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Economic Update: Australia
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Outlook for Investment Markets

World equity markets have risen further as the global economy continues to recover from the latest coronavirus outbreak, and the current upswing looks likely to continue through 2022: Global fund managers remain strongly overweight to growth assets. The two big issues for investors are inflation and monetary policy: It is still not clear whether current sharp rises in prices are largely transitory and linked to COVID-19 disruptions to supply chains, or more permanent. The likely reaction by central banks is also unclear, but interest rates globally look set to rise (and bond yields have already taken the initiative and risen ahead of central bank policy changes), and there is a risk that expensive and/or income-oriented assets are vulnerable to further interest increases. Australia mirrors the global issues: Its emergence from COVID-19 restrictions means that 2022 should see the same pickup other economies are experiencing, and local business surveys are picking up the same intense cost pressures as their counterparts overseas.

Australian Cash and Fixed Interest — Review

Short-term rates are once again unchanged, and the 90-day bank bill yield remains just above zero (currently 0.02%). Bond yields have risen significantly: The Reserve Bank of Australia, or RBA, had been trying to hold the three-year Commonwealth bond yield at 0.1% but has had to give way, and the yield has risen to just above 1% now from 0.15% at the end of August. The 10-year yield has risen by a similar amount over the same period, to 1.8% from 1.1%. The Australian dollar has been volatile in overall value – weak in September, strong in October, weaker again more recently – and has shown little net trend over the past three months. For the year to date, it is down 5.4% in overall value.

Australian Cash & Fixed Interest — Outlook

Australia has not suffered the same surge in inflation as experienced in the likes of New Zealand or the United States: The latest rate of underlying inflation, in the September quarter, was only 2.1%, and the RBA forecasts that it will average 2.25% in 2022 and 2.5% in 2023. The pressure on the RBA to move from its ultra-low interest-rate policy is consequently not as urgent as it is for some other central banks, and the RBA governor said after the bank's November policy meeting that "Given the information we currently have to hand, it is still entirely possible that the cash rate will remain at its current level until 2024". Forecasters and the financial markets are, however, unconvinced that an eventual hike is so far away. The Commonwealth Bank, for example, expects the current programme of bond buying (which helps keep bond yields down) to be gradually wound up over February through May of next year, and it expects the first rate hike from November '22, with an eventual endpoint for the cash rate of 1.25% from today's 0.1%. The financial futures markets are also picking higher short-term interest rates over the coming year, with the 90-day bank bill yield expected to be 1.2% by December '22.

Bondholders have had a difficult year: The S&P Australia aggregate bond index has lost 3.7% for the year to date. The good news is that the worst of the sell-off looks behind us, but the bad news is that there

looks to be some further capital losses ahead. Westpac, for example, expects that the 10-year yield will be 2.3% by the end of next year, and National Australia Bank, or NAB, sees it a bit higher again, at 2.5%.

The recent rise in bond yields may help the outlook for the currency: The RBA in its November *Monetary Policy Statement* noted that the currency appears to benefit when three- and 10-year interest-rate differentials widened in Australia's favour, as they did in October. If so, then the current NAB and Westpac view that the Aussie dollar will reach 78 U.S. cents by the end of next year, up from today's 72.9 cents, may well be a reasonable call. The main wild card is investor confidence about the global economy in 2022: Forecasts of appreciation depend on the foreign-exchange markets remaining in a 'risk on' mood, which tends to support the Aussie dollar. A secondary risk is investors potentially focusing on the ramifications for Australian exporters of slower Chinese import demand.

Australian & International Property — Review

The A-REITs have continued to perform well. The S&P / ASX200 A-REITs Index has made a capital gain of 14.8% and its total return including dividends of 17.8% has narrowly outperformed the 16.9% total return from the S&P / ASX 200.

Overseas REITs have also been strong. For the year to date, the FTSE EPRA/NAREIT Global Index in U.S. dollars has produced a 16.7% capital gain and has returned 20.1% including dividends, slightly behind the 21.8% total return from the MSCI World Index. The outcome continues to be heavily dependent on the U.S. market, which returned 34.9%: ex the U.S., the index was up by only 6.6%. The U.K. market also contributed, with a 20.8% return, but the Asia-Pacific region (1.7%) and the eurozone (0.6%) made little progress, while (as with the wider global share market) emerging markets were weak, with a loss of 7.5%.

Australian & International Property — Outlook

The strength of the A-REITs has been somewhat surprising and may say more about a correction from the oversold reaction to the 2020 COVID-19 outbreak--when investors had overestimated the operating hit to the sector and had underestimated the strength and scale of the subsequent rebound--and less about the immediate outlook. The results from the latest (September quarter) NAB commercial property survey showed that business conditions took a knock in the quarter because of the impact of lockdowns, but, more significantly, the forward-looking results did not shape up well. Admittedly, the hot industrial sector is on a trajectory of its own, with capital values and rents expected to increase over the next two years and vacancy levels expected to remain tight. But offices and (especially) retail are in a different place: Rents are expected to fall over the next 12 months (by 2% for offices and by 3.4% for retail properties) while capital values are expected to be steady for offices but fall further for retail (by 1.6%). Both sectors face oversupply relative to likely demand over the next three years. Ex industrial, it is not easy to see why the sector should continue to beat or match the wider share market, particularly as yield-oriented investors will increasingly compare the yield from the sector (currently 3.69%, according to Standard & Poor's) with the improving yields available from local bonds.

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Globally, the asset class shares many of the same patterns, and it is not obvious that the REITs will be able to keep matching the wider equity asset class. While the latest (September quarter) results from the Royal Institution of Chartered Surveyors, or RICS, show that the upturn in the global economy is having some positive impact on the level of tenant demand for space, the big winner is once again industrial – "Unsurprisingly, it is the industrials / logistics area where demand is continuing to grow strongly and new supply is constrained" – with offices and retail not benefiting to anything like the same degree. The RICS respondents expect that valuations of prime offices will increase slightly over the coming year, but secondary offices, and both prime and secondary retail, are expected to see lower valuations. On top of a modest operating outlook, there is also the potential impact of higher interest rates: As RICS commented, "With central banks gearing up to begin tightening monetary policy (albeit only modestly initially) in response to the sharp uplift in inflation rates in recent months, this could potentially be one area of risk for real estate markets looking ahead".

Australasian Equities — Review

Australian shares have performed in tune with the globally equity-friendly environment of 2021, and the S&P / ASX200 Index has made a capital gain of 13.0% and has returned 16.9% including dividends. The biggest contributors have been sectors bouncing back from COVID-19 setbacks: The banks have taken a much smaller hit than at first feared, and the financials ex the A-REITs are up by 25.3%, while the return of previously pent-up household demand has been good for the consumer discretionary sector, which is up by 23.9%. The miners, however, have lost ground: Although commodity prices are still generally high by historical standards, the recent weakness of the iron-ore price has contributed to a year-to-date 3.7% capital loss.

Australasian Equities — Outlook

Australian corporates have been doing well. As the RBA commented in its November *Monetary Policy Statement*, "Aggregate underlying profits of ASX 200 companies increased to a record level in the first half of 2021. The increase in profits reflected a rebound from initial COVID-19 pandemic effects and strong earnings growth across a number of sectors. Most sectors returned to pre-pandemic earnings levels over this period, with the materials sector posting its highest level of profits in history as a result of elevated commodity prices, most notably iron ore". Even if iron ore has dropped since, it has not materially affected the overall strong operating conditions, with the RBA also pointing to the turnaround for the banks, "mainly reflecting decreased provisions for credit impairments and the writing back of earlier provisions, in line with the improved economic outlook", and the gusher of dividends, which are "at their highest level in history, helped by record dividends paid by some mining companies".

The latest business surveys suggest that corporates are well placed to benefit from a post-lockdown cyclical upswing. NAB's October business survey, for example, showed that "Overall, the results provide first indications of a strong rebound in activity as the major states emerge from lockdowns, with more improvement likely in November as Victorian restrictions continue to ease". IHS Markit's October performance of services index found a similar picture: "Overall business confidence improved in October to a level slightly above the series average (since 2016) as firms viewed the coming 12 months with

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greater optimism that business activity will continue to improve as COVID-19 restrictions gradually ease”.

But both surveys also identified strong input cost pressures. NAB’s survey “continues to show a build-up in price pressures in the economy with the impact of elevated goods demand alongside supply chain disruptions and border restrictions pushing input cost inflation to the highest level in a decade”. IHS Markit’s survey “continued to indicate persistent price pressures for Australian services firms and their clients, attributed to increases in input material, transportation and labour costs”. In sum, there is a strong cyclical backing wind behind businesses, but the market is likely to most reward those companies that are better placed to pass on the current strong cost pressures.

International Fixed Interest — Review

This year’s global spike in inflation rates has proved to be a very uncongenial environment for bond yields, which have risen both as investors have looked for greater returns to compensate for higher inflation and as they have started to anticipate tighter monetary policy ahead. In the U.S., for example, the 10-year Treasury yield, at 1.58%, is up by almost 0.7% for the year, and there has been a similar increase in the U.K.; in the eurozone, the 10-year German government yield is up by 0.3%, though it is still in negative yield territory at negative 0.26%. The resultant capital losses mean that, for the year to date, the Bloomberg Global Aggregate Index in U.S. dollars is down by 4.4%, with government bonds losing 6.1% and corporate bonds 2.7%.

International Fixed Interest — Outlook

Initially, the current rise in inflation looked to be transient. The view of what has come to be called ‘Team Transitory’ was that a lot of it was down to short-term and largely COVID-19-related issues: The IMF, for example, in its October forecasts, said that “In most cases, rising inflation reflects pandemic-related supply-demand mismatches and higher commodity prices compared to their low base from a year ago ... for the most part, price pressures are expected to subside in 2022”.

The IMF conceded, however, that ‘Team Permanent’ might still have a point: “Inflation risks are skewed to the upside and could materialize if pandemic-induced supply-demand mismatches continue longer than expected (including if the damage to supply potential turns out worse than anticipated), leading to more sustained price pressures and rising inflation expectations that prompt a faster-than-anticipated monetary normalization in advanced economies”. In the event the upside inflation risk did indeed materialise in the U.S., consumer price inflation in October turned out to be much higher than expected – the 6.2% annual rate was the highest since 1990 – and even after stripping out volatile food and energy prices, the ‘core’ inflation rate of 4.6% was the highest since 1991.

There is clearly a large component of supply chain and other disruptions that will indeed drop away, but equally there are some greater risks that inflation may be more of an issue than previously thought. As a result, the financial markets are now leaning towards the idea that monetary policy will be tightened a bit earlier than previously anticipated. The Fed, for example, at its November meeting, started to wind back its programme of bond buying, and the futures markets now expect that the most likely timing for

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the first 0.25% hike in the Fed's 0% to 0.25% target range for the fed funds rate is at its June '22 meeting next year. The futures market expects either one or two further 0.25% increases by the end of '22.

Even if central banks make only limited and careful moves towards higher interest rates, bond investors may well decide for themselves that the yields on offer are inadequate compensation in a higher inflation world. The IMF thinks that inflation in the developed economies will average 2.3% in 2022: Current bond yields (even before tax) in all the major markets are well short of providing adequate inflation protection. A global economy in the middle of a robust post-pandemic upswing, with upside inflationary risk and already inadequate yields, is likely to continue to prove a difficult environment for bonds.

International Equities — Review

World shares have continued their recovery from September's sell-off, and for the year to date, the MSCI World Index of developed markets in U.S. dollars is up by 19.8%. The American market has been strongest – the S&P 500 is up by 24.7% and the Nasdaq by 23.1% – but most other major markets have done well, with the FTSE Eurofirst 300 Index up 22.6% (in euros) and the U.K.'s FTSE 100 up 13.7% (in sterling). Japan remains the laggard: The Nikkei is up 7.9% in yen, but the yen's weakness means Japanese shares are down 2.2% in U.S. dollars.

Emerging markets have struggled all year, and the MSCI Emerging Markets Index for the year to date is marginally lower (negative 0.4%) in U.S. dollars. Among the key BRIC (Brazil, Russia, India, China) markets the biggest influence on the weak overall asset-class outcome has been the Brazilian market, where the MSCI Brazil Index is down by 17.8%, but investors in Russia (MSCI Russia up 35.9%) and India (MSCI India up 28.5%) have done very well. China's performance has been somewhere in the middle of these extremes of weak and strong performance, but exactly where continues to depend on which index you prefer to follow: The Shanghai Composite, for example, is up by 4.3% in U.S. dollars, whereas the MSCI China is down by 11.4%.

International Equities — Outlook

The global economy continues to recover from the latest outbreak of COVID-19. The October J.P. Morgan Global Composite global activity index picked up a bit from September's reading, to signal 16 consecutive months of business expansion, despite the constraints of still disrupted supply chains and sharply higher input costs. It has helped, too, that the U.S. economy has picked up from what had been unexpectedly poor employment data in September, when there had been only 194,000 jobs compared with an anticipated 500,000: In October, new job creation rebounded back up to 531,000 and unemployment dropped to 4.6%, in both cases beating forecasters' expectations (450,000 jobs, 4.7% unemployment rate).

Businesses expect the recovery to continue, although at a slower pace than during the initial robust rebound from 2020's COVID-19 outbreak. IHS Markit conducts a global business outlook survey three times a year. Its latest (taken in October) found that "Companies' expectations regarding business activity in the coming year have generally held up well, although the headline global business activity net

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balance dipped to +31% in October from +38% in June. Sentiment was the lowest since this time last year, but remained well above that seen during the worst of the COVID-19 pandemic in 2020".

Ongoing growth should flow through to further growth in corporate profits and further support for equity prices. Data company FactSet's latest roundup of share analysts' expectations for 2022 showed that profits at the S&P 500 companies are expected to increase by 8.5%, with particularly strong profit growth expected from the industrials (36.3%), consumer discretionary (31.3%) and the energy sector (29.6%). The analysts expect that these results would take the S&P 500 up to 5,153 in a year's time, which, at the time of the FactSet survey, was a 10.6% gain (9.8% from its level at time of writing).

Global fund managers are on board with the story of further equity gains. The November Bank of America Merrill Lynch survey showed that they remained heavily overweight to equities and in particular are tilted towards the U.S., Europe (other than the U.K.), banks, and tech. Ongoing growth means they are underweight to defensive sectors such as consumer staples and utilities, and they are also wary of emerging markets, possibly because they see indebted developing economies as being particularly vulnerable to higher interest costs on their debt. The main risks on the horizon are the interrelated issues of higher than anticipated inflation (picked as the top risk by 33% of the managers) and potential central bank interest-rate hikes (picked by 22%).

Performance periods unless otherwise stated generally refer to periods ended Nov 12, 2021.

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