

# Economic Update: Australia

## October 2022

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### Outlook for Investment Markets

Both bonds and equities have suffered further losses as interest rates have continued to climb: Central banks in a wide range of countries (other than Japan) have been tightening monetary policy to address inflation, which has been way above the banks' target levels and which has continued to surprise in its persistence and scale. Looking ahead, further interest-rate rises look highly probable, putting ongoing pressure on the valuation of other asset classes. The central banks' tighter stance is contributing to a widely expected global economic slowdown in 2023, and risks to the outlook remain tilted to the downside, given uncertainties such as the Russian-Ukraine war, China's ongoing lockdowns, and potential financial fragility legacies from the days of very low-cost debt. Although currently in good shape from a gross domestic product growth and unemployment perspective, the local economy is expected to slow down in 2023 as too-high local inflation means that the Reserve Bank of Australia, or RBA, like its overseas counterparts, will also be tightening. Corporate profits will be under pressure.

### Australian Cash and Fixed Interest — Review

Short-term interest rates have risen a bit further, and the 90-day bank bill rate is now 2.9%, a rise of 2.8% for the year. Bond yields have been rising since early August: The 10-year Commonwealth bond yield is now 3.9%, up 2.25% for the year. The Aussie dollar is lower, largely because of its 12.9% year-to-date decline against the U.S. dollar, but it has risen against some other major currencies (notably the yen, where it is up by 12.6%), and in overall trade-weighted terms it is only slightly down (negative 1.3%) for the year.

### Australian Cash & Fixed Interest — Outlook

The RBA surprised the financial markets on Oct. 4 with a smaller than expected 0.25% increase in the target cash rate, to 2.6%. The markets had been expecting 0.5%, and the smaller rise helped fuel a temporary rally in both domestic and global equities as investors wondered whether other central banks would also take a more measured approach to lifting interest rates. In its minutes, the RBA said that "the arguments were finely balanced" between 0.25% and 0.5%, but that the case for 0.25% looked to be the better one: It reduced the risk of accidentally overtightening, given that previous increases in the cash rate still had to work their way through, and would also give the RBA more room to wait and see how domestic and international economic data were behaving. That said, inflation was still too high, and "was likely to require further increases in interest rates over the period ahead." The futures market currently expects that there is another 1.25% of tightening likely by mid-2023.

For the year to date, the S&P Australia Aggregate Bond Index has lost 10.2%, and the prospect of tighter monetary policy from the RBA inflation suggests that bond investors will continue to face headwinds in coming months. Australia's inflation rate (6.2% headline rate in June, 4.9% underlying rate excluding unusually large rises or falls) may not be as troubling as that of some other major economies, but it still needs to be brought back into the RBA's target 2% to 3% range. At some point, the RBNZ will work the

cash rate to a high enough level to put the brakes on the economy and reduce inflationary pressures, at which time, bonds may re-enter the equation as a more attractive option when growth-exposed assets will be facing the impact of an economic slowdown, but that is likely a story for mid- to late 2023.

The Aussie dollar continues to be hostage to wider global developments, notably the 'risk off' behaviour of foreign-exchange investors in a difficult year that has favoured safer-haven options like the U.S. dollar and interest-rate differentials, given the Fed's strong stance to do whatever it takes to bring U.S. inflation under control through higher U.S. interest rates, contrasted recently with the relatively more cautious approach of the RBA. There is a prospect that the 'risk off' investor sentiment and ongoing USD-friendly interest-rate differentials could continue to hold the Aussie dollar down in the near term. The median view of the big bank forecasters is that the Aussie will recover only slightly from its recent USD selloff, to U.S. 65 cents from its current U.S. 63.5 cents level, by mid-2023 but could appreciate thereafter to around 72 cents by the end of next year.

### **Australian & International Property — Review**

Although the wider Australian share market has held up relatively well by international standards, the A-REIT sector has behaved in line with the very weak performance of global listed property. The S&P / ASX200 A-REITs Index is down by 28.0% in capital value and has returned an overall loss of 25.8% including dividends, significantly worse than the S&P / ASX 200's 8.9% loss and 5.3% overall loss.

Global listed property has underperformed global equities as a whole: The FTSE EPRA-NAREIT Global Index in U.S. dollars is down by 31.2% (29.1% including dividends), compared with the MSCI World's loss of 23.9% (22.6% with dividends). In U.S. dollar terms, there were some remarkably large setbacks for eurozone REITs (an overall loss including dividends of 48.3% [and U.K. REITs' overall loss of 46.4%]) as sharply weaker local currencies amplified the impact of lower local REIT prices. The key U.S. market, which accounts for over half of the index, had an overall loss of 27.6%.

### **Australian & International Property — Outlook**

The A-REIT sector got a very brief benefit from the unexpectedly small 0.25% interest-rate hike by the RBA on Oct. 4; since then, however, it has resumed its slide, and the outlook remains demanding. As the September quarter ANZ Bank / Property Council of Australia sector survey showed, nearly everyone (90%) in the industry expects further interest-rate increases; the sector also expects cap rates (used to value property) to rise, causing capital losses; and it is also pessimistic about the outlook for economic growth. There are some subsector upsides: Respondents still expect some capital growth for retirement villages, industrial property, and the recovering tourist trade, but there are losses expected for shopping centres and offices. The office sector has now taken over from tourism as the sector seen as most vulnerable to adverse COVID-19 impacts, presumably because tourism is seen as entering a borders-reopened upswing, whereas offices look to be taking a structural hit from more permanent changes to work practices. The setback to the A-REITs thus far has improved valuations—the forward-looking P/E ratio is 13.7 times expected earnings according to Standard & Poor's—but it may not be enough to trigger sufficient investor interest to reverse the sector's fortunes.

The outlook for global listed property is also tough in the face of rising interest rates and a slowing global economy. In the United Kingdom, for example, Goldman Sachs thinks commercial property prices could drop by between 15% and 20% in the two years to mid-2024, and other markets are also likely to be under the same pressures for some time. Colliers' latest (October) *Global Real Estate Insights* said that, although prices have fallen, there is more to come: Globally, "yields/cap rates will need to move out by a further 75bps, on average. This converts to a 15% correction in capital values, which could be higher, and we expect a range of at least 0%-30% as other factors come into play. The timing at which these changes unfold will vary from 6 to 24 months. By the end of 2023 we should see investment activity bottom out and recover."

### **Australasian Equities — Review**

Like their overseas counterparts, Australian shares have also sold off but less so than many other equity markets, and the S&P/ASX200 Index has shed 8.9% in capital value and recorded an overall loss of 5.3% including dividends. It has helped that the relatively large financials sector—five of the top 10 stocks by market cap are banks—has held up well, and the financials ex the A-REITs are down by only 2.9%. The miners have also been relatively strong, and the S&P/ASX300 Metals and Mining Index is down by only 4.7%. At the other end of the spectrum, IT shares have suffered from the global wariness towards the sector and are down by 31.9%, while the cyclically exposed consumer discretionary shares are down by 22.0%.

### **Australasian Equities — Outlook**

The economy is starting from a strong point. The September monthly business survey from National Australia Bank, or NAB, for example, was outright robust: "Business conditions strengthened further in September on the back of very high trading conditions and are now above their pre-COVID peak. Both the employment and profitability indexes also remain elevated." The labour market remains strong, with the unemployment rate at only 3.5%, and NAB's September quarterly 'consumer stress' survey found that consumer stress remains below average: "Despite higher consumer stress associated with cost of living (now at its highest point since 2018), this was offset by a further easing in stress related to job security (near 4-year lows)." Export commodity prices, though down from their record peak in July, are still very high by historical standards and in AUD terms are up 30% on a year ago.

But this strong environment looks to weaken into 2023. While the NAB consumer stress survey looked solid, other readings show consumers in a wary mood: The Westpac Melbourne Institute October survey, for example, showed household confidence "in deeply pessimistic territory ... The key drags on confidence continue to come from a surge in the cost of living, rising interest rates, and concerns about the near-term outlook for the economy ... the [monetary policy] tightening cycle still has significantly further to run. That is likely to keep the Consumer Sentiment Index firmly in deeply pessimistic territory in coming months." The Westpac Melbourne Institute leading indicator weakened again in September, and Westpac said that "This signal is broadly in line with Westpac's forecast that economic growth will slow from 3.4% in 2022 to 1.0% in 2023, highlighted by a sharp slowdown in consumer spending." Australia does not look like it is headed for a recession—like Westpac, the IMF in the latest *Global Economic Outlook* also thinks that, while Australia will slow down in 2023 to 1.9%, it will keep some modest

growth going—but it is heading for a more difficult part of the business cycle, and shares will for now continue to face headwinds.

### **International Fixed Interest — Review**

International fixed interest has continued to fare very poorly as bond yields have continued to rise in several major markets, always excluding Japan, which has clung to its policy of keeping bond yields unusually low (its 10-year government-bond yield is only 0.26%). In the United States, for example, the 10-year Treasury yield has risen to 4%, a 2.5% increase for the year, and in the U.K., the misguided Truss / Kwarteng minibudget saw the 10-year yield hit 4.5% amid scenes of bond market stress, and although it is now back down to just under 4%, the yield is still up by 3.0% for the year. Eurozone yields are also higher: The German 10-year yield is 2.3%, up 2.5% for the year (it started off in negative yield territory). Overall, significant yield rises have translated into heavy capital losses, and for the year to date, the Bloomberg Global Aggregate in U.S. dollars is down by 20.9%.

### **International Fixed Interest — Outlook**

The immediate near-term outlook for bonds remains challenging as inflation outcomes have continued to disappoint and as central banks look more likely to push interest rates higher than previously anticipated.

In the U.S., for example, the September inflation rate was 8.2%, only slightly less than August's 8.3%, but, more significantly, the 'core' rate of inflation, ex volatile food and energy prices, accelerated to 6.6% from August's 6.3% and was the highest rate of core inflation since August 1982. Unsurprisingly, the financial markets concluded that the Fed will have to counter with further significant interest-rate rises: Its current target range for the federal-funds cash rate is 3.0% to 3.25%, and the most recent pricing in the futures market (as summarised by the FedWatch tool) says there is an 80% probability of the range being hiked by 1.5% by the end of this year and a strong 75% chance of a further increase of either 0.25% or 0.5% in the first half of next year. In the U.K., the inflation outcomes have been worse again, with a headline 10.1% rate in September and a 'core' reading of 6.5%, up from August's 6.3%, and the Bank of England will also have to move more actively than previously expected.

The more medium-term outlook for bonds may be improving. In the October Bank of America, or BoA, global fund manager survey, the respondents agreed that the fed-funds target range would indeed move higher than they had previously anticipated, but they also felt that the peak point of monetary tightening will be earlier in the piece (first quarter of next year) rather than the second-quarter peak they had previously picked, and a small but growing minority think that short-term interest rates will be lower in 12 months' time than they are today. If there is indeed this 'pivot' from the Fed (and from other central banks in the same position) towards an earlier than expected easing—if, for example, economies show signs of falling into serious recessions and/or inflation has finally started to ease—then bonds could potentially rally next year.

### **International Equities — Review**

Although there have been intermittent rallies, overall, global equities have continued to fall this year, and to date the MSCI World Index is down by 23.9% in U.S. dollars. All of the major markets are down by

substantial amounts in U.S. dollar terms, ranging at the low end from the 21.6% fall in the U.K.'s FTSE100 Index and the 22.0% fall in the U.S. S&P500, through to, at the high end, the 31.1% fall in the U.S. Nasdaq and the 30.3% fall in Germany's DAX. A benefit of the lower Aussie dollar, however, is that it has helped to shield local investors in overseas shares from some of the impact; in AUD terms, the MSCI World is down by 12.7%.

Emerging markets have been even weaker, and in the MSCI Emerging Markets Index is down 28.6% in U.S. dollars. Apart from some small petroeconomies, which have been beneficiaries of high world oil prices, the only other good news has been the Brazilian market, which has benefited from strong commodity prices and which helped the local Bovespa benchmark index to a 17.4% gain in U.S. dollars. The other key emerging markets—China, India, and Russia—all registered USD losses: India's Sensex is off by 8.4%, the Shanghai Composite by 25.3%, and Russia's RTS by 34.8%.

### **International Equities — Outlook**

Potential sources of support for world shares are limited. One is the current earnings reporting season, where businesses' operating results are still holding up reasonably well, albeit reflecting a period largely predating the latest rounds of monetary policy tightening. Another is the strength of the energy shares: For the year to date, the FTSE Global index of oil and gas producers is up 24.0%, and suppliers to the energy trade are doing reasonably well, with oil equipment and services up by 8.8%. And, as noted in the international fixed-interest section, some investors are beginning to anticipate an eventual loosening of monetary policy sometime next year.

Otherwise, however, the immediate outlook has darkened. The global economic business cycle has weakened markedly. The J.P. Morgan Global Composite Index, a good measure of aggregate global business activity, showed that business activity actually contracted in both August and September, led by falls in output in the real estate industry and in parts of heavy industry (forestry and paper, construction materials, chemicals, and cars). And a range of forecasters have weighed in with lower expectations, notably the IMF in its latest World Economic Outlook, which said that "More than a third of the global economy will contract this year or next, while the three largest economies—the United States, the European Union, and China—will continue to stall. In short, the worst is yet to come, and for many people 2023 will feel like a recession." The latest (October) *Wall Street Journal* quarterly poll of U.S. forecasters is picking that the American economy will go through a short recession next year, with GDP expected to fall in both the March and June quarters.

The latest surveys of the big institutional fund managers are also downbeat. S&P Global's October survey of U.S. fund managers showed that while very short-term (next 30 days) risk appetite had picked up, a function of ongoing earnings performance and improved valuations, equity managers otherwise expected a poor outlook: "The improvement in near-term market performance is not expected to last, however, with the survey panel on average expecting the US equity market to lose further value by the end of the year. The degree of pessimism recorded for US equities is nevertheless the least marked for any major market. The UK is suffering the greatest extent of bearish views, followed by the EU and then China, the latter notably seeing a reversal of prior bullishness recorded in the summer."

The October Bank of America fund manager survey was bleaker again. A large majority of those surveyed think a global recession is likely, and in response, they are holding much higher levels of cash than usual (the highest in 20 years) and are taking a highly defensive approach to the assets they have deployed. They like utilities, consumer staples, and healthcare, and they are avoiding tech, industrials, and consumer discretionary shares. They are also heavily underweighting the regions they think will fare worst in coming months (notably the eurozone and the U.K.). Eventually, improved valuations on further price weakness, and a turnaround in the global monetary policy tightening cycle, will put a floor under prices, but for now conditions remain difficult.

Performance periods unless otherwise stated generally refer to periods ended Tuesday, Oct. 18, 2022.

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