



Investment outlook Q&A - inflation, interest rates, recession, the US debt ceiling, geopolitics, house prices and other issues

Key points

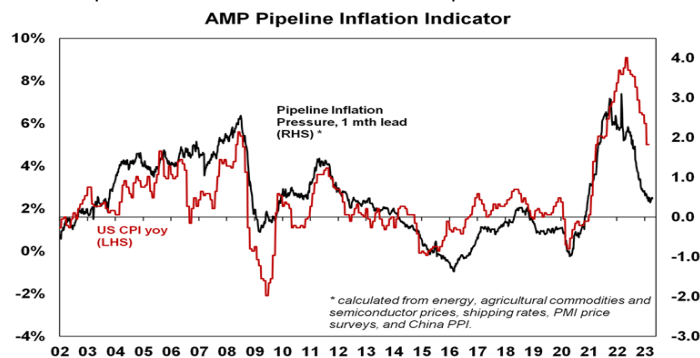
- ▶ Inflation is likely to have peaked and this means that central banks are either at or close to the top on rates.
- ▶ The risk of recession has increased but should be avoided in Australia, providing the RBA is at or near the top on rates.
- ▶ Geopolitical risk remains high and US debt ceiling brinkmanship is likely to return in the September quarter.
- ▶ Our base case is that Australian home prices still have more downside, but a shortage of property is again worsening home buyer and rental affordability and making the property market very hard to read.

Introduction

Investment markets continue to be buffeted by multiple uncertainties, but so far returns this year have been okay as shares have climbed the “wall of worry”. This note takes a look at the main questions investors commonly have in a simple Q & A format.

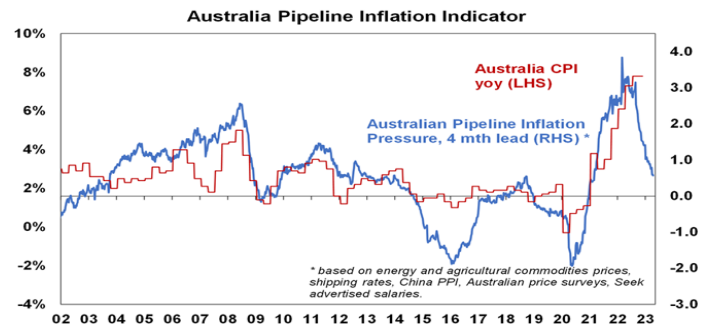
Have we seen the peak in inflation?

Inflation is still too high but it looks to have peaked. US inflation led on the way up and it looks to be leading on the way down. It has fallen to 5%yoy from a high of 9.1% in mid last year. Supply bottlenecks have improved, freight costs have fallen and slowing demand is reducing demand side inflation. While core services inflation excluding shelter remains sticky it is starting to slow, shelter (or rent) inflation also looks to have peaked and our US Pipeline Inflation Indicator continues to point to lower inflation.



Source: Bloomberg, AMP

In Australia, inflation is lagging the US by about six months and looks to have peaked in the December quarter. There is likely more upside in electricity prices and rents, and based on the US experience underlying measures of inflation may take a bit longer to peak. However, the ABS' Monthly CPI Indicator fell back to 6.8%yoy in February from a high of 8.4% in December and our Australian Pipeline Inflation indicator points to a further fall in inflation ahead.



Source: Bloomberg, AMP

What impact will US banking strains have?

Quick action by US and Swiss authorities have settled the banking problems seen in March. However, the banking strains likely have further to run as tighter monetary policy impacts borrowers & hence the quality of loans and the banking strains look to have increased bank funding costs and pressure on margins and appears to be resulting in tighter lending standards. Estimates of its impact by the Fed range from being equivalent to 0.25%-1.5% of Fed rate hikes. So it should take pressure off the Fed.

Are central banks nearly done?

The combination of easing inflation pressures, the defacto monetary tightening flowing from banking strains in the US and Europe and increasing evidence of cooling economies and labour markets suggests that major central banks are at or close to the top on interest rates:

- Several central banks have paused monetary policy tightening in the last month or so – including the RBA, Bank of Canada, Bank of Korea and the Singapore Monetary Authority.
- The ECB has continued to tighten but has softened its tightening bias.
- The sticky core US inflation evident in March likely leans the Fed towards one last 0.25% rate hike at its May meeting. But with falling job openings, a mixed jobs report for March, rising jobless claims the minutes from the last Fed meeting indicating that the Fed's staff expect bank stress to contribute to a “mild recession” it's a close call.
- In Australia, with the labour market being a lagging indicator and economic growth and inflation likely to continue to slow our view is that we are either at or very close to the peak in rates ahead of cuts later this year or early next. Another hike in May is still a very high risk though – as still strong jobs data has added to the risk of a wages breakout and the upswing in the property market if sustained could reverse the negative wealth effect from lower home prices. March quarter inflation data will be watched closely.

What is the risk of recession?

While the risk of recession has receded in Europe (with lower gas prices) it remains high in the US with various leading indicators – including inverted yield curves (where short term interest rates are above longer term

yields) - warning of a high risk of US recession in the next 6-12 months. Over the last 50 years all US recessions have been preceded by inverted yield curves as is the case now – but the lag can be up to 18 months and it can give false signals. However, if the Fed soon stops tightening a US recession could still be averted or it could be mild which would limit further downside in US shares. In Australia, the risk of recession is high. But our base case is that it will be avoided thanks to strong business investment, Chinese reopening and providing the RBA soon stops hiking. Economic growth will still slow to a crawl this year though.

Have geopolitical threats faded?

These have increased in recent years with the loss of global faith in liberal democracy and relative decline of US giving rise to a multipolar world. So far this year geopolitical issues have not had a major impact on markets, helped by the absence of significant elections in major countries and the stalemate in Ukraine. But risks remain around China and Taiwan, Iran's progress towards nuclear weapons, Russia/Ukraine and the possible return of Trump in next year's US election.

How big a problem is the US debt ceiling?

The US Congress imposes a ceiling on Government debt that needs to be raised every so often given its ongoing budget deficit. If it's not raised once reached spending would have to be slashed back to the level of revenue - leading to a 5% or so hit to GDP and talk of default on its commitments. As we saw in 2011 and 2013 raising it can lead to brinkmanship as fiscally conservative Republicans seek to reduce the budget deficit and as always Washington leaves things to the last minute to resolve. Back then it was resolved but only in the nick of time and after investment markets fell sharply. The process then caused damage to Republican's political standing so in subsequent years it was resolved relatively smoothly. However, with Republican's regaining control of the House of Representatives and demanding a commitment to spending cuts it looks like it will be an issue again this year. The US has already hit its debt ceiling but cash balances mean it can probably hold out to mid-year or the third quarter without needing to raise it. Raising it will be a long process where the House passes a bill with spending cuts that's rejected by the Senate and Biden ahead of inevitable negotiations at some point. But any resolution will again be last minute, and markets will fret at the prospect of no deal and a default causing the potential for share markets falls at the time. The odds are a deal will be reached enabling shares to rebound or Republican's will get the blame for any default and big cuts to spending which won't look good for them ahead of next year's election.

Are bonds dead as a portfolio diversifier?

Last year saw both shares and bonds sell off leading many to question the role of bonds as a portfolio diversifier to equity volatility. However, last year's poor performance from bonds and shares together was driven by a common driver of inflation. This is not that unusual historically when the surge in inflation in the 1970s and then its collapse in the 1980s into the early 1990s boosted the correlation between them. However, with bond yields now higher and inflation falling bonds are likely now to provide a better diversifier to equities should equities be hit by recession risks.

Will high levels of global debt de-rail things?

This is now estimated to be up around \$US300trn or nearly 350% of GDP globally and clearly poses a risk with interest rates rising, particularly in emerging countries with \$US debt. However, much of the rise in debt since the pandemic has been in the public sector where the risk of major problems is less (as governments can raise taxes) and high debt levels

may make central banks jobs easier as they won't have to raise rates as much as otherwise to slow down spending and hence inflation.

Have Australian house prices already bottomed?

From their low in February, average dwelling prices in the five biggest capital cities are up 1.3% led by Sydney which is up 2.6%. This appears to reflect bargain hunters, first home buyers and investors stepping in after sharp falls, expectations that mortgage rates have peaked, the return of immigrants and low listings. Our base case remains for Australian home prices to fall further out to later this year as interest rate hikes impact and slower economic growth impact. The RBA estimates that 40% of home borrowers have less than 3 months prepayment buffers, 15% of variable rate borrowers will have negative cash flow by year end if the cash rate rises to 3.75% and nearly 900,000 fixed rate mortgages are due to reset to interest rates that are more than double their initial level. This all runs the risk of increased distressed sales, particularly as growth slows. But the rapid return of immigration, very low rental vacancy rates & constrained supply mean that our expectation for a top to bottom fall of 15-20% may be too pessimistic and we may have already seen the low. So given the conflicting forces at present the property market has become hard to call.

How can we improve housing affordability?

The resurgence of immigration, record low rental vacancy rates, still very high home price to income and debt to income ratios and surging rents have all refocused attention on poor housing affordability in Australia. Fixing this requires a multifaceted solution across all levels of government with targets to be achieved over say a five-year period. My list of policies to improve affordability includes:

- Measures to boost new supply - relaxing land use rules within reason, releasing land faster and speeding up approval processes.
- Matching the level of immigration to the ability to supply housing. The pandemic driven pause in immigration provided a perfect opportunity to get this right upon reopening but we botched it yet again.
- Encouraging greater decentralisation – the “work from home” phenomenon shows this is possible, but it should be helped along with infrastructure and measures to boost regional housing supply. Excess CBD office space should be converted to residential.
- Tax reform - to replace stamp duty with land tax (to make it easier for empty nesters to downsize & cutting the upfront burden for first home buyers), cut the capital gains tax discount (to end a distortion favouring speculation) and to encourage build to rent property.

What is the risk of commercial property slump?

Commercial property benefitted like other assets from the search for yield as bond yields plunged in the decades into the pandemic providing a positive valuation effect. Some saw the asset class as a replacement for bonds in portfolios. However, its now vulnerable from the double whammy of the rise in bond yields driving a negative valuation effect at the same time as reduced space demand flowing from “work from home” in the case of office property and online retail in the case of retail property. Of these threats, the first looks more manageable as commercial property still offers a reasonable (but lower) risk premium over bonds but the second is more significant. An economic downturn would add to the threat. The experience of the early 1990s where office valuations fell for 3 years as oversupply & recession pushed vacancy rates to 20-30% warns that commercial property slumps can be drawn out.

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