Economic Update: Australia
November 2022

Morningstar Research
15 Nov 2022

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Outlook for Investment Markets

After large losses earlier in the year, bonds and equities have rallied in recent days following the surprise news that US inflation was lower than anticipated in October: The consequent possibility that central banks might not need to raise interest rates by as much, or as quickly, as previously expected was enough to boost global asset prices, though the rally still leaves all mainstream asset classes in losing territory on a year-to-date basis. At this point, it is unclear whether one bit of good news will become a longer-term supportive trend: Inflation rates have been volatile, and there could still be bad news down the track. Even if inflation does turn out to be not quite as bad as expected, financial markets will still have to cope with some further interest-rate rises in the coming months before the monetary policy tightening cycle peaks, as well as with the lagged effects on global business activity of the earlier interest-rate hikes: 2023 is shaping up as a weak year for the global economy. The same pressures will be at play locally, as the Reserve Bank of Australia still has some interest-rate increases in the pipeline: Consumer spending, in particular, looks likely to be weak, and corporates will have their work cut out to maintain profitability.

Australian Cash and Fixed Interest — Review

Short-term interest rates have risen a little bit further, and the 90-day bank bill rate is now just over 3.0%. Bond yields remained high into November but have dropped back more recently in line with lower US bond yields, and the 10-year yield is now 3.66%, down from 4.05% a month ago. The Australian dollar has been volatile in overall trade-weighted value during the course of the year, and is currently up 1.3% for the year, thanks in part to a recent 5.6% surge against the US dollar, from 62.7US cents a month ago to 66.2 cents now.

Australian Cash & Fixed Interest — Outlook

The Reserve Bank of Australia raised its target cash rate by 0.25% to 2.85% on 1 Nov, and it "expects to increase interest rates further over the period ahead," given the unacceptably high inflation rate: The RBA expects inflation to peak at 8% by the end of this year and will be around 4.75% in 2023. Westpac, for example, expects the cash rate to reach 3.85%, and the futures market currently expects a similar increase of some 1% over the coming year.

Opinions vary on the outlook for bond yields. Some think yields have not quite peaked and will rise a bit further before gradually declining in 2023. The Commonwealth Bank, on the other hand, thinks the peak is in and expects a gradual decline from here to 2.8% by end 2023. The outlook remains strongly subject to global bond market developments: Currently the key US bond market is in optimistic mood after slightly better-than-expected American inflation data for October. If inflation globally and locally does start to recede faster than expected, then bonds could do better after poor outcomes in 2021 and 2022 to date: the S&P Aggregate Bond Index lost 2.9% in 2021 and a further 9.0% so far this year. That said, so far there is only one month's better-than-expected US data to go by, and much will depend on the next string of data releases.

The Aussie dollar's bounce back in recent days is also largely a result of the better-than-expected US inflation news: With the Federal Reserve now expected to raise US interest rates less aggressively than earlier seemed likely, expected interest-rate differentials have improved in favour of the Aussie dollar. The median view of the big bank forecasters has been somewhat left behind by the recent rise–they had been expecting the Aussie to be around 65 US cents by mid-2023 and it is already just over 66 US cents–but it would not be surprising to see the next round of forecasts updated to show ongoing Aussie recovery. The wild card remains the state of investor confidence: The Aussie dollar tends to do better when investors are less worried about financial market volatility and other risks.

Australian & International Property — Review

The A-REITs, like many other asset classes, got a boost from a global equity rally in the wake of good news out of the United States–the S&P / ASX200 A-REITs Index rose by 4.2% in the two days after the US data–but the sector is still well behind for the year, with a capital loss of 20.8% and an overall loss including dividends of 18.5%.

Global listed property also got a shot in the arm from the prospect of slower interest-rate hikes than previously anticipated–the FTSE EPRA-NAREIT Global index in US dollars rose by 6.75% after the news of lower-than-expected US inflation–but it is still showing large losses for the year to date. The FTSE EPRA-NAREIT Global Index in US dollars is down by 24.8% (22.4% including dividends), with particularly large US dollar losses in the eurozone (37.2% loss) and the United Kingdom (37.0% loss) stemming from a combination of weak local property prices and weakening local currencies.

Australian & International Property — Outlook

The September quarter NAB Commercial Property survey picked up what one would have expected in the current environment: "Amid headwinds from rising inflation and interest rates, NAB's Commercial Property Index shifted back into negative territory in Q3 to a well below average -20 pts. Sentiment was lower and negative in all sectors, bar Industrial." Respondents expect retail and office rents to keep falling over the next two years, despite inflation-resetting, as both sectors are struggling with excess supply, which is likely to persist over the next five years, and capital values are expected to fall over the next two years (retail) and over the next year (offices). Vacancy rates are expected in the survey to improve a little in both sectors, but this looks optimistic given the cyclical outlook for household spending and recent data on office occupancy, which in the big Sydney and Melbourne office markets remains well below pre-pandemic levels. Industrial remains in strong shape, with a record-low vacancy rate of 3.5%, and supply is expected to remain tight in coming years, leading to expected rent increases of some 3% a year and a slight increase in industrial property values. Ex industrial, the sector has its issues, and investors may well continue to be wary until there is a clear sign that the interest-rate and business cycles have turned for the better.

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Much the same picture emerged from the September quarter Commercial Property Monitor run by the Royal Institution of Chartered Surveyors: "A shift in tone to the feedback received through the Q3 Global Commercial Property Monitor was always likely in the face of the increasingly uncertain macro environment. If anything, the surprise is that it is not more marked with the headline Global Commercial Property Sentiment Index (CPSI) slipping from -6 (in Q2) to -11. To put this in some context, it is the most negative reading since the first quarter of 2021 when the pandemic was still raging, but remains well above the lows recorded during the height of the Covid period." There was the usual sectoral tiering with industrial out in front, offices hit by changes to the world of work–"only 20% of respondents do not foresee some scaling back in the office footprint over the year ahead"–and retail facing tougher trading–"the RICS tenant demand metric has moved further into negative territory." Valuation is also an issue: "Just over half of respondents to the survey view their local real estate market as being expensive to a greater or lesser extent, highlighting the level of risk in the sector as bond yields begin to move upwards in many countries"; that assessment was corroborated by Standard & Poor's estimates that global REITs are on a prospective price/earnings ratio of 25.1 times earnings and a price/book value ratio of 1.5 times. If bond yields have indeed peaked, the sector may look more promising, but otherwise the weakening global business cycle and expensive sector valuations look likely to continue to drag on performance.

Australasian Equities — Review

Local shares have had a good run in recent weeks and are up by 10.9% from their low on 3 Oct. Given that the Australian market held up better than many others during the global bear market earlier this year, the latest rally has made a big difference to the year-to-date results, and the S&P/ASX200 Index is now down for the year by only 3.9%. Including (untaxed) dividends, it has squeaked into the black with a 0.2% total return for the year. The miners (ASX300 Metals and Mining Index up 3.6%) and the banks (Financials ex the A-REITs up 0.2%) have been the strongest sectors: Ex the A-REITs (discussed earlier), the big underperformers have been information technology (down 32.1%) and consumer discretionary (down 16.2%).

Australasian Equities — Outlook

The economy is still in good shape on most indicators. The unemployment rate remains very low, at 3.5% in the September quarter, and businesses are in a confident mood. The latest (September) National Australia Bank survey found that "Overall, the survey indicates the economy has remained resilient through Q3, despite the challenges from higher inflation, rising interest rates, and a gloomy global outlook." It may be starting to lose some momentum: The October S&P Global Australia Composite Purchasing Managers Index showed "a contraction of the Australian private sector following eight straight months of expansion. The downturn was primarily attributed to a weaker service sector performance as activity shrank for the first time in nine months." But at least until very recently conditions have been supportive of corporate profitability.

But as in many other economies, the profit cycle looks like turning. As the RBA noted in its November *Monetary Policy Statement*, the going has been good: "Underlying profits of ASX 200 companies increased in the first half of 2022 relative to the same period a year earlier … Around two thirds of ASX 200 companies reported earnings growth, despite higher cost pressures being commonly cited as a

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challenge." Now, it is tougher: "Due to uncertainty about the macroeconomic outlook, many ASX 200 companies have downgraded or removed earnings guidance for the upcoming financial year." A prime reason is the crimped financial position of Australian households confronted with still-high inflation and rising mortgage bills: In the latest (November) Westpac Melbourne Institute survey of consumer confidence, "Sentiment continues to plumb historic lows." With an economy headed for a sharp slowdown in gross domestic product growth and rising unemployment in 2023, the fundamentals for equity performance are not encouraging, though one saving grace is relatively undemanding valuations. Standard & Poor's estimates that the ASX 200 Index is on a prospective P/E ratio of only 13.65 times earnings compared, for example, with the S&P 500's 17.7 times, which suggests that even if absolute performance may be uphill, Australian equities may well continue to outperform their overseas counterparts.

International Fixed Interest — Review

Global fixed-interest investors have had little to cheer about in recent times: The Bloomberg Global Aggregate Bond Index in US dollars lost 4.7% last year and is down by a further 17.6% for the year to date. Not only have absolute numbers been very poor, but bonds have failed to deliver on their portfolio protection role in a period when equities were in sharp decline. Investors got a rare bit of good news in November, however, when America's October inflation rate turned out to be a bit lower than feared, igniting hopes that the Fed, and perhaps other central banks, would "pivot" towards less-aggressive tightening of monetary policy. Although the Gobal Aggregate Index is still very substantially down for the year, it has had a 5.4% rise from its low point on 21 Oct. In the US, the yield on the benchmark 10-year Treasury has dropped from 4.1% just before the inflation news to its current 3.8%.

International Fixed Interest — Outlook

America's inflation rate in October was a pleasant surprise for the financial markets. The headline inflation rate was 7.7%, down from September's 8.2% and, more importantly, lower than forecasters' anticipated 8.0%. The "core" inflation rate, excluding volatile food and energy prices, was 6.3%, again lower than September's 6.5%, and again coming in below the forecasters' expected 6.5%. The rare news that inflation came out below expectations after a long period of inflation running higher than feared was enough to trigger a sharp rally in US and global bonds–on the expectation that other central banks might also be in for some unexpected relief–and in local and global equities.

While investors across multiple asset classes will be pleased, the celebration may yet be premature. It is indeed helpful that markets' expectations of the pace of Fed tightening have been wound back a bit: according to the FedWatch tool, the futures market now thinks the next Fed move will be a 0.5% increase instead of the 0.75% moves it has been making.

But as the president of the San Francisco Fed observed, "We've seen a little bright spot on the data today, but again, I can't reiterate enough that one month of positive data on inflation does not a victory make." Even after this positive news, the futures market has not wound back its view on the "terminal" rate the Fed will reach at the top of this tightening cycle: Its target range for the federal-funds rate is

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expected to be either 4.75%-5.0% or 5.0%-5.25%, an increase of 1%-1.25% from its current level. The bond market remains very sensitive to inflation surprises, and they could yet go either way.

It is also worth remembering that the US is not the only bond market of importance. While inflation pressures may have eased a bit in the US, they are still remarkably strong in some other major markets. In the eurozone, for example, the latest (December quarter) Survey of Professional Forecasters, run by the European Central Bank, shows that the forecasters expect 8.3% eurozone inflation in the final quarter of this year, up from the previous quarter's survey estimate of 7.3%, and they expect 2023 inflation of 5.8%, well above their previous 3.6%. In the UK, the Bank of England expects inflation to peak at around 11% this quarter, and although the bank expects sharp falls in 2023 and 2024, it will be a challenge to achieve. Global bonds have had an unexpected boost, but the jury is still out on whether bondholders will get to keep the gains.

International Equities — Review

Like bonds, equities welcomed the news that inflation was a bit better than expected in the US and that interest rates, and companies' input costs, might not rise as quickly as previously thought: The MSCI World Index of developed markets in US dollars has gained 6.5% since the inflation news came out. But, again like bonds, the recent rally has been relatively modest in the context of the sharp falls earlier in the year, and the year-to-date performance numbers remain poor. The MSCI World Index is still down by 17.3%, with losses in US dollars across all major markets ranging from a loos of 13.3% in the UK through the S&P 500's 16.2% drop, to the weakest of the major markets, Japan, where the Nikkei is down 18.6%, a whit worse than Germany's loss of 18.5%. The depreciation of the Aussie dollar against the US dollar means that the MSCI World Index is down by 9.3% in local-currency terms.

Emerging markets have also enjoyed a recent post-inflation-news bounce, with the MSCI Emerging Market Index gaining 5.2% since the announcement. However, like the developed markets, the rally is still modest in the wider year-to-date context. The index has lost 24.0% so far this year, reflecting large losses in Russia and China: The Shanghai Composite Index is down by 24.2%, and Russia's RTS Index is down by 27.4% (both in US dollars). Brazil remains the exception, where globally strong commodity prices have helped Brazil's Bovespa Index in US dollars to a 12.0% gain for the year.

International Equities — Outlook

Equities have rallied on expectations that interest rates may not rise as rapidly or as far as first thought: as noted in the fixed-interest section, while this is good news as far as it goes, evidence of a faster return to a world of low inflation earlier than originally anticipated is still thin on the ground. It might eventually prove to be an early signal of a "pivot" in global monetary policy, but as things stand one month's US inflation data is not yet enough to support what may now be overly optimistic expectations of central banks packing their tents and leaving.

The other big challenge confronting global equity markets is the reality of an already slowing global economy and the prospect of further deceleration in 2023. The latest (October) J.P. Morgan Global Composite Indicator of world business activity, for example, showed that the world economy is already

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struggling: "The downturn in global economic activity extended into its third successive month, with the service sector rejoining manufacturing in contraction territory. Business optimism dipped to a 28-month low, as new order intakes and international trade flows continued to dwindle in the face of heightened economic, inflationary, and political pressures."

Forecasts for 2023 are also downbeat. The latest (October) quarterly survey of US forecasters run by the *Wall Street Journal* found that the respondents placed a 65% probability on the chance of a US recession over the next 12 months, with their quarterly GDP forecasts suggesting that US GDP will fall in the March and June quarters of next year. In the eurozone, the latest (December quarter) Society of Professional Forecasters survey found that "Respondents now expect a broad stagnation of economic activity in 2023 (0.1% growth), and three quarters of negative growth between the third quarter of 2022 and the first quarter of 2023, with a cumulative decline of 0.7%." In the UK, the Bank of England in its latest (November) *Monetary Policy Report* is picking that the British economy will shrink by 1.9% during the course of 2023.

Institutional investors are rightly wary. The latest (early November) S&P Global survey of the big US fund managers found that "Risk sentiment has again soured amongst US equity investors with weaker near-term returns expected." On the plus side, they expect some good individual company results, and valuations are better, but all the other drivers of potential equity performance are seen as negative. The global economic outlook and central bank monetary policy tightening are seen as particularly challenging, but the US economic outlook, the political environment, tighter fiscal policy, and equity fundamentals (presumably meaning the likes of input cost pressures on business) are all seen as cyclical headwinds.

Admittedly, the survey was taken before the US inflation news surprise, and sentiment has likely perked up somewhat since. But the sugar rush of monetary policy relief may not be enough to keep the recent strength of equity prices going as global corporates confront a difficult year ahead for growing or even maintaining corporate earnings.

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