Interest Rates Are More Likely to Plateau Rather Than Decrease

INFORMATION CONTAINED IN THIS REPORT CURRENT AS AT 14 AUGUST 2023

Continued better than expected economic news saw equity markets move higher in July. Global shares as represented by the MSCI returned 3.29% in Australian dollar terms whilst the Australian share market as represented by the ASX 200 finished 2.88% higher. The Reserve Bank (RBA) left the official cash rate unchanged at 4.10% for the second consecutive month in July despite recognising headline inflation is still too high at 6.0%. The board decided to let the cumulative interest rate hikes of 4% since May 2022 work their way through the economy and so allow time for a more sustainable balance between supply and demand to re-establish itself following the opening of the economy post Covid. According to the Reserve Bank governor, the below-trend economic growth "is expected to continue for a while" with "household consumption weak, as is dwelling investment."

The RBA's central forecast is for GDP growth "around 1.75%" over 2024 and "a little above" 2% over 2025. Per capita growth (per head of population) is likely to be near zero. "With the economy and employment forecast to grow below trend, the unemployment rate is expected to rise gradually from its current rate of 3.5% to around 4.5% by the end of 2024. Wages growth has increased in response to the tight labour market and high inflation. At the aggregate level, wages growth is still consistent with the inflation target, provided productivity growth picks up." This is critical to the forecast outcome.

Although inflation is on a slower trajectory, increases in services costs and minimum and other award wage increases on 1 July 2023 will likely delay the abatement. Increased taxes on alcohol, tobacco, automotive fuel effective from 1 August will also stunt the decline in the inflation rate. The RBA's central forecast is for the CPI to decline to 3.25% by the end 2024 and to be back within the 2-3% target range in late 2025. In its concluding comments the RBA statement highlighted that "some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon the data and the evolving assessment of risks."

At the heart of the weakness in economic growth is retail sales. Australian retail sales volumes fell 0.5% in the June quarter, the third consecutive quarter in a row. It follows declines of 0.8% in the March quarter 2023 and 0.4% in the December quarter 2022. Three straight quarters of declines have not happened since the Global Financial Crisis. Volumes are down 1.4% year-on-year, the first time since 1991 (ex-pandemic). Consumers have been focusing on essentials, buying less or switching to cheaper brands as higher interest charges and cost of living pressures weigh on their spending habits. Interestingly company share prices including Adairs, Accent Group and Premier

Emmanuel Calligeris
Chairman of the Investment Committee

Investments all sold off around 30-40% between May and June. Expectations have certainly been reset however it may be too early to be seeking bargains just yet.

The RBA is likely to raise rates again however the timing is difficult to forecast.

Inflation and labour data will be carefully monitored, but it is likely that the board will wait for the September quarter CPI to be released in October before it moves. The central bank is also focused on a degree of quantitative tightening to get the balance sheet back to a more normal level and this may involve selling bonds, despite slowing economic activity. Interest rate cuts continue to be pushed into the future and it seems unlikely that they will occur until the second half of 2024. The latest financial aggregates reveal a continued slowing in credit demand. An extended period of higher-for-longer (interest rates) is likely. Short dated fixed interest is attractive particularly considering the low earnings yield in some share markets including the US and Australia.

In the US, the Personal Consumption Expenditures Index (PCE), the Federal Reserve's preferred inflation benchmark, increased in June and was 3.8% higher over the year. The annual core reading of 4.1% is still twice the 2% long-term target. Consumers have now drained their savings pool which has supported spending over the past year. Adding fuel to the spending fire was a large increase of over USD280bn in credit card debt, with outstanding balances now at a record USD 986bn according to the Federal Reserve Bank of New York. The Bank's data also showed car loans of USD1.5 trillion, student debt of USD1.6 trillion and home loans of USD12 trillion. Total household debt is currently a record USD17 trillion. At the time of writing the market was focused on the CPI release which printed broadly as expected. The 0.2% month on month rise in both headline and core inflation bolsters the case for the FOMC to leave rates unchanged at its next meeting in September.

Fitch downgraded the US government's credit rating to AA+ and Moody's cut the credit ratings of several small to mid-sized U.S. banks and said it may downgrade some of the biggest lenders in the United States. It seemed to have very little market reaction and perversely saw the US dollar strengthen. Clearly either the market had the downgrade factored in or more likely share market risk just went up particularly the Nasdaq index. The rise and rise of the Nasdaq index, propelled by an AI-led infatuation in seven stocks has also driven the S&P 500 higher.

In China stimulus measures have fallen short of market expectations although the government continues to aim for a 5% growth target. The economy is suffering deflation because of a collapse in business and consumer confidence brought about by a negative wealth effect as housing prices remain in a slump. Consumer sentiment is plumbing historic lows. Stimulus must be directed at stabilising housing prices and lifting household spending, not more fixed asset investment. Completing unfinished residential developments should support the iron ore price and volume in the near term, but a sustained improvement in the price is unlikely. This has ramification for Australia's miners including BHP, Fortescue Metals and Rio Tinto in the longer term. The jury is still out on whether China is headed for a lengthy Japan-style workout or whether the deleveraging of housing debt there will be cyclical rather than structural.

Either way, it appears that lower growth is likely for the next few years.

Also of great importance in terms of economic news during the month was the announcement by the Bank of Japan's new governor, that the central bank would loosen its support for buying 10-year Japanese government bonds. In effect the Bank has allowed for a doubling in the trading range for the yield of long-dated debt from 0 - 0.5% to 0.5 - 1%. This 'de facto' abolishment of yield curve control, threatens a fundamental change in global investment flows. The practical end of yield curve controls marked a definitive step towards policy normalisation after decades of deflation and economic stagnation and seven years of negative interest rates.

We continue to anticipate a further slowdown in global economic activity and remain cautious that the breadth of the rise in the US share market is very narrow as it was in the late 1990's.

The Federal Reserve continues to reduce the size of its balance sheet suggesting that financial conditions will remain tight for the remainder of 2023.

Returns

31st July 2023

ASSET CLASS RETURNS ARE BASED ON

Australian Cash
RBA Bank accepted Bills 90 Days

Australian Bonds
Bloomberg AusBond Composite 0+ Yr TR AUD

International Bonds Hedged
BarCap Global Aggregate TR Hdg AUD

Australian Listed Property
S&P/ASX 200 A-REIT TR

International Property Hedged
FTSE EPRA/NAREIT Dv REITS TR Hdg AUD

Australian Shares
S&P/ASX 200 TR

International Shares
MSCI World Ex Australia NR AUD

Emerging Market Shares
MSCI EM GR AUD

RETURNS TO THE 31ST JULY 2023

	1 Month	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Australian Cash	0.36	1.03	1.90	3.39	1.29	1.25	1.71
Australian Bonds	0.52	-2.63	-0.70	-1.54	-3.46	0.58	2.39
International Bonds Hedged	-0.04	-0.75	-0.07	-3.60	-3.98	0.17	2.47
Australian Listed Property	3.83	1.96	-0.19	0.28	9.25	4.06	8.15
International Property Hedged	2.90	2.49	-3.10	-8.86	5.67	1.39	5.67
Australian Shares	2.88	2.04	1.22	11.67	11.99	7.47	8.32
International Shares	2.09	6.52	16.53	17.62	14.03	11.37	12.60
Emerging Market Shares	4.93	6.32	7.98	12.20	3.59	3.73	6.48

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