Wealth Management

2023 Economic and
Financial Market Outlook

MACQUARIE

Introduction.

As we look into 2023, it might appear that the glass is half empty.

Borrowing rates are high, economic growth is slowing, property prices are in decline and portfolio values have been under enormous pressure.

However, markets are forward looking, and they are likely to recover well before the economy has bottomed, supported by more attractive valuations, progress in getting inflation lower and central banks that are nearing the end of policy tightening cycles.

Unfortunately, the lagged effects of policy tightening are still to play out via a softening in economic growth - but just like ‘peak’ inflation and interest rate fears were a 2022 concern, we think ‘peak’ economic growth fears will also move to the rear vision mirror in early 2023.

In addition, a lack of structural overhangs and the potential for a reversal in policy rates should keep the downside in markets to a modest level compared to last year.

If 2022 was characterised by weak markets and a stronger economy, we think 2023 will be characterised by stronger markets and a weak economy, and because we are buying markets and not buying the economy, this should be a much better investment backdrop than the prior 12 months.

It might be a little early to look past near-term growth risks, but investors should not dwell on them for long, because better days are ahead.

Author:
Jason Todd, Head of Wealth Management Investment Strategy,
Macquarie’s Banking and Financial Services group.

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Key highlights

> Investors can look towards the start of a new economic upswing in late 2023”

Concerns rotate from inflation to economic growth

Headline inflation appears to have peaked or is close to peaking in laggard nations such as Australia, but a broad-based (ex-China) economic slowdown is now unfolding. The good news is that a lack of structural imbalances should keep the downturn short and shallow even if policy rates remain tighter for longer than expected. Macquarie expects economic growth momentum to be improving by year end but some pain must come before the gain.

Australia will not be immune to the global slowdown and domestic policy tightening

Australia should avoid recession in 2023 but growth will slow sharply as the lagged effects of policy tightening work their way through borrowing channels and begin to broaden out. However, a weaker A$, a solid labour market and a temporary downturn in consumer spending suggest growth concerns will be short and investors can look towards the start of a new economic upswing in late 2023.

The equity bear market is not over

Equity markets always fall during recession and recession is coming. While the valuation contraction throughout 2022 has front-loaded some of these losses, the adjustment for a period of weaker economic and earnings growth is still to be priced in. This could remove a further 10% from global equity markets – including Australia - if everything goes right. If not, markets will probably fall further.

It is too early to position for a 2H23 rebound

The consensus view is that equities rebound in 2H23 as central banks begin to cut policy rates. We share this view, but a policy pivot is contingent on inflation falling back to more reasonable levels and this is not pre-defined. If it doesn't, then policy conditions are unlikely to be eased and equities are likely to remain in a bear market until transparency on the growth outlook improves. It is too early to position for a 2H recovery that is contingent on a number of highly uncertain outcomes.

Australia will not be a safe haven equity market in 2023

Australian equities were a safe haven through 2022 as they benefited from less extreme valuations, a strong tailwind from energy and miners and a falling A$. But this was a 2022 story, and it will not be immune to an earnings downturn in 2023. Australian equities still offer a world beating dividend yield backed up by solid corporate fundamentals. But weaker earnings growth driven by falling margins (as costs rise and pricing power/sales fall) will push the market down in 1H23. Stay cautious on Australian equities until there is evidence that a meaningful and sustainable catalyst has emerged for a 2H23 rebound.

Sovereign bonds are appealing for yield and to hedge rising economic growth risks

We think sovereign yields have peaked for the current cycle and they will fulfil their traditional role as a hedge against economic risks (as the inverted US yield curve is now signalling). On the other hand, credit spreads almost always widen during recession and despite strong corporate fundamentals, we expect the same to happen in 2023. Don't bet against the traditional recession playbook. We favour sovereign bonds over credit.

The Australian property correction is not complete

Australian residential property is not close to giving back the gains captured throughout the pandemic period, yet fundamentals (borrowing rates in particular) are dramatically higher and have crushed borrowing limits. Macquarie thinks the price adjustment is only halfway through and it is premature to bet that the RBA will be forced into supporting the property sector. Post the 2022/23 property price correction, expect annualised price growth to slow significantly from prior years.

Sometimes it's not bad to be in the consensus

While 2023 starts with consensus expectations closely aligned, There is considerable uncertainty around key variables that drive the economic growth, rates and market outlook. If inflation does not behave as expected then the view on markets collapse. Rates will stay higher, the economic and earnings downturn is likely to be deeper and equities and risk assets may remain mired in a bear market. Positioning for a recovery now exposes investors to near term downside risk. But positioning for downside raises the risk that investors miss the turning point.

The long-term return potential has improved

The valuation correction seen in 2022 has led to a significant improvement in the long-term return outlook for both bonds and equities. But, this improving return outlook is unfolding at the same time that investors are trying to protect portfolios from further loses. When uncertainty is high there is always the temptation to sit on excess cash. Over the long term, this has proven to be a costly strategy versus a fully invested, well-balanced portfolio. Expect more normal correlations to resume in 2023 with bonds providing strong downside protection. Alternatives and real assets will continue to offer low-correlated return potential.

“It is premature to bet that the RBA will be forced into supporting the property sector”

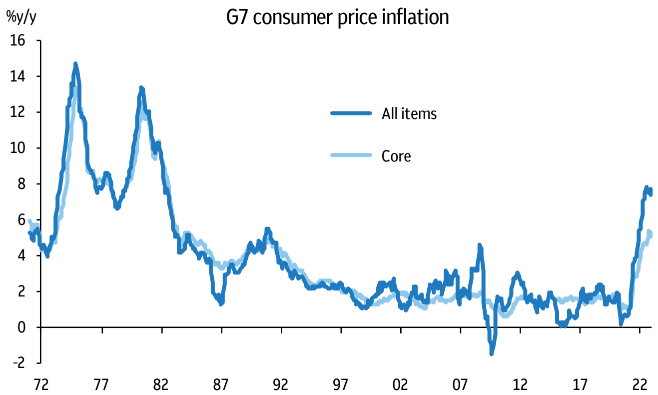
02.

Overview

Position for recession and not a 2H23 policy pivot

Last year the global economic and financial market backdrop did not evolve as expected. Inflationary pressures, thought to be transitory early in the year, continued to build rather than ease and central banks were forced to raise interest rates much more aggressively than they, or the market, thought.

Inflation spikes to 40-year highs

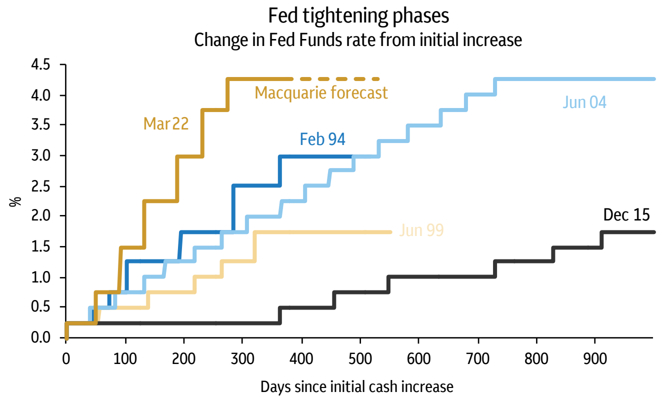


Source: Factset, MWM Research, January 2023

> Inflation has peaked, but the path back to target is unlikely to be smooth"

Despite a chaotic 12 months for financial markets, the year did end on a more positive note, with signs that inflation has probably peaked on the back of supply chain improvements, falling energy prices and a moderation in liquidity fuelled goods demand. A number of major central banks responded to this positive development by slowing the pace of rate hikes in the final months of 2022 and we believe this is the strongest signal that the end of the interest rate hike cycle is approaching. The bad news is that inflation is further above target than at any time in the past 30 years and it will take time for policy to do its work and bring it back to target. As a result, even though interest rates are likely to peak in early 2023, we think they need to remain at elevated levels for most of the year if they are to help drive inflation back down to target.

2022 saw the sharpest Fed rate hike cycle in history



Source: Factset, MWM Research, January 2023

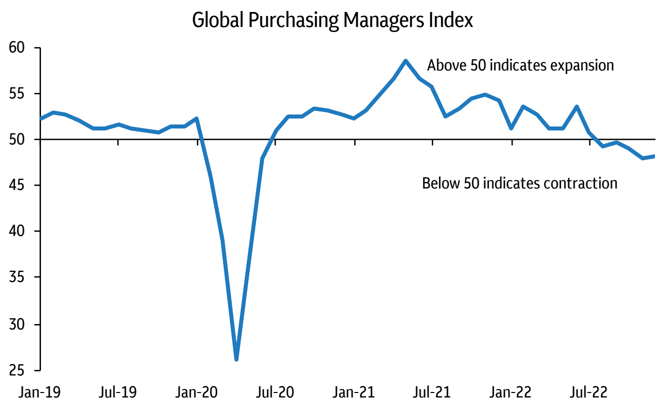
Monetary policy tightening works with a lag and the rapid increase in interest rates throughout 2022 is yet to fully flow through the global economy and when it does, Macquarie thinks recession, including a meaningful rise in the unemployment rate, is likely in the US, the UK, and Europe. Australia should avoid this fate, but growth is likely to stall as consumer spending weakens and unemployment begins to rise. With key central banks committed in their fight against inflation, the prospect of a few more late-cycle interest rate increases over the coming few months has the potential to deepen the economic downturn and even shift the consensus narrative from a "soft" to a "hard" economic landing if they continue to pursue inflation.

"Full effects of last year's monetary policy tightening lie ahead"

"An economic soft landing is not a certainty"

"Markets are yet to price in recession because its nature is still uncertain."

Leading economic indicators are now in contraction



Source: Factset, Markit, MWM Research, January 2023

Worryingly, history is not on the side of the Fed being able to engineer an economic soft landing despite the weight of the consensus thinking this will almost certainly be the case. It is unheard of for the Fed to raise rates at the pace it has and to expect a controlled economic slowdown with only a modest rise in unemployment. Therein lies the risk as we move further into the year and why we think it remains too early to position for a soft landing.

Given the rapid rise in borrowing rates, economic pain was concentrated in interest rate sensitive sectors such as property and construction. In 2023, we expect sectoral weakness to broaden into other parts of the economy including manufacturing, services and consumer spending which will ultimately lead to a rise in unemployment and weaker demand as excess savings are run down and job insecurity rises.

Like for the broader economy, 2023 is likely to see weakness spread from areas most impacted by higher borrowing rates to those which will face headwinds from slowing economic growth as well as declining profits/ margins from rising input costs like raw materials and wages. We think that most of the rise in interest rates is in the price of asset markets, but they are yet to price in recession because its nature is still uncertain. In addition, there is always the risk that asset markets become more disruptive as the full effect of tightening liquidity works its way through the system.

The good news is that there appears to be few structural imbalances relative to past recessions (such as valuations in the 1999/00 TMT bubble or corporate leverage in the 2008/09 GFC) which generally take time to purge. Before the end of 2023 we think central banks will be confident that inflation is on a path back to target and an easing cycle will begin. This is the basis of the bull view that begins to turn growth headwinds into growth tailwinds and for equities to begin pricing in an end to the tightening cycle sometime in mid-2023. But before then, we require a lot more certainty on inflation, rates and growth and hence we enter the year on underweight risk assets and overweight defensive assets and cash.

Financial market turmoil and the inability of defensive/low-correlated assets to provide downside protection has left most investors feeling cautious as we enter 2023 even though many assets have suffered significant declines. We think prudence and a degree of caution is appropriate as we navigate the 2023 outlook. We don't think the equity bear market is over and there is more downside to come across credit as well as private markets as recession takes hold. On the other hand, we think sovereign bonds are now offering a solid yield and should provide better protection against rising economic growth risks as we move further into the year. We expect the bottom in risk assets to correspond with the start of the next policy easing cycle and as a result we believe equities will more than recover 1H23 losses. However, if your time horizon is anything other than medium to long term, then we cannot ignore short-term risks that that will see risk assets trade on more appealing valuations.

> "Position for recession and not a policy pivot"

> The 2022 valuation correction has boosted the risk-adjusted return outlook for both bonds and equities"

On a positive note, the valuation correction seen across almost every asset class in 2022 has led to a significant improvement in the long-term return outlook for both bonds and equities. Perversely, this improving return outlook is unfolding at the same time that investors are trying to protect portfolios from any further loses. When uncertainty is high there is always the temptation to sit on excess cash. Over the long term, this has proven to be a costly strategy versus a fully invested, well-balanced portfolio. In addition, with inflation still running significantly above the cash rate, real purchasing power is falling (albeit less than being real return losses from most asset classes through 2022).

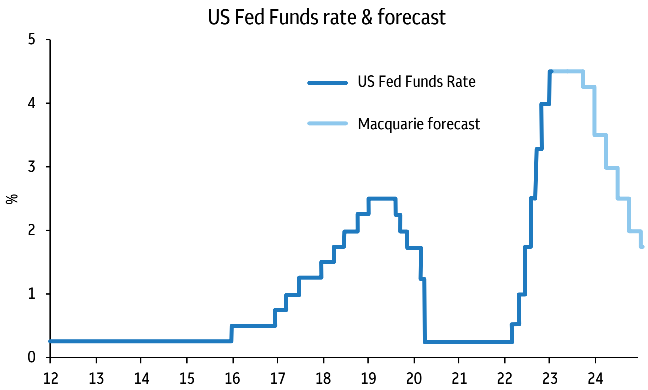
03.

Economic outlook

Growth to slow as policy tightening bites

Improvement in the functioning of global supply chains, falling energy prices and a gradual normalisation in goods demand has led to disinflation in goods prices with inflation having likely peaked in the US. With the US Federal Reserve being the major driver of global policy momentum, its reaction to these developments via reducing the increment of their policy tightening, has been greeted favourably by markets who foresee this as a precursor to the end of tightening, even if more insurance is likely over the next few months.

US Fed Funds rate is now close to peak



Source: Factset, Bloomberg. MWM Research, January 2023

It is easy to look into 2023 and be encouraged by recent inflation trends. But inflation is further above target than at any point during the past 30 years and it will take time for it to adjust back to key levels. This means policy will remain restrictive for some time. Once the peak in policy is reached, communication is likely to leave the door open to further rate increases in the event inflation remains stubborn. Central banks lost credibility last year by downplaying the inflation threat and they are not likely to make the same mistake this year.

Interest rate sensitive sectors such as housing and commercial property have already rolled over, but to be confident inflation is on a path back to target the unemployment rate needs to rise and this is a difficult calibration, particularly given the long period of time (anywhere from 6-18 months) it takes for a change in monetary policy to have its maximum effect. Tighten too much and the rise in unemployment rate unnecessarily causes too much damage. Tighten too little and the inflation problem persists. The cost of addressing the problem now far outweighs the cost of kicking the can further down the road.

What is the shape of recession?

The path taken by inflation and interest rates will determine the depth, duration, and nature of the global recession. Macquarie's central case is that that the global economy will enter a mild recession in early 2023 with this view underpinned by the following:

- Central banks have already done enough to produce a modest (say 2%) increase in the unemployment rate that should bring inflation back to target over the coming 18-24 months.
- Most major economies have very few imbalances that could cause the financial contagion seen during the GFC and this will limit both the depth and duration of the recession. Both corporate and household balance sheets are not overly stretched, and the banking system is much better capitalised than it was just prior to the GFC.
- Firms have spent a long period searching for staff and will be less reluctant to cut existing employees, at least during the early phase of the downturn. This means the economy and jobs market will remain resilient to some weakness in demand but once a threshold is reached firms will rapidly cut staff.
- Even though inflation has not been this far above target in many decades, the global economy is more flexible than it was in past episodes of elevated inflation and firms will quickly pivot from passing on costs to cutting them once demand slows enough

While Macquarie's base case is for a mild recession beginning early this year and lasting for most of 2023, the depth, duration and nature of the recession could easily change depending on the path of inflation and the reaction function by central banks. At present we assume the plumbing of the financial system remains functioning and that credit spreads will rise, but not widen dramatically.

> "Policy needs to stay tight to allow inflation to track back to target"

This implies that the financial system is not a large amplifier of financial stress in the real economy as it was in the 2008/09 downturn. However, we admit that this is a somewhat "goldilocks" view and a number of other outcomes are possible:

- **Recession lite.**
  The "uneasy truce" inflation risk implies a shallow recession or even a stall in growth for the year with interest rates on hold into 2024. This risk implies central banks have got policy tightening right, but we don't think this outcome is likely.
- **Delayed but deep.**
  The "fight is still on" implies that growth is more resilient than we expect in 1H23, and wages growth continues to accelerate. The supply chain improvements that are underway could even stall. In this case the Fed may pause over the next month or two as the market expects, but then resume tightening later in the year leaving a deep and protracted recession forming late this year or early next year.

04.

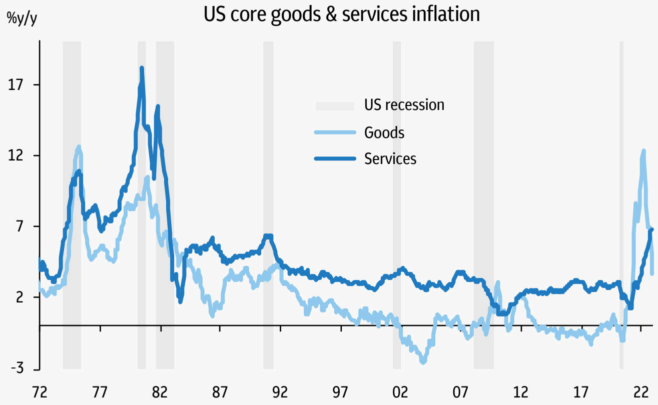
Regional economic views

Recession unfolding but short and shallow

4.1 US – Mild recession coming

The US saw inflationary pressures before the other major economies, and we think it will continue to lead inflation developments on the downside. It appears inflation has peaked in the US, Canada and the UK, but there is still upward pressure in the Eurozone and Japan. The peak has formed in US inflation due to improvements in supply chains flowing through to goods inflation and there seems to be more room for improvement.

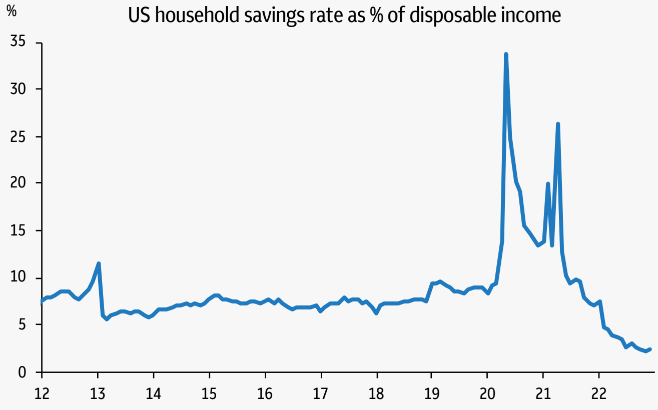
The inflation fight has not yet been won



Source: Factset, MWM Research, January 2023

Inflation can only return to target if services inflation eases, and this normally requires the unemployment rate to rise. The 1990s period is the exception to this when increasing IT penetration drove a structural increase in labour productivity growth, but this is not likely in 2023. This is where the calibration of monetary policy is not easy, and the likelihood of recession looms large. Tighten too much and below trend growth turns into deep recession. Tighten too little and inflation stays elevated with the associated costs as we discovered in the 1970s and 1980s. While we have not yet seen a rise in the unemployment rate, we know a cyclical downswing is underway. Interest rate sensitive sectors such as housing have already corrected substantially, with more downside coming. Construction activity is slowing but holding up better than demand for established housing.

The pandemic-driven savings boost has already been spent



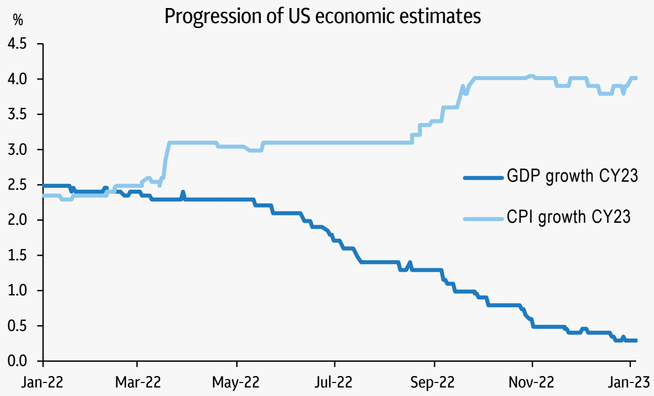
Source: Factset, MWM Research, January 2023

Macquarie is expecting a short and shallow recession, but it is the fate of the consumer that ultimately determines the depth and duration. The US consumer has remained resilient to the Fed's tightening campaign thus far with consumer confidence still well above levels seen during past recessions, but we don't expect this to last. The consumer was propped up by two factors last year. First, the low (3.7%) unemployment rate, which is close to a 50-year low and second, high household savings built up during the pandemic. However, one of these factors - the high savings rate - disappeared last year on the back of rising interest rates and inflation. Rising interest payments, and the cost of goods and services above income growth, reduced the savings ratio. Once the unemployment rate begins to rise recession will kick in.

4.2 Europe – Battling high inflation and a substantial energy shock

The composition of the increase in inflation has been different in Europe, with energy and food prices making larger contributions than goods and services due to the impact of the conflict in Ukraine. This has already forced the economy into recession late last year and drove a sharp inflation spike. However, wages growth is still rising, and Macquarie's macro team expect it to lift from 3% to 4% by the end of this year but for the unemployment rate to also rise from 6.8% to 7.9%. We think such a modest rise in unemployment with a modest rise in wages growth suggests inflation is likely to remain sticky and well above target for most of 2023.

Growth estimates have been slashed



Source: Factset, MWM Research, January 2023

The moderation in European inflation is expected to be more gradual than in the US because of the persistent pressure on electricity prices. However, European governments have recently announced several fiscal support packages, including price subsidies for consumers that will limit the contribution of rising gas prices to headline inflation compared with earlier expectations. Europe has tended to experience relatively short cyclical recoveries and busts since the end of the GFC and while this slowdown will prove to be a little deeper and longer given the energy crisis, we think growth will begin to improve towards the back end of the year. However, risks to the outlook remain skewed to the downside and despite the prospect of a cyclical upswing and appealing valuations, we think the risk-reward remains poor from an investment perspective until there is greater clarity on the shape of the economic slowdown.

4.3 China – A counterweight to the 2023 global slowdown

China is likely to be a significant counterweight to the downturn in many other major developed economies through 2023. The authorities recently announced policy changes that affect two key areas of macroeconomic weakness (property and COVID-zero lockdowns), and we believe this puts a floor under the downside risks to growth even if the recovery path is likely to be slow and bumpy.

China PMI has now fallen into recessionary levels

Source: NBS, Factset, MWM Research, January 2023

On the back of the policies supporting property and COVID reopening, our economics team expects GDP growth to accelerate from 3.3% in 2022 to 5.5% in 2023. Unlike the larger western economies, inflation is expected to remain low and this gives the authorities room provide support to the economy over and above the measures already announced if needed.

- **Property: A strong rebound likely.**
  The authorities announced 16 measures to put the property market back onto a more sustainable path in late 2023. Banks have been instructed to provide credit to developers with concern for lending risk to be a secondary consideration. Mortgage rates were cut aggressively last year but it has had limited effect on demand for property. A lack of confidence in developers delivering completed stock to buyers has undermined buyer confidence and policymakers addressed this issue by providing most of the policy support to developers. Macquarie expects property investment to pivot from a decline of 9.9% in 2022 to growth of 0.2% in 2023.

- **COVID-19: Not out of the woods yet.** Health authorities announced 20 measures designed to minimise the impact of the virus on both the health of the population and hospital system, but also the economy. Inbound travellers will see an easing of testing requirements and quarantine arrangements. Domestic travellers will see close contact isolation reduced, more use of home quarantine, an end to mass testing except when the source of infection is unclear, and an easing of quarantine restrictions for high-risk workers. The healthcare system will also be bolstered with more hospital beds and medicine, and protection for vulnerable cohorts.

Official data shows a conundrum of rising hospitalisations and declining case numbers as end of year approaches. We think the easing in testing requirements means new infections are being under-reported and are increasing rather than decreasing as the official data is showing. The experience in western economies showed that shifting from an elimination strategy to living with the virus is not easy and we should not expect the path to be smooth. Chinese New Year celebrations are on the weekend of 22 January and will likely test both the healthcare system and the resolve of policymakers.

4.4 Japan – Finally a cyclical recovery of note?

Macquarie expects Japan to avoid recession this year. The recovery from the pandemic has been slow relative to other advanced economies but household savings are still high and provide some support for consumer spending. In October last year, the Japanese government announced $US197bn in new spending to ease the impact on consumers from rising energy prices and the weak Yen. The government indicated the package would cut household electricity bills by 20% from January to September this year. It also indicated the package would lower Japan's inflation rate by more than 1.2pts and add about 4.6% to real GDP, but there was no timeframe attached. The BoJ is one of few central banks to keep policy at emergency settings, with Governor Kuroda convinced underlying demand is too weak to begin tightening policy. Nonetheless, Japanese inflation is picking up even though it is not the threat posed in other major economies.

GDP growth forecast

	2022	2023	2024
US	2.0	-0.2	0.7
China	3.1	5.5	5.0
Eurozone	3.2	-0.7	-0.1
Japan	1.4	1.1	0.6
UK	4.4	-1.2	-0.2
Canada	3.5	-1.4	0.0
Australia	3.9	1.6	1.5
New Zealand	2.4	1.0	0.2
Global (MER)	2.9	1.5	1.7
Global (PPP)	3.1	1.8	1.8

GPI growth forecast

	2022	2023	2024
US (PCE)	6.2	3.6	2.4
China	2.1	2.4	2.5
Eurozone	8.4	6.0	2.3
Japan	2.4	3.2	2.1
UK	9.1	7.8	2.8
Canada	6.8	3.6	1.9
Australia	6.6	5.5	3.0
New Zealand	7.2	5.2	2.4

Policy rate forecast

	2022	2023	2024
US	4.38	3.63	1.38
China	2.75	2.75	2.75
Eurozone	2.00	3.00	2.50
Japan	-0.10	0.10	0.20
UK	3.50	3.75	3.15
Canada	4.00	2.50	1.00
Australia	3.10	3.35	2.60
New Zealand	4.25	4.00	2.75

Source: Macquarie Macro Strategy, January 2023

Where can the consensus go wrong in 2023?

1. The global recession will be short and shallow.

The risk is not recession, but that recession will be deeper and more protracted than consensus expects. The past three recessions since the start of the new millennium have occurred against a backdrop of low inflation and the objective of monetary policy was to go all out to support growth. This time inflation is high and in some cases around 5% above target and the only way it will return to target is if growth is below potential for a considerable period. Supply chain improvements will help, but they won't be enough given strong goods demand. The risk is that in applying the brakes to slow demand, growth contracts much more than consensus expects.

Once recession begins it has been historically difficult for the Fed to put the economy back on a sustainable pace of growth and this means the recession could last longer than the expected two quarters. At some point it will become apparent that the tightening cycle has done enough to rein in inflation, and it is time to ease policy. However, monetary policy works with a long lag and it will take considerable time to lift growth.

Throughout past recessions, substantial stimulus has been coupled with expansionary monetary policy to ignite a recovery. That is, even if central banks pivot to looser policy settings, an additional boost to growth momentum is needed to see global GDP quickly recover. Large stimulus has historically come from fiscal measures, such as government expenditures, or via a lift in global trade from China and to a lesser extent, emerging markets. We believe that both these potential sources of stimuli are less likely to occur, and if they do, to pale in comparison to previous cycles. If there is no major boost to global growth from these sources, the consensus will underestimate the severity and length of a global recession.

2. Inflation has peaked and will continue to steadily decline.

Inflation forecasts see price pressures declining and falling to central bank targets within the next year. Economists have been pointing to falling goods, commodity and energy prices, along with easing supply chain pressures, as disinflationary forces that will lower inflation. It is possible the momentum of these disinflationary forces stops, particularly if the easing of COVID restrictions in China does not go to plan. There are very few signs yet that labour market pressures have begun to ease. Unemployment rates in the advanced economies remain at multi-decade lows and have been resilient to the tightening cycle thus far. If this continues, then central banks planning on ending the tightening cycle may be forced to keep tightening further than consensus expects. Services inflation is now the main enemy, but inflationary pressures remain, with most items in the US CPI basket experiencing price growth greater than 2%.

3. Equities to have a weak 1H23 but strong 2H23.

The consensus view on equities seems to be pinning its hopes on the prospect of a Fed easing cycle and a bottom in earnings in H223. However, if the recession is deeper and/or more protracted then the bottom in earnings may occur later and this will delay the rally out of recession. In addition, a 2H rally doesn't square with history which shows the S&P 500 has bottomed on average three months before the end of recession. This implies that for the market to rally in H2 the economy would now be in recession, with the recession to end around the middle of the year. The latest data such as the manufacturing ISM indicates recession has probably begun, but there will be no end in sight until the Fed begins talking about easing policy and that is not on the radar yet. Normally markets fall much further than expected and rise much faster than expected. If signs begin to emerge that central banks are on the verge of a policy pivot or that the recession will in fact be mild, equities will rally strongly. If not, we could be in for another grinding year of elevated volatility where quality and defensive stocks dramatically outperform.

4. Global liquidity conditions remain favourable.

Last year marked the end of easy money. Central banks raised rates aggressively and began the long, slow process of reducing their balance sheets which have been used to provide support to the financial system since the GFC. The increase in policy rates saw falling prices, particularly in long duration assets – bonds, listed equities, residential and commercial real estate – with some valuation adjustments yet to be reflected, particularly in infrastructure and private equity. The banking system is better capitalised and regulated than it was preceding the GFC. However, if the recession proves to be deeper than consensus expects there is a risk that asset quality is likely to deteriorate more than anticipated impacting bank balance sheets and consequently, causing a further pullback in liquidity which impacts all asset markets – a negative feedback loop begins. So far, credit and funding markets have remained functional, but banks are already tightening lending standards as they struggle to offload debt underwritten when rates were zero and valuations were high. Last year's collapse in the Gilts markets shows what can happen when fiscal mismanagement becomes apparent and the Central Bank is no longer buyer of last resort.

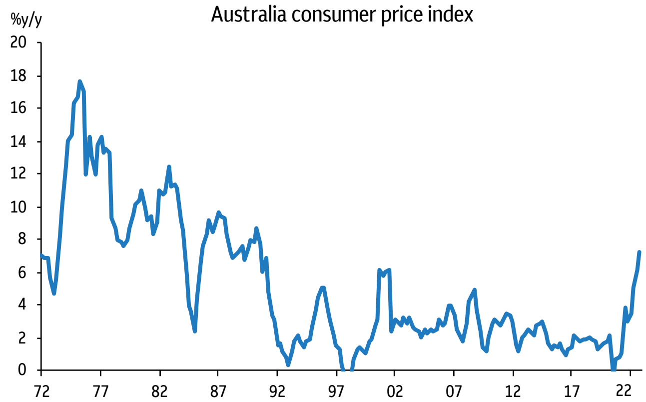
05.

Australian outlook

The lucky country... again.

The Australian economy is slowing, although we think growth is likely to stall rather than contract this year with economic growth weakening from 2.7% down to 1.1% by year end. During this year the unemployment rate is likely to drift up from 3.4% to 4.1%.

Australia is also facing a tough inflation fight



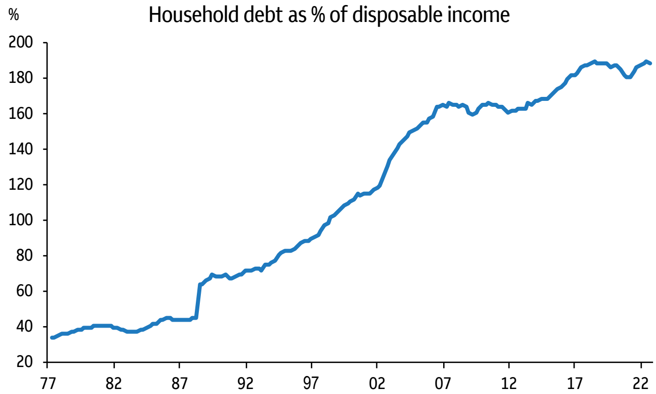
Source: Factset, MWM Research, January 2023

Nonetheless, growth of only 1.1%, with all of the major economies, apart from China, in recession will cause some pain. Inflation is 7.3% and well above the top of the RBA's target band and the only way inflation can return to target is if growth is below trend for an extended period and this means policy must remain tight for an extended period. The improvement in global supply chain pressures will help the RBA's cause, but alone it will not be enough. Demand needs to slow.

> "A difficult path for the RBA to navigate"

The RBA must then navigate a difficult path. Tighten too much and the unemployment rate rises too high and the economy tips into recession. Tighten too little and the unemployment rates stays low but inflation becomes more entrenched. Of course, policy isn't on a predetermined course and if the outlook deteriorates more quickly than the RBA expects then rates can easily be cut. Similarly, if the economy proves to be too resilient and inflation stays higher than expected then rates may need to rise further. In their communications, the RBA will likely leave the door open to further tightening if needed. Probably the key uncertainty the RBA has to consider is the magnitude of the global economic slowdown which itself is not certain.

Australian household indebtedness is at intergenerational highs



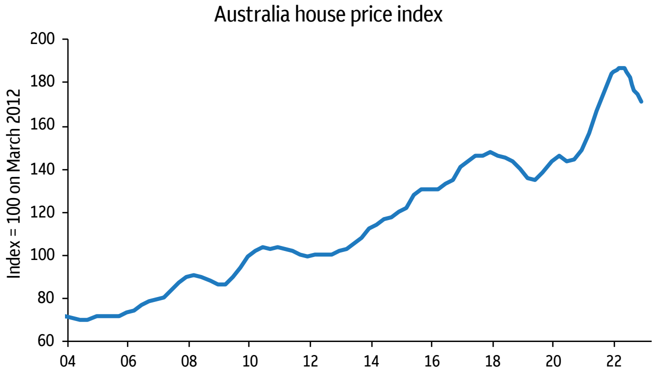
Source: Factset, MWM Research, January 2023

Household debt is the economy's Achilles heel and an important consideration for the RBA when tightening policy. As debt and dwelling prices have risen over the years, households have become more sensitive to interest rate movements. During the pandemic, household debt increased from 187% of disposable income to 190% of disposable income and two-thirds of this debt will reset at higher interest rates by the end of 2023. According to ABS data, around 58% of new loans written during the pandemic were at fixed interest rates between 2% and 3%. RBA data shows the interest rate on those same fixed rate loans is now above 6%, and the interest rate on discounted variable rate loans is close to 6%. These rates pose significant headwinds for many borrowers. On the other hand, there are a number of positive supports in place that should underpin economic growth through 2023 and help Australia avoid recession.

- **China to support commodity exports:** One key reason why Australia should fare a little better than some regions is due to its leverage to China. The rebound in growth is likely to be driven by the construction industry and steel demand which has direct positive flow on benefits for our commodity exports. Already the price of iron ore has rebounded to $US110/t since the announcement by the Chinese authorities to support the property sector. If the COVID reopening goes better than expected, then that should also provide an additional boost to Australia via a further upgrade to activity levels.
- **Wages growth to pick up:** Wages growth is picking up, but at a pace that is not likely to disrupt the path of inflation back to target, and this will provide some support to household income as the unemployment rate and interest rates rise. Wages growth has been strongest in industries that depend more upon the domestic economy such as retail trade, rental, hiring and real estate services, and wholesale trade. Wages growth in manufacturing and administration services has also been solid.
- **RBA to tighten less than peers:** Australia is a small open economy and will feel the effects of the global recession. The RBA must allow for the effects of this slowdown when calibrating its monetary policy settings. Consequently, unit labour costs (a key driver of inflation) are still slowing after the pandemic, with growth around 4% vs 6% and rising in the US. Inflation expectations also remain well anchored in Australia after rising earlier in the year. However, wages growth is beginning to accelerate, and the Macquarie economics team expects it to increase from 3% to 4% this year.

On the downside, interest rate sensitive sectors such as housing have already rolled over, although the decline in house prices has been relatively modest and orderly thus far.

The house price correction has been modest to date

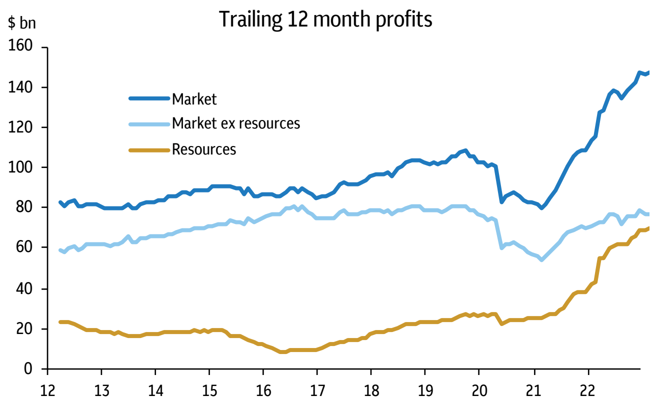


Source: ABS, CoreLogic, Factset, MWM Research, January 2023

- **Dwelling prices – the correction is not yet complete:** House prices have fallen by 12% in Sydney, but more modestly in the other state capital cities. The prospect of mortgage rates remaining high for most of the year means the decline is likely to continue and a peak to trough decline of 15% across the country seems likely (and could even prove to be a best-case scenario). However, a price fall of this magnitude won't disrupt the economy provided the unemployment rate rises very modestly as we expect. Further downside risk is likely if inflation hasn't peaked and the RBA needs to resume raising interest rates late in the year. We don't think this is likely, but nonetheless it's a risk. The other risk is that the RBA has tightened too much, and the unemployment rate rises more than we expect. This could lead to a larger default cycle than we anticipate but given the linkages back into the economy, we think this would also lead to a softening in the RBA's policy stance should it begin to undermine the broader growth backdrop beyond their expectations.

- **Company profits under pressure from rising costs and slowing demand:** The business sector has also been facing cost pressures and margins were under downward pressure for most of last year. Upstream industries such as wholesale trade and manufacturing have responded by either slowing or running down inventories, while industries close to the consumer such as retail trade were increasing inventories. We expect margins to decline further and inventories to be cut along with other costs. Earnings growth was propped up by solid demand last year, but when the full effect of the RBA's tightening cycle works its way through the economy, it will weaken, and earnings growth will come under even more pressure – potentially without as much support from the resources sector. Firms normally respond to these pressures by cutting costs (laying off staff and working more productively), but this takes time and we do not think it is factored into Australian earnings expectations yet.

Corporate profits have been boosted by resources



Source: Factset, MWM Research, January 2023

Australian industry is closely linked to the global economy and, given we expect the world's major economies, apart from China, to be in recession, then Australia will feel the effects of the slowdown. In particular, industries such as professional services, transportation (airlines), manufacturing, education, tourism and IT will feel the effects of the global recession. Industries more dependent upon the domestic economy such as construction, hiring and real estate, accommodation and food service will feel the effects of slowing demand from the RBA's tightening cycle.

The uncertainty surrounding the global and domestic economic outlook means firms are unlikely to invest in new plant and equipment or make strategic acquisitions of other businesses or their assets and this removes one lever of growth. Business confidence remains positive at the moment, but we think it will decline as growth slows.

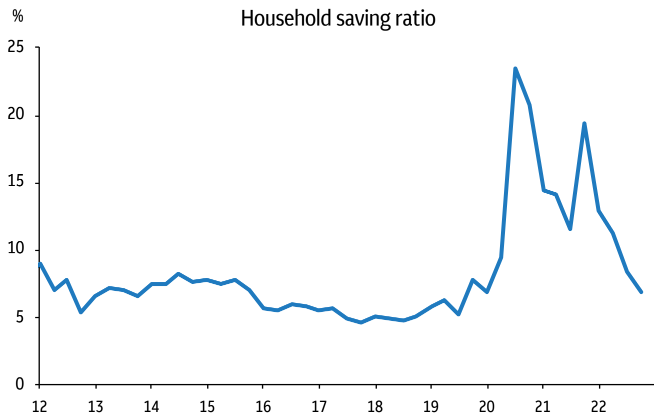
Consumer spending: Strong but not for much longer

Consumer spending remained relatively resilient to interest rate rises last year, underpinned by savings built up during the pandemic and a tight labour market. The savings rate of the Australian consumer rose during the GFC and increased sharply during the pandemic, with most of this excess income being held in deposits or cash. Higher interest rates and inflation, and the reopening of the economy after the pandemic has seen household savings fall, and this should continue back to pre-pandemic levels by year-end (following a similar roadmap to that seen in the US and other major developed economies).

Macquarie is forecasting real consumer spending to decline from 1% to just 0.1% in 2023 as a combination of headwinds increase:

- We don't expect to see much interest rate relief from the RBA.
- The savings ratio will continue to decline as consumers spend the remaining gains from the pandemic period.
- The unemployment rate will tick higher. Not enough to be a major concern but enough to bring a rising level of employment uncertainty.
- Even though cost pressures are likely to slowly ease, they are not likely to fall. Cost increases in non-discretionary items such as food, utilities, rent and insurance will act as a tax on discretionary goods and services spending.
- The wealth effect from both falling residential property values as well as weaker financial markets will add to discretionary spending headwinds.

The savings boost is only temporary



Source: Factset, MWM Research, January 2023

We think the currency will likely depreciate over the next few months as global recession becomes a reality and China battles its COVID wave. In the low inflation era, the Aussie dollar has traded down well below $US0.60 during global recessions and this is possible through 1H23. However, provided Macquarie's view is right about the depth and duration of the recession, the AUD should have a much better 2H23 alongside other risk assets, which should be boosted by easier policy conditions. As always, there are both positive and negative risks for the Aussie dollar as we enter the new year with the positive supports likely to prevent the currency from sitting at lows for an extended period or rising quickly to fresh highs during the early part of the year. For those looking to hedge out currency risk, we would look to have these in place over the first part of the year.

The risks putting downward pressure on the AUD include:

- The recession is deeper and more prolonged, with inflation remaining stubbornly high.
- The RBA reaches its terminal rate before other major central banks and at a lower level.
- The COVID outbreak in China proves problematic and growth slows sharply.
- An escalation of the conflict in Ukraine or China-US relations.

The risks putting upward pressure on the AUD include:

- The global recession is mild, and a recovery is underway before mid-year. Inflation keeps slowing and by mid-year is on a sustainable path back to central bank targets.
- China quickly gains control of the COVID outbreak and property rebounds strongly on the back of stimulus announced at the end of last year.
- An early end to the conflict in Ukraine.

> "Australia to weather the downturn but not without some pain"

Overall, Australia will not be immune from the global recession with growth expected to slow to only 1.1% this year. China is likely to be a positive driver as the property sector rebounds and the economy reopens post the removal of its COVID-zero policies, but this might not be immediate or as strong as expected through 1H23 when it is likely to be needed most. Inflation has peaked, although the path forward is uncertain. Interest rates will likely need to remain high for an extended period to put inflation on a path back to target. Dwelling prices will continue to decline, led by Sydney and Melbourne and along with a gradual rise in unemployment, will increasingly weigh on consumer spending. Household debt is high, and the RBA must navigate a tricky path to get the economy back on an even keel.

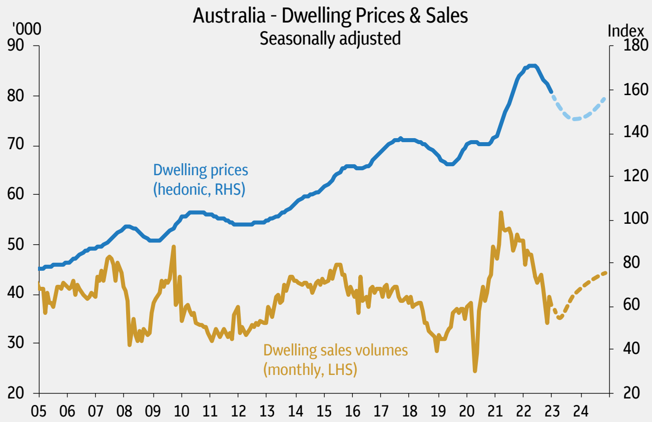
	2022	2023	2024
GDP	3.9	1.6	1.6
CPI	6.6	5.5	3.0
Unemployment rate	3.4	4.1	4.6
A$/US$	0.69	0.69	0.70
Policy rate	3.10	3.35	2.60
10-year yield	3.40	2.80	2.75

Source: Macquarie Macro Strategy, January 2023

Australian housing outlook – more pain to come

We expect the Australian housing market to remain under pressure in 2023. Higher interest rates, falling household borrowing and servicing capability and a decline in consumer confidence resulted in a 9% price decline (from peak) in 2022 and Macquarie believes the price adjustment is only around halfway complete. Several headwinds including tight monetary conditions, a weakening labour market (pressuring consumer confidence) and an evaporating household savings buffer will see sustained downward pressure on dwelling prices, if not preventing prices from quickly bouncing back. We believe the outlook for the housing market remains negative due to the high correlation between property prices and the RBA's policy trajectory. Importantly, until the RBA successfully subdues inflationary pressures, the housing market is likely to face ongoing headwinds.

Dwelling prices will remain under pressure in 2023



Source: ABS, Macquarie Macro Strategy, MWM Research, January 2023

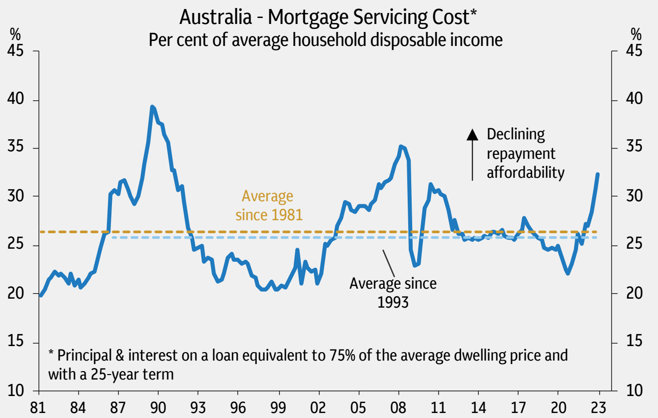
How far will housing prices decline?

Since peaking in May 2022, national housing prices have fallen by 9%. This is in stark contrast to the 21% rise seen throughout the pandemic when the combined tailwind of low interest rates and generous fiscal policies supported prices and drove a substantial boost in affordability. Macquarie's central case is a 15% nationwide decline that will see housing prices return to their March 2021 levels, implying a further 6% decrease, although we think this could be on the optimistic side and price momentum could easily deteriorate further. On a real basis, such a decline would be the largest in four decades, and while this decline is expected to be orderly (on a nationwide average basis), uncertainty surrounds the timing and magnitude of the market bottom, and we would expect to see pockets where weakness is more severe. Capital cities have withstood the worst of the price decline with Sydney (-13%) and Melbourne (-8%) experiencing the largest drops in 2022. Despite better performance across Brisbane (-1%), Adelaide (9%) and Perth (4%) these cities are now showing signs of weakness, especially in Brisbane with prices declining rapidly into year end. Housing may be a collection of markets, but affordability and rising borrowing rates seep into all areas regardless of whether price adjustments are uniform.

How much affordability has been restored?

The price decline has seen some improvement in the affordability mix that must be weighed up against the deterioration in household borrowing and servicing capability. While deposit affordability has improved with the deposit amount required as a proportion of disposable income falling to around 6x, there is still a substantial difference between current and pre-pandemic (5x) levels. Likewise, the ability to access borrowing has deteriorated with the maximum loan size available to borrowers expected to fall around 25% if interest rates rise to 3.25%, which is Macquarie's base case.

Mortgage servicing costs have risen sharply

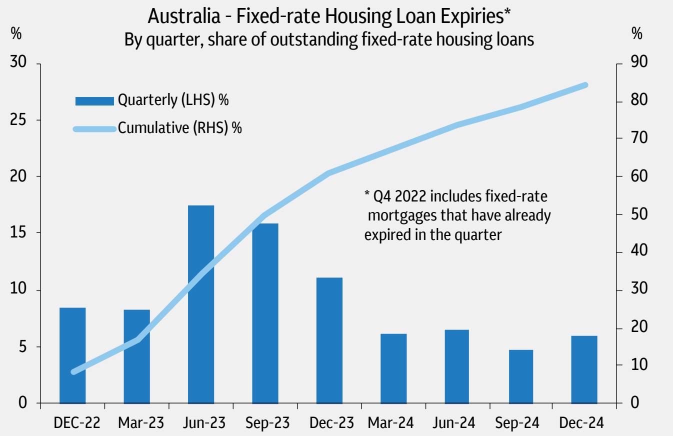


Source: Macquarie Macro Strategy, MWM Research, January 2023

The serviceability burden is equally problematic and has risen from 38% to 45% of disposal income, reflecting the pass-through of higher interest rates. Notably, the reset of fixed interest rates will prove to be a key factor in the affordability debate. At their peak, around 45% of fixed rate loans were written at one-three-year tenors between 2.0%-2.5% and will reset at between 5-6% through 2023. It is estimated that around 15% of fixed rate mortgages will have reset by 1Q23 but a further 45% will reset throughout the year, representing a significant increase in the serviceability burden.

Borrowers on variable rates are also facing a difficult obligation with the rate used to determine serviceability rising towards 8%. We believe the serviceability burden is likely to remain elevated as the RBA holds the cash rate at restrictive levels in 2023, resulting in a negative skew in the balance between affordability and accessibility.

Around 50% of fixed rate mortgages will reset by year end 2023



Source: Macquarie Macro Strategy, MWM Research, January 2023

Supply side dynamics

The supply of properties being listed for sale has fallen by 50% since the peak in March 2022. While this figure seems large, there has been little evidence of a forced selling in properties. While auction clearance rates in Sydney (55% to 60%) and in Melbourne (55% to 60%) in the last November/December period were low, they are still consistent with the relatively modest price declines. Notably, the number of auctions in both cities picked up towards the end of last year and reflects a better entry point for some buyers although we think it remains too early to think activity has now bottomed. Further on the supply side, residential construction of new dwellings is likely to be weaker in 2023. Construction activity has been lower than projected compared to building approvals, primarily due to weather disruptions and supply (building material) constraints.

Consequentially, the building pipeline has grown, and Macquarie expects the construction cycle will be longer and flatter. We believe a larger construction pipeline does not bode well for prices given the expected growth slowdown in 2023, culminating into an environment of weaker aggregate demand.

Demand side factors

Population growth is expected to pick up strongly this year, with the Federal government projecting a rebound in the residential population level. Population growth is a key contributor to inelastic demand for housing, thus any increase in the level serves to produce a natural support for property prices. An increase of 357k is expected in 2023, compared to the 273k increase in 2022. Notably, the projected level is higher than the 5-year pre-pandemic average (373k), highlighting a potential return to more normal population trends. Furthermore, population growth is concentrated across the 35–44-year-old age cohort, supporting first home buyer and upgrader demand. Net immigration levels have also recovered strongly and are likely to provide a further boost to demand. Chinese migrants are particularly likely to re-explore buying opportunities as China's pandemic travel restrictions are eased.

What cities look more/less vulnerable vis-à-vis 2023?

Sydney and Melbourne will benefit most from the opening of international borders to Chinese students and visitors, but they have also seen the sharpest price declines thus far. Brisbane saw an acceleration of price declines at the end of last year and won't see as much benefit as Sydney and Melbourne from net overseas migration. The smaller capital cities (Perth, Darwin and Adelaide) came through 2022 less scathed than the largest three eastern state capital cities and should probably outperform again given affordability is less stretched than in Sydney and Melbourne.

Overall, the decline in prices is providing some offset to the deterioration in borrowing capacity but not at a level sufficient to put a floor in prices which are still substantially above the pre-pandemic level. A rebound in immigration will provide some support for demand but ultimately confidence and prices will require a softer policy rate outlook and for mortgage resets to work their way throughout the economy. Housing is an illiquid asset where markets can take time to normalise. Corrections have been few and far between for the Australian residential sector and given the policy-induced nature of the current downturn, it makes sense to think that it will require a reversal of these conditions before an upswing can commence.

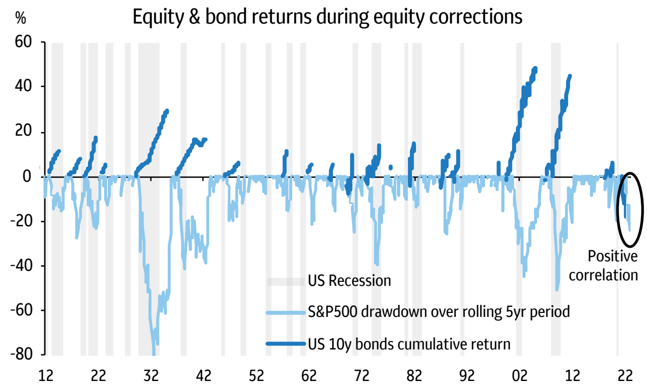
06.

Asset market oulook

More pain before some 2H23 gain.

2022 did not turn out as anticipated. Global inflation pressures proved to be less transitory than expected with the rapid reversal in monetary policy settings driving a meaningful correction in almost all assets that had benefited from cheap and plentiful liquidity for more than a decade. The broad-based nature of the correction meant there were few places to shelter from the downturn with US treasuries (supposedly one of the safest investments on the planet) posting negative returns during an equity bear market for the first time in history.

Bonds have never been down during an equity bear market... except in 2022



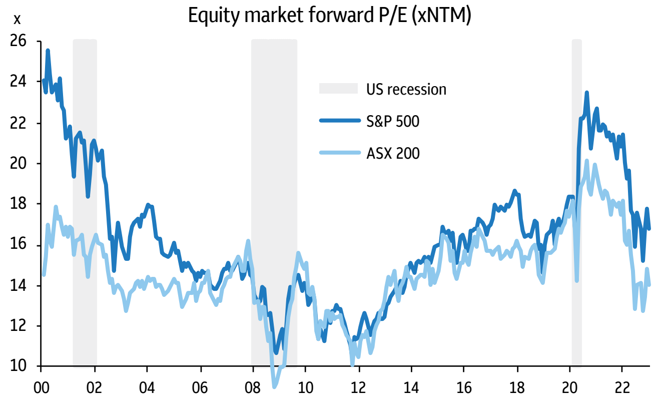
Source: Factset, MWM Research, January 2023

“Recession is not the baseline between ‘good’ and ‘bad’”

As we move further into 2023, we expect central banks to first pause and then begin cutting policy rates in response to a fairly rapid decline in inflation and in an effort to begin supporting economic growth. It is likely that inflation pressures have already peaked with supply side disruptions already some way towards normalising and as goods demand continues to slow. But inflation is unlikely to decline in a linear fashion and the absolute level suggests there is scope for disappointment. In addition, and despite the aggressiveness of rate hikes to date, we think financial markets are still betting on central banks doing just enough and not too much on the policy tightening front.

For investors, the macroeconomic backdrop is therefore one where interest rates rise a little further, where economic growth weakens into mid-year but where policy settings are starting to ease as early as the third quarter and where economic growth is also beginning to pick up by year end. This is not a particularly investment friendly backdrop. Navigating elevated inflation and a global slowdown (recession in US, UK and Europe) brings many risks that mean investors will need to stay nimble as well as favouring liquid investments that have a strong valuation and quality overlay.

Valuations are down but not at recessionary levels yet



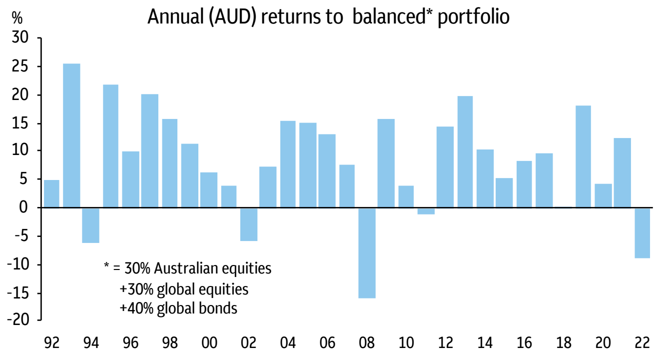
Source: Factset, MWM Research, January 2023

> “The trajectory of markets will be what matters most through 2023”

We think the trajectory of markets is what will really matter through 2023. By year end, we think equities will be around 5-8% higher than where they started the year and that bond yields could be between 75-100bps lower. At face value this is nothing spectacular. However, to get to these year-end expectations, equities in particular, could sell off up to 10%, before staging what could amount to a 15-20% recovery as policy support turns more favourable. This rebound might sound optimistic, but the early stages of recovery tend to see some of the strongest gains, and we think 2023 will be no different if Macquarie’s call on a modest recession and a policy pivot is correct.

On a more positive note, the significant valuation correction seen across almost every asset class in 2022 has led to a significant improvement in the long-term return outlook for both bonds and equities. Perversely, this improving return outlook is unfolding at the same time that investors are trying to protect portfolios from any further loses. When uncertainty is high there is always the temptation to sit on excess cash. Over the long term, this has proven to be a costly strategy versus a fully invested well balanced portfolio. In addition, with inflation still running significantly above the cash rate, real purchasing power is falling (albeit less than being exposed to most asset classes through 2022).

2022 was the worst year for a balanced portfolio since 2008



Source: Factset, MWM Research, January 2023

At this stage, we don't see any strong need to be aggressively deploying excess cash into risk assets. Having a tactical underweight to equities and credit appears prudent given downside risks, but there are also some solid "rules of thumb" that any investor who chooses to sit out market volatility should keep in mind.

1. First, it is difficult to time markets so, while a degree of cautiousness is advised, we don't recommend sitting on large amounts of uninvested capital. Rather, and despite some downside risk, we think averaging into risk assets to take advantage of lower valuations and rising return expectations is better than trying to time the bottom.
2. Second, the real return to cash is going backwards and while this offers some diversification benefits, we think bonds/high quality credit can provide a more appealing (risk-adjusted) yield while in the case of the former also providing downside protection as correlations revert back to normal.
3. Third, there are a number of strategies that can be engaged to profit from market weakness/volatility. This includes hedge funds (long/short and macro) as well as high-quality dividend payers within the equity market. There is a strong consensus view that private markets are a much safer bet than listed markets. We are careful to apply this statement generally. Private markets are less volatile, but they are not immune from valuation downgrades and so investors should also understand that valuation is a 'lagged' risk, not 'no' risk.

> "Cheaper valuations have created an attractive entry point for long-term investors"

4. A diversified portfolio is still the most effective way of creating long-term wealth. There will be periods when asset classes don't behave as expected (such as bonds throughout 2022) but over the medium to long term, we remain comfortable that a well-diversified portfolio remains the best option for investors who want a balanced risk-reward outcome. There is lots of talk around the death of the traditional 60:40 (growth:defensive) portfolio but we think this debate is more nuanced. For some time, we have been substituting non-traditional growth assets (i.e., alternatives and real assets) for traditional growth assets (equities) and so we have already moved on from the most basic level of this debate. We will address this in more detail over the coming months, but there are some simple portfolio adjustments – either adding to the growth allocation or substituting non-traditional growth assets in order to boost returns and lower risk that are solid starting points.

Our key investment views for 2023 can be summarised as follows:

1. Equities should outperform bonds, but it will be a year of two halves (corresponding with the progression in economic and rates momentum and not necessarily the calendar). Valuation corrections across both fixed income and equities lift long-term return expectations for both assets as we move into 2023.
2. Equities always fall during recession and recession is Macquarie's base case. Traditionally valuations and earnings will both decline. The correction through 2022 has front loaded the valuation adjustment, but the earnings decline is not yet priced into markets (and nor is a more severe liquidity squeeze).
3. Bond yields (almost) always fall during recession and recession is Macquarie's base case. We think long bond yields have already peaked and will trade lower as growth risks intensify. Unlike 2022, sovereign bonds now offer appealing yields and strong protection against equity market weakness and traditional correlations are re-established.
4. Credit defaults always rise during recession. We expect a modest default rate cycle where levels rise back to the average rather than hit prior peaks. Even so, spreads are likely to widen further. Quality (Investment Grade over High Yield) will be a differentiating factor but this is a relative call within credit and we think there is downside across the entire credit spectrum.

5. Cash will be a drag on performance through 2023 as real returns are likely to remain negative (inflation above the cash rate) and as risk assets recover later into the year. We prefer high-quality dividend growers and quality fixed income investments for yield and low-correlated assets such as infrastructure and hedge funds for added portfolio protection.
6. We like the long-term outlook for private markets (both debt and equity) but this asset class is not immune to the valuation adjustment seen across public markets in the short term. Equity capital market activity dried up during 2022 and this opens opportunities for large private market players to provide a financing bridge in 2023 and for more appealing rates to be sought by private debt players.
7. Cyclical demand for real assets (infrastructure, transportation, clean energy and selected real estate) will add to already strong structural demand across both private and public markets through 2023. We think this should become an ever-increasing part of diversified portfolios with long-term objectives. Listed assets are likely to provide a cheaper entry point for idle cash as cyclical transparency improves through mid-year.
8. Growth stocks have suffered their peak period of relative underperformance if our expectation that inflation and long bond yields have peaked is correct. We think cyclical/value are more likely to suffer greater downside as recession takes hold into 2023. However, extended periods of style outperformance are not likely to return any time soon, as zero rates policies are confined to history. We think investors should start 2023 being “style agnostic” but with a “quality bias”. By year-end we expect portfolios to have a more risk-on/ cyclical tilt.
9. Australian equities have been a strong relative outperformer through 2022 but will likely give back some of these relative gains as cyclical markets recover in 2H23. However, the market has a solid dividend yield, strong earnings fundamentals, a favourable political backdrop and solid defensive characteristics. A modest economic slowdown means it should continue to weather downside risks relatively well.
10. Investment thematics will rise in prominence as risk aversion declines even though they are structurally driven. The technology and other high-multiple growth sectors are not dead, but the tide has gone out on those companies which were being propped up by easy/cheap liquidity. Our key investment thematics are all things ‘security’ (food, energy and cyber) as well as all things ‘green’ (decarbonisation, the recycled economy and green transport). We think exposure to these themes should be substituted within traditional equity allocations.

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2023 Outlook was finalised on 9 January 2023.