Investment Matters

Looking through the panic

May 2022

MACQUARIE

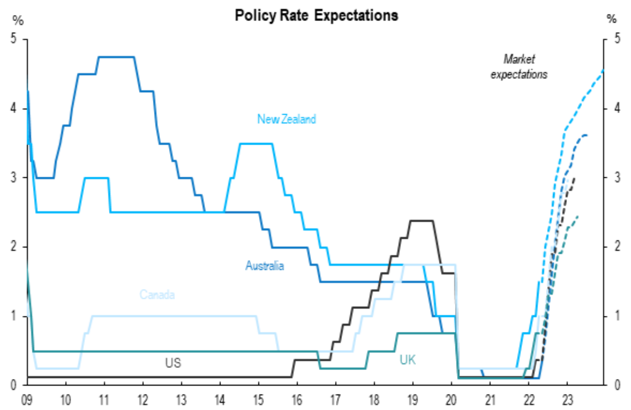
The rollercoaster ride continues for equity markets, but we position for ongoing volatility, elevated inflation and rising rates rather than economic recession.

Financial markets continue to exhibit extreme levels of volatility as multiple concerns drive ebbs and flows in investor sentiment. While the conflict in Ukraine and China's zero tolerance COVID response remain ongoing worries for global markets, it is inflation and the potential that central banks need to overtighten to bring this back under control that is the primary concern.

There is no doubt that inflation is problematic. It has risen much higher and is clearly less transitory than expected and there is a growing fear that it is becoming more entrenched as price pressures begin to broaden out. But, even allowing for a higher inflationary backdrop, Macquarie still expect it to peak sometime in the next two quarters and begin to decline as we move into 2023.

This does not mean inflation fears will completely subside. Policymakers are behind the curve and there is plenty of work to do in order to bring it back under control. But we think inflation and rate fears are at a crescendo and it is important not to extrapolate current conditions or to assume that recession is an inevitable consequence of the need for policymakers to tighten policy rates.

Policy rates are set to rise aggressively

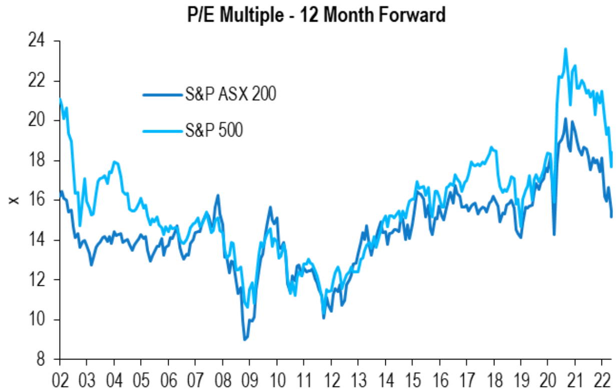


Source: Bloomberg, Macquarie Macro Strategy, May 2022

At this stage, we are not underestimating the task that lies ahead for central banks, including the RBA, if they are to put the inflation genie back in the bottle. History shows that rate tightening cycles are almost always accompanied by slower economic growth and/or recession (the latter in around 30% of instances). But we think it is too early to bet on a policy mistake or for central banks to be unsuccessful in taming inflation. At some stage there will be a global recession, but we are not prepared to position portfolios for this outcome just yet.

We think trying to protect against and/or profit from higher inflation and interest rates as well as elevated volatility is the best strategy for investors because we don't want to assume a policy mistake and that needing to crush economic growth to control inflation is the only outcome available to central banks even if there is limited room to manoeuvre and the idea of a soft landing might appear a goldilocks outcome.

Equity market valuations have corrected substantially



Source: FactSet, MWM Research, May 2022

While equities are finding it hard to look past the near-term turmoil that rates markets are causing, the global economy is slowing but not faltering. Cost pressures are beginning to weigh on corporate profit margins and pricing power will become increasingly important, but there is not yet widespread evidence of retrenchments or cutting back of investment. Until interest rate expectations begin to stabilise, we think the pressure on equity valuations will remain intense. But we have already seen a dramatic correction in P/E multiples for high growth stocks and this provides a solid platform once sentiment begins to improve.

We cannot dismiss the potential for further equity downside if inflation and rates continue to surprise on the upside and therefore, we remain tactically cautious. However, we do not think valuations need to mean revert (to a much lower level) because we see little risk that rates need to mean revert (to a much higher level).

Over the medium term, we think the equity bull market is getting old, but is not dead and we continue to run a small overweight vis-à-vis defensive assets. Australia remains well placed to outperform global equities through 2022 given attractive valuations and a broad-based earnings recovery. In a more uncertain, lower return backdrop, where equities and bonds are showing a high degree of correlation, portfolios should remain diversified with exposures into alternatives and private markets as a key ballast.

Jason and the Investment Strategy Team

Global economics

Growth risks rising but recession still not likely

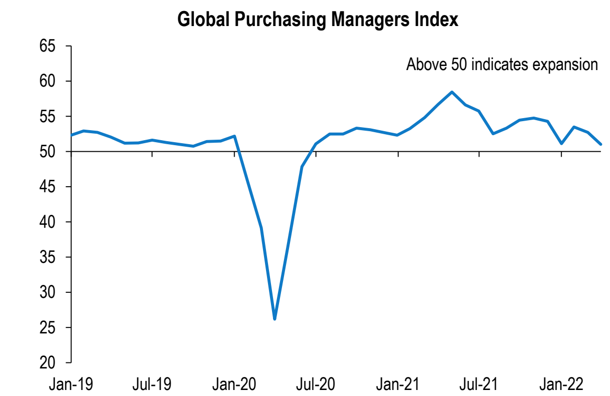
- The global recovery faces multiple headwinds but remains intact and robust versus post-GFC recoveries.
- Fears of global stagflation or recession are overdone. The global economy carried strong momentum into 2022, which has slowed but is not at risk of reversing.
- Central banks are playing catch up to inflation, but they do have the means to bring it back under control.

Downside risks rising, but recovery remains intact

Sentiment has soured dramatically in recent months and while there are cracks appearing in key global growth drivers, leading indicators still point towards a global economy that is growing despite a multitude of headwinds. Inflation and the need for central banks to tighten policy at the expense of economic growth is now the major factor raising recession fears across the globe, especially in light of the negative 1Q22 GDP print out of the US.

Leading economic indicators point to a softening in economic conditions across the world although China has been a major driver of this, and high frequency data is already showing some pick-up in activity alongside declining COVID cases. In addition, while this is the second month in a row where growth indicators have softened, most measures – whether they be manufacturing or services – are still in expansionary territory and pointing towards further economic gains.

LEIs continue to weaken but have not collapsed



Source: Factset, MWM Research, April 2022

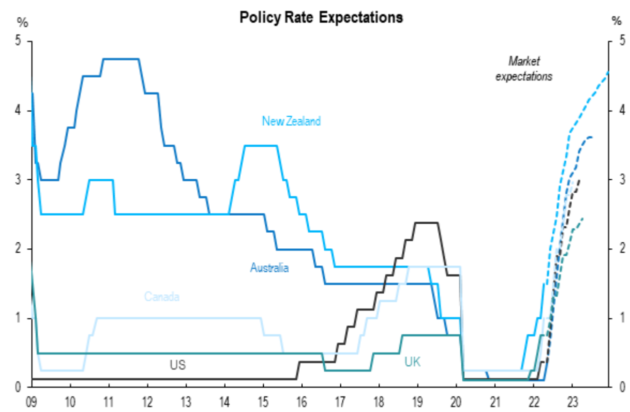
At this stage, Macquarie think the post COVID-19 recovery remains intact and while uncertainties are rising, we do not think they are sufficient to alter the positive momentum that the global economy carried into the year. There are clearly areas of stress with the conflict in Ukraine dragging on Europe and China's zero tolerance COVID policies acting as a large growth headwind for China.

But across the developed world, labour markets remain strong, and corporates are not in retrenchment mode or likely to make large cuts to investment if surveys hold true.

In addition, households are flush with savings that were put away during the pandemic which will help offset rising borrowing costs as central banks begin to normalize rates.

There is no doubt that the global economy is at an important juncture where many of the tailwinds that were supporting it through 2021 have faded and where it is increasingly vulnerable to disappointment. But there are few signs of systemic stress. Credit markets are behaving in an orderly fashion and while the cost of credit is rising (and will become problematic for some), strong corporate fundamentals suggest this will remain isolated.

Policy rates are set to rise dramatically across the globe



Source: Bloomberg, Macquarie Macro Strategy, May 2022

At this stage, we see the following factors driving our global view:

- Global inflation prints are being pushed higher due to a spike in food and energy prices and supply chain disruptions. While stickier than expected, inflation should begin to decline through 2H22.
- Inflation is forcing many central banks, including the Fed, to accelerate their rate hike timetables. But, with rates hovering around pandemic-driven lows, there is scope before financial conditions become restrictive and this allows some cushion for the recovery to continue despite rising credit costs.
- China's pursuit of a zero-COVID policy has been a major drag on growth but COVID cases are falling, and activity is slowly picking up. Macquarie believe further policy easing is likely as China look to defend a 5% growth bottom-line.

Australian economics

Well insulated from global and domestic risks

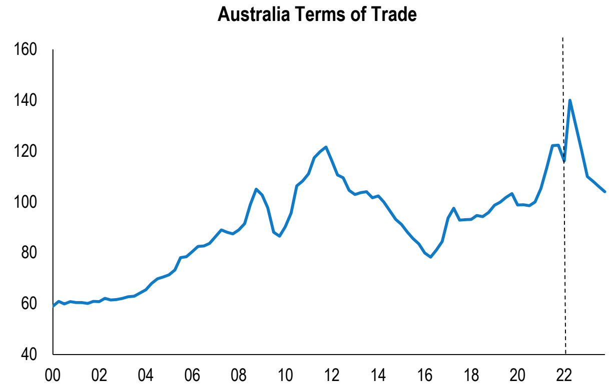
- Economic growth fundamentals remain solid despite rising headwinds.
- Robust consumer spending, elevated savings levels, strong business investment and pro-growth fiscal policy remain supportive.
- Modest inflationary pressures will see the RBA lag other central banks in its rate hike cycle.

A robust outlook despite rising risks

Macquarie remain constructive on the year-ahead outlook for the Australian economy despite the emergence of several risks. Economic growth is expected to bounce back strongly through 2022 with the economy to expand 4.8% y/y. Multiple factors should support the outlook including a solid consumer outlook, improving business investment, a tight labour market, elevated commodity prices, expansionary 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 more broadly. However, Australia is relatively well placed to absorb these headwinds with limited direct export exposure and while rising commodity prices will reduce real incomes and potentially cause some demand destruction, they will also drive an improvement in terms of trade.

Commodities to boost Australia's terms of trade

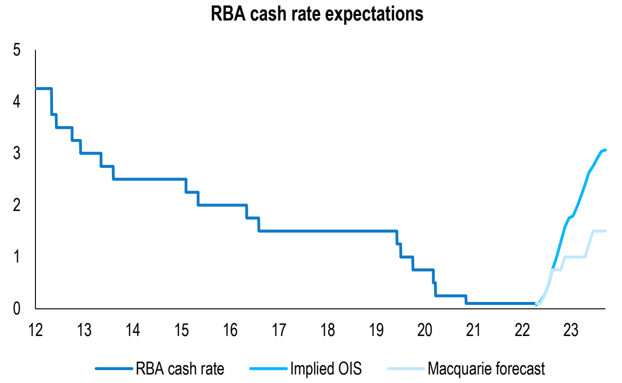


Source: Macquarie, MWM Research, April 2022

Ultimately, the more persistent the disruptions caused by the conflict in Ukraine, the greater the downside risks to growth caused by declining consumer and business confidence and more persistent inflation that erodes real purchasing power. However, we think growth supports are robust and that the economy had strong momentum into the start of 2022 that is unlikely to be materially disrupted outside of a major deterioration in the global backdrop.

- The Australian economy powered into 2022 after lockdowns weighed on activity in late 2021. While uncertainty has risen due to global developments, leading growth indicators remain solid and should support further economic gains through the year.
- Fiscal policy remains pro-growth with any meaningful consolidation now on hold given the upcoming election and deteriorating household affordability measures. Cash sweeteners – temporary fuel excise cut and one-off cost of living payments – come on top of significant excess household savings that will support consumption should higher mortgage costs and falling real income begin to bite.
- Macquarie expect the cash rate to rise to 1.75% by end-2022 and to 2.25% by mid-2023. Better than expected data and/or a worsening inflation outlook point to an even earlier "lift off" but the path will remain conditional on economic developments, and it is unlikely that the RBA would not raise rates unless unemployment begins to turn up.

The period of zero interest-rates is over



Source: Macquarie, MWM Research, April 2022

- While the east coast floods have recently disrupted activity, recovery efforts will provide some support to spending as we move further into the year. We are also encouraged by signs that the long awaited (and much needed) increase in business investment is underway, supported by favourable government policy. We think this could be a multi-year tailwind for the economy alongside further tightness in the labour market that underpins a solid bounce in wages growth over the coming 12-18 months.

On a less positive note, the slowdown in house prices has set in faster than we anticipated with Sydney and Melbourne already suffering from monthly declines. Based on our cash rate assumptions, we think housing affordability could deteriorate around 10-15% through mid-2024. This could translate into similar-sized declines in house prices, but if spread out over the next few years we don't see this as overly concerning or a threat to the consumer or growth backdrop. We remain positive on the outlook and see Australia as a relative economic outperformer in 2022/23.

Monthly performance

April 2022

Australian equities

Australian equities posted a slightly negative return (-0.9%) in April, outperforming global equities in both USD terms (-3.1%) and AUD terms (-2.8%). The best performing sector was Utilities (+9.3%), benefitting from rising energy prices, while the worst performing sector was Information Technology (-9.9%) as expectations for a more aggressive monetary tightening path weigh on the growth outlook and valuations.

The best performing large cap stocks were Ramsay Health Care (RHC, +25.3%), after receiving a takeover offer, and AMP Limited (AMP, +17.8%), following the sale of its real estate and infrastructure operations. The worst performing large caps were Block (SQ2, -25.3%), following disappointing earnings results, and the A2 Milk Company (A2M, -15.4%), as China lockdowns weigh on the near-term growth outlook.

The S&P/ASX Small Ordinaries index (-1.5%) underperformed the large cap S&P/ASX100 index (-0.7%). The best performing Small Ordinaries stock was Sayona Mining Ltd (SYA, +33.3%), following positive announcements on its lithium projects, while the worst performing was EML Payments Ltd (EML, -46.5%) following revenue and earnings downgrades.

International equities

Global equities fell -3.1% in USD terms and fell -2.8% in A$ terms. Regional performance was mixed, with US indices the weakest performers (NASDAQ, -13.2% and S&P 500 -8.7%), reflecting the selloff across the technology sector, while the UK was the strongest performer (FTSE 100 +0.8%), benefitting from its exposure to energy and financial companies. Rising bond yields, inflation and geopolitical tensions continue to be the dominant themes. The best performing global sector was Consumer Staples (+3.0%) while the worst performing sector was Communication Services (-13.0%).

Property

Global REITs posted a (hedged) return of -4.0% in AUD, underperforming all other asset classes, while Australian REITs posted a total return of +0.6%, outperforming all asset classes. The best performing stock in the S&P/ASX200 AREITs index was Charter Hall Retail REIT (CQR, +4.9%), following an earnings upgrade, while the worst performing stock was Ingenia Group (INA, -9.8%), impacted by labour shortages and supply chain headwinds.

Fixed interest and cash

Major bond indices continued to post negative returns as bond yields rose amid rising inflation and expectations of further policy tightening. Credit spreads also widened.

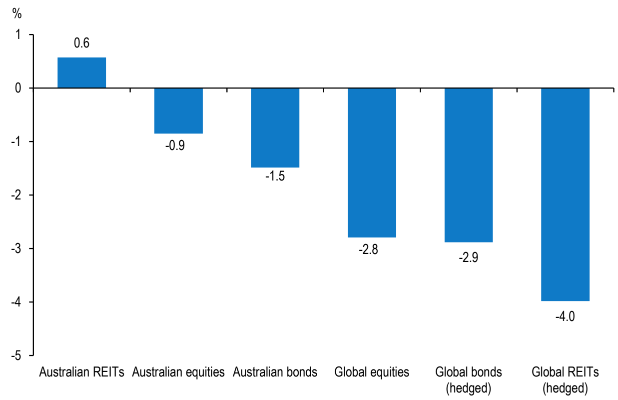
Commodities

Energy-related commodities such as oil and coal posted strong gains during the month on geopolitical tensions. However, industrial commodities were relatively weak (copper fell 5%) as a deteriorating economic backdrop weighed on commodities linked to the economic cycle.

Currency

The Australian Dollar weakened during the month as the growth outlook for China remained under pressure while the US Dollar also strengthened with expectations of more aggressive moves to come by the Federal Reserve.

Major asset class total returns during April 2022



Source: Factset, MWM Research, May 2022

Note: All returns are in AUD

Total returns (A$) – as at 30th April 2022

	1 month %	3 months %	YTD %	1 year %	3 year %pa	5 year %pa
Australian equity indices						
S&P/ASX 200	-0.9	8.2	1.4	10.2	9.4	8.8
S&P/ASX 100	-0.7	8.8	2.2	11.2	9.9	9.0
S&P/ASX Small Ordinaries	-1.5	3.7	-5.6	2.9	7.6	9.6
S&P/ASX 20	-1.1	9.6	3.9	10.5	10.1	8.6
S&P/ASX 50	-0.6	9.4	3.4	11.3	9.2	8.4
S&P/ASX Mid-Cap 51-100	-1.5	5.1	-4.0	10.4	13.6	11.8
S&P/ASX 200 Industrials	0.4	7.0	-2.2	8.2	8.1	6.9
S&P/ASX 200 Resources	-4.2	12.0	15.3	16.8	14.1	17.4
International equity indices						
MSCI AC World ex Australia	-2.8	-9.4	-11.0	3.1	9.6	11.2
MSCI Developed World ex Australia	-3.1	-9.2	-11.2	5.2	10.6	12.0
MSCI Emerging Markets	-0.2	-11.2	-10.1	-10.9	2.3	5.8
Regional equity indices						
S&P 500	-3.5	-9.0	-10.9	8.9	13.5	14.8
NASDAQ Composite	-8.3	-14.0	-19.2	-3.3	15.7	17.6
Euro STOXX 50	-1.0	-13.7	-14.7	-5.8	3.4	5.1
FTSE 100	2.2	-4.1	-0.9	11.8	3.1	5.6
Japan TOPIX	-3.0	-10.0	-11.9	-5.7	2.6	4.9
Hong Kong Hang Seng	1.1	-12.4	-8.0	-19.0	-8.3	1.1
MSCI China	1.4	-15.9	-15.8	-30.6	-5.2	3.3
International equity thematic indices						
MSCI World Cyclicals	-5.3	-12.3	-15.0	0.0	10.8	12.6
MSCI World Defensives	3.0	0.9	1.1	21.2	10.4	10.3
MSCI World Value	0.5	-5.0	-3.2	11.5	7.4	8.6
MSCI World Growth	-6.9	-12.9	-18.5	-1.4	12.9	14.6
MSCI World High Dividend Yield	2.2	-3.0	-0.6	13.4	7.8	9.3
Real estate equity indices						
S&P/ASX A-REIT	0.6	3.3	-6.6	15.1	6.3	7.4
FTSE EPRA Nareit Global Developed (hedged)	-4.0	-1.8	-7.2	5.8	4.1	5.8
Global bond indices						
Bloomberg Barclays Global Aggregate (hedged)	-2.9	-6.2	-7.7	-7.0	-0.1	1.2
Bloomberg Barclays Global Treasury (hedged)	-2.4	-5.4	-6.7	-6.0	-0.1	1.3
Bloomberg Barclays Global Corporates (hedged)	-4.5	-8.5	-11.0	-9.5	0.0	1.5
Bloomberg Barclays Global High Yield (hedged)	-3.8	-6.6	-8.8	-7.9	0.2	1.7
Australian bond indices						
Bloomberg AusBond Bank Bill	0.0	0.0	0.0	0.0	0.4	1.0
Bloomberg AusBond Composite (0+Y)	-1.5	-6.3	-7.3	-7.5	-0.9	1.4

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

Source: Factset, MWM Research, May 2022

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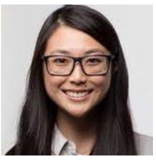

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Investment Matters May 2022 was finalised on 12 May 2022.

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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