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Economic Update: Australia
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Summary

- Core inflation pressures continue to ease, slowly, but global inflation trends are now facing near-impetus from a surge in oil prices. This surge highlights the importance of factoring in geostrategic considerations, a consideration that had been minimal for decades.
- Higher-for-longer remains the key theme across interest-rate markets, bringing income back into fixed income.
- Equity markets, which had been embracing the soft-landing narrative, have become more cautious as real interest rates rise and concerns mount toward China, geopolitics, and the durability of the economic expansion, which has proved robust so far in the face of higher interest rates.
- There remains tension and debate as to whether a soft landing for the global economy will really be sufficient to return inflation to target.

Australia Cash and Fixed Interest—Review

The Reserve Bank of Australia retained the cash rate target at 4.1% in early September, noting that "Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable time frame." Reasonable time frame is a key phrase, and a lot depends "upon the data and the evolving assessment of risks." This is central-bank speak for being in data-watch mode and standing ready.

Inflation is sticky, but China remains a key risk and clouds the outlook.

The Australian 10-year bond has risen to 4.2%, a rise of 100 basis points from mid-April, and continues to take directional leads from the United States equivalent. Unlike the U.S. and New Zealand, Australia's yield curve remains relatively flat rather than inverted.

The Australian dollar has been broadly stable over the past month at just below 0.65 against the U.S. dollar at the time of writing, after falling over late July and most of August. Signs of stability in China have helped, as have views that other central banks (the U.S. Federal Reserve and ECB) are at the end of their tightening cycles.

Australia Cash and Fixed Interest—Outlook

Market expectations are biased toward the possibility of the RBA having to lift interest rates again but not placing an overwhelming probability on that outcome, a fair reflection of the RBA's acknowledgment that some further tightening may be required. Like other central banks, the RBA considers "inflation too high" and continues to stress the importance of achieving its mandate as "High inflation makes life difficult for everyone and damages the functioning of the economy." There remains the risk of higher rates, but limited conviction to price in a high probability.

Progress toward the target is being made, but the war on inflation is not yet won. The watchlist of variables includes the usual suspects such as "the global economy, trends in household spending, and the outlook for inflation and the labor market." Add inflation expectations to that list as headline inflation rates get pushed higher owing to oil prices.

Projections for long-term bond yields are generally lower, mirroring expectations for U.S. interest rates and an eventual return in central bank policy rates toward neutral policy settings. Westpac is projecting around 3.3% by the end of 2024. NAB is less bullish but still expects lower (3.8% by the end of 2024).

The AUD/USD rate is generally projected to be higher a year from now across the bank economists, conditional on USD weakness as the U.S. tightening cycle is replaced by an easing cycle. That scenario is somewhat conditional on the outlook for China, which remains a key global risk. Commodity prices with an Australian link (iron ore, coal) have so far remained resilient (in levels terms), and the terms of trade elevated.

Australian and International Property—Review

The S&P/ASX200 A-REITs Index is down 3.3% month to date though up 3.2% from 12 months prior. The index is up 3.8% for the year to date.

The FTSE EPRA Nareit Global Real Estate Index in U.S. dollars (total return) is largely flat in September (down 0.4%), though up slightly for the year to date. The index is down 2.1% from a year ago.
Rising interest rates continue to present challenges for property portfolios.

Australian and International Property—Outlook

Bifurcation and higher interest rates remain long-term themes.

Rising interest rates and a higher-for-longer narrative to contain inflation continue to place pressure on cap rates. With rising rates also comes refinancing and economic (tenant) risk, along with pressure on leverage ratios.

CBRE's U.S. Real Estate Market Outlook Midyear Review included expectations of a later potential recession and extended projections for a recovery by one or two quarters, pushing expected improvements into 2024. Cap rate expansion is expected for the rest of 2023. It does not expect office asset cap rates to stabilize until mid-2024. It notes that "uncertainty regarding long-term hybrid working arrangements and the economic outlook is causing many tenants to delay leasing decisions."

With little relief from interest-rate pressures likely anytime soon, gearing ratios are likely to become pressured, resulting in the emergence of more-motivated vendors that will likely shift toward buyers' pricing.

The office market, as well as retail, remain challenging as they adjust to a paradigm shift that will likely take years to work through.

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Segments such as data centers, expressions of the digital economy, and industrial and real estate manifestations of the changing way we work and live are finding attraction, including a flight-to-quality in premium office. Industrial property and logistics in many nations are benefiting from structural shifts including near-shoring, friend-shoring, and onshoring. The soft-landing narrative has lessened tenant and economic risk.

The major story remains higher interest rates. Refinancing is often not immediate and can have a long tail.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is up slightly month to date, down 1.8% year to date, and down 4.3% from a year ago. The sector outperformed in August, showing defensive characteristics.

The MSCI World Core Infrastructure Index (USD net index) has underperformed broader indexes in 2023. For the year to date to end of August, a 3.3% loss was recorded compared with double-digit returns across other market indexes. Performance has been weaker in the month of August, year-to-date, and year-on-year.

Global Infrastructure—Outlook

Outperformance in 2022 for infrastructure has been followed by underperformance in 2023.

The outlook for global infrastructure remains caught between opposing forces. Infrastructure is traditionally an asset class less vulnerable to economic swings. With 61% of respondents in the World Economic Forum's latest Chief Economists Outlook expecting growth to weaken and the one-word summary of what lies ahead for the world economy in the coming year being "volatility," courtesy of geopolitics, there is a lot to like about infrastructure despite its recent underperformance.

Infrastructure is not immune from challenges. Inflation adds to construction costs, and interest rates challenge project viability. Fiscal policy is facing debt constraints in many nations. This means private capital needs to step in. Traditional infrastructure has been viewed as stable and predictable. It is now being shaken by revolutions in energy, mobility, and digitization. No sector is immune from structural shifts in the economic environment.

The bigger picture remains more positive. Decarbonization/climate change, digitization, and demographics are three clear supportive trends. In addition, trade decoupling or reshoring from low-cost to higher-cost countries will require greater use of automation and different infrastructure utilization. The sector remains a long-term play with investment in sectors such as transportation, energy, and digital infrastructure essential for economic development. For now, though, markets appear to be playing the short game.

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Australasian Equities—Review

The S&P/ASX200 Index is up 3.4% year to date and 6.4% on a year ago. The index is down slightly so far in September.

The ASX 200 fell by 0.7% in August, and the Small-cap index underperformed, recording a 1.7% drop. Ten of 11 sectors were down, the exception being consumer discretionary. Utilities led the decliners along with consumer staples. While down, the movement in the ASX 200 was less than its international counterparts.

The latest reporting season was notable for the surprising resilience of the consumer, business cost pressures, and the management of rising borrowing costs.

Australasian Equities—Outlook

The Australian economy remains in a slow growth phase with high inflation weighing on disposable income, dampening household consumption. Household real disposable income has contracted for a fifth consecutive quarter, despite continued robust labor market conditions. The two key timely gauges of the Australian consumer are the Westpac Consumer Sentiment survey and the Westpac Card Tracker. Both show difficult conditions and consumer recessions.

Encouragingly, the broader data tone to date remains consistent with inflation returning to the 2%-3% target range without an economywide severe or hard-landing economic adjustment and only a modest rise in unemployment. Monthly inflation pressures have continued to ease (4.9% year-on-year, or yoy) with the core 5.6% yoy. While encouraging, the RBA maintains a modest tightening bias for now.

Australia is experiencing a population surge, which is pushing above 2% growth. That adds to base demand in housing and consumables. Population growth can mask per capita or population-adjusted recessions. Permanent and long-term net arrivals are at a historic high, with the three-month average sitting at just under 40,000 per month. House prices have firmed while dwelling construction remains weak, tempered by construction and interest costs.

Tepid demand and cost pressures have made life difficult for businesses; the latest National Accounts showed company profits in retreat, falling by 8.6% in the June quarter, to be 6.8% down on a year ago. Nonmining profits were down by around 5% in the latest quarter.

China's headlines have not been commodity-favorable, with declining exports and property troubles sparking fears of a hit to resource demand. This has not occurred to date but needs close watching. Westpac economists note that while China's demand is a concern, they also point out that this needs to "be assessed in the context of the rise of the new economy, which has huge potential to lift economic growth, and with it, the demand for commodities," which have supported prices.

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Projections are for a modest economic improvement in 2024, and potentially the RBA providing some interest rate relief, which could provide assistance to earnings as well. Australia, like other nations, still has inflation a considerable way from the target.

According to Standard & Poor's estimates, the trailing P/E of the S&P/ASX200 Index is 17.3 (last month it was 15.0), and the forward P/E is 15.3, with an indicated dividend yield of 4.1%.

International Fixed Interest—Review

Bonds in general have moved higher in yield over the past month, driven by the soft-landing narrative (reasonable data), and the buy-in of central banks' communication around rates remaining elevated for a period. Movements have been accentuated by greater focus on fiscal positions including bond supply and issuance. The movement has occurred despite core inflation trends moving in a generally positive direction. Recent rises in oil prices and geostrategic factors risk derailing central banks' best-laid plans, and central banks will remain alert to shifts in price-setting behavior.

The Bloomberg Global Aggregate Total Return Index Value (unhedged USD) is down 0.8% for the year to date and up 0.5% from last year. The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of negative 0.5%. The return has been negative (by 1.9%) in the past year. Bond returns are down in September.

International Fixed Interest—Outlook

The movement higher in Treasury yields around the globe since midyear has intensified the debate over the outlook for growth and inflation. Growth in particular has exceeded expectations in the U.S., which has been extrapolated into a higher long-term neutral interest rate. Higher fiscal deficits also support stronger economic growth in the near term and more government bond supply. When combined with Japan's shift in yield curve control, many are thinking higher yields are here to stay. Central banks continue to warn against complacency in the battle against inflation.

Real yields have risen despite most central banks appearing to be near the end of their tightening cycles. Two reasons for this include higher bond supply/fiscal deficits and productivity growth through AI expectations rather than backed by current productivity figures. The effects of AI could be huge and absorbed into the economy faster than in previous technological revolutions such as the introduction of electricity and the internet.

Conviction remains across many, including Morgan Stanley economists/strategists, that yields will move lower toward the end of 2023 and over 2024, backing the lags in monetary policy and expectations that growth will slow. Real interest rates are now positive and well above mainstream estimates of the neutral policy rate in many countries. The U.S. Federal Reserve continues to substantially reduce the size of its securities holding. The Chair of the U.S. Federal Reserve Jerome Powell, noted in a speech at Jackson Hole, "The wide range of estimates of these lags (with which monetary tightening affects economic activity and especially inflation) suggests that there may be significant further drag in the pipeline."

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Encouragement can be taken on some levels from core inflation in the U.S., which has eased 4.3%, though that is still high and a considerable way from target. Inflation expectations from the University of Michigan survey of consumer sentiment declined to its lowest level since March 2021. Central banks continue to juggle the directional movement in inflation (lower) and respect for the lags in monetary policy with the stickiness in inflation (it's been a slow move lower), length of time away from target (risks affecting price-setting behavior), and strength across labor markets.

An emerging issue is the tension between the geostrategic and central banks' "plans" through demand management. Oil prices have risen from USD 70 per barrel to USD 90 per barrel. Headline inflation rates are now receiving a "bump" higher, and U.S. inflation has accelerated for the second successive month in August. Further disinflation may be elusive in the second half of 2023, owing to base effects and energy prices.

Such supply tensions can be looked through by central banks, with provisos. The first is no impact on pricing behavior (inflation expectations) and the shocks are one-offs. The first requires monitoring, while the second can be questioned. We appear to be in a world of regularly repeating supply shocks. Moreover, globalization is in retreat, and onshoring/near-shoring/friend-shoring is replacing offshoring, boosting U.S./North American growth at the expense of China. Efficiency in supply chains is being replaced by resilience, and the economics behind trade is being usurped by security in trade.

China is an inflation outlier, with a distressed property sector, weak consumer spending, and demographic and deleveraging challenges. Import penetration into the U.S. market is retreating. It is notable that China's currency has been under pressure and is at its lowest level against the U.S. dollar since 2007. This could prove destabilizing.

Central banks continue to monitor labor market developments closely, which so far have remained resilient in the face of higher interest rates, in line with the economic data. Central banks continue to back a turn in the labor market. Structural tensions are prevalent here, though, epitomized by the United Auto Workers strike in the U.S., which attempts to lift wages and also recoup years of lost benefits.

Most central banks have moved into a more data-dependent stage of the cycle, wary of inflation risks but also the risk of overtightening. The U.S. Fed noted risk-management considerations as now critical. Market pricing has the RBNZ, RBA, U.S. Federal Reserve, Bank of Canada, and ECB at or near peaking.

The fixed-income market continues to benefit from the return of the income component. The term premium on offer is well above conventional estimates of central bank neutral policy rates. The consensus remains for lower longer-term yields. However, the current environment does not resemble the past 30 years—witness the reversing process of globalization and rising geostrategic tension.

International Equities—Review

Equity market sentiment has turned more cautious. Key catalysts have been rising real interest rates as markets move more to the higher-for-longer narrative and weak data coming out of China, which

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weighed on the outlook for global growth. The tenor of global data has turned more circumspect with fewer upside surprises, which were a feature of the second quarter. In addition, it is natural for market trends to consolidate following large moves like those we have seen over 2023.

The MSCI World Index declined by 1.7%, and its emerging-markets counterpart fell by 4.7% in August. Major indexes including the S&P 500, German Dax 30, France's CAC 40, and Japan's Nikkei 225 showed 1.5%-3% falls. September has seen ongoing volatility.

International Equities—Outlook

Markets continue to embrace the soft-landing narrative, though the combination of rising real interest rates and concerns over China, along with geostrategic aspects to the U.S.-China relationship have seen markets become more cautious and volatility rise markedly. Heavyweights such as Apple have not been immune to geopolitics.

The soft-landing narrative continues to be supported by the concurrent data for now. One key indicator that has been giving the market confidence is that the monetary tightening seen so far has not materially weakened the labor market (though some softening is clearly occurring) or had an impact on the consumer, with the latter supported by excess savings. Structural initiatives such as the Bipartisan Infrastructure Law passed in 2021, the CHIPS and Science Act of 2022, and the Inflation Reduction Act are initiatives that support a reshoring drive by businesses. China's loss has been others' gain.

Consistent upward data surprises are now being replaced by moderation.

Earnings growth in the second quarter of negative 4.1% for the S&P 500 was the third straight yoy decline, but it still exceeded expectations according to Factset. Moreover, analysts have increased their estimates for the third quarter.

The Fed Bank of Atlanta's GDPNow model, a real-time compilation of data, suggests that U.S. gross domestic product will expand by 4.94% in the third quarter.

It remains possible that central banks will achieve a soft landing where there is enough demand taken out of the economy to return inflation to target without a recession. Fitch's latest Global Economic Outlook (September 2023) projects that the world economy is now likely to grow faster in 2023 than projected in June, though a deepening slump in China's property market is a concern at a time when monetary policy continues to tighten around the globe.

Despite the market embracing a soft-landing narrative, the New York Fed's U.S. recession probability index still projects a 66% chance of a recession within the next 12 months. Some continue to point to the yield curve as a predictor of recession, backing its historical predictive power. But yield curves today are affected by central bank balance sheets, so the signals are not the same as before.

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While the market is no longer fighting the Fed, instead embracing the soft-landing narrative, it now looks for the next catalyst. Earnings might provide it, but the market looks to be viewing the second quarter as a nadir. Economists at Morgan Stanley note that to keep multiples elevated, a clear reacceleration in growth or policy easing would be needed. They expect neither.

Some concern is being expressed about major benchmarks that adjust for mega-caps, noting that equities are leading and data is lagging.[1] Bloomberg's Markets Pulse survey pointed out that "more than half of 526 respondents said that personal consumption—the most important driver of economic growth—will shrink in early 2024."[2] The profit cycle has not yet pressured firms into aggressive cost-cutting such as layoffs and capital expenditure delays, and the clock is ticking on when households, after running down pandemic savings, will respond by cutting back on discretionary spending.

Views are divergent over the trajectory but there should be agreement on some basic facts. With both demand and supply goalposts shifting, the former by central banks and the latter by geostrategic factors, taming inflation and lining up an investment goal is challenging. A lot needs to go right. Just witness the recent surge in oil prices, which will not help control inflation. This is not a tame low-risk environment for investing.

Performance periods unless otherwise stated generally refer to periods ended Friday, Sept. 15, 2023.

[1] https://www.bloomberg.com/news/articles/2023-09-15/beyond-the-ai-euphoria-is-a-worrying-stock-signal-on-us-growth

[2] https://www.bloomberg.com/news/articles/2023-09-11/us-consumer-is-likely-to-start-cutting-back-hurting-economy-and-stocks

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