Economic Update: Australia
November 2023

Morningstar Research
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Summary

- A higher interest-rate narrative is being replaced by building expectations that central banks could loosen policy settings in 2024; however, the Reserve Bank of Australia appears to be an exception that could have further work to do.
- Continued easing signs of economic weakness have been precursors to lower bond yields.
- Risk sentiment has been buoyed, reversing movements seen over September and October.
- The path to a soft landing for the global economy and receding inflation—that Goldilocks combination remains achievable, but the past few years have also taught us that markets seldom follow the orderly.
- Inflation remains on a downward trajectory, and the coming months will be key for central banks, which remain wary of inflation's stickiness.
- Geopolitical risks have receded, and fiscal concerns have somewhat lessened, helping lower term premiums. Whether that is prudent remains to be seen.

Australia Cash and Fixed Interest—Review

The Reserve Bank of Australia resumed tightening in November following a strong third-quarter inflation print and communication from the RBA prior that they had limited tolerance for inflation remaining above target for too long.

Longer-term interest rates remain heavily influenced by global movements and have been dragged lower by falling international yields over November. After rising to almost 5%, Australia's10-year bond yield has fallen to 4.5%, tracking a sharp decline in U.S. yields as softer inflation data gave more confidence that the U.S. Federal Reserve is done with its tightening cycle.

The Australian dollar has recovered toward 0.65 as investors reassessed U.S. monetary policy settings in 2024 and moved toward expectations of lower rates, thereby lessening yield appeal for the United States dollar.

Australia Cash and Fixed Interest—Outlook

The RBA is one of few central banks still lifting interest rates, and where market expectations are, we may possibly see a further move higher.

While the door remains open to higher rates, the RBA made a subtle shift in tone in the latest statement, as "some" further tightening of policy may be required was downgraded slightly to "whether" some further tightening may be required.

The RBA, like other central banks, continues to weigh up the lagged effect of tighter monetary policy on the economy, with persistent service-sector inflation and strength across labor markets and many uncertainties, including the outlook for the Chinese economy.

Longer-term Australian bond yields are expected to continue to take their lead from the influential U.S. Treasury market, and recent U.S. inflation reads have provided more comfort that the U.S. 10-year bond yields recent surge to 5% was a blow-off move and the trend going forward is lower, not higher. The bank economic fraternity is mostly projecting a decline in the Australia 10-year bond toward 4% and a tight spread to the U.S. equivalent.

Risks are asymmetric, not symmetric. Global growth risks are skewed lower. However, inflation has proved to be sticky, and the term premium—the compensation for investing in longer-term bonds relative to short-term ones—has been sensitive of late to geopolitics and fiscal developments, especially in the U.S.

Are we beginning the start of a trend lower in the USD, and by reciprocity, a rise in the AUD? That case is strongly dependent on the combination of a soft landing (support risk appetites) and continued lower inflation seeing scope for the US Fed to start normalising policy. Markets have tilted that way though the consensus has been predicting a stronger AUD/USD over 2024 (and 2023) for a while.

Australian and International Property—Review

The S&P/ASX200 A-REITs has risen strongly so far in November, up 12.4%, reversing trends seen over September and October. The index is up 3.6% for the year to date and 2.3% on a year ago.

The FTSE EPRA Nareit Global Real Estate Index in U.S. dollars (total return) has risen 8.7% so far in November, reversing declines over the two preceding months, with a quarter to date move of 3.4%. The index is down 1.1% for the year to date and 2% on a year ago. Strength in November has been strong in Europe and the United Kingdom.

Australian and International Property—Outlook

High interest rates continue to challenge the commercial property sector. Sentiment has lifted of late, with expectations that lower rates could be around the corner in 2024 and with long-term bond yields falling.

Cap rates continue to adjust higher despite recent falls in interest rates, putting pressure on values. This is being accentuated by lower demand from tenants across the office sector caused by more workers choosing to work from home. A soft landing supports tenant demand; a hard landing does not. While views are skewed toward the former, some hold belief in the latter.

The Real Estate Institute of Australia's End of Financial Year Economic Outlook for Commercial Real Estate notes the usual suspects including higher interest rates and low occupancy but also that the rise in cap rates has been much slower than the rise in 10-year bonds, suggesting that "risk metrics are not being accurately reflected in current yields."

JLL's Global Real Estate Perspective November 2023 points to stabilizing market conditions but conditions that are set to remain challenging into 2024, with cyclical and structural uncertainty "weighing on occupier demand as companies review their portfolios and take longer to make decisions, while the high cost of capital and conservative underwriting from investors are slowing capital flows." This is particularly notable in the office sector with global leasing volumes down 6% on a year ago and 24% below prepandemic levels. Activity in logistics is also noted as having cooled.

Deloitte's 2024 Commercial Real Estate Outlook: Finding Terra Firma, whose foundations include its annual Global Real Estate Outlook Survey, reinforces common themes including capital availability and cost, deteriorating fundamentals, difficulty meeting environmental, social and governance regulations, the flight to quality, and responding to structural shifts.

Some countries such as Australia will receive impetus from booming migration, which supports not only residential but also nonresidential investment. High inflation and rebuild costs, and limited access to credit, which defer investment, are also slowly putting a floor under the value of existing commercial properties.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars has followed global moves shifting higher in November (up 6.2% for the month to date), reversing falls seen over August, September, and October. The index is down 4.2% for the year to date and 4.6% lower than a year ago.

The defensive characteristics of infrastructure were apparent in the month of October with the MSCI World Core Infrastructure Index (USD net index) outperforming the MSCI World Index (negative 0.3% versus negative 2.9%). Infrastructure has underperformed for the year to date and on a 12-month basis.

Global Infrastructure—Outlook

The outlook for infrastructure remains mixed. There are the obvious long-term opportunities, and infrastructure has many defensive characteristics that are attractive in a world facing considerable uncertainty and inflation, with little room for policy error.

Infrastructure remains a critical component of the world economy and society. GI Hub notes a $15 trillion investment gap in U.S. dollars. Themes such as transport decarbonization, energy transition including electric vehicle charging assets, digitization, and the circular economy are bringing new forms of infrastructure investment. These are adding to the traditional infrastructure sectors including regulated utilities, roading, and airports. The "theme investment" offers different risk characteristics beyond thinking of infrastructure as a haven, though.

There are growing challenges to finance the need for infrastructure. The latest IMF forecasts notes that "fiscal buffers have eroded in many countries, with elevated debt levels, rising funding costs, slowing growth, and an increasing mismatch between the growing demands on the state and available fiscal resources." There is tension between the need to rebuild fiscal buffers, which will help the disinflation process, with the need to support key themes with fiscal assistance and invest in infrastructure that is essential for driving productivity growth.

This turns attention to funding, including sources from revenue (for example, taxes, user charges, land value capture), funding instruments (for example, debt, equity), better risk management and procurement, and alternate investment approaches (for example, public private partnerships).

With many countries facing pressing needs for fiscal consolidation, but voters demanding cost-of-living support, tough trade-offs are required, and a key risk is that required infrastructure investment takes a back seat to populism policies.

Australasian Equities—Review

The S&P/ASX200 has mirrored November's global optimism, rising 4.1% for the month to date though flat over the quarter and up 0.3% for the year to date.

The ASX 200 declined 3.8% in October following weakness in September, as Australian equities underperformed broader global indexes with earnings a headwind. Those monthly declines at least helped improve valuations.

Australasian Equities—Outlook

Tighter financial conditions are starting to bite, and growth in the Australian economy is expected to remain below trend over 2023 and 2024, with a combination of cost-of-living pressures and higher interest rates exerting a restraining influence on demand and consumption.

Faced with a stickier inflation story in the third quarter, the RBA responded with the inevitable hike in November, and market pricing is assigning a reasonable probability to a follow-up move, which is counter to expectations for the Fed, European Central Bank, Reserve Bank of New Zealand, and Bank of England, who are seen as done.

Higher mortgage costs are putting pressure on household consumption and discretionary spending, accentuated by elevated cost-of-living expenses, which is a bad combination for disposable income. These pressures will continue into year-end and early 2024, affecting economic growth over coming quarters.

This suggests caution around the more cyclical sectors of the market. Guidance and results continue to offer a mixed picture across the market in general.

There are still fundamental layers of support for domestic demand and housing in Australia coming from immigration and tourism, but immigration can complicate the path to lower inflation and lower interest rates, which equity markets have been sensitive to.

Weak labor productivity is not helping the disinflation process, underpinning cost-push inflation and accentuating cost pressures across businesses, which in turn negatively affects earnings prospects.

The RBA has been late to tightening policy, and while this suggests it will also lag any global central bank easing cycle, it is worth noting the cash rate in Australia is still more than 100 basis points below the U.S. and NZ.

Bank earnings—a major part of the Australian market—were good on a year-on-year basis but also showed a year of two halves, with the first half better than the second, consistent with the economy.

Valuations appear to offer support to the market but with an absence of local economic catalysts to differentiate Australia from other markets, amid a lot of uncertainty.

The outlook remains murky, with the Australian economy showing growth but suffering weak to negative per capita growth. Any recovery in earnings looks a few quarters down the track, with tepid headline growth.

International Fixed Interest—Review

Bond markets suffered in October with a selloff in U.S. Treasuries, and geopolitical concerns in the Middle East saw a spike in volatility, with yields pushed higher, particularly at the longer end of the yield curve. Robust data pointed to the potential that the Fed might need to hike again. Term premiums—the extra yield investors earn for bearing the risk that interest rates may change over time—increased. Yield curves steepened/became less inverted.

November has seen that sentiment reverse, and higher rates have been replaced by lower rates and building expectations that central banks could starting easing policy in 2024 with weaker data, easing concerns over the Middle East, and continued progress returning inflation to target key drivers. The selloff over October also added to fixed income's attractiveness.

The S&P Global Developed Sovereign Bond Index has delivered a month-to-date return of 1.8% in November and quarter-to-date of 1.2%. The return has been slightly negative over the year.

International Fixed Interest—Outlook

Higher yields have been replaced by lower yields, with the sharp rise over September and October enticing fixed-income investors. Despite falling of late, U.S. Treasury and German bund yields remain among the highest levels they've been in a decade. Investors do not need to look for riskier parts of the credit or fixed-income market for yield.

Bond markets have responded positively to receding inflation trends, with greater confidence that central banks are at or close to peaks in the tightening and that lower rates could be prospect in 2024. Market expectations and commentators have firmed in recent weeks toward both the ECB and the Fed lowering rates by mid-2024, sharply accentuated by October inflation figures in the U.S. coming in below expectations.

A central scenario is emerging of a slowing world economy as the lagged impact of central bank tightening and rising real interest rates and easing inflation trends set in train policy easing by central banks and lower yields across developed markets. As the International Monetary Fund noted in its most recent forecasts, growth across advanced economies is expected to "slow from 2.6 percent in 2022 to 1.5 percent in 2023 and 1.4 percent in 2024 as policy tightening starts to bite". Inflation is projected to recede, though not expected to return to target until 2025 in most nations.

This scenario supports income investing and is reinforced by concerns from some about extent and speed of slowing global growth, China's property market, and a potential recession, which adds to the attractive qualities of fixed income. The balance of growth risks according to IMF remain "tilted to the downside."

Challenges remain, particularly with the disinflation process that lower interest are conditioned upon. While the most recent U.S. inflation report was welcome, core inflation remains elevated at 4% (down from 4.1%), super core inflation sits at 3.8% and service sector inflation is 5.1% (easing from 5.2%). All remain a way from target, and we now enter the more difficult stage of the disinflation process. Labor market developments, particularly wages and unit labor costs, will be critical in tracking the trajectory for these components of inflation.

The global economy continues to face structural impediments leaning against the slow disinflation process that is unfolding. Commodity price volatility could rise in response to geopolitical tension. The IMF notes uncomfortably higher core inflation and the importance of inflation expectations in retuning inflation to target. "Near-term inflation expectations have risen markedly above target, although they now appear to be turning a corner." Easing prematurely could throw away gains made, and central banks face a delicate balancing act with little room for policy error.

Contributing factors to higher yields over September and October including geopolitical risk premium, or elevated fiscal spending/deficits/debt issuance, have not disappeared either. Moody's recent decision to move the U.S. credit rating to negative from stable, while lagging other rating agencies, is a reminder there are limits on fiscal profligacy, even for the largest economy in the world.

While the U.S. and ECB appear to be at peak terminal rates, the same cannot be said for Japan, with policy still unsustainably loose. Interest rates from the Bank of Japan remain a long way from normal, with the 10-year yield residing below 1%. Core inflation eased to a 13-month low of 2.8% in September but was above expectations and has now exceeded the BOJ's 2% target for 18 months. Any exit strategy from negative rates and yield-curve control will likely require a combination of skillful execution and good luck, and risks spill over into bond markets around the globe if funds repatriate.

International Equities—Review

Risk sentiment has turned sharply to the positive, though recent moves have followed weakness over September and October and a sense of perspective needs to be maintained.

October saw good news in the form of resilient economic indicators of the U.S. economy, including gross domestic product, jobs, and retail sales, become bad news, with interest rates pushing higher and equities lower. The S&P 500 was one of the least scathed, down 2.1%. Japan TOPIX was down 3%, Europe down 3.4%, and MSCI World (USD) down 2.9%. Sentiment was not helped by the Israel-Hamas war.

November has seen markets turned sharply higher, buoyed by a pivot in expectations toward central banks and building expectations of lower interest rates in 2024. Bad news (weaker economic data) has been good for risk appetites. The S&P 500 is up 7.2% for the month to date and the Nasdaq 9%, boosted by better-than-expected (lower) U.S. inflation data, both consumer price inflation and wholesale prices.

International Equities—Outlook

Interest rates, inflation, and earnings remain front and centre. Equities have responded positively to lower interest rates (actual and expected), and that bad news (weaker data but not torrid data) is good news in terms of a lower interest-rates narrative, reversing the "higher for longer" thematic that undermined equities over September and October.

The soft landing or Goldilocks combination of subdued growth, without real economic distress, supported by a robust labor market and easing inflation has captured markets. The fourth quarter has also historically been one of the best three months for the S&P 500.

Recent inflation reads support the soft-landing hypothesis, with monthly core inflation in the U.S. of 0.3%, 0.3%, and 0.2% over August to October, representing an annualized rate of 3.2%.

Earnings have also been supportive. According to FactSet, third-quarter earnings for the S&P 500 are 4.1% higher than a year ago and for the quarter are 3.2% higher. Momentum is expected to build into 2024, with analysts projecting year-on-year earnings growth of 6.7% for the first quarter and 10.5% for the second quarter. Golman Sachs analysts noted a rise in third-quarter margins, which helped boost earnings growth amid more modest revenue growth. Profit growth is also being supported by rising productivity growth with nonfarm business sector labor productivity rising 2.2% on a year ago and an annualized rate of 4.7% in the third quarter of 2023.

Three navigational challenges remain.

The first is the trajectory for inflation. There are structural challenges to taming inflation, and the projected path to target (2025) would mean inflation has exceeded target for four successive years. The next six months' inflation expectations and labor market reads will be critical in assessing the likelihood of the path being achieved, without or needing more action by central banks. Expanding margins noted above is not disinflationary. The Fed sees no urgent need to raise rates further, and October's inflation report endorses that, with inflation easing, though "ongoing progress toward our 2% goal is not assured" according to Chaiman Jerome Powell.

The second is growth. Many leading indicators in the U.S., including the ISM PMs and consumer confidence, have rolled over and are harbingers of slower growth. Household savings buffers are being diluted, and the fiscal impulse, which has been growth-supportive, is moderating. Financial conditions remain restrictive. Europe is underperforming; China continues to navigate debt, deflation, and demographic challenges, and a world where security is influencing trade as just-in-time is replaced by just-in-case and onshoring and near-shoring. PMI's across Asia are also softening.

The third is uncertainty. This stems from the geopolitical situation, with a divergent world potentially adding to commodity price volatility and security now a key consideration in trade.

According to the IMF, there is little room for policy error. A combination of weak growth in the medium term and higher than normal interest-rate settings bring the need for structural reform into play. That could be a material driver of country portfolio allocations over coming years.

For now, regional divergences and portfolio allocation largely center on growth and interest-rate expectations, which are not uniform. Europe is weaker growthwise than the U.S., and Japan's progressive return to normality is being eyed. Countries with large China vulnerabilities are being treated with more caution.

Morgan Stanley refers to 2024 as the year of threading the needle, an apt description.

Performance periods unless otherwise stated generally refer to periods ended Thursday, Nov. 16, 2023.

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