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Australia: A Structural Story

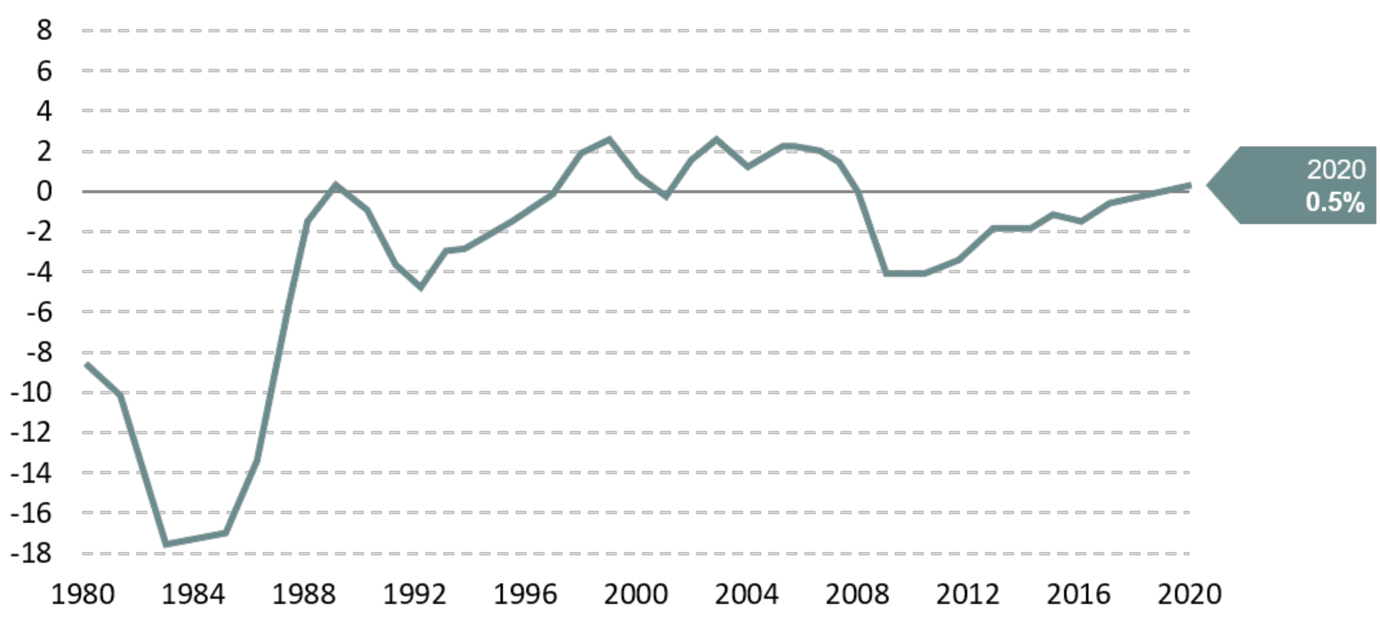
There seems to be a lot of doom and gloom hanging over markets right now, but structurally bullish cases do exist. Australia is one of them. Sure, Australia's economy has slowed, but sluggish growth is currently a global issue. Against a fairly pessimistic backdrop, what makes Australia stand out are the following structural factors:

- Imminent tax cuts
- Twin surpluses
- Real effective exchange rate (REER) of the Australian dollar
- Macroprudential policies

The recently reelected government is expected to pursue a pro-growth agenda; therefore, we expect different sources of stimulus to support the Australian economy. For example, tax cuts could be announced as early as this month. These tax cuts wouldn't be possible—or at least prudent—without the country's twin surpluses, a facet of the economy that inarguably makes Australia attractive from an investment perspective. The country currently runs a budget surplus, and as shown in Chart 1 below; the budget as a percentage of gross domestic product (GDP) should move into positive territory in 2020.

Chart 1: Australia General Government Budget

% Nominal GDP (OECD), Published on 5/23/2019

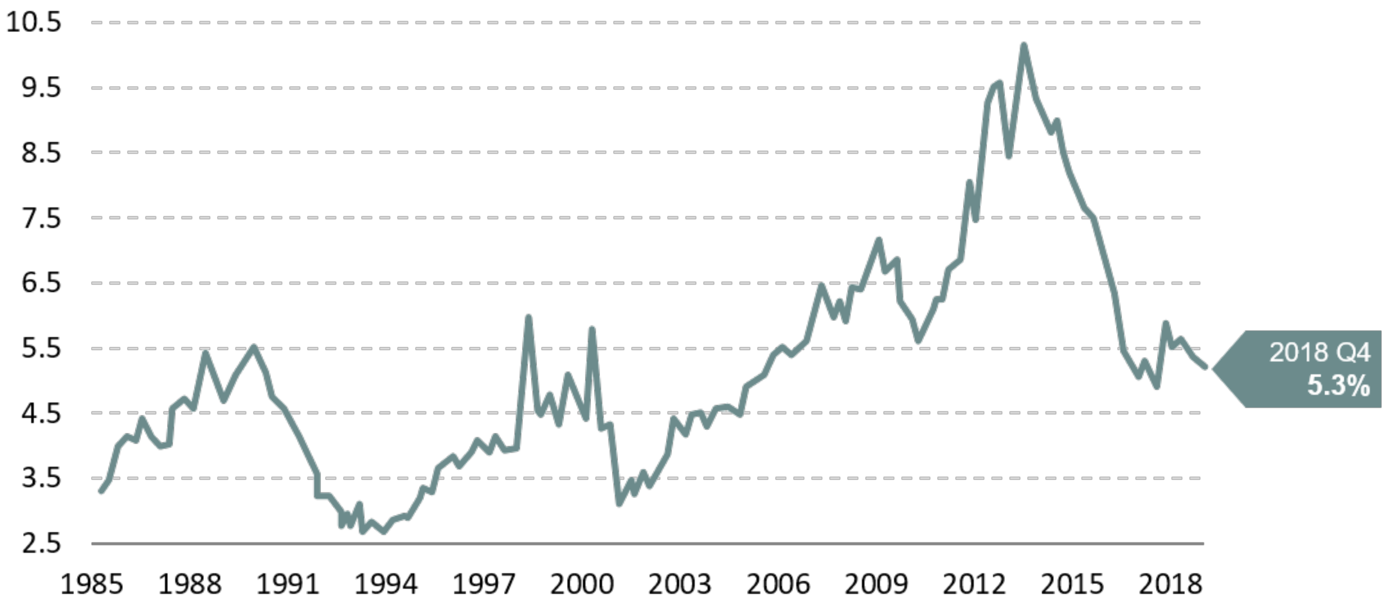


Source: Cornerstone Macro

Australia also runs a current account surplus, which we think the country will be able to comfortably maintain for two reasons. Firstly, capital expenditures (capex) have increased across all sectors, pushing investment to levels seen in the 1990s, as shown in Chart 2. We are encouraged that companies are committing to capital-intensive projects and believe activity may have found a bottom in 2018.

Chart 2: Australia Capex Structures

% Nominal GDP, Published on 5/23/2019



Source: Cornerstone Macro

Secondly, the recovery in capex could partly be explained by Australia's commodity-centric exports, which have received continual support from Chinese demand for iron ore and coal. The demand for these two Australian commodities could remain relatively insulated from other potential headwinds because of the Chinese government's strategic focus on environmental policies. Australian iron ore and coal are cleaner substitutes when compared to the resources that can be mined locally; Chinese authorities should continue to import them from Australia as long as the government remains focused on anti-pollution initiatives. This baked in demand could prop up Australian exports (see Chart 3 below), as well as the dollar.

Chart 3: Australia's Commodity Export Price Index

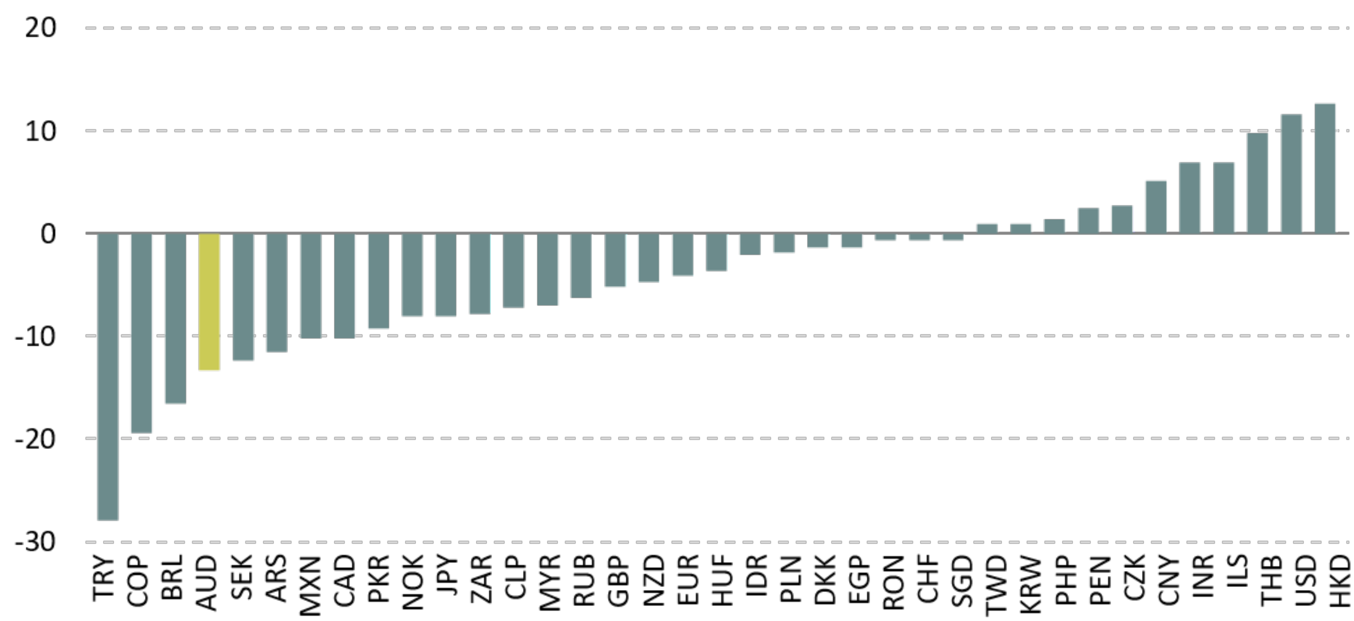
In AUD, 2005 = 100, As of 6/2019

Source: Reserve Bank of Australia

The Aussie dollar is undervalued on a REER basis as shown in Chart 4 below — making it one of the most undervalued currencies in our universe based upon this metric.

Chart 4: Real Effective Exchange Rate

Percentage Deviation from 10-Year MA, As of 6/21/2019



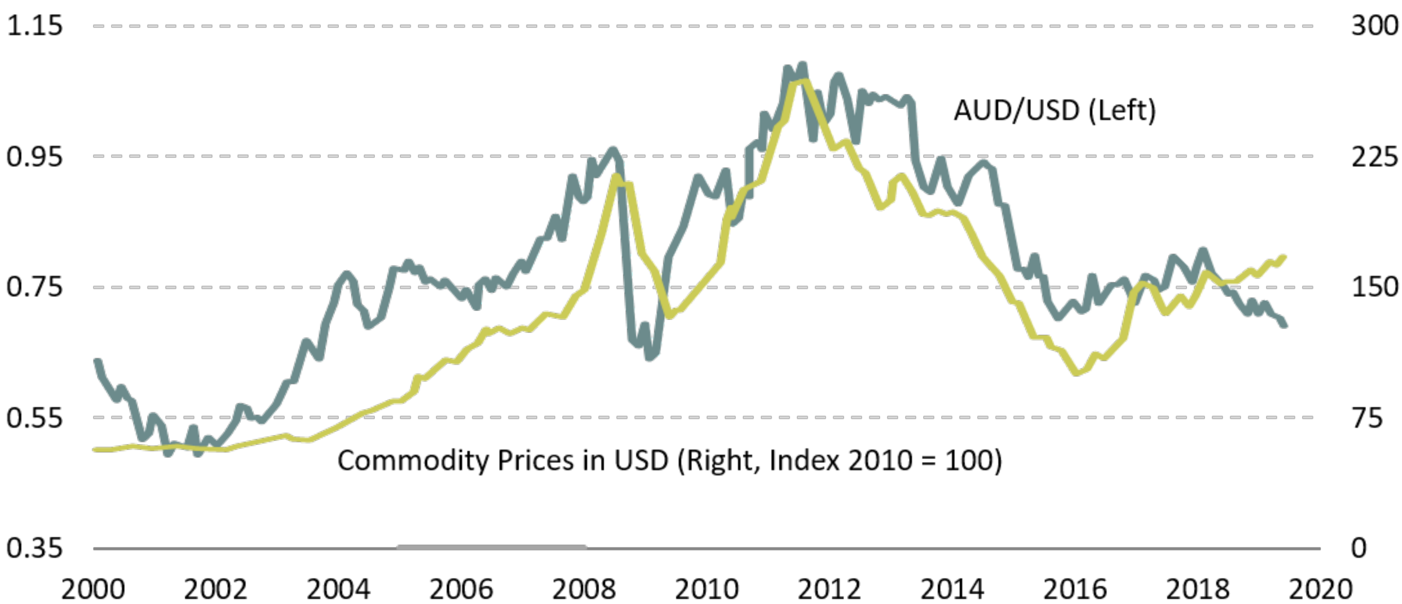
Source: Brandywine Global

The Reserve Bank of Australia (RBA) seems to agree and has projected that the currency could comfortably

appreciate to around $0.75 from its current level without hindering growth. Chart 5 illustrates the central bank's projection on the currency:

Chart 5: Australia's Commodity Prices and the AUD

As of 6/2019



Source: Reserve Bank of Australia

The RBA also recently cut rates, which implies that Australia doesn't have an inflation problem right now — another constructive sign for investors. Perhaps inflation remained benign as Australia's previously overheated housing market began to cool off. A few years ago, the government required borrowers to undergo stress tests in the event of a rising rate environment. The policy was meant to rein in real estate prices, which have seems to have worked since home prices have been weak for the last 18 months. Now, the government is expected to relax these stringent requirements to reinvigorate the housing market.

We think these collective structural forces could create tailwinds for the Australian economy. The country's twin surpluses afford the luxury to pursue ambitious stimulus efforts as a way to revive the economy without sacrificing the currency or a benign inflation backdrop. However, risks certainly remain as the U.S. and China continue to hash out their trade dispute while the Chinese government continues to implement its own stimulus.

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