

Economic Update: Australia

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Outlook for Investment Markets

Year-to-date outcomes continue to look poor across many asset classes as markets have responded to unexpectedly high inflation; central banks' monetary policy tightening response to it; ongoing pandemic-related production disruptions, including staff away ill and China's lockdowns; and the manifold impacts of Russia's invasion of Ukraine, which have included trade sanctions, spikes in commodity and energy prices, and heightened investor risk aversion. Both domestically and overseas, the cyclical outlook has become more challenging, with twin threads of increased pressure on corporate profitability in the face of sharply higher input costs, and likely weaker consumer demand as household budgets are squeezed by higher interest bills and more-expensive food and energy bills. Both bond and equity prices have risen in recent weeks from their lows in June, and it is possible that much of the bad news and weaker outlook is already reflected in asset prices as markets look ahead to central banks reaching peak tightening and to inflation dropping back in 2023, but the immediate cyclical outlook remains hard to read. Markets are likely to remain sensitive to economic, financial, or geopolitical surprises.

Australian Cash and Fixed Interest—Review

Monetary policy has been tightened further: as expected, on 5 July the Reserve Bank of Australia raised the target cash rate by a further 0.5% to 1.35%. The 90-day bank bill yield is now 2.23%, up by over 2% since the start of the year. Bond yields have risen, reflecting both higher inflation and the RBA's tightening cycle, and the 10-year Commonwealth bond yield is 3.6%, up 1.9% for the year. The Aussie dollar is up by 2.6% in overall value: Gains against most other currencies (notably a 14.3% rise against the yen and 7.2% against the pound sterling) have outweighed the Aussie's 4.8% decline against the globally strong US dollar.

Australian Cash & Fixed Interest—Outlook

At its July meeting, the RBA said that "The level of interest rates was still very low for an economy with a tight labour market and facing a period of higher inflation" and that "further steps would need to be taken to normalise monetary conditions in Australia over the months ahead." Forecasters have been revising upwards their best guesses of where the RBA will end up, with (for example) National Australia Bank reckoning that the target cash rate will rise to 2.85% by the end of this year (NAB had previously been expecting 2.35%) and Westpac picking 3.35% by February 2023 (previously 2.6%).

With the financial markets now having a clearer view of the likely peak level of the cash rate, bond yields are less exposed than before to the risk of further RBA tightening, and it is also possible that inflation is at or near its peak and will gradually drop back through 2023 (which is the RBA's own view). For both reasons forecasters think that the peak in bond yields is also here or hereabouts (and may even be behind us, looking at the retreat to today's levels from the 4.2% level of mid-June). NAB, for example, thinks the 10-year yield will be down to 3.4% by mid-2023, and Westpac has gone lower again, to 3.15%. After their recent setbacks—the S&P Australia Aggregate Bond Index has lost 9.3% for the year to

date—bond investors will be hoping the latest forecasts are proved correct, but they are not home free just yet: In many developed economies, inflation has tended to turn out somewhat worse than anticipated.

The outlook for the Aussie dollar is for appreciation against the US dollar: The median forecast of the big bank forecasters is for the currency to reach USD 0.73 by mid-2023, up from its current USD 0.69. The higher Aussie dollar view partly reflects the higher track now expected for Australian interest rates but will also need commodity prices to remain on the high side by historical standards, and global financial markets to become more settled: The Aussie dollar tends to fare better when investors are in a more risk-taking frame of mind.

Australian & International Property—Review

A-REITs for the year to date have significantly underperformed the broader equity market. The S&P/ASX200 A-REITs Index has dropped by 20.2% in capital value and delivered an overall loss of 18.3% including dividends, compared with the 8.7% capital loss and 6.8% overall loss for the S&P/ASX 200 Index.

Overseas, REITs have also underperformed, but by a smaller margin. The FTSE EPRA-NAREIT Global Index in US dollars has registered an overall loss (including dividends) of 18.2% compared with the MSCI World Index's equivalent loss of 16.5%. The key US market lost 17.6%: Among the other major regions, Asia-Pacific was relatively resilient with a 12.2% loss, while the eurozone fared worst with a 32.0% loss, a mix of asset price falls and a lower currency (the euro dropped by 10.1% against the US dollar).

Australian & International Property—Outlook

The A-REIT sector has been especially hard hit by rising interest rates, as for some time it had been sheltered by the RBA's stance that any interest-rate rises lay well down the track, and possibly not before 2023. The extent to which sentiment turned in the sector, with the RBA's subsequent change of tack towards early and significant tightening, was shown in the ANZ/Property Council of Australia commercial property survey. In the March survey, respondents had expected that the RBA's target cash rate in February 2023 would be 1.3%, but in the June survey the forecast had rocketed to 4.2%. In the circumstances it was no surprise that sector confidence took a big hit, expectations for economic growth slumped, and capital value expectations worsened significantly for offices, retail, and residential (industrial remained positive, though markedly less than before, while tourist-related property held up well as travel restrictions eased). In the meantime, market conditions have moved on yet again, the RBA's likely policy moves are now fully built into valuations, and there may even be upside if (as some forecasters reckon) bond yields have already peaked. It may be too early to talk about positive returns, given a tough outlook for retail spending and the real question marks over the office sector as (on the Property Council's latest data) the return to the office appears to have stalled, but at a minimum further significant underperformance looks less likely, and the yield on the sector (4.8% according to Standard & Poor's) may find more takers.

Many of the same considerations apply overseas. Unexpectedly large and rapid interest-rate increases across most major markets ex Japan had been a major headwind but now look to be largely incorporated into REIT prices; this should mean that the global REIT sector should not underperform to anything like the same extent. But if interest-rate concerns have abated, the cyclical outlook has darkened. As the US trade group NAREIT put it in its midyear roundup (and it also applies to other major markets), “Economists are increasingly skeptical that a soft landing is feasible; consensus growth forecasts for 2022 have fallen by one third since January, while the probability of recession has more than doubled to over 35%. While labor markets continue to look strong, with 2.7 million jobs created over the past three months and 1.7 job openings per unemployed worker, consumer sentiment is negative and retail sales are starting to sag, reflecting high energy prices and concerns about the economy.” From here the outlook is likely to mirror the broader equity outlook: Investors may well have largely priced in the prospect of a deteriorating global economy, but the eventual outcome will depend on whether investors have made the right call on its scale and duration, and there is potential for both positive and negative surprises.

Australasian Equities — Review

The global equity bear market has not spared Australia, and local shares have also sold off: For the year to date, the S&P/ASX 200 Index is down by 8.7% in capital value and by 6.8% including dividend income. Tech has been sharply sold off worldwide, and unsurprisingly the local IT sector has been the weakest of the major sectors and is down 28.1%. The darkening cyclical outlook has favoured defensive consumer staples (down only 0.9%) over the more cyclically sensitive consumer discretionary (down 16.7%). The financials ex A-REITs are also lower and are down 6.4%. The resources sector had help up well earlier in the year, but a sag in commodity prices in recent weeks—the Bloomberg Commodity Price Index dropped by some 17% between early June and early July—means that the miners are now also in the red for the year, and the S&P/ASX 300 Index of metals and mining is down by 11.1%.

Australasian Equities — Outlook

The economy is still growing: the early (flash) results from the July S&P Global Australia Composite Output Index, for example, “marked a sixth consecutive month of Australian private sector growth, albeit one that was only mild and the slowest in the current sequence of expansion.” The NAB June quarterly business survey showed a rather stronger picture: “Conditions strengthened in Q2 as the disruptions related to the virus receded. Trading, profitability, and employment were all higher with conditions approaching the high levels seen in early 2021.” Either way, businesses are still making progress.

But there are still strong profitability headwinds. NAB’s survey found that the three factors weighing most on business confidence are wage costs, availability of staff, and pressure on profit margins. While firms have some room to raise prices to restore profitability, their ability to pass on costs has limits. As NAB put it, “So far, it appears demand has held up in the face of higher prices but how long this can be sustained is a question we will be watching closely over coming months.” Consumer demand could well disappoint: The latest (June) Westpac/Melbourne Institute consumer confidence survey found that consumer confidence has dropped to low levels “that, since the beginning of the survey in 1974, had only been seen during periods of major disruption in the Australian economy.” It is possible that the

equity selloff to date has fully taken on board the challenging conditions for corporate profitability: Like many other equity markets, Australian shares have rallied in late June and into July on hopes that the worst of the surge in inflation is behind us, that supply chain shortages will ease over time, and that there is clearer visibility of how high the Reserve Bank is likely to take interest rates. But households facing higher mortgage costs and other strong pressures on the family budget may yet have a word to put into the debate.

International Fixed Interest — Review

A market backdrop of unexpectedly high global inflation and of widespread and vigorous central bank monetary policy tightening has created difficult conditions for bonds, and for the year to date the Bloomberg Global Aggregate Bond Index in US dollars is down by 14.0%. Global government bonds have lost 15.3%, and global corporate bonds have lost 10.2%.

Higher yielding subsectors have also performed poorly, with global high yield (lower credit quality) down by 15.6% and emerging-markets debt down by 17.5%.

International Fixed Interest — Outlook

At first sight the news for global fixed-interest has continued to be very poor. Inflation has continued to rage at levels not seen in a very long time. Most attention has focused on the US, where June's 9.1% inflation rate was the highest since November 1981, but the problem is widespread across the developed world. The OECD said that inflation in the OECD area in May was 9.6%, a tad worse than April's 9.2%, and was the highest inflation rate since August 1988. Nor is it just surging petrol and food prices that have been the culprit: Ex energy and ex food, prices in the OECD area were 6.4% up on a year ago and again a bit worse than April's 6.2%.

In response, many central banks have not only been tightening monetary policy but have been forced to tighten faster than the financial markets had been expecting. The most notable has been the US Federal Reserve, which raised the target range for the fed funds rate by 0.75% in June, its first 0.75% move since 1994, and which is expected to do it again at its 27 July meeting. But others have been backed into the same corner. The European Central Bank had been expected to raise its key policy rate by 0.25% at its July meeting: in the end it hiked by 0.5%. And the Bank of Canada at its July meeting raised its key rate by a full 1%, its largest move since 1998, when markets had been expecting a 0.75% increase.

Yet despite what look like ongoing macroeconomic headwinds, global bonds have rallied in recent weeks. The Global Aggregate Index bottomed out on 14 June, at which point it had lost 15.6% for the year and has since staged a modest rally: At time of writing, it was up 1.2% from its June low point. The most likely interpretations are that financial markets are now more confident that they can see how far central banks are likely to go; that central banks might have to ease the pace of tightening from now on as the global economic business cycle deteriorates; that the surge in COVID-19 cases and Ukraine-related supply chain and commodity price costs will start to ease back (for example, as Chinese lockdowns are lifted or Ukraine food exports are allowed to leave port); or some combination of all of these strands of thought. For the time being, in sum, bond investors are feeling that the worst is past,

but there is still the potential for reality checks further down the road. The yield on the JPMorgan Global Government Bond Index is still only 2.16%: Inflation will have to recede quickly and significantly to make the yield attractive in post-inflation terms.

International Equities—Review

The year-to-date outcomes for global equity markets make for sorry reading: the MSCI World Index of developed economy sharemarkets is down by 17.6% in US dollars. All major markets shared in the setback, with, in US dollar terms, American shares down by 16.1% (S&P 500), European shares by 20.6% (FTSE Eurofirst 300 Index), and Japanese shares by 19.1% (Nikkei). The only major sector clearly ahead for the year is oil and gas, while there have been especially large losses at the techier end of the asset class (for example, software and computer services down by 28.8%).

Emerging markets have been a bit weaker again, and the MSCI Emerging Markets Index in US dollars is down by 19.6%. In US dollars, among the key emerging, economies Brazil, supported by strong commodity prices, has done least badly (Bovespa down 4.3%), but there were larger losses in India (Sensex down 10.7%), China (Shanghai Composite Index down 15.6%), and Russia (RTS down 28.4%). Some countries closer to the Ukraine conflict fared notably badly (for example, MSCI Hungary Index down 41.1%, MSCI Poland Index down 37.2%).

International Equities—Outlook

Overall, world business activity picked up in June, according to the JPMorgan Global Composite Index, but the index results were a mixed bag. The upswing largely came from China, “where an easing of COVID lockdowns underpinned a solid return to growth,” but elsewhere the news was distinctly downbeat: “several survey indicators highlighted the ongoing fragility of the global economic upturn. New order growth eased to a near two-year low, international trade declined, and business confidence slumped to its lowest since September 2020.” At time of writing, the early (flash) estimate of the July US-specific composite index had just been released: It showed an unexpected drop in US output, which “signalled a further loss of momentum across the economy of a degree not seen outside of COVID-19 lockdowns since 2009.”

Businesses are wary of what may lie down the track. The S&P Global Business Outlook is run three times a year: Its June results “signalled a sharp worsening of business confidence among companies worldwide as severe price pressures are anticipated to accompany an economic slowdown. There was little sign of any respite on the inflation front, with both staff and nonstaff costs set to continue to rise sharply. The combination of slowing activity and still high inflation meant that firms globally predicted a near-stagnation of profits, in turn leading to a scaling back of plans for hiring and investment spending.”

Fund managers, at least until very recently, have also been buckling down in anticipation of tougher business conditions ahead. The June Bank of America survey of global fund managers showed that a net 79% expect the global economy to weaken over the coming year, an all-time high level of pessimism. Managers are holding unusually high levels of cash and are taking unusually low levels of risk. They are particularly worried about ongoing high levels of inflation, and about a global recession. And they are

taking a conservative approach to sector allocation, favouring defensive options like utilities, healthcare, and consumer staples, and avoiding banks, tech, and consumer discretionary; they are also less keen on resources stocks than they were before.

Against this degree of bearishness, world equities have actually been rallying from their lows. The MSCI World Index in US dollars, for example, hit its low point for the year on 16 June, and was down 23.1% at that point, but has since gained 7.2% to its current trading level. One possibility is that the previous equity selloff had already priced in a lot of the bad news. The S&P Global Investment Manager Index in July showed many of the same fund manager behaviours as the Bank of America survey—they were equally risk-averse and concerned about the economic outlook—but the survey also asked a one-off question: whether recession had already been priced into US equities. Eighty percent of the fund managers thought that a mild US recession was already priced in.

The outlook for global equities is finely poised. It may be that the worst is already allowed for. It may be that there are potentially positive surprises that are not being given due weight (China's return to filling in the holes in global supply chains, the Russia/Ukraine food export agreement, people returning from COVID-19 and relieving the chaos at airports and other areas seriously short of staff). Or it may be that the high degrees of bearishness among fund managers are an accurate sign of worse to come. The outlook is likely to be, as central bankers like to say, data dependent: It could go either way. In coming months, investors are likely to be paying particularly close attention to the latest profit guidance from corporates to get a feel for which way the cards are most likely to fall. ■■

Performance periods unless otherwise stated generally refer to periods ended Thursday 22 July 2022.

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