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Economic Update: Australia
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Outlook for Investment Markets

Although some countries, especially among the emerging markets, are still experiencing surges of new coronavirus cases, the global economy has been overall recovering strongly from the pandemic. The business outlook in many economies is currently robust, providing ongoing solid fundamental support for growth assets, with investors currently focused in particular on the more cyclically sensitive sectors in countries that have managed the pandemic relatively well. Bonds, however, have been weak, and are likely to continue to face challenges if inflation moves higher. The prospect of interest rates having to rise to compensate for higher inflation has roiled equity markets in recent weeks and may well re-emerge as an issue as the year progresses. While there have been further sporadic outbreaks of COVID-19, Australia is otherwise in a vigorous cyclical upswing and has been helped by high commodity export prices: Business and consumer surveys are pointing to strong growth ahead. An unexpectedly expansionary budget on May 11 has added to the strength of the post-COVID-19 recovery.

Australian Cash & Fixed Interest — Review

Short-term interest rates have remained steady, with the 90-day bank bill yield continuing to trade just above zero (currently 0.04%). Bond yields have mirrored the U.S. market: Yields rose in the first three months of the year and have stayed at the new higher levels, and the 10-year Commonwealth bond yield is 1.7%, a 0.7% increase for the year to date. The Australian dollar is 0.9 higher in overall trade-weighted value, with gains on most cross rates (especially against the yen) outweighing declines against the pound and the renminbi.

Australian Cash & Fixed Interest — Outlook

When last heard from, at its May 7 statement on monetary policy, the Reserve Bank of Australia said that "It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, the labour market will need to be tight enough to generate wages growth that is materially higher than it is currently. This is unlikely to be until 2024 at the earliest". But the RBA is in the same boat as many overseas central banks, with a stronger and faster recovery from COVID-19 than originally expected, and the likelihood is that the 2024 time frame has come a bit closer. Like its overseas counterparts, the RBA will not be doing anything in the near term, and cash rates (and the three-year bond yield, which the RBA also targets) will remain very low for some time, but an eventual move towards less stimulus is becoming a bigger object on the horizon. The futures market is currently anticipating one 0.25% increase in the target cash rate in late 2022.

Local bond yields have tracked U.S. bond yields upwards this year, and local bond investors have felt the pain: For the year to date, the S&P/ASX index of Australian government bonds is down 3.9%, and the S&P/ASX index of corporate bonds is down 1.0%. It is likely to remain a challenging environment, as further increases in U.S. yields look likely as they rise to compensate for an expected rise in U.S. inflation. Westpac Bank, for example, sees our local 10-year yield at 2.3% by the middle of next year,

and it could go higher again: National Australia Bank expects that the 10-year U.S. yield will have risen to 2.5%, and the local equivalent will have matched it. Whatever the decimal point turns out to be, a robust domestic economic cycle is not a helpful backdrop for bond performance.

On the other hand, the current cycle looks to be helpful for the Aussie dollar. Ongoing recovery from COVID-19 – at least in the developed world – means investors are in a more 'risk on' mentality, which tends to help the Aussie dollar, as does the strength of commodity prices: The Reserve Bank's index of Australian export commodity prices rose again in April, led by booming prices for iron ore, and is now 15.4% up on a year ago. It may be that some of the commodity strength unwinds as COVID-19 supply disruptions ease, but in the meantime the big bank forecasters tend to favour some Aussie dollar appreciation, from its current USD 77.4 cents to the low to mid 80s by this time next year.

Australian & International Property — Review

The S&P/ASX 200 A-REITs Index has eked out a small 1.1% capital gain for the year to date and returned 1.8% including dividends, underperforming the wider share market's 6.5% capital gain and 8.0% total return.

Global listed property has done well: The FTSE EPRA/NAREIT Global Index in U.S. dollars is up by 9.2% in capital value, exactly matching the rise in the MSCI World Index of the wider global share market, and has delivered a total return of 10.4%. The outcome was heavily dependent on the U.S. REIT market, which returned 15.7%: Ex the U.S., the return from the index was 5.1%. Performance has lined up with success in managing COVID-19: Countries like the U.S. and the U.K. (12.8% return) have substantially outperformed areas like the eurozone (down 0.1%) or emerging markets (0.1%).

Australian & International Property — Outlook

The sector looks to be past its cyclical worst, but investors may continue to remain wary of large parts of it (ex industrial) while there are still sporadic outbreaks of COVID-19 and while there is ongoing uncertainty over the longer-term damage done to central business district offices and to brick--and-mortar shops. As the latest (March quarter) National Australia Bank survey of commercial property showed, sentiment has continued to improve but remains negative overall. The very strong industrial sector, where sentiment has reached an all-time high, has not been enough to carry the whole asset class up with it: Sentiment still remains deeply negative (unsurprisingly) for CBD hotels but is also still strongly pessimistic for retail and office property. While industrial is forging ahead, with respondents picking rental and capital gains over the next two years, the survey found that rents and capital values are expected to continue to decline in both the office and retail sectors over the next couple of years. A return to something like normality is still down the track: The office sector is expected to be in better shape in two years' time – "likely reflecting vaccine rollout and more workers returning to the office", as the NAB commentary said – but, even two years out, the retail sector expects to still be struggling. It does not yet add up to a strong outlook for the asset class.

The same patterns can be seen overseas. In its latest (March quarter) Global Commercial Property Monitor, the Royal Institution of Chartered Surveyors, or RICS, found that the cycle is turning in favour of

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property. In December, 51% had reported that they were in a downturn: This time round, the proportion is down to 40%, while those saying they are in an upturn have increased to 36% from 26%. Sentiment has correspondingly improved, led by prime industrial, data centres, apartment blocks, aged care, and secondary industrial, but sentiment remains pessimistic in the other subsectors, particularly for secondary office property, secondary retail, and hotels. So far, the recovery is not broad-based, and a large majority of the markets surveyed by RICS (including the key U.S., U.K., German, French, and Japanese markets) expect both lower rentals and lower capital values over the next 12 months. Respondents were asked how long they think it will take for property to get back to pre-COVID-19 levels of income stream: Ex industrial (about one year) and prime office (two years). The typical answer for everything else was around a three-year time frame. While there have been some spectacular increases for some REITs oversold in the early days of COVID-19 – U.S. REITs specialising in shopping centres and regional malls have more than doubled over the past year – further progress looks like it will be a long haul.

Australasian Equities — Review

Australian shares have had a good start to the year: The S&P/ASX 200 Index up is by 6.5% in capital value and by 8.0% including the value of dividends. The financials (ex the A-REITs) have led the way, with a 16.4% gain, and high commodity prices in the recovering world economy have helped the miners to a 10.3% gain. Consumer discretionary stocks have also done well and are up 9.7%. The IT sector has suffered from the global sell-off of tech stocks and is down 119.1%, though is still up 30.2% on a year ago.

Australasian Equities — Outlook

Australia's business prospects are robust. The latest (April) National Australia Bank business survey found a "very strong result, with many aggregate indicators reaching new highs. Business conditions reset last month's record high, with trading, profitability and employment all reaching fresh highs. Business confidence also set a new record and implies that conditions will remain strong in the near term". Consumer confidence measures are also supportive. In the latest (early May) weekly ANZ / Roy Morgan consumer survey, 38% of families expect to be better off over the next year, versus only 14% expecting to be worse off. The percentage expecting worse times ahead for the economy over the next year (only 14%) was at the lowest level since October 2010. The latest official forecasts, in the May 11 budget, suggest that the economy is set for 4.25% growth in the year to June 2022 and that the unemployment rate will drop to 5% by June 2022 and to 4.75% by June 2023.

Recent equity gains are understandable against this backdrop. The banks will continue to write back the provisions they had originally made against COVID-19-related losses, which did not materialise to anything like the extent first imagined; the resources sector is in strong shape; and, as in many other countries (as the recent performance of the consumer discretionary sector shows), there is a burst of previously pent-up spending on its way. With monetary policy remaining very supportive, fiscal policy has also come to the party with a significantly more expansionary budget than had been expected from a coalition government: It contained a wide range of business- and consumer-friendly initiatives and pushed deficit repair out into the medium term. COVID-19 continues to spring unpleasant surprises, and

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previous ideas about early travel 'bubbles' have had to be revised, but with that proviso, the outlook appears to be favourable for further equity gains.

International Fixed Interest — Review

Bond yields in the U.S. rose in the first three months of the year and have broadly stayed at these new higher levels in recent weeks. The yield on the 10-year Treasury note is 1.64%, still close to the recent peak of 1.75% reached at the end of March. Bond yields in other major markets have also risen, though by less than in the U.S.: One interesting consequence is that government-bond yields in the eurozone, which had largely been negative at the start of this year, are all now positive, with the sole exception of Germany, where the 10-year yield is still marginally negative (negative 0.1%). With running yields still very low, income has not compensated for capital loss, and the Bloomberg Barclays Global Aggregate Bond Index in U.S. dollars for the year to date is down by 3.1%.

International Fixed Interest — Outlook

The big issue for the bond markets is the prospect of higher inflation. The latest data from the U.S., for example, showed that prices in April were up 4.2% on a year earlier. Most analysts agree that the April outcome exaggerates the scale of the issue: Prices this April were being compared with the unusually low prices of last April in the early days of COVID-19; there are still COVID-19-related supply shortages that are likely to ease; and there were some one-offs, notably a large rise in the price of second hand cars. All that said, bond markets worry that, because of some combination of a sustained period of ultra-easy monetary policy and a strong economic rebound from COVID-19, inflation may have moved to a permanently higher level.

The Philadelphia Fed, for example, has a long-standing survey of U.S. professional forecasters, dating back to 1968. Usefully, it includes forecasts for the Fed's preferred measure of inflation (what's happening to the prices of 'core' personal consumption items). In its latest survey, the survey found that this core measure is expected to be 2.3% this year, 2.0% in 2022, and 2.1% in 2023, or, in other words, monetary policy will have achieved its objective of a steady 2% or so. Inflation sustained at 2% or a bit more means that current bond yields would not maintain investors' real (after inflation) purchasing power, even before tax, and would need, at a minimum, to have a 2 at the front. The Fed itself is unlikely to take any explicit near-term tightening action. More likely, the bond markets will make the running themselves and take bond yields higher.

Other countries are not in America's situation, but even in places like the eurozone, where inflation has stayed stubbornly below the European Central Bank's target, the tide may also be turning. The minutes of its latest (April) policy meeting said that "while the policy-relevant medium-term inflation outlook was broadly unchanged from the March meeting, risks to this outlook could be assessed as tilted to the upside". Like the Fed, central banks like the ECB and the Bank of Japan are not likely to make any near-term changes in policy, but, as in the U.S., bond investors are likely to draw their own conclusions about the direction of bond yields in a rebounding global economy. Macroeconomic conditions are likely to remain a challenge for the asset class.

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Investors will need to be wary of the capital loss potential from rising yields, but another issue is the poor reward for taking on credit risk. Bond yields may have moved a bit higher, but in absolute terms remain very low: The ongoing hunt for yield means that credit spreads have been driven to ever lower levels. At the better end of the credit-quality spectrum, for example, Amazon.com has just issued bonds that, for some maturities, were at a record low credit spread relative to U.S. Treasuries. At the weak end, as a recent article in The Wall Street Journal said, "Risky companies are selling junk bonds at a record pace, getting ultralow borrowing costs and increasingly loose borrowing terms … Borrowers have been able to demand such easy terms because money has flooded into the junk-debt market and particularly into the riskiest parts, where the likelihood of default is highest". At some point a normalisation of credit premiums is likely to add to the challenge for the asset class.

International Equities — Review

World shares hit a bump in the road in May, largely in reaction to the news in the U.S. that annual inflation had risen to 4.2%: Investors worried that higher inflation would mean higher interest rates down the track, which would adversely impact on the valuation of equities. Tech shares proved particularly vulnerable, for various reasons: Higher discount rates have a greater impact on innovative companies where profits still lie some way down the track; sectoral rotation has favoured more cyclical sectors that will do well from the unexpectedly strong recovery from COVID-19; and the previous extended bull run for tech shares may have largely run its course in any event.

At time of writing, world shares were recovering from the inflation-linked sell-off, and for the year to date, the MSCI World Index is currently up 9.2% in U.S. dollars. The American market continues to do better than most – ex the U.S., the MSCI World is up by a smaller 7.7% – with the S&P 500, up 11.1%. The tech-heavy Nasdaq, however, is now only up 4.2% this year after the latest sell-off, but the small gain needs to be seen in the context of the previous strong performance: The Nasdaq is still just over 50% up on a year ago. European markets have also performed well, with the FTSE Eurofirst 300 Index up 10.9% in euros. Japan has been relatively weak, with the Nikkei up for year to date only 2.3% in yen and down 3.0% in U.S. dollars.

Emerging markets have lagged the developed markets, and the MSCI Emerging Markets Index is up by only 1.3% in U.S. dollars. The key BRIC markets (Brazil, Russia, India, China) have lost ground and are down by 1.7%. Russia has been the best of them: The MSCI Russia index is up 9.4%. Rather strangely, India, despite the COVID-19 catastrophe unfolding there, is also up for the year, with the MSCI India Index up 5.9%. The overall BRIC loss came from lower equity prices in China and Brazil.

International Equities — Outlook

The overall global economy continues to recover strongly from the impact of the COVID-19 pandemic. The April J.P. Morgan Global Composite indicator found that "Growth of global economic activity and new orders accelerated to 11-year highs in April. The upturn in output
was led by solid expansions in the US – survey-record increase – and the UK, while growth was weak in Japan. Brazil was the only nation to register lower activity". The 'records' may be something of a statistical artefact as increases are being measured from a low COVID-19 base, but even so, there is no

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denying that (albeit with significant regional variations) the world economy has recovered more quickly and more strongly that first feared.

Even the sectors worst hit by COVID-19 are now picking up: In the April J.P. Morgan results, "Tourism & Recreation saw the first rise in activity since January 2020 in April, lifting the sector to 16th overall [out of 21]". COVID-19 for a time had weighed heavily on the banks (via expected loan losses) and on real estate (via empty malls and offices). In the latest results, these are now the two strongest performers in terms of new business activity.

In the U.S. market, which has done the heavier lifting in delivering equity performance, the business outlook remains very strong. The forecasters surveyed in May by the Philadelphia Fed expect that the U.S. economy will grow by a remarkable 6.3% this year and follow it up with an also strong 4.3% expansion in 2022. In both cases, forecasters have upped their previous (February) estimates. Robust gross domestic product growth may not always flow through to higher corporate profits, but on this occasion, it looks likely to. On the latest (mid-May) share analyst forecasts collated by data company FactSet, profits for the S&P 500 companies are expected to rebound by 33.2% this year and to grow by a further 12.3% in 2022. Like the economic forecasters, the share analysts have also been upping their expectations: At the end of March, they had expected a 25.6% rise in profits this year.

In sum, the economic backdrop continues to support equities, with two qualifications. One clearly is the evolution of COVID-19. Globally, the number of new cases is falling: On the data collected by The New York Times, global new cases peaked in late April at around 825,000 and have dropped around 625,000, and vaccinations have risen steadily: There are now an estimated 1.45 billion people vaccinated. But COVID-19 continues to run amok in some large emerging markets (notably, on a per capita basis, Argentina, Brazil, and India) and is still a serious issue in some developed economies (notably the Netherlands, Sweden, and France). There is still no guarantee that the curve of global new cases has been bent for good, and we could see new surges along the lines of those at the turn of the year and in March-April. Viewed more positively, the countries that have done best in managing the pandemic are likely to continue to outperform.

The other major risk is the potential for inflation to rise, bringing with it higher interest rates and upsetting the valuation metrics of equities. The J.P. Morgan Composite survey, for example, found that "Cost inflationary pressures continued to build during April. Input costs rose at the quickest pace since mid-2008, with accelerated increases at manufacturers and service providers alike. Companies responded by raising their output charges, leading to the strongest increase in selling prices since data on charges were first collected in October 2009". This has already roiled the equity markets this month: At the moment, investors are not too sure how much of these cost pressures are temporary and how much might represent a more worrying step up in longer-term underlying inflation. Markets are likely to continue to have episodes of anxiety about the ultimate outcome for some time yet.

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