MANAGED PORTFOLIOS

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

Q2 2023 REVIEW - AN UNUSUAL YEAR

An unusual year

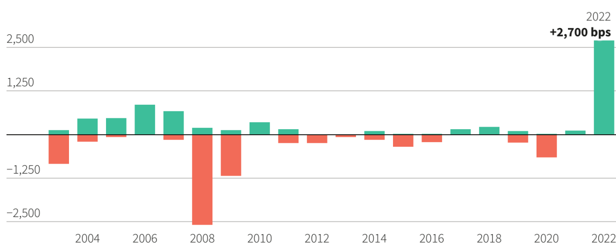
It was a truly unusual and unprecedented year for global markets that blew up many best laid forecasts. Rapid interest rates hikes saw allocations to rate sensitive sectors such as Real Estate, Utilities and Technology shrink as bearish sentiment and fund manager cash levels grew on overwhelming expectations for a global recession next year.

The year was so extraordinary according to investment bank Morgan Stanley, that looking back over the last 150 years of U.S. equity and long-term bond performance, it was the first time that both stocks and long-term bonds were down more than 10% in a year.

It highlights that fixed interest was an inadequate diversifier (cash was king) in what was a rollercoaster of a year for investors. 2022 saw an end (or at least peak) of easy money, a war between Russia and the Ukraine (added to surging inflation), while major central banks ramped up interest rates at the fastest pace and the biggest scale in two decades.

Major central banks deliver rate hike bonanza in 2022

Policy rate hikes and cuts by central banks overseeing the 10 most traded currencies



Note: Australia, Canada, Euro zone, Japan, New Zealand, Norway, Sweden, Switzerland, United States and UK
Source: Refinitiv Datastream | Reuters, Dec. 23, 2022 | By Vincent Flasseur and Karin Strohecker

Reuters Graphics

Interest rate sensitive sectors suffer

Higher interest rates weighed heavily on rate sensitive sectors to see Information Technology, Real Estate, Consumer Discretion and Communications all down double digits. On the other side the ledger Energy and Materials sectors looked through weaker Chinese demand and to the supply side constraints stemming from the war in the Ukraine.

A host of commodities rose sharply including oil, gas, nickel, and wheat while critical (battery grade) minerals such as lithium used to decarbonise and transition economies away from fossil fuels continued to climb as demand outstripped supply.

For Energy it was coal stocks that led the rally as pricing at the Newcastle Port more than doubled for the second straight year. Chinese bans on Australian coal last year shifted to surging demand from European coal fire power generators as they seek alternate energy sources from Russia.

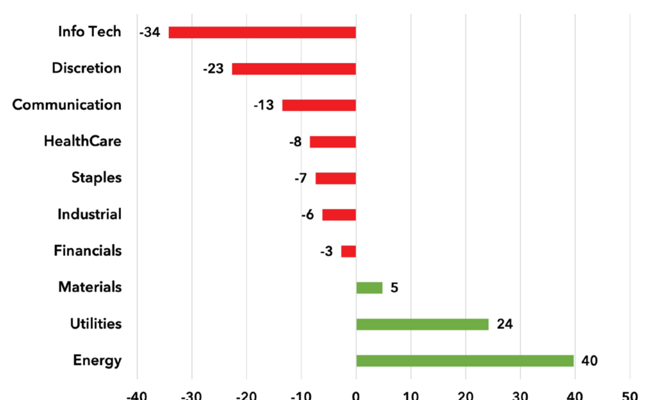
After initially spiking 40% in seven days to US$133 per barrel on the Ukraine conflict Brent Oil prices finished the year up a healthy 10% to US$86 per barrel. Oil prices did however, average closer US$100 per barrel for the year (+30%) but gradually fell from June as weaker Chinese demand and the introduction of energy price caps artificially reduced inflation (transport and distribution costs) in many major economies.

The U.S. released its largest ever drawdown of oil stockpiles to see reserves hit their lowest levels since 1984, Europe signed off electricity price caps while in Australia temporary cuts to fuel excise moved to our own $1.5bn energy relief package in December.

Domestic gas and coal price caps were passed in parliament to ease the burden on business and consumers who may have seen greater than 30% lift in energy bills next year.

It was a startling rally in the Utilities sector (that historically suffers from higher interest rates) as Private Equity takeover interest moved from beaten electricity utility AGL to peer Origin with a shock $18.4bn bid in November.

It was a surprise move given mooted government intervention and introduction of a windfall tax on the beneficiaries of higher commodities in what many industry observers say will be a disincentive for exploration spending that may further constrain supply causing future domestic energy shocks.



Lowes mea culpa

In Australia, the biggest inflation surge in 40 years forced a mea culpa from Reserve Bank of Australia (RBA) governor Dr Phillip Lowe that apologised to those that acted on the RBA's early forecast that rates would remain at record lows until at least 2024.

Eight interest rate hikes by the Reserve Bank of Australia (RBA) since May to 3.1% has so far had little impact in cooling the economy.

As monetary policy works with a lag the cumulative effect of those interest rates increases is yet to be fully felt in mortgage payments. Expectations are for the RBA to tighten policy further (peaking in the next six months) until the cash rate sits between 3.5% to 4% before patiently pausing until next year in line with U.S. Fed policy.

Australia's interest rate peak is likely to be lower than other international peers (U.S, Canada, UK, and New Zealand) that are all forecast to peak above 5% as most Australian home mortgages have variable rates, while two thirds of those fixed rate mortgages set at near 2% in 2021 will roll to higher variable rates (above 5% presently) over the next 12 months.

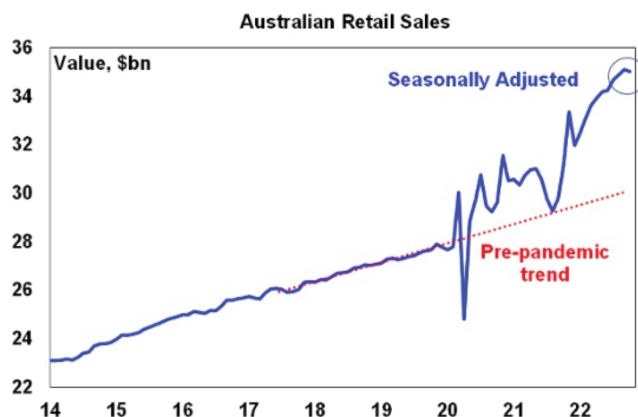
Based on RBA modelling (should you trust their forecasts) mortgage payments relative to income will increase to levels equal to their previous 2008 peak so those interest rate hikes will start putting greater pressure on household budgets.

Consumers last hurrah?

A resilient consumer continues to surprise despite cost-of-living pressures rising and confidence falling. Australia's near 50-year low unemployment rate of 3.4% and the cumulative effect of $250bn of household savings buffers over the past two years (equivalent to eight months of total retail spending) continues to underpin consumption as Australians embrace their first restriction free summer.

Expectations are for a bumper Christmas spending spree driven by revenge travel given strong forward bookings for leisure and hospitality services.

Surging demand and ongoing supply issues (worker availability and weather) was none more evident than in the travel sector where consumers are paying business class ticket prices for substandard economy class service. Capacity constraints and flight cancellations are expected to impact the reopening travel experience.



Source: AMP

One can only wonder how long consumers will be willing and able to pay for such a service. This dynamic has been a boon for global airlines such as Qantas that issued several stronger trading updates, rewarding shareholders via increased share buy backs while swamped workers are less pleased as they continue to negotiate better pay conditions.

King dollar reigns

The US Dollar (US$) reached two-decade highs to become the most crowded trade of 2022 as its interest rate differential to other weaker comparative currencies and its safe-haven appeal attracted investors. While the US Dollar Index that measures the greenback versus a basket of six other major currencies shed 8% for the quarter it managed to rise ~8% for the year, its best year since 2015.

The strength of the US$ has been a tailwind to Australian offshore earners but a headwind for commodities markets that largely fell into bear markets this year.

This trend is showing tentative signs of reversing as the outlook for US economy and corporate profit growth is weakening while cheaper valuations and stimulus supports emerging markets like China that are reopening. By virtue of Australia's close trade ties to China and as a developed market in an emerging region we should continue to see modest upside in our dollar given our relatively stronger albeit slowing growth outlook.

The prospect of recession and earnings risk in many developed markets is likely to see an eventual peak in central bank interest rates next year supporting continued US$ weakness. With inflation moderating but remaining above the Fed's 2% target this adds support to gold.

China zero Covid now in the rear-view

Approaching their fourth year of Covid China abruptly gave up on their strict zero Covid policy restrictions as discontent spread across the country. In a matter of weeks policy rapidly changed as lockdowns, testing, quarantines, and travel restrictions were being unwound.

Many had slated loosening of Covid policy in March (as they exited winter) however, this earlier than expected news saw a risk on rally as a slew of stimulus measures focused on the struggling real estate and construction sectors was also announced.

Markets ran with this reopening optimism driving Iron ore prices up 50% from their US$80 per tonne November lows to close out the year flat at around US$120p/t.

Economic bellwether Copper also surged off its lows (to finish down 13% for the year) as pandemic roll back curbs boosted the prospects for commodities demand in 2023.

The reopening of the Chinese economy poses both risks and opportunities ahead. The risks currently lie with the countries relatively low vaccination rates that have led to a spike in hospitalisations already while the risk of new variants creates some additional caution.

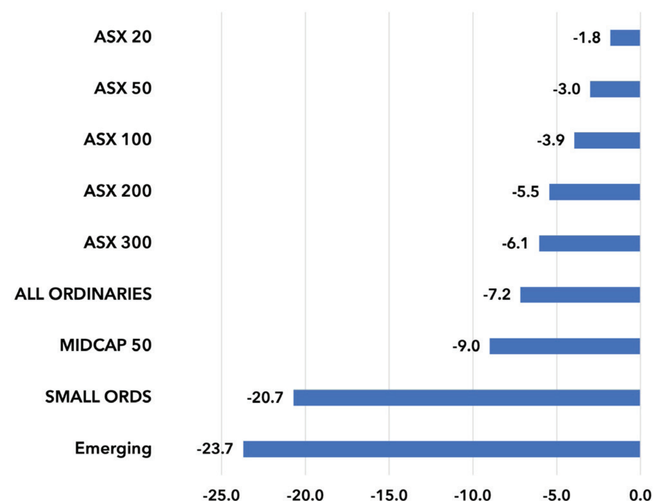
Like the path of western world's reopening this past year it's likely to be a bumpy ride to a full recovery as worker absenteeism impacts manufacturing. In December, electronic vehicle manufacture Tesla and phone maker Apple both had to temporarily suspend production in China– a move that tempers their respective near-term earnings outlooks.

Categorically the China reopening is a positive outcome for Australia and a recent thawing of trade tensions (signals reduced risk of export bans) as pre Covid-19 China was Australia's largest consumer of tourism (15%) and education (33%) so a gradual recovery over the next few years will add to the domestic growth outlook.

Large caps outshine

A 3% drop in December took some shine off the S&P/ASX 200 best quarter in 2 years – to deliver a strong 8.7% quarterly gain. The rally was driven by signs global supply chains were easing, U.S. inflation was peaking that could allow a step down in the pace of future interest rate hikes.

An abrupt U-turn on China covid policy also lifted sentiment that the world's second largest economy and Australia's largest trading partner would rebound earlier than forecast. However, in a volatile year, the Aussie market shed 5.5% or a modest 1% fall in accumulation terms (once dividends are accounted for) as the market struggled to overcome significant first half weakness.



The year was categorised by continued diverging performance by size and sector as investors sought safety in large caps. Value sectors - banks, energy, and materials - that currently benefit from stronger macro-economic outlooks (higher inflation / interest rates) rewarded shareholders via higher dividends.

Meanwhile, investors shunned riskier stock that saw smaller capitalisation S&P/ASX Small Ordinaries (ASX 100-300 stocks) and Emerging Index (micro-cap stocks 350-600 in size) shed more than 20% for the year.

Value markets outperform

It was a tough year for investors globally however, the Australian markets circa 5% fall this calendar year (worst in 5 years) did see us outperform the MSCI World Index's (down 19%) that includes many of the largest companies in advanced markets of the U.S., Europe, and Asia.

The main reasons for Australia's outperformance were our underweight technology exposure and that the outlook for economic growth remains positive (GDP moderating to 1.5% from 3.5% next year) that should see us avoid a recession unlike much of Europe and the U.S.

The Australian market also remains attractive from a global perspective due to our high dividend yields and larger proportion of Banks that are showing leverage to rising interest rates supporting near term earnings growth and dividends.

While the expected slowdown in global growth next year will be a headwind for broader commodity demand there remains a supportive backdrop for resource and energy firms given a robust recovery expected from China and globally government support for decarbonisation grows.

Furthermore, cash positions of mining companies have improved following a period of higher returns and constrained investment and those strong balance sheets may permit merger and acquisition activity (such as BHP $9.6bn move on Copper miner Oz Minerals) while continuing to pay robust dividends.

The concentration of gains in those Top 20 mega blue-chip banks, energy and miners' stocks helped avert a much deeper sell off.

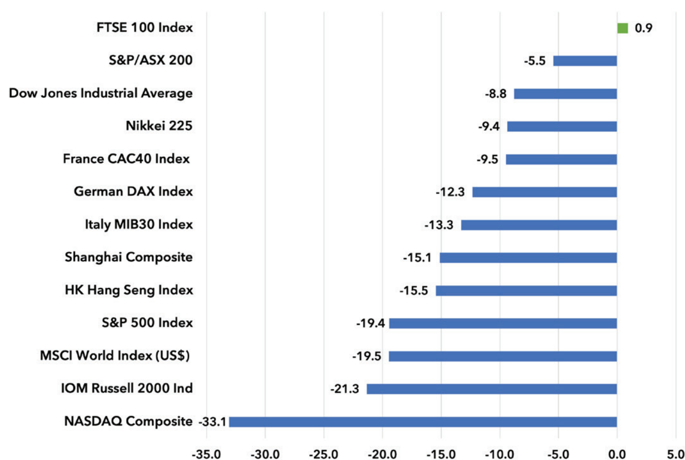
U.S. shares posted their biggest declines since the GFC (2008) as the concentration of Information Technology and Communications stocks that dominate their market plummeted.

Collectively known as the Big 5 (Google, Amazon, Apple, Facebook and Microsoft) that account for a quarter of the major growth indices fell by an average 43%. Whilst higher growth and far less profitable firms fell by much more.

Earnings multiples compressed and valuations were under pressure (given the technology sectors sensitivity to sharply higher interest rates) whilst the pull forward in demand caused by Covid and societies rush to technology is now fading.

The technology focused Nasdaq index led the losses plunging 33%, the broader S&P500 down 19% while the old economy Dow Jones Industrial Average fell 9%.

In Asia, Chinese and Hong Kong stocks fell by 15% however, Hong Kong shares entered a new bull market rising 35% from their October lows as the lure of China reducing Covid restrictions and a peak in US$ brought back investors into oversold emerging markets. Japanese shares were 9% weaker.



In Europe, double digit falls were seen on most major bourses, with the notable exception being the FTSE 100 in London that finished in positive territory. The U.K.'s outperformance was due to their similar market composition to Australia (overweight exposure to banking, resource, and energy shares) while exporters benefited from a much weaker British Pound.

No sign of policy pivot but rates nearing a peak

To help bring down inflation the US Federal Reserve (The Fed) raised its benchmark interest rate to 15-year highs taking rates from near zero in March to 4.3% by December.

The dot plots the Fed uses to signal its outlook for the path of interest rates suggests rates will rise above 5% next year (potentially peaking in the first half) with no interest cuts until 2024 when rates may moderate back towards 4%.

Fed chair Jerome Powell continues to lean on equity market strength (quashing bear market rallies) stating, "he will stay the course, until the job is done and that history cautions strongly against prematurely loosening policy" a reminder of the policy mistakes of the 1970's.

The Fed has a tough job ahead to thread the needle and engineer a softish landing that will see unemployment rise, economic growth slow to bring inflation back to its 2% target without causing major economic damage.

Worries have grown that the Fed will tighten policy too far and tip the economy into recession or conversely pause too soon to see another inflation spike.

Growth moderating, volatility rising

It's rare to finish a year with broadly negative returns across all asset classes and consensus calling for modest total returns (including dividends) in the year ahead. Or as US Investment bank chief at Goldman Sachs David Kostin calls his 2023 outlook as "less pain but no gain".

We have been through three vastly different and unpredictable years since Covid-19 and 2023 looks no different. According to Bespoke Investment Group, the S&P500 in the U.S. has swung by at least 10% in either direction the year after falling by 15% or more so anything is possible given the uncertainties around the Fed's rate hiking path in terms of whether it can control inflation without damaging the economy.

In Australia, the lagging or cumulative impact of 300 basis points of interest rate hikes this year lays ahead for households and consumers. Consequently central bank policy is set to have the desired effect of constraining demand that is running ahead of supply.

The market remains on high alert and hypersensitive to each data point on labour market tightness (wage growth) and inflation (global supply chain bottlenecks dissipating) that will permit central banks to pause and then ultimately pivot (cut) interest rates.

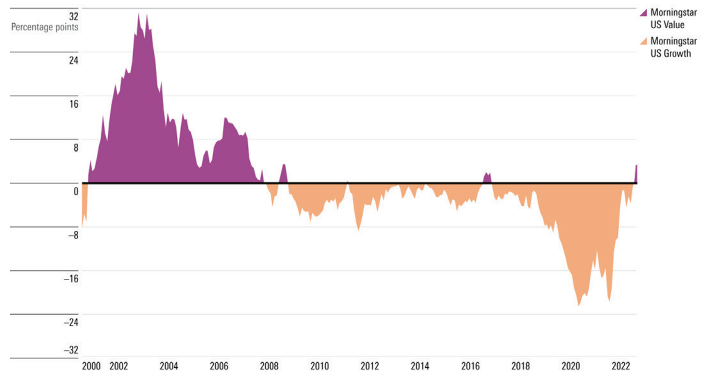
It is worth noting that the average time that interest rates stayed at a peak in the past four cycles in Australia (1994, 1999-2000, 2002-2008, 2009-2010) was 11 months and none of those cycles caused a recession.

This would be consistent with central bank and market forecasts for no interest rates cuts until 2024 and fits with the mantra of higher for longer rates.

On the proviso that we avoid a recession with soft economic landing the outlook for higher interest rates remains a supportive backdrop for value stocks and value markets like Australia.

After a decade of value underperforming growth as record low interest rates and government stimulus was spent on unproductive investment and consumption there are signs that the value trend is durable and shifts in leadership between growth and value are often multiyear cycles.

Value vs. Growth Performance Gap
Three-year trailing excess return.



Source: Morningstar Direct, Morningstar Indexes. Data as of December 16, 2022. Three-year rolling return periods are annualized.

Higher interest rates mean there is now a cost of capital and over longer timeframes share prices follow earnings so investors will need to look for companies with strong earnings, dividends, and cash flows.

For defensive fixed income investors higher starting yields (10-year Australian government bonds yield at 4%) makes the asset class significantly more appealing than a year ago.

For an average growth investor, it might be too late to throw out the baby with the bath water given the carnage over the past year and select beaten down big tech stocks are starting to look more attractive.

Many twists and turns over the past few years have mean it pays to be well diversified as different sectors and industries take leadership and momentum trading (follow the herd) has been rewarding. 2022 hurt passive index strategies as globally they were skewed to the worst performing sectors (technology) and underweight the best (energy).

Given the outlook for a volatile year ahead investors will have to contend with moderating profit outlooks so it could be a better year for active managers and stock pickers once again.

This document has been prepared for the general information of investors and not having regard to any particular person's financial situation, objectives or needs. Accordingly, in so far as any information may constitute advice (whether express or implied), it is general advice and no recipient should rely upon it without having obtained specific advice from their advisor at Baker Young Limited. Baker Young Limited makes no representation, gives no warranty and does not accept any responsibility for the accuracy or completeness of any recommendation, information or advice contained herein. To the extent permitted by law, Baker Young Limited will not be liable to the recipient or any other persons in contract, in tort or otherwise for any loss or damage (including indirect or consequential loss) as a result of the recipient, or any other person acting or refraining from acting in reliance on any recommendation, information or advice herein. Baker Young Limited or persons associated with it, may have an interest in the securities or financial products mentioned in this document and may earn brokerage and other fees as a result of transactions in any such securities. Australian Financial Services Number 246735.