Economic Update: Australia
April 2023

Morningstar Research
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Summary

- Volatility has been exceptionally high, with movement across bond yield seldom seen in 30 years, serving as a reminder of the benefits of diversification.
- Financial markets continue to anticipate most central banks nearing interest-rate peaks and rate reductions on the other side, though the easing thematic has been pushed back of late.
- The path for inflation could challenge an easing view in the near term with global labour markets very tight and unemployment low, portending of sticky inflation trends.
- While the Reserve Bank of Australia paused in April, a tight labour market suggests more work to do and potentially another rise in the cash rate target.
- Attention will be on the potential for more financial market ructions and the potential flow-on of tighter credit conditions. This is not like previous cycles where inflation was low amid credit events, allowing central banks flexibility.
- Earnings remain vulnerable to weaker growth, margin erosion, and cost pressures.

Australia Cash and Fixed Interest—Review

The Reserve Bank of Australia left the cash rate target unchanged in April, noting "The decision to hold interest rates steady this month provides the Board with more time to assess the state of the economy and the outlook, in an environment of considerable uncertainty."

This put the Reserve Bank of Australia out of step with the U.S. Federal Reserve and the European Central Bank but in tune with Bank of Canada, which also paused.

Following this pause, markets were quick to jump on to the possibility of the next moving being lower rates. Markets have now eased back on this with economic data not validating lower rates.

U.S. markets continue to set the tone across fixed-income markets, including Australia. The Australian 10-year bond started the year around 4%, rallied to 3.4% by early February, climbed to 3.9% in early March, and fell again to 3.2% before rising toward 3.5% in April. Seldom has volatility been higher; such moves within a quarter reinforce the uncertain environment in which we reside. Such volatility has served to reinforce the importance of diversification in portfolios.

In contrast with other fixed-income markets, the Australia curve (2s-10s) is relatively flat, whereas others are heavily inverted, portending of recessions in other countries.

The Australian dollar versus the U.S dollar is largely unchanged over the year but has moved within a band of 0.71 to 0.66, rising after minutes of the Reserve Bank of Australia's April policy meeting showed that members were determined to do what is necessary to bring inflation back down within target. Better-than-expected economic data in China, Australia's top trading partner, has also helped.

Australia Cash and Fixed Interest—Outlook

Markets were quick to jump on a potential easing theme following global ructions and the Reserve Bank of Australia's pause in April.

Continued strength within the labour market in March (53,000 jobs growth) and a 3.5% unemployment rate (near-50-year low) suggest the Reserve Bank of Australia could have further work to do. Whilst the labour market is a lagging indicator, global and local labour market conditions remain incredibly tight and flag continued upward wage pressure.

May's cash target meeting decision is a live one with Reserve Bank of Australia's minutes of the April decision noting, "Members noted that the forecasts produced by the staff in February had inflation returning to target range only by mid-2025 and that it would be inconsistent with the Board's mandate for it to tolerate a slower return to target. These forecasts were conditioned on monetary policy being tightened a little further."

Financial markets have subsequently reversed expectations that the next move could be down to almost fully pricing in another 25-basis-point rate hike.

Central banks, including the Reserve Bank of Australia, continue to face many challenges getting inflation down, and risks remain that inflation stickiness binds them. The environment does not look as inflation-friendly as was apparent from 1992-2000. Globalisation is reversing as just-in-time becomes just-in-case, geopolitics is influencing trade, the world is facing many transitions including a shift to cleaner energy, and labour shortages are pushing wages higher.

Forecasts across various bank (economists) have Australia's 10-year government bond stable to easing over 2023 and 2024. National Australia Bank is projecting stability around 3.5%. Westpac is more aggressive, anticipating easing to 2.5% and the Australian 10-year bond to be below the U.S. equivalent. Directional moves are strongly U.S. dictated.

The consensus remains that we will see a stronger Australia dollar against the U.S. dollar on the back of a weaker U.S. dollar as the Federal Reserve slows rate hikes. There appears to be an equivalent consensus that the Australian dollar is expected to outperform the New Zealand dollar. One challenge to that view could be the potential for volatility if inflation signals remain strong and growth signals falter.

Australian & International Property—Review

The S&P / ASX200 A-REITs Index has had a solid start to 2023. The index is up 2.1% for the year to date and 2.2% in April alone, though down 14.9% on a year ago.

The FTSE EPRA-NAREIT Global Index in U.S. dollars for the year to date (total return) is up 1.3%, though down 19.0% on a year ago. The United Kingdom series has outperformed for the year to date, rising 5.8% (U.S. dollars).

Australian & International Property—Outlook

Rising interest rates, along with bank and financial ructions, have put the spotlight firmly on commercial property as an area to watch. Commercial property can be sensitive to the economic cycle. Falling interest rates drove a chase for yield as investors sought investment alternatives, including residential and commercial property. Falling cap rates drove prices up. That is now reversing with repricing underway.

Commercial property exposures have often been a source of losses in financial crises, including following the global financial crisis of 2008/09. As this unfolds, credit conditions can tighten, exacerbating the cycle.

A recent Bloomberg article noted almost USD 1.5 trillion of U.S. commercial real estate debt comes due for repayment before the end of 2025.[1] The subsequent question is, Who is going to lend to them? The article notes regional and local banks in the United States as being big lenders to retail and office commercial property.

According to Morgan Stanley analysts, "Refinancing risks are front and center" for owners of properties from office buildings to stores and warehouses. "The maturity wall here is front-loaded. So are the associated risks."

There remains room for optimism. Lending standards have been tighter after the global financial crisis. The attributes of the property in question matter significantly. The adage of "quality counts" applies, and major structural shifts within industries continue to support industrial and high-quality and sustainably oriented office premises in good locations.

Feedback reports that office occupiers are taking advantage of the market repricing and moving into better-quality premises. A key area to watch over 2023 will be development supply, which is facing challenges from rising costs and interest rates. This could help to tighten up supply relative to demand in 2024 and 2025.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is up 5.7% for the year to date, though down 5% on a year ago. The index is up 2.5% for the month to date.

The MSCI World Core Infrastructure Index (USD) reported a 7.7% return in the first quarter.

1 Callanan, N. 2023. "A $1.5 Trillion Wall of Debt Is Looming for US Commercial Properties." *Bloomberg*. April 8, 2023. https://www.bloomberg.com/news/articles/2023-04-08/a-1-5-trillion-wall-of-debt-is-looming-for-us-commercial-properties?srnd=premium-asia

Global Infrastructure—Outlook

"We have multiple gaps to fund, requiring not billions, but trillions." Denis Crevier, Strategic Advisor, The Global Infrastructure Hub.[2]

According to GIB's InfraTracker, the largest central government infrastructure expenditure across the Group of 20 countries (which accounts for around 85% of the world economy) was transport, totalling USD 413 billion, accounting for 42% of total infrastructure spend in 2022.

Infrastructure gaps identified by the GIB include a climate gap with an estimated USD 90 trillion in climate-driven infrastructure investment required by 2030 to reach global sustainability, according to World Bank 2019 data. According to the GIB, "Experts estimate that less than USD 1 trillion a year is currently invested to address climate transition whereas a minimum of USD 3.8 trillion a year would be required to meet the Paris Agreement objectives by 2030, leaving approximately a USD 3 trillion yearly gap."

U.S. Treasury Secretary Janet Yellen delivered a strong speech in February urging the World Bank Group to accelerate its reform, to free up more capital (a major constraint) and address climate change among other global challenges.

Members of the Morningstar Expert Panel discussed the merits of infrastructure at their recent quarterly meeting and decided to retain an overweight position. This reflected the defensive attributes of infrastructure but also pressing long-term needs. Infrastructure was considered as holding both strong tactical (short-term) and strategic (long-term) attributes.

While demand and the need for infrastructure remain strong, economic factors are affecting infrastructure development. Operational assets are more resilient, but the bankability and viability of new infrastructure deals is deteriorating with increasing inflation and interest rates and with new infrastructure construction being negatively affected by supply chain, labour market, and inflation issues. The proportion of investors citing interest rates as a key challenge increased to 56% in 2022 from 12% in 2020, according to the Preqin Global Infrastructure Report 2023.

Despite challenges, GIB reports that private capital raised for infrastructure investment reached a record level of USD 173 billion in 2022, up from USD 123 billion in 2019.

Australasian Equities—Review

The S&P / ASX200 Index is up 4.1% for the year to date, though down 2.1% on a year ago. The index is up 2% for the month to date. The ASX 200 was flat in March, though up 3.5% for the quarter. March was an offsetting month with materials and telecoms up and financials down.

2 The Global Infrastructure Hub is a not-for-profit organisation, formed by the G-20, that advances the delivery of sustainable, resilient, and inclusive infrastructure.

Australasian Equities—Outlook

Australia is on a decelerating growth trajectory but appears less vulnerable to a recession than New Zealand and nations in the Northern Hemisphere, and we can see this in the fixed-income markets where the curve is flat as opposed to inverted in the United States (that is, 10-year is lower than the two-year). There is growing evidence that inflation has peaked in Australia, with the monthly inflation reading easing to 6.8% year over year, providing encouragement to the central bank.

Peaking inflation is still a long way from the inflation target.

The Reserve Bank of Australia held the cash rate steady at 3.6% in April, noting global unease including subtrend global growth, slower household consumption growth, cognisance of the scale of tightening delivered to date, and the awaiting of further data on Australian inflation and the labour market in April. Westpac-Melbourne Institute Consumer Sentiment Index lifted by 9.4% in early April, no doubt buoyed by the decision by the Reserve Bank of Australia to pause the tightening cycle.

Growth in the Australian economy has slowed, with domestic demand stagnant in the December 2022 quarter and growth over the next couple of years expected to be below trend. Dwelling consents ticked up in February but are down 31% on a year ago. CoreLogic's home value index appears to be signalling stabilisation in house prices, though, rising by 0.8% in March after a mild dip of just 0.1% in February.

Expectations have pivoted again of late that the Reserve Bank of Australia might need to lift rates again.

The March employment report showed jobs growth of 53,000, more than double the consensus of 20,000 and following February's uplift of 64,000. The unemployment rate held steady at 3.5%, where it has been since July 2022, and it remains around its lowest levels since the 1970s. This reinforces a global theme of tight labour market conditions, an inflationary area that central banks continue to monitor closely. Labour supply is being boosted by immigration. Some signs of damped labour demand can be gleaned from SEEK job ads falling 0.6% in March, down 20% from their May 2022 peak, though remaining well above prepandemic levels. Such labour market strength will likely challenge the Reserve Bank of Australia's decision to pause.

While labour costs continue to be a challenge for businesses, there has been a notable easing of supply chains, which are now much less disrupted, and this has seen a reduction in shipping rates.

The outlook for China—of importance to both New Zealand and Australia—is encouraging, though somewhat opaque. The International Monetary Fund notes, "The reopening and growth of (China's) economy will likely generate positive spillovers, with even greater spillovers for countries with stronger trade links and reliance on Chinese tourism."

Overall, the earnings environment in Australia looks less challenging than headwinds being encountered in other nations.

According to Standard & Poor's estimates, the trailing P/E of the S&P / ASX 200 is 14.9 (last month 15.4), and the forward P/E is 14.5 (last month 14.1), with a dividend yield of 4.6% (previous 4.4%).

International Fixed Interest—Review

"You can't tighten monetary policy without breaking a few eggs."[3]

Volatility across fixed-income markets has been extreme, of magnitudes seldom seen before, and market stress has reminded investors of the protective power of bonds. The MOVE index, which tracks market volatility, reached levels not seen since the global financial crisis as inflation, growth, financial stability, and a sharp repricing of rate expectations collided.

While inflation data continues to point to central banks facing challenges in getting on top of core inflation trends, financial instability in the form of SVB, Signature Bank, and Credit Suisse and concerns of more to come have driven wide swings in market pricing, narratives, and performance. It is worth noting that recent ructions are not the first since the tightening cycle started: Recall the UK market last year, with the liability-driven investment crisis, which passed.

Despite emerging financial system risks, many central banks continued to lift interest rates, including the U.S. Fed (25 basis points), the Bank of England (25 basis points, with the door ajar to further tightening if necessary to bring inflation down), and the European Central Bank (50 basis points).

The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of 2.9%, though this is still a negative 4.3% return over the year. Bonds have performed well in 2023.

International Fixed Interest—Outlook

The outlook for the U.S. Federal Reserve, global, and U.S. economy remains key in assessing fixed-income prospects.

Global growth has generally surprised positively during the first quarter of 2023, with rebounds in U.S. and European composite purchasing managers' indexes. Evidence is mounting, though, that growth fatigue is arising, and more warnings are appearing regarding the outlook, with the IMF recently trimming its growth forecasts, projecting global GDP of 2.8% in 2023 and 3% in 2024, marginally below January's projections.

The qualitative assessment is often more alluding than the quantitative, and "The risks are weighted heavily to the downside, in large part because of the financial turmoil of the last month and a half," according to Pierre-Olivier Gourinchas, IMF's chief economist.

While the quantitative adjustment is not large, the IMF is more subdued about the outlook than it was in January, when it saw this year as a "turning point" for the global economy and risks were more balanced.

[3] Rosenberg, J. 2023. "Breaking a Few Eggs." BlackRock. March 22, 2023. https://www.blackrock.com/us/individual/insights/systematic-fixed-income-outlook

Housing markets are slowing, and lending conditions have tightened. There are widespread expectations of tighter credit conditions flowing into the real economy. There are bright spots, though, including China's reopening, adding to global consumption, and Europe's avoiding a severe winter, which was a risk six months ago.

Labour markets around the globe have remained very resilient, though, epitomised by three successive robust nonfarm payroll reports in the United States and a 3.5% unemployment rate. Commentators point to structural shifts in the availability of workers as one reason, along with employer demand.

It is also clear that the level of activity matters as well as the change, and whilst easing in direction, the level of activity continues to be supported by significant monetary and fiscal stimulus from the COVID-19 and pre-COVID-19 quantitative-easing era, which is still in the system and mitigating the impact of Fed tightening. This cushioning is also being supported by savings built up over previous years.

For central banks, it is all about inflation and achieving their mandates. Are they seeing sufficient progress toward their targets that they can pause? This step has been taken by the Bank of Canada and Reserve Bank of Australia. Conversely, the U.S. Federal Reserve, European Central Bank, Reserve Bank of New Zealand, and Bank of England continue to tighten with concerns over core inflation. The latest core inflation read in the U.S. was 5.6%, slightly higher than seen in the previous month. Low levels of unemployment suggest that slowing wage gains and restraining unit labour cost and service sector inflation pressures may be very challenging.

Market expectations are that we will see one more hike from the U.S. Federal Reserve, followed by 90-100 basis points of rate cuts from late 2023 and over 2024. Markets are likewise anticipating the Reserve Bank of New Zealand is close to the apex of the tightening cycle, a prelude to rate reductions. The European Central Bank and Bank of England are assessed as having more work to do, so markets are being selective pricing in rate reductions.

Implicitly, this is a hat tip to the traditional correlation between growth and inflation, with the former leading the latter. Higher interest rates force breakages, and financial instability flows on to the real economy, which drives the traditional capitulation of central banks into an easing cycle, which for now is being expressed with the anticipated apex in the tightening cycle being close and sharp declines in short-term interest rates. A material tightening in lending standards (what we call the credit channel of monetary policy) could also have major carryover implications, meaning the U.S. Fed and other central banks will need to do less to damp growth and subside inflation.

There remains a key risk that central banks struggle to bring core inflation meaningfully lower, forcing a harsher inflation and growth trade-off. Data itself—especially inflation signals—or central bank messaging could force a realignment. Under this scenario, pressure on short-term bond market returns re-emerge as bond yields retest highs, and terminal rates reflect stubborn inflation, culminating in a deeper recession. This scenario is real.

An uncertain inflation backdrop argues against extreme positioning.

International Equities—Review

Equity returns have been strong in the first quarter of the year. The MSCI World Net Total Return Index rose 7.7%. The US S&P 500 Total Return Index rose 7.5%. Europe has outperformed. The German Dax 30 Total Return Index lifted 12.2%. France's CAC 40 rose 13.4%. Red ink has been absent by and large.

The Nasdaq 100 Total Return in the first quarter was 17%, with some technology companies trading off utility characteristics: strong balance sheets and cash flows.

International Equities—Outlook

International equities have had a strong run, buoyed by a combination of industry and firm specifics, growth support, and lower interest-rate expectations. The million-dollar question is, Can it continue in an environment of inflation, earnings, and growth risks?

Growth surprised in the first quarter, though the backdrop remains challenging. Amid the IMF's 2.8% projection for the global economy in 2023, advanced economy growth is expected to be 1.3% in 2023, less than half the 2.7% expansion in 2022. The IMF's Global Financial Stability Report notes rising risks to bank and nonbank financial intermediaries as interest rates have lifted. It notes that "historically, such forceful rate increases by central banks are often followed by stresses that expose fault lines in the financial system."

The IMF also alludes to lower trend growth, noting that the economy would not return to the rates of growth that prevailed before the pandemic in the medium term.

The Asian Development Outlook for April 2023 was constructive on Caucasus and Central Asia expecting steady growth, with growth projections of 4.4% this year and 4.6% in 2024. The People's Republic of China's reopening was noted as "brightening East Asia's outlook with positive trade, tourism, and other spillover to the rest of developing Asia."

Inflation remains a prime concern, with developed-country central banks a long way from meeting their inflation objectives. This means hard-landing risks are material. Moreover, central banks now also need to weigh up threats to the financial system against the risk of injecting stimulus prematurely (with markets pricing in rate cuts in many countries), potentially entrenching high inflation. Such an outcome would require a tougher inflation fight and economic adjustment in the future.

On many levels, it is difficult to see how inflation will return to target without a recession and real pain—and not of the soft-landing variety. The debate is about whether central banks have delivered enough of a tightening in financial conditions for the lags to work through to constrain credit, economic activity, and inflation sufficiently. Central bank views of higher for longer and market anticipations of lower rates are divergent.

The latest U.S Federal Reserve Bank minutes offered something for everyone. A hike was delivered in March amid financial ructions and despite Fed staff projecting a mild recession. Some policymakers wanted to pause, whereas others contemplated a 50-basis-point hike. Inflation risks were noted in both directions.

Corporate earnings are a critical focal point. Earnings growth peaked in most regions in early 2022 and has trended lower since. The pressures on earnings remain obvious, including interest costs, wages, and rising unit labour costs, supply chain pressures, and demand.

The Wells Fargo & Co. bank's head of equity strategy expects the S&P 500 to suffer a 10% correction in the next three to six months though a year-end target still above current levels.[4] As markets head into first-quarter earnings season, Goldman Sachs strategists say corporate profits are set for their steepest decline since the start of the COVID-19 pandemic in 2020 and a projected earnings per share decline of 7% year-over-year.[5] Others paint a more optimistic picture, pointing to economic resilience so far and the U.S. Fed's pending pivot, which is already factored into interest-rate expectations.

The earnings bar has been lowered of late. FactSet notes larger analyst cuts than average to earnings per share estimates for S&P companies for the first quarter. It also notes:

- "As of today [6th April], 106 S&P 500 companies have issued EPS guidance for the first quarter. This number is above the 5-year average of 97 and above the 10-year average of 98. Of these 106 companies, 78 have issued negative EPS guidance and 28 have issued positive EPS guidance.
- The first quarter has seen the highest number of S&P 500 companies issuing negative EPS guidance for a quarter since Q3 2019 (81). If 78 is the final number for the quarter, it will mark the fourth-highest number of companies in the S&P 500 issuing negative EPS guidance for a quarter since FactSet began tracking this metric in 2006. On the other hand, the first quarter has also seen the lowest number of S&P 500 companies issuing positive EPS guidance for a quarter since Q2 2020 (24).
- While analysts were decreasing EPS estimates in aggregate for the first quarter, they were also decreasing EPS estimates in aggregate for all of calendar year (CY) 2023. The bottom-up EPS estimate for CY 2023 declined by 3.8% (to $221.50 from $230.33) from December 31 to March 30."

Despite prospective earnings headwinds, sentiment has remained robust, seeing equities deliver one of their biggest before-earnings rallies since early 2009. The S&P 500 has risen almost 6% in the month despite expectations that first-quarter profits could be down 8%.[6]

[4] Semenova, A. 2023. "Wells Fargo's Harvey Warns S&P 500 Is Set for a 10% Correction." Bloomberg. April 11, 2023. https://www.bloomberg.com/news/articles/2023-04-11/wells-fargo-s-harvey-warns-s-p-500-is-set-for-a-10-correction?srnd=premium-asia

[5] Chittum, M. 2023. "Investors should brace for corporate profits to see their biggest drop since the start of the pandemic, Goldman Sachs says." Insider. April 6, 2023. https://markets.businessinsider.com/news/stocks/stock-market-outlook-corporate-earnings-q1-goldman-sachs-covid-pandemic-2023-4

[6] Wang, L. & Lee, I. 2023. "Best Pre-Earnings Stock Rally Since 2009 Sets High Bar for Firms." Bloomberg. April 11, 2023. https://www.bloomberg.com/news/articles/2023-04-11/best-pre-earnings-stock-market-rally-since-2009-sets-high-bar-for-firms?srnd=premium-asia

Valuations remain neutral. FactSet noted: "The forward 12-month P/E ratio for the S&P 500 has increased to 17.8 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."

Amid markets showing strong swings but battling strong thematic themes such as inflation, the benefits of diversification should be noted, and particularly where valuations across and within asset classes had converged. Greater certainty over the war on inflation is required for investment clarity. In the meantime, uncertainty is the known certainty.

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

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