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Economic Update: Australia
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Outlook for Investment Markets

World equity markets have been recovering from their September 2021 sell-off and are back close to their previous peak, as 2022 looks to be a year of ongoing recovery from the setbacks of the coronavirus. In Australia, while it is early days on the path toward removal of pandemic restrictions, business prospects also look good for the coming year. The key uncertainties ahead, other than any new mutation of the virus, are the rate of inflation (it is not clear how much of the current pricing pressures are permanent or transitory); the longer-term impacts of the pandemic (such as the eventual state of the office market); and the eventual removal of previously generous levels of fiscal and monetary policy support. Surveys of global fund managers show that they are adjusting their strategies to include more hedges against inflation and avoiding asset classes and sectors more exposed to higher interest rates.

Australian Cash and Fixed Interest—Review

Short-term rates are unchanged, and the 90-day bank bill yield remains effectively zero (currently 0.03%). Bond yields have risen significantly: At 1.8%, the 10-year Commonwealth bond yield is now up by over 0.8% year to date, having started the year just below 1.0%. The Australian dollar year to date has moved a tad lower and is 0.9% down in overall trade-weighted value. In recent weeks, however, it has attracted considerable buying support and has appreciated by 3.3% month to date.

Australian Cash and Fixed Interest—Outlook

Formally, as repeated in the minutes of its latest (Oct. 5) policy meeting, the Reserve Bank of Australia stuck to its line that the conditions for an eventual increase in interest rates—"actual inflation is sustainably within the 2% to 3% target range"—would not be met before 2024. It said that "underlying inflation pressures in Australia were more moderate than in other advanced economies," and that "while it was possible that underlying inflationary pressures in Australia could build more quickly than currently envisaged, the central forecast scenario was still that domestic inflation would pick up only gradually over the medium term."

The financial markets are not so sure and noted the unexpectedly high 4.9% inflation rate across the Tasman in September (the Australian number comes out on Oct. 27). Some forecasters are now picking an earlier move from the RBA: Westpac, for example, thinks the first 0.25% increase will come in early 2023. The futures market expects rates to be moving higher even earlier: Its current pick is that the currently zero 90-day bank bill yield will be 0.5% in a year's time. And if inflation does indeed prove less transitory or less benign than the RBA expects, bond yields will move higher again. National Australia Bank, or NAB, sees the 10-year yield at 2.4% in a year's time. Depositors in the banks will be happier, but bondholders will have a tougher time. The S&P Australia Aggregate Bond Index is down 3.2% year to date, of which 1.7% occurred in October alone, and absent any strong evidence of a quick reversal of transitory inflation pressures, the prospect is for further capital losses.

If indeed rates head higher as the market expects, it could boost the currency in the near term. As the RBA noted in the minutes, the Aussie dollar weakened earlier in the year on narrower interest-rate differentials, and the converse should also be true. It also helps that global financial markets are in a more risk-friendly mood, as witnessed by the recent recovery in world equity markets. The Aussie tends to do better in more "risk on" times. On the other hand, slower Chinese growth, and perhaps further weakness for commodities like iron, could pull the other way, offsetting the interest-rate effect. Some modest upward move might be a realistic call. Precise foreign-exchange forecasts are always precarious, but NAB's sighting shot of USD 0.76 in a year's time, or Westpac's USD 0.78, both up a bit from the current USD 0.75, look to be plausible assessments.

Australian and International Property—Review

The A-REITs have done well year to date. A 12.4% capital gain and a 15.4% total return including dividends means that the S&P/ASX 200 A-REIT Index has effectively matched the strong performance of the overall share market.

Overseas REITs have also delivered good results. Year to date, the FTSE EPRA/Nareit Global Index in U.S. dollars has logged a 15.5% capital gain and returned 18.7% including dividends, again broadly in line with the wider global share market. The outcome has been hugely influenced by the U.S. market, where prices rose by 32.1%: ex the U.S., the index was up by 6.4%. The U.K. market (up 20.2%) also did well, but there were very modest outcomes around the Asia-Pacific region (up 2.0%) and in the eurozone (1.5%), while emerging markets were very weak (down by 9.3%).

Australian and International Property—Outlook

Operating conditions are turning for the better for commercial landlords. As one example, during lockdown, office owners in the big markets of Sydney and Melbourne had been under rental pressure and were having to pay higher levels of incentives (discounts off face rents) to attract or keep tenants. According to Knight Frank, net effective rents dropped by 10.6% for prime Sydney CBD offices and by 10% for secondary properties. Now, however, "as sentiment and demand look likely to improve on the back of the vaccination rollout, incentives will likely peak at year end and then decline slowly [that is, effective rents will rise]." Institutional investors of property have been active in anticipation of the improved conditions. According to Cushman & Wakefield, "Office volumes have continued to step up each quarter this year with activity rebounding ahead of the reopening of the Sydney and Melbourne." Early reports on foot traffic through the malls after "Freedom Days" are also encouraging for the retail subsector, while industrial property had remained very strong throughout the coronavirus pandemic on e-commerce logistics demand, and REITs oriented to housing development can also look forward to a busy year. While the eventual level of post-COVID-19 office tenancy remains uncertain, in general, the near-term business upswing will provide support for REIT performance. The major challenge will be the impact of any further rise in bond yields, which could threaten the investor appeal of the current 3.75% yield.

Globally, it is the same outlook, with improved operating conditions as the world economy continues to recover. Industrials will remain in strong demand, housing developers will continue to benefit from

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strong housing markets (the residential-oriented REITs in the United States are up 44.6% year to date), retail (at least in the earlier stage of recovery) will continue to benefit from the release of previously pent-up demand, and office occupancy will pick up from lockdown levels—though the jury is out on ultimate uptake levels as at least some companies are likely to move to a hybrid mixture of remote and in-office work. Likely rises in bond yields are the main challenge to the asset class. The yield on global REITs, according to Standard & Poor's, is 3.3%, and with the 10-year Treasury bond yield in the U.S. already at 1.65% and likely to rise further, income-oriented support for REITs will be under pressure. On the other hand, as shown in the latest (October) survey of global fund managers run by Bank of America Merrill Lynch, or BAML, the current surge in global inflation pressure is a strong plus, as property is seen as an effective inflation hedge. Fund managers' allocations are currently moving heavily into more inflation-proofed sectors, and in October, REITs were the third-most overweight sector relative to fund managers' historical patterns.

Australasian Equities—Review

Australian shares have followed the wider global pattern and are well ahead for the year. The S&P/ASX 200 Index is up by 12.5% and has returned 16.1% including dividends. The key contributions have come from two sectors: the banks, with financials ex A-REITs up 26.1%, and consumer discretionary shares, which have ridden the wave of pent-up consumer demand resulting from the 2020 shutdowns and are up 20.8%. The miners have struggled, especially in the wake of a collapse in the price of iron ore, and are down by 4.2%.

Australasian Equities—Outlook

Surveys of current business conditions show that the current lockdowns are having a substantial effect on business activity. There have, however, been some hopeful signs in the otherwise poor data. The minutes of the latest RBA meeting, for example, noted that "many firms were preparing for the lifting of restrictions, and timely indicators of household spending and hiring intentions suggested the recovery in activity and employment would be well under way by the end of the year." In particular, firms looked to be getting ready for what is likely to be a tight labour market: "Some firms in New South Wales were preparing to step up hiring ahead of the easing of restrictions in October ... the central forecast scenario envisaged the level of employment, unemployment, and participation, to have broadly recovered to pre-Delta levels by around the end of the year."

NAB's latest (September) quarterly business survey showed a similar picture. It acknowledged the immediate impact of COVID-19 restrictions: "With lockdowns in place for most of Q3, it's unsurprising to see both business conditions and confidence take a fairly large hit for the quarter." But it also said that firms appeared to be better prepared (given their 2020 experience) this time around, and that although business expectations for the immediate months ahead are still weak, businesses appear to be looking to better times next year. "Expectations for capital expenditure over the next 12 months remained healthy, as did expectations for employment over the longer horizon. These results support the view that the economy is well placed to rebound when lockdowns are lifted." As NAB noted, the survey was taken before the latest reopenings in New South Wales and Victoria, and the likelihood is that business conditions will have firmed further since. With the exception of those areas of the resources sector most

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exposed to potential slowdowns in Chinese demand, the economic environment should be conducive to further equity performance in coming months, though there will be some uncertainty later in 2022 once the current levels of COVID policy support start to be withdrawn.

International Fixed Interest—Review

International bonds have had a difficult year. While an early-year rise in bond yields had reversed by August, leaving bond yields only modestly higher than where they started the year and reducing the scale of capital losses, more recently bond yields have headed back up again and are close to revisiting their earlier peaks. In the U.S., for example, the 10-year Treasury yield started off at 0.9%, peaked at 1.75% at the end of March, was back down to under 1.2% in early August, but has more recently risen all the way back up to its present 1.65%. There were similar, if smaller, cycles in other major bond markets. The upshot is that bond investors have lost ground, with capital losses outweighing very modest running yields. Year to date, the Bloomberg Global Aggregate Index in U.S. dollars has lost 4.3%, with government bonds losing 6.1% and corporate bonds 2.1%.

International Fixed Interest—Outlook

The outlook for bonds remains difficult with the prospect of further increases in yields. One reason is that as the world economy continues to recover out of its 2020 COVID-19 slump, there is progressively less and less need for central banks to maintain their previously ultra-easy supportive monetary policies. And the second is that the global economy is currently going through a period of strong price pressures. It is still not clear how much of these pricing pressures will be transitory, linked to temporary collisions between unusually strong post-COVID demand and unusually constrained supply chains, and how much might be longer lasting. But either way, higher inflation is the proverbial enemy of the fixed-coupon bondholder.

The latest (October) quarterly *The Wall Street Journal* survey of U.S. forecasters makes the points clear. At the end of next year, if the median forecast pans out, the U.S. economy will have had a year when gross domestic product will have grown by 3.6%, unemployment will be down to 3.9%, but inflation will be running at 2.5%. No central bank pursuing a conventional monetary policy will leave monetary policy on an ultra-supportive setting when an economy is effectively at full employment and inflation is well within its target range. It will move to normalise policy. The Fed has already said it is limbering up to buy fewer bonds (meaning it is less inclined to keep bond yields down), and in the *Journal* survey, the forecasters expect that it will move further and actually start increasing interest rates before the end of next year. By the end of 2022, the 10-year yield is expected to have reached 2.15%. For similar reasons, the markets expect the Bank of England to start tightening, too, with the latest futures pricing suggesting the first move could be as early as this December.

The probability is that bondholders will be looking at a period of further capital losses, and that is certainly the view of the global fund managers polled in the October BAML survey. They see higher inflation as the biggest risk ahead, and while a majority (58%) are inclined to think it is mostly transitory, they are taking no chances in case it is indeed permanent. Their allocation to bonds in October (a net 80% said they were underweight) was the lowest allocation in the 20-year history of the survey.

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International Equities—Review

World share markets have regained confidence after their September sell-off. Prices bottomed out in early October, and since then, the MSCI World Index in U.S. dollars has risen by over 5% and is nearly back to its all-time peak in early September. Year to date, the index is up by 17.0%. Performance remains significantly dependent on the U.S. market, where the S&P 500 is up 20.8% and the Nasdaq up 17.3%. But even outside the States, equities have done well, and the MSCI World ex USA Index is up 10.4%. European shares have been strong, and the FTSE Eurofirst 300 Index is up 18.5% (in euros). Japan continues to be the main drag on developed market performance, with the Nikkei up by 6.6% in yen but down 3.7% in U.S. dollars.

Emerging markets, however, made little progress. The MSCI Emerging Markets Index is up by a scant 0.8% year to date, and its core BRIC constituents (Brazil, Russia, India, China) are down by 2.9%, mainly owing to weak Brazilian shares (the MSCI Brazil Index is down 17.8%). Russia has done very well, buoyed by the strong oil price, and the MSCI Russia index is up 35.9%, and India is also well ahead (the MSCI India Index is up 28.5%). How China went very much depends on which index you prefer: The Shanghai Composite is up by 5.6% in U.S. dollars, but the MSCI China is down by 11.4%. Either way, China took a back seat to the larger moves in the other BRIC markets.

International Equities—Outlook

The recovery in equity prices reflects growing evidence that the global economy is continuing to emerge from its COVID-19 setbacks. The September J.P. Morgan Global Composite Global Activity Index showed an ongoing and broad expansion across most economies, and the same data at a sector level, as the IHS Market global sector indexes also showed a broad-based recovery, with 18 of the 21 sectors increasing output during the month. The only major exception was car production, which has been particularly badly affected by supply chain interruptions.

The latest updates from the big international institutions have also been encouraging. The OECD, for example, in its latest (September) update to its economic outlook, estimates that the world economy contracted by 3.4% in 2020 but will bounce back by 5.7% this year and follow up with another good year of 4.5% in 2022. One qualification is that it expects some emerging economies to lag, largely because they are less well placed to handle COVID-19 challenges: "There are marked differences in the pace of vaccinations and the scope for policy support across countries, particularly in many emerging-markets and developing economies." This (going by year-to-date share market patterns) is the same conclusion that equity investors have come to.

In terms of risks, the OECD said that "The distribution of risks is now better balanced than a year ago, but significant uncertainty remains." On the plus side, faster vaccination rollout could produce an even better year ahead, but in those buoyant conditions central banks would need to keep markets calm: "Clear guidance by the monetary authorities that the additional inflation pressures were only temporary would help to anchor inflation expectations and limit financial market repricing." The major downside risk to this otherwise positive outlook is some further mutation of the virus: "In such circumstances, stricter containment measures might need to be used again, confidence and private sector spending would be

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weaker than in the baseline, and some capital would be scrapped. In such a scenario, output would remain weaker than the precrisis path for an extended period. World GDP growth could drop to under 3% in 2022."

The International Monetary Fund, in the forecast update for its annual meeting in October, also sees ongoing global growth and has very similar numbers in mind: a drop of 3.1% last year, followed by a 5.9% rebound this year and a further 4.9% in 2022. The IMF also agreed with the OECD that, while the baseline scenario is positive, uncertainty remains high: "The balance of risks suggests that growth outcomes—over both the near and medium terms—are more likely to disappoint than to register positive surprises." It pointed to much the same menu as the OECD: the emergence of more transmissible and deadlier virus variants and, if inflation remains high (because of supply chain issues or otherwise), the risk of "a faster-than-anticipated monetary normalization in advanced economies." In current market conditions, that would not go down well: "Compressed volatility and elevated equity price valuations point to the possibility of rapid repricing of financial assets in the event of a reassessment of the outlook."

By and large, the global fund managers in the October BAML survey also buy the ongoing growth story: a net 50% remain overweight to global equities. But they also feel that the peak period of GDP and profit growth is behind us, and they are particularly keen to be well positioned if inflation remains high, which is by far the biggest risk on their horizon (the top choice for 48%). The survey found that allocations to inflation-linked assets such as commodities, energy, and banks, were at historically very high levels. The other main risks they mentioned were the ramifications of a slowdown in China (the knock-on impact of Evergrande may also have been in that basket, picked by 23%), the existence of asset bubbles (9%), and the impact of any Fed taper (less support for bond yields, also 9%). Oddly, given the thinking of the likes of the OECD and the IMF, the risk of COVID mutating was way down the list (picked by only 3%). It would be nice if the fund managers proved right.

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