Economic Update: Australia
December 2021

Morningstar Research
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Outlook for Investment Markets

Despite the emergence of the new omicron variant of the coronavirus, the global economy has continued to recover from the pandemic, and improving operating conditions provide a useful supportive backdrop for growth assets. Inflation has continued to surprise on the upside, and a range of central banks are likely to have to respond with higher interest rates, which means bonds (barring some resurgence in COVID-19 virulence and a consequent search for safe-haven assets) look to be facing ongoing difficult conditions. Higher interest rates also pose a valuation challenge to other asset classes, given that several look expensive. The other main risks on the international horizon are ongoing supply chain disruption and strong pressure on companies' input costs. Australia is already seeing the benefits of the lifting of lockdowns, and business activity is likely to continue to strengthen in 2022 and into 2023, though the local economy is likely to share the same issues of higher interest rates (despite the Reserve Bank's avowed intention to hold off for some time) and pressure on corporate profitability from more expensive inputs.

Australian Cash and Fixed Interest — Review

The Reserve Bank of Australia, or RBA, at its Dec. 7 policy meeting kept the target cash rate at 0.1%, and consequently, short-term rates have continued at very low levels, with 90-day bank bills yielding only 0.06%. Bond yields have also headed higher: The 10-year Commonwealth bond yield may have eased back from its recent high (2.09% on Oct. 29) but at 1.6% is still well up on where it started the year (just below 1.0%). The Aussie dollar has weakened in recent weeks and for the year to date is down by 5.4% in overall value. Part of the weakness reflects the global strength of the U.S. dollar: The Aussie dollar was worth 75 U.S. cents at the start of November but has fallen to 71 cents now.

Australian Cash & Fixed Interest — Outlook

If COVID-19 does not spring any further unpleasant shocks, the RBA looks likely to start reducing its AUD 4 billion a week bond-buying programme from February and to wind it up completely by the end of May. But otherwise the RBA does not plan any further monetary tightening, and in particular any cash rate increase, it says, is still a long way away and not before the end of 2022. The financial markets remain sceptical, however. In Treasury's Dec. 16 Mid-Year Economic and Financial Outlook, or MYEFO, inflation is expected to average 2.75% in the June '22 year and 2.5% in the June '23 year, while unemployment drops to 4.25% by mid '23. These do not look like conditions where a central bank would continue to stand on the sidelines, and currently the financial futures market is pricing in higher short-term interest rates in the second half of 2022.

If inflation evolves as Treasury expects, bond yields also look set to rise further, and the likely winding-up of the bond-buying programme will also contribute to the process.

Westpac's forecast is that the 10-year yield will be 2.3% by the end of next year, and National Australia Bank, or NAB, expects 2.5%. Even then, yields will at best match the likely rate of inflation, and investor pressure for real (above inflation) returns could see yields rising further in 2023.

The recent weakness of the Aussie dollar is with hindsight none too surprising, given that the RBA looked to be significantly slower than some other central banks (and in particular the Fed in the U.S.) to start normalising interest rates from their unusually low levels. Interest-rate differentials look to have outweighed some positives for the Aussie dollar, notably high commodity prices by historical standards. Some forecasters think the weakness will reverse —the average forecast across the ANZ, NAB, and Westpac for end '22 is 75 U.S. cents, up 4 cents from today's level—but that will only come to hand if the RBA does indeed move earlier than it currently plans.

Australian & International Property — Review

The A-REITs have had a very good year. The S&P / ASX200 A-REITs Index has made a capital gain of 22.1% and has delivered a total return including dividends of 25.4%, significantly outperforming the 16.1% total return from the S&P / ASX 200.

Overseas REITs have also done well. For the year to date, the FTSE EPRA/NAREIT Global Index in U.S. dollars has delivered a 14.4% capital gain and has returned 18.0% including dividends, close to the 18.7% total return from the MSCI World Index. Performance has, however, been even more dependent on the U.S. market than the overall share market has been: Ex the U.S., the index returned only 1.8%. The U.K. was the only other major market to do well, with a 20.7% return; there were losses in the Asia-Pacific (negative 2.6%), in the eurozone (negative 5.5%), and the emerging markets (negative 14.0%).

Australian & International Property — Outlook

There was likely an element of correcting previously oversold A-REITs in the recent rally, but the main factor was the big improvement in the operating outlook following the lifting of lockdowns. The December quarter ANZ Bank / Property Council of Australia survey of commercial property found that "Commercial sentiment rose strongly and is now at its highest level since June 2018" and that "Optimism about the economic outlook is underpinning a lift in sentiment across all property segments; residential, office, hotels, retail and industrial, despite the uneven and lingering impacts of COVID on the hotel and office sector". Up to December, respondents had been pessimistic about capital values in the office, tourism, and retail sectors, now, they see valuations stabilising for offices and retail and improving for tourism (they were highly bullish all along about industrial and have remained so). All good news, but a repetition of the recent A-REIT performance seems unlikely if interest rates continue to rise, as the survey respondents expect they will. The Property Council noted that "Interest rate expectations have lifted strongly, with nearly 60% of firms now expecting rate hikes over the next year. While this is consistent with market pricing … it contrasts with the RBA's insistence that the cash rate is likely to remain unchanged until well into 2023".

Much the same factors apply to the global asset class. There is the immediate impact of economic recovery: The U.S. trade group NAREIT in its outlook for 2022 said that "Assuming COVID-19 variants remain largely in check, this will be a period of economic growth that will drive recovery across a broad range of real estate and REIT sectors". Within the broad uplift, there will be some ongoing structural change, notably around flexible work practices (for the office sector) and online shopping (for retail), though NAREIT makes a good point that the view that has become conventional—that brick-and-mortar and online are competing substitutes—may be too simplistic: "Brick-and-mortar sales came back with a vengeance as stores reopened … Consumers have demonstrated that they still appreciate in-store shopping for certain items, even as they prefer the convenience of online purchases for others … This consumer preference for 'more of both' will likely boost the recovery of the brick-and-mortar retail sector in 2022 and also support the continuing long-term growth of REIT sectors that support the digital economy, including industrial/logistics, data centres, and infrastructure/communications towers". While the operating outlook has improved, again the big challenge will be the impact of higher interest rates, particularly as the U.S., which has driven nearly all of the 2021 REIT gains, is likely to see a series of monetary policy tightenings by the Fed.

Australasian Equities — Review

Australian shares have performed well, and the S&P / ASX200 Index is up by 12.0% and has returned 16.1% including dividends. The three big sectoral winners were the A-REITs (up 22.1% as noted earlier), consumer discretionary (up 20.8% on expectations of post-COVID-19 pent-up spending), and the financials ex the A-REITs (up 18.5% after the banks look like managing their way through the pandemic better than originally feared). The miners look to be finishing 2021 with a small gain: The S&P / ASX300 Metals and Mining Index is up by 2.1%.

Australasian Equities — Outlook

The economy has been recovering strongly as lockdowns have been lifted. The IHS Markit composite index (covering both services and manufacturing) for November showed "a faster rate of private sector output growth in November following three months of contraction between July and September". NAB's November business survey showed the same picture of improvement: All three components of business conditions (trading, profitability, hiring) have increased significantly from their September levels, and business conditions overall are now modestly above their long-term average.

COVID-19 permitting, there is further growth ahead. As the MYEFO put it, "The Australian economy is rebounding strongly from the impact of the Delta outbreaks … Real GDP is forecast to grow by 3 ¾ percent in 2021-22 and by 3½ percent in 2022-23. While the Delta outbreaks disrupted activity in the September quarter and dampened growth over 2021-22 relative to Budget, the effect on growth was less than initially expected and the economy is rebounding strongly in the December quarter. The recovery is being supported by broad-based momentum across both private and public demand".

This is a helpful overall macroeconomic backdrop for equities, but strengthening cost pressures mean that good top-line revenue growth will not always translate into good bottom-line earnings growth. Both the HIS Markit and NAB surveys picked up a strong increase in input costs, with Markit, for example, reporting that "input price inflation across both manufacturing and service sectors surged to their respective survey record rates to indicate rapid increase in input costs". This will restrain profits for companies not easily able to pass on all the increases. In the MYEFO, for example, there are forecasts for 'corporate gross operating surplus', essentially profits before depreciation. They are on the modest side: a 2.25% increase in the June '22 year, an 8.25% decline to June '23 (likely linked to assumed lower commodity prices), and then modest growth of 3.25% to June '24 and a pickup to 5.0% in the June '25 year. The likely equity winners in this world will be those best placed to defend their profit margins.

International Fixed Interest — Review

It has been a difficult year for fixed interest. Global inflation has unexpectedly surged, investors are none too sure whether the rise in inflation is temporary (and ongoing low bond yields might consequently be tolerable) or more permanent (in which case investors will hold out for higher yields), and, in general, recovery from COVID-19, despite the emergence of the omicron variant, has reduced the attractiveness of bonds as a safe-haven option. Bond yields have risen virtually everywhere (though minimally in Japan), inflicting capital losses, and for the year to date, the Bloomberg Barclays Global Aggregate Index in U.S. dollars is down by 4.4%, with government bonds down by 6.0% and corporate bonds down by 3.0%.

International Fixed Interest — Outlook

Inflation has continued to surprise on the upside, with the most dramatic example being the 9.6% year-on-year increase in producer prices in the U.S. in November, a result that was way above market expectations. Even discounting the impact of traditionally volatile elements like food and energy, the year-on-year rise in "core" producer prices was a startlingly high 6.9%. Until quite recently, central banks were facing the challenge of trying to boost inflation to get it up to where they would prefer it to be (typically around 2%). Virtually out of nowhere, they are now trying to force it back down from unacceptably high rates.

The Fed has been in a particularly difficult position, with the U.S. economy generating stronger inflationary pressures than most: Its latest rate of consumer price inflation (6.2%) is above the 4.8% average inflation rate in the big G7 economies and the 5.25% inflation rate in the wider G20 group of large economies. At its December 14-15 meeting, the Fed unsurprisingly made it clear that, by the end of March, it would wind up its bond-buying programme, which had been designed to help keep bond yields low, and would subsequently start raising short-term rates. It is likely to increase its target for the federal funds rate by 0.75%, from its current 0% to 0.25% range, to 0.75% to 1.0% by the end of 2022. Other major central banks are not quite as pressured as the Fed but face similar issues with unexpectedly high inflation and are also likely to start winding back bond-buying programmes and to move towards raising their policy rates.

Bond yields had been poor value even before this latest increase in inflation and have become even more inadequate now: The OECD reckons that inflation across its member countries (largely developed economies) will have averaged 3.6% this year and will pick up to 4.4% next year. Some of the COVID-19-related upward pressures on prices will ease in time, and there is still some merit in the value of bonds as insurance if the COVID-19 pandemic were to take a darker turn or geopolitical tensions were to spring any unpleasant surprises, but otherwise the outlook for fixed interest remains challenging.

International Equities — Review

It has been a bumpy year, with the omicron variant's impact on share prices in late November and early December the latest in a series of twists and turns, but barring any further last-minute setback, it looks as if world shares will have delivered strong returns in 2021. For the year to date, the MSCI World Index of developed markets in U.S. dollars is up by 16.7%. As was the case all year, the performance has been heavily dependent on the U.S. market: Ex the U.S., where the S&P 500 is up 23.4%, prices have risen by a significantly more modest 6.5%. Exchange-rate movements contributed to the U.S. market's dominance, with the U.S. dollar strengthening against the yen, euro, and pound and appreciating in overall value by 6.3% (on *The Wall Street Journal*'s index).

Emerging markets, however, have missed out, and for the year to date, the MSCI Emerging Markets Index is down 5.4% in U.S. dollars. The core BRIC markets (Brazil, Russia, India, China) were weaker again and dropped by 12.8%, heavily influenced by the particularly weak Brazilian market (MSCI Brazil down 23.0%). India was the best performer, with the MSCI India Index up 22.2% and the traditional Sensex index up 16.5% in U.S. dollars.

International Equities — Outlook

The world economy is doing well, despite the uncertainties posed by the latest omicron variant of COVID-19. The November J.P. Morgan Global Composite Index of business activity found that "The rate of global economic expansion edged higher in November, as output rose at the quickest pace for four months. Growth was underpinned by rising intakes of new business, stronger inflows of new export business and continued job creation". It is not completely plain-sailing, as there are still pronounced supply chain disruptions, and stronger business activity has been accompanied by heavy pressure from input costs: "Average input costs rose at the fastest rate since July 2008, while output charges increased at a pace close to October's series-record high". But the progressive emergence from the COVID-19 restrictions has nonetheless been a big plus, and companies are upbeat about the outlook: "Business optimism rose to a five-month high in November, with optimism improving in five of the sub-industries covered by the survey (business services, consumer goods, consumer services, financial services and investment goods) and was unchanged in the other (intermediate goods)".

It is also helpful that the U.S. equity market, which has been the mainstay of global equity outcomes, looks likely to make some further progress. Data company FactSet collates the individual company share price forecasts that share market analysts make and aggregates them to produce a "bottom up" forecast for the S&P 500. At the time, the S&P 500 was at 4,667.45, and the bottom- up forecast for the index in a year's time came out at 5,225, which would be an 11.9% gain. FactSet notes, however, that analysts tend to be on the optimistic side, and in normal circumstances (for example, the global financial crisis in 2008, which threw off their forecasts much more than usual), they tend to shoot 1.6% too high. Knocking 1.6% off the 5,225 target brings it back to 5,141, which would represent a gain of 10.2%. The expected gain is broadly in line with the 9.0% expected rise in S&P 500 profits in 2022, with industrials, consumer discretionary, and energy expected to be the strongest sectors.

Global fund managers are also cautiously optimistic about 2022, according to a large poll of institutional investors run by Natixis, a French investment bank and fund managers. COVID-19 has not gone away but is becoming more manageable: "58% say they believe that life will return to pre-Covid normal after the pandemic", compared with "42% believe that Covid variants will continue to disrupt the return to normal". The fund managers are keen on the "reopening trade": "64% of institutions anticipate that the reopening trade such as restaurants, theatres, and travel will outperform a stay-at-home trade (36%) focused on Netflix, online shopping and other touchstones of quarantine life".

But there are risks. The fund managers were asked about the big risks on the economic front and to their portfolios. On the economic front, COVID-19 still could have a sting in its tail and came out as the top risk: 56% mentioned ongoing supply chain issues, and 41% picked COVID-19 variants. The other top risks were less supportive monetary policy (47%), worsening U.S. – China relations (32%), and a potential slowdown in the Chinese economy side (27%). For portfolios, again the potential response from central banks was to the fore, with the top risks being the interrelated issues of inflation (69%), interest rates (64%), and valuation (45%).

In response, the fund managers plan to take an active rather than a passive investment approach, mainly with a view to earning better risk-adjusted returns, but are otherwise on the cautious side, favouring defensive over aggressive portfolios and value over growth. By region, there may be some relief in sight for emerging-markets investors: It is the favoured region for investment, with 41% planning to increase allocations and only 18% planning to reduce them. Asia-Pacific (34% increase, 16% decrease) and Europe (33% increase, 20% decrease) are also in favour, but this panel of fund managers did not share the U.S. analysts' optimism that FactSet described. The U.S. (25% increase but 36% decrease) is on the outer, very likely because it looks relatively more exposed to any valuation correction.

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

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