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Economic Update: Australia
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Summary

- The Reserve Bank of Australia has more work to do.
- Inflation pressures are receding globally, but the journey to hitting inflation targets is a long one, and many nations are seeing persistent inflation.
- Growth has been more resilient, though questions remain over whether this is just a timing issue with the lags in monetary policy, the level of activity to which economies were stimulated, or a changed environment.
- Markets are running with a soft-landing narrative: disinflation and a return to inflation targets with less collateral damage to real economies and limited rises in unemployment. That has boosted equities beyond mega-tech.
- Achieving the fabled soft-landing faces challenges, with central banks wary over the persistence of core inflation pressures.
- The potential stickiness of core inflation and uncertainty over a soft-landing or hard-landing for regions and the global economy point to diversification in asset allocation.

Australia Cash and Fixed Interest—Review

Hold but prepared to hike again was the message from the Reserve Bank Australia in July with: "Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe." The bottom line is that "Inflation in Australia has past its peak and the monthly CPI indicator for May showed a further decline. But inflation is still too high and will remain so for some time yet."

After briefly hitting 4.3%, Australia's 10-year bond has subsided toward 4%, levels similar to a month ago, mirroring US Treasury yield movements and expectations that the peak in the tightening cycle is near. The 2–10-year bond spread is slightly negative, distinct from the material inversion in the yield curve in the United States.

A weaker United States dollar has helped propel the Australian dollar higher, though it should not be characterised as a trend, yet.

Australia Cash and Fixed Interest—Outlook

The RBA alluded to higher rates in early July, and recent data signals the same, with the most recent unemployment figures of 3.5% well below where the RBA puts the nonaccelerating rate of inflation (around 4.5%). Employment growth in June came in double expectations. Like many other countries, strength in the Australian labour continues to surprise and remains an inflationary risk/reality.

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Markets are erring between one or two more 25-basis-point increases in the cash rate. Beyond that, there has been growing acceptance that where cash rates peak is only part of the equation that we need to think about in terms of central banks, and how long they might need to remain at or near peaks is the real question. Financial markets have eased back from anticipating aggressive cash rate reductions by central banks in 2024 to the prospect of rates perhaps moving modestly lower.

Projections for long-term interest rates in Australia have been raised, though the consensus remains a declining trend over the latter part of 2023 and 2024. With inflation proving more sticky, terminal cash rate expectations being pushed higher and for longer, longer-term yields are also expected to be a tad higher. Westpac remains at the more aggressive end, anticipating the Australian 10-year bond easing to 3.1% by the end of 2024, whereas National Australia Bank is projecting 3.5%.

Forecasts for the AUD are largely directionally higher, underpinned by a weaker USD. This reflects a combination of valuations (USD receding from overvaluation), and the United States' greater advancement in the inflation cycle leading to the same for the interest rate and a prospective easing cycle from the Federal Reserve. Westpac is projecting the AUD/USD rising to 0.74 by the end of 2024, ANZ 0.73, and NAB similar. Sticking points to this are China (commodity prices) and risk aversion if equity sentiment turns toward a hard-landing scenario.

Australian & International Property—Review

The S&P / ASX200 A-REITs Index is up 2.9% month to date and 4.6% year to date. The index is flat on a year ago.

The FTSE EPRA-NAREIT Global Index in U.S. dollars (total return) is down slightly quarter to date, down 3.7% for the year to date and down 13.8% on a year ago. Europe has outperformed for the quarter to date but underperformed for the year to date, easing 5.8% and 21.4% on the year prior.

Australian & International Property—Outlook

Rising inflation and interest rates have been affecting capital values globally for commercial property.

With interest rates still rising in many countries, and the full impact of rising rates yet to really bite both economically through tenant demand and financially through interest costs and leverage ratios, pressure is expected to continue, at least in the near term. Working-from-home trends continue to undermine office space demand, while the shifting nature of trade is buoying industrial property.

Some take a glass-half-full approach, such as Knight Frank's senior partner and group chair, Will Beardmore-Gray, who notes that a "a return to stronger economic growth" in the upcoming year, combined with declining interest rates, is expected to lead to an improvement in market conditions.

Others are more guarded. Morgan Stanley analysts forecast that US commercial real estate prices will fall by more than they did in the financial crisis. Invesco's 2023 Mid-Year Investment Outlook noted that "While continued downward pressure on real estate prices in the near term is expected, commercial

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mortgage rates may be lower and credit conditions may improve through 2024, at which time a significant portion of commercial real estate loans mature and need to be refinanced." Hence, a lot depends on lower interest rates and a smooth landing being able to mitigate potential refinancing challenges.

In May, the Federal Reserve released its Financial Stability Report. In that report, the Fed warned that trouble in the commercial real estate sector could pose a risk to the United States financial system. Interest rates have pushed higher subsequently.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is up 2.4% for the year to date and 0.6% on a year ago. The index has risen 1% so far in July.

The MSCI World Core Infrastructure Index (USD) net index reported a negative 0.8% return for the year to date (as at end of June) and is down 2.3% on a year ago. The infrastructure index has underperformed the broader MSCI world measure, or most other global equity measures of late, as cyclicals and mega-tech have been in favour.

Global Infrastructure—Outlook

Infrastructure benefits from the crucial role it plays in the global economy. The availability of transport, communication, electricity, water and sanitation, health infrastructure, and other basic facilities is a key influence on life quality and living standards.

Underinvestment in infrastructure remains a global theme, as pointed out by GI Hub, with material deficits around the globe and a USD$15 trillion investment gap.

The world's population is growing fast, infrastructure networks are aging, the global economy needs to transition to a more durable world—combined with public-debt limit constraints, these are key challenges facing the sector.

The year has not quite played out as expected so far with equities outperforming despite interest rates rising, and infrastructure underperforming despite having attractive defensive characteristics to prospective downturns.

With markets gripped for now by the prospect of the fabled soft-landing, infrastructure's attractiveness is more long-term in nature, a theme-based investment including energy transition and transport decarbonisation, as opposed to a sector based one.

Can the inflation dragon be slayed in a soft-landing environment, though? Markets are hopeful. If the answer is no, expect infrastructure to become more appealing given strength of cash flows, inflation protection (typically the ability to pass on price rises), and defensive characteristics.

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Australian Equities—Review

The S&P / ASX200 Index is up 4.1% for the year to date and 10.1% on a year ago. July has seen momentum maintained (1.7% for the month to date). June was a solid tough month, with Australian equities rising 1.8% and large caps beating small caps. The technology sector followed global peers with solid gains across the quarter. Energy and industrials also performed solidly. Healthcare, materials, and consumer discretionary recorded (price) losses for the quarter.

Australian Equities—Outlook

Growth in the Australian economy has eased, and there are tentative signs of a turn in the labour market. Firms report that labour shortages have moderated. SEEK job ads fell 2.3% in June, with the number of ads 24% below the May 2022 peak. Unemployment nonetheless remains very low.

While the Reserve Bank of Australia paused in July, expectations are the interest-rate cycle has not yet peaked, with "some further tightening of monetary policy may be required," and market pricing reflects this. The usual suspects feature:

- The risk that expectations of ongoing high inflation will become embedded in larger increases in both prices and wages.
- Limited spare capacity in the economy and a continued low rate of unemployment.
- Elevated unit labour costs.
- The price-setting behaviour of firms.

Despite recent interest-rate increases and prospects for more, projections for the Australian economy are consistent with positive growth, though the Reserve Bank of Australia notes the path to achieving both growth and 2%-3% inflation "is a narrow one" with a substantial slowdown in household spending underway.

Westpac economists have the economy barely skirting an official recession, with annual growth dropping to 0.3% for June 2024. National Australia Bank is similar, projecting growth to be flat over the next three quarters and 0.5% in 2023.

Consumer confidence remains weak, and in fact consumers are leading the downturn, clipped by high inflation and rising interest rates. There is emerging weakness in business conditions, aligning two sides of the economy. The NAB business survey showed that the soft business conditions apparent in May continued into June. Forward orders showed successive declines, while business confidence remains soft. This is expected to flow into subdued business investment.

Within a subdued economic environment and rises in interest rates, housing market activity is constructive on some levels. CoreLogic's home value index managed to post another gain in June. Positive factors include a rebound in population growth courtesy of strong migration, a tight rental market, and weaker supply side, with building approvals moderating.

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A key area to watch over the coming months will be tensions between the need for housing supply (migration, population driven) versus the impact of interest rates on approvals and credit growth.

China's economy expanded more slower than expected in the second quarter, with consumer spending easing notably in June, and this is raising questions about prospects for commodity prices. At the same time, tensions between the United States and China on the trade front require close attention.

The Reserve Bank of Australia is anticipating wages growth will be consistent with the inflation target if productivity growth picks up. This uplift will be a critical component of delivering on earnings estimates in what otherwise is a growth, cost, and financing challenged environment.

According to Standard & Poor's estimates, the trailing P/E of the S&P / ASX 200 is 14.6 (last month 14.2), and the forward P/E is 14.37, with an indicated dividend yield of 4.7%.

International Fixed Interest—Review

Declining headline inflation rates but concerns over sticky core inflation is the key theme, along with what it could take to get sticky inflation closer to targeted inflation.

Markets have taken some comfort from receding core inflation in the United States, with inflation ex food and energy easing to 4.8% from 5.3%, which helped turn long-term bond yields lower after briefing hitting 4%. Core inflation in the United Kingdom, meanwhile, came in at 6.4%, compared with 6.5% last month. Euro-area headline inflation dropped to 5.5% in June, but core inflation was 5.5% compared with expectations of 5.4%, supporting the view that the European Central Bank will continue raising rates in the upcoming months.

Yields in general continue to remain in ranges fixated on each inflation print. For the United States, for example, the 10-year bond has wobbled between 3.5% and 4.0%. There is curve inversion, with two-year yields well above 10-year yields, which is associated with expectations of a challenging economic environment in the United States, Europe, and United Kingdom.

The Bloomberg Global-Aggregate Total Return Index Value (Unhedged USD) is up 3.3% for the year to date and 0.7% on last year. The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of 2.4% though a negative 2.2% return over the year. Bonds returns are up slightly in July.

International Fixed Interest—Outlook

One of the most rapid tightening cycles ever seen has so far failed to derail the global economy, albeit, not without ructions and challenges including banking sector stress, debt ceiling wranglings, geopolitical tensions, and ailing asset prices in 2022. Whilst subtrend, economic momentum outside of China in the first half of 2023 has exceeded expectations.

At the same time, inflation trends are constructive and lower. The United States is leading, with Europe expected to follow with a lag.

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Most Western central banks, excluding the Bank of England, are either in or morphing into the fine-tuning stage of the cycle, balancing signs that inflation is receding and the lags with which monetary policy operates with the risk of overcooking downturns, which many yield curves are alluding to. The impact of higher interest rates on borrowing costs will grow over the coming year as firms refinance maturing debt and household's re-mortgage.

While trends are constructive and entering the fine-tuning stage is welcome, central banks are warning against inflation complacency, epitomised by two additional hikes in the most recent US Fed dot plots. The missing part of the low inflation puzzle is maintained low service sector inflation, which is significantly influenced by labour market trends with global unemployment rates still very low. Sustained elevated core inflation risks manifested in altered pricing behaviour and inflation expectations; this lifted in the most recent University of Michigan Consumer Sentiment Survey.

Structural factors including population aging, decarbonisation, and globalization tensions. This is manifesting in just-in-case replacing just-in-time as efficiency is sacrificed for certainty and stability, implying a stickier aspect to inflation that we have been used to. This, in turn, puts on more pressure for demand destruction (hard landing) to realign demand with supply. Lower inflation might be around the corner, but we might need to redefine what level of low inflation is acceptable in this environment, at some stage.

For now, central banks are on a mission, and that is to be respected. Equity markets are siding with the soft-landing, whereas bond markets are less sanguine. Each progressive nudge higher in cash rates brings hard-landing prospects further into play, but that is taking time to play out, in part because the level of activity around the globe has been propelled far in excess of the supply side capacity of economy's by monetary and fiscal policy, credit conditions and quantitative easing. The path to recession can be overstated when you are coming from an outsize rate and level of activity.

Inflation remains the enemy of bonds, and there is a scenario where central banks are forced to keep rates higher for longer to lean against inflation being dictated by supply constraints. That risk is two-sided, with recessions risk the other way. Household savings buffers are reducing, and there are some signs of turn within the labour market. The combination of tighter monetary policy, credit conditions, and quantitative tightening is simply taking longer to play out. Around current levels, fixed-income assets offer a reasonable balance between income and risk.

When Jamie Dimon, the CEO of JPMorgan Chase, says, "I don't know if it's going to lead to a soft-landing, a mild recession, or a hard recession," during a call with journalists, diversification in portfolios appears prudent.

Beyond growth and inflation trajectories, areas to watch over the coming months include:

- The progressive move to quantitative tightening beyond the United States and within Europe.

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- Treasury Bill issuance, as the US government rebuilds cash in the Treasury General Account.
- Pressure on the Bank of Japan to adjust yield-curve control settings.

nternational Equities—Review

Impressive is one way to describe the performance of equities amid a higher interest-rate environment, with gains covering successive quarters and strongly positive. Gains broadened beyond mega-tech to include cyclicals. As one JPMorgan analyst noted, "Goldilocks beats the bears."

Financial stability risks faded, optimism over growth improved, and inflation tracked down. Equity markets have appeared to somewhat discount inflation and interest-rate risk. The S&P 500 rose 8.7%, and Japan's TOPIX was 14.4% higher for the quarter. Year-to-date returns are double-digit across the MSCI World Index, S&P 500, German Dax 30, France CAC 40, and Japan's Nikkei 225.

International Equities—Outlook

Can the global and United States economies pull off the fabled soft-landing, that combination of dissipating inflation without too much collateral damage for the economy, and avoid a recession?

Sentiment has swung that way with consumer price inflation, producer price inflation, and bank earnings pointing to the soft-landing. Headline inflation in the United States receding to 3% and core inflation dropping to 4.8% from 5.3% received attention. The disinflation narrative gathered more steam, with the producer price index rising just 0.1% year on year. A tense regional banking situation has given way to strong bank earnings. June's larger-than-expected drop in inflation "means a narrow path to a soft landing is modestly wider," JPMorgan's Marko Kolanovic noted.

Fed Chair Jerome Powell had also expressed optimism about the US economy and downplayed the odds of a recession. While acknowledging that a recession is "certainly possible," he said such an outcome is "not the most likely case."

The immaculate disinflation theme faces challenges. Core inflation remains at 4.8% in the United States and stickier elsewhere. Continued labour market tightness, a shifting world with globalisation facing pressures—from economic dictated trade to security influenced trade—and moving from efficiency to resilience across supply chains is not the environment we have been used to in taming or maintaining low inflation.

Central banks remain alert to movements in inflation expectations and the last read from The University of Michigan Consumer Sentiment Survey showed a rise in consumer confidence and rebound in inflation expectations, with the one-year measure rising to 3.4% from 3.3% versus expectations of a drop to 3.1%.

If there is going to be alignment between disappearing inflation and durable growth, productivity growth will be a key variable. Productivity mitigates cost pressures. Unit labour costs in the US nonfarm business sector rose an annualized 4.2% in the first quarter of 2023—elevated, though less than

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preliminary estimates of 6.3%. Nonfarm productivity, which measures hourly output per worker, dropped at a 2.1% annualized rate in the March quarter. That adds to cost pressure. This is where artificial intelligence could be profound for companies with high staffing costs or a large share of tasks with automation potential.

Central banks remain on a disinflation mission and talk in stern tones. Financial markets are anticipating one more 25-basis-point hike from the US Fed, two from the European Central Bank, and four from the Bank of England. Real interest rates are finally starting to turn positive. We are now in the difficult zone for many central banks where the signals are mixed; core inflation says keep hiking, but each increase brings a nontrivial chance of the hard landing, which the bond market is alluding to, but not equities.

Can big tech maintain momentum? Divergent views are apparent, but suffice to say, a lot needs to go right.

The market had broadened beyond big tech anyway in recent months, which makes the economic outlook more important. Economic gauges are giving differing messages in the United States and many nations including New Zealand and Australia. Bonds are downbeat (curve inversion), whereas equities are upbeat, and cyclicals have joined in. Manufacturing is weak, services are not. Hard data has outperformed "soft" leading data sentiment. Construction—a hugely procyclical sector—is showing weakness in housing starts but strength elsewhere. The Conference Board's leading indicator for the US economy is pointing to recession in the near future, even as its coincident indicator says growth is fine for now.

According to data compiled by Bloomberg Intelligence, S&P 500 firms are expected to post a 9% drop in profits in the second quarter, making it the worst season since 2020. Projections are for a 12% drop in Europe. FactSet reports the second-quarter earnings season for the S&P 500 as "off to a strong start," with 80% of those who have so far reported showing actual earnings per share above estimates. "The blended (combines actual results for companies that have reported and estimated results for companies that have yet to report) earnings decline for the second quarter is -7.1% today, compared to earnings decline of -7.4% last week." More of the lower earnings but less bad story.

The less-bad narrative is important. Growth and earnings have followed that pattern. The longer inflation takes to come down, the more less-bad is likely to need to change and a real downturn take hold.

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