Investment Matters

Risk rally running out of steam

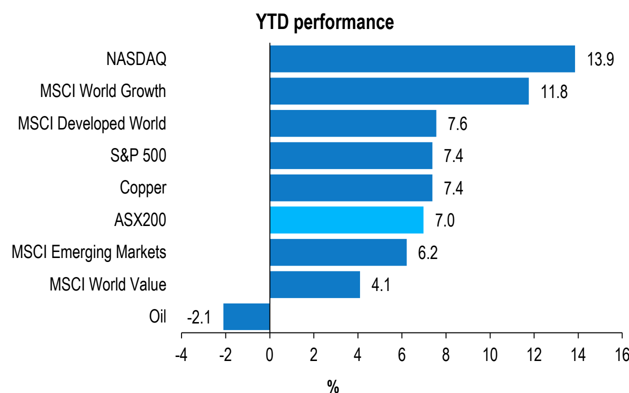
February 2023

MACQUARIE

Markets have started the year strongly, driven by a combination of technical and fundamental factors. We are encouraged by developments on the US inflation front as well as for the European and Chinese economic growth outlooks which have improved meaningfully and have played a large part in driving the rebound in risk assets.

However, policy tightening works with a long and variable lag and we are still yet to see the full impact of the rapid tightening in financial conditions throughout 2022. While we are not expecting a deep or protracted economic downturn, we are expecting to see economic activity slow through the next few quarters as higher borrowing rates begin to slow rate sensitive spending and investment.

2023 has started well for risk assets



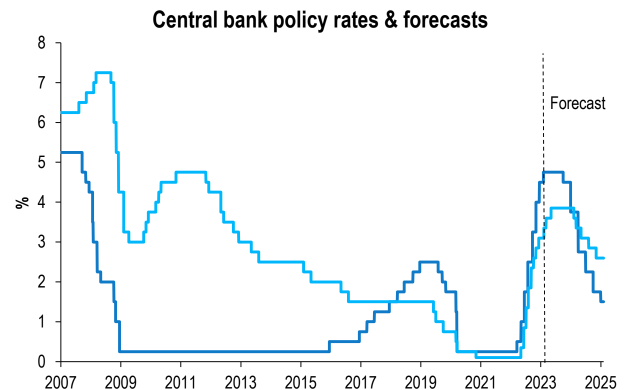
Source: FactSet, MWM Research, February 2023

We think equities and bonds will end the year higher than where they started and that the long-term return outlook (which is most heavily influenced by the price you pay now) is at one of its most appealing levels seen in more than a decade due to the 2022 correction. But regardless of where we think markets end the year, it is likely to be a volatile ride as we enter the final stages of the global rate hike cycle, as markets debate the length of time rates can/will remain at peak and as economies begin to soften.

Central banks have not yet won the inflation fight despite making some progress. While interest rates are getting close to peak in most developed economies such as the US and Australia, it is unlikely that central banks begin to soften their hawkish rhetoric until there are also signs that labour markets are weakening and unemployment rising. Unfortunately, this may require rates to remain at restrictive levels for a period of time in order to push economic growth below trend and to ensure that inflation does not reignite.

There are clear signs that economic growth is slowing across major developed economies, but this is yet to show up in resilient labour markets and we need to see this to be confident that wage-price spiral risks are being reduced. We believe the sustainability of the equity rally rests on the expectation that the Fed and other key central banks will begin to cut rates as economic conditions deteriorate. But is not certain and it rests on evidence that services inflation is starting to moderate.

Policy rates are getting close to “terminal” levels



Source: FactSet, MWM Research, February 2023

If there are no signs of this, then we are much further from the point where protecting growth is a higher priority than squashing inflation and this is not a favourable backdrop for risk assets in general and equities in particular. For now, we think the rally in equities has some fundamental support via a better than expected outlook in Europe, a faster than expected reopening from COVID-zero in China and hopes that we are nearing peak rates. But growth momentum is slowing, and a period of positive economic surprises might reduce hard landing fears, but it does nothing to avert the prospect of recession in the US and Europe, as well as a meaningful economic slowdown in Australia, which remains Macquarie’s base case.

For investors, this means the backdrop remains highly uncertain. Economic growth is slowing but we don’t know how fast or far. Inflation is falling but it is still uncomfortably above target ranges and policy rates are getting close to peak, but we don’t know how quickly cuts will come. As a result, we do not recommend chasing the rally. Equities always fall during recession and the combination of weaker earnings and tight monetary policy suggest there will be a better entry point in the months ahead.

While Australia equities have been a strong performer year to date (and relatively versus global equities through 2022), we think recent strength is unlikely to be sustained as the RBA pushes policy rates into restrictive territory and earnings growth begins to slow. However, we think downside will be relatively limited and would lean into any weakness through 1H. On the other hand, we think the return outlook for bonds is positively skewed, providing appealing yields as well as strong downside protection against economic growth risks as well as falling inflation. We think investors should avoid getting caught up rally or assume that it is the start of a new bull market. Central banks have made progress, but the job is not done.

Jason and the Investment Strategy Team

Global economics

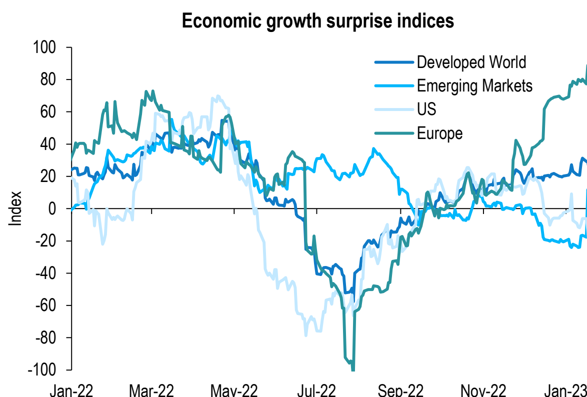
Consensus shifts to a "less bad" outlook

- A mild global recession is Macquarie's base case. Recent positive economic data has seen consensus shift towards a "soft-landing" scenario.
- Central Banks will remain focussed on inflation however, much of the heavy lifting to bring inflation back under control is behind us. We expect that inflation will continue to moderate as economic growth contracts and rate hikes begin to slow demand.
- The reopening of China together with policy supports and low inflation provides a floor to downside global growth risks.

Positive start to 2023 shifts consensus expectations

The global macroeconomic environment will continue to deteriorate throughout 1H23 as higher policy rates work their way through key economies. Macquarie's base case is for a developed world (ex-Australia) recession starting in 1H23 with global growth anticipated to slow to 1.5% in 2023 versus 2.9% in 2022. However, recent economic data suggests that the risks around the outlook have become less skewed to the downside. Consequently, consensus expectations appear to be converging towards a short shallow recession rather than a deep, protracted contraction in economic output this year.

Economic data "less bad" than anticipated



Source: FactSet, MWM Research, February 2023

Key to the improving economic outlook has been the recent resilience of economic data in the US and a much milder than expected winter in Europe. US employment resilience was underlined by the recent massive 517k (185k expected) increase in non-farm payrolls. The Eurozone composite purchasing managers index also unexpectedly rose to 50.2 in January - into the expansionary zone.

Global inflation broadly retreating

Global inflation appears to have peaked given the improvement in functioning of global supply chains, falling energy prices and gradual normalisation of goods demand. In the US, which saw inflationary pressure before other major economies, headline inflation fell in December to 6.5% y/y (the seventh straight month of consecutive declines). However, stickier services (ex housing) inflation remains uncomfortably high at 4.1% y/y down from 4.9% y/y in late January. Meanwhile, the labour market continues to show resilience; the US unemployment rate (3.4%) fell to a new cycle low on a monthly basis and wage growth remains at levels consistent with above target inflation of 3.5%. Consumer spending, the key driver of the US economy, shows signs of weakening (-0.2% in December) as cost-of-living pressures take their toll.

Much of the heavy lifting on the inflation front is behind us given the increase in policy rates seen throughout 2022. Macquarie forecast one further 25bp increase in the Fed's target rate to 475-500bps and held at restrictive levels until September.

Eurozone outlook improves marginally

Macquarie think that the Eurozone will still fall into recession in 2023 despite lower energy prices and stronger than anticipated PMIs that point to a 1Q23 expansion in activity rather than a contraction. However, key leading indicators suggest that this is unlikely to continue as weak business and consumer confidence and a higher cost of capital are expected to drive meaningfully lower business investment and demand for goods.

China now adding to upside risks

The most encouraging recent development for the global economy has been seen within China, which saw activity indicators jump back into expansion territory in January given the faster than expected exit from zero-Covid. Macquarie's China economist expects GDP growth to accelerate to 5.5% in 2023 (2022: 3.3%) and for consumption to normalise throughout 2023 back to pre-pandemic levels as policy support begins to ramp up.

Big jump in Chinese activity indicators in January

Source: FactSet, MWM Research, February 2023

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Australian economics

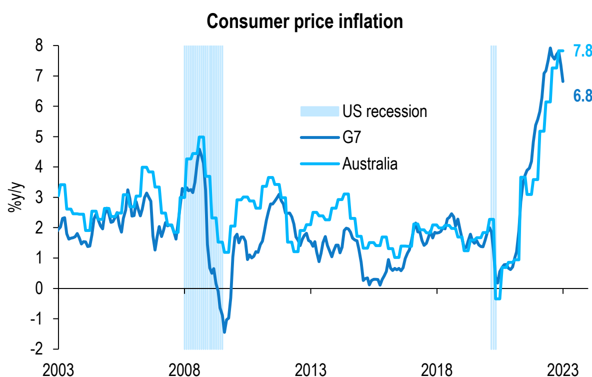
Tightening cycle to continue though 1H

- The Australian economy has been relatively resilient but is ultimately not immune to global economic forces. Recession in many other advanced economies will be a headwind as will the lagged effects from rate hikes.
- Australia lags other economies in the inflation fight. The RBA may have slowed the pace of its rate hikes, but it still has work to do to push inflation back to target.
- With the rate hike cycle not yet over, we expect further weakness to come for housing as a substantial wave of fixed-rate mortgages resets to much higher rates this year. However, we don't expect recession.

The inflation fight keeps the RBA in play

The Australian economy has remained resilient relative to its global developed peers, supported by strong consumer spending and a tight labour market and as it exited COVID lock downs later than its peers. However, we do not think this will be the case for much longer. Australia saw inflation surprise to the upside in 4Q22, with CPI increasing 7.8% y/y (versus 7.6% consensus). Ultimately, Australia remains behind other advanced economies in the inflation fight and, as such, we expect there is more work to be done on the policy tightening front by the RBA if we are to follow the path of other economies (such as the US).

Australia is lagging other economies in the inflation fight

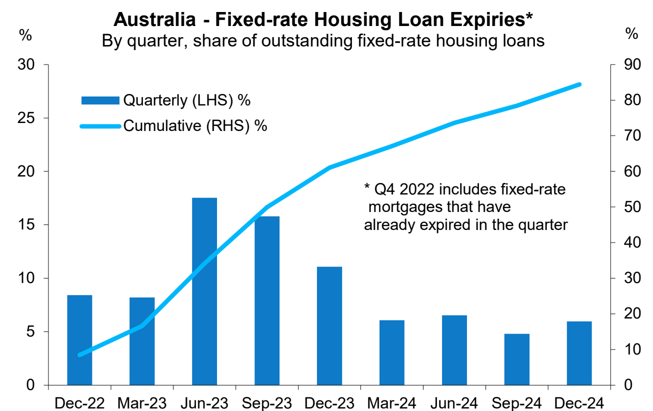


Source: ABS, RBA, Macquarie Macro Strategy, February 2023

The RBA lifted the cash rate by 25bps to 3.35% in their February meeting, the highest level since 2012. However, comments from RBA Governor Lowe were decidedly more hawkish than in December as Lowe reiterated that "further increases in interest rates will be needed over the months ahead". Macquarie has now raised its terminal forecast from 3.35% to 3.85%, while still expecting the first rate cut in 2024. Like other central banks, the RBA will only see progress when unemployment begins to rise, with the latest data suggesting there is still plenty of work to do as unemployment remain anchored at a 50-year low of 3.5%.

At the same time, the RBA has kept their forecast for GDP growth broadly unchanged at ~1½% over 2023 and 2024, with the unemployment rate to edge higher to 3¾% this year and 4½% by mid-2025. While Macquarie's base case is for Australia to avoid a recession, we are not immune from global economic developments and a slowdown from 3.9% to 1.6% over the next 2 years will still feel like recession even if the data says otherwise.

Fixed rate mortgage reset ramps up this year



Source: RBA, Macquarie Macro Strategy, MWM Research, February 2023

Housing and consumer weakness still to come

Consumer spending remained relatively resilient to interest rate rises last year, underpinned by pent-up savings and a tight labour market. However, higher interest rates, inflation and a reopened economy should see household savings continue to fall back to pre-pandemic levels by year-end (following a similar roadmap to that seen in the US and other major developed economies). Macquarie is forecasting real consumer spending to decline from 1% to just 0.1% in 2023.

Furthermore, with ~60% of fixed-rate mortgages expected to reset at higher rates by the end of 2023, this will be a significant headwind for domestic consumption as households feel the pain from rising unemployment and debt servicing costs. The prospect for higher interest rates will also weigh on property prices, with Macquarie's base case to be a ~15% peak-to-trough decline in Australian housing prices. Macquarie believe we are about halfway through the price correction, however a higher than expected terminal cash rate will drive dwelling prices further lower.

Monthly performance

January 2023

Australian equities

Australian equities posted a total return of 6.2% in January, slightly underperforming global equities in USD (+7.1%) but outperforming in AUD (3.1%). Equity markets rallied as investors saw increased potential for an economic soft landing in the USA as inflation continued to slow. The more rapid re-opening of China plus lower gas prices in Europe were also tailwinds for the global economic backdrop.

The best performing domestic sector was Consumer Discretionary (+10.1%) which rallied following positive preannouncements from several retailers. The worst performing sector was Utilities (-3.0%) impacted by concerns about government intervention and falling power prices.

The best performing large cap stock was Pilbara Minerals (PLS, +26.7%) which rallied on buoyant lithium prices. The worst performing large cap stock was Whitehaven Coal (WHC, -10.8%) which sold off on weak coal prices.

The S&P/ASX Small Ordinaries index (+6.6%) slightly outperformed the large cap S&P/ASX100 index (+6.3%), with the more cyclical Small Ordinaries Index benefitting from increasing confidence in the outlook for growth and potential for a soft landing.

The best performing Small Ordinaries stock was Westgold (WGX, +38.9%) following a rally in the gold price. The worst performing Small Ordinaries stock was Austal (ASB, -20.2%), which fell after issuing disappointing earnings guidance.

International equities

Global equities rose 3.1% AUD and 7.1% in USD during January. US equities (+2.3% in AUD) underperformed while Emerging Market equities (+3.8%, in AUD) outperformed as Chinese equities (+7.6%, in AUD) rallied sharply on China reopening.

Property

Global REITs (+8.0%, in AUD) and Australian REITS (+8.1%) outperformed broader equities, boosted by falling bond yields. The best performing stock in the S&P/ASX200 AREITs index was Goodman Group (GMG, +15.0%) while the worst performing was Arena REIT (ARF, -2.6%).

Fixed interest and cash

Global bond indices posted positive returns (+2.1% in AUD) as government bond yields fell over January. Corporate (+3.2%, in AUD) and High Yield bonds (+3.6%, in AUD) have outperformed the broader index as credit spreads declined in January.

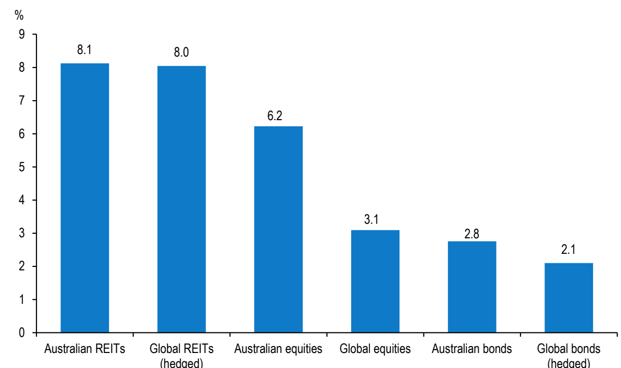
Commodities

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 11% driven by China reopening. However, the oil price saw a slight decline of -1.6% in January.

Currency

The big currency story continued to be the weakening of the US Dollar from its 20-year high in October. The Australian Dollar rallied 3.5% on US Dollar weakness and commodity price strength.

Major asset class total returns during January 2023



Source: Factset, MWM Research, February 2023

Note: All returns are in AUD

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

	1 month	3 months	YTD	1 year	3 year	5 year
	%	%	%	%	% pa	% pa
Australian equity indices						
S&P/ASX 200	6.2	9.6	6.2	12.2	6.0	8.5
S&P/ASX 100	6.3	9.7	6.3	13.8	6.5	9.0
S&P/ASX Small Ordinaries	6.6	7.6	6.6	-4.4	2.4	4.4
S&P/ASX 20	6.6	10.8	6.6	16.6	7.5	9.7
S&P/ASX 50	6.3	10.3	6.3	14.7	5.7	8.9
S&P/ASX Mid-Cap 51-100	6.0	6.1	6.0	8.8	10.4	9.7
S&P/ASX 200 Industrials	5.6	5.3	5.6	6.9	3.1	6.6
S&P/ASX 200 Resources	7.7	21.7	7.7	27.9	15.7	15.1
International equity indices						
MSCI AC World ex Australia	3.1	0.6	3.1	-7.9	5.5	9.0
MSCI Developed World ex Australia	3.0	-0.6	3.0	-7.4	6.3	10.1
MSCI Emerging Markets	3.8	10.9	3.8	-11.7	0.1	1.7
Regional equity indices						
S&P 500	2.3	-4.0	2.3	-8.2	8.0	12.6
NASDAQ Composite	6.6	-4.1	6.6	-18.0	7.2	13.5
Euro STOXX 50	7.5	15.2	7.5	-0.1	4.9	6.2
FTSE 100	2.8	7.3	2.8	-0.9	1.6	4.4
Japan TOPIX	1.7	6.4	1.7	-5.2	-0.2	3.0
Hong Kong Hang Seng	5.8	35.4	5.8	-5.6	-5.0	-2.2
MSCI China	7.6	38.4	7.6	-9.9	-3.9	-1.8
International equity thematic indices						
MSCI World Cyclicals	5.9	1.6	5.9	-11.2	6.0	9.9
MSCI World Defensives	-3.2	-4.9	-3.2	5.0	6.9	10.3
MSCI World Value	0.8	-0.5	0.8	-0.2	5.7	8.0
MSCI World Growth	5.6	-0.3	5.6	-14.2	5.8	11.5
MSCI World High Dividend Yield	-1.0	-0.6	-1.0	-0.6	4.4	8.4
Real estate equity indices						
S&P/ASX A-REIT	8.1	9.7	8.1	-5.0	-0.9	5.6
FTSE EPRA Nareit Global Developed (hedged)	8.0	9.3	8.0	-12.5	-2.7	2.3
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	2.1	3.2	2.1	-8.9	-3.1	0.3
Bloomberg Barclays Global Treasury (hedged)	1.7	1.6	1.7	-9.0	-3.3	0.3
Bloomberg Barclays Global Corporates (hedged)	3.2	6.7	3.2	-10.2	-3.2	0.5
Bloomberg Barclays Global High Yield (hedged)	3.6	7.7	3.6	-7.3	-1.5	0.7
Australian bond indices						
Bloomberg AusBond Bank Bill	0.3	0.8	0.3	1.5	0.6	1.0
Bloomberg AusBond Composite (0+Y)	2.8	2.2	2.8	-6.3	-2.7	1.1

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

Source: Factset, MWM Research, February 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

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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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