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Economic Update: Australia
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Summary

- Risk sentiment is becoming patchier after a strong initial start to 2023.
- Labour markets remain strong, and inflation, while receding in the United States, remains elevated, with central banks still saying that bringing inflation to target will take time.
- Market sentiment across interest-rate markets has pivoted more toward the US Federal Reserve's terminal view of the hiking cycle, though markets continue to press an easing cycle unfolding in late 2023 and 2024.
- The Reserve Bank of Australia has turned more hawkish in response to a stronger inflation pulse, and multiple rate increases look to be ahead to contain inflation.
- The economic outlook globally has improved, but it would be correctly categorised as *less bad* as opposed to *good*.
- Earnings are expected to remain under the spotlight given growth, cost, margin, and cost of finance jitters.

Australia Cash and Fixed Interest—Review

The Reserve Bank of Australia lifted the cash rate target by 25 basis points to 3.35% in February and delivered hawkish language including "further increases…needed over the months ahead".

"Further increases" is notable for the use of the plural, which locks in the prospect of at least two more 25-basis-point hikes over the months ahead. Financial markets have gone from pricing in a 3.75% cash rate by October to 4.15%. This move has been somewhat assisted by the markets also anticipating higher interest rates in the United States.

In public remarks in front of the Senate Economics Legislation Committee, Governor Lowes noted that "inflation [was] way too high and it needs to come down". He also noted that the risks at the moment are "two-sided" with the "risk we haven't done enough on interest rates".

The yield on Australia 10-year government bond has lifted approximately 45 basis points in the last month, to almost 3.8%, broadly in line with its US equivalent. The yield is 150 basis points higher than the same time a year ago.

The Australia dollar eased somewhat over the past month, to around 0.69 against the United States dollar at the time of writing. While the market's reassessment of the Reserve Bank's prospective interest-rate settings would normally be Australia-supportive, movements in the US dollar and more-patchy risk sentiment has dominated in the near term.

Australia Cash and Fixed Interest–Outlook

Market expectations are that Australia's cash rate target will increase by approximately 80 basis points over early 2023, or three roughly 25-basis-point increases, with a terminal rate around 4.15%.

Whilst an aggressive movement higher—and this follows sharp rises in 2022—some context is needed. The federal-funds rate in the United States is expected to move above 5%, the official cash rate in New Zealand toward 5.3%, the Bank of Canada to 4.7%, and the Bank of England to 4.4%.

Central banks remain vigilant, talking in strong tones, a natural consequence of a high inflation starting point and wariness over seepage into inflation expectations. No central bank wants to declare victory on inflation only to be forced back to the hiking table. It is better to do more up front—a "job to be done".

As such markets continue to look for a slightly overextended tightening cycle, that is followed by rate reductions in 2024. Westpac's recently released February 2023 Market Outlook hooks into this view, expecting an "abrupt slowdown" with activity effectively stalling midyear and a more constructive view on inflation than the Reserve Bank of Australia, courtesy of disinflationary pressures easing through channels such as the supply side. Australia's 10-year bond yield is projected by Westpac to ease toward 2.5% by the end of 2024.

Projections for the Australian dollar are biased higher. Westpac expects a stronger Australian dollar/US dollar, driven by a US dollar downtrend re-exerting itself, as disinflation extends into services, with labour market pressure expected to ease. ANZ Economics shares a similar view, projecting a rising profile for the Australian dollar, partially led by the US dollar returning to fair value.

FXStreet participants have a mild bearish bias over the month ahead but are more constructive over the quarter on the Australian dollar/US dollar, with 50% bullish, 25% bearish, and 25% neutral.

Antipodean currencies have been heavily influenced by risk appetites recently, meaning global dynamics have been dominant. This is expected to continue, with the market view of the interest-rate cycle (rate cuts will eventuate) versus the US Federal Reserve rates' higher-for-longer narrative having a big say. Fixed-income markets have gravitated more toward the Federal Reserve, but it is not clear that the same degree of repricing has taken place in the foreign exchange and equity markets. Purists say markets are efficient, but we also know that markets do not always sing to the same tune at the same time.

Australian & International Property—Review

Taking cues from interest-rate markets, the S&P / ASX200 A-REITs Index has had a buoyant start to 2023, rising 7.7% for the year to date, though it is nonetheless down 8.6% on a year ago.

Global listed property has also started on a firmer note, though well down when looking at annual performance. The FTSE EPRA-NAREIT Global Index in US dollars for the year to date is up 7.4%, though down 14.5% on 12 months ago.

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Strong year-to-date rises have been particularly notable in developed Europe/eurozone and the Americas.

Australian & International Property — Outlook

The key challenge for Australian and global real estate is adjusting to the new cost, and availability, of money. These were key themes from the ANZ-Property Council Survey December 2022 survey, with property sentiment back below prepandemic levels.

On top of that, there are more development factors to be mindful of, including the reimagination and re-engineering of the office for postpandemic work and the enticement of employees. Construction costs have surged. Concerns remain that a downturn will damp demand for space, vacancy rates will rise, and values will fall.

A rising cost of capital will flow into cap rates and valuations, but there is little agreement to what degree, with building characteristics and specifics also influential. These include sector type, market and lease terms, asset quality, and the asset's net operating income.

For borrowers, the cost of capital is one factor to consider that impacts borrowing costs. Other factors include lower loan/valuation ratios and the impact on covenants, increased scrutiny of loan serviceability, and more reticence from credit providers.

Property, and assets in general, need to be mindful of any potential upward movement in terminal or neutral interest rates, where monetary policy is neither stimulating nor restricting demand. Neutral interest rates declined over the past 20 years, which dragged down borrowing rates through a structural lens and buoyed asset prices. Some argue neutral interest rates are now on the rise.

JLL Global Real Estate Outlook for 2023 takes a glass-half-full view, noting the economic slowdown is likely to be relatively short and shallow (not the author's view), and the slowdown is coming from a position of strength amid tight labour markets. It notes capital sitting on the side lines and expects appetites for risk to return.

Global Infrastructure — Review

The S&P Global Infrastructure Index in US dollars is 4.3% higher for the year to date and largely flat on a year ago.

The MSCI World Infrastructure Index (USD) fell 3.9% in 2022, whereas the MSCI World Index declined 17.7%. The Infrastructure Index underperformed for January. The dividend yield on the World Infrastructure Index was reported at 3.9%, at a P/E of 18.3, compared with 18.2 for the MSCI World Index.

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Global Infrastructure—Outlook

Look no further than recent weather events in New Zealand and Cyclone Gabrielle or Australia's floods and fires, in part driven by climate change, which involve huge rebuild efforts including infrastructure. They also reinforce the need to adapt and have infrastructure that is fit-for-purpose to deal with more variable economic conditions. Other key macro drivers for infrastructure include greener and more-sustainable solutions along with energy security needs.

Stepping aside from economic disruption and the near-term economic cost of weather-related events including Cyclone Gabrielle, the bigger picture is one of decision-making, fit for purpose infrastructure, and risk management for the long haul that demands some serious action. Globally, we are potentially talking about a multidecade investment bonanza to mitigate risks. Nations have underinvested, and Mother Nature is now expressing her wrath.

Questions about the size of infrastructure deficits and how fit-for-purpose infrastructure is in a rapidly changing environment are likely to be raised more often.

With still-persistent inflation, volatility, and deteriorating conditions (climatically and geopolitically), infrastructure investments exhibit greater resilience compared with equities.

Australia Equities—Review

The S&P / ASX200 Index is up 2.6% on a year ago, boosted by a strong start to 2023 of 5.6%. Metals and mining rose 6.4% since the start of the year. Banks are up 2.6% for the year to date.

Australia Equities—Outlook

December-quarter inflation figures underscored a clear inflation problem and a need for a slower economic trajectory with elevated core and service sector inflation. Consumer price inflation lifted to 7.8% per year from 7.3%. The 'trimmed mean' measure of core inflation rose to 6.9% from 6.1%, well above the Reserve Bank of Australia's forecast of 6.5%.

Strong inflation bakes in softer economic growth if the central bank is doing its job.

Like many other countries, the labour market in Australia remains very tight. Unemployment recently lifted to 3.7%, but economists pointed to noise around that, with the January employment figures noted by National Australia Bank as "stronger than it looks". Job vacancies and job ads are at very high levels. A tight labour market is lifting wages; this is good for consumption but bad for labour costs and the potential evolution of price-setting behaviour.

The consumer showed strength in January, with spending rising 1.7%, more than reversing the small fall seen in December.

Like many central banks, the Reserve Bank of Australia is talking tough, noting "The Board's priority is to return inflation to target. High inflation makes life difficult for people and damages the functioning of

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the economy. And if high inflation were to become entrenched in people's expectations, it would be very costly to reduce later. The Board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary."

With consumer sentiment weak and house prices under pressure, there are signs of a pending slowdown in spending, which in turn is expected to push growth toward 1% in calendar-year 2023. That is weak but avoids a recession and contrasts with New Zealand, where one is projected by both the Reserve Bank of New Zealand and New Zealand Treasury.

Business confidence and conditions improved over summer according to National Australia Bank's business survey, and businesses report difficulty in finding staff.

This backdrop is eerily like many nations' and makes a challenging environment for earnings. As well as pressure from slowing growth (impacting sales), a broader story will come from margins and who wears the economic downturn: employees or profits? Continued tightness in the labour market will put more pressure for an earnings, investment, and margin-induced recession.

According to Standard & Poor's estimates, the trailing P/E of the S&P / ASX 200 is 15.2 (last month 14.2) and the forward P/E is 14.5 (last month 13.7) with a dividend yield of 4.4% (previous 4.6%).

International Fixed Interest—Review

A tug-of-war developed between the US Federal Reserve and markets over late 2022 and early 2023, with the former signalling rates needed to remain higher for some time and the latter anticipating the federal-funds rate coming down in late 2023. A swing to the latter saw yields drop and the US 10-year bond ease to below 3.5% in early 2023. At the time of writing, the 10-year bond yield had risen back toward 3.8%, broadly where it closed in 2022.

Economic developments have been more in line with the US Federal Reserve of late. Nonfarm payroll employment in the US private sector rose by 443,000 in January 2023, following an upwardly revised 269,000 gain, exceeding market expectations of 190,000, and the unemployment rate fell to a 53-year low. While US CPI figures for January showed another fall in the headline rate to 6.4% from 6.5%, core inflation remains elevated at 5.6% and service sector inflation is still accelerating.

Market expectations for the peak in the fed-funds rate have risen to 5.2% from 4.9% in the past month. The terminal rate now sits above the Federal Reserve's dot plot projection.

The S&P Global Developed Sovereign Bond Index is up 1.46% for the year to date but down 8.7% on a year ago.

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International Fixed Interest—Outlook

Fixed income continues to be strongly dictated by the path of the US Federal Reserve. Its communication has been unwavering, and data is erring toward its view. The stern messaging continued after the release of the January CPI data, with Federal Reserve Bank of Richmond President Thomas Barkin saying on Bloomberg TV that if inflation persists above the central bank's targets, "maybe we'll have to do more."

In Federal Reserve Chair Jerome Powell's own words, "Although inflation has moderated recently, it remains too high. The longer the current bout of high inflation continues, the greater the chance that expectations of higher inflation will become entrenched." The market's view is being increasingly tested, and Federal Reserve officials have been united in their communication.

While bond yields have moved higher in anticipation of a higher terminal fed-funds rate, fixed income continues to offer value in an environment where the spectre of a hard economic landing and recession remains front of mind. Fixed income also has its last name back, with income to be earned. Yields are at levels not seen for a decade, and there is a real alternative to equities. In an environment of heightened risk around earnings, fixed income offers the ability to damp portfolio risk. This did not play out in 2022, but fixed-income yields are now considerably higher.

At this juncture, the balance of risks, between a recession driving looser monetary policy, look equal, with the risks of inflation remaining sticky. Higher yields have tightened financial conditions, which will help slow growth and damp inflation. We also need to acknowledge that key drivers of inflation have pivoted; we are in less of a globally connected world.

A key issue going forward is neutral interest rates, the level of interest rate where central banks neither have the foot on the accelerator or the brake. Neutral rates across the developed world declined for decades, a reflection of an excess supply of savings relative to investment demand.

Some now point to possible rises in neutral rates, pointing to the significant investment required to fund the energy transition and the shift from a world of abundance (just-in-time production, labour availability) to scarcity (just-in-case production, demographic acceleration of an aging population reducing the workforce).

One area to watch is the normalizing of monetary policy in Japan. The Bank of Japan's balance sheet used to be about the same size relative to the economy as for the Federal Reserve and the European Central Bank. Now, it holds assets that are in excess of 100% of Japan's gross domestic product. How will the Bank of Japan normalise policy? There is pressure to, with inflation now 4%.

International Equities—Review

Difficult, that is one way to describe 2022. Most will be pleased that the door has been closed on that year with developments and returns dominated by central banks. This was led by the US Federal

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Reserve moving from accommodative monetary policy to one of the more aggressive monetary policy-tightening cycles to curb inflation, exacerbated by geopolitical ructions.

Sentiment is far better in 2023. The S&P 500 has risen 7.3% for the year to date, pared back the annual loss to 6%, and delivered a total return of 6.3% in January.

January was a buoyant month around the globe. In local-currency terms, the Nasdaq 100 total return measure lifted 10.7% in January. The Hong Kong Hang Seng total return for January was 10.4%. The MSCI World Equity Index rose 7.1%. The German DAX 30 increased 8.7% in January. The FTSE 100 total return measured 4.3%.

International Equities—Outlook

Less bad but not good either is the upshot from the World Economic Outlook Update prepared by the International Monetary Fund, a summary as good as any.

“Global growth is projected to fall from an estimated 3.4 percent in 2022 to 2.9 percent in 2023, then rise to 3.1 percent in 2024. The forecast for 2023 is 0.2 percentage point higher than predicted in the October 2022 World Economic Outlook (WEO) but below the historical (2000–19) average of 3.8 percent. The rise in central bank rates to fight inflation and Russia’s war in Ukraine continue to weigh on economic activity. The rapid spread of COVID-19 in China dampened growth in 2022, but the recent reopening has paved the way for a faster-than-expected recovery. Global inflation is expected to fall from 8.8 percent in 2022 to 6.6 percent in 2023 and 4.3 percent in 2024, still above pre-pandemic (2017–19) levels of about 3.5 percent.

“The balance of risks remains tilted to the downside, but adverse risks have moderated since the October 2022 WEO. On the upside, a stronger boost from pent-up demand in numerous economies or a faster fall in inflation are plausible. On the downside, severe health outcomes in China could hold back the recovery, Russia’s war in Ukraine could escalate, and tighter global financing costs could worsen debt distress. Financial markets could also suddenly reprice in response to adverse inflation news, while further geopolitical fragmentation could hamper economic progress.”

Some investors continue to take the view that slowing inflation is allowing central banks to first decelerate the tightening cycle, a precursor to pausing, and then rate reductions. Inflation is indeed coming down, and bulls point to a pending easing in shelter costs as adding more disinflation momentum. It is rare for equities to deliver back-to-back negative return years. The labour market, while strong around the globe, lags the general economy.

Bulls can also point to a more optimistic tone across Europe, where recessionary fears have been somewhat allayed, and in China, where the post-COVID-19 period has delivered a positive boost. Both Europe and China also seem to have valuation support and have benefited from the retreat in the US dollar.

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While the market's attention might be on the next interest-rate move or policy turn, real economies are yet to reflect the full brunt of the tightening undertaken in 2022, which will fully hit home in 2023. This makes for a challenging environment.

There are reasons for caution on numerous levels.

The first is the outlook for interest rates. Fixed-income markets have retreated (higher yields), erring more toward the US Federal Reserve interest-rate projections, but we are yet to see the same across equities, which have taken on more of a patchy mood but with a solid tone of late.

The second surrounds the outlook for earnings. IBES data from Refinitiv, which is based on fourth-quarter earnings results across 344 S&P 500 companies, are estimated to have fallen 2.8% from a year ago. One reason for falling earnings has been a tighter labour market, which adds to business costs and puts pressure on margins.

Whilst an economic positive, the longer the labour market remains strong (and firms hoard labour), the greater the pressure on earnings, margins, and business investment—that is, business profits' share of national income declines. Surging profits have been delivered by both sales growth and margin expansion over the past decade. The latter is coming under pressure now, but the former is yet to, with economies delivering solid nominal gross domestic product growth around the globe.

According to FactSet, "69% of the companies in the S&P 500 have reported earnings for the fourth quarter. Of these companies, 69% have reported actual earnings per share (EPS) above the mean EPS estimate, which is below the 5-year average of 77% and below the 10-year average of 73." Utilities and health generally reported positive surprises. Conversely, negative earnings surprises and downward revisions to earnings estimates were centred in the communication services, information technology, and consumer discretionary sector.

FactSet notes that analysts expect S&P 500 earnings to worsen then recover in the second half of 2023.

- "For Q1 2023 and Q2 2023, analysts are projecting earnings declines of -4.2% and -2.9%, respectively."
- "For Q3 2023 and Q4 2023, analysts are projecting earnings growth of 3.4% and 10.5%, respectively. For all of CY 2023, analysts predict earnings growth of 3.0%."
- "The forward 12-month P/E ratio is 18.4, which is below the 5-year average (18.5) but above the 10-year average (17.2). It is also above the forward P/E ratio of 16.7 recorded at the end of the fourth quarter (December 31)".

Earnings estimates have generally been falling, and the million-dollar question is whether markets have found a base. At least going by the jobs market, it is looking increasingly likely that an earnings recession will be recorded (two negative quarters of earnings growth) with the economy not yet in a recession. Reconciling the two can partly be put down to margins simply receding from elevated levels.

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Third, there has a welcome reprieve in geopolitical angst, but we would be naïve to think it has disappeared.

Finally, better sentiment in 2023 needs to be acknowledged on signs of moderating inflation, but taming inflation is a war against core inflation, not a falling-headline-depicted battle. Risks remain of further macroeconomic deterioration and persistent inflationary pressure.

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