What You Need to Know

Month of August: a challenging landscape for financial markets, with investors grappling with a persistent "higher for longer" stance from central banks, surging bond yields, and softer economic data, especially from China and Europe. Equities were modestly lower, losses in Emerging Markets more severe. Bond yields rose to reflect the outlook for interest rates, while commodity markets were mixed. The US Dollar continues its rise.

Policy Watch: The Reserve Bank of Australia remained on hold again in August, with a consensus forming that peak interest rates are either in, or close. The Federal Reserve held its annual Central Bank gathering in Jackson Hole, where a keynote speech from Fed Chair Powell reinforced messages that inflation was still too high, and more hikes may be needed. This is quite different to the market's outlook.

Inflation Watch: Inflation readings continue to moderate in most countries, as the heat comes out of goods inflation. In China, prices are going backwards.

Risk Budget: Equity market volatility remains sanguine, despite rising interest rates.

Our Portfolio: Our portfolio settings remain unchanged in August. We continue to generate strong returns remaining in more defensive assets. We are benefitting from a rising USD given our equity positions are unhedged and we have direct exposure to a strong USD in our Alternatives allocation. We are also benefitting from rising bond yields, as cash yields on bonds increase.

How to Position: Market multiples remain elevated, especially considering the likelihood of long dated bond yields remaining high or even rising in the coming months. Opportunities exist for building a strong, high-yield portfolio, particularly with investment-grade bonds and lower-rated corporate debt. However, caution is advised regarding high-yield bonds and loans due to tightening financial conditions, which could strain their balance sheets.

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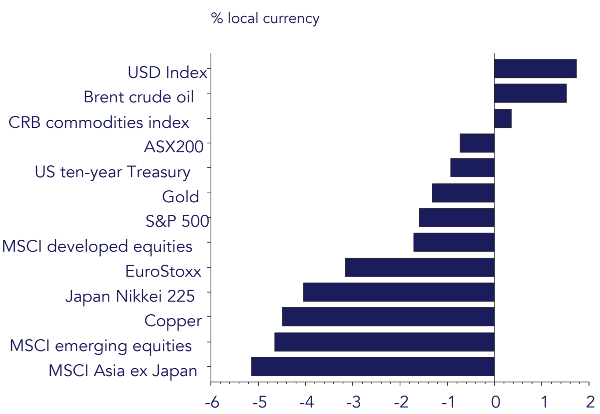
Markets in August

August presented a challenging landscape for financial markets, with investors grappling with a persistent "higher for longer" stance from central banks, surging bond yields, and softer economic indicators, especially from China and Europe. However, a shift occurred midway through the month as a "soft-landing" narrative gained prominence, partially reversing earlier losses.

Chart 1: August Asset Class Performance

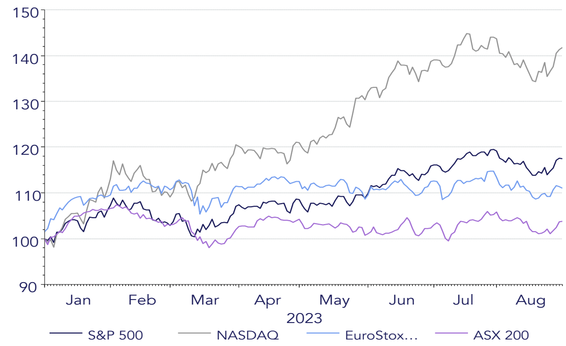


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The MSCI World index recorded a decline of 1.7%, while the emerging markets index experienced a more significant drop of 4.7%. The S&P 500 also saw a 1.6% dip in local currency terms. Australian equities outperformed global peers despite lacklustre guidance from companies during the reporting season, the S&P/ASX 200 recording a more modest decline of 0.7% in August.

The bond market took centre stage last month, with the yield on U.S.10-year Treasuries peaking at 4.35%, marking a 60-basis point increase from the mid-July low and reaching a level not witnessed since 2007. Meanwhile, the 30-year Treasury yield surged by 70 basis points from its recent low. These yield movements were not primarily driven by Fitch's credit rating downgrade of the U.S. government to AA+, but rather by a combination of increased supply issuance, robust economic data, and debates surrounding the neutral interest rate level for the U.S. economy.

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



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Commodity prices were mixed throughout August. Brent Oil prices inched up by US$0.30 to reach US$85.86 per barrel, buoyed by a drawdown in U.S. crude inventories. Meanwhile, Iron Ore prices rose by US$6.50 to US$117.50 per metric ton, underpinned by robust crude steel production in China and steady supply.

Gold prices faced headwinds due to a strengthening U.S. dollar and rising long-term yields, resulting in a decline of US$23.10 to US$1,948 per ounce.

Key Themes

Australian corporate reporting season delivered results that illustrated the strength of the underlying economy in the past 6 months. However, guidance revealed how weak corporates expect the next period to be.

ASX companies displayed resilience over the past year, posting a 2.0% year-on-year growth in profits, surpassing initial expectations of a modest 0.5% year-on-year increase. Throughout August, company profit results showed the underlying strength in the Australian economy in the past 6 months, with beats outnumbering misses at a ratio of 5:3.

The Materials sector (excluding mining) and Communication Services recorded the strongest beat rates, while Consumer Staples and Information Technology had a higher tendency for earnings misses.

Forward looking guidance however was weak, with two downgrades for every upgrade. Consensus for

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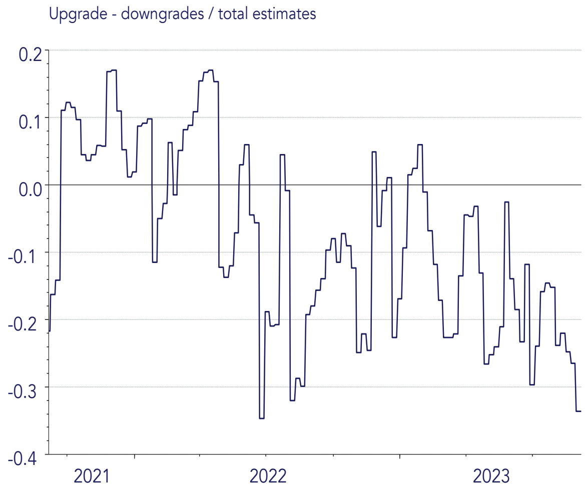
next year's profit growth stands at -5.7%, a significant shift from +0.7% six months ago.

Chart 3: ASX200 Analyst Earnings Sentiment



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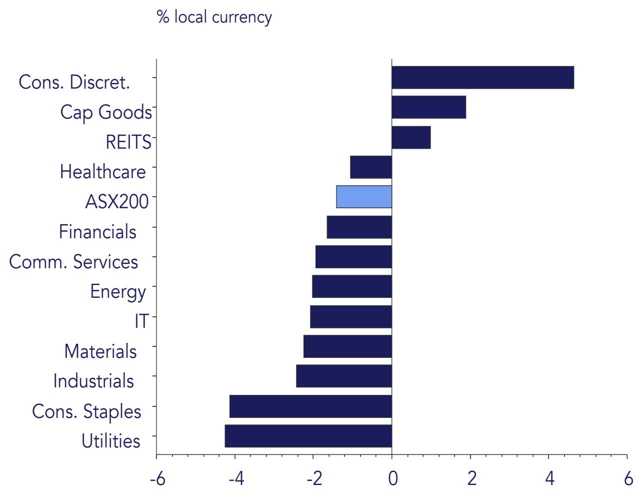
August witnessed numerous significant share price fluctuations on company results, often exceeding ±10% on the day. This volatility reflects crowded investor positioning and the unpredictability of the current economic cycle.

Chart 4: ASX200 Sector Performance August



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One persistent challenge for companies during this earnings season has been managing escalating costs. Labour, rent, energy, transportation, and technology were all repeatedly cited as areas where costs are rising. Pressure on input costs is likely to remain elevated.

Despite these pressures, companies have largely succeeded in passing these increased expenses on to customers. This ability to maintain profit margins echoes the trend observed in the February results period. Sectors such as Telcos and Insurers, have pushed through price increases without sacrificing sales.

The past 12 months have seen cyclical sectors rebound from mid-2022 lows, even as the economic storm clouds gather. With the ASX200 currently trading at a forward P/E ratio of 15.4X, compared to the long-run average of 14.5, prices and valuations appear complacent given the challenges on the horizon

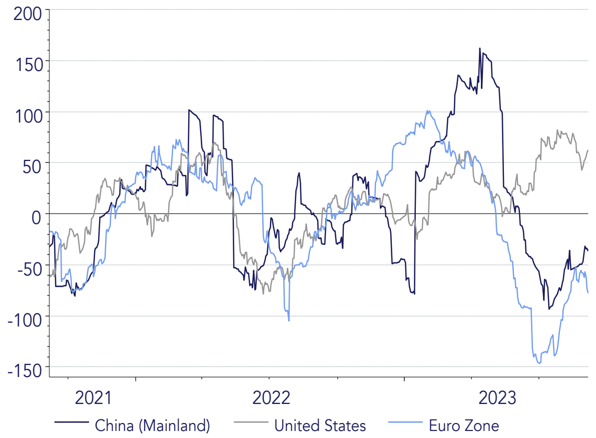
China and European Growth is faltering, while the US is proving more resilient than expected.

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 do not reoccur each month like healthcare insurance premiums and 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.

US economic data remains robust, despite tighter financial conditions, through higher interest rates. The labour market remains strong, while cost pressures, including wage pressures have eased. Towards the back end of August, this especially came through in the economic data, leading investors to the view that we could be entering another "goldilocks" period, whereby inflation is falling, the labour market strong and economic growth is robust.

Chart 5: Citi Economic Surprise Index (US, EU, CH)

A positive reading indicates better-then-expected result



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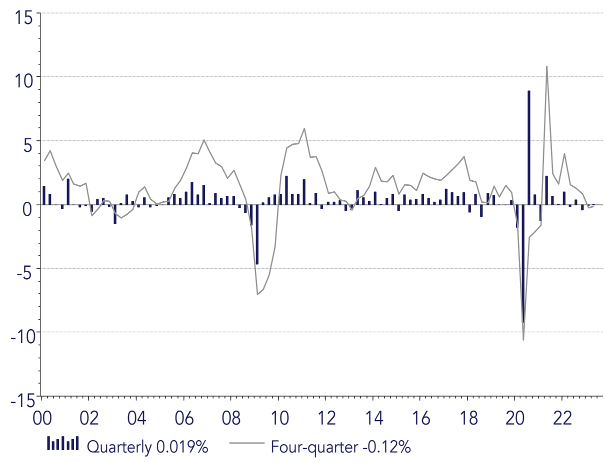
In the Eurozone, economic momentum has faltered, with the composite Purchasing Managers' Index, a measure of output, hitting a low of 47, the lowest level since 2012 outside of the COVID pandemic period. The region is at a crucial junction with a tight labour market putting pressure on wages, persistent inflation (5.3% year-on-year for August), and a weakening external sector due to softening global and Chinese demand for exports. The Germany economy, the powerhouse of the E.U. recorded negative annual GDP growth. The European Central Bank remains committed to its inflation target, but it may have to push all of Europe into a recession to reach it.

Chart 6: German GDP

Percentage changes



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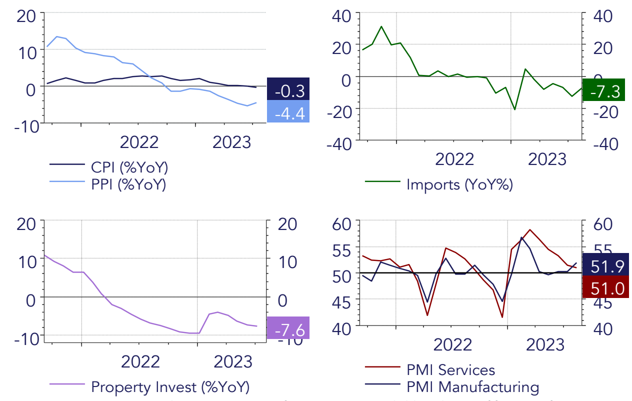
China has an inflation problem too but recorded negative inflation (-0.3% year-on-year in July). Retail sales growth was lower-than-expected at 2.5% year-on-year, and private investment is declining. Policymakers in China have responded with incremental changes in monetary, fiscal, and operational policies to stabilize the economy, focusing on the property market, consumer support, credit growth, as well as addressing weaknesses in the equity market and currency. While these measures are expected to stabilize the near-term growth outlook, they are not likely to reinvigorate it significantly. Market participants had hoped for more substantial stimulus measures.

China's economic challenges have cast a long shadow over the global economy.

Chart 7: Weak Chinese Data



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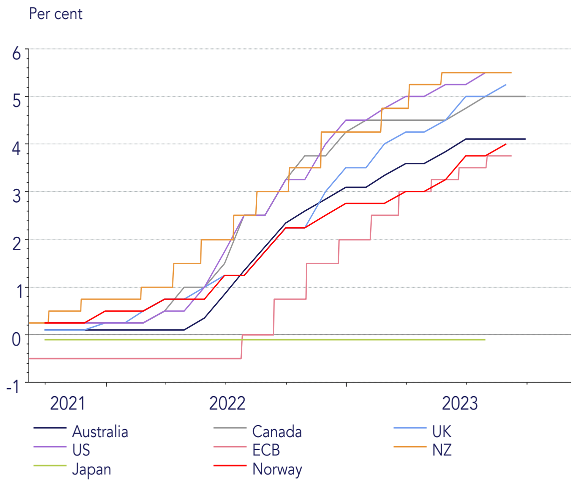
Outlook

Investment markets do not like to sit in a quiet equilibrium for long – and often swing wildly from pricing in one scenario to the reverse. While we are undoubtedly getting close to the peak in global cash rates, the dramatic swing to price in rate cuts in early 2023 look premature.

The Bank of England speech referring to the shape of Table Mountain in Cape Town as the most likely path of their cash rates is likely to apply to many more countries in our view. While rates in the US are likely above the neutral rate (implying a tightening bias), in many other countries that is less clear. Inflation hawks are still arguing that more might need to be done to stop inflation expectations being allowed to drift higher. In any event, the most likely path for cash rates will be higher for longer. And that has implications for the level of long dated bonds.

Chart 8: Global Policy Rates



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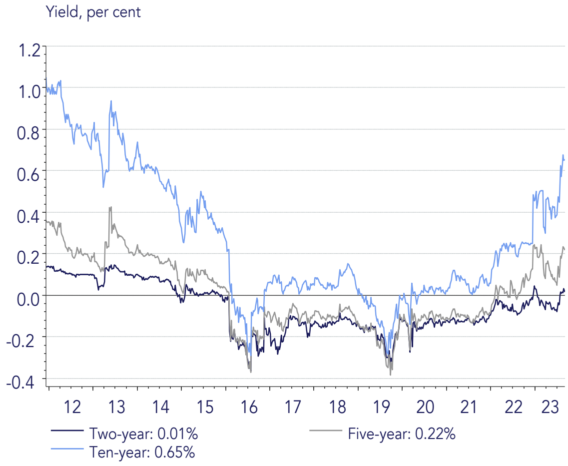
With cash rates likely to stay higher for longer, a steeply negative bond curve will be difficult to sustain, and long bond yields could track higher from here. Technically, bond yields could comfortably push 100 points higher and the lack of central bank buyers (after the cessation of quantitative easing) and the seismic shift in Japanese yield curve management, offer added pressure on bond yields. For years, Japan has anchored global yields, but that stability is unravelling as the BOJ moves away from its yield targeting in response to some welcomed moderate inflation.

Chart 8: Japanese Government Bond yields



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

The troubles in the office commercial real estate market continue to rumble through investment markets. Frozen funds and forced sales are slowly repricing illiquid assets down. High growth technology companies that relied in new equity to keep funding growth are now painfully raising equity in down rounds where existing shareholders are being forced to tip in more capital or be severely diluted.

How to Position

Much of the rally in 2023 can be attributed to the substantial liquidity injections by the Federal Reserve when banking issues arose in February. With equities rallying strongly, market positioning has shifted toward overweight, and sentiment indicators have turned positive.

While our initial projection of the S&P500 closing around 4000 by year-end appears challenging, we maintain our belief that clients are not adequately compensated for the risks associated with stocks and would be better served in more defensive asset classes.

Market multiples remain elevated, especially considering the likelihood of long bond yields remaining high or even rising in the coming months.

In the fixed income markets, opportunities exist for building a strong, high-yield portfolio, particularly with investment-grade bonds and lower-rated

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corporate debt. However, caution is advised regarding high-yield bonds and loans due to tightening financial conditions, which could strain their balance sheets.

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

James Wright and Luke Hansen
Sayers Investment Solutions Group

8 September 2023

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