US Equity markets recorded new record highs through the month as 3Q earnings gave the market comfort that some companies can pass on higher costs to consumers. However, this was not the story for all corporates, with many citing supply chain difficulties, labour shortages, and rising costs as headwinds for further earnings improvements. This came through in weaker than expected economic data in the US. Interest rate markets and bond yields made big moves as investors brought forward expectations of central bank policy action in the face of persistent inflation. Energy prices continue to be a focus, as does the regulatory environment in China.

Policy Watch: Central banks look set to hike earlier than expected in response to higher transitory inflation.

Politics Update: The upcoming United Nations Climate Change Conference (COP 26) in Glasgow dominated headlines towards the end of the month with many nations making new commitments to reduce emissions. The fallout from Australia's nuclear submarine continued to play on relations with France at the G20 Summit in Rome. China's rhetoric on a reunification with Taiwan, coupled with an increase of military activity in the Taiwan Strait and incursions into Taiwanese airspace threatened to escalate into conflict and continue to provide an ongoing concern for markets.

Vaccine Update: Victoria, New South Wales and the ACT all emerged from lengthy lockdowns in October as key vaccination milestones were achieved. After lagging much of the developed world, Australia is now predicted to become one of the most highly vaccinated countries in the OECD. With the rate of adults (16+) fully vaccinated reaching 80% in the most populated states in October, the same milestone is expected to be achieved in early November nationally. Focus is now on the states that are lagging and currently closed to travellers from VIC, NSW and ACT.

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. Australian CPI surprised on the high side raising the prospect of a move from the RBA before its stated 2024 guidance.

Risk Budget: US equity markets continued to hit new record highs through the month, recovering all ground lost in the brief sell-off last month and equity market volatility is trading at post-covid lows. However, bond market volatility has been rising as yields rise.

Call to Action: After running our risk levels well above peers in the market, we have now wound back our positions to a level more commensurate with normal market conditions. We have reduced our exposure to equities and reallocated to cash and short-duration credit. We believe this is a prudent move given the extraordinary run for risk assets since the depths of the pandemic sell off.

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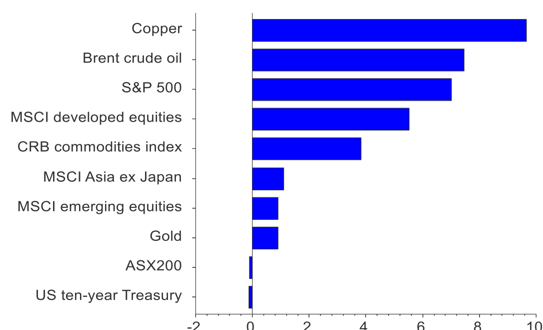
October Review

Inflation fears continued to build against a backdrop of a strong Q3 earnings season which is showing firms have some pricing power to pass on higher transitory inflation, about 82% of companies reporting 3Q earnings beating expectations. The US S&P500 index gained 6.9%, erasing September losses and is now up over 22% year-to-date.

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

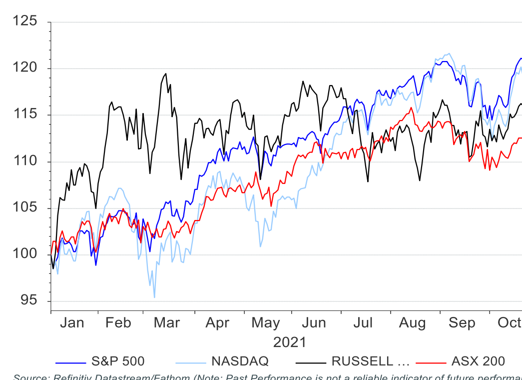


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The US Consumer Discretionary (+10.91%) sector posted a double-digit gain on the back of solid reporting updates. Energy (+10.18%) was again a top performer with companies reporting strong earning on the back of a strengthening oil price. The tech focused NASDAQ composite gained 7.3% with strong results pushing shares higher despite bonds selling off. The Russell 2000 failed to keep pace, gaining a more modest 4.2%.

Gains in Europe were more muted with the UK 2.13 per cent higher and France up 4.76 per cent. As Japanese voters return to the polls, the Nikkei bucked the global trend and lost 1.9 per cent for the month. Base metal and energy prices continued their move higher in October. Bond yields headed higher again as markets attempted to reprice when central banks are expecting to start increasing interest rates.

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

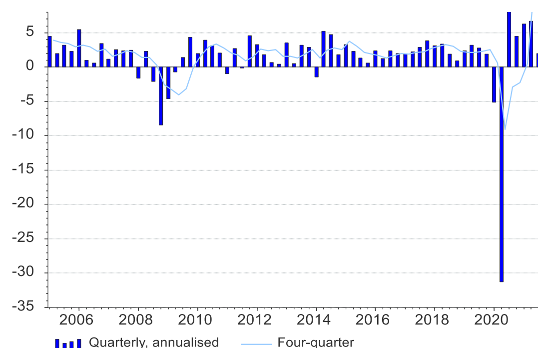


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The ASX200 finished broadly flat (-0.1%) with gains for the month erased on the last trading day of October. Gains in Diversified Financials (5.3%) and Capital Goods (5.15%) were offset by Industrials (-3.25%), Consumer Staples (-2.3%) and modest losses in a range of other sectors.

US industrial production for September missed estimates of +0.2% m/m by a long way at -1.3%. While the US is less exposed than most of the world to rising energy costs due to onshore oil production, supply bottle necks are still affecting its economy, particularly in sectors where there is a shortage of workers, raw materials, and semi-conductors. For example, US motor production fell 7.2% after a 3.2% slide in August, the sharpest drop since April.

Chart 3: US GDP Growth



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

These disruptions were also reflected in US GDP for Q3 and missed market expectations at 2% annualised, well below the 6.7% p.a. growth rate of

the previous quarter. Personal consumption was a drag on the number with supply bottlenecks, rising prices and the spread of the Delta variant weighing on spending. Consumer sentiment also failed to bounce after a week number last month.

US Core CPI came in line with expectations at 0.2% m/m, while Headline CPI beat at 0.4% m/m against 0.3% expected. Falls in used car prices (-0.7% m/m) and airfares (-6.4% m/m) offset higher rental inflation (+0.4% m/m) in the core category. The 'shelter' category, which makes up a ~40% weighting in core inflation, is now above 3% p.a.

US Consumer Sentiment survey revealed that 1yr ahead inflation expectation is at 4.8% its highest since August 2008. Respondents cited "net price increases" more frequently than any time since inflation peaked at over 10% in 1978-80.

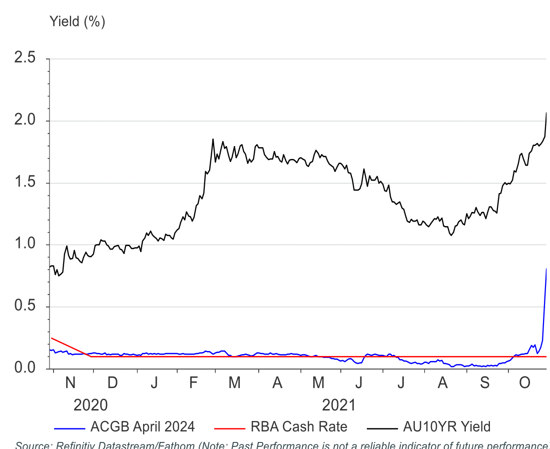
European headline CPI hit 4.1% yoy, its highest level since 2008, in part due to the recent surge in gas and energy prices in the region. Core inflation, which has not been above the ECB's 2% target for almost 20 years, jumped to 1.9%. The European Central Bank continues to explicitly state they believe this to be transitory.

Chart 3: Euro Area CPI (%)

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

Central banks look set to hike in response to higher transitory inflation. The Bank of England (BoE) Governor commented that higher energy prices will lead to longer lasting inflation and they must respond accordingly. Markets fully price a BoE rate hike by December 2021. US Fed pricing has also moved forward; there is now a 50% chance of a June 2022 rate hike and a hike fully priced by September 2022. The Bank of Canada surprised with an immediate end to its QE program and revised its forward guidance on when it would achieve its inflation target to the middle of 2022, from the end of 2022. The market was already well priced for a series of rate hikes next year, but bond yields rose in response.

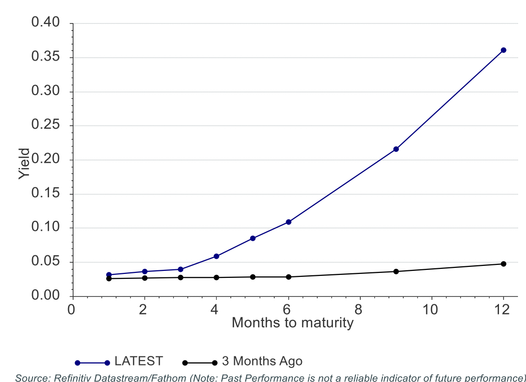
Chart 4: RBA Cash Rate, 3 & 10 Year Bond Yields



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

The Reserve Bank of Australia (RBA) has stepped away from its Yield Curve Control program. It did not purchase any bonds in the last week of the month and therefore did not enforce its target 0.1% yield target for 3-year yields. The RBA's decision not to enforce the target, coming off the back of higher-than-expected core inflation, led to renewed speculation the RBA may change its forward guidance at its Cup Day meeting and drop the Yield Curve Control policy.

Chart 4: Pricing of RBA Cash Rate (OIS)



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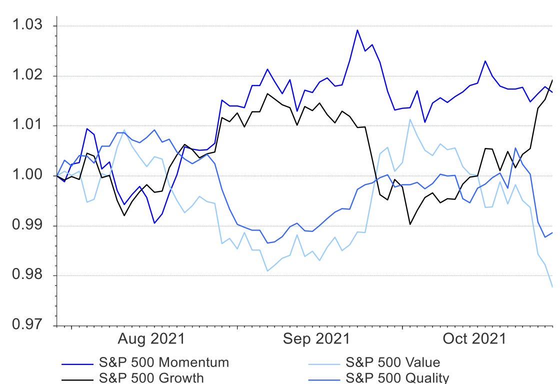
The April 2024 bond closed October above 0.80% (a long way from the target rate of .10%). With the RBA not defending this target, the market is questioning the credibility of the bank's guidance, forecasting they would leave the cash rate on hold until 2024.

China economic activity data released during the month was mostly on the weaker side of expectations, with GDP growth of 4.9% yoy. The Chinese economy is facing several headwinds, including lockdown restrictions alongside its zero-tolerance for COVID19 outbreaks (which is also severely impacting global supply chains), a weaker property sector and rising energy costs which has seen widespread power cuts and factory closures.

China's property market is still in focus, despite Evergrande meeting its USD Bond obligations, paying a couple right before the extended deadline.

Growth was a standout performer in October with some mega cap tech names rising sharply on strong earnings. Despite the fears of inflation and rising bond yields; value underperformed. Quality reversed its recent robust performance, while momentum remained a dominant factor in the US market.

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

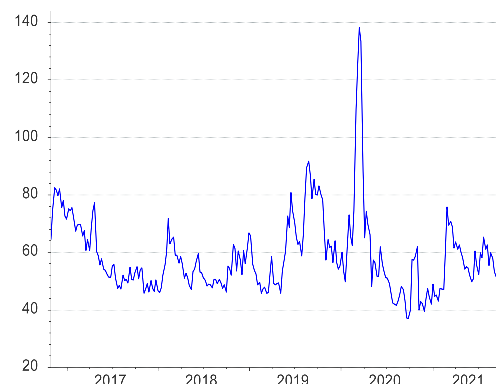


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

The CBOE VIX index — a measure of investors' expectations for future volatility — hit its post-covid lows as the market rose to new record highs. However, with the move higher in bond yields, short-term bond volatility rose sharply.

Chart 6: US bond Volatility (MOVE Index)



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

Outlook

After running our risk levels well above peers in the market, we have now wound back our positions to a level more commensurate with normal market conditions. We believe this is a prudent move given the extraordinary run for risk assets since the depths of the pandemic sell off.

While there are some signs of stress entering the system, they are only very minor at this stage. The vast bulk of indicators we watch closely are all favourable for risk assets continuing to perform. Historically, November and December are quite positive months for risk assets as the 'Santa Rally' leads markets out of usually soft patch in September and October. This year, we enter the period already at new market highs, as the shallow September pullback was quickly overwhelmed by investors buying the dip.

The broad positives we have been focussing on remain intact. The global economies are still recovering from the pandemic and more international economies are returning to normal as their vaccine levels rise (and approach herd protection levels). Australia is in this camp, with NSW, Victoria and the ACT now open to international travellers seamlessly for the first time since early 2020.

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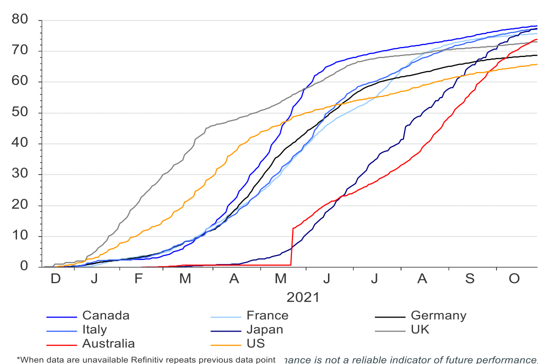
Chart 7: Vaccine Rollout (% of population with at least one dose)



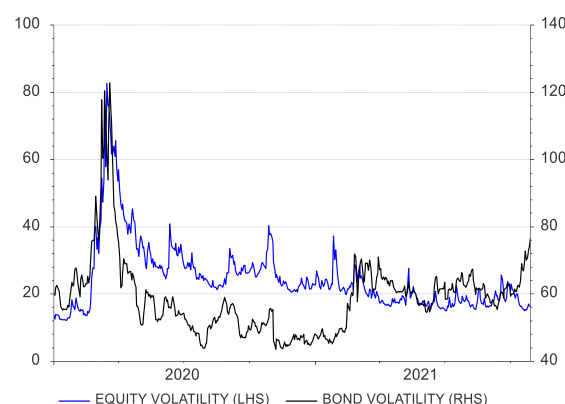
The corporate outlook for the next 6-9 months remains positive. Corporate earnings are still trending in the right direction, and in the US the Biden Administration seems to have abandoned plans to raise the corporate tax rate to 28 per cent or even a more compromised 25 per cent. Mergers and acquisition activity remains robust and bond yields have risen only a little given the big increases in inflation caused by supply chain disruption.

The argument on whether inflation is transitory or more permanent continues – but for now the bond market seems to believe that its transitory or the Federal Reserve can quickly rain in conditions should they need to move more aggressively. The curve has continued to flatten as we approach the inflexion point for policy – as central banks ramp up tapering (reduce the amount of money printing) and begin the task of normalising cash rates from the extreme pandemic levels.

So why reduce risk now – what are the indicators that increased our caution into year end?

Firstly, central bank's policy is clearly about to change in a more meaningful way. Fiscal and monetary support for markets has started to wind back and there is more to come. While policy makers will endeavour to have a smooth transition to a normalised environment, the risk of a policy mis step, misjudgement by markets and higher volatility are increasing. We are seeing volatility in the bond market spike while equity market participants are more relaxed. This can change quickly.

Chart 8: US Equity v Bond Volatility



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

Risk and asset class relationships are changing. The rally in equity markets in October was narrower than we would like to see, and we have seen some temporary periods where liquidity and market depth and is not as deep as people have come to expect. We are monitoring our risk allocation closely and believe that market moves are more evenly balanced than they have been for some time. Opportunities to add or reduce risk are just as likely to present themselves in the coming weeks and we remain ready to adjust our portfolio positioning accordingly.

James Wright and Luke Hansen
Sayers Capital Solutions Group

2 November 2021

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