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# Economic Update: Australia
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### Outlook for Investment Markets

Although there is still considerable uncertainty about the potential evolution of the pandemic, the global economic recovery from the coronavirus looks like it will continue into next year, providing a generally healthy backdrop for growth assets. Although, the pace of growth will slow down from the initially rapid V-shaped rebound, and there are likely to be ongoing differences between countries that have been able to manage COVID-19 well and those that have struggled. Even if the bulk of the current COVID-19-linked inflationary pressures ease, fixed interest will continue to be challenged by residual inflationary pressures in the strong global economy and by the prospect of eventual normalisation of monetary policy (particularly in the U.S.). In Australia, the latest local outbreak has been larger and more widespread than at first seemed likely, but at least for now equity markets are looking toward better business conditions next year.

### Australian Cash and Fixed Interest — Review

With monetary policy largely unchanged, short-term interest rates have stayed very low, and the 90-day bank bill yield remains just above zero. For much of the year, local bond yields have broadly tracked the U.S. market, but the August rise in U.S. yields has not been matched locally, probably because the Reserve Bank of Australia, or RBA, is expected to remain on a more supportive COVID-oriented policy course than the Fed. The local 10-year Commonwealth bond yield is 1.22%, slightly down on a month ago. The Australian dollar has depreciated and year to date is down 3.0% in overall trade-weighted value.

### Australian Cash and Fixed Interest — Outlook

With the latest COVID-19 outbreak proving worse than expected, some commentators had wondered whether the RBA might reverse its modest July move toward slightly less-supportive monetary policy (it had scaled back its bond-buying programme from AUD $5 billion a month to AUD $4 billion). In the event the RBA's August meeting left some wriggle room to go back to square one if it feels the need, the bank "will maintain its flexible approach to the rate of bond purchases." The latest outbreak also delays any eventual raising of interest rates--the RBA said that conditions will not be in place for any cash rate increase "before 2024." The futures market thinks it could be a bit earlier--it is pricing in the first increases in late 2022--but either way, short-term rates look like they will stay at very low levels over the coming year.

The pandemic will also likely delay any near-term increases in bond yields. Ultimately, however, the prospect is for higher yields. The RBA's latest forecasts, in its August Statement on Monetary Policy, say that inflation will be running at 2.0% to 2.25% during 2023, which means that either bondholders will independently push back against post-inflation loss of purchasing power, or, with inflation at where the RBA would like it to be, the bank will have started to wind back its efforts to keep bond yields low. On

the other side of the pandemic, the usual relationship between U.S. and Australian bond yields may well reestablish itself and will also tend to take Australia yields higher as U.S. yields rise. Westpac, for example, expects the local 10-year yield to be around 2.0% in a year's time.

The RBA, commenting in the Statement on the recent weakness of the Aussie dollar, said that "The depreciation of the Australian dollar over recent months has occurred despite prices of Australia's commodity exports having been around their highest levels in a decade. This may reflect an expectation that the very high level of commodity prices will not persist." That may be one element, but in the near term a more likely driver is the divergence in monetary policy between the Fed (likely to have to move toward less-supportive monetary policy in the booming U.S. economy) and the RBA (likely to have to go on providing high levels of support through the latest outbreak pandemic). Short-term weakness in the Aussie dollar looks likely until the local pandemic becomes better contained, but the dollar could well recover the lost ground on the other side of the current lockdowns. The dollar is currently trading at U.S. 73.4 cents. National Australia Bank and Westpac, for example, think it could get as high as $0.82 this time next year.

**Australian and International Property — Review**

While not matching the performance of the S&P/ASX200, the A-REITs have benefited from the wider strength of the local equity market, and year to date the S&P/ASX 200 A-REITs Index is up 10.0% in capital value and has delivered a total return of 12.5% including dividends.

Global listed property has also done well, and the FTSE EPRA/NAREIT Global Index in U.S. dollars is up by 15.7% in capital value and has returned 18.5% including dividends. As has been the case all year, there have been strong regional differences mirroring the wider global share market: The U.S. REITs have been very strong, returning 27.9%, and the U.K. has also done very well (returning 26.0%). Asia-Pacific markets, however, have largely missed out (a return of 3.6%) while emerging markets, hit especially hard by COVID-19, have gone backward and recorded a loss of 6.8%.

**Australian and International Property — Outlook**

The latest (June quarter) Royal Institution of Chartered Surveyors, or RICS, survey of commercial property showed that the Australian market had been continuing to improve. RICS compiles a composite index reflecting the sentiments of both investors and tenants, and on that basis the net balance of sentiment had picked up from negative 13 in the March quarter to negative 4 in June. Australian respondents expected an increase in capital valuations over the coming year--probably, as one respondent noted, because of the "huge weight of money" still looking for yield in a low interest-rate world--but also expected some modest downward pressure on rents. That, however, was before the latest COVID-19 outbreaks, and the likelihood is that operating conditions will have relapsed since then.

More importantly, the new round of lockdowns will have aggravated some longer-term structural challenges for offices and for brick-and-mortar retail. On the office front, the Property Council of Australia's latest (July) report on the office sector showed only a small increase in the national vacancy

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rate, from 11.6% to 11.9%, and it is fair comment by the Council that this showed “remarkable resilience” in the circumstances. But as the RBA found in surveying the industry (reported in its latest Statement on Monetary Policy), hybrid work arrangements, part at home and part in the office, are clearly on the rise. It found that while 50% of firms surveyed will keep the same amount of space, and 25% have not yet made a final decision, 25% will be cutting back, on average, by about 25% of their existing space. In retail, the bank said that “The COVID-19 pandemic has accelerated the shift toward e-commerce as consumers attempted to maximise social distancing and comply with lockdown measures ... The accelerated shift toward e-commerce has exacerbated the challenges and risks facing the bricks-and-mortar retail sector.”

It is not all negative. The booming industrial sector with its e-commerce logistics facilities is a big winner in structural change; COVID-19-oriented supportive monetary policy means that interest rates will stay low, helping the yield-driven demand for A-REITs; and equity sentiment is currently minded to look through COVID-19 to better post-pandemic trading conditions. But the office and retail subsectors have some uphill challenges.

Overseas, the ongoing recovery in the global economy has helped improve property performance, though, again, there are strong subsectoral and regional crosscurrents. The June quarter RICS global survey found that, “The headline reading for global capital value expectations (over the next twelve months) has edged up from -1% to +1% while rental values are viewed as being broadly flat (looking out to the middle of 2022) which compares with a projection for a 2% decline in the Q1 survey.” There was a pronounced sectoral tiering: prime industrial, data centres, and multifamily housing were expected to do well, while secondary office and (particularly) secondary retail were expected to keep falling in value.

Other analysts have found similar trends. CBRE, for example, in their latest Global Midyear Market Outlook, said that, “The big economies are reopening and a fast-paced recovery is well underway. This will extend through 2022 as vaccination programs accelerate worldwide before ‘normal’ economic growth resumes in 2023.” They saw the same tiering of sectors: At the strong end, “The industrial and multifamily sectors provided tremendous value protection during the pandemic and their rent growth outlook remains strong,” while at the weaker end, valuations of retail and the fringe office properties will continue to be under pressure. Overall, the cyclical upswing is helpful, but investors will need to continue to watch out for subsectoral allocation, which is likely to remain a decisive driver of performance. Over the past five years, for example, investors in U.S. REITs earned a 6.85% per-year return, but within that, industrial REITs returned just shy of 20% a year, offices returned only 1.9% a year, and retail REITs lost money (2.3% a year).

**Australasian Equities — Review**

The Australian share market continues to do well, and year to date the S&P/ASX 200 Index has gained 15.8% in capital value and returned 17.9% including dividends. The banks continue to be an important driver of performance, with the financials (ex the A-REITs) up 25.3%. At least until the latest lockdowns, consumer discretionary stocks had also been doing well in the rebound from the first round of COVID-19,

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and they are up 23.7%. The miners have also benefited from the cyclical global upswing and are up 15.0%. Utilities (down 3.4%) are the only sector to miss out. Recent performance was enhanced in early August by the surprise takeover offer for financial technology company, Afterpay, at a 30.6% premium to its AUD $99.66 price on July 30.

**Australasian Equities — Outlook**

As in many other economies, the reporting season currently underway in Australia will not give a straightforward view of underlying corporate performance. While some companies indeed will be doing well, in general, results will also be comparing the unexpectedly strong and fast recovery from COVID-19 in the first half of this year with the COVID-19-dampened conditions of 2020. The mixture of cyclical turnaround and corporate-specific successes meant that the early results in the reporting season were shaping up well, with one notable highlight being Commonwealth Bank's strong profit performance, which supported its AUD $10 billion combination of increased dividend and share buyback. The economy and the equity market were clearly in good shape before the latest COVID-19 outbreak hit.

Although the outbreak has proved to be larger and more widespread than initially expected, so far households, businesses, policymakers, and the equity market itself have been taking a relatively upbeat forward-looking view of business conditions on the other side of lockdowns. Westpac, for example, said the results of the latest (August) Westpac/Melbourne Institute consumer confidence survey, which understandably showed confidence down, were nonetheless "better than might have been expected given virus developments ... The virus situation locally is clearly troubling, but consumers appear reasonably confident that it will come back under control, and that once it does, the economy will see a return to robust growth. The availability of effective COVID vaccines is a key source of support for confidence."

Similarly, on the business front, National Australia Bank's July business survey saw confidence and trading conditions weaken, but even so, "With the survey showing a very strong momentum in the leadup to the recent lockdowns, the hope is that once restrictions are eased, the economy will rebound relatively quickly, consistent with the experience through the pandemic to date, and resume a strong growth trajectory – and a return to strong capex and employment plans."

The RBA, at its August policy meeting, took a similar view. There will be short-term disruption--"The recent outbreaks of the virus are ... interrupting the recovery and GDP is expected to decline in the September quarter"--but beyond that, "The experience to date has been that once virus outbreaks are contained, the economy bounces back quickly. Prior to the current virus outbreaks, the Australian economy had considerable momentum and it is still expected to grow strongly again next year. The economy is benefiting from significant additional policy support and the vaccination program will also assist with the recovery." The bank is forecasting solid economic growth down the track and expects Australia "to grow by a little over 4 per cent over 2022 and by around 2½ per cent over 2023."

The common thought is that there will be a replay of the first episode of COVID-19, where activity returned to normal faster than at first feared, and it is even possible (as the RBA modeled in an upside

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scenario in its August Statement on Monetary Policy) that anti-virus efforts go better than anticipated. The key risk for investors to monitor is the RBA's downside scenario of more lockdowns than currently expected. An upside economy, where unemployment drops to below 3.5% by the end of 2023, would be congenial for corporate performance; the downside economy, with unemployment still a bit over 5% in late 2023, would be significantly tougher.

**International Fixed Interest — Review**

Bond yields remain above where they started the year, and the resulting capital losses have outweighed the typically very low-running yields. The yield on the J.P. Morgan Global Government Bond Index, for example, is only 0.77%. Year to date the Bloomberg Barclays Global Aggregate Bond Index in U.S. dollars has consequently returned a loss of 2.2%; global government bonds are down by 3.4% and global corporate bonds are down by 0.9%. Investors taking on more risk for higher yield have also seen poor returns: emerging-markets debt has returned a loss of 0.2% while high-yield (low credit quality) has returned only 2.1%.

**International Fixed Interest — Outlook**

The key issue for the sector remains the ultimate strength of inflationary pressures and the extent of central banks' response to them.

It is clear that at the moment there are strong price pressures across the global economy. The July J.P. Morgan Global Composite Index, for example, found that, "Price pressures remained intense during July, with rates of both input cost and output charge inflation among the steepest in the survey history. Part of the increase in input prices reflected the ongoing disruption across global supply chains." The big questions that remains are, how long will the COVID-19-linked contribution of supply chain blockages last, and the similar shorter-term capacity pressures caused by a strong V-shaped recovery meeting capacity constraints continue? If current inflationary pressures are temporary, central banks can afford to sit on their hands, and bond investors will be relatively relaxed about inflation eroding the value of their bond yields. But if some of it is permanent, then central banks may have to raise interest rates to restrain it, and bond investors may independently hold out for higher yields to protect their purchasing power.

It would be nice if bondholders could see a clear view on how things will play out; but the reality is that there are respectable views on both sides. The IMF, in its July World Economic Outlook update, ticked the "mostly temporary" box: "Recent price pressures for the most part reflect unusual pandemic-related developments and transitory supply-demand mismatches. Inflation is expected to return to its pre-pandemic ranges in most countries in 2022 once these disturbances work their way through prices, though uncertainty remains high."

But forecasters are not so sure. The Philadelphia Fed, for example, conducts a long-running quarterly survey of professional forecasters in the U.S., and in the latest (third quarter) survey, forecasters reckon headline inflation in the U.S. will average 2.75% over 2021-25, up from the 2.4% they had expected in the previous survey. They also upped their estimate of PCE, or personal consumption expenditure,

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inflation (the measure the Fed watches most) to 2.4% from 2.2%. It is also worth noting that some central banks appear to be limbering up for eventual tightening. Various Fed officials have been talking about eventually winding down the Fed's bond-buying programme, which helps keep yields down. And at its latest policy meeting, the Bank of England, while in the "temporary" camp ("current elevated global and domestic cost pressures will prove transitory"), nonetheless laid out how it would eventually start winding back its own bond-buying.

Futures markets are also beginning to firm up on eventual policy tightening. The U.S. futures markets (going by the Chicago Mercantile Exchange's FedWatch tool) currently say that it is essentially a 50/50 toss-up that rates at the Fed's Nov. 2, 2022, meeting will still be where they are today, but the odds shift to a clear 66/34 likelihood of a rate hike at the Fed's Dec.14 meeting. It may not be today or tomorrow, but, assuming the global economy continues to recover robustly from COVID-19, there appears to be progressive upward pressure on bond yields. There is value in bonds' portfolio insurance role, but as things stand, investors face further capital-loss risks.

**International Equities — Review**

After a setback in July when the spread of the delta variant of COVID-19 had rattled investors, shares more recently have gone on to new highs. Year to date the MSCI World Index of developed markets in U.S. dollars is up by 16.2%. The U.S. continues to do well (S&P 500 up 19.0%, Nasdaq up 15.0%), but Europe has also had a good year, with the FTSE Eurofirst300 up 19.4%, thanks to strong performance in both of its key economies (France's CAC is up 24.2% and Germany's DAX is up 16.5%). In the U.K., the FTSE100 is up 11.1%. Japan remains the laggard, with the Nikkei up only slightly (1.9%) in yen and weaker (down 3.6%) in U.S. dollars. Emerging markets have struggled, and the MSCI Emerging Markets Index in U.S. dollars is marginally down (by 0.8%) year to date. Among the major developing economies, good performance in Russia and India was slightly outweighed by losses in China and Brazil.

**International Equities — Outlook**

While the world economy's rate of growth has slowed down a little from the initially very fast pace of the V-shaped rebound out of COVID-19, it remains in strong shape. The latest (July) J.P. Morgan Global Composite indicator of world economic activity suggests the world economy is growing at around a 5% pace, and J.P. Morgan said that, "Looking ahead, while global supply constraints and rising cost pressures may provide headwinds, the expansion is likely to maintain a similar course over the months ahead."

Investors' attention has mostly been on the U.S., where there have been some very strong data. Forecasters had been expecting good news about new jobs in July--their advance pick had been for 870,000 extra jobs. The actual number came in at 943,000, and the unemployment rate dropped sharply, from 5.9% to 5.4%. Remarkably, there are now more unfilled job openings in the U.S. (10.1 million) than there are people unemployed (9.5 million). But global activity has also increasingly been helped by a sharp recovery in the eurozone--as recent equity gains show, investors are now realising that European business activity has also picked up strongly. IHS Markit's latest (July) eurozone composite index showed that, "Eurozone business activity rose at its fastest rate in just over 15 years

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during July, with steep manufacturing output growth complemented by an accelerated expansion of services activity."

The global recovery looks like it is rolling on into 2022. The latest (late July) World Economic Outlook update from the IMF expects that world GDP will grow by 6.0% this year (the same as the IMF had expected in its previous April update), but 2022 is now looking a bit better than previously thought (4.9% growth expected now, compared with 4.4% in April). One important qualification, though, is that it is a two-tier recovery: "Vaccine access has emerged as the principal fault line along which the global recovery splits into two blocs: those that can look forward to further normalization of activity later this year (almost all advanced economies) and those that will still face resurgent infections and rising COVID death tolls."

In these circumstances, equities (at least in the countries that have been better at managing the pandemic) should continue to be able to put good results in the window. As in Australia and New Zealand, companies' latest operating results are being flattered by the comparison between the V-shape-boosted strong June 2021 quarter and the weak June 2020 quarter of the COVID-19 hit. In the U.S., for example, data company FactSet estimates that for the 91% of S&P 500 companies that have reported June quarter results, profits were up by 89.3% on a year earlier. But looking past the current anomalously high numbers, the outlook looks reasonably good: FactSet's compilation of brokers' forecasts for 2022 shows that profits for the S&P 500 companies are expected to increase by 9.4%, and share analysts currently expect the S&P 500 to be 4966.5 in a year's time, which would be an 11.3% gain on its current level.

The scenario of ongoing recovery from COVID-19 remains contingent on significant uncertainties. There could be upsides: As the IMF points out, there might be better global cooperation on vaccines, and countries currently behind the vaccination curve might catch up. If so, "a sooner-than-anticipated end to the health crisis could lead to a faster-than-expected release of excess savings by households, higher confidence, and more front-loaded investment spending by firms." And as the V-shaped recovery showed, there is the possibility that global economic activity might indeed prove more resilient than at first thought.

That said, the IMF is probably right is concluding that, "downside risks dominate in the near term." The key one remains COVID-19, given that the global news about the virus continues to get worse. According to the data published by The New York Times, new daily cases reached a temporary low in the second half of June, with some 360,000 cases a day, but have since risen sharply, to around 650,000. As the newspaper commented, "The highly contagious Delta variant, relaxed restrictions and vaccine resistance among a sizeable minority have driven cases sharply higher in wealthy countries with some of the highest vaccination rates." Israel, one of the notable early successes in quickly moving to high vaccination levels, is currently struggling to contain the latest delta outbreak.

Among nonpandemic risks, beyond the usual unpredictable things like geopolitical risk, the key one appears to be premature or excessive tightening of financial conditions. The IMF's advice is that central

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banks should largely look through current price pressures until they can be sure about how much is permanent and how much can be safely ignored. But they might either get the call wrong or be faced with genuinely persistent inflation. Tighter monetary conditions would be bad news all around for asset valuations, but would be particularly painful in markets where valuations are stretched or even frothy. As the IMF delicately put it, we might see "price corrections in segments such as crypto assets trigger broader sell-offs."

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