The 9 things to watch in 2021

February 2021

Summary

As effective vaccines are rolled out, and monetary and fiscal policies remain highly supportive worldwide, investors here and overseas are approaching 2021 with a great deal of optimism, expecting sharp rebounds in economic growth and company profits.

The 9 things to watch in 2021 lists the factors we think will be critical to whether this market consensus proves accurate, or misguided, and provides our views on how they will evolve.

Globally, we expect brisk economic growth, indeed the strongest for a decade but this follows particularly weak activity in 2020 and may prove underwhelming given investors' ebullient expectations. A steadier rebound in activity, however, would ensure inflation remains low and enable both monetary and fiscal policymakers to maintain stimulatory settings. As a result, bond yields should remain low, although corporate earnings growth may also fail to meet current high predictions.

Obviously, a key uncertainty is how quickly some forms of activity—such as international travel—can return to "normal" even with the distribution of an effective vaccine.

The success of a vaccine is not listed as a key factor to watch given we don't have any particular insights to add to comments made by epidemiologists and public health officials. For what it's worth, we believe the market consensus on vaccine effectiveness is consistent with the opinions of medical specialists.

Domestically, local analysts are even more optimistic about the ability of the Australian economy to rebound in 2021. A key factor driving this is the apparent health of the housing market, with prices turning upwards in the second half of 2020. Some analysts are even speculating that the economic recovery will be so quick that the Reserve Bank of Australia (RBA) will wind back some stimulatory policies this year. Were this to occur, it is likely to place upward pressure on the Australian dollar which has already benefited from the "risk-on" tone in markets.

Our view is that 2021 will be an "okay year" for the Australian economy, but not as blisteringly strong as investors would hope. Households will have to cope with the winding back of some generous government income support measures in coming months and, without any prospect of strong wages growth, we suspect they will be wary about dipping too far into their savings to fund much higher consumer spending.

A steadier recovery in activity would ensure that the RBA maintains its highly supportive policies. That should remove some upward pressure on the Australian dollar, which the RBA has increasingly determined as a major influence on growth and inflation outlooks. We also suspect investors in the housing market will remain cautious over 2021 as rents remain subdued and demand for new apartments remains weak due to low overseas migration. This should result in only a modest increase in house prices, driven mainly by healthy demand from first-home buyers.

Table 1: The 9 things to watch in 2021

Item	Forecast
1. Global economic growth	Strong but slower than hoped
2. US 10-year bond yields	End 2021 around 1%
3. US inflation	Ends 2021 around 2%
4. US minimum wage	Increased to $15 over time
5. US earnings growth	Up 8% over the year
6. Australian household saving rate	Modest decline over the year
7. RBA 3-year bond yield target	Maintained
8. A$	Ends 2021 at US$0.76
9. Australian house prices	Up 5% over the year

Source: TCorp

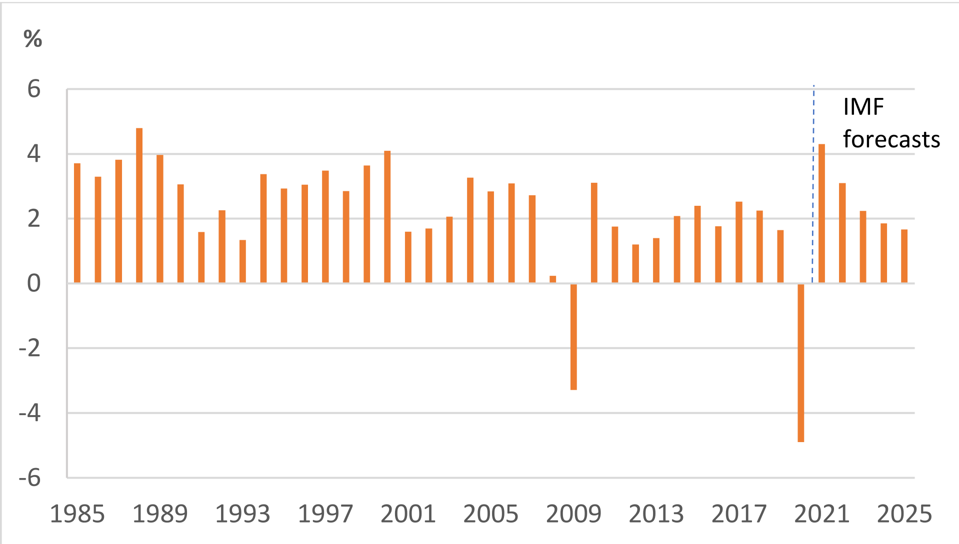
By listing the 9 things we think are most critical to the global economic outlook and expectations for how they may evolve, we can monitor how our views are tracking over time and whether (and in what direction) we need to revise our forecasts. We will revisit these forecasts regularly to see how they are performing and determine if the variables have diverged sufficiently from our baseline to warrant a shift in our overall view, or whether we can characterise this as “noise”.

1. The G8 economies will grow 3.5% in 2021 – brisk, but not as fast as hoped

Investors here and overseas have approached 2021 with a great deal of optimism. The main reason for this is they expect activity to rebound sharply as effective vaccines are rolled out and people feel confident to return to “business as usual”. This optimism has been reinforced by expectations for ongoing support from monetary and fiscal policy.

The IMF expects growth in the advanced economies to reach 4.3% in 2021 after activity fell by nearly 5% in 2020 (see Chart 1 below). Private forecasters are even more upbeat about growth forecasts. Obviously, growth in the advanced economies has only reached 4% a few times in the last 35 years, so if this is achieved it would provide a very positive backdrop for financial markets.

Chart 1: Advanced economy growth, 1985 – 2025



Source: IMF, TCorp

It is worth noting that these forecasts take into account the rapid escalation of COVID-19 cases in North America and Europe at the end of 2020 which will dampen growth at the start of 2021. Analysts are optimistic, however, that activity in the second half of the year will accelerate sharply.

While growth should be healthy in 2021, we suspect it will fail to match expectations. This is not because investors are too optimistic about the rollout of virus vaccines but due to some lasting scars from the 2020 COVID-19 recession which will continue to weigh on consumer spending and business investment.

Some consumer spending undertaken in 2020 is unlikely to be repeated in 2021. For example, once people have fitted out their home offices to work remotely, they do not have to make those purchases again. In addition, phasing out some support measures—such as rental/mortgage repayment holidays and wage subsidies—will act as a headwind. These factors are likely to prevent a good year from being a great year.

2. US 10-year bond yields unlikely to rise over 2021

There are 3 reasons why US bond yields could rise over 2021. First, strong growth could lift inflation and break-even inflation rates. Second, the US Federal Reserve (Fed) could taper its bond buying programme and may signal an eventual lift in policy rates if growth was particularly strong. Third, larger budget deficits could test the ability of investors to fund the budget and trigger higher yields.

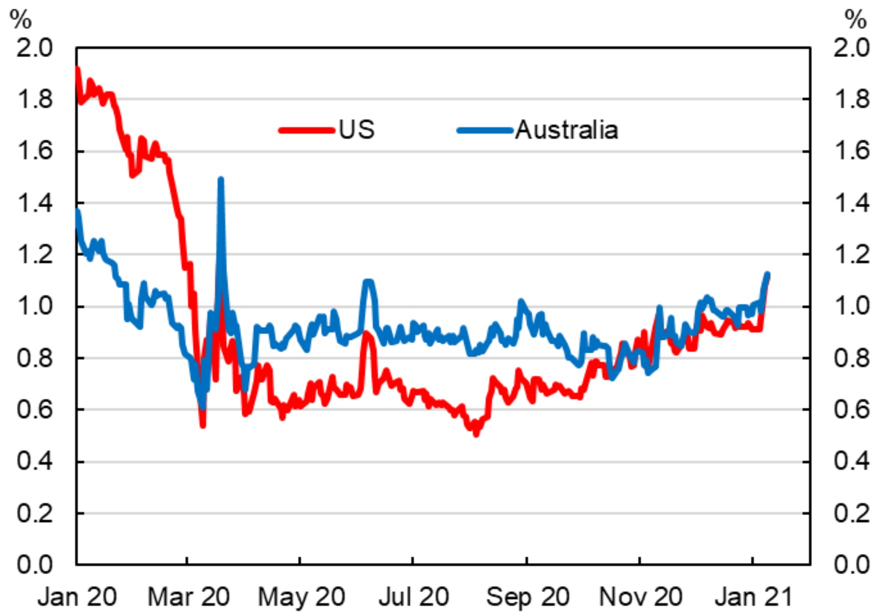
Optimism on US growth has lifted as COVID-19 vaccines are rolled out and further significant fiscal stimulus becomes more likely. If growth was particularly robust, this could leak into higher inflation which should be reflected in a rise in break-even inflation rates. Stronger growth would also be consistent with better real yields, or investors would shift to riskier assets producing higher returns linked to those levels of growth.

Of course, if growth is exceptionally strong and inflation rises there would be less need for the Fed to keep expansionary monetary policy settings. Thus, just as the fundamentals would swing towards higher bond yields, the Fed could also withdraw its support from the market.

We expect US growth will be solid in 2021, but do not believe it will be rapid enough to trigger higher inflation. Moreover, we suspect the market is underestimating the impact of the shift in monetary policy strategy that the Fed's leadership group announced last year – specifically, its commitment to only tighten policy after inflation has risen, and not simply if the unemployment rate falls to a very low level.

While we anticipate that US 10-year bond yields will periodically rise over 2021, they will ultimately be anchored by the Fed's determination to keep policy extremely supportive over the medium term.

Chat 2: US and Australia 10-year bond yields, January 2020 – January 2021



Source: Bloomberg

3. US inflation will rise close to 2%; no sign (yet) of a persistent acceleration

Inflation fell sharply in the second quarter of 2020 for a number of reasons: the pandemic-related collapse in demand, lower oil prices, and government policies (the Australian Government, for example, temporarily suspended childcare fees). Most of those factors have since reversed and prices have rebounded to some extent.

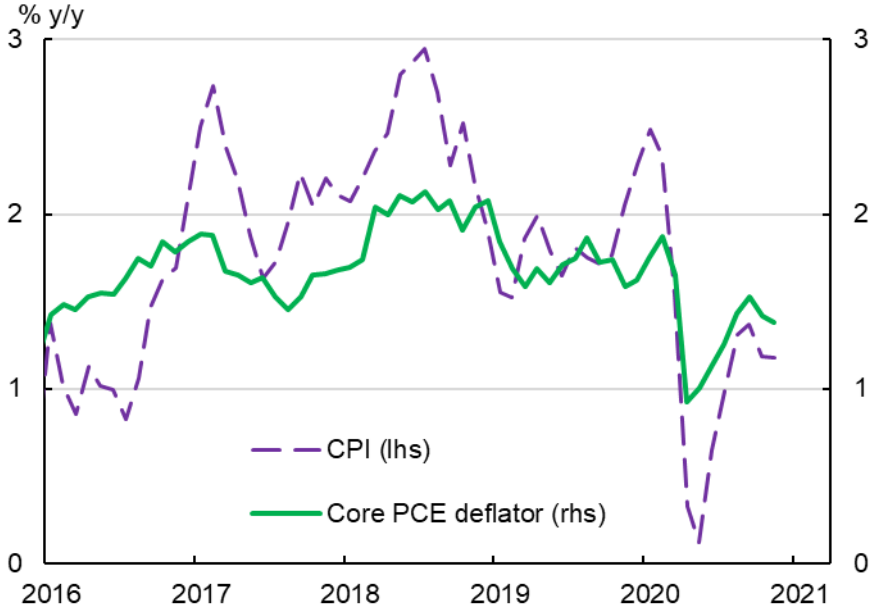
The timing, however, means that annual headline inflation rates are likely to spike around mid-2021 as the sharp price falls from April and May drop out of annual inflation rate calculations. In the US, for example, the headline consumer price index (CPI) fell by 0.9% between February and May, but rebounded by 1.4% between May and August.

This implies that even if consumer prices see a modest lift over the first half of 2021, the annual CPI inflation rate is likely to rise towards 2.5%. If growth accelerates at the same time and vaccine availability supports a rebound in activity, some investors could infer that rising inflationary pressures have finally returned to the economic landscape.

For high inflation—even a 3% increase—to be a credible threat, we would need to see a sustained rise in wages growth, as this could transform a one-off rise in the level of prices into a persistent increase in price growth. We do not believe this is likely—at least not in 2021.

The COVID-19 pandemic has also resulted in some pockets of cost-push inflation as well. Global shipping fees have risen, for example, as reduced international travel has diminished the capacity for passenger airlines to transport goods. This has kept inflation higher than it otherwise would have been, given the low level of economic activity. By itself, however, it is not sufficient to keep inflation sustainably above 2%. There is, however, one source of cost-push inflation that could have a more significant and lingering effect: a large rise in the minimum wage. Even if this is enacted in 2021, it would take some time before it boosted inflation.

Chart 3: US inflation, 2016 – January 2021



Source: Bloomberg

4. US President Biden will increase the federal minimum wage

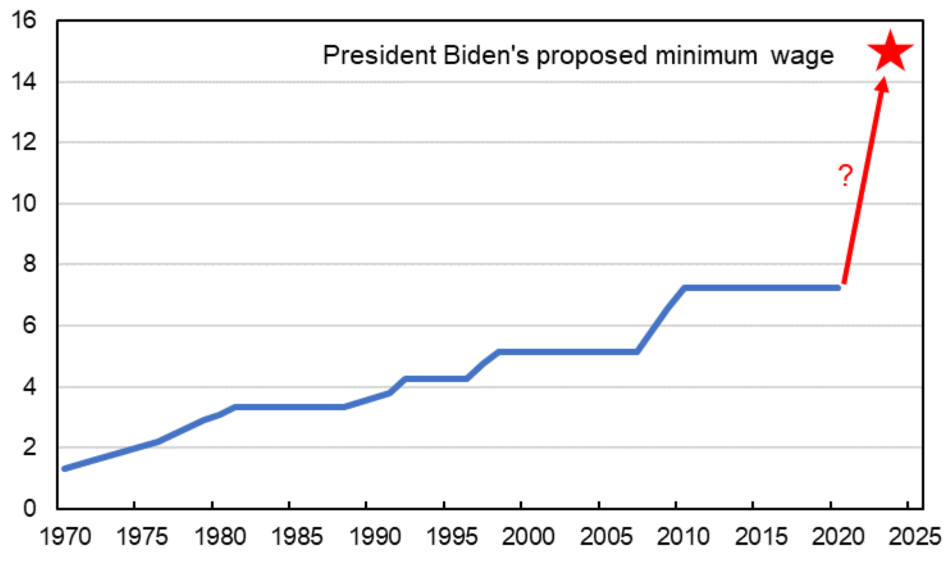
With the Democratic Party gaining control of the US Senate, House of Representatives and the White House, US President Biden has a good chance of successfully pursuing more of his policy agenda. While markets have focused on the potential impact of short-term fiscal stimulus in 2021—including further cash hand-outs to households—we believe the President's promise to raise the federal minimum wage from its current level of $7.25 to $15 per hour by 2025 could be more consequential.

The wage rise could finally shift the risks around inflation from being persistently weak, to the upside. While many fear that a large increase in the minimum wage would simply drive firms out of business as their costs rise dramatically, advocates of the policy argue that if all firms in an industry face a similar cost increase, then they will be able to raise their selling prices to maintain their margins. This would facilitate higher inflation over time.

It is less clear whether the positive effects of higher wages for those employed would be offset by less employment overall due to higher labour costs but this will likely depend on the ultimate size of wage increases. Large minimum wage increases in the 1970s were associated with higher unemployment and inflation while more moderate increases during the 2000s did not have a noticeable effect.

Several US states have introduced legislation to raise their own minimum wage rates to $15 per hour. Voters in Florida supported this policy in the November 2020 election and the state minimum wage will be raised from the federal minimum of $7.25 to $15 gradually over 5 years. We suspect that the federal minimum wage would be increased in a similar manner.

Chart 4: US federal minimum wage, $ per hour, 1970 – 2025



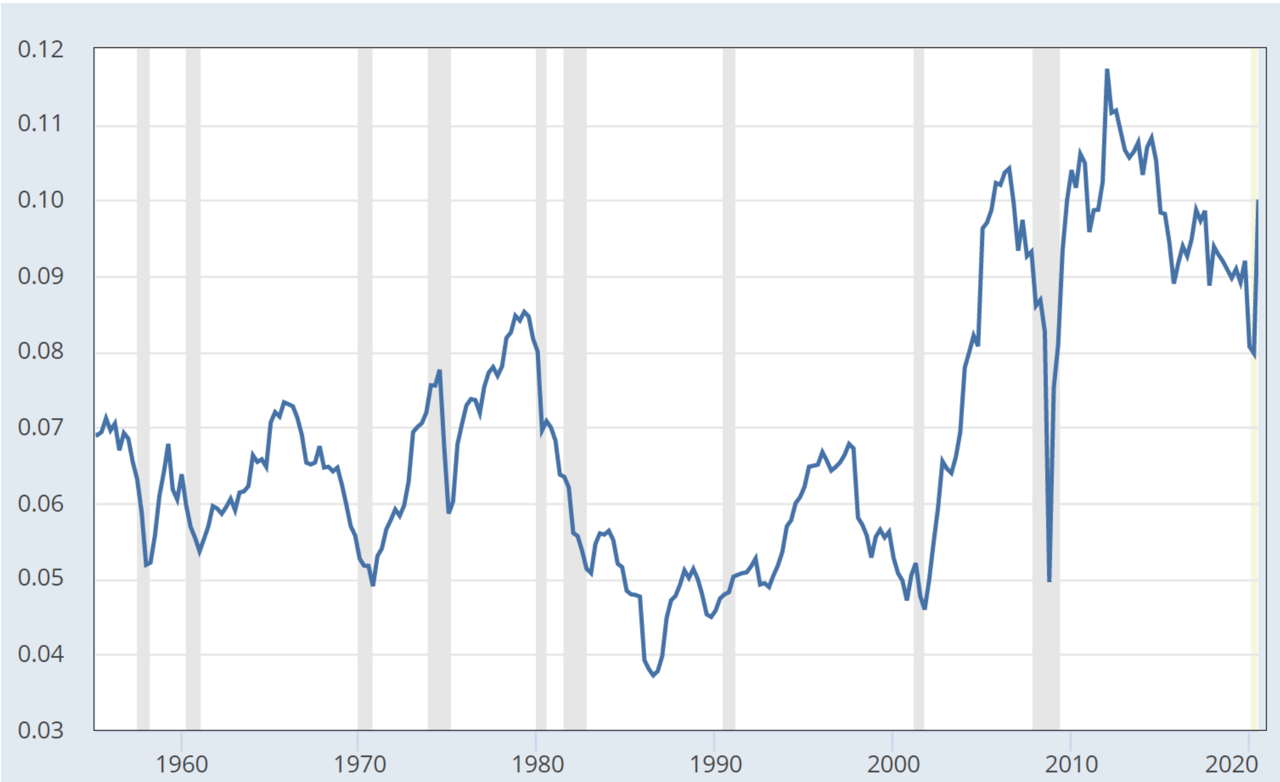
Source: Bloomberg

5. US earnings will grow by 8% - a healthy rebound but not quite as strong as hoped

Another key element underlying investor optimism is the expectation that US corporate earnings are poised to rebound particularly strongly this year. Consensus earnings forecasts for 2021 are currently around 11%. Earnings usually (but not always) grow more strongly than the economy in the early stages of a recovery. This is shown in Chart 5 below which illustrates the US corporate profit share – the ratio of corporate profits as a share of the overall economy. Following recessions (the shaded bars) the corporate profit share usually rises, and we are seeing this from the most recent recession.

This occurs because, for many firms, revenue is more variable than their cost base. As the economy enters recession, profit margins and sales get crunched and overall profits fall sharply. During the recovery phase, however, the opposite occurs and profits tend to rise rapidly.

Chart 5: US corporate profits after tax (without IVA and CCAdj)/gross domestic product, 1960-2020



Source: US Federal Reserve

But while earnings should grow solidly, we suspect they will disappoint these buoyant expectations. As can be seen in Chart 5, for 50 years the US profit share ranged between 4% and 8% of GDP. Over the last 15 years, however, it has averaged around 10%. This is not because growth was particularly strong, but rather that other factors that drive profits—interest costs, taxes, wage costs, and investment levels—have all fallen very sharply since 2000. To maintain the previous rate of earnings growth, all these factors must continue to move in the same direction; with the election of US President Biden, this now seems unlikely. The bottom line is that earnings should be healthy, but not as spectacular as hoped.

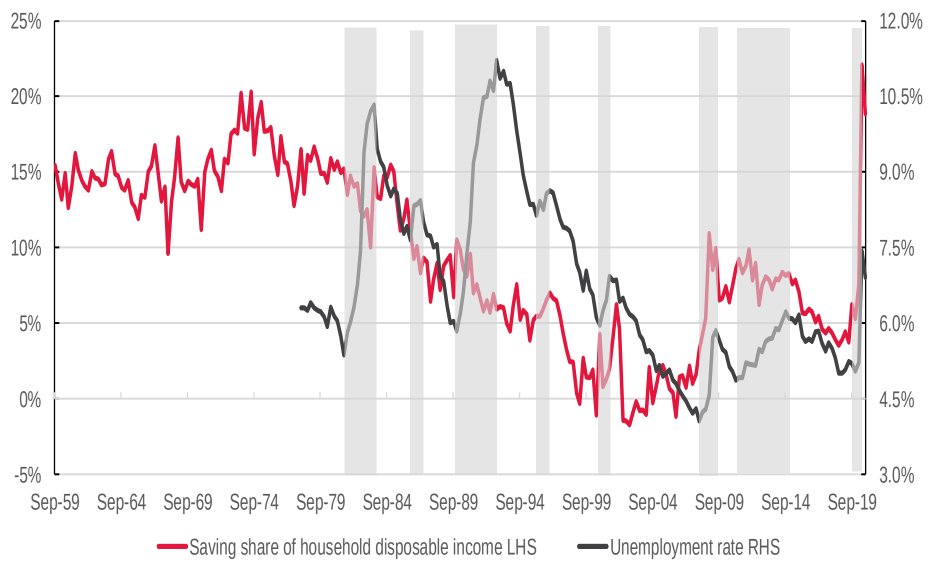
6. Australia's household saving rate will fall only modestly over 2021

When COVID-19 hit Australia in early 2020, the initial response of Australians was to cut spending. Combined with the large increases in government income support—JobKeeper and expanded JobSeeker payments—this resulted in the saving rate jumping to its highest measured level.

Historically, people save more when they are uncertain about the future. Typically, they delay spending until future income prospects become clearer. COVID-19 triggered massive uncertainty about the future – between March and June 2020, the unemployment rate jumped from 5.2% to 7.4%, and the saving rate leapt from 7.6% of household disposable income to 22.1%.

As government support payments are wound back over 2021, household income growth will weaken. It is possible, however, that households may run down their savings to fund healthy consumer spending, despite soft income growth. If this occurs, the economic recovery in 2021 could potentially be very strong.

Chart 6: Australian savings ratio and unemployment rate, September 1959 – September 2019



Source: Australian National Accounts: National Income, Expenditure and Product. Catalogue Number 5206.0, Australian Bureau of Statistics.

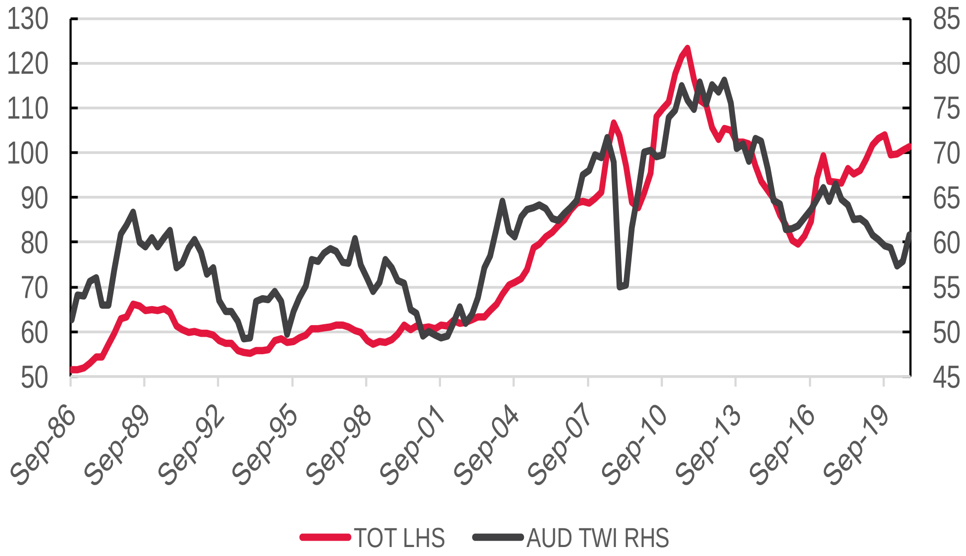
This was a factor driving economic growth in the September quarter of 2020. The saving rate fell to 18.9% in the September quarter, boosting consumer spending and adding 0.5ppt to GDP. If the saving rate suddenly dropped back to its 2019 average of 5%, this would boost spending by more than 2 ppts of GDP.

The likely scenario is that households will only gradually loosen their purse strings. Wages growth slipped to a record low of 1.4% in the third quarter of 2020. Even with an effective vaccination roll-out, it will take time to reduce the high numbers of unemployed and under-employed people and this will continue to restrain wages growth in 2021. Meanwhile, government income support measures will be wound back over the first half of 2021. Finally, the pandemic may have caused people to feel less confident on the security and stability of their job which could induce a lasting increase in household precautionary saving.

7. The Australian dollar will end the year at US$0.76 as the RBA offsets strong commodity prices

In 2020, the Australian dollar plunged from US$0.70 at the start of the year to a low of US$0.57 in March, before making a remarkable recovery to end the year on a high at US$0.78. As such, it reflected the rollercoaster ride that the global economy—and investor sentiment—experienced. We anticipate a more settled global economy in 2021, which suggests that the Australian dollar should track closer to its medium-term fundamental drivers. In our view, this suggests the Australian dollar will end 2021 around US$0.76, only a little lower than where it started the year.

Chart 7: Terms of trade and AUD trade weighted index, September 1986 – September 2020



Source: Australian National Accounts: National Income, Expenditure and Product. Catalogue Number 5206.0 and International Trade in Goods and Services, Australia Catalogue Number 5368.0, Australian Bureau of Statistics.

RBA research suggests the key drivers of Australia's exchange rate are the ratio of export prices to import prices (referred to as the "terms of trade") and interest rate differentials. Over longer periods, much of the change in Australia's exchange rate can be explained by its terms of trade. Over shorter periods, risk appetite and market positioning can also be critical.

Thus, the proximate causes of the Australian dollar's volatility in 2020 were the COVID-19 induced rush into "safe haven" US$-denominated assets in early 2020 followed by the rebound in global commodity prices—a useful proxy for Australian export prices—in the second half of the year.

Without any further global shocks sparking a run to safe-haven assets, and with most central banks keeping global interest rates suppressed, we expect the terms of trade to be the dominant force affecting the Australian dollar in 2021. Consensus forecasts imply commodity prices will fall between 10-20% from current levels by year end, and suggest the US dollar will fall modestly against its major trading partners. This combination points to "fair value" for the Australian dollar being a little below the consensus forecast of US$0.78.

8. The RBA will maintain its target for 3-year bond yields in 2021

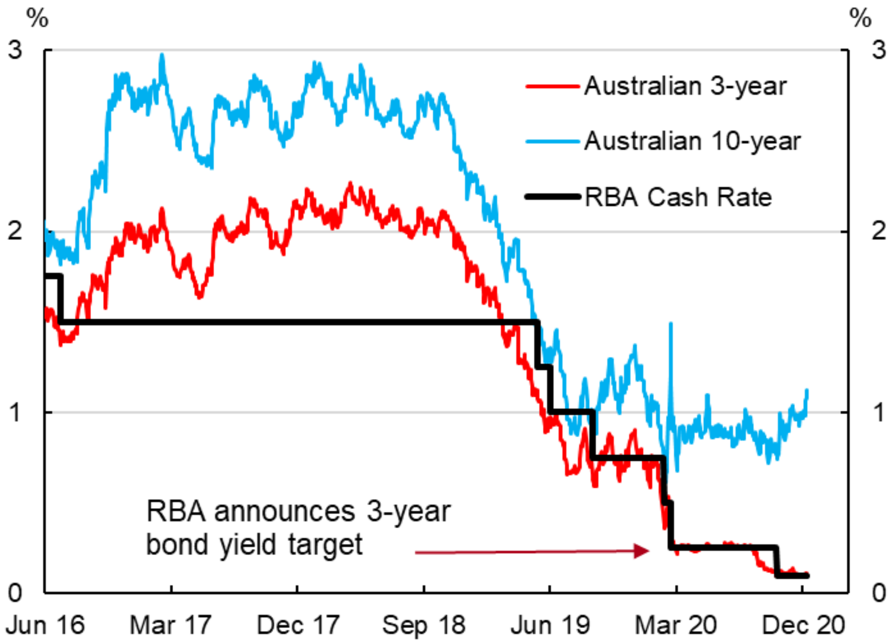
The RBA's policy response to the COVID-19 crisis in March 2020 was to cut the cash rate to 0.25%, commence a government bond-buying programme and provide very cheap funding to banks. It also committed to anchoring the 3-year Commonwealth Government bond yield to 0.25%.

The rationale for this was to provide a concrete form of "forward guidance" to investors, households and firms that the overnight cash rate will remain very low for at least the next 3 years. In November 2020, the RBA subsequently reduced its target for the overnight cash rate and the 3-year government bond yield to 0.10%. This policy has been effective in reducing fixed-rate mortgage rates to below 2%, supporting the housing market, and dampening demand for the Australian dollar.

One problem with introducing the policy in its current form, however, is the issue of "time consistency". Taken literally, the policy suggests the RBA will keep rates unchanged at least until December 2023. But if the RBA thought that it might need to raise rates during 2024, then it should technically raise its 3-year target at some stage during 2021. Indeed, some strategists are already speculating when the RBA will start raising rates given that the economy appears to have been less affected by the COVID-19 pandemic than initially feared.

If the RBA does shift its bond-target policy in 2021, we believe this would undermine the market's faith that monetary policy will remain extremely supportive of the economy over the medium term. As a result, the Australian dollar would likely rise and this would undermine the RBA's goal to get inflation back into its target band. Therefore, we do not expect the RBA will abandon the 3-year bond yield target, even if it de-emphasises the time-dimension of its commitment.

Chart 8: Interest rates and bond yields, Australia, June 2016 – December 2020

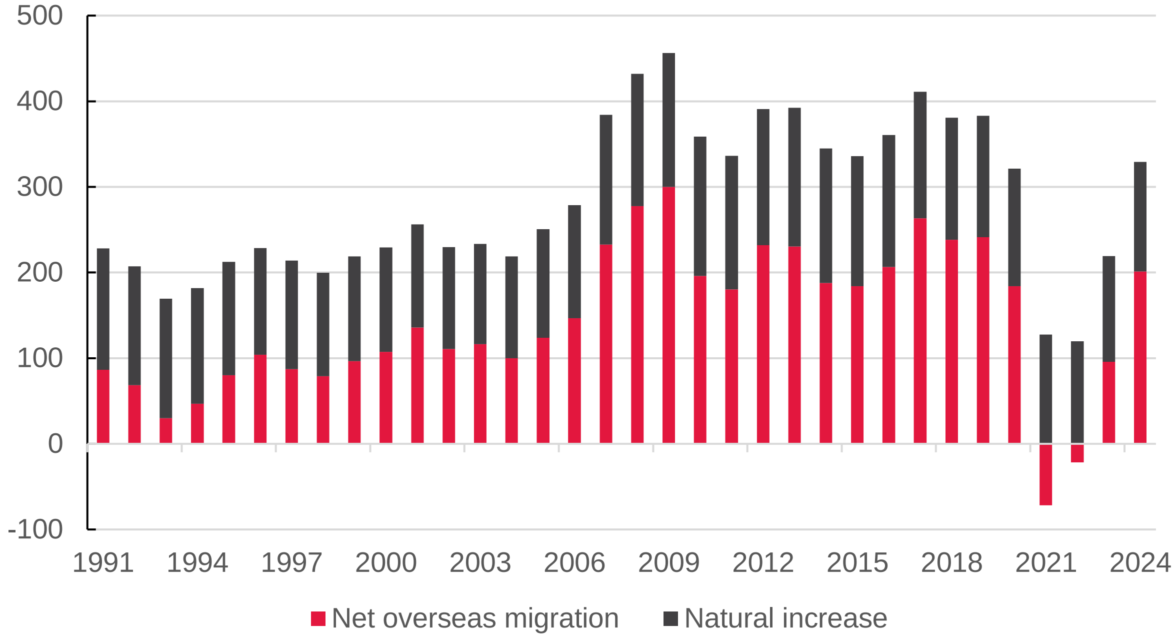


Source: RBA, Bloomberg

9. Australian house prices to rise 5% as easier lending conditions offset cautious investors

In 2020, the multi-dimensional nature of the Australian housing market was on display – houses were in demand while apartments were not, first-home buyers outbid investors, and prices rose fastest in the smaller capitals and regional areas. Key market drivers such as demographic factors, government policy, and the shift to working from home (WFH), pulled parts of the housing market in different directions. Home values increased 3% in 2020, with regional prices up 6.9% and capital city prices 2% higher. These forces will be prominent again in 2021, and in our view will limit the average rise in house prices to approximately 5%.

Chart 9: Population growth, year to June, '000s



Source: *Population*, ABS Cat. No. 3101.0, and Commonwealth Budget Papers

The pandemic triggered a sharp rise in WFH with telecommuting finally becoming a reality for many Australians. This boosted house prices in regional areas and those dwellings that were better suited to WFH (i.e. detached houses). A permanent shift to WFH among more employee groups might ensure that this remains a structural change in housing demand.

COVID-19 also forced governments to close international borders, stopping immigration which has been the main source of population growth over the last 15 years. After averaging 1.6% per annum over the last decade, population growth is expected to slump to 0.2% in FY2022, 0.4% in FY2023 and not to fully recover until FY2024. Migration is an important source of demand for apartments. Residential vacancy rates are at 15-year highs in Sydney and Melbourne of nearly 5%.

Government policies also encouraged more first home buyers and owner-occupiers to enter the market. Meanwhile, investors suffered from the weaker rental market and paused rental payments.

Looking ahead, some of the factors supporting prices in 2020 are unlikely to persist. Additional government measures to support home buyers and renters are unlikely, and household income support measures will be withdrawn, partially offsetting the recovery in the labour market. That said, mortgage interest rates will stay low. Thus, house prices are likely to rise, but modestly.

Reflecting on 2020

Just as each year we peer towards the horizon to see what the next 12 months might deliver for investors, we also think it's worthwhile (if not always pleasant) to review last year's forecasts noting what we got right and wrong, and what lessons we can learn.

Of course, 2020 was not a normal year. Although we think that there are lessons to be learnt from what transpired, simply looking at our forecasts and what eventuated is probably less helpful than usual. For example, we predicted that Australian house prices would grow 5% over 2020 with actual prices rising by 3%. Usually, we would characterise this as a successful forecast, but the rationale behind it was completely different to the factors that ultimately drove house prices over 2020. For an investor, it doesn't matter whether good luck or good analysis underpinned the result, but for a piece of research this distinction is vital.

For us, the key lesson from 2020 is how effective the combination of well-timed and well-directed fiscal and monetary policies can be for determining the path of the economy and financial markets. For years, central banks have implored politicians to provide more fiscal policy support to help boost growth and inflation. And 2020 showed just how powerful fiscal policy can be when it is deployed well.

It would be tempting to take some solace from the fact that most of our forecasts were on the right side of consensus. US employment and earnings growth was weaker than the market expected. The Fed did ease policy even though its policymakers expected to raise rates at the start of 2020 and tensions between the US and China persisted over the year. The RBA also cut interest rates in 2020 and commenced bond purchases, although its policy responses were much more aggressive than we believed likely.

It is impossible to say, however, whether these forecasts would still have been on the right side of consensus in the absence of the COVID-19 pandemic and the collapse in activity. We can, however, take some encouragement from the fact that the nine things that we nominated last year were all crucial to how the economy performed, and how markets reacted, over the course of the year. At least we were looking at the right variables.

Table 2: The 9 things to watch in 2020 – forecast vs actual

Item	Forecast for 2019	Actual (year-end)	Outcomes
Global manufacturing	Stronger	Improved	Global PMI rose from 50.1 to 53.8
US jobs growth	Slow to 130K	Ranged between -21m and +4.9m	Extraordinary volatility in job outcomes
US earnings growth	6.0%	-30%	Earnings collapsed as shutdowns hit
US-Fed Reserve	Cuts rates by 25bps	Cut by 175bps	Launched extraordinary policy stimulus
US-China trade relationship	No Phase 2 deal	No deal	Tensions intensified
Oil price	Average US$65bbl	Averaged US$43bbl	Ranged between $US70 and US$20bbl and ended the year at US$53bbl
Australian fiscal policy	Modest stimulus	Massive stimulus	The Government opened the fiscal stimulus floodgates after the pandemic hit
Australian house prices	+5%	+3%	Prices fell 4% over the first six months, but surged 7% after August as the removal of macro-prudential controls boosted lending
RBA monetary policy	-50bps	-65bps	Cut policy and embraced quantitative easing

Source: TCorp

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