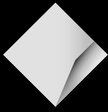

Commonwealth Private

# Market Outlook.

## April 2024

Inflation is on almost everyone's mind at the moment and since our update last month, better than expected company earnings and moderating economic data have supported central bankers in becoming more dovish in their commentary regarding interest rates. In the US, Federal Reserve (Fed) Chair, Jerome Powell, suggested that the Fed is getting close to the confidence it needs to start lowering interest rates. He stated, "when we do get that confidence – and we're not far from it – it'll be appropriate to begin to dial back the level of restriction." Similarly in Europe, Central Bank President, Christine Lagarde, indicated that policymakers may be in a position to lower interest rates in June as new projections indicated inflation will hit the 2% target in 2025.

However, just as markets were becoming comfortable, wholesale prices in the US accelerated again and consumer-price data showed underlying inflation exceeded forecasts for a second month this year. The result of this is an uneven path for the Fed in their fight against inflation and reaffirmed expectations that the Fed will be in no rush to reduce interest rates. Meanwhile, on the home front, Australia's economic environment is deteriorating somewhat faster than anticipated, presenting a fresh challenge to the Reserve Bank of Australia (RBA). In this Market Outlook, we will examine why Australia is potentially susceptible to a hard landing, China's challenges and a review of the Australian reporting season.

# Australia at risk of a more pronounced downturn

Australia's economy slowed towards the end of 2023, with data from the Australian Bureau of Statistics (ABS) showing gross domestic product (GDP) rose 0.2% in the fourth quarter, below forecasts of 0.3%. Annual growth slowed to 1.5%, down from 2.1%, the previous quarter and the lowest since early 2021. Economists had expected growth of around 0.2% in the fourth quarter and 1.4% compared with a year earlier. Strong government spending and increased business investment helped keep the economy afloat, but growth has been slowing sharply for some time, as rising interest rates and a soaring cost of living weigh on consumer confidence. For the December quarter, net trade was a big driver of growth, with a decline in imports – thanks to more Australians spending less money overseas – adding 0.7% to GDP growth. Of particular note, household spending did not add to economic growth at all in the fourth quarter, as a 0.7% rise in spending on essentials was offset by a 0.9% fall in discretionary spending – demonstrating to the RBA that average consumer spending was significantly weaker than anticipated.

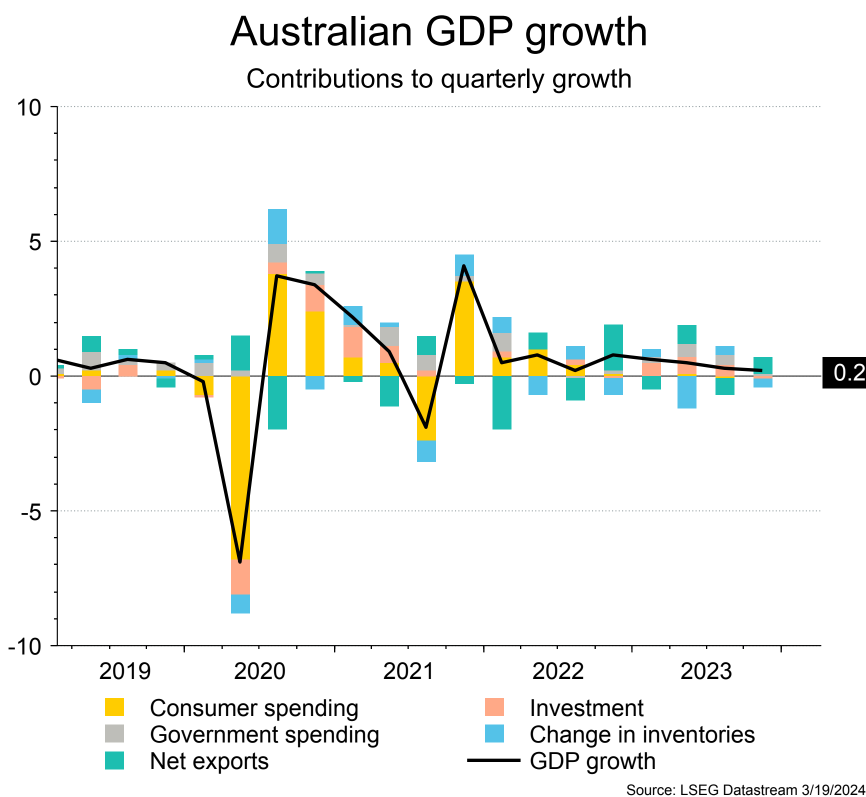


*Figure 1*

Following two years of falls, the household-saving to income-ratio increase to 3.2%, with income received by households outpacing their expenditure. Employee compensation and government subsidy payments (such as Jobseeker and the Youth Allowance) helped increase income in December. Additionally, GDP per capita fell 0.3% in the fourth quarter, shrinking for three straight quarters in the longest declining streak since 1982.

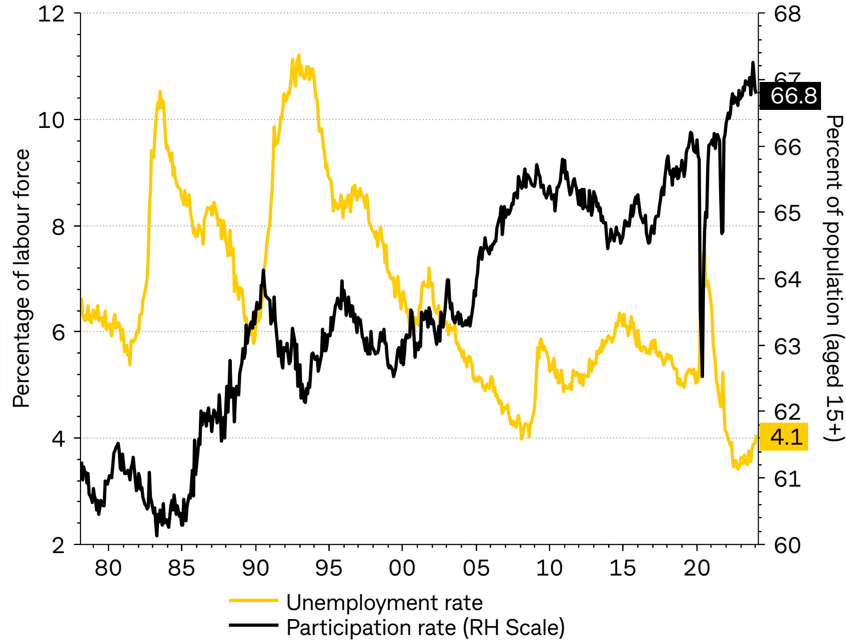


*Figure 2*

The slowdown has resulted in a rise in unemployment to a two-year high of 4.1% in January 2024, from its 50-year low of 3.4% in October 2022. The employment landscape is painting a clear picture. In trend terms, the growth in employment has slowed since March 2023. The growth in hours worked has also slowed since March, and has been negative since July 2023.

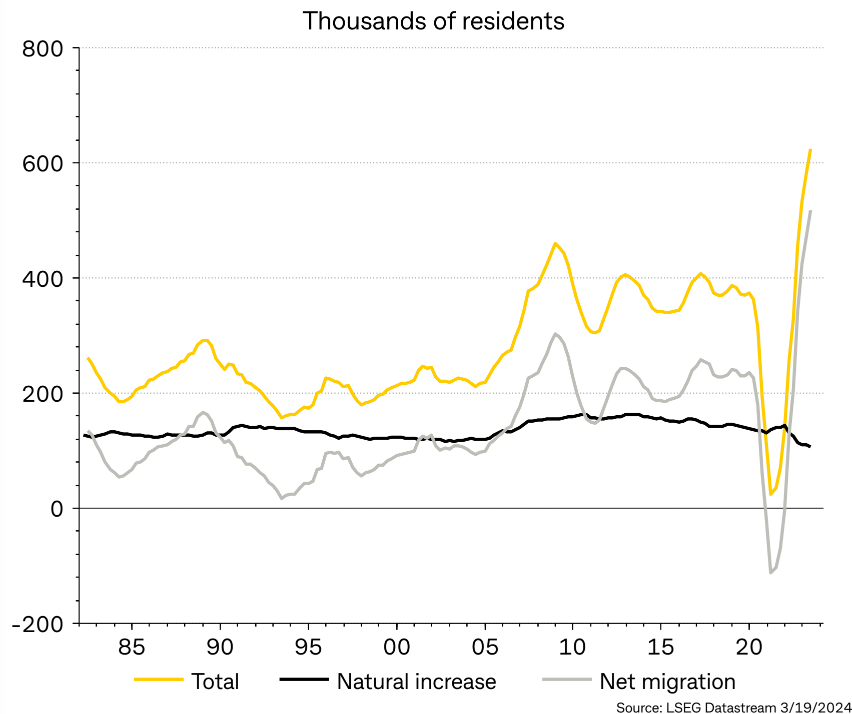


*Figure 3*

In our view, the economy has avoided a more severe contraction due to population growth, government spending and a sharp fall in imports of goods such as automobiles and appliances, as well as industrial equipment. The deceleration of economic activity should serve as a note of caution as the risks of a more severe slowdown are rising perhaps faster than anticipated.

# Unpacking the China syndrome

The Chinese economy has struggled to rebound from Covid which can, in part, be explained by the fact that China was one of the last economies to reopen travel and, in our view, relevant authorities failed to respond with enough urgency to the changing global economic and geopolitical environment. In addition, China has experienced particular hurdles over the last 18 months with an ongoing property crisis, deepening deflation, a stock market rout, and mounting local government debt woes which are putting increased pressure on China's leaders to take more dramatic policy decisions in order to steady the ship.

The International Monetary Fund projects China's economic growth at only 4.6% this year, and further declining to about 3.5% in 2028. Core to the issue is a property market which slumped after Beijing cracked down on developers' high reliance on debt-for-growth in 2020, ensnaring some of its largest real estate developers into bankruptcy and weighing on consumer sentiment and broader growth in the world's second-largest economy. China's real estate troubles are closely intertwined with local government finances since they have historically relied on land sales to developers for a significant portion of revenue.

*Figure 4*

Earlier in March, China's GDP growth target of 5% and other economic indicators were published as part of the opening of the Annual National People's Congress meeting in Beijing. China also set its inflation target at 3% and aims to keep unemployment at around 5.5% by creating over 12 million urban jobs this year.

China's economy expanded 5.2% in 2023, but it remains heavily reliant on credit-driven, state-led investment, raising concerns over whether it can sustain that pace in the longer-term. This year's target will be harder to reach as the country attempts to a 'return to normal' following favourable effects from its economic reopening.

Global economic slowdown is also affecting China's exporters, as is the increasing regulatory scrutiny on Chinese companies from the US and a general trend of capital flight from foreign investors. According to data from China's State Administration of Foreign Exchange, China's Foreign Direct Investment (FDI) liabilities declined for the first time on record in Q3 2023. To put simply, foreign investors, on balance, took money out of China. Longer-term economic challenges, including a failure to rebalance away from investment and exports towards domestic consumption, high debt levels and an ageing population, have also dented investors' confidence. And while China's role in global supply chain remains dominant, India and Vietnam's share of global trade is increasing.

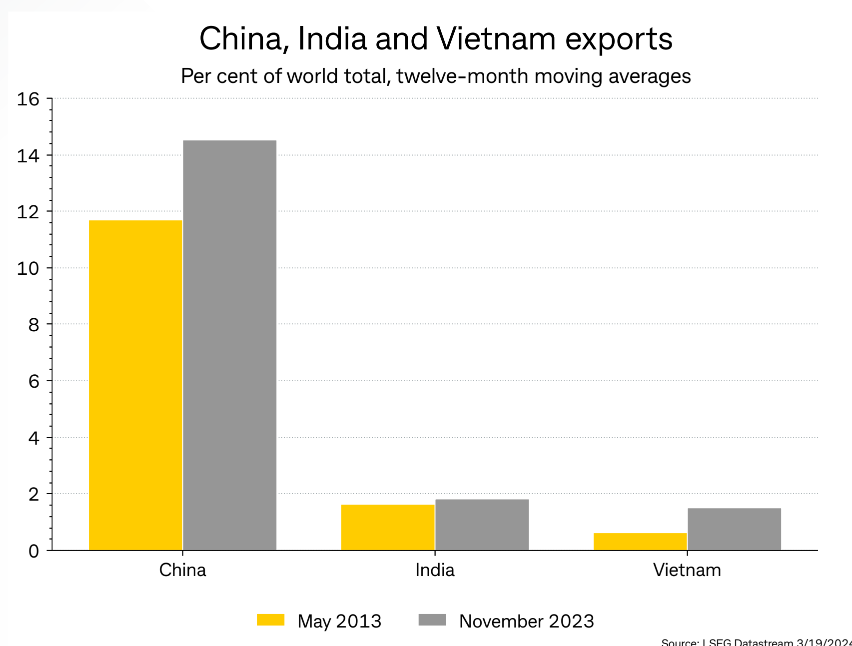


*Figure 5*

China's demographics are another hurdle that will have a more pronounced impact in the coming years. China's working-age population is expected to decline while India's is set to grow until the mid-2050s, possibly doubling that of China's by the end of the century.

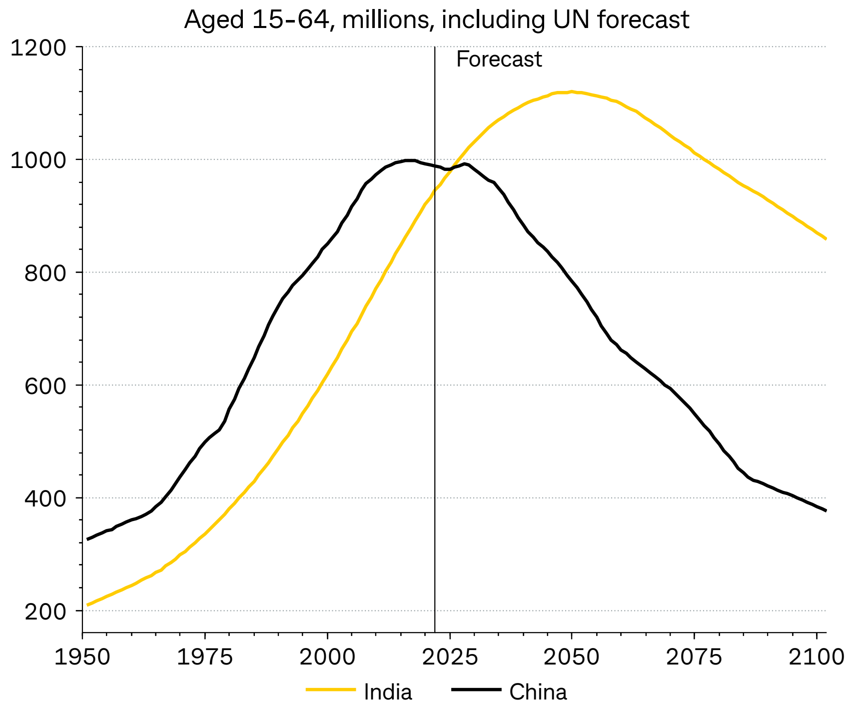


*Figure 6*

Deflationary pressures are also building with China's consumer prices down the most in more than 14 years, prior to the Lunar New Year festive period. In February 2024, inflation rose for the first time since August 2023 as consumers increased consumption during the holiday season. Recent industrial production and fixed asset investment data suggest that we are starting to see elements of a recovery however, headwinds continue to weigh down on the property market, reducing the likelihood of a meaningful revival for the aggregate economy. On the positive, there are signs of increasing support as authorities' unveiled plans to issue 1 trillion yuan ($A210 billion) of ultra-long special central government bonds this year. This rare move, marks only the fourth such sale in the past 26 years, with the most recent one in 2020 when authorities issued the same amount of bonds to pay for pandemic response measures. China has historically resorted to infrastructure building as a tried and tested measure to boost growth, particularly after the 2008-09 financial crisis and we will see if they are ultimately forced to implement policies to this effect.

Chinese equities have fallen in excess of 40%, implying that a lot of the bad news may already be priced in. Policy initiatives to-date simply have not been sufficient in restoring a great degree of confidence and recent attempts to support the equities markets has resulted in a short-term bounce.

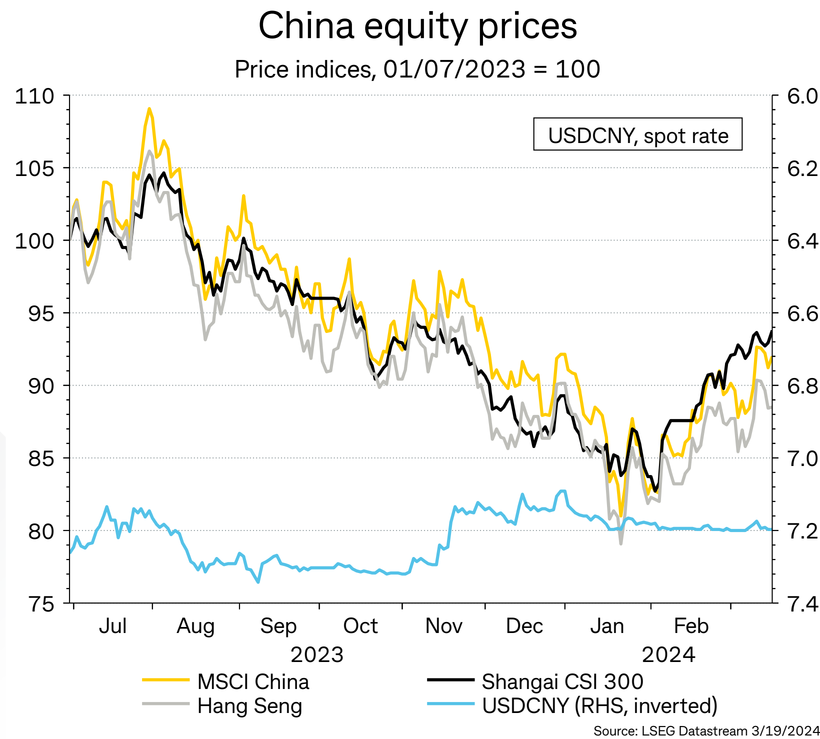


*Figure 7*

In our opinion, greater proof of a stabilising economy and improved relations with the US is required to attract foreign investors back to Chinese equity markets in a meaningful and sustained way. Attractive valuation levels have resulted in some early positioning from contrarian investors; however, we would advocate a more stock specific strategy as this point. China's impact on the Australian economy is now more limited given that we are the lowest cost producer for iron ore and we have also further diversified our agricultural and wine exports markets.

# Australian companies are so far weathering the economic slowdown relatively well

Corporate Australia has been weathering the economic slowdown relatively well so far. According to the ABS, corporate profits in Australia increased by 7.4% in the fourth quarter of 2023, compared to the previous quarter. This increase easily beat market estimates of 1.8% and shifted from a revised 1.6% fall in Q3. It was also the strongest growth since Q1 2022, with profits rebounding for miners (17.3%), transport (5.1%) and warehousing providers (also 5.1%). Profits strongly increased for financial and insurance companies (37.5%) and utility providers (7.8%). Meanwhile, profits fell among retail traders (-10.9%), arts and recreation (-2.6%), property management (-2.2%), builders (-1.7%), wholesale traders (-1.5%) and other services (-5.1%). In the lead-up to December, corporate profits shrank 5.4%, the third quarter of decline, after a 1.7% drop in the previous quarter.

We saw a similar trend during the February 2024 corporate reporting season as ASX-listed companies delivered earnings largely in line with market expectations and the historical average. Better than expected consumer spending, tight cost-management, inflation moderation and positive economic outlooks typified commentary from Australia's biggest companies. Those companies that could pass on price increases certainly did, especially insurance, healthcare and consumer staples companies. The consumer discretionary sector was the big surprise, given more resilient top line sales relative to previous conservative assumptions and largely reflective of the strength of the Australian economy in 2023.

The big four banks provided guidance with signs that the downward pressures are easing while margin drivers remain mixed, amid a very competitive market dynamic in both lending and deposit-taking. The system credit growth is tracking 4.9% year-on-year as of January 2024, and this slightly higher outcome for a third consecutive month adds further confidence that credit growth is likely to have troughed. Consumer arrears have increased in recent months but remain historically low, reflecting low levels of unemployment, and high levels of consumer savings and repayment buffers.

Despite the surprisingly resilient iron ore prices towards the end of 2023, large miners struggled to grow profit, as the commodity markets remained volatile and weaker and inflationary cost pressure remained high. Cash flow generation was sound and healthy balance sheets were maintained, supporting dividend payments and future capital expenditures. Company guidance was muted given the uncertain economic environment with companies eager to downplay expectations. After reporting season earnings have been revised slightly lower going forward given the fact that economic momentum is slowing.

The Australian equity market is trading around all-time highs, with the valuation multiple (price to 12-month forward earnings (P/E) multiple of a high-16 times) expanding to the highest level in two years and above historical-average level of mid-14 times, reflecting investors' optimism around a likely soft-landing macroeconomic scenario and the interest rate up-cycle being behind us.

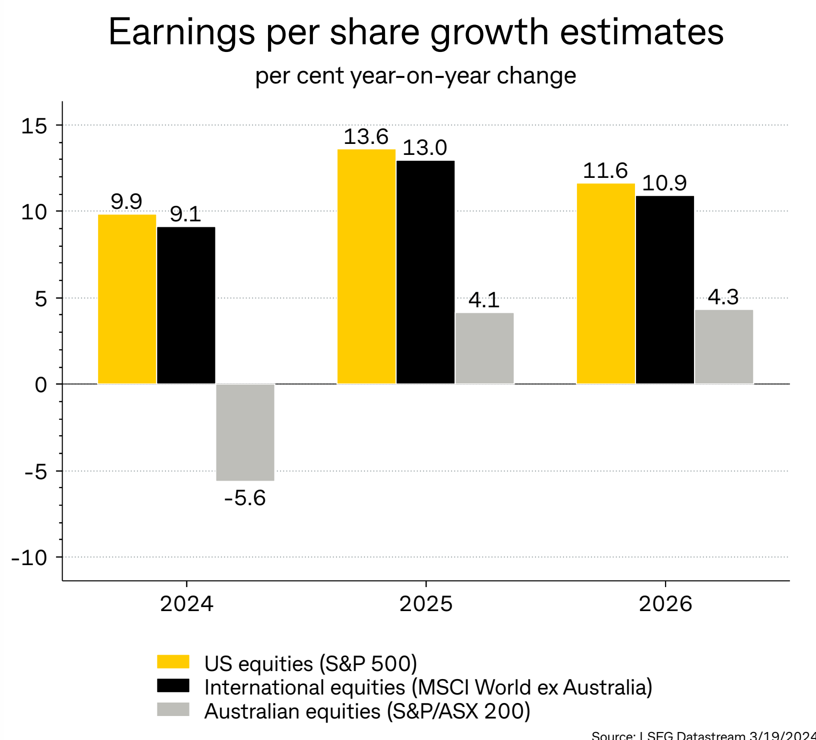


*Figure 8*

# Conclusion and Portfolio Positioning

As we close out the first quarter of 2024, new all-time-high records have been achieved across most developed equity markets and other risky assets. While recent data has been positive on the inflation front and economic conditions remain encouraging, we reaffirm our belief that markets are not fully pricing the current level of uncertainty that central banks still face and it is too early to discount the prospects of recession.

Potentially, delayed rate cuts make equities particularly vulnerable given recent record levels as companies will be faced with higher funding costs and softening demand for their goods and services.

- The rally has pushed valuation levels even higher increasing our conviction in our underweight position to equities and inducing us to increase our allocation to fixed interest. Our dynamic asset allocation views are based on a 12-18 month investment period rather than trying to time shorter term market moves. While there is short-term risk to the downside from current levels, we feel that growth assets such as equities can still provide positive (after some mid-year volatility) returns this year, especially once rate cuts eventuate.
- Patience is key as we envision higher levels of volatility which will likely lead to more attractive entry points for investors.
- We have increased our allocation to fixed interest (from cash) as bond yields have risen materially following the rapid interest rate rises in 2022 and 2023. This now means improved yields are on offer for fixed interest, as well as the opportunity for capital appreciation once central banks do start cutting interest rates. We would also expect that if a more severe economic downturn were to eventuate, at current levels longer-dated fixed interest securities will decouple from equities and return to providing the portfolio insurance that they have in prior recession-driven equity bear markets.
- We are also neutral on property and overweight on Alternative Investments which we believe will continue to deliver attractive risk adjusted returns..

As always, should market conditions or our outlook change, Commonwealth Private will consider its portfolio positioning in order to take advantage of any opportunities, or avoid any risks emerging from any changes.

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