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Economic Update: Australia
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Outlook for Investment Markets

A rally in both equity and bonds in July and the first half of August did not last, and prices resumed their slide in the second half of August and into September. With the exceptions of cash and infrastructure, most asset classes are now showing hefty losses for the year. The prime reason has been the likelihood that monetary policy will tighten more than previously expected, as inflation in a range of countries has proved to be more troublesome to corral than central banks thought. It has not helped that the global economy was weakening as the initial post-coronavirus rebound wore off and the various ramifications of the war in Ukraine (particularly very high energy prices) continue to weigh on the world economy. Market conditions are likely to remain problematic until investors can see their way to friendlier growth prospects on the other side of the current monetary policy tightening cycle. At home, the economy has been in good shape, with, for example, a solid rise in the gross domestic product in the June quarter. But Australia faces the same monetary policy challenge as many other countries, and business conditions are likely to get tougher over the coming year.

Australian Cash and Fixed Interest — Review

Short term interest rates have continued to rise reflecting both actual and anticipated interest-rate hikes from the Reserve Bank of Australia, or RBA, and the 90-day bank bill yield is now 2.7%, up 2.6% for the year. Bond yields have followed the global pattern, peaking in June, dropping in mid-August, but then rising again in more recent weeks. The 10-year Commonwealth bond yield is back up to 3.6%. Its 2.0% rise year to date has meant capital losses for the asset class. The S&P Australia aggregate bond index is down 9.0% for the year. The Aussie dollar is 2.3% higher for the year in overall value. A significant decline of 7.3% against the U.S. dollar was more than outweighed by strength on other cross rates, notably against the yen (positive 15.8%) and the pound sterling (positive 8.7%).

Australian Cash & Fixed Interest — Outlook

Further rate increases look likely from the RBA as it brings further pressure on unacceptably high inflation. On its own projections, annual inflation (on the "trimmed mean" definition) will be 6% at the end of this year and will still be 3.75% at the end of 2023, well above the 2% to 3% the bank targets. The futures market currently expects short-term interest rates to increase by some 1.3% over the coming year, which would take the target cash rate to around the 3.75% mark from today's 2.35%.

The recent rise in bond yields partly reflects the influence of higher U.S. bond yields, which have risen in response to poor inflation news in America. But it also reflects domestic circumstances, with the Australian economy generating its own local inflationary pressures—the economy is still growing at a robust rate at a time when the labour market remains tight and input costs are rising rapidly. Some forecasters expect that bond yields have risen enough to compensate for this inflationary environment

and could even decline in late 2023 as inflation progressively abates. Inflation globally, however, has proved unexpectedly stubborn, and National Australia Bank's view that yields will still be around current levels in a year's time may well be more realistic.

The value of the Aussie dollar has largely been a byproduct of wider global trends, notably this year's surge in the U.S. dollar. The greenback is up by 13.1% in overall value, buoyed by the relatively aggressive monetary policy track of the Fed, geopolitical demand for a safe haven currency, and the ongoing strength of the U.S. economy. The Aussie's value has also been affected by the slump in the yen, which is down by 19.6% against the U.S. dollar, largely due to Japan's still very low interest rates at a time when rates everywhere else have been rising. Japanese government-bond yields are still negative all the way out to four years, and low beyond that (the 10-year yield is only 0.26%). The U.S. dollar impact may well reverse in coming months. The median view of the big bank forecasters, for example, is that the Aussie will recover ground against the U.S. dollar, rising from 67.25 cents now to $0.72 cents in a year's time. Rising domestic interest rates as the RBA tightens further and ongoing good prices for Australia's commodity exports could also come into play and support the value of the Aussie in coming months.

Australian & International Property — Review

It has been a tough year for the A-REITs, which continue to underperform the wider share market. The S&P/ASX200 A-REITs Index is down by 22.8% in capital value and has delivered an overall loss of 20.7% including dividends, compared with the 8.3% capital loss and 4.7% overall loss for the S&P/ASX 200.

Global listed property modestly underperformed global equities as a whole: the FTSE EPRA-NAREIT Global Index in U.S. dollars has lost 22.3% (20.3% including dividends), compared with the MSCI World's capital loss of 19.0% (17.7% with dividends). In U.S. dollars, the Asia-Pacific (negative 12.9%) and emerging markets (negative 13.1%) fared least badly, the key American market was in the middle of the bunch (negative 17.9%), while there were large losses in the eurozone (negative 40.0%) and the U.K. (negative 35.2%) due to a combo of poor underlying asset performance and weakening local currencies.

Australian & International Property — Outlook

The A-REITs have struggled from the same combination of issues that has confronted listed property everywhere, which are that interest rates are rising faster than expected along with an impending cyclical slowdown and structural change to retail spending and working practices in the wake of COVID-19. Office occupancy rates, for example, as compiled by the Property Council of Australia, have been improving from their lockdown lows but are still well adrift of where they were before the pandemic. In Sydney, for instance, occupancy in August was only 53% of pre-COVID-19 levels, and the difference between occupancy on the peak day (67%) and the lowest day (35%) shows that there is now an entrenched culture of working from home (typically Mondays and Fridays). After the recent substantial price declines, valuations are better than they were, but potential investors may stay on the sidelines until they are more confident that bond yields are nearer a peak.

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Conditions are more difficult again in overseas REIT markets. The J.P. Morgan Composite indicator of business activity showed that in August the real estate industry was the second-weakest sector out of the 21 sectors surveyed (only cars were worse), while the September S&P Global survey of fund managers found that real estate was the second-least-preferred option out of the 11 sectors in the survey (with only consumer discretionary more out of favour). CBRE, in an end-of-August report, acknowledged that the immediate cyclical outlook is not encouraging: "macroeconomic headwinds are raising fears of a broad-based downturn as central banks address persistent high inflation"—but nonetheless felt that there could be some investment opportunities. One was inflation hedging: apartments, industrial, hotels and self-storage "can be repriced relatively quickly, making them particularly attractive in an inflationary environment." Another was bottom-fishing in a cheaper market: While "owners are increasingly mindful of the potential for falling values and profit erosion … buyers with dry powder are now evaluating how to purchase assets that were previously out of their valuation range." They may yet be right, but for now the headwind of tighter monetary policy continues to crowd out other drivers of performance.

Australasian Equities — Review

Once again local equities have followed the global trend: a fall in the first half of the year, some recovery in July and the first half of August, but further losses since then. Year to date the S&P/ASX 200 Index is down by 8.3% in capital value and has returned an overall loss of 4.7% including dividends. IT stocks continue to be the weakest sector and are down by 29.2%. The cyclically exposed consumer discretionary stocks have also suffered (negative 19.6%) whereas the more defensive consumer staples have returned (negative 5.0%). The financials, excluding the A-REITs, are down by 7.0%, and the miners have done relatively well. Although global commodity prices are down from their peak, they are still high by historical standards, and the sector has outperformed shares as a whole with a modest 3.4% loss.

Australasian Equities — Outlook

The latest economic and business data have been positive. The economy grew by 0.9% in the June quarter, for a 3.6% year-on-year growth rate, much in line with forecasters' expectations, helped by the latter stages of spending by consumers who had been saving more than usual during lockdowns and who are still catching up with their deferred purchases. Businesses are also in good standing. The latest (August) National Australia Bank business survey found that business conditions remained strong across the various states and across most industries (excluding construction), and that ."Overall, the survey showed no signs that the strong conditions of recent months—including the strength seen in official consumption and retail sales data—had begun to moderate yet." CommSec's roundup of the June company reporting season also showed good company performance, with profits (excluding BHP, which would exaggerate the numbers) up by 36.5% on a year earlier.

But these indicators are for the most part backward-looking. In the future, many companies in other countries will be feeling stronger cost pressures from rising input costs and more expensive financing, while consumers will be tightening their belts as petrol, mortgages, and wage increases—not yet matching price increases in the shops—combine to crimp their finances. The latest (September) Westpac/Melbourne Institute survey of consumer sentiment showed it slightly better, but still deeply

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apprehensive and close to historic lows. CommSec's take is that, although "Research analysts are expecting weaker earnings growth this financial year and next as the economy slows and profit margins are squeezed by higher costs," improved P/E ratios and a 4.6% dividend yield could help the S&P/ASX200 Index to a 7,100-7,400 range by June next year, which at its midpoint would be a rise of some 6% from current levels. That, however, was on an assumption that the RBA would take the cash rate up to only 2.6% between now and the middle of next year. As with other central banks, the risk to eventual equity performance is that interest rates will rise faster than first thought.

International Fixed Interest — Review

After dropping in July and August on hopes of inflation easing and central banks consequently under less pressure to raise interest rates, bond yields have changed tack in recent weeks and have headed higher. In the U.S., for example, the benchmark 10-year Treasury yield had dipped below 2.6% in early August and is now back up to 3.4%. The associated capital losses mean that bond market performance has been poor, and year to date the Bloomberg Global Aggregate in U.S dollars is down by 16.9%.

International Fixed Interest — Outlook

The big news for the asset class has been the unexpectedly poor inflation outcome in the U.S. in August. At first sight, the headline news had looked good: The overall annual inflation rate dropped from June's 9.1% and July's 8.5% to 8.3%. But when unpacked in more detail, the data showed that "core" annual inflation, excluding food and energy, had actually accelerated—it had been 5.9% in both June and July, but picked up to 6.3% in August. The month-on-month increase in "core" inflation was also bad news—at 0.6% in August, it was up from 0.3% in July.

The conclusions that the bond (and equity) markets drew from the news was that inflation was a bigger issue than previously thought, and that the Fed would have to react more forcefully with tougher monetary policy than the markets had previously allowed for—bond and equities consequently both sold off heavily after the data was released. Before the latest news, futures-market thinking (as summarised by the Chicago Mercantile Exchange's FedWatch tool) was that the target Fed funds range (currently 2.25% to 2.5%) would peak at 3.5% to 3.75%. Now, there are roughly equal probabilities of a 4.0% to 4.25% range, and a 4.25% to 4.5% range. Earlier expectations that the Fed would start easing in the future have also gone out the window, as the futures market thinks the target range will still be in the 4.0% to 4.25%/4.25% to 4.5% area at the Fed's meeting in July next year.

It has not helped that other central banks are also having to scramble hard to get on top of surging inflation. The European Central Bank raised its policy rate by 0.75% this month and indicated that there are several more hikes in the pipeline, and understandably so, given that the bank expects eurozone inflation of 8.1% this year and 5.5% in 2023. Inflation is likely even worse in the U.K., where some recent private sector forecasts are picking up that inflation will be even worse than the 13.3% the Bank of England expects. Goldman Sachs, for example, thinks it could hit 22.4% if gas prices remain high and 14.8% even if gas prices ease back.

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There is a significant global economic slowdown on the horizon, and it is still possible that inflationary pressures might drop away faster than forecasters and central banks currently expect. Although inflation is still too high, the latest (August) J.P. Morgan Global Composite indicator of economic activity picked up some moderation in the rate of increase of input and output costs. But the more likely outcome is that inflation is proving tougher to control than people had anticipated, and the bond markets' optimism in June and July that the macroeconomic headwinds were easing now looks premature.

International Equities — Review

After a poor first half of the year, when the war in Ukraine, rising energy and other input costs, and tighter monetary policy had combined to drive equity prices sharply lower, prices recovered in July and the first half of August. The recovery has not lasted, though, prices have resumed their slide, and year to date the MSCI World Index of developed markets in U.S. dollars is down by 19.0%. All the major markets are showing significant losses In U.S. dollars for the year: S&P 500, negative 17.2%; Nikkei, negative 22.3%; Eurofirst 300, negative 23.4%. The Aussie dollar's weakness against the U.S. dollar has cushioned some of the impact, but even so the MSCI World in Aussie dollars is down 12.6% year to date.

Emerging markets have followed a similar pattern, with prices also falling since mid-August, and the MSCI Emerging Markets Index in U.S. dollars has lost 21.9%. The only good news has come from commodity-buoyed Brazil, where the local Bovespa benchmark is up by 5.5% in reais and by 13.8% in U.S. dollars, thanks to the reais' 7.9% appreciation against the dollar.

International Equities — Outlook

The issue that has been top of mind for global equity investors in recent weeks has been the potential impact of higher-than-anticipated interest rates. A number of major central banks (excluding Japan) are being forced to raise rates faster and further than expected as inflation has soared well above the banks' inflation target ranges. This has had a particularly large impact on growth industries where profits mostly lie in the future, and where the effect of present value discounting of future profits at now higher discount rates is largest. The tech sector in particular has been hit hard. The FTSE Global sectoral indexes in U.S. dollars show that software and computer services equities are down by 28.0% year to date, and technology hardware and equipment shares are down by 24.8%.

The braking impact of higher interest rates on economic activity will mostly hit in 2023, but it does not help that global business activity has already slowed down significantly. The August J.P. Morgan Composite indicator "saw global economic activity contract for the first time since June 2020, as new order inflows declined, international trade volumes fell and signs of excess capacity grew... August data signalled that weaknesses in the global economy were becoming more widespread. Five out of the six subindustries covered saw downturns – business services, consumer goods, consumer services, intermediate goods and investment goods. In contrast, the financial services sector saw a mild upturn following July's contraction."

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There are a number of reasons, including the first effects of the central banks' monetary policy tightening, China's ongoing COVID-19 lockdowns, and, perhaps most importantly, the transfer of purchasing power from consumers of energy to producers in the wake of the war in Ukraine's impact on natural gas supplies in particular. Western Europe, which has been impacted the most, faces an unpleasant outlook of ongoing high prices and potential supply shortages. The more cyclically sensitive equity sectors have already priced in the likely impact of consumers retrenching. The FTSE sector indexes show large setbacks for discretionary spending, such as on leisure goods (negative 23.5%) and personal goods (negative 23.1%).

Given the circumstances, it is not surprising that global fund managers have become more concerned and more conservative. September's S&P Global survey of institutional investors found, for example, that 79% of them expect a U.S. recession in the coming year, albeit not a severe one. They reported high levels of concern about the global macroeconomic environment, about central bank policy, and about the political environment—probably meaning Ukraine, where despite the recent good news of a successful Ukraine offensive, it is not clear what happens next, and some of the possibilities (for example, a Russian counteroffensive) could be even more unsettling. By a wide margin, the surveyed fund managers have chosen two sectoral options to cope with these risks: energy, on the assumption that the war in Ukraine will keep prices high; and the health sector, which should be relatively sheltered from cyclical pressures on consumer spending.

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