Economic Update: Australia
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Outlook for Investment Markets

The global economic outlook has become more difficult. Inflation has proved to be a bigger problem than expected, and financial markets are now more concerned that central banks, in their efforts to bring inflation down, may raise interest rates to the point where they choke off the post-coronavirus cyclical recovery of the global economy (excluding China, where lockdowns have been slowing its economy). Geopolitical risk also remains elevated: Ukraine's doughty defence was good news, but more recently Russia has upped its offensive in eastern Ukraine, and the ultimate political, economic, and financial outcomes are still very unclear. In the meantime, the war-related disruptions to commodity and energy markets have furthered boosted short-term inflationary pressures and added to the residual supply chain issues caused by the pandemic. Both local and global bonds (wary of higher interest rates) and international equities (wary of a weakening economic cycle) are down for the year, although Australian shares have been a welcome exception, helped by the miners and the banks. The near-term outlook is unlikely to support any quick turnaround. In an environment of higher than usual uncertainty, prudent portfolio diversification remains key, including exposure to more-defensive sectors and inflation hedges.

Australian Cash and Fixed Interest—Review

Short-term interest rates have increased modestly, and the 90-day bank bill yield is now just over 0.3%, up 0.25% this year. Long-term interest rates have risen more significantly, and the 10-year Commonwealth bond yield is now just over 3%, a 1.4% increase for the year. The Aussie dollar has appreciated year to date and is up 4.6% in overall value. On its headline cross rate against the U.S. dollar it is up 2.8% to 74.6 U.S. cents.

Australian Cash & Fixed Interest—Outlook

Up to April, the Reserve Bank of Australia had been stressing that it was prepared to be patient about eventual rate increases, but the minutes of its April meeting said that assorted developments, notably the recent pickup in inflation, "have brought forward the likely timing of the first increase in interest rates". Some forecasters are still of the view that this means a modest, gradual process. National Australia Bank, for example, sees the RBA's target cash rate at 1% at the end of this year, compared with its current 0.1%. The futures market has a significantly more activist track in mind, and expects short-term rates to be more like 2% higher by the end of this year, which would not be surprising given the unexpected strength of recent inflationary pressures.

The bulk of the rise in bond yields, however, may be behind us. NAB, for example, expects the 10-year yield to be only slightly higher, at 3.25%, at the end of this year, and Westpac actually expects a modest decline, to 2.7%. That would potentially be good news for bond investors, who have suffered a 6.3% loss this year to date (going by the S&P Australia Aggregate Bond Index). Given the recent unexpectedly strong surge in inflation, however, it may be on the prematurely optimistic side to expect bond yields to have already done their dash.

Forecasters currently expect some appreciation of the Aussie dollar to anywhere between 75 cents (ANZ) and 80 cents (NAB) by the end of this year. If they prove to be right, the likely drivers will be a reasonably rapid schedule of cash rate hikes from the RBA, and an ongoing boom in Australian commodity prices, which in March were 42.7% up on a year ago in Aussie dollar terms (on the RBA's index). But not all the moving parts are aligned: The Fed is on its own significant tightening path, the ongoing war in Ukraine is not helpful for currencies like the Aussie that tend to do better in less unsettled times, and countries like Australia will be affected by the current slowdown in the Chinese economy. Stability, or an appreciation at the lower end of the forecast's range, could well be on the cards.

Australian & International Property—Review

The A-REITs have been one of the weaker ASX sectors this year to date. The S&P/ASX200 A-REITs Index is down by 9.0% in capital value and by 8.4% including dividends, well adrift of the wider share market's 1.1% capital gain and 2.6% total return.

Overseas REITs have broadly tracked the wider global share market, picking up in March after the late February selloff on news of the Ukraine invasion, but drifting down again in April. For the year to date the FTSE EPRA/NAREIT Global Index in U.S. dollars including dividends returned a loss of 4.3%, outperforming the 8.0% loss for the MSCI World Index.

Australian & International Property—Outlook

The latest (March quarter) ANZ—Property Council of Australia survey showed strongly positive overall industry sentiment as the immediate impact of COVID-19 wanes, though with the now familiar pattern of divergent subsector trends. ANZ said that "Industrial property sentiment continues to power ahead, with the strong construction outlook backed up by the sharp lift in building approvals over the last few years. The opening of international borders has buoyed tourism sentiment, lifting it to its highest level since 2018. While retail and office property sentiment remain in positive territory, they face headwinds, particularly office property, where sentiment declined in the March survey. Uncertainty over the medium-term demand for office space is likely to continue, as firms gradually embed more permanent arrangements around work-from-home and work-from-office".

The big issue, however, is the turnaround in the Reserve Bank of Australia's likely monetary policy stance, from originally planning to defer interest-rate increases until 2023, to its likely starting to hike interest rates from the middle of this year. This will feed through to higher cap rates (the rates used to value property), and will also affect the relative attractiveness of the A-REITs relative to bonds. There is already not much of a margin between the yield on the A-REITs (3.8% according to Standard & Poor's) and the 3.1% available on a 10-year Commonwealth bond. The sector could well remain weak until investors are more comfortable that interest rates are nearer their peak.

Global REITs at one point looked like being one of the preferred defensive strategies in this year's unsettled financial markets. IHS Markit's March survey of U.S. institutional investors, for example, had

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found that real estate was one of the sectors that fund managers were overweighting. Its April survey, however, showed a more downbeat picture, with managers now moving to underweight. The biggest moving part has been increased concerns about the scale of central bank monetary policy tightening as inflation outcomes have proved to be worse than expected, with assists from increased geopolitical uncertainty and a more uncertain global macroeconomic outlook.

Similar issues were identified in CBRE's latest poll of U.S. real estate investment intentions. Property investors' biggest headwind was poor value, from property prices having been bid up aggressively during the period of effectively zero interest rates, but their next three big risks mirrored the HIS Markit results: higher-than-expected inflation, an uncertain economic environment, and earlier-than-expected higher interest rates (the survey was taken before the Ukraine invasion, and geopolitics has likely increased as a factor since then). While still generally positive about the asset class, investors were winding back the returns they expected to receive. Overall, global REITs look likely to remain out of favour in coming months.

Australasian Equities—Review

Australian shares have bucked the global bear market and are modestly ahead for the year. The S&P/ASX 200 Index has made a small capital gain of 1.1% and delivered a total return including dividends of 2.6%. The booming resources sector has been an important contributor: The S&P/ASX 300 Index of metals and mining is up 17.4%, and the heavy weighting in the benchmark index of the banks has also helped, as the financials ex the A-REITs are up by 4.0%. At the weaker end, the IT sector is down 17.5% and consumer discretionary stocks are down 14.5%.

Australasian Equities—Outlook

At its April policy meeting the RBA was upbeat about the economic outlook: "The Australian economy had been resilient in the face of global and domestic supply shocks, including the war in Ukraine, the Omicron outbreak and the floods along Australia's east coast. Policy settings remained supportive of the recovery and national income had been substantially boosted by the large increases in commodity prices; it was likely that the terms of trade would exceed previous highs. Overall, the growth outlook remained positive for this year and next".

Business surveys tend to support this view. The Ai Group's activity March indexes for manufacturing, services, and construction showed all three sectors growing (growth accelerated in construction and manufacturing, while services grew a bit more slowly). And the March National Australia Bank business survey found that "Business conditions surged higher in March and confidence also strengthened. Trading conditions and profitability rose markedly, suggesting demand remains strong, and employment also rose". The Westpac/Melbourne Institute leading indicator, which aims to get an early read on the activity outlook over the next three to six months, also strengthened in March, with Westpac commenting that the data "are consistent with Westpac's upbeat view of the growth momentum in the economy for most of 2022".

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If there is an issue on the horizon, it is around consumer spending. The recent weakness of consumer discretionary shares mirrors households' wariness: Consumer confidence on both the Westpac/Melbourne Institute and ANZ/Roy Morgan indexes remains low, with families evidently feeling pressured by the prospect of higher interest rates and by the impact of inflation on their purchasing power. In the ANZ/Roy Morgan poll, for example, only 13% of respondents expected "good times" for the Australian economy over the next year compared with 28% expecting "bad times". Sectors most exposed to consumer spending may consequently continue to underperform, but otherwise the stability of the banks and the ongoing commodity boom suggest that Australian equities may well be able to continue to outperform overseas counterparts.

International Fixed Interest—Review

Global bond yields have continued to grind higher, and bond investors are suffering substantial capital losses. For the year to date, the Bloomberg Global Aggregate in U.S. dollars has returned an overall loss of 9.2%. The pain has been widely distributed across subsectors, with global government bonds down by 9.5%, global corporate bonds down by 7.9%, "high yield" (low credit quality) debt down by 7.8%, and emerging-markets debt down by 11.3%. Investors aiming for some reasonable level of yield by going out the long end of the yield curve have been especially badly hit. The rise in the 30-year U.S. Treasury yield from 1.9% at the start of the year to just shy of 3% now has meant that the Long Treasury Index has returned a year-to-date loss of 17.7%.

International Fixed Interest—Outlook

The bad news keeps coming on inflation. In March, consumer price inflation in the U.S. was 8.5%, the highest rate since December 1981, and even excluding the volatile food and energy components, "core" inflation came in at 6.5%, the fastest since August 1982. Across the OECD economies as a whole, inflation in February was 7.7%, the highest since December 1990, and "core" inflation was 5.5%.

The IMF, in its latest (April) *World Economic Outlook* forecasts, expects that inflation will peak this year in the advanced economies at 5.7%, and ease back to 2.5% in 2023 and to 1.9% in 2024. Even if this relatively benign outcome materialises, central banks will need to raise interest rates from the levels that were appropriate when inflation was low (it was only 0.7% across the developed economies in 2020). On the IMF's forecasts it will be at or slightly above the 2% or so the big central banks are meant to target, meaning that interest rates ought to be at neutral rather than at their current still-stimulatory levels. And the risks to inflation are on the upside: The IMF said that "Conditions could significantly deteriorate. Worsening supply-demand imbalances—including those stemming from the war—and further increases in commodity prices could lead to persistently high inflation, rising inflation expectations, and stronger wage growth".

At some point, the bond markets will start looking ahead to a world where inflation pressures from COVID-19 supply chain shocks, the Ukraine war, and capacity-constrained economies begin to abate, but that still looks some time away. In the interim both short- and longer-term yields look likely to continue to climb in the U.S., the eurozone, and the U.K., and the focus will remain on the extent to which central banks are likely to push rates higher. In the U.S., for example, the current target range for

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the fed-funds cash rate is 0.25% to 0.5%: the latest pricing from the futures market is that it will be over 2% higher by the end of this year (opinion is split between 2.5% to 2.75%, and 2.75% to 3.0%). Fixed interest continues to face headwinds.

International Equities—Review

World shares started to recover in March after the initial shock of the invasion of Ukraine, but have relapsed since the end of March. This year to date the MSCI World Index of developed economy share markets is now down by 8.6% in U.S. dollars. Only the U.K. is ahead, with the FTSE100 Index up 3.1% thanks to the London listings of some big beneficiaries of global inflation (notably oil and gas producers, up 30.4% for the year to date, and miners, up 30.2%). Elsewhere, in the U.S. the S&P 500 is down 7.9% and the Nasdaq down 14.8%, in Europe Germany's DAX is down 10.8% and France's CAC down 7.9%, while in Japan the Nikkei is down 6.9% in yen terms, with the loss compounded by a depreciating yen (down 9.4% against the U.S. dollar year to date).

Emerging markets are down 10.2% in U.S. dollars. The only bright spot has been commodity beneficiary Brazil, where the Bovespa Index is up 32.1% and the MSCI Brazil up 30.2%. In U.S. dollars, Indian shares are down a little (MSCI India down 2.8%), and Chinese shares have been weak (MSCI China down 16.2%). Unsurprisingly, Russian shares have tumbled: The FTSE Russia is down 27.7% and the RTS Index is down 42.0%.

International Equities—Outlook

The global economy is still growing. The J.P. Morgan Global Composite Index in March came in at 52.7, where numbers greater than 50 indicate ongoing expansion. J.P. Morgan commented that the waning of Omicron has allowed activity to recover in much of the developed world, though its outbreak in China and the associated lockdowns has resulted in a sizeable setback to Chinese growth, while activity has also weakened very significantly in Russia.

But the outlook from here is becoming more challenging. The IMF in its World Economic Outlook forecasts now expects 2022 to be tougher going than it previously anticipated. The world economy should still grow by 3.6% this year, but that will be 0.8% slower than the IMF had expected back in January, and a full 1.3% slower than it had expected a year ago. And the 3.6% is by no means guaranteed: The IMF said that "The risks to the outlook are to the downside. Although a fast resolution of the war in Ukraine would lift confidence, ease pressure on commodity markets, and reduce supply bottlenecks, it is more likely that growth could slow further and inflation turn out higher than expected. Overall, risks are elevated and broadly comparable to the situation at the start of the [COVID-19] pandemic—an unprecedented combination of factors shapes the outlook, with individual elements interacting in ways that are inherently difficult to predict". The IMF's long list of things that could go wrong includes a worsening of the Ukraine war, increased social tensions (for example in response to more expensive food), a resurgence of COVID-19, a sharper slowdown in China, higher inflation expectations requiring a stronger monetary response, debt fragilities in the wake of higher interest rates, geopolitical tensions spreading, and climate change events.

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Fund managers have also turned markedly downbeat. In the latest (April) Bank of America fund manager survey, the percentage of managers pessimistic about the global growth outlook has fallen to the lowest level ever recorded in the survey (which dates back to 1994), and is even lower than the depths of pessimistic sentiment recorded through the global financial crsis in 2006-08. Their top fear is now a global recession (mentioned by 26%), followed by the twin issues of hawkish central banks (25%) and inflation (21%). These macroeconomic issues have displaced the war itself (16%) and asset bubbles popping (7%), while COVID-19 is now seen as a distinctly secondary risk compared with everything else going on (1%).

The fund managers' response to this outlook is to ride the current boom in commodity prices—they are at a record level of overweight allocation to commodities, and are also keen on energy and materials—while taking a distinctly defensive approach to the rest of their portfolios. They are heavily overweight cash and given the poor outlook for the asset class (as discussed in "International Fixed Interest"), they are heavily underweight bonds. And they are broadly positioned towards the sectors that might weather a recession better than others: Consumer staples, for example, are modestly overweight, while the more-cyclical consumer discretionary sector is underweight.

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