Investment Matters

Too early to recession-proof portfolios

June 2022

MACQUARIE

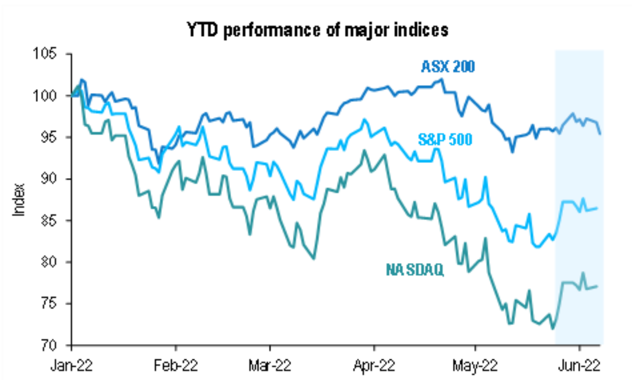
The outlook for the global economy and financial markets remains uncertain and this will keep volatility elevated. It is a time to be cautious, but not to recession-proof portfolios.

Financial markets continue to exhibit significant levels of volatility, as multiple concerns drive ebbs and flows in investor sentiment. There are still many factors impacting the outlook and many unknowns. For example, we do not know:

- When inflation will peak and how quickly it will decline
- How far central banks will go to tame inflation
- How quickly rising rates will begin to undermine aggregate demand and drive a rise in unemployment
- When supply chain disruptions will end
- When and how severe the next economic recession will be.

What we do know is that uncertainty around these risks will remain high and that most of these questions will take time to answer. The past decade has been unusual, by historical standards, and many investors have forgotten what it is like to see two-way volatility in markets (where they can go *"against"* you, not just *"with"* you). The result is an additional layer of anxiety in the unfamiliarity of it all.

Risk assets are trying to form a bottom

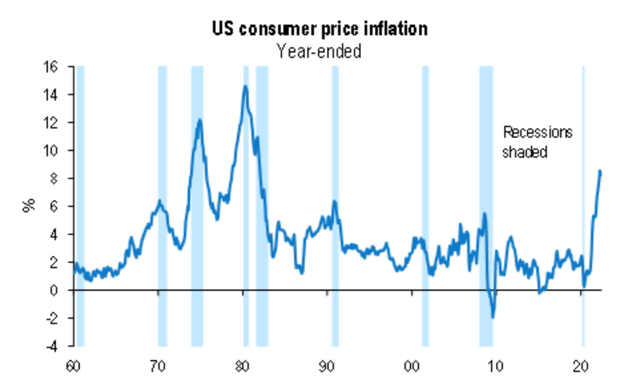


Source: Bloomberg, MWM Research, May 2022

During times of heightened uncertainty, we think it is important to focus on what we know, and add protection for things we don't, as well as recognising that there is a timing element to how the outlook unfolds.

At this stage, economic growth is decelerating and will continue to weaken in the quarters ahead. Central banks will continue to hike rates and inflation is likely to remain elevated for some time to come. Risks of a US recession are building, but Macquarie's central case outcome is that it is unlikely to happen before 2H23. A lack of imbalances means a growth slowdown will likely be short and relatively shallow, which should mean few lasting ramifications.

US inflation looks like it has peaked



Source: Factset, NBER, MWM Research, May 2022

We think it is too early to position for an end to the economic cycle and recession. On average, there is an 11-month delay from the time the US cycle peaks to the onset of recession (excluding the COVID shock this extends to 16 months). Similarly, equities peak around 6-8 months prior to recession, suggesting there is still a long runway even if volatility remains high. We have been reducing our risk exposures and adding noncorrelated assets to a balanced portfolio for over a year. Incrementally, we expect to continue this trend.

However, we think markets may get a short-term reprieve as central banks soften their tightening talk and as inflation fears reach a crescendo. It would be highly unusual for markets to begin pricing in an economic recession that is more than a year away, especially when fundamentals remain relatively robust – particularly in Australia's case.

Instead of trying to position for a highly uncertain outcome, we urge investors to return to basic investment principals:

1. When volatility is high, diversification is crucial. While bonds have compromised portfolio returns in recent months, they offer strong protection against recession, as do alternative investments and select real assets that benefit from elevated inflationary environments.
2. Valuations are correlated with long-term returns. Buying stocks/markets cheaply is a strong leading indicator of forward returns. While markets are not "outright" cheap, they are providing attractive entry points for through-the-cycle investing.

We understand the tendency to want to protect capital and move with market sentiment, but a slowing cycle beset with uncertainties can change course. We think adding protection against downside risk and focusing on core investment principals is the prudent approach when recession risks are still a long way off.

Jason and the Investment Strategy Team

Global economics

Sticky inflation raises 2023 recession risks

- The global economy is slowing but fundamentals remain solid.
- Inflation is at its peak and should decline rapidly through 2H22, but this is unlikely to slow central bank policy tightening.
- A short and shallow US recession is now Macquarie's base case for 2H23.

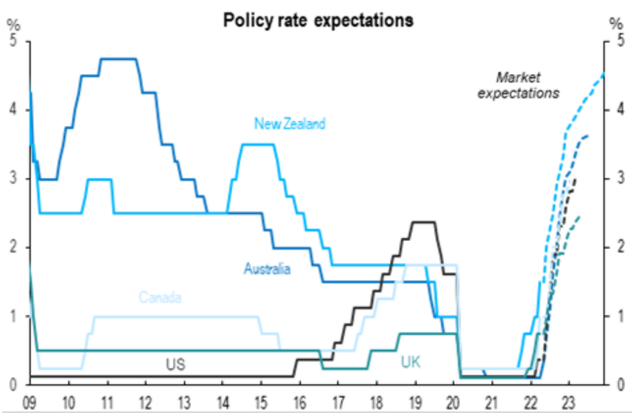
Positioning for rising downside risks, not recession

Global growth continues to slow, as financial conditions tighten and both consumer and business sentiment start to wane. At this stage, economic fundamentals remain solid and, despite ongoing declines in leading economic indicators, most (even across the Eurozone) are still in expansionary territory.

Underlying trends are becoming more widespread, with slowing demand and rising prices leading to a broad-based drop-off in forward orders. In addition, the first signs of weakness within segments of consumer spending are emerging, with incidences of trading down and product substitution becoming more widespread.

This is compounded by a notable decline in savings rates (particularly in the US) which have, for some time, shielded consumers from rising interest rates and cost of living pressures. The labour market remains a key bright spot across most developed economies with US unemployment below the natural rate and still falling fast, and Eurozone unemployment at record lows.

Policy rates are set to rise dramatically across the globe



Source: Bloomberg, Macquarie Macro Strategy, May 2022

Unfortunately, there has been no reprieve on the inflation front. European headline inflation has reached a cycle peak and the US is showing little improvement across a broad range of measures. This is not unexpected, given the ongoing conflict in Ukraine and China's lockdown restrictions. There is some hope that we are now approaching peak inflation pressures outside of labour markets.

Despite softening leading economic indicators and a substantial tightening in financial conditions (which is further progressed than the tightening in policy conditions), Macquarie does not expect this to alter the near-term path for policymakers – which we view as being behind the inflation fight.

LEIs softening but remain in expansionary territory

Source: Factset, MWM Research, May 2022

However, the absence of strong structural imbalances (such as excess inventories or elevated corporate leverage) suggests the global economy may navigate a soft transition into recession. It also suggests (outside of some exogenous shock) that a recession will be relatively short and shallow with limited long-term repercussions. There is no doubt the global economy is at an important juncture. Many of the tailwinds that were supportive through 2021 have faded, and markets are increasingly vulnerable to disappointment. But there are few signs of systemic stress and credit markets are behaving in an orderly fashion. While the cost of credit is rising, and may become problematic for some, strong corporate fundamentals suggest this will remain isolated.

Overall, the global backdrop faces varied downside risks. However, this is moderating the outlook, rather than being suggestive of imminent recession-like conditions. The US economy remains solid – supported by a red-hot labour market. China should look stronger into the second half, as it reopens. Europe and emerging economies are the weak links, given their proximity to the conflict in Ukraine, combined with rising US$ funding costs/tightening US$ liquidity. The global economy is wavering but, despite all the uncertainty, it remains in expansionary territory. Conditions are therefore slowing, but not recession-like.

Australian economics

Past peak economic conditions

- Economic growth fundamentals remain solid, but momentum has peaked and will continue to slow.
- The RBA is behind the inflation curve and will normalize rates regardless of deteriorating sentiment.
- Consumers are supported by a tight labour market and elevated savings, but these tailwinds may fade as cost of living pressures build.

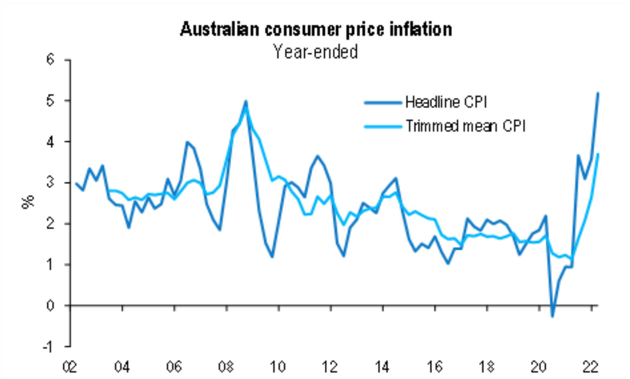
Growth supports remain strong but set to moderate

Macquarie remain constructive on the year-ahead outlook for the Australian economy, despite the emergence of downside risks. Economic growth is expected to remain robust through 2022, although peak growth rates are likely to be behind us, following the 1Q22 GDP release of 3.3% y/y.

Multiple factors are supporting forecasts – including a solid consumer outlook, with spending now rotating towards the services sector; improving business investment; a tight labour market; elevated commodity prices; modestly supportive fiscal and monetary policy; and a modest tailwind from a stronger global backdrop.

The conflict in Ukraine and sanctions on Russia are significant uncertainties, due to the disruption to global energy markets and supply chains. However, Australia remains relatively well-placed to absorb these headwinds, with limited direct export exposure. While rising commodity prices will reduce real incomes, and potentially cause some demand destruction, they will also drive an improvement in terms of trade.

Australian inflation has jumped



Source: Macquarie, MWM Research, May 2022

Ultimately, the more persistent the disruptions caused by the conflict in Ukraine, the greater the downside risks to growth. The impact will be on consumer and business confidence, causing more persistent inflation that erodes real purchasing power. However, we think growth supports are relatively strong and that the economy has solid momentum that will only gradually slow into 2H22.

We think the Australian economy will continue to outperform most other economies, which are more progressed in their fight against inflation and do not have the same (macro) support from elevated commodity prices.

Nevertheless, we do think the Australian economy is now past peak conditions. It is more vulnerable to a sharper than expected tightening in policy conditions, and this may drive a softer consumer and business investment backdrop. Labour cost growth is broadening, and has picked up faster than expected, but it is general inflation pressures which are now driving the RBA towards a faster than expected tightening phase.

Macquarie expect the cash rate to rise to 2.25% by end-2022 and to 2.50% by mid-2023. While this is slightly below market expectations, it does represent a substantial tightening in financial conditions vis-a-vis pre-pandemic levels. An increase in the cash rate to 2.50% would largely unwind the decline in households' interest servicing burden since the RBA started cutting the cash rate in 2019. However, excess savings should provide some buffer for households to manage higher rates, at least in the near term.

The period of zero interest-rates is over

Source: Macquarie, MWM Research, May 2022

Further out, Macquarie's central case is that the RBA will be cutting the cash rate by 2024, as it responds to a US recession and a sharp slowdown in domestic conditions/ rising unemployment. While we do not expect rising interest rates to drive a systemic bad and doubtful debt cycle, the risk of a sharp slowdown in consumer spending is high (particularly for discretionary spending) and not unexpected if the trends in global economies are a lead indicator. This risk rises further, if combined with a notable slowdown in house prices.

Ultimately, we think Australia is following the same path of many other developed economies which saw inflationary pressures emerge slightly earlier. Regardless of excess savings, elevated commodity prices and/or strong labour markets, the economic outlook is set to soften. The main questions being how quickly and how far.

Monthly performance

May 2022

Australian equities

Australian equities posted a negative return (-2.6%) in May, underperforming global equities in both USD terms (+0.2%) and AUD terms (-0.7%). The month of May saw considerable volatility as markets fretted over inflation, central bank attempts to subdue it through rate hikes and whether this would tip slowing economies into recession. Both the US Federal Reserve and RBA raised rates sharply during the month.

The best performing Australian sector was Materials (+0.1%), with China reopening news sparking hope for a rebound in commodity demand, while the worst performing sector was A-REITs (-8.7%) as rising rates weigh on the outlook for real estate.

The best performing large cap stocks were Allkem Limited (AKE, +11.9%) and Mineral Resources (MIN, +9.1%), benefitting from the lithium price rally. The worst performing large caps were ARB Corporation (ARB, -20.1%), following revenue guidance that was below expectations, and Nine Entertainment (NEC, -18.2%), with cyclical headwinds rising.

The S&P/ASX Small Ordinaries index (-7.0%) underperformed the large cap S&P/ASX100 index (-2.2%). The best performing Small Ordinaries stock was Infomedia Ltd (IFM, +35.7%), after receiving several M&A bids, while the worst performing was Johns Lyng Group (JLG, -32.9%).

International equities

Global equities increased +0.2% in USD terms but fell -0.7% in A$ terms. Regional performance was mixed, with US indices weaker (NASDAQ -1.9%, S&P 500 +0.2%), reflecting the continued selloff in high growth stocks, while Asian markets rebounded (Hang Seng +2.2%, Shenzhen +2.1%), following reopening optimism coming out of China. The best performing global sector was Energy (+13.1%) while the worst performing sector was Consumer Staples (-4.2%).

Property

Global REITs posted a (hedged) return of -4.6% in AUD and Australian REITs posted a total return of -6.7%, both underperforming all other asset classes. The best performing stock in the S&P/ASX200 AREITs index was Vicinity Centres (VCX, +0.8%), following a strong sales update, while the worst performing stock was Centuria Capital (CNI, -20.7%).

Fixed interest and cash

Global bond indices posted slightly negative returns (-0.2%) as market inflation expectations eased and the climb in bond yields started to soften.

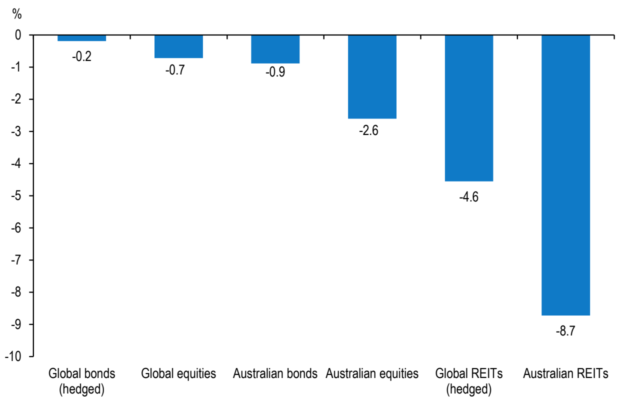
Commodities

Energy-related commodities such as oil and coal posted strong gains during the month on geopolitical tensions. Industrial commodities were relatively weak as a deteriorating economic backdrop weighed on commodities linked to the economic cycle. Late in the month there was some optimism driven by the easing of lockdowns in China although industrial commodities, nevertheless, finished the month down.

Currency

The Australian dollar rebounded in May following its drop in April, with the reopening in China sparking optimism and demand for resources. Australian dollar strength was also supported by a weaker US dollar, following speculation of a more cautious tightening path by the US Federal Reserve.

Major asset class total returns during May 2022



Source: Factset, MWM Research, June 2022

Note: All returns are in AUD

Total returns (A$) – as at 31st May 2022

	1 month %	3 months %	YTD %	1 year %	3 year %pa	5 year %pa
Australian equity indices						
S&P/ASX 200	-2.6	3.2	-1.3	4.8	7.8	8.8
S&P/ASX 100	-2.2	4.0	0.0	6.0	8.4	9.1
S&P/ASX Small Ordinaries	-7.0	-3.6	-12.3	-4.6	5.5	8.5
S&P/ASX 20	-1.7	5.0	2.1	4.7	8.4	9.3
S&P/ASX 50	-2.0	4.3	1.3	6.0	7.6	8.7
S&P/ASX Mid-Cap 51-100	-3.4	1.8	-7.3	5.7	12.5	10.9
S&P/ASX 200 Industrials	-3.7	2.2	-5.9	1.2	6.1	6.8
S&P/ASX 200 Resources	0.6	5.9	16.0	16.0	13.9	17.2
International equity indices						
MSCI AC World ex Australia	-0.7	-4.8	-11.7	0.6	11.0	10.4
MSCI Developed World ex Australia	-0.8	-4.6	-11.8	2.6	12.0	11.2
MSCI Emerging Markets	-0.5	-6.1	-10.5	-12.5	4.1	4.9
Regional equity indices						
S&P 500	-0.8	-4.1	-11.6	7.2	15.1	14.2
NASDAQ Composite	-2.8	-10.9	-21.5	-4.9	17.1	16.2
Euro STOXX 50	1.4	-4.3	-13.5	-8.2	5.4	4.3
FTSE 100	-0.3	-1.8	-1.2	7.4	4.5	4.4
Japan TOPIX	0.0	-7.2	-11.9	-6.6	3.4	4.1
Hong Kong Hang Seng	1.2	-4.1	-6.9	-19.6	-5.7	0.3
MSCI China	0.2	-9.7	-15.6	-30.1	-1.1	2.2
International equity thematic indices						
MSCI World Cyclicals	-1.4	-7.7	-16.2	-2.8	12.2	11.8
MSCI World Defensives	0.8	4.4	1.9	18.9	11.4	9.8
MSCI World Value	1.2	0.6	-2.0	9.2	9.5	8.5
MSCI World Growth	-3.1	-10.0	-21.1	-4.7	13.1	13.0
MSCI World High Dividend Yield	0.2	1.4	-0.4	10.0	9.0	8.6
Real estate equity indices						
S&P/ASX A-REIT	-8.7	-7.1	-14.7	3.3	2.2	5.7
FTSE EPRA Nareit Global Developed (hedged)	-4.6	-3.9	-11.4	-0.4	2.6	4.7
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	-0.2	-5.1	-7.9	-7.4	-0.7	1.1
Bloomberg Barclays Global Treasury (hedged)	-0.6	-5.0	-7.2	-6.7	-0.8	1.1
Bloomberg Barclays Global Corporates (hedged)	0.1	-6.4	-10.8	-9.8	-0.3	1.3
Bloomberg Barclays Global High Yield (hedged)	-0.4	-4.8	-9.2	-8.8	0.4	1.5
Australian bond indices						
Bloomberg AusBond Bank Bill	0.0	0.0	0.0	0.0	0.4	1.0
Bloomberg AusBond Composite (0+Y)	-0.9	-6.0	-8.1	-8.6	-1.8	1.0

Note: All returns are in AUD, and unhedged unless otherwise stated

Source: Factset, MWM Research, June 2022

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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