July brought investors some relief from volatile markets, as equities rallied. Investor sentiment improved on the back of better than feared backward looking corporate earnings reports in the US and a dovish interpretation of comments from the US Federal Reserve. Inflation remains a key focus for market participants with data again showing that prices continue to rise rapidly. Central banks continued to aggressively hike interest rates and talk tough, in an effort to bring down inflation expectations, soften labour markets, ease wage pressure and reduce consumer spending.

Policy Watch: The European Central Bank joined other developed market policy makers by aggressively hiking during the month. While the market was prepared for this, it was the first time European rates have moved out of negative territory since 2014. The RBA hiked by 50bps, the US Fed by 75bps, the Bank of Canada by 1% and the RBNZ by 50bps. We expect hawkish rhetoric to continue from central bankers over the coming weeks, especially those from the US Federal Reserve, in an attempt to walk the market back from its dovish interpretation of the FOMC's most recent 75bp hike.

Inflation Watch: Inflationary pressures are failing to moderate. Higher energy prices, tight labour markets, food inflation and disrupted supply chains continue to influence data. US Corporate Reporting season and economic data now suggest that higher prices are starting to impact consumer's spending habits and their confidence.

Risk Budget: Volatility eased for both equities and bonds during July. Equity markets rallied fairly consistently, while bond markets spent most of the month stuck in a trading range – albeit volatility here remains high versus historical numbers.

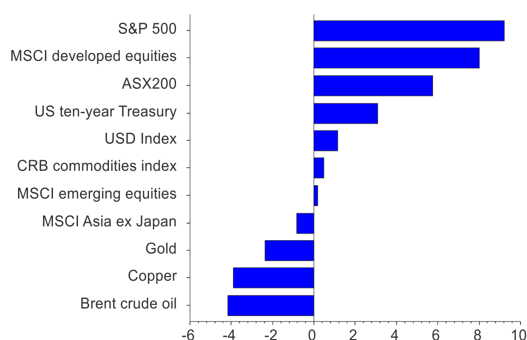
Call to Action: We have consistently been of the view that investors should remain active in 2022 and fade strong equity market rallies. We have again reduced our equity exposure into the market strength we saw during July. Despite the strength of corporate earnings, we are starting to see downgrades for future periods come through as well as weaker outlook commentary that points to slowing consumer demand and tighter margins driven by increased costs. We believe that there remains upside rise to global bond yields as central banks continue to talk tough on inflation and move aggressively to take the heat out of demand. In our view, it is too early to be bullish equities given the stickiness of inflation prints and the risks to the global economy that they pose.

Date of Publication: 5 August 2022
Sayers Wealth Pty Ltd | ABN 61 642 217 007 | AFSL No. 525093

July Review

Global equities rebounded in July, driven by a positive US reporting season and US GDP contraction which softened investor expectations of the steepness of future rate hikes. The MSCI World rose 8.0%, driven by a strong month for the S&P 500 which gained (+9.2%) in USD terms. The S&P/ASX 200 underperformed but still lifted (+5.7%) over July, driven by Mining and Energy stocks.

Chart 1: July Asset Class Performance



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

The Australian 10-year yield dropped by 60bps to 3.06%, US yields also dropped 33bps to 2.64%. Brent Oil prices declined US$5 to US$110/bbl as bans on Russian shipments are delayed. Iron Ore prices also dropped US$5 down to US$118/Mt as Brazilian shipments hit record highs and demand remains soft. Gold saw large falls as prices fell by US$60 to US$1,753.

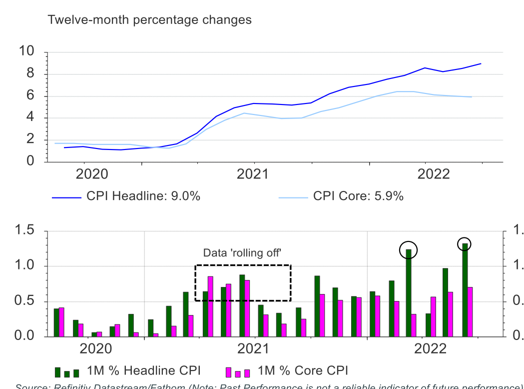
Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2022)

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

Despite equity markets bouncing back in July, recession fears certainly haven't gone away and markets remain pessimistic. Bank of America's Fund Manager Survey showed investors' equity allocation was its lowest since the GFC while cash levels were at a more-than 20-year high, indicative of a very cautious stance towards risk assets.

US economic data continues to underscore the challenge facing the Fed. Inflation continues to rise, while growth is moderating. Headline CPI printed at 9.1% against a rise to 8.8% from 8.6% expected. While the 1.3% monthly rise was driven by a 1% rise for food prices and 11.2% jump in gasoline, core CPI also exceeded expectations. By now, the market had expected large prints from last to roll off and replaced by lower monthly increases, this is clearly not playing out.

Chart 3: US CPI



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

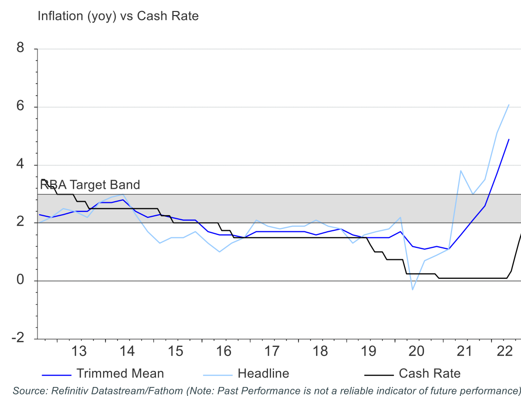
The U.S GDP print showed 0.9% decline in the second quarter, backing up from the negative 1.6% in the first quarter and it's not obvious they will bounce back in Q3. Two negative quarters forms the technical definition of a recession. However, in the US the National Bureau of Economic Research is the body that makes the final decision on whether the economy is officially in recession.

The FOMC hiked 75bp, taking the target range to 2.25-2.5%. Guidance remained unchanged that ongoing increases in the target will be appropriate with the most recent dot plot implying rates of 3.25-3.5% by year end. Powell didn't rule out another 75 hike in September, but said rate decisions would be data dependent. He also said that growth needed to slow below potential, and that the natural rate of unemployment is higher and the job market needed to soften. Markets rallied as the commentary was

less hawkish than feared latching on particular phrases; "we're getting closer to where we need to be" after front-loading hikes and that "at some point it will be appropriate to slow down". Market pricing to year-end is in line with the June dots but has around 50bp of cuts priced in over 2023. The median FOMC participant projection in June saw the fed funds rates ending 2023 higher than 2022.

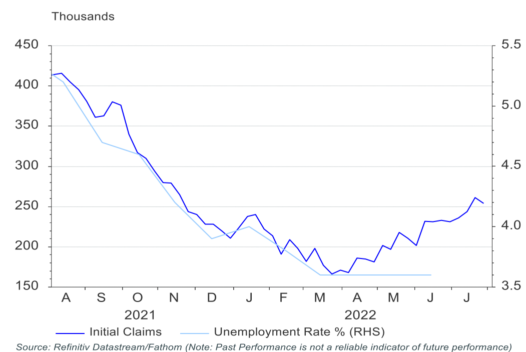
Australian inflation data printed broadly as expected, but importantly failed to provide the upside surprise that the market was fearing. Headline CPI came in at 1.8% q/q and 6.1% y/y and the more closely watched core trimmed mean measure rose 1.5% q/q which was exactly in line with consensus. Inflation in Australia is starting to reflect the same pressures seen elsewhere with trimmed mean inflation at its highest quarterly rate since 1990. This should keep the pressure on the RBA to continue to move quickly towards a more neutral setting of policy after hiking by 50bps in July. The RBA is trying to chart a credible path back to its 2-3% inflation rate, and while market pricing for future hikes eased somewhat during July, traders continue to question whether the RBA is too far behind the curve.

Chart 4: Australian CPI v Cash Rate



US Corporates updated the market on 2Q earnings throughout July, 75% of firms reporting to the end of the month had so far have beaten estimates. Technology firms on the whole reported results that largely beat expectations, but signs of declining margins on rising costs pressure were evident. Energy stocks largely reported strong earnings growth on higher oil price, while discretionary retailers were very mixed as inflation starts to reduce consumers capacity to spend on non-essential items. This is also being reflected in economic data as the Conference Board US consumer confidence measure fell to a 17-month low.

Chart 5: US Initial Jobless claims v Unemployment Rate



Weekly initial jobless claims are now trending higher, with companies now looking to reduce hiring. During July, Google said a two-week pause in hiring was needed to allow the company to review headcount needs and "align on a new set of prioritized Staffing Requests for the next three months.". This follows layoffs or hiring slowdowns at other big tech firms including Tesla and Apple as companies brace for a possible recession. Ford said it plans to cut as many as 8,000 jobs.

Chart 6: Energy prices rising again in Europe

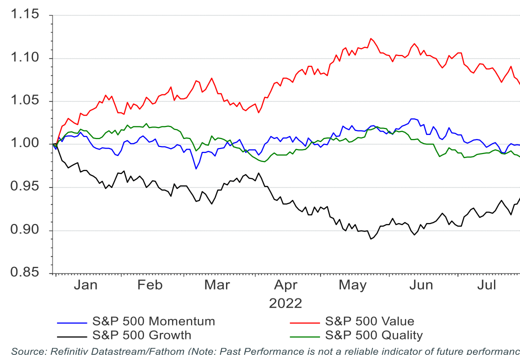
The energy crisis is starting to impact the EU economy, despite GDP exceeding expectation, Services and Manufacturing PMIs in Germany fell below 50 while the European Composite PMI fell from 52 to 49.4. Readings below 50 indicate activity is contracting with the sub 50 move in Germany, not a great sign for its economy. The EU agreed voluntarily cut their gas usage by 15% from 1 August through next winter, in anticipation of a complete halt of Russian gas supply. Gasprom is about to cut supply via Nordstream to just 20% of capacity,

increasing the chance of gas shortages later in the year. Reduced gas consumption now might help Europe to refill storage, ahead of winter, but that might still not be enough to get through winter without power rationing.

Elsewhere the focus continues to be on China where two headwinds are becoming more evident. China's zero covid policy is taking much needed momentum out of the economy. Q2 GDP fell -2.6% in the quarter (-2% expected) with the annual growth rate slipping to just 0.4% y/y. The government's 5.5% annual growth target appears now out of reach and given the zero-covid policy stimulus is unlikely to gain much traction right now. China's official PMIs came in weaker than expected. The Manufacturing PMI fall back into contraction territory at 49.0 from 51.2, sharply softer than the 51.4 expected.

All factors traded sideways last month, although Growth made a small come back with the stabilisation of bond yields.

Chart 7: S&P500 Equity Factor Relative Performance (YTD)

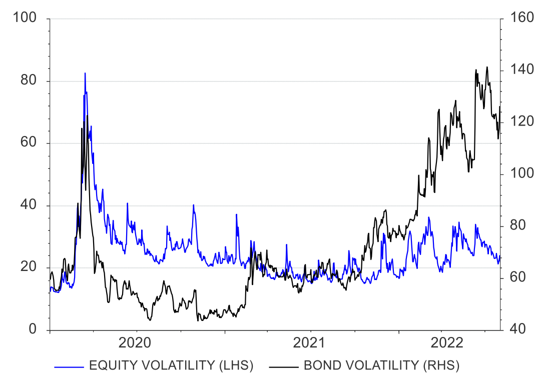


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

Equity market volatility dropped in July as markets rose. Bond volatility continues to remain elevated by historical measures but did ease last month as bonds found a trading range.

Chart 8:US equity & bond Volatility (MOVE)

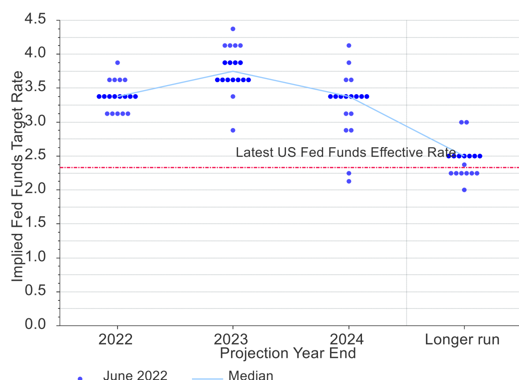


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

"Don't fight the Fed" is a saying in markets that encourages participants to invest in accordance which the policy direction the US Federal Reserve is pursuing. Since the start of 2022, the Federal Reserve has pivoted to targeting a higher and more persistent inflation concern. The substantial increase in the Federal Reserve Funds rate has been designed to tighten financial conditions and lower aggregate demand. However, the strong rally in both bond and equity markets in July is running completely counter to that objective. By anticipating a short sharp cycle and cuts to policy in 2023, financial markets have jumped the gun to price in easier conditions next year and have in effect loosened current financial conditions.

Chart 9: FOMC Dot Plot



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

We fully expect that the Federal Reserve message will be that cash rates will need to maintain at restrictive levels for an extended period in order to get inflation trending down to more comfortable levels. The market seems to be underplaying the risk to the earning outlook, and we still believe that earnings downgrades are more likely in the second half of 2022.

The wild cards in the outlook remain the Ukraine situation and the Covid Zero policy in China. There appears little progress in the Ukraine conflict and the risk of gas shortages in the upcoming European winter remain pronounced. Europe is struggling with the supply side constraints that become apparent since the Covid rebound (labour and resource shortages), but its dependency on Russian gas is triggering grave concerns for a more pronounced economic slowdown later in the year.

China continues to pursue a Covid Zero Policy, with rolling lockdowns playing havoc with global supply chains and lowering global growth expectations. We do not expect the China policy to change until at least all the Chinese elections have taken place for the People's National Congress in November 2022. After that, there may be a renewed focus on stimulating growth and more relaxed approach to living with Covid circulating in the community.

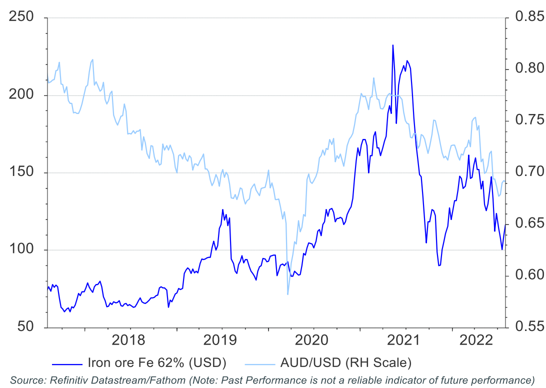
Chart 10: US 10 yr yield v S&P500 P/E

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

The moderation in long bond yields has provided some comfort to equity valuations, with price earnings edging up in July. However, market pricing is unlikely to be maintained if the Federal Reserve maintains its aggressive stance and corporate earnings begin to down grade more in line with the cautious outlook statements. Equity markets are now starting to push up against several technical resistance levels around the 4200 level, and we continue to believe that markets will struggle to push through there and investors should be looking to fade their equity positions into strength. It is way too early to be bullish equities given the stickiness of inflation prints and the risks to the global economy that they pose.

Being active to opportunities will remain our key focus. The underlying equity factors have rotated back towards growth, but we expect this to be short lived. Sectors such as [infrastructure, utilities and staples] and value factors are likely to outperform in coming months. High yield credit spreads remain vulnerable while short duration floating rate credit will remain well supported due to the relative strength of quality balance sheets and the powerful pull to par – shortening the breakeven time period in the event of any credit spread widening.

Chart 11: AUD & Iron Ore Price



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

Currencies remain relatively volatile and we remain alert to short run opportunities to capture value. While the consensus is that the Euro should strengthen against the $US, we believe that $US strength may see the currency trade through parity and approach 98. The $A continues to bounce between the big global currencies. While interest rate differentials may close as the RBA plays catch up, any significant bounce in commodities to support the currency are unlikely until we get greater clarity on the China situation and the chance of another stimulus package.

James Wright and Luke Hansen
Sayers Capital Solutions Group

5 August 2022

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Date of Publication: 5 August 2022
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