What You Need to Know

Month of May: Equity markets were mixed, with investors firmly focused on the resolution of the US Debt Ceiling debate. While a deal was eventually reached, it was left until the last week before the debt ceiling was hit. The rally in US equities continues to be dominated by just a handful of stocks in the technology sector.

Policy Watch: The Reserve Bank of Australia surprised markets by hiking by 25bps in May, after pausing in April. Central banks continue to push back on the idea that slower economic growth automatically means lower interest rates, with the fight against persistent inflation not yet won.

Inflation Watch: Price indices are mostly falling, but perhaps not at the pace that markets expect. Inflation in Europe is still running close to record highs, while price increases in Australia are also still too high for the RBA with further policy tightening expected. In the UK, food inflation is particularly concerning.

Risk Budget: Bond and equity market volatility moderated further during May. The VIX index traded around its lows for the past year.

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

How to Position: We continue to see limited upside in global equity markets through to the end of the year. The narrow breadth of stocks driving 2023 calendar year performance are now becoming extremely expensive and we would expect some natural profit taking in those names. We believe that the best risk versus reward exposure remains in income orientated investments, particularly investment grade credit.

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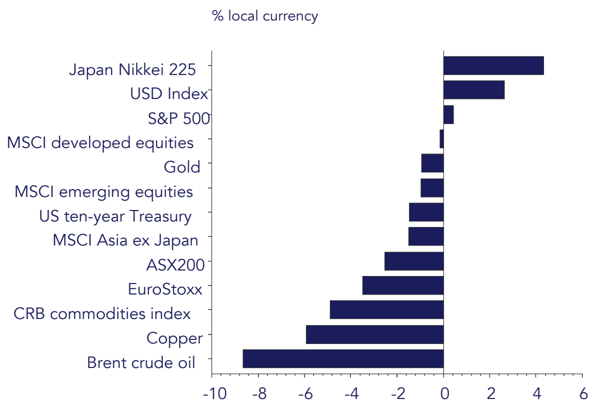
Markets in May

It was a mixed month for equities with investors increasingly concerned that US lawmakers would fail to agree on a resolution to increase the debt ceiling. The MSCI Developed Markets Index was flat (-0.1%) in May, with European and UK equity markets down for the month. The S&P 500 gained (+0.4%) in USD terms. The S&P/ASX 200 lost ground (-2.5%) as the RBA surprised markets by hiking rates. Japanese equities rose 7% for the month alone as rising inflation forces investors into the equity market. Globally, the Developed World IT sector was a standout (+8.2%), while Energy stocks fell (-9.9%) as the oil price reflected a weakening economic outlook.

Chart 1: May Asset Class Performance

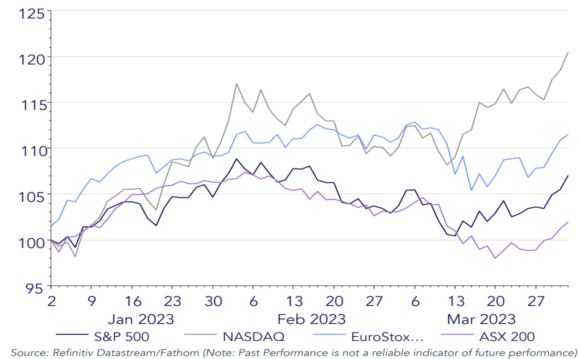


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Bond yield headed higher in May reflecting market expectations that interest rates will have to go higher and stay there for longer. Australian 10-year bond yields rose by 0.26bps to 3.60%. US yields also rose 22bps to 3.64%, on expectations of a continued aggressive rate hike path by the Fed.

Brent Oil fell by US$6.00 to US$73.54/bbl, as concerns continued around Chinese oil demand after weaker than expected economic data. Iron Ore prices fell by US$5.00 to US$100.00/Mt on seasonally weaker demand and prices. Gold prices fell by US$30.10 to US$1,952 on a stronger USD and rate hike expectations.

Chart 2: Selected Equity Markets YTD Relative Performance (100 = 1 Jan 2023)

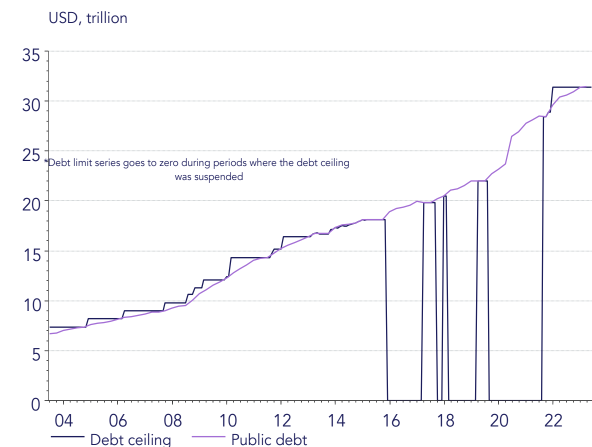


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Key Themes

The US Debt Ceiling dominated markets in the back end of May as US lawmakers failed to find a resolution by the end of the month.

Chart 3: US Debt Ceiling & Public Debt



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Markets were focused on the US debt ceiling which was forecast to reach its ceiling of US$31.4 trillion in early June. This is not a new phenomenon although partisan politics has become more extreme in recent years, leading to government shutdowns. Since 1960, Congress has raised, temporarily extended, or revised the debt limit 78 times.

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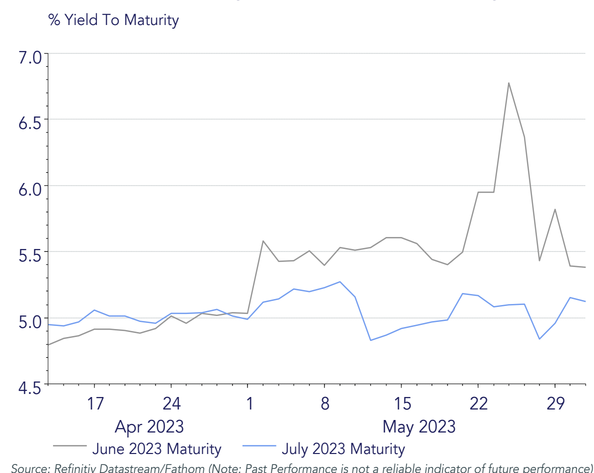
Chart 4: US Treasury Bill Yields June v July Maturity



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By the end of May a deal had been reached, whereby the debt ceiling was suspended for two years. While this averted a costly and dramatic default or government shutdown and was always the most likely outcome, bond markets were pricing in an elevated risk of a temporary default or at best delay on payment as June maturity Treasury Bills traded at a yield above 6.5% during May, 1.5% higher than the July maturity.

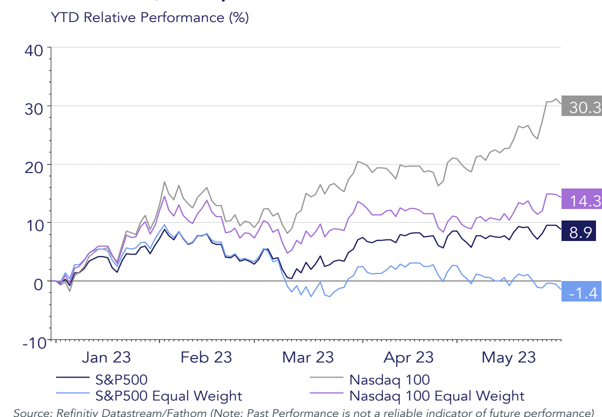
Large Cap Technology Stocks continue to drive the rally in US Equities. With stocks linked to Artificial Intelligence dominating.

The rally in US equities so far this year continues to be one dominated by just a handful of stocks. On a market weighted basis, the S&P500 ended June up 8.9% YTD, while an equal weighted measure was -1.4% YTD. The Nasdaq100 Index ended June up an astonishing 30.3%, the equal weighted equivalent was up 14.3%.

The combined weight of five companies - Apple, Microsoft, Alphabet, Amazon and Nvidia - now accounts for about 25% of the S&P 500's market cap.

A rally driven by a handful of stocks raises questions about the health of the broader market, as should volatility rise again, interest rates increase or conditions change, investors may sell these megacap holdings quickly as sentiment changes.

Chart 5: Large Cap Tech dominates



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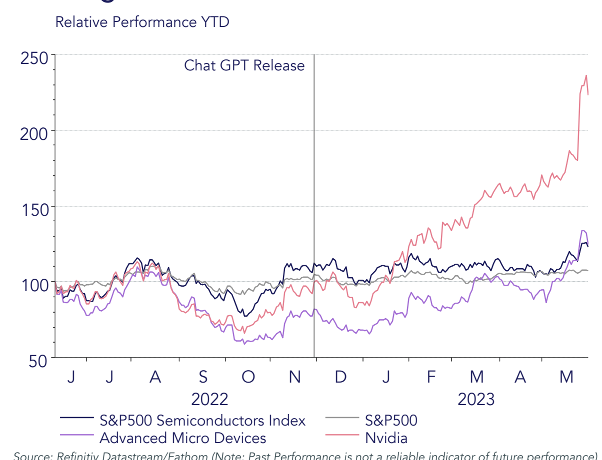
Shares in AI chipmaker Nvidia soared some 25% in a single day after issuing upgraded revenue forecasts, suggesting the rush toward generative AI is only just beginning. Since Microsoft-backed OpenAI released its artificial intelligence-driven ChatGPT last November investors have been pouring into stocks with links to AI. There has already been significant progress in the competence of AI, suggesting that the theme is only getting started.

We believe that there are many ways of playing the space, as there are several discrete parts of the semiconductor supply chain, most of which stand to benefit from the explosion in AI technologies. Additionally, given the space is politically sensitive it pays to be geographically diversified.

Chart 6: Artificial Intelligence stocks are driving market gains.



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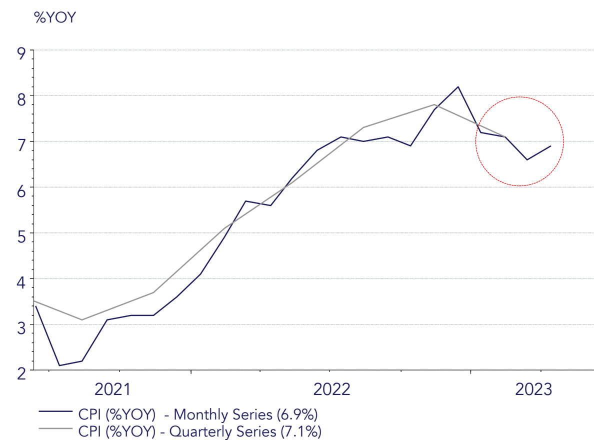
While inflation is falling, it may not be doing so at the pace many expecting.

U.K.'s April headline Consumer Price Index overshot estimates, coming in at 8.7% year-over-year. Especially worrying is the relentless rise in food prices, with an annual increase of 19% in April, down only one percentage point since the previous month. These near record figures further exacerbate the cost-of-living crisis.

Chart 7: Australia Monthly & Quarterly CPI



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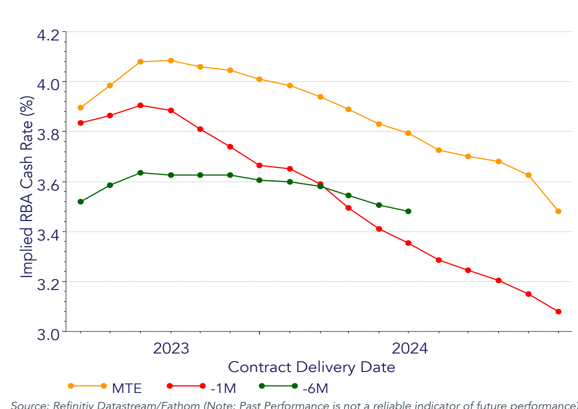
The Australian Monthly CPI came up above expectations in May. And while this is a volatile series, it was seemingly enough along with house price data and a strong labour market to move the RBA to hike by 25bps in May to 3.85%. This was against the consensus (22 out of 31 economists expected no change), and market pricing of only ~3bps. It may not be the end of the hiking cycle with a weak tightening bias retained: 'Some further tightening may be required'.

Chart 8: RBA Interest Rate Futures Curve



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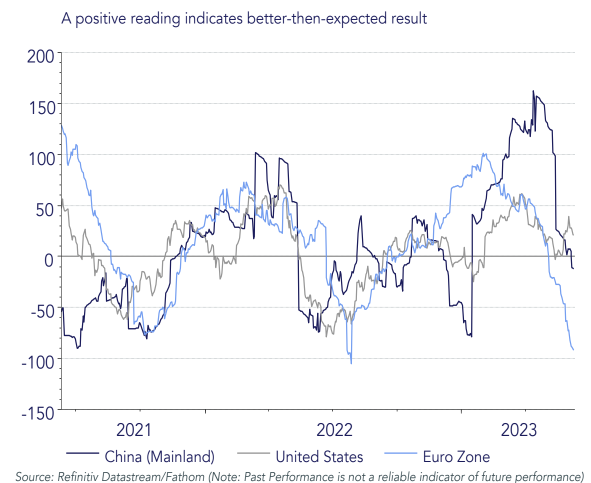
Outlook

The economic cool down continues, with both growth and headline inflation showing signs of deceleration. While economic momentum has been stronger than would have been expected given the rising global cash rates, core inflation numbers have remained stubbornly high. Employment and wages growth have continued to be an issue as workers attempt to capture lost purchasing power from the rapid run up in prices.

Chart 9: Positive Economic Surprise Rolling Over



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Central banks have responded by continuing to hold the line on higher rates despite some sectors, particularly the interest rate sensitive sectors, showing clear signs of slow down and in some cases stress. The market is attempting to link slower economic growth with lower interest rates, but central banks are so far leaning against this view. Central banks know that they need to create slack in labour and capital markets to reduce price pressures, but the market so far seems be betting that central banks resolve will dissipate as economies cool further.

The question being asked is will the inflation issue be automatically resolved by slower growth, or as the economists suggest, unwinding higher inflation expectations is going to take more work than a couple of quarters of soft growth. To complicate matters, the natural lags in monetary policy effect appear to be longer than normal this cycle. Businesses and consumers have taken the opportunity to lock in long term funding rates during the very low rates of the pandemic, and the

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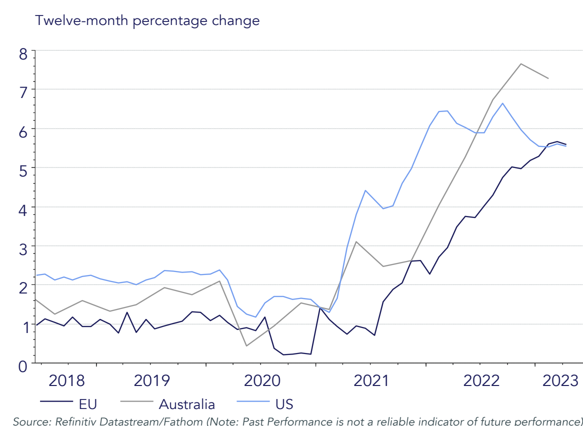
full brunt of higher mortgage and bond yields are yet to be fully felt by borrowers.

We project that global inflation will slow to 4% by year-end and growth will drop slightly below 2%. Looking ahead to 2024, inflation is expected to further decline to slightly above 2% and growth to a mere 0.3% by year-end.

Chart 10: Global Core Inflation Measures



The global economy is likely to experience divergences in growth rates, with the US cooling off more compared to other countries that are catching up or bucking the slowdown trend. China is expected to benefit from its reopening, despite a relatively modest pace to date. China authorities so far have resisted the urge to stimulate the economy post pandemic, but the anaemic reopening is building pressure for a more considered response.

Despite the risks, a globally synchronized recession is unlikely. While recession risks for the US are material, it is anticipated to be mild due to the conservative financial position of private households compared to the Great Financial Crisis in 2007. The looming crisis in the commercial real estate sector is not expected to have a significant impact on consumers, as the connection between private households and commercial real estate is not as problematic as it was with housing in 2007.

How to Position

In fixed income markets, there are opportunities to construct a robust and high yielding portfolio, particularly with investment-grade bonds and lower-rated corporate debt. However, we remain cautious of the high-yield bond and loan markets due to tightening financial conditions and potential stress on their balance sheets.

In terms of our risk budget, we continue to see very limited upside in global equity markets through to the end of the year. The narrow breadth of stocks driving 2023 calendar year performance are now becoming extremely expensive and we would expect some natural profit taking in those names. The broader market multiples remain too high given the outlook for higher bond yields and the multiples typical for the end of a tightening cycle or recession. We continue to expect that the S&P 500 will finish the year around 4000, about 5 per cent below where the index finished in June.

The Australian dollar should generally weaken as global growth cools, and we are currently running our international equity exposures fully unhedged. A more dramatic stimulus in China that triggers a strong steel response is the only real catalyst we see for upside surprise in the $A in 2023.

James Wright and Luke Hansen
Sayers Capital Solutions Group

14 June 2023

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