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Economic Update: Australia
September 2021

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Outlook for Investment Markets

Global equity markets have eased back in September reflecting the global surge in the delta variant of COVID-19. The most likely scenario is that the world economy will recover as the delta variant fades, but fund managers are no longer sure we will see a 2022 repeat of the sharp V-shaped recovery of 2020-21 that we experienced in the wake of the first COVID-19 outbreak. At home, the economy had been strong prior to the reappearance of COVID-19, and business and consumer surveys suggest there is a good prospect of solid business conditions resuming on the other side of the current lockdowns although, as with overseas markets, the rebound may not be as vigorous as it was in 2020. It is helpful that the Reserve Bank looks likely to hold off on any wind-down of its very supportive monetary policy.

Australian Cash and Fixed Interest — Review

Short-term rates are unchanged, with the 90-day bank bill yield just above zero. Bond yields have also been steady, and at 1.22%, the 10-year Commonwealth bond yield is close to where it was a month ago. The Australian dollar has weakened during September, and year to date is now down 4.7% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

At its latest (September) policy meeting, the Reserve Bank of Australia yet again reiterated that the conditions for any eventual interest rate increase look unlikely to materialise before 2024. While some forecasters, and the futures market, think there could be an earlier move—the futures market thinks late next year is a real possibility—there is not much reason to doubt the RBA will sit on its hands for a considerable time yet. Given significant COVID-19 uncertainty, the bank may well be right to want to see very clear evidence the economy is robust before doing anything.

The RBA also committed to continue buying AUD 4 billion worth of bonds each month until at least February 2022, and so will be leaning against a rise in bond yields, particularly at the shorter end, where it continues to target a three-year yield of 0.1%. Even so, there is likely to be some modest upward drift of longer maturity bond yields, either because bond holders push back against the current 10-year yield of 1.2% when inflation is likely to be running at around 2%, or because of the indirect influence of rising U.S. bond yields. Westpac expects a 10-year yield of 1.9% in a year's time, while National Australia Bank see it higher at 2.4%. Either way, investors in Australian bonds are unlikely to see much respite from ongoing losses: year to date the S&P Australia Aggregate bond index has lost 0.3%.

At the moment, the weakness of the Aussie dollar looks to be driven by a combination of the concerns investors currently have about the economic impact of the delta variant running wild, and the interest rate differential consequences of the RBA being likely to be relatively slow, compared with overseas central banks, in stepping back from very stimulatory monetary policy. Some forecasters believe the current weakness is transient: Westpac sees the Aussie dollar back up to USD 78 cents in a year's time,

and NAB sees it at USD 80 cents, compared with today's USD 73.4 cents. They may yet be proved right, but it would require either the COVID or interest differential drivers (or both) to turn for the better, and if not, then further weakness remains a real possibility.

Australian & International Property — Review

The A-REITs have done well, and have matched the strong performance of the overall sharemarket. The S&P/ASX 200 A-REITs index is up 13.3% in capital value and has returned 16.2% including dividends. The sector saw the IPO on Sept. 6 of a substantial new name, the Healthco Healthcare and Wellness REIT, with some AUD 550 million of healthcare assets. The launch went well, and at AUD 2.34 it is currently trading at a 17% premium to its listing price.

Global listed property has also performed well, and year to date the FTSE EPRA/NAREIT Global Index in U.S. dollars is up by 14.7% in capital value and has delivered a total return of 17.5% including dividends. The result has been heavily influenced by the very strong U.S. market, which has returned 27.8%, and to a lesser degree by the U.K. market, which has returned 23.6% (also in dollars). The Asia-Pacific region (3.9% return) and the eurozone (3.5%) have been subdued, while emerging markets went backwards with a loss of 8.3%.

Australian & International Property — Outlook

Australian property had been doing well before the latest COVID lockdowns albeit with strong subsectoral cross currents. According to the Property Council of Australia/MSCI Property index, for the year to June, physical property returned 7.8% (income yield of 5.0%, capital gain of 2.0%). Industrial property was streets ahead of the other sectors with a 23.2% return, with tight supply meeting strong investment appeal as the infrastructure supporting e-commerce. At the other end was retail, with a total return of only 2.5% and, as at June, 11 straight quarters of capital loss. Not all retail is equal, however, with neighbourhood shopping centres, the most defensive end of retail during 2020 lockdowns, returning 7.5%.

The latest lockdowns have done quite a bit of short-term damage. One example, the Property Council's monthly tracking of office occupancy relative to pre-COVID-19 levels showed that in August, the office towers were effectively empty in the biggest markets (Sydney at 4% of normal, Melbourne at 7%). Looking ahead, the consensus outlook is for a relatively quick rebound as vaccinations increase and lockdowns are rolled back, and the improved operating performance is likely to support the sector in the near term, and push the longer-term structural issues COVID-19 caused, or accelerated, into the background for the time being. It helps that the Reserve Bank of Australia is likely to hold interest rates where they are for an extended period, which means the dividend yield on the sector (3.6% according to Standard & Poor's) will continue to have appeal.

Overseas, there is not the same degree of confidence as there is in Australia that progress with vaccination will see a relatively quick return to business as usual for commercial landlords: the dangerous delta variant has been a significant and ongoing disruption. In the U.S., for example, the office occupancy rate in August in New York was only 22.3%, and in San Francisco was only 19.7%. The delta

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outbreak has intensified the "work from home" trend. As the chief economist for Moody's Analytics said in an article in the Wall Street Journal, "The pandemic has ignited an exit of workers from urban areas. They've been empowered to work wherever they like. Over three-quarters of a million more people have left big cities than have moved to them since the pandemic hit ... Some white-collar workers will give up the work-from-anywhere lifestyle when office buildings welcome back workers in earnest, but for most it is here to stay."

In these circumstances it is not surprising that office landlords in particular are finding it tough going. Knights Frank runs a quarterly global "dashboard" which shows where the bargaining power lies between landlords and tenants. The June quarter dashboard shows there is not currently a single market in the developed world where the landlord is in the driving seat, and in Knight Frank's view, the outlook for landlords in 2022 will be little better. While global REITs may eventually get support from improving economies on the far side of the delta variant, and industrial property in particular is likely to remain in strong demand, there are structural changes to the world of work and of shopping that are likely to limit further advances.

Australasian Equities — Review

Australian shares have done well year to date, and the S&P/ASX 200 is up 12.9% in capital value and has returned 16.4% including dividends. Two prime beneficiaries of the faster than expected recovery from the 2020 COVID-19 outbreak have led the way, with the financials (ex the A-REITs) up 23.5% and consumer discretionary stocks, boosted by the release of the spending power pent-up during the pandemic, up 21.3%.

Australasian Equities — Outlook

The June reporting season went well, though benefiting from comparison with the temporarily COVID-depressed conditions in 2020. As CommSec's earnings wrap-up said, "aggregate profits were up almost 76 per cent on a year ago (earnings per share doubled) ... Corporate Australia recorded strong financial results over the past year – although the year has effectively been a 'rebound year' – a period of recovery from the lockdowns that dominated over June quarter of 2020."

Looking ahead, CommSec are surely right to say, "The answer to all questions is COVID-19", but subject to that (major) uncertainty, the early take on the post-lockdown outlook is looking reasonably promising. Despite the latest outbreak being worse than initially hoped, both households and businesses appear to be taking it in their stride.

The September consumer confidence survey from Westpac and the Melbourne Institute, for example, found "The resilience of consumer sentiment in a period when Australia's two major cities have been locked down and the economy has been contracting is truly remarkable. The Index is still comfortably above the reads seen over the five years prior to the pandemic and is only 0.9% below its June print just prior to Sydney's move into lock-down." On the business front, National Australia Bank's latest (August) survey found that "business conditions are still elevated – and rebounded in both NSW and SA in the month – and remain well above average in all states ... The resilience of the survey during the current

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episode likely reflects the healthy momentum in the economy before the lockdowns, ongoing fiscal and monetary support as well as greater certainty that the lockdowns will end as vaccines roll out."

Forecasters are consequently largely looking through the current setbacks—Commonwealth Bank, for example, expects GDP growth this year of 3.1% this year and 3.8% in 2022, and National Australia Bank has a similar projection, of 3.8% and 3.9%. That would be helpful for corporate performance, though with the proviso that investors, having overestimated the downside impact of the 2020 lockdowns, may make the opposite mistake this time round, and underestimate the latest one: there will be businesses that could survive one lockdown, but not two, and there are still large question marks around the future of businesses linked to international tourism and education.

Valuations may also come into play: Standard & Poor's calculate the forward looking P/E ratio is 17.1 times expected earnings, and CommSec said that "While earnings over the past year have partly validated higher share prices, valuations are still high, with the [backward-looking] price-earnings ratio at 19.61." In CommSec's view, that puts some upside limit on where prices can go; they picked a 7,500–7,700 range for the S&P/ASX 200 index by mid-2022, which would be only a modest pick-up on its 7,347 at time of writing.

International Fixed Interest — Review

The environment of a strong bounce in economic activity out of the first round of COVID-19, bringing various inflationary pressures with it, has not been congenial for bonds. Yields remain higher than where they started the year, and running yields have been too low to offset the capital losses. Year to date in U.S. dollars the Bloomberg Barclays Global Aggregate Bond Index is down by 2.1%: government bonds have lost 3.4%, while higher yields have helped protect the overall return from corporate bonds, which are down by 0.5%.

International Fixed Interest — Outlook

The likelihood is that monetary policy will, very gradually, move away from the highly supportive settings that had been appropriate in the period leading up to COVID: inflation had been lower, and unemployment higher, than central banks would have liked, and the easy money policies needed to get both moving to target levels got a further lease of life when COVID-19 hit in 2020 and economies needed further support again. Now, however, there has been a strong initial rebound from COVID, and both inflation and growth prospects have improved (albeit with a considerable overhang of uncertainty), so extremely stimulatory monetary policy no longer looks necessary.

In the first instance, this is likely to manifest as a wind-back of "quantitative easing" programmes of bond buying, which had been targeted at keeping bond yields very low. In the U.S., for example, comments from various Fed officials suggest that the current USD 120 billion a month pace of bond buying could well start to be wound back by the end of this year: one plausible scenario is that the Fed will start the process at its Nov. 2-3 meeting, with a "heads up" advance signal at its next meeting on Sept. 21-22. Similarly the European Central Bank said after its latest (September) meeting that it would ease back

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from the EUR 80 billion a month of bonds it had been buying under its "pandemic emergency purchase programme."

Any move to move beyond slower rates of bond buying, and to raise interest rates, is still a long way away, however. In the U.S., for example, the futures market thinks the Fed's first rate increase will not occur before 2023, and in Europe the ECB reiterated that interest rates will remain where they are until the bank "sees inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon." On the bank's own projections, updated this month, "core" (ex food, ex energy) inflation will be 1.4% in 2022 and 1.5% in 2023, meaning interest rate increases in the eurozone are still a dim and distant prospect. But even so, peak monetary policy support looks to be behind us, and markets are likely to start anticipating rate rises even before central banks finally press the hike button.

Bond market optimists argue that the current surge of COVID-related inflation will largely or completely die away, and took some heart from the latest inflation numbers in the U.S. In August both headline and core inflation rates eased back a little from July (annual core inflation dropped to 4.0% from 4.3%, for example), and they expect inflation to keep on dropping, reducing the likelihood that central banks will move towards tightening. While COVID-19 might yet lead central banks to hold off, entirely transitory inflation looks a somewhat unlikely scenario. In any event, even if inflation in the U.S. were to drop back to its pre-COVID-19 2% or so, and eurozone inflation drops back to the ECB's expected 1.5%, bond holders are unlikely to tolerate current yields indefinitely. Holders of the benchmark 10-year U.S. Treasury bond earn 1.3%, and their German equivalents are paying the German government 0.3% a year. Both yields are well below likely inflation, even before tax. Whether through investor pushback, or ongoing monetary policy normalisation, market conditions look likely to remain difficult for bonds, absent any major setback to the global economy.

International Equities — Review

September has not been kind to world shares, with prices peaking early in the month and sliding since then. The recent weakness has been modest relative to the substantial gains earlier this year, however, so year to date, the major share indexes are still well ahead: the MSCI World index of developed markets in U.S. dollars is up by 15.8%. Performance has remained regionally diverse: the U.S. (S&P500 up 18.3%) and the eurozone (FTSE Eurofirst300 up 13.3% in U.S. dollars) have led the way, while Japan (Nikkei up 4.2% in dollars) has lagged. Emerging markets are barely ahead (MSCI Emerging Markets in U.S. dollars up 0.4%) and the key BRIC markets (Brazil, Russia, India, China) are down 4.8%.

International Equities — Outlook

The recent weakness has reflected several factors. A key one is that the pace of growth of the global economy, which had initially recovered much more strongly and quickly than expected from the initial 2020 COVID-19 outbreak, has eased back. The J. P. Morgan Global PMI Composite Output Index, which aggregates the latest business surveys across more than 40 countries, shows that the world economy is still growing, but in August it was growing at the slowest rate in seven months: "There was some

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evidence from companies that supply-chain disruptions (especially at manufacturers), COVID-19 issues, and signs of labour and skill shortages all impacted on growth during the latest survey month."

The mood of investors about the pace of growth was not improved by poor jobs numbers in the U.S. In August, there were an extra 235,000 jobs, hugely short of the 720,000 that forecasters had expected and way below the 962,000 extra jobs in June and the 1.1 million in July. One month could yet prove a blip, but it looks to be significant that the sectors most dependent on face-to-face interactions with customers were hit hardest: the leisure and hospitality trades, which had been booming in earlier months, created no new jobs in August, and retailers and restaurants shed staff, all of which is consistent with the delta variant posing a severe challenge to business activity. While the initial robust recovery from 2020's COVID-19 had been very encouraging, investors have now had to reassess the realism of the impact of COVID-19 being largely behind us. As the New York Times noted in its latest coverage, "The virus continues to spread rapidly around the world, averaging about 550,000 new cases and almost 9,000 deaths per day. The most recent global wave peaked in late August, at more than 650,000 daily cases, but unlike previous peaks in January and April, the latest one has not been followed by a steep drop" and countries are having to adopt new policies (such as booster shots) to try to manage the latest outbreak.

Investors may also have been lulled by the scale of the profit boom as the global economy surged out of the 2020 outbreak. In the U.S., for example, according to data company FactSet, profits in the June quarter were 91% up on a year earlier. While investors will have recognised, at some level, that profit growth of that order was an artefact of the COVID-19 bust and subsequent rebound, they may also not have adjusted expectations adequately for the more mundane profit outlook in 2022. FactSet's polling of share analysts, for example, shows they currently expect profit growth of 9.4%, which would be a satisfactory outcome, but the analysts also expect this will underpin an 11.8% rise in an already expensive S&P500. Consumer discretionary stocks are now trading on a forward looking multiple of 30.3 times expected profits, which suggests that analysts are taking a remarkably upbeat view on the willingness of consumers to go on spending in a still COVID-bedevilled world.

Equity markets are also starting to face up to the prospect that central banks (as noted earlier) are starting, however, cautiously and gradually, to edge away from their previous very supportive monetary policy settings. Equities will not be benefiting from the same degree of valuation support they enjoyed in the period of peak liquidity and ultra-low interest rates. In these circumstances, it is not surprising that global fund managers, polled in the latest (August) Bank of America Merrill Lynch survey, have turned markedly more cautious about the equity outlook. They are still pro-equities, and have not increased cash levels, but they are now taking a much less exuberant view. Back in March, in the middle of the strong V-shaped recovery from 2020, fund managers had been overwhelmingly upbeat: 91% expected the global economy to improve. Now, only 27% do. There was also a slump in the percentage of managers expecting global profits to improve, from 89% to 41%. The chances are that, as the managers expect, the global economy will continue to recover, but more slowly from now on, and further equity gains will be more difficult to bank.
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