Research

Macquarie Wealth Management

Investment Strategy Update #58

Fed policy shift is not yet a signal for concern

- We see no reason to panic following last week's announcement by the US Federal Reserve to bring forward its first rate hike expectations. The Fed simply moved its dot plot for rate hikes to now mimic what was already priced into market expectations and importantly did not increase the number of rate hikes – meaning its terminal rate forecast remained unchanged.

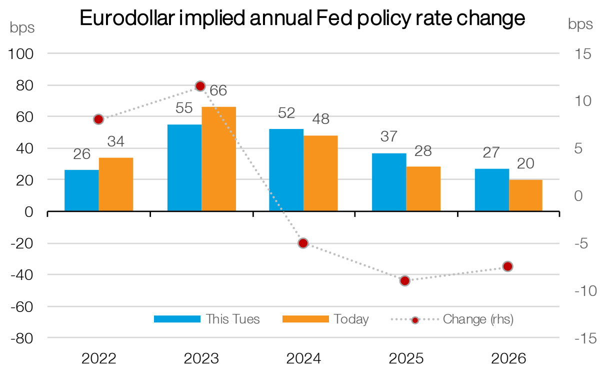
- While the initial reaction saw equities fall, bond yields spike and yield curves flatten, by the close of the week, bond yields had reversed their rise and inflation hedges had also fallen further (including commodities). We think this is consistent with a peak in near term inflation expectations and a more sanguine inflation outlook as implied by the Fed.

- Some are already calling this the beginning of the end to the cycle and to begin moving more defensive. We don't agree. The first hike remains over 2 years away and conditions are long way from becoming restrictive. The cycle is slowing but it remains intact and will continue to be supported by policy makers both in the US and here in Australia.

- Between now and year end 2023, growth is expected to improve significantly, unemployment will continue to fall and inflation will rise only modestly. Two years is a long time to be on the sidelines when economic fundamentals continue to improve. These remain good conditions for growth assets and we remain overweight equities while reiterating our short call on bonds.

Last week the US Fed brought forward the date for its first two interest rate hikes to the back half of 2023 as well as raising its growth and inflation forecasts to support this potential policy action. This is important for a number of reasons not least that the US tends to lead global interest rate policy and because markets / assets have been on a multi-year sugar high from low interest rates - particularly post the global pandemic.

Market has priced in higher rates for 2022-23



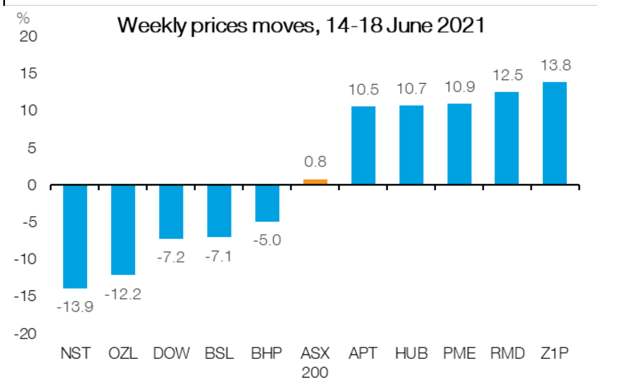
Source: Bloomberg, Vanda, June 2021

The initial reaction saw a sell-off in equities and commodities, a sharp move higher in the US dollar and a flattening of yield curves as short rates rose more than long rates.

The accompanying narrative was that the Fed has now signalled its intention to begin removing the extraordinary levels of monetary policy stimulus that have been a powerful tailwind for markets, starting with the tapering of its asset purchases sometime in early 2022 before raising interest rates in late 2023.

Closer to home, the implication is that where the Fed goes on short rates, the RBA usually follows and the same can be said for long bond yields. We think domestic investors can use a similar timeline for tightening in financial conditions. A blowout jobs report, with Australia's unemployment now at only 5.1%, has also seen a similar pull forward of expectations domestically.

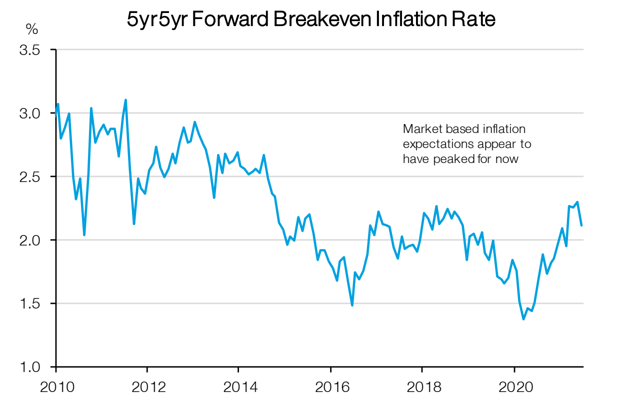
Growth stocks rebounded with commodities hit hard



Source: MWM Research, FactSet, June 2021

At some stage the cocktail of zero rates and central banks buying bonds to further suppress yields will come to an end. Emergency policy settings were put in place as a response to the global financial crisis and then failing to reach the conditions that would have led to an unwind of these measures over the following decade, were raised further as the COVID-19 crisis hit. If the intention was to restore economies back to full employment and inflation back up to target ranges, then the next few years should see this mission completed and so naturally comes with a reversal of policy - starting with plenty of forward guidance of what is to come.

Inflation expectations look to have peaked



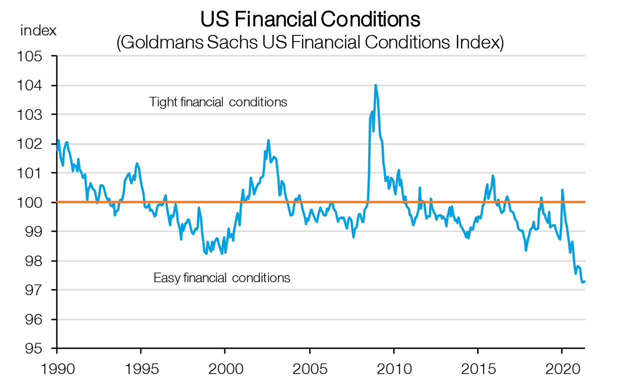
Source: Bloomberg, June 2021

How much should we fear rising rates? Rising interest rates and a higher cost of capital will hurt valuations for interest rate sensitive assets and drive potential losses across some areas of the fixed income market.

But, the fact that rates will eventually rise is not cause for panic as the initial price action last week might have suggested. At this stage the Fed has signalled its intent, but the first moves remain over 2 years away, in both the US and Australia. Between now and the end of 2023, we can therefore expect to see a combination of very positive developments including - stronger economic growth, further (and significant) progress in reducing unemployment and some increase - albeit still modest - in inflation.

If we don't get this combination then rate hikes will not proceed as expected and if this combination emerges faster than expected, then we'll see an acceleration in the rate hike timetable but for good reasons. In other words, fundamentals should get a lot better over the next 18-24 months before we get the first rate hike and while markets will begin to price in this eventuality much earlier (history says by around 12 months), the prospect of continued economic improvement means we still want to be overweight to equities as two years is a long time to sit on the sidelines.

Financial conditions remain very easy



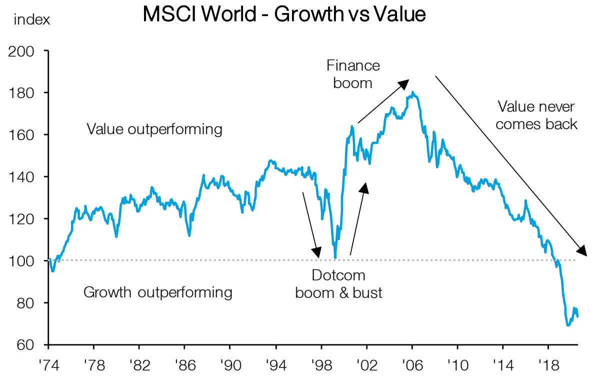
Source: Bloomberg, June 2021

Investors should not fear higher rates per se. They should fear policy makers getting behind the curve such that they have to tighten more aggressively than expected, or that they make a series of policy mistakes such as premature tightening or poor signalling, that causes market dislocation (like the taper tantrum in 2013). However, these are risks rather than our base case.

What does last week's announcements mean for positioning? We don't think last week's announcements amount to a whole lot. We now know that the Fed is prepared to remove the policy punchbowl but that this remains contingent on further economic progress which it expects is coming. We also know they are less concerned about the recent inflation spike and this was reflected in their modest inflation vis-a-via growth upgrade. This is consistent with the recent message from the market (including surveys) that inflation risks have likely peaked and are already factored into expectations. And last, we see the move by the Fed as now bringing it back into line with where market expectations for rate hikes were already sitting.

Stay overweight equities and avoid becoming overtly defensive. We think investors should remain overweight risk assets but we acknowledge that the window for outperformance is closing and is at risk of getting smaller. Similarly, the prospect of stronger growth and higher (but not high) inflation is more supportive of growth stocks than a scenario of stronger growth and high inflation which was previously an overhang for this group due to expectations that rates might need to rise further.

The value recovery has been shallow so far

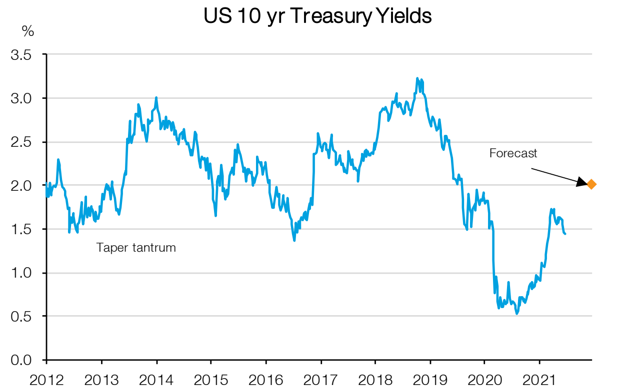


Source: Macquarie, FactSet, June 2021

Cyclicals and value stocks, while coming under pressure post the Fed's announcement, will still benefit from further earnings upside as economies reopen and temporary pricing power due to inflationary pressures. There is some pressure to add defensive exposure into equity portfolios - due to a slowing cycle and rising rates outlook - but we think this is at the margin rather than something to dominate stock selection.

It's premature to call an end to the cycle. We do not think the cycle has ended for equities and there is a long way to go before monetary conditions are considered "restrictive" and this should remain a reasonable backdrop for outperformance versus defensive assets. We have been recommending a split between value and growth and these developments continue to support this allocation split. Australian equities should remain supported by a strong domestically driven recovery on top of ongoing fiscal support and easy monetary conditions. Earnings for many cyclical sectors and those exposed to the reopening trade have significant upside potential over the coming few years.

Bond yields to creep higher



Source: Bloomberg, Macquarie, June 2021

We are underweight sovereign bonds / overweight credit and maintain these positions. We don't think bond yields are at risk of a major (disorderly) spike, but our expectation that they will rise alongside further cyclical improvement remains the base case and we see long rates between 1.80-2.00% by year end.

We have been overweight both commodities for leverage to the cycle and alternative assets as a hedge against public market valuation risk and volatility. Recent price action in hot commodities such as lumber, nickel and copper has taken the gloss off the sector due to falling inflation concerns and China policy moves, but we still think conditions for selected commodities remains positive, particularly those with a combination of cyclical and structural demand.

We stick with Alternative assets as both a hedge against adverse market moves and a rise in volatility. While this asset class remains somewhat untested for these conditions, we like the valuations discount on offer versus public markets.

We think investors should stay focused on the medium term, which is for gains in growth, earnings, employment and only a modest rise in inflation. The easiest gains for markets are in the past, but equities should continue to provide reasonable returns. It will pay to look through the noise in coming months and quarters and instead focus on the bigger picture which remains intact.

Macquarie WM Investment Strategy

The report was finalised on 20 June 2021.

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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