Investment Strategy Update #114

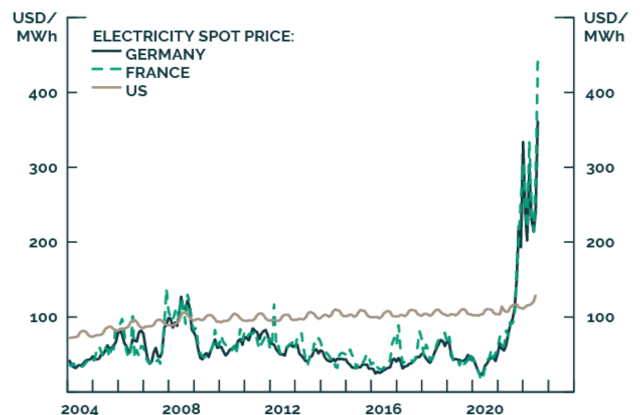
Downside economic growth risks intensify

- We think downside growth risks are rising as we head into 2023 and this is likely to cap any sustained upside in equities and/or risk assets, but more likely leads to further weakness as markets battle the prospect of higher than expected policy rates alongside weaker than expected economic growth.
- In recent weeks, key central banks have flagged their intention to bring inflation back under control regardless of the hit to economic growth. In addition, soaring energy costs are raising concerns that Europe / UK may suffer deeper and/or more prolonged recessions while China is also struggling to revive its economy as another wave of lockdowns are implemented off the back of its zero-COVID policy.
- There are some powerful tailwinds that will support global growth regardless of rising rates (such as tight labour markets and solid consumer fundamentals) but there is limited cushion for further economic weakness and the risk that cracks in credit markets and/or EM economies become wider fissions cannot be overlooked.
- We have stayed cautious in recent months, citing numerous uncertainties which we had limited transparency on. The fog clouding the outlook has not cleared and markets are not cheap enough, or earnings expectations realistic enough, to suggest they can trade through growth downgrades or disappointment.
- It will take time for policymakers to get on top of inflation and for economic risks to dissipate. Until then investors should maintain a defensive asset allocation tilt. Equities remain vulnerable to further downside or at best will trade sideways with extreme volatility.

Downside growth risks are emerging: We think downside growth risks are rising as we head into 2023 and this is likely to cap any sustained upside in equities and/or risk assets, but more likely leads to further weakness as markets battle the prospect of higher than expected policy rates (tighter than expected financial conditions) alongside weaker than expected economic growth. We think markets are now facing four major headwinds, with three of these rising significantly in recent weeks:

1. **The Fed has stepped up their policy tightening / inflation fighting rhetoric** in an all or nothing bid to tame inflation. The Fed has made clear that the inflation fight has not been won, that policy rates are not yet where they need to be, and that they (and other central banks) are willing to endure some economic pain in order to bring inflation back under control. This is a significant hardening in narrative vis-à-vis less than a month ago.
2. **European / UK economic growth risks are rising as the region faces a multitude of growth headwinds** including soaring energy costs that are undermining industrial output, elevated inflation which has driven a collapse in consumer sentiment and tightening monetary conditions which are now beginning to feed into slowing credit demand. While Macquarie was already forecasting modest but relatively short recessions in 2023, it is likely that the depth of the downturn is sharper than previously thought.

Europe is facing soaring energy costs

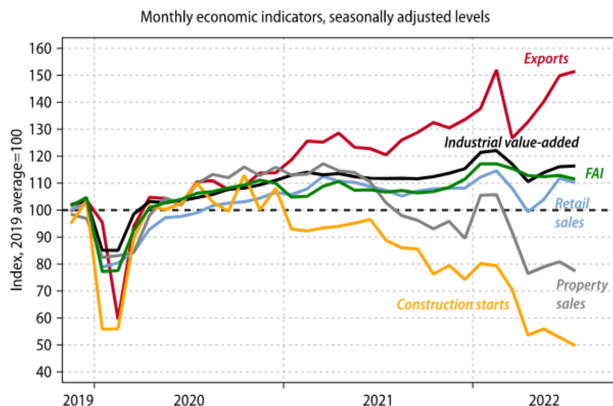


Source: BCA, MWM Research, September 2022

3. **China is now battling to arrest a deterioration in economic activity** on top of ongoing weakness in the property sector due to its zero tolerance COVID policy. While policymakers are now cutting rates in order to put a floor in the property sector, another wave of COVID related shutdowns has limited the effectiveness of policy easing. We think targeted policy support will be ongoing through 2H22 but the extent of mobility restrictions will determine its effectiveness and there is

limited transparency on how this will evolve. This suggests that any upside boost to the global economy because of a 2H22 growth rebound (form 1H lock downs) is likely to be much more muted than thought in recent months.

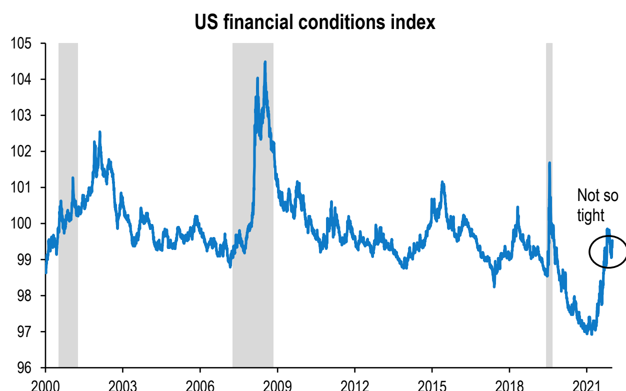
Property & construction sectors drag Chinese growth lower



Source: Gavekal, MWM Research, September 2022

4. **Emerging markets are facing a trifecta of headwinds** with a stronger US$ and higher US policy rates increasing debt service costs, elevated energy and food prices exacerbating inequality and poverty concerns, and finally a rapidly weakening external environment also putting downward pressure on commodity prices and demand. Although much improved external positions reduce pressure from rising borrowing costs, consumer dissatisfaction as a result of rising costs is already driving political instability in several countries. Macquarie is not expecting a systemic deterioration across EMs, but they are unlikely to de-couple from DMs where inflation and growth risks remain high.

Financial conditions are not tight despite Fed rate hikes



Source: Bloomberg, MWM Research, September 2022

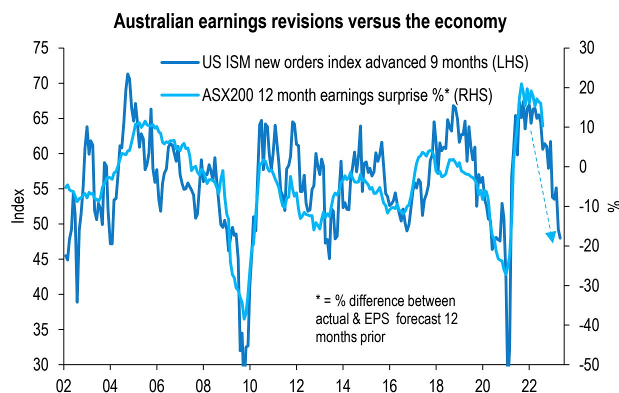
We believe this combination of growth risks and uncertainty around policy direction will prevent any meaningful improvement in equity markets through year end and is more likely to see markets trade lower off the back of any further economic and/or rates disappointments.

While central banks have been raising rates at breakneck speeds (and the pace will slow as we move forward), US financial conditions are not yet tight and this means markets need to absorb further hikes, a potential widening in credit spreads, ongoing US$ strength and tighter financial conditions for some time. This will also come against fears that weakness in European / UK growth could begin to infect the US and global growth backdrop (like it did during the European financial crisis in 2011/12).

At this stage we think it can remain contained, but this is a stepped-up economic risk especially if it leads to concerns throughout the European periphery or if the ECB and BoE continue to push rates higher into an energy crisis which the most recent statement by ECB President Christine Lagarde *“we want all economic actors to understand that the ECB is serious”* would suggest they are prepared to do.

We believe Australia is facing similar macroeconomic headwinds with the RBA committed to getting inflation back down to its target range of 2-3% and ensuring that inflation expectations remain anchored. Govenor Lowe has repeatedly emphasised the fine line it is treading in reducing inflation and ensuring economic damage can be contained. While we are confident that the RBA has the tools to bring inflation back under control (blunt as they may be), the fight is not over and households as well as investors should prepare for further pain whether that be economic downside, market volatility and uncertainty or even further equity weakness.

Australian earnings growth is set to meaningfully slow



Source: MWM Research, Factset, September 2022

In fact, we do not think domestic equity market strength should be seen as resilience. We think it reflects an unwind of pent-up consumer demand, an elevated savings rate (that is now normalising), inflation that is yet to undermine incomes and the impact of policy tightening that works with a lag. In other words, we think the equity market has been resilient because headwinds are yet to work their way through the broader economy and because policy

tightening, and consumer behaviour, is lagged versus other economies which exited lockdowns earlier.

Australian equities do retain some appeal. The local market has limited exposure to the conflict in Ukraine, and will likely play its traditional ‘low-beta’ role relative to global equities, and provide an attractive dividend yield of ~4.5%. However, domestic equities have benefited from an exceptionally strong period of commodities strength which is now showing signs of peaking. Earnings forecasts are now starting to fall, and we see greater risk for Australian equities given the very strong YTD earnings uplift. In addition, valuations (ex-resources) are not yet pricing in a meaningful economic slowdown or cut to earnings, and this leaves limited cushion as conditions begin to weaken.

From an investment standpoint, we maintain a cautious stance towards asset allocation with a preference for assets which are priced for inflation and/or can weather downside growth risks. Equities are priced for a soft landing and not recession, so this leans towards stable income and quality exposures (whether it be growth or value). We like sovereign bonds which now provide an appealing risk-adjusted yield as well as downside protection against a growth scare, but we remain cautious on credit where softening corporate fundamentals and economic growth may undermine returns. Heightened uncertainty supports noncorrelated assets with hedge funds able to profit from elevated volatility and real assets are our preferred exposures for stable and inflation protected incomes.

Macquarie WM Investment Strategy Team

This report was finalised on 12 September 2022.

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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