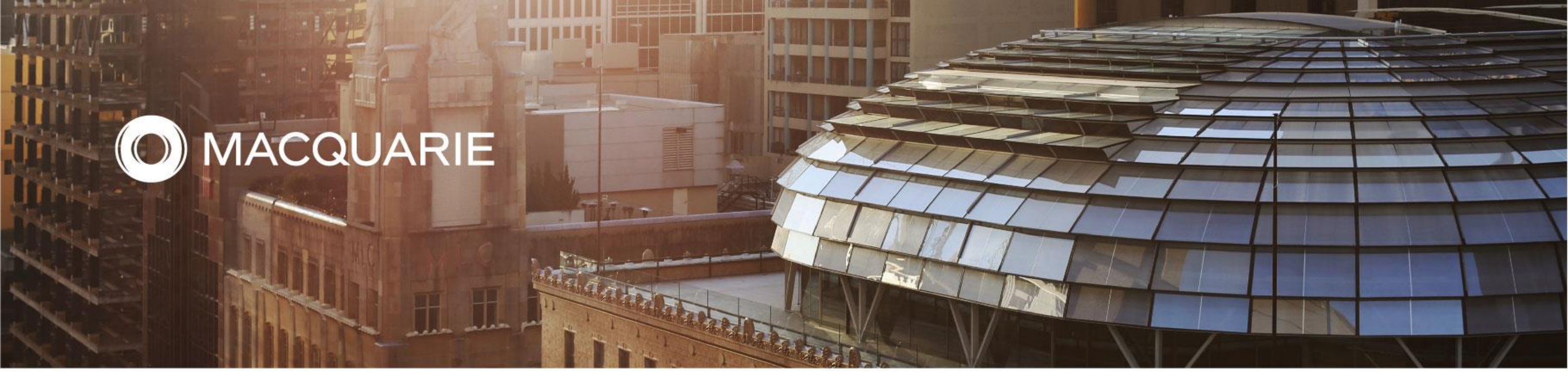


Investment Strategy Update #107

Why we are underweight Australia versus global equities

- For now, the era of free money is over as central banks attempt to get surging inflation back under control. We expect global policy tightening to continue well into 2023 via a combination of aggressive cash rate hikes and quantitative tightening.

- An unconditional commitment by central banks to bring inflation back under control (including the Reserve Bank of Australia) is raising fears of economic recession, or if not, a sharp economic slowdown across many economies into 2023.

- This tug-o-war between inflation and growth is likely to keep investors on edge and markets highly volatile until there is greater transparency on the outlook. While global equity markets have already suffered a large correction, we do not think they are priced for recession should this eventuate.

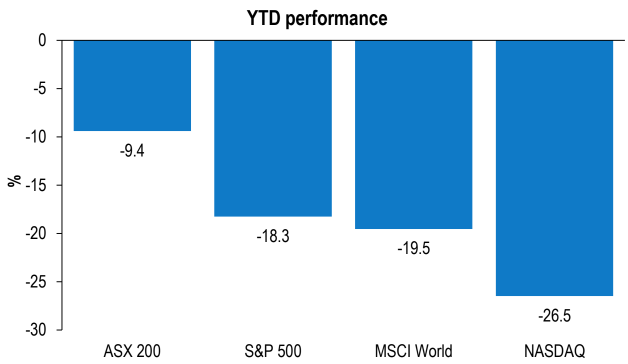
- Over 1H22, Australian equities outperformed global equities by nearly 10% as they benefited from strong gains in resources as well as energy and limited exposure to the technology sector which was the primary loss leader for global equities.

- We think the tailwinds that drove outperformance for Australia through 1H22 are likely to reverse in 2H22. Consequently, we move underweight Australian equities where we think slowing economic growth will weigh on cyclically sensitive areas such as commodities with rate sensitive sectors also coming under rising earnings pressure (consumer, real estate, banks).

- We do not expect underperformance to be prolonged. Australian equities have several structural attractions including a solid dividend yield and strong market internals driven by superannuation inflows. However, these are unlikely to prevent further downside as rates move higher and cyclical pressures mount on earnings (see *“Investment Matters: 2H22 Outlook – the end of easy money is not always easy – July-22”*)

Markets remain in an inflation vs. growth tug-o-war: We believe it will take some time to see how the path of inflation and monetary policy is tracking and this will keep investors and markets reactive to positive and negative data surprises. This does not mean markets are on a path lower, but it does mean that equities and other risk assets are unlikely to trade sustainably higher and at the same time remain vulnerable to disappointment on the data front.

Australian equities have outperformed Global equities YTD



Source: Factset, MWM Research, July 2022

Over 1H22, the Australian equity market outperformed global equities by ~10%, supported by strong gains from resources and energy, a recovery in some cyclical areas of the market where domestic fundamentals were still bouncing back from late 2021 lock downs and a relative underweight in the worst hit high growth sectors such as technology which came under substantial de-rating pressure.

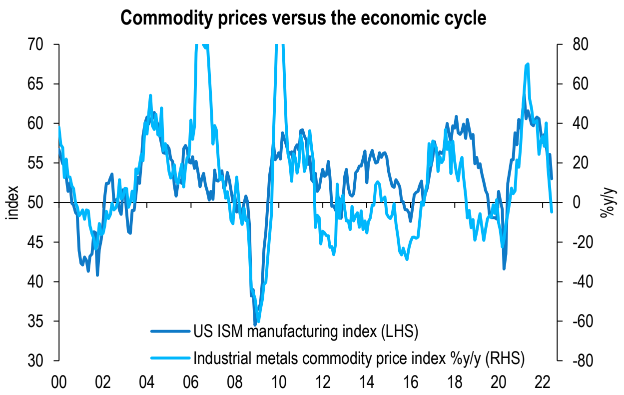
Australian equities to underperform peers through 2H22: As we move into 2H22, we think several of the factors that drove relative outperformance through 1H22 will begin to reverse and this will likely see the Australian equity market underperform its global peers in local currency as well as in US$. This goes against the norm of the Australian market being a low beta (and relative safe-haven) market during global equity market sell-offs due to its high dividend yield, strong internal dynamics (where superannuation inflows are a natural tailwind) and where index composition provides strong defensive characteristics.

But, despite these strong defensive and low beta characteristics, we think several tailwinds will turn into headwinds as we move into 2H22 and beyond. This includes:

1. Australia's economic and inflationary cycles have lagged other developed economies due to lockdowns that were still in place as late as 2H21. As a result, inflation has been slower to pick up and is now still rising at an accelerating pace versus the US where it appears close to peak. Similarly, the RBA was slower to start its rate hike cycle vis-à-vis the Fed and other key central banks and is now playing catch up in the race to normalize policy settings and ultimately slow the economy which is operating above capacity.

2. The market is overweight resources (both energy and mining) which were boosted by the conflict in Ukraine, the push for climate change action, a lack of investment and the prospect of a rebound in Chinese economic activity after 2H21/1H22 economic shutdowns. However, the fear that central banks have an unconditional commitment towards bringing inflation back under control is raising the risk of recession which has driven a dramatic reset in industrial commodity prices in recent weeks. If growth fears continue to rise, we would expect further downside pressure on cyclically sensitive commodities.

Weakening economic cycle to weigh on commodities



Source: Factset, MWM Research, July 2022

We moved underweight Australia vs Global equities: We have moved to an underweight allocation on Australian equities versus global equities (*see "Investment Matters: 2H22 Outlook – July 2022"*). While it might not take long for Australia's equity market stabilisers to kick in, we don't think it is priced for downside risk to global cyclical sectors or for the earnings deterioration that is expected to come in 2023 as economic growth begins to slow.

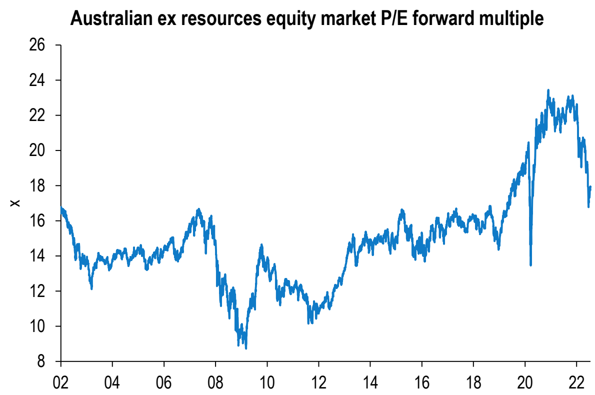
We don't think Australia is entering a sustained period of underperformance that might result from a period of weak growth and/or high inflation (stagflation). Equity market valuations have corrected significantly since the beginning of the risk asset sell-off (falling from around 22x to 17x forward earnings), although they have not hit bear market lows and corporates are well capitalized and remain largely underleveraged which reduces to the need to tap capital markets during a period when risk aversion is high and the cost of capital is rising. In addition, the economy will slow significantly into 2023 (particularly 2H23) but should avoid recession according to Macquarie's Macro Strategy Team.

What drives our underweight on Australia?

We think earnings estimates remain overly optimistic given the deterioration in broader macroeconomic fundamentals both offshore and domestically and a combination of rising interest rates and earnings growth which combined will act as significant headwinds for the market regardless of the correction to date. Even into rising market (should fears around inflation and economic growth subside), we think Australia will struggle to match its global peers.

- **Valuations are not cheap enough to cushion for higher rates and lower earnings**. While the Australian economy should avoid recession, Macquarie's macroeconomics team expect growth to slow dramatically into 2023 particularly for rate sensitive areas like consumer spending and housing. This is likely to stretch into key areas such as banks and real estate which are also large components of the ex-resources complex. The P/E of the ASX200 ex resources currently stands at 18x, well above recent lows. The average P/E during recessions over the last 60 years has been 11x.

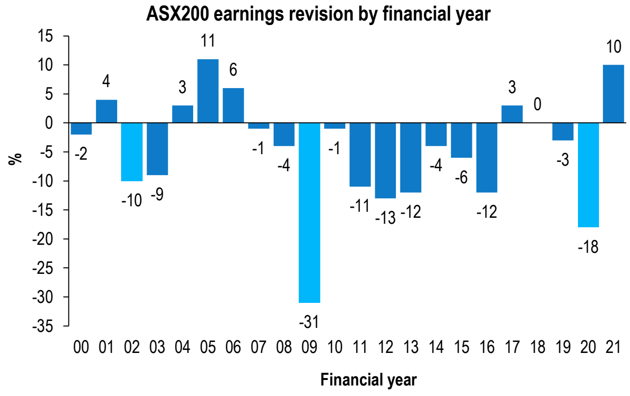
Valuations are not low enough to cushion against EPS falls



Source: Factset, MWM Research, July 2022

- **Earning expectations are optimistic.** Despite the economic backdrop deteriorating significantly in recent months, there has been limited flow through to the broader earnings backdrop, with bottom-up consensus expectations for ASX200 earnings growth of +9% (+12% ex resources) compared to +4% (+11% ex resources) expected at the start of the year. Rising raw material costs due to supply disruptions, inflationary pressures and spiking energy costs alongside rising wage pressures and rising financial costs are likely to see profit margins peak in the coming quarters. Australia has the benefit of a slightly lagging economic cycle (due to shutdowns in 2H21) but we expect that these pressures will be on full display as we move further into the year. This will see a more broad-based earnings downgrade cycle begin to emerge.

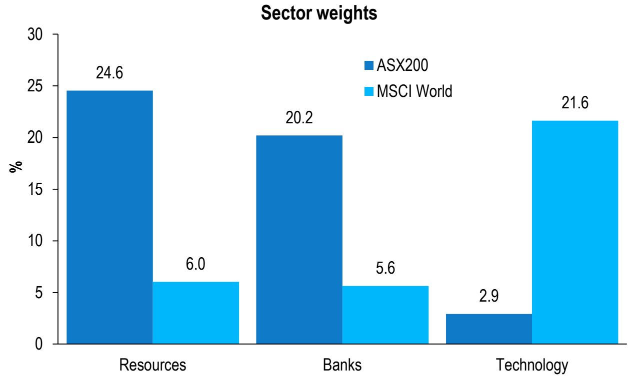
Based on past cycles, ASX FY23 EPS could be 10-20% too high in a recession scenario



Source: Macquarie Equity Strategy, MWM Research, July 2022

- **Resources now under recession risk pressure**. Australia has benefited from exceptionally strong earnings with 12-month forward estimates up 24% YTD due to energy and mining. We do not expect this to carry over into 2H22 with commodities already under pressure as recession risks mount and fears of an industrial slowdown build. In addition, we expect to see downgrades to rate / housing sensitive areas of the market as higher borrowing rates begin to bite on overleveraged households as well as put pressure on loan growth for the banking sector (even though we are not worried about a bad and doubtful debt cycle).

ASX200 overweight resources/banks & underweight tech



Source: Factset, MWM Research, July 2022

- **Australia is underweight growth stocks**. The Australian market is underweight 'growth' stocks (particularly Technology) that have historically displayed greater resilience to economic cycles than cyclical sectors, and which could also get a boost if bond yields fall.

Investment Strategy Update #107 was finalised on 18 July 2022.