Investment Matters

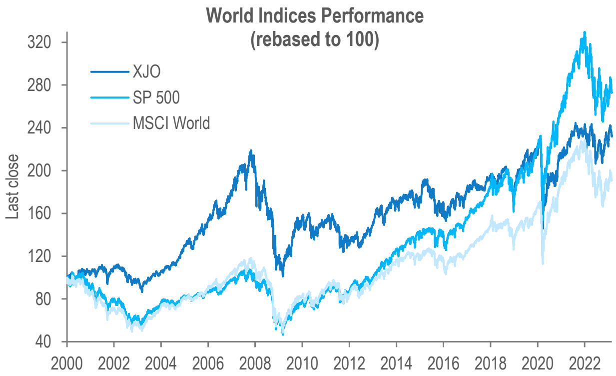
Caution needed: Rising rates and recession will bite

March 2023

MACQUARIE

Markets have remained largely resilient in the face of ongoing central bank tightening and persistently hawkish rhetoric. Despite some softening in global and domestic equity markets in February, major US, European, UK and Australian markets remain at or near all-time highs. We still expect the slowdown in growth to transition into recession, so the rebound we have seen this year is not likely to be sustained.

Global markets remain exuberant



Source: IRESS, MWM Research, March 2023

Risks have actually increased since the start of the year. Services inflation remains stubborn and there are few signs labour markets have softened. Consequently, terminal rate expectations have been revised meaningfully higher and are likely to remain in restrictive territory for some. However, there are increasing signs growth is slowing across major developed economies. And although recession timing has been delayed six months, consensus is for a recession commencing in 2H23.

Despite these rising risks, markets remain relatively buoyant. We can only offer two explanations for this, either the market is staring down the Fed's hawkish stance, believing we are closer to the end of the rate cycle and the pace and velocity of rate increases will ease sooner than the Fed's commentary would suggest. Or, it believes the growth trajectory is more bullish and we will continue to see strength in spending, labour and employment data. We suspect it is a combination of these two things.

On balance we think markets will ultimately succumb to a softening in cyclical conditions and earnings will follow valuations in resetting lower. Policy tightening works with a long and variable lag, but we know that economic output will continue to dampen as tighter policy flows through to the consumer. A lack of structural imbalances however, would suggest an impending recession will be shallow and short. It is worth remembering that when growth slows below trend for a period of time, inflationary pressure abates.

Inflationary expectations are coming down

Source: New York Fed, Factset, MWM Research, February 2023

The momentum and direction of inflation is what is important for markets and the path of inflation since 2020 has not been linear. We think investors should be focused on the following key messages:

- Inflation has peaked and while the path lower might be sticky, it will be sticky at much lower levels which should not phase markets.
- Central banks are nearly through their tightening cycle. It is enough for markets to focus on progress made rather than the problem solved.
- Recessions are disinflationary and historically inflation has fallen as fast as it has risen. We think inflation was a 2022 problem – corresponding with peak inflation fears – and while it might take time to decline, inflation will not preoccupy markets as the primary concern for much longer.
- The effects of policy tightening cannot be reversed but most leading indicators are pointing towards a mild growth slowdown. Macquarie forecasts global growth to bottom in 2H23. This is an improving backdrop regardless of other concerns.
- Australia is also set to slow meaningfully. Equities will not be immune to a weakening economic backdrop, and we stay cautious on the near-term outlook.

In summary, investors face a challenging backdrop as markets grapple with the opposing forces of tackling inflation against risks of a recession. Domestic and global equities should see a derating on a cyclical slowdown and longer-term investors should see this as an opportunity to reallocate excess cash. The outlook for sovereign bonds is improving as growth continues to slow, but a proper lift in returns will only be brought about by a policy pivot and that is still a long way off.

Jason and the Investment Strategy Team

Global economics

Recession delayed by recent strength

- The global economy has been more resilient to rising interest rates than Macquarie had previously thought, with China's reopening exceeding expectations. Consequently, both global growth and interest rate forecasts have been revised upwards.
- The timing of the recession in advanced economies has been pushed back into 2H23 from 1H23, but Macquarie still expect it to be relatively shallow and short in duration. There seem to be few imbalances that could trigger a protracted, sharp downturn, but once policy peaks it is likely to remain restrictive for some time.
- The upside risk to global growth lies in even greater China re-opening momentum. A recent pick up in credit growth suggests the upswing in growth is broadening.

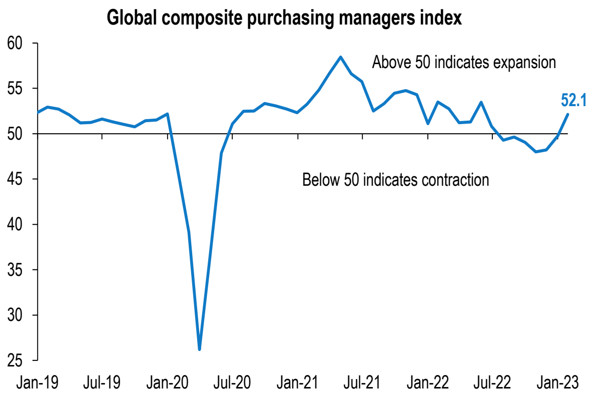
Policy rate expectations raised meaningfully

Activity has remained more resilient than previously thought as 2023 has unfolded. Consequently, Macquarie is now calling for more central bank tightening. The Fed funds rate is now expected to peak at the 5.50-5.75% in 3Q23 (compared to a previous forecast peak of 4.50-4.75% in 1Q23). New Zealand, Canada and the Euro area have also seen significant upgrades to policy expectations.

US recession call pushed back as growth upgraded

Recession is still the base case, but Macquarie have pushed back its commencement into 3Q23 (from 1Q). In addition, they have materially raised their U.S. GDP growth forecast for 2023 from -0.2% to 1.3%. This is despite a tightening in credit conditions as the Fed has pushed interest rates higher and which now sit at levels consistent with past recessions.

Global growth data is back into expansion territory.



Source: FactSet, MWM Research, March 2023

China to underpin upgrades to global growth

The drag on global growth from recession in the US, Europe, the UK, Canada, and New Zealand was always expected to be (largely) offset by a pickup in growth in China and this remains the case. However, the Chinese recovery appears to be going much better than envisaged late last year (as the pace of reopening exceeds expectations) and growth is being brought forward even though forecasts for the full calendar years of 2023 and 2024 are unchanged.

Chinese growth has surprised on the upside

Source: FactSet, MWM Research, March 2023

European conditions deteriorate

A warmer than expected winter in Europe has put downward pressure on energy prices, but that appears to only have delayed the inevitable. Our economics team expects the region to dive into a deeper recession over the next 5 quarters than previously expected. The UK is now also in a technical recession given the mild contraction in output has already lasted 3 quarters to date.

Recession isn't the line in the sand that separates good from bad

The past three global recessions had a backdrop of relatively low inflation, and this gave central banks room to pivot and cut rates to support growth. The magnitude of imbalances is the key to whether the recession is deep and protracted or not. Macquarie call remains a short and shallow recession with growth momentum picking up by 2H and recovering strongly into 2024.

The good news this time around is that there seems to be few imbalances (such as excess inventories or the need for deleveraging), and this means the recession that Macquarie expects should be shallow. The bad news is that central banks have very little room to cut rates to support growth (meaning the pendulum remains firmly in favour of reducing inflation over boosting growth at this stage).

Australian economics

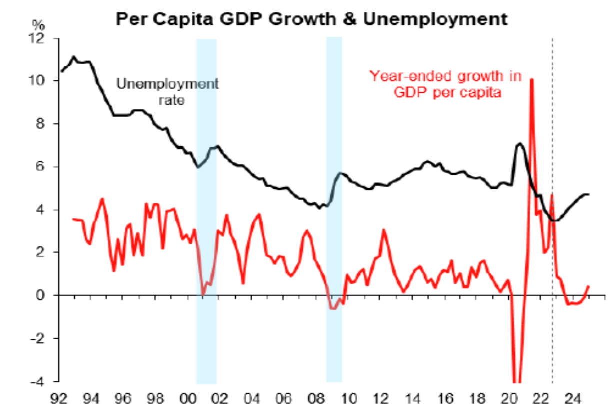
Cracks appearing

- There are burgeoning signs of cracks appearing in the economy, with discretionary spending in both goods and services slowing, wages growth softening and labour mobility lessening.
- While the RBA views these developments favourably, the tightening work is not yet done, with Macquarie forecasting a terminal cash rate of 4.1% (versus 3.6% at present).
- Macquarie forecasts a 15-20% peak-to-trough decline in domestic housing prices. With no end in sight yet for rates to begin falling, this will be a headwind for consumption, particularly in discretionary areas.

Australia is at a turning point

Australia's economy grew strongly over 2022 (+2.7% y/y) relative to global developed peers, although this is now showing signs of slowing. GDP over the December quarter finally began to slow, growing below consensus at 0.5% q/q (versus 0.8% q/q). The consumer is starting to show signs of strain under the pressure of the RBA's tightening campaign of 10 consecutive rate hikes, with demand for retail goods slowing sharply in December and momentum in discretionary services also easing.

Australia's per capita GDP growth to slow sharply



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

Although there are positive developments in the fight against inflation, the turning point remains when and how far the unemployment rate will rise. For now, the labour market remains tight, with unemployment at 3.7% (slightly up from its lows). Wages growth has reflected these tight labour market conditions, however average hourly earnings in 4Q22 was well below RBA expectations and at a level still consistent with the inflation target.

We also see a reduced risk of any wage-price spiral which could exaggerate any recessionary risks as higher policy rates begin to soften the labour market. Macquarie has now lifted its terminal rate forecast from 3.85% to 4.10%, with consecutive 25bp cash rate increases pencilled in for April and May, on top of the recent 25bp rate rise in March, and a first rate cut in early 2024.

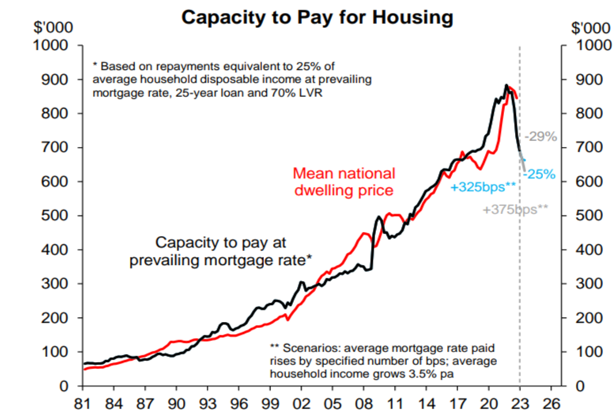
Macquarie is still not forecasting a recession for Australia in 2023. Nevertheless, economic growth is expected to slow materially this year, with Macquarie forecasting GDP to grow only ~1¼% over 2023 (down from 2.6% in 2022). This is primarily reflecting upward revisions to expected population growth 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.

Near-term, Macquarie expects inflation to remain elevated but should moderate noticeably through the year. Macquarie expect underlying inflation to return to the RBA's target range of around 3% on an annualised quarterly basis by early 2024, although risks are to the downside in that it could take longer. This paints a picture of higher rates that remain in place out through year end, of a slightly weaker labour market and with a sharp fall in areas of consumption as house prices and real wages fall further.

Further housing and consumption pressure to come

Macquarie forecasts a peak-to-trough decline of 15-20% for Australian housing prices. They 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.

Capacity to pay has already fallen ~25% since the start of the tightening cycle



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

Rising interest rates and falling dwelling prices are also weighing on demand for new houses, with new home sales having fallen sharply since mid-2022. While there remains a solid pipeline of housing construction due to previous supply disruptions, dwelling investment is forecast to weaken sharply later this year.

Monthly performance

February 2023

Australian equities

Australian equities posted a total return of -2.4% in February, underperforming global equities in local currency (-1.9%) and AUD terms (+1.6%) given the weakness in the Australian Dollar. The Australian market was weighed down by resource stocks, with ASX 200 Resources down 6.0% relative to ASX 200 ex resources which fell 1.0%.

The best performing domestic sector was Utilities (3.4%), helped by stock specific news, while the worst performing sector was Materials (-6.7%), hurt by falling commodity prices.

The best performing large cap stocks were Orora Limited (ORA, +18.5%) and Medibank Private Ltd (MPL, +13.6%), which rallied following a well-received half-year result, while the worst performing large-cap stocks were Domino Pizza Enterprises (DMP, -34.0%) and AMP Limited (AMP, -22.5%), following poorly received half year results.

The S&P/ASX Small Ordinaries index (-3.7%) slightly underperformed the large cap S&P/ASX100 index (-2.4%).

The best performing small cap stock was Infomedia (IFM, +26.7%) which rallied following a well-received half-year result while the worst performing large-cap stock was Temple & Webster (TPW, -39.6%) which sold off following a poorly received half year result and trading update.

International equities

Global equities rose 1.6% AUD but fell 2.4% in local currency, weighed down by rising bond yields as stronger economic data and lingering price pressures meant central banks would continue raising interest rates. US equities (1.9% in AUD) outperformed while Emerging Market equities (-2.3%, in AUD) underperformed due to a sharp fall in Chinese equities (-6.3%, in AUD).

Property

Global REITs (-3.6% in AUD) underperformed Australian REITS (-0.3%) as global bond yields have risen more sharply than Australian bond yields.

The best performing stock in the S&P/ASX200 AREITs index was National Storage (NSR, +9.1%) while the worst performing was Ingenia Group (INA, -13.2%).

Fixed interest and cash

Global bond indices posted negative returns (-1.8% in AUD) as government bond yields climbed higher over February on concerns that central banks would keep rates higher for longer due to lingering price pressures and resilient consumer demand.

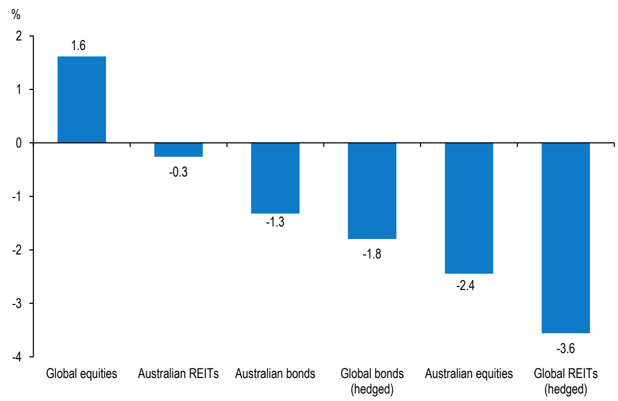
Commodities

Commodity prices generally declined during the month, in part due to the rally in the U.S. Dollar (commodity prices are priced in U.S. Dollars). The gold price was the standout underperformer, falling almost -5.2% as gold faced headwinds from rising real bond yields.

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 February 2023



Source: Factset, MWM Research, March 2023

Note: All returns are in AUD

Total returns (A$) – as at 28th February 2023

	1 month	3 months	YTD	1 year	3 year	5 year
	%	%	%	%	% pa	% pa
Australian equity indices						
S&P/ASX 200	-2.4	0.3	3.6	7.2	7.9	7.9
S&P/ASX 100	-2.4	0.3	3.7	8.5	8.4	8.4
S&P/ASX Small Ordinaries	-3.7	-1.2	2.6	-8.0	4.2	3.6
S&P/ASX 20	-3.2	0.0	3.2	10.0	8.7	8.8
S&P/ASX 50	-2.3	0.7	3.9	9.0	7.6	8.3
S&P/ASX Mid-Cap 51-100	-3.2	-2.2	2.6	5.7	13.0	8.8
S&P/ASX 200 Industrials	-1.0	0.5	4.6	5.2	5.0	6.3
S&P/ASX 200 Resources	-6.0	-0.2	1.2	13.0	18.8	13.8
International equity indices						
MSCI AC World ex Australia	1.6	-0.7	4.7	-1.5	7.2	8.9
MSCI Developed World ex Australia	2.1	-0.7	5.1	-0.5	8.3	10.1
MSCI Emerging Markets	-2.3	-1.2	1.5	-8.8	-0.5	1.0
Regional equity indices						
S&P 500	1.9	-3.0	4.3	-0.7	10.5	13.0
NASDAQ Composite	3.4	-0.6	10.2	-9.6	9.4	13.7
Euro STOXX 50	4.0	10.0	11.8	13.6	8.7	7.6
FTSE 100	4.0	5.1	7.0	5.9	6.3	5.8
Japan TOPIX	1.1	2.9	2.8	-1.1	2.8	2.8
Hong Kong Hang Seng	-5.5	5.1	0.0	-3.5	-7.7	-2.8
MSCI China	-6.3	4.7	0.7	-9.6	-7.5	-2.6
International equity thematic indices						
MSCI World Cyclicals	2.6	1.6	8.7	-2.8	8.7	10.3
MSCI World Defensives	0.6	-5.4	-2.7	8.4	9.0	11.0
MSCI World Value	1.5	-1.4	2.3	6.0	8.4	8.6
MSCI World Growth	2.6	0.4	8.3	-6.1	8.1	11.9
MSCI World High Dividend Yield	1.1	-2.6	0.0	4.9	6.8	8.9
Real estate equity indices						
S&P/ASX A-REIT	-0.3	3.4	7.8	-6.5	0.7	6.3
FTSE EPRA Nareit Global Developed (hedged)	-3.6	0.4	4.2	-13.5	-1.1	2.9
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	-1.8	-1.0	0.3	-9.4	-4.1	0.0
Bloomberg Barclays Global Treasury (hedged)	-1.4	-1.5	0.3	-9.3	-4.2	0.0
Bloomberg Barclays Global Corporates (hedged)	-2.7	-0.3	0.5	-10.8	-4.4	0.2
Bloomberg Barclays Global High Yield (hedged)	-1.6	1.8	1.9	-6.6	-1.5	0.5
Australian bond indices						
Bloomberg AusBond Bank Bill	0.2	0.8	0.5	1.8	0.7	1.1
Bloomberg AusBond Composite (0+Y)	-1.3	-0.7	1.4	-6.4	-3.4	0.8

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

Source: Factset, MWM Research, March 2023

The Wealth Investment Strategy Team

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Investment Matters March 2023 was finalised on 10 March 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