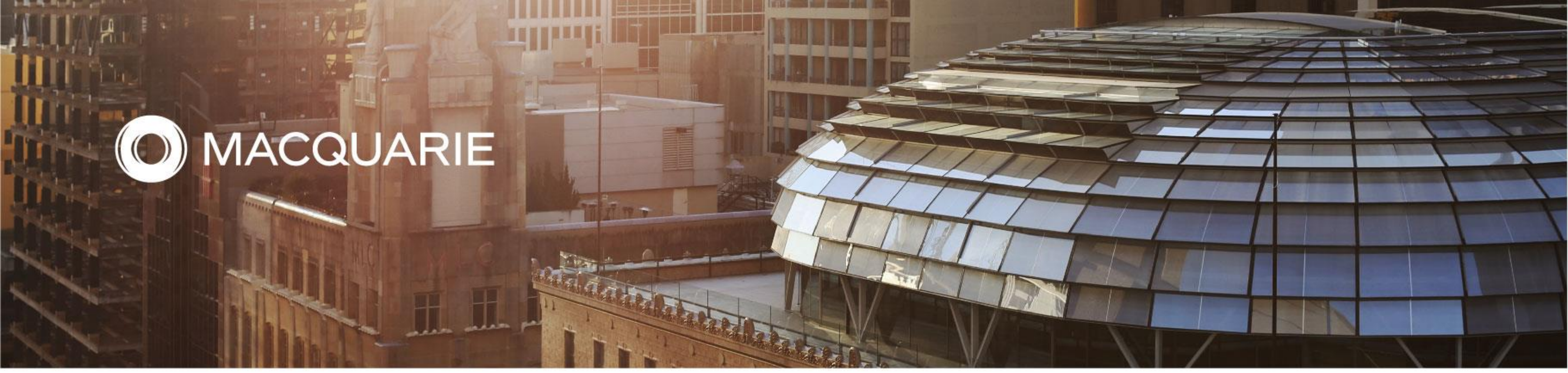


Investment Strategy Update #129

2023 Asset Market Outlook: A once in a decade entry point for long-term investors

- We are positive on the financial market outlook for 2023. While markets will remain volatile and are susceptible to a deterioration in economic growth, by year end, they will be pricing in lower policy rates and the start of a new economic cycle. This should see both bonds and equities have a “better than average” return year.

- However, in the near term, a meaningful deterioration in both global and domestic economic growth momentum on top of uncertainty around how close policy makers are to peak rates and/or a policy pivot is likely to weigh on market performance. We think this has the capacity to undo the recent risk rally but provided the economic downturn is short and shallow and policy makers are in fact getting close to peak policy rates, we think downside should be modest and markets will more than recover losses by year end.

- We think long term investors should be leaning into weakness in coming months and using it as an opportunity to either deploy excess cash or ensure that risk allocations are appropriate for the start of a new upswing. For investors who are focused on near term performance, a more cautious approach is needed as risk assets begin to reflect the reality of a weakening macro backdrop and the effects of policy tightening seen through 2022.

- However, with inflation already in decline (ex-Australia) and policy rate expectations near peak, we think sovereign bonds will provide reasonable downside protection during periods of equity market weakness. In addition, although low quality credit spreads do not yet reflect the coming deterioration in macro fundamentals, we think spread widening will be minor relative to prior cycles and importantly relatively short lived.

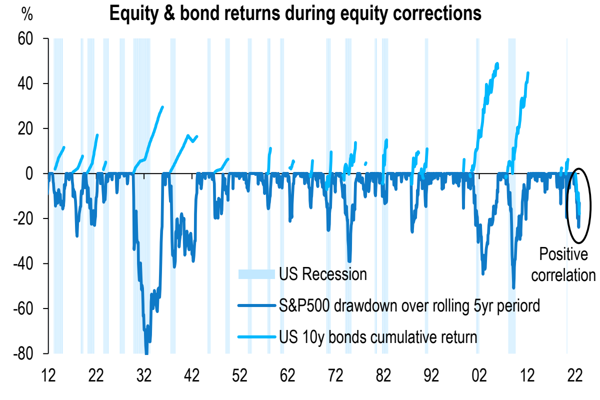
- We think investors should understand near term risks as they contemplate the investment outlook but avoid becoming fixated on them. The correction through 2022 has provided an extremely appealing entry point for long term investors who should use weakness to add to risk positions. We think better days are ahead. ***See “2023 Outlook: Better Days Ahead” for more detail***:

The upside of downside:

2022 did not turn out as anticipated. Global inflation pressures proved to be less transitory than expected with the rapid reversal in monetary policy settings driving a meaningful correction in almost all assets that had benefited from cheap and plentiful liquidity for more than a decade.

The broad-based nature of the correction meant there were few places to shelter from the downturn with US Treasuries (supposedly one of the safest investments on the planet) posting negative returns during an equity bear market for the first time in history.

Bonds have never been down in an equity bear market … except in 2022

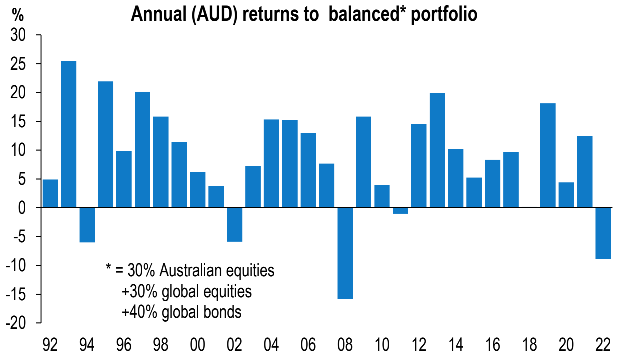


Source: Factset, MWM Research, January 2023

As we move further into 2023, we expect central banks to soften their hawkish rhetoric, eventually pause and then begin cutting policy rates in response to a fairly rapid decline in inflation and in an effort to begin supporting economic growth.

Outside of Australia, it is likely that for many developed economies, inflation pressures have already peaked with supply side disruptions already some way towards normalising and as goods demand continues to slow. But this is perhaps the most contentious point for investors and it will ultimately determine the path for financial markets.

2022 was a very poor year for "balanced" portfolios



Source: Factset, MWM Research, January 2023

We enter 2023 with a positive outlook on markets which, at this stage, appears to be quite out of line with consensus, which is intensely focused on the prospect of economic recession. We accept that there is likely to be some short-term pain before a new cycle can begin and recession does not appear to be in the price of risk assets and in particular equities.

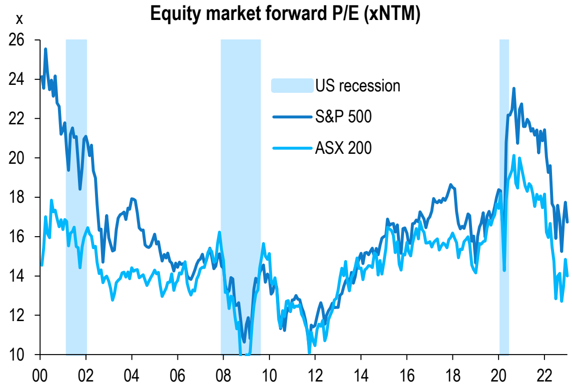
Recession is a short-term, not long-term investor headwind

However, if inflation continues to moderate and recession is short and shallow (which is Macquarie's base case), then we do not think it will lead to prolonged weakness across asset markets, including Australia. We think the focus on an economic slowdown is overshadowing the improvement in the drivers of market weakness throughout 2022 which includes inflation, supply chain disruptions, elevated energy prices and policy tightening.

For investors who are focused on long term wealth creation, while we cannot dismiss the potential for near term downside in equities and other risk assets (such as credit), we think this weakness is an opportunity to add to risk allocations and to ensure that portfolios are set for the start of the next rate cut cycle. We would not have this view if a "hard" economic landing was expected or if we thought that inflation was likely to be a lingering concern for central bank policy. But neither of these are central to the house view as we move into 2023 and beyond.

As a result, while we are not dismissive of near-term risks, but investors with a longer-term outlook should not be overly worried. Moreover, we find it a little inconsistent that many believe the recession will be short and shallow yet fail to 'look through' this short-term pain to the other side.

Equity valuations have corrected significantly despite remaining above "recession" lows



Source: Factset, MWM Research, January 2023

2023 provides highly appealing entry point for long-term investors

We think the significant valuation correction seen across almost every asset class in 2022 has led to a significant improvement in the long-term portfolio return outlook driven predominantly by bonds and equities which make up the majority of allocations.

The result is that we enter 2023 with one of the most attractive entry points for diversified investors in more than a decade. Not only have return expectations risen for equities as a result of lower valuations, but also for bonds where yields now back to levels not seen in over a decade.

In addition, along with expectations that rates are getting close to peak and inflation is set to fall, this is likely to support a return to more normal correlations with equities (during 2022 both equities and bonds fell as the correlation turned positive, but in 2023 we think correlation should fall if not turn negative, with bond prices rising as equities fall).

Peak inflation/rates should help reverse equity/bond correlations

Source: Factset, MWM Research, January 2023

Investors now have a full "toolkit" of options for portfolios

For the first time in over a decade, we think investors will have a full toolkit of asset classes at their disposal when constructing portfolios, given the strong appeal of sovereign bonds on top of the more stable return generating alternatives and the structural tailwinds for real assets.

… in the short term … Ultimately, how investors approach the year should be a function of their investment time horizon. For those focused on the very near term, we think taking a cautious approach is warranted. Equity markets have started the year off with a bang (S&P 500 +6.2%, NASDAQ +10.8%, ASX 200 +8.0%) and we don't see anything wrong with this as downside growth risks have fallen. But, regardless of near-term improvements, global growth momentum is still set to weaken further as the lagged effects from policy tightening finally hits resilient labour markets and slows aggregate demand, but if recession unfolds, then markets are not priced for this outcome and will trade lower.

… but further out … The combination of a short and shallow recession without lingering economic growth headwinds and rising return expectations for equities and bonds (and as a result diversified portfolios) mean those focused on the longer term should be looking at using any weakness as an opportunity to ensure that risk allocations are appropriately set for the start of a rate cut cycle and the new economic upswing.

- It is difficult to time markets so, while a degree of cautiousness is advised, we don't recommend sitting on large amounts of uninvested capital. Rather, and despite some near-term downside risk, we think averaging into risk assets (equities in particular) to take advantage of lower valuations and rising return expectations is better than trying to time the bottom.

- The real return to cash is still going backwards and while this offers some downside protection, we think bonds / high quality credit can provide a more appealing (risk-adjusted) yield while in the case of the former also providing downside protection for equity weakness as correlations revert back to normal.

- There are a number of strategies that can be engaged to profit from market weakness / volatility. This includes hedge funds (long / short and macro) as well as high quality dividend payers within the equity market. There is a strong consensus view that private markets are a much safer bet than listed markets. We are careful to apply this statement generally. Private markets are less volatile, but they are not immune from valuation downgrades and so investors should also understand that valuation is a "lagged" risk not "no" risk.

- A diversified portfolio is still the most effective way of creating long term wealth. There will be periods when asset classes don't behave as expected (such as bonds throughout 2022) but over the medium to long term, we remain comfortable that a well-diversified portfolio remains the best option for investors who want a balanced risk-reward outcome.

Please see our "2023 Outlook: Better Days Ahead" for more detail on our investment views, asset allocation and key recommendations.

Macquarie WM Investment Strategy Team

The report was finalised on 30 January 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

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