INFORMED INVESTOR |

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Antipodean Advisory

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Welcome to the May edition of our quarterly newsletter, Informed Investor.

ECONOMIC UPDATE

Investment markets were relatively calm in April, following a period of heightened volatility in March when banking failures in the US and Europe had shaken confidence.

Most major share markets closed the month around 2% higher, extending gains in the calendar year to date.

Overall there was increasing optimism that major economies might be able to avoid recessions this year, despite persistently high inflation and rising borrowing costs. This augurs well for company profitability and provided a tailwind for equity markets.

Bond markets were relatively quiet too, with yields little changed in most regions. Central banks in Australia, the US, Europe and the UK all left official interest rates on hold during the month of April.

Continued over...

FURTHER INFORMATION

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ECONOMIC UPDATE CONTINUED

AUSTRALIA

All eyes were on the release of quarterly inflation data for the first three months of 2023. Headline inflation slowed to an annual rate of 7.0% during the period; well below the 7.8% year-on-year rate in the December quarter of last year.

The 'trimmed mean' – the preferred measure among Reserve Bank of Australia policymakers – moderated too, to an annual pace of 6.6% from 6.9% previously.

Against this background, most economists expected the Reserve Bank to leave official interest rates unchanged at 3.60% at its scheduled meeting in early May. In fact, interest rates were raised by a further 0.25% at this time.

There is a growing sense that 3.85% might be the peak in official borrowing costs in this cycle. With inflation slowing as anticipated, officials seem unlikely to continue tightening policy settings in case doing so strangles growth and sends the economy into recession.

In other news, the latest data showed that more than 50,000 jobs were created in March; a stronger result than the +20,000 consensus forecast. For now, Australian firms appear to remain confident enough to keep hiring staff, despite ongoing cost pressures and an uncertain economic outlook.

NEW ZEALAND

Inflation moderated more than anticipated in the first quarter of 2023, suggesting CPI might have peaked. The annual rate of inflation slowed to 6.7%; still a high number, but meaningfully lower than the 7.2% year-on-year rate seen in the final quarter of 2022.

The Reserve Bank of New Zealand raised official interest rates by half a percentage point early in the month, to 5.25%, but the softer than expected inflation print prompted suggestions that the interest rate hiking cycle may now be close to ending.

Consensus forecasts indicate the central bank will raise interest rates one more time – most likely by 0.25% – before pausing to assess the impact of significant policy tightening over the past 18 months or so.

US

Investors increasingly focused on a looming liquidity crisis, following warnings of a potential problem earlier in the year.

The US currently has a debt limit, or 'ceiling', of around US$31 trillion. This results in a considerable repayment burden, as regular interest payments on this debt need to be made.

Janet Yellen, Secretary of the Treasury, has warned that the US government could essentially run out of cash in as little as a month if current borrowing limits are not raised. Increasing borrowing limits is a political hot potato however, and we can probably expect the Republicans and Democrats to clash on the issue in Congress in the weeks ahead.

That said, the issue is likely to be resolved one way or another, as the consequences of the US defaulting on its debt – i.e. being unable to afford to pay interest that is due or repay debt on its maturity date – could be catastrophic for the global financial system. The permitted debt ceiling will therefore probably be increased, as it has been several times previously.

EUROPE

GDP growth in the Eurozone appears to have stagnated but at least remains positive. The Euro-bloc economy expanded by just 0.1% in the March quarter; slightly below the +0.2% consensus forecast.

Activity levels picked up in France and Italy over the quarter but GDP growth remained subdued in the region as a whole.

On the inflation front, price rises are still accelerating in some areas – France and Spain, for example – and food price inflation has risen above 20% year-on-year in Germany.

These releases must be a concern for European Central Bank policymakers, who have already increased official interest rates by 3.5% in the past year to combat escalating pricing pressures.

There were some more encouraging indicators in the UK, where previously most observers had anticipated

a recession in the months ahead. The Institute of Directors' economic confidence index rose for a fifth consecutive month, returning to levels last seen prior to Russia's invasion of Ukraine more than a year ago.

Households in the UK appear to be feeling more optimistic too; consumer confidence improved for a third consecutive month.

Encouragingly, unemployment remains extremely low in the UK at just 3.5% and industrial action is helping to secure meaningful wage increases for public sector workers.

The Bank of England now believes the world's sixth largest economy will grow modestly this year, despite ongoing cost pressures and rising borrowing costs.

ASIA

The Chinese economy saw the fastest growth in a year in the March quarter, buoyed by resilient consumer spending. The relaxation in COVID related restrictions early in the new year appears to have benefited the economy, as officials anticipated at the time.

Industrial output in China appears to be tailing off, however, which could be a concern for other export oriented economies. Factory activity in China has historically been quite closely correlated with global demand levels.

The latest data showed that industrial production is weakening in Taiwan too. Industrial output in March was down 14.5% compared to a year ago.

In other news, India has overtaken China as the world's most populous country; the first time it has topped the list since data started being collected in 1950.

AUSTRALIAN DOLLAR

The Australian dollar did not move significantly in April, trading in a channel between 66 and 68 US cents throughout the month.

The currency finished the month down 1.1%, at 66.2 US cents.

The AUD depreciated by 0.8% against a trade-weighted basket of international currencies but did gain ground again selected majors. The 'Aussie' appreciated by 1.6% against the Japanese yen, for example.

AUSTRALIAN EQUITIES

Like elsewhere, it was a relatively quiet month for Australian equities. Market movements were dictated by domestic and international company announcements, continuing bouts of mixed economic data and persisting hopes that the global interest rate tightening cycle might be nearing its end.

Overall, the S&P ASX 200 Accumulation Index ended the month 1.9% higher, extending gains in the year-to-date to 5.4%.

Sentiment towards the Information Technology sector (+4.8%) continued to improve. Megaport (+36.7%) was the strongest performer, rallying off the back of a positive trading update. The company materially increased its earnings guidance for FY23 and FY24, suggesting results will exceed consensus forecasts. WiseTech Global (+5.3%) and Xero (+4.4%) also fared well in this part of the market.

Financials (+3.3%) also performed well, recouping some of their March losses.

The iron ore price fell by around 16% in April reflecting an uncertain outlook demand from China (the world's largest buyer) and associated concerns about oversupply in the market. This adversely affected Materials stocks including Mineral Resources (-8.6%), Fortescue Metals Group (-6.9%), Rio Tinto (-6.6%) and BHP (-6.0%). Negative contributions from these stocks resulted in the Materials sector moving -2.6% lower; the only sector to produce a negative return.

Utilities was another relative underperformer, rising 'only' 1.4%. Origin Energy (+0.6%) announced its Final Investment Decision on the construction of a battery at its Eraring Power Station. This announcement was in line with the firm's stated strategy to accelerate the energy transition.

Small caps outperformed their larger peers, with the S&P/ASX Small Ordinaries returning 2.8%. Like in the S&P/ASX 200, Materials stocks were among the worst performers in the Index.

LISTED PROPERTY

Global property securities fared reasonably well, with the FTSE EPRA/NAREIT Developed Index adding 2.0% in AUD terms.

The best performing regions in local currency terms included Germany (+11.5%), the UK (+6.4%) and Japan (+5.7%).

Generally speaking, European property markets recovered some of their losses from recent months. Sentiment improved towards various property sub sectors that had been hampered by downgrades in the first quarter of the year. The most notable example was the German residential sector, where valuations have begun to appear more attractive.

Laggards included Canada (-0.7%), Spain (-0.3%) and Hong Kong (-0.1%).

Asian property markets such as Hong Kong and Singapore underperformed due to weaker than expected data from China's economic recovery, which eroded confidence in the region.

Locally, the Reserve Bank of Australia left the cash rate unchanged at 3.60% at its meeting in early April. This helped support long duration sectors of the share market, including A-REITs, which returned 5.3%. Mirvac Group was the top performer in the sector, rising 15.9%, despite announcing a downgrade to earnings guidance. Delays in residential projects seem likely to reduce the number of settlements.

GLOBAL EQUITIES

Listed companies started releasing their earnings for the first quarter of the year. The reports will gather pace in May, but so far there have been few no major trends in the releases.

In general, resilient earnings and hopes that major economies might avoid recessions this year benefited equities and enabled most major share markets to gain ground. The MSCI World Index added 3.2% in Australian dollar terms.

The S&P 500 Index in the US added 1.6%, benefiting from broad based strength. Oil company Exxon released particularly stellar results, announcing its strongest ever start to a year. Net income more than doubled to US11.4 billion in the three-month period, which was the highest first quarter profit in the firm's 140-year history.

Technology stocks typically fared less well, which held back the NASDAQ (+0.0%). Among the major tech firms, Amazon spooked investors by suggesting that sales growth in the cloud segment may be slowing. That said, the ecommerce giant had earlier reported stronger than expected revenues and profitability.

Most of the large European markets including France, Germany and Switzerland added between 1% and 3%, which supported positive returns from the Euro Stoxx 50 Index. In the UK, the FTSE 100 closed the month 3.1% higher.

Performance in Asian markets was more mixed. Share markets in Japan and Singapore made solid progress but we saw negative returns in China and Hong Kong. This appeared to be due to the release of some less encouraging economic data in China. Although overall GDP growth quickened in the March quarter, the latest industrial production data was worse than expected. This clouded the earnings outlook for Chinese firms operating in various industry sectors.

The downbeat indicators in China hampered shares in other exporting countries in Asia and prevented the MSCI Emerging Markets Index (+0.2% in Australian dollar terms) from making more meaningful progress.

GLOBAL AND AUSTRALIAN FIXED INCOME

Bond yields were less volatile than they have been in recent months, as forward looking interest rate forecasts stabilised in most major regions.

Most importantly in the US, there were growing suggestions that the Federal Reserve might be preparing to pause its interest rate hiking cycle. Consensus forecasts indicate the Federal Funds rate might be raised one more time by a quarter of a percentage point at the central bank's meeting in early May – but that borrowing costs will then be unchanged for a period.

Treasury yields drifted slightly lower against this background, which supported positive returns from global fixed income. The Bloomberg Global Aggregate Index (AUD hedged) added 0.4% over the month.

Assuming inflation continues to come off the boil as the economy digests higher borrowing costs, there are even suggestions that the Federal Funds rate could be lowered before the end of this year, or in early 2024. Encouragingly, breakeven rates which reflect the market's expectations for future inflation moved lower during April.

Yields were little changed locally too, as forward looking interest rate projections did not move much during the month. Australian bonds performed slightly less well than comparable securities in the US but the Bloomberg AusBond Composite 0+ Year Index nonetheless added 0.2%.

GLOBAL CREDIT

The general improvement in risk appetite supported credit markets. Spreads narrowed slightly in both the investment grade and high yield sub sectors.

The start of the Q1 corporate earnings announcement season was generally supportive, with few firms disappointing relative to market expectations. With profitability holding up quite well, most companies appear well placed to service their debt repayment obligations and default rates are not expected to increase significantly. The higher prospective yields available from credit relative to comparable government bonds therefore remain appealing for income oriented investors.

Source: Bloomberg. Issued by First Sentier Investors.

FIVE CHARTS ON INVESTING TO KEEP IN MIND IN ROUGH TIMES

INTRODUCTION

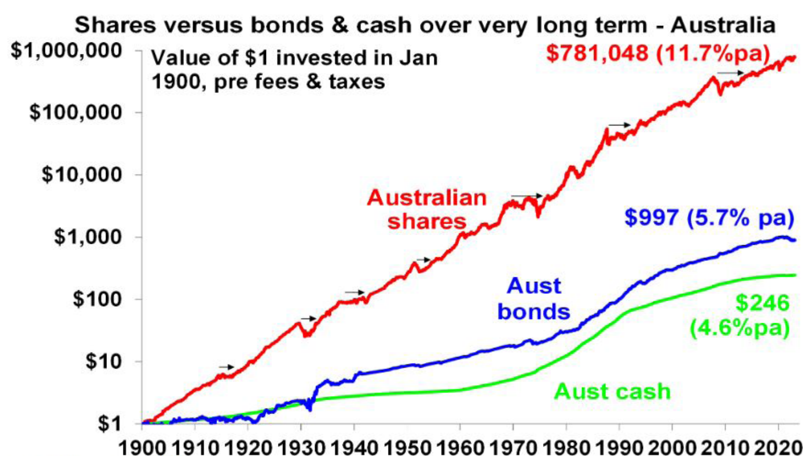
Every so often the degree of uncertainty around investment markets surges and that's been the case for more than a year now reflecting the combination of high inflation, rapid interest rate hikes, the high and rising risk of recession which has been added to in the last few weeks by problems in US and European banks. And all of this has been against the background of increased geopolitical uncertainties. Falls in the value of share markets and other investments can be stressful as no one wants to see their wealth decline. And so when uncertainty is high a natural inclination is to retreat to perceived safety. As always, turmoil around investment markets is being met with much prognostication, some of which is enlightening but much is just noise. I will be the first to admit that my crystal ball is even hazier than normal in times like the present. As the US Economist, JK Galbraith once said "there are two types of economists – those that don't know and those that don't know they don't know." And this is certainly an environment where we need to be humble.

But while history does not repeat as each cycle is different, it does rhyme, in that each cycle has many common characteristics. So, while each cycle is different the basic principles of investing still apply. This note revisits once again five charts I find particularly useful in times of economic and investment market stress.

CHART #1 THE POWER OF COMPOUND INTEREST

This is my favourite chart. It shows the value of $1 invested in various Australian assets in 1900 allowing for the reinvestment of dividends and interest along the way. That $1 would have grown to $246 if invested in cash, to $997 if invested in bonds and to $781,048 if invested in shares up until the end of February. While the average return since 1900 is only double that in shares relative to bonds, the huge difference between the two at the end owes to the impact of compounding or earning returns on top of returns. So, any interest or return earned in one period is added to the original investment so that it all earns a return in the next period, and so on. I only have Australian residential property data back to 1926 but out of interest it shows (on average) similar long term compounded returns to shares.

Key message: to grow our wealth, we must have exposure to growth assets like shares and property. While shares and property have had a rough ride over the last year as interest rates surged, history shows that both will likely do well over the long term.



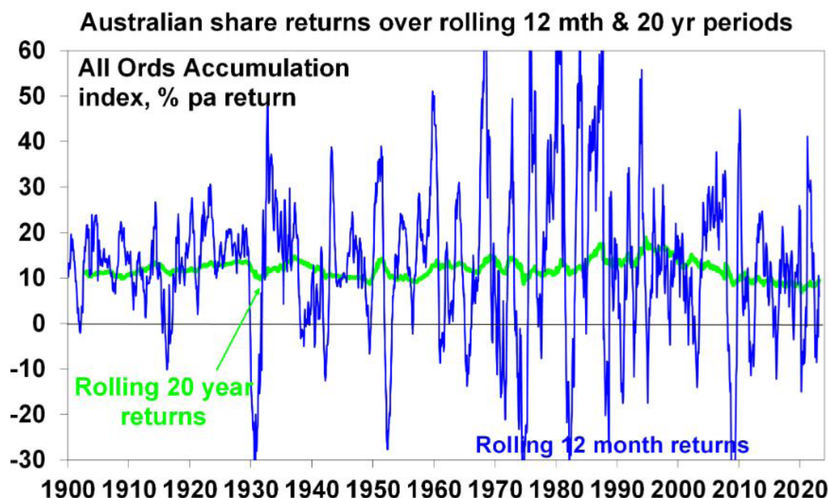
Source: Bloomberg, AMP

CHART #2 DON'T GET BLOWN OFF BY CYCLICAL SWINGS

The trouble is that shares can have lots of (often severe) setbacks along the way as is evident during the periods highlighted by the arrows on the previous chart. Even annual returns in the share market are highly volatile but longer term returns tend to be solid and relatively smooth, as can be seen in the next chart. Since 1900, for Australian shares roughly two years out of ten have had negative returns but there are no negative returns over rolling 20-year periods.

The higher returns that shares produce over time relative to cash and bonds is compensation for the periodic setbacks they have. But understanding that these periodic setbacks are just an inevitable part of investing is important in being able to stay the course and get the benefit of the higher long term returns shares and other growth assets provide over time.

Key message: short term, sometimes violent swings in share markets are a fact of life but the longer the time horizon, the greater the chance your investments will meet their goals. So, in investing, time is on your side and it's best to invest for the long term when you can.

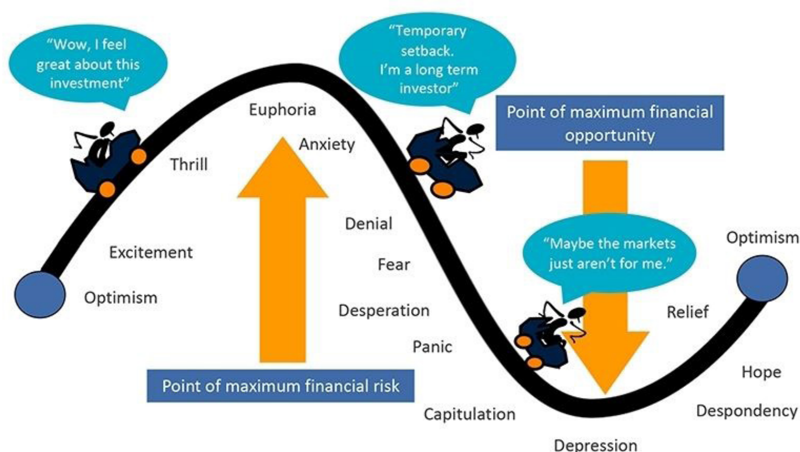


Source: Bloomberg, AMP

CHART #3 THE ROLLER COASTER OF INVESTOR EMOTION

It's well known that the swings in investment markets are more than can be justified by moves in investment fundamentals alone – like profits, dividends, rents and interest rates. This is because investor emotion plays a huge part. This has been more than evident over the last year with all the swings in markets. The next chart shows the roller coaster that investor emotion traces through the course of an investment cycle. Once a cycle turns down in a bear market, euphoria gives way to anxiety, denial, capitulation and ultimately depression at which point the asset class is under loved and undervalued and everyone who is going to sell has – and it becomes vulnerable to good (or less bad) news. This is the point of maximum opportunity. Once the cycle turns up again, depression gives way to hope and optimism before eventually seeing euphoria again.

Key message: investor emotion plays a huge role in magnifying the swings in investment markets. The key for investors is not to get sucked into this emotional roller coaster. Of course, doing this is easier said than done, which is why many investors end up getting wrong footed by the investment cycle.



Source: Russell Investments, AMP

CHART #4 THE WALL OF WORRY

There is always something for investors to worry about it seems. And in a world where social media is competing intensely with old media it all seems more magnified and worrying. This is arguably evident again now in relation to uncertainty about inflation, interest rates and associated recessions risks. The global economy has had plenty of worries over the last century, but it got over them with Australian shares returning 11.7% per annum since 1900, with a broad rising trend in the All Ords price index as can be seen in the next chart, and US shares returning 9.9% pa. (Note that this chart shows the All Ords share price index whereas the first chart shows the value of $1 invested in the All Ords accumulation index, which allows for changes in share prices and dividends.)

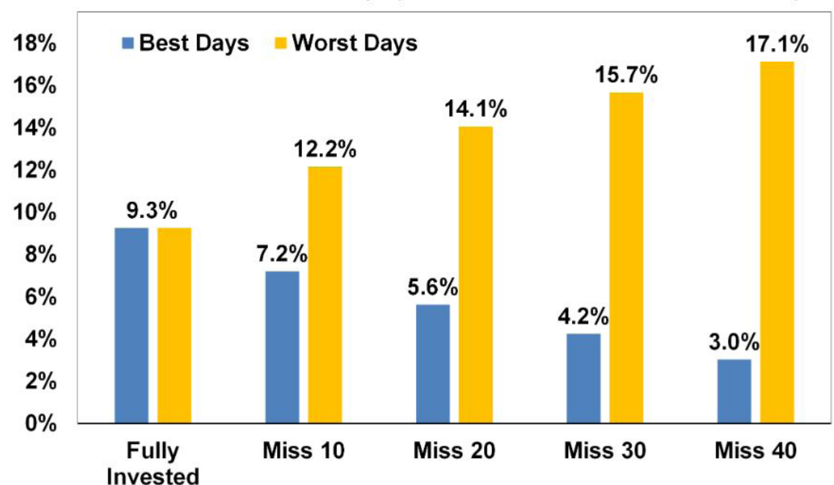
Key message: worries are normal around the economy and investments and sometimes they become intense – like now but they eventually pass.

Source: ASX, AMP

CHART #5 TIMING IS HARD

The temptation to time markets is immense. With the benefit of hindsight many swings in markets like the tech boom and bust and the GFC look inevitable and hence forecastable and so it's natural to think why not switch between say cash and shares within your super fund to anticipate market moves. This is particularly the case in times of emotional stress like now when much of the news around inflation, interest rates and recession risks seem bad. Fair enough if you have a process and put the effort in. But without a tried and tested market timing process, trying to time the market is difficult. A good way to demonstrate this is with a comparison of returns if an investor is fully invested in shares versus missing out on the best (or worst) days. The next chart shows that if you were fully invested in Australian shares from January 1995, you would have returned 9.3% pa (with dividends but not allowing for franking credits, tax and fees).

If by trying to time the market you avoided the 10 worst days (yellow bars), you would have boosted your return to 12.2% pa. And if you avoided the 40 worst days, it would have been boosted to 17.1% pa! But this is very hard, and many investors only get out after the bad returns have occurred, just in time to miss some of the best days. For example, if by trying to time the market you miss the 10 best days (blue bars), the return falls to 7.2% pa. If you miss the 40 best days, it drops to just 3% pa.



Covers Jan 1995 to 17 March 2020. Source: Bloomberg, AMP

Source: Bloomberg, AMP

Key message: trying to time the share market is not easy. For most its best to stick to an appropriate well thought out long term investment strategy.

Source: Shane Oliver, AMP

WHAT TO DO WHEN YOUR FIXED RATE HOME LOAN TERM IS ENDING?

Many Australians were fortunate to lock in record low interest rates but this may be drawing to an end.

A large portion of mortgages will be approaching the end of their fixed term, leaving many households paying two to three times their current fixed rate.

In this article, we'll explain what to expect when your fixed interest rate ends and how to prepare for it.

WHAT HAPPENS WHEN YOUR FIXED RATE HOME LOAN ENDS?

When your fixed term is nearing its end, you'll need to decide whether to re-fix your loan at a new rate, change to a variable rate or consider switching to a new mortgage provider.

If you don't do anything before the fixed term lapses, on expiry your mortgage provider generally switches your loan to its standard variable rate, which can be much higher than some of the discounted options available to new customers.

The best thing to do is contact your provider and ask them about your options, including what rates they can offer you.

HOW TO PREPARE

Consider reviewing your mortgage at least 3 months before the fixed rate expires, as this will give you time to implement changes if required.

Here are some steps to go about this:

1. Negotiate with your current mortgage provider

It's worth speaking to your current provider in advance to find out what variable rate you'll be paying. This gives you an opportunity to check out other rates available in the market and think about whether switching providers is a better solution.

You can also see if you can negotiate a better rate as this may save you a lot of effort in moving to a new provider.

2. Research what other mortgage providers are offering

Now is a good time to see how your loan stacks up against other loans out there. This will help you determine if you're getting a competitive interest rate.

If you do find a better offer, switching providers can be a smart move but it's important to look at the costs involved in switching, borrowing costs and switching fees, as these can often outweigh the benefits.

Before you make any decisions, crunch the numbers with an online mortgage switching calculator.

3. Consider re-fixing your loan

If you like the predictability that comes with a fixed rate loan, you can re-fix your mortgage with an up to date interest rate.

However, you will be locked into the new fixed interest rate for a period of your loan term, unless you choose to end the contract earlier which may result in break costs.

Be sure to also carefully check out the features of a fixed loan too, such as fee-free extra repayments, redraw and linked offset accounts. Many fixed rate loans do not provide these features.

4. Consider a split loan

If you're struggling to decide between a variable or fixed rate, or if you're keen on a combination of flexibility plus certainty, you can choose to have part of your mortgage fixed and part of it variable.

For example, you could have 60% of your loan on a fixed rate and 40% on a variable rate.

This approach can provide the best of both worlds. The variable rate component gives you flexibility, while the fixed portion shelters part of your loan from rising interest rates.

5. Get help from an expert

If you can't decide which option is best for you, a mortgage expert may be able to steer you in the right direction.

Mortgage experts can look at your finances and recommend some of the best home loan options to suit your specific needs. They'll also be able to guide you through switching to another provider if that's the path you choose to take.

Get a home loan health check

A home loan health check could help you to:

- find ways to fine tune your loan
- get more certainty or flexibility on interest rate options
- reduce your repayments
- pay off your loan sooner.

6. Make extra repayments before your fixed rate ends

If it's possible for you to do so, consider paying off as much of your mortgage as possible before you're hit with a higher interest rate.

By reducing your mortgage balance before your interest rate increases, you could save a lot of money on interest payments before it moves to the new rate.

HOW TO MANAGE HIGHER REPAYMENTS

When your fixed mortgage rate finishes and your repayments start increasing, your finances may need to be reviewed to cope with the new reality of rising interest rates.

There are ways to help you save and potentially earn more money, which may compensate for the rate increase.

1. Review your budget

While it may not be an option for everyone, there are expenses you can cut back on such as:

- taking public transport to work to reduce petrol costs and parking
- online shopping habits
- expensive memberships that you don't regularly use
- taking advantage of government and council rebates to reduce your energy bill
- switching to energy efficient appliances and lightbulbs
- reviewing your utility and insurance providers – there may be better deals on offer which could save you hundreds of dollars.

2. Increase your income

Looking for ways to increase your income can help you manage higher repayments once your fixed rate expires.

Consider asking your manager for a salary raise or look for a higher paying job.

You could also consider starting a side hustle like dog walking or online tutoring to make extra cash. Another option is to rent out a room or parking space.

3. Consider opening an offset account

An offset account is like a transactional savings account linked to your mortgage balance. The funds in this account can reduce the amount of interest you pay on your mortgage, so holding your savings here can be beneficial.

For example, if you have a $600,000 mortgage balance and $100,000 in your offset account, you'll only be charged interest on $500,000.

Source: IOOF

EXPANDING SMSFS FOR THE EXPANDING FAMILY?

It has finally happened. Recommended by the Cooper Super System review in 2010, put forward in the Federal Budget four years ago by then Treasurer Scott Morrison and finally passed on 17 June 2021, the maximum amount of members allowed in a Self Managed Super Fund (SMSF) has expanded from four to six.

Despite the previous maximum of four members, the vast majority of SMSFs had only one or two members therefore this increase did not exactly stop the press. Yet the question remains, why would an SMSF want six members and what are the disadvantages?

The most logical reason for a fund to grow to six members is to gather a larger pool of assets to invest. A larger amount to invest could open up residential and commercial property investment, or other nonstandard assets that require a large capital outlay, such as fishing licenses or marina berths.

Greater diversification for what many would consider standard assets, such as shares and managed funds, could be better achieved with six members.

Additionally, if the SMSF is paying fixed accounting and administration costs, having six members would also result in a lower cost per member.

If a large family is running two funds currently due to the previous four member limit, the funds can now be consolidated. However, it would be a capital gains tax event for the fund that is being closed down. Therefore consideration should be given to the unrealised tax position for each fund when deciding which to keep and which to close.

The main disadvantage of a six member fund is just that, the six members. The larger the fund, the greater number of people who are involved in the decision making process and the greater number of people who have to agree. With a greater number of members there is also the greater likelihood that there will be a falling out or there will be a marriage breakdown that could result in the division of superannuation. This would be particularly detrimental if the six member fund was established to invest in one large illiquid asset.

The chances of one of these unfortunate events occurring magnifies with each additional member, so it goes without saying that six member funds and the accountants and advisers that assist them will see their fair share of grief and the financial consequences that result.

For current SMSF trustees who are considering taking advantage of this legislation change, a review of the trust deed should be completed and a corporate trustee should be appointed if one is not already in place.

The SMSF member limit increase to six is good. It provides more choice in a superannuation environment which is known for restrictions and adverse government legislation changes. Opening up self managed superannuation funds to six members does increase additional investment opportunities, however serious consideration should be given to potential ramifications prior to proceeding down this path.

If you would like to discuss establishing an SMSF with six members, or adding members to an existing SMSF, please contact your financial adviser.

Source: Bell Potter

CREDIT RISK IN FOCUS AMID BANK TUMULT

KEY VIEWS

1. **Tightening financial conditions and a return of credit risk have reinforced our risk-off stance.**
2. **The Credit Suisse deal highlights policymaker actions are negative for bank shareholders and some bondholders.**
3. **We stay underweight most equities, cut credit to neutral, and prefer short term government bonds.**

The ongoing bank tumult on both sides of the Atlantic has reinforced a tightening of financial conditions, making credit risk reappear across the board. This has prompted us to change our investment views while sticking with a risk-off stance: We stay nimble and underweight most equities, downgrade credit to neutral on tighter credit supply for borrowers and prefer very short maturity government bonds for income.

The latest development: an agreement that Swiss bank Credit Suisse would be taken over by a larger rival in a deal that forced punishing losses on its shareholders and some bondholders. The deal has reduced the near term risk of potential contagion. The key now: whether it can halt the deposit flight from Credit Suisse that had added pressure to its longstanding issues. Policymaker measures to stabilise the situation in both the U.S. and Europe have hurt the bank's shareholders and some bondholders. We think these events should drive up the cost of bank funding, crimping the supply of credit to the economy.

One unusual feature of the Credit Suisse deal was that Additional Tier-1 bonds, or AT1s, were written down to zero even as shareholders received a small payout. AT1s were developed as an asset after the global financial crisis to help buttress bank capital. AT1s typically convert to equity in times of stress and are not expected to suffer larger losses than equity. In this case, the Swiss government backstopped the takeover – and Credit Suisse's bonds had hard wired into their terms that they would be written down to zero if the bank benefited from government support. Such terms are rare outside Switzerland, so this would not happen elsewhere, in our view. The European Banking Authority confirmed in March that euro area ATIs will not suffer greater losses than shareholders. Yet the write down of Credit Suisse's AT1s has caused a re-evaluation of their risks. We see issuance costs increasing as a result.

Markets have been quick to price in central banks cutting rates to stabilise the situation. That's the old playbook and we think it no longer applies. The reason: persistent inflation, as confirmed by the mid March U.S. CPI. We see central banks sticking to a "separation principle" – using balance sheets and other tools to ensure financial stability while keeping monetary policy focused on reining in inflation.

The bottom line: We stay underweight developed market (DM) shares. We cut investment grade credit to neutral and turn underweight high yield bonds given tighter financing conditions. We stay overweight short term government bonds and prefer very short maturities. We upgrade inflation linked bonds to a bigger overweight. We prefer emerging market (EM) assets and add an overweight to local currency bonds to our relative preference for EM equities.

Source: BlackRock

WHERE IS THE RECESSION?

KEY POINTS

- **A progress report on inflation:** Inflation appears to have peaked, led by improvements in core goods prices and rate sensitive sectors like housing. The policy focus has shifted to labour market normalisation where early signs of progress are emerging.
- **Is a soft landing in sight?** The Fed remains committed to doing "whatever it takes" to bring inflation to the targeted level. Despite the aggressive tightening we've seen so far, alternative data indicators suggest that the economy remains on relatively solid footing.
- **Equity market positioning:** We are positioned for themes of continued high rates, improving sentiment outside the US and a potential soft economic landing. This is expressed with a preference for value particularly in cyclical sectors including capital goods, consumer durables, autos and airlines.

2022 was a year where extreme macroeconomic and geopolitical events shaped market behaviour. The US Consumer Price Index (CPI) peaked at 9.1%, the highest level in over 40 years. The subsequent policy response saw the US Federal Reserve (Fed) deliver 4.25% of rate hikes across only seven meetings. This was the fastest cycle of rate hikes since the early 1980s, a period of stubborn inflation and aggressive policy action that ultimately ended in a recession.

As we begin 2023, there's a greater level of clarity around some of the questions that have driven markets over the last year. Recent inflationary data shows improvements in the trajectory of core goods prices and rate sensitive components. Now, the focus of policymakers has shifted towards restoring balance in the labour market and doing "whatever it takes" to bring inflation to the targeted level. As we enter a new phase of tightening beyond peak price pressures, what does alternative data reveal about the path of inflation and the recession that so many are expecting?

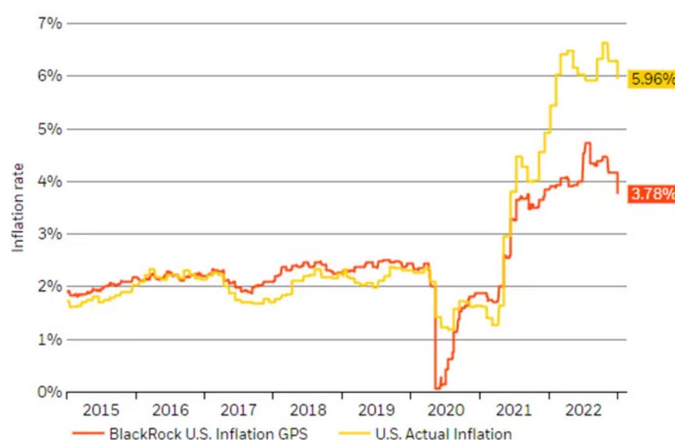
A PROGRESS REPORT ON INFLATION

In the final months of 2022, long awaited improvements in the trajectory of inflation began to surface. Figure 1 shows the widening gap between current reported inflation and where US CPI is expected to stand in six months based on a broad range of leading economic indicators and text mined commentary on inflation.

Peak inflation seems to be behind us and a clearer path towards meeting central bank objectives has started to appear. As observed in the inflation GPS measure, the sentiment of corporate comments around cost pressures and the effects of inflation on margins hasn't showed signs of deteriorating as the outlook improves.

Figure 1: US Inflation GPS shows continued decline in the trajectory of consumer prices

Current US Inflation vs six month inflation expectations

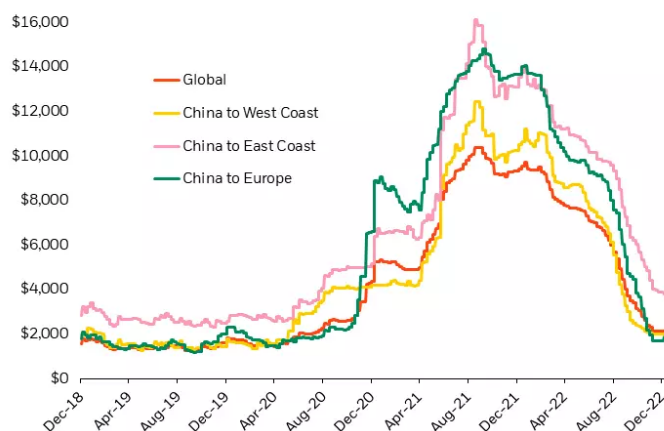


Source: Refinitiv DataStream, chart by the BlackRock Investment Institute, December 2022. The BlackRock Inflation GPS shows where core (excluding food and energy) consumer price inflation may stand in six months' time. The GPS models the relationship between rates of core inflation and a broad set of economic indicators including measures of slack, inflation expectations, and other inflation related data such as business surveys and wages. It also incorporates a proprietary Systematic Active Equity signal measured through text mining of commentary on inflation.

Core goods prices, where the initial surge in inflation was the most robust, are showing significant progress. This has continued to play out with the shift in spending from goods to services throughout the economic reopening and the healing of supply chain bottlenecks. Figure 2 shows average freight transportation costs which have fallen back to pre pandemic levels. These costs were previously 14 times greater during the peak of supply chain issues.

Figure 2: Global supply chains have mostly recovered with shipping costs returning to pre COVID levels

Average freight costs for shipping a 40ft container

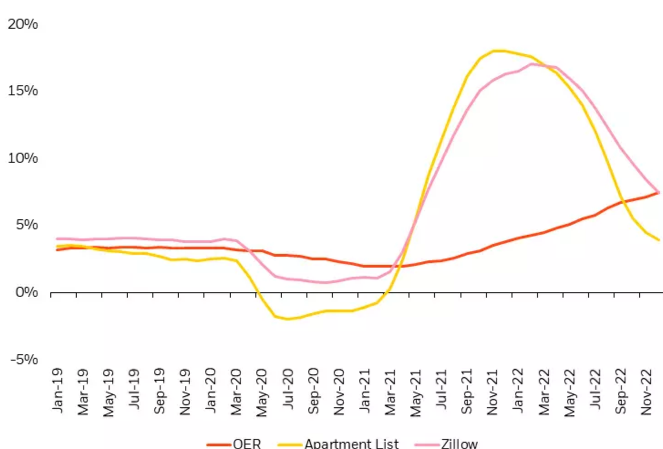


Source: BlackRock, with data from Bloomberg, as of January 2023. All amounts in USD.

Shelter is another category where alternative data is pointing to a clear disinflationary trend throughout 2023. Shown in Figure 3, the growth rate of new online rental listings in the US has started to decline. The Owners' Equivalent Rent (OER) component of CPI which captures both new and continuing leases tends to lag this alternative rental data by 6 to 9 months. This suggests that the trend we're seeing in new leases will increasingly impact CPI data as the year goes on.

Figure 3: The growth rate of new rental leases has started to decline, a trend that will increasingly impact CPI data

Online new rental leases vs. Owners' Equivalent Rent (OER)



Source: BlackRock, with data from Apartment List and Zillow, January 2023.

For the next phase of the tightening cycle, Fed officials have shifted their focus to labour markets. Wages have remained a persistent driver of broad-based services inflation since the economic reopening began. Historical periods of inflation have shown that reining in wage inflation is a critical step in restoring price stability and preventing long-run expectations from becoming unanchored. In early November, Fed Chairman Jerome Powell identified 3.5% wage growth as a targeted level that would be consistent with the Fed's 2% inflation objective.

To monitor the trajectory of wage growth, we use online job postings in the US for a real time view of employment cost data ahead of official releases (Figure 4). Wage growth has started to moderate in recent months and shows signs that the labour market is finally beginning to cool. However, more progress is needed to reach the Fed's target especially in the services sector where inflationary pressures remain the most stubborn.

Figure 4: Wage growth is showing signs of moderating, but more progress is needed

Year over year wage growth for goods vs services roles

Source: BlackRock, with data from Burning Glass Technologies, as of January 2023.

IS A SOFT LANDING IN SIGHT?

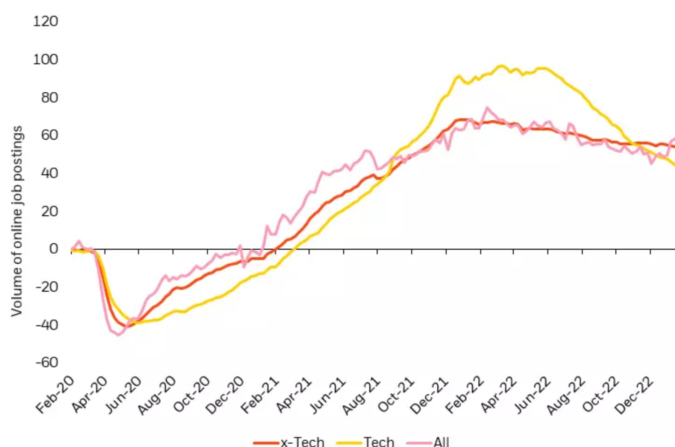
The likelihood of a soft vs hard landing depends on how healthy the economy remains as inflation continues to normalize and how policymakers react to ongoing developments. So what does the data tell us about where the economy is heading?

Let's first examine the underlying drivers of the readjustment that's taking place in labour markets. Following COVID-19, a labour shortage emerged as many individuals didn't immediately return to the workforce. Simultaneously, the economic reopening drove robust demand for workers and a significant increase in job openings, many of which remained vacant due to labour supply constraints. As a result, the recent normalisation in labour markets and wages has mostly come from a decrease in job openings. This differs from past periods of inflation where monetary tightening caused severe job losses and high unemployment that ultimately ended in a recession.

Figure 5 shows the decline that we've seen in the number of online job postings as labour demand falls. Most of the pullback in job postings is concentrated in the technology sector. This is also the case for layoffs which remain extremely benign across the broader economy. Importantly, job openings remain elevated in aggregate relative to pre COVID, suggesting that the gap between labour demand and supply can continue to narrow through a decline in job openings rather than severe layoffs.

Figure 5: Falling labour demand has come through declines in job openings, not layoffs

Volume of online job postings normalised to 2020 levels

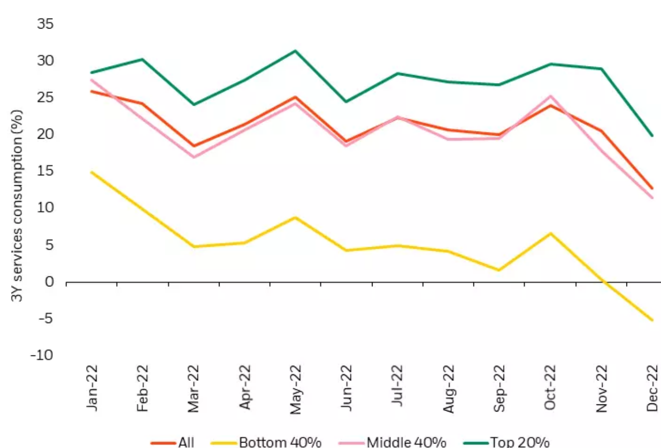


Source: BlackRock, with data from Indeed.com, as of January 2023.

Along with company behaviour, we're closely monitoring consumer activity for signs of weakness. Figure 6 shows US inflation adjusted consumer spending in the services sector which remains relatively stable and above pre COVID levels despite starting to decline particularly for the lowest income cohort. How has this level of consumer activity been sustainable as savings rates have fallen to historical lows amid higher interest rates? The previous period of unprecedented fiscal stimulus throughout the pandemic has kept the total level of household savings in excess, even long after stimulus payments have tapered off. Furthermore, household interest payments remain well below the pre COVID trend with less debt on consumer balance sheets. The combination of sustained excess savings, lower debt levels, and muted layoff activity has allowed consumer spending to remain relatively resilient over the course of the Fed's tightening cycle.

Figure 6: US Services spending remains above 2019 levels despite signs of weakness

3Y Discretionary service consumption by income cohort adjusted for inflation



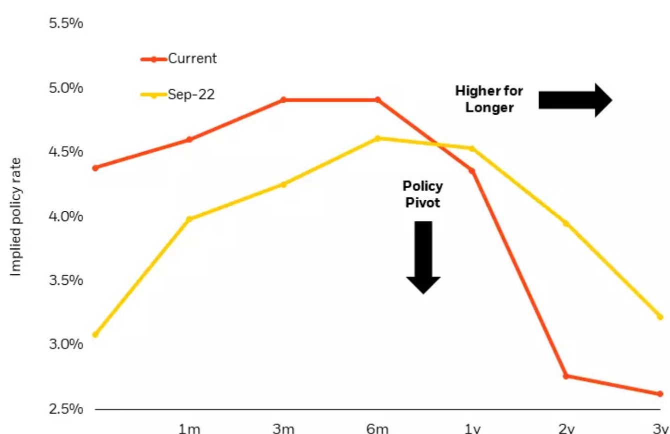
Source: BlackRock, Yodlee/ConsumerEdge, Earnest Research, as of December 2022.

Alternative data reveals an improving picture for inflation, orderly rebalancing of the labour market and a relatively healthy consumer – each currently more supportive of the case for a soft landing than a hard landing.

Market pricing has increasingly shifted towards the expectation for interest rate cuts by the end of 2023 (Figure 7). This can be supported by two opposing viewpoints: 1) the hard landing scenario which expects policymakers to overtighten and engineer a recession, or 2) a scenario where inflation swiftly returns to the 2% target and the Fed is able to begin easing financial conditions. In our view, both of these scenarios are unrealistic. Instead, we believe rates will remain higher for longer rather than a near term policy pivot. Today's relatively stable economy may remain more resilient to high rates and policymakers are likely to delay easing financial conditions due to the lingering effects of two years of excessive inflation.

Figure 7: Market is currently pricing in rate cuts by the end of 2023

Market implied policy rates



Source: BlackRock, with data from Bloomberg, as of January 19, 2023.

EQUITY MARKET POSITIONING FOR Q1 2023

After a challenging year for equity markets in 2022, the downward trajectory of inflation and continued economic stability point to a slightly more positive outlook in the coming months. How are these insights shaping our positioning across the global equity landscape?

An expanding global opportunity set

Like the US, the outlook for Europe has started to improve despite core inflation remaining at record highs. A warmer than expected winter has relieved some of the pressure from the energy crisis. Wage growth has also started to come down in Europe as labour markets normalise at an even faster pace than in the US. In China, the economic reopening has quickly

taken off. Along with relaxed COVID-19 restrictions, there's been an easing in common prosperity and antimonopoly regulations. This is an added tailwind to the improving sentiment towards Chinese assets, particularly in sectors like education, internet and real estate that were most impacted by these regulatory initiatives.

Sector positioning for a potential soft landing

Our global portfolios maintain a preference for value vs growth based on continued themes of high rates and inflation followed by a potential soft landing. Notably, we've seen a shift in the underlying sectors driving the top down leadership of value. What was previously led by the energy sector has shifted to favour cyclical sectors that have been heavily discounted over the last year, including capital goods, consumer durables, autos and airlines where we're currently overweight. These are well positioned for a continued high interest rate environment where the economy ultimately avoids a deep recession.

CONCLUSION

As we enter the next phase in the fight against inflation, market focus has shifted to whether policymakers can achieve a durable decline in inflation without causing a recession. Using alternative data to cut through the noise of hard vs soft landing speculation, we see signs of progress in restoring price stability while maintaining economic strength. At the same time, macroeconomic uncertainty remains high and we expect market volatility to persist as conditions evolve. This makes a data centric investment approach crucial to navigating today's complex environment, allowing us to remain nimble as investors during a time where dynamism matters most.

Source: BlackRock

WHAT CAUSES MARKET MOVEMENTS?

When the news is filled with headlines about market movements, it's normal to feel a bit anxious. Here are three things to keep in mind the next time share markets aren't behaving the way you'd like them to.

1. MARKETS CONSTANTLY GO UP AND DOWN

As long as we've had share markets, we've had share market volatility. Share markets operate on a supply and demand model, so if there are more investors wanting to sell shares instead of buying them, markets will go down. If there are more buyers than sellers, markets will go up. This is one of the fundamental principles of investing – and it's what makes markets unpredictable.

However, every now and again an event will occur that will have a more substantial impact on markets than these daily fluctuations.

Here are some examples:

- Industrial and economic developments
- Government fiscal and monetary policies
- Change in political leadership
- Technology changes
- Wars and civil unrest
- Natural disasters and extreme weather events
- Company performance and profits (particularly with large, influential companies)
- Pandemics (such as Coronavirus)

These types of events tend to impact business and consumer confidence, which can lead to more investors selling shares instead of buying them. This can create a market downturn that could stretch for days, weeks or even months.

The Australian market will be impacted by events, particularly economic activity, in the major economies of the world.

2. THE LONG TERM TREND IS USUALLY POSITIVE

History has shown us that even though share markets fluctuate regularly, the general trend is always upwards over the long term. For example, the S&P/ASX 300 Accumulation Index, which tracks the performance of the largest 300 companies on the Australian stock market, increased from 4,052 on 30 December 2011 (the last trading day of that year) to 7,453 on 31 December 2021, despite a lot of bumps along the way. When you add in the return of dividends paid over that period, that's a total return of 184%.

In other words, if you had invested $10,000 in the S&P/ASX 300 on 30 December 2011, it would have been worth $18,393 on 31 December 2021. You would have also received a healthy flow of dividends along the way.

S&P/ASX 300 Accumulation Index market price over 20 years

Past performance is no indication of future performance.

Market downturns are inevitable but they usually have periods of strong returns in between. Keep in mind that even if the immediate outlook for markets doesn't look promising, it's likely that they'll pick up again at some point in the future.

That's why, when it comes to your super, it's important to take a long term view. Your balance will likely go up and down over the short term in line with market movements, but if you stay invested your balance will generally increase over the long term.

3. YOU CAN'T PREDICT WHAT WILL HAPPEN NEXT

Another reason to keep your super invested, even during periods of volatility, is because there's no simple way of predicting when or what the next change will be.

While it can be tempting to sell up or switch your super into different types of investments during a market downturn, it's a risky strategy that may impact long term performance. This is because you may end up buying back the same shares at a higher price once the market picks up again.

However, everyone has different financial goals and timeframes. Your stage of life, in particular, can make a big difference to your investment strategy, because you may not feel comfortable experiencing market volatility if you're approaching retirement or already retired.

That's why we recommend speaking with a financial adviser if you're concerned about market movements. They know how to deal with market volatility and can calculate the potential risks to your super to make sure you're still on track to reach your long term goals.

Source: Colonial First State

THE OPPORTUNITIES IN ENERGY TRANSITION

After the wild ride experienced by investors in 2022, Perpetual's Deputy Head of Equities, Anthony Aboud is seeing opportunities in high quality companies which have traditionally been classified as growth stocks. He also notes the decarbonisation trend as a key investment thesis for 2023 and beyond.

Looking at the Australian market, which was down just over 1%, you would have thought that 2022 was a pretty boring year in the markets. However, nothing could be further from the truth. Global stock markets were hit hard with the NASDAQ down 33%, S&P down 19% and bond markets getting decimated. While 2022 seemed to be an atypical year relative to the previous decade, we think that there is a decent chance that it could be the new norm for markets. For the last decade, and more acutely in the last five years before 2022, momentum was the strongest factor and narratives were more important than earnings and cashflow.

As a result, passive and momentum strategies worked superbly well up until late 2021. However, with interest rates now materially above zero (and central banks likely to be gun shy about zero interest rate policy for the foreseeable future), business models, cashflows and balance sheets are going to matter again. The nice thing about this type of market for fundamental, value focused investors is that it throws up opportunities as the masses reject the old narratives to chase the shiny new macro theme. This allows us to pick up good businesses at good prices.

One of the themes which we believe has had a massive impact on sector performances over the year – and will continue to play a major role in returns in the coming years – is the decarbonisation trend. Whether you believe in its merits or not, decarbonisation momentum continues to build. As investors of other people's capital, it is important that we take away our own biases and try to generate a return wherever the opportunities may be. We may feel strongly about the need for policies on climate change and we may dislike the unintended consequences of some of these policies, however, our goal is not to complain about how fast or slow this energy transition will be. Our job is to try to identify emerging trends and then look for money making opportunities for our unit holders.

This played a role in some of our stock picks over the last twelve months and will likely play a part in some of our long and short ideas in the years to come. For us, there are two multi year themes from which we think there will be money making opportunities on the long side. The first angle we have identified is that there seems to be a level of over optimism about the speed and efficacy of renewable sources of electricity in Australia. Large scale electricity generation and distribution is extremely complex, however, in this age where good long term policy plays second fiddle to vote winning soundbites, we are going to end up with some irrational policies in the shorter term. Where we have a differentiated view from the consensus is that we are probably a little less optimistic about the speed of transition and the efficacy of intermittent energy, especially in light of the likely under investment in gas reserves likely to persist.

The other side of the decarbonisation strategy is to look to invest in the wind farms, solar farms and battery technologies that will be required. A lot of people focus on the raw materials (lithium, rare earths, cobalt, nickel, copper, etc.), which is a bottleneck in itself but the other bottleneck is the refining of such materials. In most cases this is completely dominated by China. The area we think is interesting is ex-China refining of some of these important materials. There is a lot to play out in the decarbonising thematic and we believe understanding the likely winners and losers from a spike in the carbon price is going to yield some good ideas.

Source: Perpetual