Australia: 2022 Market Outlook

Transitioning from tailwinds to headwinds.

December 2021

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KEY INSIGHTS

- The withdrawal by governments and central banks of massive post-pandemic stimulus is set to become a significant headwind for global growth in 2022.
- We believe we are entering a new phase of the market cycle - the “deceleration” phase characterized by slowing economic and earnings growth.
- We are less keen on cyclical stocks that outperformed in 2021. Overall, we see the market environment in 2022 as being suited to quality defensive companies.

As 2021 draws to a close, a year of partial rather than full recovery from COVID-19, global investors face a more uncertain outlook as central banks begin to withdraw liquidity and extraordinary fiscal stimulus turns into extraordinary fiscal drag (Figure 1). Inevitably, the withdrawal by governments and central banks of massive post-pandemic stimulus is set to become a significant headwind for global growth in 2022. This clearly matters a lot for a trade dependent, open economy like Australia.

A Challenging Global Backdrop for Investors

The enormous fiscal injection since 2020 – proxied by the change in the cyclically-adjusted primary fiscal balance as a % global GDP – is fast fading and may already be negative. The same is true for global monetary policy stimulus – proxied in Figure 1 by the credit impulse[1] for the major economies. This has turned negative for the U.S., Europe, and China. Inevitably, the flip side of massive fiscal stimulus in 2020 and 2021 is fiscal drag in 2022, a headwind for company earnings as well as for economic growth. Reflecting this deterioration in the near-term outlook, GDP growth forecasts for 2021 have been revised lower since the summer for many countries, both developed and emerging, by over 100 basis points for both Australia and the U.S. Reflecting the downgrades, Citi's economic surprise indices turned negative in Q2 of this year for the U.S. and China as economic data disappointed. More recently, the U.S. surprise index has turned up, a sign perhaps that the growth deceleration phase could soon be over.

The flip side of extreme monetary accommodation is higher volatility in financial markets, which has remained very subdued during the past twelve

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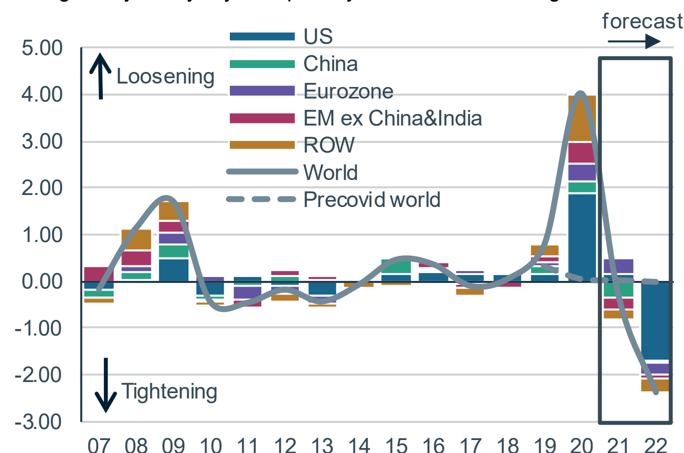
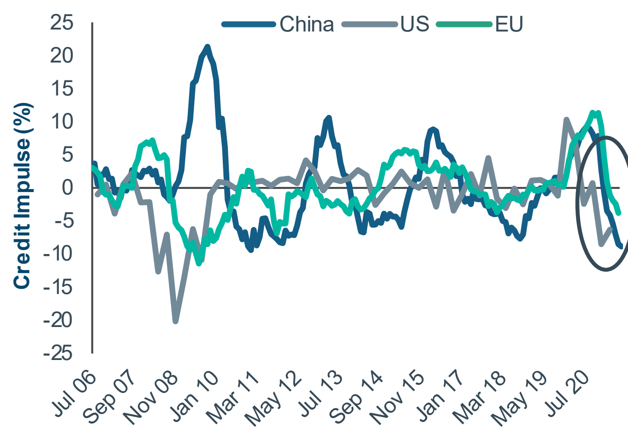
[1] The credit impulse equals the growth in new credit over a period such as a year or three months, expressed as a percentage of nominal GDP.

Global Policy Stimulus Is Being Withdrawn

(Fig. 1) Monetary & fiscal policy tighter in 2022



Source: UBS, Haver, European Commission, CBO as October 18 2021. There is no guarantee that any forecasts made will come to pass. Actual results may vary.



Source: E&P, Bloomberg Finance LP, as at end July 2021.

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months. An earlier tightening of liquidity conditions by central banks in 2022 is important for equity investors, as low global interest rates resulting from unprecedented quantitative easing (QE) provided major support for equities since the pandemic. We are at a major inflection point, as QE support is ending. Monetary policy normalization is already underway, led by the emerging markets (EM). A growing number of EM central banks have already begun to raise interest rates.

A potentially very different environment lies ahead for financial markets in which volatility is no longer held back by global QE. Recent surveys point to a growing uncertainty over corporate earnings forecasts in FY22. We believe that the global economy no longer needs exceptional policy support, since it is back on a firm growth trend. However, markets may still protest loudly when support is withdrawn next year. Equally, there are many who believe that some governments, notably the U.S., have overstimulated their economies in response to the pandemic, resulting in rising inflation pressures.

Contradictory fears of policy withdrawal and higher inflation suggests a difficult quarter or two lies ahead. Investors will need to navigate their way carefully through potentially volatile, fragile markets; this increased uncertainty and dispersion favours active managers.

The View on China Matters for Australia

Markets in 2021 under-estimated the amount of short-term pain Beijing is willing to incur in order to tackle some of its structural problems, including its overreliance on residential property investment to drive growth. Property has been the biggest single driver of China's economic growth over the past two decades. This contributed to some undesirable side effects such as a widening wealth gap, a rising cost of living, and the rapid growth in financial leverage.

We believe the government of President Xi Jinping is determined to address these structural issues and the round of financial deleveraging that started 5-6 years ago still continues today. Since property and its related sectors account for almost one third of China's GDP, some slowdown in the overall economy looks inevitable, although Beijing probably has enough

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policy tools to avoid a 'hard landing.' We believe we have passed the peak in Chinese residential property investment, which will flow through to the global demand for iron ore and other commodities and to Australia's terms of trade.

The most significant linkage between the Australian economy and a slowdown in China's property sector is via the price of iron ore, Australia's largest export. The price has fallen by around 50% in recent months from its previous record highs. Iron ore prices have continued to come under pressure due to the weakness in Chinese steel production associated with the slowdown in the Chinese property market. For the rest of the world, China's financial deleveraging means fewer growth opportunities. It is unlikely, for example, that China will drive another commodities 'super cycle.'

It was fortuitous that the strong post-pandemic rebound in China's residential property sector caused the price of iron ore to rise as sharply as it did in 2021. It gave a large, if temporary, boost to Australia's terms of trade. In fact, the rise in the iron ore price almost fully compensated for the decline in Australia's exports of coal and other products caused by Beijing's undeclared trade war against Australia. The increase in real national disposable income provided Australia with a useful buffer in what has been a very challenging year.

Global Inflation to Fall in 2022, Domestic Inflation Not a Problem

Inflation is another growing concern for global investors in 2022 that could drive equity volatility higher, defined as a persistent increase in the general level of prices rather than a one-off shock to the price level. We have seen a surprisingly large spike in post-pandemic inflation in the U.S. in 2021 and many investors are worried that higher inflation is in store over the medium term. We, however, are in agreement with the Fed that a significant part of the spike in U.S./ inflation is transitory rather than permanent, driven by post-COVID disruption to labor markets and supply chains. As production normalizes in most economies, inflation pressures should begin to moderate. In 2022 there will no longer be a base effect pushing up CPI inflation. Rather the reverse will apply, as the higher base in 2021 should see annual inflation decelerate as 2022 unfolds. The conditions for a surge in global inflation next year are absent. Instead, we could be seeing downside inflation surprises by 2H 2022.

With regard to domestic inflation, markets recently pushed back against the The Reserve Bank of Australia (RBA)'s low inflation outlook. The recurring and protracted COVID-19 outbreaks in key states during 2021 have prevented a strong rebound in Australia's economy. With GDP growth averaging no more than 1.0% over 2019-21, there is a large margin of spare capacity. As such, we believe Australia does not have an inflation problem, and the average headline CPI inflation rate is expected to fall from around 2 1/2% this year to around 2.0% in 2022. As such, the RBA is right not to worry unduly about domestic inflation pressures. The RBA was one of the first developed market economies to join the QE party and may be one of the first to leave. In view of mixed evidence of QE's ability to boost the real activity in either the U.S. or Europe, and its very real disadvantages in distorting the price of capital and encouraging asset bubbles, the RBA's apparent reluctance to fully embrace QE is to be welcomed.

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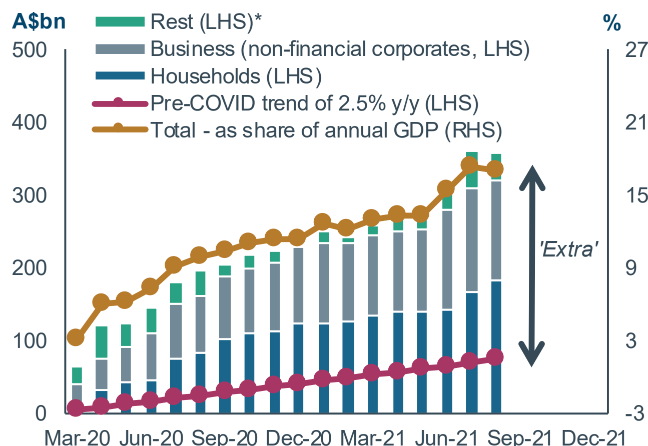
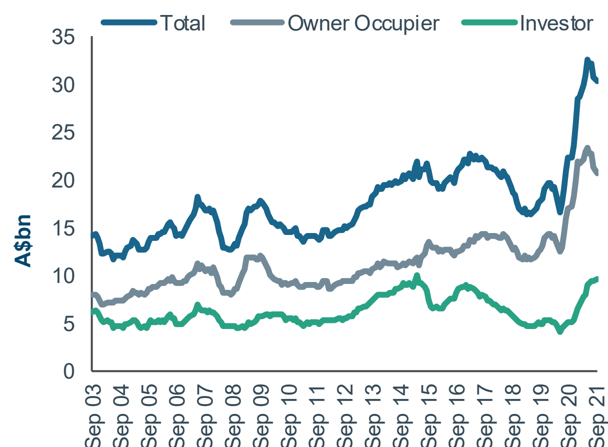
Domestic Economic Trends Remain Broadly Favorable

Most economists project only a moderate recovery in Australia's GDP growth in 2022, with significantly less inflation pressure than in other DM economies, including the U.S. and the UK. Will the household savings ratio remain high next year, or will it fall as consumer spending increases temporarily? The lengthy recurring COVID-19 outbreaks in 2021 have so far prevented a full recovery in consumer demand in Australia, despite strong government income support.

Australia: Domestic Trends

(Fig. 2) Excess household deposits / new housing loan commitments





Source: ABS, UBS, RBA, as at end August 2021, currency is AUD.
*UBS calculation of rest is a residual using spliced data of the total (excluding General Government).

Source: ABS, as at end September 2021.

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Most parts of the domestic economy are expected to do well next year as the economy reopens, provided there are no major setbacks caused by the new 'omicron' strain of the coronavirus. Households are liquid and cashed up, with large excess bank deposits, which will likely be drawn down, albeit gradually. The health of the Australian property market is always a key talking point for investors and here we see the current strong environment continuing for at least another two to three quarters. While new loan commitments appear to have peaked (Figure 2) and the Australian Prudential Regulation Authority (APRA) has recently introduced its first macroprudential controls, we think we are still in the best phase of the property cycle. Only if rates rise much faster than in our base case scenario is the property market likely to become a significant headwind for the Australian economy.

Market Outlook for 2022

We believe we are entering a new phase of the market cycle - the “deceleration” phase characterized by slowing economic and earnings growth. This phase also typically see’s late cycle behaviour, such as increased corporate activity. The complication for investors in this deceleration phase will be the ongoing impact of the delta and omicron COVID-19 variants on economic activity. We expect a dampening impact on growth and inflation. Economic indicators have recently started to disappoint, and GDP growth trajectories are being revised downwards in most parts of the world. Seen in this context, the decline in bond yields in recent months is hardly surprising.

Markets are currently having to grapple with the competing issues of economic growth deceleration and persistently higher-than-expected inflation caused by ongoing supply chain disruptions and by excessive demand stimulus. This is occurring at the same time that central banks around the world are gradually starting to remove their emergency level pandemic support, such as tapering their bond buying programs. Slowing growth is a headwind for earnings, particularly for cyclicals and value stocks. Conversely, supply chain issues leading to stubbornly high inflation and rising bond yields in 2022 would be bad for highly-valued growth stocks due to the impact on valuations. The latter is more of a risk than a central scenario in our

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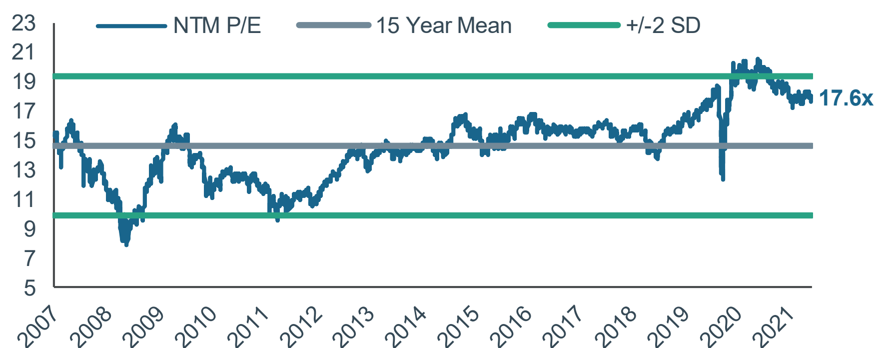
view, since we believe the impact of slowing growth will be the factor that will matter more to investors in 2022, as inflation concerns start to fade. Supply chain disruptions will eventually be solved, even if it takes a bit longer than many expected.

With equity markets hitting new highs on a monthly basis and economic risks rising we are becoming increasingly cautious. Reflecting our near-term caution, we have increasingly favored quality and the more defensive areas of the market such as healthcare, staples, and utilities. We are less keen on domestic and global cyclical names that have outperformed in 2021. Overall, we see the market environment in 2022 as being suited to quality defensive companies. An interest rate environment where rates are low in absolute terms, albeit with the first hikes expected later in 2022, may not prove to be such a big headwind for growth stocks.

In short, we believe the big challenge for markets in 2022 will be slowing, albeit still reasonable, growth and inflation remaining higher for longer at a time when liquidity is being withdrawn by central banks and market valuations appear uncomfortably high (Figure 3). Total market returns can be expected to be lower than in the recent past and with uncertainty likely to remain high, a highly selective approach favouring quality companies is prudent in our view.

Domestic Valuations Remain Elevated

(Fig. 3) S&P/ASX 200 forward P/E ratio



Source: Factset, as of 30 November 2021.
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APAC-PAN-2760
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