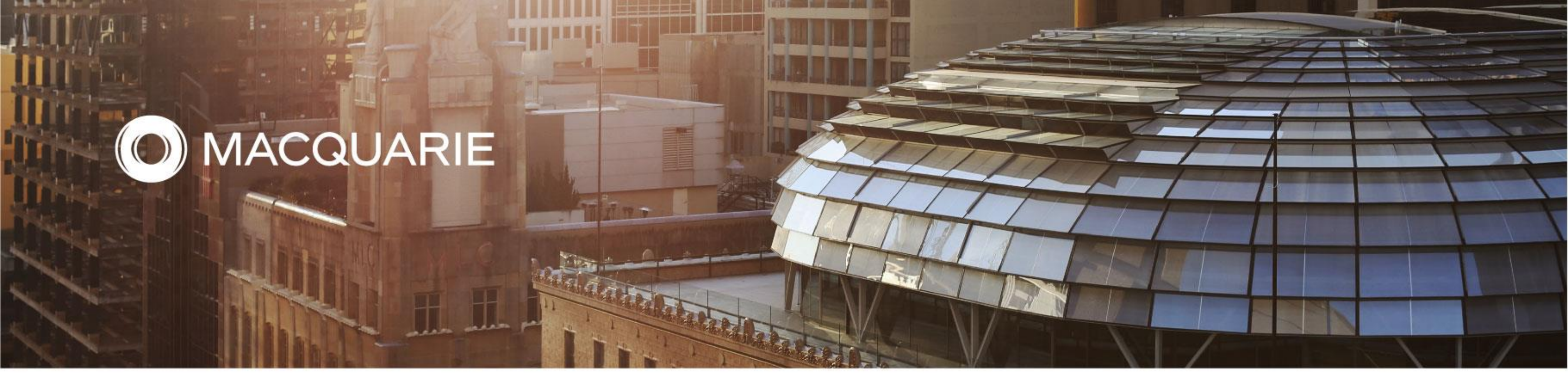


Investment Strategy Update #147

Sense checking portfolio positioning – Part 2: Equities

- This is the second in our "Sense checking portfolio series". For an update on Credit, please see Part 1 (*Investment Strategy Update #146: Sense checking portfolio positioning – Part 1: Credit*).

- After rising interest rates caused a sharp correction through 2022, equity markets have made a strong start to 2023 with the global benchmark (MSCI World Index) rising 15%.

- Coming into the year, consensus expectations were for a 1H23 recession that has not materialized. Consequently, a reversal in bearish positions alongside better than expected economic and corporate earnings have driven markets higher and not lower.

- However, this economic and earnings resilience in the face of aggressive central bank rate hikes does not mean a downturn is not on the horizon. Macquarie's economics team are still forecasting a mild global recession beginning in 4Q23 and led by downturns in the US, Europe and UK.

- If economic growth – both here and abroad - remains resilient to inflation and rising rates, then the rally that began in 2Q22 is likely continue, albeit, we think its best days have already passed. On the other hand, history shows that equity drawdowns associated with even mild recessions are meaningful and this risk sits on the horizon.

- This leaves investors with some important decisions. If they have participated in the rally, then remaining invested until there are clear signs that policy tightening is having a more meaningful impact on growth seems appropriate. On the other hand, for those who have sat on the sidelines, the rally is getting old with upside contingent on how resilient growth remains.

- With cracks already emerging in the outlook, we think there is limited upside vis-à-vis downside risks and this guides our view that, over the medium term, the risk-reward for equities is still poor. Being at such a critical point in the cycle, we think investors should "sense check" their allocations to ensure they are not overly concentrated in areas that might be exposed to economic slowdown risks.

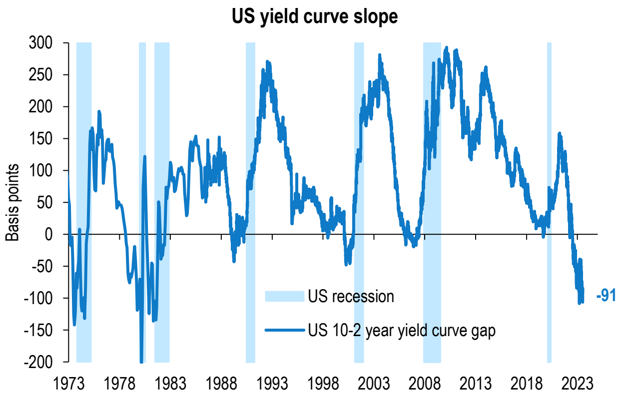
- In an economic slowdown, where rates and inflation remain elevated, investors should ensure they are not overly exposed to the following risks: 1) Asset class risk (being too overweight equities vs bonds); 2) Regional risks (being too overweight cyclical vs. growth markets); 3) Cyclical risks (being too overweight economically sensitive stocks vs. high quality / structural growth stocks); and 4) Valuation risks (being too overweight high multiple stocks vs. stocks with little growth premium priced in). Finally, investors can also reduce long-only equity exposure risk by having exposure into strategies that can benefit in falling markets such as long/short equity and/or equity neutral exposures.

- For investors who have a well-diversified portfolio, these decisions are considered in the construction of asset class and/or investment selection. However, for those who have had a shorter term focus (in order to take advantage of the rally) and/or are less diversified, we recommend sense checking exposure levels.

Resilience to rising rates and inflation

Despite the Fed raising the Fed funds rate by 500bp since March last year and the RBA by 400bps, economic data has been better-than-expected this year. The resilience has been put down to several factors, some related to the pandemic and some unexpected. Excess savings built up during the pandemic has been a key cushion for consumer spending. But spending on services was also cut to such a low level during the pandemic that the payback was always going to be long tailed.

Recession indicators are still on red alert



Source: Factset, MWM Research, July 2023

For the US, the key unexpected area of resilience has been the lack of a broad tightening in financial conditions that are normally associated with a Fed tightening cycle. In March we saw the first sign of this when several regional US banks collapsed, but policymakers stepped in quickly and ring-fenced the problem. The lack of broad tightening in financial conditions probably also reflects a lack of imbalances in household, financial and corporate balance sheets. However, time will tell whether there are skeletons in the closet that have yet to be uncovered.

The other good news this year has been the easing in inflationary pressures. Global supply chains have begun to normalise and this has lowered goods inflation. But services are around 70% of the US economy and services inflation remains high. Lowering it can only be achieved by raising the unemployment rate and doing this while maintaining growth has always proven difficult.

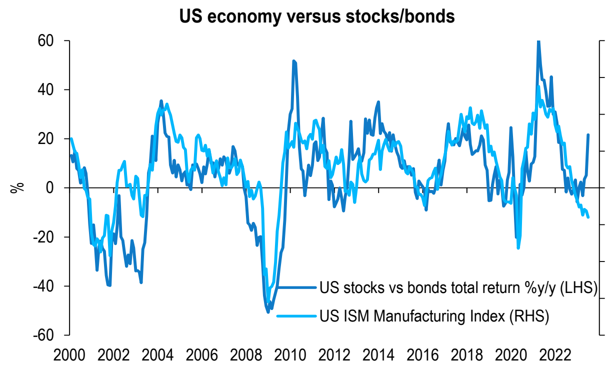
While the resilience of the US and Australian economies to policy tightening has been good news for equities, warning signs are growing as cracks begin to emerge in the consumer outlook despite neither the Fed nor RBA signalling it has yet finished raising rates.

Be mindful of downside risks

Markets react to the latest data, company guidance and analysts' assessment of the earnings outlook. All this has been positive thus far this year, albeit it is at risk of turning as we move deeper into 2H23. As a result, we think investors should still approach equites with a degree of caution, sense checking the following exposures:

1. **Don't be too overweight equities vis-à-vis defensive assets such as bonds:** Equities are growth assets and bonds are defensive (income) assets. During economic downturns, bonds outperform equities and during upswings, equities outperform bonds. This relationship has historically been the case. With economic risks rising, investors should ensure they are not too heavily overweight equities at the expense of bonds which offer downside protection against equity weakness.

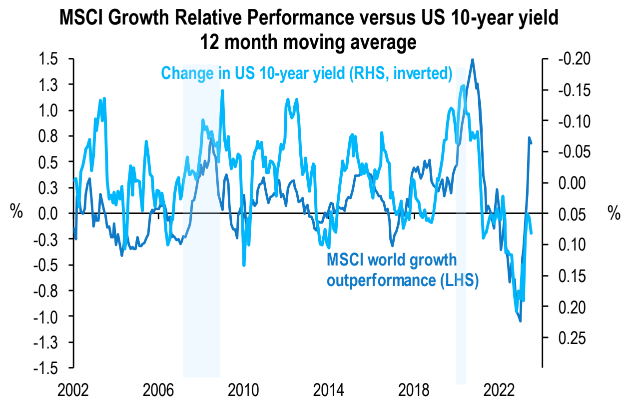
Stock/bond performance correlated to economic cycle



Source: Factset, MWM Research, July 2023

2. **Don't be too overweight "style":** Growth stocks normally outperform Value stocks when interest rates are falling, and Value stocks normally outperform Growth stocks when earnings are improving. The sharp rise in inflation and interest rates is in the rear vision mirror but lower rates might still be some way off. Similarly, while there are no strong macro tailwinds for Growth, the same could be said for Value stocks which are more economically sensitive. We don't have a strong preference for either Growth or Value, but we do prefer stocks with a quality / defensive / income bias which in fact cuts across areas of both style indices.

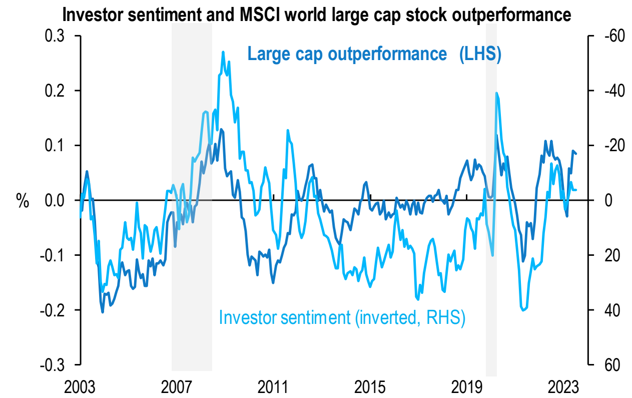
Growth outperforms the peak in bond yields



Source: Factset, June 2023

3. **Don't be too overweight "size".** Sentiment is likely to ebb and flow until growth uncertainties are resolved. Large cap stocks tend to outperform when sentiment turns sour, such as during a recession or when interest rates are rising. On the other hand, small caps tend to be a more "risk-on" proxy because they have greater cyclical leverage (more sensitive to economic conditions). Sentiment is not overly negative, and it has supported the riskier parts of the equity market such as small caps. However, we think performance by size will swing back towards large caps as economic risks rise.

Large cap stocks outperform when sentiment dips

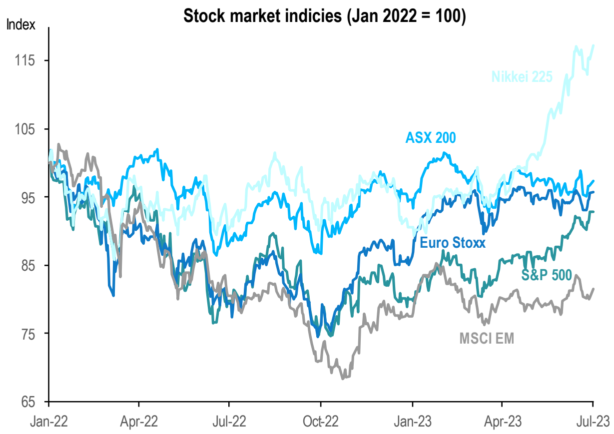


Source: Factset, MWM Research, July 2023 Shaded grey areas indicate a recession.

4. **Don't be overly exposed regions that have high cyclicality.** Regional equity market positioning is often an easy way to optimise exposure to style and quality preferences. The US is considered "Quality/Growth". Europe and Japan are considered "Cyclical/Value", while EMs are a straight risk-proxy.

   This is because the US market has a larger weight in IT stocks than other major markets and offers a less cyclical exposure than Europe, which has larger weights to Financials, Healthcare and Industrials. Japan has larger weights to Consumer Discretionary and Industrials, but smaller weights to Financials than Europe or IT than the US. Finally, EM tends to rally when the US dollar weakens, or the Chinese market outperforms.

The US and Japan have outperformed this year



Source: Factset, July 2023

We like the defensive Growth qualities of the US market and prefer it over Europe, and Australia. The ASX is exposed to the highly indebted Australian household sector via the large weight to the Banks and Resources are exposed to the slowing global economy. Europe is a cyclical market, and the region is currently in recession.

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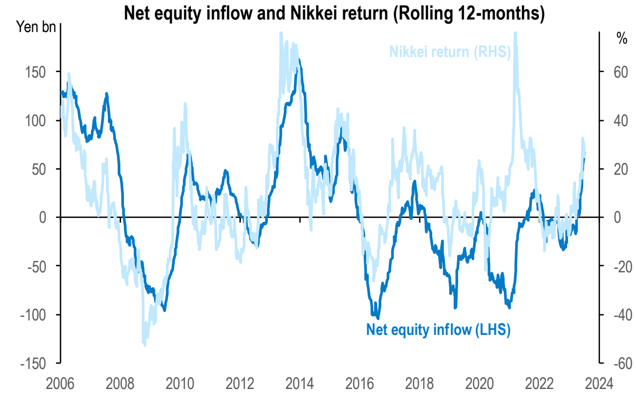
Japan has been the strongest performing major market this year, but only because of its sector composition or style attractiveness. Japanese regulators have also been reforming the laws of governance for companies listed on the Tokyo stock exchange. Foreign investors have embraced the changes to governance as a game changer and in the past have driven the market's significant outperformance. The market has rallied on the positive news of the reforms, but there are still uncertainties about how this translates into returns for investors over the longer run.

Foreign investors help drive Japanese outperformance



Source: Factset, July 2023

5. **Long/short equity allocations can help smooth downside risk of long only positions:** The risks we have outlined for markets can create opportunities for long/short funds and investors should include a long/short strategy in their mix of funds. Active managers with the ability to short stocks can significantly outperform during market downturns where long-only funds are more restricted to delivering the same directional return as the benchmark.

Macquarie WM Investment Strategy Team

The report was finalised on 17 July 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