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Economic Update: Australia
February 2024

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Summary

- Inflation (and growth in the US) has not validated expectations that central banks will be lowering rates in the first half of 2024, but expectations remain for policy easings given the starting point, with monetary policy in a restrictive stance across most of the developed world and inflation easing.
- Risks appear balanced. Lingering sticky inflation concerns remain. Conversely, the lagged impact of restrictive monetary policy is still felt, and higher rates expose vulnerabilities.
- Microeconomic (firm-level) factors remain mostly resilient in Australian earnings reports, illustrating the importance of fundamentals when the macroeconomic backdrop is less appealing.
- Artificial intelligence and better growth in the US have supported risk assets in the face of higher yields and inflation risks. Valuations are not appealing, but AI is a powerful force.
- Uncertainty remains elevated, though the risk profile around inflation and growth appears more balanced in 2024. Elections and geopolitics remain wildcards. Uncertainty supports diversification in portfolios and increasing attention to microeconomics such as business fundamentals and valuations.

Australia Cash and Fixed Interest—Review

Australian bond markets took a pause in the month of February as the Reserve Bank of Australia stemmed interest-rate cut expectations owing to persistent inflationary concerns. However, the inflationary trend does still appear to be trending down. US Treasury markets are still having a large impact on Australian interest rates by nature of the global economy.

Australian bond markets, as measured by the AusBond Composite Index, fell 0.3% through February, with cash returning 0.34% in the same month. Australian bond markets are now slightly down to start 2024.

Australia Cash and Fixed Interest—Outlook

Despite CPI prints below expectations in January (4.1% year-over-year versus 4.3% consensus) and February (3.6% year-over-year versus 3.8% consensus), Australian government bond yields rose marginally in February. This was consistent across a range of maturities, though maturities of five years or greater saw a larger rise than the nearer maturities. This move was heavily influenced by a hawkish Federal Reserve FOMC meeting in early February. The meeting produced no cut to the benchmark US rate, and Fed chair guidance indicated no cut is to be expected from the March meeting, leading to a selloff in bonds.

The RBA's outlook on a future interest-rate path is uncertain, with mixed signals from economic data. CPI continues to moderate, though at an ever-declining pace, and remains meaningfully above the RBA's

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target. Consumer retail sales volumes remain weak, while wage growth strength continues and moderating inflation is increasing real purchasing power for households for the first time in a few years. Guidance from the RBA is deliberately loose with a preference to maintain rates until there is considerable confidence that inflation is moving predictably toward the target. The RBA has acknowledged a persistent risk of upside inflation shocks or downside economic shocks, which may require further hikes or cutting ahead of schedule.

Market expectations of rate cuts have moved consistently with the RBA's guidance, pricing in 35 basis points of cuts by the end of 2024 compared with a more dovish 50 basis points at the start of February. Volatility is to be expected for longer maturity yields, as each upcoming economic datapoint paints a clearer picture of Australia's economic progress. The US' own economic recovery will also remain a key driver of rate volatility, as investors extrapolate US economic data and Fed guidance to Australia.

Australian and International Property—Review

The Australian property sector continues to rip higher with a 5.1% increase in February off the back of strong earnings being reported from major property groups: Goodman Group and Screntre Group. This performance is impressive considering long-term interest rates slightly rose on the month.

International property didn't exhibit the same level of strength as the Australian market, although it did increase 1.31% as represented by FTSE EPRA Nareit Global REIT, during February in Australian dollars. Downward pressure on interest rates globally generally supports property valuations; however, this month's strength was in lieu of downward interest-rate movements.

Australian and International Property—Outlook

Prospects for lower interest rates brought some confidence into the property sector, but with inflation proving to be sticky and prospective interest-rate relief being pushed back, the property sector continues to face realignment pressure along with the need to respond to structural changes (both positive and negative) such as working from home or quests for premises that meet sustainability needs, supporting the quality end of the market.

Property yields have risen in the past years, but not at anywhere near the magnitude as interest rates. An immediate conclusion is that, lacking strong rental growth, further repricing is needed to restore spreads and entice buyers/investors.

Uncertainty around interest rates, questions about fundamentals and a standoff between buyers and sellers suppressed sales in 2023. This looks set to change with more motivation appearing recently and improving price discovery.

Bloomberg reports that deal flow is starting to pick up, a positive step, though it is revealing in terms of how far real estate prices have fallen, with many financial institutions bracing for bad loans.[1] Data firm Trepp reports about than $1 trillion AUD in commercial loans are set to mature this year (around 20% of

[1] https://www.bloomberg.com/news/features/2024-02-14/real-estate-lenders-confront-falling-us-commercial-property-prices

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debt), and interest rates are a lot higher, adding encouragement for vendors to meet the market. Bloomberg recently reported that Treasury Secretary Janet Yellen noted that losses in commercial real estate are a worry but that the situation is manageable.

Some argue that such risks and challenges are largely anticipated and priced into the market with listed entities trading at large discounts. They point to weakness concentrated in the office sector, with other parts of commercial property supported by economic growth (at least in the US but not in Europe, the UK, or Australia), and themes such as onshoring (industrial).

If the US Fed can successfully pivot to an easing cycle amid a soft landing, property will be a beneficiary. That scenario, however, which was embraced in late 2023 and early 2024, is being challenged.

Global Infrastructure—Review

Global infrastructure had another positive month with a gain of 1.45% for the S&P Global Infrastructure Index, in AUD. This beat out global property on the month, as swings in interest rates don't tend to generate as much volatility within infrastructure as it does in property.

After a lackluster end to last year, the S&P Global Infrastructure Index is up 6.6% to start the year in 2024, in AUD.

Global Infrastructure—Outlook

One would have hoped infrastructure assets would have performed better in 2023 given the combination of inflation, elevated interest rates and volatility, factors that infrastructure has normally been more resilient to. That characterization can still be applied, depending on what comparable index you measure infrastructure to, and especially if you remove the impact of mega-cap or the "Magnificent Seven" stocks (Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla) from broader index movements.

The case for infrastructure investment exposure rests in part on its perceived better insulation and diversification from broader economic conditions and uncertainty. Infrastructure holds up better than property during volatility, though there is a counter to that, too: It is less responsive to pivots and lower interest rates, and 2023 saw a clear pivot late in the year. That pivot, though. is being questioned.

While cash rates and longer-term interest rates have likely peaked, market volatility, risk factors such as geopolitical fracturing and core inflation's stickiness represent an environment conducive to infrastructure in portfolio construction. The case is less compelling if interest rates fall rapidly, though that partly depends on the driver (economic weakness and rising risks or gradually lower inflation and a soft landing).

Thematic mega-trends such as decarbonization, digitization, geopolitical security rising in importance, and demographic shifts remain supportive. A legacy of underinvestment and the need to lift the resilience of infrastructure to natural disasters represent pending demand.

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Financing remains a challenge, particularly with the mega-trends often requiring government support in some shape or form. Many governments are facing fiscal durability pressures at the same time as investment needs and support for structural themes such as decarbonization.

Australasian Equities—Review

After a strong end to the year in 2023 and a strong January for Australasian equities, February was a mixed bag.

The S&P/NZX50 Index fell 1.1% in February, while the S&P/ASX 200 rose 0.79%, both in their respective currencies.

New Zealand markets lagged Australian markets; a significant number of companies experienced profit misses through reporting season than beats. It was more positive during the Australian reporting season, as beats outnumbered misses.

Australasian Equities—Outlook

NZ equities remain dependent on economic conditions and interest-rate settings, and more so than other markets, given the NZX50's lack of exposure to technology.

While core inflation is easing, measures remain a long way from the desired 2%. This places the economy in a required stage of continued underperformance relative to trend, to bring demand back into line with the economy's capacity to meet it. Retail sales volumes have now contracted for eight quarters in a row and illustrate the adjustment from boom times to normalcy.

Domestic inflation is receding at a slower rate than expected while growth data showed a weaker economy in 2023. A conclusion from weaker growth over 2023 and more persistent inflation is that the productive capacity of the NZ economy is lower than previously assumed. Productivity is weak, with hours worked and employment rising but growth contracting year on year. Weak productivity undermines earnings.

The earnings reporting season has proved lackluster, with more downgrades featuring, with costs and weaker demand in commentary.

On top of macroeconomic challenges, microeconomic factors (firm-level issues) have had an impact on earnings, an example being Fletcher Building.

There is rising hope that the new government's approach to managing the economy will provide more solidity, and business sentiment has improved markedly, though that is not yet reflected in real economic variables. Migration continues to provide support, tourism has continued to recover, and farm sentiment is improving courtesy of higher dairy prices. Infrastructure and healthcare remain long-term

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plays. For earnings to improve in a lasting and solid trend fashion though, the productive capacity of the economy and productivity will need to be raised.

Cheaper valuations for the Australian market remain a key support variable amid an economic outlook for Australia that remains challenging, experiencing sluggish economic growth and negative per capita growth, a byproduct and function of restrictive monetary policy. Consumer spending remains subdued and consumer sentiment gloomy, though supported by low unemployment and savings buffers.

Underlying inflation in Australia remains higher than that of several economic peers, and the RBA has warned there was a risk of inflation taking longer than expected to fall to its 2.5% target. Moderating inflation in November (4.3% annual versus 4.9% in October) has provided comfort that progress continues to be made, helping validate expectations the cash rate will fall. Expectations of falling interest rates have already buoyed interest-rate-sensitive sectors, including commercial real estate.

The combination of somber growth and continued elevated inflation presents challenges to delivering growth in earnings. This is being exacerbated by weak productivity growth. Continued weakness in productivity growth is a key risk to the growth and inflation outlook, with the RBA's December cash rate decision noting, "Wages growth…remains consistent with the inflation target, provided productivity growth picks up."

With the RBA one of the last central banks to tighten monetary policy, and the lags between monetary policy still working through amid sticky inflation, any prospective interest-rate relief over 2024 is less likely than in other developed markets. A further hike cannot be ruled out.

Despite weakness in global industrial production, demand in the resources and mining sector appears robust, helped by policy mechanisms to support China's growth. However, China continues to face the "triple-D" challenges: demographics, deleveraging, and deflation.

While near-term challenges and risks persist, and 2024 looks set to be another year of weak growth for the Australian economy, Australia's growth performance is expected to exceed the OECD average over the coming three years.

February saw reporting season for most of Australia's listed companies. Although there were some large moves among individual stocks, the overall reporting season was benign. There were similar quanta of upside and downside earnings surprises, although some sector-level results outlined a few key macro themes driving performance.

Of note were a series of positive earnings surprises for consumer discretionary companies. Despite concerns from declining Australia-wide retail sales volumes and inflation-induced cost of living pressures, leading retailers have reported robust discretionary spending from customers. Stemming from low levels of unemployment and a residual glut of excess savings from pandemic stimulus, consumers have not yet resorted to extreme budgeting measures on a macro scale. Although leading indicators

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suggest cooling in the job market, it will likely be some time before this meaningfully stresses consumer balance sheets.

The RBA's February meeting encouraged investors in rate-sensitive equities like commercial real estate that the path to easing is on the horizon if inflation continues an orderly decline to the RBA's official target. Mortgage arears and bad debts have begun rising and will continue for the banks, though they are not yet showing extreme levels, while credit quality is finding some support from rising house prices.

China's steel production has surprised to the upside with strong exports driving above-expectation demand for iron ore and strong earnings for the major miners. Future downside risks are elevated as China's property market woes continue and the Chinese Communist Party contends with elevated debt levels that may restrict infrastructure investment.

A weakening job market combined with poor but recovering labor productivity and headwinds from an expectation of reduced immigration present challenges for economic growth going forward. This is seemingly incongruent with a rich valuation for the S&P/ASX200 and should be cause for moderated optimism of future stock market performance.

International Fixed Interest—Review

Bond yields are generally higher over the month and since the start of the year, as inflation outcomes, growth data, and central banks pushing back against expectations of lower interest rates in the near term work against expectations of rate cuts before midyear.

Bond markets ended 2023 strongly, with the rally (fall) in interest rates (yields) over November extending into December, led by the US Treasury market, as inflation moderated, and the Fed endorsed market sentiment that lower interest rates are in prospect for 2024. The debate is now about to what degree, speed, and timing.

The Bloomberg Global Aggregate Bond Index rose by 0.24% in February as the rally cooled to await further cues from the Fed.

February saw a cooling of interest-rate hike expectations from markets as the Fed pared back expectations of the amount and timing of interest-rate cuts because of sticky inflation numbers, although cooling.

International Fixed Interest—Outlook

We noted last month that markets could be vulnerable to higher-than-expected growth or inflation outcomes, which has played out.

Immaculate disinflation–the combination of lower inflation without a sharp rise in unemployment–has indeed been challenged. Anticipation of lower interest rates across markets, far more than what the US Fed pivot justified, has been scaled back, and some are even saying central banks might not be done

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raising rates. A positive though low probability can be assigned to that scenario, with progress toward 2% inflation slowing and financial conditions not appearing that restrictive, an example being recent equity market performance.

Concerns linger over the trajectory for inflation and the Fed's dovish pivot; in hindsight, it possibly went too far, too early. Core inflation in the US has started to move sideways, goods inflation has picked up, geopolitical tension could manifest in commodity price rises, and service sector inflation is still elevated, reflective of a tight labor market, which is a global phenomenon.

Fixed-income markets have accordingly moved to price in a less aggressive and delayed start to lower rates, but lower rates over time.

The path to lower rates, while far from assured, remains favored. This is due to:

- The lagged impact of tight monetary policy expected to be felt in 2024. Pockets of vulnerability remain including commercial property, shadow banking, and dissipating savings buffers. The UK, Germany, and Japan are already in recession. The US has been the outperformer, supported by rising productivity.
- Central bank cash rates siting well above perceived neutral levels.
- Shelter inflation in the US having room to drop and assist headline inflation moving lower.
- The risks to inflation being more balanced, with supply-side disruption offset by global growth risks.
- Geopolitical tension not manifesting excessively in oil markets, though adding to shipping costs.
- Expectations that fiscal policy will normalize, though elections may challenge this.

The recent rise in yields has taken interest rates above fair value. For example, assuming a real rate of around 1.5%-2.0% plus 2.0% inflation equates to 3.5%-4.0% for the US 10-year Treasury yield. The income is back in fixed income, with risk-free rates in the highest range for a long time; this offers reasonable risk/reward if global growth slows faster or inflation remains stubbornly elevated. The recent rise in yields provides more of a cushion in an environment of uncertainty.

The recent rise in yields also offers some protection from significant sovereign bond issuance as governments balance fiscal durability with investment needs and rising pressures in areas such as defense and core government services, decarbonization, and infrastructure. Elections in the US and UK could increase fiscal impulses, adding to term premiums, but also lean against central banks cutting cash rates.

Japan remains the exception to an easier policy picture. Despite entering a recession, inflation signals look sufficient to continue toward more normalized policy settings. A recent Reuters poll showed that 80% of economists expect the Bank of Japan to scrap negative interest rates in April.

International Equities—Review

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Global equity markets continued the march higher in February with a 4.24% rise in the MSCI World Index in USD. United States technology continued to lead the index higher with the Nasdaq rising 5.41% in USD.

The start to 2024 has been more cautious as investors weigh what is already priced in and remain cautious of high valuations in some regions. Some momentum in the unloved emerging-markets region of China emerged toward the end of February.

International Equities—Outlook

Three key themes are dominating: the outlook for AI, growth (affects earnings), and the trajectory for interest rates.

AI enthusiasm has been so strong, far usurping the potentially negative impact of the recent rise in interest rates, with the Magnificent Seven soaring, accelerated by Nvidia's latest earnings results. The top five stocks now account for a much higher percentage of the S&P 500's market cap than they did in early 2020. Despite this concentrated strength, equity markets have also seen some breadth beyond AI. Momentum and trends have been higher. Growth has surprised on the upside in the US, though China, Japan, and Europe are exhibiting weakness and show regional divergences.

The latest projections from the International Monetary Fund note the "clouds are beginning to part," adding a mildly more supportive growth backdrop than was apparent in 2023, and markets are forward-looking. "The global economy begins the final descent toward a soft landing, with inflation declining steadily and growth holding up. But the pace of expansion remains slow, and turbulence may lie ahead." Resilience in 2023 is expected to carry over in 2024, with global growth of 3.1% in 2024, an upgrade from its prior forecast of 2.9%. Headline and core inflation is expected to move closer to central banks' inflation targets.

As long as this Goldilocks scenario unfolds, riskier assets should benefit, and continued AI uptake could add further growth upside to the central scenario presented by the IMF, boosting investment and spurring rapid productivity growth.

Goldman Sachs recently lifted its 2024 S&P 500 target to 5,200 on an upbeat profit outlook, supported by economic growth and mega-cap profit margins. UBS Group did the same. US productivity figures have supported a robust growth/receding inflation combination. FactSet reports an earnings growth rate for the fourth quarter of 3.2%, the second consecutive quarter of year-over-year growth in earnings. Results have been sufficient and guidance solid, with extrapolations of further gains and 10% earnings growth over 2024. While that is well in excess of projected nominal GDP growth, earnings show more variability than the economic cycle.

While markets have pared back the magnitude of interest-rate cats in 2024, the trajectory is still lower, anticipating "victory" cuts in the inflation war. Market views now appear more in line with the Fed's and a modest easing cycle. Some commentators continue to point to the lagged impact of tighter monetary

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policy having a greater impact on growth in 2024, as savings buffers run out, necessitating a more rapid easing in monetary policy.

Is the recent equity rally worth chasing? The above views provide a supportive backdrop.

However, with each push higher, valuations stretch farther. US stocks appear expensive, trading on 20 times their 12-month forward earnings, a level rarely maintainable outside of the dot-com bubble.

Key downside risks include new commodity and supply disruptions, China, and core inflation proving more persistent, requiring a higher-for-longer rates/slower growth combination. According to the IMF, "Markets appear excessively optimistic about the prospects for early rate cuts." The pace of disinflation has slowed in the US. There remains the possibility that too much growth in 2024, while positive for earnings in the near term, will keep inflation elevated, requiring an interest-rate response and deeper economic adjustment in 2025.

Getting core inflation to 2% from 4% carries higher economic costs than getting it to 4% from 6%. The strength of global labor markets and strong anticipated rebound in earnings in the US challenge the notion that inflation will comfortably return to 2%. The improvement in US productivity growth could be the glue that helps that combination stick.

The coming months are likely to be critical in assessing the market's central scenario of a smooth landing. Higher rates are not likely, but a positive probability still needs to be attached to the possibility as a tail risk. Across many metrics including equities, it can be questioned whether financial conditions are sufficiently restrictive to continue damping inflation, particularly if fiscal policy around the globe does not consolidate, increasing pressure for even tighter monetary policy. The projected improvement in earnings is strong, considering a key channel that disinflation works through is margin compression.

Regional growth divergences are also notable. China continues to struggle. Japan and Germany are in recession. India, Brazil, and Southeast Asia are showing resilience, offering selective investment opportunities.

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