FNCE 102: Financial Markets and Instruments

AY 2022/2023 Term 2

Australia Equity Market

Prepared for: Dr. Karen Gan

Section G8, Group 5

Name	Metric
Khoo Jinying Crystal	01440523
Kohchet-Chua Dean Cedric Lopez	01404709
Ly Meileang	01407635
Oliver Tan Teng Wee	01371569
Shona Yap Woon Hwee	01387182
Sithi-Rukaiyaa Arssath	01475171

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Executive Summary

This report seeks to understand the intricacies of the Australian equity market and explore the impact of various significant events on the Australian equity market over the past 2 decades. This includes the 2008 Global Financial Crisis, the 2000s-2010s Mining Boom, the 2019 COVID-19 Pandemic, the 2020 China Real Estate Crisis and the 2021 Australia – Chinese trade tensions. In particular, we examined how the ASX Index (S&P/ASX 200) has reflected market sentiments towards the events above and the effect on the economy as a whole.

Despite current market volatility and bleak economic conditions as we enter 2023, we see a bearish short-term outlook for the Australian equity market against rising inflation, interest rates and its housing crisis. However, The Lucky Country has a proven track record of a resilient economy that supports the potential long-term upside in the attractiveness of the valuation of the Australian equity market, especially in its commodities markets and managing headline inflation compared to its European and US counterparts.

1. Introduction

1.1 Introduction to Australia Securities Exchange (ASX)

The Australia Securities Exchange (ASX) is Australia's primary securities exchange platform. It operates as a market for trading equities, fixed-income products, derivatives, and other financial instruments. It is headquartered in Sydney and is one of the oldest stock exchanges in the world. It was founded in July 2006 because of the merger of the Australian Stock Exchange and the Sydney Futures Exchange, and according to market capitalization, it is among the top 10 listed exchange companies globally (ASX, n.d.).

The ASX plays a crucial role in the Australian economy, providing investors access to various financial products and enabling companies to raise capital through equity and debt offerings. The ASX operates a range of market indices, including the S&P/ASX 200, which tracks the performance of the top 200 companies listed on the exchange (ASX, n.d.).

To be publicly listed on ASX, companies must meet specific eligibility criteria outlined in the ASX Listing Rules. Some key criteria include: 1. Structure and Size: The company must be incorporated under the Australian Corporations Act, have at least 100 shareholders, and have a minimum of $4 million in net tangible assets. 2. Financial Performance: The company must meet specific financial performance standards, such as having a minimum operating profit of $500,000 in the last 12 months and a positive net profit after tax for the last three full financial years. 3. Compliance: The company must comply with all legal and regulatory requirements, including environmental, occupational health and safety, and anti-corruption laws (ASX, n.d.).

2. Structure of AU Equity Market

2.1 Current Size

As of 21 March 2023, the ASX has 2085 listed companies with a combined market capitalization of around AUD 2.7 trillion, making it one of the largest exchanges in the Asia-Pacific region.

2.2 Breakdown of ASX Index by Sector and Share Type

The ASX market can be separated into 11 GICS Sectors (Appendix A). The materials sector has the highest representation, up to 40%, followed by the financials and healthcare sectors, which amount to 9% each.

2.3 Key Players

The Reserve Bank of Australia (RBA) is Australia's central bank and is responsible for conducting monetary policy, issuing and managing the country's currency, and promoting financial stability. Australian Prudential Regulation Authority (APRA) is Australia's primary financial regulator responsible for regulating banks, insurance companies, and superannuation funds to ensure their safety and soundness. Australian Securities and Investments Commission (ASIC) is Australia's corporate, markets and financial services regulator. ASIC ensures compliance with corporate and financial services laws, including market integrity and consumer protection. Australian Treasury is the department of the Australian Government responsible for economic policy development and implementation, including fiscal policy, tax policy, and financial sector regulation (IMF, 2019).

2.4 Risk and Returns

2.4.1 ASX 200 Performance Comparison against TSX60

Furthermore, we analysed the historical stock prices over a five-year period, starting from January 2018 to January 2023, to better understand the Australian Stock Exchange juxtaposed against the Toronto Stock Exchange (TSX).

The graph depicts the overall trends of both stocks, which move somewhat similarly (Appendix B). Both indexes experienced a stark decline in early 2020, which can be linked to Covid-19, where prices started to fall across all sectors, as policies were then put in place to cushion the impact of the pandemic (Johnson et al., 2022). However, both indexes were able to gradually recover as Australian banks claimed to have had their "best year" since 2013 post-pandemic (Garg, 2021), and the TSX200 was capable of rebounding through positive management, being able to navigate back to pre-Covid levels (Hugessen, 2021).

2.4.2 Australia Securities Exchange Top 5 Market Capital Companies

The top 5 companies in the ASX currently are BHP Group Ltd, Commonwealth Bank of Australia, CSL Ltd, National Australia Bank Ltd and Westpac Banking Corporation. These companies are established firms across the materials, financial, and healthcare sectors. Analysing our Single Index Model for Australia Securities Exchange results (Appendix C), the correlation of this portfolio with ASX is 0.92794 and 86.11% of the portfolio's returns can be explained by the market, signaling that the regression line fits the actual data strongly. The portfolio alpha (-0.03063) and beta (1.07893) are both statistically significant since the p-value is less than 0.05 (Appendix C).

2.5 Trading Composition of the ASX

The ASX market is comprised of various investors, whether it be retail, domestic, or foreign. In the average register, the breakup is as follows (Ellis, 2019):

68% of the market capital is from Australia, 35% is from institutional investors, and 33% is from retail investors.

The market capitalisation distribution on ASX can be influenced by the larger listed companies, which hold more weight. Australia still holds the largest share of the average ASX 200 (70%), with institutional investors making up 43% of the total and retail investors holding 27%. However, North America remains the largest share outside of Australia at 15% of the issued capital.

3. Key Events Impacting AUS Equities Market: Historical Crisis

3.1 Global Financial Crisis (GFC) (2008)

3.1.1 Overview and Resilience of the Australian Financial Market

The GFC of 2008 was triggered by the ongoing US subprime mortgage problems in 2007 and intensified in September 2008 after the collapse of the Lehman Brothers (Michelis, 2009). It was considered the most significant downturn since the Great Depression.

Interestingly, Australia did not experience a technical recession during the GFC due to 3 main reasons; Australian banks were not directly affected by the sub-prime crisis in the US due to minimal exposures to the US housing market and US banks (Thomson Reuters, 2008). In addition, a sound and liquid banking system by the Australian Prudential Regulation Authority (APRA) maintained higher lending standards and higher capital charges for non-conforming loans (Bloxham & Kent, 2009). Thus, these standards imposed by the APRA ensured less exposure to such risky assets. Last, a crucial factor working in Australia's favour was China's demand for Australia's natural resources, which had high revenue exposure to China during the GFC, as governments often turn to infrastructure spending as a fiscal measure to expand economic growth in an economic downturn. At the end of 2009, China's YoY infrastructure investment skyrocketed to 54% from 10% the previous year (Tsui, 2011). The spending helped resurrect economic growth during the lows of the GFC. As a result, Australian commodity export prices soared, boosting Australian resource companies and cushioning its GDP.

Although the Australian financial markets proved a bulwark against the global economic storm, it was, however, not entirely immune to the spillover effects of the crisis.

3.1.2 Impact

First, there was a reduction in demand for Australia's exports and the exchange rate. Australia's total merchandise trade decreased by 11.6% in 2009; the first export fall was experienced from 1964 to 1965. Exports fell by $27.4 billion or 12.2% to $196.9 billion from their record peak in 2008 of $224.3 billion (Priestly, 2013). The fall in the value of total merchandise trade cut 0.04% off GDP the growth rate of 2.3%; terms of trade fell by around 10% over the December 2008 and March 2009 quarters, mainly reflecting movements in prices key commodity exports (McDonald & Morling, 2012). The Australian dollar fell from $0.98 US in July 2008 to $0.60 in October 2008 (D'Arcy & Poole, 2009).

Second, there was a collapse in capital flows, especially private foreign investment in Australia contracted sharply over 2008 from a historically high level relative to GDP and showed more volatility in capital flows to AU since the beginning of the subprime crisis (RBA Bulletin, 2009). This was mainly attributed to increased risk aversion among investors, leading to a global fall in cross-border investment activity after several years of rapid growth. Not only was it difficult for borrowers to obtain funding in international markets, but many international investors repatriated existing offshore investments. The crisis induced a temporary bout of 'home bias' among global investors (D'Arcy & Ossolinski, 2009).

Last, by the end of 2008, business and consumer confidence had fallen dramatically due to news releases about the pessimistic outlook for the US economy after Lehman's bankruptcy, Merrill's sale, and AIG's rescue (Wilchins & Somerville, 2008). Business conditions were at their lowest level since the 1990-91 recession. Meanwhile, domestic spending weakened through a contraction in household consumption with a dramatic increase in the household savings rate from 1.2% in the March quarter of 2008 to 8.5% in December 2008 (Lowe, 2011). Furthermore, the unemployment rate rose from 4.1% in February 2008 to 5.8% in August 2009 (Plumb & Spence, 2010)

Overall, the ASX 200 plunged by more than 54% from the historical peak of 6,851.5 in November 2007 to 3,145.46 in March 2009, and its market capitalisation fell by 19% from \$1.5 trillion to \$1.2 trillion at the end of 2008 (S&P Capital IQ, 2023). The sharp decline in equity prices drove down the P/E ratio of the ASX 200 by 52.69% from 22.5 on 1 January 2007 to 10.6 on 1 January 2008[1].

[1] https://companiesmarketcap.com/asx/pe-ratio

3.1.3 Timeline of Government's Response

In response to the GFC, the Australian Government acted swiftly to cushion the impact of the GFC on the economy through 3 strategic steps. The first significant macroeconomic policy came from the RBA in reducing interest rates. On 7 October 2008, the RBA dramatically cut interest rates by 100 basis points to stimulate demand (Reserve Bank of Australia, 2009). The cash rate target dropped from 7 percent in September 2008 to 3.25 percent in the first quarter of 2009 (Thomson Reuters, 2009). Second, on 12 October 2008, the Australian Government introduced The Australian Guarantee Scheme for Large Deposits and Wholesale Funding, guaranteed deposits of up to $1 million held by deposit-taking institutions to reassure depositors of the security of their funds and to ensure that banks' access to capital markets was maintained (Schwartz & Tan, 2016). Thirdly, to alleviate the contraction in private spending, the Government introduced an initial stimulus package and injected $10.4 billion in October 2008 and a further stimulus package of $42 billion in February 2009. 30% of this spending was directed to pensioners and low-income families through cash bonuses, $29.4 billion to infrastructure projects and $1.5 billion to support housing construction (Taylor, R. 2009).

The overall responses and prompt actions taken by the Australian Government and the RBA looked to bolster confidence in authorised deposit-taking institutions (ADIs) and minimise the impact of financial distress due to a shortage of funding (International Monetary Fund, 2012). The aim was to promote the stability of the Australian financial system and an ongoing supply of credit to the economy, successfully ensuring that Australia did not experience a significant economic downturn during the GFC.

3.2 Australia’s Mining Boom (2000s-2010)

3.2.1 Overview

China was going through industrialization in 2000 and required a lot of raw resources to build and manufacture. Many of its economic drivers are due to an increase in the manufacturing, real estate, and construction sector, and they require a lot of their raw materials from Australia. This caused iron ore volume exports in Australia to grow an average of 23% from 1999 to 2011 due to increased demand from China, while mining had doubled its GDP share. As many mining companies rushed to increase output to sell to China, this triggered a huge influx of China investments as they wanted to ensure a steady stream of resources. This caused the total Australia’s share of export value of coal and iron ore to increase by 10% from 2000 to 2010. The rampant increase in demand and the subtle supply to meet it had caused iron ore prices to skyrocket 437% since 2000.

4. Events: Modern Crisis

4.1 COVID-19 (2019-present)

4.1.1 Overview

The outbreak of the Coronavirus Disease, also known as COVID-19, impacted the global economy to an extent last seen during the Global Financial Crisis of 2008. Australia recorded its first COVID-19 case on 25 January 2020, resulting in Australia's nationwide lockdown on 23 March 2020 (Australian Bureau of Statistics, 2022). Australia closed its borders, instilled social distancing measures, temporarily closed businesses until early May. However, the lasting effects of the pandemic continued with regional lockdowns and the introduction of the Delta and Omicron Variants.

4.1.2 Economic Impacts

In 2020, unemployment rates rose from 5.7% in March to 7.4% in June, with an estimated net loss of jobs equalling 871,000. Consumption expenditure declined by 12.5% during the quarter of June, and GDP growth was around –7% (Lim et al., 2021). The COVID-19 Pandemic had long-term repercussions for various sectors of Australia, including trading, tourism, and hospitality sectors.

Australia's trading sector took a significant hit due to world trade declining. Exports contracted by 11% and continued to decline even when imports were rising, showing weak domestic demand. Likewise, Australia's tourism industry was disrupted by the COVID-19 Pandemic (Bruno et al., 2022). By April 2020, the country's international tourist arrivals had dropped by 90% due to COVID-19 restrictions. The hospitality sector was hit the hardest, as jobs dropped the most due to abruptly disrupted tourism and domestic business, decreasing jobs by 31.4% or about 371,000 (Lim et al., 2021).

4.1.3 Impact on the Equity Markets

The impact of the pandemic hitting many of Australia's sectors affected the Equity Prices in Australia. The S&P/ASX 200 dropped by 35% below its peak on 20 February. (Johnson et al., 2022). Analysing the ASX 200 even further, it is evident that the equity prices became more volatile, almost quadrupling the daily absolute price changes compared to past years. Turnover rates also increased, and more investors were buying and selling shares due to the pandemic's impact on domestic businesses and households. This is due to the increased uncertainty in the global financial markets that reduced investors' confidence in the stock market, which led to more investors selling shares remaining liquid during these times (Johnson et al., 2022).

From March to June 2020, listed firms raised large volumes of equity funding via secondary issues. However, there were few initial public offering (IPO) listings. The lack of domestic revenue and unfavourable economic conditions heightened the risk-averseness of many individuals and companies; many were reluctant to invest in IPOs because it was considered riskier (Sedlacek & Sterk, 2020).

4.1.4 Government Response

The government played an essential role in mitigating the impact of the pandemic. First, the government committed over $314 billion in direct economic support (Australian Government DISR, 2022). Tax debt relief was also provided, allowing tax money to flow into the economy to boost domestic consumption.

Moreover, the government implemented JobSeeker Wage Subsidies and supplement schemes to helped to maintain employment levels and support business payrolls (Klapdor & Giuliano, 2020). The scheme disbursed payments of A$89 billion through end-March 2021 (IMF, 2021). Likewise, with the help of ASIC, it announced it would expand and expedite the existing economic hardship access arrangements, allowing individuals and sole traders to access up to $20,000 of their superannuation (Australian Government DISR, 2022). Insolvency relief measures for businesses were also put in place to help protect and restructure the liquidation of small businesses.

Aside from the government, the RBA introduced various policies to support financial institutions. First, the RBA cut target rates by double, and the overnight cash rate was cut to 0.25% in March 2020 and further reduced to 0.1% in November (IMF, 2021). Furthermore, the RBA ensured market liquidity by conducting longer-term repurchase agreements and broadening the range of eligible collateral for open market operations.

The RBA established a A$90 billion term funding facility in March 2020 to give banks access to three-year funding at 25 basis points until September 2020 to support the provision of credit (Parliament of Australia, 2021). Moreover, when demand for government bonds was low, the RBA announced secondary market purchases of A$100 billion to support the financial institutions (IMF, 2021). Because of the government response, risk premiums, risk-free rates, and the weighted average cost of capital (WACC) rebounded to pre-COVID-19 numbers by the end of 2020.

4.2 Australia-China Trade Tensions (2020-2021)

4.2.1 Overview

The Australia-China trade war consisted mainly of China's one-sided sanctions on Australian exports. One of the reasons attributed to Australia's lack of response was the country's dependence on trade with China as the largest trading partner, which accounted for 1/3 of the country's total export (Carpenter, 2021). The situation was exacerbated by the COVID-19 pandemic as the Australian government questioned China's involvement with the virus.

4.2.2 Timeline

The first significant discord between the two countries was Australia's ban on the Chinese company "Huawei" from its 5G network in 2018 (Reuter, 2020). Following the event, China started an anti-dumping investigation on Australian barley, which resulted in an 80.5% tariff (S&P Global,2022). In the subsequent months, Australian coal also encountered administrative difficulties, which was a part of China's non-trade barrier strategy. In 2019, coal exported to Australia was worth $13.8 billion. From 2 November onwards, the Chinese government also discouraged local factories from importing

Australian commodities such as cotton, sugar, timber, etc. (Geopolitical monitor, 2023). Cotton, which China usually imports 65% from Australia, was threatened with a 40% tariff (Sullivan & Barbour). As of May 2021, China still had an unofficial ban on Australian coal, with no import records since Dec 2020. This has made it more difficult for China to source coals from other countries, such as the USA, which was 34% more expensive. Nevertheless, China was still reliant on Australia in terms of Iron ore. In June 2021, iron export accounted for 80% of total export to China (Geopolitical monitor, 2023). In Nov 2022, both trade ministers requested a meeting to alleviate the restrictions. Finally, in Jan 2023, China partially lifted its unofficial ban on Australian coal , easing trade between the two countries.

4.2.3 Impact

Due to Australia's reliance on export to China, imposing tariffs and sanctions by China has resulted in enormous losses for Australian exporters. Tracking commodity prices YoY between 2019 and 2022, there was a decline between late 2019 and early 2021 (Appendix L), which indicates that export value was negatively impacted as the price can usually explain ¾ of the export since 1990 (Trading economics, 2023).

The ASX also felt the impact on export, reflecting the policy changes over time. It is evident that towards the end of 2018, there was a persistent decline in value of up to 13% of the ASX (Appendix M), and one of the possible reasons for this is the anti-dumping investigation by China on Australia. At the start of 2020, there was an even steeper decline in the Index value mainly due to the COVID-19 pandemic and the strain on the relationship between the two countries. Soon after, the Australian Index was hit with more negative news when the Chinese government informed local producers to stop purchasing Australian commodities such as cotton, reflected in the fall in price between Sept-Nov 2020. Nevertheless, the most traded commodity, iron ore, remained high since China is heavily dependent on Australian iron. Even with its restriction on iron in Dec 2020, the impact on ASX was minimal, partly due to the importance of iron for the Chinese economy.

Australia has also established relationships with other EM, such as Indonesia, Vietnam, and India, by entering into the CPTPP and RCEP trade agreement in Nov 2020 to diversify its export destination and avoid an over-reliance on China, helping stabilize the ASX value (S&P Global, 2022). Regarding coal export, Australia found other destinations such as Japan, South Korea and other Asian countries which protected coal export (Geoscience Australia, n.d). As the trade war subsided and both countries reached an agreement at the end of 2022, the ASX recovered to its initial position.

4.3 China’s Real Estate Crisis (2021)

4.3.1 Overview

Evergrande is one of China's largest property developers. Due to its massive debt burden, the company has been facing financial difficulties. When the company defaulted on its debt obligations and entered bankruptcy proceedings, this led to a steep decline in demand for commodities such as metals, concrete, and copper used in infrastructure projects (The Guardian, 2022).

4.3.2 Impact on the Australian Commodities Market

China mines many of the commodities they import, such as Iron, Coal, Zinc, Gold, Copper, Lead, Tin, Tungsten, and Nickel (Commodity, 2022). They import a total of 42% crude oil, 27% iron ores, and 10% gas (Appendix H). China imported commodities take up 13.3% of total imports, and the top 3 countries these imports mainly originate from Asia-Pacific, Australia, and Brazil (Appendix I). China's largest GDP contributors are construction, manufacturing, and energy. The key resources required by those sectors are mostly metals (30-40%), energy (20 – 30%), and steel rebar (20 – 30%) (Appendix K). Most of these resources required are imported from Australia. China's import value from Australia has increased yearly from 19% to 24%. In 2020 (Appendix L), Australia's exports to China were 33% of total exports, showing increased reliance on China.

Due to the mining boom from 2000 to 2011, China created a larger mining market in Australia. Australia's export share percentage to China increased from 5.5% in 2000 to 48.4% in 2020 (Appendix N). Through extensive investments in ports and trading infrastructure from Chinese investors, they managed to increase the output capacity of the mining industry, directly increasing the supply flow of commodities and their production and mining efficiency. This led to (a) non-diversified buyers' risk and (b) currency risk due to commodity price fluctuation.

4.3.3 Non-diversified Buyers Risk

Australia's heavy reliance on exports to China could pose a significant economic risk. Her exports to China are concentrated in key industries, such as iron ore, coal, and LNG[2]. Australia has sought to diversify its export markets and reduce its reliance on China. This includes efforts to expand trade relationships with others in the Asia-Pacific region and investments in industries such as renewable energy and advanced manufacturing.

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[2] Liquefied natural gas is natural gas that has been cooled down to liquid form for ease and safety of non-pressurized storage or transport.

4.3.4 Currency Risk

The Australian economy is heavily reliant on commodity prices, and fluctuations in these prices can significantly impact the country's currency. When commodity prices are high, trade improves, meaning the country can purchase more goods and services from other countries for the same number of exports with an increased demand for the Australian dollar, resulting in the currency's appreciation.

4.3.5 Impact on the Australian Equities Market

In May 2021, the iron ore price decreased due to supply shocks. China restricted steel output to reduce carbon emissions, which led to a reduction in demand for iron ore. Moreover, a Covid-19 outbreak in a critical region in China that produces iron ore had caused supply chain disruptions due to a fall in demand and, coupled with an increase in supply from Brazil, had caused the stock prices of BHP, Rio Tinto, and Fortescue Metals Group to decrease (Manthey, E.,2022). In 2020, China placed taxes on Australian wine, barley, and beef imports due to political tensions. Moreover, China started restricting its imports of Australian LNG (BBC, 2020). This led to a decline in demand for Australian LNG producers such as Woodside Petroleum and Santos; hence the stock prices of these companies have decreased.

5. Outlook and Prospects

5.1 Uncertain Short-term Outlook for Equities

Household consumption has been the main driver of the Australian economy, contributing to the bulk of GDP growth (Bishop, Boulter & Rosewall, 2022). Australia's Private Consumption accounted for 49.9% of its Nominal GDP in December 2022, with an average share of 56.2% from September 1959 to December 2022 (CEIC Data, 2022).

However, the combination of falling house prices, rising interest rates, high inflation, low consumer confidence levels, and negative real wage growth in the Australian economy is expected to decelerate spending growth considerably over the coming months.

5.1.1 Rising Interest Rates, Persistent High Inflation combined with aggressive Monetary Policy Tightening

Australia's central bank revises up its inflation forecasts as further rate hikes flagged. On 7 February 2023, the RBA raised its cash rate for the ninth straight time to a decade-high of 3.35%, bringing the total tightening since last May 2022 to a whopping 325 basis points as a priority to return to the target inflation rate at 2-3% (Qiu, 2023).

5.1.2 Australia's Housing Crisis

Australia's housing market weakness includes gastronomical house prices, and even with recent sharp house price declines, housing affordability poses a key challenge for the Australian government. The average house prices in Australia fell 9%, reaching a peak in April 2022; despite the correction, the country's large cities continue to have some of the priciest homes globally. Sydney's housing market was named the second least affordable in the world after Hong Kong (Sathyan & Mishra, 2023). In addition, the shortage in housing supply is evident, with vacancies in rental apartments across the country hitting a record low of 0.8% in February 2023 (Malo & Razaghi, 2023).

Combined with rising interest rates and inflation mentioned previously, these have increased indebted households' loan payments and living expenses, leading to a decline in 'spare cash flows' by more than 20% over the next couple of years and putting more pressure on the market as developers struggle to complete projects with rising construction costs (Reserve Bank of Australia, 2022).

Australia's household debt, primarily mortgages, is currently around 130 per cent of GDP, among the highest levels globally (Das, 2022). Household debt to disposal income is at 203%, compared with 50% in the 1980s, according to the OECD. A rise in debt service costs reduces the household's ability to spend. Furthermore, the effect is magnified by a sharp rise in the cost of living at a time of modest wage growth. Australian banks are also heavily exposed to house prices, with residential mortgages constituting over 60 per cent of total loans, one of the highest levels in the world (Heath, Cadman, & Dormido, 2018).

5.1.3 Low levels of Consumer and Business Confidence further dampened by volatility in financial markets

The fall in consumer and business confidence was recently dampened by the collapse of Silicon Valley Bank (SVB) and Signature Bank, and issues around Credit Suisse have generated significant volatility in financial markets.

The most direct impacts of the two US bank failures are on these banks' depositors and creditors. The S&P/ASX 200 dropped 1.46%, dragged by the banking sector, with mid-size banks hit the hardest as Bendigo & Adelaide Bank fell 3 per cent to $8.82 while ANZ tumbled 2.5 per cent to $22.72 (Bedi, M., 2023). The recent weeks' events are also likely to lead to a tightening in financial conditions more broadly as lenders reduce their risk appetite. This will likely result in increased borrowing costs and reduced credit flows, which will affect the global economy and even further dampening of business and consumer confidence.

Even though rising interest rates contributed to SVB's liquidity crunch and the tightening in financial conditions, we believe that in the absence of further shocks, it is likely that central banks will see the risks from inflation as too great to leave rates at their present level. As such, we expect the US federal funds rate to rise to 5- 5.25% by May and continue to see the Australian cash rate rising to a peak of 4.1% in May.

Overall, misalignment in housing prices, combined with the expected rise in interest rates as central banks normalise monetary policy, suggests a significant risk of a correction in housing prices and further dampening consumer and business confidence given the volatility in the financial markets from the banking crises which could have widespread consequences for spending behaviour through a fall in consumption and the country's vulnerability to a recession. Australia's GDP is expected to grow a mere 1.5% over 2023 from 3.5% in 2022[3], where this slower growth should see labour demand growth soften and the unemployment rate expected to steadily increase to 4.4% by mid-2025 from the current 3.5%[4].

5.2 Reopening of China's Economy combined with Easing of Trade Tensions

With China striving for a growth renewal and aiming for 5% GDP growth as it reopens after three years, Chinese infrastructure spending will likely get a boost in 2023 (Yao, 2023), as well as the coal-hungry power sector to drive it as they shift from de-risking to pro-growth in alignment with China's priorities such as the goal of Carbon Neutrality by 2060 (McGrath, 2020). In addition, iron ore and iron ore miners have surged on news from China of support for the property sector and easing COVID restriction, with China aiming to produce a record 4.6 billion tons of coal this year, buying Australian coal for the first time in two years, signalling that domestic supplies are tight, presenting an

[3] https://www.rba.gov.au/publications/smp/2023/feb/economic-outlook.html
[4]https://www.reuters.com/business/finance/australias-central-bank-revises-up-inflation-forecasts-further-rate-hikes-2023-02-10/

opportunity for Australia's commodities exports (Amir, 2023). Metal prices have mounted over 50% in China, taking mining giant shares such as BHP, Rio Tinto and Fortescue Metals and Whitehaven Coal to record highs (Thomson, 2023). Whitehaven Coal saw the most earnings growth and share price, which rose over 300 percent in 2022[5]. With strong demand and underinvestment in supply fundamentally supporting prices over the medium to longer term, stocks for key producers have started to rally and boost the return for respective equity markets like Australia's ASX.

Other sectors that will benefit Australia's economy the most will be the exports of services, especially education and tourism. At its peak in 2019, Australian service exports accounted for 20% of total shipments and education made up around 40% (Heath, 2023). COVID border closures hit tourism particularly hard, with only 9,000 short-term visitor arrivals from China in November 2022 compared to 1.5 million Chinese visitors while international student numbers fell from 260,000 to 155,000 in 2022. (Rumbens, 2023).

Overall, China's reopening is expected to boost Australia's economy by 1%, with the Australian mining sector's earnings expected to rise over 70% (Burgess, 2023). Thus, we overweight energy, materials, and metals equities as the sectors are vital to China's energy transition. Moreover, a full recovery in Australia's tourism will add 0.5% to its GDP, and the return of Chinese international students will add another 0.4% to the economy (Lee, 2023).

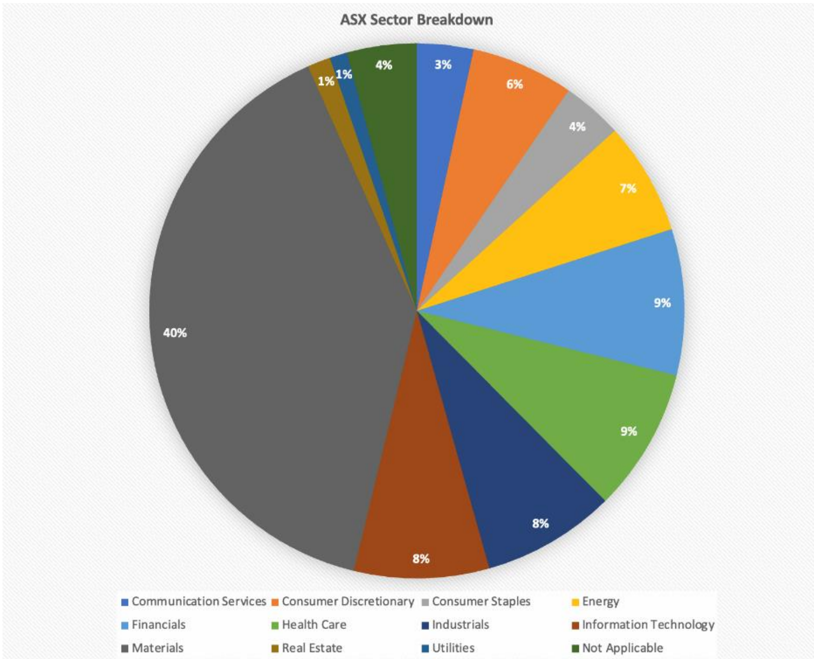
[5] https://www.home.saxo/en-sg/content/articles/quarterly-outlook/china-reopening-a-boon-to-australian-assets-07022023

6. Conclusion

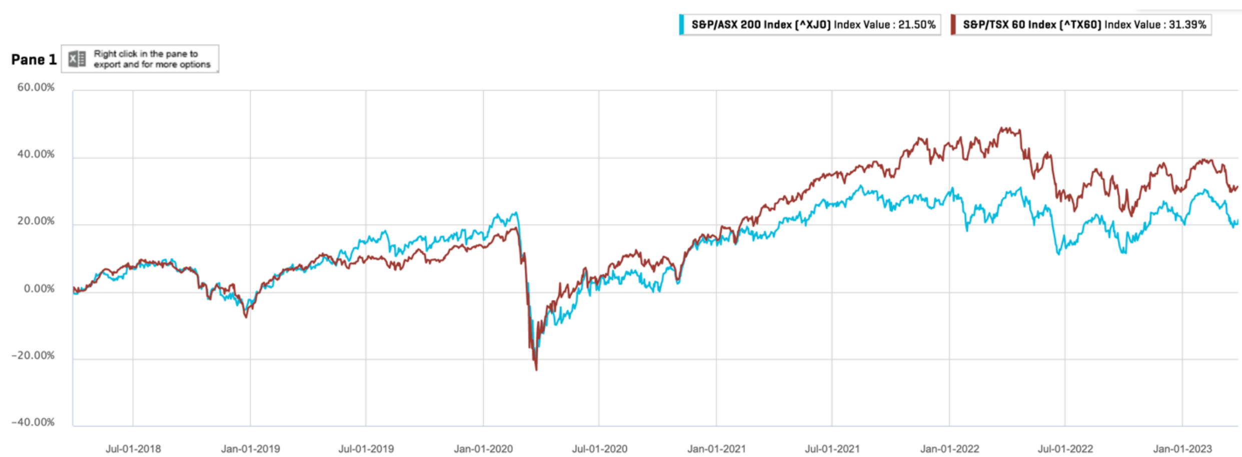
The Australian economy has proven to be one of the most resilient economies in the world, with its economic prosperity very broadly built on these strong foundations: good governance, open markets, and the rule of law. It is undeniable that Australia's and China's markets are heavily intertwined, as evidenced by the immense impact on Australia's equity markets in most major events such as the 2008 Global Financial Crisis, 2000s – 2010 Australia's Mining Boom, COVID-19 and 2020-2021 Australia-China trade relations. After three years of harsh restrictions, China's reopening and easing of trade tension fuels optimism that the Asian giant could drive global growth beyond expectations and help avoid a broader recession. As we navigate the coming market volatility stemming from the remaining effects of COVID-19, rising interest rates and inflation, as well as the recent financial banking crises, we continue to remain overweight on Australia's equities in the longer run, with a focus on the energy and mining sector that we believe will out-perform market expectations given the attractiveness in current valuations owning to increasing commodity prices and commodity export windfalls. Looking ahead, we would have to evaluate the ramifications of the Australian government's support to counter the housing crisis and rising inflation rates. The economy will weigh heavily on the Reserve Bank's monetary policy outlook for the coming years ahead.

7. Appendix:

Appendix A: Breakdown of ASX Index by Sector and Share Type



Appendix B: ASX 200 Performance Comparison against TSX60



Appendix C: Single Index Model of the ASX

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.927936391
R Square	0.861065946
Adjusted R Sq	0.860955943
Standard Error	0.004759338
Observations	1265

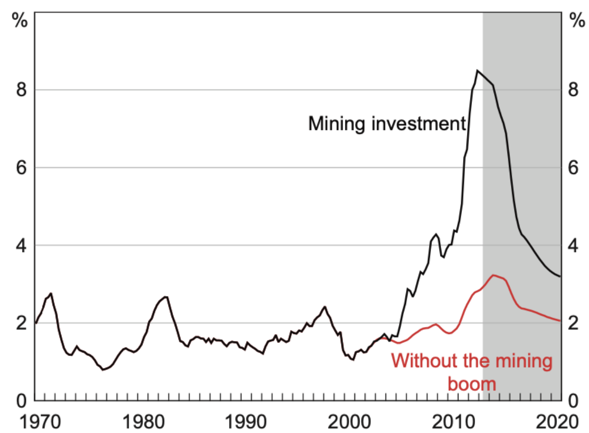
T-bill Rate = 3.07% (5Y Govt. Bond)
(WORLD GOVERNMENT BONDS, 2023)

ANOVA

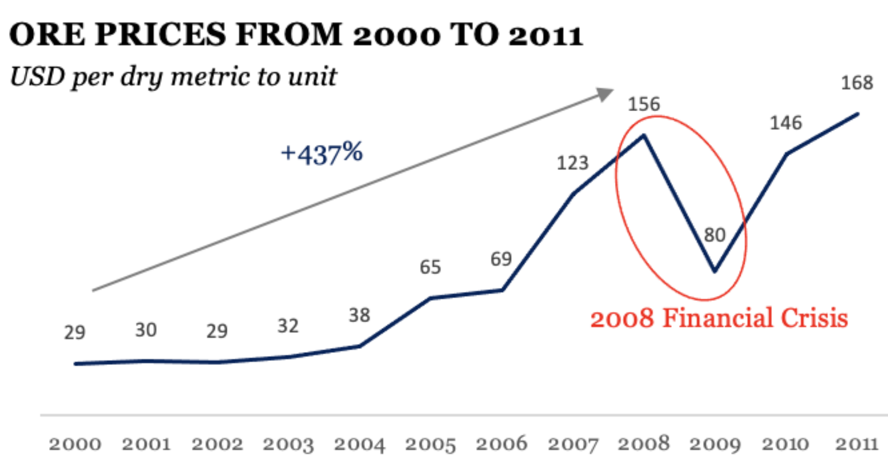
	df	SS	MS	F	Significance F
Regression	1	0.177306299	0.177306299	7827.643857	0
Residual	1263	0.02860859	2.26513E-05		
Total	1264	0.20591489			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	-0.03062777	0.00013384	-228.8395076	0	-0.030890342	-0.030365198	-0.030890342	-0.030365198
X Variable 1	1.078926451	0.012194846	88.47397277	0	1.055002065	1.102850836	1.055002065	1.102850836

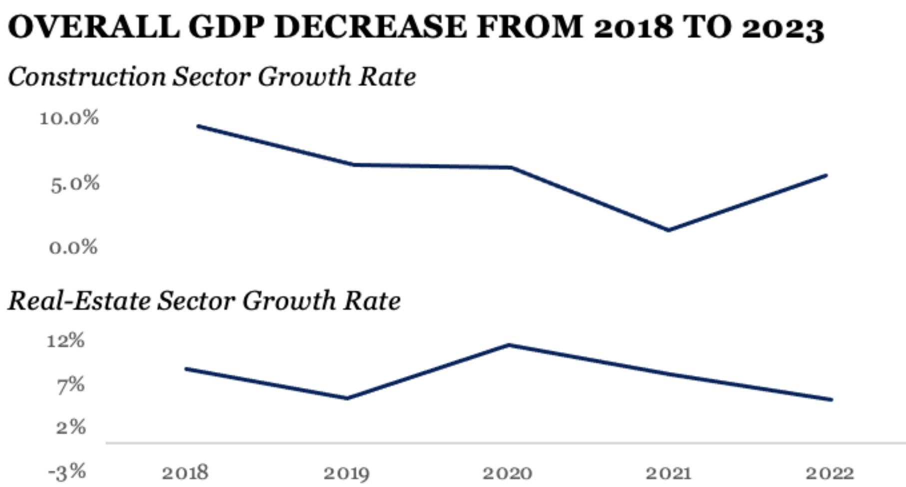
Appendix D – Investments into Australia Mining Market



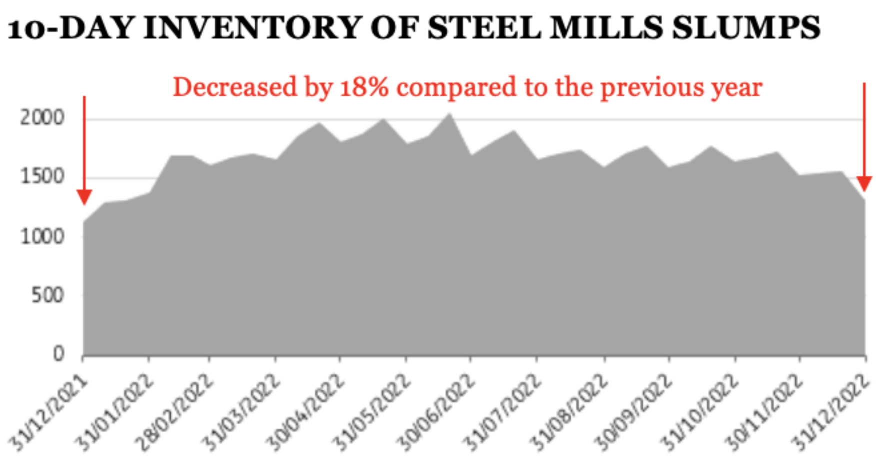
Appendix E – Ore Prices from 2000 to 2011



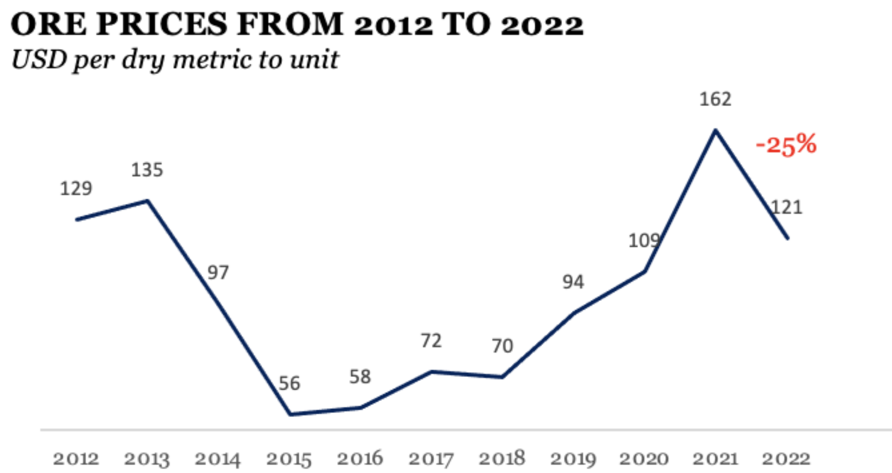
Appendix F – China sector specific GDP decrease from 2018 to 2023



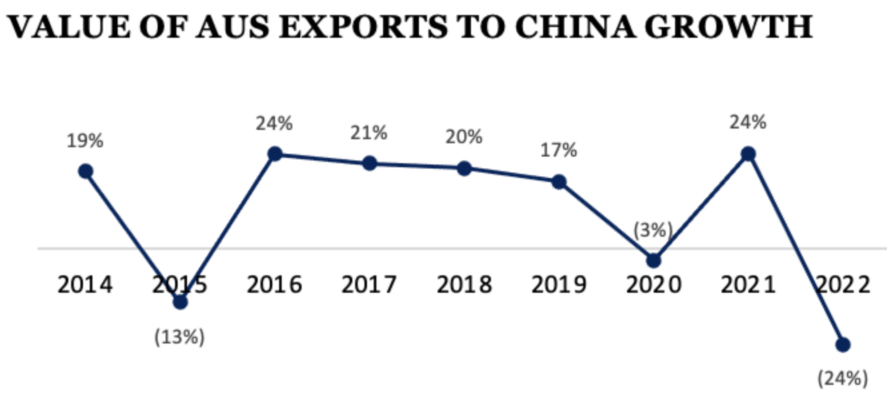
Appendix G – 10-day inventory of steel mills



Appendix H – Global Ore Prices from 2012 to 2022



Appendix I – Growth rate of value of Australian exports



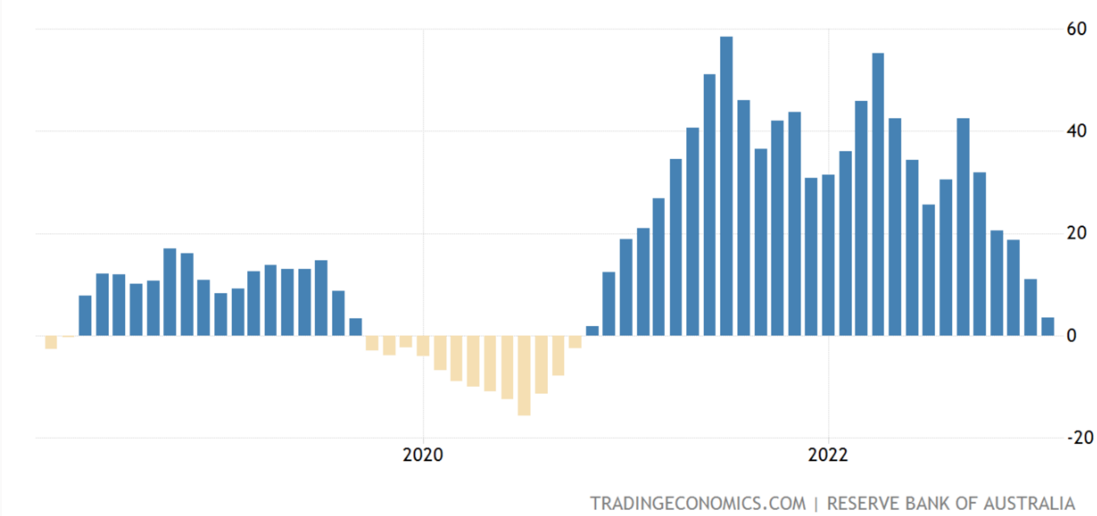
Appendix J – Comparison of export share of Australia

CREATED A LARGER MINING MARKET IN AUS

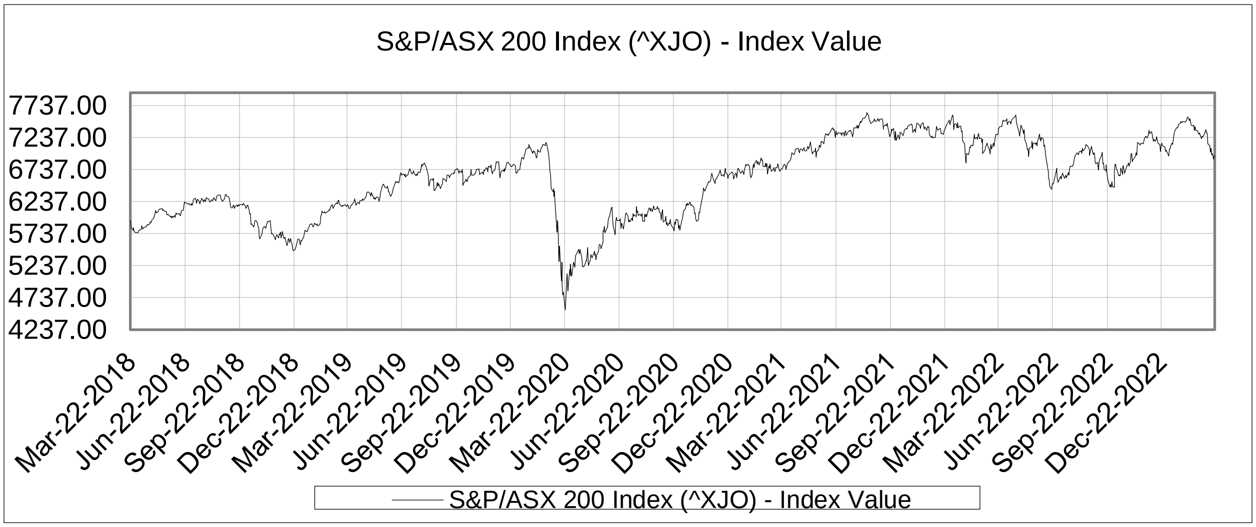
Exports Share %	Breakdown In 2000	Breakdown In 2020	Growth Rate
China	5.5%	48.4%	+ 42.9%
Japan	39.9%	13.5%	- 26.4%
South Korea	15.6%	11.3%	- 4.3%
Europe	3.3%	3.1%	- 0.2%
USA	6.1%	-	- 6.1%
Others	25%	11.9%	- 13.1%

Appendix K – FDI investment into Australian mining market

Appendix L - Australian Commodity Prices YoY, 2018 - 2023



Appendix M - ASX 200 Index value, 2018-2022



Source: Capital IQ

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