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Economic Update: Australia
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Summary

- Higher-for-longer interest-rate policy settings from central banks have been accentuated by widening term premiums lifting longer-term interest rates.
- Interest rates are not high relative to their longer-term history, but the recent rise is the most significant increase over a three-year period since 1980.
- Growth and labor market conditions continue to support a soft landing.
- Given the material lift in interest rates of late, and lags between monetary policy and the real economy, late-cycle risks, including earnings, growth, and credit, have risen.
- These risks are being accentuated by geostrategic and geopolitical shifts. Some have been positive for U.S. growth, such as reshoring at the expense of China. However, recent Middle East tension and higher oil prices add additional complexity to the required disinflation process.
- While some risks have receded, the International Monetary Fund notes the balance of risks as being tilted toward the downside. This supports caution and diversification in portfolio allocation and construction.

Australia Cash and Fixed Interest—Review

The Reserve Bank of Australia retained the cash rate target at 4.1% in October, noting some further tightening may be required.

The minutes subsequently released were more hawkish than the statement, with the board considering a rate rise, before concluding there was no need to move. A "low tolerance for a slower return to inflation to target than currently expected" has seen the market embrace a 50% probability of a further rise in the cash rate target by year-end and almost fully priced by May 2024.

Longer-term term interest rates have followed offshore (U.S.) direction, rising around 50 basis points over the past month, with the Australia 10-year bond increasing to 4.6%.

The Australian dollar has settled below AUD 0.65 against the U.S. dollar. Risk sentiment, central bank policy settings and China are key drivers. While the exchange rate to the U.S. dollar is down in 2023, the trade-weighted index has changed little since the start of the year.

Australia Cash and Fixed Interest—Outlook

Market expectations are for another rise in the cash rate target, though timing is split between 2023 and early 2024.

With limited "tolerance for a lower return to inflation," attention is on upcoming inflation figures, and any surprise above the RBA's expectations will be a key determinant of the need for higher rates before

year-end. Domestically, "progress in lowering services price inflation remains slow," a challenge shared by other central banks.

Higher-for-longer interest cash rate expectations are now also manifesting in bond projections, which have risen in tandem with the rise in actual yields. Westpac has lifted its year-end 2024 projection for the Australia 10-year bond to 4.2%, almost a full percentage point higher than a few months ago. National Australia Bank's economics team is projecting 3.8% by the end of 2024. "Higher for longer" is a theme for actual and interest rates.

Assuming a neutral real cash rate of 1%, inflation of 2.5%, and term premium of 1%, the 10-year bond yield is possibly not too far away from fair value, though those working assumptions can be challenged, such as the assumed real neutral cash rate. Neutral cash rates, the rate at which central banks are neither stimulating nor restricting the economy, appear to be on the rise, though the magnitude is uncertain.

The Australian dollar /U.S. dollar is generally projected to be stronger over the next year according to bank economists but like projections of bond yields falling, there appears less conviction about the magnitude of direction, with the U.S. dollar, risk sentiment, commodity prices, and China as major influences and carrying considerable uncertainty. A more-hawkish tone from the RBA has added a layer of support.

Australian and International Property—Review

The S&P/ASX200 A-REITs Index is up 7.6% on a year ago, though down 1.1% this year to date. October has seen a small rise so far. September saw the index fall substantially, sensitive to interest-rate movements.

The FTSE EPRA Nareit Global Real Estate Index in U.S. dollars (total return) has fallen 5.7% over the past month, and marginally over October. The index is down 4.9% this year to date, though up 6% from a year ago. Weakness has been apparent over the past month across the Americas, Europe, Japan, and Asia-Pacific.

Australian and International Property—Outlook

Commercial property values continue to face pressure from rising interest rates, which have increased borrowing costs and the cost of capital, and placed upwards pressure on cap rates.

Uncertainty remains a key theme, with rising interest rates restraining demand and forcing cap rates to rise and values to fall, coupled with higher inflation/construction costs, which restrain supply, and structural shifts in demand accentuated initially by the coronavirus pandemic but also wider trends including working from home, sustainability, and e-commerce.

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According to one of Bloomberg's Markets Pulse surveys, the commercial real estate market faces at least another nine months of decline, and the office market is not expected to trough until the second half of 2024 or later.[1]

The RICS Global Commercial Property Monitor reported negative sentiment in the second quarter of 2023 and since then interest rates have continued to rise and credit availability tighten.

The IMF's latest assessment noted that "the real estate crisis could deepen further in China, an important risk for the global economy," and the economy needs to pivot away from a credit-driven real estate model of growth.

Within a challenging environment for a sector heavily linked to the trajectory for interest rates, segmentation and bifurcation continue to feature. Building quality and accessibility (transport), along with sustainability, is affecting returning-to-office work patterns. Industrial property and logistics in some countries remains attuned to structural shifts, including near-shoring, friend-shoring, and onshoring.

While the central scenario for the global economy remains for a soft landing, risks surrounding this have risen as interest rates have pushed higher and inflation proven to be stickier. Asset protection from rent growth is more difficult to achieve and there is greater tenant risk. Elevated construction costs and interest rates will also affect supply, which will eventually help restore balance to the market, which is currently skewed in favor of buyers. Questions remain as to whether the sector and valuations have fully adjusted to the higher interest-rate world.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is down slightly this month to date in October, and down 8% year to date, though up 3.6% on last year.

The MSCI World Core Infrastructure Index (USD net index) underperformed broader indexes in September 2023 (down 5.3% versus down 4.3%). Infrastructure returns have been flat on a year ago according to this infrastructure measure, below double-digit returns seen across the MSCI World Index.

Global Infrastructure—Outlook

Infrastructure remains caught between cyclical headwinds and a combination of long-term challenges and opportunities. It is an asset class that appears to have a more balanced risk/return scorecard around it compared with others in a rising interest-rate and sticky inflation environment. However, it has struggled relative to broad equity indexes over the past year, the latter somewhat boosted by enthusiasm related to artificial intelligence.

[1] https://www.bloomberg.com/news/articles/2023-10-02/us-office-market-is-poised-for-a-crash-investors-say-in-survey

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A higher cost of capital, expressed by higher world global 10-year bond yields, raises financing costs and hurdle rates for investment, including infrastructure. Inflation is adding to construction risk. For instance, in May the Australian government announced a review of the country's Infrastructure Investment Program, saying cost overruns mean some projects previously announced would not be able to be delivered. Some positive attributes of infrastructure, including strong cash flows and typically inflation-protected pricing, help to offset these challenges.

Governments are facing pressure on finances, and the IMF recently urged governments everywhere to focus on rebuilding fiscal buffers. Some nations such as the U.S. are receiving more attention over the trajectory for debt. That means constraining spending. The hope is that it takes place via slowing or reducing operating spending as opposed to capital spending.

Long-term needs are well documented. They include:

- The importance of infrastructure for a well-functioning economy and society.
- Addressing under-investment.
- New infrastructure to cover modern needs, including:
    - Climate change and a massive energy transition.
    - Urbanization, demographic shifts, cyber needs, and digitization.
    - The need to protect supply chains and make then more resilient in a fracturing global economy.

Security spending is rising as an investment theme, and critical infrastructure stocks could be beneficiaries.

Australasian Equities—Review

The S&P/ASX200 Index is up 0.3% this year to date and 5.9% on a year ago. The index is largely flat so far in October. The ASX 200 fell in September, mirroring global movements, with small caps underperforming and 10 of 11 sectors declining, the exception being energy. Real estate, IT, and healthcare led the declines. While down, the ASX outperformed many global markets, partly due to having less IT influence.

Australasian Equities—Outlook

Given Australia's sensitivity to the global economic cycle, caution appears prudent in a highly uncertain environment.

With interest rates in a higher-than-normal phase relative to recent history, and world growth in an underperformance stage, the backdrop is challenging, particularly when overlaid with specific risks, including China's economic trajectory, with ongoing stresses in the property market and geopolitical fragmentation.

The IMF has revised gross domestic product growth for Australia in 2024 down from a projected 1.7% in April down to 1.2% in October. The IMF does not expect Australia to achieve annual growth greater than

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2.3% out to 2028, a similar story to other nations also facing a lower trend rate of growth over the medium-term and forewarning of the need for structural reform.

Countries that embrace structural reform could be re-rated as improved microeconomic foundations not only lift growth, but they also help alleviate inflation from the bottom up (supply), thereby limiting damage from the top down (demand) from higher interest rates.

Bank economists are projecting GDP growth in 2023 barely above 1%, and negative on a per-capita basis with consumer spending at the epicenter of the slowdown as disposable income comes under pressure due to higher interest rates and elevated cost of living expenses. Discretionary spending sectors of the economy are already seeing the impact and that is expected to continue.

Population growth (up 2.4%, a 50-year high) continues to support headline growth and some sectors including construction, though interest rates act as an offset.

With the timing of interest-rate relief from central banks being pushed out more and more, including the RBA, and rising bond yields now a global headwind for stock prices given narrowing earnings-bond yield spreads, equities continue to face challenges.

Inflation may be past its peak in Australia, but remains too high, with service sector inflation rising briskly and fuel prices increasing considerably of late. This does not suggest any potential for the RBA—like other central banks—to pivot any time soon.

Like many markets, it is not easy to identify a catalyst to drive the Australian market higher in the near term given inflation (cost), growth and interest-rate headwinds, and an overlay of geopolitical risks.

International Fixed Interest—Review

Bond markets continue to embrace a higher-for-longer narrative.

The catalysts include tough-talking central banks, such as the most recent U.S. Federal Reserve Minutes, which signaled a possible further interest-rate hike; central banks who continue to point to core inflation stickiness; inflation outcomes which support central bank concerns; and the tenor of data, particularly across labor markets. Recent rises in oil prices are adding to headline inflation pressure and risk becoming embedded in pricing behavior and shifting inflation expectations.

The higher-for-longer narrative is being accentuated across longer-term interest rates by a greater focus on fiscal positions, including bond supply and issuance.

The yield on a U.S. 10-year bond—a widely used benchmark for the global cost of capital or risk-free interest rate—has risen 50 basis points in the past month. Bond bulls can point to some turn in the tenor of data and some positive inflation signs, including easing rates of annual core inflation, but it is far from conclusive.

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The Bloomberg Global-Aggregate Total Return Index (unhedged U.S. dollar) is down 2.7% for the year to date and up 3.2% on last year. The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of negative 0.6%. The return has been slightly positive over the year. Bond returns are down in October.

International Fixed Interest—Outlook

Fixed-income markets and commentators have moved from the level of peak interest rates, to how long policy needs to remain restrictive, with a higher-for-longer narrative dominating as inflation's potential persistence continues.

The impact of tighter monetary policy over the past 18 months has been somewhat offset by coronavirus-era stimulus overhang, including quantitative easing, and government spending tied to climate, building supply chain resilience, and infrastructure in the U.S., which has supported growth and worked against the conventional impact of monetary policy. Central banks such as the U.S. Fed continue to embrace higher-for-longer narratives via higher member Fed-funds rate dot plot projections, but also wary that monetary policy works with long lags.

The IMF's latest projections noted that, "With many countries near the peak of their tightening cycles, little additional tightening is warranted. However, easing prematurely would squander the gains achieved in the past 18 months. With tight labor markets, ample excess savings in some countries, and adverse energy price developments, inflation could become more entrenched, requiring even more forceful action from central banks."

The IMF is projecting real-long-term (10-year) interest rates averaging 1.3% from 2025 to 2028, slightly above the average of 1.2% from 2005-14, and well above the negative 0.7 average from 2015-24.[2] This serves to reinforce the real income derived from fixed-income investing in a higher-for-longer environment and structural shift in fixed-income market pricing.

Goldman Sachs Asset Management has a view that policy rates in the U.S., Eurozone, and United Kingdom have likely peaked, a view in line with financial markets which are pricing in the possibility of higher rates from central banks, but not an overwhelming probability.

While there has been progress in the disinflation battle, the recent surge in oil prices has added another layer of challenge to the broad disinflation trend seen over 2023. Recent inflation figures in the U.S. have had both encouraging and warning signs, with the annual rate of core inflation heading in the right direction, cooling for the sixth month in a row, but super core inflation rose 0.5% in the month, a timely reminder of inflation's stickiness amid a continued tight labor market. Measures of inflation expectations will be closely watched given oil prices' near-term impact on inflation.

[2] GDP weighted across Canada, France, Germany, Italy, Japan, the U.K., and the U.S.

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Inflation's persistence and the higher-for-longer narrative goes some way to explain higher interest-rate settings. There are numerous other considerations adding to fixed-income premiums. These include larger fiscal deficits, particularly in the U.S., and concerns over debt issuance. Fiscal policy settings face intense spending pressures to address income inequalities and assist energy and digital transitions. The process of quantitative tightening has replaced quantitative easing, with the Bank of England to shrink its balance sheet by GBP 100 billion annually from October. Policy normalization is being eyed by the Bank of Japan. Trade decoupling—which is becoming more apparent in U.S. and China trade figures—could have flow-on consequences for capital flows, and China's currency is facing pressure, which could lead to China selling U.S. Treasuries. China remains a focus for economic weakness, especially in real estate.

While recent months have been difficult months for bond investors, analysis from JP Morgan demonstrates that following the end of a US Federal Reserve tightening cycle, "US Treasuries have delivered more consistently positive performance relative to their equity counterparts."[3] The path to lower rates tends to be higher rates.

International Equities—Review

September was a tough month for equities as prospects for higher-for-longer interest rates set in, and a sharp repricing in bond markets contributed to the same across equities, with the correlation between the two turning positive again in a similar fashion to 2022.

Caution has been accentuated by rising geopolitical and geostrategic tension, the latest being the situation in Israel and Gaza.

The MSCI World Index declined by 3.7% in September. Heavy-weighted IT names weighed on the NASDAQ and S&P 500. Europe markets also fell however the UK FTSE 100 recorded a rise. October has seen ongoing volatility.

International Equities—Outlook

The outlook for risk-based assets including equities is becoming more challenging.

Inflation and interest rates are front and center, and a sticky inflation dynamic has now become embedded in higher-for-longer interest-rate expectations. We have seen aggressive movements higher in bond yields before but the sequence of movements over the past three years is the highest movement in the U.S. 10-year bond yield over three years since 1980. Interest rates, borrowing costs, and the cost of capital are not high in a historical sense, but the re-rating is nonetheless significant. A 4-percentage point movement in three years is almost an unprecedented rise in a proxy for the risk-free interest rate.

The wider geopolitical situation is becoming more challenging, which adds to risk, and the CEO of J.P. Morgan recently described the situation as the most dangerous in decades. Security in trade is now

[3] Beyond the pause: What happens after peak rates?

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trumping the economics of trade. Efficiency is being replaced by the need for supply chain resilience, which has helped boost growth in the U.S. in the near term at the expense of China as trade decoupling and reshoring takes place. The world is shifting from rules to power, characterized with rules more contested and relative power more influential in shaping international affairs and the global economy. The latest Middle East tension adds to the list of geopolitical and geostrategic hot spots.

The recent forecasts from the IMF noted "slow and uneven growth with growing global divergences," commodity prices could be more volatile under renewed geopolitical tension, and a "darker" medium term picture. With "slower growth, higher interest rates, and reduced fiscal space, structural reforms become key." Structural reform requires real political leadership and populism is widespread.

Some encouragement can be taken from:

- The growth outlook which continues to be supported by robust labor market conditions and continued expectations of a soft landing according to the IMF's latest projections.
- Some signs of improving earnings growth with Factset noting the S&P 500 is reporting year-on-year earnings growth of 0.4% for the third quarter, the first quarter of positive growth since third-quarter 2022.
- Excitement around AI, although IT has underperformed of late. Tight labor markets will accelerate technology uptake.
- Earnings-revision momentum (a gauge of upward to downward changes to expected per-share earnings over the coming 12 months) has turned positive according to data prepared by Bloomberg Intelligence.[4]

Against this backdrop of encouragement, questions will remain how long companies can pass on price increases before demand is curbed sufficiently to affect pricing, with margins a key disinflation compression variable. The disinflation process requires also wage restraint and higher unemployment, which pressures the consumer. Questions surround whether central banks have yet done enough to sufficiently alter the price setting. This is where soft landing prospects face a reality test: Is the projected soft landing going to be sufficient to squeeze and alter pricing behavior?

Growth divergences, including the U.S. surprising on the upside, and growing risks across real estate in China highlight the need for diversification as an investment theme, and also active strategies as opposed to passive. An encouraging aspect to recent market moves is that the narrow market that dominated in the first half of 2023, with seven stocks ruling the S&P 500, has broadened. This is healthy and conducive to stock-picking and identifying value opportunities.

Performance periods unless otherwise stated generally refer to periods ended Wednesday, Oct. 18, 2023.

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[4] https://www.bloomberg.com/news/articles/2023-10-11/wall-street-is-marking-up-forecasts-as-profit-downturn-nears-end

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