Economic Update: Australia
December 2023

Morningstar Research
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Summary

- Market expectations of lower interest rates have been endorsed by the United States Federal Reserve, the world's most influential central bank.
- Risk sentiment has been buoyed, supported by the continued consensus on a soft landing and easing inflation. Growth is slowing, but soft-landing prospects remain.
- Headline inflation trends remain supportive, but the stickiness of core inflation will be closely watched by central banks and could challenge market expectations of 100-150 basis points of policy easing over 2024. We are now entering the more difficult stage of disinflation with attention on labor markets and margins.
- The Australian economy remains in an underperformance stage of the business cycle, presenting challenges to earnings growth.
- Bonds have returned to more neutral levels, though they still appear to offer better risk/reward than equities.

Australia Cash and Fixed Interest—Review

The December Monetary Policy saw no change in the cash rate and a watered-down tightening bias delivered with the Reserve Bank of Australia, or RBA, noting "Whether further tightening is required…", with limited new information since the last meeting to act on.

The RBA maintaining a soft tightening bias is not reflected in market expectations, which have been heavily influenced by a global view. Interest rates are headed lower in 2024 and endorsed by U.S. Federal Reserve policy member dot plots of 75 basis points of easing over 2024.

A 100-basis point rally in the U.S. 10-year bond yield has manifested in Australian equivalent yields moving from 4.9% to 4.1% at the time of writing, delivering strong fixed-income returns.

Prospects for lower interest rates led by the U.S. Fed has undermined the U.S. dollar and resulted in the Australian dollar, or AUD, being higher, pushing from 0.63 at the end of October to 0.67 by mid-December. The NZD has been broadly stable against other currencies.

Australia Cash and Fixed Interest—Outlook

Australian markets are not immune from global trends focused on lower inflation outcomes and signs of economic softening, resulting in views that monetary policy is too restrictive and central banks around the globe will need to lower cash rates.

Markets and analysts have also digested local data, including a higher unemployment rate in November and a softer monthly Consumer Price Inflation Index, or CPI, which has seen fourth-quarter CPI expectations lowered. Reserve Bank of Australia Governor Bullock recently noted the central bank was taking a cautious approach and would continue to watch incoming data, adding that they are not falling behind in the global inflation fight. The latest monthly CPI figures support that.

The September quarter national accounts data highlighted a squeezed household sector, and not just from monetary policy, with tax payments (fiscal policy) rising due to bracket creep (fiscal drag). Inflation forces earners into higher tax brackets.

Having lifted the cash rate by less than Reserve Bank of New Zealand, Bank of Canada, Bank of England and the U.S. Fed, the RBA is expected to be less aggressive, normalizing the cash rate to a more neutral setting over 2024 and 2025.

The magnitude of the recent fall (rally) in longer-term bond yields has been a surprise, undershooting economists' expectations. Though when something goes up sharply, such as in October, there is always the potential for the reverse, which we have seen.

Such has been the extent of the decline in longer-term yields that expectations for the Australia 10-year bond yield across both ANZ and Westpac economic teams by the end of 2024 are not too dissimilar from current levels.

The consensus appears to be for a slight upward bias for the AUD as 2024 progresses, with a weaker USD and expectations of Fed rate-cuts a key influence. China and commodity risks linger in the background, highlighted by Moody's downgrading its outlook on China's credit rating to negative from stable.

Australian and International Property—Review

Lower interest-rate expectations have been positive for the property sector over November and December. The S&P/ASX200 A-REITs is up 8.9% month to date and 13.8% over the quarter in what has been a quarter of two halves, where the sector suffered in October but bounced back strongly in November and December. The index is up 11.4% year to date and 7.2% on a year ago.

The FTSE EPRA Nareit Global Real Estate Index in U.S. dollars (total return) has risen 7.8% so far in December, building on gains over November and 13.4% over the quarter. The index is up 8.5% year to date and 6% on a year ago. Strength and recovery have been most pronounced in Europe and the United Kingdom, assisted by weakening inflation figures.

Australian and International Property—Outlook

A calmer and more favorable interest-rate environment, if sustained, is welcome news for the property sector that has been facing pressure from rising interest rates and constrained access to finance.

Internationally, transaction volumes have been low as investors and financiers weighed a higher interest-rate environment than has been experienced for many years, structural changes that are manifesting across many markets including shifts in office and industrial demand, and balance sheets and leverage access being impacted by revaluations.

Hines' 2024 Global Investment Outlook noted that office vacancies in the largest 54 U.S. markets have hit levels unseen since 1992 and expected a "continued bifurcation between premium and commodity assets." Asian real estate markets are noted as having strong growth drivers including robust regional growth and urbanization driving demand. Europe is viewed as being "further along in its cyclical reset than other regions."

Colliers' Global Investor Outlook anticipates pricing continuing "to adjust to a more realistic equilibrium, and we expect transactions to pick up in H2 2024," along with, "Pockets of opportunity are continuing to emerge under tighter conditions," and "a calmer rate environment is coaxing out capital." Industrial and logistics continues to cement "its position as the investor favourite" and there is "expanding acceptance that ESG is a key strategic element of investment decision-making."

Given the magnitude of the recent falls in interest rates since early November, these trends have the potential to move earlier, particularly with tenant demand less at risk under the assumed soft landing for the global economy, which is the central scenario.

Though recent falls in interest rates have been welcome and provided relief, the rise in interest rates is still the largest over a three-year period seen since 1980, and market transactions (cap rates) do not yet align with the magnitude of that increase in capital costs.

Global Infrastructure—Review

Infrastructure has benefited from positive risk sentiment with the S&P Global Infrastructure Index (USD) rising 9% over the quarter and 2.9% so far in December. The year-on-year return is now flat and year-to-date positive 1.5%.

Infrastructure broadly matched world market equity gains over November with the MSCI World Core Infrastructure Index (USD net index) rising 9.9% compared with 9.4% for the MSCI World Index. Infrastructure has outperformed on a three-month basis but underperformed year on year. The dividend yield on the MSCI World Core Infrastructure Index is 3.8% compared with 2% for the MSCI World Index.

Global Infrastructure—Outlook

Though listed infrastructure has underperformed global equities over the past two years, it hasn't had the benefit of mega-cap or IT, and the sector has a lot going on at the micro level. Trends noted in GI Hub's *Infrastructure Monitor 2023* included:

Higher levels of private investment in infrastructure in 2022, including energy transmission, digital infrastructure (reinforcing the changing nature of infrastructure assets), renewables, clean energy, and several airport transactions with investment concentrated in North America and Europe as the world bounced back from the pandemic.

In contrast to 2022, 2023 saw a significant decline in capital raised, and 70% of the private capital is being raised by funds that are aiming for lower-risk strategies at a time when equity markets and economies surprised with resilience.

While listed infrastructure returns have been negative over the year, unlisted infrastructure returns were reported at 6% year-to-date. Green unlisted have the same results, which is still below equity returns but at least they are positive numbers.

While infrastructure assets are generally considered an investment that offers protection from inflation, it can also be sensitive to interest-rate changes, the degree to which varies by sector and revenue model. Hence, asset selection and infrastructure portfolio construction remain key. Recent falls in 10-year bond yields have helped valuations.

Climate change offers upside to infrastructure as the world decarbonizes, but it is also a challenge as rising sea levels, greater weather variability, and rising temperatures put pressure on infrastructure assets such as airports, toll roads, power stations, seaports, and pipelines. A recent report by the EDHEC Infrastructure and Private Asset Research Institute noted that infrastructure investors potentially face losing a third of their money if countries do not adapt to a greener economy.

With the long-term need for infrastructure investment to be well-documented, a sticking point of funding remains, which is required from revenue (for example, taxes, user charges, and land-value capture), funding instruments (debt, equity), better risk management and procurement, or alternate investment approaches (public private partnerships).

Governments around the globe have a delicate balancing act, with many facing large deficits and rising debt burdens yet strong demand for infrastructure investment to drive productivity and public assistance/incentives to assist with decarbonizing the global economy and maintaining security over energy.

Australasian Equities—Review

Following the ASX 200's decline of 3.8% in October, the index gained 5% in November (the largest monthly rise since January 2023), with small caps outperforming and eight of 11 sectors in the black, led by healthcare, real estate, and IT. Energy, utilities, and consumer stables declined.

Strength has extended into December (positive 5% month to date). Despite a large bounce, Australian equities underperformed U.S., European, and Japan markets over November with the gap narrowing in December.

The scale of movements over November and December have lifted valuations, which could prove challenging with the outlook for earnings not following suit.

Australasian Equities—Outlook

Australia remains conditioned to international risk sentiment, and positive nuances globally have translated locally. But those global nuances remain subject to inflation showing continued progress toward its target, providing central banks scope to move monetary policy to a less restrictive and less growth-punitive stance.

The Australian economy remains in an underperformance stage of the business cycle, with growth tracking well below trend, and GDP per capita growth negative, as weaker global growth and the lagged effects of tighter monetary policy have taken hold. These lags suggest monetary policy will remain a restraining influence right through 2024 and early 2025, especially impacting spending trends.

High inflation is weighing on people's real disposable income and household consumption growth is weak along with dwelling investment. The former contrasts with demand signals from a 500,000-600,000 surge in migration (adding 2% to the population), which increases demand (growth) but also adds to inflation risks.

Monthly inflation statistics point to an ongoing move lower in inflation—more so in goods and less so in services—and the RBA remains watchful with productivity weak. The easy inflation wins have been achieved. Now comes the hard part.

Margin compression/absorption remains a common theme, with rising costs difficult to pass on in a weak demand environment, putting pressure on earnings with the specter of a 5%-10% decline in 2024.

Expect sectoral divergences with consumer discretionary to be challenging, with banks (a major part of the ASX) having undershot expectations. Construction is caught between demand stimulus (population) and cost/interest-rate squeezes. Iron ore prices have performed well, offset by weaker natural gas and coal prices. Given Australia's economic sensitivity to commodity prices, we note the RBA's watchful statement in early December: "a high level of uncertainty around the outlook for the Chinese economy and the implications of the conflicts abroad."

Overall, though, and in appreciation of the recent risk-on move, equities look likely to range trade until there is greater clarity on the growth and inflation mix. Market views are dispersed, and differing views reinforce the importance of diversification.

International Fixed Interest—Review

October was a hard month, but November and December so far have included strong periods for fixed-income markets, with government bonds and credit all rallying (falling in yield) on the growing expectations that interest-rate hikes are over and that cash rates will fall in 2024.

A key catalyst has been inflation, which continues to edge lower in the U.S. and Europe, in combination with generally weaker reads on economic momentum around the globe, albeit with some sticky inflation signals, too. Pockets of resilience such as the U.S. labor market remain, but the tenor of economic news has been more consistent with slower growth and monetary policy having more of an impact. Easing oil prices have helped.

Nervousness over bond supply (particularly in the U.S.) has subsided though Moody's did announce a change to its AAA U.S. rating outlook from stable to negative due to increased downside fiscal risks. This is a reminder that bond and credit fundamentals remain and need to be considered in conjunction with the business cycle. The Bank of Japan, or BOJ, continues to weigh its exit strategy from negative interest rates and yield-curve control, which has now been compounded by the Fed prospectively loosening policy at a time when the BOJ will tighten.

The S&P Global Developed Sovereign Bond Index has delivered a month-to-date return of 2.5% in December and quarter to date of 4.8%. The annual return has now returned to positive territory. The Bloomberg Global Aggregate Index rose by 5.0% in November (total returns in local currency).

International Fixed Interest—Outlook

Fixed-income markets including long-term U.S. Treasury yields have moved a long way in the last month with the U.S. 10-year yield dropping an eye-watering 100 basis points from the 16-year high reached in October, as investors embraced the allure of positive real yields, locked in the yields on offer, and responded to growth, inflation, and central bank signals.

This move lower to lower yields has been supported by business-cycle factors including slowing world growth expectations as the lagged impact of restrictive monetary policy takes hold, further progress toward inflation targets, deflation in China, and U.S. Fed policy member dot plots flagging 75 basis points of potential rate reductions in 2024. The pivot from the Fed in December endorsed financial markets' views of lower rates.

The consensus is that 2024 will be the year where interest rates really bite and dampen growth further, necessitating lower interest-rate policy settings from the U.S. Fed, the European Central Bank, and the Bank of England, and boosting the attractiveness of safe assets such as government debt. Treasury markets have historically rallied strongly after the last increase of each hiking cycle back to 1988 in anticipation of lower rates. The U.S., the world's biggest economy, is seeing weaker credit creation and rising arrears on consumer and car loans, providing evidence that restrictive monetary policy is having an impact. Growth is even weaker in the euro area and U.K., where fiscal policy has been less stimulatory and the impact of restrictive monetary policy more apparent. Long-term trends including slower labor force (demographics) and lackluster productivity growth are also supportive of lower yields.

While business-cycle factors support expectations of lower rates, the consensus remains for a soft landing for the world economy, which leaves those in the more bearish economic camp leaning toward even more aggressive movements in interest rates than implied by markets, with a view the rally could extend further.

The counter is that markets have gotten ahead of themselves, again, potentially underestimating economic strength and inflation's stickiness, or that the spreading adoption of artificial intelligence could lead to a productivity boom. U.S. payrolls for November surprised on the upside, core inflation remained at 4%, and the service sector inflation at 5.2%. European Central Bank President Christine Lagarde recently noted policymakers must not get complacent and must remain wary of upside risks to consumer prices from ongoing negotiations over wages. Some Fed members have pushed back against the policy-easing anticipated by markets.

Significant structural changes across the global economy including geopolitical fragmentation, demographics, rising populism, and the low-carbon transition create a disconnect with the traditional business cycle that many interest-rate views are built upon. Governments, including the U.S., face a difficult task consolidating weak fiscal positions, with a rising mismatch between the demands on governments, and available fiscal resources adding to political polarization, which could pressure term premiums.

There is also a growing school of thought that neutral interest rates, the level where central banks neither have the foot on the accelerator or the brake, are on the rise, and that means higher long-term yields than we have been accustomed to over the recent decade.

Market views of lower interest rates are common, but expect strong debate over the magnitude and speed of travel over coming months and pay close attention to core inflation.

International Equities—Review

November and December so far have been strongly positive periods for equities following weakness in months prior, supported by slowing inflation and rising expectations central banks will soon pivot, which was subsequently endorsed the U.S. Fed.

A key factor has been declining interest rates with the U.S. 10-year bond yield falling 60 basis points in November and around 100 basis points from the 5% peak in October. This has helped ease discount rates, lower borrowing costs, and reinforce expectations of a soft landing for the global economy. Geopolitical tensions have subsided, oil prices turned sharply lower as demand outweighed supply concerns, and China showed deflation (negative 0.5% year on year) amidst economic concerns.

The S&P 500 increased 9% in November, Nasdaq 10.8%, German Dax 9.5%, Nikkei 225 8.5%, and MSCI 9.4% as markets responded, resulting in the strongest month in three years, and firmness has extended into December.

International Equities—Outlook

The U.S. Fed has endorsed positive market sentiment toward risk assets, and that interest-rate relief is on the way in 2024. Other central banks are assumed to follow suit.

Avoiding recession and a soft landing for the global economy, despite greater weakness in areas such as Europe and concerns over China, remains the consensus. A recent survey by Bank of America found that 74% of fund managers expect a soft landing in 2024.

Inflation is less of a problem, with the latest U.S. inflation figures declining to 3.1%—still not on target but showing progress. Europe, the U.K., and other nations are also evolving toward their inflation targets.

This provides scope for less restrictive monetary policy settings, with markets anticipating 100-150 basis points of easing from the Fed, European Central Bank, Bank of Canada, and Bank of England by late 2024. Long-term interest rates have been quick to reprice lower.

Disinflation, falling interest rates, a continued strong job market, a prospective AI productivity boom, and prospective improving earnings are a strong combination.

FactSet reports that analysts expect the S&P 500 to report earnings growth in 2024 of 11.8%, above the trailing 10-year average of 8.4%, exceeding nominal GDP growth, and with expanded margins (12.3% versus a 10-year average of 10.6%). Industry analysts, using a bottom-up approach, predict the S&P 500 will have a closing price of just under 5,100 in 12 months.

There are expectations of an uplift in earnings despite forecasts for lower global and U.S. growth in 2024. Economists polled by Reuters predict 1.2% U.S. GDP growth for 2024 on average, which is hardly stellar. The International Monetary Fund has been pointing to below-trend growth in 2024, with 2.9% global growth and 1.4% for advanced economies.

Can markets avoid the catch-22? Lower interest rates buoy risk appetites. Yet, a sustained interest-easing cycle is conditioned on weaker inflation, traditionally influenced by lower growth impacting profits (margins) and a weaker labor market affecting the consumer. Maintaining or extending pricing power, which analysts are alluding to according to FactSet, is challenging when achieving 2% inflation in the absence of a productivity boom.

Markets, nonetheless, continue to express confidence in the ability of profits to recover, along with wage inflation trends to return to levels consistent with central bank inflation targets, and without driving unemployment up too far or impacting a critical ingredient of the soft-landing view, which is a buoyant labor market.

Those who are less constructive on the outlook for stocks, point to the disinflation process being more gradual, preventing central banks from following through on lower interest-rate expectations. Geopolitical risks, a weak consumer, and recessionary risks are noted headwinds, particularly when combined with current valuations and low volatility with low equity risk premiums, suggesting the risk/reward balance toward stocks is too low.

Hard-landing risks for the global economy remain as fiscal support fades (a big source of support to the U.S. economy), the consumer battles the lagged impact of tighter monetary policy, and savings buffers erode. Rising mortgage, credit card, and loan stress are signs monetary policy is starting to have a more profound impact. Inverted yield curves in 2023 are flag bearers of weak growth outcomes in 2024.

Around the globe, the U.S. is set to deliver a more favourable growth and earnings backdrop than Europe.

Markets have ended 2023 on a firm footing, exceeding expectations, in contrast to 2022. This year bought surprises to the upside, though heavily concentrated in mega-cap. Expectations over what 2024 will bring are diverse reflecting the delicate balancing act ahead, delivering on low inflation within the parameters of a soft landing, and reinforcing the importance of diversification. Expect a stronger focus on valuations and business fundamentals.

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

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