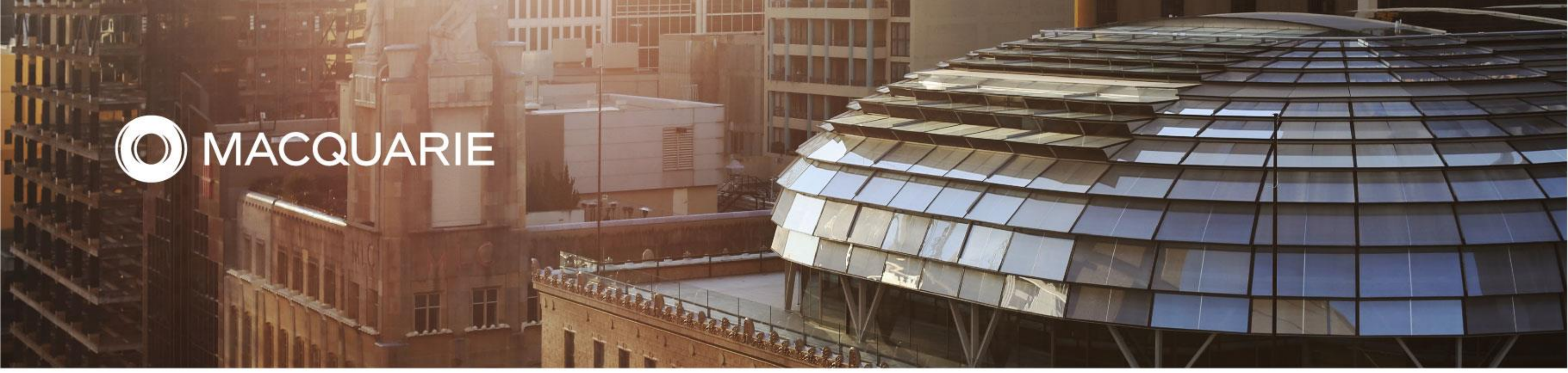


Investment Strategy Update #117

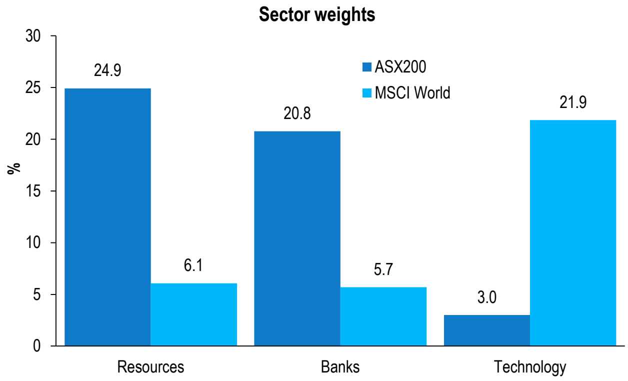
Australian equities: Headwinds are set to intensify

- We remain underweight Australian equities. On a risk adjusted basis we expect the market to underperform bonds and cash on a 6-month basis.
- We do not think a more appealing relative outlook will be enough to see the equity market outperform more defensive orientated assets against a backdrop where most risks are skewed to the downside.
- While there is a desire to look through weakness and to position for the other side of the inflation fight, we caution against this strategy. Unless valuations are cheap enough to cushion additional macro disappointment or downside risks begin to dissipate, then equities will remain vulnerable to further profit taking.
- We think avoiding recession is insufficient to get bullish when earnings expectations remain stubbornly high and valuations above recession-like levels. In fact, despite PE's declining by 6 points YTD, the ASX200 still trades more expensively than during 98% of the time prior to the pandemic. This is too high in our view.
- Historically there is a close correlation between leading economic indicators and earnings growth. With LEI's now in retreat, we expect further falls in earning to undermine valuations. In fact, if earnings were to decline by the average level during a recession, then the ASX200 is trading on 23x. This is expensive even in a (lower) bond yield environment.

Recent outperformance drivers are now firmly in reverse

The local market strongly outperformed global equities YTD due in large part to the sector composition with a relatively high weight in outperforming resources but low weight in underperforming technology. However, over the past few months, a number of the positive tailwinds have been working in reverse especially energy and commodities which have seen rapid corrections in spot prices.

A fortunate sector composition helped YTD performance



Source: Factset, MWM Research, September 2022

Going forward we think there are 5 key drags that will weight on equity performance:

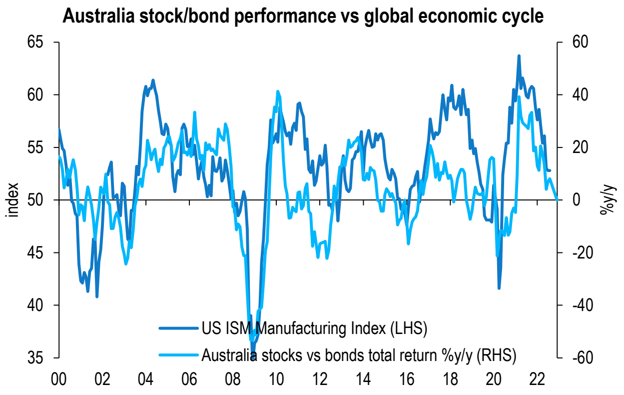
1. Weaker economic growth

Consecutive rate hikes through 2H22 will pressure the consumer/housing as well as business investment and hiring, which will increasingly show up in company earnings and guidance. Australia is likely once again following the US, with a lag, and significant job cuts will feature over the next 12 months.

Australia is expected to avoid recession, but growth will slow meaningfully into 2023. Macquarie is forecasting the cash rate to peak at 3.35% (currently at 2.35%) in early 2023 but this will be data dependent and the sensitivity of the housing market to recent rate hikes suggests policy tightening is already impacting some rate sensitive areas, with more to come as the transmission mechanism works with a lag.

The Australian consumer is highly leveraged to RBA rate hikes with most mortgages variable or at best fixed for several years (versus 30 years for US mortgages). We expect to see large downgrades for rate/housing sensitive areas of the market as rate hikes begin to bite.

Australian stocks to underperform bonds as economy weakens



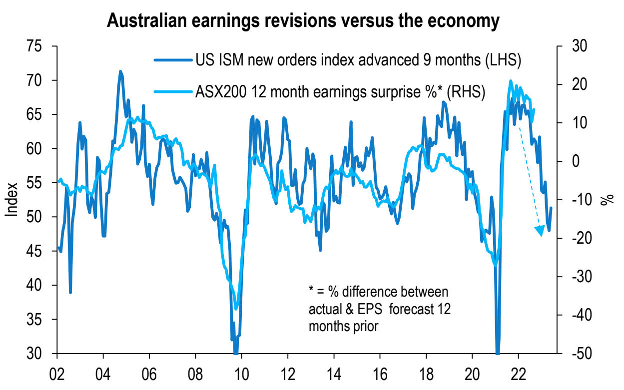
Source: Factset, MWM Research, September 2022

2. Rising earnings pressure

We see earnings risks to increase as rate hikes reduce consumption, rising costs pressure margins and cooling demand impacts revenue growth. Twelve-month forward earnings growth for the ASX200 of +5% (ex-resources = +12%) looks unrealistic and under a recession scenario could fall 10-20%.

Historically earnings have fallen around 18% during recessions (see Investment Strategy Update #104: The anatomy of an equity bear market).

Earnings downgrades coming



Source: Factset, MWM Research, September 2022

3. Valuations not cheap enough

Valuations have retraced from peak levels but are not 'outright cheap' with the S&P/ASX 200 ex-resources trading on a P/E of 17x forward earnings. Australian equities are not priced for recession. They are priced for higher bond yields and a moderate growth slowdown, but valuations have not reached bear market lows and earnings expectations are too optimistic. With earnings likely to fall imminently, this makes valuations even higher than they first appear.

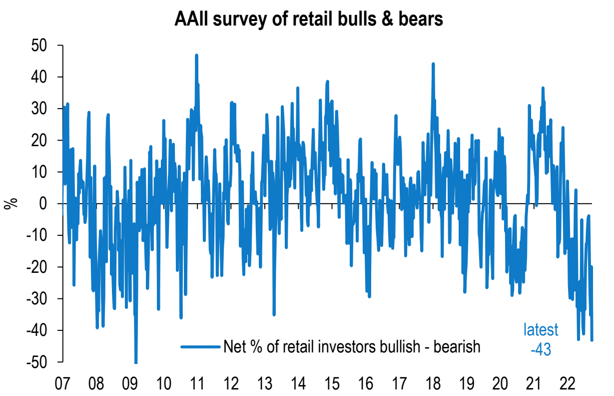
Equity market valuations not cheap enough

Source: Factset, MWM Research, September 2022

4. Deteriorating sentiment towards equities

Sentiment towards equities has plunged to levels not seen since the GFC. While this *could* be interpreted from a contrarian point of view as a positive, this deteriorating sentiment could be a negative as it may portend a "loss of faith" in equities, which had previously been the beneficiary of TINA (There Is No Alternative). Given how aggressive flows were to equities as a result of this TINA trade, an extended unwind of this trade could weigh on equities for a while.

Retail investor sentiment towards equities has plunged

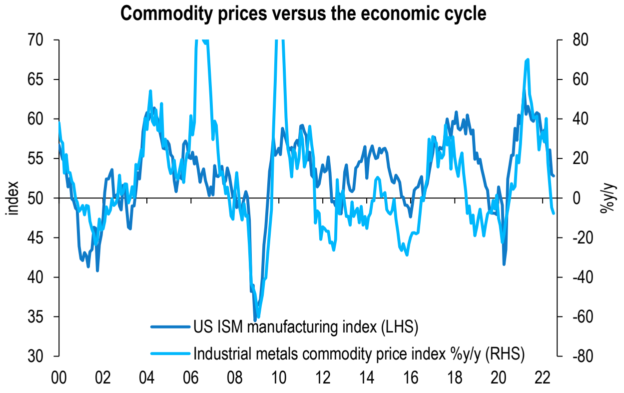


Source: Factset, MWM Research, September 2022

5. Commodities to struggle

Commodities will remain under pressure in the near term from a weakening global economy and the worst Chinese property sector downturn in living memory. A more aggressive pro-growth policy push by the Chinese authorities could potentially spark a commodity rally although to date the authorities have only announced policies aimed at curbing extreme downside.

Slowing global economy to weigh on commodities



Source: Factset, MWM Research, September 2022

Macquarie WM Investment Strategy Team

Investment Strategy Update #117 was finalised on 28 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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