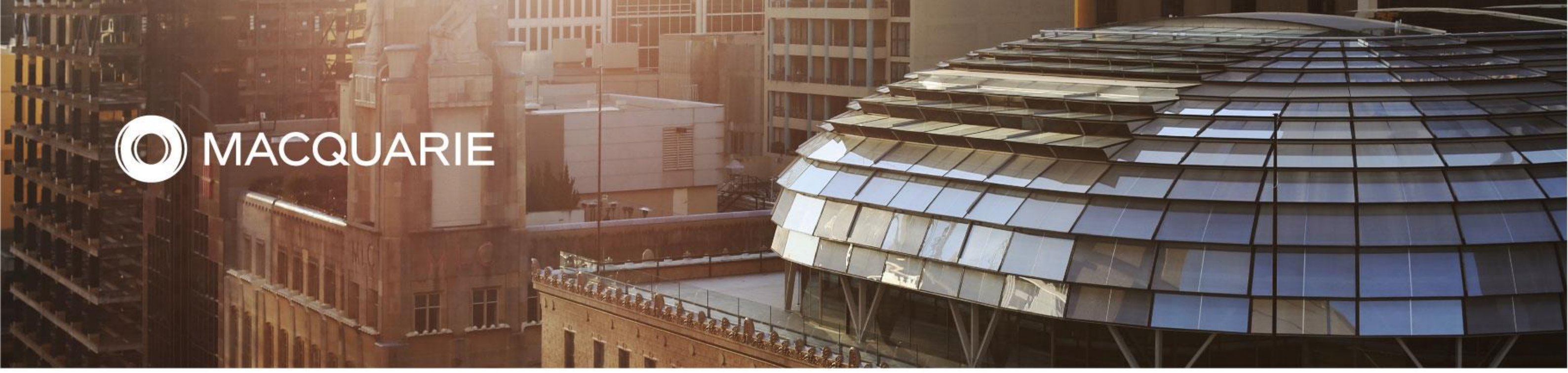


FY23: The financial year in review

Rising rates and economic recession fears can’t stop a risk asset rally

- FY23 saw central banks attempt to tame inflation with the sharpest rate hike cycle since the early 1990s. The reversal in monetary policy conditions eventually led to a slowdown in economic growth across many large, developed economies. However, the impact was much slower and shallower than expected given a resilient consumer (supported by excess savings accumulated during the pandemic), solid corporate earnings fundamentals and ongoing tightness in labour markets.

- By FY23 year end, it became clear that policy tightening was finally doing its job with a meaningful decline in both headline inflation as well as economic growth. At this stage, most major economies have avoided slipping into recession, although leading economic indicators are pointing towards further growth weakness in the quarters ahead.

- Despite rising policy rates, the rapid removal of easy liquidity conditions (both monetary and fiscal) and expectations of an economic slowdown, risk assets such as equities and corporate bonds performed extremely well over the full year period.

- The trajectory of returns throughout the year was an important differentiator. 1Q23 was weak as rising rates drove a valuation correction, but expectations of peak inflation and policy rates as well as resilient economic and earnings growth, saw markets stabilize in 2Q23 and then rally into 2H23. This was also accompanied by falling long bond yields which provided some support for long duration assets.

- Over FY23, global equities (MSCI AC World Index) posted a total return of +16.5% in US$ (+20.4% in A$). Global equities suffered a 1Q23 sell-off, falling 6.8% in US$ before stabilizing in 2Q23 and rallying strongly in 2H23. A key feature of the rally was narrowness in breadth with a handful of IT stocks leading US equities and ultimately global equities higher.

- Most major equity markets posted double-digit gains over the financial year, with the EU (+36.1% in US$) and Japan (+17.7% in US$) the standouts in part due to cheaper valuations while China (-16.8% in US$) lagged behind as its economic recovery stalled.

- Australian equities also defied bearish consensus expectations coming into FY23 with the ASX200 index posting a total return of +14.8% (in AUD) albeit underperforming global equities. Domestic performance was underpinned by resource stocks (+23.0%) which received a strong tailwind from the China reopening trade late in the year. Surprisingly, Australian tech stocks matched their global peers (total return ~38%) but the low index weight meant they provided little upside for the broad market measure.

- Global bonds posted a total return of -1.3% in US$ (-1.2% in AUD hedged) – a mild decline but much improved compared to the -15% (in US%) return seen during FY22. However, much like risk assets, it was a year of two halves for bonds with yields rising sharply in 1H23 before trading sideways for the remainder of the year – albeit in a wide range as inflation and central bank policy expectations waxed and waned.

- Short-end rates rose relative to longer maturities, resulting in an ‘inverted’ yield curve (short rates above long rates) for both the US and Australia – a phenomenon that has historically preceded economic recessions. Markets briefly fretted about the systemic implications of a number of US bank failures in March/April 2023, which resulted in a sharp move lower in short end rates, although this had reverted back by financial year end.

- Corporate bonds: The rally in risk assets also saw corporate bonds perform strongly (global corporate bonds +2.1% in US$, global high yield bonds +10.5% in US$) as expectations of a shallower and shorter recession and solid corporate fundamentals drove a narrowing in corporate credit spreads over the full year. Concerns rose about a pending commercial real estate (CRE) correction although to date this has remained relatively contained with credit spreads still assessing default rise as idiosyncratic rather than systemic.

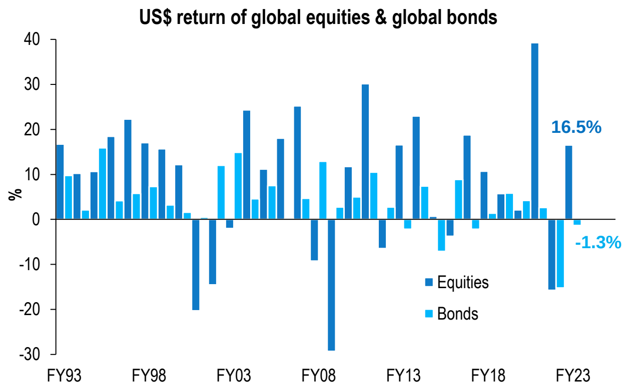
- Commodity prices: The broad index (S&P GSCI) of commodity prices fell 23.8% in US$ over FY23, dragged down by energy (oil (-38.0%) and coal (-66.8%)). Excluding energy, commodity prices fell 4.8% due to the rising US Dollar (commodities are priced in US Dollars) but also to concerns over the global and particularly Chinese economic backdrop, as well as receding concerns about the impact of the war in Ukraine.

- Currencies: The US Dollar Index (DXY) hit its highest level since 2002, initially strengthening against most major currencies, driven by expectations of a relatively more aggressive US rate hike cycle and safe-haven buying, then weakened as other central banks began to play 'catch up' with the Fed in raising rates and prospects of an imminent recession eased.

A good year for 'risk' assets

Over FY23, global equities posted a total return of +16.5% in US$ (+20.4% in AUD) while global bonds posted a total return of -1.3% in US$ (-1.2% in AUD hedged). This was a substantial improvement on the -15% (in US$) return for both equities and bonds during FY22 and meant that balanced funds posted much better returns compared to FY22. Interestingly, equities managed to post strong returns despite the sharpest rate hike cycle in decades and waxing and waning fears of an imminent recession. Other 'risk' assets such as corporate bonds also rallied as corporate credit spreads narrowed (the Bloomberg Global High Yield Bond Index posted a total return of +10.5% in US$) although commodity prices fell 23.8% in US$.

A good year for equities



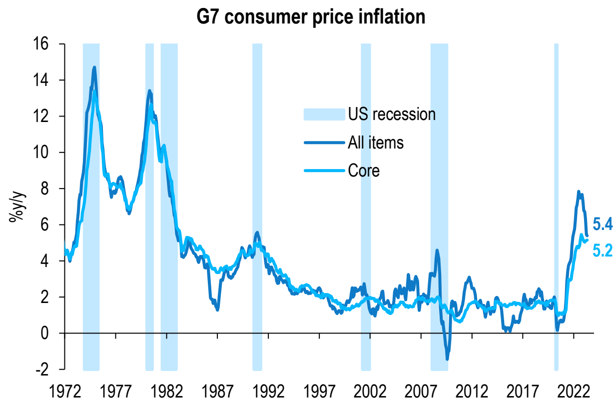
Source: Factset, MWM Research, July 2023

Economic backdrop

Central banks scramble to tame inflation…

The surge in inflation that began in late 2021 forced central banks to embark on the sharpest rate hike cycle in decades in an attempt to bring inflation back under control. While goods inflation peaked in June (as supply chains began to normalise) services inflation proved stickier, albeit appearing to peak in September. By the end of the financial year, most inflation measures were back down from their peaks although they remain elevated.

Inflation began to ebb over FY23

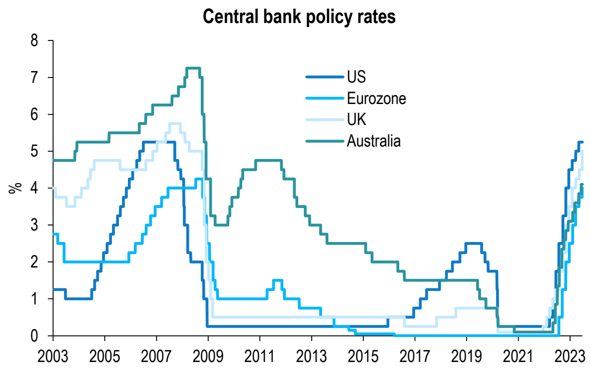


Source: Factset, MWM Research, July 2023

…with the sharpest rate hike cycle in decades…

Elevated inflation prompted central banks to continue rate hike cycles that had begun earlier in the year, resulting in the sharpest rise in rates in decades. Over the financial year, the US Federal Reserve raised rates by a cumulative 350 basis points from 1.50-1.75% to 5.00-5.25% with other central banks following suit.

Policy rates rose dramatically around the world in FY23

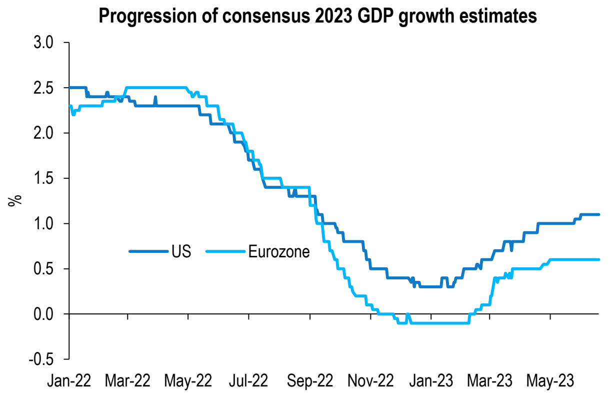


Source: Factset, MWM Research, July 2023

The global economy slowed in 1H…

Sharply rising interest rates, as well as the impact of stubbornly high inflation, began to meaningfully slow economic growth across the global economy in the first six months of the financial year and raised fears of an imminent global recession. However, in the second half of the financial year, spurred on by an improving inflation backdrop, hopes began to rise that central banks might successfully engineer an economic 'soft landing'.

Economic growth expectations fell from June to December



Source: Factset, MWM Research, July 2023

…but labour markets held firm

While the overall global economic backdrop over the financial year was weakening, there was a divergence between manufacturing (which bore the brunt of the weakness) and services (which remained relatively strong). The strength in services manifested itself in a robust labour market and multi-decade low unemployment rates.

Unemployment rate hit multi-decade lows

Source: Factset, MWM Research, July 2023

China's economy recovers, then fades

The Chinese economy started the financial year still reeling from the impact of stringent lockdowns stemming from the government's 'zero COVID' policy, which also resulted in a major property downturn. However, in November, China's policymakers relaxed COVID controls and announced measures to support the property sector. The economy initially rebounded before losing momentum after authorities 'tapered' policy support in April.

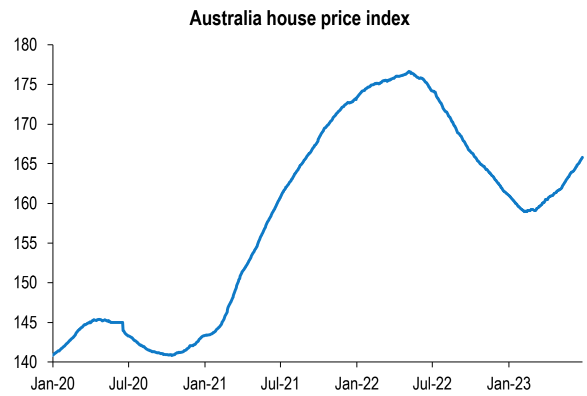
Australian economy resilient…

Australia's economy grew strongly during the year, outpacing most global peers, aided by strong exports and in the second half of the year, a sharp increase in immigration. The labour market continued to tighten with the unemployment rate reaching a 48-year low of 3.4%, with demand for labour remaining strong. However, consumer sentiment remained in the doldrums, hit by high inflation and rising interest rates. As was the case overseas, inflation rose sharply, hitting 7.8% y/y in the December quarter - its highest rate since 1990.

…as the housing market falls, then recovers

Australian house prices initially continued to fall, having peaked in April 2022, bottoming in February 2023 10% down from the peak according to CoreLogic. However, a temporary pause in rate hikes by the Reserve Bank of Australia in April 2023, low turnover and a tight rental market led to a rebound in housing prices. Questions remain about how sustainable the turnaround will be, given the RBA is expected to lift the cash rate a little further, but the recovery in the last few months of the financial year had solid momentum.

Australian house price bear market ended during FY23



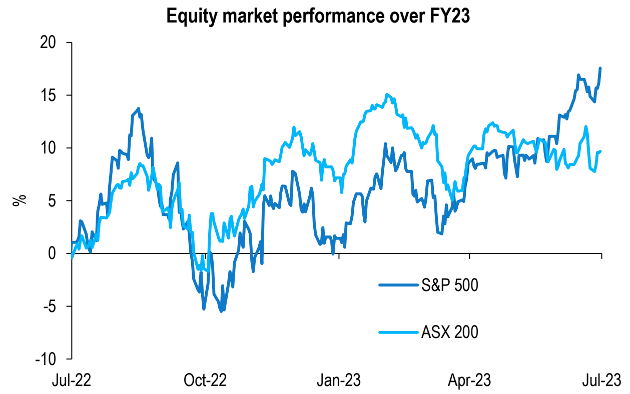
Source: Factset, MWM Research, July 2023

Market backdrop

A choppy 1H, strong 2H for global equities

FY23 proved to be a good year for equities, in contrast to FY22 and CY22. Over FY23, global equities (MSCI AC World Index) posted a total return of +16.5% in US$ (+20.4% in A$). Global equities were mostly range-bound during the first half, falling 6.8% in US$ in 1Q, of the financial year as markets wrestled with inflation and the impact of the sharpest rate hike cycle in decades. However, equities posted a strong return over the second half of the financial year as declining inflation and better-than-expected economic data in the US spurred hopes of an economic 'soft landing'. Global equities posted a total return of +2.3% in US$ from July to December and +13.9% in US$ from January to June.

Equity markets post strong gains over FY23



Source: Factset, MWM Research, July 2023

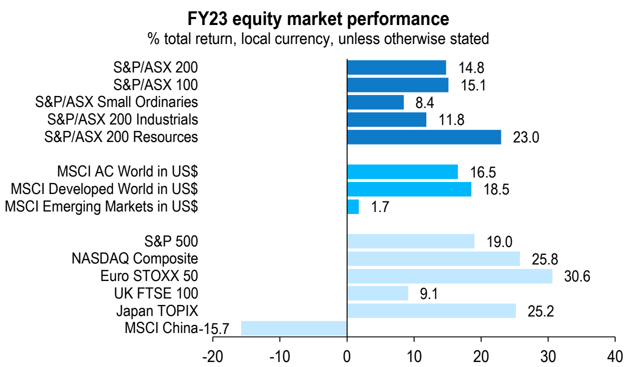
Most equity markets post double-digit returns…

Most major markets posted double-digit gains over the financial year. The strongest performing major market was the EU (Euro Stoxx 50 index +36.1% in US$, +30.6% in local currency), aided by relatively cheap valuations and improvements in Europe's energy supply situation (Europe gas prices fell 90% from their August peak).

Closely following behind was Japan (TOPIX +17.7% in US$, +25.2% in local currency) as the Japanese stock market hit its highest levels since 1990 on 1) optimism about an end to Japan's long-running deflation, boosting corporate pricing power, 2) changes to corporate governance regulations by the Tokyo stock exchange, aimed at improving shareholder returns, 3) the weak Yen making Japan more attractive to foreign investors.

The worst performing major market was China (MSCI China -16.8% in US$, -15.7% in local currency) as China struggled initially with continued COVID-related lockdowns followed by a lacklustre recovery following reopening. Consequently, the MSCI Emerging Markets Index (+1.7% in US$) underperformed developed markets, although this was due to China, which makes up 29% of the index. Excluding China, performance was much better, with Brazil (+29.8%) a standout.

Most equity markets up strongly over the year

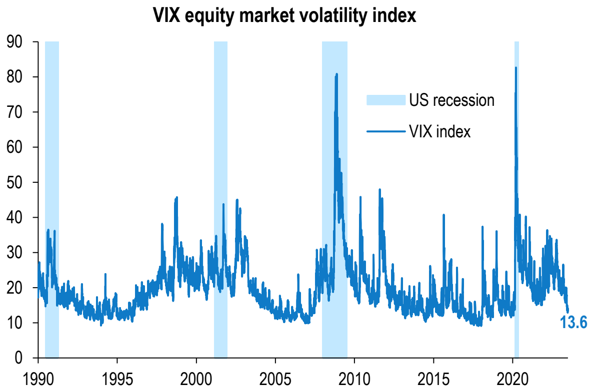


Source: Factset, MWM Research, July 2023

…as valuations rise, earnings hold & volatility falls

The overwhelming driver of equity market returns was valuation expansion: The S&P500 and ASX200 indices saw their forward P/E multiples expand by 21% and 17% to 19x and 15x respectively while earnings held steady. Following a spike in the equity market volatility VIX index to 34 in October, it steadily fell to 13.9 – its lowest level since January 2020.

VIX sees a 13-handle for first time since February 2020



Source: Factset, MWM Research, July 2023

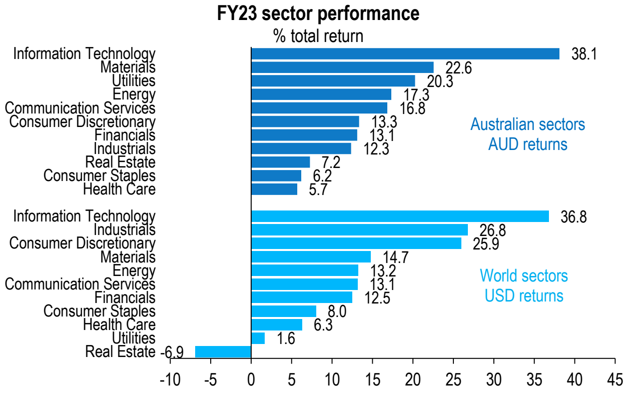
IT the standout, real estate underperforms

Thematically, global cyclical sectors (+23.3% in US$) outperformed defensive sectors (+7.3%) and global growth stocks (+26.4% in US$) outperformed value stocks (+10.7%) – aided by the strong performance from the Information Technology (+36.8%) and related sectors.

IT stocks received a boost from Artificial Intelligence euphoria following a strong result from semiconductor company Nvidia Corporation (+36% in May, +179% in FY23). This triggered very strong rallies in a narrow group of large-cap IT and IT-related stocks. Consequently, global large caps (+19.5% in USD$) outperformed small caps (+12.9%).

Real estate (-6.9% in US$) was by far the worst performing sector, as commercial property prices sank, weighed down by rising interest rates and high vacancy rates in the office market. The office market in the US was particularly hard hit, with the FTSE EPRA/NAREIT United States Office Index falling 27.1%.

IT the outstanding sector performer



Source: Factset, MWM Research, July 2023

Australian equities underperform slightly

The ASX200 index posted a strong total return of +14.8% in AUD, albeit underperforming global equities (MSCI AC World +20.4% in AUD). The domestic market's performance was boosted by resource stocks (+23.0%) with the ASX200 ex Resources (+11.8%) underperforming global peers due to an underweight in the strongly performing IT sector.

As was the case overseas, IT (+38.1%) was the strongest performing sector while Materials (+22.6%) received a boost from China's economy reopening. Utilities (+20.3%) benefitted from corporate activity in the sector. Real estate (+7.2) underperformed, although the domestic real estate sector fared better than its overseas counterpart given a relatively stronger Australian commercial real estate market. Defensive sectors Health care (+5.7%) and Consumer Staples (+6.2%) were the laggards.

Best & worst ASX100 performers over FY23

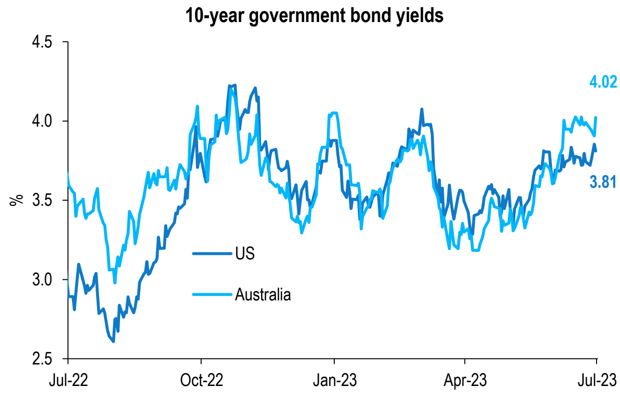
Code	Company name	Sector	Total return
Best performing			
PLS	Pilbara Minerals	Materials	119.3%
WTC	WiseTech Global	Information Technology	111.3%
NST	Northern Star	Materials	81.2%
AKE	Allkem	Materials	55.4%
IGO	IGO	Materials	55.2%
XRO	Xero	Information Technology	54.5%
ORG	Origin Energy	Utilities	54.0%
MIN	Mineral Resources	Materials	52.5%
WHC	Whitehaven Coal	Energy	52.0%
SVW	Seven Group	Industrials	51.8%
Worst performing			
DMP	Domino's Pizza Enterprises	Consumer Discretionary	-30.0%
RHC	Ramsay Health Care	Health Care	-22.0%
LYC	Lynas Rare Earths	Materials	-21.5%
ASX	ASX	Financials	-20.3%
DOW	Downer EDI	Industrials	-15.4%
AMC	Amcor	Materials	-14.0%
EDV	Endeavour Group	Consumer Staples	-14.0%
LLC	Lendlease Group	Real Estate	-13.5%
RGN	Region Group	Real Estate	-12.3%
ALX	Atlas Arteria	Industrials	-12.2%

Source: Factset, MWM Research, July 2023

Bond yields ratchet up, then range-trade…

US bond yields rose strongly from July to October. The US 10-year Treasury yield increased from 2.98% in July and to 4.23%, which is its highest level since mid-2008. The Australian 10-year government bond yield reached 4.20% in October, its highest level since 2014. However, between October and the end of the financial year, bond yields were largely range-bound as market expectations of the future course of inflation and central bank policy waxed and waned. The Bloomberg/Barclays Global Aggregate Bond Index posted a total return of -1.3% over FY23 although Australian bonds (+1.2%) eked out a small gain.

Bond yields hit multi-year highs then range-trade

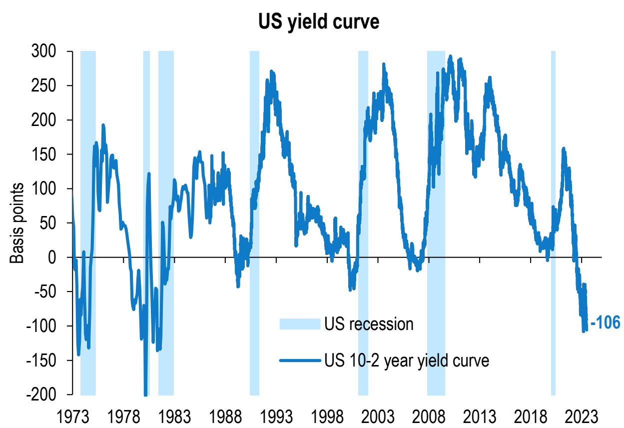


Source: Factset, MWM Research, July 2023

…as yield curve 'inverts'

The US two-year Treasury yield rose above the 10-year yield in July, a phenomenon known as an 'inverted' yield curve, and which has historically preceded recessions by 12-18 months. In fact, the two-year yield rose as high as 5.06% in March, resulting in the most 'inverted' yield curve since 1981.

Yield curve most inverted since early 1980s



Source: Factset, MWM Research, July 2023

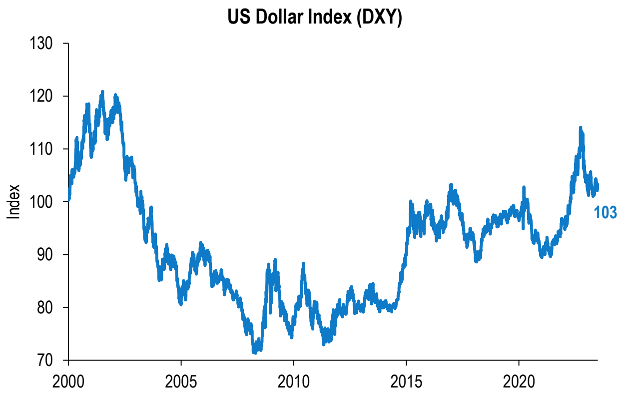
Corporate bonds do well as credit spreads narrow

The rally in risk assets also saw corporate bonds perform strongly as corporate credit spreads narrowed. The Bloomberg/Barclays Global Corporate Bond Index posted a total return of +2.1% and the riskier Bloomberg/Barclays Global High Yield Corporate Bond Index posted a total return of +10.5%.

US Dollar the big currency story

The US Dollar initially strengthened against most major currencies, driven by expectations of a relatively more aggressive US rate hike cycle, which would make US interest bearing assets relatively more attractive. The US Dollar is also a safe-haven asset and the prospect of a recession also added to the bid on the dollar. The US Dollar Index (DXY) in September hit its highest level since 2002. However, the US Dollar then began to weaken as other central banks began to play 'catch up' with the Fed in raising rates and prospects of an imminent recession eased.

US Dollar Index hit highest level since 2002

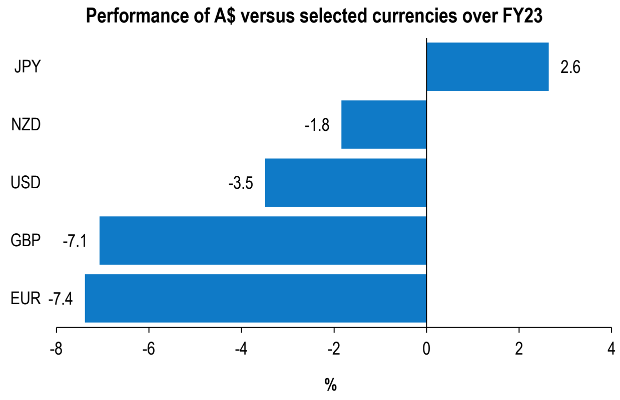


Source: Factset, MWM Research, July 2023

Conversely the other big currency story was the weakness in the Japanese Yen, which in October hit its lowest level against the US Dollar since 1990, driven by Japan's relatively low interest rates and inflation.

The Australian Dollar fell against most major currencies, driven by falling commodity prices.

The Australian Dollar fell against most major currencies



Source: Factset, MWM Research, July 2023

Commodity prices generally fall

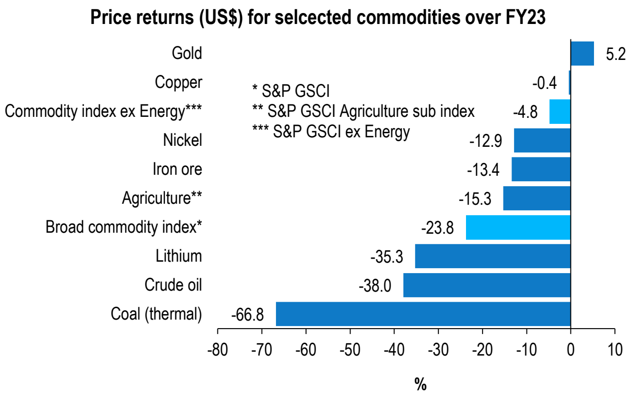
On contrast to the good year for 'risk' assets, commodities fell, in part due to the rising US Dollar (commodities are priced in US Dollars) but also to concerns over the global and particularly Chinese economic backdrop as well as receding concerns about the impact of the war in Ukraine. The broad index (S&P GSCI) of commodity prices fell 23.8% in US$ over FY23, dragged down by energy (oil (-38.0%) and coal (-66.8%)). Excluding energy, commodity prices fell a more modest 4.8% as the USD rose and as rising rates took a toll on the economy (particularly manufacturing).

- **Coal**: Coal had initially rallied sharply to record highs at the start of the financial year, driven by supply shortages and the war in Ukraine. However, after that 'shock' subsided, and with a weak global manufacturing sector, the coal price fell sharply.
- **Lithium**: The lithium price rose to a record high in November then fell 80% on weakening demand for electric vehicles, and by extension for lithium used in electric vehicle batteries, before rallying once again, ultimately finishing the year down 35%.
- **Oil**: The oil price fell steadily over the financial year on a weakening global economic backdrop and healthy supply, despite announced OPEC supply cuts.
- **Agriculture**: The prices of key agricultural commodities (such as wheat and corn) fell over FY23 but nevertheless remained well above levels pre-pandemic levels.
- **Iron ore**: The iron ore price finished the year down 13% although this masked a 38% peak to trough fall from July to November on weakening demand from China as it struggled with lockdowns and a property downturn.
- **Industrial metals**: Long considered economic bellwethers, copper (-0.4%) and nickel (-12.9%) fell

over FY23, as the global economy slowed, and recession risks rose.

- **Gold**: The gold price rose despite a rise in real bond yields (the gold price has historically been negatively correlated with real yields), likely boosted by central bank buying, particularly from China and Russia, as they sought to diversify their reserves away from US Treasury bonds given geopolitical tensions.

Commodities mostly lower, led down by coal & oil



Source: Factset, MWM Research, July 2023

Performance of major asset class indices

	AUD return % return	Local currency % return	USD return % return
Australian Equity Indices			
S&P/ASX 200	14.8	14.8	10.8
International Equity Indices			
MSCI AC World	20.4	16.5	16.5
MSCI Developed World	22.4	18.2	18.5
MSCI Emerging Markets	5.1	3.3	1.7
Country Equity Indices			
S&P 500	22.9	19.0	19.0
NASDAQ Composite	30.0	25.8	25.8
Euro STOXX 50	41.0	30.6	36.1
FTSE 100	17.4	9.1	13.3
Japan TOPIX	21.9	25.2	17.7
MSCI AC Asia ex Japan	2.1	0.8	-1.1
MSCI China	-14.1	-15.7	-16.8
Bond Indices			
Bloomberg Barclays Global Aggregate (hedged)	-1.2	-1.3	-1.3
Bloomberg AusBond Composite (0+Y)	1.2	1.2	-2.0
Commodities			
S&P GSCI	-21.3	-23.8	-23.8

Source: Factset, MWM Research, July 2023

Macquarie WM Investment Strategy Team

FY23 The year in review was finalised on 3 July 2023.