MarketSay

What You Need to Know

Month of April: Equities rallied and bonds traded sideways. Investors had a lot to digest with ongoing financial instability in the US, mixed economic and inflation data, and a growing belief that central banks are going to pause their hiking. Global economic growth concerns are increasing, with copper prices falling and oil erasing all of its gains after OPEC+ cut production.

Policy Watch: The Reserve Bank of Australia paused at its April meeting, after 10 consecutive rate hikes. Markets increasingly expect that the US Federal Reserve will hike by 25bps in May and then pause, as economic and credit growth fade.

Inflation Watch: inflation appears to have peaked, but remains sticky. Strong wages growth continues in the US, leading to sustained service inflation. While the CPI moderated in Australia, it is still too high for the RBA, which does not see CPI moving into its target band until 2025 – risking further hikes.

Risk Budget: Bond and equity market volatility moderated as equities rallied modestly. The VIX index traded below 16 during the month, its lowest point so far this year.

Our Portfolio: Our portfolio settings remain unchanged in April; we remain underweight equities, overweight alternatives and credit.

How to Position: With global equity markets already trading well above the multiples normally associated with the end of a tightening cycle (or recession), we see limited upside. We expect equity markets are close to the top of their 2023 trading range and are likely to edge lower over the course of the year.

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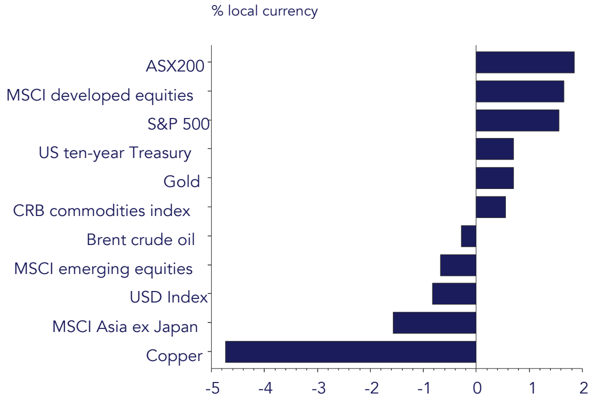
Markets in April

Equities rallied modestly on better-than-feared US earnings and a moderation in inflation data. The MSCI Developed Markets Index rose (+1.7%) in April, with European and UK equity markets strong. The S&P 500 gained (+1.6%) in USD terms. The S&P/ASX 200 rallied (+1.8%) as investors took confidence as the RBA paused. Emerging markets equities fell (-1.78%) in USD terms as the recent China equity rally took a breather. Globally, Consumer Staples (+4.3%) and Healthcare (+3.5%) and outperformed, financials (+3.2%) also regained some lost ground.

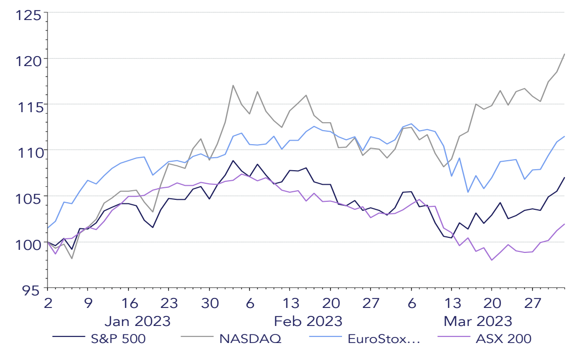
Chart 1: April Asset Class Performance



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

Bond yields tracked sideways during the month as the RBA remained on hold, and market expectations for a Fed pause grew. Commodity prices were mixed over the month, with copper a big underperformer on growth fears. Brent Oil fell a fraction to US$79.54/bbl, on demand fears and despite an OPEC+ production cut. Iron Ore prices fell by $22.00 to US$105.00/Mt on lagging steel demand from China.

Chart 2: Selected 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

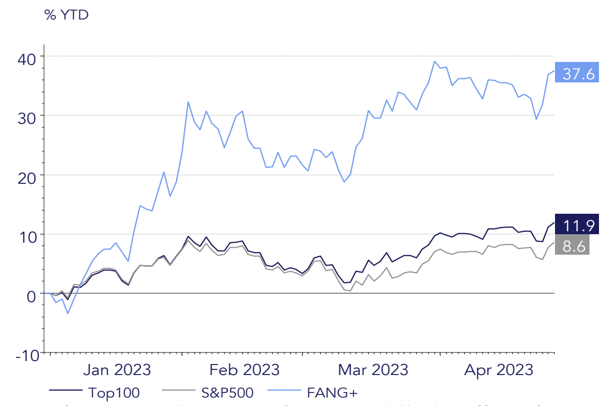
US Quarterly Corporate Earnings reports are better-than-feared, but earnings are still going backwards. Most of the markets gains this year have been driven by just a handful of stocks.

US 1Q earnings season has been better-than-feared, S&P 500 EPS growth is now tracking at -5% year-on-year, vs. a consensus estimate of -7%. This will be the first time since 2020 the US has had two quarters of negative earnings growth. Both sales and margins have exceeded expectations so far. Analysis done by Bloomberg suggests that the positive reaction to surprises has been very muted, with the average share price reaction just 0.1% on a positive beat.

Inflation and higher costs were seen as a key risk for this earnings season but consumer staple names with pricing power have been able to combat this. 95% of the consumer staples sector that has reported so far has beaten expectations.

Microsoft, Alphabet (owner of Google) and Meta Platforms (owner of Facebook) all delivered results that beat expectations. Amazon also beat expectations but gave a weak outlook. Market breadth – a key indicator of how strong or convicted investors are in their views on equities is at its lowest point since 2020. The ten largest stocks are responsible for nearly 90% of the S&P's return this year. The NYSE FANG+ index is up 37% YTD, the S&P100 is up 11.9% and the broader S&P500 is up just 8.6%.

Chart 3: Large Cap Tech dominates rally

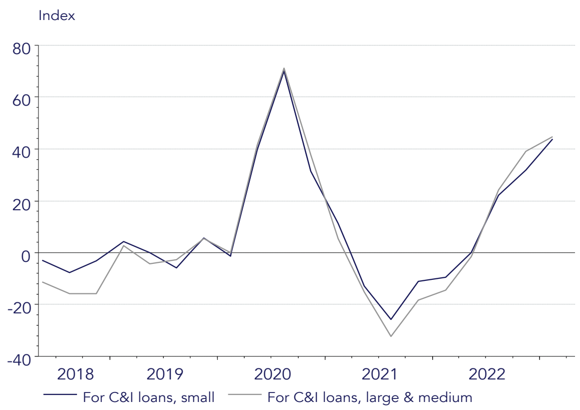


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The fallout from ongoing US Banking instability may tighten financial conditions and do the Fed's job for them.

The ongoing instability and lack of confidence in US regional banks is leading to more widespread risk-aversion, not just on where consumers put their deposits, but how banks are lending. The US Fed's most recent survey data suggests that businesses of all sizes were already finding it increasingly costly and more difficult to get access to, largely due most of this increase has been caused by Fed hiking interest rates and reducing its balance sheet.

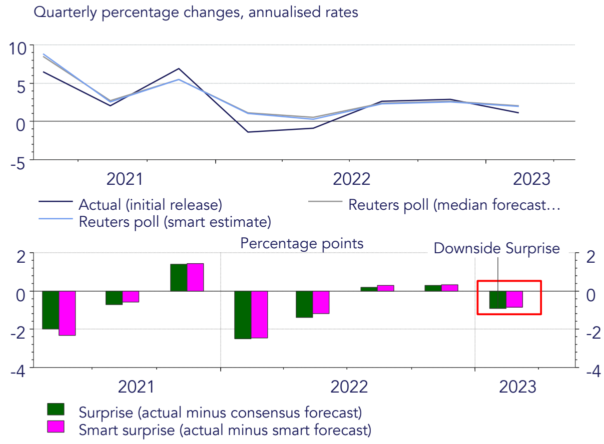
Chart 4: Fed Lending Survey – Tightening Credit Conditions



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

With data released in April confirming that US economic growth was weaker than expected. Although the underlying source of weakness was the running down of inventories, rather than broad consumer weakness, there is a growing view that the economy there will enter a recession in the second half of 2023.

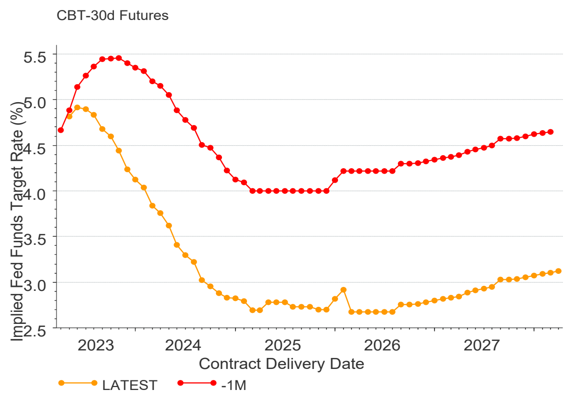
Chart 5: US GDP surprised to the downside



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

The key will be whether the further tightening in conditions leads to a greater than anticipated slowdown, and whether that then gets inflation back to target earlier than forecast. The US Fed is widely expected to hike rates by 25bps in May to 5.00-5.25%. This has been well flagged by Fed speakers through April and was also the forecast peak in the March FOMC dot plot. Then a pause appears likely. The market has 61bps of cuts priced in before the end of the year although most Fed speakers continue to push back on this pricing.

Chart 6: FOMC Interest Rate Futures Curve



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

Risk

Both bond and equity volatility moderated as the month progressed.

Outlook

Markets have been quick to look through negative developments over recent months and seize on any news supportive to growth assets. Historically the end of the tightening cycle has been a positive catalyst for stocks and equity investor positioning has accordingly rebounded strongly. Combined with a better-than-expected earnings season and the end of the blackout window for corporate buy-backs, equities may receive a short-term boost.

On the negative side of the ledger, we are now entering a seasonally weak stretch of the year in US equities ("Sell in May and go away") and a focus on tax positioning ahead of the financial year in Australia.

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While central banks may not lift interest rates much from here, the market appears to be underestimating their capacity to remain elevated for an extended period. The US economy remains in relatively good health and the stickier components of inflation (mainly on the services side of the economy) and still showing signs of moving higher.

The debt ceiling in the US represents a potential negative catalyst for equities. The US sovereign credit default swap spreads (the cost of insuring against a default by the US government) and Treasury yield curve are showing signs of risk.

Chart 6: US 5 Yr Government Credit Default Swap

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

The US Regional Banking Crisis continues to evolve with the Federal Reserve working hard behind the scenes to stabilise the system. At best, this likely continues to be a deleveraging event for commercial real estate, private equity and technology companies.

Fiscal policy stimulus continues to be wound down from the pandemic policy settings. Governments are attempting (to varying degrees) to attempt fiscal repair following the massive debt build up over the past could of years. We expect the Federal budget to be handed down in May to show a strong rebound in the budget position, driven by strong commodities prices and employment. While there will be some cost-of-living relief, overwhelming we expect that the budget to be moving more contractionary.

How to Position

With global equity markets already trading well above the multiples normally associated with the end of a tightening cycle (or recession), we see limited upside. We expect equity markets are close to the top of their 2023 trading range and are likely to edge lower over the course of the year. The S&P 500 is expected to end the year at 4000 (-4%) and we will look to be opportunistic with our positioning, looking to re-enter in the mid-3000s and exit around current levels.

Bond markets are delicately poised between two widely differing scenarios. While inflation remains stubbornly high, the consensus view is that bonds are likely to remain elevated at higher levels (and could sell off) while there are some warning signs about a more serious slow down or systemic risk (US banks, credit growth) which has markets thinking there is potential for central banks to quickly reverse course and cut rates aggressively. This response would be unlikely to prevent equities falling.

The $A dollar at round US$0.665 has been a little weaker over recent weeks on lower iron ore prices. We expect the $A might move a little lower to test recent lows and are looking to establish a $US hedge at better levels.

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4 May 2023

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