MarketSay"

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Bond market yields moved higher on shifting central bank rhetoric and the impact that policy normalisation might have on the future path of interest rates. Rising yields in the second half of the month took the shine off the recent equity market rally, where in August repeated record highs were recorded. Rising energy costs, driven by high demand and a shortage of supply further fed into the narrative that the high inflation prints seen in many economies, might be less transitory than first thought. The Chinese government continued to flex its regulatory muscle. This month, authorities decided they wouldn't intervene into the issues with Evergrande, one of the country's largest property developers which has been struggling to make interest payments having after failing key leverage tests.

Policy Watch: Central bank policy language has shifted. The US Federal Reserve had previously signalled and has now made clear, that the economy and labour markets are strong enough and inflation high enough, for a tapering of its bond purchasing program to occur before the end of the year. This was now paved the way for interest rate increases in the US as early as next year. The Bank of England has flagged that an interest rate increase may occur before the end of 2021 as inflation persists. The Bank of New Zealand's October meeting will be of interest with at least 25bps of hiking priced in by markets. The Reserve Bank of Australia however, continues to push back on market expectations for interest rate increases before 2024, despite a positive view on the economy once lockdowns in NSW and Victoria end.

Politics Update: Geopolitical tensions were again a feature in markets, with Australia entering into a submarine deal with the US and the UK, putting both the French and the Chinese offside. Locally, the inconsistent approach to reopening both state and international borders before Christmas despite high vaccination rate forecasts continue to hamper consumer and business confidence.

Vaccine Update: With the supply of Pfizer continuing to ramp up and the Moderna vaccine also now available in Australia, the vaccination rates of most states continue to increase at a fast pace. Those states currently battling outbreaks are becoming increasingly confident that well over 80% of their adult populations will be fully vaccinated well before the end of the year. The ACT, NSW and Victoria now appear to be pursuing their own reopening roadmap through October and November.

Inflation Watch: Inflation growth in the US moderated slightly this month, with some of the price rises associated with reopening easing somewhat. However, inflation in Europe continues to rise with German CPI rising above an annual rate of 4% for the first time since 1993.

Risk Budget: We had flagged last month that the northern hemisphere autumn is historically weak period for markets, and this has played out. The question now on our mind is whether the moderate sell-off in risk assets to date is more pronounced or a more of a shallow correction after a strong and sustained move higher. We maintain our view that the run into the end of the calendar year is likely to be more volatile as markets continue to digest central bank policy shifts.

Call to Action: Pull backs such as what occurred during late September are to be expected in rising markets. We saw several days where "buy the dip" investors came in to support equity markets. However, should we see sustained weakness we would view this as a potential buying opportunity. We believe that the economic recovery and in particular US corporate earnings growth are likely to remain robust and support valuations. As we flagged previously, we have so far not added to our Asian or emerging markets allocation but continue to look for a higher confidence around the China regulatory environment.

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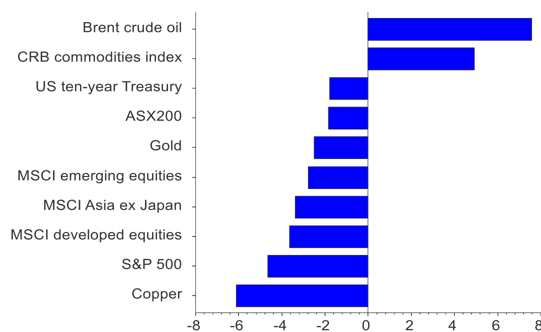
September Review

Energy and commodity prices headed higher while equity markets fell in September as bond yields moved sharply higher on hawkish central bank rhetoric. The US S&P500 index lost 4.7%, posting its worst month since March 2020, illustrating how strong the rally has been since the lows of last year.

Chart 1: September Asset Class Performance
Percentage Change (total return in local currency)



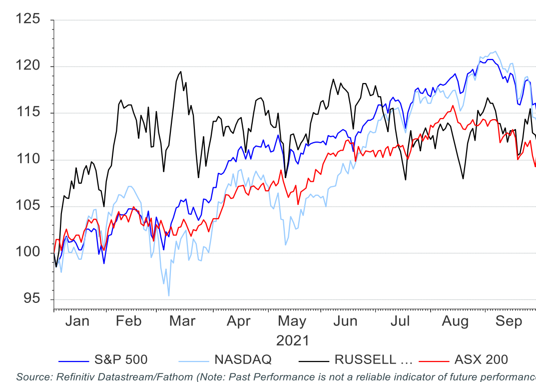
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

A pullback in the iron ore price drove Materials (-7.5%) to be the worst performing sector in the US. While Energy (8.7%) was the standout positive performer on higher oil prices. The tech focused NASDAQ composite declined 5.3 per cent in September, as higher bond yields undermined high growth names. The Russell 2000 fell a more modest 3 per cent for the month.

Some European equity markets fared a little better than the US, with the French market losing 2.3 per cent. The UK market, which has lagged the recovery in continental Europe, was almost unchanged for the month, losing just 0.5 per cent.

After months of underperformance the Japanese market rallied strongly after the Prime Minister resigned, with hopes for more stimulus and better management of Covid driving equities 4.8 per cent higher.

Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2021)

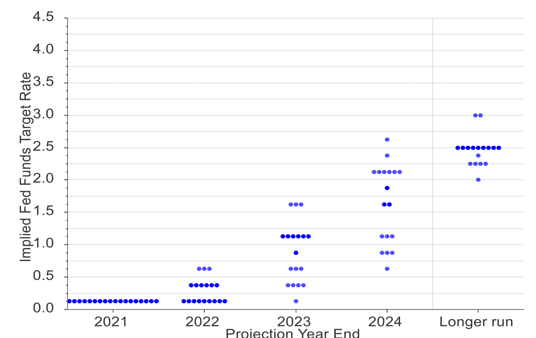


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The ASX200 lost 2.6% after hitting a record high in August. Energy companies enjoyed an incredibly strong rise (+16.4%), while utilities (2.3%), telcos (+1.6%) and financials (+1.6%) were places to hide. Materials (-12%) stocks were hit hard by falling iron ore prices, Health Care (-5.5%) and IT (-4%) were also poor performers. The market remains 11.3% higher year-to-date.

The US Federal Reserve met during September and confirmed that its bond purchasing program is on track to be reduced before the end of the year. This had been well telegraphed and was expected by the market. Fed Chair Powell confirmed that the FOMC believes that the labour market recovery and inflation were both strong enough to warrant removing some support from the financial system, in a gradual way.

Chart 3: FOMC Dot Plot



Source: Refinitiv Datastream / Fathom Consulting

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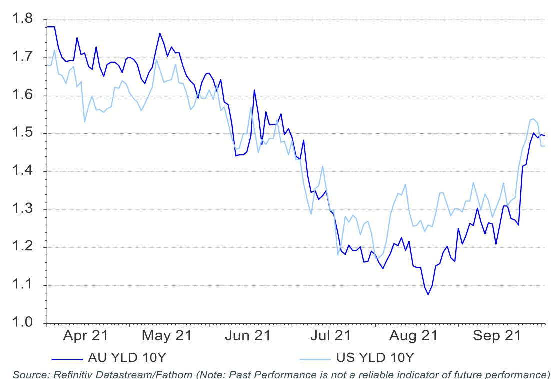
The much watched "dot plot" of committee members interest rate expectations was also released, with expectations for 2024 now featuring. Half of the committee now see a rate increase occurring in 2022. Subsequent Fed speakers have further added to this more hawkish rhetoric.

The Bank of England flagged in both in minutes and via committee speakers that an interest rate increase may be warranted before the end of the year. While the Reserve Bank of New Zealand is expected to hike in October. It is a different story in Europe with ECB President Legarde continuing to talk down inflationary impacts on the economy.

There was a muted initial reaction to the Fed meeting, however bond markets sold off during the second half of the month. There was no clear catalyst for this move, but we believe that concerted hawkish rhetoric from a range of central banks has been compounded by higher energy costs potentially leading to more persistent inflation.

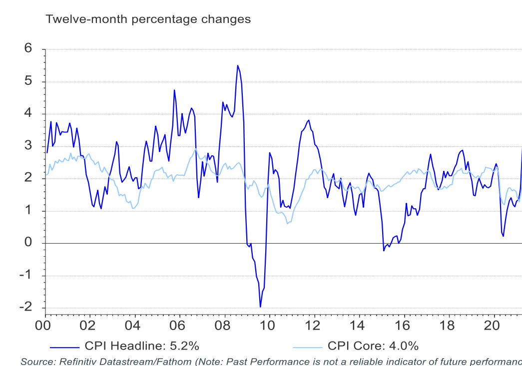
US Government ten-year bond yields ended the month 22 basis points higher than the end of August. With almost all that move occurring in just a matter of days in the last week of the month.

Chart 4: 10 Year Bond Yields (%)



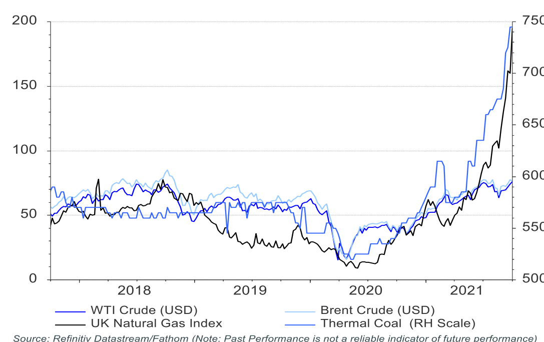
The market was expecting for US inflation to ease, and the US CPI came in weaker than expected (.3% v .4% expected) while the core reading rose 0.1%, well below expectations of 0.3%. Some of the key drivers of previous high prints moderated significantly with a 9.1% collapse in airline fares on the back of the Delta wave. Used car prices declined 1.5% in the month, the first decline since February. The German CPI was a tenth more than expected, rising 0.3% on its harmonized measure, to be 4.1% on a yearly basis from 3.4% last month (big base effects at play here). This is the first time Germany inflation has been above 4% since 1993.

Chart 5: US Inflation (CPI)



China again provided investors with a range of issues to digest. Rolling power outages have added weight to China's current growth challenges, on top of sporadic covid-related lockdowns and the regulatory crackdown in some sectors. Some China commentators believe that the domestic growth momentum will slow as China pivots away from maximising growth to an agenda focussed on social order and stability. A case in point is the potential demise of property developer Evergrande. Carrying a large amount of debt, the company has failed to make several coupon payments on USD denominated debt, with the Chinese Government so far refusing to step in with a bail out the company. Fears of contagion in the banking sector and nervousness on economic growth led to weakness in Chinese and Hong Kong Equity markets in September.

Chart 4: Oil, Natural Gas and Thermal coal prices



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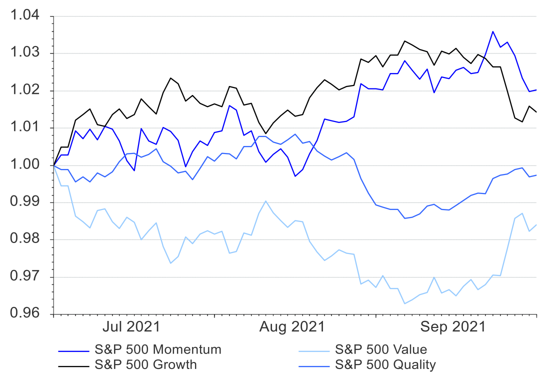
Higher energy prices were also a focus outside of China, with Europe experiencing large increases in natural gas prices as well as thermal coal. Oil prices continued to rise.

With bond yields rising, growth and quality were hit the hardest of the factors through the month. Value clawed back some of the ground it has lost in recent months, while momentum traded sideways.

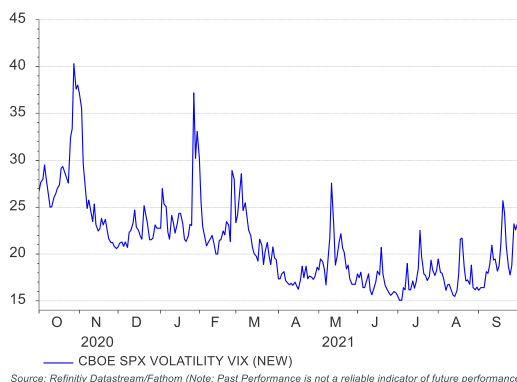
Chart 5: S&P500 Equity Factor Relative Performance (3 months)



Risk

The CBOE VIX index — a measure of investors' expectations for future volatility — rose from benign levels as the market sold off. The cost of put protection increased with volatility and as investors positioned themselves for a larger drawdown.

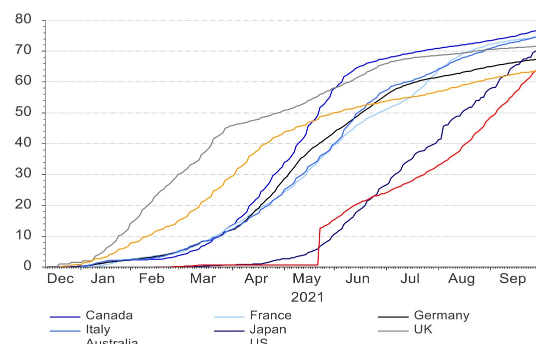
Chart 6: S&P 500 Volatility Index (VIX)



Outlook

In Australia, an easing of lockdown restrictions is getting closer for NSW and Victoria. Both states are expected to reach 70% of their adult population fully vaccinated during October, with NSW reaching 80% before the end of the month. Australia continues to play 'catch-up' with the rest of the developed world. The Commonwealth government has flagged it wants international borders reopened in November and will remove additional welfare support when the 80% double-dose vaccination target is met.

Chart 7: Vaccine Rollout (% of population with at least one dose)



The Iron Ore price has fallen rapidly from its heights, having a negative impact on the share prices of local miners such as BHP, Rio, and Fortescue. Steel production has been reduced in China due to high input costs and we believe that it is unlikely to bounce back quickly with softness to be compounded with holiday periods (China starts October on holidays for Golden Week) and "clear sky" initiatives in place in the lead up to the Beijing Winter Olympics in February 2022.

Chart 9: Iron Ore 62%/tonne & AUD (USD)

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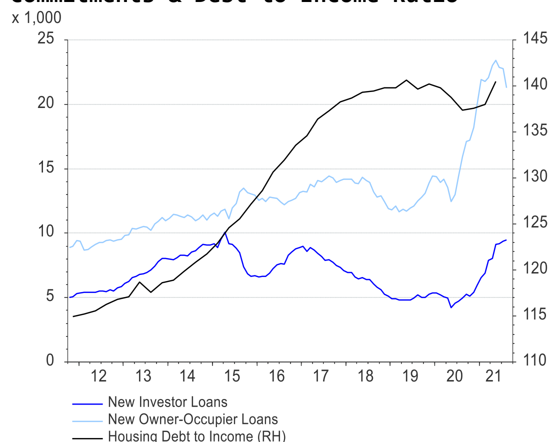
The Council of Financial Regulators (the RBA, APRA, ASIC, and Treasury) have formally discussed a potential tightening in macro-prudential policy. The banking regulator - APRA is set to release an "information paper on its framework for implementing macroprudential policy" in the next couple of months.

In contrast to when these types of measures were last introduced in Australia from late 2014 to 2017, the main concern does not stem from any deterioration in lending but rather the risks to the economy should credit growth continue to materially outpace growth in household income (i.e. debt to income ratios rising materially).

The last time these types of measures were introduced, house price growth moderately. With interest rates likely to rise at some stage, the RBA is likely to have concerns with households taking on too much leverage in the current environment. Taking some modest steps now to limit excessive price increases and gearing would appear a prudent measure for long term financial stability.

Chart 10: Australian Housing Loan commitments & Debt to Income Ratio



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Through October we will gain further insight into the health of the US economic recovery, with 3Q corporate earnings to be released. Expectations are high, so misses or disappointing outlook commentary is likely to be punished.

Despite the recent pullback in equities, we have maintained an overweight exposure to risk assets and feel reasonably positive on the outlook for the remainder of 2021. However, we believe and would reiterate that gains from here will be harder to come by. We maintain our view that volatility is likely to increase as higher prices persist, doubts about the transitory nature of inflation and further moves by central banks to normalise policy will at times be hard for markets to digest.

We are monitoring our risk allocation closely and believe that opportunities are likely to present themselves to adjust our portfolio positioning in the coming month/s.

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Sayers Capital Solutions Group

5 October 2021

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