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Economic Update: Australia
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Outlook for Investment Markets

Investment markets have continued to struggle. Year to date, global and domestic bonds, and global and domestic equities, have all gone backward. Returns from cash in the bank are slowly improving, and global listed infrastructure has been a rare example of capital preservation. And investors have suffered portfolio losses. The factors that have weighed on returns are, unfortunately, still occurring. The ramifications of the Ukraine crisis are still playing out, the initial recovery from the coronavirus is losing some momentum, and, significantly, markets are bracing for further tightening of monetary policy in several major economies as central banks wrestle with inflation that has surged beyond acceptable limits. Although Australian businesses have been doing well up to now, and local equities have been relatively resilient, Australia looks likely to feel the effect of weaker consumer confidence as budgets are further eroded by inflation, and the outlook for the second half of this year is becoming more difficult. In an environment of ongoing uncertainty, prudent portfolio diversification remains a key defence, including exposure to more defensive sectors and to inflation hedges in current conditions.

Australian Cash and Fixed Interest — Review

Short-term interest rates have started to move higher as the Reserve Bank of Australia, or RBA, has started to tighten monetary policy. On May 3 the RBA raised the target cash rate by 0.25% to 0.35%, and started to wind down the stock of bonds it had bought when it was aiming to keep bond yields low. The 90-day bank bill rate is now just shy of 1%, up 0.9% since the start of the year. Bond yields have risen significantly, and the 10-year Commonwealth bond yield is now 3.4%, up 1.7% year to date. The Aussie dollar has been a mixed bag. Its headline rate has weakened, largely because of a global strengthening in the value of the U.S. dollar (up 8.0% in overall value year to date, on *The Wall Street Journal* index). At 69 U.S. cents, the Aussie is down 4.9% in terms of its headline rate. But strength against other currencies (notably a 6.5% appreciation against the yen and a 5.0% appreciation against the pound sterling) has offset the weakness in U.S. dollar terms, and year to date the Aussie is up by 1.1% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The RBA is in the same tough spot as many of the world's other central banks: inflation has risen to unacceptably high levels (the latest headline rate was 5.1% for the year to March) and has to be brought back under control. Forecasters expect that a series of cash rate increases is expected. Westpac, for example, sees the cash rate at 2.25% in a year's time, up almost 2% from its current level. The futures market expects a slightly stronger lift in short-term rates, with 90-day bills expected to be yielding 3.6% by next June, up 2.5% from today. The only thing that might stay the RBA's hand would be any significant deterioration in economic activity, which remains a possibility given the recent darkening of the global economic outlook.

Bond yields have already risen significantly, and the likelihood is that the bulk of the capital losses suffered by bond investors is already behind us. The S&P Australia Aggregate Bond Index has lost 8.5% year to date. Westpac, for example, reckons that yields have already peaked and will start to ease back later this year and into 2023, reaching 2.5% in a year's time. But with inflation domestically and globally still running at higher than expected levels, it would not be surprising if bondholders required higher yields again to compensate for the threat to their purchasing power, and the risk is that bond yields still have a bit further to go.

Current forecasts suggest that the recent weakness of the Aussie dollar, linked to investors diving back into the U.S. dollar as a safe haven option in currently unsettled financial markets, will reverse during the rest of this year. National Australia Bank, or NAB, sees a modest pickup to U.S. $0.72 U.S., while the ANZ and Westpac see a stronger recovery, back up to U.S. $0.76-0.78. The assumption that the skies will clear and investors in a more upbeat frame of mind will return to risk-on currencies like the Aussie dollar is, however, somewhat questionable. The world's central banks have their hands full trying to tame inflation without causing recessions, and the geopolitical outlook (notably Ukraine and its ramifications) remains deeply unsettled. The more bullish predictions of a rapid recovery in the Aussie dollar may be premature.

Australian & International Property — Review

The A-REITs have significantly underperformed the wider Australian sharemarket, and the S&P/ASX200 A-REITs Index has delivered a capital loss of 16.9% and an overall loss of 16.4% including dividends, compared with the ASX 200's capital loss of 5.0% and overall loss of 3.3%.

Overseas REITs have also done badly in absolute terms but have fared slightly better than overseas equities as a whole. The FTSE EPRA/NAREIT Global Index in U.S. dollars including dividends has returned a loss of 14.5%, slightly better than the equivalent 15.7% loss for the MSCI World Index.

Australian & International Property — Outlook

The impact of the recent rise in bond yields, and the prospect of more to come, remain the key influence on performance. In reality, the effect of rising interest rates on A-REIT performance may be more nuanced than it looks on the surface. Shopping centre operator Scentre, in its March quarter operational update, for example, said that if you looked at its debt as of January 2023, some two thirds will have been hedged against rate rises, locking in an average cost of debt of only 1.9%. Scentre also said that shoppers have been returning to its malls as COVID-19 dissipates, and that its rental agreements provide strong inflation protection: "Approximately 80% of our speciality leases are inflation linked with average annual rent escalations of CPI + 2%, the remaining 20% of speciality leases have fixed annual rent escalations with an average escalation of 4%." These positives are, however, not currently getting much of a look as investors continue to draw simple comparisons of the yields available from bonds and from property, and the sector may well continue under the weather as bond yields rise further. A secondary medium-term issue will be the health of the office subsector. Although in general the impact of COVID-19 is waning, the rate of return to the office still remains low. The Property Council of Australia's late-

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April estimates are that in Sydney, office occupancy was still only 42% of prepandemic levels, and in Melbourne, it was only 36%.

Until very recently, the global business cycle had been performing well, and the improved business conditions flowed through to global commercial property. The March quarter global survey of commercial property run by the Royal Institution of Chartered Surveyors, or RICS, saw both tenant demand and investor demand pick up in the quarter. Respondents were expecting increases in valuations and rentals in the vast majority of markets (excluding China, Hong Kong, and Japan). But that was then, and in the interim, Ukraine, and the prospect of globally higher interest rates, have darkened the outlook. It is not helpful that property goes into a prospective slowdown and looks expensive. RICS found that "At a global level, close to 50% of contributors to the GCPM [Global Commercial Property Monitor] concluded that real estate could currently be viewed as either expensive or very expensive … By contrast, only around 10% judge the real estate market to be either cheap or very cheap." RICS rightly commented that "The shift in policy from central bankers across much of the globe could be seen as exacerbating the risk to real estate," and despite some helpful inflation-hedging characteristics, global REITs look likely to face ongoing headwinds.

Australasian Equities — Review

Australian shares are down year to date but have been relatively resilient compared with overseas markets, with the S&P/ASX 200 Index down by a relatively modest 5.0% (3.3% including dividend income). Performance has been helped by the miners (the S&P/ASX 300 index of metals and mining is marginally up, by 0.4%), the stability of the banks (the Financials excluding the A-REITs are effectively unchanged), and the defensive appeal of consumer staples (marginal loss of 0.7%). The big losses have been in IT (negative 32.4%), echoing the global weakness of tech stocks, and in consumer discretionary (negative 17.6%).

Australasian Equities — Outlook

Businesses are generally doing well. The latest (April) Ai Group Indexes of business activity showed that manufacturing and services had already been growing at a robust rate, and both grew a bit faster again in April. Even though the pace of growth in the construction trade eased back a tad in the month, it too was still enjoying solid growth. NAB's April business survey also picked up strengthening business conditions (a composite measure including trading, profits, and hiring). It has helped that the recreational and personal services sector, which had been especially hard-hit by COVID-19 restrictions and by people's avoidance of the risk of infection, is also strongly on the mend. And despite the input cost and wage squeeze that firms all over the Western world are currently experiencing, Australian firms are reporting good levels of profitability, which are now above the levels they were reporting in 2019 before COVID-19 hit. The relative resilience of Australian shares versus their overseas counterparts makes sense in these conditions.

The outlook from here, though, is more debatable. The biggest challenge, again mirroring the global picture of inflation outpacing household income, is the threat of weak consumer spending ahead, which the equity markets have identified with the very weak performance year to date of shares linked to the

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consumer's discretionary dollar. The April Westpac/Melbourne Institute consumer survey saw a further decline in consumer confidence: Westpac said that "The Index is now at its lowest level since August 2020 when households were unnerved by the 'second wave' lockdown in Victoria. The weakness in this survey is not related to another pandemic shock but to the combination of rising cost of living pressures and the prospect of rising interest rates." Consumers are reporting that they are more pessimistic about the outlook over the coming year for their own family finances and for the economy as a whole. Australian shares may continue to outperform overseas equities, but the headwinds facing the consumer mean that share prices will remain under some pressure.

International Fixed Interest — Review

Conditions have remained very difficult for investors in bonds, as bond yields have continued to rise, inflicting further capital losses. For example, in the key U.S. market, the benchmark 10-year Treasury yield is now just over 2.9% and is up 1.4% for the year. As a result, the Bloomberg Global Aggregate in U.S. dollars year to date has returned an overall loss of 12.2%, with global government bonds losing 12.6% and global corporate debt losing 9.9%. Investors hoping to gain some protection in higher-yielding subsectors have also lost out. Global high yield (low credit quality) has lost 12.3%, while emerging-markets debt has lost 14.6%.

International Fixed Interest — Outlook

Inflation continues to run at levels that are unacceptably high for many of the major central banks. In April, for example, consumer price inflation in the U.S. was 8.3%, only marginally lower than March's 8.5% rate, and it does not help that what little improvement occurred during the month was down to a temporary fall in petrol prices, which has since reversed. And while a lot of attention is paid to the U.S. market, the reality is that the problem is prevalent across much of the developed world. The OECD has reported that "Year-on-year consumer prices in the OECD area have leapt from 7.8% in February to 8.8% in March 2022 (having stood at just 2.4% in March 2021), the sharpest increase since October 1988."

The relatively good news is that some of the inflation pressure appears to be temporary. As the OECD said, "The fallout from Russia's invasion of Ukraine in February has led to a fresh supply shock in energy and other commodities, resulting in further inflationary pressure this year." And while the conflict may yet have some way to go, it is possible to envision an eventual endgame where political disruptions to energy and commodity markets wind down. Similarly, the large COVID-19 disruptions to supply chains will also eventually dispel, even if, for now, China continues to maintain strict lockdown controls.

But the relatively bad news is that some of the inflation appears that it will last longer, particularly in the U.S., where stimulatory fiscal and monetary policies have added to the cyclical upswing out of COVID-19. Excluding food and energy, inflation in the U.S. is now 6.2%, and in the OECD as a whole was 5.9% in March. It has become evident, admittedly only with hindsight, that the degree of vigorous monetary policy support after the pandemic was maintained for too long in many economies, adding to the inflationary pressures.

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The end result is that excluding Japan, where monetary policy is likely to remain stimulatory (inflation in March was only 1.2% and core inflation, excluding food and energy, was still negative, with prices dropping by 1.5%), the central banks in the U.S., the U.K., and the eurozone, among others, will all be moving to raise interest rates and to withdraw previous programmes of bond-buying that had kept bond yields low. On May 4, for example, the Fed in the U.S. raised the target range for the Fed fund rate by 0.5%, to a new range of 0.75% to 1.0%, its first 0.5% increase since 2000, and it started to run down its stock of bonds. Further rate increases are on the way in the U.S.—the futures market currently expects that the target range will be 2% higher, at 2.75% to 3.0%, by the end of this year—and elsewhere in a wide range of other major economies. Bonds will remain in a difficult place while the central banks continue to tighten and until investors have some confidence that the current inflationary pressures have been brought back under control.

International Equities — Review

A temporary equity market recovery in March after the initial Ukraine selloff was followed by a renewed selloff through April and into May, and year to date the MSCI World Index of developed economy sharemarkets is now down by 16.4% in U.S. dollars. The weakness has been widespread. In the U.S., the S&P 500 is down by 15.6% while the tech-heavy Nasdaq is down by 24.5%; Germany's DAX is down by 11.7%; European shares are more generally down by 10.2% (FTSE Eurofirst 300 Index); and Japan's Nikkei by 8.2%, aggravated for overseas investors by a lower yen (the Aussie dollar has appreciated against the yen by 6.5%). Only the U.K., the listing domicile of some major global energy and commodity firms that have done well as resource prices have boomed, is ahead for the year. But even then, the FTSE 100 Index has managed only a marginal 0.5% increase in sterling terms.

Emerging markets have been weaker again, with the MSCI Emerging Markets Index in U.S. dollars now down by 18.5%. Brazil remains the only major country in emerging markets to repay investors' attention, thanks to commodity revenues. The MSCI Brazil is up by 10.3% and the Bovespa by 12.3% (both in U.S. dollars). The other key economies have recorded large losses, headed, unsurprisingly, by Russia, where shares are down by some 30% in U.S. dollars (RTS Index is negative 29.0%, and FTSE Russia is negative 31.3%).

International Equities — Outlook

The latest slide in share prices reflects increasing concerns about the global economic outlook. The J.P. Morgan Global Composite Index of world business activity in April slipped a bit further, with the world economy now growing at a slower pace and businesses becoming more downbeat about their prospects: "The outlook also became more subdued, with business optimism slipping to a 19-month low." Much of the latest slowdown is related to strict anti-COVID-19 controls on activity in China, which will hopefully dissipate in time. But there are also other concerns: "More broadly, a lockdown-driven downturn in mainland China, the war in Ukraine and disruption caused by stretched supply chains and rising inflationary pressure have all sapped much of the vigour from the upturn. On the prices front, output charges rose to a record high rate and input costs to one of the greatest degrees on record."

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Rising interest rates are seen as a particularly serious threat to the global economy. S&P Global Investment Manager Index for May showed that the big institutional fund managers are currently worried about central bank policy, which they see as the biggest immediate threat to equity performance (geopolitical risks linked to Ukraine and a deteriorating global macroeconomic environment also rated highly on their threat radar).

As one illustration of the potential impact, Goldman Sachs recently reckoned that, on their baseline scenario, the S&P 500 could finish this year at 4,300, which would be a 7% gain from its current level. But if interest rates were to rise more than Goldman Sachs currently expects, the S&P 500 could be 3,800 by year-end, which would be a 5.6% loss. And if the interest rate increases were to tip the U.S. into recession, the S&P 500 could drop to 3,600, a 10.5% loss. Along the same lines, American business news TV channel CNBC runs a regular survey of U.S. fund managers and economists. In May it found that 57% of the respondents believe the Fed's rate increases will cause a U.S. recession (33% said no; 10% were not sure), with mid-2023 the most likely starting point. The only good news in the survey was that the recession was not expected to be severe (53% picked "moderate"; 43% picked "mild").

On the plus side, the extent of the share price setbacks year to date means that there has been an appreciable improvement in valuation. The forward-looking P/E ratio on the MSCI World Index, for example, has dropped from around 22 times expected earnings in 2021 to around 16 times earnings now, and valuation as a concern has dropped down the list of risks reported in the S&P Global survey. It is also possible that a lot of the potential bad news is already factored into equity prices, and arguably may even have gone too far. The American Association of Individual Investors, or AAII, runs a regular poll of individual investor sentiment. Its latest results show that "At current levels, bullish sentiment and the bull-bear spread (bullish minus bearish sentiment) are all unusually low … Historically, the S&P 500 index has gone on to realize above-average and above-median returns during the six- and 12-month periods following unusually low readings for bullish sentiment and for the bull-bear spread." Current levels of investor apprehension may be a contrarian indicator that prices already more than adequately incorporate whatever the global economy will eventually deliver.

However events unfold, fund managers for now are taking a defensive approach. The S&P Global survey showed that they are particularly keen on energy shares, given high oil prices, and on healthcare. They are highly averse to consumer discretionary stocks, and to a lesser degree the industrials, which are the areas most exposed to weak consumer spending and a global economic slowdown.

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