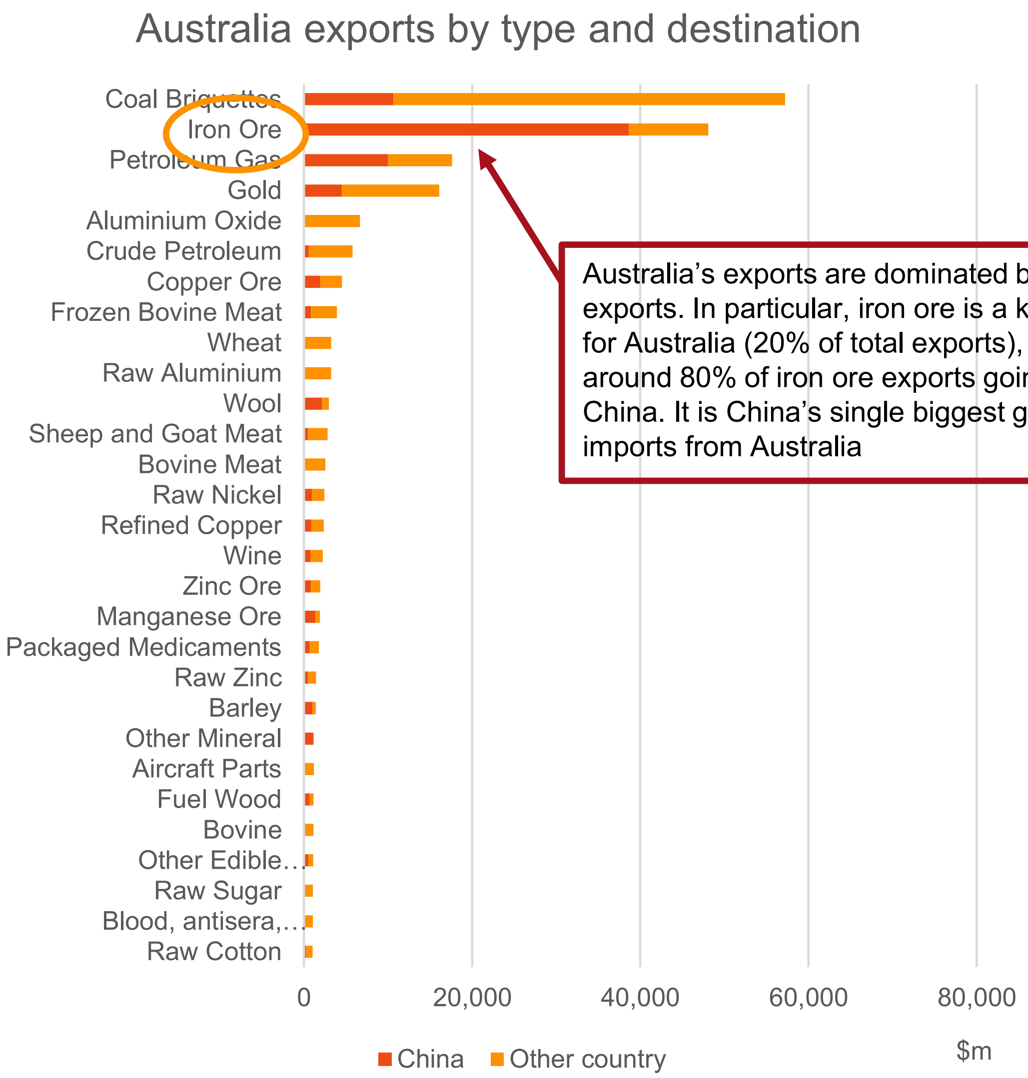
Did you know? Economic forecasting for investment strategy at Frontier

- Econometric modelling, like that described in this paper, is one input into our broader macro forecasting framework. This includes detailed quarterly forecasts for a range of key indicators across a range of economic scenarios.
- These set of economic projections are then used to model portfolio returns across a range of forward looking macro scenarios. This analysis is available through our *Portfolio Analytics* technology solution.
- For further details on our full suite of economic projection or to find out more about *Portfolio Analytics*, please contact your client consultant.

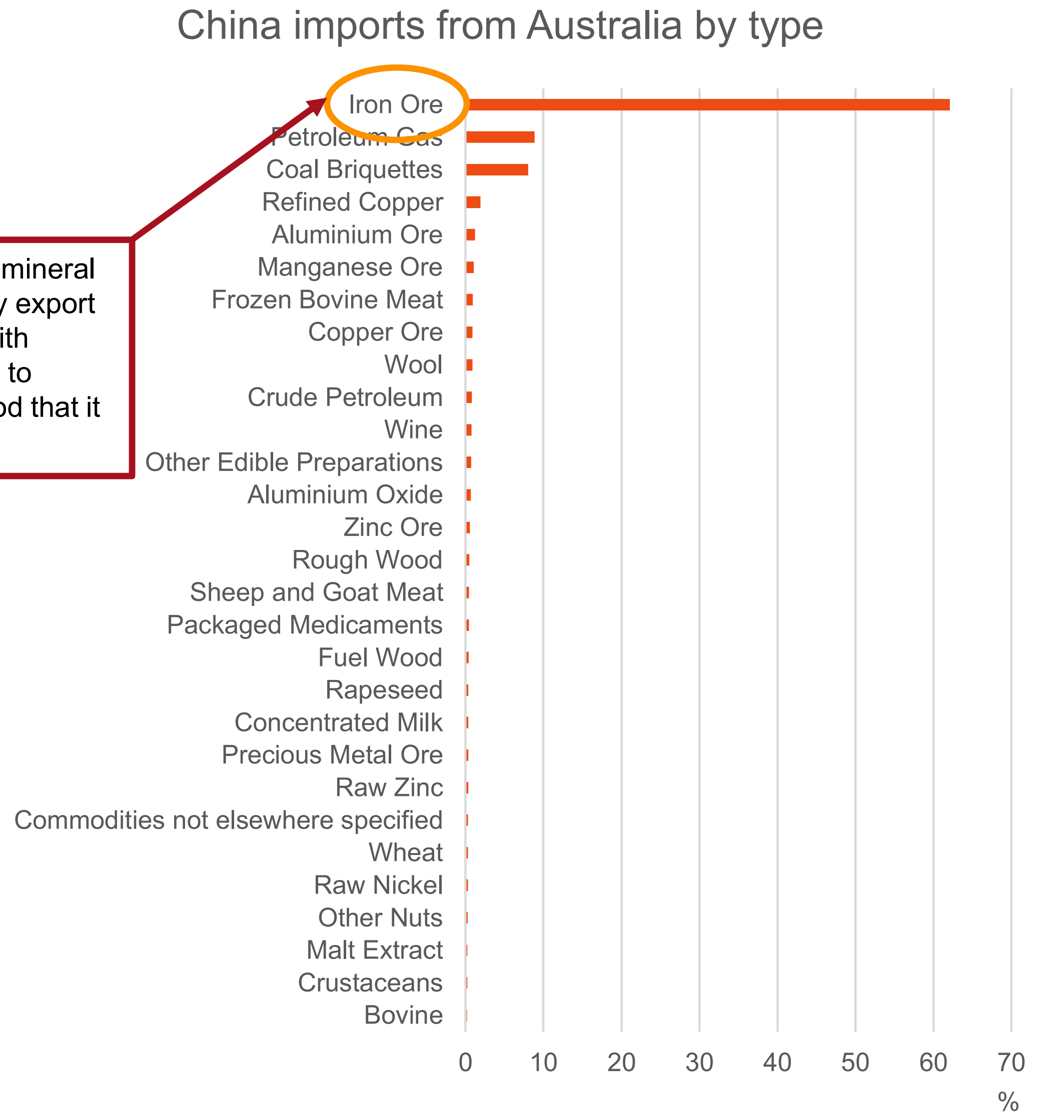
What the modelling says about recovery

Our downside scenario considers the potential effects of a large escalation in tensions with China.

Our downside modelling scenario is extreme and assumes a halt to all mineral exports to China and incoming student numbers. Details of the modelling assumptions can be found in the Appendix.



Australia's exports are dominated by mineral exports. In particular, iron ore is a key export for Australia (20% of total exports), with around 80% of iron ore exports going to China. It is China's single biggest good that it imports from Australia



What the modelling says about recovery

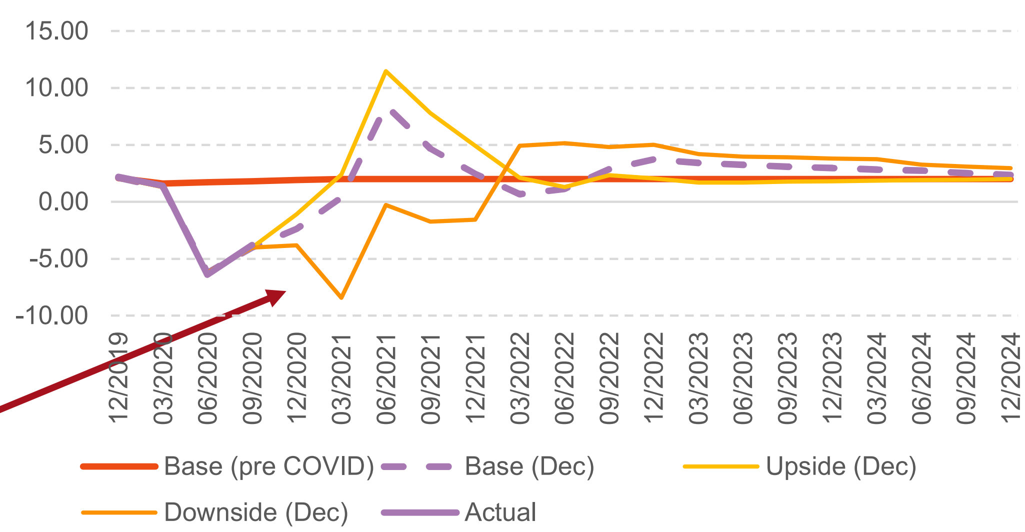
Our modelling produces forecasts which suggest the economic recovery could continue in a ‘V’ shape.

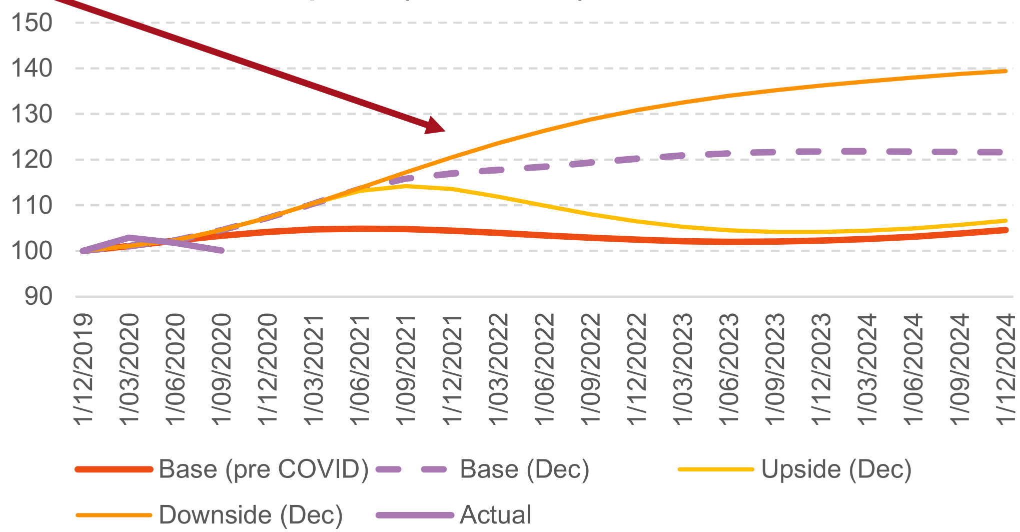
Our modelling shows that ongoing policy support could see the ‘V’ shaped recovery continue. However, our ‘downside’ scenario highlights how the recovery could be derailed if tensions with China were to escalate in an extreme way. Our modelling considers quite an ‘extreme’ escalation in tensions with China, so our economy may perform better if exports are not fully disrupted.

The modelling also shows the economic spillovers that could occur during the recovery. For example, the modelling suggests that as a result of low interest rates and a rebounding economy, house prices could rise by around 20% in the next 12- to 18-months.

Escalating tensions with China could cause a double-dip recession for Australia.

Ultra-easy policy could have spill overs, like for example, a sharp rise in house prices.

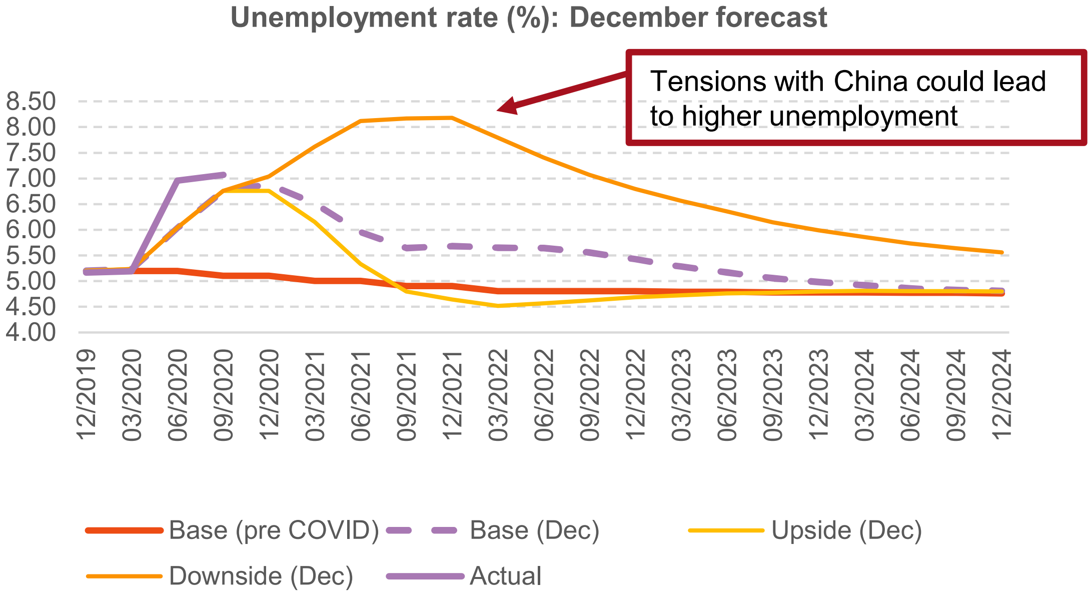




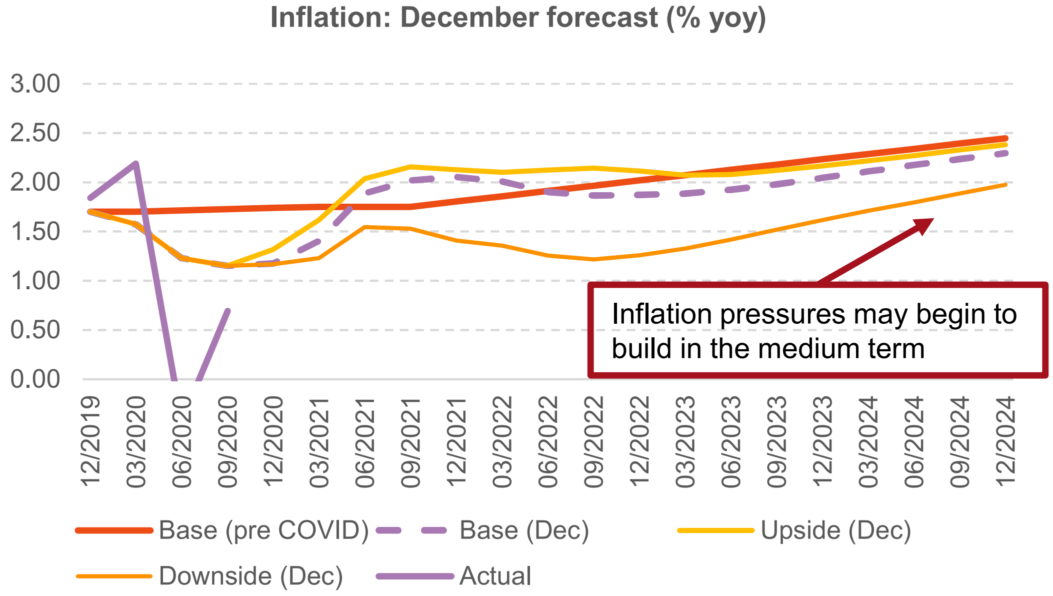
Source: Frontier, Datastream

What the modelling says about recovery

The recovery in labour market would be moderate even under a V-shaped recovery.



Source: Frontier, Datastream



Source: Frontier, Datastream

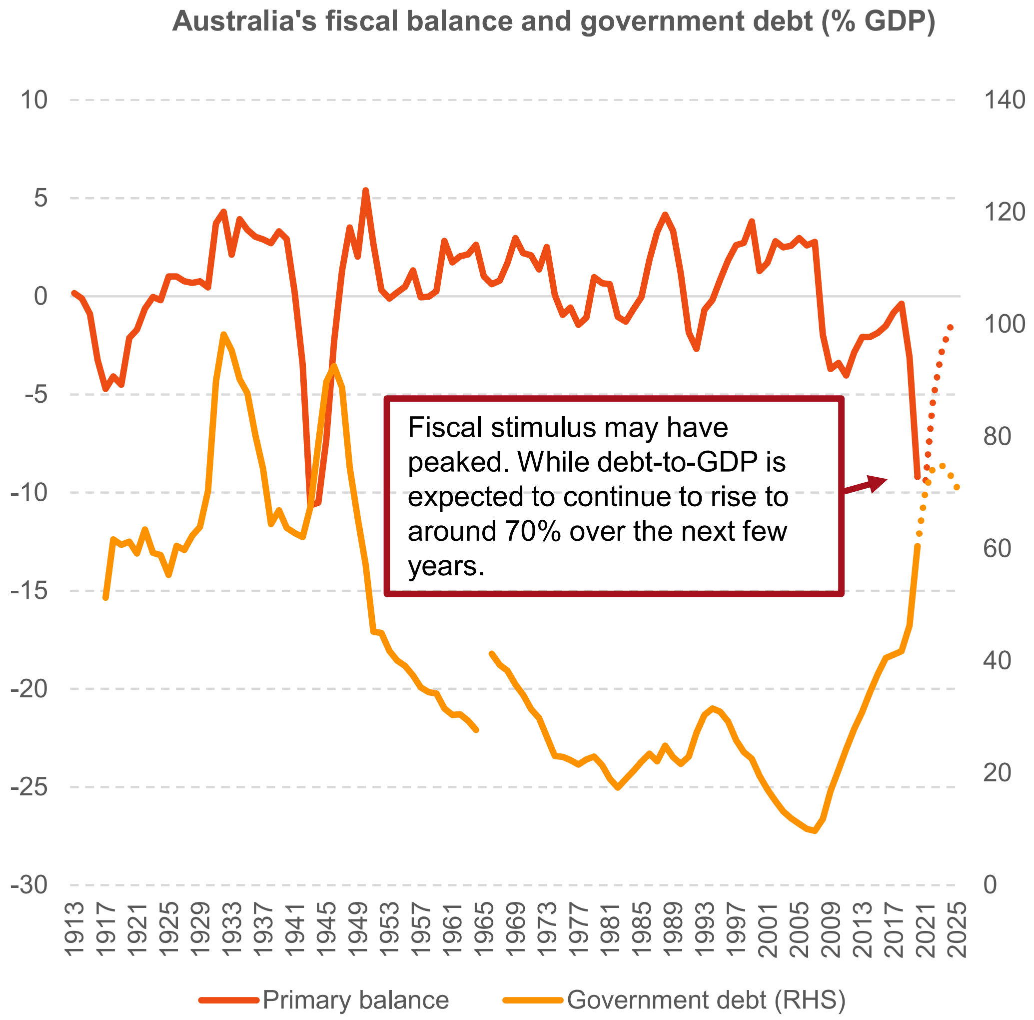
The modelling results suggest we may have seen the peak in the unemployment rate. However, under the downside scenario, China's bans on Australia's resource and service exports could cause the unemployment rate to increase to over 8%, a level not seen since the early 1990s.

The modelling suggests high inflation is not likely to be seen in the near term, even under an upside scenario when fiscal stimulus is extended and the economy recovers rapidly. However, the model does highlight the risks that inflation could be back within the RBA's 2 to 3% target range within the next five years.

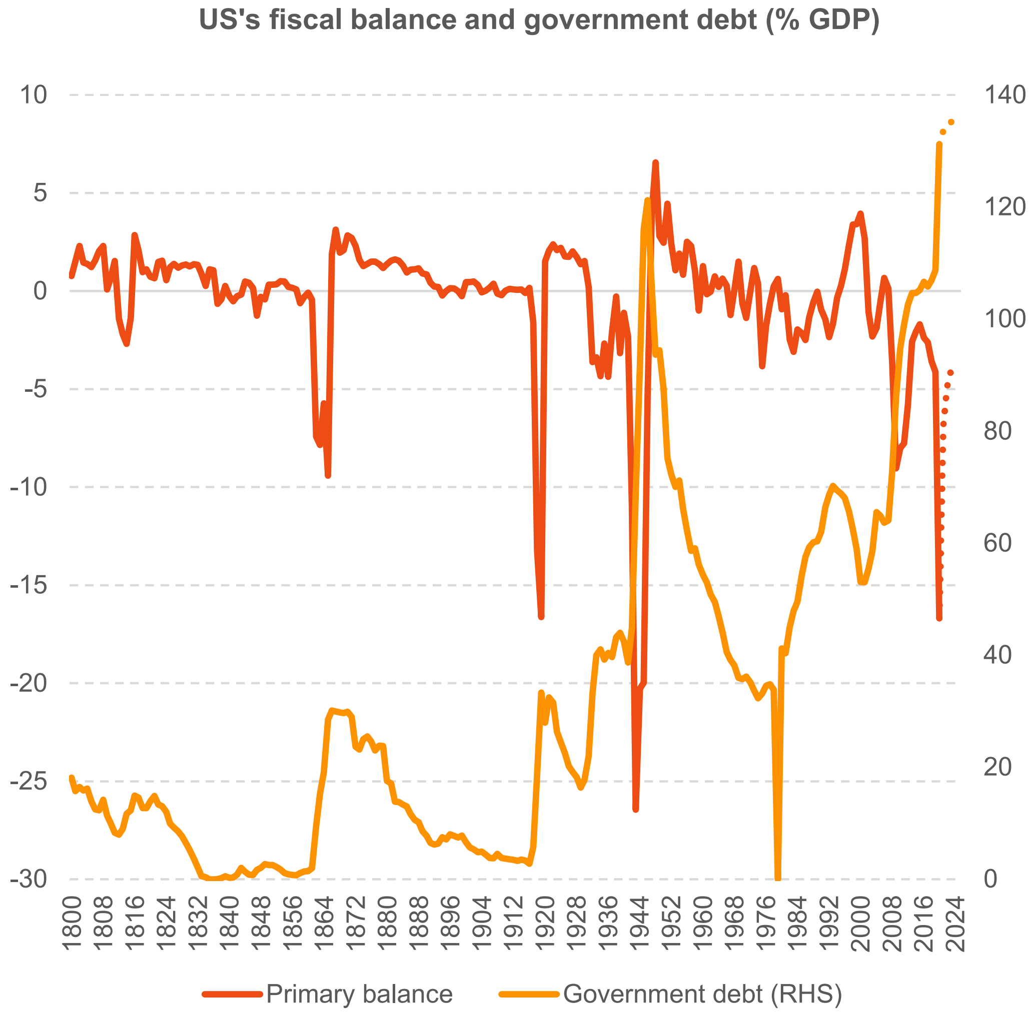
The role of fiscal policy

Ongoing deficit spending is likely to underpin the recovery. However, we may have reached ‘peak support’.

Our base case modelling is calibrated to the government’s fiscal outlook as published in the 2020/21 Budget. Deficits are expected to continue into the future. However, the ‘peak’ level of support may have already passed. This is true for other countries as well, like the US.



Source: IMF



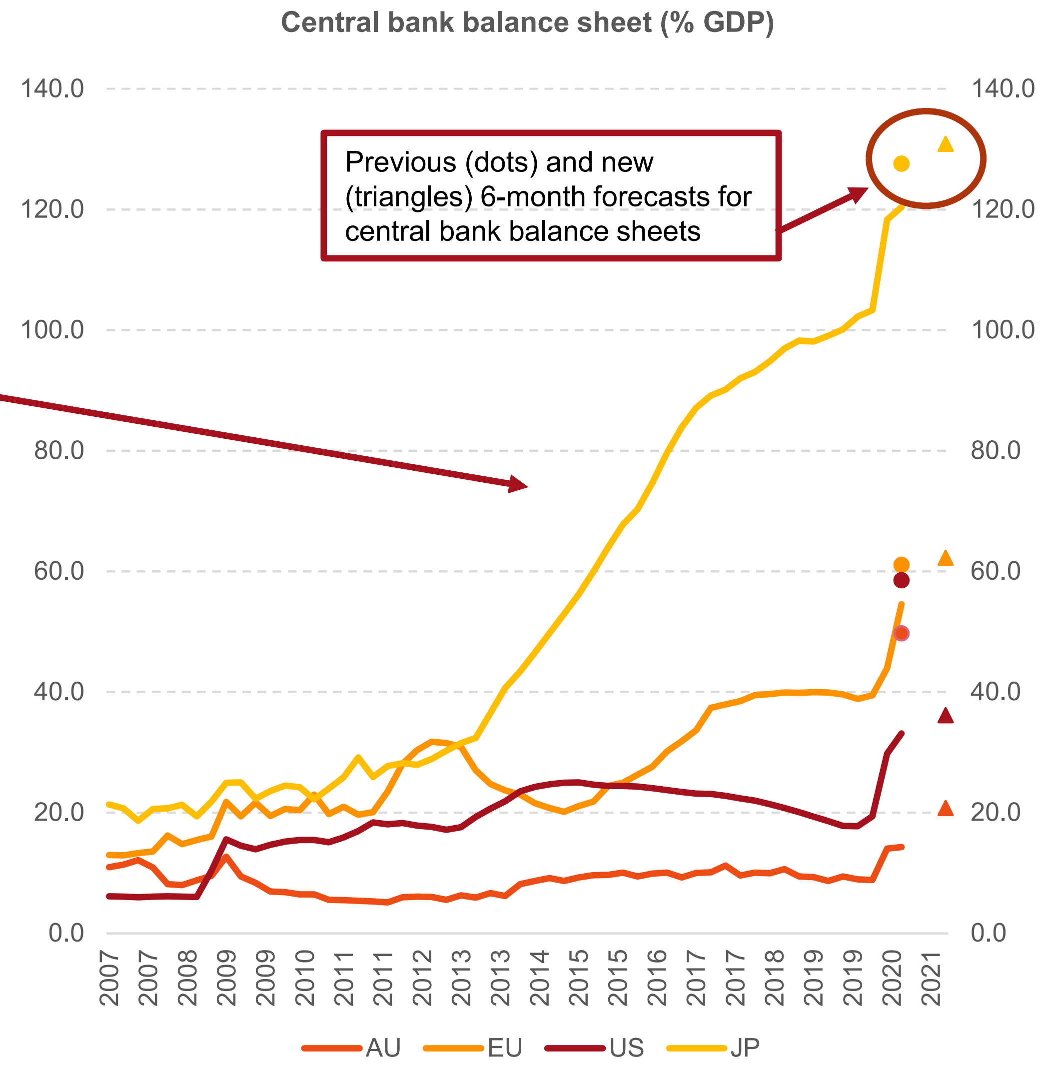
Source: IMF

The role of monetary policy

Monetary policy will provide ongoing economic support, but the policy impulse is fading.

Central banks moved quickly to provide support at the onset of the COVID-19 crisis. However, the pace of ongoing support has slowed. Looking ahead, we expect measures like Quantitative Easing will result in further expansion of central bank balance sheets. However, we now expect the pace of this extra support to continue to slow.

Central bank balance sheets are now expected to expand at a slower rate than what was expected at the onset of the COVID-19 crisis

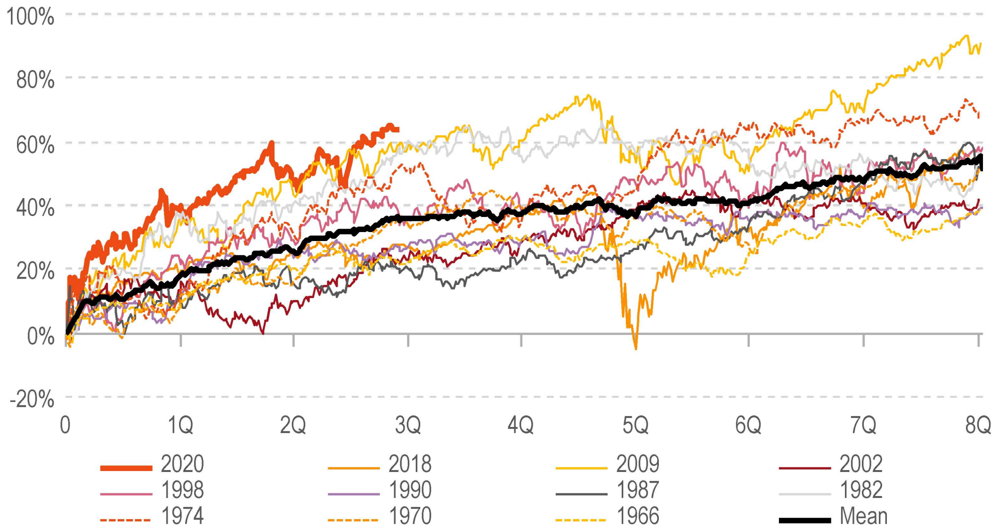


Source: Frontier, Datastream, central bank's websites
The circle markers show central bank's assets estimated if they continued to purchase securities at the pace seen end of March 2020. The triangle markers show their assets estimated if they continued to purchase securities based on the current pace or purchase targets.

Implications for investment strategy

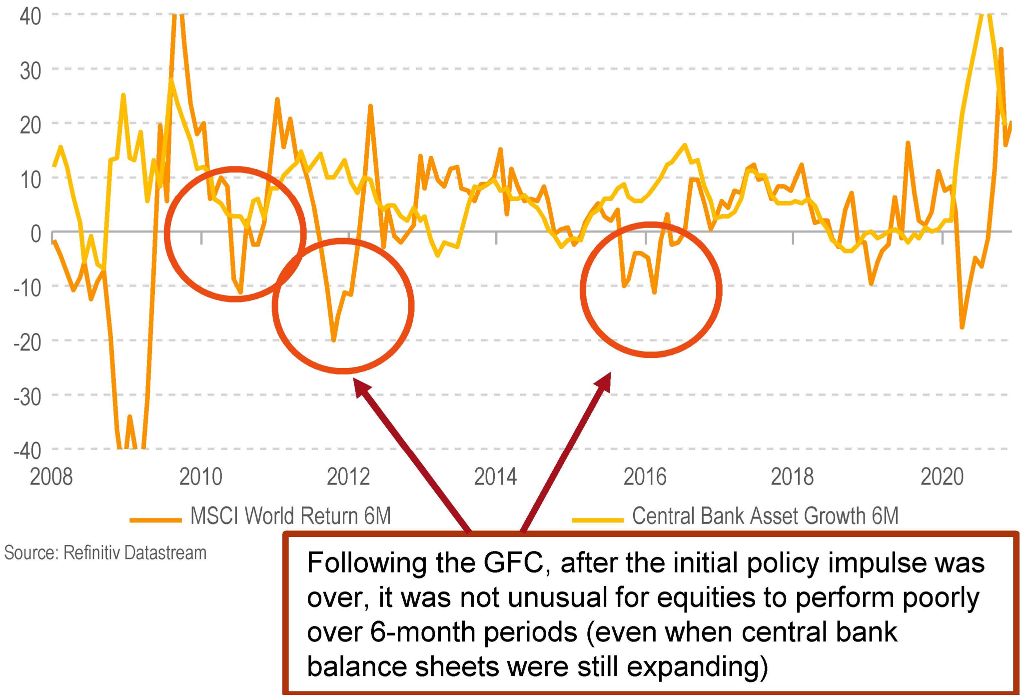
It is possible that policy may support the ongoing economic recovery, but not risk assets.

S&P 500 bear market rebound returns



Source: Refinitiv Datastream

Central bank assets change vs equity returns



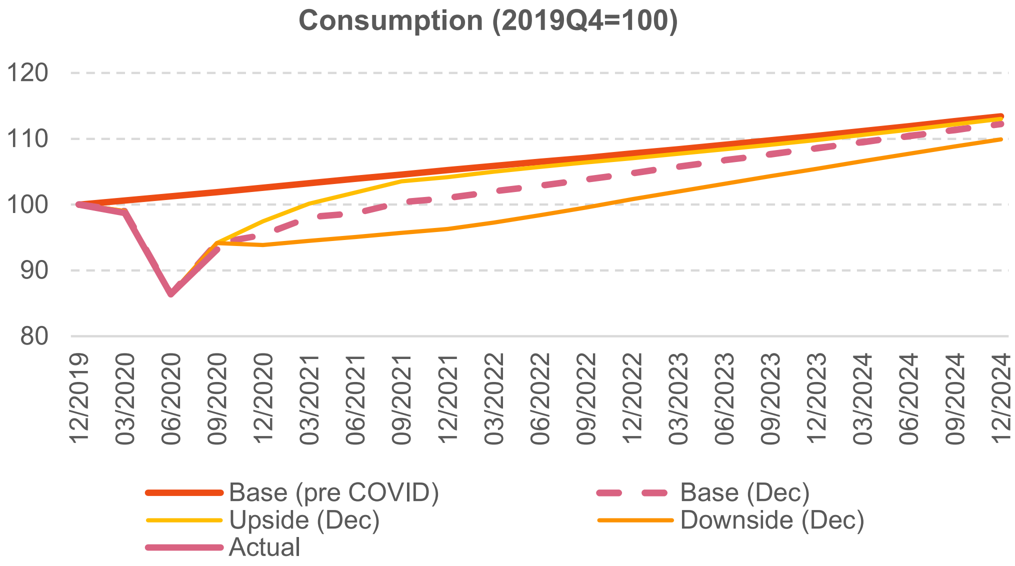
Source: Refinitiv Datastream

Markets have rebounded sharply since the lows earlier this year – one of the sharpest bounces on record. Equities have been underpinned by the rapid economic expansion, low interest rates and positive developments towards a vaccine.

However, looking forward, a slowdown in the *pace* of new stimulus from policy-makers could become an important driver of equity returns. For example, following the GFC, a slowdown in 'new' stimulus resulted in periods where it was not unusual for equities to deliver negative returns over a 6- to 12-month horizon (despite the overall level of stimulus remaining high).

Appendices

Assumptions – domestic shocks



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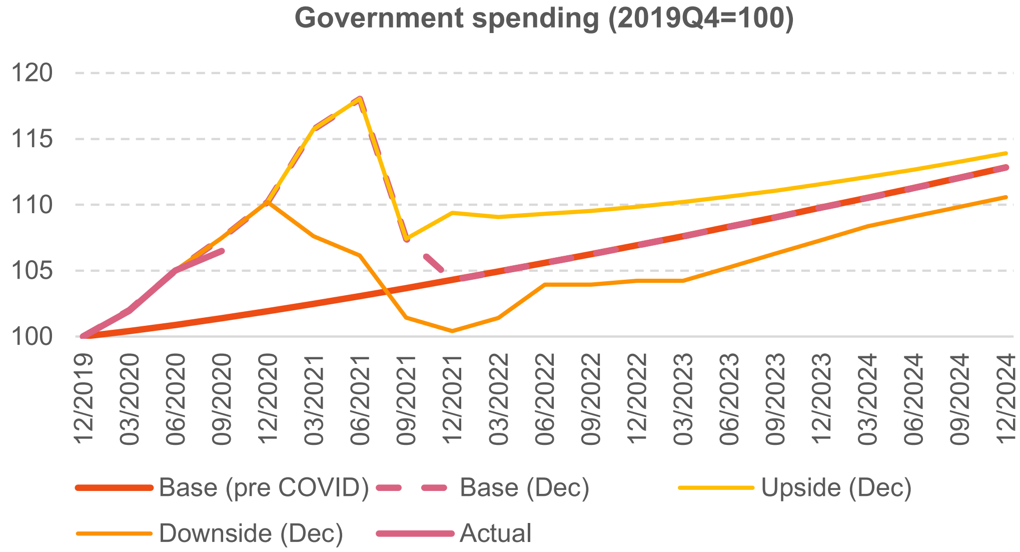

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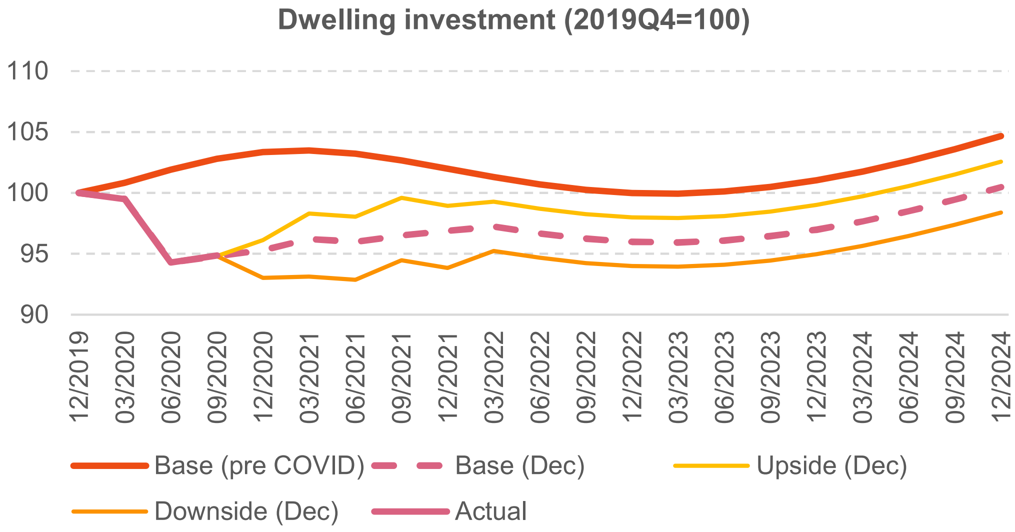

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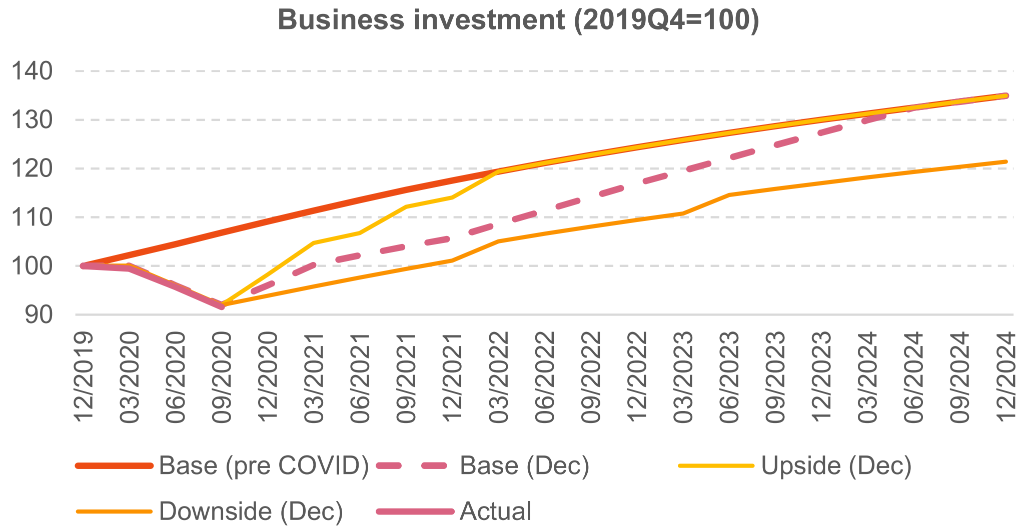
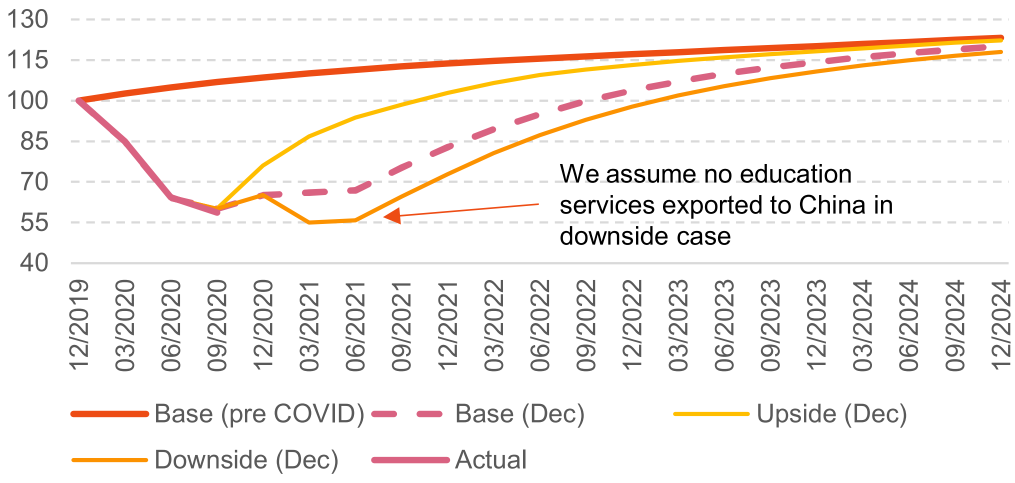


Source: Frontier

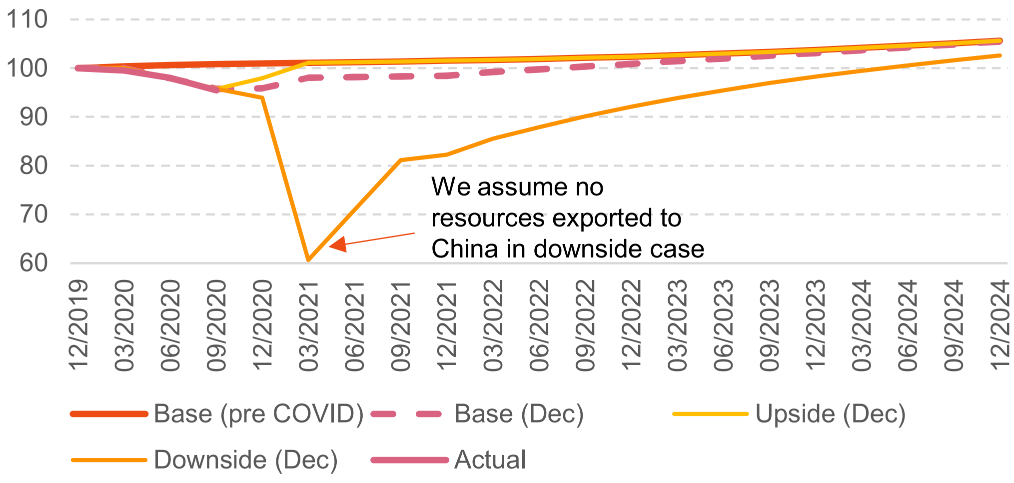
Assumptions – domestic shocks

Services export (2019Q4=100)



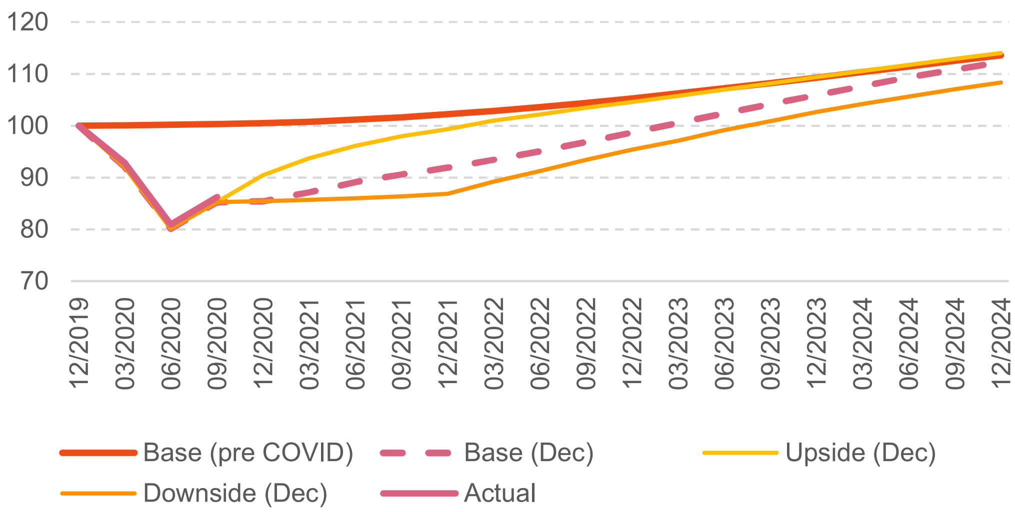
Source: Frontier

Resource exports (2019Q4=100)



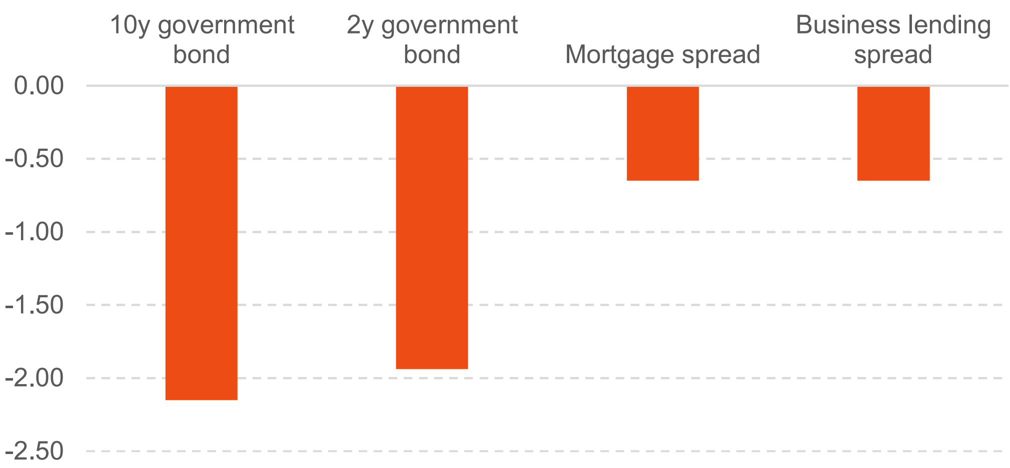
Source: Frontier

Import (2019Q4=100)



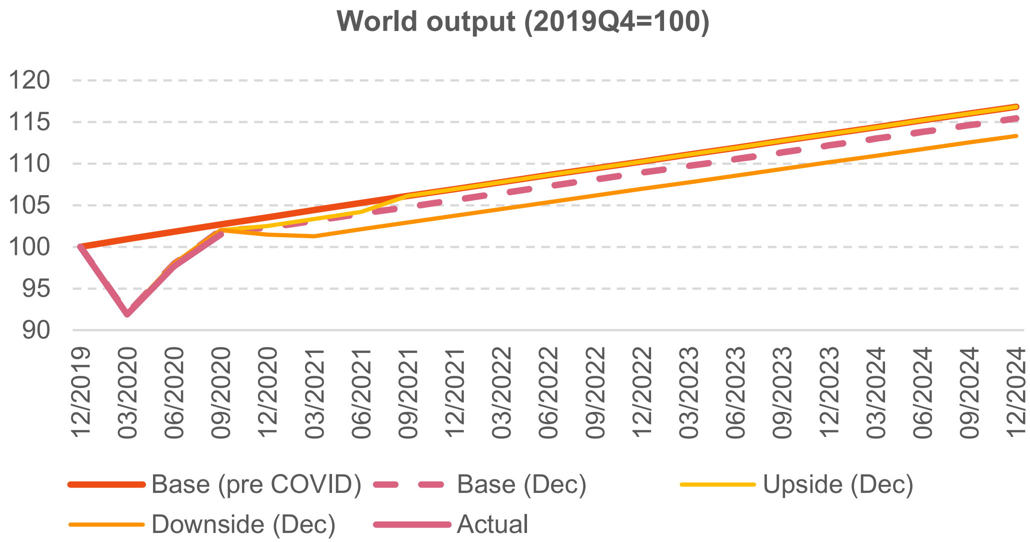
Source: Frontier

Monetary policy: quantitative easing shocks (deviations from the baseline, bpts)



Source: Frontier

Assumptions – external shocks



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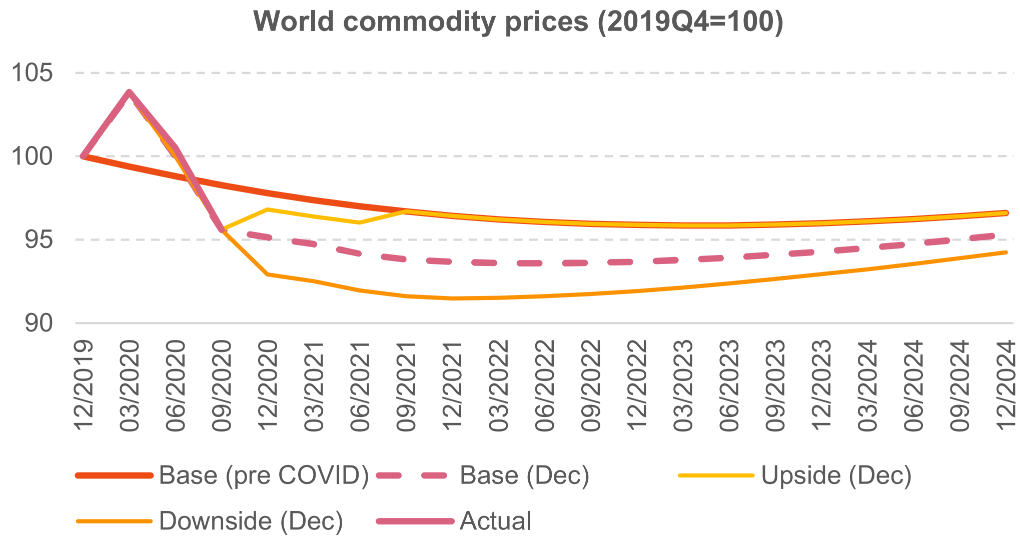

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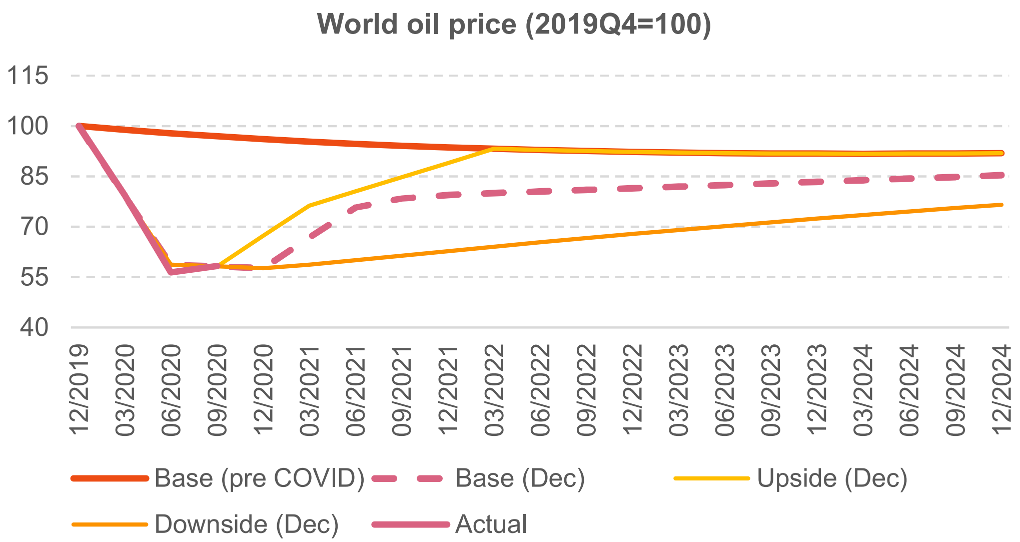

Source: Frontier

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