Quarterly economic and market update

September 2021

Quarter in review

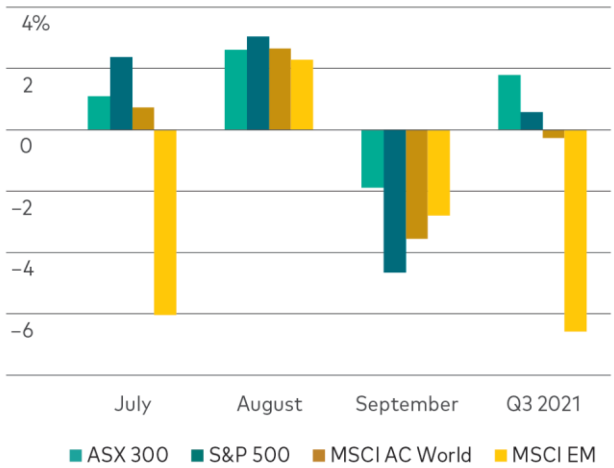
The September quarter saw global markets finish largely flat as investors weighed rising vaccination rates and signs of economic resilience against sporadic outbreaks and a gradual tapering of support from central banks.

For developed markets, an early-quarter rally through August was supported by strong company earnings results and accommodative monetary policy expectations. However, sentiment softened in September as inflation numbers proved stubborn, prompting the Federal Reserve to adopt a more hawkish tone, while high-stakes negotiations over the U.S. debt ceiling rattled markets. The final weeks of the quarter saw investors shift away from interest rate sensitive growth shares to cyclical sectors such as energy and financials, narrowing the gap between value and growth performance.

Meanwhile, emerging markets were weighed down by the underperformance of Chinese equities. Uncertainty over the Chinese administration's regulatory actions in the services and property sectors continued to dampen investor appetite, causing volatility to briefly spill into international shares. Falling commodity prices and a relatively dovish Reserve Bank of Australia saw the Australian dollar weaken over the quarter, providing AUD investors with a buffer against international woes.

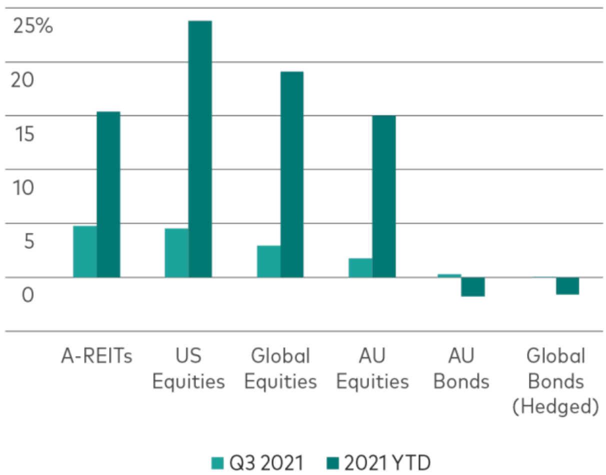
In bond markets, returns were positive but nonetheless modest. Treasury yields came under pressure in the latter half of the quarter

Figure 1. Local currency returns for global indices



Notes: Returns are cumulative total returns denominated in local currency.
Source: FactSet, Refinitiv

Figure 2. AUD returns broadly advanced



Notes: Returns are cumulative total returns denominated in AUD.
Source: FactSet, Refinitiv

as markets sensed that central banks may speed up their timeline for monetary policy tightening—meaning potential interest rate hikes and a pullback in bond purchases may come sooner than expected.

Economic and market outlook

Vaccination progress has ramped up significantly around the world. Around 45% of the world's population has received at least one dose as of Q3, close to double the rate seen at the end of June. A closer look at the data, however, suggests that vaccination rates still differ widely across regions, with developed markets far outpacing emerging markets.

The unevenness in vaccination outcomes has led to different health policy responses around the world. Countries with high vaccination rates, such as the United States and United Kingdom, have proven less sensitive to rising cases than countries with lower vaccination rates like Australia.

The exception to this rule is China, which continues to pursue a zero-COVID strategy despite close to 70% of its population having received at least one dose of the vaccine. Differences in health policy responses are likely to produce divergent economic results. The United States is projected to return to its pre-pandemic trend levels by Q1 2022, while China and Australia will return to trend in the second half of 2022.

We expect the Australian economy to shrink in Q3 after declining by 7% in Q2 2020 as a result of the extended lockdown restrictions in New South Wales and Victoria. Nonetheless, the gradual move away from a zero-COVID strategy in exchange for a higher rate of vaccination suggests that conditions are in place for a stronger rebound into 2022, with the national vaccination target of 70% likely to be met by Q4 2021. This could pave the way for improved mobility and add more resilience to the economic reopening going forward.

As a result, we have upgraded our 2022 growth forecast from 3.5% to 4% to reflect a more sustainable social easing. Notably, there remains downside risks to our forecasts, especially if the vaccine rollout flattens and vaccine hesitancy rates increase, as observed in Queensland.

Weak inflation pulse to delay RBA rate hikes

From the RBA's perspective, the near-term economic outlook has clearly deteriorated when compared with its August forecasts. The bank's explicit intention is now to delay interest rate lift-off until inflation is established around the middle of its 2–3% target range. This suggests that rate hikes are likely off the table in 2022.

We do not expect core inflation—which excludes volatile food and energy prices—in Australia to return to the lower end of the 2–3% range until 2023 given the delayed economic recovery as well as ongoing competitive cost pressures in the labour market, which are depressing wage growth. Against this backdrop, we expect the RBA to keep the cash rate at 0.1% until at least 2023 and maintain a tapered form of quantitative easing until Q3 next year.

Expectations for global equities remain positive but modest. Forecast returns for equity are sitting in the range of 3.4% to 5.4% annualised over the next decade, compared with forecast fixed income returns in the range of 1.4% to 2.4%.

As 11 consecutive months of Australian share market gains come to an end, it is timely to remind investors to maintain discipline and stick to their investment plan. Attempting to time the market or make impulsive decisions can often come at the detriment of long-term objectives. Investors are well advised to stay calm and focus on the factors within their control: having a well-planned and diversified strategy that is aligned to their specific goals and the discipline and resolve to stay the course, even during the most volatile times.