MACQUARIE

Investment Strategy Update #123

The RBA has not finished raising rates

- The RBA has raised the cash rate by 275 basis points to 2.85% since May of this year. Despite this considerable tightening, inflation continues to rise in Australia and is yet to reach its projected peak of around 8%. While policy works with a lag, the RBA has more work to do with market implied forecasts sitting at 4.00% compared to the current level of 2.85%
- At this stage, Australia's inflation backdrop is looking increasingly like its global developed market peers, consistently surprising on the upside and broadening out into the services sector at a rising rate. Unless we begin to see indications that service sector inflation pressures are moderating (or that wages growth begins to stagnate), the RBA is likely to follow through on expected rate hikes despite its detrimental impact on domestic demand.
- To date, the Australian economy has remained robust despite rising interest rates. Retail spending remains strong, the labour market shows few signs of weakening and there has been no material decline, anecdotally, in investment intentions. However, monetary policy works with a lag and so we expect the full impact of tightening credit conditions to be felt in early 2023.
- We remain surprised at the level of ambivalence towards the inflation outlook and the shift in financial conditions that is underway. While sentiment towards the housing market has soured considerably (and Macquarie believes it will get worse), and the tightening to date could not have been expected to significantly slowed activity, we get the sense there is little fear of a policy mistake (overtightening) or that Australia will only suffer a mild slowdown from the current tightening phase.
- Macquarie does expect Australia to avoid a recession, but this also assumes the RBA gets it right. Even if GDP growth remains above zero, some households will face recessionary-like conditions, and this will likely weigh on consumption for a time
- For financial markets, it is likely that Australian sovereign bond yields creep a little higher but are dragged in this direction by global yields. Macquarie thinks the A$ has further downside (versus the US$) but in the low US$0.60s, we think hedging the currency is prudent given the declines seen to date. For the equity market, provided bond yields don't surprise meaningfully on the upside, we see little threat to valuations unless the growth slowdown is deeper than Macquarie forecasts. Earnings are set to fall, and this will make it hard for the market to bottom until there is transparency on the depth of the economic slowdown. Stay patient. We wait for more transparency on where rates peak and the hit to growth.

What has happened to cash rates?

Since May this year, the RBA has raised the cash rate by 275 basis points to 2.85%, the highest level in nearly a decade and at the fastest pace since 1994.

In his most recent press conference, Governor Lowe signalled more tightening is to be expected as ***'inflation in Australia is too high'*** while also revealing revisions to inflation, unemployment and growth forecasts. While the pace of tightening was kept modest (25 basis points), the RBA has the benefit of additional meetings compared to the Fed and is relatively more flexible in adjusting policy in line with changes in macroeconomic conditions.

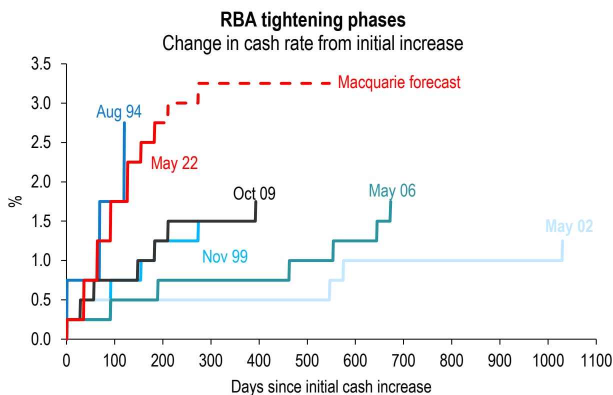
Inflation is now forecast to peak around 8% later this year, up on the 7.8% projected in August. Likewise, growth over 2023 and 2024 is expected to average only 1.5%, compared to the initial 1.8% forecast just a few months ago. In addition, unemployment is now predicted to increase to a little over 4%.

These revisions to the forecasts speak to the reality facing all central banks, that is, inflation is a difficult factor to forecast with any degree of certainty and unless a substantial decline in prices towards target levels is seen, central banks (the RBA included) will have to continue tightening monetary policy settings until monetary conditions are highly restrictive.

Macquarie is forecasting a terminal policy rate of 3.35% by Feb-23, which is lower than current market pricing that projects a cash rate as high as 4.0% in July 2023. However, Macquarie's economics team have also stated that the risk to their cash rate forecast is now to the upside

although they continue to think market pricing is overly hawkish.

The RBA may need to be more aggressive to control inflation if it surprises to the upside



Source: Macquarie Macro Strategy, MWM Research, November 2022

What is the RBA focusing on?

Inflation is a tax on society and it's the RBA's mandated role to get price growth back down into the 2-3% target range. Beyond the natural challenges posed by higher prices for the cost of living, inflation also poses risks to financial stability, particularly if pockets of risk build up across asset markets.

To justify any change in the trajectory of the interest rate path, the RBA is focusing on several domestic and international factors. In Australia, they will be closely watching:

1. **Wages**: The RBA has noted that wages growth is picking up. While still below the levels in other advanced economies (2.6%), they are particularly focused on avoiding a prices-wages spiral which then becomes entrenched into expectations.

2. **Labour market**: The RBA noted once again that labour market conditions remain tight, with unemployment levels at 50-year lows (3.5%). A tight labour market keeps demand for labour elevated and adds to wages pressures. In addition, a fully employed economy will continue to keep spending and aggregate demand levels high which can also add to inflation pressures. Until there are some signs of a weakening in the labour market, the RBA will find it difficult to slow the pace of rate hikes.

3. **Breadth of inflation**: While some progress has been made on goods prices, services inflation has accelerated in recent months igniting concerns that inflationary pressures are broadening out from goods. The RBA will closely follow the evolution of services prices to gauge if inflation is expanding into categories that may result in broader price stickiness such as rents which are also harder to unwind.

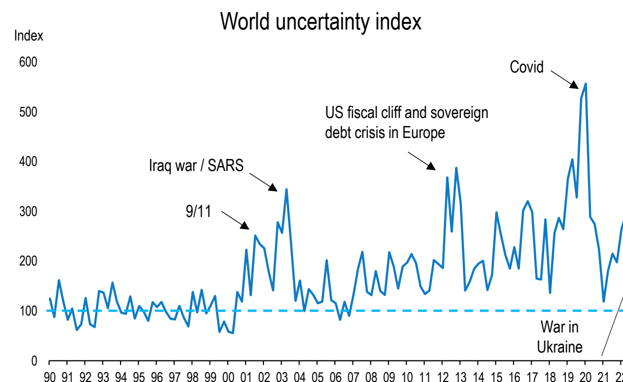
On the global front, the macroeconomic backdrop remains a key concern. As an export-dependent economy, a slowdown in global growth will weigh on international trade flows and will naturally affect Australia's GDP growth. A few key global factors the RBA will be watching closely include:

1. **The Fed**: One argument the RBA has made for slowing the pace of rate hikes in recent months (from 50 to 25 basis points) has been that global monetary policy is doing some of the heavy lifting for the Australian economy given the speed and progression of the Fed and other central banks. The US drives global monetary conditions, so a rising US$ and expectations of a 5% Fed Funds rate is working to tighten global financial conditions and slow demand (exports).

2. **Geopolitical tensions**: A key source of uncertainty for global growth is the conflict in Ukraine (and to a lesser extent, tensions over China and Taiwan). If the Ukraine conflict continues, energy and food prices are likely to remain elevated which could see inflationary pressures persist and spill over into the Australian economy. In addition, geopolitical risks are much harder to offset via policy stimulus when inflation is high which then adds to the risk premium for financial assets.

3. **China**: As Australia's largest trading partner, lingering pandemic restrictions and negative sentiment surrounding the property sector will continue to undermine growth in China. A weaker China does not bode well for Australian commodity, tourism and educational exports.

Heightened geopolitical tensions are exacerbating policy and inflation uncertainty



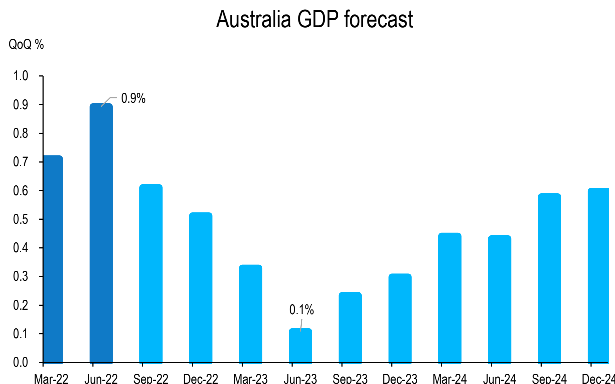
Source: Bloom and Furceri (2022), MWM Research, November 2022

What does inflation / higher rates mean for the economy and financial markets?

Macquarie expects the Australian economy will avoid a recession, but downside growth risks are rising driven by stickier than expected inflation that cause more aggressive rate hikes emanating from the US. Recession or not, the growth slowdown will be substantial and is most likely

going to create recessionary-like conditions for many households that are already dealing with cost-of-living pressures. In particular, higher mortgage rates will slice into household savings. As it stands, growth will decline sharply to around 0.1% by mid-2023 before rebounding thereafter into 2024.

Australia will avoid a recession, but the growth slowdown won't be easy



Source: Macquarie Macro Strategy, MWM Research, November 2022

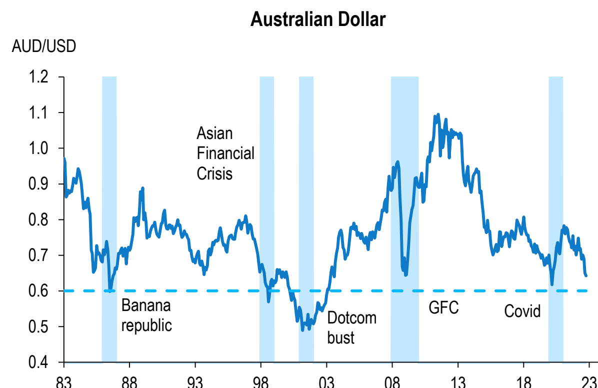
Bond yields – close to a peak but limited downside: The most substantial impact resulting from the RBA's tightening will be felt across sovereign bond yields. Bond yields have spiked sharply as inflation risks have risen. For Australia, the rise in long yields has not been as aggressive as in the US, the 10-year yield has risen from a low of 0.6% in 2020 to the current level of ~3.92% (vs 0.5% to current ~4.15% in the US) However, mortgage rates which are being set of short rates, are already in the 5-6% range (having doubled since early in the year) and can be expected to move even higher in coming months.

The yield curve may also see further inversion, as short rates continue to rise in line with the cash rate and long rates begin to reflect a weakening growth backdrop.

We moved overweight sovereign bonds too early based on our expectation that the fixed income market would begin to price in downside growth risks and not upside inflation risks. It has proven to be ill-timed as the bond rout (a once in a 50-year sell-off) has continued unabated.

We think a lot of pain has been taken in sovereign bonds. We are not sure when they peak, but we believe there is limited upside if forecasts of inflation now close to peak are correct. While investors have had to endure capital losses, government bonds now provide a very appealing yield at 4-5% and we think excellent downside protection against a global recession.

The Australian Dollar has historically played the role of an economic 'shock absorber'



Source: Macquarie Macro Strategy, MWM Research, November 2022

The A$ has not bottomed: Macquarie thinks risks to the A$ remain skewed to the downside. While the currency has already fallen around 15% against the US$ year to date, widening differentials between Australian and US interest rates are likely to remain a strong headwind for any sustained upside. In addition, a reset in expectations for a Chinese economic rebound are also likely to weigh on the commodity price outlook (iron ore prices have come back sharply) and reduce the A$ tailwind.

While historically the Australian Dollar has played a role of shock absorber in times of economic uncertainty, permitting a boost in exports, the current situation is one where all economies are simultaneously facing risks to growth. Thus, we believe that a substantial portion of global negative sentiment has been priced in the Australian Dollar. In this sense, it is a sensible time to start considering hedges to unhedged international portfolios that have benefited this year from a stronger US Dollar.

Equities - expect ongoing volatility and more downside: Equities have been largely moving in tandem with bond yields. As yield rise, equities have fallen, led by technology and other richly valued growth stocks. Valuations for many equity markets are now back to more appealing levels including Australia. However, fears have now shifted from higher rates to lower growth, and this is beginning to undermine stocks which are traditionally more sensitive to the economic cycle.

We are not so concerned about a short and/or shallow economic downturn. Equity markets can adjust to this reality quite quickly as earnings forecasts are downgraded. However, there is limited transparency on just how deep a slowdown will be and/or whether rates might have to go higher and stay higher in order to bring inflation back down to target ranges.

This means that until there is greater transparency on the inflation, rates and growth debate, equities might not need to trade much lower (unless disappointed by inflation or growth), but the start of a more sustained upside is unlikely. This is a backdrop where markets will move with the data and volatility will remain high as the bulls focus on any positive developments, but the bears also focus on any negative outcomes. This tug-o-war is to be watched from the sidelines rather than participated in.

We continue to think near term risk-reward is unfavourable for equities. Investors are taking on a lot of volatility and uncertainty for limited upside unless we are through the other side of the inflation fight or central banks are close to a policy pivot (on average 4 months post the final Fed rate hike).

On a relative basis we have been underweight Australian equities since mid-year. Our rationale was that the drivers of 1H22 performance (strong energy and commodity prices and an underweight in the technology sector) would reverse as oil prices fell from peak levels (they have), as commodity prices weakened off the back of cyclical risks (they have) and as technology stocks found a floor (they have not). In addition, we underestimated the "defensive" characteristics of the market where investors have sorted out stable cash flow/dividend payers and took a more positive relative outlook on the economy and market.

Australian equity market only down 6% in total return terms

Source: Macquarie Macro Strategy, MWM Research, November 2022

We continue to think that at only 6% off the peak (in total return terms), the Australian market is not priced for growth and rate risk. But a more favourable relative outlook is likely to mean it will remain an outperformer versus other global peers, particularly in A$ terms (for offshore investors which are picking up the currency benefit).

We are not buyers of the Australian equity market yet, and a better "relative" outlook is cold comfort for investors, but Australia, as it usually does, should emerge from the current inflation / rates / growth shock better than its peers.

Macquarie WM Investment Strategy Team

The report was finalised on 04 November 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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