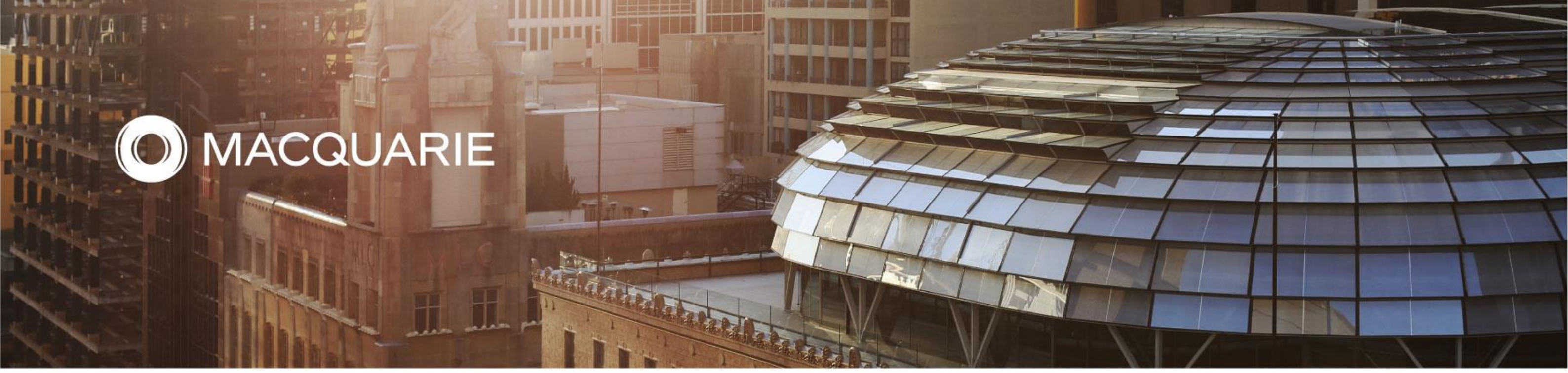


Investment Strategy Update #125

Bear market not yet over

- Macquarie's Macro Strategy team have just released their 2023 Australian equity market outlook titled "Buckle Up". We highlight five key takeaways from this report.

  i. Macquarie does not believe equity markets have bottomed. They expect further downside to markets in line with earnings revisions (in the range of 15-25%) as investors shift their attention from inflation to economic recession.

  ii. The October rally has been impressive, but Macquarie's Macro Strategy team do not think the bear market is over. It has the hallmarks of a bear market rally driven by a reversal in technical factors and hope that the global rate hike cycle end is near.

  iii. Equity market valuations have already corrected (dramatically in some cases). While the Australian equity market is not cheap at 17x forward earnings, there is limited need for further widespread valuation de-rating unless economic growth disappoints, or inflation proves stickier than expected. Neither of these fit with Macquarie's central case outlook.

  iv. Weaker economic growth (recession in many developed economies) is not yet reflected in Australian earnings expectations. While interest rates will become a less meaningful headwind as we move into 2023, investors must still navigate an earnings downgrade cycle where earnings growth expectations could fall up to 20% under a recession scenario.

  v. Macquarie's Macro Strategy team think it's too early to begin pricing in a permanent policy pivot and to position for a durable bottom in equities. Australia has been resilient throughout the global sell-off but in part that has reflected a lagged inflation and rates tightening cycle. It would be unusual for the next bull market to begin before rates have peaked and/or we know how deep the economic downturn will be.

We think investors should remain patient until there is greater transparency around macroeconomic headwinds. We expect equity markets to begin a new upcycle in 2023 but they must first price in a more severe earnings slowdown, and we need to be closer to a peak in the RBA's cash rate hiking cycle.

Too early to position for a policy pivot

The headwind to equities from the rate hike cycle will begin to abate in 2023 as growth, production and unemployment concerns take precedence. But it remains too early to be repositioning back into equity markets.

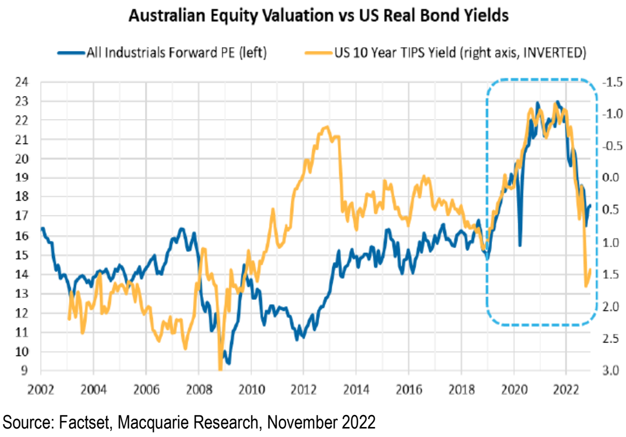
Macquarie's Macro Strategy team think rate hikes will continue across the world as inflation remains the primary issue dominating the economic landscape. While inflation remains above policy rates, and until unemployment rises noticeably, an agenda of rate hikes will be pursued to curb inflation. Australia is not unique in this respect with markets pricing in a terminal cash rate of 3.80% by late 2023.

Importantly for equity markets, an easing in the velocity and quantum of rate hikes is unlikely to be sufficient to support share prices. While a slowing pace of rate hikes is an acknowledgement of a shift in growth risks over inflation risks, a demonstrable pivot to rate cuts will be needed to drive a material fall in bond yields to support equity PE's. Macquarie expects the RBA to cut rates in late 2023.

Valuation correction mostly done but earnings expectations have downside risk

ASX Industrial valuations have de-rated in response to tighter monetary conditions, falling from 23x to 17x. However, it remains above long-term averages and above levels where bull markets usually begin (closer to 10-12x).

Based on the rise in real yields the All-Industrials PE should trade lower

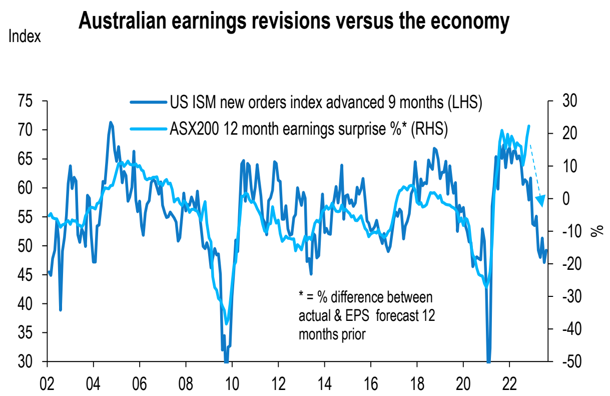


Source: Factset, Macquarie Research, November 2022

The level of real yields suggest equity market valuations could still have downside risk in the region of 1-2 PE points. But given the magnitude of the de-rating that has already occurred, we don't see this as a major headwind. Similarly, while "high" PE stocks remain above long-term levels (in comparison to "low" PE stocks), we think the de-rating will be more stock specific as inflation and rate expectations begin to move lower.

Market expectations for ASX earnings growth (at 10% EPS growth for 2023) also seems overly exuberant in the context of a US recession and ASX300 earnings could fall up to 20% over the next 12 months. Even if earnings do not fall to this degree, a broad-based downgrade cycle presents a significant headwind for the market outside of offsetting positive factors such as the expectation that rates will begin to decline or that the economic slowdown is more modest.

Material downgrades coming to Australian earnings in 2023



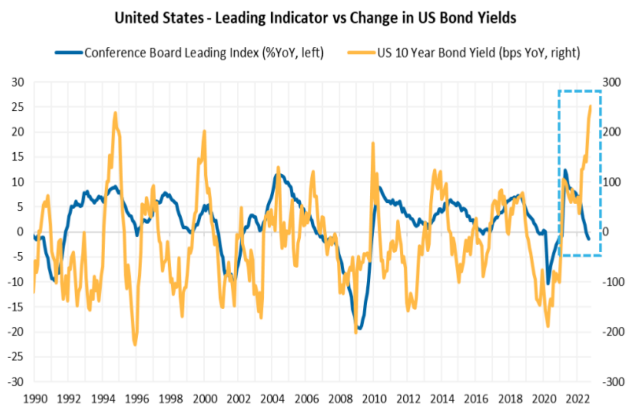
Source: Factset, MWM Research, November 2022

Australia is not in the same stage of the cycle as the US

Macquarie's Macro Strategy team think a US recession is imminent, but that Australia should avoid this outcome (albeit with a significant growth slowdown). For the US, multiple leading indicators are now signalling a recession starting around 1Q23. This would mark the shift from "Late Cycle Expansion" to "Early Cycle Contraction", and likely change the nature of the bear market.

In 2022, the bear market was driven by a PE de-rating due to rising yields. But the divergence between bond yields and the growth cycle is large and at levels last seen in the inflationary 1970s. In other words, bond yields have been rising despite growth risks rising. Traditionally bond yields tend to fall in recessions (as deflationary forces rise), and despite what central banks say today, we think cuts will occur in 2023 after jobs replace inflation as the key concern.

Bond yields have decoupled from the growth cycle in 2022



Source: Factset, MWM Research, November 2022

Where to from here?

Macquarie's Macro Strategy team remains cautious on the outlook. Downside for equities of between 15-25% is significant when viewed in absolute terms or versus bonds which are getting close to a peak.

There is a risk they are being overly bearish, but this will be dependent on when policy makers end their rate hike cycle and when the rate cut cycle begins. Traditionally there has been a lag of around 4 months so even if rates peak in 1Q, a pivot will not come until sometime in 2H. At this stage we feel it is premature to begin reweighting back into equities even though a lot of the downside risks are now better understood.

While we agree that inflation appears to have peaked (driven by a decline in goods prices) and that recession tends to be deflationary, it is possible that the decline is not as fast as expected or that it continues to spread into wages and other stickier components. If that is the case, then 2023 does not look like a weak 1H and recovery into 2H but in fact much more drawn-out grind where inflation remains elevated and growth weak.

This is not Macquarie's central case scenario, but it is not an immaterial risk. Until we are confident that inflation is coming down as expected, that rates have peaked and that the economic growth downturn will be modest, we think the risk-reward for equity investors is to remain cautious and underweight versus bonds with a preference for quality (across both growth and value).

Macquarie WM Investment Strategy Team

Investment Strategy Update #125 finalised on 22 November 2022.