Economic Update: Australia
June 2023

Morningstar Manager Research
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Summary

- The Reserve Bank of Australia has played catchup, with more inflation risk/higher interest rates adding to downside growth risks.
- Core inflation and headline inflation pressures are easing globally, but the former is glacial in pace and central banks are becoming more concerned elevated inflation could be embedded in pricing behaviour.
- Fixed-income markets are gravitating towards central banks keeping interest rates higher for longer, though still expecting some modest interest-rate relief in 2024.
- Equities have performed well, in part buoyed by economic resilience, artificial intelligence prospects, receding headline inflation, and liquidity.
- Weaker global growth looks set to extend into 2024, the sacrificial pawn to containing inflation. With liquidity set to tighten, equities buoyancy will be reliant on an anticipated recovery in earnings, which is at odds with growth prospects and productivity trends.
- The stickiness of core inflation and uncertainty over a soft or hard landing for regions and the global economy point to diversification in asset allocation.

Australia Cash and Fixed Interest—Review

Pause, hike, and another hike has been the pattern for the past three months from the Reserve Bank of Australia.

The Australian 10-year bond has risen to almost 4%, up almost 50 basis points in a month. This is close to its highest level this year. Global inflation factors have been at play including inflation risks, but also the hawkish stance from the RBA, which has seen the Australian 10-year bond now trade with a positive spread to its United States equivalent. The curve (one-year bond versus 10-year) is marginally inverted (by 35 basis points), which contrasts to negative 150 basis points in the US.
The Australian dollar has broken north of its 0.66-0.68 range versus the US dollar.

Australia Cash and Fixed Interest—Outlook

The tightening cycle might not yet be over, with the RBA noting "Some further tightening of monetary policy may be required" with close attention on the global economy, household spending, inflation, and the labour market.

Markets have moved to price in two more 25-basis-point rises in the case rate and the cash rate sitting around 4.5% by mid-2024. The realities of inflation stickiness are hitting home, with Australia no longer immune to the challenges that other central banks are facing.

Forecasts across various banks (economists) have Australia's 10-year government-bond stable to easing over 2023 and 2024, though endpoints have been raised of late following higher expectations for short-term rates. Westpac remains at the more aggressive end, anticipating the Australian 10-year bond easing to 2.7% by the end of 2024 (previous 2.5%) and no longer projected to be below the US equivalent—rather trading at a slight positive spread. This reflects cash rate convergence. National Australia Bank is likewise expecting the Australian 10-year bond to ease, though by a smaller magnitude: 3.5% by the end of 2024.

A stronger Australian dollar remains the consensus. Westpac is projecting a bullish 0.77 for the AUD/USD rate by the end of 2024. National Australia Bank projects 0.73. The Australian dollar is projected to outperform the New Zealand dollar.

Australian and International Property—Review

The S&P/ASX200 A-REITs Index has given up gains reported last month. The year-to-date rise is now 0.5%, down from 6.4% last month, with rising interest rates a headwind. The index is down 1.5% for the month to date, though up 2.3% on the year prior.

The FTSE EPRA-NAREIT Global Index in US dollars (total return) for the year to date is 1.7%, largely unchanged on the year prior. Europe has underperformed, down 1.5% year to date and 15.1% on the year prior.

Australian and International Property—Outlook

"Economic uncertainty remains high for commercial real estate through the rest of 2023," according to JPMorgan's 2023 Midyear Commercial Real Estate Outlook.

This uncertainty stems from many factors. Top of mind remains the outlook for interest rates with a peak likely in, but the experience of the Bank of Canada, which resumed its tightening cycle on concerns inflation could get stuck materially above the 2% target, is that the peak in interest rate might not yet be in.

With many central banks now pausing tightening cycles, they are entering that delicate judgment zone, hoping the lagged impact of previous tightening is sufficient to return inflation to target. Meanwhile, the European Central Bank and Bank of England continue to lift rates.

While the peak in interest rates might have arrived within some countries, refinancing challenges and the lagged impact of higher interest rates are yet to fully hit, and the economic outlook will have a major say over tenant demand and rent prospects. The commercial property sector's challenges as interest rates rise appear frequently across commentators. [1]

[1] Kehnscherper, L., & Sidders, J. 2023. "Europe's Commercial Property Slide Is Catching Up to UK Rout." Bloomberg News. https://www.bnnbloomberg.ca/europe-s-commercial-property-slide-is-catching-up-to-uk-rout-1.1931991

The future of office space is another uncertainty. JPMorgan notes positives including "Multifamily and industrial continue to perform well, and the industry may have underestimated the strength of neighbourhood retail."

Funding remains an issue. This was illustrated within CBRE's Australian commercial real estate lenders survey for the first half of 2023, which noted a moderate decrease in lending appetite since our second half of 2022 survey, though 32% still want to grow their book, industrial remains a favoured asset class and prospects for wider credit margins of approximately 20 basis points over the next three months.

Global Infrastructure—Review

The S&P Global Infrastructure Index in US dollars is up 1.5% for the year to date and 0.7% on a year ago. The index has had a solid June rising 2.5% so far.

The MSCI World Core Infrastructure (USD) net index reported a 3.3% loss for the year to date (as at end of May). The dividend yield sits above the MSCI World Index (3.7% versus 2.1%). The infrastructure index has underperformed the MSCI World Index measure up for the five months ended May (negative 3.3% versus 8.5%), and year on year (negative 11.7% versus 2.1%).

Global Infrastructure—Outlook

Underinvestment in infrastructure remains a global theme, as illustrated locally in the 2023 budget in New Zealand. The Infrastructure Commission assesses that New Zealand has a public infrastructure deficit of approximately $104 billion (against a $400 billion economy), which in the author's mind is conservative.

KPMG's 2023 Global Construction Survey noted that "The Australian government is undertaking an independent review of its 10-year $120 billion infrastructure pipeline under the Infrastructure Investment Program. For context, 10 years ago there were about 146 projects under this pipeline, and today there are 738." [2]

GI Hub estimates a $15 trillion investment global gap, with $94 of investment needed versus $79 trillion current investment trend. [3]

So, the demand and need are obvious.

Beyond demand, the attraction of infrastructure stems from stability in cash flows, less cyclicality or defensive characteristics, and inflation protection. GI Hub also notes that "Infrastructure sits at the nexus of all we want to achieve, and we often refer to it as the backbone of our economies and communities."

[2] KPMG. 2023. "2023 Global Construction Survey." https://kpmg.com/au/en/home/insights/2023/06/global-construction-survey-trends-2023.html

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

Despite the obvious attractions, challenges remain. Higher interest rates have lifted hurdle investment rates. Government balance sheets across the OECD are becoming progressively more stretched, meaning alternate private and public sector partnership models are needed. Rapidly increasing labour costs, high inflation, and longer waiting times for equipment and materials mean successful project delivery faces significant challenges.

Like many industries, infrastructure will need to embrace robotics, AI, and data analytics to improve productivity and supply-side capacity to meet demand.

Australasian Equities—Review

The S&P/ASX 200 Index is up 1.9% for the year to date and 8.7% on a year ago. May was a tough month, with Australian equities falling on global growth factors (China) as well as a hawkish turn (hike) by the RBA. The ASX 200 Index was down 2.5% for the month. IT outperformed (following global trends), and consumer discretionary underperformed. Valuations are in line with historical averages. June has seen the S&P/ASX 200 Index lift slightly (to date).

Australasian Equities—Outlook

The Australian economy is slowing, but not of sufficient magnitude to deter the RBA from raising interest rates and signalling a preparedness to do more. Growth in the Australian economy has eased, and pressures on the labour market have moderated slightly, with the unemployment rate rising to 3.6%. However, employment surged in May (76,000 versus expectations of a 17,500 rise), reinforcing that wage growth risks are to the upside.

The RBA is attuned to the damage associated with inflation and risks that higher inflation expectations and a prolonged period of elevated inflation become entrenched in price-setting behaviour. Of note was that the June decision statement omitted a key line that "Medium-term inflation expectations remain well anchored …." The inflation pressure from the housing market as well as higher wages are expected to keep core rates of inflation above target for some time. Hence, the need for higher interest rates, which means a deeper economic adjustment on the other side.

Economists have been lifting their forecasts for the RBA's cash rate. National Australia Bank economists lifted their peak RBA cash rate forecast to 4.6%. Goldman Sachs and Capital Economics are projecting 4.85%. Higher rates mean less growth, particularly from interest-sensitive sectors.

The economy grew by an anaemic 0.2% in the March quarter 2023, a material slowing on the 0.6% gain in the December quarter. Annual growth is now 2.3% and struggling to outpace population growth. Growth projections for the Australian economy remain positive, though largely population-driven, with migration providing a big boost. Productivity growth remains subdued, and unit labour costs are rising.

According to the RBA, "The Board is still seeking to keep the economy on an even keel as inflation returns to the 2%-3% target range, but the path to achieving a soft landing remains a narrow one." If the path to a soft landing is a narrow, the risks of a hard landing are nontrivial, and that signifies risks to earnings.

Over the past year, the RBA's Index of Commodity Prices has decreased by 22.2% in SDR (special drawing rights or international reserve asset) terms and decreased by 17.5% in Australian dollar terms. That recoil is coming from elevated levels, though it still shows a rapid reversal and another earnings risk to a commodity-dependent nation.

A slowing economy has encouraged China's central bank to cut interest rates, with industrial production, retail sales, and fixed-asset investment data undershooting expectations. While potentially helpful for nations such as Australia with material China trade linkages, concerns remain over high debt levels in China and worries about financial stability.

According to Standard & Poor's estimates, the trailing P/E of the S&P/ASX 200 Index is 14.2, and the forward P/E is 14.3 with a dividend yield of 4.8%, valuations in line with averages.

International Fixed Interest—Review

Global bonds yields have generally nudged higher, led by the bellwether US 10-year bond.

Markets remain attuned to growth and US banking risks. This has served to cap upside long-dated bond movements, with the US Federal Reserve striking a balancing act, noting in June that "The US 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."

A resumption of the tightening cycle by the Bank of Canada, and hawkish overtures by the US Fed and RBA, have helped push short-term rates higher and more inversion of yield curves. Central banks are wary of how long it is taking core inflation pressures to subside. US core inflation has now been above 5% since the start of 2022, though at 5.3% it is down from its 6.6% peak.

The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of 1.9%, though a negative 0.6% return over the year. Bonds returns are down slightly in June.

International Fixed Interest—Outlook

Are we there yet? That is the question markets continue to ask of central banks in their taming inflation/higher interest rate crusade. The answer is maybe for some central banks (Reserve Bank of New Zealand) and no for others (Bank of England). The European Central Bank recently lifted interest rates by another 0.25 percentage point, with President Christine Lagarde describing a further hike in July as "very likely." High wage settlements are now replacing energy as the biggest threat to Europe's inflation outlook.

Central banks that paused raising rates (The Bank of Canada, RBA) have had to resume tightening cycles. The US Fed paused in June but left the door open to resuming the tightening cycle, lifting the median rate forecast to 5.6% in 2023. The forecasts imply the officials expect two additional 0.25-percentage-point rate hikes before the end of the year. The inflation fight is not over.

The script is the same. The Bank of Canada noted “concerns have increased that CPI inflation could get stuck materially above the 2% target.” The RBA said, “Recent data indicate that the upside risks to the inflation outlook have increased and the Board has responded to this.” Chairman Powell from the US Fed pointed out that there had not been a lot of progress when it came to core inflation. Labour markets are showing extraordinary resilience: “Inflation pressures continue to run high and the process of getting inflation back down to 2% has a long way to go.”

The International Monetary Fund recently encouraged the US Fed and other global central banks to "stay the course" on monetary policy and remain vigilant in combating inflation.

The past month has also been notable for the pushing out of expectations that lower rates could be around the corner and markets embracing central bank’s view. Last month we noted a disconnect between what markets thought would happen with interest rates and what central banks were saying. A month ago, the market was saying the federal-funds rate could be lowered 120 basis points over the coming 12 months. That has now been reined in to 60 basis points.

There are some encouraging signs on the inflation front, particularly when it comes to goods inflation, with pricing pressure dissipating as global supply chain pressures ease. However, service sector inflation is still very high around the globe and proving to be persistent. Unit labour costs globally are on the rise. US core inflation is receding, but at a glacial pace, and at 5.3% it remains more than 150% above target.

Meanwhile, global growth, while slowing, is reasonable, consistent with the fabled soft landing. However, sticky inflation, prospects for higher interest rates, or rates remaining higher for longer do not eliminate the path to a soft landing, but it does make it more difficult to engineer. The enemy of bonds has always been inflation, and central banks are firm in their disinflationary rhetoric and following it up with action. This adds to the attraction of long-dated bonds in portfolios.

One area to watch over the second half of 2023 is Treasury Bill issuance, as the US government rebuilds cash in the Treasury General Account. With the Fed continuing with quantitative tightening, and the European Central Bank and Bank of England following suit, bonds could see some temporary gestation issues.

International Equities—Review

Equity returns have been strong in 2023, and returns have generally turned positive year-on-year across markets. Key influences have been a better performing global economy and some narrow strength in a few names across the technology sector, with enthusiasm around AI. While AI is getting attention, market strength has recently broadened beyond the tech mega-cap industry.

Divergences were notable in May, though, with the MSCI All Country World Index losing 1.3% on the month. Developed markets (0.1% loss) outperformed emerging ones (1.0% loss), which were weighed down by China. Japan's TOPIX rose to a 33-year high by gaining another 3.6% in May.

International Equities—Outlook

Can the market remain resilient? The S&P 500 officially entered a bull market midmonth.

Certainly, some factors such as prospects for AI could drive a new wave of investment and select opportunities. Global growth has surprised in 2023, despite some regions such as Europe entering a recession. Better growth has been against a backdrop of low investor sentiment; positioning was wrong for positive surprises. Liquidity remained supportive, with the Bank of Japan continuing to expand its balance sheet and central banks aiding banks following the collapse of Silicon Valley Bank and follow-on ructions to avert financial stability problems. Equities have remained somewhat immune to a gradual repricing of central bank actions and higher-for-longer interest-rate narrative.

Morgan Stanley's Global Strategy Mid-Year Outlook was aptly titled "Crunch Time" and possibly signals a turning point (if they are correct). Others are more sanguine on prospects.

More-resilient growth in 2023 is now being offset by prospects of lower growth in 2024, with commodity prices, bank lending conditions, and the yield curve all pointing to another year of subdued growth. The World Bank lifted growth forecasts for 2023 to 2.1% from 1.7% but cut its 2024 global growth forecast to 2.4% from 2.7% in its latest Global Economic Prospects report. Central bank monetary tightening and increasingly restrictive credit conditions were key factors in the cut. World Bank chief economist Indermit Gill said 2023 would still mark one of the slowest growth years for advanced economies in the last five decades, but the real story was one of successive years of subdued growth.

Sticky inflation and rates remaining higher for longer bring into play an L-shaped cycle. With inflation persistent, global unemployment rates low, real interest rates barely positive in some jurisdictions and still negative in many countries, fiscal and monetary policy facing coordination challenges, and liquidity set to be withdrawn by central banks, this is not a set of circumstances pointing to a conventional V- or U-shaped cycle. The levels of activity matters just as much as the change in activity. Liquidity pumped up the level, and it will take time for liquidity to be withdrawn.

Upside economic surprises are now becoming less common and downside surprises more common. Commodity prices point to weaker growth. Oil prices are a case in point, with reduced prospects for supply from some nations failing to materially affect prices.

With markets now embracing higher-for-longer interest rates, two key factors to watch over the coming months are liquidity and earnings.

The US Fed continues to reduce liquidity via its quantitative tightening program of $95 billion per month. Morgan Stanley expects a large (more than USD 1 trillion) increase in US T-Bill issuance over the months following debt-ceiling resolution. Liquidity is set to tighten in Europe, with a EUR 480 billion targeted longer-term refinancing operation repayment due in June. QT starts the following month.

Corporate earnings are projected to fall around 6% in the June quarter according to FactSet. Containing inflation involves an inevitable contraction in margins. Earnings are, however, expected to turn around in the second half of the year, increasing 8% in the fourth quarter. This would be the highest year-over-year earnings growth rate reported since since the first quarter of 2022. Leading that rebound expectation are communication services, utilities, consumer discretionary, IT, and financials. Stripping out communication services and IT decreases the rebound to 3.9% from 8.2%.

The consensus is that the worst of the earnings recession is largely behind us, at a time when core inflation remains above 5% and bond markets are erring towards rates being higher for longer. Hence "crunch time," and Morgan Stanley is projecting a deeper earnings recession in 2023 of a 16% decline, followed by a strong earnings rebound in 2024-25, conditioned on a more accommodative policy in 2024.

Economic and specific conditions have somewhat supported surprisingly resilient equity markets. Fixed-income markets have moved towards central banks' view of inflation. Equity markets do not appear to share the same view, and whether there are real reasons for that dichotomy remains open to debate. K

Performance periods unless otherwise stated generally refer to periods ended Friday, 16 June 2023

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