Investment Matters

Volatility to persist

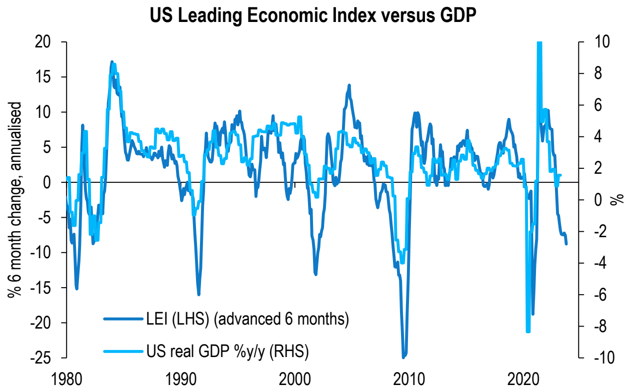
May 2023

MACQUARIE

A lot of time is being spent trying to work out where we are in the macroeconomic cycle and what it means for investors. Macquarie is still calling for a short and shallow recession (a soft economic landing) as the lagged effects of policy tightening finally slow the pace of consumer spending and begin to soften extremely strong labour markets. Our expectation has been that weaker economic growth combined with (still) elevated inflation and peak policy rates would keep equities largely rangebound until more realistic earnings expectations emerged and/or the start of a new rate cut cycle began.

For now, we stick with this view, although the resiliency of economic growth to rising policy rates and the strong rebound in risk assets through the first 4 months of the year is raising some doubt as to whether this view is overly pessimistic given developments on inflation and rates and how willing markets have been to look through rising economic growth risks. It is encouraging how resilient economic growth has been despite rising headwinds such as tightening lending standard, falling property prices, weakness in manufacturing and elevated inflation.

LEIs are signalling further economic growth risks



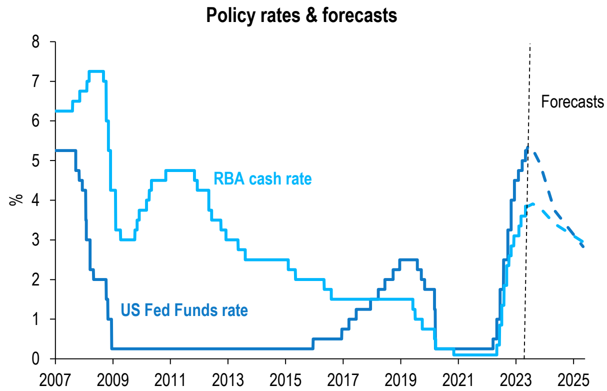
Source: Factset, MWM Research, May 2023

There is still a great deal of uncertainty around the timing, duration and depth of a global slowdown. While this is not a reason to be bearish and a lack of structural overhangs suggest economic scarring should be minimal, we do think markets are priced for the very best of economic outcomes (a goldilocks soft landing) as well as a quick reversal in policy tightening, which is certainly possible, but remains uncertain.

Optimists will point out how markets have recovered into rising macroeconomic concerns as evidence they are prepared to look through near term risks on the expectation that inflation continues its descent, policy makers stand ready to alleviate any near term financial sector stress, financial conditions have not tightened dramatically and that rate cuts will begin as early as 3Q23. These are solid reasons to become incrementally more positive on the investment outlook particularly in terms of the progress made in driving down inflation from peak levels.

However, we think this collection of factors is a strong reason why markets no longer need to take out their 3Q22 lows rather than driving the start of a sustained new upswing. We do not want to dismiss positive developments in order to hold onto our cautious view, but we think there remain enough uncertainties to cap upside in equity markets until we see greater transparency on where inflation begins to settle, when central banks feel comfortable in starting to ease policy rates and the path of economic growth.

Policy rate expectations have quickly shifted to rate cuts



Source: Factset, Bloomberg, MWM Research, May 2023

From a pure investment standpoint, it's unusual for equities to look through a recession (or meaningful growth slowdown in Australia's case), and while we did see a front loading of the correction in 2022, transitions take time and are often accompanied by false starts (bear market rallies) as investors oscillate between periods of optimism and pessimism before enough evidence builds in one direction. If we are wrong, and markets have already started a new bull run, then it will be the first time in history where a bear market bottom has occurred well before a recession has even started.

For Australia, the economy is now showing signs of cooling with some slippage across the labour market and consumer spending beginning to slow. While business confidence has remained robust, consumer confidence remains weak, and this foretells further weakness in spending. While excess savings and a large proportion of fixed rate mortgages have slowed the transmission of higher policy rates into the broader economy, they have only delayed rather than prevented this tightening from taking place.

Jason and the Investment Strategy Team

Global economics

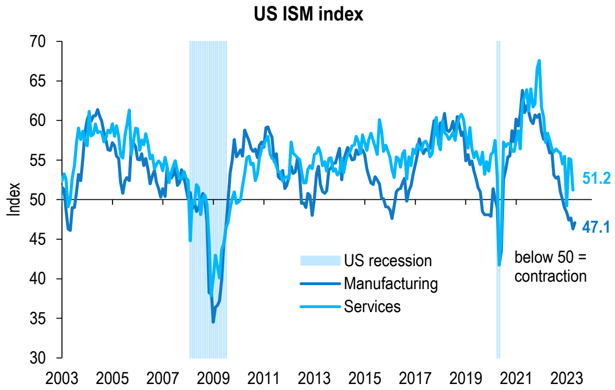
Recession on the horizon

- Forward looking activity and labour market indicators are suggesting a slowdown is approaching.
- Macquarie expect recession for advanced economies beginning in 2H23, but still expect it to be relatively shallow and short in duration.
- Central bank rate hikes are nearly complete but tough talk will continue until inflation is finally tamed. Expect sticky inflation to keep rates higher for longer.

Manufacturing activity weakening

There are increasing signs that global (ex-China) growth is slowing. US manufacturing activity (as measured by the ISM index) indicated contraction for a sixth-straight month in April, the longest such stretch since 2009. Likewise, the Eurozone manufacturing PMI for April hit a 35-month low of 45.8, signifying contraction.

US manufacturing in contraction for the last 6 months



Source: FactSet, MWM Research, May 2023

Labour market firm but weakness coming

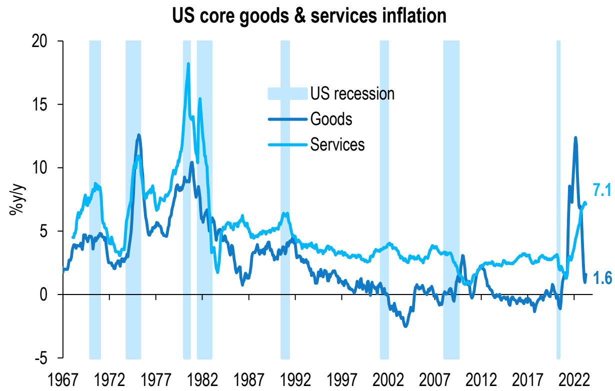
While the US labour market remains strong with an unemployment rate of 3.5%, just shy of its recent multi-decade low of 3.4%, there are signs of weakening in forward looking labour market indicators. Initial and continuing claims continue to deteriorate and remain consistent with an upcoming recession. Additionally, job openings recently fell to their lowest level in almost two years. Macquarie expect the US unemployment rate to begin rising soon, reaching 5.5% by Q423. Consequently, they remain cautious on the consumer spending outlook.

Inflation moderating but remains elevated

Headline inflation prints in the US (and elsewhere) continued to fall although core measures are proving stickier than desired, suggesting there is some way to go before inflation is tamed. This should reinforce to the FOMC and Chair Powell the need to show continued commitment (via not easing rates too quickly) if they are to return inflation to the 2% target.

Indeed, the US Federal Reserve lifted the Fed Funds rate by a quarter-point to the highest level in 16 years (5.00-5.25%), but recognised that tighter credit was now having an impact on the economy with Fed Chair Jerome Powell saying “It’s possible that we will have, what I hope, will be a mild recession”.

US services inflation may have peaked but remains high



Source: FactSet, MWM Research, May 2023

Macquarie still forecasting recession in US

Commercial real estate woes, tightening lending standards, regional bank fragility, as well as a potential upcoming U.S. debt ceiling drama, add to near-term risks to the outlook. Macquarie’s outlook for the U.S. remains for a recession, with 3Q23 the first quarter of contraction. Macquarie’s baseline is for this to last 3 quarters and for it to involve a peak to trough decline in real GDP of -1.6%. This is more severe than the consensus economist forecast for a “softish landing” with only a -0.2% peak to trough decline.

China continues to rebound

China remains on a firm growth path, with reopening driving a surge in services spending. China’s economic activity data releases during April was unequivocally strong: GDP growth in 1Q23 came in stronger than expected, accelerating to 4.5%y/y (Q4 22: 2.9%). Although Beijing has set a growth target of “around 5%”, Macquarie believe China is more likely to grow 5.5-6% this year. Consumption will be the main growth driver, driven by services. Policy is supportive, both monetary and fiscal. Additionally, the previously ailing housing sector is on the mend.

Australian economics

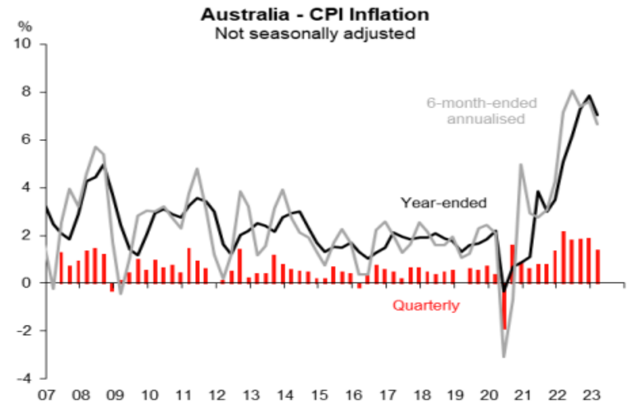
The path narrows even more for a soft landing

- The RBA surprised markets this month and increased the cash rate by 25bps, amid still rising services inflation and a still tight labour market.
- Additionally, early signs of stability in housing prices likely provided the RBA further confidence that the economy could handle more tightening if required. Macquarie forecast one more rate hike to come, taking the cash rate to 4.10% by August.
- Macquarie is not forecasting a 2023 recession for Australia. However, economic growth is expected to slow materially, and more rate rises further narrow the path being walked by the RBA to achieve a soft landing.

Growth slowdown still to come

Australia's economy had remained resilient relative to global peers coming into the year, with strong consumer spending, a tight labour market and a high household savings buffer supporting economic activity. However, like the rest of the world, Australia is battling sticky inflationary pressures even after a large amount of monetary tightening (375bps of rate hikes have been passed through so far). Economic growth is expected to slow materially this year even though a recession is still not the Macquarie economics team's base case, with GDP forecast to grow by only ~1¼% in 2023 (down from 2.6% in 2022).

Inflation has peaked but remain above target bands



Source: ABS, Macquarie Macro Strategy, May 2023

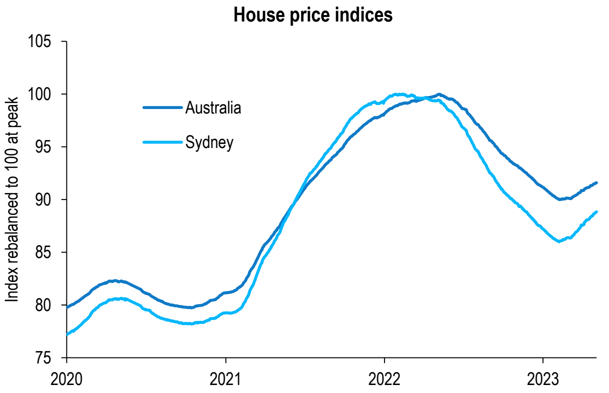
RBA hikes again amid a resilient labour market and still high services inflation

Recent economic data has been mixed: The 1Q23 CPI print saw a slight moderation in consumer prices, with the trimmed mean increasing by 1.2% q/q (versus consensus of 1.4%) and 6.6% y/y (versus consensus of 6.7% y/y). Goods prices led the moderation, while services inflation remained robust. However, underlying inflation remains well above the RBA's 2-3% target band.

We do not see services inflation to ease while labour market conditions remain very tight. Although the return of immigration has mainly been good news for labour supply, it adds to price pressures in the rental market. For now, the labour market remains very tight, with employment rising by 53k in March, strongly beating the consensus of 20k and the unemployment rate remaining at 3.5% versus expectations for a slight increase to 3.6%.

With services inflation still rising and no easing in labour market tightness, the RBA surprised markets this month by increasing the cash rate 25bps after the tactical pause in April. Governor Lowe highlighted that services price inflation remained "still very high and broadly based" and "some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve", suggesting the Board will be in assessment mode for the time being. Macquarie does not believe the RBA's job is yet done to cool demand and anticipates one more rate hike to come, taking the cash rate to 4.1% by August.

Australian dwelling prices are on the rise again



Source: CoreLogic, MWM Research, May 2023

U-turn for housing prices

Despite the 375bps of tightening since May 2022, Australian dwelling prices appear to have bottomed in recent months, with the rebound stronger in Sydney (prices now 3% higher in 1Q23) and Perth (prices recovering 1% year to date), while other capital cities such as Melbourne (0.3%), Brisbane (0.1%) have seen price declines moderate. Macquarie's economics team believe that more likely than not the 'correction' in (nominal) housing prices has now occurred, with housing prices in real terms having fallen ~15% peak to trough. Macquarie's central case is now for nationwide dwelling prices to rise modestly (~2%) over the remainder of 2023 before increasing by ~7% over 2024 alongside some monetary policy easing. A different path for interest rates than anticipated will be the main risk for housing prices, in either direction.

Monthly performance

April 2023

Australian equities

Australian equities posted a total return of 1.8% in April, underperforming global equities (+2.8% in AUD). The Australian market was weighed down by Resources (-2.6%) with the market ex Resources (+3.5%).

The best performing domestic sector was Real Estate (+5.1%), following a selloff in March on US banking turmoil and concerns over commercial property. The worst performing sector was Materials (-2.6%), which was dragged down by weak commodity prices.

The best performing large cap stock was Mirvac Group (MGR, +15.9%) which rallied on housing sector optimism following a pause in RBA rate hikes. The worse performing large cap stock was the BNPL giant - Block (SQ2, -11.1%) which tumbled as its US counterpart was impacted by the escalating credit concerns due to US banking turmoil.

The S&P/ASX Small Ordinaries index (+2.8%) slightly outperformed the large cap S&P/ASX100 index (+1.7%) although excluding resources the performance was almost identical. The best performing small cap stock was biotech business Telix Pharmaceutical (TLX, +47.1%) which rallied after reporting solid Q1 revenue growth. The worst performing small-cap stock was Syrah Resources (SYR, -37.1%) impacted by uncertainty in China anode market conditions.

International equities

Global equities rose 2.8% in AUD. Concerns over a systematic banking crisis in Europe and the US was offset by expectations of policy relief and the settlement of multiple banking blow-ups. Defensive sectors outperformed cyclical sectors: Consumer Staples (+3.9% in AUD) and Energy (+3.6% in AUD). Materials (-0.7% in AUD) underperformed as commodity prices weakened.

Property

Global REITs (+3.3% in AUD) and Australian REITS (+5.3%) outperformed broader equity indices as real estate markets recovered from heavy selloffs in March.

The best performing stock in the S&P/ASX200 AREITs index was Mirvac Group (MGR, +15.9%) while the worst performing was Pexagroup (PXA, -1.6%).

Fixed interest and cash

Both global bond and Australian bond indices posted slightly positive returns (+0.4% and +0.2% in AUD) as an uncertain macro environment supported the markets' preference for defensive assets, driving bond yields lower.

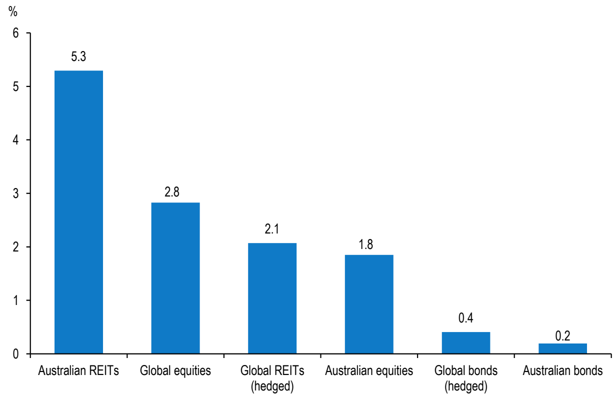
Commodities

Commodity prices were mixed. The gold price (+5.4% in USD) was the standout, benefitting from a fall in real bond yields and US Dollar Index. The oil price (-11.4% in USD) continued fell given concern weakening energy demand, particularly from China.

Currency

The big currency story was the continued weakness of the US Dollar, with the US Dollar Index falling by 0.8%.

Major asset class total returns during April 2023



Source: Factset, MWM Research, May 2023

Note: All returns are in AUD

Total returns (A$) – as at 30th April 2023

	1 month %	3 months %	YTD %	1 year %	3 year % pa	5 year % pa
Australian equity indices						
S&P/ASX 200	1.8	-0.8	5.4	2.8	14.0	8.3
S&P/ASX 100	1.7	-0.9	5.3	3.7	14.6	8.8
S&P/ASX Small Ordinaries	2.8	-1.7	4.7	-9.4	9.2	3.9
S&P/ASX 20	0.9	-2.1	4.3	4.1	14.9	9.3
S&P/ASX 50	1.5	-0.7	5.6	4.1	14.0	8.7
S&P/ASX Mid-Cap 51-100	3.5	-2.3	3.5	1.1	17.5	9.1
S&P/ASX 200 Industrials	3.5	0.3	6.0	0.3	11.7	6.8
S&P/ASX 200 Resources	-2.3	-3.5	3.8	10.1	21.5	13.3
International equity indices						
MSCI AC World ex Australia	2.8	8.5	11.8	9.9	11.6	9.9
MSCI Developed World ex Australia	3.2	9.4	12.6	11.1	12.7	11.1
MSCI Emerging Markets	0.2	1.6	5.5	0.5	4.0	1.6
Regional equity indices						
S&P 500	2.9	9.5	12.0	10.4	14.2	14.5
NASDAQ Composite	1.4	12.8	20.2	7.6	11.7	15.6
Euro STOXX 50	4.7	14.6	23.1	32.6	17.3	8.4
FTSE 100	6.5	11.7	14.8	15.4	13.4	5.7
Japan TOPIX	1.2	7.3	9.1	13.1	5.3	3.6
Hong Kong Hang Seng	-1.1	-2.6	3.0	4.9	-4.7	-2.8
MSCI China	-3.9	-5.3	1.9	1.5	-6.4	-2.3
International equity thematic indices						
MSCI World Cyclicals	2.4	9.2	15.7	10.5	13.6	11.5
MSCI World Defensives	5.1	9.7	6.2	14.1	12.8	11.8
MSCI World Value	3.4	5.0	5.8	10.4	13.9	8.8
MSCI World Growth	3.0	13.8	20.1	12.1	11.9	13.8
MSCI World High Dividend Yield	3.3	7.8	6.6	10.5	11.2	9.8
Real estate equity indices						
S&P/ASX A-REIT	5.3	-2.1	5.8	-9.9	10.7	4.9
FTSE EPRA Nareit Global Developed (hedged)	2.1	-5.2	2.4	-15.5	5.2	1.5
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	0.4	0.7	2.8	-2.3	-3.2	0.4
Bloomberg Barclays Global Treasury (hedged)	0.3	1.2	2.9	-2.7	-3.6	0.3
Bloomberg Barclays Global Corporates (hedged)	0.7	0.0	3.3	-1.9	-2.4	0.8
Bloomberg Barclays Global High Yield (hedged)	0.2	-1.0	2.5	-1.7	2.5	0.7
Australian bond indices						
Bloomberg AusBond Bank Bill	0.3	0.8	1.1	2.4	0.8	1.1
Bloomberg AusBond Composite (0+Y)	0.2	2.0	4.8	2.1	-2.3	1.4

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

Source: Factset, MWM Research, May 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

Investment Matters May 2023 was finalised on 8 May 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

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at https://www.macquarie.com.au/advisers/financial-services-guide.html.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e-mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research.

Important disclosure information regarding the subject companies covered in this report is available at macquarie.com/disclosures.