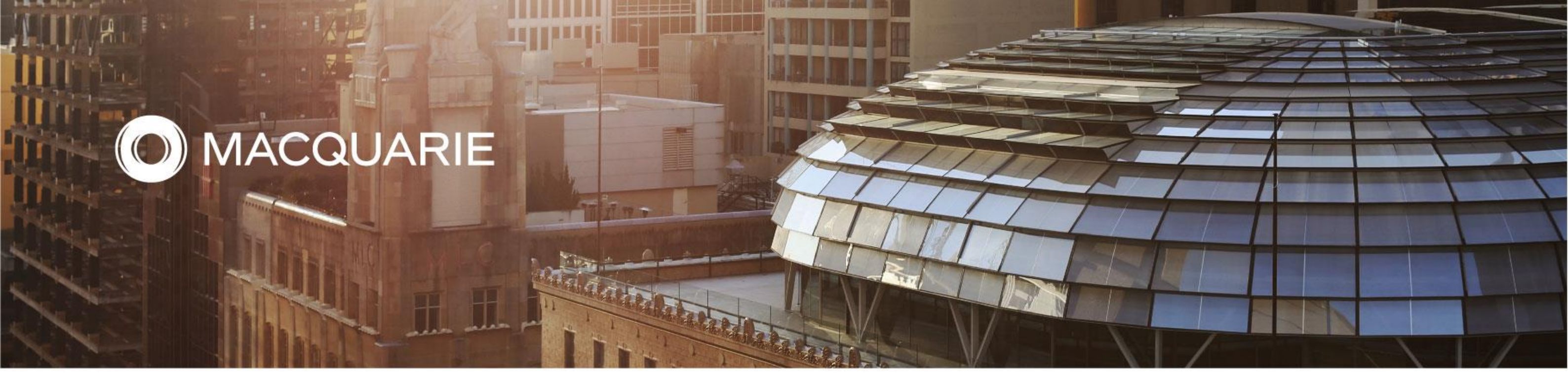


Investment Strategy Update #102

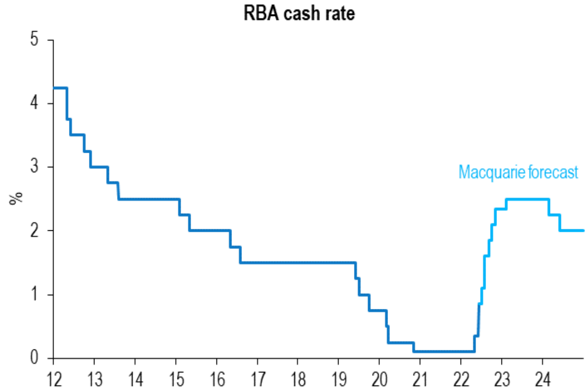
The RBA removes all ambiguity in an effort to tame rampant inflation

- The RBA has sent an unambiguous message to the market that it is behind the inflation fight, that the problem is significant and that it is going to do something about it.
- A faster than expected rate hike cycle raises downside economic growth risks and adds another headwind to equity markets already under pressure from tighter financial conditions. But it does not mean recession or a bear market is imminent.
- Historically, the start of a rate hike cycle has not been a sign to sell equities, but it has been a sign that cyclical outperformance will quickly reverse vis-à-vis defensive and/or quality areas of the equity market.
- It is possible that higher than expected inflation means this time (really) is different. The bond yield driven valuation de-rating within equity markets would attest to this. But think a slower economic growth, higher interest rate and more volatile market backdrop drives a more cautious and selective approach rather than the need to avoid equities as an asset class.
- We recognize that we are now late cycle and that downside risks are growing. But equities still provide a strong yield attraction and valuations have corrected a reasonable degree (and this is the best indicator of long term forward returns). We are neutral equities.

The RBA has sent a message

The RBA has finally sent an unambiguous message to the market that it is behind the inflation fight, that the problem is significant and that it is going to do something about it. Central banks have two avenues for surprising the market on policy. They either move earlier (and hence out of cycle) or they raise rates by more than expected. The RBA has chosen the second and the decline in equities, rise in bond yields and rally in the A$ immediately following the rate announcement are consistent with the direction of the surprise and accompanying narrative that there is more to come.

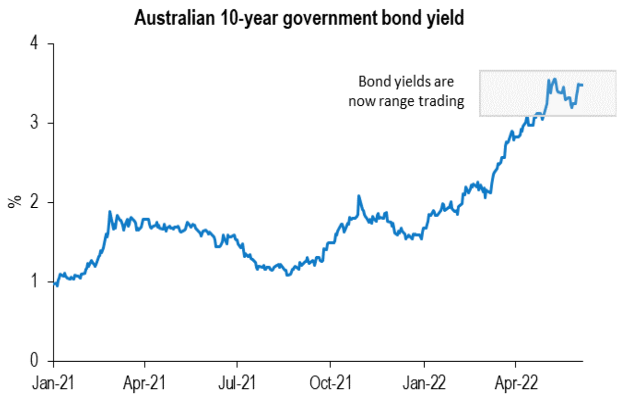
The RBA is now playing catch up



Source: Macquarie, MWM Research, June 2022

Given ultra-easy monetary conditions, unemployment at 48-year lows and inflation at multi-decade highs, yesterday's 50bps rate hike should not have been a surprise to anyone. While the magnitude of the rate hike was a shock, as much because the RBA has conditioned the market to think it moves in slow measured steps, we don't see yesterday's actions as a reason to immediately turn bearish on the equity outlook and would point out that over the medium to long term there are several positives that emerge from taking a more aggressive policy tightening stance.

Long bond yields are range trading with 2-way volatility



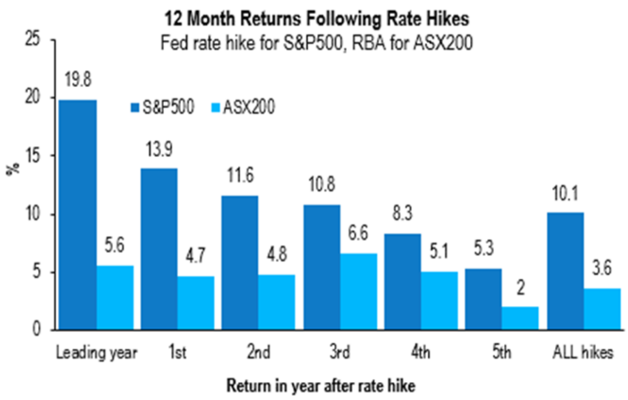
Source: FactSet, MWM Research, June 2022

The economy is now overheating

Interest rates are used to adjust the speed of the economy and so when they are raised faster than expected, it is a strong signal that there is a problem. The RBA in its actions and its narrative has made this clear. But there is a two-step tightening process underway. First, is the removal of ultra-easy monetary conditions that were put in place prior to the pandemic. Australia's economy is overheating, and rates set at record low levels have done their job in traversing the slowdown.

Getting policy rates back to more normalized levels should not be seen as a huge drag on either the economy or financial markets and we maintain this view. It is the second phase when financial conditions become restrictive and begin to undermine aggregate demand (in turn driving up unemployment and lessening broad price pressures) that markets need to become more concerned of. Unfortunately, it is not always clear when we transition from normalized to restrictive financial conditions and this is the risk for investors who might want to hold onto risk positions during the early phases of a rate hike cycle.

Equities have absorbed rate hikes by the RBA

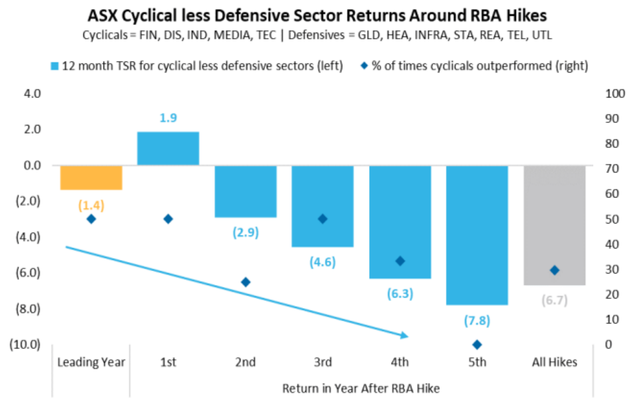


Source: FactSet, MWM Research, June 2022

Historically, the start of a rate hike cycle has not been a signal to sell equities. In fact, through past cycles, equities are usually always higher in the 12 months post the start of a rate hike cycle. There are always exceptions, and we look at these past episodes as a guide rather than a rule with the current situation more complicated due to where inflation pressures currently sit and how far behind the curve the RBA and other central banks have gotten.

Rather than complicate the backdrop, we think in the near term, a faster than expected policy tightening cycle adds another headwind to markets that were already under pressure from elevated bond yields, rising profit margin pressures, economic growth that was already decelerating and external inflation pressures that domestic monetary policy will have limited impact on. But a more aggressive stance by the RBA does come with some positives.

…but defensive sectors outperform cyclicals



Source: FactSet, MWM Research, June 2022

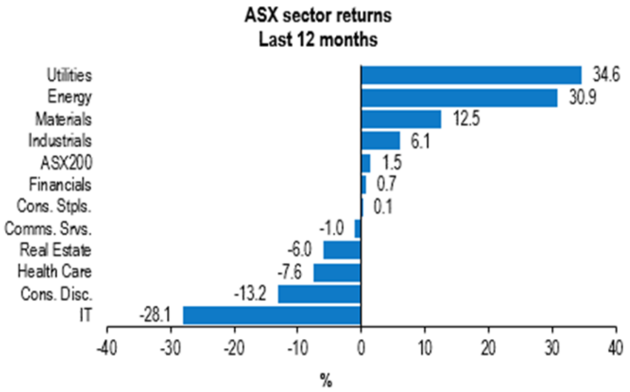
Expect more large rate hikes

The RBA is front loading its tightening rather than drawing out the process. This does not mean it will raise rates any higher than previously expected and Macquarie maintain its 2.25% peak by year end and 2.50% by mid-2023. However, it does mean it is intent on getting there faster and this may then give it time to pause and reassess.

Over the medium term, we think this is a better option for markets as it reduces policy uncertainty in the months and quarters ahead as well as removing any ambiguity on policy intent and giving less time for inflation to become entrenched. In addition, front end loading rate hikes does not mean the hit to the economy will be any worse. Simplistically, the faster rates rise, the greater the risk to economic growth.

But, as is always the case, the forward profile will be determined by incoming information, including the behaviour of other central banks. This implies that the RBA will be watching developments and can adjust the pace of tightening if necessary. In addition, economists have continuously pointed to elevated household savings and strong balance sheets as supports for the consumer with strong credit quality control by banks (the % of new loans with a LVR > 90% sits around 7%) suggesting any rise in bad and doubtful debts is not likely to be systemic.

Rates & Growth risks are already being priced in



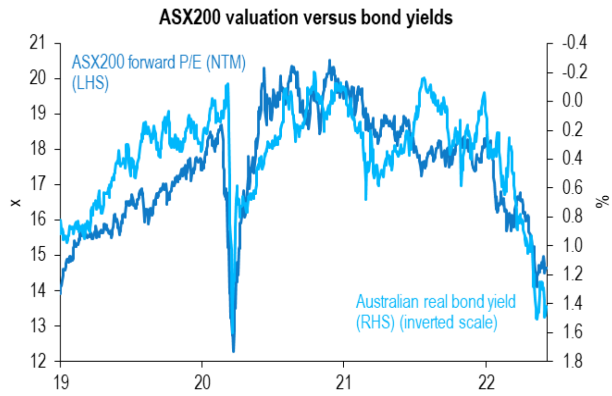
Source: FactSet, MWM Research, June 2022

There is no doubt that a faster than expected rise in policy rates will drive a faster deceleration in economic growth and in particular rate sensitive areas such as housing consumer discretionary and we have already seen this in price performance of stocks and sectors. Similarly, if equity markets get no valuation support from falling bond yields, then slowing earnings growth is another headwind.

But the yield curve flattened overnight (meaning short rates rose more than long rates) and we think most of the valuation correction due to higher bond yields is largely complete. Going forward, additional weakness will be concentrated in areas where earnings are vulnerable to tighter monetary conditions and this is in cyclically exposed stocks and sectors – consumer discretionary, consumer services, real estate, industrials and potentially banks.

This does not mean we are heading for a recession even if the risk of this outcome is rising and it means defensive sectors take stronger leadership over cyclical sectors. Throughout the past 6 months our strategy has been to position for things we have certainty on. This is a sharp economic growth slowdown, elevated and sticky inflation, higher rates and ongoing volatility. This means avoiding the most rate sensitive areas and high valued stocks and focusing on quality with a value overlay, raising exposure to areas that benefit or can offset inflation – such as real assets and alternatives – and trimming our equity exposure.

…but peaking bond yields slows de-rating pressures



Source: FactSet, MWM Research, June 2022

Macquarie WM Investment Strategy Team

The report was finalised on 8 June 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

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at **https://www.macquarie.com.au/advisers/financial-services-guide.html**.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e-mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research. Investors should obtain and consider the Product Disclosure Statement ("PDS") or offer document of the financial product before making any financial investment decision. You can obtain the relevant PDS or offer document by contacting the issuer of the product, or as identified below:

Important disclosure information regarding the subject companies covered in this report is available at **macquarie.com/disclosures**.