Investment Matters

2H22 Outlook

An end to *"easy"* money isn't always easy

July 2022

MACQUARIE

Economic outlook sours as the inflation fight continues

The era of free money is over as central banks attempt to get surging inflation back under control. We expect global policy tightening to continue well into 2023 via a combination of aggressive cash rate hikes and quantitative tightening.

- Macquarie expect the US, UK and Europe to all fall into recession in 2023. Australia should avoid this fate, but economic growth is set to slow substantially as we move into 2H23 with many areas of the economy, like consumer spending and housing, are likely to face recession-like conditions.

- Macquarie forecast Australia's cash rate to hit 2.60% by year end and to peak at 3.10% by mid-2023. This represents a substantial tightening in monetary conditions and will be a major drag on rate sensitive spending and asset prices for some time to come.

Financial markets to remain under pressure as growth risks intensify

- The tug-o-war between inflation/policy tightening and slowing economic growth will continue to drive volatility, as sentiment oscillates between hope and fear. We think inflation is nearing a peak (ex-Australia) with bond yields likely to have seen their cycle highs.

- Equity valuations are now more attractive, but market bottoms usually correspond with trough multiples and both global (14.6x) and Australian (12.9x) equities remain some way above these levels.

- We don't think equity markets are priced for recession or further back news that drives economic and earnings growth downgrades. Based on historical declines around recession periods, equities could fall a further 10-15% if this scenario unfolds.

- If central banks engineer a soft landing while also managing to bring inflation (expectations) down, then equities will bounce sharply. But the liquidity tailwind that has helped fuel growth and markets over the past decade will be much weaker in the coming years and this will also limit the recovery.

- While bond yields are peaking, credit spreads will likely widen further as corporate fundamentals weaken and recession risks rise. However, systemic risks for the financial system are low and we see little risk that the functioning of credit markets will face major disruption.

- Private market assets will not be immune to the disruptions that have driven public market assets lower. We expect to see sizable write-downs in the value of private assets, but this will remain modest given traditional offsets such as investment holding periods and little forced selling.

Caution is required with a skew towards defensive over risk assets

- We believe portfolio construction should factor in protection against a deeper economic downturn, and/or a combination of weak growth and elevated inflation (stagflation). Portfolios will need to be resilient against many different outcomes, as we navigate elevated uncertainty.

- We have downgraded equities to underweight by reducing our Australian equity allocation where we expect 1H outperformance will be given back as commodity markets weaken and rate sensitive sectors come under rising earnings pressure.

- We expect bonds to outperform equities through 2H22 where yields are now relatively attractive and where they act as protection against recession risks. We remain underweight credit where we expect the riskier end to trade in line with a deteriorating economic outlook.

- The bear market continues to roll through markets with the cyclically exposed areas of the commodity complex the latest causality. Given recession is now our base case for many major developed economies, we think further downside is likely in areas which are not supported by structural demand and/or supply side shortages.

- Alternatives remain our preferred exposure with a preference long/short & macro strategies as well as private markets where valuation risks are lower.

- More generally, raising cash and adding liquidity, to avoid selling assets at a discount, is prudent. Focusing on private markets, quality and defensive assets can help protect against volatility – as will reducing exposure to areas where valuations remain expensive. We prefer areas that stand to benefit from current disruptions or exploit a strategic tailwind – such as energy efficiency, food security, automation and cyber security.

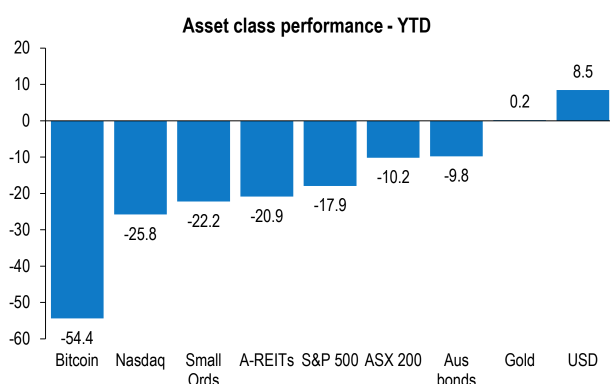
Jason and the Investment Strategy Team

Breaking up is hard to do:

An end to “easy” money isn’t always easy

We entered 2022 expecting to see economic growth momentum slow, inflation to peak and gradually decline, and for interest rates to begin rising at a measured pace. We also expected equity market gains to normalise and financial market volatility to pick up, as is normal during a phase of economic transition. On a *“pain scale”* of 1-10 (where 1 is a smooth “goldilocks” transition and 10 is a volatile transition), we were expecting these changes to rank somewhere in the middle.

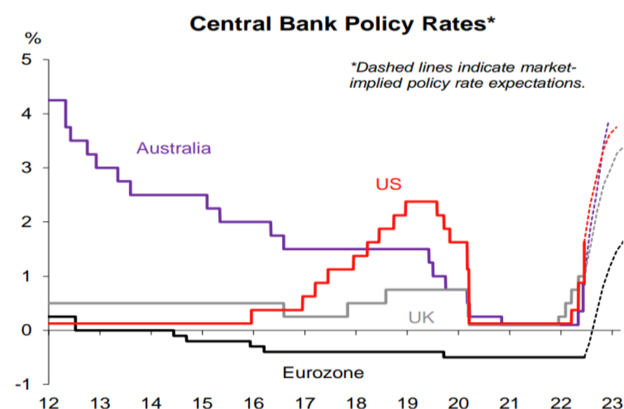
Few assets performed well in 1H22



Source: FactSet, MWM Research, July 2022

This is not what eventuated. The rapid reset in inflation and rate expectations blew through markets like a whirlwind ranking somewhere between 9-10 on our *“pain scale”*. In fact, if the year was to end now, then 1H returns would put equities on track for one of their worst performances in 50 years while bonds (depending on the type) are close to posting their worst ever half. Impressive statistics but for all the wrong reasons!

Policy rates are now tightening at an unprecedented speed



Source: Macquarie Macro Strategy, July 2022

What actually happened in 1H22? Many factors combined to undermine the economic and financial market outlook in 1H22. However, if we were to simplify the problem, it was the continued rise and broadening out of inflation pressures that drove an unexpected repricing (in both the pace and magnitude) of central bank policy tightening.

Higher bond yields and expectations of central bank rate hikes then began to impact equity valuations and other risk assets that had been beneficiaries of cheap and easy liquidity. Valuations were no longer consistent with the new cost of capital outlook. This marked the first phase of the sell-off, but inflation concerns then transitioned into recession fears as central banks began to communicate a *“whatever it takes”* approach to containing inflation. As a result, the bear market that started as a valuation correction in growth stocks then broadened into more economically sensitive areas of the equity market.

The economic outlook is souring:

Fighting inflation comes at the expense of economic growth

We expect the economic and financial market uncertainty that has featured throughout 1H22 will continue throughout the remainder of the year.

Periods of economic transition take time and are rarely linear. They often take many turns, particularly as the risk of policy mistakes increase and/or when economies face exogenous forces – like the conflict in Ukraine, which has ramifications for global energy and food prices as well as supply chains.

Global growth is set to slow substantially into 2023

Source: Macquarie Macro Strategy, July 2022

At this stage, Macquarie expects the global economy to escape recession in 2023. There’s a material chance that this view proves optimistic, but it’s unlikely that the economy surprises to the upside and enters a reflationary phase. This suggests that the best outcome for the coming 12-18 months is one where growth slows sharply but where a global recession is avoided.

It has become clear that faced with a once-in-a-generation surge in inflation, most central banks will need to tighten policy until inflation slows back towards target. This is likely

to require an uptick in unemployment in many developed economies. Macquarie expect several major advanced economies (US, UK, Europe) will enter recession over the next 12-18 months, as strong inflation weighs on real incomes and sentiment, and monetary policy moves from being highly accommodative to contractionary. However, China is expected to be the outlier due to 2H22 stimulus measures and this should provide enough support for the global economy to skirt recession.

China - the only major economy avoiding a 2023 slowdown

% y/y	2020a	2021a	2022f	2023f
US	-3.4	5.7	2.3	1.0
China	2.2	8.1	5.0	5.0
Eurozone	-6.5	5.3	2.8	0.0
Japan	-4.6	1.7	1.4	1.1
UK	-9.3	7.4	2.9	-0.3
Canada	-5.2	4.5	3.2	-0.5
Australia	-2.1	4.8	4.1	2.6
New Zealand	-2.1	5.7	2.1	1.4
Global (MER)	-3.5	6.0	3.2	2.4
Global (PPP)	-3.4	6.2	3.5	2.7

Source: Macquarie Macro Strategy, July 2022

Central banks inflation fight has become "unconditional": Simply put, by waiting too long to act, central banks left themselves with little choice but to do "whatever it takes". This seemingly unconditional fight against inflation is why Macquarie's macro strategy team believe the economic outlook has changed materially.

We believe it will take time for economic data to show some degree of consistency (either good or bad). Until that happens, markets will be driven by the ebbs and flows of data prints. We believe protection against ongoing economic volatility, alongside the potential for a deeper economic downturn or a stagflation scenario, should feature in portfolio construction as we move into 2H22 and beyond.

Economies are difficult to manage via interest rates alone. Once growth begins to slow and unemployment picks up, a negative feedback loop can take hold, propelling weakness in confidence and employment. The risk of a policy mistake by central banks intent on bringing inflation down remains high, but ultimately will depend on how willing they are to live with inflation above target ranges. The next 3-6 months remain highly uncertain as we wait to learn how aggressive and unconditional the fight against inflation will be and the economic cost central banks are prepared to pay.

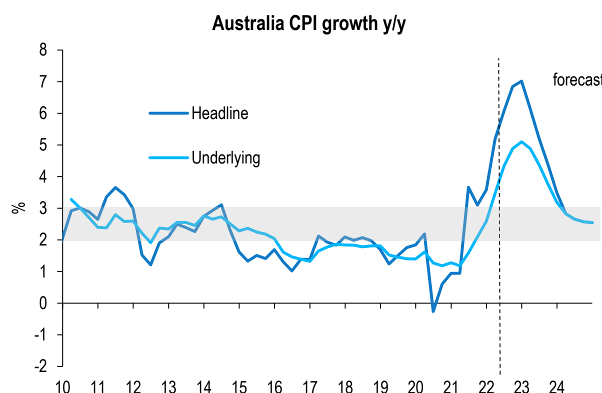
Structural overhangs that prolong recessions are generally absent: Underlying economic conditions are relatively robust with limited signs of structural excesses that would deepen and/or prolong an economic downturn (such as excess inventories or an overleveraged consumer/corporate sector). In fact, consumer balance sheets are solid with excess savings accumulated over the pandemic period available to support spending patterns for some time. In addition, there are few signs of credit stress at a corporate level, nor signs that the plumbing of the financial system is vulnerable to tightening liquidity conditions. This should lessen the drag from higher borrowing rates, and an uptick in unemployment, even if it is not enough to avoid a short and shallow recession for advanced economies.

Australia to escape economic recession:

But recession-like conditions may be felt by many households

Despite expecting a notable slowdown in economic growth, Macquarie is not forecasting Australia to fall into recession in 2023. That said, many sectors within the economy stand to experience recession-like conditions (i.e. consumer spending, housing). Other sectors are likely to remain reasonably well supported and offset the weaker household sector (i.e., business investment, corporate profits and unemployment).

Australian inflation has not yet peaked



Source: ABS, Macquarie Macro Strategy, July 2022

Like the rest of the world, Australia has an inflation problem. Macquarie expect inflation to rise further, from 5.1% y/y in March, to peak at around 7% by end-2022. Over the following 12-18 months, we expect quite a rapid decline to between 3-5%. However, it is not likely to get back down to the RBA's 2-3% target band before 2024. Like other central banks, the RBA is now playing catch up – so Macquarie is forecasting the cash rate to reach 2.60% by year end, before peaking at 3.10% in 1H23. Thereafter, Macquarie expect the RBA will be forced to reverse its policy tightening, with cuts of 100bps by year end 2024 needed to reduce recession risks.

Overall, Australia's growth should remain solid relative to other economies such as Europe and the US as stimulus continues to wash through the economy for two key reasons: 1) Monetary policy is not expected to tighten as much as the other economies, given inflation pressures are less intense; and 2) Australia has more direct exposure to

China, which should provide some support to growth over the next couple of years.

Financial market risks remain elevated:

Uncertainty to prevail as growth fears take over from inflation fears

We think financial markets will remain volatile and largely rangebound until there is greater transparency around key uncertainties, as we move into 2H22 and beyond. It is likely that fears around inflation are reaching a crescendo, suggesting we are nearing peak hawkishness on interest rates. But the question then shifts to how quickly inflation decelerates and how comfortable central banks are with the pace of decline. If inflation drops off quickly and expectations stabilize or fall, then economic growth fears will also ease. If inflation proves to be stickier than expected, then it is likely equities will begin to price in a greater risk of recession.

It will take some time to see how the path of inflation and monetary policy is tracking and this will keep investors and markets reactive to positive and negative data surprises. This does not mean markets are on a path lower, but it does mean that equities and other risk assets are unlikely to trade sustainably higher for now. The concern is an accumulation of policy errors (excessive tightening) that tip us into a deeper and potentially more prolonged global recession.

What else will help support an equity market bottom / bond yield top? Ultimately, we think the inflation versus growth mix is key to how we position portfolios into 2H22 and beyond. Several other factors will help raise conviction that we might be through the worst. This includes:

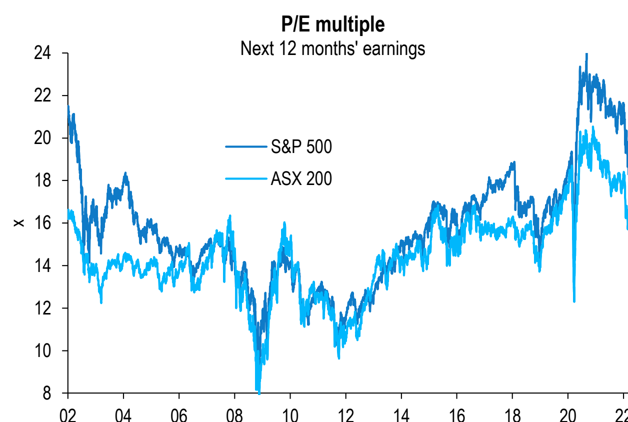
- A more dovish shift in central bank rhetoric which in turn will help alleviate overtightening and fears of a hard landing (recession).
- An end to the conflict in Ukraine and/or a more aggressive pro-growth policy push by the Chinese Administration. A resolution to the conflict in Ukraine appears difficult to predict. However, Macquarie's China economist expects China to stimulate around the July Politburo meeting. Depending on the scale, this could be an important 3Q catalyst for boosting global growth momentum.

Macquarie think there are many signs pointing towards a peak in global inflationary pressures:

- Evidence that goods demand is moderating and getting closer toward long-term trajectories.
- Lower demand, improving goods supply, and easing of supply bottlenecks are leading to a build-up of inventories, both absolute and relative to orders.
- Leading indicators signal that aggregate demand is getting weaker under the twin pressures of eroding fiscal stimulus and tightening monetary policies.
- Evidence of weakening public sector liquidity, money supply and credit momentum.
- Although China is stimulating, it is a different type of stimuli when compared with previous cycles (i.e. less capital- and commodity-intensive).
- Inflationary break-even rates might have already peaked, and the flatness of yield curves suggests limited scope for any further significant tightening.
- Most industrial commodities have already been retreating for several months. The commodities complex (e.g., CRB index) appears to have stabilised and, for the first time in 12 months, inflationary surprises are no longer strongly positive.

Equity markets have not priced in a recession: While equity markets have experienced a challenging start to the year, we do not think they are priced for recession because earnings expectations remain overly optimistic. At this stage, earnings are still forecast to grow strongly in 2023, and this would be at odds with an average earnings decline of ~15-20% during recession periods.

Sustainable recoveries start with valuations at "cheap" levels



Source: FactSet, MWM Research, July 2022

While valuations have retraced from peak levels, they are not yet 'outright cheap'. Global equities trade on a P/E of ~14.6x, still above the 2018 trough of 13x and GFC / Euro Crisis bottom of ~10x. Australian equities are trading on ~12.9x, above the GFC / Euro crisis trough of 9-10x. Traditionally, bull markets begin with valuations well below long-term averages and this leaves scope for further

downside should growth risks begin to pick up as we move into year end.

Australian equities are not priced for a recession

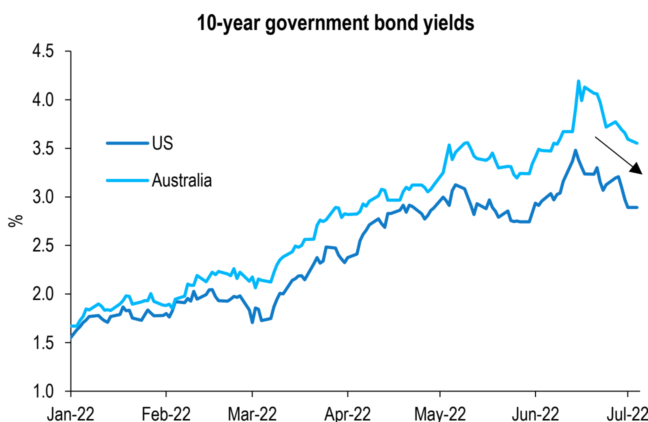
US recession starting	ASX Peak date	ASX Trough date	ASX Price fall	Duration months	ASX P/E fall	ASX Earnings fall
Nov-73	31-Jan-73	31-Oct-74	-54.1%	21.0	na	na
Jan-80	14-Feb-80	28-Mar-80	-20.3%	1.4	-21.0%	-17.3%
Jul-81	17-Nov-80	08-Jul-82	-40.6%	19.6	-18.5%	-11.5%
Jul-90	29-Aug-89	16-Jan-91	-32.4%	16.6	2.6%	-40.3%
Mar-01	07-Mar-02	13-Mar-03	-22.3%	12.2	-33.2%	-10.0%
Dec-07	01-Nov-07	06-Mar-09	-54.6%	16.1	-46.4%	-36.6%
Feb-20	20-Feb-20	23-Mar-20	-37.1%	1.1	-37.0%	-25.9%
	04-Jan-22	14-Jun-22	-13.2%	5.3	-25.6%	16.7%
	Average		**-37.3%**	**12.6**	**-25.6%**	**-23.6%**

Source: Factset, MWM Research, June 2022

A mild recession could drive a further decline for equity markets: We are cautious on equities as we enter 2H22. Valuations are not yet low enough to cushion against earnings risks, which are rising. There is still a disconnect between the macro message and guidance provided by corporates, particularly given profit margin pressures are building. We think a recessionary outcome could push equities down a further 10-15% because while the valuation bear market is complete, the earnings bear market is not. Encouragingly, the starting point for fundamentals is strong and capital shortfalls have been largely replenished. Similarly, equities have a long history of quickly recovering from recessions, which means any further weakness may not be prolonged. But with growth set to weaken, rates to continue rising and liquidity support some way off, we see the path of least resistance still on the downside.

Fixed income correction nearly complete: We think bond yields will be largely rangebound out through 2H22, as they navigate competing forces. On the upside, bond yields will continue to traverse high inflation and ongoing policy tightening. On the downside, they will be capped by slowing global growth momentum and recession risks.

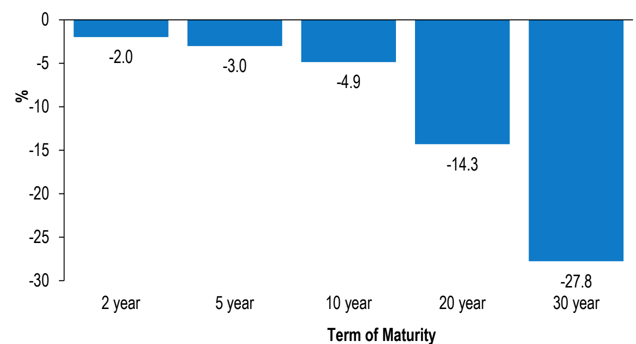
Bond yields have fallen in response to rising growth risks



Source: FactSet, MWM Research, July 2022

The good news is that we expect the reset higher has already occurred and this limits the scope for further losses. It also makes bond yields more sensitive to the direction of economic data surprises in coming months. The bad news is that there's been little progress made to bring inflation back down, even if price pressures might be close to a peak (ex-Australia). In addition, an end to quantitative easing (QE) and a shift to quantitative tightening (QT) may also drive upward pressure on bond yields. With central banks stepping back from their government bond buying programmes, investors will likely demand a higher term premium vis-à-vis central banks, who are less price sensitive.

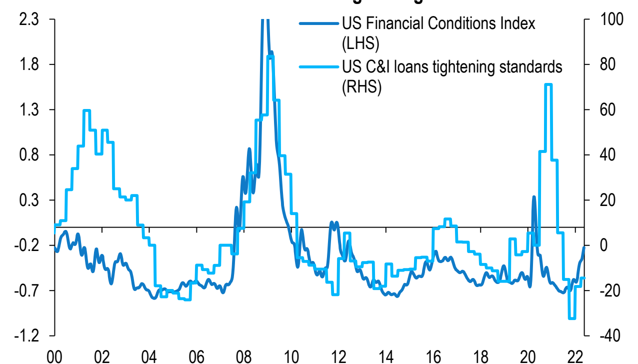
Being short duration has paid off in 1H22



Source: Morningstar, MWM Research, July 2022

While only on a relative basis, investors have been paid handsomely to be in short duration assets across both bonds and equities (via value stocks). Going forward, short duration may no longer be appropriate, given the substantial increase in long bond yields combined with a reduced need to sell bonds for equities. Consequently, we are positioning neutral duration, if not overweight, heading into 2H22.

Tighter financial conditions lead wider credit spreads



Source: Factset, MWM Research, July 2022

Credit markets are more nuanced and, while the cycle is intact and fundamentals remain strong, we don't see credit

staying immune to the dislocations impacting the global economy. With economic growth set to slow and corporate fundamentals unlikely to improve, we think spread widening will remain the underlying trend across credit markets. It is possible that credit, like other risk assets, gets a short-term reprieve if bond yields are sustainably topping out. However, we don't see a material or sustained narrowing in spreads as we look beyond the next quarter or two. We remain cautious on global credit, even though it provides an attractive yield, because we doubt strong fundamentals will prevent further spread widening.

For Australia, long bond yields have played catch up to global bond markets in recent months, as Australia's inflation outlook has shifted. A strong labour market has seen the RBA step up its hawkish narrative and raise rate hike expectations. Macquarie expects a cash rate of 2.60% by end 2022, rising to 3.10% by mid-2023. This is a substantial increase from where expectations sat just a few months ago. We don't see a lot of upside for Australian long bond yields, but neither do we see much capacity for a sustained move lower – given the RBA's hawkish policy stance.

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Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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