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Economic Update: Australia
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Summary

- Headline inflation is receding, though core inflation is elevated around the globe. Tightness across labour markets points to a long disinflationary journey ahead.
- Elevated core inflation risks seeping into inflation expectations.
- Financial markets are erring toward lower rates over 2024, a hat tip toward where the major economic and financial risks reside.
- Prospective for earnings remain hinged to the economy and disinflationary battle, which is negative for margins.
- Expectations of a basing and improvement in earnings in late 2023 could face challenges given the economic and inflation backdrop.
- Uncertainty continues to point to diversification and caution in asset allocation.

Australia Cash and Fixed Interest—Review

The Reserve Bank of Australia resumed tightening in May, after pausing in April, a surprise to markets. Some inflation nervousness was apparent in the decision, with a greater emphasis on "the importance to returning inflation to target within a reasonable timeframe".

The Australia bond market continues to largely mirror offshore as financial stability (United States bank) concerns go head-to-head with inflation pressures. The Australian 10-year bond is trading around 3.4% and has settled in a 3.2%-3.6% trading range, oscillating as opposed to trending such as it did over 2022. The curve (one-year bond versus the 10-year) is relatively flat, which contrasts with inverted yield curves in other nations.

The Australian dollar has been largely range-bound as well around 0.66-0.68 versus the United States dollar.

Australia Cash and Fixed Interest—Outlook

Markets are pricing in some chance (well under 100%) that the Reserve Bank of Australia could raise the cash rate once again. As noted by the Reserve Bank of Australia in the May hike, "Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve." We are moving into a mode of data-dependency, and the door remains open.

Key focal points include the global economy, households, inflation, and the labour market.

One-year ahead cash rate expectations are lower, a trend being led by views on the U.S. Federal Reserve with 150 basis points of rate reductions being anticipated. However, given Australia's lower

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cash rate starting point, the magnitude of the easing being anticipated is far more modest, though still lower in direction.

Forecasts across various banks (economists) have Australia's 10-year government-bond stable to easing over 2023 and 2024. National Australia Bank continues to project stability around 3.5%. Westpac remains at the more aggressive end, anticipating the 10-year bond easing to 2.5% and the Australian 10-year bond to be below the U.S equivalent.

A stronger Australia dollar appears to be the consensus, supported by a weaker U.S. dollar as the Federal Reserve lowered the federal-funds rate in response to easing inflation. The commodity price cycle could challenge that, though that risk is offset by U.S debt-ceiling gyrations. There appears to be an equivalent consensus that the Australian dollar will outperform the New Zealand dollar, with the latter weighed down by an 8.9% current account deficit.

Australian & International Property—Review

The S&P / ASX200 A-REITs Index has had a great 2023, rising 6.4% for the year to date, mostly from the second half of March. The month of May so far has continued momentum from March. The annual return is back in positive territory.

The FTSE EPRA-NAREIT Global Index in U.S. dollars for the year to date (total return) is up 0.9%, though down 7.9% on a year ago. The United Kingdom series has outperformed for the year to date, rising 4.0% (US dollars).

Australian & International Property—Outlook

Economic uncertainty remains high for commercial real estate through the rest of 2023 and likely 2024. Some major questions include the economic outlook, which affects vacancy rates, trajectory for interest rates, refinancing risks, and the future of office space.

Interest rates around the globe has risen at their fastest pace in decades, and it is taking investors time to adjust. Markets are saying lower rates are around the corner, but central banks are saying otherwise, which adds more uncertainty, and irrespective, rates are a lot higher than they were two years ago.

Some fund managers are warning of problems in the $5.6 trillion United States commercial real estate industry, as markets adjust to higher interest rates, loans need to be refinanced, and refinancing risks are accentuated by turmoil in the banking sector.[1]

Higher interest rates force assets to reprice lower, and this is combined with a structural decline in occupation rates and aging assets. Refinancing risks continue to feature as a theme and particularly toward regional bank's capability in the United States. According to *The Wall Street Journal*, smaller banks in the United States hold around $2.3 trillion in commercial real estate debt.[2]

1 https://www.ft.com/content/a77695ac-a516-4654-8e0f-5aeb4f4fff71
2 https://www.wsj.com/articles/commercial-property-debt-creates-more-bank-worries-b36184ba

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While the overall narrative toward the sector remains very cautious and an adjustment is underway, a strong theme of a flight to quality continues with demand for best-in-class assets.

JP Morgan's midyear commercial real estate outlook notes, "Multifamily, industrial and neighbourhood retail continue to perform well. But B- and C-class office buildings may have an uphill battle."

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is up 4.8% for the year to date and 1.5% on a year ago. The index has lost ground slightly in May so far.

The MSCI World Core Infrastructure Index (USD) reported a 2.6% return for the year to date. The dividend yield sits above the MSCI World Index (3.5% versus 2%). The infrastructure index outperformed the MSCI World measure in 2022 (negative 7.9% versus negative 18.1%).

Global Infrastructure—Outlook

Infrastructure hits a lot of the high notes in the current environment of inflation and uncertainty as a more defensive asset. These include:

- Less cyclicality with the general economy.
- Stable, more predictable cash flows.
- An element of inflation protection via investing in real or physical assets such as bridges, roads, highways, sewage systems, or energy.
- Often governed by long-term contracts with built-in inflation pass-through mechanisms.

In addition, the sector offers portfolio diversification from traditional asset classes.

The sector also taps into broader secular themes including climate change, renewable energy investment, transport decarbonisation, waste, and the circular economy.

GI Hub recently released Transition Pathways to Sustainable Infrastructure. It analysed more than 250 long-term national infrastructure plans of 25 G20 economies, finding that USD 11.5 trillion is planned for investment in infrastructure between 2020 and 2030.[3] This augurs for meeting the need, and it is well documented that many countries face large infrastructure deficits.

However, infrastructure still has elements of vulnerability. These include the overall macroeconomic situation and availability of debt financing due to high interest rates. The latter includes the cost of finance with higher interest rates increasing the hurdle rate for new investment.

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[3] GI Hub is a not-for-profit organisation, formed by the G20, that advances the delivery of sustainable, resilient, and inclusive infrastructure.

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While there is the inevitable need for infrastructure investment, the provision is becoming more challenging. While exacerbated by inflation and finance challenges, other sticking points include rising pressures on public finances and debt burdens. Greater private sector involvement appears necessary, though that faces political sticking points.

GI Hub notes that as globalisation reverses (a trend since the global financial crisis), "reductions in free trade will, all other things being equal, drive up costs and reduce choice. This plays out in the infrastructure sector as higher costs for taxpayers, reduced investment, and less building of socially beneficial infrastructure. In an environment that has seen the infrastructure investment gap more than treble from a 2017 global forecast of $0.7 trillion a year to around $3 trillion a year today, this is a significant concern."

Australia Equities—Review

The S&P / ASX200 Index is up 3.1% for the year to date, though down 4.6% on a year ago. The index is slightly down in May so far, following global nuances. Small cap outperformed large caps in April. Technology and industrials led, followed by healthcare, telecoms, and financials. Materials suffered. With markets having a spring in their step in 2023, valuations have moved higher, though the Australian market is still trading in line with long run average at 14.8 times.

Australia Equities—Outlook

Australia is on a decelerating growth trajectory, though of a less deep magnitude than New Zealand and other global peers. According to the Reserve Bank of Australia's May Statement on Monetary Policy, "Over the period ahead, GDP growth is expected to be below trend. It is expected to trough at around 1¼ per cent and then to pick up gradually to 2 per cent by mid-2025 as the drag from higher inflation and interest rates wanes and household wealth recovers." Westpac expresses a similar view. Containing inflation requires subtrend growth to bring demand back into line with the economy's capacity to meet it.

The latest NAB business survey showed a further easing in business conditions—particularly across consumer sectors, with inflation and interest rates acting as headwinds. Real retail sales recorded a larger than expected 0.6% decline in the first quarter.

Resilience across the Australian economy, amid some sectoral weakness, was reflected in an improved starting point for Budget 2023/24, with the strength of the economy delivering an AUD 121.5 billion windfall through to 2025/26.

Demand for new housing has been weak recently, with dwelling approvals in a trend decline; borrowing for housing has slowed. The trend decline in dwelling approvals stands in contrast to strong population growth. The latest civilian 15 years plus population data show an increase of 482,000 over the past year. A shortfall in housing supply relative to population could put upward pressure on rents and inflation.

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The labour market remains tight in Australia, with the same theme apparent globally. The unemployment rate, at 3.5%, sits at its lowest level in almost 50 years. While job vacancies and Seek job ads have eased, they remain at high levels. Unit labour costs are rising at a fast pace, with productivity growth remaining subdued. Such trends portend of continued pressures on inflation to which the Reserve Bank of Australia needs to be alert.

With rising global growth uncertainty, Australia's terms of trade could come under pressure via lower commodity prices negatively affecting the resources sector.

More robust growth prospects and a lower terminal rate for the cash rate (which is expected to peak at 4%) whilst in a deceleration and weak phase of the economic cycle imply less earnings risk across Australia, although sectoral divergences are expected to be significant.

According to Standard & Poor's estimates, the trailing P/E of the S&P / ASX 200 is 14.9, and the forward P/E is 14.5 with a dividend yield of 4.6%, valuations in line with averages.

International Fixed Interest—Review

The drop in bond yields seen in March as markets lurched on banking sector stresses subsided somewhat in April and May, as inflation realities came back into play.

Central banks face a delicate balancing act. When interest rates rise, things break. The hope is inflation will ease sufficiently without engineering a full-blown recession. The U.S. Federal Reserve noted in its recent decision to hike rates, "The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks." Summary: We are aware of the risks, but we have a job to do.

Central banks continue to lift interest rates in response to inflation outcomes considerably away from their target, getting on with the job at hand, including the Bank of England, U.S. Federal Reserve, and European Central Bank.

The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of 3.1%, this is still a negative 3.5% return over the year. Bonds are flat so far in May.

International Fixed Interest—Outlook

Financial markets and central banks agree and are also in disagreement.

There appears to be broad agreement that the peak in the tightening cycle across many nations including the United States is close, though the Bank of England and European Central Bank appear to have more work ahead of them.

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While inflation remains elevated globally, pressures are receding, with headline inflation moderating. Monetary policy works with a lag. The United States Federal Reserve is no longer saying it expected additional interest-rate increases, rather moving into a mode of data dependency.

There is disagreement over the trajectory for rates in the second half of 2023 and 2024, however.

Financial markets are anticipating sharply lower interest rates from late 2023 and into 2024. The rationale for such outcomes rests with recessionary risks (not central bank's central scenario, so recession prospects are used as a reason that a central bank will need to change course), easing inflationary pressures (though slowly), the accumulated impact of policy tightening to date, and potential impact of recent bank closures and deposit flight on credit growth and lending standards on the real economy. The yield curve continues to flag a recession.

The counter are underlying and core inflation pressures, including some key drivers. As the Federal Reserve notes, "Job gains have been robust in recent months, and the unemployment rate has remained low: Inflation remains elevated." Unit labour costs in the United States nonfarm business sector rose an annualized 6.3% in the first quarter of 2023. This was up sharply from a 3.3% increase in the previous period and above market expectations of a 5.5% increase.

One way to reconcile the divergent views is that, while risk of a financial crisis seems low, the fallout could be significant and very destructive, which skews market expectations toward the possibility of an extreme outcome.

Three key issues include:

- Are regional banking difficulties in the United States potentially systemic or merely macro-significant?
- The resilience of growth and labour markets in the midst of rising interest rates. Can "immaculate disinflation" occur through moderate job losses and without a hard landing for the economy?
- Real (inflation-adjusted) adjusted yields are only now positive and in restrictive territory. For how long do they need to be in restrictive territory?

Views and answers to these questions differ across experts and commentators. The net is an outlook for fixed-income markets that is delicately balanced, with risks in either direction. This reinforces the benefit of diversification and fixed income in portfolios.

One key area to watch over the coming months will be inflation expectations. While headline inflation rates are moving lower, the trajectory for core inflation is much slower, and any longevity of elevated risk inflation risks seeping into inflation expectations. The recent rise in the University of Michigan long-run inflation expectations to 3.2% in May from 3% in April is an example.

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United State debt-ceiling negotiations look set to go down to the wire. The central case looks likely to be some sort of a deal, but the broader thematic is of many governments facing tough fiscal choices as higher interest rates siphon more taxpayer dollars to debt servicing. While the G7 communique made no mention of the U.S. debt-ceiling stalemate, it reportedly figured constantly in discussions. Finally, Japan's yield-curve control strategy looks on borrowed time. Its existence is inconsistent with recent inflation expectation reads.

International Equities—Review

Equity returns have been strong in the first four months of the year, supported by a resilient global economy, bond yields settling in a lower range, and expectations that an easing cycle from central banks is around the corner, despite the prevalence of inflation. The MSCI World Index is up 12.6%. The US S&P 500 Total Return Index rose 12.1%. The German Dax 30 Total Return Index lifted 11.5%. France's CAC 40 rose 13.0%. Returns across April were buoyant, almost entirely across the board.

The Nasdaq 100 Total Return in the first four months was 20.3%, with some technology companies trading off utility characteristics: strong balance sheets and cash flows. The month of May has seen the arrival of risk-off movements.

International Equities—Outlook

Can the United States and the world avert a recession and make inflation go away at the same time? The head of the U.S Federal Reserve, Jerome Powell, thinks so, noting a strong labour market is smoothing the way for a soft landing. Equities have been resilient in 2023 amid a raft of challenges and market swings.

Global growth has remained robust in the face of a material tightening in financial conditions as interest rates have increased around the world so far. Labour markets have remained strong, and receding headline inflation offer some hope that a soft landing could be achieved. Westpac is pointing to much lower inflation in the coming year, forcing the U.S Federal Reserve to lower rates. Other have similar views.

That view faces challenges.

The recent G7 meeting warned of economic challenge around the globe.[4] "We need to remain vigilant and stay agile and flexible in our macroeconomic policy amid heightened uncertainty about the global economic outlook". Maintaining macroeconomic flexibility amid geopolitics is not easy. A communique is one thing; implementing policy is another.

Reuters reported that "G7 central bank chiefs vowed to combat 'elevated' inflation and ensure expectations on future price moves remained well-anchored, a sign many of them will not let their guard

[4] https://www.reuters.com/markets/g7-finance-chiefs-warn-global-uncertainty-us-debt-crisis-looms-2023-05-13/

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down against stubbornly high inflation." This once again hits the "high" notes, but taming inflation requires tough trade-offs, and we are entering the trade-off zone.

Market sentiment and opinion remains divided over the trajectory ahead. An earnings recession is underway, but key questions surround the depth and duration, and margin/labour market adjustment is required to bring core inflation back down. The greater the persistence of core inflation more than 5%, the more difficult the inflation battle becomes if pricing becomes entrenched, and the more significant the economic/earnings/unemployment adjustment required.

The profits of the S&P 500 are down 3.7% on average on a year ago. Bloomberg Intelligence data and FactSet reports that 78% of firms beat forecasts in the latest reporting season and the beats exceeded estimates by 6.5%. Those beats were off reduced expectations, though.

Expectations are for second quarter to be down more than 7%, according to Bloomberg Intelligence, the third successive quarterly drop, something last seen in late 2015/early 2016. However, according to FactSet, 57% of the S&P 500 companies (50 out of 87) that have issued earnings per share guidance for second-quarter 2023 have issued negative guidance, which is below average.

Warren Buffett noted recently, "The majority of our businesses will report lower earnings this year than last year." The "incredible period" for the U.S. economy has been coming to an end, he said.

Despite earnings pressure, equities have remained resilient, though that in part reflects certain compositional aspects, with some technology heavyweights trading like utilities. Risk-off has started to feature more of late, given U.S regional banking concerns (and tightening conditions reported in the U.S. senior loans officer survey), U.S. debt-ceiling gyrations, and wariness over global demand, with recent commodity price action pointing to weakness. Bank of America and Pantheon Macroeconomics are predicting a downturn to hit within the next few months, broadly in line with the typical 15-month gap between the start of a tightening cycle and recession.

Key earnings-centric themes over the coming months are expected to include margin pressure, the ripple effects of tightening credit conditions on businesses and the consumer, and whether the economy can remain infallible and immaculate disinflation can be achieved without breaking too many economic bones along the way. Some are optimistic it can be achieved. The bar is high, though, with core inflation still exceeding 5%, which remains a long way from target and implies a considerable economic adjustment. A soft adjustment would be consistent with an earnings recovery in late 2023 and 2024. The hard landing is not.

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