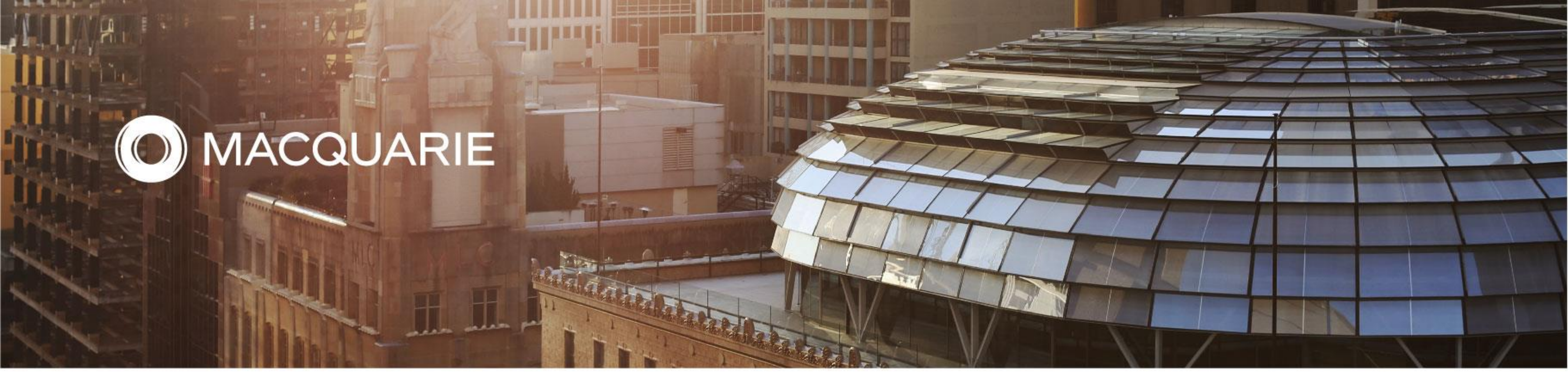
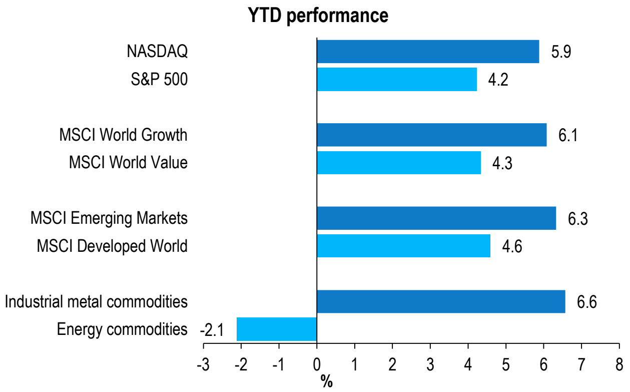


Investment Strategy Update #127

Markets start the year optimistically

Markets have started off 2023 with a bang. Equities are rallying (led by last year's loss leaders), bonds are rallying and the US$ is falling. We don't want to make too much of the first few weeks of the new year, but the strength and consistency of performance does raise the question of whether macroeconomic conditions have changed since many (at least in the Southern Hemisphere) left for their holiday break.

Risk assets have started 2023 off with a rally



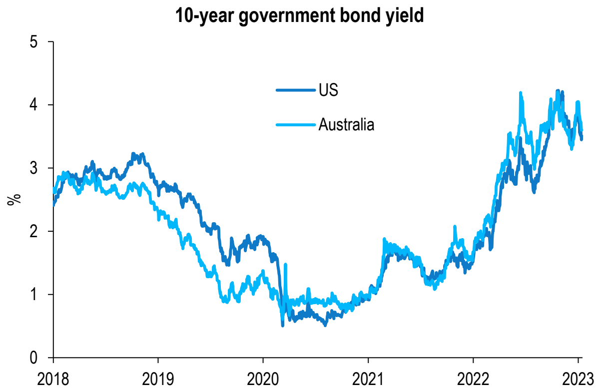
Source: Factset, MWM Research, January 2023

We put the rally in risk assets down to a few things:

- First, US inflation data has been better than expected and has given the bulls further ammunition for the view that it will continue to fall back sharply as supply chain disruptions continue to clear, commodity prices weaken, and growth (demand) slows. Clearly the pace of declines will vary from country to country (Australia the case in point where the latest CPI reading rose to a fresh cycle high), but it now looks like the roadmap for a decline in prices is in place.

- Second, bond yields are falling. In part this is likely to be the result of ongoing economic growth concerns but falling inflation is also helping. If 2022 saw bonds rise as a result of inflation driving policy rates higher then it also makes sense that falling inflation will help bring these back down. In addition, if rising bond yields were the primary factor that led to a de-rating in high growth multiple stocks / sectors through 2022, then it stands to reason that lower bonds yields will see the reverse. This is exactly what the first few weeks of the year have seen with the NASDAQ outperforming the S&P500, growth outperforming value and consumer discretionary blitzing consumer staples.

Bond yields are falling amid economic growth concerns



Source: Factset, MWM Research, January 2023

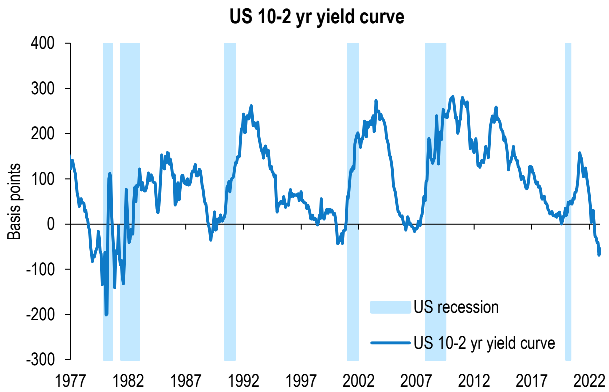
- Third, China continues to ramp up its reopening post late 2022 zero-COVID lockdown policies. The results of the Politburo meeting and Central Economic Work Conference last December put economic growth as the top priority for policymakers in 2023. As a result, the exit from zero-COVID has been faster than expected. Macquarie believes that instead of "flattening the curve", the policy goal turns out to be "rushing to herd immunity". The result is a deeper contraction in 4Q22 but also a faster reopening and recovery into 2023 as credit growth picks up and supports for the property sector begin to kick in.

The culmination of more favourable inflation data lowers the risk of an upside surprise in policy rates, and a faster than expected reopening by China gives the global growth backdrop a much stronger tailwind heading into 2023 when we know many economies are facing the prospect of recession. At this stage, a lot of the damage to economies via policy tightening throughout 2022 cannot be undone as the inversion of the US yield curve is suggesting. But removing downside risks to economic growth expectations will be a powerful support for markets, especially as the downturn has been well telegraphed (some suggest the "most expected" recession ever) and is forecast to be short and shallow. Similarly, it becomes harder to argue that the global economy will be mired in a structurally higher inflation and lower economic growth backdrop if the pace of inflationary declines continues.

We do think the worst for global equities is over but there is a lot of water to pass under the bridge before we can be confident that the ills of 2022 have passed and that we can be positioning for recovery. Inflation is falling (outside of Australia) and policymakers are likely near the end of rate hikes cycles. But the economic consequences of tightening liquidity and higher borrowing rates will come, regardless of whether the potential for a soft landing might be rising. If 2022 taught us anything, it's that markets will move with the data when there is no established trend. If it's better than expected then markets are up and when its worse than expected, they don't absorb this disappointment, they fall. The combination of weaker earnings and lower bond yields is better than weaker earnings and elevated bond yields if inflation is/was to have remained elevated. But it's still the best of a bad set of combinations.

If we step back, economists are forecasting a sharp economic slowdown through 2023 but markets (particularly equities and/or credit) are not priced for this and recent price performance is now raising questions around whether this slowdown can simply be looked through or whether economists are just going to be wrong. It's too early to tell and two weeks of light trading across equity markets does not provide us with a confident signal. At this stage, the US yield curve remains heavily inverted, expectations for policy easing are very modest (from the Fed or, closer to home, the RBA) as we move into 2H23 and early 1H24, bond yields have been falling but from multi-year highs and earnings – which are closely correlated to economic growth – have barely budged.

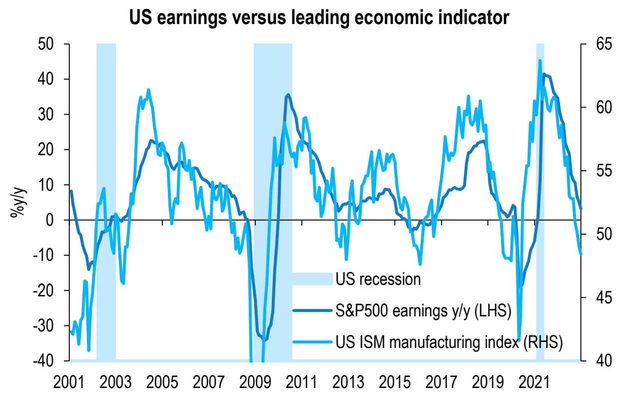
US yield curve remains heavily inverted



Source: Factset, MWM Research, January 2023

It is possible that policymakers end their tightening cycle slightly earlier than expected but in reality, forward expectations are already close to peak so maybe this doesn't really matter much now. It is possible that central banks begin to cut policy rates earlier than expected but if economic data continues to hold, then this will only come if inflation continues to fall, and it still remains well above comfort levels. It is possible that we don't see a meaningful decline in corporate earnings and, with valuations already at reasonable levels, this key drag does not eventuate. However, history is not on the side of this outcome and even for a modest slowdown, expectations are likely to still move lower.

Earnings not yet reflecting economic slowdown



Source: Factset, MWM Research, January 2023

We think risk assets will perform relatively well in 2023 given the pain suffered through 2022 but it is conditional on the consistency of the decline in inflation, where policy rates go from here and the shape of the economic downturn. If we were to prioritise these variables, it is the pace at which the Fed and other central banks begin to unwind policy that really matters and has the most power to juice up the next upswing for markets. At this stage it is still too early to think that this is coming either earlier than expected or faster than expected. So, while it is encouraging that US inflation and labour market prints are working in the favour of equities and bonds, it's also premature to think that we are now through the other side, we just think we are past the worst.

Macquarie WM Investment Strategy Team

The report was finalised on 16 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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