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Economic Update: Australia
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Morningstar Research
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Outlook for Investment Markets

Global equity markets continue to focus on the upside from the coronavirus vaccine rollout. Progress to date has been limited and getting to effective national-level protection will be a protracted process, but there is now a good prospect that global economic activity will gradually recover over 2021-22, providing fundamental economic support for most risk assets. Some sectors, particularly commercial property, may nonetheless take a permanent hit as a result of structural change caused by the pandemic. A strengthening world economy is less good for bonds, where a variety of channels, including the possibility of higher inflation, have been pushing yields higher and prices lower. Australia has experienced a robust V-shaped bounceback from its 2020 COVID-19 setback, and while companies' operating results may show strong near-term performance, a key issue will be the outlook for longer-term profitability as conditions normalise.

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Australian Cash & Fixed Interest — Review

Short-term interest rates have been steady, with the 90-day bank bill yield still just above zero (0.02%). Bond yields have moved a bit higher, mirroring rises in overseas bond markets, and the 10-year Commonwealth bond yield, at 1.23%, is up 0.25% since the start of the year. Year to date the Australian dollar is modestly (0.5%) higher in overall trade-weighted value and is up a similar amount (0.6%) in terms of its headline exchange rate against the U.S. dollar, at 77.45 U.S. cents.

Australian Cash & Fixed Interest — Outlook

The outlook is for short-term rates to remain low for an extended period. At its February policy meeting the Reserve Bank of Australia, or RBA, said that it did not expect to raise the cash rate until inflation was back in a 2% to 3% range and the labour market was tight, and it "does not expect these conditions to be met until 2024 at the earliest." The financial futures market agrees and sees little chance of any increase over the next two years.

The recent global rise in bond yields has also been felt locally, and as both the domestic and world economies continue to recover, bond yields are likely to move a bit higher again as the markets start pricing in the possibility of higher inflation and an eventual move by central banks to ease back on their degree of monetary policy support. But as with the target cash rate, any significant rises in bond yields are likely to be a long way off, as the RBA will probably want to curb the pace. At its February meeting the bank decided to buy an additional AUD 100 billion of bonds from mid-April onwards, so it has ample leeway to keep buying bonds and leaning against yield rises. National Australia Bank, or NAB, expects the 10-year yield to be a little higher at the end of this year, at 1.5%, and Westpac has a very similar view, with a 1.55% forecast.

If the outlook for the world economy continues to look positive, the Aussie dollar could be one of the beneficiaries. Currencies like the Aussie (and the kiwi) dollar tend to do well when global foreign-exchange markets are optimistic. It helps that both currencies are also regarded as partly commodity-backed, and local commodity prices have picked up in recent months--the RBA's index of Australian commodity prices rose by 4.8% in Australian dollars in January. A rise against the U.S. dollar by the end of this year looks plausible, with Westpac picking U.S. $0.82 U.S. and NAB $0.83.

Australian & International Property — Review

The A-REITs substantially underperformed the wider share market in 2020 and have continued to lag year to date. The S&P/ASX 200 A-REITs Index is down by 4.1% in capital value compared with the 3.3% gain for the S&P/ASX 200.

Global listed property has performed better, and the FTSE EPRA/NAREIT Global Index in U.S. dollars has delivered a total return of 3.0%, not too far behind the 4.9% return from the MSCI World Index. One qualification, however, is that the performance relied almost exclusively on the U.S. market, which returned 5.6%: ex the U.S. the index returned a marginal 0.3%, weighed down by a 5.6% loss from eurozone REITs.

Australian & International Property — Outlook

Established sectoral themes continue to play out in the A-REIT sector. For offices, the latest (January) half-yearly office market report from the Property Council of Australia, or PCA, showed large rises in vacancy--at a national level, from 9.6% to 11.7%--which one might initially have thought was mostly down due to COVID-19. In fact, the PCA CEO said that "While it was not a surprise to see office vacancies increase in the middle of a pandemic, it is the new supply of office space that is responsible for three quarters of this impact, not reduced tenant demand." Even if COVID-19 was not the prime driver this time around, it clearly continues to be an issue until the future of work processes and the role of remote working become clearer.

In retail, there have been some winners--for example, SCA Property, which owns neighbourhood malls, found that shoppers displaced from locked-down CBDs were doing more of their shopping locally at its properties. Overall, however, the sector remains battered by the inroads of e-commerce, which had been a strategic challenge even pre-COVID-19. Industrial remains by far the strongest sector--rentals were less affected during lockdown, and it has expanded strongly to service the increased e-commerce demand. Centuria, the largest industrial REIT, showed in its latest results presentation how the old model of industrial REITs largely housing manufacturing tenants has changed: 32% of its tenants are still manufacturers, but the large majority is now made up of distribution centres (27%), data centres (17%), transport logistics (15%), and cold storage (9%). Some of these tenants would have predated the recent surge in e-commerce but much of it is riding the e-commerce wave. Centuria pointed to online sales growth of 32% in 2020. While there may be some mispricing opportunities if industrial is overhyped and retail is oversold, overall it is not too surprising that investors have preferred to stand aside for now and wait to see how the post-COVID-19 issues play out.

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Internationally, conditions are still week but have improved from the nadir of COVID-19 gloom. The Royal Institution of Chartered Surveyors, or RICS, found in its latest (December) quarterly Global Commercial Property Monitor that sentiment has become less pessimistic among both tenants (where a net balance of negative 46 in June has picked up to negative 35) and investors (up from negative 29 to negative 19), but is still markedly downbeat. RICS produces a graph showing expected capital gains and expected rental income moves over the next year. Nearly all the countries in the survey, and all the major investable markets, fall into the quadrant of expected capital losses and expected rental decline.

RICS also pointed to the same sectoral trends that are evident in our local market: "The occupier demand net balance for offices is still at -58, albeit better than the -69 in each of the last two quarters. For retail, the comparable figures are -71 as against -77 and -81 previously. The contrast is provided by industrials/ logistics where the latest net balance of +19 compares with +11 and -9." The scale of retail's issues is exemplified by global mall owner Unibail-Rodamco-Westfield, where it said that in 2020 it had collected only around 80% of its rent due, its malls operated without COVID-19 restrictions for only 70 days, and it will not be paying a dividend before 2023. Global property's prospects will eventually improve as vaccinations roll out, but for now the asset class does not offer much investor encouragement.

Australasian Equities — Review

Australian shares are ahead for the year, and the S&P/ASX 200 Index is up 3.3%. Consumer discretionary stocks have led the way with a 7.8% gain, slightly ahead of the 7.3% gain for the financials (excluding the A-REITs), and, as overseas, IT stocks have been doing well and are up 6.1%. The miners, which had started the year robustly, have given up some of their earlier gains but are still up 2.2% ahead for the year. The laggards have been healthcare (down 0.4%) and the industrials (down 3.1%).

Australasian Equities — Outlook

A five-day West Australian lockdown starting at the end of January, and a five-day Victorian lockdown, which started on Feb. 12, were reminders that COVID-19 may not be finished with us yet. At the time of writing it appeared likely that the Victorian lockdown would be lifted. On the hopeful assumption that the Victorian lockdown is indeed short and that no further significant outbreaks occur, it looks as if the Australian economy is heading down the path of an initial strong recovery, easing to more modest rates of growth as the year progresses.

Currently the economy is still largely in the initial V-shaped bounceback from the depths of COVID-19 lockdowns. The slump was not as bad as originally feared, where there had been projections that the unemployment rate could go as high as 10%, but it peaked at 7.5% (in July last year) and has already dropped back to 6.6% (December). A wide variety of other indicators confirm a relatively quick and robust turnaround. The latest (December) Westpac/Melbourne Institute leading index, for example, "is still signalling healthy above trend growth for the Australian economy in the first half of 2021," and Westpac expects that by the June quarter the economy will have regained its pre COVID-19 level of GDP, which, in the bank's view "will be an exceptional result, comparing very favourably with other developed economies."

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The results from the latest (January) NAB business survey also showed strong current performance, as did the latest (January) IHS Markit Index of activity in the services sector, which reported that "Both activity and new business recorded further strong expansions in January, with firms citing the lifting of interstate restrictions and resumption of projects on hold due to the COVID-19 pandemic." Business confidence about COVID-19 abating looks reasonable, with a targeted goal of 4 million vaccinations by the end of April.

All of these measures look, however, as if they are starting to ease from the peak bounceback in late 2020, and the trick for investors will be distinguishing between the strong recovery in profits, which is likely to be seen in the 2020-21 reporting year and the longer-term prospects for corporate profitability beyond midyear. Pre-COVID-19, the key issue for Australian investors had been a sustained period of subpar economic growth and consequent underperformance by local equities. While the market is not overexuberantly priced, on a forward-looking P/E ratio of 20.6 times expected earnings, it will need to see corporate profit performance kick on from the easy runs scored during the immediate recovery.

International Fixed Interest — Review

Modest rises in bond yields across most major bond markets have translated into modest setbacks for bondholders. The Bloomberg Barclays Global Aggregate Bond Index in U.S. dollars is down by 1.3% year to date. Investors in long-maturity bonds who are more exposed to duration risk have done poorly, with the Bloomberg Barclays Index of long (20 years plus) maturity U.S. Treasury bonds dropping by 6.5%. Lower-quality credit has been an exception, with the Bloomberg Barclays Index of global high-yield bonds up 0.8% year to date.

International Fixed Interest — Outlook

In the U.S., the stated policy stance of the Fed remains, as Fed chair Jay Powell said in a recent speech, "patiently accommodative." It plans to keep monetary policy on its current strongly stimulatory setting "until labour market conditions have reached levels consistent with the [policymaking Open Markets] Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time." That still looks some considerable distance away, and the median forecaster in the latest (February) *The Wall Street Journal* poll expects that the Fed will keep its current target range of 0.0% to 0.25% for the Fed funds rate all the way out to the middle of June 2023. Other major central banks are likely to remain on hold for at least as long. Recovery in the eurozone, for example, is currently facing strong headwinds from COVID-19 lockdowns.

If short-term policy rates look set to stay very low, there is a bigger question mark around longer-term yields. Global financial markets are in an optimistic frame of mind about global growth prospects. *The Wall Street Journal* poll, for example, asks the U.S. forecasters whether they feel the risks to their forecast GDP-growth view are to the upside or the downside, and a large majority picked the upside. While central banks will still be using their quantitative easing programmes of bond buying to resist rises in bond yields, the bond markets are wondering whether inflationary pressure in a post-COVID-19 world might be building earlier or more strongly than expected. *The Wall Street Journal* forecasters expect that

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this will translate into a gradual rise in the 10-year U.S. Treasury yield to a little under 1.5% by the end of this year and to 1.8% by the end of 2022.

The recent price gains for low-quality bonds raise a separate set of questions. Even though yields on government bonds have risen slightly, this has been nowhere near enough to satisfy the high demand for yield, and a result is that normal credit spreads for lower-quality borrowers have been driven down even further. As one example, the ICE Bank of America U.S. High Yield Index Option-Adjusted Spread measures the difference in yield between sub-investment-grade U.S. debt and U.S. Treasury bonds. Pre-COVID-19, this had been trading at a historically low 3.5% pickup in yield and shot up to very high levels in the first half of 2020. Now, it is all the way back down to 3.5% again. Other indicators also suggest that investors may be pushing the limits of acceptable reward for risk. For example, Portugal, one of the less-creditworthy eurozone economies, is currently able to sell 50-year maturity bonds. Investors in the higher-yield end of the asset class risk buying at or near the peak of credit optimism.

International Equities — Review

World shares started the year well but dropped back to be roughly all square for the year at the end of January, partly due to a downbeat reminder from U.S. Fed chair Jay Powell that the U.S. economy is not out of the COVID-19 woods yet. They have moved up in more recent weeks, and the MSCI World Index of developed economy share markets is now up 5.0% in U.S. dollars. The U.S. markets have generally led the way, with the S&P 500 up 4.8% and the tech-oriented Nasdaq up 9.4%. Japan also continues to do well, and the Nikkei Index is up 7.6% (in yen). European shares have shown relatively modest gains, with the FTSE Eurofirst 300 up 3.8% (in euros).

Emerging markets have continued their strong start to the year and the MSCI Emerging Markets Index is now up by 10.7% in U.S. dollars, led by the core BRIC--Brazil, Russia, India, and China--markets, which are up by a strong 13.7%. China continues to be the strongest BRIC market, and the MSCI China Index has gained 18.1%, but there has also been a good performance from Indian shares, where the Sensex Index is up by 7.7% in rupees and by 8.3% in U.S. dollars. Russian shares are also up, with the FTSE Russia Index up 7.6% in U.S. dollars. Brazil has returned a small U.S. dollar loss, with the Bovespa Index down by 3.0%.

International Equities — Outlook

The Fed's warning in January had said that "The pace of the recovery in economic activity and employment has moderated in recent months, with weakness concentrated in the sectors most adversely affected by the pandemic ... The path of the economy will depend significantly on the course of the virus, including progress on vaccinations. The ongoing public health crisis continues to weigh on economic activity, employment, and inflation, and poses considerable risks to the economic outlook."

Various indicators supported the Fed's caution. In the U.S., the latest jobs numbers were disappointing, with only 49,000 net new jobs in January. At that rate it will take a long time to refill the 9.9. million jobs that have been lost since the start of the pandemic. Globally, too, there were signs that the initial V-shaped bounce in world economic activity was easing back. The latest (January) reading for the J.P.

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Morgan Global Composite Index (which adds up a wide variety of national business surveys) showed that the world economy was still growing, but at a slower rate than before. J.P. Morgan said that "The slowing is taking place across both the manufacturing and services sectors though it is expected to be more pronounced in the services sector, a focus of concentrated lockdowns."

The market shares, however, are looking at the bright side of the ledger. They are focused on eventual success in bringing COVID-19 under control, on fiscal stimulus in the U.S., on good prospects for corporate profit growth, and ongoing equity valuation support from exceptionally low interest rates.

On the COVID-19 front, the news has been broadly good. The numbers are necessarily imprecise but on *The New York Times*' tally of new cases, global COVID-19 infections peaked at close to 740,000 a day in early January but have dropped steadily since to some 380,000. Deaths are also reducing, albeit more slowly, from their peak of some 14,400 people a day in late January to under 12,000 now. The numbers are still high in absolute terms, but the trend is encouraging, and despite the various COVID-19 mutations, the rollout of vaccinations should lead to further progress in controlling the pandemic (though the rollout is still in its very early stages). Although there have been some 172 million vaccinations globally to date, that is only 2.2 per 100 people, and even in the wealthier countries, there is a long way to go. The best of the major countries is the U.K., with 22.7% of the population having had a first dose. The U.S. is at 11.5%, but France is up to only 3.4% and Germany to 3.3%. Even so, the equity markets are likely right in thinking that a global economy largely free of COVID-19 setbacks is, gradually, coming into clearer view.

Markets are also expecting a healthy dose of fiscal stimulus in the U.S., which could well go a long way to underpinning a faster American recovery. If enacted in full, the Biden administration's package would be worth around USD 1.9 trillion, which would be a massive boost equivalent to about 9% of the U.S. GDP, and one which would have an early impact, with one key component being sizable cheques to less-well-off households.

Getting on top of COVID-19 worldwide, and U.S. stimulus, would form a good backdrop for corporate profitability. FactSet's latest compilation of sharebroking analysts' expectations for the companies in the S&P 500 shows that profits are estimated to have fallen by 11.4% but they are expected to come roaring back this year, with an expected 23.6% increase, and--although it is still a long way out--to increase by a further 16.0% in 2022. The analysts expect the S&P 500 to end 2021 at 4,364, which would be a gain from its current level of nearly 11%.

Although valuations are on the high side--FactSet estimates that the one-year forward-looking P/E ratio for the S&P 500 is 22.2 times expected earnings, which is well above its 10-year average of 15.8 times--interest rates look likely to remain at unusually low levels by historical standards, which will support what could otherwise look like an expensive rating of corporate profits.

There are still signs that markets may be in an overly optimistic mood, and the latest price of Bitcoin (USD 48,000, up from around USD 9,600 a year ago) or the GameStop episode suggest there may be at

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least pockets of overexcited speculative activity. But, nonetheless, the longer-term outlook for gradual global economic recovery provides some genuine fundamental support for equity prices.

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