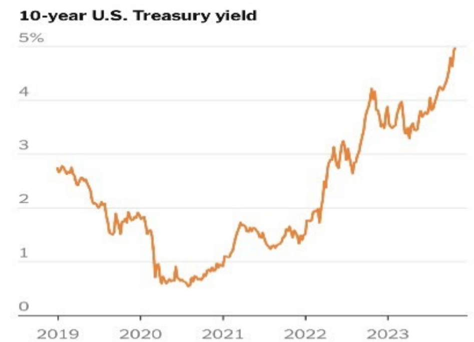
Economic & Investment Update - October 2023

During the September quarter, global equity markets started off positively, as economic data reinforced investor expectations for a soft-landing in the US. However, a surge in long term bond yields, associated with stubbornly high inflation, sapped risk appetite and weighed on equity markets in August and September.



With inflation falling more slowly than expected, primarily due to rising energy costs, long term bond yields rose as investors bet that central banks would be forced to leave interest rates at high levels for longer than previously anticipated.

In the US, 10-year Treasury yields climbed to a 16-year high. In the UK, 30-year bond yields rose to their highest level since 1998 while in Australia, 10-year bond yields finished at their highest level since October 2011.

Economic growth was also more resilient than expected, particularly in the US and Europe (ex-Germany), despite the most aggressive round of interest rate increases in decades. In the US, GDP growth continued to surprise positively, versus consensus expectations, highlighting the durability of consumer and business spending. Annualised growth in the US through to September was 4.9%, the strongest result since 2021, albeit with aircraft purchases a major contributor.

However, China underperformed with credit growth, retail sales, industrial output and investment data all coming in below expectations, indicating a subdued post-COVID recovery, prompting a flurry of policy measures to help boost the Chinese economy.

In Australia, despite growth slowing by less than expected, the RBA held the cash rate at 4.1% during the September quarter, reserving the need for future increases to ensure that inflation returns to its target in a reasonable timeframe (now expected in late 2025). Whilst moderating from its peak late in 2022, Australia's inflation rate quickened in September, adding pressure on the Reserve Bank to hike rates again in the coming months.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index returned -0.8% over the September quarter. The stand-out sector was Energy (+11.6% for the quarter) which strengthened on rising oil and coal prices. Consumer Discretionary also performed well (+5.6%) as retail sales remained robust. With CSL Limited's share price falling, the Health Care sector retreated by -9.0% over the quarter, while Consumer Staples (-5.8%) and Information Technology (-4.9%) also finished lower.

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

Smaller ASX-listed companies (top 100-300) returned -1.9% for the quarter, continuing their underperformance in comparison to the S&P/ASX 200 Accumulation index.

Global equity markets also retreated over the September quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) down -2.9%. With the Australian Dollar weaker, unhedged investment returns were slightly better (albeit still negative), with a quarterly unhedged return of -0.4%.

During the quarter, most developed markets ended lower with the German equity market (as measured by the Deutsche Boerse DAX 30 PR Index) down -4.7% and the Japanese equity market (as measured by the Nikkei 225 PR Index) down -4.0%. US markets were also weaker

with the broad-based S&P 500 PR Index down -3.7%. The UK was one of the few positive performers, with the FTSE 100 Index returning a gain of 1.0% (in local currency terms). This was driven by a decrease in domestic core inflation and surprising GDP data above expectations.

While Emerging markets outperformed, a slowdown in Chinese growth impacted Chinese shares (-4.0% for the quarter, as measured by the Shanghai Shenzhen CSI 300 Index).

Within the property sector, Australian listed property finished down -2.9% for the September quarter with the "higher-for-longer" rhetoric regarding interest rates and the potential impact on property values affecting returns. Global property securities also continued to struggle, down a further -5.2% for the September quarter.

Within fixed interest, a sharp repricing of global bond markets took place with yields rising to cycle highs. The Australian 10-year bond yield finished up 47 basis points over the quarter to finish at 4.49%, while the U.S. ten-year bond yield increased by 75 basis points to 4.57%. Against this backdrop, the Bloomberg AusBond Composite Index was down -0.3% over the quarter while the Bloomberg Barclays Global Agg TR Index (AUD Hedged) was down -2.1%.

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	-0.8	13.5	6.7
	S&P/ASX Small Ordinaries TR (Accum) Index	-1.9	6.9	1.6
International	MSCI World ex Aust NR Index (AUD)	-0.4	21.6	9.8
	MSCI World ex Aust NR Index (AUD Hedged)	-2.9	19.4	6.5
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	0.1	11.3	2.9
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-2.9	12.5	2.5
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-5.2	-0.4	-1.7
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	-6.3	3.7	4.0
Currencies				
AUD v USD	Against US Dollar	-3.4	0.6	-2.3
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-0.3	1.6	0.3
	Bloomberg Ausbond Credit All Maturities	1.3	4.7	1.7
International	Bloomberg Global Agg TR Index (AUD Hedged)	-2.1	0.5	-0.2
Commodities				
Gold	Gold – USD	-3.7	11.3	9.2
Oil	WTI Oil $/b – USD	28.5	14.2	4.4

OUTLOOK

Within financial markets, the outlook remains challenging. Alongside concerns about the impact of inflation on interest rates and bonds yields, the conflict between Israel and Hamas and the potential for this to escalate into a broader regional war, has rattled equity markets.

While recent growth data has been mixed, “higher for longer” interest rates and elevated bond yields are expected to slow the global economy, as they raise the cost of borrowing for businesses and households – weighing on company investment and consumer spending. As a result, the IMF recently forecast global growth to slow in 2023 and 2024 to rates, 'well below the historical average', increasing the prospect of stagflation (elevated inflation and stagnating growth).

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

In the US, the recent acceleration in economic activity is expected to be brief. Pitfalls loom, including the depletion of savings, the resumption of mandatory student loan payments and the need to refinance corporate debt at higher rates. Given their desire to avoid a recession, the US Federal Reserve is likely to raise interest rates modestly from current levels, with the battle to return inflation to its 2% target now stretching out to 2026.

In Europe, the economy is expected to continue to suffer under the weight of high inflation and high interest rates, with the global factory downturn having a pronounced impact on German manufacturing. After raising interest rates to a record high, the European Central Bank is now expected to maintain interest rates at elevated levels for a prolonged period.

In China, recent stimulus measures are likely to have a positive impact on economic activity with the government’s full-year 2023 growth target of about 5% likely to be achieved. However, the government continues to walk a tightrope as it tries to restore economic equilibrium. Policymakers are having to navigate a domestic property crisis (Evergrande and Country Garden), depressed private sector confidence, a slowdown in global growth and tensions with the US over trade, technology and geopolitics.

In Australia, growth is expected to decline from current levels as high interest rates lead to less household spending while recent weakness in China has raised concerns about its impact on the domestic economy. Despite the Reserve Bank continuing to balance fighting inflation while maintaining employment as high as possible, higher than expected inflation and stronger retail sales in September have increased the prospect of a further 0.25% interest rate rise in November or December.

Our views on the various asset classes are outlined below.

<u>Australian Equities</u>

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

While Australian Equities recently fell to a 12-month low, we do not believe that now is a time to increase weightings back to neutral given the risks associated with rising bond yields, the possibility of further interest rate rises, the Middle East and Ukraine conflicts and the potential for an economic slowdown.

Within portfolios, preference should continue to be towards sectors that are well insulated from downgrade risk and able to weather macroeconomic headwinds and rising borrowing costs. 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

With the outlook for equity markets challenging, we recommend investors retain a neutral to underweight position to International developed markets and emerging market economies.

We expect that higher bond yields and slowing growth will act as an obstacle to further valuation expansion and/or earnings acceleration as investors digest the prospect for central banks to keep interest rates higher for longer to dampen economic growth, while reducing the likelihood of a scenario where central banks pre-emptively cut interest rates ahead of a recession.

On the earnings front, investors remain vulnerable to bad news in the form of a deteriorating economic backdrop. A re-acceleration in economic growth that would sustain this year's earlier gains is highly unlikely – particularly given the expectation that growth will slow to below-average levels.

Property

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

Rising bond yields are increasing the cost of debt while recent transactional data has confirmed falls in asset valuations (particularly office properties). We maintain 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 slowing growth, 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

Following recent rises in yields, we see value in Australian and International sovereign bonds. Government bonds currently offer a reasonable coupon rate and historically have provided investors with a hedge against share market volatility. However, should bond yields rise further, Australian and International sovereign bonds are at risk of further capital falls.

While not offering a similar hedge against share markets, higher rates continue to be available from term deposits.

Bank hybrids offer a strong return, albeit with some risk, whilst official interest rates remain high with the sectors variable coupon rates providing some protection against further rate rises. 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 despite the impact of rising bond yields on short term returns. Private Equity investments are expected to continue to be well supported, underpinned by strong returns.

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, as well as physical silver, through ASX listed entities, provides additional diversification within portfolios and some protection against ongoing inflation.

Sources: Lonsec, IMF, RBA, US Federal Reserve. 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.