MarketSay"

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Risk assets rallied in January, as investors bet that central banks may be close to the end of their hiking cycles as inflation data showed the pace of price rises is slowing.

Policy Watch: There was a lack of central bank meetings in January, so focus was largely on the Bank of Japan after their surprise change to their yield curve control program late in 2022.

Inflation Watch: Inflationary pressures eased in January, with an encouraging CPI print in the US spurring an equity rally. Inflation continues to run hot in Europe but is also showing signs of slowing. In Australia however, there was significant upward surprise to data released in January, with price measures reaches heights not seen in over two decades, suggesting there is more work for the Reserve Bank of Australia to do.

Risk Budget: Equity market volatility dropped in January as markets rallied after a difficult December.

Call to Action: After implementing a currency hedge on some of our global equity exposure at the end of November 2022, when the AUD was at 62 US cents, we unwound this position by switching back to an unhedged position after the Australian Dollar traded through 71 US cents. Despite the improvement in economic growth and inflation data, particularly in Europe and the US, we believe there is little upside to equity markets from here. Markets continue to focus on central banks pausing and cutting rates in the latter half of 2023 as the economy slows, but are not pricing in the earnings recession that would come with an economic slowdown. There will be opportunities to add to equities in our view. While we wait for a better entry point, we are focusing our efforts on earning above cash income streams for clients, taking advantage of higher short-term interest rates and ensuring we utilise any spikes in equity market volatility.

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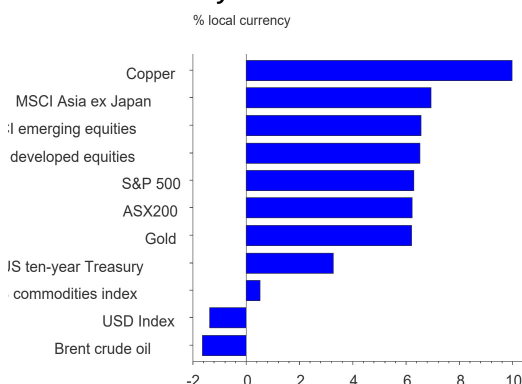
January Review

Equities rallied strongly in January on better-than-expected global economic growth and the accelerated reopening in China. Investors continue to believe that despite continued strong economic data that Central Banks will slow their rate hikes in coming months, before being pushed to cut rates in the second half of 2023.

Chart 1: January Asset Class Performance

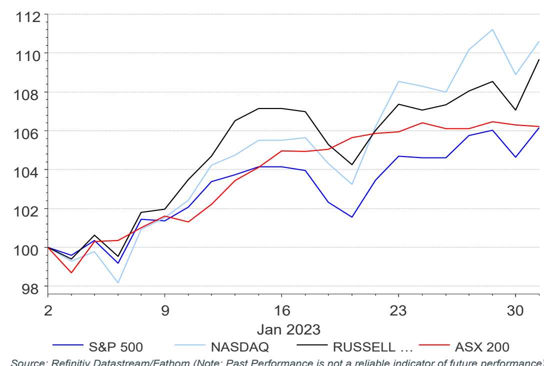


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The view on central banks was reflected in bond markets with the Australian 10 year bond a major mover, with the yield falling by 50bps to 3.55%. US yields moved lower as well with 10-year's 35bps lower to 3.53%.

Commodities were mixed, with oil prices softer on doubt that demand can be maintained. Iron Ore prices continued to rally, but at a slower pace as China shut down for Lunar Year, finishing January at US$129/mt.

Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2023)



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

To the end of January about 30% of the S&P500 had reported Q4 earnings. While most companies continued to beat earnings estimates, these estimates had been revised lower throughout the previous quarter, with earnings declining year-on-year by about 2.9%.

Microsoft reported an overall disappointing result, revenue growth was at the low end of their guidance and issued a subdued outlook due to a larger-than-expected Azure deceleration. Investor expectations were already depressed into the print, but the Azure trajectory and the fact that Microsoft rescinded its FY23 revenue growth targets will weigh on sentiment. The company did impress on cost control, which is likely to be a strong focus for technology companies moving forward in a more subdued environment. Netflix's Q4 '22 earnings report showed strong subscriber growth and a return to a positive margin. Management also provided upbeat guidance. Tesla reported a strong order book and a revenue number that slightly beat market expectations.

Chart 3: China, US, and Euro Zone Citigroup Economic Surprise Indices

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

Hopes continued to build that major economies may avoid recessions and have a "soft landing" with economic data in China and Europe surprising to the upside. In the US, the story is more mixed, but recent US Q4 GDP beat expectations again at 2.9% quarter annualised vs. 2.6% expected. While the headline number surprised to the upside for the second quarter running, there was some underlying softness suggesting that future growth may not be as rosy. Private consumption purchases cooled significantly and around half of the overall rise in GDP

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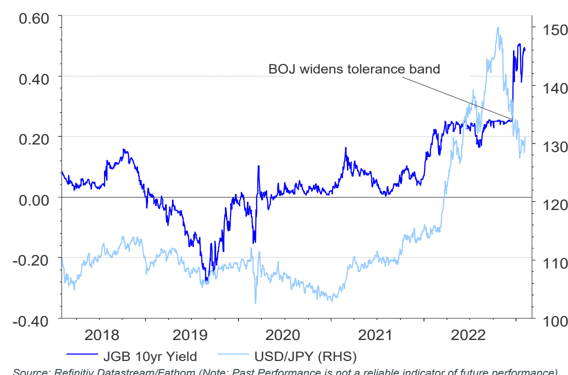
came from building inventories in the face of continued strong consumer spending.

Eurozone Q4 GDP surprised at 0.1% q/q against a -0.1% q/q expected. While it does raise the hopes that recession may be avoided on the continent, Italian GDP was weaker at -0.1% q/q, along with German GDP at -0.2% q/q.

China's Q4 gross domestic product (GDP) beat expectations at 2.9% year-over-year, well above low expectations of 1.6%. 2023 GDP forecasts have been revised higher, from 5.2% to 5.5% on the back of a faster reopening, with flow on impacts to the rest of the world. China also reported its first population decline in more than 60 years, dropping 850K to 1.4 billion. January 22 marks the start of the Lunar New Year celebration, which lasts until February 5, which will be a significant test for covid management given the significant movement of people for the holiday.

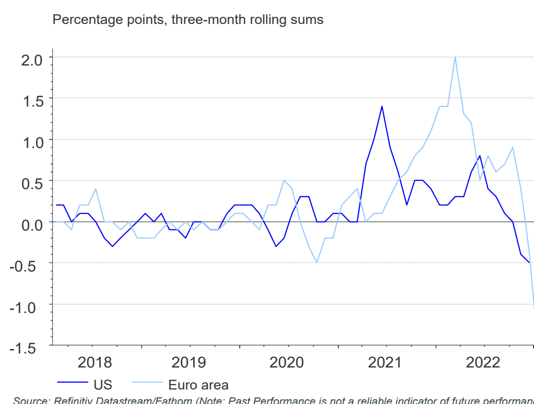
Chart 4: Japanese Yields v Yen



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

With few central banks meeting in January, the Bank of Japan was closely watched following its surprise move in late 2022 to widen its tolerance band for Japanese Government Bond Yields. The BoJ kept the yield target unchanged but the market was positioned for another possible surprise move. The BoJ has been buying JGBs in record amounts at an unsustainable pace and the unchanged policy stance won't budge market expectations that yield curve control will end sometime in H1 2023. The Japanese Yen has been rising rapidly as the potential for a contraction in interest rate differential between Japan and other major economies may not be far away.

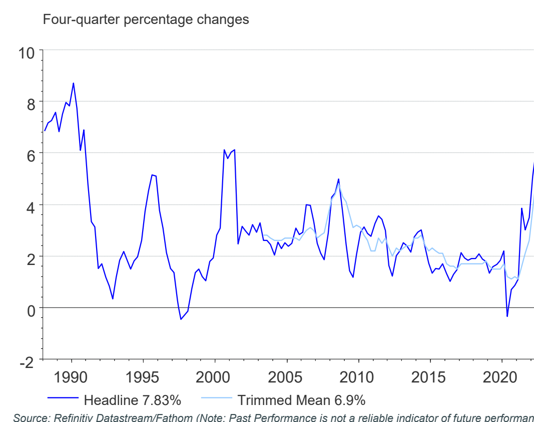
Chart 5: US and euro area CPI surprises



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

Slowing inflation got the markets attention in January with US Core Consumer Price Inflation (CPI) coming in as expected at 0.3% m/m and 5.7% y/y. Importantly the 3m annualised core rate is now running at 3.14%, its lowest reading in 15 months. The split of Core CPI was even more favourable with the Powell's glamour statistic of 'services less shelter' now running at 1.2% 3m annualised, while 'goods excluding energy' is in outright deflation at -4.8% 3m annualised. Overall inflation is easing in the US, with markets taking that as a sign that the Fed will be able to pause, and that as the economy starts to react to the monetary tightening put into place, the Fed will cut rates in H2 2023.

Chart 6: Australia CPI



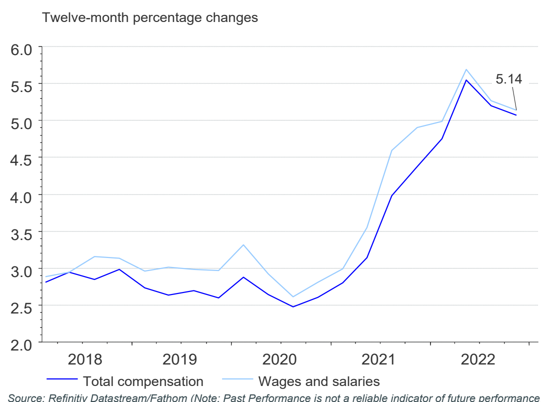
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

While inflation surprises are declining in the US and Euro zone, in Australia it is a different story. Headline CPI in Q4 22 lifted 1.9% q/q (0.3% more than expected) and 7.8% p.a, the highest since 1990 but below the RBA's 8% forecast. The RBA's preferred 'underlying' Trimmed Mean lifted sharply to 6.9% -

the highest since 1988, and well above the RBA's forecast of 6.5%. For many the result confirmed a 25bp hike on 7 February, with debate on whether it means a further hike in March. The result pushed the AUD through 71 US cents, a level not seen since mid-2022.

The US labour market remains incredibly hot, despite anecdotal layoffs from large corporates announced through the course of January. The Employment Cost Index (ECI) is closely watched by the Fed as it compositionally adjusts wages growth. Overnight the Headline ECI did decelerate to 1.0% q/q, down from 1.2% previously, and was also one tenth below the 1.1% consensus. While the annual y/y rate is still high 5.1%, the quarter annualised rate is clearly slowing.

Chart 7: US Employment Cost Index (Private)

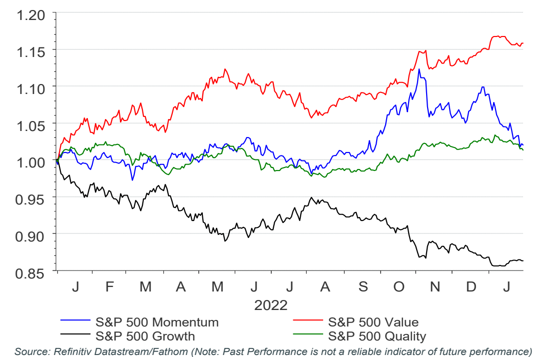


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Factors

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

Chart 8: S&P500 Equity Factor Relative Performance (YTD)

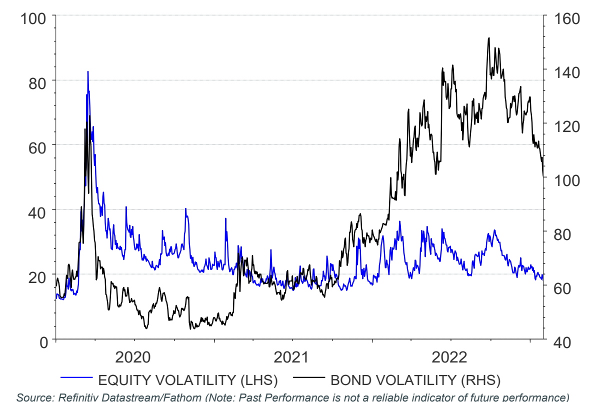


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

Equity market volatility fell and remained under 20 for most of January, which is only just above cyclical lows. Bond volatility to has fallen from its recent heights with a consolidation of yields in January.

Chart 9: US Equity & Bond Volatility

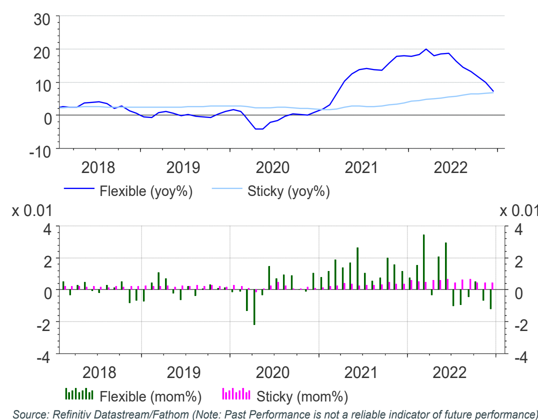


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

Central banks have done a lot of tightening in this cycle after letting inflation get away from them – and the hawkish language is clearly moderating. Equity and bond markets have taken this as a sign to both rally hard in 2023. While the chances of a soft landing have increased, it is extremely rare to engineer these and we believe that the rally in both equities and bonds is premature for several reasons.

Chart 10: Atlanta Fed Flexible & Sticky CPI



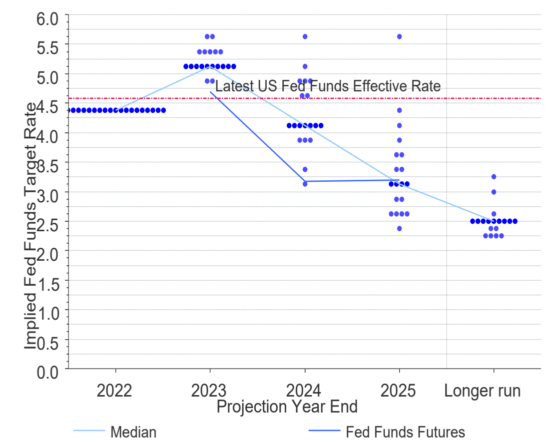
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Inflation has likely peaked in most developed markets with goods inflation moderating sharply. However, we continue to believe that there are a number of structural reasons why inflation will remain stubbornly above central bank target zones. History has shown that once non-discretionary (needs based) inflation rises and spills over into wages demands – significant pain in required in the labour market before wage demands moderate.

While playing out over a much longer time frame – factors such as rapidly aging populations, migration challenges, deglobalisation, reshoring of manufacturing and rising trade tensions between trading blocs will all tend to push up the cost of goods and services.

Markets are currently pricing in rate cuts in the US during 2023 – despite central bank governors not predicting rates to decline until 2024 at the earliest. If the history of the 1970s repeats, claiming victory against inflation too early can lead to a resurgence in prices along with a weakening in aggregate demand.

Chart 11: FOMC Dot Plot vs Market Pricing



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

Markets are trying to digest a Federal Reserve with a new reaction function (the automatic put to save equities no longer exists – despite the Federal Reserve pumping in significant liquidity into the financial system in the second half of 2022). The Fed's program of quantitative tightening draining liquidity from the system will continue in 2023 even if interest rates stay steady. Corporate earnings are now starting to decline sharply as the cumulative effects of the rate hikes in 2022 impact margins through borrowing costs and depressed revenue growth.

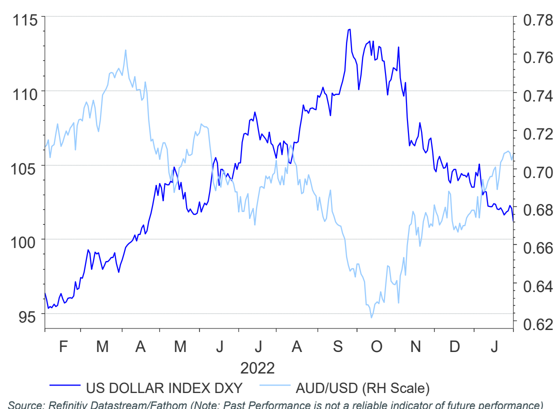
After the strong rally so far this year, the risks to market look asymmetric and we are positioning our portfolios for equities and, to a lesser degree, bonds to sell off.

Triggers for a potential sell off are likely to be Federal Reserve commentary, surprising resilience in inflation prints, tough corporate earnings and any increase in geo-political tensions. To that end, Russia, Taiwan, and weather balloons will be front and centre on investors' minds.

Retaining liquidity and income generating assets will be critical during the next down leg of the market. We are positioned defensively in equities (with a slight value bias), underweight duration (invested in floating rate short duration assets), overweight

alternatives that we believe will be negatively correlated to equities. When volatility is high – we have looked to lock in strategies that support our directional view and derive decent income.

Chart 12: USD Index and AUD/USD



Foreign exchange markets continue to be volatile – and we have recently reduced our positioning in risk currencies (particularly $A) for those currencies that perform well when there is a flight to safety.

James Wright and Luke Hansen
Sayers Capital Solutions Group

6 February 2023

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