Investment Matters

Not ready to raise risk yet

October 2022

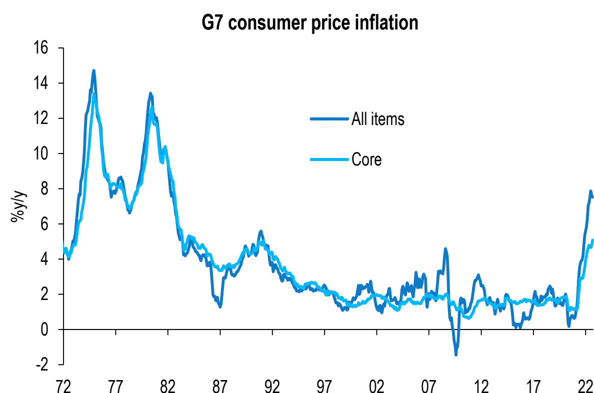
MACQUARIE

It has been a tough quarter for asset markets. Equities and bonds have now posted their worst start to a year in over a half century with the drivers of the correction - rising rates and tightening financial conditions - meaning there have been few places to shelter.

These are difficult times, but it is important to remain objective and avoid becoming overly emotional in response to market volatility and broad-based declines. Diversified portfolios are constructed on the basis that markets are not always rising, that volatility is part and parcel of the investment backdrop and that there will be periods when even diversification will not be enough to prevent portfolio values from declining.

We think markets are having a hard time calibrating economic and policy uncertainty and this is pushing bond yields higher and equity markets lower. On the economic front, there is uncertainty around the inflation and growth outlook and on the policy front, there is uncertainty around how fast and far central banks may need to raise policy rates to get inflation back under control, how much growth they are willing to sacrifice to do this and ultimately what the broader spill over effects might be.

Inflation is not yet under control

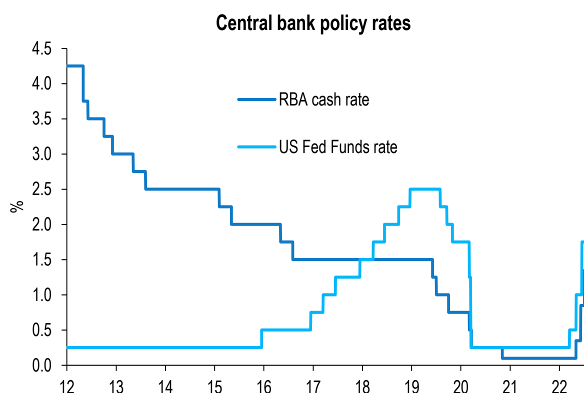


Source: FactSet, MWM Research, October 2022

While we have been battling these uncertainties for most of the year, we think limited progress on the inflation front and concerns that central banks will tip the global economy into recession are now starting to be priced into asset markets. The view that central banks will be able to thread the needle and bring inflation down with only a minor impact on economic growth has all but disappeared from market expectations. So too has the view that policymakers would quickly revert towards supporting growth with a policy pivot. We expect the pace of policy rate hikes to begin slowing as we enter 2023, but this will not signal the end of the rate hike cycle unless we see a meaningful decline in inflation in coming months, which is unlikely.

We think investors should prepare for a continuation of current conditions. Inflation will begin to decline as supply chain disruptions moderate alongside declining energy and food prices. But there are few signs that services inflation is slowing or that the breadth of price increases is about to narrow. This means investors can expect a decelerating inflation trend, but one that might take some time to fall back to levels that markets are comfortable with. Against this backdrop, rates will need to rise further and in combination with tighter financial conditions this will keep growth risks elevated.

A slowing rate hike cycle does not signal a new bull market



Source: FactSet, MWM Research, October 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 will need to see some evidence that inflation is improving or that domestic demand is slowing.

Against this backdrop, we think portfolios need to be resilient and able to withstand any number of negative developments which might come from inflation being stickier than expected, rates moving higher than expected or economic growth being lower than expected. Until we see some evidence that inflation is beginning to decline, or central banks are softening their narrative, then investors should avoid trying to align portfolios with short term oversold rallies.

Stay diversified as a first line of defence. Focus on raising the quality of holdings across both equities and bonds/credit. Look for inflation hedges that can withstand softening demand such as infrastructure and selected commodities. Finally, we like equity markets which have strong internal fundamentals and liquidity, are not overly exposed to global cyclical developments and geopolitical risks, have some commodity independence and have a strong structural growth component such as the US and, over the longer-term, Australia.

Jason and the Investment Strategy Team

Global economics

Recession in US and Europe our base case

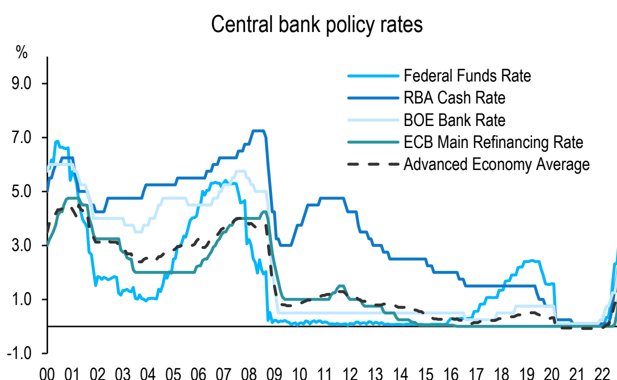
- The global growth outlook continues to deteriorate.
- Higher policy rates have resulted in tighter financial conditions, increasing the probability of an economic hard landing. Our base case is a recession for the US and Europe. Although a global recession should be avoided.
- China continues to ease monetary policy settings, although it remains to be seen if it can mitigate a global recession.

Global growth momentum continues to weaken

Global growth momentum has continued to slow with leading economic indicators revealing a further weakening in economic activity. For both the US and Europe, PMIs fell deeper into contractionary levels (49.3 and 48.2) and global trade volumes declined further, reflecting the combined effects of policy tightening, high inflation and elevated geopolitical tensions.

While inflation has likely peaked in most economies and tentative signs are emerging that show price growth is slowing, a potentially stickier pace of deceleration remains the key factor justifying further central bank tightening. While policy rates across most advanced economies have risen rapidly, tight labour markets (especially in the US) suggest further tightening is needed to dampen aggregate demand and stabilise prices.

Central banks will continue to tighten policy settings

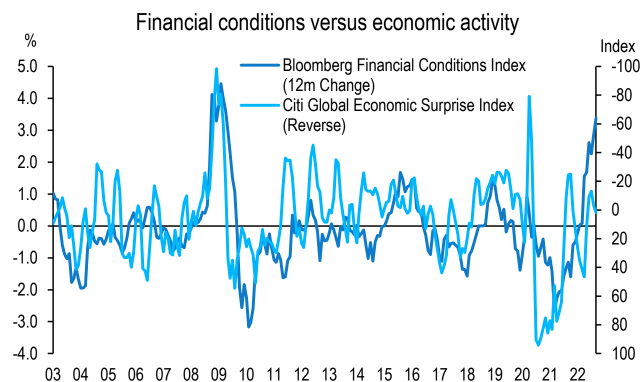


Source: Bank for International Settlements, MWM Research, October 2022

Higher policy rates in the US are resulting in a stronger US dollar, which poses significant risks to the global growth outlook. Specifically, widening interest rate differentials between the US and other economies renders the cost of borrowing funds in US dollars more costly, which can dampen economic activity.

Our base case is a recession for the US and European economies. In Europe the situation is dire given the additional strain of high energy prices and its proximity to the fallout of the conflict in Ukraine.

Tighter financial conditions will weigh on economic activity

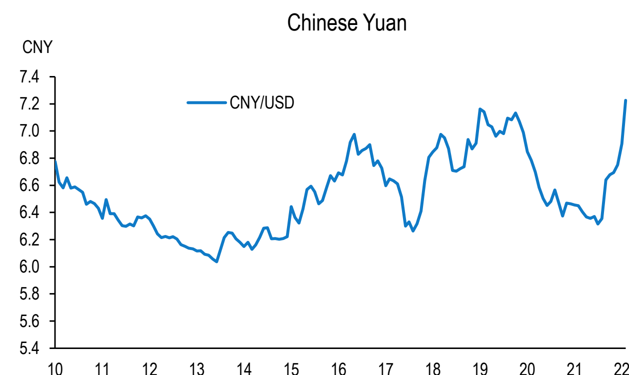


Source: Bloomberg, MWM Research, October 2022

China continues to follow an asynchronous policy stance, easing financial conditions while the rest of the world tightens. This easing bias stems from doubts surrounding the soundness of the property sector and lingering pandemic restrictions. In response, Chinese policymakers have been quick to provide policy support for the property sector.

This divergence in the stance of policy has not come without costs. A sharp depreciation in the Chinese Yuan saw the central bank request state-owned banks sell US dollars, a form of indirect intervention. While China's policy flexibility has *historically* proven beneficial for global growth, we think the extent to which additional support can offset a global recession is limited. Any further Chinese stimulus is likely to be targeted and sector specific, which does little to support the global economy.

Chinese policy divergence comes with a cost



Source: Bloomberg, MWM Research, October 2022

The global economic outlook remains vulnerable. As central banks remain steadfast in their commitment to fight inflation, the risk of an economic hard landing grows.

Australian economics

Demand at risk of a significant slowdown

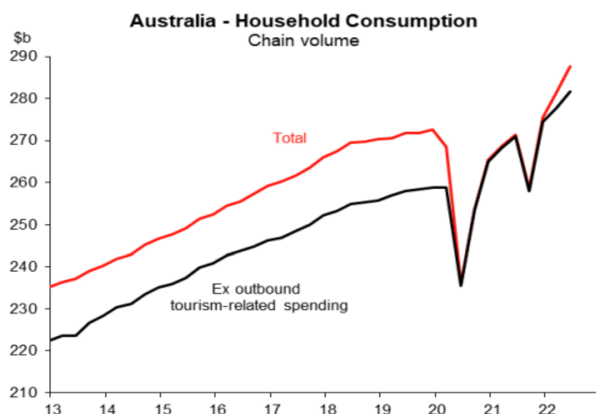
- Domestically, we do not expect a recession however, we expect economic growth to slow materially.
- The Australian economy is facing multiple headwinds including inflationary pressures, rising interest rates and weaker employment prospects leave domestic consumption vulnerable to a material slowdown.
- While the RBA surprised market participants with a lower-than-expected rate hike, adopting a pragmatic 'wait and see' approach to policy, Macquarie expect the trajectory for tightening to remain unchanged.

Domestic consumption to slow materially

The Australian economy has been relatively robust despite several challenges that have seen other developed economies fall closer to recession. Solid consumer spending, a tight labour market and only a modest decline in housing prices despite higher interest rates have all supported the solid performance of the economy to date. However, the outlook for the Australian economy is set to worsen as domestic demand slows materially, suggesting current economic conditions are as good as it gets.

Macquarie expects that consumer spending will slow significantly in 2H22. As financial conditions continue to tighten, several factors will contribute to the attrition of consumer spending; an erosion in household savings in line with the experience of other developed economies, negative wealth effects resulting from weaker housing activity and a higher interest burden for mortgage holders will ultimately weigh on domestic activity.

Domestic demand at risk of a significant slowdown



Source: ABS, Macquarie Macro Strategy, September 2022

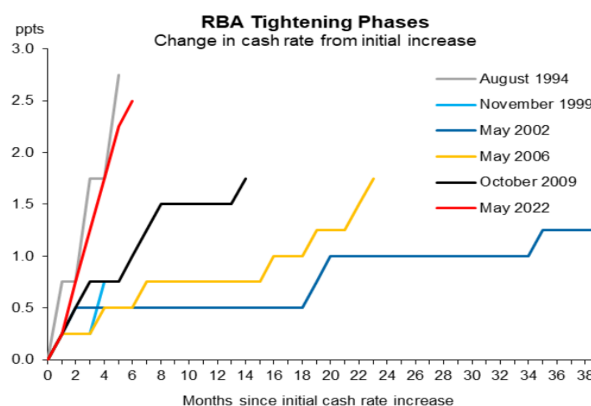
RBA slows the pace, but rate hikes to continue

The RBA surprised market participants by raising the cash rate by a less-than-expected 25 basis points to 2.60%. This is in comparison to Macquarie's (and the market) consensus of 50 basis points. In the post-meeting statement, the RBA Board noted that the cash rate has increased substantially over a brief period, suggesting that a slower pace of rate hikes is appropriate moving forward.

While the RBA's decision emits a slightly less hawkish tone compared to other central banks, the trajectory for policy tightening is expected to remain unchanged; the RBA still expects inflation to peak at 7¾% by year-end and has signalled further increases in the cash rate to come, maintaining what has been a relatively aggressive tightening path compared to past tightening cycles.

Macquarie expects a further 25 basis points worth of rate hikes for both November and December, which will take the cash rate to 3.10% by year end. Likewise, the terminal policy rate is expected to remain unchanged at 3.35%, albeit it is anticipated the peak will be reached in February 2023, compared to the original forecast for December 2022.

The RBA will continue its path of tightening



Source: RBA, Macquarie Macro Strategy, September 2022

We continue to think that the Australian economy will ultimately feel the effects of elevated inflation and tighter financial conditions like other developed economies. While the RBA may have adopted a more pragmatic approach to tightening moving forward, inflation still remains far beyond target levels. Our base case remains that Australia avoids a recession, but economic conditions will further deteriorate.

Monthly performance

September 2022

Australian equities

Australian equities posted a total return of -6.2% in September, outperforming global equities in local currency terms but underperforming in common AUD currency terms. Rising interest rates and recession fears weighed down the market. The best performing domestic sector was Energy (+7.8%) on elevated commodity prices while the worst performing sector was Real Estate (-3.2%) weighed down by rising bond yields.

The best performing large cap stocks were Pilbara Minerals Limited (PLS, +27.4%) and Whitehaven Coal (WHC, +11.8%), benefitting from strong lithium and coal prices respectively. The worst performing large caps were Goodman Group (GMG, -21.7%), impacted by rising bond yields, and Origin Energy (ORG, -19.1%), following its announcement of the divestment of an exploration asset.

The S&P/ASX Small Ordinaries index (-11.2%) underperformed the large cap S&P/ASX100 index (-5.7%), driven by its overweight in technology, which was negatively affected by rising bond yields. The best performing Small Ordinaries stock was lithium miner Argosy Minerals Limited (AGY, +31.7%) while the worst performing was Pointsbet Holdings (PBH, -43.5%), following recent concerns surrounding corporate governance.

International equities

Global equities fell 9.5% in USD terms and 3.5% in AUD terms, as global central banks remained committed to their rate hiking paths. The announcement of a fresh fiscal proposal by the UK government drove global bond yields higher before the BoE intervened to restore stability. The best performing global sectors were Health Care (-3.2%) and Materials (-6.1%) while the worst performing sectors were Real Estate (-11.7%) and Information Technology (-11.6%).

Property

Global REITs posted a (hedged) return of -11.7% in AUD and Australian REITs posted a total return of -13.6%, both underperforming other asset classes. REIT performance was negatively affected by rising bond yields. The best performing stock in the S&P/ASX200 AREITs index was Mirvac Group (MGR, -6.5%) while the worst performing stock was Goodman Group (GMG, -21.7%).

Fixed interest and cash

Global bond indices posted negative returns as government bond yields rose as central banks continued to raise interest rates. In addition, the announcement by the UK government for the proposal of stimulatory fiscal policy further drove bond yields higher.

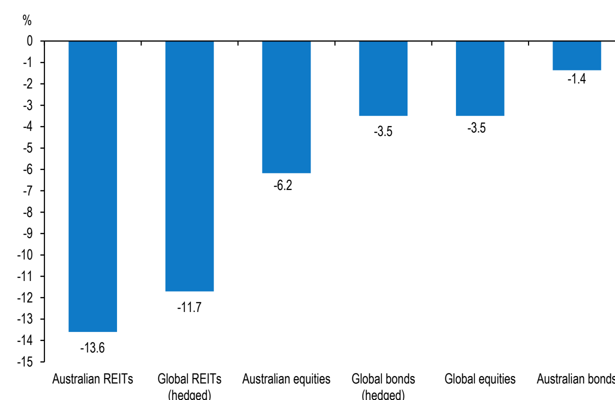
Commodities

Commodity prices generally fell due to economic weakness weighing on the outlook for demand, as well as a sharply appreciating US dollar (commodities are generally priced in USD). WTI oil was hit particularly hard.

Currency

The US dollar continued to strengthen this month, with the US dollar index hitting a 20-year high against a basket of currencies, following hawkish commentary from the US Federal Reserve. The Australian dollar saw the deepest loss among the major currencies.

Major asset class total returns during September 2022



Source: Factset, MWM Research, October 2022

Note: All returns are in AUD

Total returns (A$) – as at 30th September 2022

	1 month %	3 months %	YTD %	1 year %	3 year %pa	5 year %pa
Australian equity indices						
S&P/ASX 200	-6.2	0.4	-9.6	-7.7	2.7	6.8
S&P/ASX 100	-5.7	0.6	-7.9	-5.9	3.2	7.2
S&P/ASX Small Ordinaries	-11.2	-0.5	-24.1	-22.6	-0.8	4.1
S&P/ASX 20	-4.9	0.4	-5.8	-4.5	3.8	7.4
S&P/ASX 50	-5.4	-0.1	-7.1	-5.6	2.3	6.8
S&P/ASX Mid-Cap 51-100	-7.5	5.2	-12.6	-7.5	8.3	9.4
S&P/ASX 200 Industrials	-7.6	-0.5	-13.9	-13.5	0.7	5.0
S&P/ASX 200 Resources	-2.1	2.8	6.7	17.0	9.8	13.7
International equity indices						
MSCI AC World ex Australia	-3.5	-0.2	-15.7	-10.5	6.0	9.3
MSCI Developed World ex Australia	-3.2	0.5	-15.5	-9.4	6.8	10.2
MSCI Emerging Markets	-5.8	-5.3	-17.3	-18.9	-0.1	2.6
Regional equity indices						
S&P 500	-3.2	1.7	-13.9	-5.0	9.9	13.7
NASDAQ Composite	-4.5	2.8	-23.1	-17.1	12.4	15.8
Euro STOXX 50	-1.6	-2.8	-22.2	-19.0	-1.4	1.8
FTSE 100	-2.3	-3.5	-9.5	-5.3	-0.1	3.0
Japan TOPIX	-3.1	0.3	-14.7	-19.4	-0.7	3.2
Hong Kong Hang Seng	-7.4	-14.6	-14.6	-19.3	-8.8	-2.2
MSCI China	-8.9	-17.0	-22.1	-27.3	-5.6	-1.6
International equity thematic indices						
MSCI World Cyclicals	-4.4	0.4	-20.8	-15.3	6.4	10.2
MSCI World Defensives	-0.5	0.6	0.8	8.5	7.8	10.1
MSCI World Value	-2.3	-0.6	-7.3	-1.2	4.2	7.2
MSCI World Growth	-4.2	1.6	-23.4	-17.7	8.3	12.5
MSCI World High Dividend Yield	-1.4	-2.5	-5.2	0.9	3.6	7.7
Real estate equity indices						
S&P/ASX A-REIT	-13.6	-6.7	-28.7	-21.5	-5.3	2.6
FTSE EPRA Nareit Global Developed (hedged)	-11.7	-10.3	-26.6	-19.0	-5.8	0.4
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	-3.5	-3.8	-12.8	-12.8	-3.6	-0.2
Bloomberg Barclays Global Treasury (hedged)	-3.0	-3.4	-11.5	-11.4	-3.6	0.0
Bloomberg Barclays Global Corporates (hedged)	-4.9	-4.8	-17.6	-17.7	-4.3	-0.5
Bloomberg Barclays Global High Yield (hedged)	-4.9	-1.9	-17.5	-17.9	-3.6	-0.9
Australian bond indices						
Bloomberg AusBond Bank Bill	0.1	0.4	0.5	0.5	0.4	0.9
Bloomberg AusBond Composite (0+Y)	-1.4	-0.6	-10.0	-11.4	-3.4	0.8

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

Source: FactSet, MWM Research, October 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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