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Q3 2023 REVIEW - RBA TIMEOUT

The Australian share market (S&P/ASX 200) kicked off the year with a surging 6% rally (its best January gain since 1994) as European and Chinese growth positively surprised aided by a mild northern hemisphere winter that allowed Oil and Coal prices to ease 7% and 56% respectively for the quarter.

China's economic reopening gathered pace with their government conservatively guiding to a 5% GDP growth target this year (up from a 46 year low of 3% last year) driving iron ore 8% higher and copper 7% firmer for the quarter.

Stubbornly resilient inflation and steady jobs growth continued to allow the U.S. Federal Reserve (The Fed) to hike interest rates for a ninth successive meeting to 4.75% and the Reserve Bank of Australia (RBA) lifted interest rates for a 10th straight time to 3.6%.

The RBA did, however, indicate a likely pause at their April meeting as they take a timeout to size up the impact of cumulative effects of their tightening with some cracks starting to show as a wave of insolvencies was hitting the construction industry, which accounts for 10% of total employment in Australia.

Despite tightening financial conditions labour markets remain tight (50-year low unemployment in Australia) while high aggregate household savings is generating both wage growth and robust retail spending that currently supports the notion of a soft economic landing.

US earnings nadir coming

While Australia's earnings have held up comparatively well this year, U.S. earnings are expected to mark the third consecutive quarter of negative earnings growth which meets the criteria of an earnings recession. The recent strong rally in global growth stocks looks premature (bear market rally) again as corporate earnings usually follow GDP which are all trending lower.

The upcoming earnings results may be reaching the trough in corporate profits that could see an improvement towards the end of the year. One of the key variables to the expected second half earnings recovery will be that the banking stress won't be felt for several months as lending standards tighten and credit to households and business slow.

In Australia, we have a robust financial system that is well capitalised and ready to manage possible future shocks.

However, our banks like global peers will have earnings headwinds from more expensive funding costs, higher bad debts and tighter regulation that will likely constrain earnings growth. We remain cautious and see many of the inflationary pressures abating (that will permit a lower path of interest rates), but remain pragmatic that financial conditions are continuing to tighten and likely to constrain market returns. While there is always a wall of worry to climb, May is often a seasonal weaker period impacted by quarterly earnings updates and major bank dividends.

The Federal Budget set to be delivered in early May is likely to also reflect a deteriorating global macro-economic outlook and be less stimulatory than previous budgets.

Treasurer Jim Chalmers is framing a hard budget that will likely focus on addressing the cost of living and housing crises, urgent climate action and fixing Australia's mental health system.

Credit conditions to tighten

By mid-March, price stability (inflation) worries had shifted to concerns about the stability of overseas financial institutions as the impact of the steepest U.S. tightening cycle since the 1990's reminded us of the consequences of sharp policy changes.

Liquidity concerns around some mid-tier U.S. banks and well documented issues with troubled Swiss investment bank Credit Suisse prompted a spike in volatility. Decisive central bank action (to provide short term liquidity to banks) stemmed the bleed and restored confidence that allowed markets to recover strongly (window dress) in the final week of the quarter.

The Fed was quick to reinforce that expanding the balance sheet and turning back on the liquidity taps (reversing recent Quantitative Tightening) was short term in nature to ensure that inflation expectations do not become unanchored as their 2% inflation goal is unlikely to be met until 2025.

According to Fed chair Jerome Powell, the banking sector disruption provides restraint (akin to one or two more rate hikes) so may contribute to significant tightening in credit conditions meaning that monetary policy may have less work to do. Powell forewarned the Fed tightening cycle is likely to pause soon, possibly after their May meeting.

Markets disconnect with central banks

This was good news for those concerned about higher inflation and interest rates, but the downside was it came with an outlook for three years of below trend growth to bring inflation down to target at the end of 2025.

This was music to the ears of beaten down technology and growth investors who have suffered a torrid 12-months as lower future interest rates will relieve pressure on valuations. While economists are divided on the path forward for interest rates, money market futures are pricing in around 50 basis points (½ percent) in U.S. interest rate cuts by the end of the year contrary to the Fed's most recent forecast for no cuts until early 2024.

A defining feature of the quarter was volatility in global bond yields that whipsawed but ended meaningfully lower on safe-haven fears as the mini banking crisis may bring forward the much-anticipated U.S. recession.

Consequently, the US Dollar (US$) continued its slide, gold rallied to 2-year highs and battered, and bruised fixed income (bond) investors finally enjoyed a stellar quarter. Those lower yields saw the Nasdaq and technology stocks outperform up 17% (best quarter since 2020), the more diverse S&P500 rose 7% while the old economy Dow Jones lagged to be flat. European stocks, as measured by the broader European STOXX 600 index, rose a robust 7% as the drawback from better economic growth was interest rates moving much higher (to 3%) and into restrictive territory that supported the Euro Dollar.

Australia lags global rebound

After a strong start, from mid-February the Australian market experienced a 7-week slide (the longest losing streak since the 2008 GFC) as a mixed domestic reporting season highlighted early signs that higher interest rates and inflation were starting to impact business. Limited forward earnings guidance and a larger second half skew to earnings does pose a risk that the confession season in May (major banks and mid cap seasonal quarterly reporting period) has increased.

A notable trend that has led to a bias towards Quality stocks (companies that have more defensive characteristics - stable earnings, pricing power and lower gearing that support dividend payments) continued to drive the outperformance of Large caps (S&P/ASX 200).

Large caps registered their most significant earnings beats (to expectations) in 7 years finishing the quarter 3.5% higher (13.5% financial year to date). Conversely a larger than usual number of smaller cap companies missed expectations that saw S&P/ASX Small Ords (ASX 101-300 stocks) lag to be up less than 2% for the quarter (9% financial year to date).

Emerging economies to drive growth

A weaker US$ saw fund flows into emerging markets and broad-based gain was seen across Asian markets. Key trading partner China benefiting from its reopening to rise 6% for quarter. Recovering Chinese domestic consumption is offsetting slower global growth that according to the International Monetary Fund (IMF) is expected to grow less than 3% this year - its weakest since covid.

Despite resilient labour markets and consumer spending in developed economies the prospect of a recession in the U.S. (the world's largest economy) will see emerging economies be the bright spots this year. The IMF forecasts that India and China are expected to account for 50% of global growth this year.

As a developed market in an emerging region Australia's proximity to Asia and close trading ties with those emerging market juggernauts (India and China) should see lower recession risks. Slowing demand will be partially offset by immigration growth. This should help ease wage pressure for business however, the downside may mean rising immigration along with low housing supply creates even tighter rental markets potentially adding to inflation.

After a volatile ride so far this year investors are hoping for a calmer period ahead and one where markets can build on the excellent double-digit gains recorded so far, this financial year.

Historically, April is a stellar month for US markets (rising by over 2% on average over the past 50 years) so having survived a mini banking crisis, inflation moving lower with a still strong jobs market all eyes will on U.S. quarterly earnings season (April) and our seasonal May reporting period.

The focus on earnings will be on rising input costs and labour inflation that will pressure margins for some firms and importance of forward guidance is likely to take precedence over the results themselves.

M&A making a comeback

Despite the increased volatility due to the rising cost of capital (interest rates) that's pressuring segments of the economy, a host of private equity and industry heavy weights are taking advantage of share price weakness by launching takeover offers.

We saw Merger and Acquisition (M&A) activity ramp up this quarter that included the world's largest gold miner Newmont launch a $17bn takeover for Australia's largest gold miner Newcrest. In the lithium space U.S giant Albemarle launched a surprise $5bn bid (63% premium) for emerging miner Liontown.

While outside the resource sector we saw United Malt Group receive a $1.5bn bid from Europe's largest commercial maltster Malteries Soufflet, Funeral home operator InvoCare obtained a $1.8bn bid from private equity firm TPG while aged care provider Estia Health is subject to a $775m offer from private equity outfit Bain Capital.

These takeover offers highlight that sectors might be down but not out of the sights of longer-term investors and provides some valuation support for stocks given the significant premiums offered.

Overall, the Australian market remains attractive as its not expensive trading at 14 times forward earnings (a modest discount to its long-term average) while continuing to enjoy a yield advantage above global peers. The 4.3% (5.5% grossed up) yield is much higher than the US markets (S&P500 1.8%) and Europe's (3.6%) rate, so equities remain attractive for income seeking investors prepared to take on a bit of extra risk.

The banking sector continues to remain a standout offering a 5.8% dividend yield or 8.3% grossed to include the benefit of franking credits. We continue to see Australia well placed to benefit due to the outlook for modest earnings growth, relatively low valuations, and appealing dividend yields that should continue to grow - albeit at a slower pace than last year.

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