Investment Matters

Biding time

August 2022

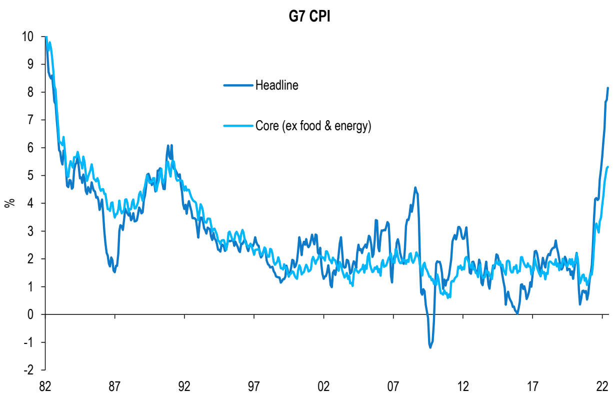
MACQUARIE

After a torrid first half, financial markets got a reprieve through July with equities bouncing back sharply and bond yields falling meaningfully from year-to-date highs. A combination of factors drove these moves with a moderation of inflation fears and a repricing lower of central bank policy rates as the focus shifted towards economic growth downside.

Our view heading into 2H22 was that the tug-o-war between inflation (policy tightening) and economic growth would remain centre stage in determining how markets performed. This has changed. Runaway inflation pushed bond yields higher and equity market valuations lower through 1H22. But, as inflation expectations have begun to moderate and concerns around recession intensified, bond yields have fallen dramatically (the US 10-year yield has fallen more than 70bps while Australia close to 100bps) and equity markets have bounced back strongly with the most severely derated sectors leading the charge.

It is easy to get caught up in sentiment shifts when volatility is high and investors are willing to chase returns and momentum. However, a moderation in rate hike expectations will, at this stage, not drastically change the risk skew to economic growth which will remain under pressure as higher borrowing rates work their way through economies.

Inflation is a global problem



Source: Factset, MWM Research, August 2022

We think it is important to continue to monitor developments around the path of inflation, rates and economic growth but to also understand that while some progress has been made in fighting inflation and in normalizing interest rates, the battle has not yet been won and investors should remain cautiously positioned until there is clear evidence that central banks are comfortable with policy settings and that the costs to economic growth are not too severe. Our outlook for 2H22 stands as:

1. **Policy rates to rise further:** Central banks let inflation get away with overly accommodative monetary policy and now they are trying to rectify this mistake by implementing the fastest policy tightening cycle since the early 1980's. Regardless of whether expectations of peak policy rates have fallen, the path through 2H is for rates to continue rising, just not at the same pace.

2. **Policy mistake risks remain high:** Central Banks have stated a strong commitment towards bringing inflation back under control with economic growth the collateral damage. The goldilocks outcome is for rates to peak at a level which brings inflation under control while ensuring recession can be avoided. This provided some fuel for the equity market rally recently but the last time central banks fought inflation of this magnitude was in the early 1980's and fine tuning a soft landing (a moderate decline in growth and small increase in unemployment) will be extremely difficult. We still don't know what central banks will deem "success" and it remains difficult to know with any degree of certainty how fast or far they will raise rates.

At this stage we believe it is premature to assume that central banks can now take a softer stance against inflation after a brief period of super aggressive policy tightening. While the valuation correction that has been driven by a reset higher in bond yields is complete, the adjustment towards slower economic growth is not priced into equity markets and we think this creates an unfavourable risk-reward skew.

From an investment standpoint, we maintain a cautious stance towards asset allocation with a preference for assets which are priced for inflation and/or can weather downside growth risks. Equities are priced for a soft landing and not recession, so this leans towards stable income and quality exposures (whether it be growth or value). We like sovereign bonds which now provide an appealing risk-adjusted yield as well as downside protection against a growth scare, but we remain cautious on credit where softening corporate fundamentals and economic growth may undermine returns. Heightened uncertainty supports non correlated assets with hedge funds able to profit from elevated volatility and real assets our preferred exposures for stable and inflation protected incomes.

Finally, we think concerns which are overhanging the investment backdrop will ease as we move into deeper into 2023. We believe policymakers will be prepared to ease settings once they have inflation under control and a lack of structural excesses suggests the global (and domestic) economy can recover and settle into a more modest growth and slightly higher inflation and rates backdrop. These are not conditions that will drive a return to the boom times for equities and bonds, but lower volatility and more certainty will be greeted positively by investors as markets set a new course in a new normal.

Jason and the Investment Strategy Team

Global economics

Mild recession our base case

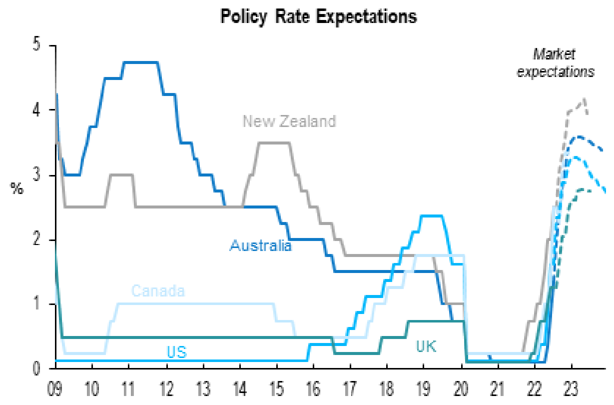
- Global inflation pressures are near close to peaking but central banks will continue raising rates as they play catch up.
- Policy tightening will slow economic growth with recession now our base case in the US, UK, Europe but at a global level we expect a soft landing.
- A lack of structural excesses, a solid household & corporate sector and a strong labour market should keep growth weakness short and shallow.

Positioning for a short and shallow recession

Growth and recession fears picked up throughout July as the US economy contracted for a second straight quarter in Q2, putting it in a 'technical' recession. Even more importantly, forward-looking purchasing manager indices for both the US and Europe fell to levels suggesting economic contraction.

The labour market remains a bright spot with unemployment rates in the US and Europe at or near record lows. However, there are clouds on the horizon, with US weekly initial jobless claims rising to an eight-month high and a flurry of high-profile hiring freezes and layoff announcements.

Policy rate expectations are peaking across the globe

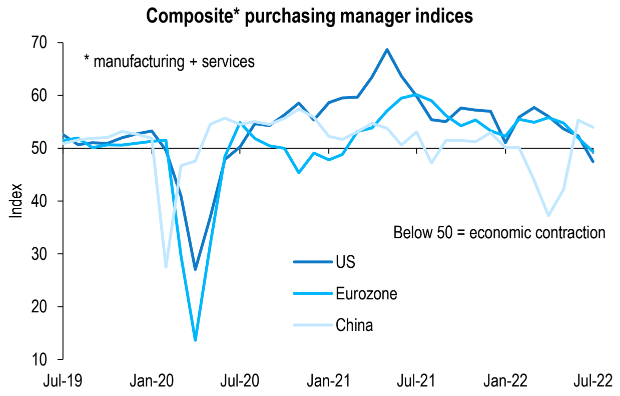


Source: Bloomberg, Macquarie Macro Strategy, August 2022

Unfortunately, there has been no reprieve on the inflation front, with US and European inflation measures continuing to accelerate to levels not seen since the early 1980s. Also concerning is that the breadth of inflation has broadened out beyond goods and has now moved into services. However, the recent fall in commodity prices provides some hope that we may be approaching peak inflation outside of labour markets. Nevertheless, labour market inflation remains a concern, with the US employment cost index rising sharply, a development that is likely to carry weight with policymakers.

Despite softening leading economic indicators and a substantial tightening in financial conditions (which is further progressed than the tightening in policy conditions), Macquarie does not expect this to alter the near-term path for policymakers – which we view as being behind the inflation fight.

Leading economic indicators for US/Europe move to contraction territory



Source: Factset, MWM Research, August 2022

Policy tightening will slow economic growth/raise unemployment with localised recessions now our base case in the US, UK and Europe. However, we do not expect a global recession. However, a lack of structural excesses, a solid household & corporate sector and a strong labour market should keep growth weakness short and shallow.

Chinese growth had shown some signs of recovery, following the Q2 lockdown-induced contraction. However, further lockdowns seem likely as authorities stick with their zero-COVID policy. Furthermore, China's Politburo dropped its previous 5.5 percent growth target while vowing to "stabilise the property market".

Risks to global growth include sticky inflation, more severe slowdowns in emerging markets and/or Europe alongside deeper housing corrections and/or a self-fulfilling consumer downturn. Once growth slows, it is very difficult to fine tune.

Markets have recently been getting bullish on expectations of rate cuts/lower peak rates in 2023. However, there is limited evidence that central banks are close to a pivot and even a lower peak rate remains consistent with a mild US recession. There will be some good news over the coming 12 months as inflation begins to decline, supply chains improve, and bond yields are better behaved. Nevertheless, the risk that policy makers overtighten and push economies into recession remains high.

Australian economics

Risks are rising but recession should be avoided

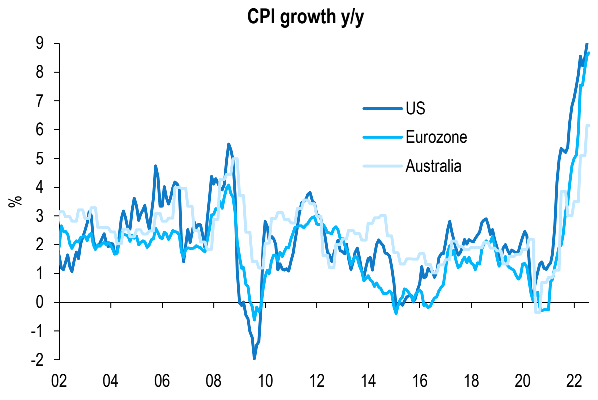
- Australia should escape recession, but growth will continue to slow into 2H22 with consumer confidence and housing prices under stress as interest rates rise.
- We expect policy conditions to get "tight" as the RBA continues to play catch-up to control inflation. Macquarie expect cash rates to peak at 3.1% in 1H23.
- In the near term, the economy remains well supported by still solid consumption, business investment and corporate profits and a strong labour market.

Growth set to moderate, but recession risk is low

Overall, Macquarie remain constructive on the year-ahead outlook for the Australian economy. While domestic growth is set to slow, with GDP now forecast to grow 3½% on a year-end basis in 2022 (versus 4½% previously) and 1¾% in 2023 (versus 2% previously), Macquarie still expect Australia's growth to remain solid relative to other economies such as Europe and the US.

Multiple factors continue to sustain the economy including still solid consumption as spending rebalances back towards the services sector, ongoing business investment and corporate profits, and a strong labour market. Ongoing employment growth and labour force participation saw the unemployment rate fall to a 48-year low of 3.5% in June, which combined with strong business surveys should provide strong support for overall economic activity in the near term.

Australian inflation is lagging other developed economies



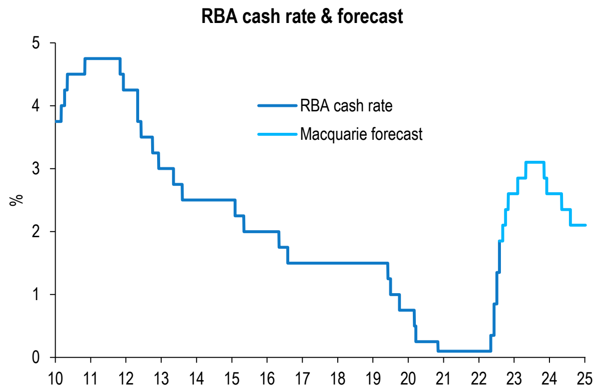
Source: Macquarie Research, ABS, August 2022

Even so, downside risks are growing with Australia lagging the rest of the world in inflation data. Inflation rose 6.1% y/y in Q2 and is expected to continue to accelerate over 2H22 before peaking at ~7% on a year-end basis. Over the medium term, inflation is expected to remain in the range of 3-5% over the next 12-18 months before retreating back towards the RBA's 2-3% target band in 2024.

Risks are to the upside should supply disruptions (conflict in Ukraine, further lockdowns in China) persist. This will cause more persistent inflationary pressures, placing further strain on consumer and business confidence, and ultimately impacting growth.

With the RBA firmly committed to getting inflation back down, Macquarie expect the cash rate to rise to 2.85% by year-end before peaking at 3.10% in 1H23 - a substantial tightening in financial conditions vis-a-vis pre-pandemic levels. A very strong Q3 CPI report in late October would risk an even higher cash rate later this year, unless labour market conditions deteriorate noticeably. Further out, Macquarie's central case is that the RBA will begin cutting rates by 2023, as it responds to a US recession and a sharp slowdown in domestic conditions / rising unemployment.

RBA still has a lot of work to do



Source: Macquarie, MWM Research, August 2022

While we do not expect rising interest rates to drive a systemic bad and doubtful debt cycle, the risk of a sharp slowdown in consumer spending is high (particularly for discretionary spending) and not unexpected if the trends in global economies are a lead indicator. This risk rises further if combined with a notable slowdown in house prices, with Macquarie now expecting a ~15-20% peak-to-trough decline in national house prices driven largely by a deterioration in affordability.

Ultimately, we think Australia is following the same path of many other developed economies which saw inflationary pressures emerge slightly earlier. Regardless of excess savings, elevated commodity prices and/or strong labour markets, the economic outlook is set to soften. The main questions being how quickly and how far. Australia's growth should remain solid relative to other economies given 1) monetary policy is not expected to tighten as much as the other economies as 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.

Monthly performance

July 2022

Australian equities

Australian equities posted a total return of +5.7% in July, performing approximately in line with global equities, which rallied strongly following the previous month's heavy losses. The best performing sector was Information Technology (+15.4%) as 'growth' stocks rebounded as bond yields fell while the worst performing sector was Materials (-0.4%) on commodity price weakness, particularly iron ore.

The best performing large cap stocks were Pilbara Minerals (PLS, +21.0) as lithium miners staged a recovery following the previous month's selloff, and IDP Education (IEL, +19.8%). The worst performing large caps were Newcrest Mining (NCM, -7.6%) which was weighed down by a falling gold price, and Tabcorp Holdings (TAH, -7.0%).

The S&P/ASX Small Ordinaries index (+11.4%) outperformed the large cap S&P/ASX100 index (+5.3%), driven by its overweight in outperforming technology, gold and lithium stocks. The best performing Small Ordinaries stock was online retailer Kogan.com Ltd (KGN, +65.8%) while the worst performing was cobalt producer and miner Jervois Global Ltd (JRV, -24.5%) which fell after downgrading guidance.

International equities

Global equities rose 7.0% in USD terms and 5.5% in AUD terms. Regional performance was mixed, with US indices (NASDAQ +12.4%, S&P +9.2% in USD) posting their strongest calendar month return since November 2020. Expectations that weakening economic conditions will cause central banks to pivot from hiking to cutting interest rates drove the rally in equities. However, Asian markets struggled (Hang Seng -8.7%, MSCI China -10.8%) due to China's zero COVID policy weighing on the economy.

The best performing global sectors were Consumer Discretionary (+15.6%) and Information Technology (+13.2%) as they benefitted from the rebound in 'growth' stocks while the worst performing sector was the relatively defensive Communication Services (+3.2%).

Property

Global REITs posted a (hedged) return of +7.7% in AUD and Australian REITs posted a total return of +11.9%, both outperforming all other asset classes. REITs benefitted from falling bond yields and Australian REITs in particular benefitted given the heavy weighting of 'growth' REITs in the domestic index. The best performing stock in the S&P/ASX200 AREITs index was Home Consortium Limited (HMC, +18.6%) while the worst performing stock was Charter Hall Long Wale REIT (CLW, +6.6%).

Fixed interest and cash

Global bond indices posted positive returns, following the previous month's heavy losses, as bond yields eased back on expectations that weakening economic conditions will cause central banks to pivot from hiking to cutting interest rates.

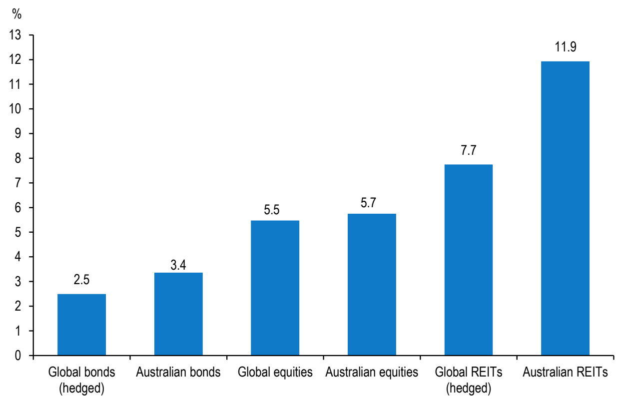
Commodities

Commodity prices generally fell due to economic weakness weighing on the outlook for demand. Iron ore was particularly hard hit on growing concern over the state of China's property sector – a major consumer of iron ore.

Currency

The Australian Dollar rebounded in July following its drop in June, despite a weakening global economy and falling commodity prices. The Australian Dollar may have been supported by a weaker US Dollar, following speculation of a more cautious tightening path by the US Federal Reserve.

Major asset class total returns during July 2022



Source: Factset, MWM Research, August 2022

Note: All returns are in AUD

Total returns (A$) – as at 31st July 2022

	1 month %	3 months %	YTD %	1 year %	3 year %pa	5 year %pa
Australian equity indices						
S&P/ASX 200	5.7	-6.0	-4.7	-2.2	4.3	8.0
S&P/ASX 100	5.3	-5.7	-3.6	-1.1	4.7	8.3
S&P/ASX Small Ordinaries	11.4	-9.9	-15.0	-10.9	2.5	7.3
S&P/ASX 20	4.6	-5.5	-1.8	-2.2	5.0	8.2
S&P/ASX 50	4.7	-5.7	-2.6	-1.1	3.9	7.9
S&P/ASX Mid-Cap 51-100	9.2	-5.4	-9.2	-0.9	9.1	10.4
S&P/ASX 200 Industrials	8.2	-4.3	-6.4	-1.5	3.7	6.8
S&P/ASX 200 Resources	-0.8	-10.7	3.0	-3.8	6.8	13.8
International equity indices						
MSCI AC World ex Australia	5.5	0.2	-10.9	-5.4	8.7	11.4
MSCI Developed World ex Australia	6.4	0.8	-10.5	-3.9	9.8	12.5
MSCI Emerging Markets	-1.6	-4.6	-14.2	-15.5	0.8	4.1
Regional equity indices						
S&P 500	7.6	2.2	-8.9	0.5	12.9	15.9
NASDAQ Composite	10.8	2.5	-17.1	-10.4	15.3	18.5
Euro STOXX 50	3.5	-2.8	-17.1	-15.2	1.7	4.4
FTSE 100	2.5	-3.1	-4.0	0.8	2.3	5.2
Japan TOPIX	4.3	0.7	-11.2	-9.5	2.1	5.0
Hong Kong Hang Seng	-8.7	-0.7	-8.7	-16.5	-7.8	-0.2
MSCI China	-10.8	-0.5	-16.2	-24.4	-3.9	1.3
International equity thematic indices						
MSCI World Cyclicals	8.0	0.1	-14.8	-8.9	9.7	12.9
MSCI World Defensives	2.8	1.8	2.9	11.0	9.7	11.3
MSCI World Value	3.1	-0.7	-3.9	3.0	6.5	8.8
MSCI World Growth	9.9	1.7	-17.2	-11.2	11.8	15.3
MSCI World High Dividend Yield	1.2	-1.1	-1.7	3.4	6.3	9.5
Real estate equity indices						
S&P/ASX A-REIT	11.9	-8.4	-14.4	-2.1	0.1	6.8
FTSE EPRA Nareit Global Developed (hedged)	7.7	-5.1	-11.9	-6.4	1.7	4.2
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	2.5	0.6	-7.2	-8.2	-1.0	1.2
Bloomberg Barclays Global Treasury (hedged)	2.1	0.3	-6.4	-7.6	-1.2	1.2
Bloomberg Barclays Global Corporates (hedged)	3.3	0.4	-10.6	-11.7	-1.1	1.2
Bloomberg Barclays Global High Yield (hedged)	4.4	-3.6	-12.1	-12.6	-1.9	0.6
Australian bond indices						
Bloomberg AusBond Bank Bill	0.1	0.2	0.2	0.2	0.3	0.9
Bloomberg AusBond Composite (0+Y)	3.4	0.9	-6.4	-9.1	-1.8	1.5

Note: All returns are in AUD, and unhedged unless otherwise stated

Source: Factset, MWM Research, August 2022

The Wealth Investment Strategy Team

Head of Investment Strategy
Jason Todd, CFA
23 years industry experience
M Com (Hons)
Global & US Equity Strategist
JPMorgan & Morgan Stanley
Head of Australian Macroeconomics Macquarie Group

Investment Strategist
Leah Kelly, PhD
19 years industry experience
B. MathFin (Hons 1st)
Senior Portfolio Manager Multi-asset solutions CFSGAM,
Portfolio Manager, Credit CFSGAM, Risk Analyst,
Reserve Bank of Australia

Senior Research Analyst
Aaron Lewis, CFA
11 years industry experience
Research analyst, Macquarie
Wealth Management

Investment Strategist
Dean Dusanic
26 years industry experience
BEc (Actuarial Studies & Finance)
Strategist, UBS Securities Australia
Strategist, JPMorgan Securities Australia

Research Analyst
Shirley Huang
4 years industry experience
B. Com (Finance)
Macquarie Private Bank

References

Aussie Macro Moment – Jobs go ka-boom!, 14 July 2022
Aussie Macro Moment – Strong inflation…RBA to hike with purpose, 27 July 2022
Global Economic and Market Update – Running To Stand Still: The Day the Music Died, July 2022

Investment Matters August 2022 was finalised on 4 August 2022.

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