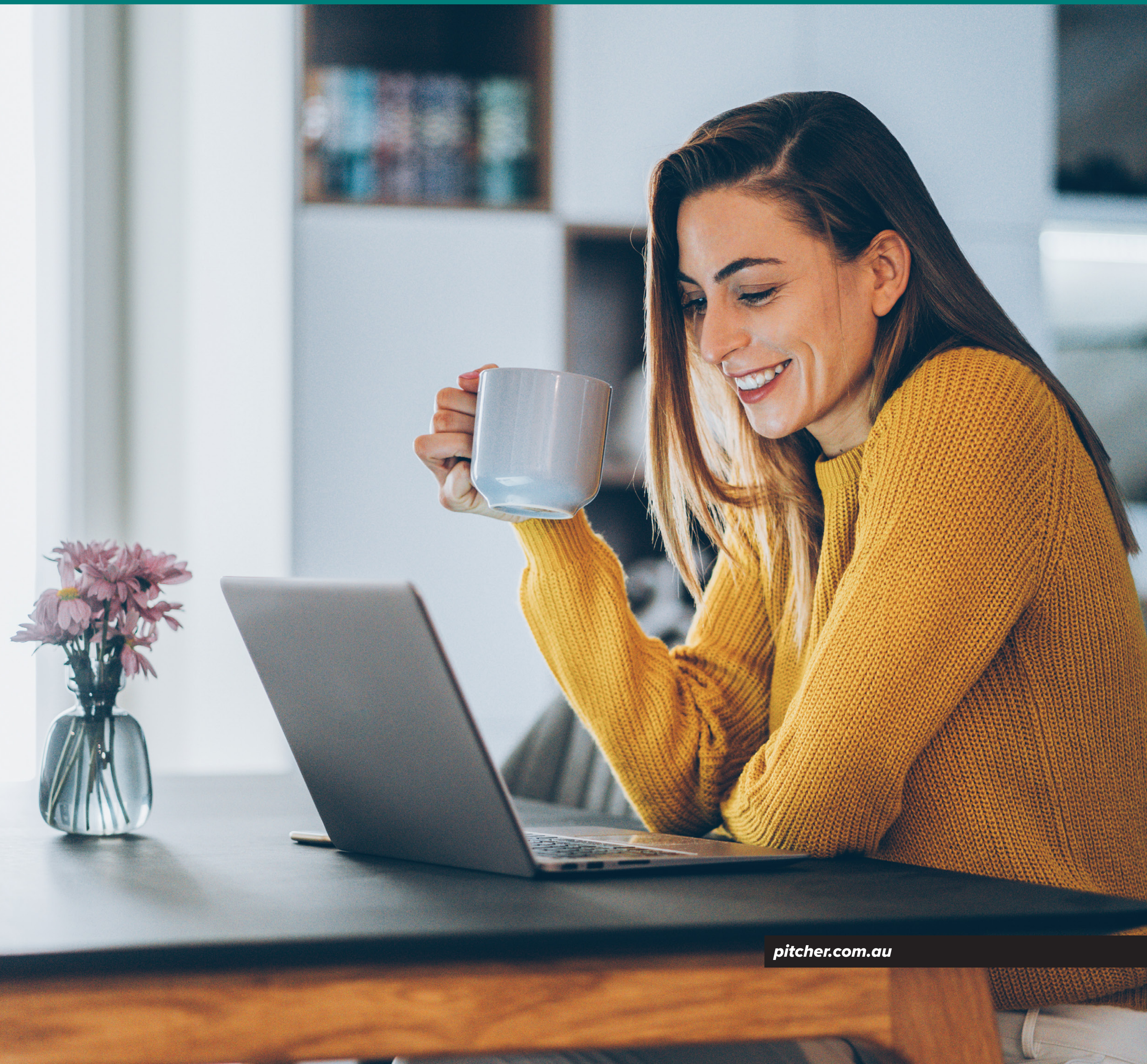
Economic and Market Outlook

October 2021



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International economy

Part 1: Overview

Against the backdrop of the worst pandemic for 100 years, global economic growth rebounded strongly over the last 12 months. This can be attributed to the potent combination of pent-up demand, unprecedented government income support for businesses and individuals, accommodative monetary policy that has ensured liquidity for financial markets, ultra-low interest rates, diminishing lockdowns, and accelerating vaccination rates.

In Europe, the benefit of looser restrictions and the reopening of limited international tourism has resulted in a marked expansion in activity over recent months. Jobs growth has been strong, manufacturing and service sector Purchasing Managers Index's (PMI) have been high and business confidence survey results remain elevated. This suggests that aggregate output is on track to be back at pre-pandemic levels by the end of 2021. Although inflationary pressures are rising, the European Central Bank (ECB) will allow inflation to temporarily run above the 2% target and will only lift interest rates if it stabilises at, or above, that level.

In the United States the recovery has been even stronger. The economy grew by over 13% over the past year and has exceeded pre-COVID levels[1]. Annualised growth rates of around 6.5% in each of the first two quarters of 2021 has been underpinned by strong consumer spending and business investment[1]. In response to this strength, the Federal Reserve (the 'Fed') has signalled its intent to wind down its asset purchases in the months ahead and commence the process of normalising monetary policy in 2023. Whilst there is a risk that rising inflationary pressures may force the Fed to lift interest rates earlier than expected, the Fed continues to argue that any inflation is likely to be transitory. They would need to see a complete recovery in the labour market as well as an inflation rate sustainably above 2% before raising interest rates.

The solid footing that the world's largest economy finds itself on, however, has shown recent signs of fragility. Whilst employment numbers grew by a combined two million in June and July, August's employment gain paled in comparison as jobs in the leisure and hospitality sector tapered off[2]. A dramatic easing in employment levels from such high readings would normally not be a cause of concern, but a weakening in other economic indicators tempers optimism. Whilst the manufacturing sector remains solid as evidenced by the PMI, the services sector is being impacted by labour shortages, inflation, supply chain disruptions and weakening foreign orders[3]. While industrial production has been rising steadily over recent months, the rate of growth has weakened.

The recent decline in growth is largely due to two main factors. The first is the debilitating impact of the Delta variant that has proven to be far more infectious than early forms of SARS-CoV-2. Even in well-vaccinated countries such as Israel and Singapore, there has been a sharp rise in COVID-related hospitalisations. The latest wave of infections is forcing new containment measures such as lockdowns and restrictions across various economies that continue to disrupt supply chains, production and trade. Importers of key manufacturing components such as semi-conductors have been grappling with this issue over the past year but the insatiable demand in the past few months has made the situation worse. Demand for shipping containers has also skyrocketed. The shortage of containers has led to sharp increases in freight charges and further delays in getting parts used in the manufacturing process to the factory gate. As a result, the gap between supply and demand is likely to widen further as the peak Christmas demand period approaches, exacerbating near-term price inflation.

The second main factor is the recent economic slowdown in China. Although the scale of COVID-19 outbreaks has been relatively small, the Chinese government's zero tolerance policy on the virus has led to severe restrictions. After modest second quarter growth outcomes (where the economy grew at 1.3% on a quarterly basis)[4], recent factory and port interruptions have exacerbated supply-chain issues resulting in industrial production growing at its slowest annual rate for over a year (5.3%)[4]. The country's manufacturing sector (with a PMI of 50.1[5]) has slowed considerably and is on the cusp of contracting. Consumer confidence has also taken a hit, evidenced by a muted annual growth rate of 2.5%[6] to the end of August, considerably lower than the annual rate of 12.4%[7] just three months earlier. This slump in confidence coincides with the well-documented troubles of China's

[1] US Department of Commerce, 'Bureau of Economic Analysis', 2021, https://www.bea.gov/news/2021/gross-domestic-product-2nd-quarter-2021-second-estimate-corporate-profits-2nd-quarter, (accessed 1 October 2021).

[2] US Department of Labor, 'Bureau of Labor Statistics', *BLS,* 2021, https://www.bls.gov/news.release/pdf/empsit.pdf, (accessed 1 October 2021).

[3] Institute for Supply Management (ISM), 2021, https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/august/, (accessed 1 October 2021).

[4] National Bureau of Statistics of China, 'National Economy in the First Half Year Witnessed the Steady and Sound Growth Momentum Consolidated', *National Bureau of Statistics of China*, 2021, http://www.stats.gov.cn/english/PressRelease/202107/t20210715_1819447.html, (accessed 1 October 2021).

[5] National Bureau of Statistics of China, 'Purchasing Managers Index for August 2021', *National Bureau of Statistics of China*, 2021, http://www.stats.gov.cn/english/PressRelease/202109/t20210901_1821512.html, (accessed 1 October 2021).

[6] National Bureau of Statistics of China, 'Total Retail Sales of Consumer Goods Went Up by 2.5 percent from January to August 2021', *National Bureau of Statistics of China*, 2021, http://www.stats.gov.cn/english/PressRelease/202109/t20210916_1822208.html, (accessed 1 October 2021).

[7] National Bureau of Statistics of China, 'Total Retail Sales of Consumer Goods Went Up by 12.4 percent from January to May 2021', *National Bureau of Statistics of China*, 2021, http://www.stats.gov.cn/english/PressRelease/202106/t20210617_1818519.html, (accessed 1 October 2021).

biggest property developer, Evergrande, that reportedly owes over US$300 billion[8]. Its potential collapse could send shockwaves through China's property markets that have long suffered from chronic over-investment and an unsustainable property boom. Although the first order effects are likely to be significant as many unpaid employees and suppliers will be forced into insolvency arrangements, the second order effects from such a collapse have the potential to be seismic. With estimates of nearly 70% of Chinese household wealth being tied up in real estate[9], the risk of a broader property market correction could not be ruled out. Such an outcome could unleash a spiral of deleveraging (households facing a diminution in wealth focus on debt repayments over consumption) that could easily plunge the economy into recession.

Conclusion

The strong global economic recovery has begun to lose some momentum in recent months as many countries are forced to impose new restrictions to prevent their health systems from being overwhelmed by the Delta variant. Nevertheless, as vaccination rates continue to improve, we expect growth to remain solid in 2022 buoyed by excess savings and the further relaxation of travel and other restrictions. There are, however, numerous factors that could hinder the recovery in coming quarters including the tapering of fiscal and monetary stimulus, continued sporadic lockdowns to limit the spread of the Delta and other novel variants, ongoing inflationary pressures caused by supply chain and labour market disruptions, and the potential for a significant slowdown in China.

Real Gross Domestic Product (GDP) growth[10]	2021	2022
World	6.0%	4.9%
United States	7.0%	4.9%
Euro Area	4.6%	4.3%
China	8.1%	5.7%

[8] W. Tan, 'China's embattled developer Evergrande is on the brink of default. Here's why it matters', *CNBC*, 2021, https://www.cnbc.com/2021/09/17/china-developer-evergrande-debt-crisis-bond-default-and-investor-risks.html, (accessed 1 October 2021).

[9] C. Li, Y. Fan, 'Housing wealth inequality in urban China: the transition from welfare allocation to market differentiation', *The Journal of Chinese Sociology*, 2020, https://doi.org/10.1186/s40711-020-00129-4, (accessed 1 October 2021).

[10] World Economic Outlook Update, 'Fault Lines Widen in the Global Recovery', *International Monetary Fund*, 2021, https://www.imf.org/en/Publications/WEO/Issues/2021/07/27/world-economic-outlook-update-july-2021, (accessed 1 October 2021).

Part 2: Key economic indicators

United States

Economic snapshot	Last reported result	Comments
Growth (GDP)[11]	6.6% (annualised) Q2'21	Real GDP increased strongly in the second quarter of 2021 as the economic recovery progressed and establishments continued to reopen.
Unemployment[12]	5.2% Aug'21	The unemployment rate declined by 0.2% in August to 5.2%, with a lower-than-expected 235,000 jobs added over the month. There was significant job growth in leisure and hospitality, public and private education, and healthcare and social assistance.
Industrial Production[13]	0.4% m/m Aug'21 5.9% y/y Aug'21	Industrial production rose for the third successive month, but the rate of growth slowed due to shutdowns of petroleum refineries and petrochemical plants caused by Hurricane Ida, curbing manufacturing activity.
ISM Manufacturing[14]	59.9 Aug'21 61.2 May'21	August's PMI reading of 59.9 reflected an increase of 0.5 percentage points from the July reading, and continues to signal a manufacturing sector in expansion for a twelfth successive month.
Retail sales[15]	0.7% m/m Aug'21 15.1% y/y Aug'21	Retail turnover unexpectedly rose in August as online sales surged. Furniture sales were also strong, offsetting continued declines in car dealerships. The yearly reading remains very strong, albeit off a very low COVID-19 induced base.
Credit growth[3]	4.7% y/y Jul'21	Credit increased by 4.7% year-on-year and stands at $4.33 trillion.
Outlook	Growth in the United States is set to moderate in 2022 to 4.9% (still high from a historical perspective). The biggest threat to the continuation of the recovery is the rising impact of the Delta variant and rising inflationary pressures.	

Eurozone

Economic snapshot	Last reported result	Comments
Growth (GDP)[16]	2.0% q/q Q2'21 13.6% y/y Q2'21	The Eurozone emerged from recession during the June quarter as the easing of coronavirus restrictions spurred economic activity. The economy has now expanded 13.8% since the second quarter of 2020, when the fallout from the pandemic was at its worst.
Unemployment[6]	7.6% Jul'21	The unemployment rate declined slightly in July but continues to remain higher than the level of 7.4% in January 2020 as the scarring to the economy continues to recede.
Industrial Production[6]	1.5% m/m Jul'21 7.7% y/y Jul'21	Industrial production recovered strongly in July after two months of contraction and has risen solidly over the past year.
Manufacturing PMI[17]	61.4% Aug'21	The Manufacturing PMI confirmed the manufacturing sector expanded for the fourteenth successive month.
Retail Sales[6]	-2.3% m/m Jul'21 3.1% y/y Jul'21	Retail sales were lower in July as internet and mail order sales declined 7.3%, sales of automotive fuel dropped 1.6% and sales of food fell 0.7%. Retail sales remain higher over the past year.
Credit Growth[6]	6.0% y/y Jul'21	The annual growth rate of total credit to euro area residents decreased to 6.0% in July, from a level of 6.2% in June. The annual growth rate of credit to general government decreased to 12.4% in July from 13.1% in June, while the annual growth rate of credit to the private sector decreased to 3.4% in July from 3.6% in June.
Outlook	The Eurozone emerged from recession during the June quarter as the continued easing of virus containment measures allowed services-sector businesses to reopen and the tourism industry to recover. Consumer and business confidence have strengthened as a result of a pickup in vaccination rates. With the ECB pledging to accelerate its bond buying program, the Eurozone economy is likely to grow solidly over the next few years.	

China

Economic snapshot	Last reported result	Comments
Growth (GDP)[18]	1.3% q/q Q2'21 7.9% y/y Q2'21	China's growth rate was sluggish in the second quarter amid weakening business confidence, factory output and consumer confidence.
Unemployment[8]	5.1% Aug'21	The unemployment rate of 5.1% masks the extremely high youth unemployment rate.
Industrial Production[8]	5.3% y/y Aug'21 8.8% y/y May'21	Industrial production posted its weakest yearly growth rate since July 2020.
Manufacturing PMI[19*]	50.1 Aug'21 51.0 May'21	The latest reading of 50.1 was lower than the July reading and shows the manufacturing sector has stopped expanding.
Retail Sales[8]	2.5% y/y Aug'21 12.4% y/y May'21	Retail sales grew modestly in the year to August as rising local COVID-19 cases and floods dented consumer confidence levels.
Fixed Asset (Urban) Investment[8]	8.9% y/y Jan-Aug'21	Fixed Asset Investment (FAI) grew modestly in July but remains solid over the year, supported by an 11.5% increase in private sector investment.
Outlook	Growth in China is slowing and is expected to moderate further in 2021 to around 5.7%. Risks remain to the downside as the spillover effects from the potential collapse of the country's largest property developer have the potential to trigger a property market correction, denting confidence and crimping growth.	

Japan

Economic snapshot	Last reported result	Comments
Growth (GDP)[20]	1.9% (annualised) Q2'21	The Japanese economy grew in the second quarter, albeit modestly. Private consumption and private residential investment underpinned economic growth over the period.
Unemployment[21]	2.8% Jul'21	The unemployment rate decreased slightly in July but remains higher than the level of 2.2% recorded in December 2019.
Industrial Production[22]	-1.5% m/m Jul'21 11.6% y/y Jul'21	Industrial production remains near year-high levels despite the contraction in July.
Manufacturing PMI[23]	52.7 Aug'21 53.0 May'21	The latest reading of 52.7 marks the seventh straight month of expansion in the manufacturing sector.
Retail sales[12]	1.1% m/m Jul'21 2.4% y/y Jul'21	Japan's retail sales were supported by strong demand for fuel, cars, clothing, general merchandise and food.
Outlook	Lockdown restrictions and a sluggish start to its vaccination program have hindered Japan's economic recovery despite elevated global demand. With 70% of its population forecast to be fully vaccinated by year end, we expect growth to accelerate in 2022.	

[11] US Department of Commerce, 'Bureau of Economic Analysis', 2021, https://www.bea.gov/, (accessed 1 October 2021).

[12] US Department of Labor, 'Bureau of Labor Statistics', 2021, https://www.bls.gov/news.release/pdf/empsit.pdf, (accessed 1 October 2021).

[13] United States Federal Reserve, 2021, https://www.federalreserve.gov/, (accessed 1 October 2021).

[14] Institute for Supply Management (ISM), 2021, https://www.ismworld.org/, 2021, (accessed 1 October 2021).

[15] United States Census Bureau, 2021, https://www.census.gov/, (accessed 1 October 2021).

[16] Eurostat, 2021, https://ec.europa.eu/eurostat, (accessed 1 October 2021).

[17] IHS Markit, 2021, https://ihsmarkit.com/index.html, (accessed 1 October 2021).

[18] National Bureau of Statistics of China, 'National Economy in the First Half Year Witnessed the Steady and Sound Growth Momentum Consolidated', *National Bureau of Statistics of China*, 2021, http://www.stats.gov.cn/english/PressRelease/202107/t20210715_1819447.html, (accessed 1 October 2021).

[19] China Federation of Logistics and Purchasing, 2021, http://en.chinawuliu.com.cn/cflp-pmi/, (accessed 1 October 2021).

[20] Cabinet Office, 2021, https://www.cao.go.jp/index-e.html, (accessed 1 October 2021).

[21] Ministry of Internal Affairs and Communications, 2021, https://www.soumu.go.jp/english/, (accessed 1 October 2021).

[22] Ministry of Economy, Trade and Industry (METI), 2021, https://www.meti.go.jp/english/, (accessed 1 October 2021).

[23] Jibun Bank and IHS Markit, 2021, https://www.markiteconomics.com/, (accessed 1 October 2021).

*The Manufacturing PMI data is compiled by the China Federation of Logistics & Purchasing (CFLP) and the China Logistics Information Centre (CLIC), based on data collected by the National Bureau of Statistics (NBS). The Manufacturing PMI data is NOT the Caixin Manufacturing PMI.

Australian economy

Part 1: Overview

The Australian economic recovery continued during the second quarter, albeit at a much slower rate than the swashbuckling growth witnessed during the year to the end of March. In July, an outbreak of the highly infectious Delta variant spread through Greater Sydney, and later Melbourne, prompting lockdowns that combined to depress economic activity and undermine confidence.

In spite of these lockdowns, the unemployment rate actually fell in August to its lowest level since 2008. Yet this impressive headline rate masked a more sobering reality. Hours worked across the country fell by 3.7% as 146,300 positions were lost[24], and the number of individuals looking for work declined significantly. New South Wales bore the brunt of job losses (173,000 or 4.2% of the state's workforce), with its unemployment rate rising by 0.5% to 4.9%[23]. Retail trade has been similarly impacted with a decline in July, the first full month where lockdowns were imposed in New South Wales, the state's sales collapsing 8.9%[25]. The retail sector accounts for 18% of GDP[26]. As weakness is expected to continue over the next few months with Victoria's lockdowns likely to impact trade figures, the domestic economy looks likely to suffer a contraction over the second half of the year.

Unlike recent years, business investment has been relatively strong as the sector took advantage of generous tax breaks, cheap money, and strong balance sheets to boost spending on both equipment (including plant and machinery) and buildings. Not unexpectedly, investment is likely to soften in the last two quarters of 2021 as businesses exercise more caution until a path out of lockdown is clearer. This deterioration in confidence is exemplified by the latest Australian Performance of Manufacturing Index (PMI) survey, which posted its worst reading in a year[27].

The greatest threat to Australia's growth prospects remains the risk of a further slowdown, and deterioration in the relationship, with our major trading partner, China. A change in policy direction by President Xi Jinping to reduce inequality, improve air quality, and reduce leverage in the property sector has led to unintended consequences. The clampdown on emissions has effectively coerced steel producers to cap output at 2020 levels and forced power rationing as energy supplies run low. Furthermore, the tightening in credit conditions for property developers has left the country's largest development company, Evergrande, on the verge of collapse. The combined impact has led to a sharp slowdown in iron ore exports, on top of the existing ban on Australian coal exports. With mines in Brazil ramping up supply again, iron ore prices appear destined to fall further. This will have a significant effect on the terms of trade and subsequently, GDP. To put this into perspective, Australia's terms of trade increased 7.0% in the second quarter to its highest level in history[28].

The combination of lockdowns and challenges with our largest trading partner will damage consumer and business confidence in coming months, possibly plunging the Australian economy into another, albeit technical, recession. The outlook beyond the remainder of this year appears brighter. Accommodative interest rate settings and continued fiscal support will sustain the recovery into 2022. Notwithstanding the expected rebound in growth, the spare capacity that was evident even before the crisis is likely to remain for some time. To this end, the Reserve Bank of Australia (RBA) only forecasts that the inflation rate will rise to between its desired range of 2% to 3% by the end of 2023. As a result, the RBA is not expecting to raise interest rates until well into 2024, at the earliest. Given the current level of input price inflation and likelihood that labour market movements will limit the availability of offshore workers for some time, we would not be surprised to see wage pressures build when lockdowns end, potentially leading to interest rate rises earlier than the market currently expects.

Conclusion

The Australian economy will be lucky to avoid a technical recession in coming months as prolonged lockdowns crimp output and a slowdown in China impacts our key exports. High vaccination rates, however, are likely to ensure that most states will largely be reopened by December. Pent-up demand coupled with ongoing stimulus measures should pave the way for a strong recovery in 2022, supercharged as travel and hospitality reopens and consumers spend excess savings, helping boost both business and employment conditions once more.

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[24] Australian Bureau of Statistics, 'Labour Force Australia', 2021, https://www.abs.gov.au/statistics/labour/employment-and-unemployment/labour-force-australia/latest-release, (accessed 1 October 2021).

[25] Australian Bureau of Statistics, 'Retail Trade, Australia', 2021, https://www.abs.gov.au/statistics/industry/retail-and-wholesale-trade/retail-trade-australia/jul-2021, (accessed 1 October 2021).

[26] W. Cole, 'Australia retail sales plunge in July, economy set to shrink', *Reuters,* 2021, https://www.reuters.com/world/asia-pacific/australia-retail-sales-plunge-july-economy-set-shrink-2021-08-27/#:~:text=The%20A%24360%20billion%20retail,lockdowns%20engulf%20Melbourne%20and%20Canberra, (accessed 1 October 2021).

[27] Australian Industry Group, 2021, https://www.aigroup.com.au/, (accessed 1 October 2021).

[28] Australian Bureau of Statistics, 'Australian National Accounts: National Income, Expenditure and Product', *Australian Bureau of Statistics,* 2021, https://www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-national-income-expenditure-and-product/latest-release, (accessed 1 October 2021).

Part 2: Key economic indicators

Economic snapshot	Last reported result	Comments
Growth (GDP)[29]	0.7% q/q Q2'21 9.6% y/y Q2'21	The Australian economy grew moderately in the second quarter, underpinned by solid increases in private demand and household spending.
	12-month outlook: The economy is likely to contract over the second half of 2021 as a result of lockdowns across the country, before rebounding as restrictions ease.	
Retail trade[14]	-2.7% m/m Jul'21 -3.1% y/y Jul'21	Retail trade decreased in July as a result of a sharp contraction of 8.9% in New South Wales.
	12-month outlook: Retail sales are likely to be muted for the remainder of 2021 as a result of lockdowns across the country but will recover in the first half of 2022 as restrictions are lifted.	
Manufacturing PMI[30]	51.6 Aug'21 61.8 May'21	The Australian Industry Group (AIG) stated that the Performance of Manufacturing Index (PMI) fell 9.2 points over the month and is the weakest result since September 2020.
	12-month outlook: The manufacturing sector should strengthen as lockdowns progressively end.	
Business investment (Private New Capital Expenditure)[14]	4.4% q/q Q2'21 11.5% y/y Q2'21	Private new capital expenditure rose solidly over the quarter. In particular, spending on equipment, plant and machinery increased 17.1% over the past year.
	12-month outlook: Business investment is expected to remain solid, supported by rising business confidence and a strong infrastructure pipeline.	
Unemployment[14]	4.5% Aug'21	The unemployment rate decreased 0.1% in August to its lowest level in almost 13 years, but the labour market is far from strong when one considers 146,300 jobs were lost last month and there was a steep fall in hours worked.
	12-month outlook: We expect a slight rise in unemployment in the next few months as the prolonged lockdowns force some businesses to shed labour. We expect the rate to start to fall again in 2022, however, as reopenings gather momentum.	
Inflation[14] and interest rates	**Inflation:** 0.8% q/q Q2'21 3.8% y/y Q2'21	The Consumer Price Index (CPI) rose solidly for a third consecutive quarter, due in large part to elevated fuel prices.
	Interest rates: 0.10% cash rate Sep'21	The RBA left the cash interest rate unchanged in September at a record low of 0.10%.
	12-month outlook: The RBA is likely to retain the cash rate at the lower bound of 0.10% over at least the next 6-12 months. However, we do see inflation risks building earlier than markets currently anticipate. The temporary halt on migrant workers, immigration and border closures have led to labour and skills shortages in some industries. This has been compounded by workers that have temporarily left the workforce because of health risk concerns (especially public facing roles). We expect some of these supply side issues to persist in 2022 which could see wage pressures build, potentially feeding into inflation by the end of 2022. If this happens (heavily dependent on the strength of the recovery), there is an outside chance that the RBA could be forced to lift rates as early as the end of 2022.	
Australian dollar	AU$1 = US$0.72	The Australian Dollar declined over the past quarter on signs of a weakening Chinese economy. Adding to the decline in the local currency is the relative strength of its US counterpart on expectations that the Federal Reserve may start winding back its stimulus measures within months.
	12-month outlook: The Australian Dollar is expected to trade around current levels, supported by moderate global growth expectations.	

[29] Australian Bureau of Statistics, 2021, https://www.abs.gov.au/statistics/, (accessed 1 October 2021).

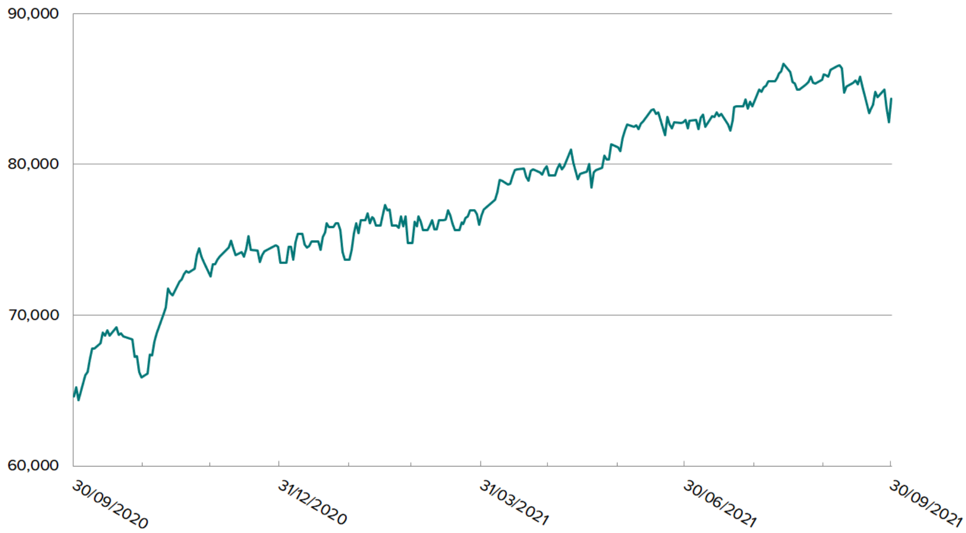
[30] Australian Industry Group, 2021, https://www.aigroup.com.au/, (accessed 1 October 2021).

Australian equities

Overview

The S&P/ASX 200 Total Return Index returned 1.7% over the three months and 14.8% over the nine months to 30 September 2021.

S&P ASX200 Accumulation Index



Source: S&P

Outlook

Recommendation: Increase to overweight.

Domestic shares appear fully-priced compared to historical valuations but there are several reasons why their robust performance is likely to continue over the next year. First, short-term headwinds relating to lockdowns and supply-chain bottlenecks should progressively ease towards the end of the year as vaccination rates improve and restrictions ease. Corporate profits are expected to gather momentum at that time. Second, expected global growth of 6.0% in 2021 and 4.9% in 2022 is consistent with a stronger domestic sharemarket. Third, the low interest rate environment is likely to continue to remain accommodative. The RBA has signalled that interest rates are unlikely to move until at least 2024. This has allowed both individuals and businesses to borrow money at historically low rates. Individuals have therefore had more disposable income which can be directed into the economy, supporting economic growth, or directly into assets like shares. Fourth, balance sheets of companies have become stronger over the past year as many have benefitted from fiscal stimulus measures to the broader economy, as well as lower interest payments on their debt. Fifth, shares continue to look attractive relative to fixed interest where yields remain low. Dividends that were either suspended or dramatically reduced due to the virus have, for the most part, returned to pre-pandemic levels. China's slowdown is likely to temper some of these positives but overall, the outlook remains bright for the Australian sharemarket.

Sector view

Our outlook for some of the major sectors of the S&P/ASX 200 is as follows:

Banks

Recommendation: Retain neutral.

The banking sector continued its strong recovery in the third quarter as the Australian economy grew moderately and the unemployment rate declined further. As economic conditions have improved, the banks have written-back impairment charges from the previously announced multi-billion-dollar loss provisions. These writebacks have underpinned the strong profit rebound in the sector. The banks continue to benefit from strong capital positions, which exceed by some margin the minimum regulatory levels. These have provided scope for capital management initiatives with many banks either announcing or flagging intentions to initiate buybacks.

Both credit growth and quality have improved significantly over recent months as consumer confidence increased. The low interest rate environment has enticed both first-home buyers and investors to deploy the significant savings built-up since the onset of the pandemic. However, with lockdowns affecting many parts of NSW and Victoria in recent months, in turn notably impacting the services sector in particular, arrears are expected to increase should restrictions continue through to the end of the year. However, as a result of new loan deferral programmes, the effects of these lockdowns on credit quality may only fully surface after several months.

Notwithstanding the greatly improved economic landscape, cost pressures remain. Banks continue to invest in compliance, technology and cybersecurity. High levels of amortisation, remediation measures and fines have pressured the cost base across the sector. Further, growth continues to be impacted by weaker markets income.

Eventual interest rate rises will increase the historically low Net Interest Margins (NIM's) of the banks, providing a boost for profit growth. NIM's across the sector are currently being supported by the Reserve Bank of Australia's $209 billion Term Funding Facility (TFF), which was launched in March 2020 with the intention of providing liquidity and stimulating business credit. Notwithstanding this objective, businesses' reluctance to borrow coupled with strong deposit growth left banks with a funding surplus. This, in turn, allowed banks to price fixed-rate mortgages at ultra-low interest rates. With the winding down of the TFF, interest rates on fixed-rate loans are likely to increase over the short-run as banks refinance loans at a higher cost base. Further, mortgage competition remains strong, pressuring margins and limiting any solid NIM expansion.

After strong recent price appreciation, banks appear fully priced. Although they remain leveraged to a rising interest rate environment, this will be offset to some extent by funding cost increases and competitive pressures.

Resources

Recommendation: Downgrade to neutral.

The resources sector continues to benefit from the reflation of the global economy, with stimulus measures and accommodative interest rates providing tailwinds for commodity prices. Massive infrastructure packages across the globe continue to be announced, the latest being US$1 trillion-plus packages in the United States and India. Further, the IMF forecasts the global economy to grow at around 4.9% in 2022, which would imply continued strong demand for commodities.

Strong commodity prices have not just been a result of solid demand to satisfy burgeoning infrastructure projects. Prices have also benefitted from supply-side constraints, with supply being impacted by COVID-19-related disruptions. As a result, inventories are at historically low levels across most commodities. This thematic is likely to continue over the short-term given the underinvestment of recent years. Over the longer term, demand for steel and copper as a result of rising urbanisation rates across the world is expected to remain solid.

The recent reporting season saw the large Australian mining companies post record earnings, with cash generation the highlight. This has resulted in many companies returning huge dividends to shareholders, given that balance sheets for these large miners carry negligible gearing levels. Cost pressures are starting to bite, however, as labour, freight and other input costs have risen. The fall in commodity prices of late is unlikely to be unwound but cash generation is likely to remain strong over the medium-term.

Nevertheless, the biggest threat to the sector remains the current slowdown in China and risks posed by China's largest property developer, Evergrande. Despite meeting its latest bondholder commitment, it remains on the verge of collapse. China is the world's biggest importer of crude oil, coal, iron ore, copper and natural gas[31]. If Evergrande fails then the risk of a broader property market correction and construction downturn in China could not be ruled out. This would cause a slump in demand for numerous commodities. Iron ore prices, in particular, have already fallen sharply exacerbated by a return of supply from Brazil.

Given the mixed outlook, we downgrade our recommendation from overweight to neutral.

Retail

Recommendation: Retain neutral.

The Australian retail sector has performed strongly over the past year as the country successfully navigated the financial fallout from the pandemic. However, over recent months this trend has waned. Lockdowns in the financial hubs of Sydney and Melbourne have seen retail sales slide significantly. This trend could persist until the end of the year if restrictions are not significantly eased. As a result of these lockdowns, consumer confidence levels, whilst high, have started to lose momentum. Restrictions in NSW and Victoria have seen only essential shops remain open, with many retailers reverting to trading online.

Prior to the most recent lockdowns, there appeared to be no significant impact of the termination of JobKeeper on retail sales, with strong jobs growth underpinning sales.

This augers well for a recovery in retail sales as the vaccine rollout gathers steam and restrictions progressively ease.

Australian Real Estate Investment Trusts (AREITs)

Recommendation: Retain neutral.

AREITs have performed strongly over the past year as the economy has rebounded. The AREIT Total Return Index is 30% higher over the past year and has risen over 4% during the past quarter.

The retail sub-sector has suffered during the lockdowns as many shops were forced to close and only those with online offerings were able to minimise revenue losses. Government support packages have offered some respite for struggling businesses as employees have been kept on payrolls and rents, to varying degrees, have been paid. The services sector in and around the CBDs have suffered as a result of the lockdowns and even restaurants and food establishments outside of CBDs have seen a reduced number of customers. The eventual move out of lockdown will see more, though not all, workers return to their workplaces on a regular basis (predominantly in CBDs) and allows consumers to frequent bars and restaurants more easily.

The office sub-sector is still recovering from the carnage inflicted on it by the pandemic. The lockdowns in recent months has forced many office workers to perform their duties from home. The ease in communicating with colleagues and peers will force many managers and workers to rethink their work practices and how employees are deployed when lockdowns end. A flow-on effect from this is that many businesses who lease offices will rethink their need for such footprints in a post-COVID world. The renegotiation of leases as they expire will be a headwind for the sector, with leases either less likely to be renewed or, if renewed, will be done so on less favourable terms.

The residential sub-sector continues its strong performance, with continued solid rises in mortgage pre-approvals and borrowers increasingly able to resume mortgage repayments. House prices continue to rise strongly as borrowers and investors take advantage of the low interest rate environment to purchase properties. The sub-sector will benefit from a lifting of restrictions on international travel as demand for accommodation will rise.

The industrial sub-sector has been the standout from the outset of the pandemic. Strong investor demand has compressed capitalisation rates, to the point where they are now lower than both office and retail assets. Industrial space close to transport hubs has been especially sought after, not only by investors but also by businesses, who seek to minimise disruptions in their supply chains. We maintain our neutral recommendation on the AREIT sector. The moderate gearing levels of companies across the sector, as well as an improving economic climate, continue to provide support.

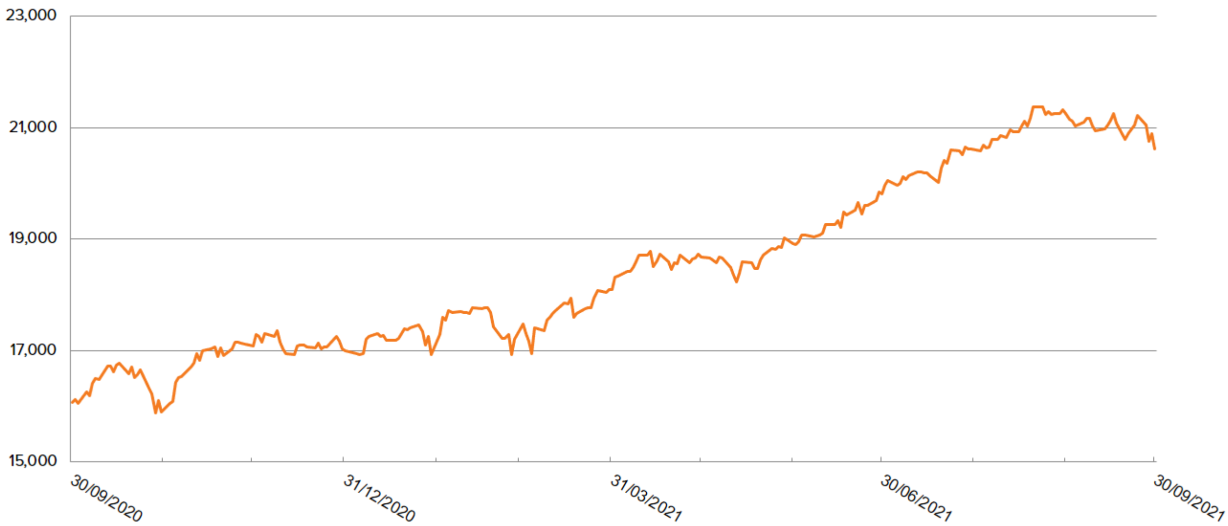
[31] C. Russell, 'Were China's August commodity imports strong? Depends on your time frame', *Reuters,* 2021, https://www.reuters.com/article/uk-column-russell-commodities-china-idUSKBN2G50PD, (accessed 1 October 2021).

International equities

Overview

The MSCI World (ex-Australia) Accumulation Index (AUD) returned 4.1% over the three months and 21.3% over the nine months to 30 September 2021.

MSCI World ex-Australia Accumulation (Gross) Index (AUD)



Source: MSCI

Outlook

The relentless rise on global equity markets up until August was propelled by a rapid rebound in activity from the pandemic induced lows of March 2020. The foundations for this recovery were based on massive fiscal stimulus packages that provided a safety net to displaced workers and shuttered businesses, as well as central bank policy measures that provided liquidity to markets and enabled an ultra-low interest rate environment that favoured equities over low returning bonds. In September the momentum began to waver as China's economy began to slow and the Delta variant forced a new wave of lockdowns.

As vaccination rates improve, lockdowns end and borders reopen, we expect that consumers will accelerate the deployment of excess savings into goods and services, in particular travel and tourism. The positive wealth effect from asset price inflation coupled with a continuation of low interest rates should ensure that growth remains well above trend in 2022. This, in turn, should provide the backdrop for further corporate earnings growth. The rate of growth, however, may well decelerate and come in below expectations as China faces its sternest test yet. Evergrande threatens to expose the chronic over-investment in property that has been the backbone of China's 20-plus year economic miracle.

Valuations

In the United States, operating earnings for S&P 500 companies are currently expected to rise by 62% in 2021 and 10% in 2022. Using these forecasts (and assuming a 10% growth rate in 2023) and conventional long-term multiples, we estimate that the United States sharemarket (as measured by the S&P500) is overvalued by between 36% in the near-term and 12% over the medium-term.

2021 calendar year forecast	EPS earnings estimates	S&P 500 fair value estimate	Over/(undervalued) S&P 500 = 4,308
Consensus	$199	3,178	36%
If 10% below	$179	2,860	51%
If 10% above	$218	3,496	23%
2022 calendar year forecast	**EPS earnings estimates**	**S&P 500 fair value estimate**	**Over/(undervalued) S&P 500 = 4,308**
Consensus	$218	3,485	24%
If 10% below	$196	3,137	37%
If 10% above	$240	3,834	12%
2023 calendar year forecast	**EPS earnings estimates**	**S&P 500 fair value estimate**	**Over/(undervalued) S&P 500 = 4,308**
Consensus	$240	3,834	12%
If 10% below	$216	3,451	25%
If 10% above	$264	4,217	2%

Source: S&P consensus estimates for 2021 and 2022 as at 10 June; 2023 is an assumption.

In contrast, forward Price-to-Earnings (P/E) multiples remain only slightly above longer-term averages in most other major markets, as follows:

Region	MSCI Forward PE[32]
All Country World (ex-US)	14.6
Emerging markets	14.2
United Kingdom	12.1
Japan	15.7
Euro Area	15.4
China	14.0

Conclusion

Recommendation: Retain slight underweight.

Over the next 12 months we expect corporate earnings to continue to rise on the back of the recovery in the global economy, albeit tempered by a likely further slowdown in China. We would not be surprised if stubbornly high inflationary expectations persist, in which case the Federal Reserve may well lift rates by the end of 2022. As asset prices are a function of aggregate expectations of the present value of future earnings, higher earnings will be partly offset by a higher cost of capital (that will effectively reduce the present value of the future income stream), potentially limiting sharemarket gains over the next 12 months to single digits.

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[32] Forward PE = price divided by 12-month forward consensus expected operating EPS.

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