MarketSay

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What You Need to Know

Month of June: Equity markets mostly rose in June, although Australian equities materially underperformed global peers. Equities moved higher betting that we are entering a goldilocks environment where inflation is slowing but not at the expense of economic growth or the labour market. Bond yield rose on more aggressive talk from central bankers, who continue to push back on market pricing of rate cuts.

Policy Watch: The Reserve Bank of Australia hiked by 25bps in June. The US Fed did not hike in June but reaffirmed its view that two more rate hikes are likely in 2023, and no cuts. The European Central Bank held its annual conference in Portugal, where the heads of most major central banks spoke, and all had similar views that rates were going higher and staying there for longer.

Inflation Watch: Price indices are mostly falling, but most of the move lower is in headline inflation readings where lower energy prices are having an impact. In an Australian context, monthly inflation data is also slowing, but this could be temporary, with recent wage increases, rising energy costs and insurance premiums likely to reaccelerate inflation in the coming quarter.

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 June; we want to take risk and be rewarded for it. At present we do not believe moving into equities presents the right balance of risk for potential reward.

How to Position: Being conservatively positioned for the first half of 2023 has not hurt our returns and the risk reward in growth assets favours maintaining a more defensive stance until the slowdown forces fully play out. Furthermore, the overall market valuations remain too high, given the recent increases in bond yields and the multiples typically associated with the end of a tightening cycle or a recession. We maintain the expectation that the S&P 500 will end the year around 4000, which is approximately 10 percent lower than its June closing level.

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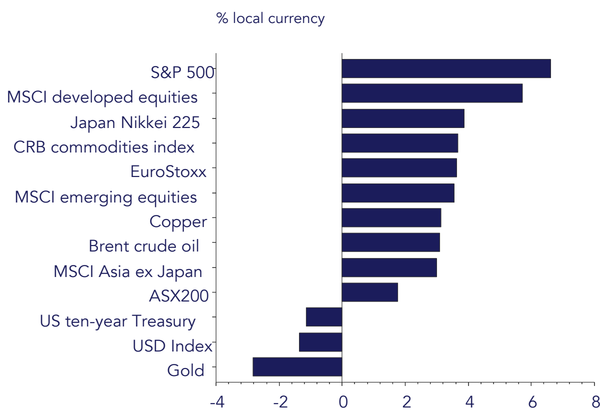
Markets in June

Equity markets rose in June, spurred on by surprising resilience in economic data, especially in the US. Central banks continue to push back on market pricing of future interest rate cuts, pushing bond yields modestly higher over the month. Developed market equities delivered a 6% gain, driven largely by US and Japanese equities, outperforming emerging markets (3.8%). Australian equities continue to underperform other markets, the ASX200 rose just 1.76% in June.

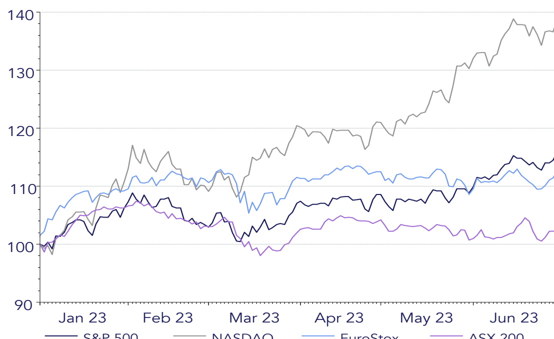
Chart 1: June Asset Class Performance



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

While inflation data was broadly in line across the month, central bank rhetoric remains hawkish, and this pushed bond yields higher over the month. Australian 10-year bond yields rose over 40bps to close the month above 4%. US yields also rose 20bps to 3.84%.

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



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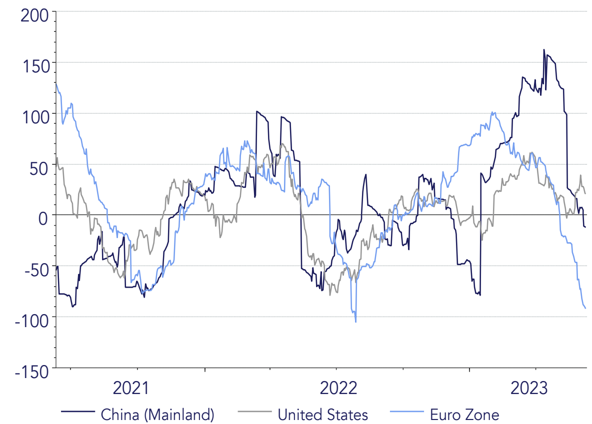
Brent oil gained in June 4.1% on positive economic data, and further supply cuts from OPEC+ members. Higher interest rates resulted in weakness in Gold (-2.7%). The U.S. dollar was down 1.4%. Against the U.S. dollar the Australian dollar had 2.9% gain in June.

Key Themes

The US Economy and labour market remain very strong, while European and Chinese data continues to disappoint.

Chart 3: Citi Economic Surprise Index

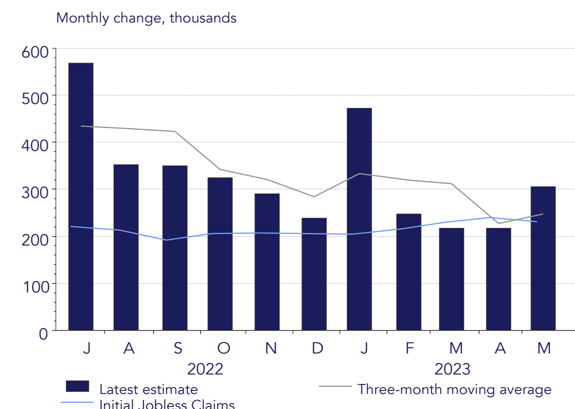


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The risk of a US default or government shut down abated in early June after the debt ceiling was extended for another two years. US Equity then rallied as investors bet that markets could be entering a 'goldilocks' environment where growth and employment remains strong, while higher interest rates break the back of persistent inflation.

In the US jobs data has been consistently strong for some time, with thousands of jobs being added each month, offsetting initial jobless claims and keeping the unemployment rate near record lows.

Chart 4: US Consistent Jobs Growth, Low claims



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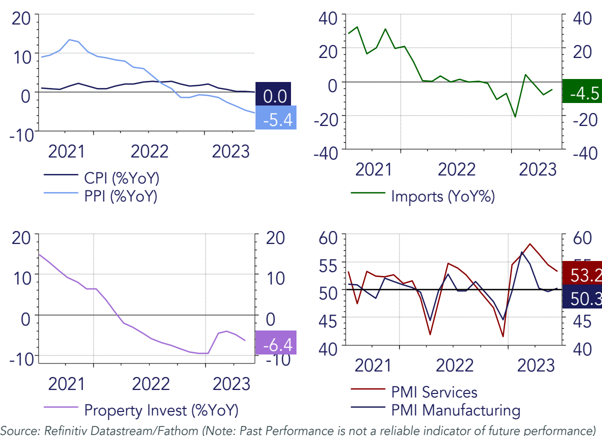
In Europe and China, it is a different story. The gloss of a better-than-expected European winter has worn off. Germany appears to be in recession, while other economic data is disappointing, and inflation remains incredibly high. The European Central Bank has flagged it must keep hiking interest rates, despite the weakening economic environment.

In China, the hopes of an early reopening would result in a big growth boost have gone. While the Chinese Government has recently reaffirmed its view that data is improving and a 5% GDP target should be achieved in 2023, the data suggests that is unlikely without more stimulus.

Chart 5: Chinese data disappoints.



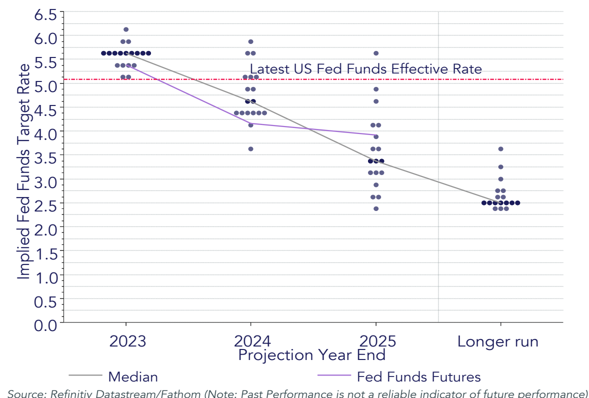
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Unlike the rest of the world, China is battling a deflation problem i.e. they have no inflation. Imports are negative suggesting that the Chinese consumer is buying less product and property investment is also going backwards. The manufacturing sector is flatlining. The result has been a stalling Chinese equity market, dragging on Emerging Market returns.

Interest rate expectations continue to be revised upwards.

The Fed held rates on hold as expected, but the hawkish surprise was in the updated dot plot. The median 2023 'dot' is 50bps higher than in March, only two current FOMC members seeing no need for any further hikes this year (9 of the 18 members see the need for two more hikes, four for one more and three for three or four). Three rate cuts are in the dots for 2024, which is inconsistent with Powell's comment that we 'are talking about a couple of years out' for rate cuts. The new 2024 dots range from 5.875% down to 3.625%, illustrating just how uncertain the outlook remains.

Chart 6: FOMC Dot Plot

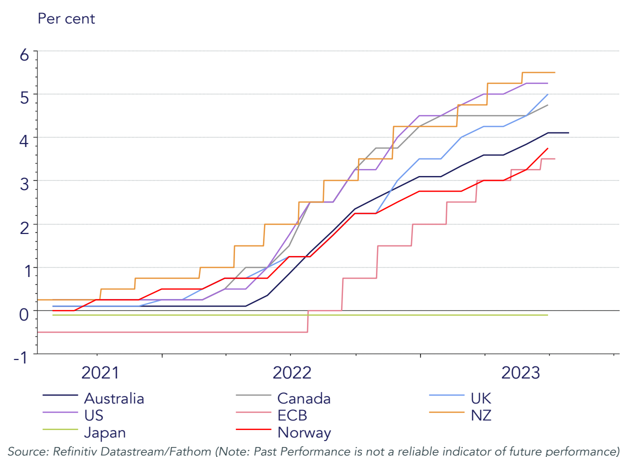


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The European Central Bank held its annual conference in Sintra, Portugal during the month. Most central bankers seem to be following the same script. ECB President Lagarde warned that rising wages are going to sustain inflation and that "We need to ensure that firms absorb rising labour costs in margins. This hinges on our policy dampening demand for some time so that firms cannot continue to display the pricing behaviour we have recently seen.".

Lagarde also commented the market must avoid expectations of a rapid policy reversal which suggests the ECB may intend to hold rates at the peak for longer.

Chart 7: Global Policy Rates



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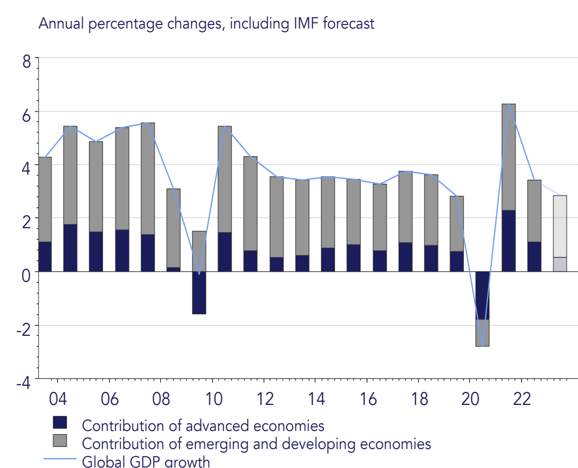
Central bankers are now aggressively pushing back on market pricing for cuts later in 2023 and in 2024. The outlook for interest rates remains uncertain, even amongst the central bankers themselves. We believe that the chance of a policy reversal is slim, and banks are likely to hold interest rates around current levels for some time, increasing pressure on equity market valuations and bond yields.

Outlook

After resisting for much of the past year, the global economy is beginning to show clear signs of the much-anticipated slowdown. Europe is in a technical recession and purchasing manager indices in most developed economies are now beginning to point to an economic contraction. In addition, the China reopening post Covid continues to be significantly slower than had been expected. We would expect the economic slowdown to continue in Europe, while the US remains stronger on a relative basis. We believe that the Chinese Government is likely to stimulate the economy, but at this stage we are unsure what form that may take.

Chart 8: Global GDP



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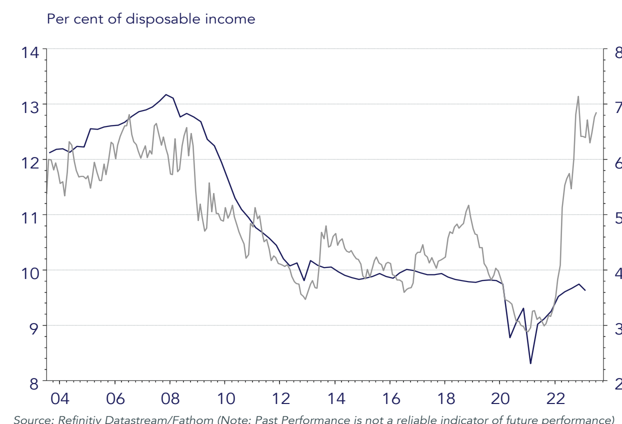
A combination of a lack of labour supply (early retirements associated with the pandemic) and companies desperately trying to hoard staff; remembering how hard it was to hire post Covid, are maintaining record low unemployment rates. Strong employment, combined with rising wages, is supporting certain sectors while keeping services inflation stubbornly high.

While central banks understand the necessity of creating room for manoeuvre in labour and capital markets to alleviate inflationary pressures, the market appears to be betting that their resolve will wane as economic conditions cool down. Markets are focused on signs of a pause or a pivot while central banks are openly talking tough about the need to increase cash rates further or hold for longer.

Chart 9: US household debt service ratio



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Adding to the complexity, the natural time lags in the effects of monetary policy appear to be longer than usual in this cycle. Businesses and consumers have taken advantage of the opportunity to secure long-term funding at historically low rates during the pandemic, and the full impact of higher mortgage and bond yields on borrowers has yet to be fully felt.

Corporate earnings have been downgraded over the past two quarters but have been more resilient than we had expected. Equities indices have been relatively buoyant this calendar year but has been driven by a relatively few technology names surging to expensive levels as investors seek the relative haven of the big tech blue chips.

How to Position

At the risk of stating the obvious, we want to be adequately rewarded for the risks we are taking. Being conservatively positioned for the first half of 2023 has not hurt our returns as our income and alternative strategies have performed well. The risk reward in growth assets favours maintaining a more defensive stance until the slowdown forces fully play out.

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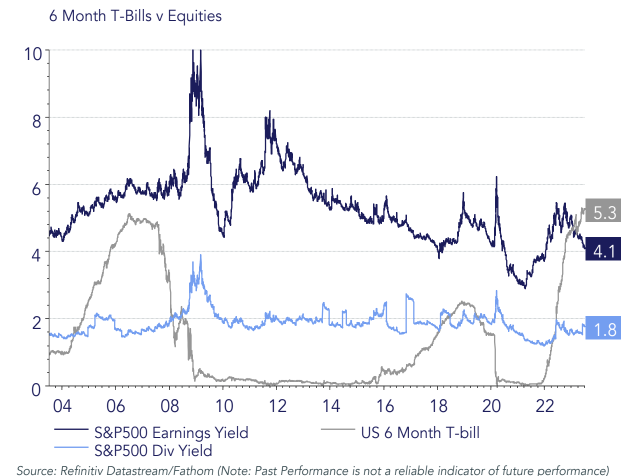
Opportunities exist in fixed income markets to construct a strong and high-yielding portfolio, particularly by investing in investment-grade bonds and lower-rated corporate debt. However, caution is advised when it comes to high-yield bonds and loans, as financial conditions are tightening and there is potential stress on their balance sheets.

Considering our risk allocation, we have a limited expectation of positive returns in global equity markets for the remainder of the year. The stocks that have been driving performance in the 2023 calendar year have become highly priced, and we anticipate some natural profit-taking in those technology names. Furthermore, the overall market valuations remain too high, given the recent increases in bond yields and the multiples typically associated with the end of a tightening cycle or a recession. We maintain the expectation that the S&P 500 will end the year around 4000, which is approximately 10 percent lower than its June closing level.

Chart 10: T-Bill v Equity Earnings Yield



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As global economic growth cools down, we anticipate a general weakening of the Australian dollar. Currently, our international equity exposures are completely unhedged. The only significant catalyst we foresee for a potential positive surprise in the value of the Australian dollar in 2023 would be a substantial stimulus in China that triggers a strong response in the steel industry.

James Wright and Luke Hansen
Sayers Capital Solutions Group

12 July 2023

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