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Most assets struggled in February, with equities lower and bond yields higher. The USD caught a strong bid as interest rate expectations shifted higher yet again on stronger than expected economic and inflation data, clearing the way for more policy action from central banks. Corporate Earnings in both the US and Australia paint a picture of an economy that is likely past its peak, with earnings heading lower.

Policy Watch: There were a series of interest rate hikes around the world in February, with the Reserve Bank of Australia, the US Federal Reserve, the European Central Bank, Bank of Canada, the Reserve Bank of New Zealand and others all increasing rates in the face of sticky inflation and wages growth. These moves were largely expected, markets are now focused on how many more moves are to come.

Inflation Watch: data surprised on the upside consistently across the global in February. Inflation had been surprising on the downside in recent months, but this reversed sharply during the month, especially in the less volatile or sticky core readings, suggesting that central banks have more work to do.

Risk Budget: Bond market volatility spiked, as yields headed sharply higher after a strong rally in January. Equity volatility rose marginally, but remains mostly subdued, for now.

Call to Action: Our portfolio settings remain unchanged in February; we remain underweight equities, overweight alternatives. Given the starting point for March, the risks to equity markets look asymmetric. We see little prospect for equities to rally in the short term – as earnings are likely to weaken further and price earnings multiples should remain consistent. For now, we believe investors should position their portfolios defensively with income-generating assets and alternatives negatively correlated to equities.

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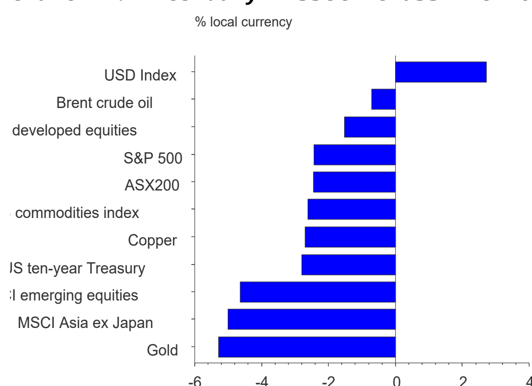
Markets in February

Most assets lost ground in February with the MSCI Developed Markets Index declining by 1.5% and the S&P 500 losing 2.4% in local currency terms. The S&P/ASX 200 underperformed, falling by 2.4% due to slowing earnings momentum and ongoing rate hikes. In comparison, Emerging markets experienced a larger decline, falling by 4.3% throughout the month.

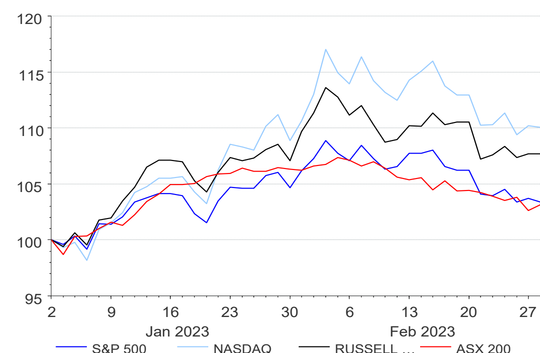
Chart 1: February Asset Class Performance



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

Investors have priced in further monetary policy tightening following rate hikes, causing Australian 10-year yields to sell off by 30bps across January to 3.86%. In February, the RBA continued their hawkish tone by raising the cash rate by 25bps to 3.35%. US 10-year yields also sold off, moving from 3.53% to 3.92% by 39bps, in response to strong US economic data and ongoing Fed rate hikes. While the strengthening of the USD caused crude prices to weaken slightly.

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)

Key Themes

Corporate reporting season continued in the US and Australia. We believe that a common theme across reporting season both domestically and in the US is that the economic environment is changing.

The rate of positive earnings surprises from ASX companies declined, indicating a waning earnings momentum and a potentially peaked operating environment. On average, companies' actual NPAT earnings for the half came in 2.1% below what was expected, with resource stocks showing an even wider miss range at 4.2%.

In the US, to the end of February, 68% of firms have beat consensus earnings estimates and 62% have beat on revenue. Despite this, the S&P500 reported a decline in earnings of 4.9%, the first decline since Q3 2020. The Energy sector reported the highest earnings growth at 57%.

It was clear to us from outlook commentary that businesses fear a hard economic landing, and they continue to worry about rising costs. The term "inflation" was mentioned at least once during earnings conference calls for 332 companies in the S&P500 according to Factset.

In Australia, falling house prices continue to drag on many sectors, such as online classified stocks, building material and steel stocks. There are also concerns regarding the labour market, with companies struggling to fill positions and dealing with the rising cost of labour. However, retailers showed that there are pockets of consumer strength, and the travel sector seeing significant pent-up demand. Supply chains are easing, but some sectors such as food producers and agricultural stocks continue to face rising rail and trucking costs.

Economic data, including labour and inflation data continued to surprise on the upside.

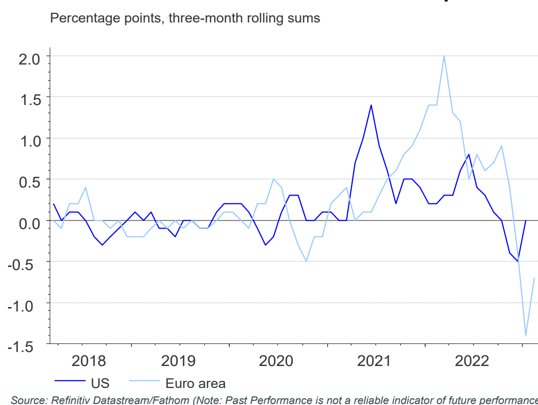
Early in February US employment came in significantly stronger than forecast, with 517,000 new jobs added in January, exceeding consensus expectations for the tenth straight month. This was followed on the same day by a report showing that the US services sector (~80%) of the US economy is also growing at a faster rate than forecast. It was much the same story in other countries, with the Chinese economy reopening faster than expected, its manufacturing sector rebounding strongly. And Europe, after a mild winter, is not as dire as expected.

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)

Core inflation (which strips out volatile items such as energy costs) in both the US and in Europe were higher than market expectations. US Producer Prices, the US Core Consumer Price Index and US Core PCE readings were all higher than expectations. Suggesting that a tight US labour market, wage increases, and strong demand has led to sticky inflation in the services sector of the economy. Inflation had been surprising on the downside, but this trend has sharply reversed.

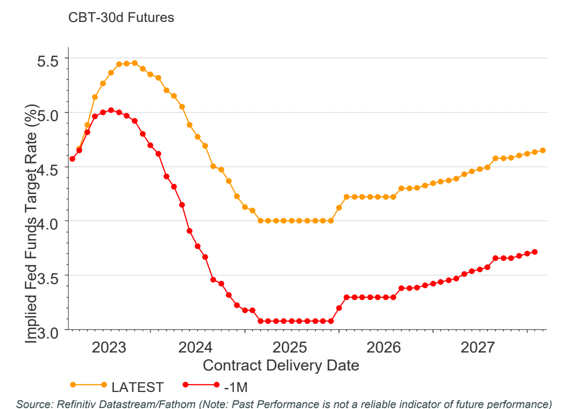
Chart 4: US and Euro area CPI surprises



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

Strong economies and stronger than expected inflation data led to a repricing of interest rate expectations across many developed economies in February with the US Federal Reserve now tipped to hike to just short of 5.5%, a full 1% higher than just a month ago and a now very small chance of a cut by 2023.

Chart 5: FOMC Interest Rate Futures Curve



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

Risk

Bond volatility reverse sharply higher in February, as yield jumped higher after a strong rally in January. Equity volatility is yet to follow suit.

Outlook

While central banks around the world have continued to tighten monetary policy into surprisingly strong economic data and relatively sticky inflation prints, their hawkish language is clearly moderating. These is providing ammunition for both the bulls and bears on risk assets.

Inflation has likely peaked in most developed markets, with goods inflation moderating sharply. However, the base effects of lower goods inflation is starting to weaken – meaning the comparison will with last year's prices will get more challenging and continued falls in headline goods inflation is less likely. We continue to believe that inflation will moderate but remain stubbornly above central bank targets for the next year.

Interpreting how the central banks will react to new data is proving difficult for markets. Last year we had periods where markets where listening to the commentary from central banks, and periods where market pricing reflected an expected change in stance from central bankers. We expect the rest of this year to play out in a similar fashion, with runs in risk assets to be followed by periods of weakness.

The most recent reporting season has shown that it is taking a little longer for this view to filter through to corporate earnings. The cost of higher debt servicing will be slowly feeding through companies cost of borrowing

as fixed rate debt matures and new funding arrangements need to be put in place.

Given the starting point for March, the risks to the market look asymmetric. We see little prospect for equities to rally in the short term – as earnings are likely to weaken further and price earnings multiples should remain consistent.

How to Position

Investors should be thinking about adjusting their portfolios accordingly to take advantage of opportunities as they present themselves.

Now, we particularly like short dated corporate bonds and other yield plays. We believe there will be better opportunities to add to equities throughout the year. Foreign exchange markets remain volatile, and risk currencies have been reduced in favour of currencies that perform well during a flight to safety.

Chart 7: USD Index and AUD/USD

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

Being nimbler in portfolio construction is likely to pay dividends through 2023. While inflation may have peaked in most developed markets, structural reasons suggest that it will remain above central bank target zones. For now, we believe investors should position their portfolios defensively with income-generating assets and alternatives negatively correlated to equities. Being a little cautious and protecting capital can't be a bad thing.

James Wright and Luke Hansen
Sayers Capital Solutions Group

7 March 2023

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