September was a month of extreme volatility and asset price weakness. Economic data provided no relief to central banks with inflation remaining stubbornly high and labour markets tight. The USD continues to strengthen while equities fell, and bond yields rose. Central banks continued to hike, while the Bank of England had to take the extraordinary step of purchasing bonds to stabilise the UK market following the government's mini budget.

Policy Watch: The US Federal Reserve delivered a third successive 75bps funds rate hike as expected. The new dot plot which maps future expectations of Committee members provided a surprise for markets with a higher terminal rate and a wide range of views for longer-term policy settings. The RBA hiked by 50bps as expected, while most other developed market central banks (except the Bank of Japan) following suit hiking rates.

Inflation Watch: Inflationary pressures in Europe persist, while US price measures are starting to slow but not as fast as anticipated with services inflation driven by rising wages remaining stubbornly high.

Risk Budget: Volatility across a range of asset classes rose significantly in September, with large moves in equity, bond and currency markets. Large intraday moves do little to improve negative investor sentiment.

Call to Action: We have seen many forecasts for year-end equity levels drastically revised down – most to current levels – implying a flat market for the December quarter. This would be a very unusual occurrence as the December quarter usually sees the "Santa rally". Markets have pulled back considerably in 2022 and we need to ensure that we do not remain too defensive and miss the turn in markets. We maintain our large underweight to equities for the time being and will be looking at US Corporate Reporting season as a potential catalyst to deploy cash on a further pullback.

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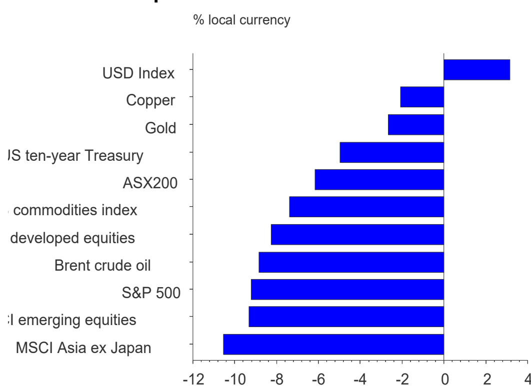
September Review

Asset prices fell across the board in September with a strong risk-off tone taking hold in the second half of the month as central banks reinforced their fight against inflation. The MSCI Developed Markets Index fell (-8.3%), and the S&P 500 fell 9.3% and hit fresh yearly lows to close out a third consecutive quarter of declines. The S&P/ASX 200 slightly outperformed falling 7.3%. Asian equities were hit hard on a rising USD and bond yields.

Chart 1: September Asset Class Performance



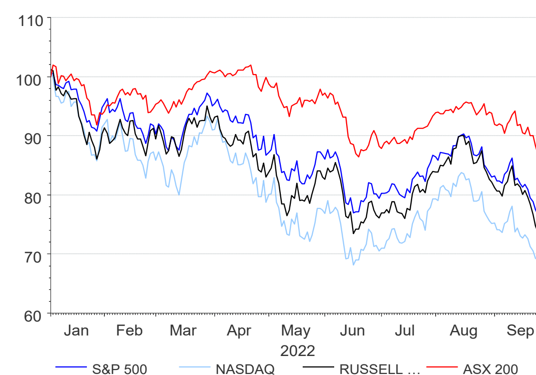
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Bond markets remain very volatile with interest rates trading through large intraday ranges. Overall, yields headed dramatically higher through the month the US 10-year treasury closed at 3.78 after trading over 4% during September.

Oil gave back some of its recent gains with the outlook for demand falling on recession fears. Brent Crude fell 8.8% in September. Gold prices slid 2.7% lower on the back of US dollar strength and higher real bond yields. The US dollar continued its dominance, the DXY rising 3.1%.

US equities were dramatically weaker with a combination of high inflation, a hawkish Federal Reserve and fears of recession taking hold. Bellwether corporates are now starting to warn of lower demand for goods and outlining the impact of higher costs. Apple flagged that it was abandoning plans to step up iPhone 14 production due to weaker demand, while global logistics giant Fedex withdrew earnings guidance after a dramatic fall in volumes (and revenues) driven by weakness in Asia and service challenges in Europe. Ford, the world's largest automaker, also issued a profit warning due to rising inflationary pressure and commodity cost headwinds brought on by supply chain bottlenecks. Meta (Facebook) is cutting headcount for the first time in its existence.

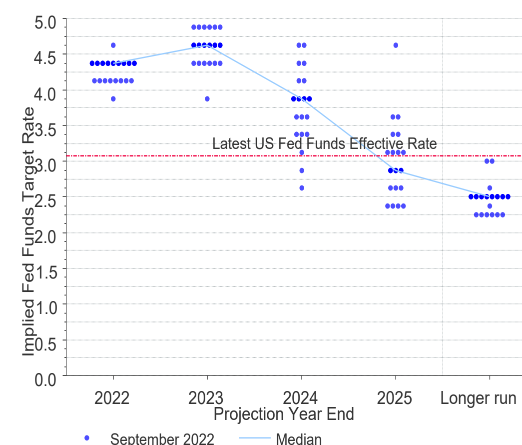
Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2022)



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

As expected, the Fed delivered a third successive 75bps funds rate hike taking the cash rate to a range of 3.0-3.25%. What was not expected was the lift to the median dots in the new Fed dot plot. These see a further 125bps of hikes this year (forecast +75bps in October then 50bps in December) followed by a further 25bps hike in 2023. The Fed Funds rate is expected to peak at 4.50-4.75% with no cuts seen before 2024.

Chart 3: FOMC Dot Plot



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

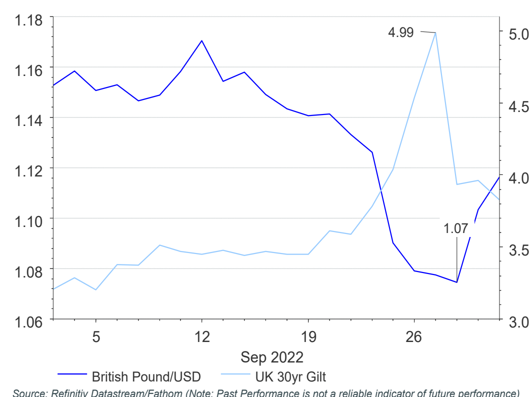
What is of particular interest is the extent of the dispersion in the dots in 2024 and beyond – there is

a wide range of views on the committee on how high rates will have to stay and for how long. The median estimate of the long run (so neutral) Funds rate is unchanged at 2.50%, while the 2025 median, produced for the first time at this meeting, is 2.875%. So, a restrictive policy stance is seen as likely to be in place for more than three years from now.

The RBA increased the cash rate +50bp to 2.35%, in line with consensus expectations. Forward guidance was broadly unchanged, with the statement noting the Board "expects to increase interest rates further over the months ahead, but it is not on a pre-set path". Later in the week Governor Lowe acknowledged "the case for a slower pace of increase in interest rates becomes stronger as the level of the cash rate rises." The market now expects the RBA to hike by a further 75bps by the end of the year with many expecting the pace of hikes to be 25bp per meeting.

In an effort to combat rising cost of living and a faltering economy, the UK unveiled a "mini-budget" which included the largest tax cuts since 1972. The impact on markets was immediate and violent with the Pound falling to a record low and UK gilts hitting an intraday high of 5.12% after starting the month at 3.2%. This reflected dual concerns on what the monetary policy response would be given inflation was already running in double-digits and how the UK government would fund the package.

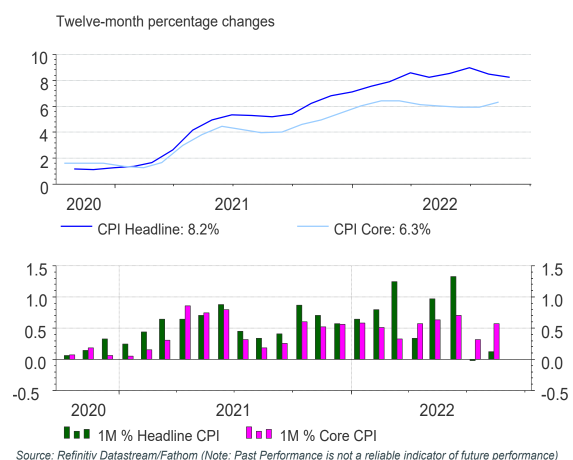
Chart 4: UK Gilts and Pound Turmoil



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

In an extraordinary turn of events, the Bank of England had to step into the bond market, pledging to buy up to £5bn of longer dated gilts each day for up to 13 days (£65bn total). This is to protect the UK pension industry, specifically those operating final salary pension schemes who utilise what are called 'Liability Driven Investment' (LDI) strategies and who hedge their future liability streams via long dated gilts. There was at one point reportedly no buyers of long-dated UK gilts. The impact of the BOE's announcement was to see the 30-year gilts yield fall from an earlier high of 5.12% to a low of 3.92%. This is a significant albeit temporary policy reversal from the BOE, who had flagged that start of the run-down of its balance sheet.

Chart 5: US CPI

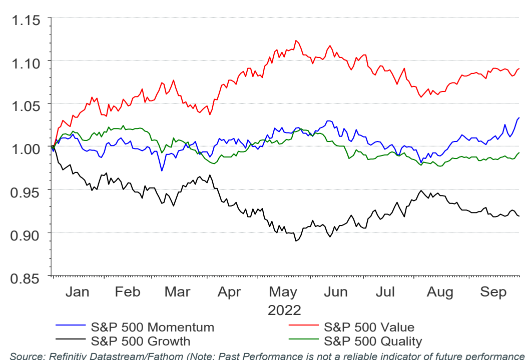


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Data flow showed no letup in inflation and no relief for central banks. Eurozone inflation rose 10.0% y/y in September vs 9.7% expected, while US August PCE data showed real consumption holding on to positive growth, with the PCE deflator rose faster-than-forecast. The market moving piece of data was the US CPI, with the core measure jumped by 0.6% to see the annual rise lift to 6.3% from 5.9% (vs the 6.1% consensus) and while headline CPI fell back to 8.3% from 8.6%, this fall was not as much as expected. What is perhaps most disconcerting for the Fed is that the strength in core inflation is service sector led (items such as vehicle repairs, dental and hospital services), categories which are primarily driven by wage inflation.

Momentum dominated US equity markets in September, while Quality was also influential. The continued rise in rate also meant that Value outperformed Growth.

Chart 6: S&P500 Equity Factor Relative Performance (YTD)

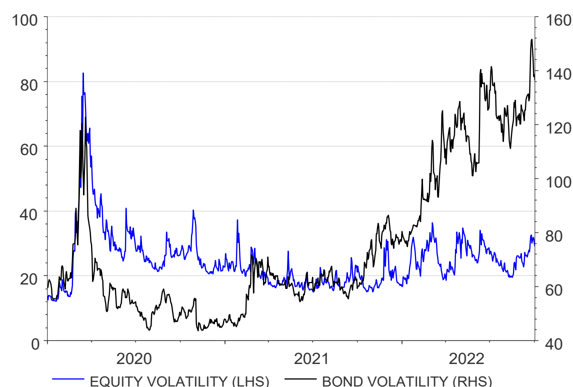


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

All measures of volatility rose during September with large moves in both the equity and bond markets throughout the month.

Chart 7: US Equity & Bond Inflation



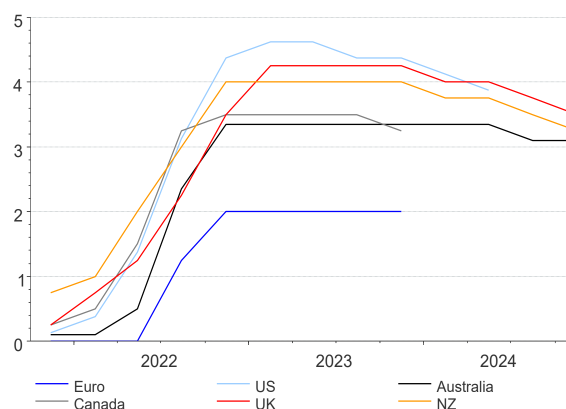
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

The struggle between "buy the dip" versus central banks resolve to deflate inflation expectations continues to play out. So far this year the central banks have been winning although with markets having set new lows in September, the battle is now becoming more evenly poised.

While earnings numbers and multiples for next year still appear elevated, there are tentative signs that the worst of inflation has past, and the pivotal question remains - how long to cash rates need to stay restrictive (assuming they are now) before inflation gest squeezed back to target.

Chart 7: Central Bank Policy Rate Forecast



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

The theory is easier than the practice. When liquidity is drained from the system, there are always unforeseen issues – usually associated with those that have taken excessive risk. Leverage works well when markets are rising but can have catastrophic consequences in sell offs. We have seen some interesting challenges so far in 2022, including the more recent speculation around the solvency of global investment bank Credit Suisse. The chance of a policy mistake relating to an event which can trigger contagion issues is rising.

We have seen many forecasts for year-end equity levels drastically revised down – most to current levels – implying a flat market for the December quarter. This would be a very unusual occurrence as the December quarter usually sees the "Santa rally". Global geopolitical risk remains a concern – with the war in Europe moving into a more dangerous phase and the tension surrounding Taiwan and North Korea heating up. Markets will look to ignore these issues in the main, but they remain front and centre in peoples thinking – and markets will respond very quickly to anything which is likely to lower global trade and growth.

Bond yields remain extremely volatile – which is not conducive for risk on events or pricing long tail assets. We have seen episodes more recently where bond markets have failed to function, and central banks have been forced to intervene. This is not a positive for risk assets. The idea that central banks are looking to lower bond yields is not correct, as they remain committed to higher yields, smaller balance sheets and generally tighter financial conditions. With financial markets interdependencies

so high – we remain wary of an event which can trigger a more pronounced contagion event.

Chart 9: S&P500 P/E v 10yr Bond Yield

While focussing on the negatives does remain important, markets have pulled back considerably in 2022 and we need to ensure that we do not remain too defensive and miss the turn in markets. It does not feel like the right time to add risk now – but turning points never do feel like the right time to add risk.

James Wright and Luke Hansen
Sayers Capital Solutions Group

6 October 2022

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