MarketSay"

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April was a difficult and volatile month for almost all asset classes. Equity markets are attempting to price a potentially lower global growth outlook stemming from inflationary pressures, monetary policy response, Russia's invasion of Ukraine and China's zero covid policy. Bond yields continue to rise as more central banks get more aggressive on monetary policy, both via actions and words.

Policy Watch: The hawkish rhetoric from US Federal Reserve members continued, preparing the market for consecutive hikes of 50bps in May and June. The Bank of New Zealand did hike by 50bps in April, while the RBA is expected to move in May along with the Bank of England. Finally, a pivot appears to be slowly occurring in Europe, with a July rate increase now also being priced into market expectations.

Inflation Watch: The conflict in Ukraine and sanctions against Russia continue to impact energy and commodity prices, while the continuation of China's covid-zero and associated lockdowns are further impacting already disrupted supply chains. While these pressures are starting to ease slightly and base effects in inflation data suggest that peak CPI numbers in the US may now be behind us, inflation is unlikely to fall away dramatically, and will be front of mind for investors and policy makers alike.

Risk Budget: Bond market volatility remains as elevated as in the early days of the covid-19 pandemic. While equity volatility again spiked to similar levels experienced in the March sell-off. Large intraday swings in equity markets and large market draw-downs, make building investor confidence difficult.

Call to Action: Although this is hard to judge we believe that most of the rise in bond yields and the damage done to equity valuations are both close to be done. Concern around the strength of corporate earnings growth is likely to linger, however should we see inflation pressures moderate in coming months as expected we believe that confidence is likely to return, market volatility subside, and a more positive view of growth assets return. Opportunities can be powerful and short lived in this environment, it will pay to be nimble around a long-term asset allocation strategy.

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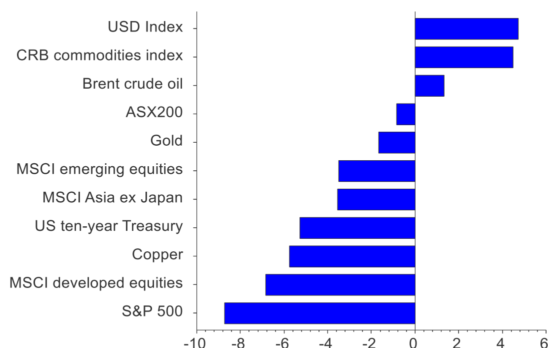
April Review

Equity markets came under pressure in April, as a combination of rising inflation fears, the ongoing conflict in Ukraine and lockdowns in China fuelled concerns of a slowdown in economic growth. MSCI World dropped 8.4% in USD terms for the month, largely driven by the S&P 500 which fell 8.8%. Australian equities held up relatively well declining 0.9% over the month, protected by a smaller index weighting to IT companies.

Chart 1: April Asset Class Performance



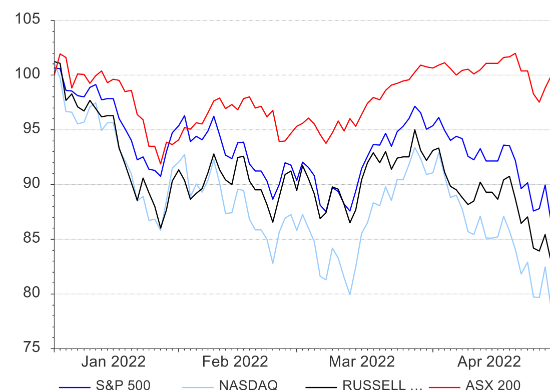
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Bond markets saw material moves through April, as Australian 10-year yields sold-off 30bps to 3.12% as investors priced in aggressive rate hikes beginning at the RBA's May meeting. US 10-year yields backed-up 56bps to 2.89% off the back of rising inflation fears and further Federal Reserve rate hikes. Brent Oil climbed US$1 to US$109/bbl while Iron Ore prices dropped US$11 to US$142/Mt as markets priced in a potential demand shock from China.

In Australia, the Utilities sector (+9.3%) was the strongest performer, as investors seek predictable cash flows and a hedge against inflation while Transportation (+5.4%) also outperformed as travel bounces back. The IT sector (-10.3%), Materials (-4.3%) and Consumer Discretionary (-3.1%) sectors all underperformed erasing strong gains in March.

The S&P500 fell for four consecutive weeks in April. US Consumer Discretionary stocks lost 13% in April, with the Financial (-10%) and Technology sectors (-11.3%) also hit hard. The Nasdaq had its worst month in a decade, losing 13.2% to be 21% lower year-to-date, its worst start to a year on record. A look at the big US tech companies' performance shows Netflix dropping 49% in April. Nvidia down 32% and PayPal -24%. The FAANG stocks collectively lost more than $1 trillion in market value in April.

Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2022)



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European (Stoxx 600 -1.1%) and Japanese markets (Nikkei -3.5%) fared better given lower technology exposures. These, along with Asian equities where we recently increased our allocations versus US Equities, held up well in comparison.

The vast majority (~80%) of US S&P500 companies that had reported quarterly earnings by the end of April beat consensus estimates, yet it is the 'misses' from some of the high profile/household names that are having the bigger impact on the overall stock market performance and investor sentiment. Weak or conservative outlook commentary from companies citing rising costs and supply chain issues have been punished. There are concerns that corporate earnings, however strong now, might tail away in the face of strong inflation, supply chain issues and economic headwinds stemming primarily from the ongoing war in Ukraine and China's Covid-Zero policy.

Should the current level of US Equity and Bond markets be maintained until year end, 2022 would mark an extraordinary year where both Equities and Bonds deliver negative returns.

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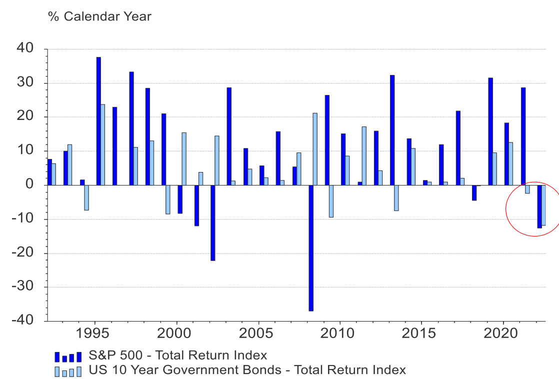
Chart 3: US Equity & 10yr Bond CY returns



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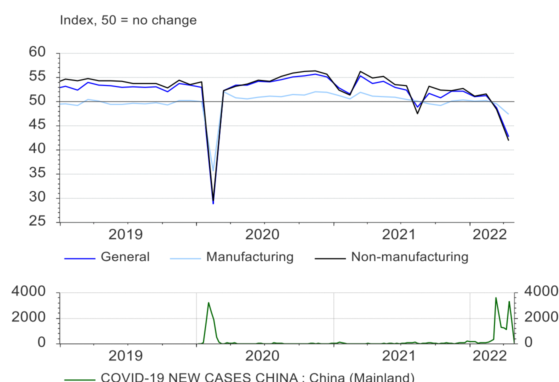
News form China throughout April was mostly negative. Shanghai remained in a strict lockdown, with quarantine centres separating covid-positive people from their households. Recent reports of case numbers dropping have been encouraging but has been little help to sentiment, nor able to erase the damage being done to the economy or the pressure being placed on already disrupted supply chains. China saw sharp declines in PMIs in April, especially on the services side of the economy. All numbers were below 50 indicating that manufacturing and services output were all shrinking versus previous readings.

Chart 4: Chinese PMI & New Covid Cases

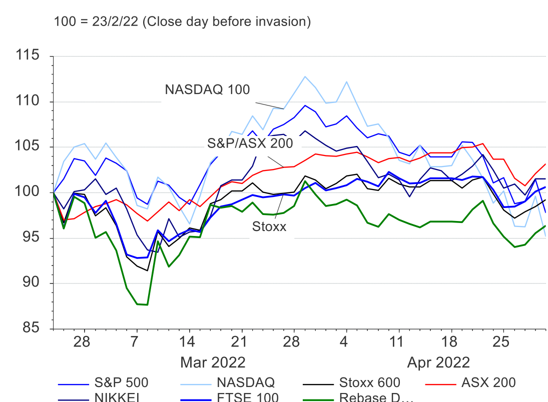


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Markets also focused on weaker than expected Retail Sales figures (-3.5% y/y vs. -3.0% expected) instead of the better than expected but now outdated pre-lockdown Q1 GDP (1.1% q/q vs. 0.7% expected). A sharp Chinese economic slowdown in the second quarter remains a realistic outcome at this stage with consequences for global growth.

Towards the end of the month Chinese policymakers continue to make more noises about providing support to the economy. A statement from the Politburo vowed to introduce policies to meet the country's ambitious 5.5% annual growth target while promising to "strengthen infrastructure construction in an all-around way". For now, however, there has been a lot of promises with very little real support for the economy. Given it is still very unclear when China will pivot away from its zero-Covid policy, it is difficult to see how any stimulus will help given the widespread lockdowns across the country.

Chart 5: Equities since Russian Invasion



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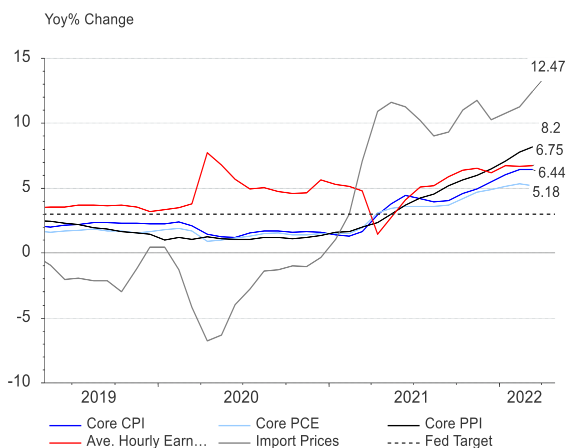
The Ukraine war remains another major headwind for risk appetite. With the conflict shifting to the east of the country, there has been no progress made on peace negotiations. Russia is attempting to annex the entire southern coast of Ukraine, cutting off its access to the sea. With the Russian military performing poorly against a motivated and NATO equipped Ukrainian defence force, the result is likely to be a significantly longer conflict than first envisaged. Russia has stopped supplying gas to Bulgaria and Poland. Russia supplies about 40% of gas to Europe with a substantial portion of this goes to Germany and Italy. The German government has estimated that its economy could shrink 5% if Russian gas were halted.

The market remains focused on the current inflationary pressures. US CPI Headline inflation rose 1.2%m/m and 8.5%y/y. Gasoline prices, up 18.3% drove much of the increase. However, the core measure slowed, due to a reversal of the used car prices (-3.8%) but are still up 35.3% over the year. Elsewhere, airline fares (+10.7%) and lodging away from home (3.3%) rebounded from Omicron impacts. Base effects should begin to put downward pressure on future numbers from next month, suggesting the peak in the CPI numbers may now be

behind us. But with the broad-based price increases and tight labour markets, a dramatic fallback is the CPI prints appears unlikely.

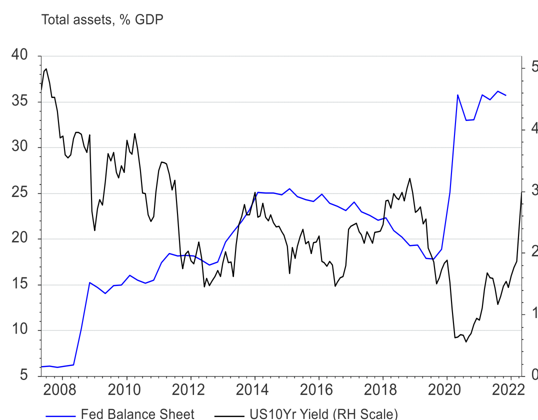
Chart 6: US Inflation Measures



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

Minutes of the March FOMC meeting revealed that "many participants would have preferred a 50 basis point increase in the target range for the federal funds rate at this meeting", had it not been for the uncertainty triggered by the war in Ukraine and that "many participants noted that one or more 50 basis point increases in the target range could be appropriate at future meetings." Markets are pricing in a near certain 50bp increase in May, another in June, with the chance of a 75bp increase also possible. Markets now expect the Fed Funds Rate to hit 3% by February next year.

Chart 7: Fed Balance Sheet & Bond Yields



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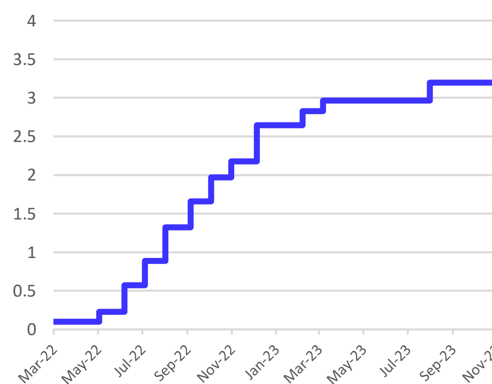
May appears to be the starting point for the Fed's balance sheet reduction. Monthly caps of about $60 billion for Treasury securities and about $35 billion for agency Mortgage-Backed Securities appear to be likely. This compares with a rate of $50bn in 2017-2019, a rate that was only achieved a year after the process of balance sheet reduction commenced.

Elsewhere in April, European Central Bank officials continued to edge open the door to a rate rise as soon as July after leaving setting unchanged. The Reserve Bank of New Zealand became the first G10 central bank to lift rates in the post-pandemic cycle and the first to do so by 50bps – quickly followed by the Bank of Canada. UK money markets are flirting with a 50bp increase from the Bank of England when it next meets on 5 May.

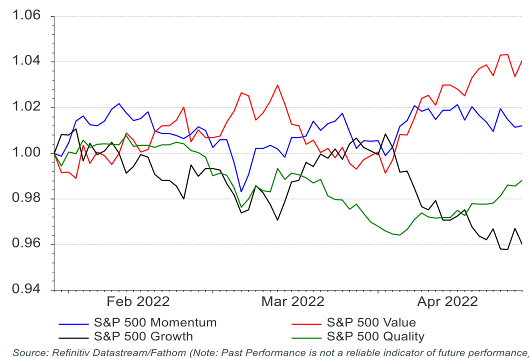
Chart 8: Implied RBA Cash Rate



A stronger than expected Australian Q1 inflation print has paved the way for the Reserve Bank of Australia to lift rates. Headline CPI came in much stronger than expected, at 5.1% y/y (vs 4.6% exp) while the RBA's preferred measure, the trimmed mean core inflation measure was 1.4% higher on the quarter (3.7% y/y). This is significantly higher the RBA's most recent 0.8% forecast. With the RBA's preferred core inflation measure now well above the top of its 2-3% inflation target range, markets expect the RBA to lift rates in May.

Both value and growth traded sideways through April, with both enjoying periods of strong rallies and drawdowns. Quality rose significantly as investors looked to reliability of earnings and companies with strong balance sheets. Momentum took a modest hit.

Chart 9: S&P500 Equity Factor Relative Performance (3 months)

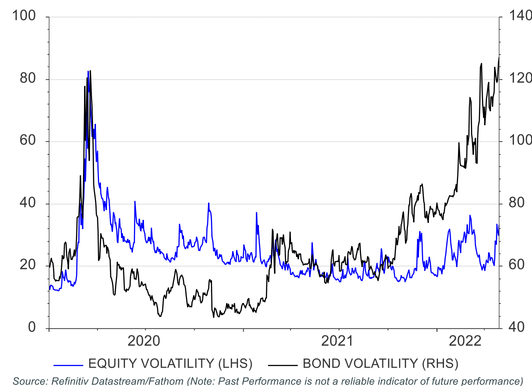


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

Bond volatility continues to trade at extreme levels, not seen since the early days of the Covid-19 pandemic. Equity volatility rose during April to trade at similar levels seen in the March sell-off.

Chart 10:US equity & bond Volatility (MOVE)



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

Outlook

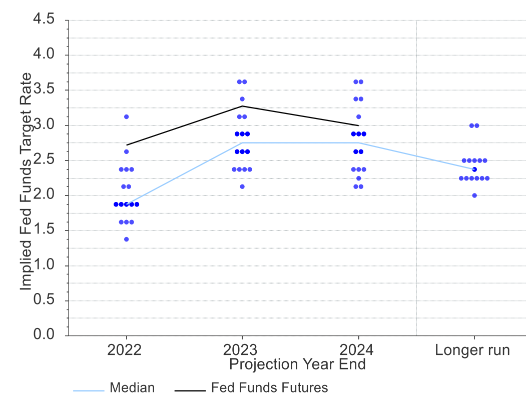
Persistent inflation and fears of a policy induced slowdown are now undermining confidence in equity market earnings estimates and valuation metrics.

The fundamental question being imposed on markets is what level of interest rates will be required to bring inflation levels back into central bank's target ranges. Many pundits are arguing that cash rates will have to go above neutral to soften demand and bring more balanced demand to product and services markets. The pace of quantitative tightening through central bank balance sheet reduction is making this cycle more difficult to judge.

The war in Ukraine and the zero covid tolerance policy in China is adding to supply uncertainties. While supply disruptions are likely to persist through the rest of 2022, we are now starting to see some signs in air and sea shipping that logistics is at least turning the corner.

While the chance of a policy mistake is high, central banks do not actively look to create recessions. Despite market spending their time trading every nuance, central banks have a broad tightening picture in mind (as indicated by the dot plots) but look at the situation at every meeting on its merit – weighing up the risk reward of action against the consequences.

Chart 11: US FOMC Dot Plot

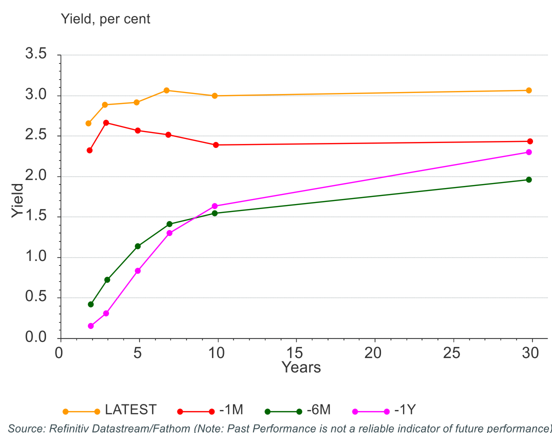


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Where the neutral cash rate sits is open to debate. The broad system now has significantly more leverage than previous cycles, the level required to drive a reduction in demand may not be as high as

many forecasters would think. While long bond yields have pushed higher, with 10-year yields now around 3 per cent, bond curves are flattening at lower levels than would be expected given the current inflation prints. The bond market implies a slowdown in economic growth is imminent because of the expected front-loaded cash rate moves.

Chart 12: US Yield Curve



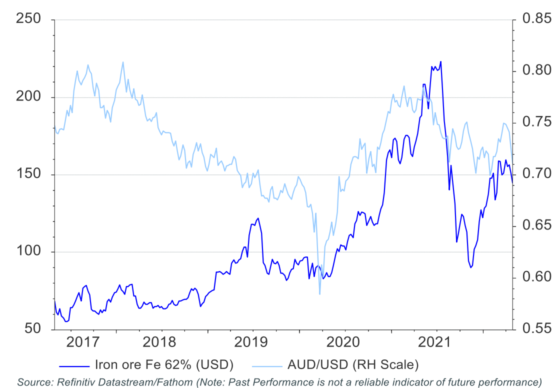
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

High multiple equities have suffered decent repricing in the first four months of the year, and with little confidence in the outlook – volatility is expected to remain high for the next few months. The defensive sectors like staples and the more inflation beneficiaries like energy, material and financials have outperformed and are likely to continue to attract haven rotation flows looking for a safe haven within equity markets. Private markets continue to attract investors who get some comfort from the perceived lack of volatility in monthly pricing.

Many commentators are now drawing parallels with the period of 2001 and 2002 following the Tech Wreck. No revenue and high multiple businesses have been punished. Flows out of equity markets have been significant over the past year, sentiment indicators are at bearish levels, and major technical support levels appear well below the prevailing market level. In this environment it difficult to judge whether a market bounce signals we have reached a turning point or is just another violent bear market rally.

The outlook hinges on how quickly inflation returns to the band. Financial conditions are tightening with lower equity prices and a stronger USD. Despite strong energy and commodity prices, the commodity currencies like the AUD have been week over the past month.

Chart 13: AUD & Iron Ore Price



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

In this environment – it will pay to be nimble around a long-term asset allocation strategy. Opportunities can be powerful and short lived. However, after such steep falls in risk assets already, we will be looking for signs that inflation is coming under control and market volatility moderates and confidence in growth assets can return.

James Wright and Luke Hansen
Sayers Capital Solutions Group

4 May 2022

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