Investment Matters

Progress made but job not done

December 2022

MACQUARIE

I suspect most investors will be looking forward to the holiday season and the start of 2023 with the hope that it will be more fruitful than 2022. We think it will but there is still plenty of water to flow under the bridge before we can confidently say that the ills of the past year are well and truly in the rear vision mirror.

As we go to print, equity markets are coming off a strong rally driven by expectations of an early interest rate pivot, a decline in long bond yields and energy prices, hopes of an economic soft landing and elevated cash levels. Unfortunately, we don't think these tailwinds are sustainable and equities will soon be fretting about slowing economic and earnings growth, and the need for further interest rate hikes.

Into the new year, we think markets will begin to price in a slightly rosier picture as growth troughs and policymakers shift from tightening to easing. But at this stage there is too much uncertainty around the near-term trajectory of inflation, interest rates and economic growth to begin positioning for this outcome. We also think markets remain priced for an economic soft landing and a pending policy pivot which could easily prove to be too optimistic if inflation is sticker than expected, consumers begin to pull back spending at a faster pace or financial markets become a transmission agent for weakness.

Macquarie's base case is for recession in the US, UK and Europe but for Australia to narrowly escape this outcome. On a positive note, there is little doubt about the resolve of central banks in bringing inflation down. Recessions also cause disinflationary effects, so rising unemployment and weaker economic growth should provide a solid tailwind to cap and then drive down inflation. However, on the negative side, finessing policy-driven slowdowns is difficult and history shows that aggressive rate hike cycles tend to drive hard rather than soft economic landings. While we side with the consensus view that a global economic downturn should be short and shallow, the risk that something goes wrong prevents us from becoming more positive on risk assets as we move into 2023.

However, if all goes to plan, central banks will soon begin to slow the pace of rate hikes (the RBA already has) and headline inflation will continue its decent. Credit spreads will creep higher as corporate fundamentals deteriorate although not dramatically so and with few signs of systemic concerns, it is unlikely credit markets will amplify the downturn as is usually the case during recession. While corporate earnings will face the cumulative effects of rate hikes, we don't expect a major correction given the size and duration of the economic downturn.

For investors, we expect a continuation of elevated volatility as sentiment oscillates between optimism and pessimism. As we have seen throughout 2022, the fickle nature of markets will mean consistent outperformance will be hard to generate as the market flip-flops between risk-on and risk-off periods meaning portfolio performance will at times look troubling even for investors who have stayed close to "core" allocations. In addition, it may also mean that those who chose to shelter in cash are protected during risk-off periods but will suffer cash drag when markets go the other way. Investors are likely to face a difficult backdrop until there is consistent evidence inflation is under control.

The good news is that we now know more about how persistent inflation is proving and how committed central banks are in bringing it down to more acceptable levels. In addition, significant progress has been made in moving policy into restrictive territory. However, the bad news is that the job is not done given inflation has not fallen by any meaningful degree and further policy tightening has an increasingly negative impact on growth. Therein lies the problem that central banks are grappling with. Tighten too much and you start a growth spiral that is hard to arrest. Tighten too little and inflation becomes more entrenched. Central banks are walking a tightrope with huge consequences if they get it wrong.

Against this backdrop, we think portfolios need to be defensive 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. We think it would be highly unusual for risk assets to look through the recession that is coming even if it is only mild and relatively short. In addition, a deterioration in corporate fundamentals will mean some underperformance from credit even against a backdrop where long bond yields begin to fall. We don't think the conditions for a sustainable bottom are in place despite the meaningful correction we have seen in valuations over the past 9 months.

Australia remains in a strong position to withstand policy tightening via a robust labour market and 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 favourable capital flows (both domestically and internationally via a weakening A$).

Stay diversified as a first line of defence even if sentiment continues to improve as we move into 2023. 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, select equity markets that have strong internal fundamentals and liquidity, are not overly exposed to global cyclical developments and geopolitical risks, have some commodity independence and have a robust structural growth component such as the US and, over the longer-term, Australia.

Jason and the Investment Strategy Team

Global economics

Global growth momentum continues to slow

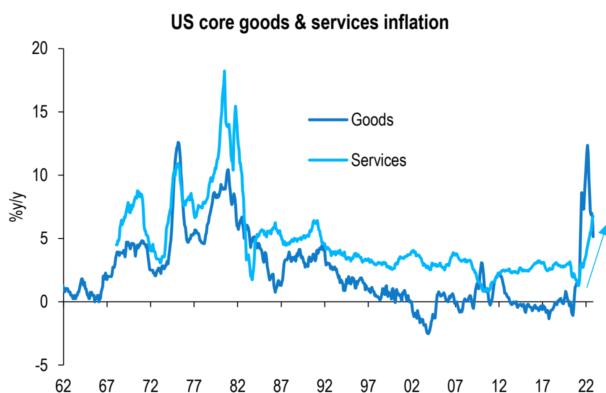
- The momentum for global growth continues to slow with leading economic indicators pointing to a sustained deterioration in business activity.
- While central banks are likely to slow the pace of rate hikes moving forward, they will keep financial conditions tight enough to keep growth subpar until inflation is on track to return to target.
- The outlook for the Chinese economy is highly uncertain as rising COVID-19 cases undermine a normalisation of pandemic restrictions and keep the economy at bay from a material reopening.

Global growth continues to slow

The global macroeconomic environment continued to deteriorate in November. Leading economic indicators illustrated a sustained decline in business activity with PMIs across most economies falling further into contractionary territory. Specifically, flash PMI readings revealed a worse-than-expected decrease in global manufacturing and services activity (49.4), constituting the deepest decline since the depth of the pandemic.

In the US, a positive surprise for the October inflation print supported financial markets. Headline CPI growth came in at 7.7% and was far below Macquarie's and the market's consensus forecast of 8.1%. The weaker-than-expected result was driven by lower goods and energy prices. While this progress is encouraging, services inflation continued to rise (and now outpaces the growth of goods prices). Costlier services may prove problematic, especially if price pressures continue to broaden across the economy.

Services inflation is now outpacing goods prices



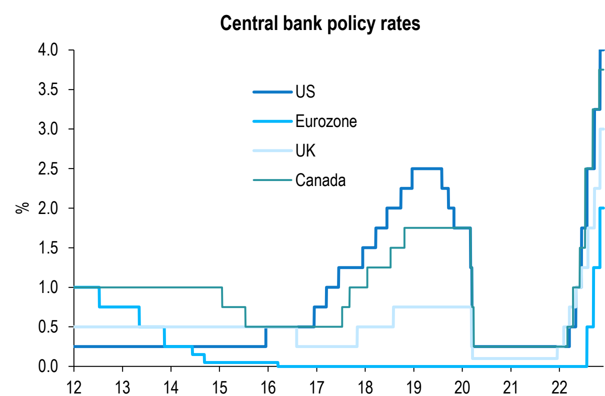
Source: FactSet, MWM Research, December 2022

Central banks will continue to raise policy rates, albeit at a slower pace

Globally, central banks have continued to tighten financial conditions in their pursuit of getting inflation back down to target levels. November saw the Fed raise the policy rate by 75bps to 3.75 – 4.00%. The ECB and Bank of England also followed suit and imposed 75bps hikes. The Fed minutes following the policy decision and a speech by Chair Powell revealed a growing likelihood that the pace of rate hikes will be slowed from 75bps to 50bps. Macquarie expects the Fed to hike by 50bps in December and 25bps in February, resulting in a peak policy rate of 4.00 – 4.75%. A similar sentiment is being echoed by policymakers across the developed world.

However, a slowing in the pace of rate hikes does not constitute a pivot in the stance of policy, and it is likely that financial conditions will remain restrictive for longer if limited progress is made on inflation and/or labour markets prove to be tighter than what is required to sufficiently dampen aggregate demand.

Central banks have substantially tightened financial conditions this year



Source: FactSet, MWM Research, December 2022

China continues to struggle with pandemic restrictions

The outlook for the Chinese economy has worsened due to a recent and rapid rise in COVID-19 cases that undermines the likelihood of materially reopening the economy. Despite policymakers taking several steps to marginally ease pandemic restrictions, daily infection numbers have reached the highest level since the outbreak started and have prompted concentrated lockdowns in certain cities, sparking social unrest. A continued spread of the virus challenges the probability of a substantial near-term easing in zero-COVID policies and does not bode well for global growth.

Encouragingly, Chinese policymakers introduced 16 measures to support the property market including loan term extensions and lines of credit. While support for the property market, which is a substantial contributor to China's GDP, may not remedy broad bearish sentiment, we think Chinese policymakers have the will and the means to safeguard domestic financial stability.

Australian economics

Strong performance but a challenging outlook

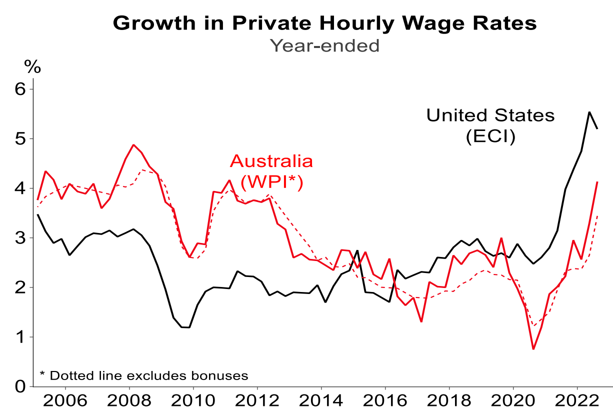
- The Australian economy continues to perform relatively strongly compared to developed peers. However, it is not immune to the challenges the global economy faces.
- A substantial wave of fixed-rate mortgage resets is a key risk against domestic consumption and will weigh heavily on households, especially given their high degree of leverage compared to incomes.
- The RBA may have slowed the pace of its rate hikes, but it still has work to do as inflationary pressures continue to intensify.

Strong performance despite signs of economic softening

The Australian economy continues to perform strongly relative to the developed world. Leading economic indicators point to continued expansion with recent PMI readings showcasing healthy business activity (52.7) in contrast to the contractionary conditions most advanced economies face. Further, a tight labour market and excess household savings have underpinned robust consumer spending even as sentiment for the economic outlook has deteriorated.

Australia is, however, not immune to the challenges faced by other advanced economies. While October labour market data was better than expected, with the unemployment rate falling to 3.4% from 3.5% in September, evidence of slowing employment growth points to the effects of tighter financial conditions starting to work through the economy. The momentum for wages growth has also started to pick up (3.1%), and while it yet does not signal a 'prices-wages spiral', any further force in wages growth will add to elevated inflationary pressures.

Australian wages are catching up with the rest of the developed world



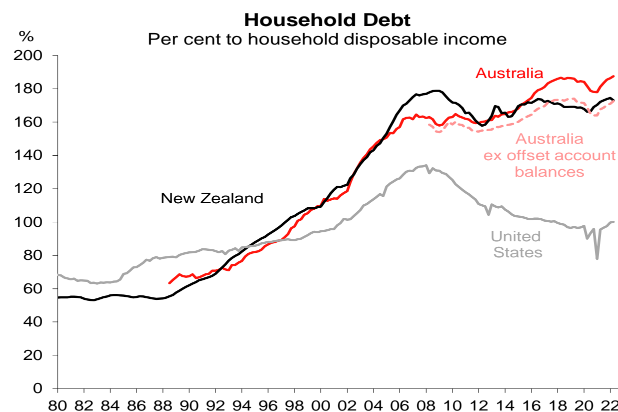
Source: Macquarie Macro Strategy, MWM Research, December 2022

Fixed-rate mortgages a key risk

While the Australian economy has benefitted from the RBA's delayed start to the tightening cycle, restrictive financial conditions are starting to permeate throughout the economy. This is occurring at a time when a large proportion of fixed rate mortgages are expected to reset and reflect current market pricing. The RBA estimates that 60% of fixed-rate mortgages by value will reset between now and the end of 2023, and this will act as a substantial drag on domestic consumption (RBA Financial Stability Review, October 2022).

Macquarie still expects Australia will avoid a technical recession, but the growth slowdown will not be easy, nor will the effects be felt equally across the economy. Australian household debt as a proportion of disposable income remains one of the highest levels in the world and thus renders many households vulnerable to changes in mortgage servicing costs.

Household cash flows are sensitive to changes in interest rates



Source: Macquarie Macro Strategy, MWM Research, December 2022

The RBA still has work to do

The RBA has slowed the pace of its rate hikes and is likely to increase the cash rate by 25bps in December and February. However, further rate rises could be required if inflation proves to be more stubborn than expected. Macquarie still expects a peak cash rate of 3.35% but risk is certainly skewed to the upside on the house view. Headline inflation printed at 6.9% for October, compared to the market's consensus forecast of 7.4%. While this is a substantial positive and welcome surprise, the future path of price growth remains uncertain especially as services inflation continues to rise

Monthly performance

November 2022

Australian equities

Australian equities posted a total return of 6.6% in November, outperforming global equities. The Australian market's performance was boosted by Resources (+14.6%) with the ASX200 ex Resources returning (+3.8%)

The best performing sector was Utilities (+20.8%) due to a takeover offer for a major company in the sector. The worst performing sector was Communication Services (+2.1%) as defensive sectors generally lagged the rally in equities.

The best performing large cap stocks were Origin Energy (ORG, +41.1%), which rallied following a takeover offer, and Fortescue Metals Group (FMG, +31.8%) which rallied on a rising iron ore price. The worst performing large caps were James Hardie Industries (JHX, -14.1%), which sold off after a weaker than expected 2QFY23 result, and Lend Lease Group (LLC, -12.4%), which sold off following weak guidance issued by the company.

The S&P/ASX Small Ordinaries index (+4.9%) slightly outperformed the large cap S&P/ASX100 index (+6.7%) due primarily to Small Ordinaries underweight in outperforming iron ore stocks. The best performing Small Ordinaries stock was EML Payments (EML, +59.3%) following its Annual General Meeting in which shareholders voted against reappointing the Chairman, while the worst performing was City Chic Collective (CCX, -39.1%), after the company warned at its AGM of margin contraction.

International equities

Global equities rose 2.9% AUD during November. US equities (+0.8% in AUD) underperformed while Emerging Market equities (+9.7%) outperformed as Chinese equities rallied sharply on optimism that lockdown restrictions would be eased shortly. Materials was the best performing sector as commodity prices rose while Energy was the worst performing sector as the oil price fell.

Property

Global REITs posted a (hedged) return of +5.0 in AUD, outperforming broader equities, and Australian REITs posted a total return of +5.8%, slightly underperforming Australian equities. REIT performance was aided by a fall in long bond yields over October. The best performing stock in the S&P/ASX200 AREITs index was Goodman Group (GMG, +12.5%) while the worst performing was National Storage REIT (NSR, -8.4%).

Fixed interest and cash

Global bond indices posted positive returns as government bond yields fell on falling inflation expectations as US and European consumer price inflation data releases during the month were lower than expected.

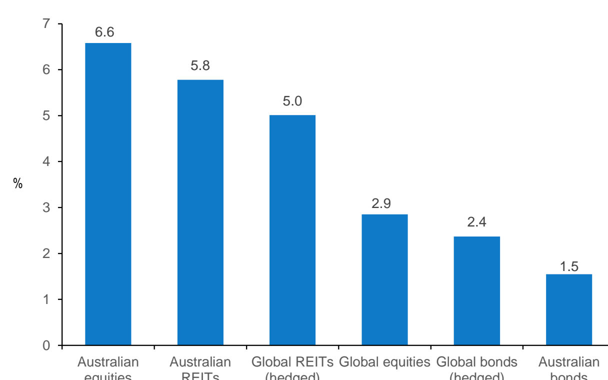
Commodities

Commodity prices generally rose during the month, in part due to a falling US Dollar as commodity prices are priced in US Dollars. The iron ore price was the standout, rising almost 30% as China announced measures to support its ailing property sector. However, the oil price (-10%) bucked the trend, falling in part due to slowing demand from China as well as impending European Union price caps on Russian oil.

Currency

The big story was weakness in the previously strong US Dollar, with the US Dollar Index (DXY) falling from its 20-year high, set in late September on expectations that its rally may have been over stretched and on expectations that the Fed might slow its pace of rate increases. The Australian Dollar bounced on US Dollar weakness and commodity price strength.

Major asset class total returns during November 2022



Source: FactSet, MWM Research, December 2022

Note: All returns are in AUD

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

	1 month	3 months	YTD	1 year	3 year	5 year
	%	%	%	%	%pa	%pa
Australian equity indices						
S&P/ASX 200	6.6	6.0	2.2	5.0	5.9	8.2
S&P/ASX 100	6.7	6.6	4.0	7.0	6.4	8.7
S&P/ASX Small Ordinaries	4.9	-0.8	-15.2	-14.0	2.6	4.4
S&P/ASX 20	7.2	8.0	6.9	9.9	7.6	9.3
S&P/ASX 50	7.0	7.0	5.1	7.8	5.6	8.4
S&P/ASX Mid-Cap 51-100	5.0	4.0	-1.7	2.4	11.2	10.1
S&P/ASX 200 Industrials	3.8	3.3	-3.7	-1.9	3.6	6.3
S&P/ASX 200 Resources	14.6	13.7	24.0	32.3	14.2	15.5
International equity indices						
MSCI AC World ex Australia	2.9	5.9	-7.5	-6.2	7.5	9.7
MSCI Developed World ex Australia	2.1	6.6	-7.0	-5.4	8.5	10.7
MSCI Emerging Markets	9.7	0.6	-11.7	-12.2	0.8	2.5
Regional equity indices						
S&P 500	0.8	6.1	-5.7	-3.9	11.3	13.8
NASDAQ Composite	-0.2	-0.4	-19.8	-21.2	11.0	14.6
Euro STOXX 50	9.0	18.0	-6.7	-2.8	3.1	4.8
FTSE 100	6.2	9.5	1.4	6.0	2.1	4.5
Japan TOPIX	4.5	3.7	-8.7	-9.0	-0.3	2.5
Hong Kong Hang Seng	21.8	-3.3	-10.9	-13.3	-7.8	-3.2
MSCI China	23.9	-5.6	-19.3	-23.8	-6.2	-2.6
International equity thematic indices						
MSCI World Cyclicals	2.6	5.0	-13.1	-12.4	7.7	10.4
MSCI World Defensives	1.1	10.4	11.8	17.0	10.2	11.2
MSCI World Value	2.5	10.4	4.8	8.9	7.1	8.4
MSCI World Growth	1.9	2.7	-18.0	-18.3	8.6	12.2
MSCI World High Dividend Yield	3.2	10.0	5.8	11.1	6.2	8.8
Real estate equity indices						
S&P/ASX A-REIT	5.8	0.4	-17.1	-13.0	-1.6	4.2
FTSE EPRA Nareit Global Developed (hedged)	5.0	-4.4	-20.5	-15.8	-3.6	1.5
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	2.4	-1.6	-11.1	-11.5	-2.8	0.1
Bloomberg Barclays Global Treasury (hedged)	1.7	-1.5	-10.2	-10.8	-2.8	0.2
Bloomberg Barclays Global Corporates (hedged)	4.1	-1.6	-14.8	-14.9	-3.3	0.0
Bloomberg Barclays Global High Yield (hedged)	4.0	0.8	-12.5	-11.1	-1.9	0.2
Australian bond indices						
Bloomberg AusBond Bank Bill	0.2	0.6	1.0	1.0	0.5	1.0
Bloomberg AusBond Composite (0+Y)	1.5	1.1	-7.8	-7.7	-2.7	0.9

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

Source: Factset, MWM Research, December 2022

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

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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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