# Australia: Market Outlook 2023

Navigating an expected downturn in earnings.

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### KEY INSIGHTS

- Spillovers from higher U.S. interest rates to global rates, liquidity, currencies, and markets are simply collateral damage for other countries, including Australia.
- Our base case for 2023 is that Australia is likely to experience an earnings recession even if we do not suffer an economic recession.
- We therefore maintain a defensive posture in Australian stocks. Quality, defensive and growth should outperform as their earnings prove more resilient.

## Sticky Inflation The Biggest Risk

The main concern for the world's major central banks currently is that inflation has become ingrained or 'sticky,' proving difficult to eradicate without triggering an economic recession. For investors, this concern is of particular relevance with regard to the U.S. Federal Reserve (Fed), the central bank viewed as having fallen behind the most in meeting its inflation target. The Powell Fed has made it clear that it will continue to raise interest rates until it feels that U.S. inflation is coming back under control. Spillovers from higher U.S. interest rates to global rates, liquidity, currencies, and markets are simply collateral damage for other countries, including Australia.

The big story in 2022 has been how growing inflation fears have fed their way into financial markets. The essence of the 'sticky inflation' problem is captured in Figure 2, which plots the Atlanta Fed's measure of sticky consumer prices[1] index (CPI) against wages growth. There is a clear relationship between the two series. What has alarmed policymakers and investors is how the post-pandemic surge in sticky consumer prices has been accompanied by a commensurate surge in wages, reminiscent of a 1970s style 'wage-price spiral.'

This link has not gone unnoticed by markets. What we have here is wages growth tracking closely the Atlanta Fed Sticky CPI series, a measure of inflation based on the more enduring components of inflation, particularly the services sector, where prices are closely tied to wage trends.

That's the real concern here, because when we started to talk about inflation over twelve months ago, the concern was really about supply chain issues and how they had impacted the goods market. The inflation situation today

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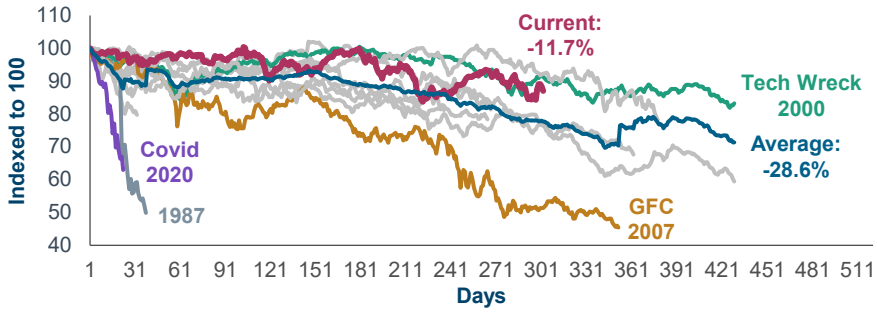
[1] The Sticky CPI index represents a weighted basket of items that change price relatively slowly over time.

## 2022: A "Bear Market" of Ordinary Proportions

(Fig. 1) All Ordinaries Index during bear markets




As of October 10, 2022.
**Past performance is not a reliable indicator of future performance.**
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> In Australia, post-pandemic stimulus and macro imbalances were less than in the U.S.

has developed well beyond that simple channel from component shortages to goods prices. Now the concern is that inflation has become embedded in the services sector and is in wages, as our chart clearly shows. So the challenge for central banks around the world, including the RBA (Reserve Bank of Australia) is "How do you get inflation back to your target, when wages growth is running as strongly as it is?

In the U.S. the problem is the most acute among the major economies, with wages growth north of 6%. In Australia, post-pandemic stimulus and macro imbalances were less than in the U.S. Consequently, the wages problem is also less, with annual wages growth a little over 3%, though there is some risk Australia may just be lagging behind the global trend. Currently, we are seeing more and more EBAs (enterprise bargaining agreements) being struck at higher rates than we've seen in the recent past. Also, the minimum wage decision came in at a little over 5%. In short, we believe we are seeing pressures on Australian wages in a way we haven't seen in recent years. That's why we think it is so important that central banks continue on this path to bring wages down. Unfortunately, this means that demand is going to have to slow, and unemployment rise as part of this process, creating a challenging business environment in the short term.

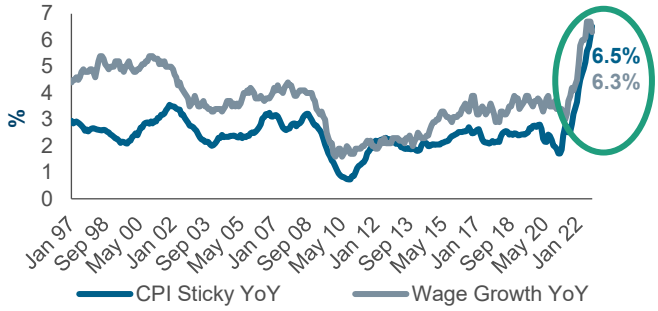
### We Expect an Earnings Recession in 2023

Our base case for 2023 is that Australia is likely to experience an earnings recession even if we do not suffer an economic recession. The reality is that the starting point for earnings is at a historically very high level. Although earnings have held up reasonably well until now, that's largely because the impact of the rate hikes that we've seen domestically is really only just starting to bite. The real pain will be felt next year when fixed rate mortgages originated during the COIVID period roll off to considerably higher variable rates. Ironically, the more resilient the consumer might be in the short term, the more the RBA will need to tighten in order to curb aggregate demand.

We expect the lagged impact of rate hikes to drive a slowdown in aggregate demand in 2023. Figure 3 shows that an index of financial conditions for Australia from Credit Suisse bears a close relationship with ASX 300 12-month forward earnings per share (EPS). The average decline in ASX earnings during an earnings recession has been close to 30%. Australia has only just started to experience this process when we saw during the August reporting season earnings downgrades in the order of 3% to 4%. The August EPS downgrades largely came from the mining sector, principally because of higher mining costs driven by inflation, and also

## "Houston, we have a problem"

(Fig. 2) Atlanta Fed sticky CPI and wage growth



As of September 30, 2022.
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Sticky CPI represents a weighted basket of items that change price relatively slowly.

higher capex spending. We have yet to see earnings weaken in domestic cyclical sectors but believe that this is still to come. Meanwhile, commodity prices have continued to fall back, so we should expect further earnings downgrades for the mining sector.

The key message for investors is that it is early days with regard to earnings projections cut and it will be 2023 when the biggest downgrades occur. The more cyclical sectors of the economy face the greatest risk going forward because demand is slowing, unemployment is rising, and earnings are coming under pressure. So the sectors that suffer most are energy, materials, mining, and financials, notably banks. The part of the market that tends to hold up the best is the more defensive part that is more stable when it comes to underlying business conditions. This includes areas like healthcare, consumer staples, retail, communication services and utilities.

### Wealth Destruction Not Creation in 2022

The steep declines in asset prices in 2022 have caused an enormous amount of wealth destruction. Sharp falls in equity markets were accompanied by the worst performance from bonds ever. With both stocks and bonds in negative territory, the traditional 60:40 balanced portfolio failed to diversify risk and limit the erosion of household wealth. More recently, we have started to see house price falls. All told, this is the most significant period of wealth destruction since the Global Financial Crisis. And typically, when you go through sustained periods where wealth declines, you will also see a consumption response or "negative wealth effect."

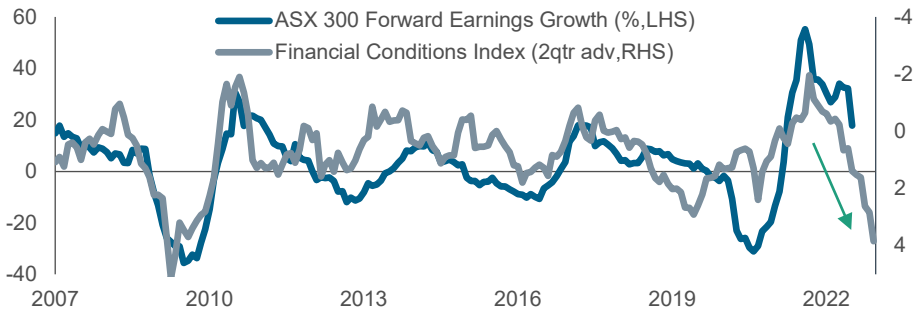
When their wealth has taken a big hit, consumers naturally become more cautious and are inclined to save more and spend less. This is a key reason why we are very cautious toward domestic cyclicals. Domestically, we believet house price declines in Australia will continue through 2023. Looking at where we are in terms of a bear market in housing, we're probably only about halfway through the downturn. As a result, our expectation is that household wealth continues to fall, causing consumption to slow as a result.

Our caution extends to global cyclical sectors because there is strong agreement between economic forecasters that the world is entering a global synchronized downturn, even if a deep recession in 2023 is only a tail risk. During such a slowdown, commodities and energy inevitably come under pressure, denting the prospects for Australia's important resources sector.

"When their wealth has taken a big hit, consumers naturally become more cautious...

## Earnings Vulnerable as Financial Conditions Weaken

(Fig. 3) Australian financial conditions index vs earnings growth




Source: The Bloomberg Professional TM service, Credit Suisse. Financial Conditions Index created by Credit Suisse and incorporates rates (10y, 3y, cash rate, BBB yield), monetary data (credit growth, M3) and asset prices (ASX 200, AUDUSD).

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### Sector Returns Led by Energy and Utilities

What has happened this year in terms of sector returns in the Australian stock market? There was a very wide return dispersion with energy and utilities at the extreme positive end of the spectrum. Within utilities, it was really the energy component that outperformed. Part of this dispersion reflects rising interest rates and a derating in the "growthier" parts of the market that were trading on high multiples prior to the rise in rates.

It also reflects the impact of the war in Ukraine which has resulted in a big energy crunch in Europe. Europe's insatiable demand for energy to replace Russian natural gas ahead of the winter has driven global energy prices in 2022. But we think the picture might change in 2023, as peak energy prices lie in the past and the sector suffers further share price weakness.

### Stay Cautious on Energy and Mining

At the global level there is a clear relationship between economic activity and the performance of resources and energy stocks (Figure 3). When overall activity is strong, so too is the demand for energy and mining commodities. But when demand weakens, the demand for energy and commodities also declines. And this is the global environment which we are now in, with measures of activity like the U.S. ISM PMI Index in negative territory in November.

As the global economy slows in 2023, we expect energy and mining stocks to underperform. When the price of their underlying commodities rolls over, as we have already witnessed recently, there will be eventual declines in earnings and cash flows. We think that is going to be the real story for these sectors in 2023.

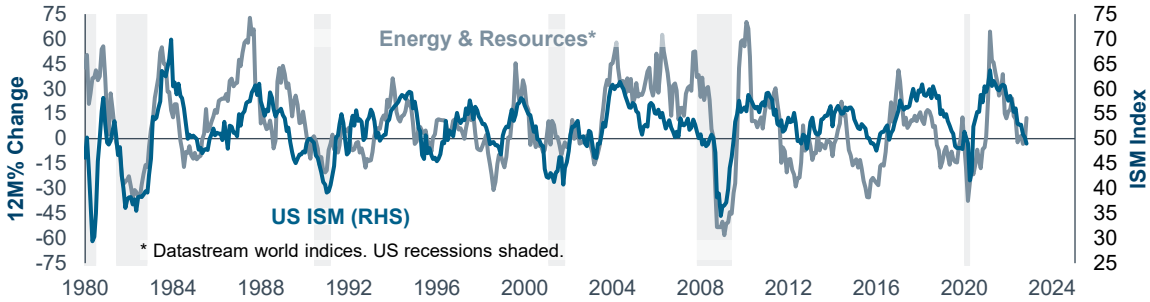
From a longer-term perspective, we still see select opportunities in the resources sector related to the green energy transition and EV manufacturing. However, in the short term we expect the broader commodity complex and in turn the mining sector to come under pressure.

### Summary and Conclusions

The key issue facing markets is how much interest rates needs to rise in order to slow economic growth and get inflation down to central bank targets. Central bank concerns have broadened out from the goods market and supply chains to now include the services sector and in particular the labour market. The bottom line is that labour markets are too tight and not consistent with inflation reaching central bank targets which therefore requires the unemployment rate to rise. The collateral damage from rising rates will be corporate earnings, which are expected to be downgraded going forward. It is likely any policy error will be one of overtightening causing a recession. Whether or not we have an economic recession it is highly likely

## Global Cyclicals Vulnerable in Downturns

(Fig. 4) US ISM vs. global resource & energy equities



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Sources: Minack Advisors, DataStream.

> The key market drivers of the last decade are reversing, and investors need to transition to a new paradigm.

we will have an earnings recession as economies slow.

Whilst the market has been pre-occupied by valuation risks in 2022, given rising bond yields, we expect this to change going forward as earnings downgrades gather pace. We maintain a defensive posture in the face of rising earnings risks and continue to selectively look for opportunities in oversold growth names. We expect the more cyclical parts of the market to come under earnings pressure going forward, which should see growth companies with more quality and defensive attributes outperform in 2023 as their earnings prove more resilient.

The key market drivers of the last decade are reversing, and investors need to transition to a new paradigm (Figure 5). Normalising from excess liquidity is proving painful for Australia, but like Omicron it is not fatal. In fact, Australia is relatively well-positioned for the new global investment regime that is unfolding, with many good long-term investment opportunities. In the short term, however, we advise caution towards the more expensive high P/E names, banks that face rising bad debts, and businesses generally that are more vulnerable to a cyclical slowdown, preferring quality defensive exposure to companies with lower earnings risk and margin stability.

## Paradigm Shift for Investors

(Fig. 5) Old regime versus new regime

Source: T. Rowe Price.
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