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Insights from the CIO Office

June 2024

Key Messages for Investors

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- We are in the late stage of the economic cycle with economic growth in Australia moderating to 1.1% year-on-year in the March quarter, well-below trend.
- With consumer spending accounting for 50% of Australian GDP, understanding the health of the Australian consumer is key to understanding how this cycle may ultimately play out.
- Over the last year we have observed a 'two-speed consumer' whereby the impact of higher rates and cost-of-living crisis has disproportionately fallen on the younger cohort.
- Those under the age of 44 have already cut back significantly on their discretionary spending.
- The older, wealthier cohort have so far continued to spend. Benefiting from higher cash rates on savings and less debt, the above 55-year cohort in particular, have been increasing their spending on discretionary items.
- We think this older cohort will be key in determining how this cycle plays out. While they are still spending, we think the 'soft-landing' scenario remains most likely.
- Upcoming Stage 3 tax cuts and announced budgetary measures to support the younger cohort with cost-of-living pressures add additional weight to our view.

Economic growth is below trend and slowing

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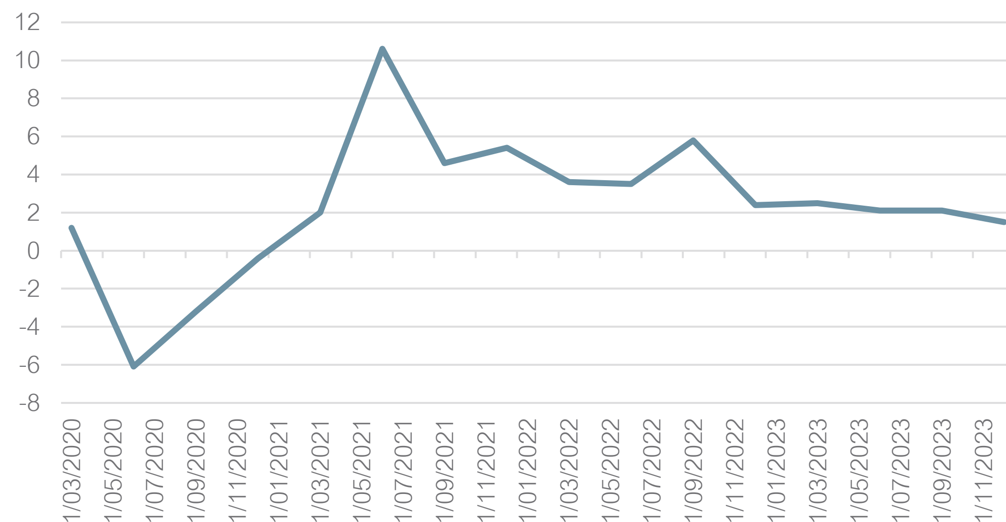
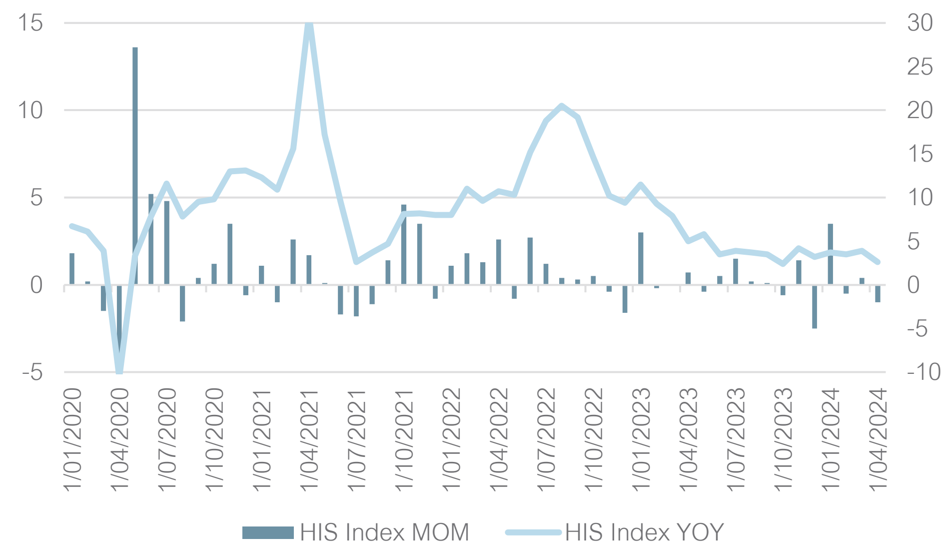
This is consistent with being late in the economic cycle

Australia GDP YoY (% change, seasonally adjusted)



- We are in the late stage of the economic cycle with economic growth moderating to 1.1% YOY in the March quarter, well below trend. With inflation remaining sticky and RBA rate cuts unlikely this year, is a 'soft-landing' scenario still plausible?
- Understanding the health of the Australian consumer provides an insight into how this cycle might end. Consumer spending forms the largest component of Australian GDP at close to 50%.

CBA Household Spending Index (YOY % change, seasonally adjusted)



- Household spending has weakened with consecutive rate rises and cost-of-living pressures beginning to take their toll on the consumer.
- The CBA Household Spending Index (HSI) weakened materially in April from 3.9% to 2.6% YOY. Spending on food and beverages, hospitality and recreation have led the declines.

Source: CBA, Bloomberg

Not all consumers have been impacted evenly

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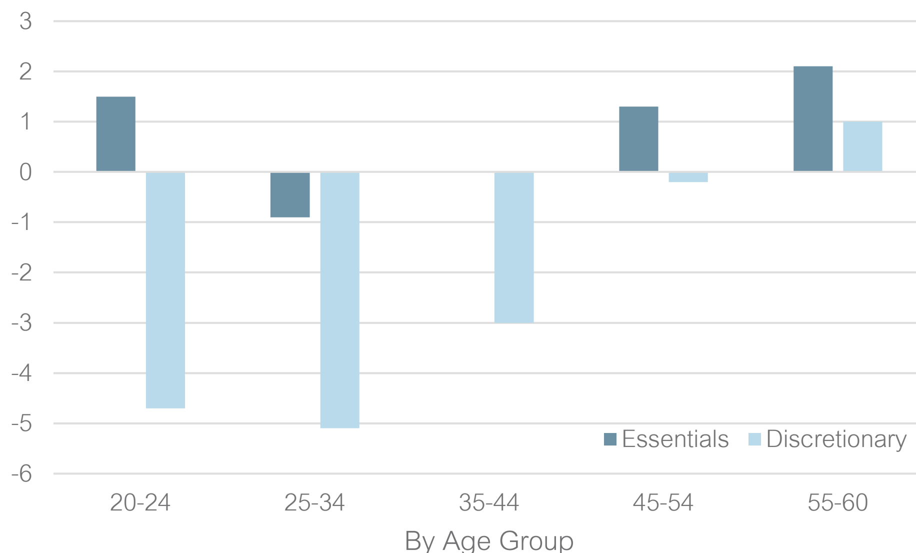
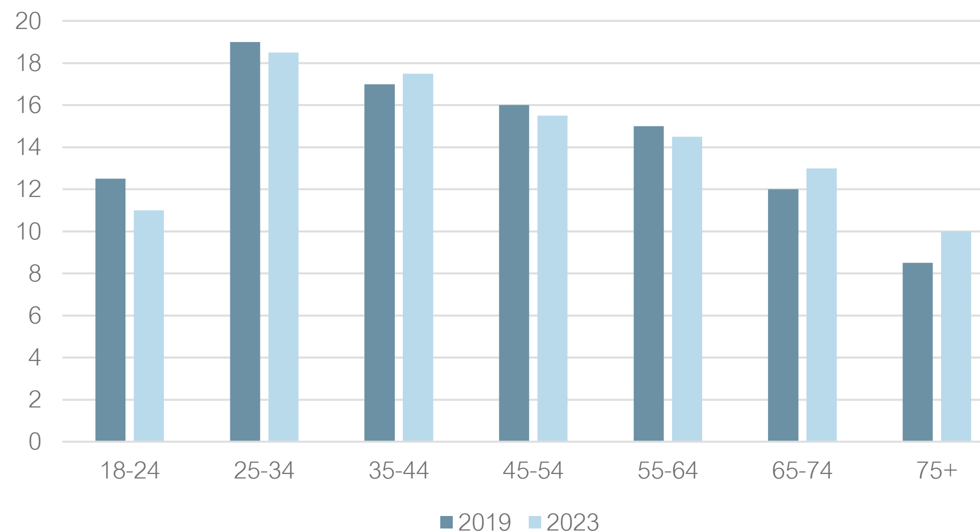
Tight monetary policy has impacted age cohorts differently





- The impact of higher rates and rising cost-of-living pressures have fallen disproportionately on the younger cohorts (44 years and under) who have, by necessity, cut back significantly on their discretionary spending over the last 12 months.
- In stark contrast, the older, wealthier cohort have continued to spend. Benefiting from higher cash rates on savings and less debt, the above 55-year cohort in particular, have been increasing their spending on discretionary items.

- The 45-year and above cohort now accounts for 53% of the population (up from 51.5% in 2019). They have more wealth, higher incomes and importantly, are still spending. This cohort have weathered higher interest rates well, underpinning the relative resilience of the Australian economy to date.
- We think this cohort will be key in determining how this cycle plays out. While they are still spending, we think the 'soft-landing' scenario remains most likely.

Source: Westpac, ABS, CBA.

Household spending by homeownership type paints a similar picture

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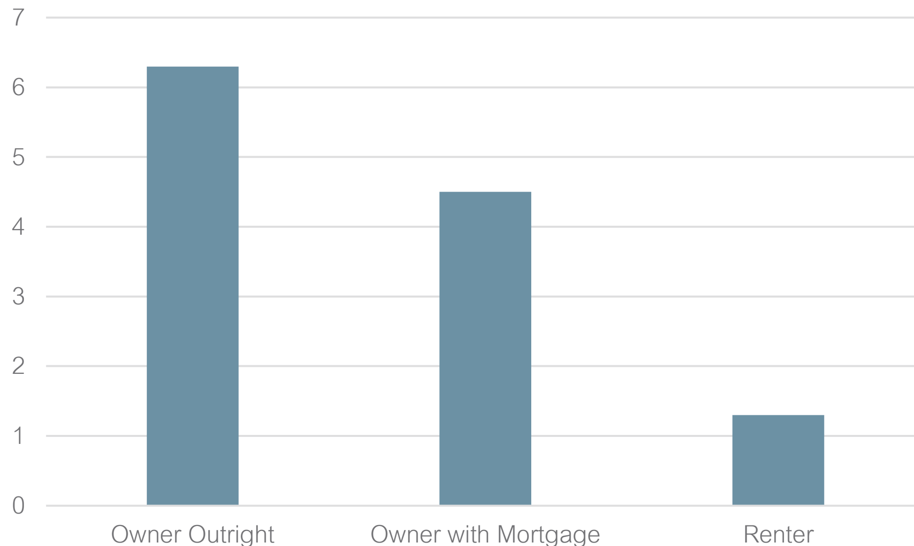
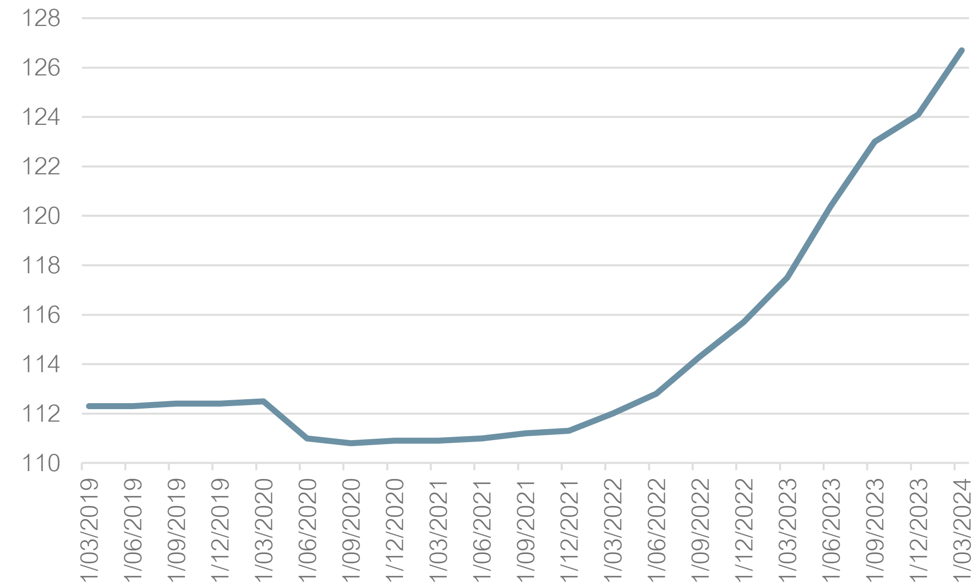
Restrictive monetary policy is impacting cohorts differently

Household spending by homeownership group April 2024 (Annual % Change)



- Seen through the lens of homeownership type, a similar picture emerges. Those who own their homes outright (typically the older, wealthier cohorts) have increased their spending by 5X that of renters over the last year.
- Higher cash rates on savings, solid equity market returns, and rising property prices have boosted the 'wealth effect' for both outright owners and to a lesser extent, owners with mortgages.

Australia CPI Rent Index



- Renters on the other hand, are doing it tough. Rents have risen 8% YOY to March 2024 on the back of a 5% increase the year prior.
- Renters, typically younger cohorts, have reduced spending on recreation, hospitality, food & beverage goods and household services over the past year. Renters typically devote a large share of their wallet on these items, highlighting the very real stresses being experienced by this cohort.

Source: CBA, Bloomberg.

Mortgage holders may be the swing factor

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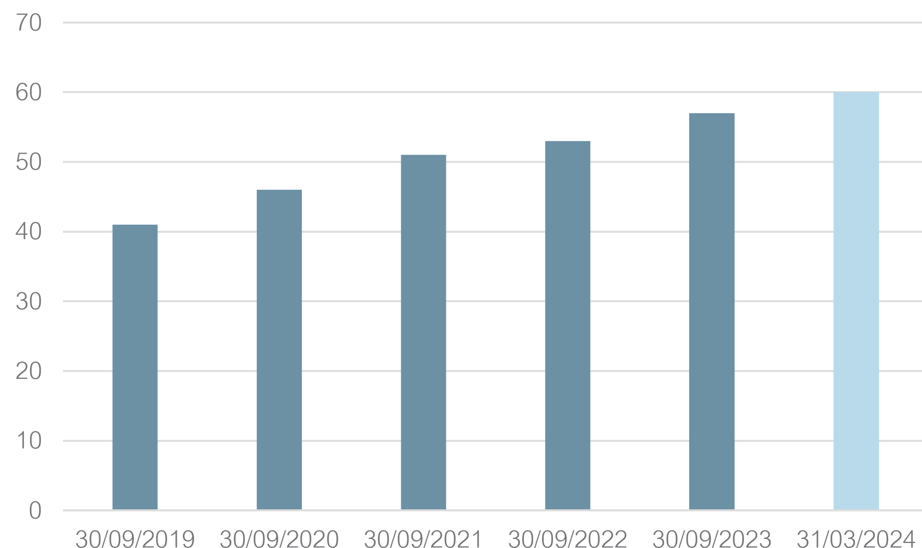
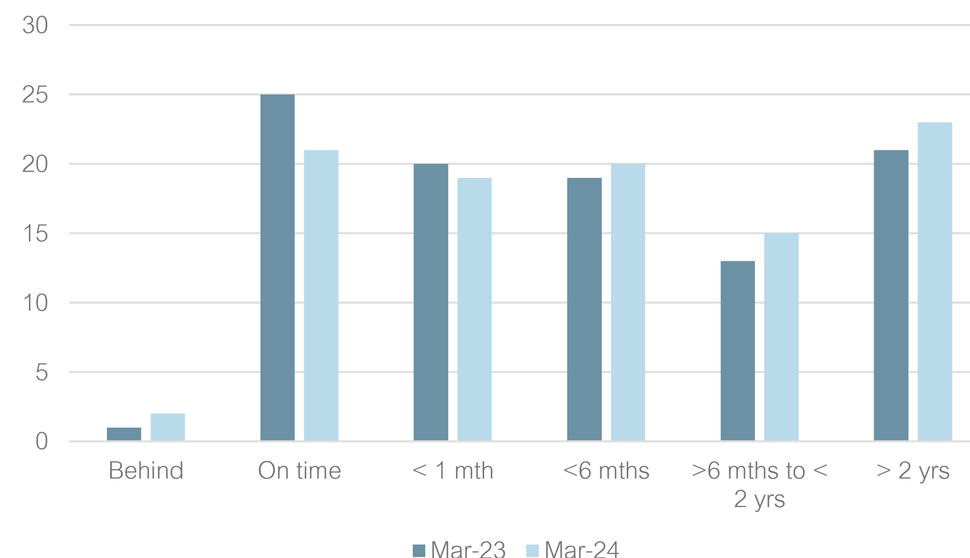
Mortgage holders have shown resilience thanks to high buffers in offset accounts

Westpac Offset account balances ($Bn)



- Mortgage holders have so far been surprisingly resilient to much higher rates as significant buffers have been built up in offset accounts in recent years.
- There is now $60bn sitting in offset accounts according to Westpac.
- Customers remain ahead on their repayments with no significant deterioration in customers' ability to service their mortgage debt despite 13 rate rises.

Westpac Customers ahead on repayments (% by balances)



- The labour market remains key here. While this cohort remains employed, they are managing to service higher interest costs. However, mortgage holders will not be immune to higher rate environment indefinitely.
- If we did see a deterioration in offset account buffers or an increase in customers falling behind on their repayments, that may be an indicator of a more serious economic slowdown ahead. While this is not our base case, it is something we are monitoring closely.

Source: Westpac

Outlook and Positioning

We remain in the "soft landing" camp. Central Banks should be cutting interest rates, but sticky inflation will temper the pace. We are broadly neutral from an overall growth/defensive split.

Growth Assets	Underweight			Neutral	Overweight		
Australian Equities				●			
Large Caps				●			
Small Caps				●			
Developed Market (DM) Equities				●			
Large Caps			●				
Small Caps					●		
Emerging Market (EM) Equities				●			
Australian Listed Property				●			
Global Listed Property				●			
Global Listed Infrastructure			●				
Growth Alternatives				●			

Defensive Assets	Underweight			Neutral	Overweight		
Australian Bonds					●		
Global Bonds				●			
Diversified Income				●			
Conservative Alternatives				●			
Cash				●			

Growth Assets

- Growth assets should continue to do quite well under a 'soft landing' scenario.
- We prefer DM Small Caps over DM Large Caps. Small caps typically move ahead of the turn in the economic cycle. US Small Caps, in particular, could move with the Fed starting its easing cycle later this year.
- Global Listed Infrastructure. We see better risk/return opportunities in other asset classes for those seeking yield or capital appreciation.

Defensive Assets

- Australian Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios. Focus on long-duration assets.
- Global Bonds. Supply/demand imbalances in the US treasury market remain a focus, reducing their relative preference versus Australian government bonds. The end of YCC policy in Japan should lead to an extended period of relative underperformance in Japanese Government Bonds.
- The potential start to an easing cycle reduces the relative attractiveness of floating rate yields.
- We maintain an allocation to gold which acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.

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