BAKER YOUNG LIMITED

MANAGED PORTFOLIOS

L6, 121 King William St
Adelaide SA 5000
bakeryoung.com.au
ABN 92 006 690 320 AFSL 246735

Q1 2023 REVIEW - SEPTEMBER SWOON

September swoon....again!

September's reputation as one of the most volatile and weakest months of the year continued for global markets as a confluence of economic (rampant inflation, aggressive monetary policy tightening) and political crises (food and energy security) made it a difficult period for policymakers to navigate.

The S&P/ASX200 index fell over 6% in September to give back most of its third-quarter gains as global equities and bonds sold off as investors priced in the most aggressive Reserve Bank of Australia (RBA) rate hiking cycle since the 1990s. Higher global inflation readings and surging interest rates are stoking fears that a cost-of-living crisis could spiral out of control, given ongoing energy concerns and increasing recession risks.

The UK gets pounded

Meanwhile, extreme volatility ensued this time across the Atlantic as the newly elected UK prime minister Liz Truss' unfunded 'mini budget' saw wild market swings.

> **Stimulatory tax cuts and two-year energy price caps for households and business lifts government debt thereby heaping pressure on Bank of England (BOE) to raise interest rates higher for longer to curb surging inflation.**

The British Pound fell to a record low against the US$ and UK Gilts (bond) spiked to more than decade highs as a result. A sharp drop in the government's approval ratings saw an abrupt U-turn on policy (forcing temporary bond buying) to avert a liquidity crisis as markets took risk off the table on the final stanza of the quarter.

Some have viewed BOE's move as the 'first blink' (or policy pivot) in that when a crisis occurs, central banks revert to the old playbook of easier policy settings kicking the can down the road a move which markets have been accustomed to over the past decade that's supported risk assets (equities).

Premature policy pivot

Markets however, started the quarter with an air of optimism that inflationary pressures were nearing a peak (oil prices retreated 30% from highs) that may permit a slower path for central bank tightening (or policy pivot) by pricing in potential interest rate cuts in 2023.

A strong rally in equity and bonds in July through August was supported by better-than-feared domestic and US quarterly reporting seasons as strong demand allowed companies to pass on higher input costs to customers.

In late August, at the annual central bank symposium the US Federal Reserve (The Fed) President Jerome Powell used an unequivocal 8-minute speech reiterating their commitment to forceably restore price stability.

> **The Fed acknowledged that higher rates, slower growth, and a softer labour market were required to bring down inflation and some pain to households and business will come.**

This hawkish stance quashed a premature policy pivot, and the selloff in equities and bonds resumed. This culminated in a late September swoon taking markets back to yearly lows as the Fed enacted its third straight supersized 75 basis point hike to 3.25%.

The accompanying forward projections (dot plots) by its voting members suggest that the terminal rate for policy is now higher at 4.6% in 2023 (up from 3.8% last quarter) and that any interest rate cuts won't are unlikely to come until 2024 at the earliest – a much more hawkish outlook to market pricing.

The Fed sent a clear message that it's not done yet or even close to neutral or restrictive territory. History cautions strongly against prematurely loosening policy with markets mindful of policy mistakes of the 1970's Great Inflation period where fiscal stimulus was met by a similar inflation sparked oil crisis that drove growth lower and interest rates much higher for longer.

Australia in better shape than most

At home, the Australian economy is in better shape than most as June quarter GDP was robust at 3.6%, the unemployment rate sits near 50-year lows (3.5%) and built-up stimulus savings buffers have supported consumption and retail sales that remain 20% above pre pandemic levels.

Despite the host of positives inflation headwinds have seen consumer sentiment hit historic lows in August (yet spending patterns suggest less pessimistic behaviour) while business sentiment remains upbeat allowing the RBA to lift rates to 2.35% - the quickest 5-month pace of hikes since 1994.

To date we've seen just a modest 5% drawdown in housing prices from their April peak (to remain 15% above their pre pandemic highs) while supply side constraints have kept building material costs elevated.

The RBA like other central banks isn't done yet in this tightening cycle despite RBA governor Phillip Lowe suggesting that we are approaching the restrictive range of 2.5%-3.5% so the pace of further interest rates is likely to shift down a gear to 'business as usual' 25 basis point moves in the coming quarter.

Greenback surges on safe-haven buying

The US Dollar Index, which tracks the Greenback versus a basket of six major currencies hit fresh multi decade highs on rising interest rate differentials in favour to the US$ and safe haven buying. This came despite The Fed, BOE, European Central Bank (ECB) and along with the RBA all lifting interest rates this quarter and vowing to do much more to rein in inflation.

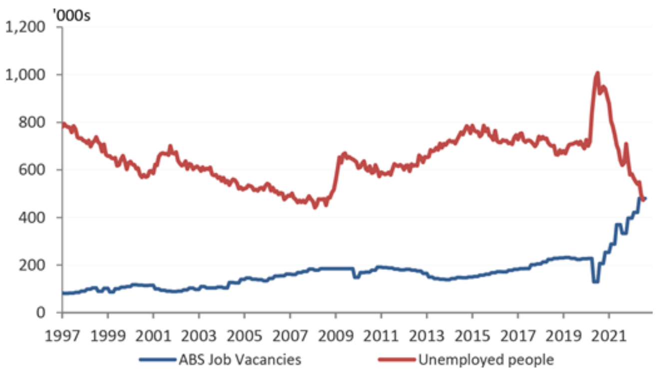
The Japanese yen fell to 24-year lows, the Euro fell below parity and the British Pound fell to a record low against the Greenback. Even with Australia's relatively robust economy the Australian Dollar (A$) fell to by 7% against the greenback this quarter to US64c (-12% for the year) helping our overseas (export) earners, however, the weakness increases the cost of imported goods so modestly adds to the inflation outlook.

Tighter labour markets add to wage pressures

While much of the economic data is now backward looking the transmission of sharp front loaded interest rate rises will soon start to flow through as a large portion of homeowners (65%) are on variable mortgage rates so we face the same monetary policy challenges as other countries and business conditions are likely to get tougher over the coming year.

Currently, Australia's labour markets are very tight (as depicted in the chart below) as there's a record one job available for every unemployed person and this trend is even more dire in the United States at two times the jobs available for each unemployed person.

Much tighter financial conditions are required globally to ease inflation and wage pressures. Perversely markets will cheer for weaker jobs and inflation reports so central banks can pause (pivot) to easier policy again.



However, based on RBA forecasts that the unemployment rate is set to fall further to 3.25% by the end of the year before modestly rising in 2023 interest rates are likely to remain higher for longer and when interest rates lifted this strongly in 1994 it took over 12months for interest rates to ease from their peak.

Australia outperforms developed market peers

Australia's S&P/ASX 200 fell 6% in September giving back most of its Q3 gains to finish the quarter up 0.4% in accumulation terms (once dividends are accounted for) as major resource and energy firms returned super profits to shareholders via monster dividend payments. September's risk off move saw more pronounced falls across smaller capitalisation stocks with double digit falls recorded in the S&P/ASX Small Ordinaries (ASX 100-300 stocks) and Emerging Index (micro-cap stocks 350-600 in size).

Higher interest rates weighed heavily on interest rate sensitive sectors to see Real Estate, Information Technology, Utilities and Consumer Discretionary all register significant losses in September while on a quarterly basis Energy and Healthcare were the better performers.

While the markets circa 12% fall this calendar year is notable Australian shares did perform admirably and ahead of major US and European peers. This came despite a myriad of global events that (for now) remain supportive for our resource and energy firms. It was however, pleasing to see the local market register modest quarterly gains amidst the renewed global volatility given the sell-off in neighbouring Asian markets as investors continue to move out of emerging markets in favour of developed markets.

In Asia, Japanese shares fell a modest 2% as the Bank of Japan (BOJ) contrary to other central banks remains committed to ultra-loose monetary policy benefiting exporters via a weaker currency. Chinese and Hong Kong markets lagged the region, declining by 11% and 21% respectively as a zero Covid policy stance stifles growth while a weaker property market has seen them all but abandon their annual 5.5% GDP growth target.

All eyes will be on China's Communist Party 20th National Party Congress in October. President Xi's vision to make China strong via technological self-sufficiency, economic security, and social harmony will be watched while geopolitical (trade) tensions are on the rise.

Earnings bar gets lowered

US indices that are significantly overweight long-duration growth (technology) stocks led the global equity falls. The S&P500 fell 9% recording its worst monthly decline since the depths of Covid (March 2020). According to Bespoke Investment it was the first time in over 80 years that the S&P500 posted a quarterly loss after being up more than 10% at one point in the quarter highlighting the extreme volatility and light positioning given current poor investor sentiment.

The S&P500 and tech-heavy Nasdaq, both posted a third straight losing quarter (longest streak since 2009) losing 5% and 4% respectively while the large cap old economy Dow Jones Industrial Average shed over 6% for the quarter. For the year, the Dow's now down 20% a smaller decline than the S&P500 25% fall and Nasdaq 32% slide.

Investor sentiment continued to weaken late in the quarter as the upcoming US third quarter earnings due in mid-October is now on pace to grow at the slowest rate in two years at just 2.9% (a steep fall from 10% growth forecast in June) as negative earnings revisions grow.

Several economic bellwethers have warned on earnings. Postal service firm FedEx, retail giant Walmart and footwear maker Nike citing higher inventory levels and a significant drop off in demand as the economy shifts to services from manufactured goods. Meanwhile, Technology giants Microsoft has slowed hiring and Apple has not upgraded guidance for new phone sales souring the growth outlook for US earnings season.

In Europe, the Stoxx 600 (largest stock by market cap) had a torrid end to the month shedding 10% in the final 13 days to finish 6% weaker for the quarter. Disappointing corporate updates added to growing energy concerns ahead of critical northern hemisphere winter as the Russian/Ukraine conflict is no closer to resolution. Eurozone inflation reached 10% in September its highest ever since the common currency was formed strengthening the case for the ECB to lift interest rates towards neutral (2%) from current levels of 0.75%.

Despite political turmoil and recession fears rising in the UK, markets in London fared relatively well falling by less than 4% for the quarter as greater market exposure to mining and energy companies helped them outperform while a weaker British Pound benefited exporters.

Energy shortage a national income boost

In commodity markets, Oil prices have eased by around 30% from their March peak providing some inflation reprieve (yet remain up over 50% from their pre-Covid levels). As a weaker demand outlook is being countered by OPEC+ supply-side production constraints. Europe is scrambling to fill gas storage ahead of looming Russian energy sanctions and the northern hemisphere winter.

Germany's backtracking on coal fired and uranium power generation closures and pivot to old reliable energy sources adds support to alternate energy sources. Gas prices have continued to rise taking their year-to-date gains to over 90% while coal surge over 108% meanwhile new energy Lithium (used in battery technology) is up over 2-fold in the past 12 months as supply is slow to respond to the demand surge.

This dynamic continues to support the Australia's resource and energy exports that are forecast to reach a record $450bn in 2022-23 as the global energy shortages and the lower A$ boost our national income.

Conversely, base (copper, lead, zinc) and bulk (iron ore) metals prices have continued to slide this quarter supporting a modest step back in inflation on a weaker global (China) growth outlook.

Cash is no longer trash

As interest rates rise at the fastest pace in several decades and with global equity and bond market sporting sizeable losses cash (while a losing in real inflation terms) has become more appealing asset for risk averse investors.

Australian and US 10-year government bonds are now approaching 4% (highest level in 12 years) and 1 year term deposits now offer 3% and are likely to rise further as interest move towards neutral.

The acronym TINA (There Is No Alternative) has been used for much of the past decade as ultra-low interest rate settings have forced more money into risk assets to seek better returns. With cash management trusts having offered trivial returns for investors (helping protecting bank profit margins) lower risk term deposits returns are becoming more appealing for conservative investors.

Private equity sniffs some value

While we remain cautious and see many of the pandemic supply chain inflationary pressures abating (that will permit a natural slowing of inflation and interest rate hikes) we remain pragmatic that financial conditions are continuing to tighten and likely to constrain market returns.

We continue to favour a bias towards Quality and those companies that have more defensive characteristics - stable earnings, pricing power and lower gearing – that support dividend payments.

There is, however, some value emerging in the beaten down interest rate sensitive technology sector that is currently suffering multiple compression, so the sector's expected to remain volatile.

The Australian Information Technology sectors 36% slide in the fist 9 months of the year (nearly 3 times the broader markets fall) has been severe and several private equity bids have emerged in the past quarter - even if not yet completed. Geospatial Information (mapping) technology firm Nearmap leapt 95% on a $1bn offer, Merchant payment provider Tyro Payments rose 116% on $650m proposal while eSignature firm Nitro Software rose over 40% on $400m buyout proposal.

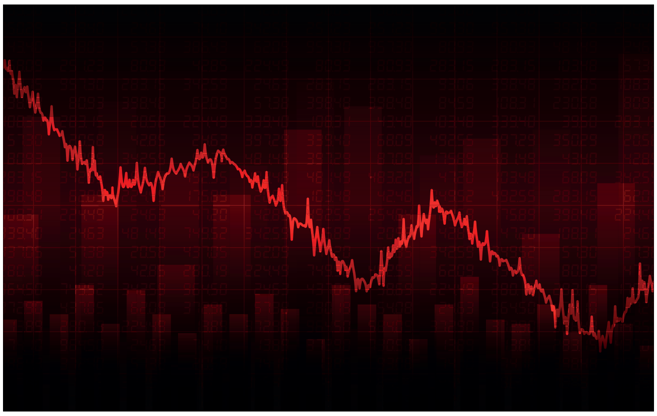
This highlights the sector might be down but not out of the sights of longer-term investors especially as the Small Ordinaries Index is now trading on a one-year forward price to earnings multiple of less than 14x, a 17% discount to its five-year average.

Poor investor sentiment a contrarian buy signal?

Having fallen by 13% from our April highs local shares are now a long way from euphoric overvalued levels so we are more upbeat on the prospects on 12-month time horizon.

Investor sentiment hit extremely pessimistic levels as fear overtook greed this quarter which is often a bullish sign from a contrarian perspective.

Further short-term volatility can't be discounted given the seasonal weakness that can spill into October but given the sharp falls in global equities and rise in bond yields means share are trading below fair value and starting to become more attractive. The gap between the grossed-up dividend yield on Australian shares (which is now around 6.5%) and Term Deposit Rates (around 3%) means that Australian equity yields still remain attractive for local investors and self-managed super funds.



Stay nimble bear market rallies likely to continue

A paper from leading Australian Asset manager Perpetual that is courting peer Pendal Group to create a combined $200bn global funds under management business has provided some interesting insights into current state of play for global markets. While expectations of rate cuts in 2023 sparked a very strong +18% rally around the globe in July-August resulting in lower bond yields and narrower credit spreads, that are working against the Fed's plan to tighten financial conditions.

These sorts of rallies can be temporarily painful for investors who are underweight risk or conversely can be an opportunity for nimble traders. However, according to Perpetual bear market rallies of this size and nature are very common, even in equity bear markets. Perpetual looked at US equity markets during the Great Depression, the S&P 500 sold off -89% in 33 months, but within that time frame the index recorded 10 periods in which it rose more than 10% and had five periods of gains more than 25%.

Similarly, in the six bear markets since 1979, the S&P 500 has recorded an average bear market rally of +16% and the majority of these have occurred in recessions as investors responded to a combination of improved valuations and increased stimulus.

Depending on investor attitudes towards risk any such future volatility may provide nimble investors the opportunities to dial up (buying the dip) or dial down risk (sell the rally) as markets are likely to bounce around until interest rate uncertainty subsides.

Shocktober?

August and September have historically been the weakest months for global markets and while Black Swan (rare and unforseen) events have occurred in October - Wall Street Crash (1929) and Black Monday (1987) - October is on average a positive month for markets. Whilst current trends suggest things are likely to get worse before they get better for markets there is a host of catalyst for markets to work through in the coming quarter that could prove better than feared and spark another bear market rally into the end of the year.

Firstly, expectations for US third quarter earnings season in October are low and now provide room for upside surprises to those downgraded consensus expectations.

Domestically, Annual General Meetings season (October) acts as quarterly trading update for many local firms while major bank reporting season (November) should show their leverage to rising interest rates and better margins given the size of recent rate hikes and deposit pricing that supports shareholder returns.

The Labor Governments first Federal Budget is due in late October and tipped to be more restrained as the economy is in good shape with household and corporate balance sheets in a much stronger position than previous interest rate hiking cycles.

In China, the 20th National Party Congress in mid-October offers hope that pro-growth policy execution may step up in the final quarter given their lacklustre economic growth that should support relatively strong demand for mineral commodities which underpin our economy.

Finally, the US midterm elections in November (that may see the Democrats lose control of the senate and the house) have historically (since 1950) seen US stocks record positive (double digit) returns in the twelve following than in other non-election cycles.