Investment Matters

The tightening cycle continues

November 2022

MACQUARIE

As we head into the final months of the year, it is worth assessing the current state of play for investors as they start to consider portfolio positioning into 2023. Without doubt, 2022 will go down as a year which has continually surprised on the downside with both bond and equity market returns ranking amongst some of the worst on record.

It's been difficult to avoid being sucked into the negative inflation, rates and growth narrative that has developed and been an almost constant talking point for investors for most of the year. It's also been hard to protect portfolios against downside when the two largest asset classes (bonds & equities) have suffered such steep declines.

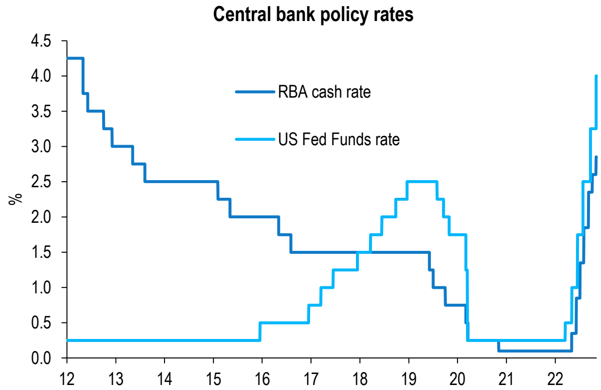
However, while central banks may not yet have tamed the inflation beast (either globally or domestically) and further rate hikes and growth weakness can be expected as we move into the new year, there is now a deep familiarity with the extent of the problems that financial markets are facing and with the side effects that the medicine is being used to confront the illness brings.

It's normal for investors to look towards the start of a new year with optimism (and hence why Christmas rallies are so common). It would be nice to start 2023 with the expectation that we are now on the other side of the inflation problem, that we know what is coming from the RBA and other central banks on the rates side, and that we are confident that the economic costs of financial tightening will remain modest – at least for Australia.

The good news is that we now know more about how persistent inflation is proving to be and how committed central banks are to bringing it down. The bad news is that the job is not done given inflation has not fallen to any meaningful degree (still rising in Australia) and we are at the stage where the economic impacts of further rate hikes are not linear. In other words, further policy tightening has an increasingly negative impact on the economic growth outlook and therein lies the problem for central banks. Tighten too much and you start a growth spiral that is hard to arrest. Tighten too little and inflation becomes more entrenched into expectations. Central banks are walking a tightrope with huge consequences if they get it wrong.

Unfortunately, this means the level of transparency that investors might be looking for as we move into 2023 is not yet there and they should prepare for a continuation of current conditions at least into the first half of the new year. We don't think investors should expect anything near the scale of losses suffered through 2022 in either fixed income or (global) equity markets as they look ahead to the new year, but the possibility that there is additional downside in both asset classes remains high, if not the potential for a lot of volatility without much gain.

Rates are getting closer to peak ... but are not there yet



Source: FactSet, MWM Research, November 2022

If history has taught us anything, it's that you generally have to address the root of the problem before financial markets can form a sustainable bottom. In the TMT crash, it was valuations and unrealistic growth expectations. In the GFC it was the plumbing of financial markets and in the pandemic, it was containment of the virus via vaccines. This time, we need to see evidence that inflation is improving or that domestic demand is slowing enough to bring pricing pressures down. This will come, but not yet, particularly for Australia where economic conditions remain buoyant despite the fastest RBA rate hike cycle since 1994.

Against this backdrop, we think portfolios need to be resilient and able to withstand negative developments which might come from inflation being stickier than expected, rates moving higher than expected or economic growth being lower than expected. Australia is in a strong position to withstand policy tightening via a robust labour market and large pools of excess savings that will support the spending backdrop. A more favourable inflation outlook should see domestic sovereign bonds outperform their global counterparts and more than likely, a similar scenario for the equity market which is supported by a solid dividend yield and highly favourable flows (both domestically and internationally via a weakening A$).

From a tactical asset allocation perspective, we maintain our large underweight to equities (-4%) while offsetting this with equal overweights in both alternative assets (+2%) and real assets (+2%). However, we have reduced our underweight on Australian equities (from -2% to -1%) which was added following a strong 1H22. We thought the drivers of this outperformance (elevated energy/commodity prices and an underweight on technology) would begin to reverse and while they have, it has not been enough to drive the degree of losses we thought coming. We think Australian equities will still underperform bonds and still have absolute downside risk which sees us remain underweight, but with a more modest rate tightening outlook and the expectation that the economy can avoid recession, is likely to perform better than we had expected earlier in the year.

Jason and the Investment Strategy Team

Global economics

Recession in US and Europe looming

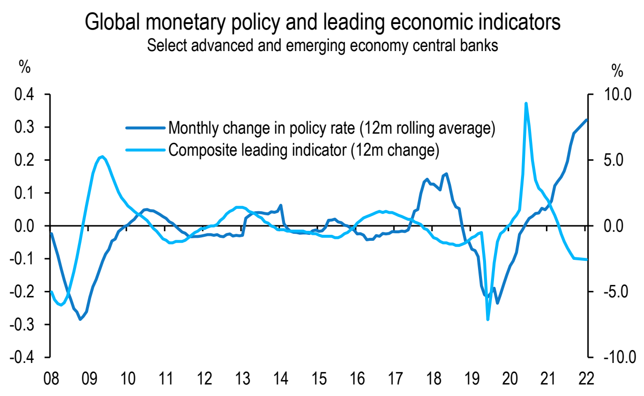
- The global growth outlook continues to deteriorate as central banks maintain their policy tightening bias.
- Inflation is proving to be higher and stickier than expected, with services inflation picking up across many key economies.
- However, it has not been all bad news. There are signs supply chain cost pressures are easing as well as a decline in energy prices which should help moderate pricing pressures.

Global growth continues to slow

Global economic growth continues to slow as we head into the last quarter of 2022, with inflationary pressures and central bank tightening remaining in force. Several leading economic indicators are now suggesting that recession is rapidly approaching; PMIs across Europe and the UK are both indicating manufacturing is contracting (46.6 and 46.2, respectively). Additionally, China has been a major source of weakness to global growth, due to its zero-COVID policy, ongoing property sector weakness and low levels of domestic consumption.

In the US, inflation continues to surprise to the upside; headline inflation at 8.2% (versus 8.1% consensus) and core services prices increasing at a faster rate than core goods prices for the first time since late 2020. While there are some early signs of the labour market cooling, with September nonfarm payrolls increasing by 263k vs the average of 420k year to date, the unemployment rate remains at a 51-year low of 3.5%, reinforcing the need for further rate hikes by the Fed.

Higher policy rates continue to weigh on economic growth

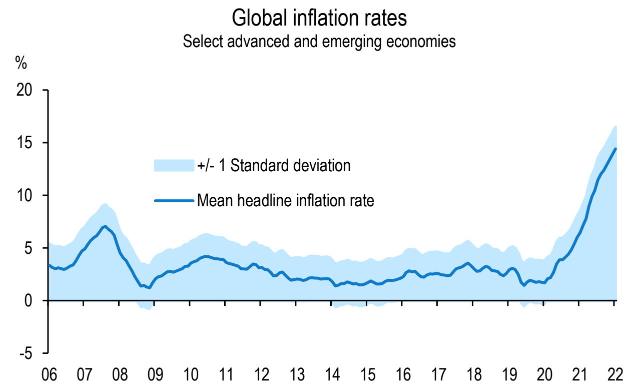


Source: Bank for International Settlements, OECD, MWM Research, November 2022

Inflation is proving to be problematic globally…

The Fed, ECB and BoE all increased their policy rates by an aggressive 75bp, with smaller central banks such as the RBA (25bp), the Bank of Canada (50bp) and the RBNZ (50bp) also delivering further rate hikes. Macquarie's base case remains a recession for most economies including the US, UK, and Europe although Australia is expected to avoid this fate. Emerging economies, especially those with US dollar denominated debt are also seeing tightening financial conditions with recessionary risks and contagion effects building.

Global inflationary pressures continue to rise

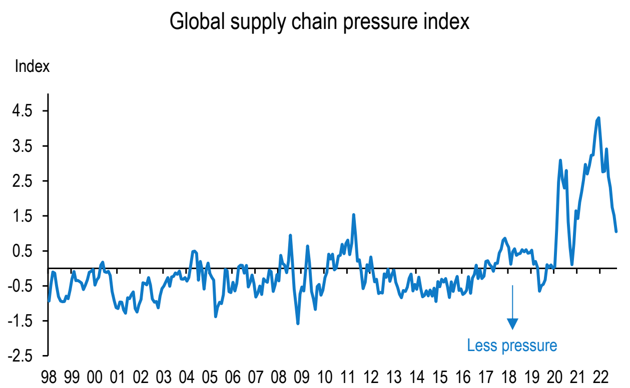


Source: Bank for International Settlements, MWM Research, November 2022

…although there are some signs of price pressures easing

The relaxation of COVID restrictions in many countries has helped ease global supply chain pressures. However, for supply chains to reach pre-pandemic levels, restrictions in China would need to be scaled back or eliminated. In the US, the September ISM showed delivery times eased and prices were still increasing, but at a slower pace than seen earlier in the year. While it is still too early to gauge how this easing in upstream price pressures will flow through inflation prints, it is nonetheless a positive development.

Global supply chain pressures are starting to ease



Source: Federal Reserve Bank of New York Bloomberg, MWM Research, November 2022

Australian economics

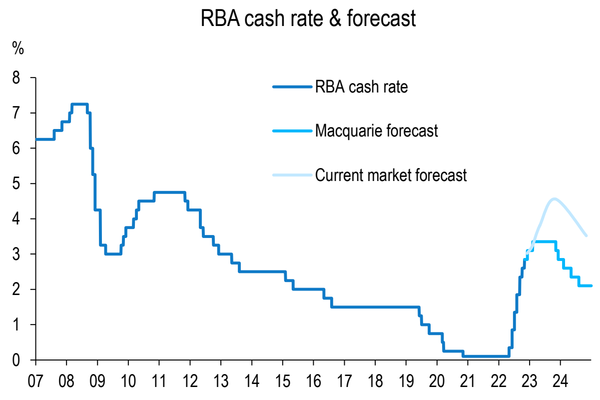
Not immune to a growth slowdown

- Macquarie's base case is for the Australian economy to slow but avoid recession in 2023, for unemployment to rise modestly, and for inflation to now peak at ~8%.
- For the time being, the Australian economy continues to perform relatively well, with spending supported by excess savings and the unemployment rate at its lowest level in almost 50 years.
- However, rate increases are beginning to impact house prices and consumer sentiment is collapsing despite spending remaining at elevated levels. Housing remains a key downside risk as elevated inflation drives further rate hikes.

Solid performance despite growing challenges

The Australian economy has remained resilient despite a rapid rise in policy rates by the RBA. However, it faces similar challenges to most other advanced economies. Housing prices have declined sharply, but the labour market remains robust with unemployment sitting close to 50-year highs. The consumer is still resilient, with retail sales posting back-to-back growth of 0.6% in both August and September, despite consumer sentiment being at recessionary levels. However, the threat of more stubborn price pressures remains, with inflation for 3Q22 surprising to the upside compared to Macquarie's forecast (7.3% vs. 7.1%).

The terminal policy rate is skewed to the upside



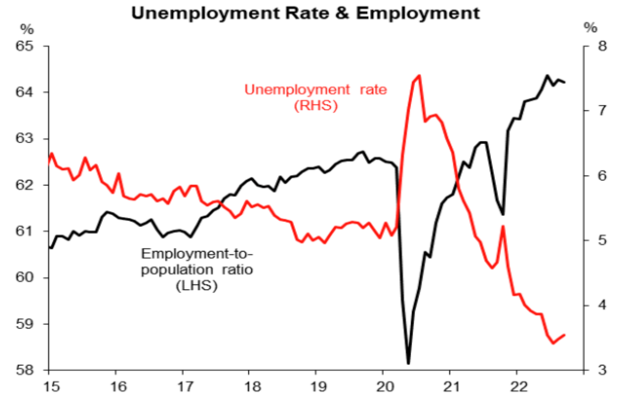
Source: FactSet, MWM Research, November 2022

Additionally, house prices continue to fall, with the national average down 7% from its May peak. Macquarie expects a 15% peak-to-trough fall in house prices although it has flagged this could also be exceeded should the cash rate forecasts prove to be too cautious. Worryingly, there are signs that incremental demand for housing is fading further. New detached home sales and new orders for houses reported by builders have fallen sharply and loan commitments for September also showed further decline, as did new borrowing by households to build a home.

The RBA surprised markets in October by being one of the first major central banks to ease the pace of rate hike tightening (from 50bps to 25bps). This sparked a global lift in risk sentiment, albeit short-lived, with equities seeing this as potentially an indication of what the Fed may do in the months ahead. The RBA stuck to this slower pace of tightening again on Melbourne Cup Day taking the target cash rate to 2.85%, despite the larger than expected September quarter inflation reading.

Macquarie expects another 25bps rate increase in the target cash rate in both December and February, taking it to a peak of 3.35%. But, the risk to the house view is skewed to the upside with consensus expecting the RBA to raise rates closer to 4%. At this stage, the Bank continues to take comfort from the fact that Australia has limited prices-wages pressures, with this signalled in recent communication as a tipping point for a return to more aggressive tightening.

The labour market will need to soften further to help ease price pressures



Source: Macquarie Macro Strategy, MWM Research, November 2022

RBA revises forecasts

The RBA forecasts growth to slow from 3% this year to 1.5% in both 2023 and 2024, broadly in line with Macquarie's expectations. No recession, but a much sharper slowdown next year, with GDP growth of only 0.1% by June 2023. The RBA acknowledges it has a very fine line to walk over the next year or so to bring inflation back to target and at the same time avoiding recession. It needs to not only weigh up its own actions on the domestic economy, but also the actions of the other major central banks, especially the Fed, on the global outlook.

We are encouraged at the resiliency of the Australian economy to date. However, the lagged impacts of policy tightening are coming, and the only question is how far the RBA has to push on rates in order to slow inflation. There is a risk that growth could deteriorate faster than expected but it will take a deeper global slowdown on top of the need for more aggressive policy tightening. Neither are Macquarie's base case at this stage, but risks are rising.

Monthly performance

October 2022

Australian equities

Australian equities posted a total return of 6.0% in October, albeit slightly underperforming global equities. The best performing sector was Financials (+12.2%) as banks in particular benefitted from elevated margins as rates rise. The worst performing sector was Consumer Staples (-0.2%) as defensive sectors generally lagged the rally in equities.

The best performing large cap stocks were Domino Pizza Enterprises (DMP, +23.7%), which rallied on strong sales results from its US parent, and Challenger Limited (CGF, +20.0%) which rallied on rising bond yields. The worst performing large caps were Medibank Private (MPL, -19.0%), which announced it had fallen victim to a data breach from hackers, and Fortescue Metals Group (FMG, -12.6%), weighed down by a falling iron ore price.

The S&P/ASX Small Ordinaries index (+6.5%) slightly outperformed the large cap S&P/ASX100 index (+5.9%). The best performing Small Ordinaries stock was Life360 Inc. (360, +39.6%) which announced changes to its monthly pricing for subscribers to its software while the worst performing was EML Payments (EML, -49.4%), following an announcement of concerns over its products by the UK regulator.

International equities

Global equities rallied 6.7% in AUD during October despite a worsening economic/earnings backdrop, likely reflecting a tactical bounce given extremely depressed sentiment. US stocks (+8.7% in AUD) was the standout market while Chinese equities (-16.4% in AUD) underperformed heavily, weighed down by developments from the recent Party Congress, as well as continuing housing and COVID headwinds.

Property

Global REITs posted a (hedged) return of +3.1 in AUD, underperforming broader equities, and Australian REITs posted a total return of +9.9%, outperforming other asset classes. REIT performance reflected a bounce following severe underperformance in the previous months. The best performing stock in the S&P/ASX200 AREITs index was Arena REIT (ARF, +18.0%) while the worst performing was Dexus (DXS, +0.5%).

Fixed interest and cash

Global bond indices posted slightly negative returns as government bond yields rose as global central banks continued to aggressively raise interest rates. However, high yield bonds managed to post positive returns as credit spreads narrowed.

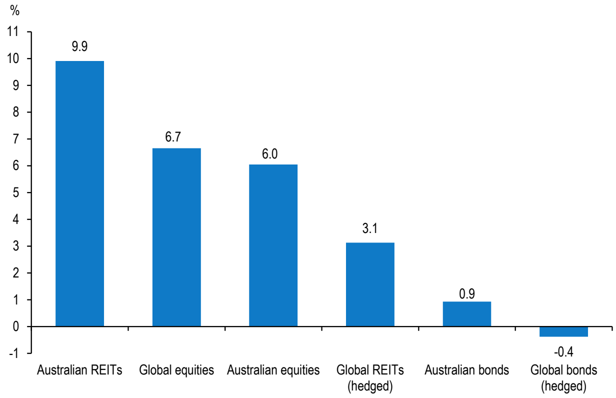
Commodities

Commodity prices generally fell due to economic weakness weighing on the outlook for demand, as well as a sharply rising US Dollar (commodities are generally priced in USD). The iron ore price fell 18% on continued weakness from major consumer China. However, oil bucked the trend, rising on continued tight supplies.

Currency

The US Dollar Index (DXY) continued to hover near the 20-year highs it reached late September as the US Federal Reserve maintained an aggressive outlook for rate hikes. The Australian Dollar hovered near its lowest levels against the US Dollar since the pandemic, weighed down by US Dollar strength and commodity price weakness.

Major asset class total returns during October 2022



Source: Factset, MWM Research, November 2022

Note: All returns are in AUD

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

	1 month %	3 months %	YTD %	1 year %	3 year % pa	5 year % pa
Australian equity indices						
S&P/ASX 200	6.0	0.7	-4.1	-2.0	4.8	7.2
S&P/ASX 100	5.9	1.1	-2.5	-0.3	5.3	7.6
S&P/ASX Small Ordinaries	6.5	-4.9	-19.2	-18.3	1.5	4.2
S&P/ASX 20	5.9	1.6	-0.3	1.1	6.1	8.0
S&P/ASX 50	5.7	0.8	-1.8	-0.1	4.3	7.3
S&P/ASX Mid-Cap 51-100	7.1	3.2	-6.4	-1.2	10.9	9.6
S&P/ASX 200 Industrials	7.8	-0.8	-7.2	-6.9	3.3	5.8
S&P/ASX 200 Resources	1.5	5.1	8.2	20.2	10.9	13.0
International equity indices						
MSCI AC World ex Australia	6.7	0.9	-10.1	-5.6	8.1	9.7
MSCI Developed World ex Australia	7.8	1.8	-8.9	-3.9	9.4	11.0
MSCI Emerging Markets	-2.6	-6.2	-19.4	-18.6	-1.7	0.9
Regional equity indices						
S&P 500	8.7	2.7	-6.4	0.3	13.0	14.5
NASDAQ Composite	4.5	-3.0	-19.6	-16.1	13.5	15.4
Euro STOXX 50	10.0	3.3	-14.4	-11.7	1.4	3.1
FTSE 100	5.5	-0.6	-4.6	0.0	1.3	3.5
Japan TOPIX	2.3	-1.6	-12.7	-10.9	-0.9	2.4
Hong Kong Hang Seng	-14.3	-19.8	-26.8	-30.3	-13.7	-6.1
MSCI China	-16.4	-22.2	-34.8	-38.7	-11.6	-6.2
International equity thematic indices						
MSCI World Cyclicals	6.9	-0.6	-15.3	-11.2	8.5	10.5
MSCI World Defensives	9.7	7.4	10.6	18.4	11.3	11.7
MSCI World Value	10.3	6.4	2.3	8.4	7.7	8.6
MSCI World Growth	5.2	-2.8	-19.5	-15.7	9.8	12.5
MSCI World High Dividend Yield	8.1	4.2	2.5	10.6	6.2	8.8
Real estate equity indices						
S&P/ASX A-REIT	9.9	-8.4	-21.6	-14.1	-2.7	4.1
FTSE EPRA Nareit Global Developed (hedged)	3.1	-14.1	-24.3	-20.9	-5.4	1.0
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	-0.4	-6.5	-13.2	-12.9	-3.7	-0.3
Bloomberg Barclays Global Treasury (hedged)	-0.2	-5.6	-11.7	-11.3	-3.5	-0.1
Bloomberg Barclays Global Corporates (hedged)	-0.6	-8.4	-18.2	-18.1	-4.6	-0.8
Bloomberg Barclays Global High Yield (hedged)	1.9	-4.3	-15.9	-15.9	-3.1	-0.7
Australian bond indices						
Bloomberg AusBond Bank Bill	0.2	0.5	0.8	0.8	0.4	1.0
Bloomberg AusBond Composite (0+Y)	0.9	-3.0	-9.2	-7.2	-3.0	0.7

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

Source: Factset, MWM Research, November 2022

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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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