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Economic Update: Australia
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Summary

- Markets were increasingly erring toward the United States Federal Reserve view of the trajectory for interest rates, namely higher for longer.
- When rates rise, something invariably breaks.
- Financial stability is now a consideration following the issues with Silicon Valley Bank and others that has seen interest-rate-ascent expectations rescinded and driven fixed-income yields lower. While financial stability is a consideration for central banks, inflation signals remain sticky, making for a prickly environment.
- For now, SVB appears a sentiment issue rather than a systemic one; policymakers are working hard to make sure it remains that way (and the European Central Bank ploughed ahead and hiked), but market tentacles are very interlocked, as we know from the global financial crisis.
- The environment remains uncertain and unclear, which in a normal environment would urge caution favouring cash, infrastructure, and bonds over equities and property. Markets have not been normal for a long time, though, and this is one of the challenges we face.
- The Reserve Bank of Australia signalled a subtle shift in tack suggesting potential for a pause, and global ructions have accentuated a view that the cash rate could be lower by year-end. An ongoing tight labour market could challenge that.

Australia Cash and Fixed Interest—Review

It all started normal enough, with short-term interest rates generally pushing higher on expectations that central banks would be lifting rates. Then it all reversed.

The Reserve Bank of Australia lifted the cash rate target by 25 basis points to 3.60% in early March and noted that "further tightening of monetary policy will be needed to ensure that inflation returns to target and that this period of high inflation is only temporary." Some economists did note hints of softer tones in the assessment.

Major variables on the watchlist included the global economy, trends in household spending, and the outlook for inflation and the labour market.

After starting February at just under 3.5%, the Australian 10-Year Government Bond yield rose to around 4% by month-end before giving back those increases in March, taking a lead from the US equivalent.

After peaking around 0.71 against the U.S. dollar at the end of January, the Australian dollar weakened, subsequently easing to 0.66 in early March. The initial catalyst was higher terminal interest expectations for the U.S. federal-funds rate. The Australian dollar has subsequently clawed back some lost ground.

Australia Cash and Fixed Interest—Outlook

Market expectations of the path for interest rates via cash rate have been revised significantly, a reflection of a rapidly changing global environment but also local specifics and softer language from the Reserve Bank of Australia.

Latest expectations priced into the forward curve are that the Reserve Bank of Australia could be cutting by the end of 2023. This follows similar sentiment in the United States.

To put that in perspective, market expectations after the Reserve Bank of Australia's March hike were for rates to rise to 4%. Markets had eased off from pricing in a 4.25% terminal rate before the March decision to 4% after it. Westpac has lowered its terminal rate for the Reserve Bank of Australia in this tightening cycle to 3.85% from 4.1%.

Prospects for lower terminal rates and cracks in the global financial system manifesting across the real economy drive projections for the Australian 10-year bond yield lower. Westpac is projecting a move to 2.5% by 2025, broadly mirroring the U.S. equivalent bond. Conversely, National Australia Bank is projecting a more stable trajectory for longer-term rates over the coming two years.

The bias remains across many forecasters for the AUD/USD to rise over the coming year, heavily influenced by a USD downtrend dragging it back toward notions of fair value. National Australia Bank is projecting 0.78 by year-end. Westpac has a similar view, though less aggressive in nature over 2023, and projections are moving around, as are interest-rate expectations.

Risk aversion would typically favour the U.S. dollar at this juncture but not necessarily when the U.S. banking system is a key focal point.

FXStreet participants are bearish the AUD in the near term, but more constructive a month and quarter out.

Australian & International Property—Review

The S&P / ASX200 A-REITs Index has eased back after an initial strong start in 2023. The index is up 2.9% for the year to date (it was up 7.7% a month ago), though down 12.6% on a year ago.

The FTSE EPRA-NAREIT Global Index in U.S. dollars for the year to date is down 1% and 20.8% on a year ago. Month-to-date, the index is down 4.3%. Europe is down 7.2% for the month to date.

Australian & International Property—Outlook

Quality remains a dominant theme when soothsayers look to the years ahead for commercial property.

Key questions also surround the impact of slower growth and remote work on vacancy rates. The challenges were laid bare in a recent Bloomberg article.[1]

[1] https://www.bloomberg.com/news/articles/2023-03-09/work-from-home-shift-spurs-office-building-defaults

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The demise of Silicon Valley Bank is naturally drawing attention to business models that could be exposed to recent rises in interest rates and the potential for those rises to be maintained to contain inflation.

A month ago, the major challenges for commercial property were interest rates and valuations. Cap rates were lagging interest-rate movements.

Now, attention will broaden and include the ability to refinance and access to credit. As one scribe noted, SVB and subsequent events looks like a "baby version" of the global financial crisis. Being a baby version does not mean you underestimate the potential impact of debt becoming hard to access as refinancing at higher rates needs to take place.

A key message from the SVB saga is that business models conditioned to incredibly low interest rates could be exposed. The past year has seen a huge reshaping in both the level of interest rates and the yield curve. This has major impacts on government finances, financial institutions, corporate leverage, households, and bond portfolios.

The hope is that commercial property will navigate the challenges ahead. There are more concerns being expressed around commercial property or the leveraged loan market (think private equity), though. On some levels, this is natural as people look for the next weakest link. But when interest rates move up quickly, realignment occurs, and unfortunately some things—and sectors—break.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is largely flat so far for the month of March, up 1.3% for the year to date and down 1.4% on last year.

The MSCI World Core Infrastructure Index (USD) reported a negative 4.2% gross return in February.

Global Infrastructure—Outlook

The infrastructure sector remains favoured, backed by the drive toward reducing emissions, clean energy investment needs, and investment in renewables.

The basics of risk management are also coming back into play, with the crisis in Ukraine reinforcing supply-chain dependency and forcing a rethink on supply chains and self-sufficiency.

Infrastructure is aligned with the digital age. The World Economic Forum has been noting the need for inclusive, secure, and equitable digital infrastructure for the world. This includes data centres, fibre optic networks, and servers with the United Nations projecting that two thirds of the world's population will live in urban areas by 2050.

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Around the corner is the Global Infrastructure Summit for 2023, being held in Berlin. "Navigating energy insecurity, market volatility and geopolitical tensions: an infrastructure roadmap" is an apt description of many factors in play.

With government finances under rising pressure to cover the operational basics such as healthcare, education, pensions, and cost-of-living pressures, it seems inevitable the private sector will become a stronger partner to fund critical infrastructure needs.

With inflation taking time to come down, this backdrop may provide a further push to infrastructure fundraising, as these assets often have longer-term inflation-linked contracts and offer a degree of protection.

Many countries face tough trade-offs over the decades ahead, with huge operational and capital spending needs and climate change demands, with some countries having greater flexibility (less debt) than others. Attention could turn more and more toward raising taxes.

Australasian Equities—Review

Australian equities are largely following global trends. After a buoyant start to 2023, gains have been eliminated.

The S&P / ASX200 Index is down 2.6% on a year ago; this was somewhat helped by strong gains in January and February offsetting movements in 2022. Initial gains have all but been eliminated in March (down 3.4%), leaving the index down 0.4% for the year to date.

Over the month of February, utilities was the strongest performer (3.4%), followed by IT (2.7%), industrials (1.5%), and consumer staples (1.1%), though February appears a long time ago given recent developments.

Australasian Equities—Outlook

Events overseas have overtaken domestic considerations in Australia, though some specifics are worthy of note.

Markets have been quick to jump onto some comments from RBA Governor Philip Lowe that insinuated that a pause in the hiking cycle could take place in April, and more recently global developments have accentuated that view. Some economists including Westpac are now calling a pause in the tightening cycle though resuming tightening in May. Specifically, Lowe noted "with monetary policy now in restrictive territory, we are closer to the point where it will be appropriate to pause interest-rate increases to allow more time to assess the state of the economy". The Bank of Canada has hit the pause button, and markets are keen on signals that others may follow suit.

Softer-than-expected data in Australia adds some conviction to that view as well. Consumer sentiment is near a 30-year low. The RBA noted that "The monthly CPI indicator suggests that inflation has peaked in Australia." "Growth over the next couple of years is expected to be below trend. Household

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consumption growth has slowed due to the tighter financial conditions and the outlook for housing construction has softened." "At the aggregate level, wages growth is still consistent with the inflation target and recent data suggest a lower risk of a cycle in which prices and wages chase one another."

Westpac's card tracker for the first two weeks of March shows further slowing, adding conviction to views that consumers are tightening the belt.

Seek job ads decreased 1.6% month on month in February and are down 12.2% year on year. House prices are down 9% from their peak, and monetary policy has a more direct effect given the prevalence of floating loans compared with fixed-rate loans in New Zealand.

While any central bank's potential pivot is encouraging for risk assets and equities, we should not lose sight of the fact that a tightening bias remains, and that inflation is not projected to return to the 2%-3% target until mid-2025.

February's labour market report showed above consensus employment growth (65,000 versus consensus of 50,000) and the unemployment rate fell back to 3.4% and its December level. The labour market and the stickiness of service sector inflation remains a key inflation battleground.

The Australian earnings (and U.S.) reporting season contained some consistent themes. Overall. companies delivered reasonable revenue figures but pressure on earnings. Nominal growth continues to support the top line, but the bottom line and margins are being eaten into by costs that are proving more difficult to pass on. These themes are expected to persist through 2023.

One key aspect to financial system ructions is that nations with a highly concentrated banking system (that is, fewer second-tier and small players) with regulatory supervision from an overarching entity could be better placed (that is, not state by state such as regional banks in the United States).

According to Standard & Poor's estimates, the trailing P/E of the S&P / ASX 200 is 15.4 (last month 15.2), and the forward P/E is 14.1 (last month 14.5) with a dividend yield of 4.4% (previous 4.4%).

International Fixed Interest—Review

To say the last month has been one of contrasting developments is an understatement.

Last month's noted tug-of-war between the U.S. Federal Reserve and markets over the trajectory for interest rates progressively erred more toward the Federal Reserve (and beyond) view—a higher terminal rate for the U.S. federal-funds rate and for an extended period. Successively strong payrolls figures, in both January and February (311,000 in February alone), a sticky private consumption expenditure deflator read, and general health across the overall economy contributed to the U.S. 10-year bond yield rising to 4%.

Construction employment, which is driven by the procyclical construction sector, continued to increase. The industry added 24,000 jobs in February, even amid a decline in the housing market. In aggregate,

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more mixed signals are appearing from the labour market. Payrolls remain strong, and businesses are struggling to find staff, but wages are cooling, as is gross income.

Curves continued to invert (higher two-year rate relative to the 10-year) on expectations of tighter monetary policy and growth bumps.

The collapse of SVB, a specialist in tech industry banking, and the biggest failure since 2008 saw the U.S. 10-year bond yield drop back to 3.5% and the two-year yield drop close to 100 basis points, as systemic risks were contemplated. Whilst SVB is exposed to the tech industry, the failure underscores the impact that rapid rises in interest rates are having on small lenders, and it follows crypto-friendly Silvergate Capital liquidating and winding down operations. Signature Bank was seized after regulators lost confidence in management, and a recent Bloomberg article noted the organisation faced a criminal probe prior to the collapse. Another has noted SVB did not have a chief risk officer for most of last year. It appears mismanagement could be a common theme.

The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of 2.5% (with 2.1% for the month to date) but a negative 7.5% return over the year.

International Fixed Interest—Outlook

Global bonds will continue to take their lead from U.S. development, the U.S. Federal Reserve, and the more recent financial stability concerns, with the reaction to the latter improving after a large risk-off initial reaction.

Fed Chairman Jerome Powell's recent semiannual Monetary Policy Report provided a useful summary of the economic side, though it was recorded prior to financial stability concerns emerging.

- "The data from January on employment, consumer spending, manufacturing production, and inflation have partly reversed the softening trends that we had seen in the data just a month ago.
- From a broader perspective, inflation has moderated somewhat since the middle of last year but remains well above the FOMC's longer-run objective of 2%.
- That said, there is little sign of disinflation thus far in the category of core services excluding housing, which accounts for more than half of core consumer expenditures.
- Despite the slowdown in growth, the labour market remains extremely tight.
- We continue to anticipate that ongoing increases in the target range for the federal-funds rate will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time. In addition, we are continuing the process of significantly reducing the size of our balance sheet.
- Although inflation has been moderating in recent months, the process of getting inflation back down to 2% has a long way to go and is likely to be bumpy.
- As I mentioned, the latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated.
- Restoring price stability will likely require that we maintain a restrictive stance of monetary policy for some time."

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Market expectations prior to SVB developments were that the U.S. fed-funds rate will rise beyond 5.5% (up 20-30 basis points on a month ago) and the projected easing in policy continues to be pushed out. Some commentators were calling 6% for the fed-funds rate ("the 6% club"). Expectations toward the trajectory for the European Central Bank had likewise risen around 30 basis points.

Economic data continues to support the case for higher rates, with the U.S. Consumer Price Index excluding food and energy prices rising 0.5% in February, or 5.5% on a year ago. Service sector inflation rose 7.6% and remains sticky.

However, when rates rise—and the past year has seen one of the most aggressive tightening cycles in history—something invariably breaks. We may have hit that moment with SVB and rising financial and credit stresses being closely watched. This reinforces the tightrope that the U.S. Federal Reserve is walking, as possible systemic issues start to emerge and need to be balanced against broader economic developments. While this does not appear to be a systemic issue, it is a certainly a sentiment one, and regional banks, nonbank finance providers, commercial property, and leveraged loans are seen as possible candidates for difficulties given the impact of higher interest rates.

Market expectations are that the U.S. Federal Reserve will continue to raise interest rates, but the mood has shifted from 25 or 50 basis points to 0 or 25 basis points, a lower terminal rate, and markets are back to pricing in lower rates in late 2023 and 2024 with financial stability swatting aside Chairman Powell's statements. Look no further than the roller-coaster two-year Treasury yield, which, after breaking through 5% for the first time since 2007, dropped to 4% and is now back to 4.3%.

The ECB did, however, plough ahead amid financial sector ructions and raise rates, and sentiment is divided over what the U.S. Federal Reserve should do, with many still arguing for higher rates to contain inflation. The ECB's decision to still raise by 50 basis points at its March meeting despite Credit Suisse's woes and concerns over the potential for worries to broaden highlight that central banks have confidence that identified issues will not turn systemic. It also reinforces the importance of monetary and financial stability decision-making being kept separate, despite the obvious overlap. It is the unidentified issues that we should be wary of.

The drop in the U.S. 10-year bond to 3.5% from 4% serves to reinforce both the yield and income value on offer across fixed-income markets but also the liquidity the market offers in an environment Powell notes as "bumpy". The SVB situation is a reminder that Fed hikes are having an effect, even if the economy has held up so far, which in turn limits prospects to interest rates rising much further.

Attention will be on credit markets as potential harbingers of deeper problems. Banks share sentiment has improved in recent days before taking further hits as more concerns emerged. Ratings agency Moody's downgraded the debt rating of collapsed New York-based Signature Bank deep into junk territory and placed the ratings of six other U.S. banks under review for a downgrade.

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While financial stability concerns are dominating narratives and commentary at the time of writing, two other issues are worth mentioning. The first is U.S.-debt-ceiling haggling. Many countries face difficult choices ahead, with elevated debt levels and tough spending/tax choices. President Joseph Biden has presented a plan to raise taxes. That will be hotly debated, but it is a potential narrative that other countries will need to pursue to maintain prudent or nonexcessive debt levels. The second is the challenges the Bank of Japan faces going forward. Prior to financial stability ructions, Japan's 10-year bond crossed the Bank of Japan's policy cap. It has subsequently subsided to 0.3%, but questions remain how the Bank of Japan will normalise monetary policy.

International Equities—Review

The year so far has been bumpy. Positivity has been replaced by caution. Year-to-date gains have largely been eliminated as myriad challenges remain on the horizon including the economic and earnings cost of taming inflation and more-recent financial stability ructions.

Europe has outperformed the United States.

The S&P 500 has risen 0.4% for the year to date, though recorded an annual loss of 8.3%. The S&P Global BMI (broad market index) is up 1.4% for the year to date but down 7.9% on the prior year. The S&P Europe BMI is up 4.8% for the year to date and down marginally on a year ago. The S&P Global ex U.S BMI is up 2.7% for the year to date but down 6.1% a year ago.

International Equities—Outlook

Global growth revisions have generally been positive, though as noted last month, revisions have been of the less-bad variety as opposed to fundamentally good. Upgrades reflect China's reopening after coronavirus lockdowns, the easing in Europe's gas crisis, and buoyant U.S. consumer demand, all solid developments though amid an environment of inflation and tough-talking central banks.

Fitch, for example, has revised up China's 2023 growth forecast to 5.2% from 4.1%, eurozone growth to 0.8% from 0.2%, and U.S. growth to 1.0% from 0.2%. However, growth estimates for 2024 have been lowered, reflecting the lagged impact of Fed and ECB interest-rate hikes.

The Organization for Economic Cooperation and Development raised its global economic growth forecast recently but warned of vulnerabilities as seen in the U.S. financial sector turmoil. The OECD said it now expects the global economy to grow by 2.6% this year compared with 2.2% in its previous forecast in November and titled its latest projections "A Fragile Recovery".

Among a modest improvement in growth prospects, inflation pressures remain, with the latest U.S. core inflation (ex-food and energy prices) figures dipping to 5.5% from 5.6% but showing persistence across many other core measures and particularly across services.

Markets, trying to juggle the dilemma over central banks, who are trying to solve an inflation problem without causing a recession, which would include a large rise in unemployment, crushing the consumer.

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Another factor is now in the mix, namely, financial stability. Higher rates are needed to fight inflation, but higher rates could spark financial, financier, and banking system problems.

Investors had started the year hoping the worst had passed, with inflation easing. Headline inflation in the United States has dropped to 6% from 9.1%. Euro-area inflation has eased to 8.5%, the lowest read since May 2022 but above market expectations of 8.2%.

Inflation is clearly remaining sticky, though, according to various core measures, which makes for a prospective volatile year ahead and a tough balancing act for central banks who neither want to engineer a recession nor pause the tightening cycle only to be forced to resume tightening on persistent inflation pressures.

Containing inflation puts pressure on earnings both through slower growth and margins, which needs to compress to stop cost-push pressures from flowing into final goods prices. Moreover, inflation risks remain from an incredibly tight labour market around the globe. While inflation risks and pressures need to be read in the context of better economic news, it remains a negative factor for risk assets, not a positive one.

Fourth-quarter earnings figures were not good, but not bad either. S&P 500 companies reported a 4.8% year-over-year decline according to Forbes Advisor. An earnings recession is upon us, with analysts projecting S&P 500 earnings will drop 5.7% year over year in the first quarter and another 3.7% in the second quarter. While negative, those declines are modest and possibly one reason that large-cap stocks have remained somewhat resilient.

Recessionary concerns linger, one sacrificial pawn to containing inflation and, with that, fluctuating earning estimates. FactSet notes that:

- Analysts have lowered earnings-per-share estimates for the first quarter by a larger margin than average. The first-quarter bottom-up EPS estimate decreased by 5.7%.
- "The decline in the bottom-up EPS estimate recorded during the first two months of the first quarter was larger than the 5-year average, the 10-year average, the 15-year average, and the 20-year average."
- Estimates for all of 2023 also declined, by 3.4%, partly reflecting lower estimates for the first quarter of 2023 but also other quarters.
- "The forward 12-month P/E ratio for the S&P 500 has increased to 17.5 from 16.7 since December 31, as the price of the index has increased while EPS estimates for CY 2023 have decreased during this time."

While SVB might not be a systemic event and might be contained for now, the potential for sentiment contagion remains real, and those with long memories will recall how 2008 unfolded. Optimists note SVB did not have a diversified source of depositors; it was a special type of financial institution with customers being startups, venture capital, and tech founders; and its problems were a function of industry exposure to a sector that has been hit hard from higher interest rates.

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Nonetheless, some nervousness will remain. Quality will count, and deposit flows are already benefitting the majors over the minors. Money will likely shift from the periphery into the core. It is a reminder that business models that have been conditioned on low or effectively "free" money are going to be vulnerable in a higher-cost-of-capital world.

Uncertainty is high on many levels including what the U.S. Federal Reserve and other central banks will do or should do as they weigh up inflation and financial stability challenges. That suggests lower multiples, not higher ones, at least until we have more clarity.

Performance periods unless otherwise stated generally refer to periods ended Wednesday, 15 March 2023.

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