Economic & Investment Update - July 2023

Global inflation appears to have peaked in April but is proving sticky. While goods inflation has come down as the covid-era shortages have largely eased, services inflation and rising wage costs are preventing a return to targeted inflation rates.

Despite central banks raising interest rates, global growth has been positive thanks in part to resilient consumer spending, tight labour markets, a mild European winter and China re-opening post Covid-19. This is hampering efforts to further bring down inflation.

In its July meeting, the US Federal Reserve raised the cash rate to 5.5% with officials suggesting one more 0.25% increase this year. The annual core inflation rate dropped from 5.3% in May to 4.8% in June while the unemployment rate remained low at 3.6%. The US economy grew at an annualised rate of 2.4% in the June quarter, with the chair of the central bank saying that he no longer expects the country to fall into a recession this year.

In Europe, the headlines have been around record high temperatures, continuing protests in France and the ongoing war in Ukraine, relegating economic news to a distant fourth. On the economic front, the European Central Bank raised the key interest rate in July by 25 bps to 4.25% with an expectation of further raises to come. The annual inflation rate dropped to 5.5% in June with unemployment flat at 6.5% in May. Across the Channel, the Bank of England increased interest rates by a surprising 50bps to 5.0% in June in response to stubbornly high inflation (7.9% in June) whilst unemployment remains below 4%.

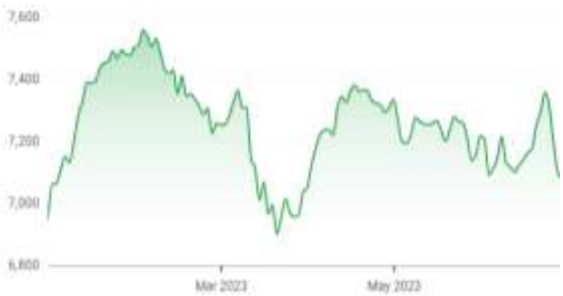
China's economy grew faster than expected in the first quarter largely due to a strong post-Covid rebound in consumption, but policymakers have been unable to sustain the momentum in the second quarter. The government is expected to announce more stimulus measures, but these are likely to be smaller and more targeted as concerns over debt remain. Annual inflation in June was 0%, with the unemployment rate unchanged at 5.2%.

In sharp contrast to other major central banks, as expected, the Bank of Japan kept its key short-term interest rate unchanged at -0.1% with inflation just above 3% and unemployment at 2.6%.

In Australia, 25bps increases in both May and June, resulted in the RBA cash rate climbing to 4.1%. This is the highest level since 2012. Inflation has passed its peak and the monthly core CPI indicator for June fell below 6%. The unemployment rate fell in June to 3.5%. Philip Lowe's term as Reserve Bank Governor was not renewed, however the door remains open for further tightening given that inflation remains persistently high as well as the recent pick up in wages growth.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index returned 1.0% over the June quarter. The stand out sector was Information Technology (+18.5% for the quarter and 32.2% for the year). Utilities also performed strongly (+5.5% for the quarter and 20.3% for the year). Weakening commodity prices led to poor returns in the Materials sector (-2.6% for the quarter). The Health Care sector also retreated over the quarter (-3.1).



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

Smaller ASX-listed companies (top 100-300) returned -0.5% for the quarter, continuing its short to medium term underperformance in comparison to the S&P/ASX 200 Accumulation index.

Global equity markets performed strongly over the June quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 7.1% again, equivalent to the previous quarters gain. With the Australian Dollar relatively flat over the quarter, unhedged market gains were only slightly enhanced, with the quarterly unhedged return +7.6%.

Within developed markets, the standout performer again was the tech heavy US NASDAQ composite index, returning around 15% for the quarter compared to the S&P 500 8.3%. The Japanese equity market (as measured by the Nikkei 225 PR Index) also performed very strongly, finishing up 18.4% for the quarter. Chinese shares (as measured by the Shanghai Shenzhen CSI 300 Index) were down -5.2% over the same period as export demand started to falter. The Hong Kong Hang Seng Index was also down -7.3% over the quarter, now down a hefty -8.2% p.a. over the last five years.

After a flat March quarter, Australian listed property finished the financial year strongly, up 3.4% for the June quarter and 8.1% over the year. Global property securities continued to struggle given the downturn in the global economy, finishing up slightly at 0.9% for the quarter but down - 5.9% for the financial year.

Within fixed interest, despite falling inflation, Central Banks continued to raise interest rates. Against a backdrop of increasing long term bond yields, the Bloomberg AusBond Composite Index was down -3.0% over the quarter while the Bloomberg Barclays Global Agg TR Index (AUD Hedged) was down -1.1%.

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	1.0	14.8	7.2
	S&P/ASX Small Ordinaries TR (Accum) Index	-0.5	8.5	2.3
International	MSCI World ex Aust NR Index (AUD)	7.6	22.6	11.5
	MSCI World ex Aust NR Index (AUD Hedged)	7.1	16.6	8.3
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	1.5	5.1	3.1
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	3.4	8.1	3.5
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	0.9	-5.9	-0.6
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	-0.4	2.7	5.1
Currencies				
AUD v USD	Against US Dollar	-0.3	-3.5	-2.1
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-3.0	1.2	0.5
	Bloomberg Ausbond Credit All Maturities	-1.1	3.3	1.6
International	Bloomberg Global Agg TR Index (AUD Hedged)	-0.3	-1.1	0.2
Commodities				
Gold	Gold – USD	-2.5	6.2	8.9
Oil	WTI Oil $/b – USD	-6.7	-33.2	-1.0

Outlook

Despite global inflation having peaked, Central banks still have more work to do to drive down inflation to within their target bands. A lengthy period of subpar growth may be required to tame inflation. One or two more interest rate rises followed by a pause is more likely than an outright pivot, barring any further financial instability.

The World Bank and OECD both released updated growth forecasts for the remainder of this year and 2024. The World Bank increased its global growth forecast for 2023 to 2.1%, up from the earlier 1.7%, with the OECD increasing its estimate marginally to 2.7%. For 2024, the OECD estimate is unchanged at 2.9%, however the World Bank cited central bank monetary tightening and increasingly restrictive credit conditions for its decision to cut its estimate from 2.7% to 2.4%.

In the US, inflation is coming under control despite unemployment remaining low. Wages growth and the potential for a weakening US dollar are likely to provide barriers to further reducing inflation, a scenario for sustained higher interest rates. A hard landing (i.e. recession) seemed inevitable at the start of this year but there is a possibility this may not materialise and that a period of very low growth may eventuate. 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.

The recession in the Eurozone is already underway with a mild contraction in GDP since late 2022. Ongoing weakness in global demand will put further pressure on the Eurozone, potentially leading to a further contraction in GDP.

In China, the concern is global demand for its exports rather than the fight against inflation. The expected post Covid bounce did not occur and unemployment is now at 5.2% and much higher in the younger generation. As the developed world enters a period of low or negative growth, further pressure will be put on the manufacturing behemoth. The government has responded to the slowdown, however a very rapid and significant stimulus package will be necessary for China to achieve its annual growth target of 5.0% for the 2023 calendar year.

In Australia, despite an upcoming change in Reserve Bank Governor, one or two further rate increases can be expected over the coming months as inflation remains doggedly high. Significant pressure on household budgets continues and will be further exacerbated as mortgages come off fixed term rates. Weaker consumer demand and the resulting rise in unemployment is likely to push the country closer to, or into, recession. The saviour may be the unexpected commodity price gains that have started to fill the Government's and the resource sector's coffers.

Our views on the various asset classes are outlined below.

Australian Equities

Within Australian Equities, we recommend investors retain neutral to underweight positions in large cap stocks and smaller companies. We do not believe that now is a time to increase weightings back to neutral given the risks associated with further short term interest rate rises and any subsequent economic slowdown.

Within portfolios, preference should be towards sectors that are well insulated from downgrade risk and able to weather macroeconomic headwinds. Consumer discretionary stocks are likely to come under further pressure.

In relation to smaller companies, these are usually more economically sensitive and fears of a credit crunch is not favourable for smaller company earnings expectations.

International Equities

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

This is a change from our previous underweight position to International developed markets given the resilience of major economies and the stronger than expected unemployment numbers. A shallow US recession (or a period of low growth) is now a distinct possibility, albeit small. However, we recommend that investors do not lift holdings back up to a neutral position given the inherent risks that remain as the global economy falters.

The US market looks the most expensive of the major developed nations. The recent strong gains have been concentrated around seven mega stocks and the trend towards AI. Further momentum and associated volatility can be expected in this area.

Property

We recommend investors move to a neutral to underweight position to Australian property (previously neutral) and an underweight position to International property.

The increased cost of debt has forced cap rate expansion and we are now seeing further downward revisions to asset valuations (particularly office). We hold a negative view on office space and the retail sector, positive views on industrial property and are neutral on the healthcare sector.

We remain 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 seen a material deterioration in occupancy rates and rising loan defaults.

Fixed Interest

We see value in Australian and International sovereign bonds. With bond rates seemingly having peaked, Government bonds offer a reasonable coupon rate and a good a hedge against share market volatility. However, although not offering a similar hedge, much higher rates can be currently found in term deposits.

Bank hybrids offer a strong return whilst official interest rates remain high. Yields on corporate bonds look reasonable on face value, but we remain pessimistic given the expectation of an economic downturn and credit contraction.

Alternatives

We retain a neutral setting for Infrastructure investments. 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 and despite recent weakness, 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.

Sources: Lonsec, The Economist, Macquarie Bank