Investment Matters

Why markets have proven resilient

June 2023

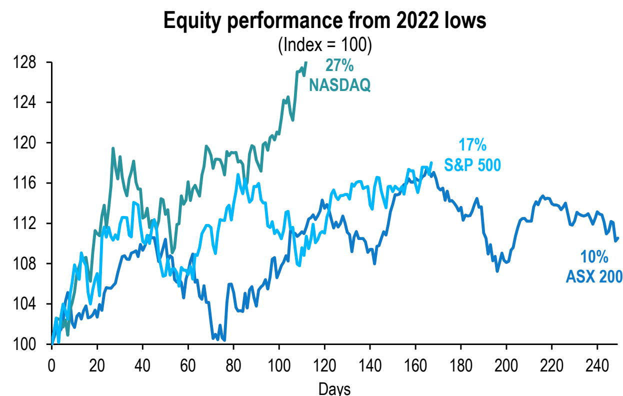
MACQUARIE

Coming into 2023, the consensus expected equity markets to resume their downward path as rising interest rates began to slow economic growth and falling margins weighed on corporate profits. However, despite the emergence of a number of other uncertainties such as US bank defaults, debt ceiling negotiations and rising services inflation, equity markets have climbed a wall of worry to post strong gains (NASDAQ +27%, S&P500 +17%, ASX200 +10%) since their 2022 lows.

The equity rally has been driven by a resilient economic growth: We think the rally in equities has been driven by more resilient economic growth across most developed economies as well as a stronger than expected reopening of China, which has seen expectations of a 1H23 global recession pushed back into the second half of the year.

To be clear, rising policy rates are starting to bite into economic activity, but offsets to tightening financial conditions such as excess consumer savings and tight labour markets have afforded a much greater cushion than expected as we entered the new year. Similarly, rolling recessions rather than a "shock" that takes all areas of the economy lower at the same time has also provided downside support for the growth outlook.

Equity markets have climbed a wall of worry in 2023



Source: Factset, MWM Research, June 2023

The slowdown is coming … just slower than expected: We know that interest rates work with long and variable lags and so we maintain our view that it is just a matter of time before the economic backdrop begins to slow more meaningfully. However, short and shallow remains the base case for the economic downturn both here and abroad, with few cyclical indicators in deep downturn territory and, for Australia, it would be difficult to see a recession while immigration is being dialled up so strongly. At this stage, and while equities are a pain trade for anyone who came into the year with a cautious (defensive) stance, we remain committed to this view. While progress has been made on bringing inflation down (and survey data suggests further declines are coming), it has not fallen to levels that central banks would be happy with.

Be wary of an imminent policy pivot: In addition, although headline inflation measures have certainly peaked across most developed economies, it does not look like wage inflation has peaked and, while this might not require policy rates to go much higher (in either the US or Australia), it will reduce the potential for an imminent policy pivot, which we think investment markets have become a little too optimistic on pricing into the outlook. Investors should not forget that central banks, after making a policy mistake in not raising rates to fight inflation earlier, are looking to restore their credibility by ensuring that they don't make another mistake by loosening conditions too early.

Near term caution but be balanced not defensive: We think equity markets have seen their worst which corresponded with the 4Q22 lows, but that they are still not out of the woods and investors should remain wary of chasing the rally or assuming that a new "bull" has started. History shows that equities always fall during recessions, and as a starting point, valuations need to provide a much larger cushion than current levels suggest. For Australia, we entered the year thinking that it would underperform in global markets as the positive drivers of 2022's outperformance reversed. This is exactly what has transpired. As commodity prices have normalised and global tech stocks have rallied, Australia has been left with few areas of outperformance especially as domestically-exposed cyclicals and financials have come under downward pressure. We do not expect a quick reversal as cracks appear in the domestic economic landscape.

A short and shallow economic downturn might mean we are remaining too cautious, especially as markets appear willing to look through the upcoming slowdown. But this is why we think portfolios should be diversified rather than defensive. A defensively positioned portfolio delivers positive returns for a single outcome - a negative outlook for growth assets - while a diversified portfolio is set up to perform across a range of scenarios. Bear market rallies are supposed to be uncomfortable. They are supposed to confront, raise doubts and to drag reluctant investors into the market only to subsequently disappoint. Given current inflation readings (both here and abroad) and with global growth likely to decelerate further, we think investors should be patient and wait for further transparency on how far and fast macroeconomic conditions slow before putting all their eggs into the "soft landing and imminent policy pivot" basket.

Jason and the Investment Strategy Team

Global economics

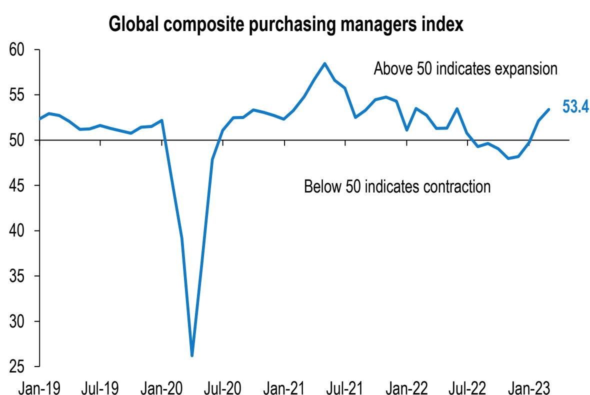
Resilience in the face of rising rates

- Better economic data over the past couple of months has raised the prospect of a soft landing. However, inflation is still far too high and stronger growth could simply attract more tightening than markets expect.
- Despite the 500bp of tightening by the Fed, overall financial conditions are not tight, and this probably explains the better run of data. There have been little second order tightening effects thus far. Upside surprise from China has also likely contributed.
- However, a recession is still our base case. Bank lending is tight as it normally is prior to a recession and even though other contributors to financial conditions are not tight, they can turn quickly.

A surprise run of good data

Despite central banks raising interest rates aggressively, recent data has surprised on the upside. China's reopening is going better-than-expected, and the US and Japan have surprised on the upside. However, news that Germany fell into recession will add to the weakness in Europe over the past few months.

Economic data surprised on the upside recently

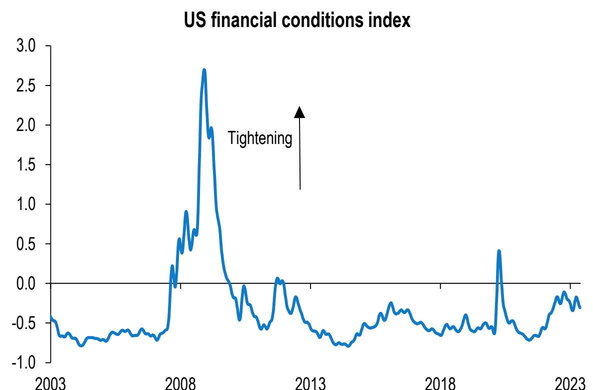


Source: Factset, MWM Research, May 2023

The good run of economic data has helped risk assets weather turbulence from the regional banking crisis in the US, the debt ceiling negotiations. But at the same time, it sends a potentially potent signal to the world's central banks when inflation is still well above their targets and unemployment rates are still at multi-decade lows.

Markets think central bank tightening is reaching the end game, but the rebound in growth could mean that more needs to be done. Growth will either weaken from tightening already done; or central banks will do more. Either way, it's a zero-sum game and growth must slow further.

Financial conditions are actually not that tight



Source: Federal Reserve Bank of Chicago, Factset, MWM Research, May 2023.

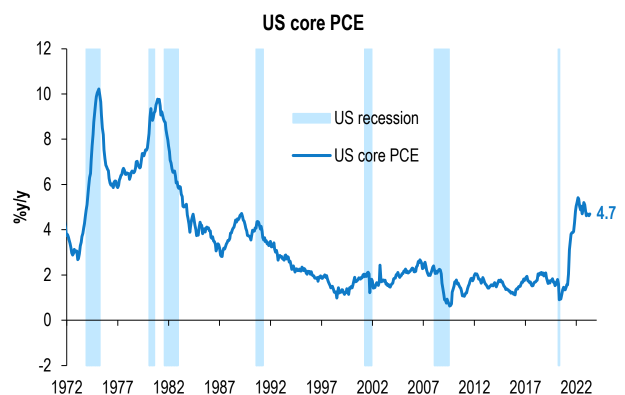
Why then has growth been so resilient?

Central banks have only one blunt tool to achieve their mandate. The improvement in inflation thus far has had little to do with slowing demand. Yes, interest rate sensitive sectors have weakened, but the slowdown has not yet been deep enough or broad enough to slow the demand for labour and herein lies the problem.

History shows it takes an increase in the unemployment rate to lower services inflation (around 80% of jobs in advanced economies are in service industries). Central banks must then continue to tighten until the unemployment rate rises. History also shows increasing the unemployment rate and avoiding recession very rarely occurs.

Despite the Fed tightening policy by 500bp, broad measures of financial conditions are not tight and may be the key reason why growth has been relatively resilient. Core measures of inflation are proving stickier than desired, suggesting there is some way to go before inflation is tamed.

The Fed's preferred inflation measure remains high



Source: Factset, MWM Research, May 2023

Australian economics

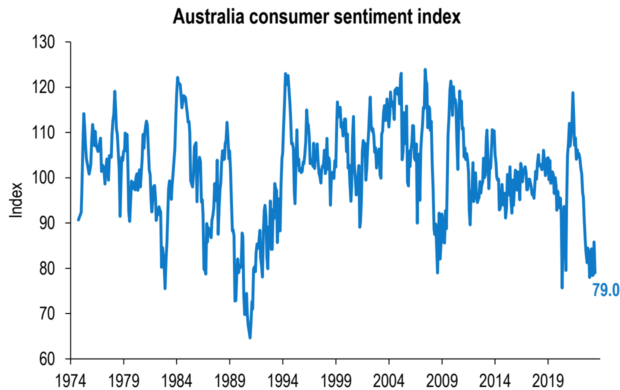
Cracks are starting to appear

- The downturn in Australia seems to be accelerating against a backdrop where the global economy has shown some resilience in the face of central bank tightening.
- The rebound in immigration has strengthened in the past few months, offering some support for economic activity, with a domestic recession likely to be avoided. However, the consumer is now buckling under the weight of rising interest rates and the cost of living.
- While immigration is positive for growth, it is adding to pressures in the rental market and narrowing the gap between renting and buying. This is providing a timely support for housing prices.

Growth slowdown still to come

The Australian economy has been relatively resilient to the interest rate rises by the RBA and the slowdown in global growth across the world's major economies. However, cracks are now starting to appear.

Consumer sentiment remains depressed



Source: Westpac/Melbourne Institute, Factset, MWM Research, June 2023

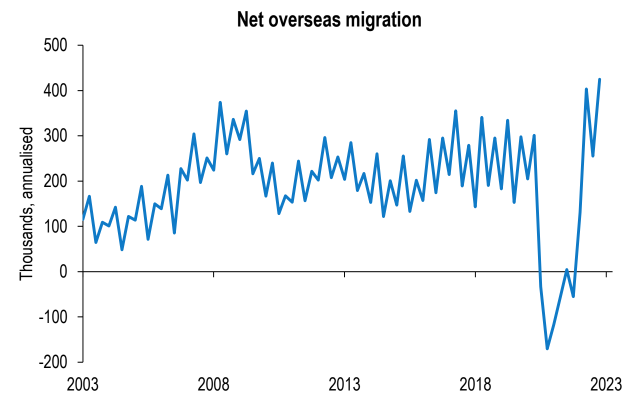
The April labour force data released this month saw a surprise decline in employment (-4.6k vs consensus +25k) and a rise in the unemployment rate from 3.5% to 3.7%. However, seasonality around Easter has likely made it difficult at this stage to assess if this trend will continue.

Retail trade in April was also weak (0% vs consensus 0.2%) and follows a 0.6% fall in volumes in the March quarter. Building approvals were also weak in April (-8.1%) after a 1% fall in March, leaving approvals at their lowest level since March 2012.

House prices and immigration are the bright spots

The two bright spots are house prices and immigration. Immigration is a two-edged sword; it adds supply to the labour market especially in skilled jobs, but it also boosts demand for housing, which was already exceeding supply before the borders reopened.

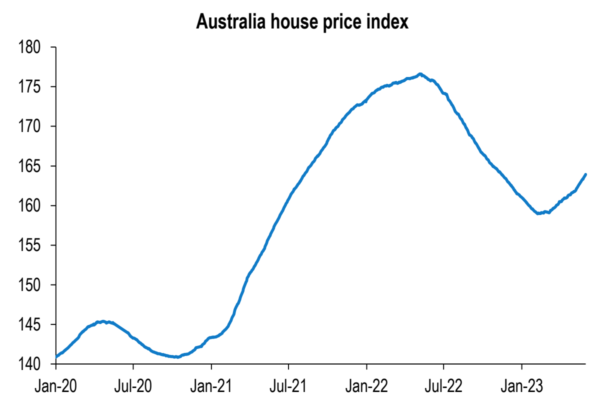
Immigration is surging post border reopening



Source: ABS, Factset, MWM Research, May 2023.

The housing imbalance has also been exacerbated by the impact of rising interest rates on new construction. However, rising rent means the difference between the cost of renting versus the cost of servicing a mortgage is narrower than they would otherwise be, which in turn provides support for dwelling prices. Data on auction clearance rates shows positive price momentum in Sydney and Melbourne has continued, despite the May interest rate increase.

House prices are on the rise again



Source: CoreLogic, Factset, MWM Research, May 2023.

The consumer has remained resilient to the RBA's tightening campaign and falling housing prices (until the recent rebound), propped up by 1) a tight labour market, and 2) a high level of savings. Even collapsing sentiment didn't derail spending up until this point. However, behaviour now appears to have changed and the weight of rising rates and the rising cost of living is now impacting spending, even while the factors that have so far propped up the consumer over the past year remain.

Monthly performance

May 2023

Australian equities

Australian equities posted a total return of -2.5% in May, underperforming global equities in both USD terms (-0.9%) and AUD terms (+1.2%). The month of May saw broader developed equity markets rally, boosted by strong performance from technology stocks, which weighed on the domestic market given our comparative underweight to the sector.

The best performing domestic sector was Information Technology (+10.4%), following a broader global rally in technology stocks that was driven by AI advancements. The worst performing domestic sector was Consumer Discretionary (-6.2%), as consumer spending continue to face headwinds from rising rates and cost of living pressures.

The best performing large cap stocks were Allkem Limited (AKE, +21.2%), which rallied following a merger announcement, and Xero (XRO, +17.8%), following a positive earnings result which saw revenue and subscriber growth. The worse performing large cap stocks were IDP Education Ltd (IEL, -22.5%) following heightened competition in the market, and Whitehaven Coal (WHC, -21.4%), as coal prices come under pressure from softening demand patterns.

The S&P/ASX Small Ordinaries index (-3.3%) underperformed the large cap S&P/ASX 100 index (-2.4%). The best performing small cap stock was Leolithiumlimited (LLL, +69.5%, following the signing of a new strategic placement agreement. The worst performing small cap stock was 29Metalslimited (29M, -40.5%), following poor metal production guidance for next year.

International equities

Global equities posted a positive return (+1.1%) in AUD terms, while finishing slightly negative in USD terms (-0.9%). This was mainly driven by the strong performance of a selection of mega-cap stocks within the Technology sector, with the NASDAQ index finishing +5.9% in USD terms and +8.2% in AUD terms. In general, cyclical sectors such as Information Technology (+10.5% in AUD terms) and Consumer Discretionary (+2.2% in AUD terms), outperformed defensive sectors such as Energy (-8.0% in AUD terms), Consumer Staples (-4.7% in AUD terms) and Utilities (-3.6% in AUD terms), amidst expectations for peaking interest rates and lower bond yields.

Property

Global REITs (-3.8% in AUD) and Australian REITs (-1.8%) underperformed broader global equity indices given widening credit spreads due to US debt ceiling concerns combined with structural headwinds for office and retail. The best performing stock in the S&P/ASX200 AREITs index was HMC Capital Limited (HMC, +12.2%) while the worst performing stock was Vicinity Centres (VCX, -11.7%).

Fixed interest and cash

Both global and Australian bonds traded largely rangebound, finishing slightly negative for the month (-0.5% and -1.2% in AUD terms, respectively), although bond market movements still exhibited intra-month volatility amidst headlines surrounding the US debt ceiling negotiations.

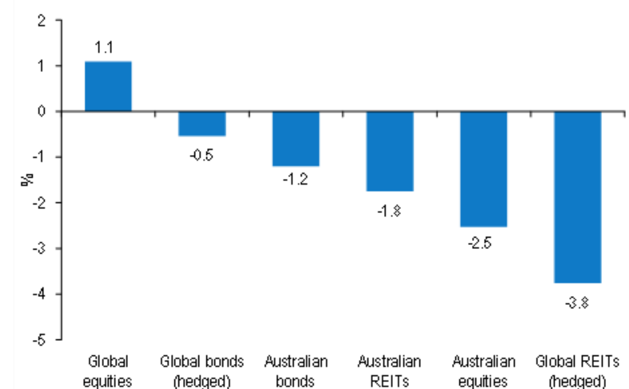
Commodities

Returns for commodities were negative across the board. Oil and coal prices (-11.3% and -28.8% in USD, respectively) were the standouts, suffering from increasing global growth concerns and depressed market sentiment, largely driven by weaker-than-hoped demand from China as reopening momentum softens.

Currency

The US dollar rose 1.7% against the Australian dollar throughout the month, bolstered by still solid economic data prints that helped dampen expectations for a near term Fed pivot and optimism on a US debt ceiling resolution.

Major asset class total returns during May 2023



Source: Factset, MWM Research, June 2023

Note: All returns are in AUD

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

	1 month	3 months	YTD	1 year	3 year	5 year
	%	%	%	%	% pa	% pa
Australian equity indices						
S&P/ASX 200	-2.5	-0.9	2.7	2.9	11.4	7.5
S&P/ASX 100	-2.4	-0.9	2.7	3.4	12.3	8.1
S&P/ASX Small Ordinaries	-3.3	-1.3	1.3	-5.8	4.5	2.5
S&P/ASX 20	-3.2	-2.2	1.0	2.5	12.7	8.3
S&P/ASX 50	-2.8	-1.2	2.6	3.2	11.8	7.9
S&P/ASX Mid-Cap 51-100	0.0	0.9	3.5	4.7	14.7	9.0
S&P/ASX 200 Industrials	-2.0	-0.7	3.8	2.1	9.7	6.2
S&P/ASX 200 Resources	-3.9	-1.4	-0.2	5.2	16.9	11.8
International equity indices						
MSCI AC World ex Australia	1.1	8.0	13.0	12.0	11.0	10.2
MSCI Developed World ex Australia	1.2	8.4	14.0	13.4	11.9	11.3
MSCI Emerging Markets	0.4	4.4	5.9	1.4	4.4	2.5
Regional equity indices						
S&P 500	2.6	10.2	14.9	14.1	13.9	14.5
NASDAQ Composite	8.2	17.9	30.0	19.8	12.7	16.3
Euro STOXX 50	-3.2	6.6	19.1	26.5	14.5	9.0
FTSE 100	-4.2	2.8	9.9	10.8	12.2	5.0
Japan TOPIX	3.2	9.5	12.6	16.7	5.2	4.6
Hong Kong Hang Seng	-5.6	-2.8	-2.8	-2.2	-4.0	-3.8
MSCI China	-6.5	-5.4	-4.7	-5.3	-7.9	-3.9
International equity thematic indices						
MSCI World Cyclicals	3.3	9.9	19.5	15.8	13.2	12.0
MSCI World Defensives	-3.9	4.8	2.0	8.8	10.6	11.1
MSCI World Value	-2.5	0.9	3.2	6.4	12.4	8.6
MSCI World Growth	4.6	16.0	25.6	21.1	11.7	14.3
MSCI World High Dividend Yield	-2.3	4.1	4.2	7.7	10.0	9.5
Real estate equity indices						
S&P/ASX A-REIT	-1.8	-3.6	4.0	-3.0	7.6	3.9
FTSE EPRA Nareit Global Developed (hedged)	-3.8	-5.4	-1.4	-14.8	3.8	0.2
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	-0.5	2.0	2.2	-2.6	-3.4	0.2
Bloomberg Barclays Global Treasury (hedged)	-0.4	2.2	2.4	-2.5	-3.7	0.2
Bloomberg Barclays Global Corporates (hedged)	-1.1	1.6	2.1	-3.1	-3.2	0.5
Bloomberg Barclays Global High Yield (hedged)	-0.6	0.0	1.9	-1.9	0.7	0.7
Australian bond indices						
Bloomberg AusBond Bank Bill	0.3	0.9	1.4	2.6	0.9	1.1
Bloomberg AusBond Composite (0+Y)	-1.2	2.1	3.5	1.7	-2.8	1.0

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

Source: Factset, MWM Research, June 2023

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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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