Economic & Investment Update - April 2023

Against a backdrop of rising interest rates, the March quarter saw equity markets produce solid returns, buoyed by receding recession fears and data indicating that inflation was cooling.

Gains came despite turbulence in the financial sector in March as the collapse of Silicon Valley Bank and Signature Bank in the US and concerns about troubled lender Credit Suisse in Europe raised fears of contagion across the global financial sector. However, markets settled as central banks quickly stepped in with the provision of emergency cash and the Swiss government brokered a sale of Credit Suisse to UBS.

In the US, after months of inflation at close to 40-year highs, prices cooled during the March quarter. Readings on consumer and producer prices showed inflation at its slowest pace since 2021, with the Consumer Price Index (CPI) inflation rate indicator falling to 5%, down dramatically from its 9.1% peak in 2022. With unemployment only slightly above the 50-year low of 3.4% and consumer spending strong, the US Federal Reserve continued to raise interest rates, citing entrenched inflation as the primary risk to the economy.

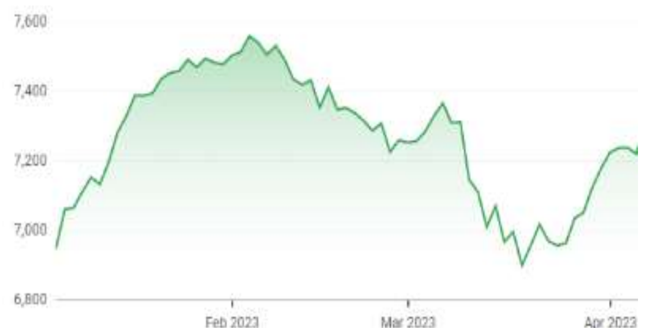
In Europe, the European Central Bank (ECB) raised interest rates by 50 basis points in both February and March despite Eurozone inflation declining to a one-year low in March. Consumer prices rose by 6.9%, down from 8.5% in February, however, core inflation (excluding food and energy costs) rose to 5.7% from 5.6%. Unemployment remained steady at 6.6% in February while consumer confidence edged down. In France, government plans to raise the retirement age saw extensive protests across the country. President Macron's government narrowly survived a no-confidence vote over the issue.

In Asia, China's inflation remained subdued creating an environment conducive for economic stimulus as China comes to terms with living with COVID. However, the country's economic rebound remained uneven with the services sector seeing strong recovery but the manufacturing sector losing momentum amid still-weak export orders.

In Australia, the CPI inflation rate indicator decreased to 6.8% in February - the second consecutive monthly decline and the lowest since June 2022. The slowing rate of inflation supported the RBA Board's decision to pause interest rate rises on 4th April, maintaining a cash rate of 3.6%. This should allow the RBA to gain a better insight into the full effects of recent interest rate hikes. The labour market remained tight with the unemployment rate falling back down to 3.5% in February.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index returned 3.5% over the March quarter. Sector returns were largely positive over the quarter with the Consumer Discretionary sector producing the best return, up 9.9%. The Information Technology (+7.6%) and Telecommunications (+7.4%) sectors also performed well. The Energy sector generated the lowest quarterly return (-5.3%) as energy prices fell while the banking crisis led to weakness in the Financial sector (-3.6% for the quarter).



S&P/ASX 200 Acc Index (Source: Google Finance)

Smaller ASX-listed companies (top 100-300) returned 1.9% for the quarter, underperforming the S&P/ASX 200 Accumulation index.

Global equity markets performed strongly over the March quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 7.1%. With the Australian Dollar weaker against

most major currencies, unhedged market gains were enhanced, with the quarterly unhedged return +9.2%.

The Small Ordinaries Index (top 100-300 companies) also performed well and returned +13.8% for the December quarter and +9.2% for the 2020 calendar year.

Within developed markets, US markets produced the highest returns for the quarter with the technology focussed Nasdaq Composite Index up 16.8%. A fall in bond yields provided strong support for the share prices of growth companies listed on this Index. The Japanese equity market also performed well, finishing up 7.5% for the quarter. Chinese shares (as measured by the Shanghai Shenzhen CSI 300 Index) returned 4.6% for the March quarter.

Listed property finished largely flat over the quarter despite a major sell off in March. Australian listed property securities returned -6.8% in March but finished 0.5% higher over the quarter while global property securities finished 2.9% lower in March but up 0.1% for the March quarter.

Within fixed interest, while the March quarter was generally positive, the March banking crisis led to a significant amount of volatility in markets. Bond yields fell dramatically, and several sectors of the credit market were particularly impacted, as central bank hiking expectations were wound back. With the fall in bond yields, the Bloomberg AusBond Composite Index returned +4.6% over the quarter while the Bloomberg Barclays Global Agg TR Index (AUD Hedged) gained 2.4%.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	S&P/ASX 200 TR (Accumulation) Index	3.5	0.1	8.7
	S&P/ASX Small Ordinaries TR (Accum) Index	1.9	-13.2	3.9
International	MSCI World ex Aust NR Index (AUD)	9.2	4.3	11.0
	MSCI World ex Aust NR Index (AUD Hedged)	7.1	-7.6	7.6
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	5.3	0.1	1.8
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	0.5	-13.9	4.8
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	0.1	-21.3	0.7
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	3.5	-1.7	6.3
Currencies				
AUD v USD	Against US Dollar	-1.9	-10.7	-2.7
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	4.6	0.4	1.3
	Bloomberg Ausbond Credit All Maturities	3.4	1.2	2.0
International	Bloomberg Global Agg TR Index (AUD Hedged)	2.4	-5.5	0.3
Commodities				
Gold	Gold – USD	8.0	1.6	8.2
Oil	WTI Oil $/b – USD	-5.7	-24.5	3.1

Outlook

Significant uncertainty currently faces the global economy. Economic growth remains low and financial risks have risen, yet inflation has not yet decisively turned the corner.

While inflation around the world appears to have peaked, it's not yet clear how quickly it will come back towards central bank targets. Demand remains robust, consumers keep spending and companies are maintaining profit margins by raising prices. Structurally higher inflation may also be locked in by pauses in central bank policy and as a consequence of government spending, deficits and debt. Should interest rates continue to rise, the narrative will increasingly focus on the prospect of a recession as the impact of higher interest rates makes its way through the economy, impacting households and demand, which in turn will make its way to corporate earnings by Q3 in 2023.

In the wake of the March banking crisis, there may also be more negative 'surprises' for markets as the financial system remains vulnerable to tighter monetary conditions.

In the US, a recession remains a possibility in the second half of 2023 with ongoing credit tightening, cooling labour market and a broad-based slowdown. The US Federal Reserve is expected to raise rates once more in May to a range of 5.00-5.25% before pausing. However, due to excessive core inflation, the restrictive policy rates are likely to be required for a prolonged period.

In Europe, while lower energy prices have assisted in bringing down headline inflation, stickiness in core CPI inflation and wage growth signal that the European Central Bank fight against inflation is not over and further rate rises are anticipated.

In China, following its Covid reopening, year-on-year growth has accelerated, and most Chinese regions have announced strong infrastructure plans, which should further support GDP and employment. However, lingering challenges could re-emerge as the initial post-pandemic recovery momentum recedes and the global economic slowdown impacts the Chinese economy.

In Australia, following a pause in April, the RBA is likely to raise interest rates further in the months ahead with inflation data remaining elevated. While the likelihood of a recession in Australian remains low with Australia's growth rate tipped to be 1.6% this year and 1.7% in 2024, there are growing concerns about stagflation - where the inflation rate remains high and economic growth, is low.

Our view on the various asset classes is outlined below.

Australian Equities

Within Australian Equities, we recommend investors retain neutral to underweight positions in large cap stocks and smaller companies.

While the domestic equity market remains reasonably well placed to outperform other developed markets and benefit from stronger economic conditions in China, risks associated with lingering inflation and tighter monetary policy remain. Should issues with the global financial system re-emerge, Australian banks may underperform.
Within portfolios, preference should therefore be considered for sectors that are well insulated from downgrade risk and able to weather macroeconomic headwinds.

In relation to smaller companies, while lower bond yields provide some support, smaller companies are usually more economically sensitive and a reduction in bond yields due to fears of a credit crunch is not favourable for smaller company earnings expectations.

International Equities

We recommend investors hold an underweight position to International developed markets and a neutral to underweight position in emerging market economies.

While developed markets have rallied early in 2023, mostly driven by several megacap stocks, rising costs and higher borrowing costs are expected to slow global economic growth, putting downward pressure on corporate earnings and valuations. The US looks particularly expensive with the S&P 500 trading at 18 times forward earnings, compared to its long-term average of 15.6 times. Consequently, we suggest that international equity holdings remain well diversified.

We currently slightly favour emerging markets due to the likelihood that Emerging Market growth will outpace developed markets, China's economic recovery translating into stronger earnings and the appealing valuations on offer. However, risk factors remain elevated given the expected global economic contraction.

Property

We recommend investors retain a neutral position to Australian property and an underweight position in International property.

Despite strong performance at the start of 2023, many domestic REITs continue to trade at significant discounts to net tangible asset value (NTA). The increased cost of debt has forced cap rate expansion and we believe there will be further downward revisions to asset valuations (particularly office) later this year. While short term returns may be muted by lower valuations, we expect improved returns from the REIT sector, once asset revaluations have washed through.

We are less confident on global property especially with rising recessionary conditions, higher refinancing costs and waning demand in some sectors. US office and residential REITs have recently seen a material deterioration in occupancy rates and rising loan defaults.

Fixed Interest

The recent reduction in long term yields on domestic Government bonds has reduced the attractiveness of these securities and we now recommend a neutral position. At quarter end, the yield to maturity for Australian Bonds was 4.05% (based on the index duration of 5.2 years).

Despite a reduction in international sovereign bonds yields, we retain our neutral recommendation in this area. While yields on corporate bonds look reasonable on face value, we remain pessimistic on global corporate bonds given the expectation of an economic downturn.

Alternatives

We retain a neutral setting for Infrastructure investments despite the recent rally. Private Equity investments are expected to continue to be well supported, underpinned by strong returns. Unlisted holdings also help to mitigate volatility in portfolios.

In this climate of market uncertainty, we continue to support an allocation to gold or silver in diversified portfolios. Exposure to gold, either through gold producers or via an investment in physical gold, provides additional diversification within portfolios and some protection against ongoing inflation. The recent fall in bond yields has supported gold holdings and further falls could result in additional gains.

Sources: Lonsec

Please note that the information above is general in nature and does not take into account your personal circumstances, financial needs or objectives. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation and needs. In particular, you should speak to Kevin Smith of The Professional Super Advisers on (02) 9955 5800 prior to acting upon this information.