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Economic Update: Australia
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Outlook for Investment Markets

Markets have been roiled by a series of unpleasant shocks—most recently by the Russian invasion of Ukraine, on top of a pre-existing spike in inflation, the ongoing evolution of the coronavirus, and the prospect of central banks unwinding the ultra-easy monetary policies that had helped sustain asset performance (other than the returns from cash) in previous years. Both bonds and equities are in the red for the year to date. The outlook remains subject to a high level of economic and geopolitical uncertainty: What happens next in Ukraine remains impossible to predict, and further deterioration in financial markets if (for example) there are expanded sanctions or a wider conflict cannot be ruled out. The scale and duration of the current inflationary surge, and the size and timing of central banks' likely response, are also in play. As always, prudent portfolio diversification remains the first best defence against heightened risks, and some emphasis on the relatively defensive end of growth assets, and on assets which provide a degree of inflation hedging, look useful options in current circumstances.

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Australian Cash and Fixed Interest—Review

Short-term rates have inched up, with the 90-day bank bill yield now 0.16%, up from close to zero (0.07%) at the start of the year. Long-term interest rates have risen more strongly, and the 10-year Commonwealth bond yield is now 2.4%, up 0.75% for the year to date. The Aussie dollar is up by 1.1% for the year to date in overall trade-weighted value. It has been steady in terms of its headline U.S. dollar rate, at just under 72.6 U.S. cents, but has gained against European currencies, which have weakened since the Russian invasion of Ukraine.

Australian Cash & Fixed Interest — Outlook

Officially, the Reserve Bank of Australia, or RBA, has largely maintained its "prepared to be patient" rhetoric, with any interest-rate hikes said to be still some distance off. But the slight rise in short-term rates is a small signal that the financial markets are increasingly of the view that an RBA move is getting closer after all: At a business conference earlier this month, for example, the RBA governor said that "it is plausible the cash rate will be increased later this year". Forecasters are shifting in that direction: National Australia Bank, or NAB, for example, changed its monetary policy call this month and now expects a 0.15% increase in the cash rate in August, followed by two 0.25% increases later this year and further rises in '23. The futures market is also pricing in substantial increases in the 90-day bank bill yield, which is expected to be more than 2% higher, at 2.45%, by mid-2023.

An inflationary environment and tightening monetary policy make for ongoing difficult market conditions for bonds: For the year to date, the S&P Australia Aggregate bond index has lost 3.8%. Some forecasters reckon that the rise in yields is largely complete: Both NAB and Westpac, for example, expect the 10-year yield to be around 2.5% in a year's time, only slightly higher than today. But with inflation continuing to surprise on the upside, the risk is that bond yields might yet have to rise further than currently anticipated.

The currency has held up better than might have been expected: Normally, events like the invasion of Ukraine and its associated financial market volatility tend to lead investors to retreat back home and not incur the foreign-exchange risk of holding currencies like the Aussie dollar. The 'risk off' retreat home, on this occasion, appears to have been counterweighed by the prospect of higher Australian interest rates, with the RBA expected to move earlier than previously thought; by Australia being a beneficiary of soaring commodity prices (the RBA's commodity price index in Aussie dollars in February was 23% up on a year earlier); and, possibly, by Australia being seen as a relatively safe harbour well away from the worst of the postinvasion impacts. Some forecasters even reckon that the Aussie could rise in value in this environment: NAB, for example, see it rising to 77 U.S. cents by the end of next year, and Westpac have it even higher, at 80 cents. That said, foreign-exchange forecasting is even more than usually problematic in the current geopolitical fog.

Australian & International Property — Review

The A-REITs had been one of the weaker-performing sectors even before the latest round of Ukraine-linked losses, and it has continued to underperform. For the year to date, the S&P / ASX200 A-REITs index has made a capital loss of 10.5% and an overall loss of 10.0% including dividends, compared with the wider share market's 4.0% capital loss and 2.6% total return.

Overseas, REITs have also sold off, but, although the absolute numbers have been weak, there is some comfort in the fact that the REITs fared less badly than global shares overall. The FTSE EPRA/NAREIT Global Index in U.S. dollars including dividends returned a loss of 8.4%, rather better than the 12.2% loss for the MSCI World index. All the major regions fared much the same, with returns ranging from a loss of 6.5% in the Asia-Pacific region through to a loss of 9.6% in the U.K., while the key U.S. market lost 9.3%.

Australian & International Property — Outlook

The operating outlook continues to show strong subsectoral patterns. As NAB's latest (December '21 quarter) commercial property survey shows, industrial is strongest: Respondents expect capital values to grow by 3.4% this year and 3.1% in '23, rents to grow by 3.3% in both years, and vacancy rates to stay low (below 4%). Offices are in the middle: Capital values are expected to increase a little (0.7% this year, 1.1% next year), but rents will show little net change (down 0.6% this year, expected to increase by 0.6% next year). Vacancy rates will be slow to come down from their current 9.9% (9.8% by end of year, 9.2% by end '23): Office occupancy data from the Property Council of Australia for late February show that the worst of omicron has passed, with occupancy levels improving all round, but they are still at low levels, especially in the two largest central business district office markets (Sydney occupancy is running at only 18% of pre-COVID-19 levels, and Melbourne at 15%). Retail remains weakest, with the NAB respondents expecting further modest falls in rents this year (down 1.6%) and next (down 0.4%).

For now, it appears that the new reality of the RBA tightening monetary policy earlier in the piece than previously expected is holding back A-REIT performance. Longer term, the outlook is stronger, particularly as Australia looks well placed on the radar of global and local institutional investors looking for real assets as inflation hedges. CBRE, for example, reckons that Australian super funds are currently

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underinvested in property (7.7% of their portfolios now, compared with a longer-term allocation of 8.2%). Restoring the status quo would see some AUD 68 billion of additional demand for property, and CBRE expects increased institutional demand to support capital values, the level of corporate activity, and the creation of new listed A-REITs.

Global REITs have provided some modest degree of downside defensive protection in the latest global equity market weakness: IHS Markit, which has been running a relatively new monthly survey of U.S. institutional investors (it has been going for 18 months), found in March that real estate was one of the relatively defensive sectors, with the likes of utilities and healthcare, that investors had been warming to in response to the heightened postinvasion uncertainties. And as with domestic property, the asset class has attractions as an inflation hedge. One significant challenge, however, will be the prospect of narrowing yield differentials: Global REITs (on S&P's index) offer 3.4%, which will become progressively less attractive as bond yields continue their rise. A better approach to the sector might be to concentrate on opportunities at the subsector level, where the operating outlooks remain quite diverse. JLL's latest (March quarter) *Global Real Estate Perspective – Highlights* noted, for example, the ongoing boom-time conditions in industrial logistics—"In both the U.S. and Europe, rents increased [in Q4 2021] at an annualized rate of around 10% amid record low levels of vacancy, with aggregate vacancy rates sub-4% in both regions"—and there are also opportunities in the premium CBD office space and in hotels and hospitality as COVID-19 runs its course and current travel restrictions are progressively relaxed.

Australasian Equities—Review

Australian shares, while not immune to the global weak equity tone of the year to date, have fared relatively well by international standards. The S&P / ASX200 index is down by a relatively modest 4.0% (2.6% including the value of dividends). On the plus side, the miners have ridden the global commodity price surge and are up by 6.2%, and the utilities, a useful defensive option in the current uncertainties, are up by 6.1%. The large banking sector has also held up reasonably well, with only a small 1.0% loss. On the down side, IT has shared in the global tech selloff and is down 24.0%, and consumer discretionary (down 13.4%) and healthcare (down 12.4%) have also been notably weak.

Australasian Equities—Outlook

In Australia, the latest data suggest that the economy, at least pre-Ukraine invasion, was poised to recover from its omicron setback. The Ai Group's suite of activity indicators for manufacturing, services, and construction all showed growth in February. Services, the largest sector of the economy, were particularly strong, with a reading of 60 when 50 is breakeven. Ai Group said that "All five of the services sectors available in the Australian PSI® showed robust expansion in February (seasonally adjusted). Activity was strongest in the consumer-oriented sectors; retail trade & hospitality recorded a large increase in activity, as did 'personal, recreational & other services' ".

NAB's latest business survey was also upbeat: "Business conditions and confidence strengthened in February as the Omicron virus wave eased and the late 2021 momentum was regained. After a fall in January, the conditions index rebounded to be above its long-run average". The Roy Morgan survey of business confidence landed in the same place: It "jumped by 19pts (+18.7%) in February to 120.5, its

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highest mark since the beginning of the Delta wave of COVID-19 in June 2021 (128.3) … The quick recovery in the index came as the highly contagious, but relatively mild, Omicron variant dissipated during February which again highlights the underlying strength of the Australian economy".

As Roy Morgan pointed out, however, the February results predate the Ukraine invasion and the latest leap in petrol prices, and the latest consumer confidence surveys for March clearly show a knockback to the expected economic outlook. Roy Morgan's latest survey (second week of March) found that "Consumer Confidence dropped to its lowest since October 3/4, 2020 (95.7) this week as the Russian invasion of Ukraine led to sanctions on Russian energy exports and led to steep increases in the prices of petroleum products. The price of petrol in Australia has hit record highs above $2 per litre for the first time. Consumer Confidence is now below the neutral level of 100 in all States … Driving the weekly drop were declines in sentiment in regards to personal financial situations and also the performance of the economy over the next year and next five years". The March Westpac / Melbourne Institute consumer survey found much the same: "This is the weakest print since September 2020 … Views on the economic outlook recorded the sharpest pullback".

Clearly, the road ahead has become bumpier, but Australia drives it down from quite a good starting point. CommSec's roundup of the corporate reporting season ended December said that "Earnings results are supporting Aussie shares with corporate profits on track to hit record highs. In fact, consensus earnings forecasts, using the S&P/ASX 200 index 12-month forward estimate earnings per share (EPS) have jumped 7.5 per cent in the past month to a near record $437, according to Bloomberg data. The increase reflects better-than-expected earnings results from an array of Aussie banks, miners, healthcare and energy companies, delivering above analyst expectations, as companies manage rising costs". Some of the optimism will have been left behind by subsequent events, but it would not be surprising to see Australian equities continue to outperform in coming months.

International Fixed Interest—Review

The year 2022 has been a challenging one for fixed interest: For the year to date, the Bloomberg Global Aggregate in U.S. dollars has returned a loss of 6.0% (a 5.5% loss on global government bonds, and an 8.7% loss on global corporate bonds). Investors looking to boost returns by opting for higher-yield options like junk bonds or emerging-markets debt have also been disappointed: Global 'high yield' (low credit quality) bonds have lost 7.8%, while emerging-markets debt has lost 10.8%. Making a duration bet—aiming at the higher yields at the longer end of the yield curve—has also misfired: In the U.S. market, for example, the Long Treasury index (maturities of over 20 years) is down by 10.5% as yields have risen, with the 30-year Treasury yield increasing from 1.9% at the start of the year to 2.5% now.

International Fixed Interest—Outlook

The poor performance of bonds reflects two linked factors. Yields are way below current rates of inflation, which means that bondholders will continue to suffer erosion of the purchasing power of their investments unless yields rise even further (or inflation unexpectedly drops back quickly, which currently looks unlikely). And central banks faced with these price pressures need to reverse their previously stimulatory monetary policies: With inflation running well above their mandated targets (typically around

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2%), they are highly likely to raise interest rates and to wind back or reverse previous programmes that had kept bond yields unusually low.

The scale of the current inflationary surge has been a surprise. In the U.S., for example, the latest (February) inflation rate was a startling 7.9%, the highest in 40 years (since the 8.4% recorded in January 1982). In the U.K. in January, it was 5.5%, and in the eurozone the early 'flash' estimate for February is 5.8%, up from January's 5.1%. Japan, with a January inflation rate of 0.5%, is the only major developed economy not facing a spike in inflation. While some of the factors behind the surge may be short-term—temporarily strong post-lockdown demand meeting temporarily COVID-19-constrained supply—the risk is that there may be more permanent elements, notably fiscal and monetary policies that may be too loose for economies that no longer need that level of support. In the U.S., for example, the February unemployment rate was only 3.8%. People—whether producers, employees, or consumers—may also be tempted to change their behaviour on the assumption that inflation is higher than it used to be (for example, by asking for large pay rises), further cementing in higher inflation. In addition, there is the new risk that flow-on effects from the Russian invasion of Ukraine will exacerbate price pressures for food, energy, and industrial metals.

At time of writing, the Fed in the U.S. had just announced its policy response: On Feb. 16, it raised its target range for the fed-funds rate by 0.25%, to a range of 0.25% to 0.5%. Projections made by the officials at the policy meeting showed that the Fed expects to keep raising rates for the rest of the year, with the median forecast of the participants being an end-year target range of 1.75% to 2.0%. The immediate reaction of the U.S. futures market was that the Fed's projected target looked either realistic (a 31% probability) or slightly on the low side (there is a 40% probability of a 2.0% to 2.25%% range). In the U.K, the Bank of England had already raised rates twice, and it did so again on March 18, citing the risk of 8% inflation in coming months, while in the eurozone, the European Central Bank, or ECB, is sidling up to the idea. This month, the ECB unexpectedly said that it would end its bond-buying programme earlier than previously announced (it will wind up by September at the latest), a preliminary step towards subsequent interest-rate increases.

It is possible, with the current geopolitical uncertainties around Ukraine in particular, that bonds might benefit from nervous 'safe haven' demand. There was, for example, a brief episode of buying of U.S. Treasuries immediately after the invasion, which saw the 10-year yield drop to 1.73% from just under 2%. And it is possible that the world economy could soften, easing inflationary pressures and reducing the need for interest-rate increases. But the more likely outcome is inflation continuing to run higher than central banks would prefer and investors needing to see higher yields to protect the real (after inflation) value of bonds. Conditions remain difficult.

International Equities — Review

World shares had been weakening in any event, even before the invasion of Ukraine on Feb. 24. Over that period, the MSCI World index had dropped by 7.8%. The invasion made things worse, with a further 5.2% fall since then, for a cumulative year-to-date loss of 12.5%. In the U.S., the S&P500 is down 12.4%; in Japan, the Nikkei is down 12.3%; and in Europe, the FTSE Eurofirst300 is down 9.8%.

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Measuring the performance of the emerging markets postinvasion has become very difficult: Russian shares, while almost certainly worth substantially less than before, have not traded since Feb. 25. MSCI said that it "received feedback from a large number of global market participants, including asset owners, asset managers, broker dealers, and exchanges with an overwhelming majority confirming that the Russian equity market is currently uninvestable and that Russian securities should be removed from the MSCI Emerging Markets Indexes". They subsequently have been. The ongoing Emerging Markets index is down 14.4% in U.S. dollars. The Brazilian market has done very well on the back of booming commodity prices (MSCI Brazil up 15.9%), but the overall result has been pegged back by weaker performance in China (MSCI China down 25.4%) and India (MSCI India down 6.7%).

International Equities — Outlook

Before the invasion of the Ukraine, the outlook for the world economy was looking positive. The most recent (February) J.P. Morgan Global Composite index of activity "saw the rate of global economic expansion revive from January's one-and-a-half year low, as growth of new orders and employment accelerated and business optimism strengthened to a near record high". IHS Markit, who compile the national activity indexes that build up to the Global Composite index, run a three-times-a-year business outlook survey, and its February readings showed the same upbeat picture: "The story they tell is of a global business community relieved at the prospect of a lack of pandemic disruption for the first time in two years amid hopes that the Omicron variant spells the end of strict restrictions across much of the world. The expected return to normality fed record optimism around hiring and investment".

But as IHS Markit cautioned, the data were gathered largely around the middle of February, before the invasion of Ukraine, and IHS Markit warned that "It remains to be seen how much of this positive outlook will be maintained following the invasion of Ukraine, the energy price spike and imposition of sanctions". It has not helped that China has in recent days imposed a new series of strict COVID-19 lockdowns, raising further issues about interruptions to global trade.

The immediate impact has been to put a severe dent in investors' expectations about the global outlook. The latest IHS Markit survey of U.S. institutional investors found that "The mood among US equity investors has turned much gloomier in March as the intensifying Ukraine crisis exacerbates existing headwinds and concerns. Geopolitics are exerting a greater drag on the market than at any time in the survey's one-and-a-half-year history, as is the deteriorating global economic environment. The invasion has led to heightened worries over slowing growth, soaring inflation, a cost-of-living squeeze, and more protracted supply chain bottlenecks". Investors also reported large changes in sectoral preferences: "Sector preferences have changed dramatically as the Ukraine crisis has flared up, most conspicuously with favour shifting sharply towards energy and utility stocks but away from financials".

The long-running Bank of America Merrill Lynch, or BAML, survey of international fund managers also found a sharp deterioration in sentiment. Expectations for global economic growth have dropped to levels last seen in the depths of the global financial crisis in 2008, and expectations for global corporate profits, while not sinking to global financial crisis levels, have also turned deeply pessimistic and are not far short of the gloom that hit investors during the first outbreak of COVID-19 in early 2020. The three biggest risks seen on the horizon are Ukraine/Russia, a global recession, and ongoing high inflation, and

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fund managers have responded by raising the level of cash in their portfolios and (like the IHS panel) by shifting equity sectoral allocations, with commodities and energy heavily favoured.

Investors have not completely panicked. The BAML respondents are still slightly overweight to equities, although that may partly reflect the unattractiveness of alternatives: As noted earlier, bonds are in a hard place, and the BAML panel is unsurprisingly a net 56% underweight. It may be that the worst of the Ukraine impact is already in equity prices. On the other hand, geopolitical uncertainty remains very high, and the track record of analysts trying to understand President Putin's motivations and his likely next moves is not strong. There is clearly room for worse to befall, either on Putin's side or on the West's (for example, through intensification of sanctions). As always, diversification remains the key protection against setbacks and uncertainty, and within the equity sector, it might be no bad idea to follow the pros and either surf the inflationary pressures with exposures to subsectors like commodities and/or derisk by favouring relatively defensive subsectors like utilities.

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