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Economic Update: Australia
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Outlook for Investment Markets

Both equities and bonds have rallied in recent weeks, but the gains have not been enough to outweigh large losses earlier in the year, and many asset classes continue to show year-to-date losses. On the equity side, the recent rally more reflects an assessment that previous price falls may have overstated the cyclical and geopolitical challenges to the world economy, rather than any assessment that the underlying outlook has improved: the outlook remains clouded by higher interest rates, China's lockdowns, the Russia/Ukraine conflict (and potentially risks around Taiwan), and straitened household finances. On the bond side, investor have taken some comfort from clearer visibility of peak monetary policy tightness by the world's central banks, and from some evidence that unexpectedly high inflation may be beginning to ease back. At home, businesses have been performing well up to now, but, as overseas, a cyclical slowdown looms, and recent economic forecasts (including from the Reserve Bank) suggest that growth assets will be facing more difficult conditions.

Australian Cash and Fixed Interest — Review

Short-term interest rates have risen further, in line with continued monetary policy tightening by the Reserve Bank of Australia: The RBA raised the target cash rate by 0.5% on 2 Aug, taking it to 1.85%. 90-day bank bills now yield 2.3%, up 2.2% for the year to date. Bond yields have followed the international pattern and have eased back from their earlier peak: The 10-year Commonwealth bond yield reached 4.2% in mid-June but is now down to 3.4%. The Aussie dollar is higher in overall value for the year (up 4.4%) with rises against the yen (up 13.0%), the pound (up 8.8%) and the euro (up 7.9%) outweighing a 2.4% fall against the US dollar.

Australian Cash & Fixed Interest — Outlook

As in many other countries, inflation in Australia has been higher than the central bank would like (headline inflation of 6.1% in the June quarter, and "trimmed mean" or underlying inflation, excluding unusually sized price moves, of 4.9%). The RBA also expects things to get a bit worse before they get better: The minutes of its August meeting said that "Underlying inflation was also expected to pick up further, to peak around 6% at the end of the year. Inflation was then forecast to start to decline in 2023." This means further rate hikes, or as the bank put it, "further steps in the process of normalising monetary conditions over the months ahead." Forecasters are picking a peak cash rate in the high 2's or low 3's: National Australia Bank expects 2.7% by June 2023, while Westpac has picked 3.35% by March 2023.

Recent lower bond yields reflect the fact that the financial markets are now less worried about the ultimate degree of RBA policy tightening; indeed, some forecasters are starting to look ahead to eventual easing. The Commonwealth Bank, for example, thinks the cash rate will peak at 2.6% later this year, and will be followed by two 0.25% cuts in the second half of 2023. There is also an expectation that inflation will come back under control within a reasonable time frame: the RBA's view is that "Inflation was expected to be around the top of the target band [that is, around 3%] at the end of 2024."

Against that background, bond yields may well have peaked and may even be headed down: Westpac, for example, thinks the 10-year Commonwealth bond yield will be as low as 2.65% by the end of next year.

Forecasters continue to expect an appreciation of the Aussie dollar against the US dollar: The median forecast from the big banks is for the currency to reach 72.4 US cents by mid-2023 and 74.7 cents by end 2023, up from today's 70.8 cents. A stronger dollar would sit with historically high Australian commodity prices, and with the RBA's likely higher interest rates over coming months. The wild card that might derail the forecasts is renewed market volatility, either because the global economic outlook surprises on the downside or geopolitical issues (particularly Ukraine and Taiwan) flare up worse: The Aussie dollar tends to sell off in riskier market conditions.

Australian & International Property — Review

A-REITs have substantially underperformed the wider share market. The S&P/ASX 200 A-REITs Index has lost 16.7% in capital value and registered an overall loss of 14.6% including dividends, compared with the 5.1% capital loss and 3.0% overall loss for the S&P/ASX 200.

Globally, REITs have also underperformed, but not by much. The FTSE EPRA-NAREIT Global Index in US dollars is down by 14.2% (12.4% including dividends), compared with the MSCI World's capital loss of 12.0% (10.8% with dividends). In terms of total return in US dollars including dividend income, the Asia-Pacific region fared best (down 9.2%) and the key US market had a loss of 10.3%: overall asset class returns were held back by large losses in the eurozone (down 26.2%) and the UK (down 21.6%).

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 (per 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.

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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 and 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

Local equities have followed the global pattern and have rallied from their June lows, but the rally has not been enough to regain all the ground lost earlier in the year. The S&P/ASX 200 Index is down by 5.1% in capital value and by 3.0% including dividends. IT stocks have been worst affected: Despite a strong 23.4% rise from its 17 June low, the sector is still down by 26.8% for the year. Consumer discretionary stocks have also taken a hit, given the stresses on household budgets, and are down by 16.0%, but the more defensive consumer staples are marginally ahead for the year (up 0.8%). The financials ex the A-REITs are down by 2.5%, and the miners, reflecting the recent decline in global commodity prices, are down by 2.7%.

Australasian Equities — Outlook

The economy thus far has been holding up reasonably well. The RBA, in its latest minutes, said that "The domestic economy had grown strongly over the first half of 2022, showing resilience to disruptions caused by the Omicron outbreak and the floods on the east coast. Timely indicators suggested that domestic demand had grown strongly in the June quarter, supported by consumer spending. Spending on discretionary services had continued to recover, while spending on goods had held up. Growth in consumption was expected to remain strong over the second half of the year, reflecting current strong labour income, still-high saving rates, and strengthened household balance sheets." The latest (July) NAB business survey was also strong: While there were strong input cost pressures, "Business conditions remain well above average … with trading conditions, profitability, and employment all higher."

But there is a slowdown in prospect. It may not be as significant as in some other economies: Local monetary policy may not need to be tightened as much as will be required in countries where inflation has risen to higher levels than it has in Australia. But monetary policy will nonetheless be applying the brakes to some extent, and the RBA reckons that the 3.2% GDP growth likely in 2022 will slow down to 1.8% in 2023 and to 1.7% in 2024. A slowdown of that order would mean that unemployment will

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gradually start to rise, on the RBA's projections from 3.4% at the end of this year to 4.0% by the end of 2024. Private sector forecasters tend to agree: NAB, for example, has GDP growth slowing from 3.6% this year to 1.7% in 2024, and the unemployment rate rising from 3.7% to 4.2%. By current international standards that would be a reasonably good outcome, and the share market may attract some support on its relative performance. In absolute terms, though, the outlook is getting harder for companies to maintain profitability, and the recent investor preference for more defensive sectors looks like a good advance signal of cyclical pressures to come.

International Fixed Interest — Review

This year has been a game of two halves for bonds. In the US, for example, the yield on the benchmark 10-year Treasury bond rose steadily to a peak of just under 3.5% in mid-June but has fallen steadily since to its current 2.8%. The benchmark German bond followed a similar trajectory, peaking at 1.78% in June and then dropping to today's 0.9%. The recent declines in yields and associated capital gains have improved the performance of the asset class, but the capital losses earlier in the year mean that fixed interest has still done badly for the year to date, with the Bloomberg Global Aggregate Bond Index in US dollars down by 12.3%.

International Fixed Interest — Outlook

The recent decline in yields reflects two factors. One is an expectation that inflation may be at or past its peak. The chief evidence for this view is that annual US inflation, which reached 9.1% in June, unexpectedly dropped back to 8.5% in July; even after stripping out the effect of lower energy prices, the "core" rate of inflation was also unexpectedly low. And some other indicators are also pointing in the same direction, notably world commodity prices: The Bloomberg Commodity Index, for example, is now down 11.1% from its mid-June peak level.

The second factor is that bond markets are less worried than previously about the potential scale of monetary policy tightening. The financial markets have even begun to look beyond the current tightening phase and to anticipate an eventual easing by the big central banks. In the US, for example, the financial futures market currently expects that the target fed fund range (currently a range of 2.25%-2.5%) will peak at 3.5%-3.75%, and that there is a chance policy will start easing in the second half of next year. The pricing around the Fed's policy meeting on 23 July next year, for example, has almost equal probabilities of the range staying at 3.5%-3.75% or being cut to 3.25%-3.5%.

While investors will be hoping that this bond market optimism proves correct, it is far from a given. The Bank of England, for example, is not convinced that the worst of the current inflationary surge is behind us: In its August monetary policy report, the bank expected UK inflation to hit a remarkable 13% in the final quarter of this year, and while the bulk of it was down to higher fuel prices, the bank also said that "Though responsible for much less of the rise in headline inflation, domestic inflationary pressures have also increased and are projected to remain strong in the near term." The same might well happen elsewhere, particularly in the US, where the unemployment rate has dropped to 3.5%. There might also be further inflationary pressures if, for example, Russia were to restrict its energy or other exports as part of its pressure over Ukraine. A final consideration is that, even if inflation does drop back rapidly, the

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yield available on global government bonds (2.17% going by the J.P. Morgan index) offers little value in aftertax after-inflation terms. All that said, there looks to be a realistic chance that the previously strong headwinds for the bond markets have eased.

International Equities — Review

World equity prices dropped steadily through to mid-June–at its low point on 16 June, the MSCI World Index of developed markets was down 23.1% in US dollars for the year–and then traded sideways till mid-July. In more recent weeks, however, share prices have regained some ground, and are up by 14.3% from their mid-June lows. Despite the recent rally, the scale of the earlier losses means that global equities are still showing large losses for the year to date, with the MSCI World Index down by 12.0%. Nearly all major markets have lost ground: In US dollars the S&P 500 is down 9.8%, the Nikkei in Japan is down 13.4%, the FTSE Eurofirst Index of European shares is down 17.9%, and the FTSE 100 Index in the UK is down 9.4%. A small depreciation of the Aussie dollar against the US dollar gave a small fillip to the outcome in local-currency terms, with the MSCI World Index in Aussie dollars down by 9.9%.

Emerging markets have fared worse than the developed markets. While the MSCI Emerging Markets Index in US dollars had a similar sized selloff in the first half of the year–it dropped by 21.9% to its low point on July 14–it has not matched the scale of the recent rally in the advanced economies, and for the year to date it is down 17.6%. The one bright spot among the core developing markets has been Brazil, which has benefited from strong commodity prices, and the Bovespa index is up 17.9% in US dollars. The other big emerging markets have recorded sizeable losses, with the worst outcome in Russia, where shares have lost roughly a third of their value (the FTSE Russia Index is down 31.4%, and the RTS index is down 36.3%).

International Equities — Outlook

There are mixed conditions across different regions, but overall global economic activity looks to be headed for a weak patch. Going by the J.P. Morgan Global Composite indicator of business activity, "July saw the rate of global economic growth ease to its weakest during the current 25-month sequence of expansion. The slowdown was mainly centred on developed nations, where output contracted (on average) for the first time since June 2020. Emerging markets showed greater resilience in comparison, with growth staying close to June's 11.5 year high."

The data are not completely clearcut. On paper, official figures for the US economy, for example, show that the American economy contracted in both the March quarter (at an annualised rate of 1.6%) and the June quarter (at an annualised rate of 0.9%). These numbers do not line up with the boom figures coming out of the US labour market, where there were far more jobs created in July (528,000) than the 250,000 forecasters had expected, and where the unemployment rate dropped to a new low of 3.5% (the forecasters had picked it would stay at 3.6%).

That said, the J.P. Morgan index tends to track world GDP quite closely, and even if the US may actually be more resilient than its official numbers say, the probability is that the near-term outlook is downbeat.

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The immediate challenges have been the ongoing pressures from supply shortages and price rises for commodities affected by the conflict in Ukraine, wage pressures in tight labour markets, and recent weakness in the Chinese economy, where a raft of recent indicators have fallen short of expectations as China continues to run a coronavirus-elimination policy of tight lockdowns. Beyond the immediate issues, there is the eventual impact of the monetary policy tightening that many central banks have already carried out, and the likelihood of further hikes in interest rates still to come.

One might well wonder why equity markets have rallied in the face of the likely prospect of a cyclical slowdown ahead, and the answer appears to be that investors had already discounted the worst, and events look to be unfolding a bit better than they had previously expected. As Bank of America said in its latest (August) survey of global fund managers, "Sentiment remains bearish, but no longer apocalyptically bearish as hopes rise that inflation and rates shocks end in coming quarters." The same pattern of still bearish sentiment, but not quite as depressed as before, also came through in the latest (August) S&P Global survey of institutional investors: "of the 11 monitored sectors, 10 recorded improving sentiment on a monthly basis, with only communications services registering a deterioration since July. That said, eight of the 11 monitored sectors are reporting a negative outlook, with real estate and consumer discretionary stocks at the bottom of the rankings."

The good news is that the outlook is not quite as difficult as first feared: the bad news is that there are still many challenges ahead. For the Bank of America panel, the three biggest risks are inflation remaining high (mentioned as their top risk by 39%), a global recession (24%), and central bank interest-rate hikes (16%). The S&P panel had a similar set of issues which they saw as the drivers of the US equity market in the near term: the global macroeconomic environment, the political environment, and central bank policy.

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