MarketSay"

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Risk assets recovered some lost ground in October, largely on investor hopes that central banks may be slowing the pace at which they hike interest rates. Despite some measures of economic data softening, inflation readings across the world showed little signs of easing and labour markets tight. The USD continued to strengthen and bond yields rose.

Policy Watch: With no US Fed meeting held during October, other central banks were in focus. The Reserve Bank of Australia unexpectedly slowed its hiking pace to 25bps (from 50bps). The Bank of Canada followed suit moving to 50bps (from 75bps) and the European Central Bank hiked by 75bps as expected but reports that some committee members advocated a smaller hike all contributed to the view (or perhaps hope) from equity markets that a central bank pivot may be underway.

Inflation Watch: Inflationary pressures in Europe hit new records, 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: Equity market volatility subsided as markets rallied in October. Bond volatility remains extremely elevated with large swings in yields across the curve continue as investors second guess what central banks may do next.

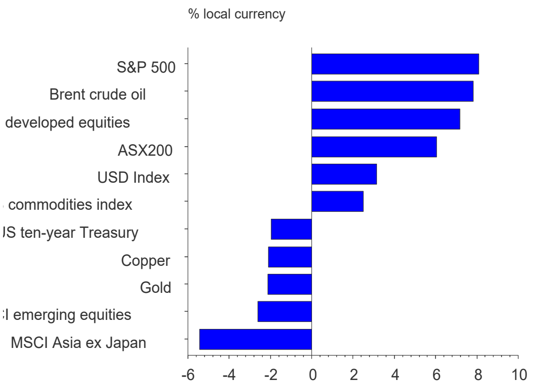
Call to Action: On recent Australian Dollar weakness, we moved some of our global equity exposure from unhedged to hedged, as we believe the AUD is more likely to appreciate from the low 60s. US Reporting season was slightly better than we had anticipated, but earnings growth is slowing considerably as we expected. Outlook commentary from some companies revealed an environment that is becoming increasingly difficult with rising costs a key issue. We suspect that 4Q earnings in the US to slow further. We have been concerned that central banks had started a pivot in October, however given the strength of the US economy and persistent high inflation, our expectation is that the US Fed will remain hawkish and committed to its fight against inflation. We maintain our large underweight to equities for the time being. The time to reduce this underweight however is growing nearer. Despite the gloomy economic outlook and the strong chance of a global recession in 2023, the equity market is not the economy, and markets often rally during a recession on expectations of future earnings recovery.

Date of Publication: 3 November 2022
Sayers Wealth Pty Ltd | ABN 61 642 217 007 | AFSL No. 525093

October Review

Equities made a come-back in October, rallying strongly on the hopes that the central bank hiking cycle may be slowing. Additionally, US earnings proved to be more resilient that many expected, although earnings growth continues to slow. The MSCI World Index (USD) rose 7.2%, and the S&P 500 was up 8.1%. The S&P/ASX 200 lagged the rally up 6% for the month – continuing the recent trend of being less volatile than other markets. Asian equities were hit hard again after investors fear further hard line economic policies in China.

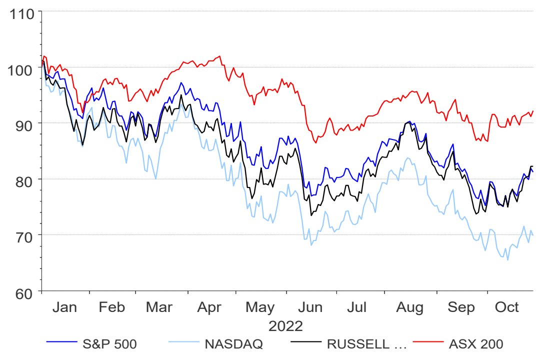
Chart 1: October Asset Class Performance



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

Bond markets volatility remains incredibly elevated as the market continues to second guess what central banks may do next. Overall, yields headed higher through the month the US 10-year treasury closed at 4.09% after trading over 4.25% during September.

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

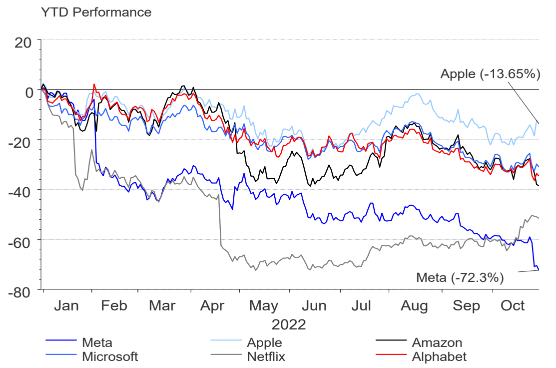


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Gold prices continue to slide, despite high inflation with US dollar strength and higher real bond yields taking their toll. The US dollar continued its dominance, the DXY rising yet again.

US equities rallied strongly through the month recording consecutive weekly gains for the first time in months. Corporate earnings largely met or exceeding expectations, with 71% of S&P 500 companies that have reported beating expectations, slightly below the 5-year average of 77%. Energy companies reported a high jump in earnings. Exxon Mobil, the largest U.S. major, reported nearly $20 billion in net income in the quarter ending in September, exceeding expectations and surpassing its previous record set just three months earlier.

Chart 3: US Mega-cap Tech Stock Performance

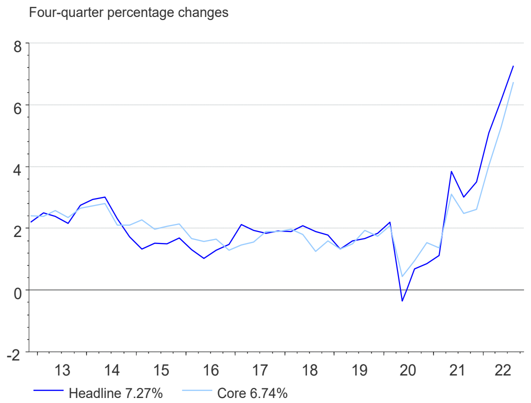


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

In a key test for the market Apple, Microsoft, Alphabet and Amazon all reported within 2 days of each other. Apple has been the standout in the tech space this year albeit still 13% lower YTD. Its result slightly beat expectations. However, Amazon gave weak guidance for the next quarter as rising costs are starting to reduce demand, while Alphabet (Google) cited slowing advertising revenues as a drag on its result. This is telling given costs like advertising are often the first thing to get cut in a slowing economy.

A shock jump in Australian inflation to a 32-year peak put into question the RBA's step down to 25bps in early October. Critically, price rises were broad based with most key categories higher. Food prices (+3.2% qoq) rose by more than expected, with meals out and takeaway (+2.9%) prices higher due to rising input costs and labour shortages, and fruit & vegetable prices (+4.5%) impacted by flooding events. Housing costs (+3.2%) continued to rise strongly, utilities prices (+4.8%) were boosted by higher gas prices (+10.9%), partially offset by electricity rebates from various state governments.

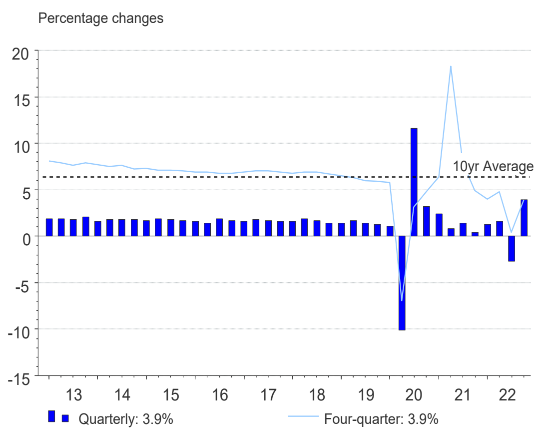
Chart 4: Australia CPI



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

The RBA's downshift from 50bp increments to 25bps reverberated around the world adding to speculation that other central banks might follow suit. The Bank of Canada downshifted later in the month to hike by 50bps (down from 75bps). The European Central Bank hiked by 75bps as expected, with reports of some committee members pushing for a smaller increase. As the month wore on investor's grew more confident that the US Fed would follow suit in November, and equities rallied.

Chart 5: Chinese GDP

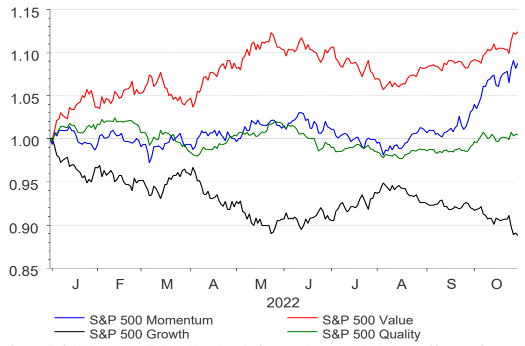


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Throughout the middle of the month the Chinese Communist Party held its 20th National Congress. As expected, President Xi secured an historic third term as leader and installed supporters around him in a re-shaped Politburo and Standing Committee. Investors had hoped that the Congress may contain a signal that the Chinese Government would pivot away from its Covid-zero policy or commit to stimulating the economy given economic growth is both below trend and below the Party's own goal for this year, but neither eventuated. Instead, Chinese linked equities sold off on the prospect of more hard-line policy from Xi, and a renewed determination to reunify Taiwan with the mainland.

With mixed results from Tech (Growth/Quality) during the month, the market rally was led by Value as interest rates increased further.

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

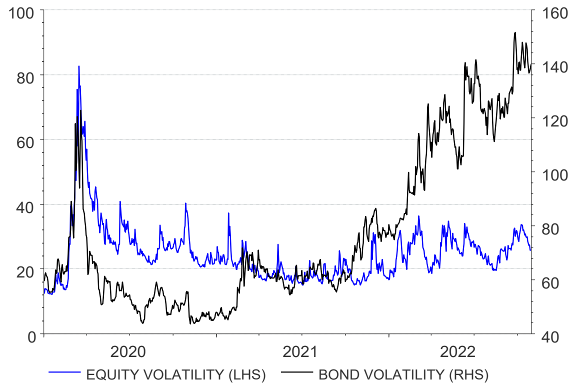


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

Equity market volatility declined slightly in October as markets rallied. Bond volatility however remains incredibly high – indeed higher than during the market turmoil of the early days of the Covid-19 pandemic.

Chart 7: US Equity & Bond Volatility



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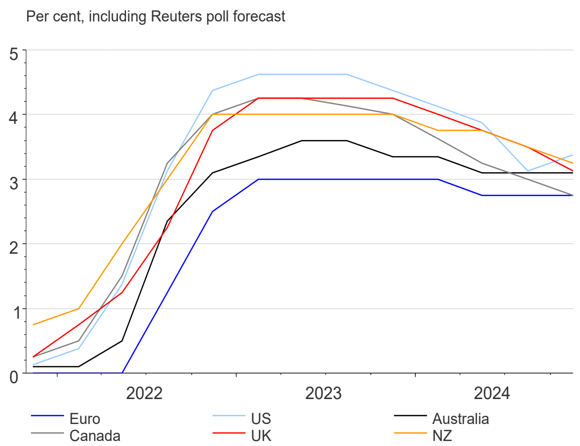
Outlook

Market sentiment and positioning had become very bearish over the third quarter, and we have seen equity markets bounce off their lows in the middle of October. Short covering and hope of a pivot from central banks has driven a number of bear market rallies in 2022 and we continue to believe that this bounce will be short lived.

The lack of liquidity is often the catalyst for pronounced risk off events. With central banks lifting cash rates and reducing the sizes of their balance sheets in 2022, the draining of market liquidity was always going to be a challenge. More recently, with the most pronounced example being in the UK, we have seen long rates being incredibly volatile and seemingly vulnerable to significant spikes higher. In response, central banks have had to walk a fine line between higher rates and supporting markets. Central banks have made more dovish comments of late, injected liquidity and several banks have started to reduce the size of their interest rate rises.

While commentary has centred around the need for intervention to ensure an orderly functioning of the bond market, most central bankers would have an eye on the outright level of yields and the implications for real borrowing rates. With the market pricing of the terminal cash rate still edging higher, it is still likely that long bond yields will ratchet higher over coming months.

Chart 8: Central Bank Policy Rate Forecast

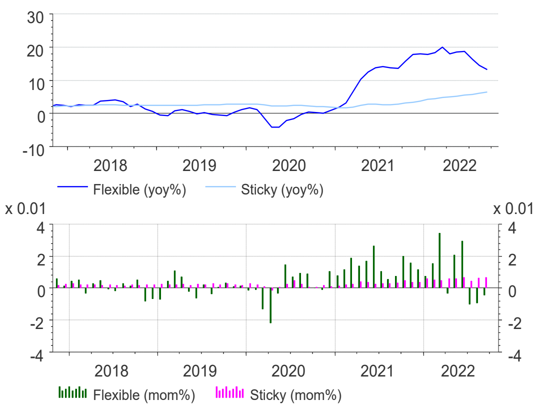


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

In the US, the Atlanta Federal Reserve produce a CPI measure of basket of items that change price relatively slowly. This sticky-price consumer price index (CPI) increased 8.5 percent (on an annualised basis) in September, following a 7.7 percent increase in August. On a year-over-year basis, the series is up 6.5 percent.

The flexible cut of the CPI—a weighted basket of items that change price relatively frequently—decreased 5.1 percent (annualised) in September and is up 13.3 percent on a year-over-year basis. We believe that while headline inflation may edge down over coming months, the persistent rise of the sticky inflation series is likely to lead to higher inflation outcomes than the market consensus.

Chart 9: Atlanta Fed Flexible & Sticky CPI



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

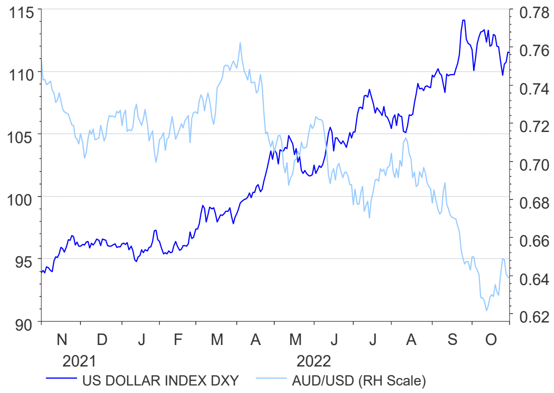
While pockets of the global economy are starting to slow, particularly those very highly interest rate sensitive sectors like housing, overall activity remains relatively solid and corporate earnings growth has only modestly declined. Third quarter corporate earnings in the US reported so far rose 2 per cent against an overall expectation of 3 per cent. That would be the slowest earnings growth in two years and is down from an expectation of 4.5% at the start of October.

Outlook statements are becoming more cautious and companies are reducing the size of stock buybacks, cutting advertising spending and beginning to shed labour. Corporate borrowing costs have increased substantially, but many companies had locked in term funding at lower levels and will only gradually be exposed to the higher rates as current borrowing matures. Overall, we continue to believe that margins will be under pressure and earnings expectations remain too high for Q4 and 2023.

Currencies have been very volatile in 2022 and we expect that this volatility will continue. The US central bank remains the most hawkish and has driven a very strong rally in the $US. While this is now entering uncomfortable territory for many economies, the trend is likely to continue. While the $A has lost ground against the $US since April, it has

been stronger against most other currencies. While major risk off events could conceivably hurt the $A, we continue to believe that the currency is likely to slowly move back towards US$0.70.

Chart 10: USD Index and AUD/USD



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

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Sayers Capital Solutions Group

3 November 2022

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Date of Publication: 3 November 2022
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