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Economic Update: Australia
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Outlook for Investment Markets

World and local equity markets have started 2022 badly, as valuations in some expensive sectors such as tech unravelled, triggering a wider sell-off in equities as a whole, against a background of rising interest rates and ongoing uncertainties about the short- and medium-term impacts of the pandemic. Despite these setbacks, the outlook for business activity both globally and domestically is still positive. And barring some virulent mutation of the coronavirus, the reopening trade should see strong economic growth this year, although the pace of growth is likely to ease back in 2023. The big issues for investors, again both overseas and at home, are inflation and interest rates. Also, rising cost pressures are making it an ongoing challenge for companies to translate higher sales into higher profits. Higher interest rates, as central banks battle the war on inflation, make bonds an unattractive option and also threaten the valuations of other asset classes.

Australian Cash and Fixed Interest — Review

Short-term rates have been steady since the start of the year and the 90-day bank bill yield remains a little under 0.1%. Longer-term rates have also risen, and the 10-year Commonwealth bond yield is 0.25% higher at 1.91%. The currency has weakened, and the Aussie dollar year to date is down 1.1% in overall trade-weighted value; in terms of its headline rate against the U.S. dollar, it is down 0.9% to 71.9 U.S. cents.

Australian Cash and Fixed Interest — Outlook

The official position from the Reserve Bank of Australia, or RBA, has been that any interest-rate increases are still a distant prospect, and a survey of economists run by the *Australian Financial Review* in early January showed that the median forecaster did indeed expect the cash rate to still be at 0.1% at the end of this year. Recent events, however, suggest tightening might be earlier. The latest (December quarter) inflation rate, published on Jan. 25, showed that headline inflation rose to 3.5% from 3.0% in the September quarter, and, importantly for the RBA, the trimmed mean measure showed underlying inflation (shorn of unusually large moves), running at a higher than expected 2.6%. As the Australian Bureau of Statistics noted, this was the highest trimmed mean rate of inflation since June 2014. Earlier, there had been much better than expected November employment data, meaning that on both the inflation and unemployment fronts, the RBA looks likely to be prodded into earlier action than it had first preferred. The futures market expects several rate increases that would take the 90-day bank bill yield 1.25% higher by the end of this year. Savers will see better returns from money in the bank, although the return will still not compensate for the impact of inflation.

Longer-term rates are also likely to increase, reflecting eventual RBA tightening and the phasing out of its bond-buying programme, rising bond yields overseas, and investors' need for better returns in the

current inflationary climate. The RBA is clearly keen to take a very measured approach to tightening and will lean against bond-yield rises, but even so a yield somewhere around mid-two looks plausible by the end of this year--both National Australia Bank, or NAB, and Westpac expect 2.5%. Last year was a difficult year for local bonds (the S&P Australia Aggregate bond index lost 2.9%), and market conditions look to remain difficult in 2022.

The opening weeks of the year confirmed that the Aussie dollar tends to do worse than most when global financial conditions are unsettled (equity markets have been very weak to start the year). In this risk-off environment, the Aussie dropped against all its major counterparts other than the kiwi dollar, an even more risk-off currency. Some forecasters currently expect some recovery from the recent sell-off, with, for example, Westpac expecting U.S. $0.73 and NAB 0.77 cents. And they may be right, as both the strength of Australia's commodity prices and the strong domestic economy could help it appreciate, although relatively slow tightening by the RBA relative to other central banks' plans may be a constraint. But in any event, recovery will only eventuate once international foreign-exchange investors are in a more risk-on frame of mind.

Australian and International Property — Review

After a very strong 2021, when the S&P/ASX200 A-REITs index made a capital gain of 21.6% and returned 26.1% including dividends, the sector has done badly in the opening weeks of 2022, and the index is down by 8.9%, underperforming the wider share market's 3.6% decline.

Overseas REITs have also weakened, though they have done slightly better than world shares as a whole. The FTSE EPRA/NAREIT Global Index in U.S. dollars is down by 5.1%, modestly less than the 6.4% decline in the MSCI World Index. As with the wider equity market, weakness was concentrated in the U.S. REIT market, where prices fell by 7.6%. Excluding the U.S., the sector turned in a usefully defensive decline of only 1.8%.

Australian and International Property — Outlook

The weakness of the A-REITs has been somewhat surprising. Unlike in the U.S., the U.K., or New Zealand, where central banks are in the early stages of multi-hike tightening of monetary policy, the Reserve Bank of Australia has been keen to avoid early rate rises, and the A-REITs might have been expected to do better than their overseas counterparts. One possibility is that investors have started to suspect that the RBA will have to act earlier than it planned, a view vindicated by December's higher than expected inflation rate, and that the yield on the sector (3.6%) is now at greater risk than originally thought. It may be that the huge surge in the Australian omicron variant led investors to take a more downbeat view of property owners' revenues. Another possibility is that there may have been an element of profit-taking after the strong performance of last year. Whatever the reasons, the decline looks unusually large, as the operating outlook in what is likely to be a good year for economic growth is supportive, and the reopening trade, as COVID-19 becomes more of an endemic nuisance than a virulent pandemic and borders reopen, could well benefit previously battered subsectors, such as shopping malls and tourism. The A-REITs may well do better in the rest of the year than their opening weakness might suggest.

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The same factors are playing out overseas. There are generally supportive economic fundamentals as the impact of COVID-19 diminishes, but with strong subsectoral differentiation. Industrial is still strong virtually everywhere, but there are lingering challenges for offices and retail as a result of pandemic-accelerated behavioural changes to work and shopping. On the other hand, there is the offsetting issue of rising bond yields. So far, global REITs have done reasonably well in the wider equity sell-off, and property company CBRE may be right (when arguing about the U.S. market) that there is enough of a yield cushion to fend off the threat from bonds, and that the operating outlook will win for the time being: "Rents should continue rising, supporting higher property net operating income (NOI) for most asset types. Although cap rates [capitalisation rates, the interest rates used to value property] typically follow the direction of real interest rates in the long run, NOI expectations are more influential in the short term."

Australasian Equities — Review

Australian equities have shared in the global equity weakness of early 2022, and the S&P/ASX200 index is down 3.6%. Globally, tech shares have been under pressure this year, and the local sector followed suit, with IT stocks down 14.4%. Most other sectors are also in the red, though the banks (likely beneficiaries of rising interest rates) did relatively well, with the Financials, excluding the A-REITs, down by a smaller than average 2.8%. The miners, on the other hand, have profited from ongoing strong world commodity prices, while the S&P/ASX300 Metals and Mining Index is up 6.2%.

Australasian Equities — Outlook

At this early stage of the year there are not many surveys available of how the business sector is performing, but what was available at the end of 2021 was reasonably encouraging. NAB's November business survey, for example, found that: "Overall, the results suggest a strong recovery is continuing as reopening progresses, with activity now settling at a more 'normal' post-lockdown level. Conditions remain below the levels seen in early 2021 but forward indicators point to momentum continuing into 2022." There was also a major positive surprise in the labour market in November, when there were 366,100 more people employed. Forecasters had expected a big number--they predicated around 220,000 people would come back to work post-lockdown--but the actual result blew well past all expectations, with the unemployment rate consequently dropping to an unexpectedly low 4.6%.

While omicron will complicate the outlook, and it has, for example, knocked back the early 2022 readings on consumer confidence in the most recent ANZ/Roy Morgan poll, the best take at the moment is that the economy should experience a strong year of post-lockdown recovery. The *Australian Financial Review*'s survey of 30 economists published in early January found the median expectation for GDP growth this year is 5.0%, with growth continuing, albeit at a slower 3.0% rate, through to mid-2023. Australian businesses will face the same input cost pressures being experienced globally, so strong top-line sales growth will not translate straight into strong profit performance. CommSec's outlook for 2022 noted the challenges of "Persistent virus mutation risks, rising interest rates and elevated inflation," but concluded that, "Aussie shares could outperform their global counterparts in 2022, supported by

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stronger relative economic growth and higher relative dividend yields. CommSec expects the ASX 200 index to end 2022 between 7,600-7,800 points."

International Fixed Interest — Review

Bonds lost ground in 2021, with the Bloomberg Barclays Global Aggregate index in U.S. dollars losing 4.7%. The early weeks of 2022 have also been difficult, as the Global Aggregate year to date is down by 0.9%, with government bonds losing 0.6%, and corporate bonds down 1.9%. Higher-yielding riskier subsectors, where investors have looked for better returns in a world of otherwise very low yields, have also gone backward, with emerging-markets bonds down 2.3% and global high-yield (low credit quality) down by 1.5%.

International Fixed Interest — Outlook

Bonds continue to face difficult conditions as inflation has unexpectedly risen to high levels by recent standards. The first of the big flagship forecasts for 2022 from the international organisations--January's *Global Economic Prospects* from the World Bank--said that "The rebound in global demand and activity since mid-2020, together with supply disruptions and rising food and energy prices, have pushed headline inflation to decade highs across many countries. Core consumer price inflation — excluding food and energy — has also increased globally; in some economies, this has in part reflected rising housing price inflation. The increase in inflation has led various central banks to partially unwind their accommodative monetary policies." The OECD estimates that inflation in the developed economies was 5.8% in November, and it has likely become worse since. In the U.S., for example, November's 6.8% inflation rate rose to 7.0% in December.

With inflation higher, central banks have had little option but to change monetary policy tact and have started to wind back previous programmes of bond-buying (which kept bond yields lower than otherwise) and are likely to progressively raise policy interest rates through 2022. Some have moved already, with the Bank of England, for example, raising its policy rate from 0.1% to 0.25% on Dec. 16. Even without the central banks moving, bond market investors may well have held out for higher returns on bonds to preserve their purchasing power against the surge in inflation.

The outlook is for further monetary policy tightening, although opinions vary on how much. In the key U.S. market, for example, the futures market is confident about a March hike. The Chicago Mercantile Exchange's FedWatch tool, based on the futures pricing, puts an 89% probability on a 0.25% increase in the Fed's target cash rate range (currently 0% to 0.25%) at the Fed's March 16 meeting and expects a string of rate rises for the rest of the year, but is not sure how many. The best guess at the moment is four 0.25% increases (31.5% probability), but it could easily be three (27%) or five (20%). Either way, global economic conditions at the moment remain difficult for fixed interest.

International Equities — Review

World shares have had a rocky start to 2022. The MSCI World Index of developed markets in U.S. dollars has dropped by 6.4%. American shares have done especially badly--the S&P 500 is down 7.7% and the Nasdaq is down 12.2%--but many other major markets have also been weak, with Japan's Nikkei index

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down 4.4%, Germany's DAX down 1.8%, and France's CAC down 1.2%. The U.K. has been a rare exception, with the FTSE100 up 1.5%.

One thing that is comforting is that one of 2021's laggards, the MSCI Emerging Markets Index--down 4.6% last year--is up so far, with a modest 1.0% gain. The gain was largely down to a surprising turnaround for Brazilian shares. The MSCI Brazil had lost 23.5% in U.S. dollars in 2021 but is up 7.7% year to date, as buyers were attracted by cheap Brazilian energy and commodity stocks in an environment of strong global commodity prices.

International Equities — Outlook

The world economy is still growing, although the impact on staffing levels with the surge in omicron cases, other lingering supply chain issues, and some inevitable slowdown from the original rebound from the severe COVID-19 setback, have combined to slow down the rate of growth. The December J.P. Morgan Global Composite Index of business activity was 54.3, consistent with ongoing growth at a respectable rate, though down from the 54.8 registered in November.

Global businesses remain optimistic about the outlook. In the Global Composite survey, it was reported that they are planning to take on more staff: "Companies maintained a broadly positive outlook for output levels over the coming year, with the overall degree of optimism ticking up to a six-month high."

The World Bank's *Global Economic Prospects* forecasts are also picking ongoing growth, but at a slowing rate: "Global growth is projected to decelerate from 5.5 percent in 2021 to 4.1 percent in 2022, reflecting continued COVID-19 flare-ups, diminished policy support, and lingering supply disruptions. Growth is envisioned to slow further in 2023, to 3.2 percent, as pent-up demand is depleted and supportive macroeconomic policies continue to be unwound." The good news is that if something like the World Bank's expectations come to fruition, next year the developed world will have returned to where it would have been pre-COVID-19: "Despite the slowdown, the projected pace of expansion will be sufficient to return aggregate advanced-economy output to its pre-pandemic trend in 2023 and thus complete its cyclical recovery."

All that said, there are clearly risks to this good economic outcome. Beyond some further malign evolution of COVID-19, the World Bank said that risks are tilted to the downside: "The recovery is also at risk from more persistent supply disruptions, mounting inflationary pressures, financial stresses, climate-related disasters, and weaker-than-anticipated long-term growth drivers." Among the potential financial stresses, the World Bank mentioned central banks withdrawing monetary policy support in an "inadequately forewarned" way. But even if central banks do a fine job of explaining their intentions, less liquidity and higher interest rates have the potential to undermine global share markets. The recent sell-off in equity markets has partly been down to investors readjusting equity valuations in a world of rising interest rates, especially given that some sectors of the market (notably tech) had been priced on very expensive valuations. Other higher-risk assets, such as cryptocurrencies, have been heavily sold off for the same reason.

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If all goes well, ongoing growth will support improved corporate performance, though profit growth will be harder to come by in 2022 than in 2021. Data company FactSet's latest collection of sharebrokers' profit forecasts for the U.S. market suggests that earnings at the S&P 500 companies are expected to grow by 9.4% this year, compared with an estimated 45.3% in 2021. The numbers exaggerate the likely slowdown (2021 numbers were bloated by a sizable loss-to-profit turnaround in the energy sector), but the core proposition of slower profit growth is likely correct against a background of top-line sales growth slowing and cost pressures rising. The big risk remains investors' valuation of corporate profits as bond yields continue to rise.

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