MarketSay

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What You Need to Know

Month of October: Markets struggled to navigate rising interest rates, geopolitical tensions, and mixed US corporate earnings updates. The 'Higher for longer' interest rate theme dominated price movements, especially towards the end of the month as economic data in the US continued to beat expectations. Investors have repriced the chance that central banks will start cutting in 2024, especially in the US and Australia.

Policy Watch: The Reserve Bank of Australia remained on hold in October, but retained its hawkish bias, with the quarterly CPI a critical input into its November decision. A Melbourne Cup Day rate rise is live. The Bank of Japan continued to loosen its grip on yield curve control and allowed its bond yields to drift higher.

Inflation Watch: Inflation readings continue to moderate in most countries, as the heat comes out of goods inflation. Australia is experiencing sticky services inflation, which is causing concern for the RBA, with October's number coming in above where the RBA was expecting it to.

Risk Budget: Equity market volatility jumped to peak out above 20 for the first time in months.

Our Portfolio: We had been calling for a rise in bond yields and associated fall in equity prices, both occurred in October, however both yields and equity index levels fell short of where we believe it made sense to change our allocations. We continue to benefit 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: The mixed picture on growth and inflation leaves us little reason to change our view on risk assets. A better growth picture especially in the US and Australia should be supportive of equity markets, it comes with the risk of tighter monetary policy in response, which may weigh on corporate profitability.

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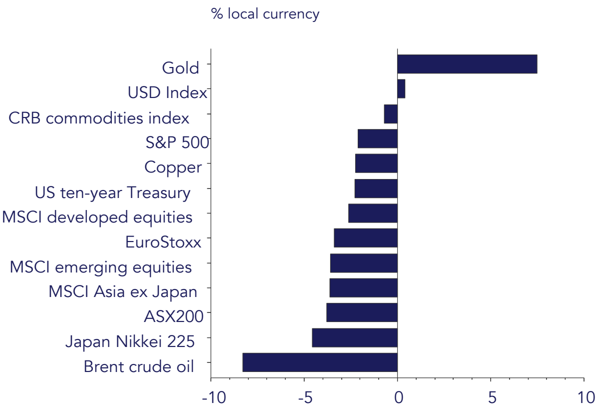
Markets in October

Another weak month for risk assets in October, as equities struggled to navigate an environment of growing geopolitical concerns and a resetting of interest rate expectations. Government bond yields moved violently higher, and the U.S. 10-year Treasury yield breached 5% as investors worried about inflation and bond supply, negatively impacting equity markets as both bonds and stocks sold off.

Chart 1: October Asset Class Performance



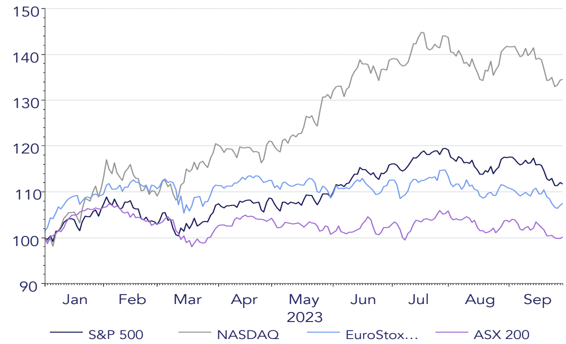
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The MSCI World Index lost 2.6%, with few equity markets escaping weakness. The S&P 500 fell 2.1%, Japan -3.0%, and Europe -3.4%. Emerging Markets fell 2.9%. For local investors with unhedged equity exposure, a weak AUD smoothed out some of the volatility in global equity returns.

Australian equities underperformed global equities with the ASX 200 recording another poor month, falling 3.8%. This follows the negative September month. Small caps stocks suffering more falling 5.5%. 10 out of the 11 sectors finished lower, while utilities managed to stage a rally (1.7%). The worst performers were IT (-7.6%), health care (-7.2%), industrials (-6.4%), and real estate (-6.1%).

The U.S. 10-year bond yield moved through 5% for the first time since 2007, although it retreated from this level late in the month to close at 4.90%, it finished the month 33bps higher. The Australian 10-year bond yield moved a larger 44bps to 4.92%, with inflation falling less quickly here than other markets, resetting expectations for a hike in November.

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)

Brent Oil fell by US$7.86 to US$87.45/bbl, on economic growth concerns offsetting geopolitical news flow in the Middle East. Iron Ore prices held, rising by US$2.50 to US$122.00/Mt. Safe haven demand has continued to drive gold higher, rising by US$127.10 to US$1,998.

Key Themes

"US Economic Exceptionalism"

The US economy continues to show resilience despite higher interest rates. The consumer continues to spend despite low confidence and elevated cost of living pressures. The job market in the US continues to remain tight, but encouragingly wages growth is showing signs of slowing.

The catalyst, for October's interest rate repricing and move higher in bond yields was a US GDP number that significantly beat expectations, growing at 4.9% in the third quarter, above the 4.5% estimate. This was the strongest rate since the post pandemic reopening in 2021. There was strength in consumer (+4.0%), Federal (+6.1%), and state and local (+3.7%) spending. While inflation in the US appears to be falling gradually, it was this display of economic strength that renewed the calls for interest rates to stay higher for longer.

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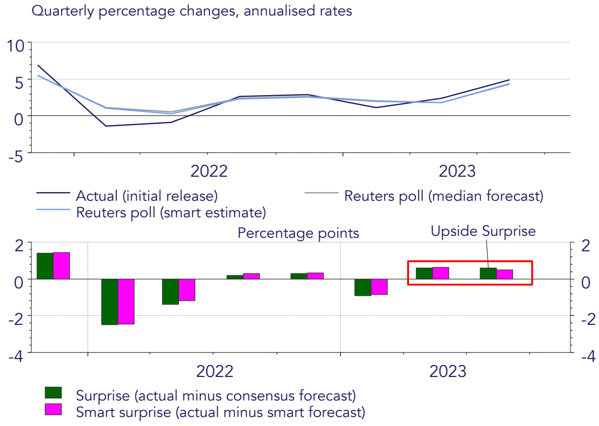
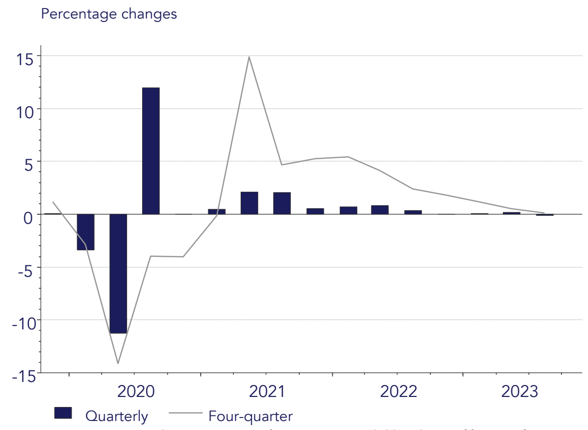
Chart 3: US GDP Upside Surprise



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

Europe is heading in the other direction as the economy contracted in the third quarter in an environment where growth has been anaemic for some time. The post pandemic recovery appears well and truly over, with the region failing to fully recover from its big hit to growth and confidence when energy prices spiked around the invasion of Ukraine. The weakening of growth and the significant slowing in inflation seen in Europe has eased the pressure on the European Central Bank to do anything further with the policy rate.

Chart 4: Euro Zone GDP

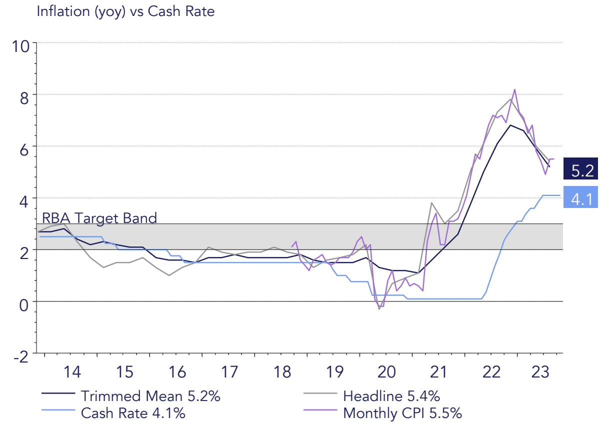


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

"Australian Inflation Declining Too Slowly"

In October, Q3 CPI was the big news locally, and at 1.2% q/q on both the trimmed mean and the headline measure, confirmed that the RBA's August projections were too optimistic. A key upward driver in Q3 was automotive fuel, which jumped by 7.2% q/q and contributed 26bps q/q to headline CPI.

Chart 5: Australia CPI vs Target Band



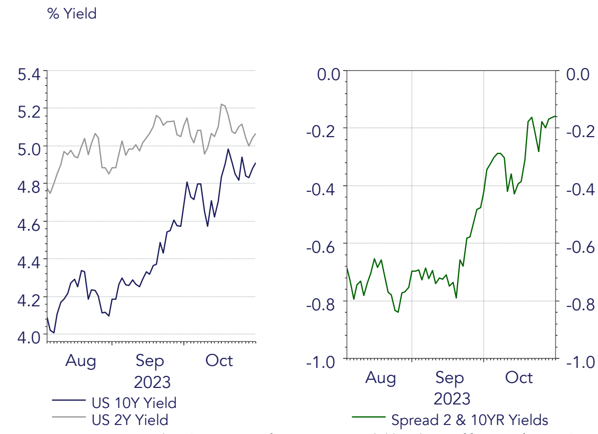
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Importantly, even though fuel was a major driver of headline CPI, the RBA's preferred 'underlying' inflation measure – the Trimmed Mean CPI – still lifted by 1.2% q/q in the quarter, despite not having fuel prices in its components. This measure is running at annualised rate of 5.2%, well above the RBA's target band and where they expected inflation to be. Unlike most of the rest of the developed world, inflation in Australia is gradually slowing, but too slowly for the RBA. This data point was the catalyst for a repricing of interest rate expectations in Australia.

Outlook

The repricing for the future path of interest rate expectations continues. Higher for longer we believe, is likely to be a dominate theme for some time to come.

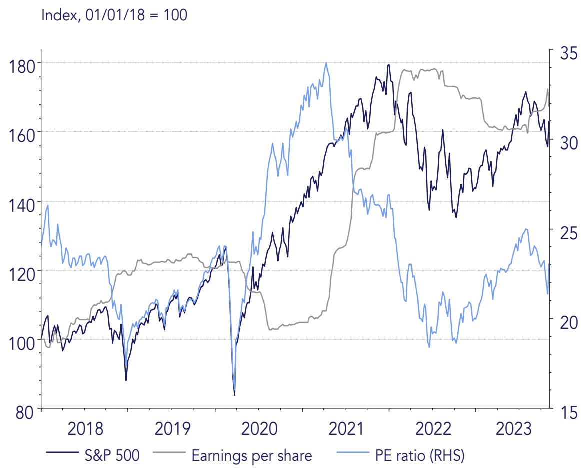
Chart 8: US Bond Yields & 2s-10s Curve



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

Most central banks, except for the Bank of Japan, are arguably done hiking rates or are close to it. However, the disconnect between the markets and central bankers' views for some time has been what would happen next. The dramatic rise in bond yields and flattening of the yield curve in the US reflected a repricing of expectations that the Fed would cut rates next year. The chances of a deep recession appear to be shrinking, making aggressive interest rate cuts seem unlikely.

Chart 8: S&P 500 index, EPS, and PE ratio



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

Corporate earnings in the US and in Australia continue to paint a mixed picture. While to date over 70% of US corporates have beaten expectations, these are expectations that have been continually lowered as the year as progressed. We expect further earnings revision into 2024 as the global economy continues to slow.

Earnings per share growth in the US has levelled off after accelerating rapidly on the back of government stimulus and ultra-low interest rates giving consumers and business excess capital to spend and deploy. That tail wind is now gone and with financial conditions continuing to tighten as higher interest rates start to bite, earnings may continue to decline.

If higher interest rates do end up causing a recession, then corporate earnings will not be immune from the economic contraction. The associated fall in interest rates will provide some valuation support in such an event but are unlikely to fully offset in our view.

How to Position

The mixed picture on growth and inflation leaves us little reason to change our view on risk assets. A better growth picture especially in the US and Australia should be supportive of equity markets, it comes with the risk of tighter monetary policy in response, which may weigh on corporate profitability.

The resetting of interest rates gives clients an opportunity to position in defensive assets at more attractive yields and entry points. With equity risk premium at its lows and the earnings yield from equity below that of bonds, the risk-reward equation does not add up in our view.

We continue to focus on growth and income alternatives, that can generate returns that are not correlated with equities or bonds.

The recent upside surprise to the Australian CPI gave some support to a falling Australian Dollar. The AUD bottomed out at 63 cents in October before recovering, just short of where we would implement a hedge for a portion of our equity exposures.

James Wright and Luke Hansen
Sayers Investment Solutions Team

10 November 2023

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