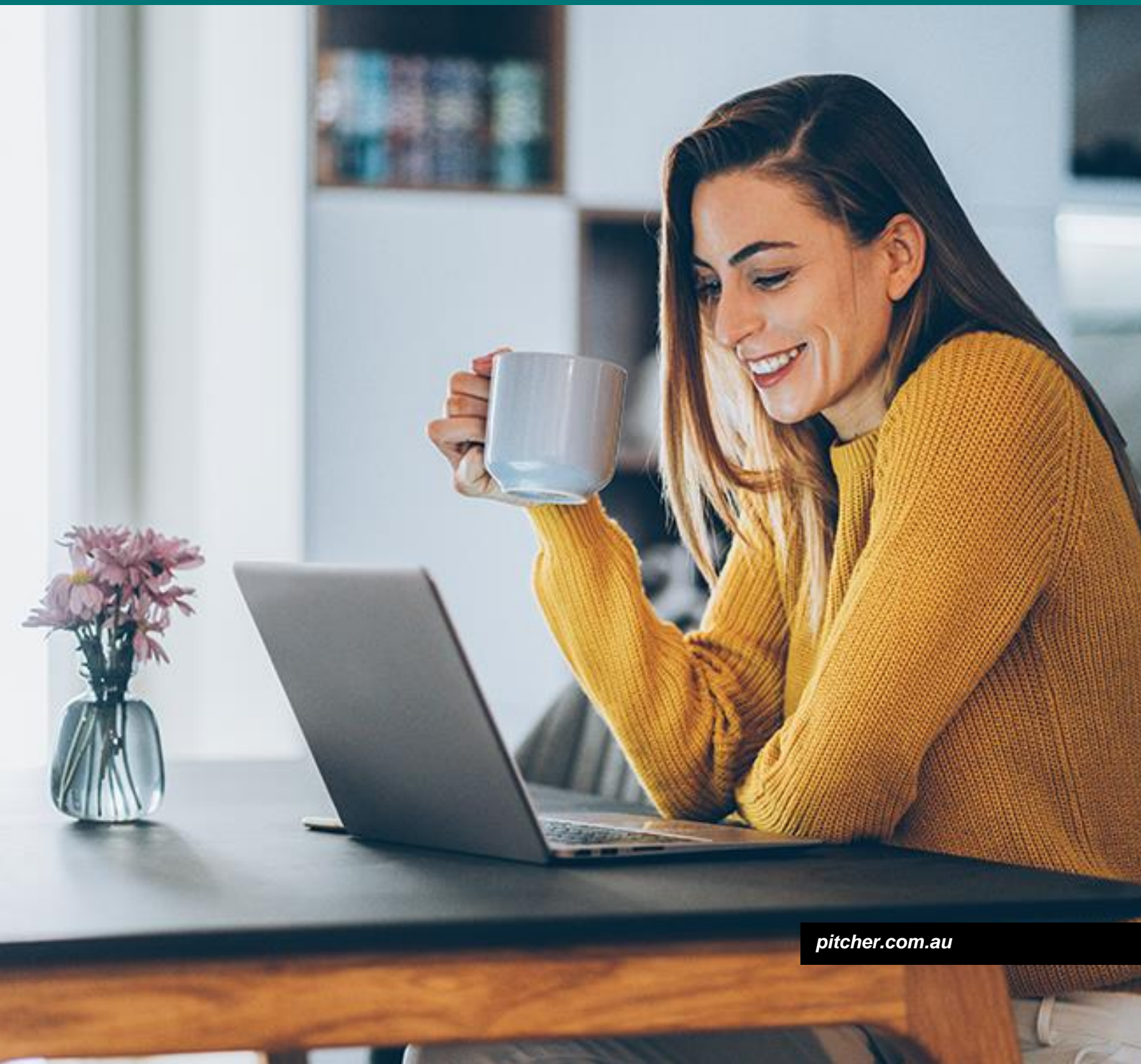


Economic and Market Outlook

October 2022

Current as at 1 October 2022



International economy – “no other choice”

As Northern Hemisphere nights grow longer, central bankers face the unenviable choice of allowing prices to run rampant, or risk plunging economies into recession anyway by lifting interest rates too aggressively.

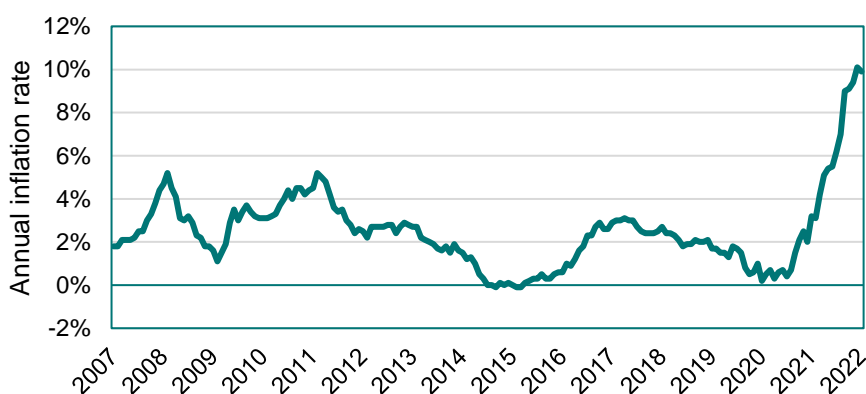
While there are some signs to suggest inflation may have peaked (global supply chains blockages are beginning to ease¹, firms are building inventory levels² and many commodity prices such as oil have fallen from recent peak levels), other coincident indicators particularly in the US remain strong, such as rent and wage growth. Recently in August, US core inflation, which strips out changes in food and energy prices, surprised to the upside at 6.3% for the year versus a consensus forecast of 6.1%. However, we should note that a big driver of this change (approximately 40% in fact³) is due to the cost of rent and housing. This is expected to persist until next year because of the way this is measured in the US. Fearful of a wage price spiral, the Federal Reserve economic department's (Fed's) focus has shifted to reducing inflation to a 2-3% range at all costs even if this weakens the economy and causes job losses.

Although we have already seen two quarters of negative GDP growth in the US, this was more due to GDP accounting anomalies that were at odds with underlying strength in the labour market. Nevertheless, weakness in other indicators besides consumer spending suggest a material slowdown is now indisputably underway. The Markit Composite PMI for the US was 44.7 in August, with new orders falling at their fastest pace since May 2020 (the first set of coronavirus lockdowns). The overall weakness is being led by services sector (Services PMI at 43.7 vs a still positive 51.7 for manufacturing firms), implying that job losses are likely. Recession risks for the US are continuing to rise in our view.

In Ukraine the war rages on. Over recent weeks Ukrainian forces have mounted a successful offensive, retaking sizeable tracts of land from Russian occupiers. Even in the face of these setbacks, there has been a marked reluctance from Russia to negotiate an end to the conflict. Given Western support has remained intact, we expect the war and its consequences to persist for some time. The withdrawal of many Russian commodity exports, including oil and gas from global markets has helped fan global inflation. This worsened in August with Russia effectively weaponising its gas supply by halting the flow of gas to Europe in retaliation to EU sanctions.

This has seen electricity prices continue to soar as European countries race to stockpile enough for winter later this year. In some countries such as the UK, headline inflation for the year is nearing double-digit territory at 9.9% for the year to August.

UK annual inflation rate (Aug-07 to Aug-22)



Source: Bloomberg

¹ 'Global Supply Chain Pressure Index', New York Federal Reserve, <https://www.newyorkfed.org/research/policy/gscpi#/interactive> (accessed 1 October 2022).

² K. Broughton, 'Retailers Face Pressure to Offer Discounts while Combating Inflation', *Wall Street Journal*, <https://www.wsj.com/articles/retailers-face-pressure-to-offer-discounts-while-battling-inflation-11663932601> (accessed 1 October 2022).

³ 'US Consumer Price Index for All Urban Consumers', US Bureau of Labor Statistics, <https://www.bls.gov/news.release/cpi.t01.htm> (accessed 1 October 2022).

Governments are working to support households and businesses in the face of these unprecedented energy price hikes. Energy prices have been capped for UK households at £2,500 per annum until September 2024⁴ as part of an overall support program costing £150bn. In Germany, energy retailers such as Uniper are being nationalised to avoid bankruptcy⁵. This situation has triggered a broad economic slowdown as household budgets are diverted to necessities such as electricity. The Eurozone Composite PMI for August was 48.9, its lowest since February 2021, indicating a contraction in economic activity.

Somewhat counterintuitively, the European Central Bank (ECB) has compounded these challenges by lifting interest rates for the first time since 2011, adding further pressure onto households and businesses. After holding its nerve for over a year, the focus has shifted to more political goals, such as being seen to be “doing something” to reduce inflation. Given the economic damage already underway, we think the ECB may well be cutting again before long to support the economy.

In China, the well documented problems with its property market and the consequential downstream impacts on investment and consumption, continue to wreak havoc on the broader economy. Real estate investment was down 7.4% for the year to August⁶. Coronavirus lockdowns remain part of the Chinese landscape with rapid shutdowns of major cities being a continued source of disruption. Chengdu, a city of 21 million people⁷, has been the latest victim of the country's Covid Zero Strategy, following on from Shanghai's major two-month lockdown earlier this year. These have added to economic disruption including a slowdown in demand and investment spending. The government launched a new US\$146 billion stimulus package in late August targeting new infrastructure spending (US\$44 billion), energy supply security (US\$29 billion) and local government funding (US\$73 billion). This follows moves to lower interest rates by the People's Bank of China, while the country's official growth target of 5.5% for 2022 was dropped by Chinese officials after a parlous start to the year with growth of 2.5%.

Overall growth prospects have continued to weaken with US growth revised down to 1.4% for 2022 (down from 1.7%)⁸. Although EU growth has been revised slightly higher to 3.1% (due to positive economic surprises in the first half of 2022), aggregate demand is expected to slow sharply to just 0.9% in 2023⁹. For many, it is becoming increasingly expensive to just “keep the lights on”, let alone meet other expenses. Recession risks are elevated in our view and growth forecasts may well be revised lower in the months ahead. This is supported by leading indicators that have turned sharply negative in recent months including the Composite PMI survey shown below.

⁴ R. Wait, and L. Howard, 'Ofgem Energy Price Cap And New Govt Price Guarantee Explained', *Forbes Adviser*, <https://www.forbes.com/uk/advisor/energy/energy-price-caps/#:~:text=Cap%20increases%20further%20still%20to,October%202022%20%E2%80%93%20September%202024> (accessed 1 October 2022).

⁵ E. Smith, 'Germany nationalises energy giant Uniper as Russia squeezes gas supplies', *CNBC*, <https://www.cnbc.com/2022/09/21/german-government-agrees-nationalization-deal-for-energy-giant-uniper.html> (accessed 1 October 2022).

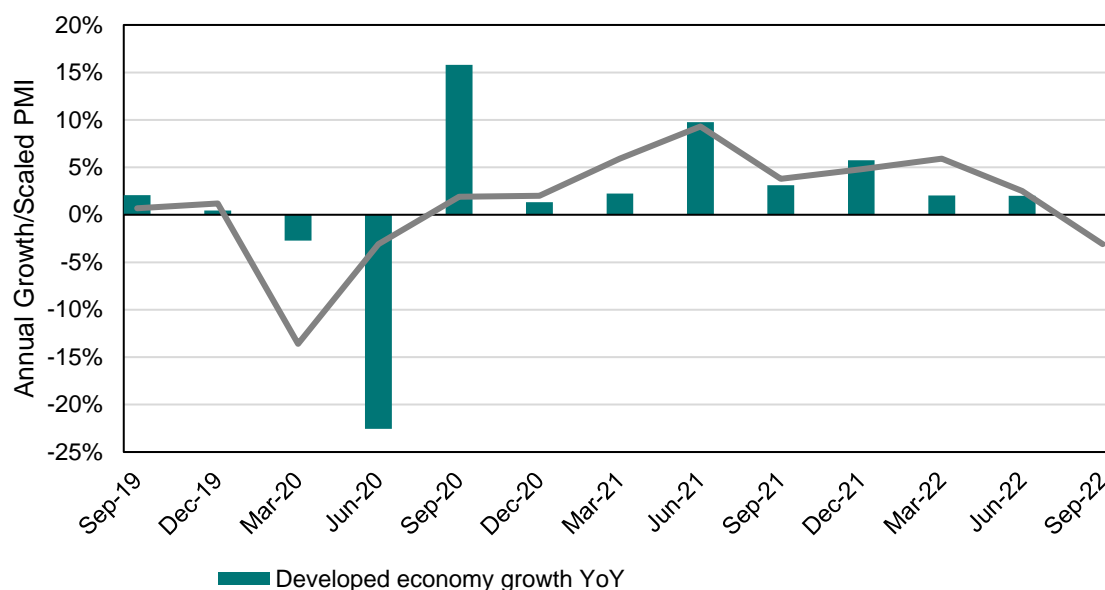
⁶ E. Cheng, 'China's retail sales, industrial production beat expectations in August', *CNBC*, <https://www.cnbc.com/2022/09/16/china-economy-august-industrial-output-retail-sales.html> (accessed 1 October 2022).

⁷ J. Hou, and L. Lew 'China Lifts Two-Week Lockdown in Chengdu, City of 21 Million', *Bloomberg*, <https://www.bloomberg.com/news/articles/2022-09-18/china-s-chengdu-lifts-lockdown-of-whole-city-from-monday> (accessed 1 October 2022).

⁸ 'Conference Board Economic Forecast for the US Economy', *Conference Board*, <https://www.conference-board.org/research/us-forecast> (accessed 1 October 2022).

⁹ 'Macroeconomic projections', *European Central Bank*, https://www.ecb.europa.eu/pub/projections/html/eb.projections202209_ecbstaff~3eafaaee1a.en.html#toc2 (accessed 1 October 2022).

Developed economy annual growth versus Composite PMI survey (Sep-19 to Sep-22)



Source: Bloomberg — Developed markets Composite PMI (PMI-50 scaled by 0.01)

Conclusion

In summary, risks to global growth have continued to climb. While we have seen some signs of inflation peaking, this has been countered by rising wage growth, especially in the US, and soaring energy prices, particularly in Europe. In response, central banks worldwide have continued to tighten monetary policy. With the economies of the US and Europe barely expected to grow over the coming 12 months, and China facing significant challenges of its own, the risk of a global recession is rapidly increasing in probability. We are in a turbulent period for the global economy, that suggests being cautious is well-advised.

Part 2: Key economic indicators

United States

Economic snapshot	Last reported result	Date	2022e	2023e
<i>Growth (GDP)</i>	1.70%	Jun-22	1.6%	0.9%
<i>Inflation</i>	8.30%	Aug-22	8.0%	3.8%
<i>Interest rates</i>	3.12%	Sep-22	4.1%	3.9%
<i>Unemployment Rate</i>	3.70%	Aug-22	3.7%	4.1%
<i>Composite PMI</i>	49.3	Sep-22		

Eurozone

Economic snapshot	Last reported result	Date	2022e	2023e
<i>Growth (GDP)</i>	4.10%	Jun-22	2.9%	0.3%
<i>Inflation</i>	9.10%	Aug-22	8.2%	5.0%
<i>Interest rates</i>	0.75%	Sep-22	2.3%	2.5%
<i>Unemployment Rate</i>	6.60%	Jul-22	6.8%	7.0%
<i>Composite PMI</i>	48.2	Sep-22		

China

Economic snapshot	Last reported result	Date	2022e	2023e
<i>Growth (GDP)</i>	0.40%	Jun-22	3.4%	5.1%
<i>Inflation</i>	2.50%	Aug-22	2.3%	2.3%
<i>Interest rates</i>	1.82%	Sep-22	4.3%	4.3%
<i>Unemployment Rate</i>	3.96%	Dec-21	4.1%	3.9%
<i>Composite PMI</i>	53	Aug-22		

Japan

Economic snapshot	Last reported result	Date	2022e	2023e
<i>Growth (GDP)</i>	1.60%	Jun-22	1.6%	1.5%
<i>Inflation</i>	3.00%	Aug-22	2.1%	1.3%
<i>Interest rates</i>	-0.10%	Sep-22	0.0%	0.0%
<i>Unemployment Rate</i>	2.57%	Jun-22	2.6%	2.5%
<i>Composite PMI</i>	50.9	Sep-22		

Source: Bloomberg

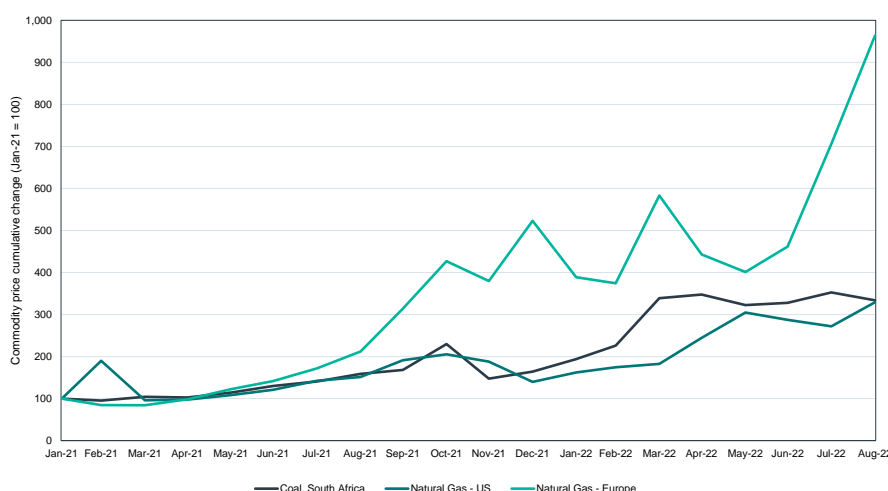
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How the Australian economy will avoid a recession

Part 1: Overview

The Australian economy grew by 3.9%¹⁰ over the year to 30 June, recording its strongest growth since 2012. Household spending grew by 6%¹⁰, benefitting from government stimulus measures, elevated savings and pent-up demand. Spending on travel, and services in particular accelerated as the economy reopened. Exports too benefited from sharp rises in the price of coal and liquefied natural gas (LNG)¹¹ due to supply side shortages caused largely by the war in Ukraine.

Energy Prices¹²



Source: Bloomberg

Despite this underlying strength, the Australian economy is veering towards a critical inflection point. The pandemic induced global supply chain delays that caused sharp rises in the cost of everything from freight to semiconductors, has only been inflamed by the war, sending energy prices soaring. Given the importance of oil and gas as an input into household heating, transport costs and innumerable manufacturing processes, the flow on effects of these input price pressures have caused prices of many goods and services to rise generally. As a result, central banks around the world have had little choice but to lift interest rates to reduce demand to prevent inflation spiralling out of control.

Australia has not been immune to these events. In just 5 months, the Reserve Bank of Australia (RBA) has lifted the cash rate from 0.10% to 2.35%¹³. Further rises remain dependent on the trajectory of inflationary expectations, that in turn are a function of the main inputs: food, transportation costs, accommodation (rent) and wages. First, food price pressures in our view are likely to remain persistent due to elevated input costs (including fertilisers, transportation and a strong USD). Second, fuel prices have begun to decline in recent months on expectations of a slowdown in global growth, however, is likely to remain a headwind in the December quarter as fuel prices will rise from 1 October on the expiration of the 22.1 cent fuel excise hiatus. Third, landlords have been passing through the cost of higher interest rates to tenants in the form of higher rents, putting upward pressure on inflation. We expect the ability to pass through further rental hikes will

¹⁰ 'ABS Australian National Accounts June 2022', <https://www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-national-income-expenditure-and-product/latest-release> (accessed 1 October 2022).

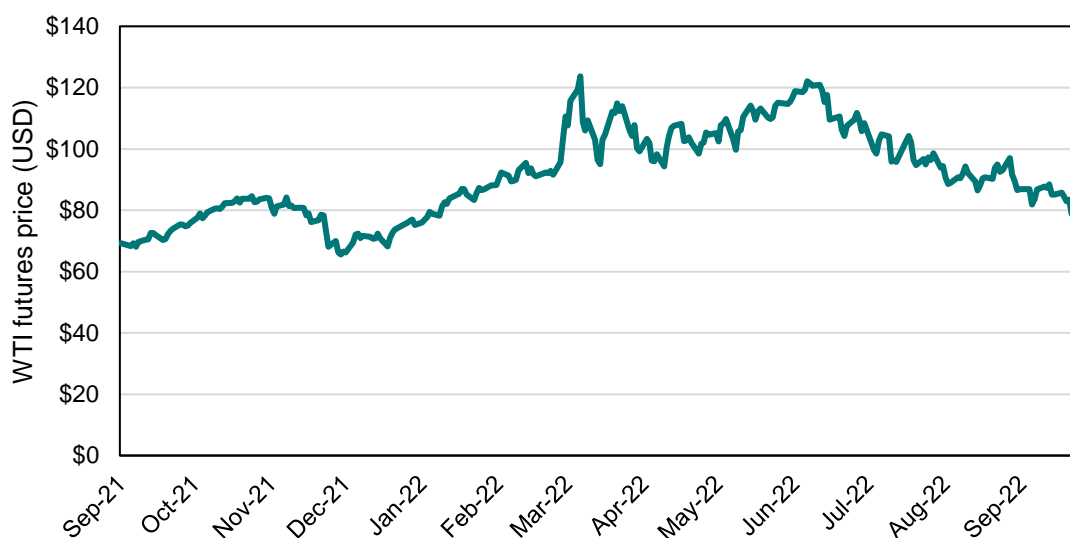
¹¹ P. Nagle, and K. Temaj, 'Energy Market Developments Reach Record Highs', *World Bank*, <https://blogs.worldbank.org/opendata/energy-market-developments-coal-and-natural-gas-prices-reach-record-highs>, (accessed 1 October 2022).

¹² 'Bloomberg', *World Bank*, (accessed 1 October 2022).

¹³ 'Cash Rate Target', *Reserve Bank of Australia*, <https://www.rba.gov.au/statistics/cash-rate/> (accessed 1 October 2022).

diminish in 2023 as the economy slows. Fourth, despite unemployment near record lows, wages in Australia overall have confounded expectations and have generally grown well below the rate of inflation. As the supply of labour begins to improve again, with international students returning and the renewed issuance of migrant working visas, we expect this trend to continue and wage price pressures should gradually moderate in 2023.

Oil price - West Texas Intermediate (WTI) Futures (Sep-21 to Sep-22)¹⁴



Source: Bloomberg

The combination of these factors points to inflation potentially moderating after the December quarter. This view is broadly consistent with the RBA's current projections. With inflation running at 6.1% at the end of June, the RBA now expects a peak of around 7.75%¹⁵ by year's end, before gradually falling to just over 4% in 2023.

Opinions differ on where the official cash rate might peak, but the median forecast from a recent survey of economists predicts a high of 3.35%¹⁶ in Q1 2023. In contrast futures markets are currently predicting a peak of 4.3%¹⁷ in May 2023.

The large variance is due to divergent views on how rapidly the economy responds to the change in interest rates. It is estimated that households accumulated over \$250 billion in savings during the pandemic. Pent up demand and the deployment of savings since the end of lockdowns has helped propel a robust recovery as well as give rise to a very strong labour market. This would support the view that the cash rate may have to be lifted materially higher (above 4%) to slow the underlying momentum in the economy and reduce price pressures.

On the other hand, Australia is a country with one of the highest levels of household debt in the world and so the average household is far more sensitive to rises in interest rates. This is illustrated by the Westpac Consumer Sentiment survey print in August which plummeted to 81.2¹⁸, the lowest level since the deep recession experienced in the early 1990's. This would support the alternate view that rates may not have to be lifted too much further to have the desired impact.

¹⁴ Bloomberg, (accessed 1 October 2022).

¹⁵ 'Forecast Table', Reserve Bank of Australia, <https://www.rba.gov.au/publications/smp/2022/aug/forecasts.html> (accessed 1 October 2022).

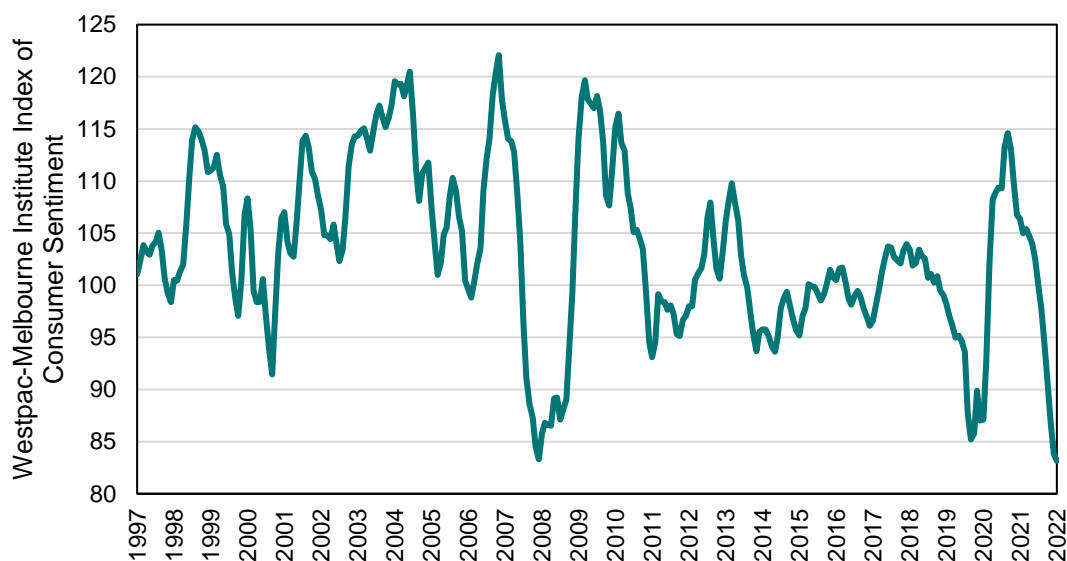
¹⁶ C. Li, 'Economists Raise RBA Cash Rate Outlook to 3.1% by Year's End', *Bloomberg*, <https://www.bloomberg.com/news/articles/2022-09-23/economists-raise-rba-cash-rate-outlook-to-3-1-by-year-s-end> (accessed 1 October 2022).

¹⁷ 'ASX 30 Day Interbank Cash Rate Futures', ASX https://www.asx.com.au/data/trt/ib_expectation_curve_graph.pdf (accessed 1 October 2022).

¹⁸ 'Westpac Melbourne Consumer Sentiment Index, Westpac, '

<https://www.westpac.com.au/content/dam/public/wbc/documents/pdf/aw/economics-research/er20220809BullConsumerSentiment.pdf> (accessed 1 October 2022).

Westpac Melbourne Institute Index of Consumer Sentiment (3-month moving average, Sep-97 to Sep-22)



Source: Bloomberg

Conclusion

The latest internal credit card data from the Commonwealth Bank for the week ending 16 September¹⁹ shows that while household spending remains elevated, the rate of growth has begun to slow. We would expect this trend to gather speed in coming months as savings rates fall and households pare back spending in the wake of materially higher interest rates. This is likely to be exacerbated by the slowdown in global growth as well as falling asset values in both property and share markets, which typically have a deleterious impact on future spending intentions (often referred to as the negative wealth effect). As a result, we would expect growth to gradually slow in the December quarter and become more pronounced into 2023. At this stage the RBA is forecasting growth to slow meaningfully in 2023 to 1.75%²⁰, but importantly, avoid a recession.

Household Debt to net disposable income²¹



Source: OECD

¹⁹ 'CBA Weekly Card Spend Charts Data to 16 September 2022', *Commbank*, <https://www.commbankresearch.com.au/apex/researcharticlevieww2?id=a0N4y00000mCpAs> (accessed 1 October 2022).

²⁰ 'Forecast Table', *Reserve Bank of Australia*, <https://www.rba.gov.au/publications/smp/2022/aug/forecasts.html> (accessed 1 October 2022).

²¹ 'Household debt', *OECD*, <https://data.oecd.org/hha/household-debt.htm> (accessed 1 October 2022).

Part 2: Key economic indicators

Economic snapshot	Last reported result	Date
<i>Growth (GDP)</i>	3.60%	Jun-22
<i>Inflation</i>	6.10%	Jun-22
<i>Interest rates</i>	2.35%	Sep-22
<i>Unemployment Rate</i>	3.50%	Aug-22
<i>Composite PMI</i>	50.8	Sep-22

Economic snapshot	2022e	2023e
<i>Growth (GDP)</i>	3.9%	2.2%
<i>Inflation</i>	6.3%	4.4%
<i>Interest rates</i>	3.2%	3.2%
<i>Unemployment Rate</i>	3.6%	3.8%
<i>US Dollars per 1 Australian Dollar (\$)</i>	0.68	0.73

Source: Bloomberg

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Our recommendations on significant current challenges for Australian equities

Overview

The S&P/ASX 200 Total Return Index returned 0.4% over the three months and -7.7% over the year to 30 September 2022.

S&P/ASX 200 Accumulation Index cumulative return (Sep-21 to Sep-22)



Source: S&P, Bloomberg

Outlook

Recommendation: *Move from neutral to underweight.*

Australian equities are facing a period of significant uncertainty and challenges. While valuations are not necessarily unattractive, we believe there is meaningful scope for consensus downgrades in the months ahead. Current valuations look “cheap” but in reality, this is more akin to a “calm before the storm” moment with downgrades still to come in our view.

The macro backdrop has worsened materially, especially globally. A weaker global economy and slowdown in China bodes poorly for resource demand and other cyclical sectors such as industrial businesses. Higher interest rates support bank revenues by raising margins on their loan books, but this can often be more than offset by higher bad debts and weaker credit growth. Consumer sentiment has also fallen sharply, which bodes poorly for the retail sector.

In conclusion, risks have risen markedly. The RBA and international commitment to rate hikes raise the prospect of a global recession with equities tending to fare poorly in that environment. Accordingly, we maintain our underweight recommendation on the Australian sharemarket.

Sector view

Our outlook for some of the major sectors of the S&P/ASX 200 is as follows:

Banks

Recommendation: *Downgrade to underweight.*

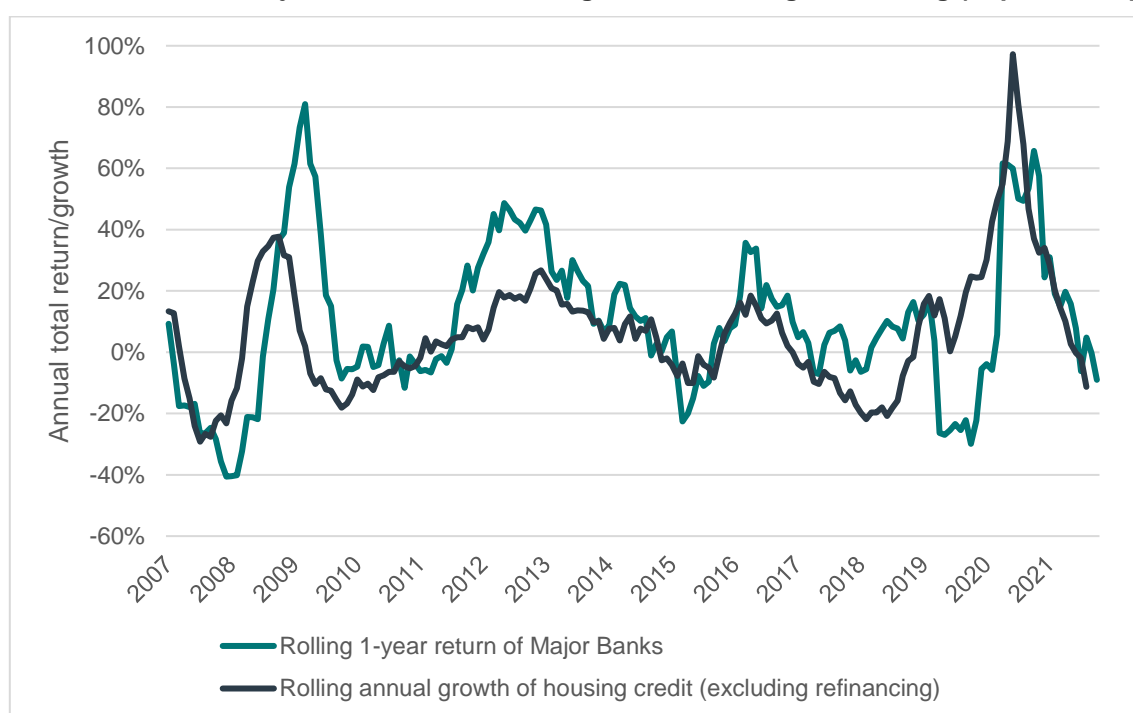
Our outlook for the banking sector rests on four key areas:

1. How are net interest margins (the return earned on bank assets less the cost of funding these) trending?
2. What are the overall prospects for credit growth?
3. Our view on bank underwriting quality i.e. are they going to be writing off loans as bad debts?
4. The trend in bank operating efficiency.

On the positive side of the ledger, bad debts are at extremely low levels with the RBA itself constantly reiterating the strength of household balance sheets in aggregate. The picture for bank operating efficiency is somewhat more mixed with Commonwealth Bank one of the sector standouts whilst others are embarking on sizeable capital spending programs or acquisitions to “catch up” to rivals. Net interest margins are also trending higher in the wake of the RBA interest rate hikes with banks arguably benefitting more than non-banks thanks to their greater reliance on retail deposits as a source of funding with the rising gap between these and loans the banks are writing accruing to the banks’ bottom line.

On the downside however, the economic backdrop is weakening. This would suggest the current period of strong net interest margins and low provisioning for bad debts appears unlikely to last in the year ahead. The rising cost of debt in the form of higher mortgage rates is having a material impact on the housing market and credit growth. While the other factors we consider are important, credit growth is one area that can dominate the outlook for bank returns. This is because a period of weaker expansion in credit means lower revenue growth with lower earnings and dividends for shareholders. We can see this illustrated below in the strong relationship between bank total returns (price growth and dividends) as compared to credit growth. We believe the downside risks are currently outweighing potential upside factors and we move to an underweight position on the banking sector.

Annual total return of major banks versus credit growth excluding refinancing (Sep-07 to Sep-22)



Source: Bloomberg

Resources

Recommendation: *Downgrade to underweight.*

Commodity prices have corrected sharply from peak levels in March. The below chart highlights the trajectory of base metal prices (iron ore, aluminium etc), now down 16% for the year to September. It also shows the rate of change in the OECD Composite Leading Indicator, a measure of the likely direction of economic growth for developed economies such as the US. This series tends to have a slight lead on commodity prices and its current trend is decidedly negative. We believe this will not change in the near term given rate hikes in the US and elsewhere are dragging on global economic growth.

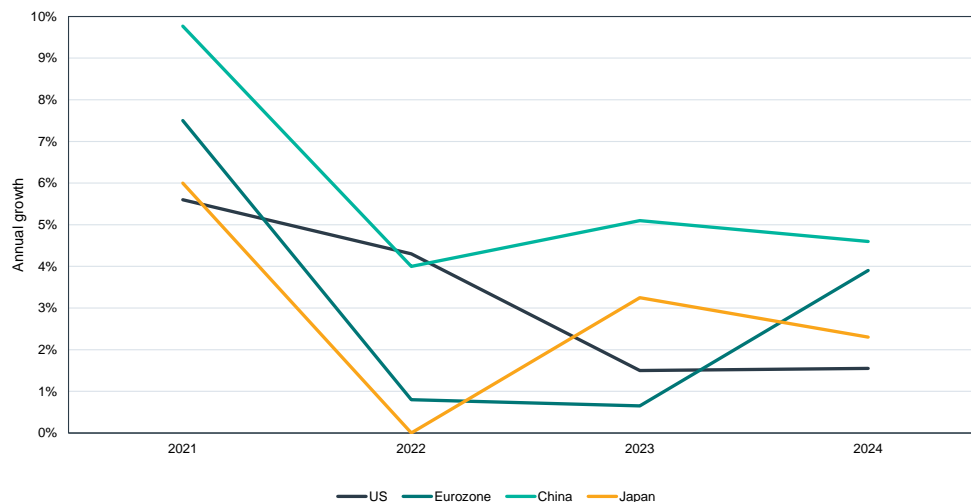
Annual price growth of base metals versus OECD Leading indicator change (Sep-02 to Sep-22)



Source: Bloomberg

While in China, we have seen new stimulus packages brought forward. These are dwarfed by the demand destruction due to rate hikes in the US and elsewhere as well as soaring energy prices in Europe. We can see this depicted below in forecasts of global industrial production with 2022-23 expected to be difficult spells for both the US and Eurozone, a decidedly negative prospect for resource demand. The bounce back anticipated for China and Japan is an inadequate offset in our view.

Industrial production – actual and forecast for major countries (2021 to 2024)



Source: Bloomberg

Accordingly, we switch our positioning on the resource sector to underweight. While there are some segments of the market seeing a sizeable secular trend supporting demand e.g. lithium and other metals tied to electric vehicle production, our overall view suggests caution is warranted.

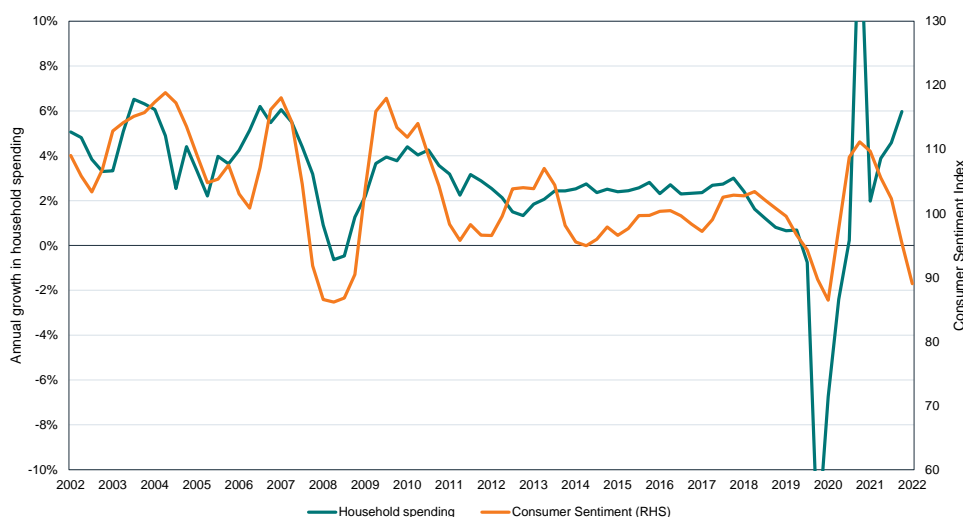
Retail

Recommendation: *Downgrade to underweight.*

In the latest reporting period, consumer discretionary stocks saw strong performance relative to market consensus with more companies reporting earnings above consensus forecasts relative to the number missing consensus views.

We are seeing a shift in spending away from goods towards services with real consumption in services rising 6.9% for the year to June 2022, over twice the growth of spending on goods (3.3%) for the same period. Consumer sentiment has fallen precipitously in recent months with the decline accelerating since the RBA rate hikes began in May. The index is now nearing lows last seen during the depths of the first coronavirus lockdowns in 2020. This result has been consistent with a marked decline in household spending historically.

Annual growth in Australian household spending against Consumer Sentiment (Sep-02 to Sep-22)



Source: Bloomberg

That does not yet appear to be the case with a timelier indicator, the Commbank Household Spending Intentions Index, pointing towards strong consumer spending continuing into September. While we accept these current coincident indicators, we believe the outlook has worsened markedly. The feedback from RBA rate hikes is only being felt on a delay given the much higher percentage of households on fixed rates relative to the pre-pandemic position. Household balance sheets were also in a stronger position thanks to government stimulus spending since 2020 to support the broader economy.

While these are powerful offsetting factors, we are beginning to see signs that they are breaking down. First, household savings are almost back towards the pre-pandemic average. This coupled with the parlous wage growth (negative after inflation) suggests households are only maintaining this spending by reducing savings, which cannot be sustained indefinitely. Second the fixed rate “shield” will be progressively eroded over the next two years with many households facing a material mortgage rate hike given the uplift in rates relative to the lows offered during the years following the pandemic. This will also act as a drain on household spending.

Overall, we believe meaningful drags on consumer spending are beginning to emerge. This will bode poorly for the retail sector after recent years of above-average profits (boosted by government stimulus programs) with a return to pre-pandemic profitability likely to be accompanied by further share price weakness.

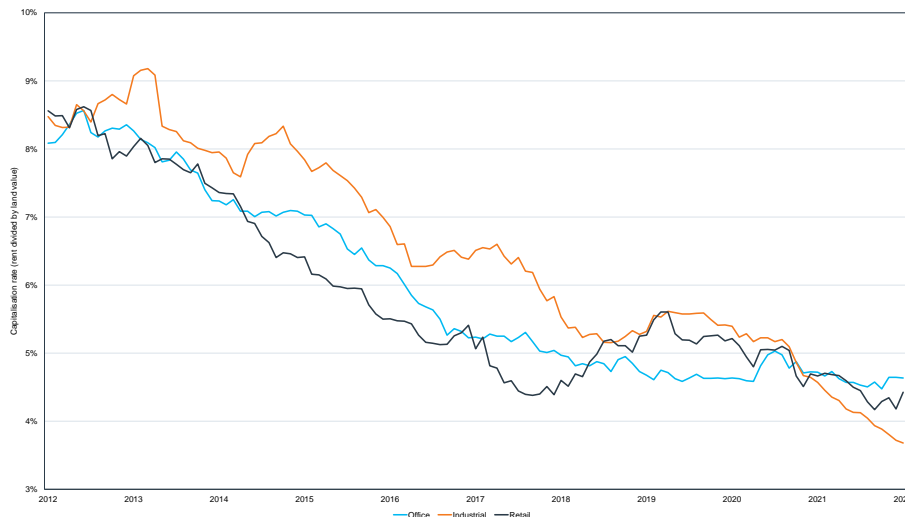
Australian Real Estate Investment Trusts (AREITs)

Recommendation: *Downgrade to neutral.*

The AREIT universe continued to soften in the September quarter, underperforming the broader market index. Part of this is driven by the rise in interest rates and bond yields following RBA rate hikes. AREITs are often treated as bond substitutes due to their high distribution yields. As such, when bond yields rise, we typically see weakness in AREIT prices as they are now a less attractive alternative and see investors retreat from them. In addition, higher rates mean higher financing costs for property trusts which has the effect of lowering earnings and distributions to investors.

On balance, the price weakness has made AREIT valuations appear more attractive in terms of share prices relative to the assessed net tangible asset (NTA) value (a measure of the value of the underlying properties net of debt and intangible assets). However, this view assumes that underlying valuations are reasonable. We think that there is room for doubt with yields still trading at post-financial crisis lows for some sectors, particularly industrial property.

Property yields by sector (Aug-12 to Aug-22)



Source: Bloomberg

The above yields do not account for the lift in bond yields since the pandemic began with the 10-year bond yield up over 3% since February 2020. At some point these higher borrowing costs will be felt in property valuations, posing a risk to investor returns.

Most AREITs do however offer a measure of inflation protection not easily found elsewhere via the value of the properties themselves. In a higher inflation environment, it costs more to replace these assets, supporting the value of existing properties. Many AREITs also have a measure of inflation protection due to rents automatically escalating with inflation as part of lease agreements.

We remain concerned at the degree of potential risk of cap rate expansion for the sector. However, we cannot ignore the share price weakness seen year-to-date which has already, in our view, priced-in a bleak scenario for the property sector. The valuation case and the potential for inflation protection sees us maintain a neutral position, down from our June view of overweight.

AREIT sub-sector outlook

The office sub-sector recovery since the pandemic has continued to be a gradual one. Many workers have retained a more flexible workplace arrangement. This has seen businesses move to shrink their floorspace with even industry heavyweight Dexus doing the same as noted in their... presentation. Vacancy rates are also elevated in both Sydney and Melbourne. There are signs of gradual stabilisation with new supply to the sector slowing materially but this is a medium-term support in our view. It must also be measured against the cyclical nature of the sector which tends to underperform in weaker economic periods as office demand tends to shrink.

The residential sub-sector is seeing material signs of weakness with house prices correcting appreciably since the RBA began to hike. Developers such as Stockland have seen a sizeable decline in enquiries for their planned communities which halved across Australia from 36.7 thousand in the March quarter to 18.4 thousand in the June quarter. Higher borrowing costs with the rise in rates far outpacing wage growth are expected to continue weighing on the sector. The gradual recovery in immigration flows should act as a support over the medium term, but we would expect the current trend to persist until prices have sufficiently corrected.

The industrial sub-sector continues to benefit from solid investor demand, notwithstanding increased construction costs and maintenance expenses. Category leader Goodman Group has highlighted the ongoing demand with guidance of 11% growth in operating EPS for FY23. While the underlying demand dynamics are positive, we remain concerned at the tightness of current valuations and believe that there is potential for a material correction considering the current rate environment coupled with a slowing economy, both factors that should see demand fall and subsequently property valuations.

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Answers to the clouded outlook for international equities

Overview

The MSCI World (excluding Australia) Net Total Return Index (AUD) returned 0.3% over the past three months and -9.8% over the year to 30 September 2022.

MSCI World excluding Australia Net Total Return Index (Sep-21 to Sep-22)



Source: MSCI, Bloomberg

Outlook

The outlook for international equities has become more clouded in recent months.

On the positive side of the ledger, valuations are more favourable, particularly outside the US, with major markets trading at discounts of over 10% to their long-term average price-earnings multiple. Normally these circumstances are attractive moments to enter the market as you avoid the headwind of overpaying for equities. If we look at the table below it might suggest an opportune entry point with the US market (the S&P 500) appearing attractive over the medium-term assuming prices revert to long-term valuation averages.

However, there are several counterarguments that give us pause.

First, central banks have shown surprising commitment to combat inflation relative to past hiking cycles. This suggests that rate hikes can continue over the near term until we start to see meaningful drops in the annual inflation rate. When interest rates are rising, this raises the relative value of holding cash versus other assets. It typically triggers a price correction as investors sell out of riskier assets in favour of safer options. We do not have a good gauge on what inflation rate the Feds will consider as “a job done” point to halt hikes. Given that backdrop we think there is meaningful risk of further price falls in the near term.

Second, our outlook for slowing economic growth is not adequately reflected in earnings forecasts. The US is still predicted to grow profits in the high single digits over the next three years. This is hard to reconcile with an expected decline in economic growth which typically sees profits fall. The bulk of equity price declines to date has been driven by multiple contraction, i.e. the S&P 500 in the US now trades at 15.8 times forward earnings, down from 21.4 times at the start of the year, with the 15-year average being 15.8 times. If earnings disappoint, as would seem likely over coming quarters, then the risk of further share price falls in the short term is high.

Lastly the geopolitical environment has been incredibly testing this past year. Uncertainty abounds with the ongoing conflict in Ukraine, volatility in energy prices, tensions with China and impacts of global warming, among others. Government policy too has become another source of uncertainty with the British pound declining over 12% in the quarter to date as investors reacted violently to large deficit-spending budget announcement by the new Truss government. We believe the balance of geopolitical risks in this case could also contribute to weaker equity performance until the policy and political environment stabilises.

On balance we believe the case for being underweight global equities has strengthened over the past quarter with meaningful risk of downgrades to future earnings growth and further derating on the back of rising interest rates. This has seen us move from **neutral** to **underweight** global equities.

Valuations

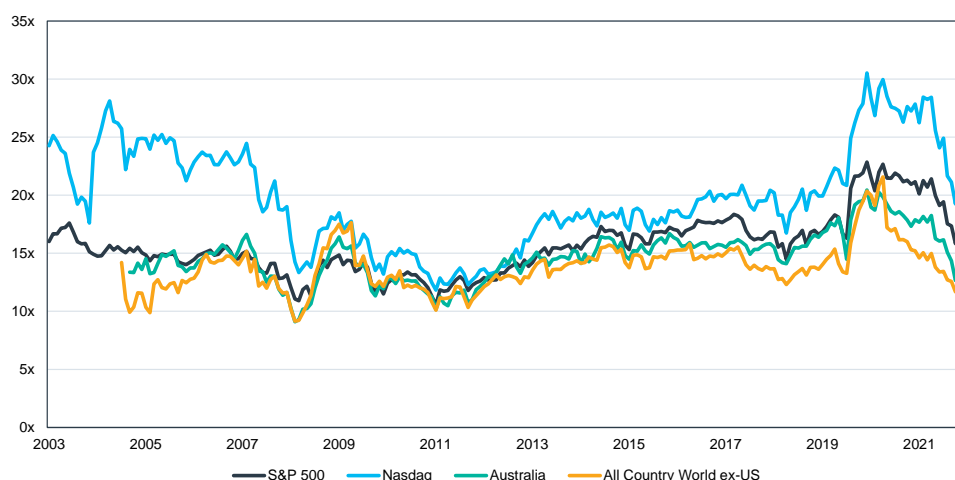
In the United States, operating earnings for S&P 500 companies are currently expected to rise by 9.5% in 2022, 8.8% in 2023 and 8.6% in 2024. Assuming conventional long-term multiples, we estimate that the United States sharemarket (as measured by the S&P500) is overvalued by 2.2% in the near-term and undervalued by over 15% in the medium-term.

2022 calendar year forecast	EPS earnings estimates (US\$)	S&P 500 fair value estimate	Upside/(downside) S&P 500 = X
<i>Consensus</i>	223.3	3573.0	-2.2%
<i>If 10% below</i>	201.0	3215.7	-12.0%
<i>If 10% above</i>	245.6	3930.3	+7.5%
2023 calendar year forecast	EPS earnings estimates (US\$)	S&P 500 fair value estimate	Upside/(downside) S&P 500 = X
<i>Consensus</i>	243.0	3887.7	+6.4%
<i>If 10% below</i>	218.7	3498.9	-4.3%
<i>If 10% above</i>	267.3	4276.4	+17.0%
2024 calendar year forecast	EPS earnings estimates (US\$)	S&P 500 fair value estimate	Upside/(downside) S&P 500 = X
<i>Consensus</i>	263.7	4218.6	+15.4%
<i>If 10% below</i>	237.3	3796.7	+3.9%
<i>If 10% above</i>	290.0	4640.4	+27.0%

Source: Bloomberg consensus estimates for 2022, 2023 and 2024 as of 27 September 2022.

Over the quarter we saw a derating with expected earnings growth declining for most sectors outside of energy (one of the few to see upgrades on the back of higher oil and gas prices). A rising US dollar contributed to this backdrop, with many businesses flagging the downside risk this posed to their profit guidance due to making international sales worth less in US dollar terms. More cyclical markets have borne the brunt of this move with the MSCI All Country ex-US (an index including developed and emerging market economies besides the US) continuing to de-rate and trade closer to the lows experienced during the global financial crisis.

12-month Forward Price-Earnings Ratios for major markets (Sep-02 to Sep-22)



Source: Bloomberg

Consistent with the above, forward Price-to-Earnings (P/E) multiples for markets around the world are now well below longer-term averages as follows:

Region	Forward PE	15-year Average Forward PE	Potential upside/downside
<i>All Country World (ex-US)</i>	10.6x	13.0x	+22.2%
<i>Australia</i>	12.7x	14.8x	+16.5%
<i>Europe</i>	10.4x	13.1x	+26.4%
<i>Emerging markets</i>	10.3x	11.6x	+12.7%
<i>Japan</i>	11.7x	14.5x	+23.8%
<i>UK</i>	8.4x	12.4x	+48.7%
<i>China</i>	9.8x	11.5x	+16.7%

Source: Bloomberg.

Conclusion

Recommendation: *Move from neutral to underweight.*

Valuation multiples (including price to earnings and price to book) fell further in recent months with most major share markets are now trading below their long-term averages. Our concerns however over falling profits given a slowing global economy and rising interest rates suggest there is scope for equities to move another leg down from current levels. Signs of stabilisation on the macro front or further price falls are needed before we can build confidence. Accordingly, we downgrade our recommendation from neutral to underweight.

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