Investment Matters

Testing times

April 2023

MACQUARIE

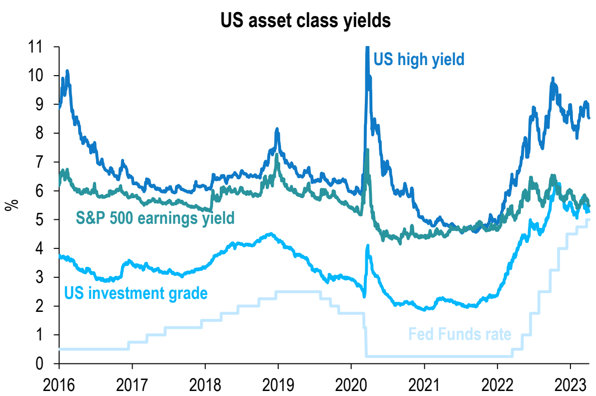
It has been a volatile first quarter as markets digested a barrage of positive and negative developments. While equities finished the quarter on a strong note, and for the most part looked through downside risks, we remain cautious given rising economic growth risks, still elevated inflation prints and little chance that policy rate cuts are imminent, even if key central banks are getting close to a peak / pause.

At this stage we think it is premature to believe central banks have slayed the inflation dragon and that we can begin to position for a rate cut cycle and/or an economic upswing. Considerable progress has been made but headline prints still remain well above comfort levels in most key economies and this suggests further caution is needed. At this stage, we think markets are more likely to be surprised by an early finish to rate hike cycles rather than an early start to rate cuts.

While markets were initially upended by the collapse of a number of US banks and the absorption of Credit Suisse by UBS in a takeover reminiscent of what we saw during the GFC, they quickly settled back down and we are confident that policy makers have the tools (and urgency) to ensure confidence in the financial system is not undermined.

Unfortunately the result which saw a rise in credit spreads and a tightening in lending standards, does add to downside growth risks but Macquarie doesn't think it is a precursor to broader financial sector concerns for a number of reasons: First, the risk of further bank runs due to deposit flight have been alleviated by liquidity supports; Second, there were a number of one-off circumstances that drove the recent collapse of US/European institutions such as poor deposit concentration, poor investment decisions and asset-liability mismatches that are idiosyncratic and not systemic; And third, while credit conditions have tightened, the financial system continues to operate smoothly.

Borrowing costs have risen across the board

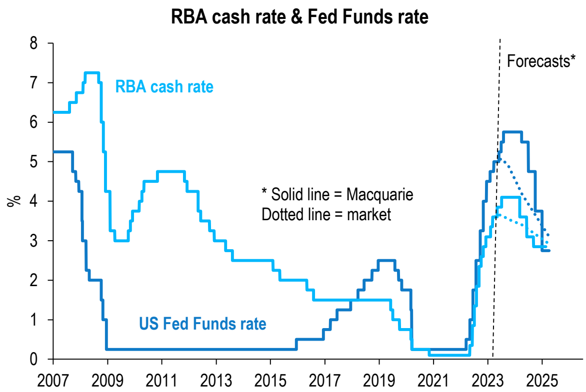


Source: Minack Advisors, Bloomberg, NBER, Federal Reserve, April 2023

Against a backdrop of slowing economic growth, elevated inflation and central banks that are juggling the need to ensure inflation is on a path back to target levels but without causing more financial market turmoil, investors should expect ongoing volatility and for defensive assets to generally outperform.

We don't think markets have set a permanent course upward despite a strong showing through 1Q23 as bond yields and policy rates collapsed. Growth slowdowns that are policy driven take time to unfold and policy makers cannot undo the damage that rising rates have/are inflicting on economies.

Policy rate expectations have quickly shifted to rate cuts



Source: Factset, Macquarie Macro Strategy, Bloomberg, April 2023

For Australia, the economy is now showing signs of cooling with some slippage across the labour market and consumer spending beginning to slow. While business confidence has remained robust, consumer confidence is at rock bottom levels, and this foretells further weakness in spending. While excess savings and a large proportion of fixed rate mortgages have slowed the transmission of higher policy rates into the broader economy, they have only delayed rather than prevented this tightening from taking place. We think the RBA has one further rate hike of 25 basis points (taking the cash rate to a peak of 3.85%) before it takes a longer pause to assess the damage.

From an investment perspective we don't see the need to alter our defensive strategy that we came into the year recommending. A peak in policy rates supports our overweight in bonds which now offer attractive yields as well as downside growth protection. We think investors should be trying to lock in yields before they begin to fall from current levels. We remain cautious on equities where near term upside is limited and volatility is likely to remain high. We had an overweight on global vis-à-vis Australian equities and we maintain this preference. We straddle growth and value strategies – preferring neither until there is greater transparency on rates and growth. We are cautious on the valuation hit coming for private markets, but the structural appeal remains in place.

Jason and the Investment Strategy Team

Global economics

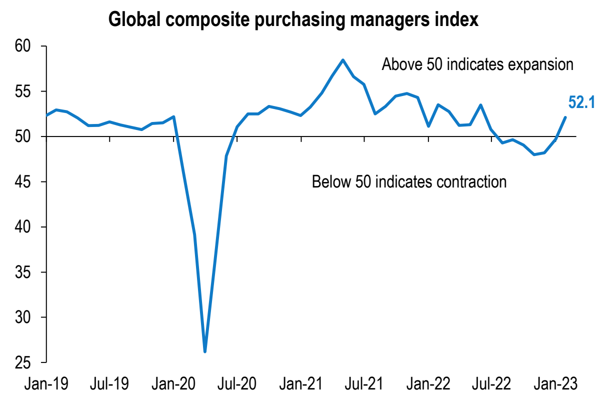
Financial turbulence adds to downside risks

- Macquarie forecast a recession for advanced economies in 1H23, but still expect it to be relatively shallow and short in duration.
- Central bank rate hikes are nearly complete but tough talk will continue so financial conditions don't loosen.
- Heightened uncertainty around the economic outlook will linger until "high rates", which we see as the primary cause of recent financial sector instability, is addressed.

Activity was proving resilient

Prior to the banking events of mid-March, global economic activity was proving resilient, with data surprising positively across major economies. The global manufacturing PMI rose well into expansion territory, driven mostly by a rebound in services.

PMI's have recovered back into expansionary territory

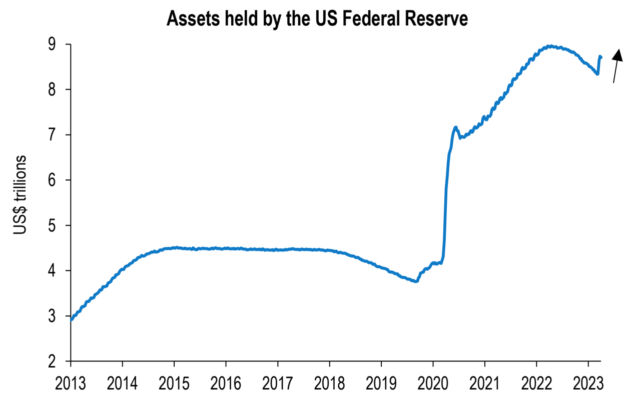


Source: FactSet, MWM Research, April 2023

Crisis averted…

The speed at which the US Federal Reserve (and other central banks) reacted to the failure of Silicon Valley Bank was encouraging, as was the size of the liquidity boost, but we still don't know whether this signals a permanent reversal of the Fed's QT ("Quantitative Tightening" or reduction in the size of the assets held on the Fed's balance sheet) program or whether they are prepared to step back from their rate hike path. Bank failures clearly add to the growth slowdown narrative in the US and, by association, the global economy.

Fed has reversed QT as financial risks rise



Source: FactSet, MWM Research, April 2023

…but problem not solved

It is likely that heightened uncertainty around the economic outlook will linger until "high rates", which we see as the primary cause of recent financial sector instability, is addressed. Markets will take comfort from the willingness of policy makers to immediately address areas of stress, but if the response is temporary and does not come with measures to permanently reduce the cost of borrowing (i.e., lowering rates), then underlying problems will likely keep building.

China reaffirms easing bias and goes against the developed market tide

On March 17th, the People's Bank of China announced a surprise 25bp cut in the reserve requirement ratio for financial institutions, effectively sending a 'pro-growth' signal and supporting the view that China's "around 5%" GDP growth target is more a floor than an actual target. Additionally, existing home prices increased in February, marking the first increase since the beginning of China's property crisis in September 2021. This move by the PBoC is against the tide of policy tightening by most other major developed economies.

Given the desynchronised nature of China's recovery, its growth rebound will go a long way towards offsetting the downdraft from the slowdowns in the US, Europe and UK. Macquarie expect global growth to bottom in 2H23 despite US recession not coming until 3Q23. This means global growth momentum is already rising into the second half and 2024, even though policy rates are not likely to be falling. A number of risks could disrupt this including the recent rise in the oil price as well as the rise in credit spreads and tightening in US lending standards. However, we doubt that the duration or depth of the global slowdown is likely to alter significantly from current expectations.

Australian economics

Australian economic growth slowing

- Cracks are starting to appear in consumer spending and household finances will come under more pressure as the year unfolds.
- The tightness in labour market conditions is starting to ease with unemployment already ticking higher.
- Macquarie is not forecasting a 2023 recession for Australia, but economic growth is expected to slow materially.

Consumer spending beginning to weaken

While the Australian economy remains resilient to rate hikes, key economic data is now more mixed. Labour market conditions remain very tight, but there are signs of some easing in difficulties sourcing workers, with the surge in net immigration likely a contributing factor. High-frequency indicators of wages growth remain well-contained. Consumer spending headwinds persist with retail sales for February rising only modestly and major bank credit/debit card data point to ongoing softness in March.

The softness in consumer spending will give the Reserve Bank of Australia some confidence that emerging signs of disinflation should persist. The recent February monthly CPI release (6.8% versus 7.4% previous) showed that inflation remains too high but is slowly moderating. Macquarie's 'nowcast' for the March quarter CPI suggests that Q1 headline inflation could print around the +1.4% q/q mark. This would be lower than the RBA's February SoMP forecast of around +1.7% q/q.

Is Australia immune from global financial sector risks?

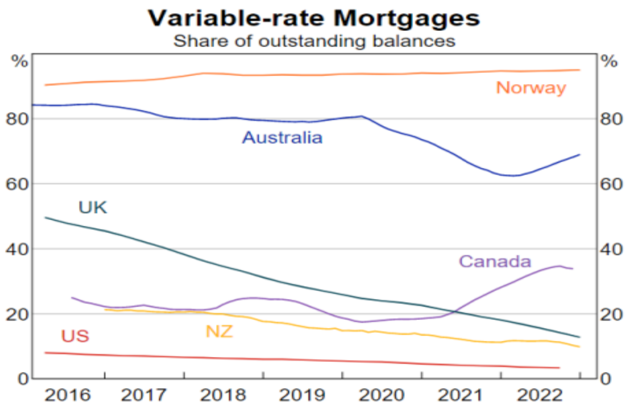
Australia is not immune from global financial sector risks although it is better placed than some countries due to stringent regulation, a robust banking system that is unlikely to suffer from the same concerns that drove a deposit run in the US, as well as a credible central bank. From an economic perspective, Australia will suffer from a global tightening in lending conditions, but domestic fundamentals remain solid. China's re-opening could provide modest support to Australia's economy this year.

Concerns around Australian banks is misplaced. They are profitable, well-capitalised, and the financial sector is also strongly regulated. There are also significant differences in Australian banks' balance sheets, compared to the banks that failed in the US which means Macquarie sees very little risk of similar liquidity issues as was seen in the US.

Housing to continue to weigh on the consumer

While March saw housing prices across Australia's 5 major capital cities rise (+0.5% m/m, led by +1% m/m growth in Sydney), Macquarie does not think the trend of weakening prices is over yet. Our forecast of a 15-20% peak to trough decline remains in place. Prices have fallen 9% since the April 2022 peak, which has been coupled with lower housing turnover, and further expected declines in prices will continue to be a headwind for some types of discretionary consumption growth. Headwinds will build from rising interest rates and fixed-rate mortgage resets given the high level of indebtedness of Australian consumers and their high exposure to variable rate mortgages.

Australian consumers exposed to rising interest rates



Source: RBA, April 2023

Australia to slow, but dodge recession

While the RBA paused raising rates in its April update, it's likely that they have not yet finished. While we are conscious of lags and that domestic demand growth has slowed, Macquarie's economics team is not yet convinced that the actual and forthcoming squeeze on demand from higher interest rates is enough to bring inflation back to target over time, suggesting at least one more hike is coming.

Macquarie is still not forecasting a recession for Australia in 2023. Nevertheless, economic growth is expected to slow materially this year, with Macquarie forecasting GDP to grow only ~1¼% over 2023 (down from 2.6% in 2022). This is primarily reflecting upward revisions to expected population growth and masks a modest downgrade to growth in per capita GDP. Although Macquarie expect net immigration to help ease some of the tightness in labour markets, the real driver for rising unemployment is expected to come from weaker growth in demand.

Monthly performance

March 2023

Australian equities

Australian equities posted a total return of -0.2% in March, underperforming global equities (+3.8% in AUD). The Australian market was weighed down by its heavy weighting to Banks (-4.8%). The best performing domestic sector was Materials (5.9%) while the worst performing was Real Estate (-6.5%) on rising concerns over the commercial real estate sector. Gold stocks (+18.9%) shone as the gold price jumped.

The best performing large cap stock was gold miner Northern Star Resources (NST, +19.8%) which rallied following a sharp rise in the gold price while the worst performing large-cap stock was rare-earths producer Lynas Rare Earths (LYC, -22.7%) which sold off following news that major rare earths consumer Tesla would instal new technology on its next generation of EVs that would reduce its demand for neodymium.

The S&P/ASX Small Ordinaries index (-0.7%) slightly underperformed the large cap S&P/ASX100 index (-0.2%). The best performing small cap stock was battery metal producer Liontown Resources (LTR, +89.7%) which rallied after receiving a takeover offer while the worst performing small-cap stock was cobalt producer Jervois Global (-63.3%) after it suspended construction of a cobalt operation in the United States.

International equities

Global equities rose 3.8% in AUD. Concerns over the failure of multiple US banks was offset by an expansion of the Federal Reserve balance sheet as it provided liquidity support for banks. Bond yields fell, aiding longer-duration Information Technology (+10.8% in AUD) and Communication Services (+9.7% in AUD) sectors. Financials (-7.1% in AUD) underperformed on jitters over the stability of the financial sector following bank failures.

Property

Global REITs (-2.4% in AUD) and Australian REITS (-6.8%) underperformed on concerns over the commercial real estate sector's deteriorating fundamentals.

The best performing stock in the S&P/ASX200 AREITs index was Stockland (SGP, +3.7%) while the worst performing was Charter Hall Group (CHC, -17.4%).

Fixed interest and cash

Global bond indices posted positive returns (+2.1% in AUD) as instability in the US and European banking sectors pre-empted a flight to safety, driving bond yields lower.

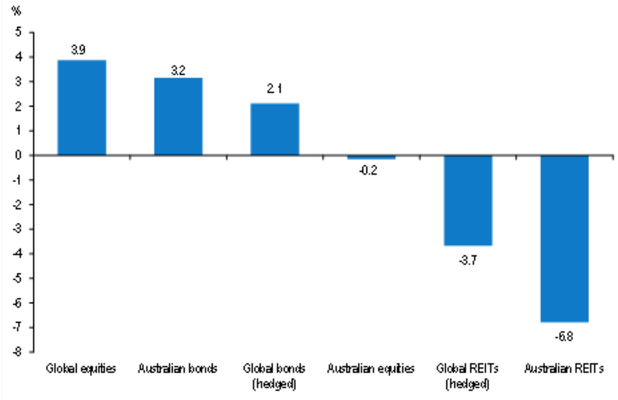
Commodities

Commodity prices were mixed. The gold price (+8.5% in USD) was the standout, benefitting from a fall in real bond yields and rising risk aversion. The coal price (-8.1%) continued its fall amid a milder-than-usual Northern winter and the falling price of natural gas.

Currency

The big currency story was the U.S. Dollar reversing its weakening trend in January and rallying once again. The AUDUSD fell 4.6% on the U.S. Dollar rally and commodity price weakness.

Major asset class total returns during March 2023



Source: Factset, MWM Research, April 2023

Note: All returns are in AUD

Total returns (A$) – as at 31st March 2023

	1 month %	3 months %	YTD %	1 year %	3 year % pa	5 year % pa
Australian equity indices						
S&P/ASX 200	-0.2	3.5	3.5	0.1	16.5	8.7
S&P/ASX 100	-0.2	3.5	3.5	1.1	17.1	9.3
S&P/ASX Small Ordinaries	-0.7	1.9	1.9	-13.2	13.1	3.9
S&P/ASX 20	0.1	3.4	3.4	2.0	16.8	9.9
S&P/ASX 50	0.2	4.0	4.0	1.9	16.1	9.2
S&P/ASX Mid-Cap 51-100	-2.5	0.0	0.0	-3.8	22.1	8.9
S&P/ASX 200 Industrials	-2.1	2.4	2.4	-2.7	13.0	6.6
S&P/ASX 200 Resources	5.0	6.2	6.2	8.0	28.7	15.9
International equity indices						
MSCI AC World ex Australia	3.9	8.7	8.7	3.8	11.9	9.9
MSCI Developed World ex Australia	3.9	9.2	9.2	4.3	12.9	11.0
MSCI Emerging Markets	3.7	5.3	5.3	0.1	4.6	1.8
Regional equity indices						
S&P 500	4.4	8.8	8.8	3.5	15.1	14.2
NASDAQ Composite	7.5	18.5	18.5	-2.8	14.1	15.7
Euro STOXX 50	5.2	17.6	17.6	25.4	14.9	8.7
FTSE 100	0.7	7.8	7.8	10.7	10.8	5.8
Japan TOPIX	4.9	7.9	7.9	8.4	4.4	3.9
Hong Kong Hang Seng	4.2	4.2	4.2	7.3	-5.1	-1.8
MSCI China	5.2	6.0	6.0	7.0	-5.4	-1.2
International equity thematic indices						
MSCI World Cyclicals	3.9	13.0	13.0	2.2	14.3	11.5
MSCI World Defensives	3.8	1.0	1.0	11.7	11.7	11.5
MSCI World Value	0.1	2.4	2.4	7.3	13.3	8.7
MSCI World Growth	7.7	16.6	16.6	1.4	12.7	13.7
MSCI World High Dividend Yield	3.2	3.2	3.2	9.3	10.4	9.6
Real estate equity indices						
S&P/ASX A-REIT	-6.8	0.5	0.5	-13.9	13.6	4.8
FTSE EPRA Nareit Global Developed (hedged)	-3.7	0.4	0.4	-20.5	6.6	1.6
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	2.1	2.4	2.4	-5.5	-2.8	0.3
Bloomberg Barclays Global Treasury (hedged)	2.4	2.6	2.6	-5.2	-3.4	0.2
Bloomberg Barclays Global Corporates (hedged)	2.0	2.5	2.5	-7.0	-1.3	0.5
Bloomberg Barclays Global High Yield (hedged)	0.4	2.3	2.3	-5.6	3.8	0.7
Australian bond indices						
Bloomberg AusBond Bank Bill	0.3	0.8	0.8	2.0	0.7	1.1
Bloomberg AusBond Composite (0+Y)	3.2	4.6	4.6	0.3	-2.4	1.3

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

Source: Factset, MWM Research, April 2023

The Wealth Investment Strategy Team

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

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

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

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

Investment Matters April 2023 was finalised on 6 April 2023.

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