What You Need to Know

Month of September: September proved to be a reality check on the markets. Bond yields rose rapidly as investors realised that interest rates are likely to stay higher for longer triggering a broad sell-off across equity markets. The Oil price rose strongly as tight supply dynamics overcame any demand concerns. The US Dollar continued its rise on the risk off tone and that US interest rates are likely to head higher, while others may have peaked.

Policy Watch: The Reserve Bank of Australia remained on hold again in September but left the door open for future rate hikes. The Federal Reserve also remained on hold, but the messaging was hawkish as was the new dot plot forecast. Expectations from FOMC members is for one further hike in November, and fewer cuts for next year, providing the catalyst for the rise in bond yields.

Inflation Watch: Inflation readings continue to moderate in most countries, as the heat comes out of goods inflation.

Risk Budget: Equity market volatility rose from cyclical lows in September, with the VIX rising from a low of 13 to 19. Elevated from lows, but still well below levels associated with a large risk-off event or market capitulation.

Our Portfolio: Despite the pull-back in risk assets and rise in bond yields we continue to believe we are not being adequately compensated to add to either. 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.

How to Position: Our view has not changed despite the pull back in growth assets. Bond yields are normalising but could and should push even higher, in our opinion. We believe that equity multiples remain out of line with this and need to adjust lower. We have adjusted our equity portfolios additional investment in defensive sectors.

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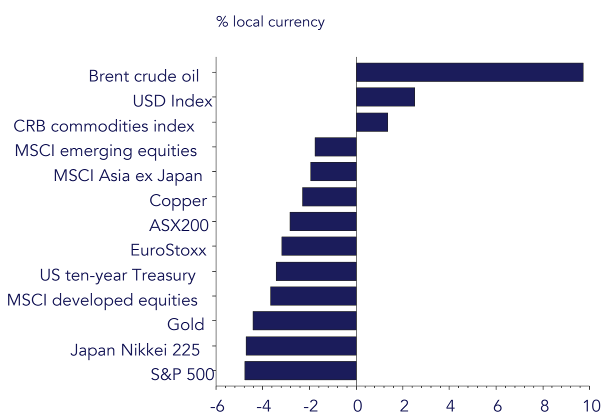
Markets in September

September provided a reality check for most asset classes. A sharp repricing in bond markets occurred with yields rose to post-GFC highs lead to a broad sell-off in equity markets. This repricing is driven by concerns that central banks will hold rates at elevated levels for an extended period. A very different market expectation of cuts early next year, which was the dominant view a few months ago. Adding to the negative sentiment was the risk of a US Government shutdown, only averted at the last minute.

Chart 1: September Asset Class Performance

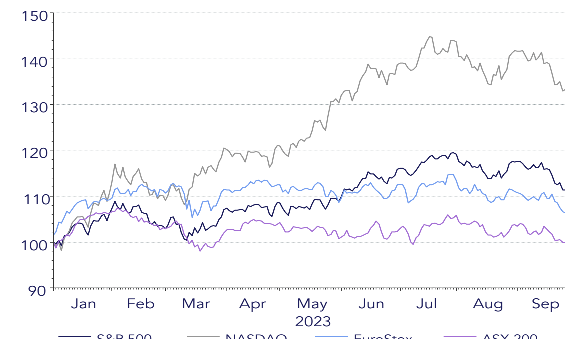


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The MSCI World index fell by 3.7% and the emerging market index by 1.8%. The S&P 500 fell more heavily and recorded a 4.8% drop in local currency terms. Australian equities outperformed global peers aided by higher oil and iron ore prices, the S&P/ASX 200 recording a more modest decline of 2.8%. The heavy weight of IT names punished the NASDAQ to the tune of -5.8%. European equities did marginally better as the MSCI Europe was down 1.3%. The surprising market is the UK, as the FTSE 100 rose by 2.4% on the month aided by the falling currency. A weaker currency is also helped the Japanese equity market to a gain of 0.5% in September.

The repricing in bond markets dominated markets, with the higher for longer narrative dominating. The Australian 10-year bond yield rose to 4.49% (+46bps). U.S. 10-year Treasury yields rose to 4.57% (+48bps) after the U.S. Federal Reserve held rates steady but reinforced their hawkish messaging. The committee released policy forecasts of another rate hike this year and fewer rate cuts in 2024.

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



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

Commodity prices were once again mixed but there were some bright spots. Brent Oil spiked 9.2% in September, reaching US$95.30 per barrel. Tight supply dynamics overwhelmed any growth concerns. Stronger than expected Chinese steel production pushed Iron Ore through US$120/tn.

Gold prices failed to provide any protection due to a strengthening U.S. dollar and rising long-term yields, falling US$23.10 to US$1,948 per ounce.

The USD Index was one of the best performers for the month, on higher interest rate expectations. The Australian dollar continued to weaken against the U.S. dollar, falling to 0.645.

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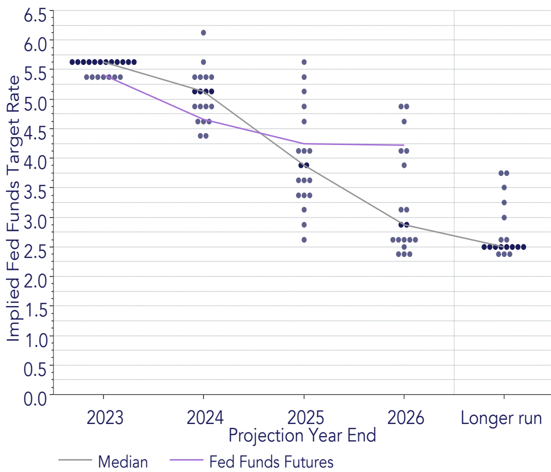
Key Themes

"Higher for Longer"

The US Federal Reserve left rates unchanged, but its commentary was hawkish overall, and a majority of members still expect one more hike this year. The Fed's dot plot (below) is the central bank's outlook for the future path of interest rates. It shows each committee member's expectations for future interest rates.

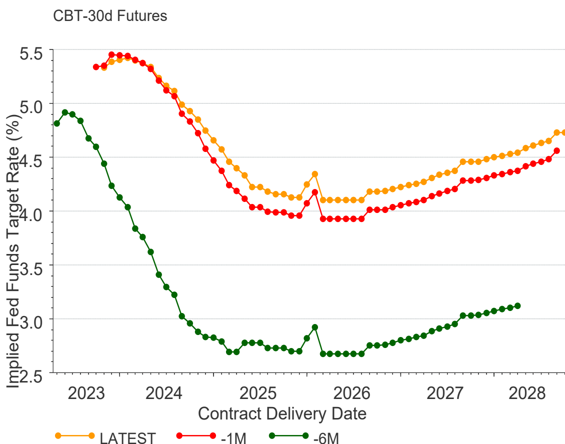
Chart 3: FOMC Dot Plot



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

Compared to the last dot plot (June), higher rates in 2024 and 2025 are now forecast by most members. Only two rate cuts are now forecast next year, down from four previously, and fewer cuts are expected in 2025, the median expectation has from 175 bps to 125 bps. The range of expectations in 2025 and 2026 is wide, adding further to the market's uncertainty on the future path of rates.

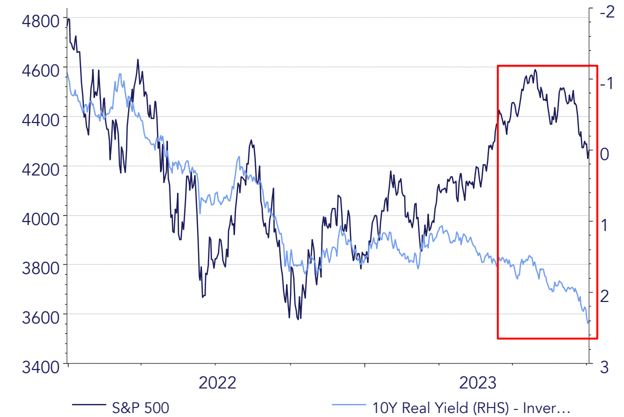
Chart 4: US Fed Futures Curves (Now, -1M, -6M)



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

Six months ago (green line) the market expected rates to peak in 2023 before a series of cuts through 2024, on lower inflation and potentially weaker economic growth or recession. Now the path is higher, with the cuts coming later and in fewer number.

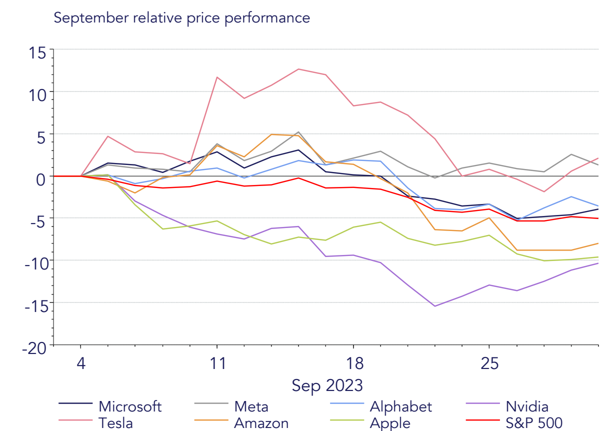
Chart 5: S&P500 v Real Bond Yields (inverted)



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

With higher interest rate expectations bond yields have headed higher too. Real Yields, a bond investor's return after inflation, have been rising. This suggests it's the underlying strength in economic conditions and potentially concerns over the supply of government bonds that is driving bond yields rather than inflation concerns. It was these rising yields that did all the damage to equity markets in 2022, especially on stocks with lofty valuations. For much of this year, the equity market and the technology sector has ignored these rising yields, with huge growth expectations around artificial intelligence dominating. This is now being challenged by the higher bond yields.

Chart 6: Big Tech Performance September



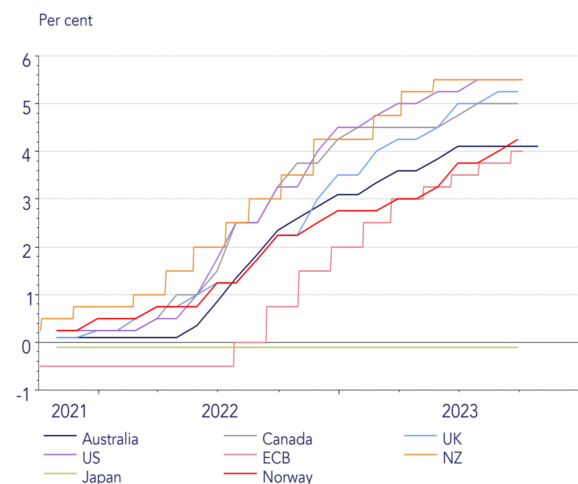
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

A shift in investor sentiment has been building in recent weeks.

Central banks around the world have been signalling for many months that while rates are getting closer to their peak (or restrictive enough), they have been at pains to emphasise that rates are likely to stay higher for longer to ensure that inflation expectations remain anchored, and services inflation is contained. The fear has been that a premature cut to rates would encourage a resurgence in inflation influences. The market is having to re-learn you don't fight the Federal Reserve.

Chart 8: Global Policy Rates

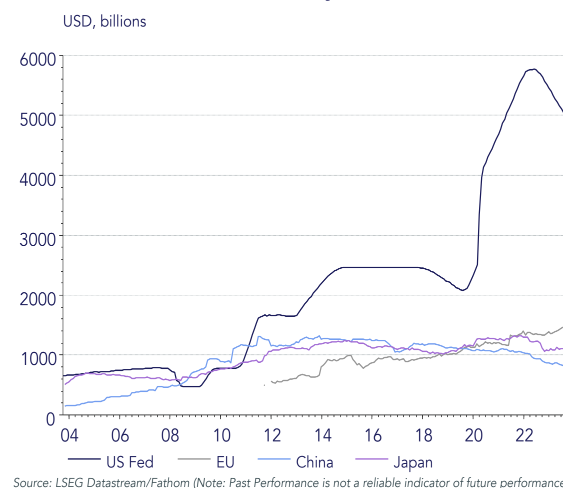


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Goods inflation has been moderating but the base effects have largely worked through the system and are now likely to flat line or start to show some more modest increases. Recent bounces in energy costs are likely to lead to headline inflation bouncing over the next couple of releases. Services inflation remains sticky as labour markets remain tight and increased industrial action across many sectors leads to higher wages down the track.

Bond yields are now pushing higher in response, but in our view, they will need to push higher to attract private capital in a period where central banks are no longer the main buyer.

Chart 8: US Treasuries: Major Holders



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

Corporate earnings in the US and Australia have generally met downgraded expectations but the outlook for strong growth in top line revenue and margin expansion looks optimistic. We continue to believe that analysts will revise down the next couple of quarterly earnings numbers in response to higher borrowing costs and wages.

Our view remains that growth markets will continue to give back the excessive pandemic gains. The stimulus that pushed bond yields lower and growth and equity valuations higher are now in full reverse. Most countries are now looking to regain control over fiscal deficits (the US is threatening a shutdown if more aggressive action isn't taken). Higher bond yields will force governments to respond as the public sector borrowing costs continue to grow.

How to Position

Our view has not changed despite the pull back in growth assets. Bond yields are normalising and could push even higher. Equity multiples remain out of line with bond yields and need to adjust lower. Earnings expectations remain too optimistic.

Our focus remains on being appropriately compensated for the risks we are taking, and our preference is to focus on opportunities in fixed income markets, particularly with investment-grade

bonds and better-rated corporate debt. Our equity portfolios have further adjusted towards defensive sectors.

The Australian dollar has been weakening and is now approaching a zone where would contemplate hedging some of our international equity holdings. Catalysts for a short-term rally $A remain tough to find, but the stretch from its long-term fair value is getting to extreme levels.

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Sayers Investment Solutions Team

10 October 2023

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