Economic Update: Australia
June 2021

Morningstar Research
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Outlook for Investment Markets

The world economy continues to recover strongly from the impact of the coronavirus, although some regions are still badly affected, and the latest forecasts suggest that the upswing will continue through the rest of this year and into 2022, with the U.S. outlook particularly buoyant. The strong business cycle is generally supportive for equities, although there is a risk that the scale of the recovery may lead to higher than expected inflation even after the current COVID-19-related cost pressures dissipate. Central banks may start to withdraw some of their previous stimulus, which means that bonds will remain challenged. Australia is also recovering well, with both official data on the March quarter gross domestic product and more recent surveys showing strong business conditions, and it helps that export commodity prices are doing very well. Provided recent COVID-19 cases are contained, and COVID-19-related input-cost pressures ease, the outlook remains supportive for local equities.

Australian Cash and Fixed Interest — Review

There has been no change to short-term rates, and the 90-day bank bill yield continues to track along just above zero. Long-term yields have maintained a close link with the evolution of U.S. bond yields, rising in the March quarter and stabilising at the new higher levels in more recent months--year to date the 10-year Commonwealth bond yield has risen 0.4% to its current 1.41%. The Australian dollar is slightly stronger in overall trade-weighted value, up 0.6%, and at U.S. 77.5 cents is 0.7% higher on its headline rate against the U.S. dollar.

Australian Cash and Fixed Interest — Outlook

A strong post-COVID-19 economic recovery and clear evidence of rising inflationary pressures mean that monetary policy support from the Reserve Bank of Australia, or RBA, no longer needs to be quite as stimulatory as before. For now, the RBA believes that starting to reel back some of the stimulus is a long way away--the minutes of its June 1 policy meeting said that its goals of high employment and inflation at its target level are "unlikely until 2024 at the earliest." The financial markets remain of the view, however, that some move toward reduced support will happen before then. Westpac, for example, expects that the three-year bond yield, which the RBA as part of its current policy settings is currently holding at 0.1%, will have risen to 0.6% in a year's time. Similarly, the futures market sees an increase in the target cash rate on the horizon before 2024 and currently expects a 0.25% increase around the end of next year and another by mid-2023.

If local bond yields continue to track developments in the U.S., then yields look likely to head higher, as U.S. yields look likely to rise further, reflecting the strength of the current U.S. economic recovery. Westpac Bank, for example, sees the U.S. 10-year Treasury yield at 2.4% by the end of next year, up from today's 1.5%, and expects the local equivalent to reach 2.5%. National Australia Bank, or NAB, also expects a stronger track, with a U.S. yield of 3.0% and a local yield also of 3.0%. The strong cyclical upswing, both in the U.S. and at home, is likely to remain an uncongenial backdrop for bond performance--year to date the S&P/ASX government-bond index is down negative 1.8%, and more of the same headwinds look likely.

The Aussie dollar has been slightly stronger year to date, and forecasts are generally upbeat about further gains, likely reflecting the relatively successful containment of COVID-19 by international standards and the impact of Australia's strong export commodity prices, which in May were up 23.8% in Australian dollars a year earlier. NAB, for example, sees the Aussie dollar at USD $0.82 in a year's time, while Westpac sees it higher again, at USD $0.85.

Australian and International Property — Review

While not matching the even stronger returns from the overall share market, listed property shares have done well in their own right. Year to date the S&P/ASX 200 A-REITs Index has delivered a capital gain of 8.8% and an overall return including dividends of 9.5%.

Global listed property has done even better again: the FTSE EPRA/NAREIT Global Index in U.S. dollars has returned a very strong 19.0%. A very strong rise in the U.S. REITs, which have returned 26.2%, has underpinned the overall outcome, but even excluding the U.S., the Global Index has returned 12.0%, with a strong performance in the U.K. (18.4% return).

Australian and International Property — Outlook

As in many other economies, the strength of the recovery from COVID-19 has been a pleasant surprise, and there will be more shoppers through the door and more staff back at their desks than earlier thought. It is no surprise that the A-REITs have rallied in response. From here, the general upswing will remain important, but investors are likely to have to continue to pay close attention to the subsectoral trends to maximise performance.

Industrial remains likely to be the strongest performer, with high demand and limited supply. CBRE's latest (March quarter) MarketView report on industrial and logistics property showed that demand is very high, especially for the very best "super prime" property: "The weight of capital seeking well tenanted super prime assets has seen pricing become increasingly competitive. Australian super prime yields now average 5.15%, the lowest on record. Favourable growth forecasts have seen investors seek to re-weight their portfolios to include industrial and logistics assets with demand not expected to slow any time soon." CBRE's recent (June) report on the outlook for e-commerce property assets says that "Australia's current supply pipeline indicates a shortage of new space required to meet future e-commerce demand. Therefore, capital and rental value uplift will continue and vacancy is likely to remain at relatively low levels." At the other end, there are growing questions over the future market for office space. The Property Council of Australia's latest (May) office-vacancy survey showed that office space was still way below pre-COVID levels (in Sydney, at 68% of pre-COVID occupancy, and in more COVID-affected Melbourne, 45%). While CBD landlords are trying to refill the slack, the reality is that the office sector has been hit by a longer-term structural torpedo to the five days in the office world.

Similar developments are underway overseas. In the U.S., the swing from poor COVID-19 management to more-effective vaccination rollout (and even the ability to offer surplus vaccine to poorer countries), coupled with strongly supportive fiscal policy, has markedly improved the outlook for the asset class. No one had expected that the U.S. economy could grow by 7% in 2021 (the Fed's latest projection). A recovery so much above previous expectations has meant that retail property REITs, for example, have been rapidly revalued to reflect the prospect of much higher consumer spending. Year-to-date regional mall REITs are up by 57.4%, and shopping centre REITs by 50.0%. Again, though, there are subsector cross currents swirling, particularly around office property. Fortune magazine surveyed the CEOs of the Fortune 500 firms in May and found that roughly three quarters of the respondents expected to need less office space than they used pre-COVID, and only 7% expected to use more. It looks as if the change to more decentralised work will stick: Fortune found that "The majority – 53% – believe a hybrid approach, with 2 or 3 days in the office and 2 or 3 days at home, is optimal." Brick-and-mortar retail was originally seen as the most obvious casualty of COVID, as online shopping accelerated, and there is now a real chance that offices may take a similar kind of hit.

Australasian Equities — Review

Australian shares have performed well--year to date the S&P/ASX 200 Index up is by 11.0% in capital value and has delivered a total return, including dividends, of 12.7%. The large financials sector has been an important driver, with the banks taking a much smaller hit from COVID-19 than earlier feared, and the financials (excluding the A-REITs) are up by 20.2%. Strong commodity prices have been very helpful for the miners, who are up 11.9%, and the pent-up demand of consumers emerging from lockdown has helped consumer discretionary stocks to a 13.9% gain. IT stocks have been the only weak spot, down 6.6% year to date, but strong performance last year means that they are still 36.5% up on a year ago.

Australasian Equities — Outlook

As the recent Victoria COVID-19 cases remind us, the pandemic has not gone away completely, but on the assumption that containment in the near term and vaccination in the longer term will progressively take the COVID-19 risk off the table, the outlook for the Australian economy is looking robust. Official GDP data for the March quarter showed that the economy grew by 1.8% in the quarter, on top of a 3.2% increase in the December quarter. As brokerage CommSec commented, "The economy now exceeds the pre-pandemic highs, up 1.1 per cent on the year. It has been the fastest recovery from recession in 45 years." CommSec thinks that the current momentum means that "the economy could grow by near 5 per cent in 2021," and it is not alone--NAB is picking 5.1% growth, and Westpac 4.8%.

Business surveys show that the economy has remained in strong shape since the end of March. The NAB May business survey, for example, "Continues to point to strong outcomes in the business sector, with business conditions resetting their record high for the second month in a row and forward orders also holding at a record level. The employment, profitability and trading sub-components all also reset last month's highs – with trading conditions now at exceptional levels. By state and industry, the strength in activity is evident everywhere."

The latest (May) Westpac/Melbourne Institute leading indicator is also flashing a green light: "The Leading Index growth rate continues to point to strong above trend growth momentum carrying through the second half of 2021 and into early 2022 ... With initial reopening rebounds now largely complete, other drivers are set to take over with upbeat, cashed-up households and booming housing markets setting what will still be a strong pace for growth." CommSec's assessment is that "The economy is responding as hoped to unprecedented fiscal and monetary stimulus. The stimulus continues and further solid economic growth can be expected. Company revenues will continue to lift and so should profits, if firms have tight control of costs. Higher earnings are expected to translate to higher share prices. CommSec has lifted its end-2021 target for the ASX200 to 7350 points." In the event the index is already there, six months ahead of schedule, the ongoing strength of the cycle looks likely to take it higher again.

International Fixed Interest — Review

Apart from some day-to-day volatility in response to new economic or financial news, bond yields have generally gone sideways in recent weeks. The outcome for investors is that the rise in bond yields, and associated capital losses, which occurred in the March quarter have not been reversed--the Bloomberg Barclays Global Aggregate Bond Index in U.S. dollars is down 2.3% year to date. Investors who took on duration risk to boost yields have been particularly impacted, with the U.S. Long Treasury (maturities of 20 years-plus) Index down 9.8%. Investors taking on higher credit risk to boost returns have fared better, with low-quality corporate bonds returning 3.1% in the U.S. and 3.7% in the eurozone.

International Fixed Interest — Outlook

Probably the biggest issue for both the bond and equity markets now is the likely evolution of inflation and the response of central banks, who, up to now, have been vigorously providing massive monetary policy support. There has been a huge debate over whether current inflationary pressures are temporary or permanent. If temporary, and inflation drops back as COVID-19 supply pressures ease and the immediate bounceback from lockdowns moderates, then central banks might well sit on their hands and leave existing levels of monetary stimulus in place, which would be helpful for both bonds and equities. But if they are permanent--some have argued for example that hugely expansionary U.S. fiscal policy, rather than COVID-19, is creating an inflation issue--then central banks might start to wind back some of the existing support earlier than previously expected.

The debate intensified after the release of the U.S. inflation data for May, which showed that prices were 5% up on a year earlier, the highest inflation rate since August 2008. And even after stripping out more-volatile elements like food and energy, core inflation was 3.8%, the highest since June 1992. The issue is not confined to the U.S., as the May J.P. Morgan Global Composite activity indicator found that "Demand outstripping supply also led to increased price inflation. Input costs rose to the greatest extent since August 2008 and output charges at the quickest rate on record (since at least October 2009)."

The latest official and survey data, while on their face suggesting that inflation is becoming more of a threat, did not settle the matter, as prices now are being compared with unusually low COVID-19-era prices last year. There was, as a result, an unusually keen interest in what the Fed would make of the situation at its June meeting, which had just taken place at time of writing, particularly as the meeting would include the Fed's quarterly update of its economic forecasts and its officials' best estimates of when they were likely to start normalising monetary policy.

The Fed said that "Inflation has risen, largely reflecting transitory factors," which is some comfort for the bond markets. But it also forecast that its preferred measure of inflation would be running at 2.1% in 2022 and 2.0% in 2023, while unemployment will have dropped to 3.8% (2022) and 3.5% (2023). In these circumstances, with both its inflation and unemployment targets pretty much in the bag, you might expect the Fed to be thinking of easing back on its monetary policy earlier than previously anticipated, and it is. The average expectation of the 18 Fed officials polled in the forecast is that the midpoint of the target range for the Fed funds rate (currently 0.125%) will be 0.6% by the end of 2023, which is equivalent to two 0.25% increases in late 2023. Previously, at the March meeting, officials had not expected hikes before 2024. The actuality is still a long way away, and other central banks may not be facing the same degree of inflationary pressures that the Fed is, but the main takeaway from the Fed's latest decision is that, barring any unexpected shock to the strength of the current global recovery, the outlook for bond prices is likely to remain challenging.

International Equities — Review

May's setback to world equities, largely a reflection of fears that interest rates might be heading higher in the wake of global inflation pressures, did not last long: the MSCI World Index of developed share markets had regained all the lost ground by the end of May and has gone on to new highs since.

Year to date the index is up 12.3% in U.S. dollars. Until recently, performance has been disproportionately dependent on the strong American market, where the S&P 500 is up 13.3% and the Nasdaq up 10.0%, but other markets, notably the eurozone and the U.K., are now making a stronger contribution. The FTSE Eurofirst 300 Index is up 15.0% (in euros) and the U.K.'s FTSE 100 Index is up 10.6% (in GBP). Japan is the only major market to lag badly, with the Nikkei up by 6.3% in yen but the yen itself weakening by 6.1% against the U.S. dollar.

Emerging markets are also up, though not as strongly as the developed economies, with the MSCI Emerging Markets up by 7.1% in U.S. dollars. Its core BRIC--Brazil, Russia, India, China—members are up 4.4%, led by Russia (MSCI Russia up 19.5%) and India (MSCI India up 14.7%).

International Equities — Outlook

Overall the world economy continues to power back from the impact of COVID-19, although there is still a great deal of variation at a country-by-country level in how economies have coped with the pandemic. The latest J.P. Morgan Global Composite indicator reported that "May saw a further solid acceleration in the pace of expansion of global economic activity, as output and new orders rose at the quickest rates since April 2006. Growth of activity was led by survey-record increases in the U.S. and the U.K. The euro area was also a bright spot, with its rate of expansion the highest in over three years." By sector, all 21 sectors in the Composite index are recording increased business activity, with particularly strong rebounds in the sectors that been previously been worst hit by COVID-19 (real estate, and tourism and recreation).

The outlook from here is also promising. The OECD, in its latest update to its economic outlook, said that "Prospects for a lasting global recovery continue to improve, helped by the gradual deployment of effective vaccines, continued macroeconomic policy support and signs that economies are now coping better with measures to suppress the virus. In many countries, the scale of the economic disruption from the pandemic has been exceptionally large, and the recovery is likely to be prolonged." The OECD now expects growth of 5.8% this year, after an estimated 3.5% decline in 2020, and growth of 4.4% in 2022.

Fund managers are also convinced that there are strong economic conditions ahead. The latest (May) Bank of America Merrill Lynch survey of global managers found that large majorities are upbeat: 69% of the managers believe that both growth and inflation will be stronger than normal, and 78% expect that global corporate profits will increase over the coming year. Unsurprisingly, they have adjusted their asset allocation toward cyclically sensitive sectors, notably commodities, banks, materials, industrials, and consumer discretionary, and toward equities in general, with reduced allocations to cash and bonds.

For the OECD, the main downside risk to this otherwise promising backdrop for equity performance is the evolution of COVID-19: "There is a possibility of new more contagious and lethal variants that are more resistant to existing vaccines, unless effective vaccinations are quickly and fully deployed everywhere. This would necessitate the reimposition of strict containment measures, with associated economic costs related to lower confidence and spending." Even without new variants, some countries will struggle: While the global count of daily new cases has dropped, according to The New York Times tracker, from a peak of over 800,000 in April to around 400,000 now, it is still rampant in some places. The Times says that "South America is being hit harder than any other continent, with nearly all of its countries having among the highest rates of new infections and deaths," and we have seen a serious outbreak in our own part of the world, with new cases in Fiji surging.

The OECD also sees an upside risk, that consumers will splurge with the pent-up savings they were forced to build up during lockdowns: "Given the amounts involved, the spending of only a fraction of accumulated "excess" saving would raise GDP growth significantly." The good news is that businesses would see even stronger spending with the world economy (if vaccination goes well and households spend up at large) growing by boom-time rates of around 6% both this year and next. There would, however, be "ensuing price pressures as spare capacity is used up," and this is also what most worries the surveyed fund managers. In order of priority, the risks that most worry them are inflation; a bond market collapse (an inflation-linked possibility if central banks were forced to start raising interest rates); asset bubbles (fund managers are particularly sceptical of bitcoin valuation, and many other commentators have pointed to evidence of wider speculative froth); and any further complications from COVID-19.

Performance periods unless otherwise stated generally refer to periods ended June 14, 2021.

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