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Q4 2022 REVIEW - UNCONDITIONAL TIGHTENING

The Inflation genie is out of the bottle

It was a challenging financial year (particularly the second half) as investors had to grapple with a war on Covid, a war in Ukraine, and now a war on inflation. The inflation genie is out of the bottle, and central banks have a job to orchestrate a soft economic landing by making necessary adjustments to remove excess liquidity and emergency interest rate settings so supply can catch up to demand.

Markets initially shrugged off a tumultuous start to 2022 as they slid in January on central bank hawkishness. Heavier falls followed in February as Russia's invasion of Ukraine created an immediate threat of higher food and energy prices, adding to already hawkish rhetoric from central banks.

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March was a strong month as equities rebounded in hopes of peace talks between Russia and Ukraine. This came despite higher inflation fuelling talk (and subsequent action) of accelerated interest rate hikes and ultimately a bond yield curve inversion - usually a reliable future recession indicator. By mid-April, the market peaked near all-time highs above 7600 on the S&P ASX200 before a late quarter swoon saw the index shed 9% in June to deliver its worst quarter (-12.5%) since the depths of covid (March 2020). Australia was not alone in the steep second-half global equity sell-off. Our circa 15% fall in just nine weeks (from April peak to June low) was a much shallower decline from all-time highs compared to overseas peers (US, Germany, and China) that have now fallen into bear markets, being down 20% to 30% from their peaks.

Australia's resilience finally fades

The Australian market was resilient for most of the year as its Value focus (just 4% exposure to higher growth technology) and barbell exposure to Value sectors Materials, Energy, and Banks (that represent 55% of our market) benefited from higher commodities and interest rates.

> **After rising 28% in the previous financial year, the S&P/ASX 200 fell 6.5% this year (after accounting for dividends), marking the market's 6th worst Financial Year since 1983.**

Gains were concentrated mainly in those Value sectors as 5 of the top 10 best-performing stocks for the year were either coal or lithium.

While around a third (77 stocks in total) considerably lagged the index falling by more than 20%, as many mid-caps and highly priced unprofitable technology stocks derated significantly further. Value sectors did, however, finally succumb to late quarter profit-taking as investors flipped from inflation concerns to growth (recession) fears. By the end of the year, only two sectors finished up, Energy and Utilities. At the same time, Technology and Consumer Discretion lagged due to higher valuations and cost of living concerns due to higher energy prices.

Central banks' hawkish hard pivot

A catalyst for market weakness is central banks' hard pivot to an even more hawkish stance as strengthening employment data, and record job vacancies are leading to rising wages and persistently high inflation – that's no longer transitory.

Markets have been rapidly repricing how aggressive central banks will now have to be to fight runaway inflation and unanchored consumer expectations for future higher prices. The US Federal Reserve (The Fed) and other central banks are unanimously leaning against equity market strength to hike faster and harder than in previous cycles to curb 40-year high inflation readings. The Fed has lifted interest rates three times this year, taking interest rates from zero to 1.75%, with June's latest 0.75% hike, its largest since 1994.

An unconditional tightening cycle lies ahead for the US with a commitment to do whatever it takes to restore price stability. This is likely to push interest rates towards restrictive territory around 2.75% by the end of the year. While being slow to normalise interest rates, the Reserve Bank of Australia (RBA) looks set to follow a similar rapid tightening path that could take interest rates above 2% (from the current levels of 0.85%) by year's end. Meanwhile, the runoff in the Fed's bloated $9 trillion balance sheet will come via Quantitative Tightening (non-reinvestment or sales of maturing bonds), adding too much tighter financial conditions ahead.

Worst start for US shares in 50 years

On the back of higher interest rates and a lower (albeit still above trend) growth outlook, US shares fell sharply to record the S&P 500 worst start to a calendar year in 50 years as long-duration growth (technology) stocks that dominate their market lagged.

Leading the falls this quarter was the tech-heavy Nasdaq, which shed 22% to fall into bear market territory (down >20% from its peak). The broader S&P500 corrected 16%, while the old large-cap economy 30 stock Dow Jones Industrial index shed 11% for the quarter.

In Europe, the Stoxx 600 (largest stock by market cap) finished down 16%.

Europe bears the brunt of the Russian sanctions due to their energy dependence on Russia, which supplies 40% of their gas and 25% of their oil needs.

This higher cost impost to businesses and households is a significant driver of inflation and weakens the growth outlook in the region, increasing recession risks. Europe, a favoured investment thematic this year (cheaper valuations and lower technology exposure), saw a swift reversal in fund outflows as the stagflation debate grew in the region. Despite political turmoil brewing and recession fears rising in the UK (following five interest rate hikes), markets in London bucked the trend rising over 1% for the year as they benefited from greater market exposure to mining and energy companies that outperformed.

In Asia, Japanese shares shed 8% for the year as the Bank of Japan remains committed to ultra-loose monetary policy sending the Yen to 24-year lows against the greenback.

Chinese markets fared best in the region, declining by just 5% as markets looked through their zero covid policy stance and month-long shutdowns of economically important cities of Shenzhen (key technology manufacturing hub) and Shanghai (26m people) that put their 5.5% yearly GDP growth target at risk. Hopes for more significant stimulus initiatives and reductions in regulatory red tape remain supportive for a second-half recovery in the region.

Energy prices soar

In commodity markets, Energy surged on supply-side constraints as sanctions on Russian minerals exports had brent crude oil soaring over 50% and coal prices surging 138%. The Materials sector was mixed as battery metals led the gains as Lithium prices nearly doubled and Nickel prices rose to decade highs.

Iron Ore prices that cycled record highs of US$230 a year ago shed 20% for the quarter (down 43% for the year) as global steel production softens on those Chinese shutdowns.

Russian/Ukraine supply concerns were also pronounced in soft commodities combined; they produce 25% of the world's Wheat and 15% of the world's Corn, which drove 30% and 6% respective higher moves for the year.

Commodities drive returns

On the earnings front, an upbeat February reporting season in Australia generally proved favourable, with more than two companies exceeding forecasts for every one missed. Firms showed resilience to Covid-19 supply chain issues with rising operating costs generally passed through to customers supporting margins, profits, and dividends. The clear highlight of that reporting season was massive earnings upgrades to mining and energy firms and dividend payments.

Commodity producers and banks with excess franking credits pushed total dividend payouts to a record level. Those encouraging updates that saw Australia as one of the few significant markets with positive earnings revisions this year are now backward-looking, given increasing supply-side challenges from the Ukraine conflict.

Analyst earnings forecasts for many companies are stale as they have not been updated since the February reporting period. Hence, confessions of higher costs and potentially weaker profit margins are likely to see analysts adjust their numbers lower.

Markets have been falling in part on the expectation of lower earnings, and the US reporting season in July and our own in August could provide the catalyst for the next market move as investors seek clarity on the earnings outlook.

US$ rallies on safe-haven buying

Interest rate differentials in favour of the $US saw it reach a two-decade high against a basket of 6 major world currencies on safe-haven buying. Commodity-sensitive currencies such as the Australian Dollar (A$), which had been a robust performer given our strong trade performance and foreign investment inflows, finally fell 8% for the quarter (and year) to close the year at US$69c. Over the year, the A$ was mixed yet outperformed many developed peers, rising 4% against the Euro and British Pound 5-year highs while A$ surged 12% against the Japanese Yen (to 6-year highs).

In addition to surging commodity prices and the positive impact on the trade account, another reason for the A$ relative strength has been the continued flow of offshore funds into the Australian equity market, attracted by the relative value compared to the US market and the dividend yield of over 4%.

This compares favourably to the S&P 500 1.4% dividend yield in the US, which sees the dividend yield gap between Australia and developed markets at record levels.

Offshore investors' primary focus has been to seek an inflation hedge via commodity equities that are also the market's dividend darlings.

Offshore investors have benefited enormously by picking up market and currency gains but how long they stay around is debatable, as should supply-side commodity constraints ease in the back half of the year (inflation peaks) as higher interest rates start to bite a reversal of this fund flow could see Australia give back a portion of its recent relative outperformance.

Yield curve warning

A central talking point this quarter was global bonds tumbled on the hawkish Fed that saw the US bond yield curve invert for the first time since 2019. Losses in the international bond markets are massive and the worst on record. Such volatility in bonds relative to equities is rare, and bonds have proven inadequate diversifier for investors. They have done little to protect or hedge portfolios as surging inflation erodes returns and reduces the purchasing power of those fixed interest coupons.

The inverted yield curve is a rare phenomenon where the long-term yield (10 years) falls through the short term (in this case, the 2-year yield), implying that an economy is approaching a recession within the next 18 months. Yield curve inversions have historically occurred before recessions, as investors signal their doubts about the near-term health of the economy by selling out of short-dated bonds in favour of longer-dated debt.

There are concerns that the Federal Reserve's aggressive hiking of interest rates and rising inflation could weigh on economic growth.

While a yield inversion is a warning to markets, according to analysts at Swiss investment bank UBS that since 1965 the S&P500 in the US has returned an average of 8% in the 12 months following the inversion of the 2/10-year US yield curve, meaning investors could see positive albeit below-average returns going forward assuming the inversion is a mild and short-lived event.

Deglobalisation grows

Another significant trend over the past year, which grew wings this past quarter given the geopolitical risks in Europe, was governments' fast-tracking stimulus spending for decarbonisation and defence, a move that further erodes the deglobalisation of trade.

The Russia/Ukraine war has accelerated the energy transition in Europe to reduce their reliance on fossil fuels and to regain energy and military security. However, this will come at a higher cost (inflation).

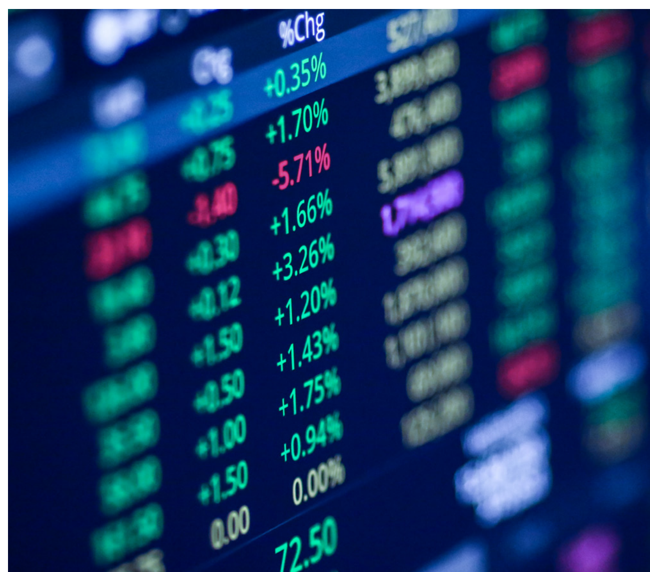
For the past decade, China had been exporting deflation as corporations outsourced cheaper manufacturing, which was a boon for corporate profitability. US/China trade wars, Covid-19, and now the Russia/Ukraine war has accelerated the push for higher government defence spending; a key theme in Australia's Federal Budget (that preceded the Labor party's Federal election win in May) was a record $10bn commitment to cyber security and $10bn for a nuclear submarine base in NSW - to the ire of major trading partner China.

Wages add to inflation

The Federal Budget continued a trend of significant fiscal stimulus measures (by passing on surplus commodity windfalls) in a move aimed to alleviate the cost-of-living pressures via temporary cash handouts (to pensioners and low-income earners) and petrol excise cuts that have weighed on recent consumer sentiment surveys.

The cost-of-living prelection payments were soon followed by the Fair Work of Australia awarding a 5.2% lift in the national minimum wage (highest increase since 2006) and above market expectations.

This wage rise helped vindicate the incoming Albanese government's election pledge to lift low-paid workers so they weren't losing in real (inflation) terms. This will add to inflation and heaps pressure on the RBA to act in the second half of the year as economic reopening gathers pace, inflation and wages are rising as labour markets continue to tighten.



Policy misstep risks rise

Looking forward geopolitics remains a wild card for markets as the humanitarian and economic toll is hard to quantify given the unknown duration of the invasion. For now, markets are optimistically pricing in tensions easing in the year's second half (that should ease inflation concerns) as economic sanctions have been favoured over escalated western forces and a full-blown war.

Markets remain comfortable that the US Fed is ready to act on inflation by raising interest rates harder and faster to restrictive levels.

The rapid path to restrictive territory remains a fine line and a tricky balancing act for central banks that increase the risk of a policy misstep as sharply higher interest rates could also destroy demand and lift unemployment.

Ultimately, central banks globally who struggled to achieve inflation objectives post the GFC will learn to live with higher inflation meaning real yields (inflation-adjusted) remain low (or negative), which for now is supportive for equities.

Given recent geopolitical events, governments and businesses are economically and politically incentivised to decarbonise economies supporting demand for resources and battery-grade metals nickel, cobalt, and lithium. At the same time, the deglobalisation of trade reduces competition and global growth, so investors will ultimately bear the higher cost of the transition through lower investment returns.

Stocks derate but is it enough?

Australian shares are now trading back below fair value at just 12 times forecast earnings (down from 20 times earnings last year and well below their 5-year average); however, this is likely to be overstated as analyst earnings are stale, and positive earnings contributors in resource and energy are now peaking.

Meanwhile, US stocks are trading back around their long-run average of 16 times forward profits, offering better value than in recent times. However, the upcoming US reporting season brings on even more importance for earnings to deliver after a softer outlook in the previous quarter.

An extended period of excess central bank liquidity has afforded investors a degree of forgiveness on poor news.

A buy-the-dip mentality has been a supportive market feature but has most recently flipped to a sell the rally mantra, especially in high-risk growth stocks, as central banks reduce liquidity. Investor sentiment around earnings misses and beats will be closely watched, and increased volatility in company results is likely to create more opportunities for active investors.

Focus on quality

Higher-quality companies continue to be favoured as typically they have more defensive characteristics such as higher returns on equity, stable earnings and low financial leverage that benefit investors in volatile periods.

However, a continued rebalancing of portfolios can help long-term returns by trimming sectoral outperformers and higher cash levels that have grown on the fall to selectively top up cheaper equity holdings, particularly in essential services such as healthcare and technology that have underperformed as they have lower debts and greater pricing power that defends high-profit margins.

A panic sell-off may create the next big buying opportunity

While recession fears have increased, we believe that if such a scenario eventuates, its likely to be shallow (or a mild bear market) in Australia.

We have relatively robust domestic growth, strong jobs markets, rising wages, expansionary fiscal budgets, record household wealth and a savings rate of 11% (double pre-pandemic levels) suggesting households are in good financial shape.

Furthermore, the current cycle has been liquidity-driven, encouraging investment in speculative assets such as cryptocurrencies and unprofitable technology companies that have fallen by around 70% from their peak with minor damage so far to the broader global economy.

Given tightening financial conditions, we expect more negative economic and corporate headlines. Hence, a capitulation (sell anything) drawdown is still possible that usually signals a turning point for markets (as it did in March 2020). These panic selloffs can provide the best buying opportunities for long-term investors.

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