ECONOMIC SNAPSHOT

MAY 2021

SUMMARY

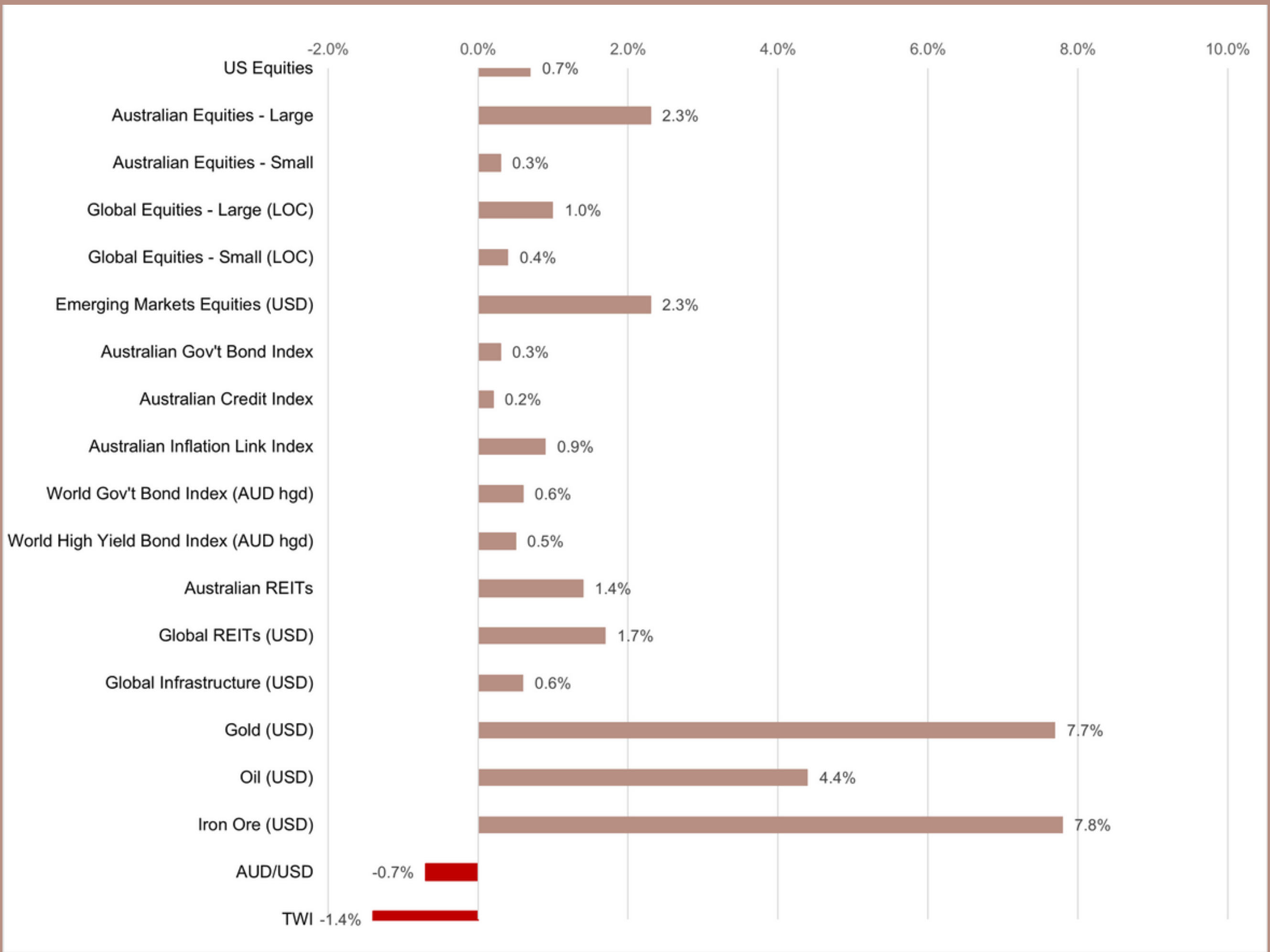
May was a month of consolidation for most asset classes. Global investors have been grappling with the trade-off between the benefits of stronger global growth for corporate profits and the potential cost to bonds from higher inflation that might flow from the stronger growth. In May, the balance of sentiment appeared to shift from inflation to growth, leading bond markets to stabilise and equities to post modest gains despite a number of markets being at record highs.

The A$/US$ traded in line with the Australia/US bond differentials, slipping a bit over the month despite the higher iron ore price. In recent months the A$/US$ has been dominated by the bond differentials and has paid less attention to iron ore.

Gold had its best month in a while, driven by the stabilisation of US bond yields and a lower US$. Some commentators have suggested the recent weakness of Bitcoin helped push speculators into gold, with Bitcoin falling 35% in May.

MAY WAS A MONTH OF CONSOLIDATION FOR MOST ASSET CLASSES, BUT GOLD DID WELL

Selected market returns May 2021



Sources: Thomson Reuters, Bloomberg. Equity returns are total return.

MAY 2021 KEY DEVELOPMENTS

May was a month of consolidation for most asset classes. Bonds and equities posted positive returns across the board, but the A$ slipped a bit even though the price of iron ore had another strong month.

Global investors have been grappling with the trade-off between the benefits of stronger global growth for corporate profits and the potential cost to bonds from higher inflation that might flow from the stronger growth. In May, the balance of sentiment appeared to shift from inflation to growth, leading bond markets to stabilise and equities to post modest gains despite a number of markets being at record highs.

The latest inflation data from the US was somewhat higher than expected. Headline inflation in the year to April was 4.2%, while core inflation was 3%. Economic activity slowed a bit with both the ISM manufacturing and services indices moderating in May, though still maintaining very respectable levels. Employment rose strongly in April, but the unemployment rate remained just over 6% as new job seekers entered the labour market. Overall, while investors are highly tuned to the inflation narrative, they have not yet seen enough in the data to be convinced higher inflation is here to stay. Investors have also been reassured by the Federal Reserve's repeated message that any immediate signs of inflation are likely to be temporary and will not derail the Fed's accommodative monetary stance. As a result, US nominal 10 year bond yields finished May around the same level as at the start of the month, while 10 year inflation-adjusted yields fell slightly.

The bond market's pricing of expected inflation rose in the first half of the month but eased back again in the second half. This allowed the US equity market, which lost ground in the first half of the month, to recover that in the second half and finish a touch higher for the month as a whole. Non-US equity markets performed even better, with European equities helped by prospects for improving growth and progress on managing COVID-19. Emerging market equities were boosted by a weaker US$.

Here in Australia, the Q1 CPI report came in softer than markets expected, with both headline and core inflation coming in well below the Reserve Bank's 2% - 3% target range.

The April labour market report was also softer than expected with a loss of 31,000 jobs, but a small fall in the unemployment rate to 5.5%. Wages growth remains muted with the wage price index rising only 1.5% in the year to the March quarter. However, on the brighter side of the ledger, measures of business confidence and conditions posted solid gains in April to record highs. Measures of employment within NAB's business survey indicate further declines in the unemployment rate in the coming months. The Reserve Bank upgraded its economic outlook and the Federal Government delivered a pro-growth budget. These factors, plus further strength in commodity prices, helped the ASX200 post a respectable 2.3% gain for the month. AREITs also had a good month, helped by the stabilisation of bond yields.

The A$/US$ traded in line with the Australia/US bond differentials, slipping a bit over the month despite the higher iron ore price. In recent months, the A$/US$ has been dominated by the bond differentials and has paid less attention to iron ore.

Gold had its best month in a while. The gold price peaked just over US$2,000/oz in August last year and then declined, with some volatility, to just under US$1,700/oz in March this year. Since then, the gold price has bounced back to around US$1,900/oz, most of which happened in May. The main underlying driver of this rally has been the stabilisation of US bond yields as markets have moved past their initial fears of higher US inflation and tighter monetary policy. Associated with this, the US$ has slipped back as well. These conditions favour a higher gold price. However, some commentators have noted an apparent inverse relationship between the gold price and Bitcoin. The story goes that gold and Bitcoin are similar speculative assets in that they both have finite supply, but potentially infinite demand. Their prices could theoretically be anything or nothing. Some also see them as alternative forms of money to those issued by governments. However, gold and Bitcoin are seen as substitutable, not complementary, assets. That is, speculators sell one to buy the other, but do not buy or sell both at the same time. Under the influence of social media gossip, the price of Bitcoin fell 35% in May, apparently helping the gold price rise.

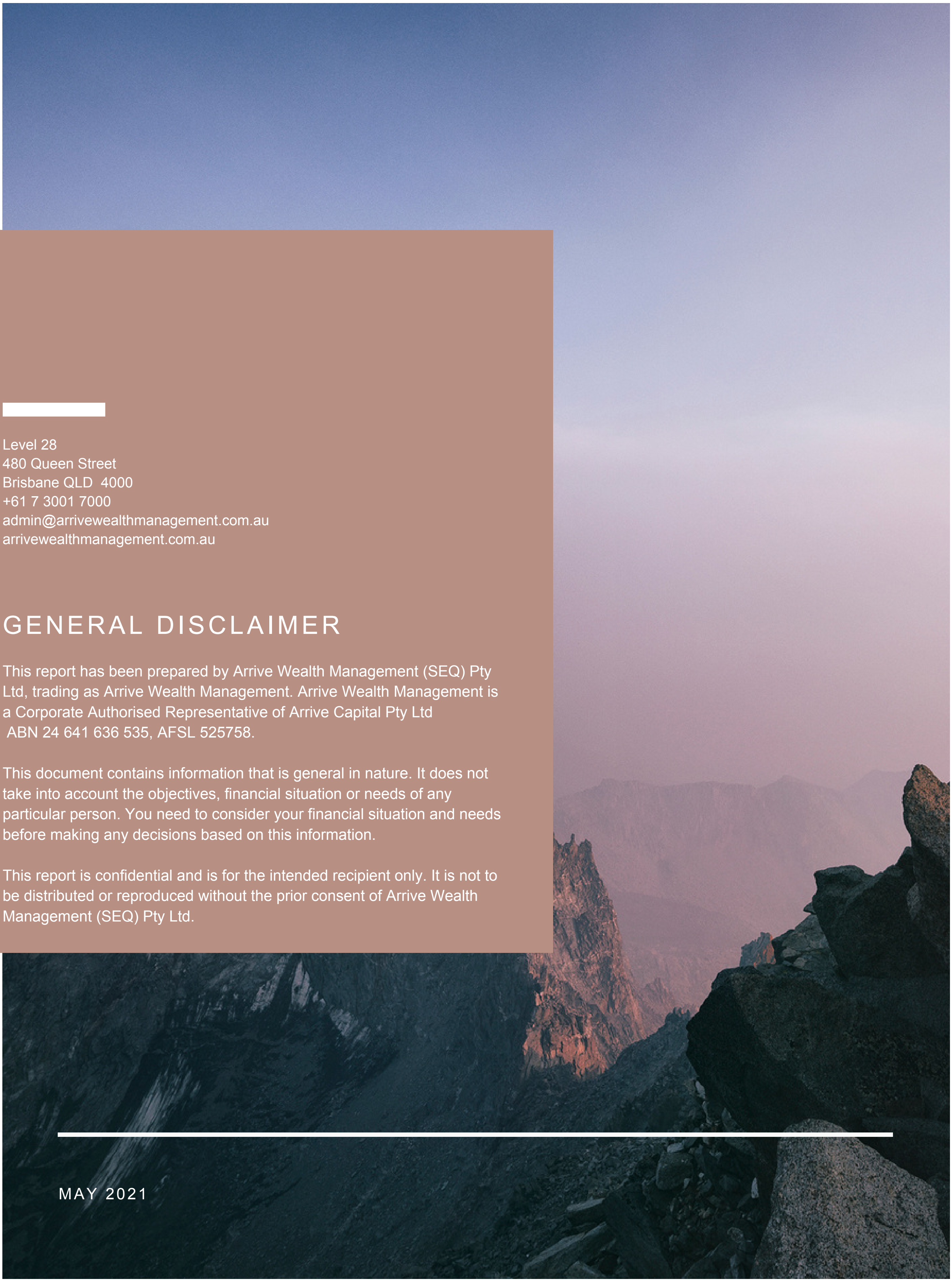
Finally, China has announced a further easing of restrictions on the number of babies a couple may have. For many years China ran the “one-child” policy, but in 2015 lifted the limit to two children. Now, in the face of the slowest rate of population growth since census data began in 1953, the limit has been lifted to three children. The authorities have recognised that China’s future growth and prosperity cannot be maintained with the ageing population that inevitably follows from too low a birth rate.

Japan and parts of Europe face the same problem, but while immigration is a feasible solution in Europe, it is less so for Japan or China. It is worth remembering that immigration has been a key driver of Australia's growth for decades and it is apparent how much COVID-19 has adversely impacted this. However, unlike the deeper structural problems faced by these other countries, the slowing of Australia's population growth should be temporary.

MAJOR MARKET INDICATORS

	31-May-21	Changes over periods shown:*			
		1 Month	3 Months	6 Months	12 Months
Cash rates					
Australia	0.10%	0.00%	0.00%	0.00%	-0.15%
USA	0.02%	-0.01%	-0.06%	-0.06%	-0.03%
Japan	-0.10%	0.00%	0.00%	0.00%	0.00%
Europe	0.00%	0.00%	0.00%	0.00%	0.00%
10 Government bond yields					
Australia	1.59%	-0.06%	-0.29%	0.69%	0.70%
USA	1.61%	-0.02%	0.16%	0.78%	0.98%
Japan	0.07%	-0.01%	-0.09%	0.04%	0.06%
Europe	-0.18%	0.02%	0.08%	0.39%	0.26%
Equity markets					
ASX200	7162	1.9%	7.3%	9.9%	24.4%
AREITs	3416	1.4%	10.0%	1.4%	18.1%
S&P 500	4204	0.5%	10.3%	16.1%	38.1%
Topix	1923	1.3%	3.1%	9.6%	23.0%
EuroStoxx	4039	1.6%	11.1%	15.7%	32.4%
MSCI Emerging Markets	1376	2.1%	2.8%	14.2%	47.9%
VIX volatility index	17	-10.1%	-39.7%	-18.4%	-39.1%
Currency markets					
AUD/USD	0.7725	-0.7%	-1.3%	4.5%	16.0%
AUD TWI	63.50	-1.4%	-1.6%	3.3%	8.0%
USD/Yen	109.40	0.1%	2.7%	4.9%	1.5%
Euro/USD	1.2226	1.6%	0.7%	2.2%	9.9%
Commodity markets					
Gold	1906.0	7.7%	10.3%	7.4%	10.1%
Oil	66.3	4.4%	7.7%	46.7%	86.4%
Iron Ore	201.5	7.8%	15.8%	54.4%	98.5%
Coal	93.9	0.0%	9.1%	49.7%	81.8%

*For cash rates and bonds the changes are % differences. For the rest of the table, % changes are used.



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