MarketSay

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What You Need to Know

Month of July: a positive month for many asset classes. Equities moved higher on slowing inflation numbers and solid economic data in the US. Bond yield rose again as central bankers maintain data dependence, rather than signalling victory over inflation. Oil recovered after recent weakness while commodities were mostly steady.

Policy Watch: The Reserve Bank of Australia paused in July after surprising the market in June. The US Fed hiked by 25bps as expected. The Bank of Japan altered its yield curve control allowing a wider range for bond yields and it slowly adjusts policy.

Inflation Watch: Headline inflation readings in the US and Australia continued to moderate. In some geographies, including the US, core inflation readings remain higher than headline, suggesting that only some labour market weakness and slowing wages growth will take the heat out of price rises.

Risk Budget: Equity market volatility continues to be range bound, with the VIX trading around 15-16 through July. Bond volatility spiked briefly mid-month and US Treasuries sold off.

Our Portfolio: Our portfolio settings remain unchanged in July. We seem limited upside in many parts of the equity markets, where valuations remain near cyclical highs, while bond yields continue to rise.

How to Position: We have been surprised by the strong rebound in US stocks in 2023. While this has largely centred in the 'magnificent 7' technology companies, lagging sectors now appear be attracting more attention and some rotation of capital. We believe that much of the rally can be attributed to the significant amounts of liquidity that Federal Reserve has injected into the US market since the banking issues in early 2023. This liquidity is now being withdrawn. We continue to believe that clients are not being compensated enough for the risks they are taking in stocks and would be better served in more defensive asset classes.

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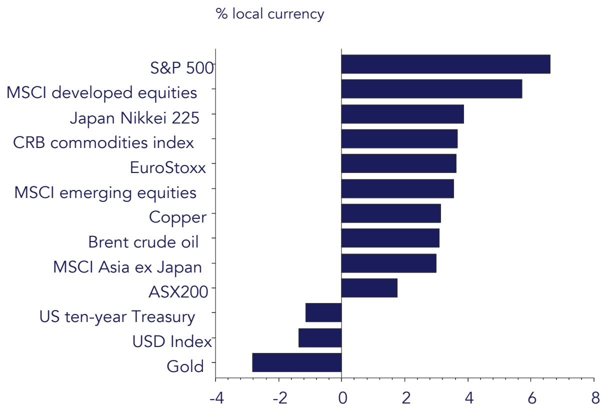
Markets in July

July saw mostly positive market movements across regions and asset classes. Australian equities saw gains, driven by a rally in energy stocks on rising oil prices. The MSCI Developed Markets Index rose by 2.9% over the month, while the S&P 500 gained 3.2% in local currency terms. Similarly, the S&P/ASX 200 matched the performance of the DM World, rising by 2.9% in July.

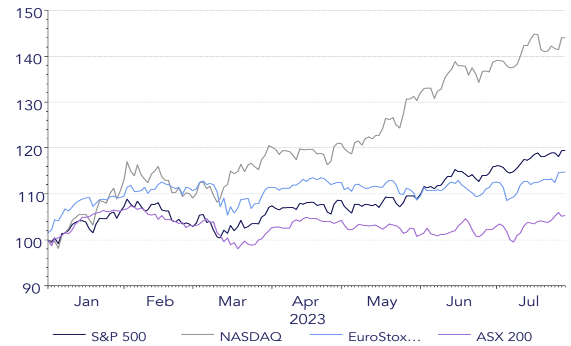
Chart 1: July Asset Class Performance



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

In the bond market, Australian 10-year bond yields experienced a modest 3bps sell-off, reaching 4.05%. This movement came as the Reserve Bank of Australia (RBA) decided to pause the cash rate at 4.10% in its July 2023 meeting. In contrast, US yields saw a more significant increase, rising by 14bps to 3.95% as the Federal Reserve hiked by 0.25%, bringing the Fed Funds rate to 5.5%.
Brent Oil prices surged by US$10.09 to reach US$84.99/bbl, supported by tighter market fundamentals and improved macroeconomic data in the US. Iron Ore prices were slightly higher to US$114.50/Mt, driven by Chinese steel demand and seasonal rises in iron ore supply. Despite fluctuations in the dollar and uncertainties in the rates space, gold prices remained steady, rising by US$42.00 to reach US$1,954.

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

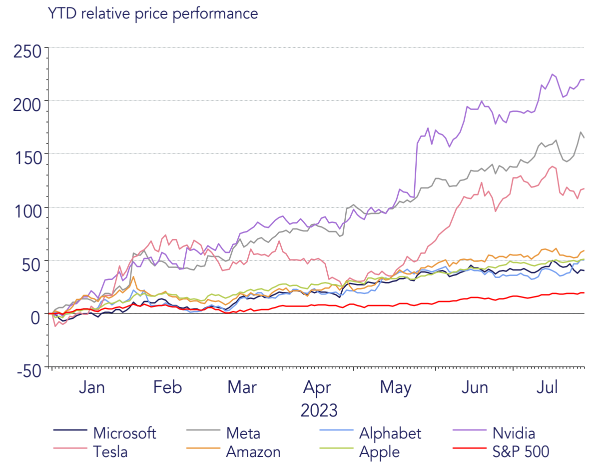


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Key Themes

US Megacap dominance was tested through US Corporate Earnings season, with some of the 'Magnificent Seven' reporting mixed results after very strong share price appreciation.

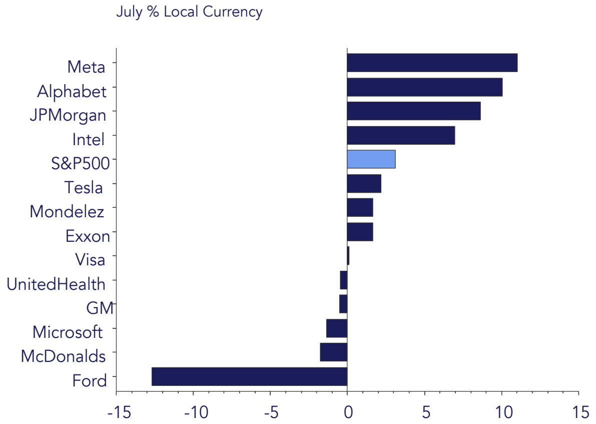
Chart 3: S&P500 'Magnificent Seven'



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

As at the end of July, second-quarter earnings for S&P 500 companies are estimated to have fallen 6.4% year over year, according to Refinitiv. While still negative, the forecast is an improvement from initial forecasts. As at end of July based on results from 254 of the S&P 500, 79% of reports are beating analysts' earnings expectations, but only 59% of firms have beaten revenue expectations, the lowest level in 3 years. Expectations for future earnings growth are high and not pricing in a recession. Third-quarter S&P 500 earnings are seen rising 1.3% p.a. according to Refinitiv, before 9.7% fourth-quarter earnings rise and a 11.9% full-year increase in 2024.

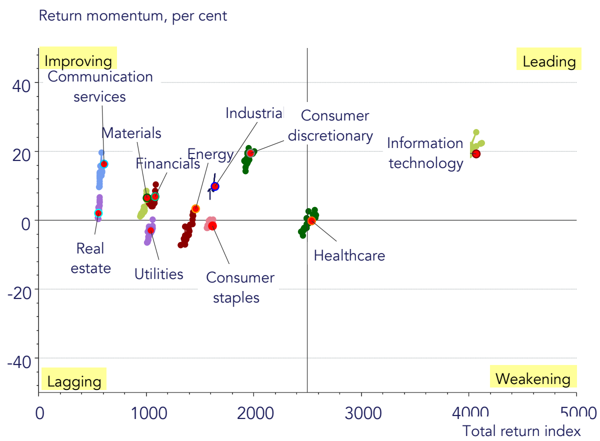
Chart 4: US Corporate Reporting Highlights, % Move in July



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

With a handful of megacap and technology names still to report in August, IT stocks maintained strong return momentum through July, with standout results from Meta and Alphabet. However weak guidance from Microsoft detracted. Healthcare and Utilities were mixed throughout the month on the back of weak results on higher cost pressures for some healthcare names while lower energy prices hampered the momentum of Utilities stocks.

Chart 5: US equity sector price momentum

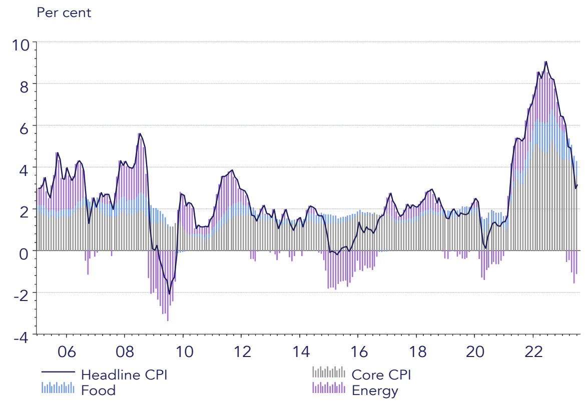


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Inflation continues to moderate, for now?

US inflation Core consumer price index (CPI) numbers rose by 0.16%, the smallest increase since February 2021. While this is certainly encouraging and the market rallied on the result, the composition of CPI shows that the biggest reduction occurred in items that don't reoccur each month like healthcare insurance premiums and also the decline in energy costs, which since the CPI data was gathered have increased again. Also of note is that Core CPI, which excludes such volatile items like energy remains higher than Headline. This suggests that price rises in more day-to-day goods and services are sticker and may only slow with economic or labour market weakness.

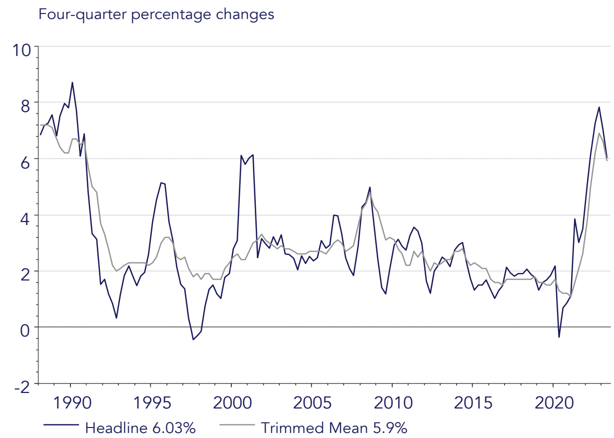
Chart 6: US Headline & Core Inflation (CPI)



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

Regardless, of the slowing inflation picture in July, the Fed still hiked by 25bps. Many pundits are now calling that the last hike of this cycle. That may be the case, but as is the case with other central banks, our view remains that the Fed is likely now to be data dependent and on hold for an extended period. Meanwhile markets are pricing in a 30% chance of another 25-bps hike by November, with 120 bps of cuts priced into 2024.

Chart 7: Australia Headline & Trimmed Mean Inflation



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

In Australia Q2 CPI came in below expectations at both Headline (6.0% y/y vs. RBA exp 6.3%) and Core Trimmed Mean (5.9% y/y vs. RBA exp 6.0%). The lowest quarterly read since the September quarter of 2021. Faster than expected goods disinflation drove the result. The main concern now remains sticky services inflation.

Q3 services inflation could tick higher, as the latest award and minimum wage increase, energy price rises, insurance increases and rates, telecommunication, and postage fees all impact at the same time. So again, while many believe that the RBA may be done.

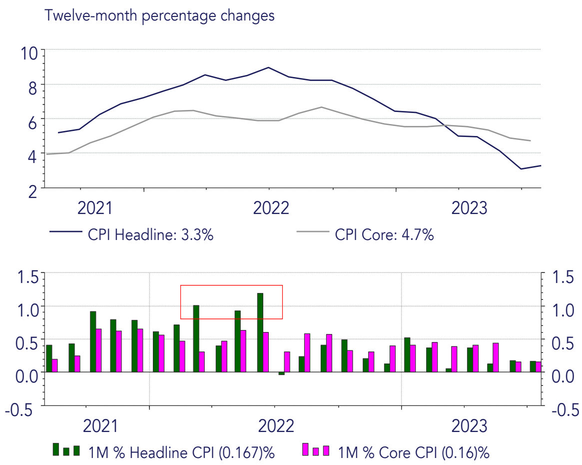
Outlook

The ongoing economic slowdown persists, as both growth and headline inflation exhibit signs of deceleration. However, core inflation remains stubbornly high, posing challenges for employment and wages growth as workers strive to offset lost purchasing power resulting from steep price increases.

Central banks have generally maintained a more hawkish tone to their communications and opted to maintain higher interest rates, despite certain sectors, especially interest rate-sensitive ones, displaying clear signs of slowdown or stress. With some of the very large inflation increases now beginning to roll through the 12 months calculations, we expect the July CPI prints may present somewhat of a low and trend a little higher over the next few months.

The key question remains whether the inflation issue will automatically resolve itself with slower growth or if, as economists suggest, unwinding higher inflation expectations will require more extensive efforts beyond a few quarters of soft growth.

Chart 8: US Inflation (CPI)



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

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

The global economy is likely to witness diverging growth rates. China has recently announced measures to stabilise the property sector and promote growth after a muted response to their reopening. US second quarter growth was better than expected and economists long-awaited recession keeps getting pushed out if priced at all.

Bond yields have pushed higher in recent weeks, particularly as the focus has shifted to the potential ending of the Japanese yield targeting policy. For so many years, Japan has provided the anchor for global yields but that is becoming untethered.

The sector most at risk of higher for longer bond yields in the commercial real estate sector – noticeably the office market. In the US, the official vacancy rate is around 13 per cent but there are measures that have that number as high as 50 per cent when working from home is being considered.

Chart 9: US & AU 10 Year Bond Yields

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

Banks are being less forgiving when dealing with leases with large work from home workforces and are applying more pressure on landlords. After the GFC in 2009, the property liquidation really did not occur in earnest until 2011-13. We expect more

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funds to stop redemptions and close, forced sales of properties and lower revaluations to be a key feature of this sector over the next few quarters.

Despite these risks, a globally synchronised recession seems unlikely. Projections indicate that global inflation is expected to slow to 4% by year-end, with growth dropping slightly below 2%. Looking ahead to 2024, inflation is anticipated to further decline to slightly above 2%, and growth is expected to be a mere 0.3% by year-end.

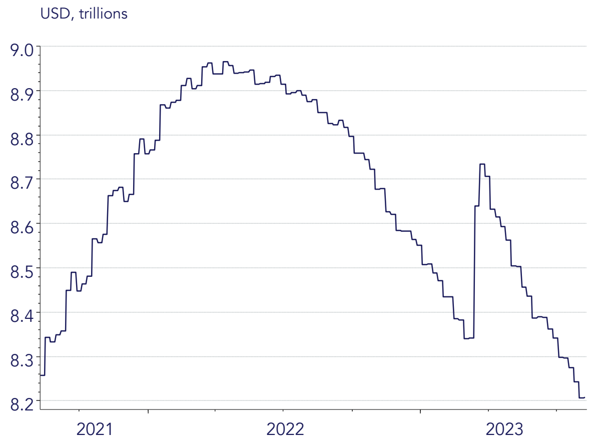
How to Position

We have been surprised by the strong rebound in US stocks in 2023. While this has centred in the 'magnificent 7' technology companies, lagging sectors do now appear be attracting more attention and some rotation of capital. But much of the rally can be attributed to the significant amounts of liquidity that Federal Reserve has injected into the US market since the banking issues in early 2023. Market positioning has switched to overweight and sentiment indicators have swung into positive territory.

While our projection of a market close around 4000 for the S&P500 at the end of the year now looks challenging, we continue to believe that clients are not being compensated enough for the risks they are taking in stocks and would be better served in more defensive asset classes.

Importantly, the Federal Reserve is now reversing the liquidity injections from the first half of 2023, and we are confident that there is limited upside potential in global equity markets for the rest of the year. Overall market multiples remain too high, especially given the likelihood that long bond yields will remain elevated (or even higher) over coming months.

Chart 10: US Fed Balance Sheet



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

As global growth cools, we expect the Australian dollar to weaken. Consequently, our international equity exposures are presently fully unhedged. The only significant catalyst we foresee for an upside surprise in the AUD in 2023 would be a substantial stimulus in China, triggering a strong steel response.

James Wright and Luke Hansen
Sayers Capital Solutions Group

16 August 2023

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