

Impact of Rising Rates Yet to Fully Play Out

As the impact of monetary policy tightening is yet to fully play out in the real economy, there is a real risk to further slowing in economic growth and corporate profits globally and in Australia.

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When people have multiple health issues, the brain tends to prioritise and focus on resolving the most acute pain first, before attending to other less important issues. An analogy that can be applied to the current market turmoil. The recent banking crises has been an acute pain point for financial markets and has been the primary focus for investors, central banks and regulators. As the intensity of the banking pain subsides, market participants will likely refocus on other less acute economic health issues. However, based on history there may be some further issues.

Figure 1 shows the Federal Funds Effective Rate since 1955 and periods of economic recession. It highlights the unfortunate truth that most rate hiking cycles tend to be followed by recession. It highlights the difficulty faced by central banks when using monetary policy to control inflation.¹ Even when recession is avoided, a slowdown of some extent is expected.

Figure 1: US Federal Reserve Interest Rates and US Economic Recessions



Source: <https://fred.stlouisfed.org/series/FEDFUNDS#>, Federal Reserve Economic Data, (FRED). Shaded areas indicate U.S. Recessions. Data as of 01.02.2023

In comparison to other rate hiking cycles this current one has been:

- one of the fastest and intense
- global in nature with most developed markets tightening to similar degrees.
- a change from close to zero rates after a prolonged period of very low rates (average of 0.51% from Jan 2009 to Jan 2022) and
- at the end of a 40 year period of rates declining. Short rates have been in broad decline since 1981 as shown in Figure 1.

Changes in long term established trends tend to be more destabilising. The longer a trend remains in place the more we accept that it will be the case and build that assumption into our lives. So the disruption to this current 40+ year down trend may still create further economic consequences as the lagged impact of higher rates plays out.

So far the Australian equity market has been one of the best performing markets in the world and has been reasonably insulated from global markets. Figure 2 highlights the almost flat performance of the Australian S&P/ASX 300 Index, down only -0.3% compared to the MSCI World Index (-11%). It also highlights the underperformance of the US banks, the relative outperformance of the Australian banks and the positive +9% return from iron ore and steel stocks. The Australian equity market has a large concentrated weight to both iron ore and steel companies as well as the banks.

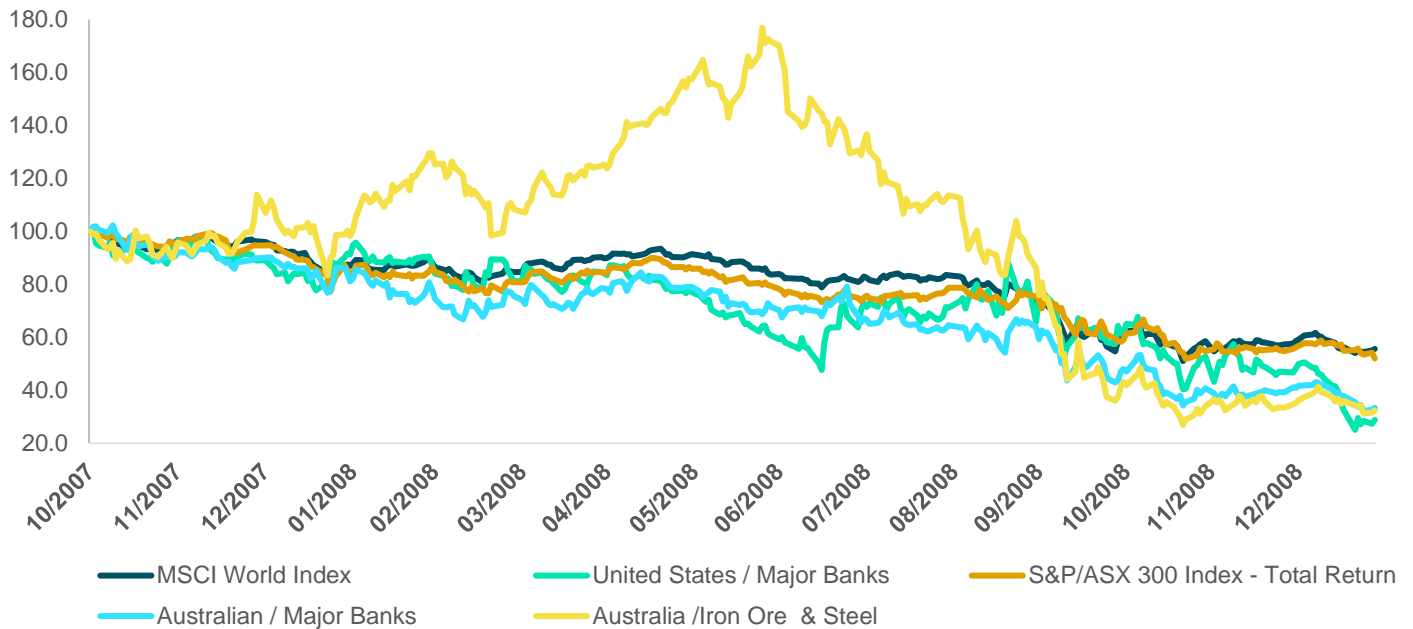
Figure 2: Relative Performance of Select Indices and Industries (31/12/2021 to 30/3/2023)

	MSCI World Index	United States / Major Banks	S&P/ASX 300 Index	Australian / Major Banks	Australian / Iron Ore & Steel
Total Return*	-11%	-25%	-0.3%	-9%	9%

Source: State Street Global Advisors, FactSet. *Total Return for Indices (MSCI World Index and S&P/ASX 300 Index) and FactSet industry classifications (US major Banks, Australian Banks, Australian iron ore and steel) from 31/12/2021 to 30/3/2023. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

In the early stages of the Global Financial Crisis (GFC) the iron ore and resource related companies outperformed as indicated in Figure 3, but as the global slowdown spread, the global resource companies also derated.

Figure 3: Relative Performance of Select Indices and Industries During the GFC Period (30/10/2007 to 28/02/2009)



Source: State Street Global Advisors, FactSet. *Total Return for Indices (MSCI World Index and S&P/ASX 300 Index) and FactSet industry classifications (US major Banks, Australian Banks, Australian iron ore and steel) from 30/10/2007 to 28/02/2009. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

The Bottom Line

The impact of monetary policy tightening is yet to fully play out in the real economy and there is a real risk to further slowing in economic growth and corporate profits globally and in Australia. The Australian economy has proven resilient to date but is not immune to rising interest rates especially in the rate sensitive Australian housing market

Footnotes

¹ The impacts of the tightening operate with long lags, with other interaction effects and come with much uncertainty.

Disclosure

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