Investment Strategy Update #113

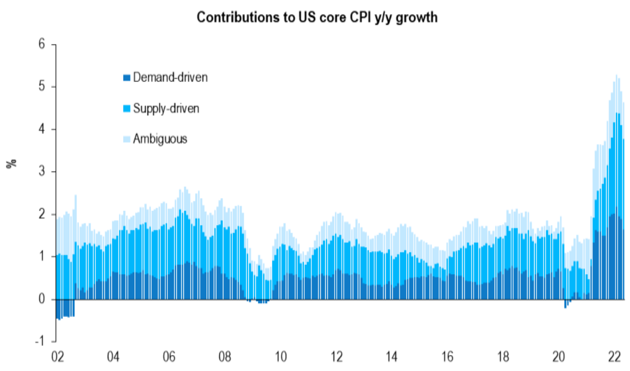
Central bankers deliver a healthy dose of reality

- Last week Fed Chairman Jerome Powell and other ECB officials provided a hawkish reality check to markets that had begun to price in peak rates and/or an imminent policy pivot.
- In clear and precise language (something often missing from central bank commentary), a message was sent that the inflation fight has not been won, that policy rates are not yet where they need to be, and that the Fed (and other central banks) are willing to endure some economic pain in order to ensure inflation is brought back under control.
- It remains "guesswork" as to how high rates will need to go to bring inflation back under control and therein lies the conundrum. Will central banks (including the RBA) push too hard, will they lose their nerve as growth begins to slow or will they achieve the holy grail of a soft economic landing. With certainty, we simply don't know.
- What we do know is that there are some powerful tailwinds that will support growth regardless of rising rates (such as tight labour markets and solid consumer fundamentals) and for Australia this should help avoid recession. But, when economic growth falls back to stall speed, there is little cushion for negative surprise.
- Investors should not read into last week's statements as a "new" negative development (other than for those that somehow thought the inflation fight was over and a new bull market has already begun). The risk-reward outlook for equities remains poor with valuations extended and earnings growth set to slow. A bull case is that investors see minor upside but with huge volatility. The base case is that markets trade lower with huge volatility. We think strategies that benefit from market turmoil are appealing (such as equity long/short) with long bonds now an attractive hedge against rising growth risks.

The inflation fight is not over … For as long as anyone cares to remember, it has paid off handsomely not to fight the Fed. When the most important central bank on the planet has been cutting rates, risk assets have had a powerful tailwind. When they have been raising rates, this tailwind has gone into reverse.

It's been a pretty simple strategy that has worked for the most part. Yet, in the past few months, markets have taken a different tack and have been betting against the Fed by assuming that they are near the end of their rate hike cycle and that a policy pivot (switching from raising rates to cutting rates) is imminent. As a result, equity markets have rallied strongly off their lows, led by growth stocks which has been under the most severe de-rating pressure.

Inflation is not yet under control even if it has peaked



Source: Factset, MWM Research, August 2022

Unfortunately, bets against the Fed came crashing back to earth on Friday after Fed Chairman Jerome Powell delivered a short and sharp rebuke to the bulls with an unusually clear but very hawkish statement. In particular, he reaffirmed his *"unconditional"* commitment to tackling high inflation and stressed that tackling inflation will probably have economic costs, including a *"sustained period of below-trend growth"*. In layman's terms, if anyone thought inflation was not a serious problem that would require a serious solution, then they were aptly reminded of this by Powell's statement as well as in follow up comments made by ECB officials who also warned of the *"sacrifice"* needed to tame surging inflation across the Eurozone.

But a more hawkish Fed (or RBA) does not change our view … At this stage, and unless investors had been suckered into the most recent rally, we don't think the commentary out of Jackson Hole changes much. Central banks have the tools to bring inflation down and they have simply reiterated their desire to do this to ensure that inflation does not become entrenched.

The market may have gotten a little too optimistic on where rates would peak and likewise premature on when the Fed might begin to change tack in order to support economic growth, but we don't think it requires taking a more negative view. We think it brings a dose of reality back into expectations and reaffirms the size of the problem at hand (in the US inflation is running above 8% versus a target of 2% and in Australia it is heading towards 8% versus a target of 2-3%).

A more hawkish Fed doesn't necessarily mean rising recession risks … We don't interpret the hawkish statement by the Fed and other ECB officials as necessarily raising the risk of economic recession, although it certainly doesn't reduce this risk. Central banks including the RBA are walking a fine line between bringing inflation down and avoiding recession. If policy tightening brings economic growth back down to stall speed, then it will not take much to push growth down to recessionary levels.

Australia's earnings backdrop is set to weaken

Source: Factset, MWM Research, August 2022

In addition, neither the Fed nor the RBA can be expected to back off raising rates at the first signs of economic pain if they are not comfortable that inflation is under control. But our assumptions for a short/shallow recession in the US and slightly deeper downturns in Europe/UK remain unchanged. Similarly, we maintain our view that Australia will avoid recession even though growth will slow considerably into 2H23 as the lagged effects of policy tightening are felt.

Investors should remain cautious … We think investors should remain patient until there is clear evidence of how successful central banks (including the RBA) are in bringing inflation back under control. We know policy settings are not yet at restrictive levels and hence there is more tightening to come. We also know that policy works with a lag and so economic strength via a tight labour market and ongoing consumer spending will fade. We also know that a large chunk of the developed world is heading into recession (US & UK), may already be in recession (Europe) and/or easing policy to stave off a more significant growth slowdown (China). These are not great global growth tailwinds for Australia even if domestic fundamentals are reasonable.

Little valuation cushion for inflation/rates disappointment

Source: Factset, MWM Research, August 2022

It is possible that inflation falls faster than expected, central banks don't raise rates as much as expected, economic growth proves more resilient than expected or that markets just look through all of this uncertainty. But it is also possible that none of these scenarios turn out better than expected in which case equities are not priced for this outcome – especially Australia which is trading on 19x forward earnings (ex-resources) despite a 200bps rise in long bond yields and the expectation of a drastic growth deceleration into 2023.

Don't get bearish … We don't think investors need to get bearish following last week's hawkish statements. But anyone who thought that central banks were on the verge of a policy reversal and that markets could start to price in an end to the inflation fight have likely received a reality check. Since we published our 2H22 outlook, our view was that the risk-reward for equities had become increasingly poor. The rally off the back of a peak in US headline inflation and then an imminent pivot in policy rates is now looking premature, but this does not mean investors need to sell risk assets.

Instead, we would not be adding fresh money to equities unless it's into volatility strategies (see ***Investment Strategy Update #112 - Hedge Funds: Offering diversification and downside risk protection***) or longer duration assets such as infrastructure. Despite the rise in bond yields we are firmly of the belief that long yields have peaked for this cycle and that they offer a solid risk-adjusted yield with downside growth protection (see ***Investment Strategy Update #111 - Sovereign bonds: Offering yield and capital preservation***). We don't think investors should be panicked by the sell-off that accompanied last week's hawkish statements from Chairman Powell and other ECB officials. The outlook remains uncertain with many different paths depending on how fast inflation falls, how committed central banks are in getting it lower and in how much growth they are willing to sacrifice. This is a backdrop where we wait to see how the chips land.

Investment Strategy Update #113 finalised on 29 August 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