Economic News June 2023

Equity rally has been driven by resilient economic growth

At the end of 2022, fears of rising interest rates, slowing economic growth and falling margins weighed on corporate profits. Despite the emergence of a number of other uncertainties such as US bank defaults, US debt ceiling negotiations and continued rises in inflation, equity markets have climbed a wall of worry to post solid gains since their 2022 lows.

The equity rally has been driven by resilient economic growth across most developed economies as well as a stronger than expected reopening of China. Rising interest rates are starting to bite into economic activity, but offsets to tightening financial conditions such as excess consumer savings and tight labour markets have afforded a much greater cushion than expected as we entered the new year. In Australia, high levels of immigration have boosted our economy, and renewed confidence has helped housing prices start to rise again after falls over the last twelve months.

While progress has been made on bringing inflation down (and survey data suggests further declines are coming), it has not fallen to levels that central banks would be happy with.

Be wary of an imminent change in interest rate policy

Although headline inflation measures have certainly peaked across most developed economies, it appears wage inflation has some way to go. While this might not require policy rates to go much higher (in either the US or Australia), it will reduce the potential for an imminent change or reduction in interest rates, which investment markets appeared to price into the outlook. Investors should remember that central banks, after making policy mistakes in not raising rates to fight inflation earlier, are looking to restore their credibility by ensuring that they don’t make another mistake by loosening conditions too early.

Near term caution but maintain diversified portfolio not too defensive

Equity markets have likely seen the worst, corresponding with late 2022 lows, but are still not out of the woods. Investors should remain wary of chasing the rally.

Australian equities have underperformed global markets, as the positive drivers of 2022’s outperformance have been reversed. As commodity prices have normalised and global technology stocks have rallied, Australia has been left with few areas of outperformance, especially due to the downward pressure faced by financial stocks like the banks. A quick return to normal is not expected, with cracks appearing in the domestic economic landscape.

However, investment markets appear willing to look beyond any short-term economic slowdown. Generally diversified portfolios will hence perform better in current conditions than strictly defensive portfolios. Defensively positioned portfolios deliver positive returns for a single outcome - a negative outlook for growth assets - while diversified portfolios are set up to perform favourably across a range of scenarios.

Resilience in the face of rising rates

Despite central banks raising interest rates aggressively, recent economic data has shown better than expected results. China’s reopening has fared well, and the US and Japanese economic data has improved. However, news of Germany’s fall into recession will add to weakness in Europe over the next few months, whilst uncertainty persists in Ukraine and Russia amidst continuing conflict.

Global markets have predicted central bank interest rate hikes to stabilise, but current rebounds in economic growth could mean that more needs to be done to tackle inflation. Growth will either weaken from previous interest rate increases; or central banks will need to continue to raise rates. Regardless, growth must slow further to bring both inflation and central bank interest rate hikes under control.

Why then has growth been so resilient?

Generally, it takes an increase in the unemployment rate to lower services inflation, as around 80% of jobs in advanced economies are in service industries. Central banks must then continue to raise interest rates until the unemployment rate rises off very low levels in Australia. History shows increasing the unemployment rate does cause a slowdown in economic growth.

Despite the US Federal Reserve increasing interest rates by 500 basis points, broad measures of financial conditions are not tight and may be the key reason why growth has been relatively resilient. Core measures of inflation are proving stickier than desired, suggesting there is some way to go before inflation is tamed.

In Australia, economic growth has continued its resilience due to the rebound in Australian immigration, which has strengthened in the past few months. This has offered some support for economic activity, with a domestic recession likely to be avoided. Despite this, consumers are now buckling under the weight of rising interest rates and the ever-increasing cost of living.

House prices and immigration are the bright spots

In Australia, the two bright spots of economic activity are house prices and immigration. Immigration is a double-edged sword; it adds supply to the labour market, especially in skilled jobs, but it also boosts demand for housing, which was already exceeding supply before borders were reopened.

The housing imbalance has been exacerbated by the impact of rising interest rates on new construction. However, rising rent means the difference between the cost of renting versus the cost of servicing a mortgage is narrower than it would otherwise be, which in turn provides support for housing prices. Data on auction clearance rates shows positive price momentum in Sydney and Melbourne has continued, despite the May interest rate increase.

Consumers have remained resilient to the RBA's tightening campaign and falling housing prices (until the recent rebound), propped up by both a tight labour market and a high level of savings. Even collapsing sentiment didn't derail spending up until this point. However, behaviour now appears to have changed and the weight of rising rates and the rising cost of living is now impacting spending, even while the factors that have so far propped up consumers over the past year remain.

Normal Allocated pension drawdowns to apply from 1 July 2023

The Australian Taxation Office has stated that the 50% reduction in the minimum allocated pension drawdown will not be extended beyond 2022/23. This means that the minimum allocated pension payments will return to normal levels from 1 July 2023. These individual policy adjustments, if required will be made automatically by allocated pension providers.

The table below shows the age-based annual minimum payment required this financial year and from 1 July 2023.

Age	2022/23	From 1 July 2023
Under 65	2%	4%
65 – 74	2.5%	5%
75 – 79	3%	6%
80 – 84	3.5%	7%
85 – 89	4.5%	9%
90 – 94	5.5%	11%
95 +	7%	14%

Allocated pension recipients can expect increased allocated pension payments from the new financial year onwards if they were previously on the reduced minimum rate.

If you have any questions or wish to discuss anything, please call us on 03 9544 1004.

All the best,

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