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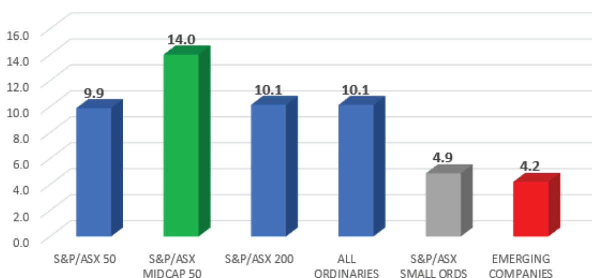
Q4 2023 REVIEW - MARKET RESILIENCE CONTINUES

An extraordinary year of strong employment, higher inflation and surging interest rates added to cost of living pressures that slowed household spending.

Amidst increasing global uncertainty markets absorbed all these headwinds to deliver a resilience performance and positive above average returns.

Research from SuperRatings showed that average balanced funds delivered returns of 8.5% last year (above 7.1% long term average) as domestic and international equities drove those gains. In Australia, the S&P/ASX200 Index delivered gains of 10% for the year or in Accumulation terms (accounting for dividends) returns of around 15%, which was well above its 30-year average of 9.8%.

Returns by ASX capitalisation size 2023



Investors gravitated to the safety of Large cap (ASX50) industry leaders that have strong pricing power and balance sheet strength to not only weather higher input costs but grow market share all whilst continuing to pay healthy dividends. Higher interest rates and cost of living pressures impacted the Small Ordinaries (ASX 100-200) stocks given their larger exposure to Discretionary and Real Estate relative to large caps exposure to Financials. Emerging (non-dividend paying) growth companies suffered as investors shunned risk to deliver around half the returns of their large cap peers.

The standout index was the MidCap50 (Stocks 50-100) on the market that have a greater skew to large cap profitable technology firms and lithium stocks that surged on energy transition demand.

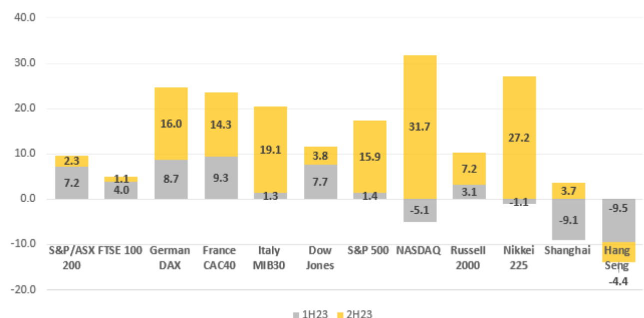
Tale of two halves

The out performance of economical sensitive value stocks globally (Banks, Energy and Miners) in the first half gave way to Growth (Technology) stocks in the second half as markets start to price in peak inflation and future lower interest rates. Given the U.S. market's larger representation of technology stocks (30%) relative to Asia's (13%), Europe's (7%) and Australia's (3%) we saw tailwinds reverse for value markets in the past 6 months. Australia and the UK that are classic value markets (minimal tech exposure and overweight Banks and Miners) benefited from higher interest rates (supporting bank profit margins) and China's economic reopening from October boosted commodities.

2022 tailwinds reversed in 2023 as lacklustre property markets weighed on confidence and China's stimulus measures broadly underwhelmed bullish expectations.

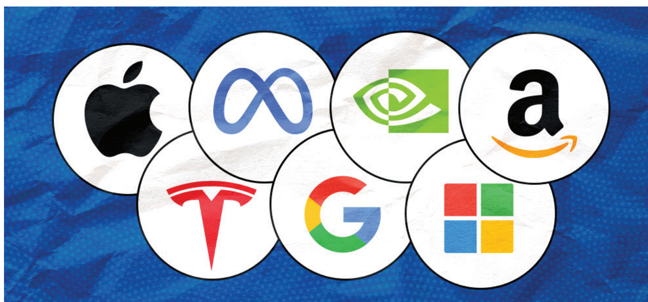
Momentum faded as weakness in China's trading partners resulted in a global manufacturing recession (U.S. manufacturing contracted for an 8th straight month and Europe for 12 straight months) as consumer spending shifted away from manufactured goods to services. Consequently, Chinese and Hong Kong markets lagged to be down for the year. Bucking the trend of its weaker Asian peers were Japanese shares that breached 33-year highs as ultra loose policy, improving economics (and corporate governance) plus a vote of confidence from investment guru Warren Buffet who increased his holdings in the region boosted returns. Starting the year from a low base European bourses across Germany, France and Italy surged to all hit records in the past six months as investors were attracted to relatively low valuations. However, recessionary headwinds are building in the second half of the year as expected higher interest rates and slowing eurozone growth took its toll on investor sentiment.

World market returns FY23



The magnificent seven

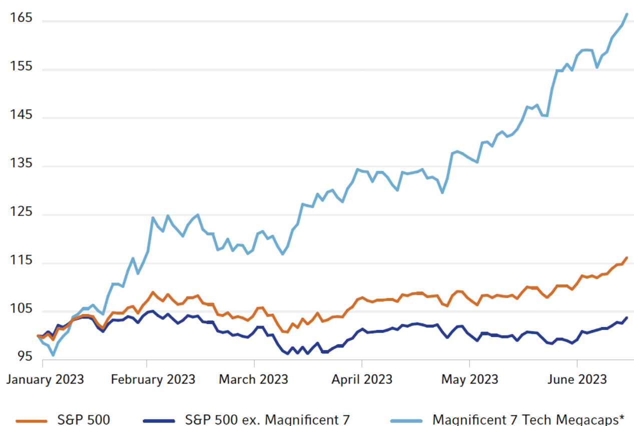
U.S. markets witnessed a similar rotation away from old economy value stocks that outperformed in 2022 (Dow Jones Industrial Average) as investors chased growth in major technology stocks. The rotation of funds helped drive the broader S&P 500 to a new bull market having risen by more than 20% from its October lows. It has however, been a staggering rally in 2023 by group of mega-cap technology stocks that rose on average by over 35% in the past six month.



The Magnificent 7 - Apple, Amazon, Microsoft, Nvidia, Alphabet, Meta and Tesla - helped the Nasdaq rise twice as much as the S&P 500 16% gain this half for its best first half since 1983.

According to investment bank UBS around 80% of the S&P500 index returns were from those seven stocks supported by an Artificial Intelligence (AI) frenzy as machine learning promises productivity and efficiency gains across many industries. While tech behemoth Apple has minimal AI exposure it didn't stop it reaching a new record high. Apple is now valued above US$3tn which is more than combined value of the entire small cap Russell 2000 index. Apple price earnings ratio has surged from 22x to 32x over the past six months (nearing record peaks) so earnings delivery will be critical from here.

Technology mega-cap stocks have dominated US market returns



Source: Refinitiv® DataStream®, Russell Investments' calculations, last observation as of June 15, 2023. *The Magnificent 7 is comprised of Apple, Meta Platforms, Alphabet (Google), Amazon, Tesla, Nvidia, and Microsoft.

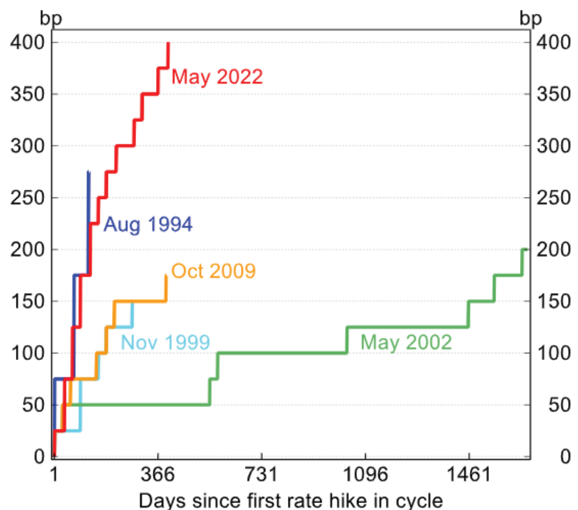
Higher inflation here to stay?

Excess savings from pandemic era stimulus (still $300bn held by mainly wealthier and older households), continued strength in labour markets (unemployment holding 50-year lows of 3.6%) have spurred wage growth and consumer spending. While core inflation (ex-volatile food and energy items) peaked at 7.3% in December and has softened to 6.4% it still remains stubbornly high - more than twice the RBA's preferred 2%-3% targeted inflation range.

The RBA has voiced concerns about inflation that it could stay higher in Australia for longer than other countries.

The board referenced the 5.75% lift in the annual award wages to our lowest paid workers was both above productivity and their expectations. Meanwhile, Australia's first budget surplus in 15 years was driven by higher income taxes from record employment and higher corporate taxes from elevated commodity prices. This windfall has partially redirected to cost of living relief that could hinder the disinflation process if spent on goods and services.

RBA rate hike cycles



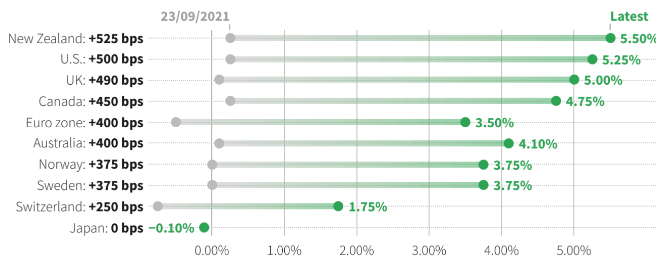
Source: CBA, Macrobond

The race to the top

Like many central banks around the globe the RBA has maintained a hawkish tone vowing to do more to bring down inflation with terminal (peak) interest rates expected to move to 4.6% in the next few months. This has all but quashed expectations for any near-term interest cuts with the RBA's assistant governor recently suggested unemployment needs to lift to 4.5% by the end 2024 to achieve their 2%-3% inflation goal - so a long pause maybe ahead once rates eventually reach their peak. Other major central banks including the Federal Reserve in US, BOE in England, ECB in Europe all suggest a further 0.50% or more of tightening ahead and that rates will be at higher levels for longer. The outlier on the race to raise interest rates remains the BOJ in Japan whose ultra loose policy is being challenged given inflation has surged to 4.3% (42-year highs) and well above their stated 2% target.

The race to raise rates

Change in policy rates by central banks overseeing the 10 most traded currencies since the start of the interest rate tightening cycle in September 2021.



Source: Refinitiv Datastream | Reuters, July 4, 2023 | By Past Kongkunakornkul.

Recession ahead?

The U.S. Fed at its most recent meeting revised up growth and inflation expectations and unemployment down all suggesting a resilient economy.

Interest rate policy works with long and variable lags, so it takes time for rates to filter through the economy and the strength in labour markets and consumer spending has seen recession fears fade.

However, many economists still expect the US to head into a recession in the next 12 months as the widely used recession prediction indicator the spread between the US 2-year treasuries and US 10-year treasuries has been inverted for 9 months reaching its widest disparity (of more than 100 basis points) since 1981. Despite these recession flags higher risk bonds while elevated in recent months suggest investors see no imminent threat to markets or the economy from higher rates, bond yields and borrowing costs. Higher interest rates do remain a headwind for corporate profits and company valuations and tech leadership has been surprisingly given their sensitivity to interest rates. Investors instead bid them up on their perceived safety as they cut costs and test their pricing power to support profit margins.

Should recession fears be pushed out further then sector rotation and the broadening of gains away from those mega tech names would be a healthy development that may extend the rally in the next six months as capital finds better value opportunities than leaves the market.

Housing ticks up

Despite all the media noise regarding housing markets the impact from tighter policy has seen only a modest impact on national average house prices.

According to CoreLogic data national house prices bottomed in February and are now 4% off those lows to be down just 6% from their April 2022 peak.

The impact of record low residential vacancies come as approvals for new dwellings collapse adding to a housing shortage. Meanwhile lower listings and sharply higher immigration are all helping drive asking rent inflation of 10% that's putting upward pressure on house values. The real risk may come in the second half of the year when 500,000 fixed rate mortgages expire and those 2% fixed rates reset at levels closer to 6%. Homeowners have had some time to adjust their budgets and when you consider record low unemployment and the Australian sharemarket that has recently rallied back to within 5% of its all-time highs the downside impact of the falling 'wealth effect' is modest at this stage.

Tougher times ahead

February's half year results underwhelmed. Profit margins were squeezed as revenues failed to keep pace with high-cost pressures (wages and financing) which also led to lower dividends relative to a year ago. Earnings misses exceeded beats for the first time in 3 years according to investment bank Morgan Stanley and the outlook is similarly challenging as we head into the August reporting season.

Undeniably conditions get tougher from here as real household incomes are under pressure with inflation growing faster than wages.

Cost of living expenses are on the rise as retail electricity prices are set to increase by 20% or more as states pass through wholesale prices with a lag.

Insurance premiums will rise by double digits as cost inflation and adverse weather events through the La Nina cycle have increased reinsurance costs that policy holds will bear.

Earnings confession season in late June centered on discretionary retailers that have cited shifting consumer behavior and trading down to home brand or frozen versus fresh grocery items.

Inventory clearance sales have picked up as investors shun discretionary spending as cost-of-living pressures mount that eat into disposable income. Inflation will be keenly watched in the upcoming results and easing costs may help support earnings that have been lowered over the next year on the above-mentioned challenges.

Can the tech train roll on?

Following a surging six months across major developed markets (led by US technology stocks) the US market is now expensive given the outlook for subdued earnings over the coming quarters. The 12-month forward P/E ratio on the S&P500 has grown to 18.9x which is above both the 5-year average (18.6x) and 10-year average (17.4).

This type of earnings multiple expansion is a move that you normally see when investors expect policy easing to drive a new upgrade cycle which seems at odds with recent hawkish shift from central banks.

We therefore maintain a cautious approach as to the new financial year ahead of US quarterly earnings in July.

Subdued quarter ahead

July's traditionally a stronger month for global markets as funds and dividends reinvested for the new financial year.

Nonetheless, we expect a relatively subdued quarter ahead as the challenging backdrop of slowing corporate profits evident by slew of weaker trading updates across the mid cap discretionary consumer space. We do however, see plenty of opportunities to deploy cash across select real estate, technology, financials, energy, and communications sectors should weakness come over the reporting season when 170 companies of the S&P/ASX200 index report earnings in August. While China's economy is decelerating due to a cautious consumer and a slow recovery in property markets inflation remains low. Further targeted accommodative monetary stimulus is expected so any upside surprises could be a welcome boost for our mining sector that has lagged this quarter.

After an above average year of returns (that few would have predicted 12 months ago) brought about by select sectors. We expect volatility to persist which should create opportunities for nimble investors.

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