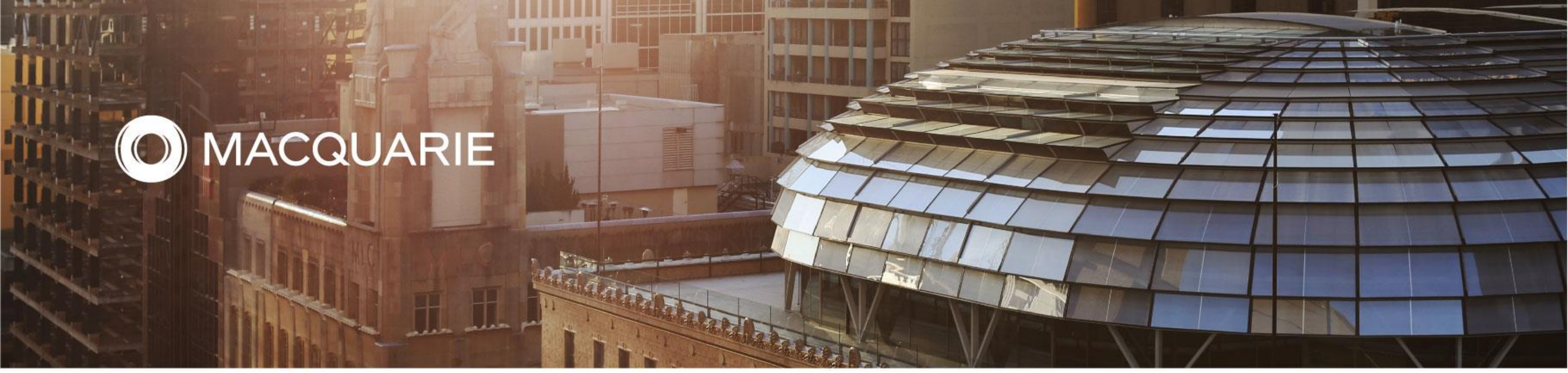


Investment Strategy Update #106

Why markets remain under pressure

- It has been difficult to escape financial market weakness year to date as both bonds and equities have come under intense selling pressure. Despite near term recession risks remaining low and valuations improving dramatically, equity markets (and more broadly risk assets) remain subject to ongoing news flow – good or bad.

- We think a number of factors are contributing to two-way volatility in financial markets.

    - First, it remains too early to determine whether inflation has now peaked and hence its impacts on driving bond yields and rate expectations higher. We saw that as Fed rate hike expectations ratchetted higher in recent weeks and then again last week when some of this was unwound and markets rebounded.

    - Second, rising growth risks are now starting to undermine bullish earnings expectations. While near term recession risks are low, concerns are growing the Fed and other central banks will have to crush growth to control inflation. Earnings expectations are likely to be too optimistic regardless of whether recession is likely (or not).

    - Third, valuations across both bonds and equities are not yet back to levels that cushion against rising yields and/or slower growth.

    - And fourth, ongoing geopolitical risks with the conflict in Ukraine, and its impact on energy markets, continuing to weigh on risk-appetite and are ensuring markets remain susceptible to developments – good or bad.

- In hindsight, any view other than being bearish has proven too bullish given recent declines across equity markets and ongoing losses within fixed income. While the correction in equities is now significant given it is not (yet) accompanied by a recession, the fundamental drivers for a sustainable bottom are not yet present. A bounce (rather than a bottom) can come at any time (as we saw last week), but our markers for a sustainable bottom in equities and stabilization in bond yields / credit spreads include: 1) a moderation in inflation pressures; 2) A more dovish shift in central bank rhetoric; 3) An end to the conflict in Ukraine and/or a more aggressive pro-growth policy push by the Chinese Administration; and 4) Risk assets becoming outright cheap.

- For Australia, while a number of factors have supported relative equity outperformance (commodity pricing, limited tech exposure, geographical isolation), we think further downside is likely if 1) the RBA plays further catch up; 2) economic growth begins to weaken, borrowing costs rise and supply chain disruptions continue to weaken earnings; 3) Weakness across consumer / housing that drives sentiment (spending and potentially employment) lower; 4) valuations that have de-rated but yet to fully reflect recession risks and the YTD movement in Australian bond yields.

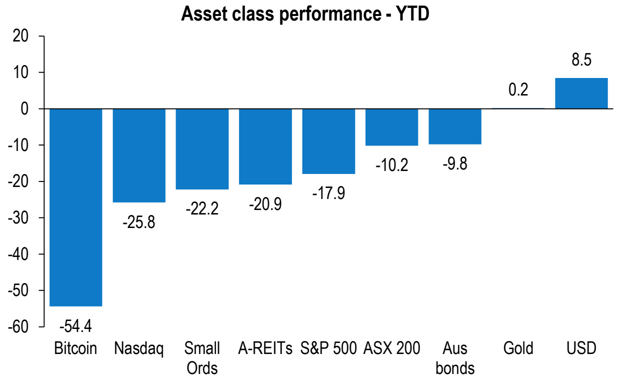
- Investors should be prepared for ongoing elevated volatility and for the market to remain hostage to the direction of news flow. While risk assets have corrected by a large amount, the next few quarters are likely to remain unpredictable given many unforecastable factors influencing markets. We have trimmed risk over the last year and continue to prefer non-correlated assets to hedge against further downside and enhance diversification.

Why are markets so volatile when they have already corrected?

Equities and other risk assets have suffered significant downside through 2022. A very poor starting point of exuberant sentiment and expensive valuations came under pressure from a once in a multi-decade rise in bond yields (decline in bond returns) and a rapid reset of central bank policy expectations driven by a combination of factors (rebounding demand, supply disruptions, tight labour markets and war driven impacts on energy and food).

This has resulted in the riskiest / highest-valuation assets (bitcoin, small caps, tech stocks) underperforming while outright defensives (US dollar, gold) have shined. While the sell-off started in areas where valuations were most susceptible to rising bond yields (non-profitable tech, crypto, IPOs), fears of rates needing to go to levels that would put additional pressure on valuations and or economic growth then began to drive weakness into other areas such as industrials, consumer stocks, property and financials.

Selling pressure has been broad-based year to date

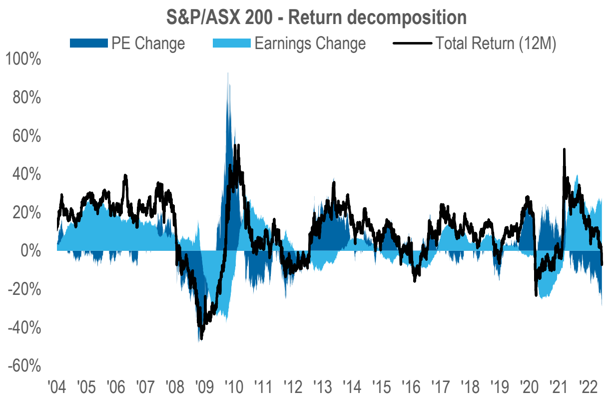


Source: FactSet, MWM Research, June 2022

Why did selling accelerate in recent weeks?

Higher and stickier than expected inflation has been the root cause of the reset in interest rates over the past year. It therefore makes sense that inflation surprises – both positive and negative – continue to be the dominant factor impacting markets. Despite inflation and rates risks being well picked over by the market, the May US inflation print came in well ahead of expectations at 8.6% yoy and with investors having positioned for a moderation of inflation pressures, this came as a brutal reality check that the inflation problem might well be longer lasting and more difficult to bring back under control. In addition to this extremely negative print, other economic indicators are also starting to deteriorate as a result of high inflation and fears that growth is about to collapse such as US consumer confidence (Michigan) which fell to an all-time low.

Valuations have driven weakness, earnings likely next



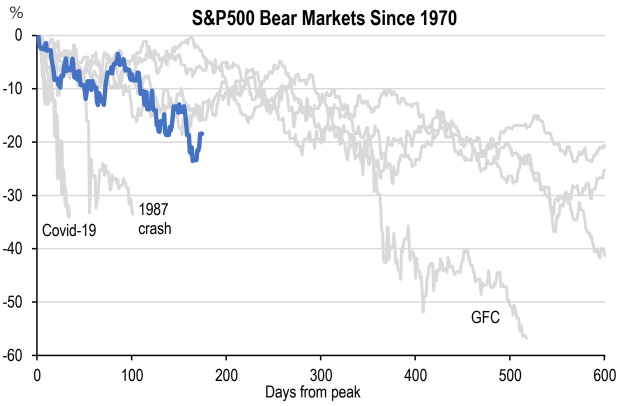
Source: Macquarie Quant, MWM Research, June 2022

The concern for those worried about a pending economic downturn is that the correction in equities has been entirely driven by valuation contraction with earnings still providing a positive contribution. Earnings estimates have increased YTD, particularly for Australia due to its high exposure to resources and energy e.g. consensus EPS estimates have increased +66% YTD for the S&P/ASX 200 energy sector. However, profit margins have peaked in the US and have almost certainly peaked for Australia given rising raw material, labour and interest costs (the last three US recessions have seen earnings decline an average of 24% peak to trough).

How much further can equity markets fall?

At time of writing, last week's rally saw US equities rebound out of bear market territory. However, this could prove temporary and if we are in a traditional bear market, history suggests a drawdown from peak of ~30-40% over a multi-year period. The average drawdown for a short/shallow recession is ~30%, but it is inevitable the market will oscillate between hard and soft-landing scenarios. For a full rundown see our recent note Investment Strategy Update #104 - The anatomy of an equity bear market, 15 June 2022.

Bear markets typically take time to work through



Source: FactSet, MWM Research, June 2022

From here, the extent to which equities fall (or rise) will largely depend on the trajectory of inflation and policy rates. Last week's rally was in part driven by moderating inflation / rate expectations: inflation breakevens are back below 3%, industrial commodities have sold off (e.g. copper -25% from peak) and market pricing for Fed hikes has eased. The risks of a global recession have risen (flash PMIs were very weak) and is placing downward pressure on inflation expectations.

It is important to recognise equities are bouncing off very oversold levels and this is consistent with our expectations for two-way volatility. It is not yet clear if this is a sustainable change, another US inflation surprise could see rate expectations reset higher, but it is a reminder that equities are forward looking and investors will be quick to re-enter once recent headwinds (inflation, rates, bond yields) start to ease.

What is needed for a market bottom?

We look to the following markers as being required to drive a sustainable bottom in equities and a stabilization in bond yields / credit spreads:

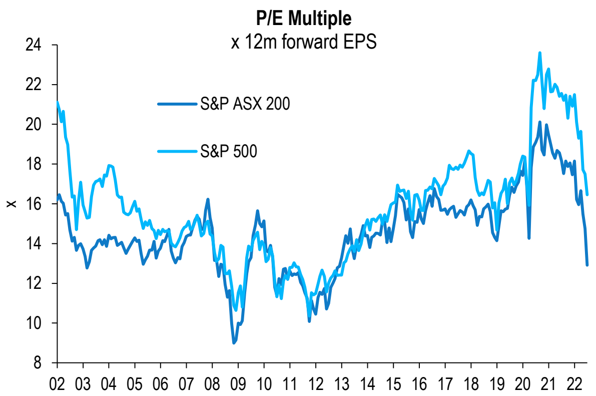
1. **A moderation in inflation pressures** and/or some evidence that the breadth of price increases is lessening. We view this as the most important catalyst in the current market. Macquarie expects inflation pressures to ease through 2H22, but previous expectations for a sharp 2H decline appear optimistic.

2. **A more dovish shift in central bank rhetoric** which in turn will help alleviate overtightening fears. This also appears unlikely in the immediate term as central banks are behind the curve and looking to dampen inflation expectations with hawkish guidance.

3. **An end to the conflict in Ukraine and/or a more aggressive pro-growth policy push by the Chinese Administration.** A resolution to the conflict in Ukraine appears difficult to predict and so we assume this remains a negative drag albeit one that doesn't increase. However, Macquarie's China economist expects China to stimulate around the July Politburo meeting. Depending on the scale, this could be an important 3Q catalyst for global growth momentum.

4. **Risk assets becoming outright cheap**. Valuations have retraced from peak levels but are not yet 'outright cheap'. Global equities trade on a P/E of ~14.8x, still above the 2018 trough of 13x and GFC / Euro Crisis bottom of ~10x. Similarly, high yield bond spreads have risen but are only back to long-term averages of ~500 basis points. Traditionally, bull markets begin with valuations well below long-term averages.

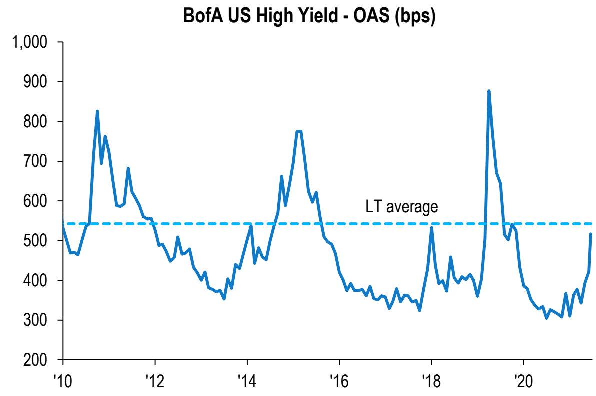
Equity valuations are back to LT averages but recoveries start from "cheap" levels



Source: FactSet, MWM Research, June 2022

At this stage our markers for a bottoming out in risk-assets look are still not evident. That does not mean a lot of the damage has not been seen. If a soft landing can be engineered by the Fed and/or the RBA, then bond yields are probably close to a peak and we do not need to see recessionary conditions incorporated into earnings expectations (although they will still need to go a lot lower). It is still likely inflation will peak in 2H22, but central banks are unlikely to turn dovish beforehand. We do know that inflation will eventually start to ease, but it could continue to march higher before doing do. We think for equities to move higher we will need to see inflation decline that would release some of the pressure on the Fed and other central banks to raise policy rates. For now, the timing of this remains highly uncertain.

High yield spreads are also only at LT averages



Source: FactSet, MWM Research, June 2022

We think investors should prepare for ongoing elevated volatility. If inflation does not begin to ease then the risk of recession increases as central banks are forced into overtightening. In this context, valuations are not cheap enough and earnings have not been downgraded enough, particularly for the most cyclical areas of the market which are typically hit hardest by recession.

From an investment perspective our key recommendation is to remain appropriately diversified and not to turn too bearish on equities. While bonds have disappointed YTD, they now offer more attractive yields and offer strong protection against recession, as do alternatives and select real assets with inflation protection. Equities will generate the bulk of portfolio returns over the long-term and while valuations are not yet outright 'cheap', they currently offer an attractive entry point for patient capital. The current headwinds plaguing the market can reverse course quickly and the potential for a sharp bounce-back is real given the starting point for valuations.

Macquarie WM Investment Strategy Team

The report was finalised on 27 June 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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