Aviator Update – October2020
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Australia – My Way

It's understandable that the economy has been a hot topic over the past 6 months. I'm repeatedly being asked for my take on the outlook. Today, I want to share my thoughts along with most of my workings with respect to how I view and interpret the economy.

Economies are incredibly complex and trying to condense all the thoughts that swirl in my head into a few pages is near-impossible. We could write an essay on dozens of the topics touched on in here. But let's give it a go anyway…

I'm basically going to break this up into two bits. Firstly, we will examine the economy from a theoretical perspective – how we measure it and what drives it. Then, we can apply these concepts to what's going on at the moment to hopefully get a sense of the economic outlook.

Let's start here… What is the "economy"?

Well, as I like to think about it, the economy is basically the by-product of 26 million Australians going about their lives. The decisions they make every day;

Buying things they need.
Buying things they want.
Not buying things they want.
Deciding to acquire new education or skills.
Deciding to switch jobs.
Deciding to open a new business.
Deciding to invest in expanding their business.
Deciding to shift business operations overseas.
Deciding to downsize their business.
Buying a home.
Upgrading the home (and mortgage!)

The sum total of all these decisions is the Australian economy.

When we think about the economy this way, we immediately hit on an important economic factor – confidence…

How people feel has a big influence on the economy. If you're uneasy about your economic future – for example, job security - discretionary spending goes out the window. If you're

confident about the demand outlook for your business's products or services, you're willing to take on more debt to expand operations.

Of course, not everyone will feel the same way at the same time so measuring confidence is not easy.

Measuring the economy

Measuring the economy has traditionally been all about measuring the *size* of the economy. And for this we most commonly use the good old "Gross Domestic Product".

But measuring the size of the economy isn't necessarily a particularly good gauge of the "health" of the economy – how the bulk of the population are faring.

In the USA, they recognise this and their "National Bureau of Economic Research" (the body charged with mapping economic cycles, including deciding when the economy is in recession) use a broad measure of economic metrics to determine how the economy is performing. In Australia, there's no equivalent to this – GDP is about all we have, although there's surely some economists that have created their own proprietary models of economic health and performance.

This aside, an understanding of how GDP is calculated is actually very powerful for evaluating economic prospects.

GDP = C + I + G + (exports – imports)

Gross Domestic Product is the sum of:

- C: consumption (business and personal),
- I: investment,
- G: government expenditure,
- Net exports (Export less Imports).

These components are all pretty easy to grasp. The main one I want to touch on in greater detail is *investment*.

Investment is a key feature within the longer-term economic outlook. But we need to realise that everything we might refer to as "investment" is not equal.

Broadly, economic growth results from an increase in the production of goods and services. Investment is key to this in terms of fuelling the ability to generate more goods and services in the future. Hopefully, investment will fuel productivity growth. But not always.

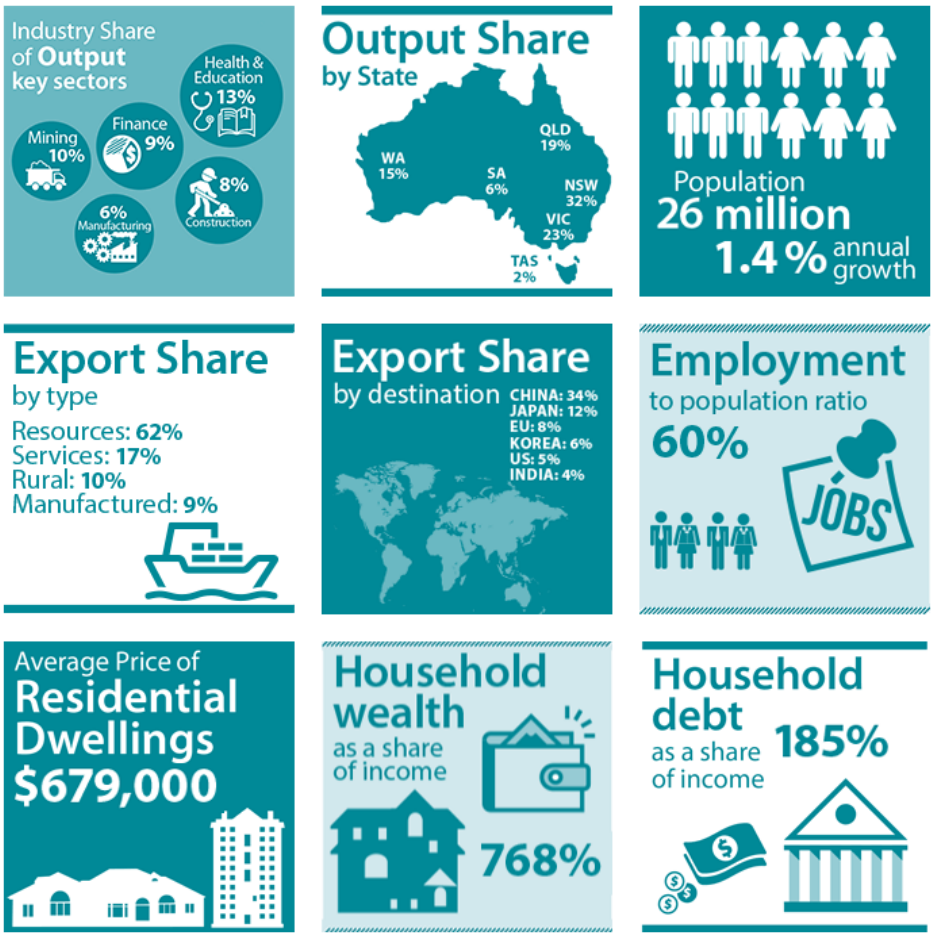
The "worst" type of investment is the type of stuff many of us engage in as individuals – speculating on asset price movements. Whilst speculating on share prices, or property

prices, currencies and the like can result in an increase to our personal wealth, it's completely unproductive.

On the other end of the spectrum, the "best" investments will add to the nation's productive capacity. A new, state-of-the-art manufacturing facility that will produce goods more efficiently – ideally making the business in question highly competitive on a global basis, opening up export opportunities. It could be an investment in infrastructure assets which reduce the operational costs of other businesses. Investments that create jobs – good jobs.

Then we have everything in between. The proliferation of "buy yourself a job" services businesses – investment in a coffee shop, a gin bar, a tattoo parlour, a barber shop. All these individuals "living the dream" – being their own boss. The thing is that very few of these business ventures really create anything – the principals aren't building an asset to on-sell. Whilst the business activity adds to GDP, they aren't activities that fuel productivity growth – it's just money changing hands for services. (I best add that I don't mean any disrespect to anyone engaged in such businesses – I'm a big fan of some of these businesses! It's just not comparable to, say, an aerospace engineering company producing world-leading technologies that it sells to the US military).

Here's another way of viewing the economy. This cool little graphic is courtesy of the Reserve Bank of Australia (current as at October 2020):



I want to focus on the first item in the top left – sectoral output. We're accustomed to hearing that the "services sector" of the economy is by far the largest. That's very true.

A quick detour into economic theory is necessary at this point. Under the "three sector theory", an economy can be broken up into three main components:

- The primary sector – production of raw materials
- The secondary sector – basically manufacturing
- The tertiary sector – also called the services sector – being the production of services

"Services" is very broad – hairdressers, restaurants, financial services, engineering services, architects, transportation (goods and people), information technology. The list is almost endless.

According to the national accounts, the services sector is responsible for somewhere around 60% of total economic activity and close to 80% of employment.

Ultimately, when you think about it, services is just money passing back and forth between people. And when we think about it that way, we hit on another reality that is powerful for evaluating economic prospects.

One person's spending is another person's income.

The source of "money" in the economy.

It's fairly logical that the more money there is sloshing around in the economy, the greater the potential for economic activity. In the simplest sense, there's effectively three sources of money;

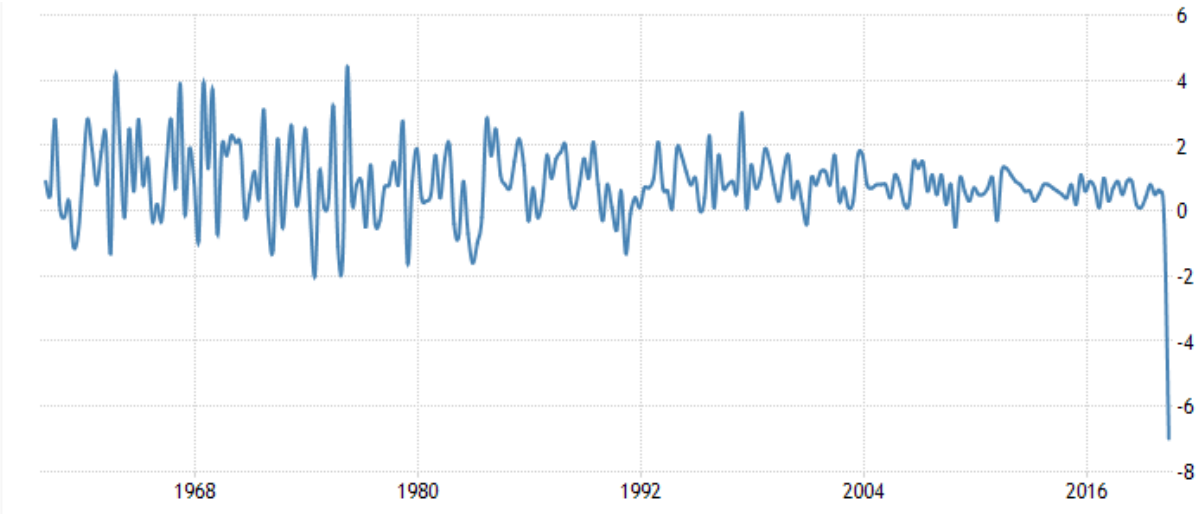
Debt. As we have covered at length in previous missives, under the monetary system used in Australia and most nations, "money" is created within the private banking system via loans. Loans create deposits – "money".

Taxes basically drain money out of the economy – robbing people of spending capacity. If you are struggling to fully picture this, think of it this way; how would your disposable income be affected if the government abolished taxes?

Net Exports. If we're able to sell goods and services overseas, we essentially import money received from those sales. Subtracting imports, if we're able to run a trade surplus (exporting more than we import), we essentially import money on a net basis.

Armed with the above, now let's start to examine the economy.

Aussie GDP fell 7% in the quarter ending in June from the prior quarter. 7%. This is what that looks like compared with other quarterly moves going back to the 1960's:

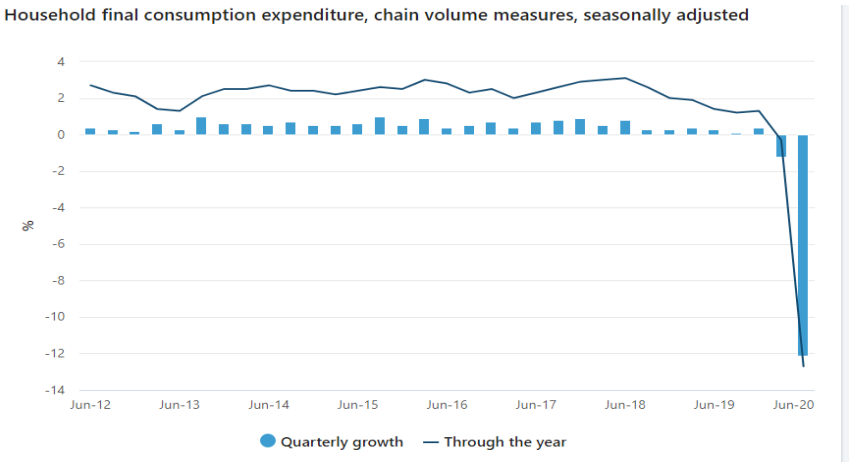


Now, here's some good news. Many economic commentators are already rejoicing in our exit from recession.

It's probably true. In a purely technical sense, it's probable that GDP rose in the September quarter. But who cares? The trajectory is what's important to us.

The services sector bore the brunt of the Covid fallout, although we need to remember that the sector is incredibly broad and not all parts were majorly affected. Hospitality and travel got annihilated, whilst significant rises were recorded in alcoholic beverages and furnishings/household equipment.

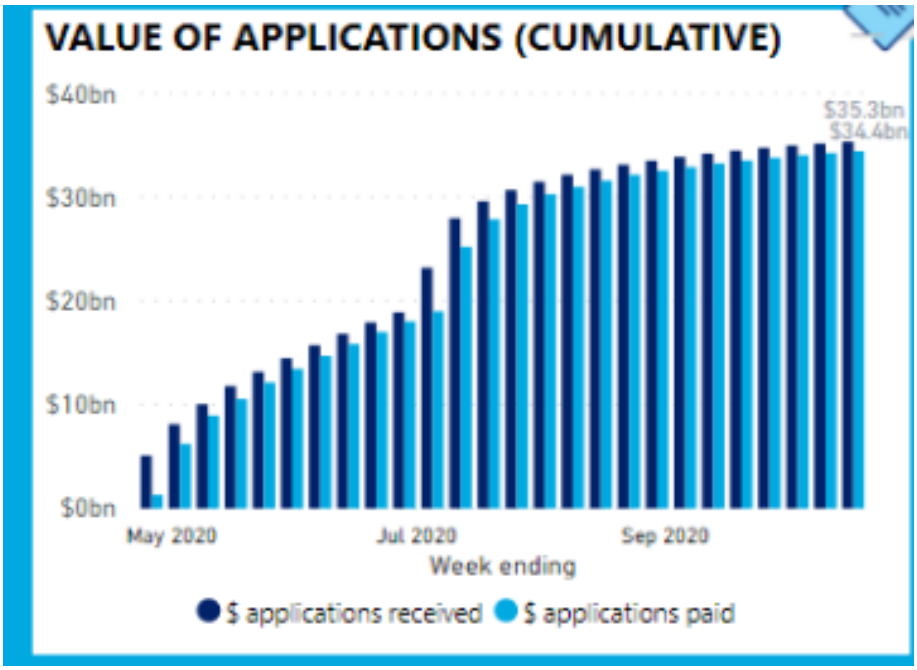
Referring back to our GDP equation, the net outcome however was a big decline in "C".



The government did largely what they should have – they beefed up the “safety net” for affected citizens. Jobkeeper was necessary and, in my view, it was appropriate and successful.

This was a good jump in “G” in our GDP formula and without that, GDP would have cratered even lower.

Stimulus during Covid also included the ability to access superannuation savings. APRA has been tracking and publishing data for all the funds they oversee (basically all except SMSF’s).



As we can see, withdrawals have slowed to a trickle – surely almost everyone that wants to access some money has by now. The total to date - $34.4 billion!

It’s probable that quite a bit went to reducing debt but I think it’s fair to assume that the bulk of it got spent. Induce people to spending their own retirement savings early - quite effective stimulus.

Mortgage deferrals – back in March as an outcome of Covid the banks graciously agreed to defer mortgage repayments for 6 months. As of August, APRA figures revealed round 9% of home loans on hold worth about $160 billion. Further, 16.2% of small business loans were on hold worth around $53 billion.

This is all ending at the moment with businesses and households facing a resumption in repayments.

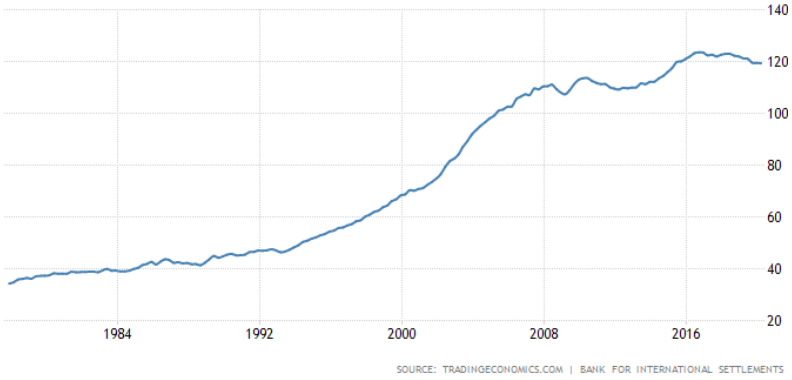
We're aware that these government stimulus measures are beginning to wind back. This is the cause of quite a lot of consternation.

Interest rates – our Reserve Bank reasonably did what it could – cutting interest rates to a record low 0.25%. It threw in a bit of "unconventional monetary policy" as well.

From comments made in recent weeks, it looks as if the RBA is set to look at further stimulus in the coming month or two. A further rate cut (0 - 0.1%!) seems likely, along with the possibility of more interventions in bond markets to try and suppress longer-duration bond yields.

It's possible the RBA have their sights set on a lower Aussie dollar – this would provide a boost to exports although it isn't' instantaneous. In terms of interest rates themselves, there is the question of what good a further modest decline will do – will it really stimulate more demand for debt?

On the general subject of debt, here's a snapshot of Australian household debt to GDP:



Country	Last
Switzerland	134
Australia	119
Denmark	111
Canada	106
Norway	106
Netherlands	101
South Korea	95.9
New Zealand	94.8
Sweden	89
United Kingdom	84.5
Hong Kong	82.7
United States	75.2
Thailand	69.5
Malaysia	68
Finland	66.7
Luxembourg	66.7
Portugal	64
France	62.7
Belgium	62.5
Japan	59.3
Euro Area	58.2

Just to put some context around that, here's the global leader board on the right.

Go Australia! Almost Global leader.

The data is through to March and it's inevitable that this has declined over the past 6 months of Covid.

Household savings has skyrocketed – just as you would expect. Faced with a highly uncertain outlook, people will choose to pay down debt.

As touched on earlier, an increase in debt basically means an increase in money. How much more debt do Aussie households have in them?

To digress a moment, our banks have made out like bandits selling all this debt to households over the past 30 years. Its debt to us but an income-producing asset to them. Bank earnings growth is heavily tied to debt growth. If you're expecting the same earnings and share price growth experienced over the last 20 years in the coming 20 years, you're basically saying debt will continue to grow at the same incredible pace.

House prices - I intended not to mention asset markets in this commentary, but some comments on house prices is almost mandatory when discussing the Aussie economy. The main reason is that it's been observed a number of times in the last few decades that people make spending decisions relative to their perceived "permanent wealth". Share price movements typically have quite weak correlations to consumer spending. House prices however have tended to have a strong relationship to spending.

The logic is simple. People either consciously or unconsciously know that their share portfolio value isn't permanent – prices fluctuate frequently. There is however a tendency for people to view house prices as stable.

According to the ABS, the total value of Australia's residential housing stock at the end of the June quarter was $7,138.2 billion. To put that into perspective, GDP is worth somewhere around $1,990 billion.

A 15% fall in house prices will have a significant wealth effect. It will make people feel poorer and have some impact on consumer spending.

A meaningful fall in house prices will also impact development activity, which could have a meaningful impact on all those Aussies engaged in the property development industry.

Population Growth – Australia's set to achieve another rare event this year. Its projected that we will see a net decline in population. The first time in over 100 years. Next year might be similar.

Population growth is a controversial topic. Loading two major cities already bursting at the seams with more residents isn't necessarily a good thing. It does however have some impact on boosting demand and therefore the absence of population growth should be a drag on economic activity. Population growth also adds demand for homes and thus property prices.

Exports – referring back to our ABS graphic, mining is currently around 10% of the economy. That's risen a bit in recent years. Also note from that graphic that resources are by far our largest export and China our largest customer.

China's economic model of building more stuff, all fuelled by new debt, remains intact. However, even they know it's not sustainable. It's probable – in fact, it's inevitable – that

the debt-fuelled building binge will end at some point. This has major implications for Australian exports.

Another major export is tourism…which of course has gone. Sure, Aussies can't take their money outside of Australia and spending this money holidaying at home will certainly go a decent way to offset the incoming tourists, but certainly not completely. It's going to hurt a lot of tourism operators and represent a "pay cut" for Australia.

Federal Budget:

The last budget was the most important budget in, well, a very long time. It comes at a time when the Aussie economy is trying to emerge from this Covid lockdown, whilst much of the rest of the developed world is still being ravaged by the virus and the government's emergency financial measures wind back.

It was very under-whelming.

Australia (most of the developed world, for that matter) is suffering from a lack of "demand" – demand for goods and services. Sadly, the major budget measures are focused on the "supply-side" – assisting businesses in producing/supplying more goods and services.

The tax cuts are nice, but most of it will be saved.

Incentives for businesses to hire more staff. But what most businesses crave is more customers, not more staff.

Then we have incentives for business to invest in new assets via tax write-offs. Sure, it incentivises a bunch of tradies to buy a new Ram monster truck. But it's not about to herald a manufacturing renaissance.

With a mandate to support the economy at basically any monetary cost, our government has an opportunity to do something really special during this remarkable moment in history. Initiatives that could have a lasting impact on the economy.

Sadly, they seem set on squandering the opportunity. Here's one example, which has been talked about frequently;

Australia could be a global leader in renewable energy. Renewable energy is no longer a costly experimental technology. The technology exists to produce electricity as reliably and more economically than existing generation mechanisms and we have the natural resources and know-how to make it happen.

With significant slack in the economy, massive investment in renewal energy could yield some amazing outcomes. Real "nation-building" stuff. It would stimulate the economy from

a much-needed “demand” perspective – creating jobs – good jobs. Credible analysis shows it would meaningfully lower electricity prices – putting money back in the pockets of households and providing businesses with a much-needed boost. Last but not least, it’s a great thing for the environment.

Sadly, our federal government, beholden to oil and gas lobbyists, instead has announced recently that its energy and carbon reduction policies will include funding for initiatives such as carbon capture and storage, which in itself is energy-intensive and has limited support from the scientific fraternity in terms of true effectiveness.

Conclusions:

When we survey the current economic landscape… evaluate our government’s actions… understand the key sectors and drivers of our economy… my view on the economic outlook in the coming couple of years is…

“Meh”…

As Covid lockdowns lift, the services sector will bounce back – not in one “V” shaped recovery, but it will bounce back. I’m optimistic that we’ve nearly beaten Covid in Australia (provided we/our government doesn’t do anything stupid like prematurely throwing the borders open to international students).

Further RBA easing will help support lending activity and house prices to a degree (hey, if I can get a home loan for 1.5% interest rate, I might even look to buy a house!).

The government will throw the borders open ASAP and the immigrants will return.

China will chug away for a while longer – consuming vast resources as it goes.

To the average man on the street, I don’t think the economy is going to be any more of a discussion point than it usually is. Based on measures such as per-capita GDP, our economy has been pretty lacklustre for quite a while now. But few of us notice, understand or care. We’re going “okay”.

A big part of this prognosis is based around confidence and naivety. Aussies are a pretty optimistic and confident bunch. As referred to earlier, these are important traits for a healthy economy. Naivety – well, most of us really don’t have much clue about economics. We can rely on all the mainstream media to paint a rosy picture. Collectively, we will have the confidence and optimism needed to spend our incomes, providing others with income and keeping this services-based economy ticking along.

So basically, what I’m saying is that I don’t feel the economy is going to get so significantly worse from here as to make anyone really notice. It won’t get significantly better either.

We’re set to plod along. Never fear – there will be plenty of opportunities to make things happen in our own lives with respect to career and business.

There are surely meaningful downside risks. Downside risks, as far as I’m concerned, vastly outnumber upside risks. The end of Jobkeeper and mortgage deferrals. An abrupt halt in China. A significant decline in house prices. But honestly, I just don’t think these will be major issues in the near-term.

Plodding along. Meh…