Investment Matters

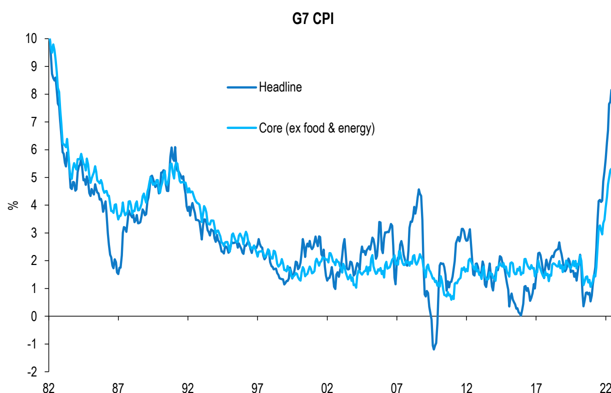
Reality bites

September 2022

MACQUARIE

The investment backdrop remains challenging and we see limited scope for meaningful improvement out through year end and into 2023. We started 2022 worried about rising inflation, the need for central banks to begin hiking policy rates and for economic growth to slow. As we move into the latter stages of the year, the report card shows that limited progress has been made on bringing inflation back under control, policy rates have exploded higher but have not yet reached restrictive territory in key developed economies and economic growth is in various stages of deceleration across the globe, including China which is now easing policy to support the property sector.

Inflation is not yet under control



Source: Factset, MWM Research, August 2022

The limited progress in containing inflation highlights the severity of the problem and that despite a strong intent, policymakers were starting from well behind the curve and had a long way to get in front of the problem. There remain many uncertainties as we look out to the next 12-18 months and while we are confident that policymakers have the tools to bring inflation back under control (blunt as they may be), we don't believe the fight against inflation is anywhere near over and we make the following points surrounding the near-term outlook:

- There has been some positive news around US inflation prints due to falling energy prices, but most countries are at different stages of the inflation cycle, and there is still limited evidence to suggest that central banks now have inflation under control, including Australia where, according to the RBA, inflation has not yet even peaked.

- Following the Jackson Hole Central Bank Symposium, the US Fed Chair reaffirmed his "unconditional" commitment to tackling high inflation and stressed that doing so will probably have economic costs, including a "sustained period of below-trend growth". This statement was immediately followed up by comments from a number of ECB officials who also warned of the "sacrifice" needed to tame surging inflation across the Eurozone.

- It remains "guesswork" as to how high rates will need to go in order to bring inflation back under control and therein lies the conundrum. Will central banks (including the RBA) push too hard by raising rates too far, will they lose their nerve as growth begins to slow and allow inflation to run too hot, or will they achieve the holy grail of a soft economic landing while bringing inflation back under control. With certainty, we simply do not know and neither do they.

- While Macquarie is not forecasting a global recession, we are forecasting short/shallow recessions in the US, UK and Europe with China likely to experience a sharp slowdown due to COVID lockdowns and a plummeting real estate sector. While avoiding a global recession is a positive outcome, growth will approach stall speed which makes the outlook vulnerable to any negative developments on inflation or rates.

- Australia is expected to avoid recession, but growth will slow meaningfully into 2023. Macquarie is forecasting the cash rate to peak at 3.10% (currently at 1.85%) in early 2023 but this will be data dependent and the sensitivity of the housing market to recent rate hikes suggests policy tightening is already impacting some rate sensitive areas, with more to come as the transmission mechanism works with a lag.

In general, monetary conditions are not yet tight enough to materially slow economic growth, inflation expectations have not yet fallen to levels consistent with long term inflation objectives and inflation is still running at levels that will take considerable time to revert to mandated targets. In other words, there is still significant work to be done by central banks. We can expect further rate hikes across the globe and for policymakers to be increasingly prepared to weaken economic growth in order to achieve this.

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.

Jason and the Investment Strategy Team

Global economics

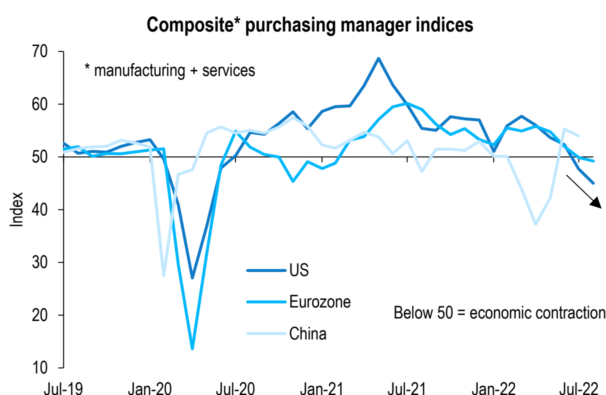
Mild recession our base case

- Global inflation pressures are near peak but central banks will continue raising rates to bring inflation back to target.
- Policy tightening will slow economic growth with recession our base case in US, UK, Europe but growth weakness should be short and shallow.
- Targeted policy support by Chinese authorities is unlikely to provide a strong enough offset to slowing growth in Western economies.

The Fed makes it clear it will do whatever it takes

Global growth momentum has continued to weaken with economic indicators for both the US and Europe continuing to fall to levels suggesting contraction; the US PMI's sharp fall suggested the fastest decrease in US output since the pandemic. On the inflation front, there were some tentative signs that US inflation pressures may have peaked as US underlying inflation decelerated. However, inflation in Europe hit new multi-decade highs on sharply rising energy prices. While labour markets are currently very strong, there are clouds on the horizon, with US weekly initial jobless claims recently hitting an eight-month high and a flurry of high-profile hiring freezes and layoff announcements.

Leading economic indicators for US/Europe in contraction territory



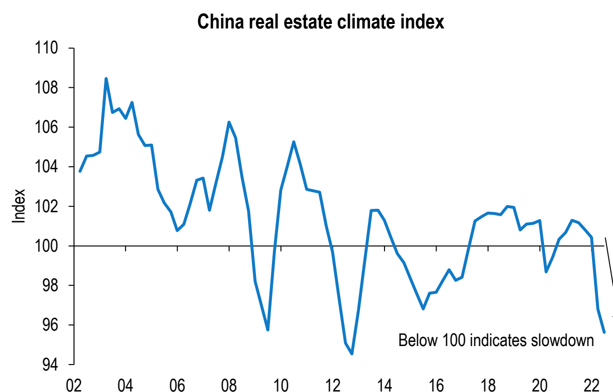
Source: Factset, MWM Research, August 2022

Weakening economic growth and easing inflation pressures will not deter the Fed. Chair Powell recently stated that the Fed will not abandon its goal of taming inflation, preparing to exact pain on households and businesses now to prevent even more challenging conditions in the future. "Restoring price stability will likely require maintaining a restrictive policy stance for some time," Powell announced. This was followed up by similar comments from several ECB officials who warned of the "sacrifice" needed to tame surging inflation across the Eurozone.

Policy rates have risen at a dramatic pace across the developed world, but financial conditions are not yet restrictive. More hikes are coming given that policymakers are behind in the inflation fight. Policy tightening will slow economic growth/raise unemployment with recession now our base case in the US and Europe. The European economy looks particularly fragile, dealing with a massive energy price shock in addition to spillovers from the conflict in Ukraine.

The Chinese property market is in dire straits with sharp falls in prices and activity weighing on the economy. Additionally, a loss of consumer confidence in the ability of property developers to deliver is exacerbating the crisis. Authorities have responded with rate cuts and policy support aimed at putting a floor in the property sector, rather than providing a large boost to economic growth.

China property sector has weakened dramatically



Source: NBS, Factset, MWM Research, August 2022

We don't think investors should fear a China growth collapse. Policymakers can mobilise national resources and have a history of showing this. But we think these measures are likely to remain targeted given the desire to achieve the broader mandate around social and economic objectives and, as such, we think it's unlikely that policy action will provide a strong enough offset to slowing economic growth in the West.

There are numerous risks to the global outlook, but the clearest ones are that policymakers raise rates too far (and drive a deeper than expected recession) or that they lose their nerve and let inflation run too hot (driving a stagflation outcome).

Australian economics

Growth to slow as policy tightening continues

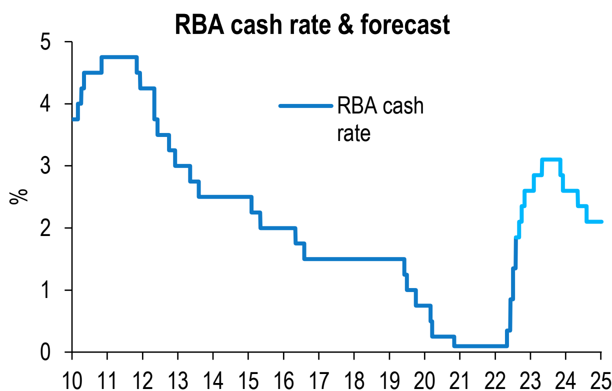
- Current momentum in the Australian economy remains relatively strong, supported by still solid consumption, business sentiment and a tight labour market.
- But pockets of weakness are emerging (housing prices, consumer confidence), as the economy absorbs rising rates.
- While ultimately Macquarie expects Australia to avoid a recession, economic growth will continue to slow into 2H22 as the RBA stay committed to getting inflation back under control.

Further growth slowdown still to come

Central banks around the world have sent an unequivocal message that they remain committed to the inflation fight removing budding hopes for a near term policy pivot. With domestic inflation numbers yet to peak and forecast to continue rising further into 2H22, the Australian economy is expected to follow a very similar path to their global counterparts in terms of growth trajectory and policy tightening, just with a lag.

The Australian economy has remained relatively robust thus far, with multiple factors continuing to hold including still solid consumer spending, with services having further room to recover, stable business investment and corporate profits, and a strong labour market. Ongoing employment growth and labour force participation saw the unemployment rate fall even further to 3.4% in July (from a 48-year low of 3.5% in June), which should be supportive for overall economic activity in the near term – although this is likely to be as good as it gets.

RBA still has a lot of work to do…

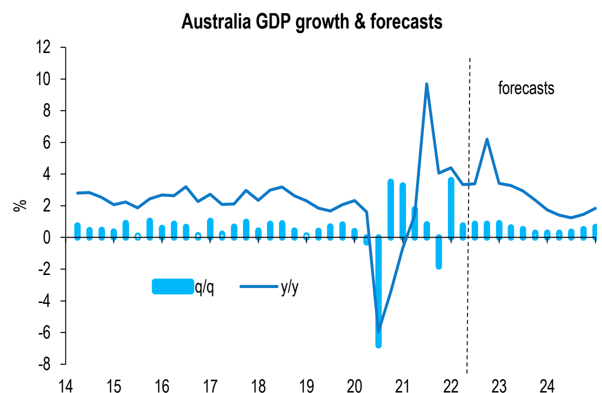


Source: RBA, Macquarie, MWM Research, August 2022

Inflation has now picked up sharply and become more broad-based, but still lags the rest of the world, with the RBA expecting inflation to continue to accelerate over 2H22 before peaking at ~7¾% yoy. Over the medium term, inflation is expected to stay sticky, in the range of 3-5% over the next 12-18 months before coming back down to RBA's 2-3% target band in 2024.

Like other central banks, the RBA will be dependent on data, and will likely remain firmly committed to tightening policy until they see inflation numbers peak and begin to decline. 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. However, should data surprise to the upside, there is risk for 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 be cutting the cash rate by 2024, as it responds to a US recession and a sharp slowdown in domestic conditions / rising unemployment.

…with growth expected to slow substantially into 2023



Source: ABS, Macquarie Research, August 2022

While we do not expect rising interest rates to drive a systemic bad and doubtful debt cycle, the impact on consumers will not be insignificant and the risk of a sharp slowdown in consumer spending is high (particularly for discretionary spending) – this will not be 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 expecting a ~15-20% peak-to-trough decline in national house prices driven largely by a deterioration in affordability.

Further risks are to the downside 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 impact growth. We think Australia is following the same path of many other developed economies which saw inflationary pressures emerge earlier. Regardless of excess savings, elevated commodity prices and/or strong labour markets, a much larger slowdown in growth may be needed in order to tame inflation.

Monthly performance

August 2022

Australian equities

Australian equities posted a total return of 1.2% in August, outperforming global equities. Australian equities benefitted from a strong performance from resource stocks. The best performing sector was Energy (+7.8%) on elevated commodity prices while the worst performing sector was Real Estate (-3.2%) as rising bond yields weighed on the sector.

The best performing large cap stocks were Oz Minerals (OZL, +36.6%) after it received a takeover offer and Pilbara Minerals (PLS, +31.8%) which benefitted from a strong lithium price. The worst performing large caps were Bendigo & Adelaide Bank (BEN, -12.2%) which slumped following its FY22 result and Reliance Worldwide Corporation (RWC, -11.4%).

The S&P/ASX Small Ordinaries index (+0.6%) underperformed the large cap S&P/ASX100 index (+1.3%), driven by its overweight in underperforming technology and gold stocks, both of which were negatively affected by rising bond yields. The best performing Small Ordinaries stock was lithium miner (LKE, +44.4%) while the worst performing was PPK Group (JRV, -42.7%).

International equities

Global equities fell 4% in USD terms and 2%% in AUD terms. Hawkish commentary from the Fed reaffirming its commitment to taming inflation even at the cost of slowing the economy saw global equities sell off. US and European equities underperformed. The best performing global sectors were Energy and Utilities while the worst performing were Health Care and Information Technology.

Property

Global REITs posted a (hedged) return of -5.7% in AUD and Australian REITs posted a total return of -3.5%, 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 Charter Hall Group (CHC, +6.0%) while the worst performing stock was Arena REIT (ARF, -12.7%).

Fixed interest and cash

Global bond indices posted negative returns as bond yields rose on hawkish US Federal Reserve commentary.

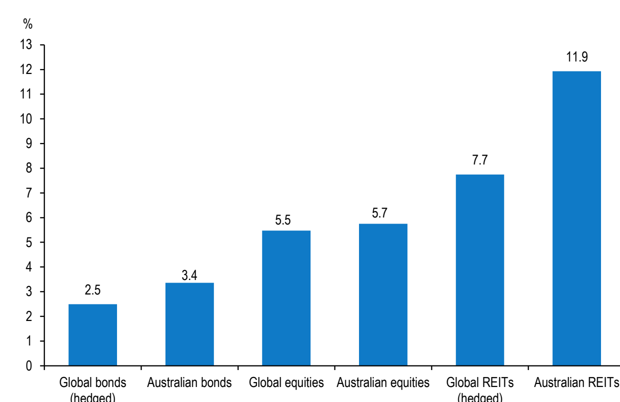
Commodities

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 big story during the month was US Dollar strength, with the US Dollar Index hitting a 20-year high against a basket of currencies, following hawkish commentary from the US Federal Reserve.

Major asset class total returns during August 2022



Source: Factset, MWM Research, August 2022

Note: All returns are in AUD

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

	1 month %	3 months %	YTD %	1 year %	3 year %pa	5 year %pa
Australian equity indices						
S&P/ASX 200	1.2	-2.4	-3.6	-3.4	5.5	8.1
S&P/ASX 100	1.3	-2.4	-2.4	-2.1	5.9	8.4
S&P/ASX Small Ordinaries	0.6	-2.6	-14.5	-14.7	4.1	6.9
S&P/ASX 20	0.8	-3.1	-1.0	-2.1	6.3	8.5
S&P/ASX 50	0.8	-3.0	-1.8	-2.3	4.9	8.0
S&P/ASX Mid-Cap 51-100	4.2	2.0	-5.5	-0.6	11.4	11.1
S&P/ASX 200 Industrials	-0.4	-1.0	-6.8	-7.1	3.9	6.7
S&P/ASX 200 Resources	5.9	-6.1	9.0	11.7	11.7	13.9
International equity indices						
MSCI AC World ex Australia	-2.0	-1.1	-12.7	-10.1	8.0	10.7
MSCI Developed World ex Australia	-2.5	-1.0	-12.7	-9.2	8.7	11.7
MSCI Emerging Markets	2.2	-1.9	-12.2	-16.3	2.5	3.9
Regional equity indices						
S&P 500	-2.4	0.6	-11.1	-5.4	11.7	15.1
NASDAQ Composite	-2.8	2.6	-19.5	-16.8	14.3	17.3
Euro STOXX 50	-4.6	-8.6	-20.9	-21.1	0.2	3.3
FTSE 100	-3.6	-6.3	-7.4	-4.0	1.9	4.4
Japan TOPIX	-0.9	-0.1	-12.0	-13.2	1.6	4.6
Hong Kong Hang Seng	1.0	-0.9	-7.8	-16.0	-5.9	-0.7
MSCI China	2.0	1.3	-14.5	-23.3	-2.6	0.7
International equity thematic indices						
MSCI World Cyclicals	-2.8	-1.2	-17.2	-14.2	8.8	12.0
MSCI World Defensives	-1.6	-0.6	1.3	6.6	8.4	10.8
MSCI World Value	-1.3	-3.2	-5.1	-0.6	6.3	8.6
MSCI World Growth	-3.6	1.2	-20.1	-17.6	10.0	14.0
MSCI World High Dividend Yield	-2.3	-3.5	-3.9	-0.7	5.3	8.8
Real estate equity indices						
S&P/ASX A-REIT	-3.5	-3.2	-17.4	-11.1	-1.5	5.8
FTSE EPRA Nareit Global Developed (hedged)	-5.7	-6.2	-16.9	-13.0	-0.9	3.0
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	-2.7	-1.9	-9.7	-10.5	-2.7	0.5
Bloomberg Barclays Global Treasury (hedged)	-2.6	-1.7	-8.8	-9.8	-2.8	0.5
Bloomberg Barclays Global Corporates (hedged)	-3.2	-2.9	-13.4	-14.3	-2.9	0.4
Bloomberg Barclays Global High Yield (hedged)	-1.2	-4.5	-13.2	-14.3	-1.8	0.2
Australian bond indices						
Bloomberg AusBond Bank Bill	0.2	0.3	0.4	0.4	0.4	0.9
Bloomberg AusBond Composite (0+Y)	-2.5	-0.8	-8.8	-11.5	-3.1	1.0

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

Source: Factset, MWM Research, September 2022

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References

Australia & NZ Macro Outlook – Threading The Needle, 19 August 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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