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Economic and equities outlook: Summer of 2022/23 and beyond

Research & Insights

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What is the outlook for the economy and earnings in this environment of high inflation, rising rates, an energy shock and slowing growth? Ausbil's Executive Chairman, Chief Investment Officer and Head of Equities, Paul Xiradis (PX); and Chief Economist, Jim Chronis (JC) share their views and outlook for 2023.

Paul Xiradis
Executive Chairman,
Chief Investment Officer,
Head of Equities

Jim Chronis
Chief Economist, Associate Director – Debt and Diversifieds

Key points

- Major COVID stimuli, a resurging post-pandemic economy and an energy shock has seen inflation spike to recent records.
- Central banks have responded with rapid rate rises to pare back inflation. We believe inflation is on the way down now but it will take some time.
- Although the Australian economy is slowing on contractionary monetary policy, Australia's resource economy is well-placed to outperform other developed markets. Ausbil sees below-trend growth, but no recession in Australia.
- Australian equities on average have strong balance sheets, relatively low gearing and are expected to deliver single-digit earnings growth in FY23.
- Ausbil expects key sectors to offer strong EPS growth opportunities above consensus. There are also some quality leaders across the market that can deliver positive earnings growth, particularly those that have the capacity and ability to manage margins in a higher inflation environment.

Q: How is the Australian economy looking in 2023?

JC: In the noise of inflation, front-loaded rate increases and war, Australia remains relatively well positioned from the economic perspective due to its natural advantage as a net exporter of commodities. This is expected to continue into 2023, supporting the Australian economy to outperform other advanced economies on a relative basis. Domestic real GDP growth is forecast to slow into the range of 1.7% to 2.2% in 2023 (well below trend pace), the loss in activity momentum driven by rising interest rates and a slowing global backdrop.

Domestic confidence surveys have diverged between a robust business sector and a pessimistic consumer. Business forward orders remain supportive of domestic demand but consumer confidence has declined on rate hikes and cost of living pressures. Paradoxically, the consumer has a high degree of confidence in the labour market where the ratio of job vacancies to persons unemployed has fallen to a record low of 1:1. In summary, we do not see Australia entering a recession with the economy remaining close to full employment levels. That said, as the situation is fluid, we are watching the data very closely for any signs of deterioration, or any consumer stress that emerges with higher rates and the higher borrowing levels reached when cash rates were at record lows.

Globally, GDP is expected to remain positive, but on a much slower growth trajectory, pushing well below trend levels into the mid to low 2% range for 2023. Europe is materially weaker and flirting with recession, driven by the unpredictable risk from Russia and significant uncertainty as to whether Europe will have ample energy supplies next winter. The risk of a recession in the United States has risen with the tightening in financial conditions. We expect a below-trend growth rate in the range of 0% to 1% for the period ahead. A soft landing is the primary policy objective, but we expect a bumpy ride on the way with the US likely skirting recession as broadly defined by the US National Bureau of Economic Research, particularly given that we still have robust employment levels running well below the long-run estimate of full employment.

Q: Where are we in the inflation cycle?

JC: Inflation is a global phenomenon running at its highest rate in decades. Inflation has been driven by the interruptions to global supply chains; Russia's invasion of the Ukraine causing major disruptions to energy and food; and excessive demand fuelled by prior expansionary fiscal and monetary policies. Looking at the forward indicators on inflation – US goods inflation is falling as supply constraints are easing quickly and pipeline input pressures are falling. Meanwhile, US services inflation is rising and will have an upward bias over the near term, driven by the sizeable CPI basket weighting to the shelter component. This in spite of the leading indicators showing a recent turn lower in rental and housing prices. In summary, we believe inflation is peaking and over the medium term the path ahead is for a longer and gradual return to the upper central bank target levels. In the meantime, Central banks are focused on fighting persistent inflation and are willingly prepared to move policy settings to restrictive levels. The primary and only objective is to keep inflationary expectations well anchored despite the downside risks it presents to global economic growth. The US Federal Reserve's response to date has been the fastest tightening since the 1980s.

PX: Given the quantum of COVID stimulus unleashed in 2020, Ausbil had seriously turned our attention to the potential impact of inflation on earnings and markets as early as February 2021. Detailed work on inflation helped identify the sectors that would benefit from higher inflation (with a backdrop of positive economic growth) and rising rates. Conversely, we identified sectors to avoid. In terms of key positioning, Ausbil had set our portfolios to capture the opportunities that arose from inflation across 2021, and as such we were already positioned when the market began seriously worrying about inflation.

While we are seeing evidence that inflation may have peaked, and that the current tightening cycle is almost over, we are not convinced of the arguments for a Fed pivot at this stage. Rather, we see central banks holding rates once the tightening cycle is over. This is expected to last through 2023. Any rate cuts, if they do occur, are more likely in 2024. Looking ahead, we see a relief rally for quality stocks once the tightening cycle is seen to have ended, following which firms that can grow earnings in a slower economy will show some attraction. We also see some rerating of high quality, high free cash flow growth stocks that were caught in the inflation-driven rotation from 2021 to 2022.

Q: How are Australian companies going? Can you give us a post-reporting season update?

PX: FY22 delivered a strong earnings season, with FY22 EPS growth of +22% (S&P/ASX 200). This is on top +30% EPS growth in FY21, following the FY20 -19% EPS[1] decline experienced with the COVID crisis.

The Australian economy has been markedly resilient to date, even with the rising rate environment and the energy shock the world is experiencing. However, the Ukraine invasion has triggered an energy and food inflation shock in the context of the aggressive front-loading of global and domestic interest rate rises. In response, economic activity is slowing.

We saw the economy's strength reflected in earnings for FY22, but some uncertainty is likely in FY23. That said, with Australia expected to outperform other advanced economies, and trading conditions still strong, we see some companies still capable of delivering double-digit earnings growth, even if consensus is only expecting mid single-digit EPS growth for FY23 (S&P/ASX 200) as at mid-December.

Good Australian listed companies on average still have strong balance sheets, relatively low gearing, and enjoy an active and targeted consumer (particularly in leisure, travel and other service experiences). Australian resource companies are also benefitting from strong underlying demand for Australian commodities, from iron ore to lithium, base metals, rare earths, the energy complex, and even in soft commodities. Yes, there are inflationary pressures, and this will impact differently across sectors, though we see a range of quality leaders that are resilient in being able to pass these onto customers without impacting end demand.

Q: What about valuations? Are stocks expensive or cheap?

PX: With rising rates and a higher 10-year bond yield, stock valuations had shifted down across the board as a function of the time value of earnings relative to interest rates. However, the rising inflation that precipitated the rising rates outlook is not bad for all sectors, in fact we had identified those that benefit back in 2021 such as resources, banks, general insurers and energy. The additional volatility that came with the invasion of Ukraine, the energy shock and the inflation-driven monetary tightening has seen values come off more, to the point that a portion of the market looks oversold. Of course, opportunities become more relevant to us if earnings or positive revisions are better than what market consensus is expecting. In other words, even with lower valuations across the market compared to last year, we are still seeing superior earnings growth in a range of areas for FY23.

1. Source: Canaccord Genuity

Q: What do you see as being the main risks and opportunities in equities at the moment? Are you worried about inflation with respect to your outlook for equities?

PX: Looking ahead, there are a number of secular themes driving activity and sustaining higher inflation. These include decarbonisation and the shift to renewable energy, the shift from globalisation to regionalisation, sovereign security and energy surety. These drivers, including the expected strong post-COVID Chinese recovery in 2023, are very supportive for a range of commodities in which Australia is dominant, providing a platform for higher commodity prices and hence earnings for the wider resources sector.

The relative outperformance expected for Australia's economy compared to advanced economies is also offering opportunities. Across a number of sectors, quality leaders that have relatively low elasticity of demand and can pass on the costs of inflation are offering earnings growth across the cycle. Finally, as the economy slows, there are opportunities in businesses that can deliver earnings growth across the economic cycle, be they in consumer staples, health care, specialist real estate or in companies with relatively unassailable global businesses for which there may be little competition, but significant pricing power.

We are still seeing risk in sectors that are too cyclical, over-exposed to slowing economic growth, and whose earnings are adversely impacted by inflationary pressures. This includes construction and housing, and retailing and discretionary sectors generally, particularly those that are consumer facing.

Q: What is your outlook for equities looking forward?

PX: Market volatility, and concerns around inflation and rate rises remain an issue, but some clear caution in the rhetoric of central banks has given some hope that the hard steps may have already been taken in the battle against inflation. We are expecting more caution, perhaps even a pause in 2023, around rate rises as central banks look at the data for feedback on how successful they have been to date in the arrest of inflation. That said, we believe the bulk of the monetary tightening has already occurred.

We have clearly entered a period of slowing growth. However, given the relative strength of the Australian economy, the demand for our resources, low unemployment, and the current strength in the job market, Ausbil does not currently see Australia entering recession.

We think earnings growth will be hard to come by in 2023, but there will be some clear opportunities. Given the inflationary environment we are still in, resource companies generally (including energy and gold), general insurers and select diversified financials are expected to deliver positive earnings growth again in FY23, some delivering upward earnings revisions yet to be recognised in the consensus outlook. Quality leaders across the market, particularly those with relatively inelastic demand and the capacity to pass on inflationary rate costs are also expected to deliver superior earnings growth in FY23.

Conversely, we are expecting earnings downgrades in sectors where demand profile and margins are adversely impacted by higher cost inflation, rising funding costs, and a slowing economy. These include housing and construction, retailing, consumer discretionary and media.

In terms of preparing our thinking, today is when we need to be considering what sectors will benefit as inflation falls back, when central banks have ceased raising rates, and looking for the seeds of the next expansion. The complex issue is, when does this occur? Regardless, while we believe earnings growth in 2023 will undershoot the last two years, there are companies with earnings upside that are yet to be appreciated by consensus. There are also quality leaders whose earnings are immune to the vagaries of the cycle. This is where we are seeing the potential for outperformance in FY23.

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