



Market Outlook

June 2022

In the March edition of [Market Outlook](#), we wrote that weak investor sentiment can sometimes be a good contrarian market indicator. However, we suggested investors should not rush to buy equities or bonds, given our view that uncertainty would most likely linger for several months. We also warned that further bond yield rises were probable and, along with weak sentiment, higher yields would act as a headwind for equity valuations. This has largely played out as expected, with additional falls in bond and equity prices, yet, we now see the investment outlook as being more balanced with further sharp price declines less likely, despite ongoing uncertainty.

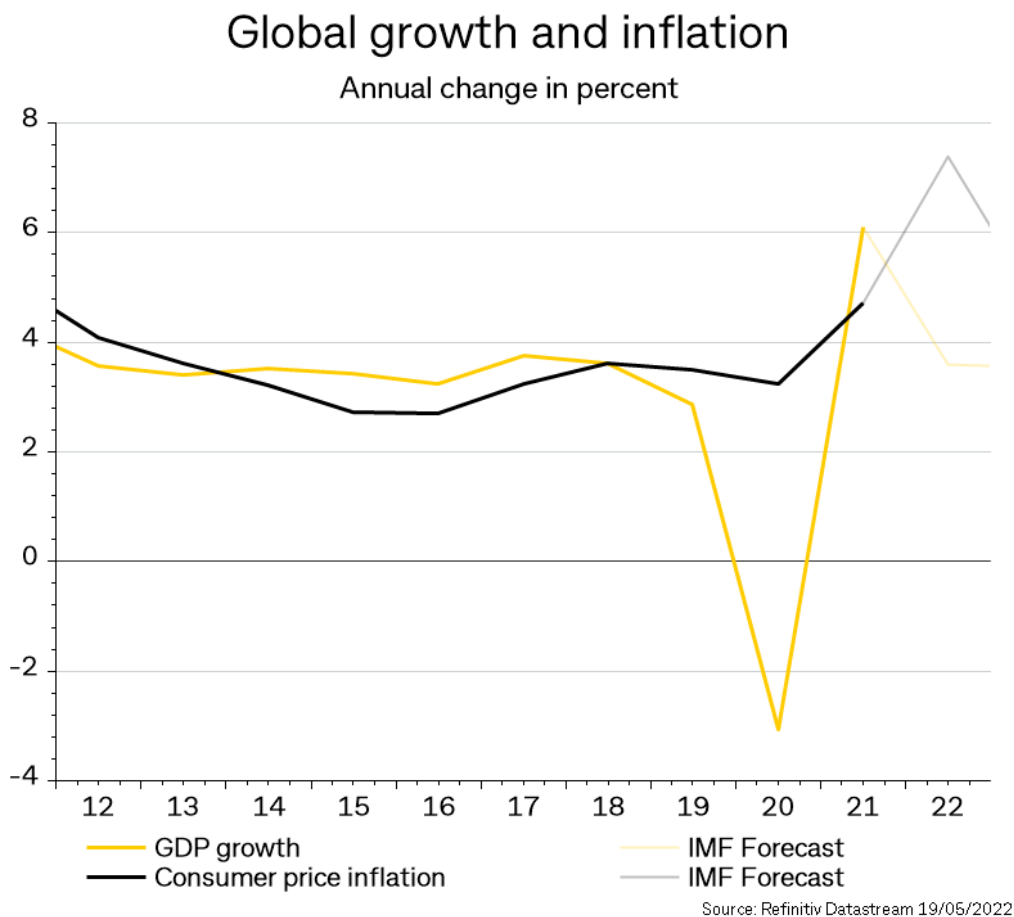


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Rising economic and market volatility

The macro-economic environment prior to the pandemic was characterised by low economic volatility with relatively stable growth and inflation. This was a good environment for asset prices, particularly high growth shares such as technology companies, which offered attractive earnings growth in a low growth, low interest rate environment. In recent months, investors have had to come to terms with what could be the start of a different regime, where geopolitics and the pandemic have created economic shocks that result in higher economic volatility. As we have seen, economies have been buffeted by lockdown-driven contractions, vaccine-driven rebounds and now fears of a possible recession due to monetary policy tightening.



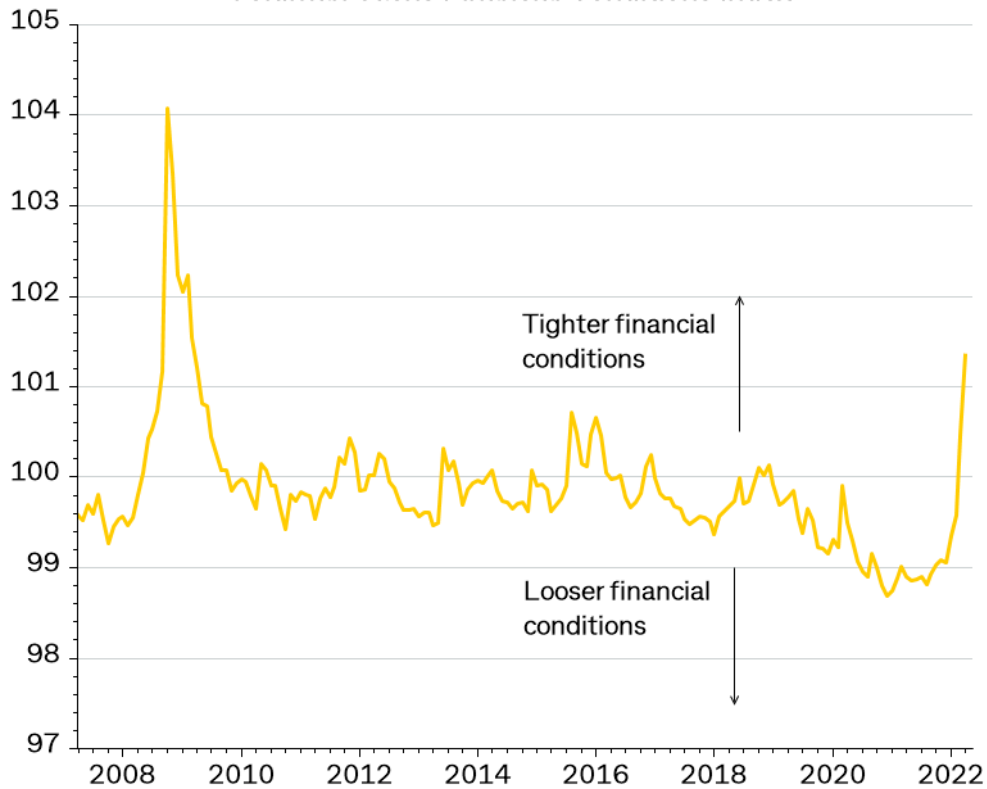
Central banks have all come on board with the new narrative that it's better to deal with inflation quickly. If necessary, this could be at a cost to economic growth and unemployment, as they recognise the impact of allowing a wage-price spiral to develop is potentially much greater. Hawkish commentary – or guiding interest rate expectations higher – is now a more important tool in central banker arsenals. This is why we have seen bond markets pricing in higher future interest rates, which potentially reduces the need for as many actual interest rate rises down the track.

Allowing stock markets to decline on growth fears also appears to be part of the current central bank toolkit as this helps tighten financial conditions, reduce wealth and lower consumer sentiment, which should help slow discretionary spending. In the past, central banks such as the US Federal Reserve

would often step in and pre-emptively cut interest rates or restart quantitative easing programs when stock markets decline and tighter financial conditions warned of a growth slow down, in what was referred to as the “Fed put” or “Powell put”. In the current cycle it appears this “Fed put” is now off the table, unless there is a major market dislocation that increases risks of financial instability.

Global financial conditions

Goldman Sachs Financial Conditions Index



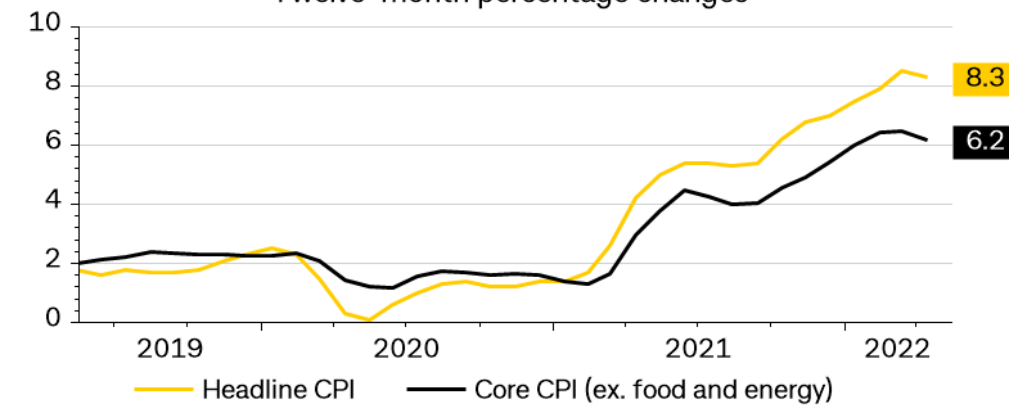
Source: Refinitiv Datastream 19/05/2022

Mid-cycle slowdown rather than recession

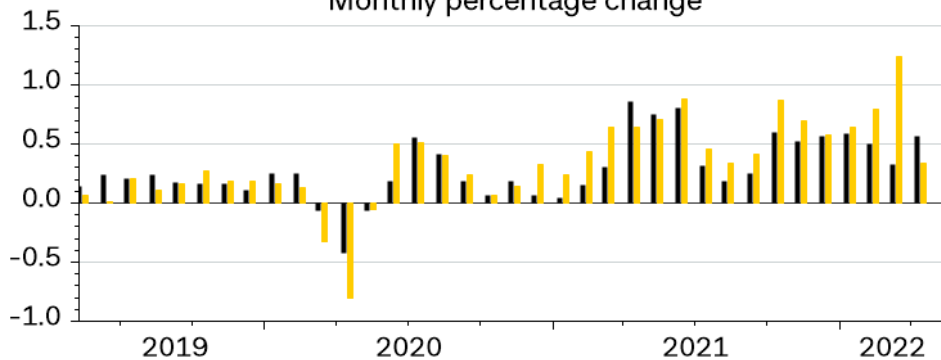
As we covered in the [April Market Outlook](#), the prospects of a global recession in the next 12-18 months have risen, however, we continue to view the likelihood of a recession as being relatively low. In our view, a mid-cycle growth slowdown looks more likely and economists have been cutting growth forecasts for the US, Eurozone, UK and China over the past few months. Drivers for the slower growth include weaker consumer discretionary spending due to cost of living pressures, tighter fiscal and monetary policy and China's slowdown due to property sector issues and lockdowns.

US consumer price index

Twelve-month percentage changes



Monthly percentage change



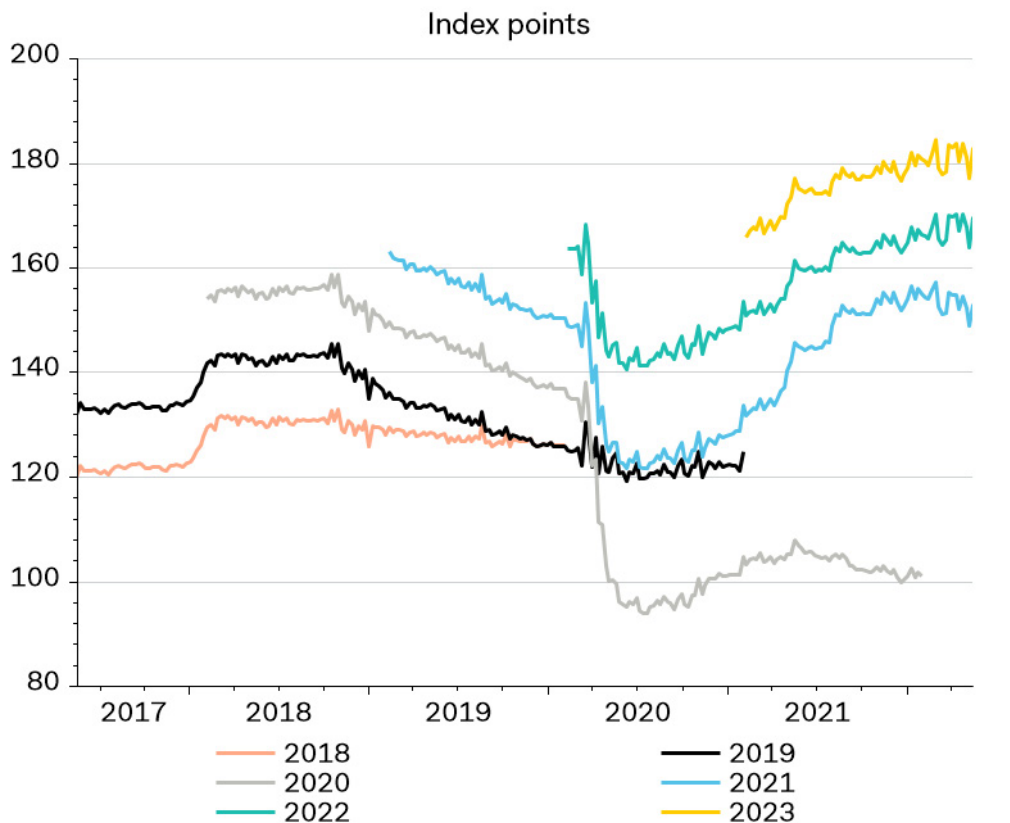
Source: Refinitiv Datastream 19/05/2022

If growth continues to slow as expected, and inflation peaks in coming months as appears likely, then central banks at worst only need to deliver on the rate hikes currently priced into bond markets. At best, they don't need to deliver as many rate hikes as currently priced, which would be beneficial for both bond and equity prices. Recent commodity price falls along with slowing growth and the normalisation of spending, from goods to services, should all help lower inflation. Over the next few months there is the potential that slowing inflation could put a floor under bond and equity prices.

Corporate earnings still solid

The recent decline in equity prices has been almost entirely due to lower price-to-earnings valuation multiples which have tracked the move in bond yields, particularly real bond yields which exclude expected inflation. Meanwhile, corporate earnings forecasts have continued to be revised higher, helped by strong March quarter earnings reports in the United States and Eurozone. Much of the upgrade to earnings forecasts relates to energy and materials companies, due to higher commodity prices. Yet, earnings at other companies have generally also remained resilient, with the exception of some consumer discretionary companies which are most sensitive to rising cost pressures.

MSCI World earnings per share forecasts

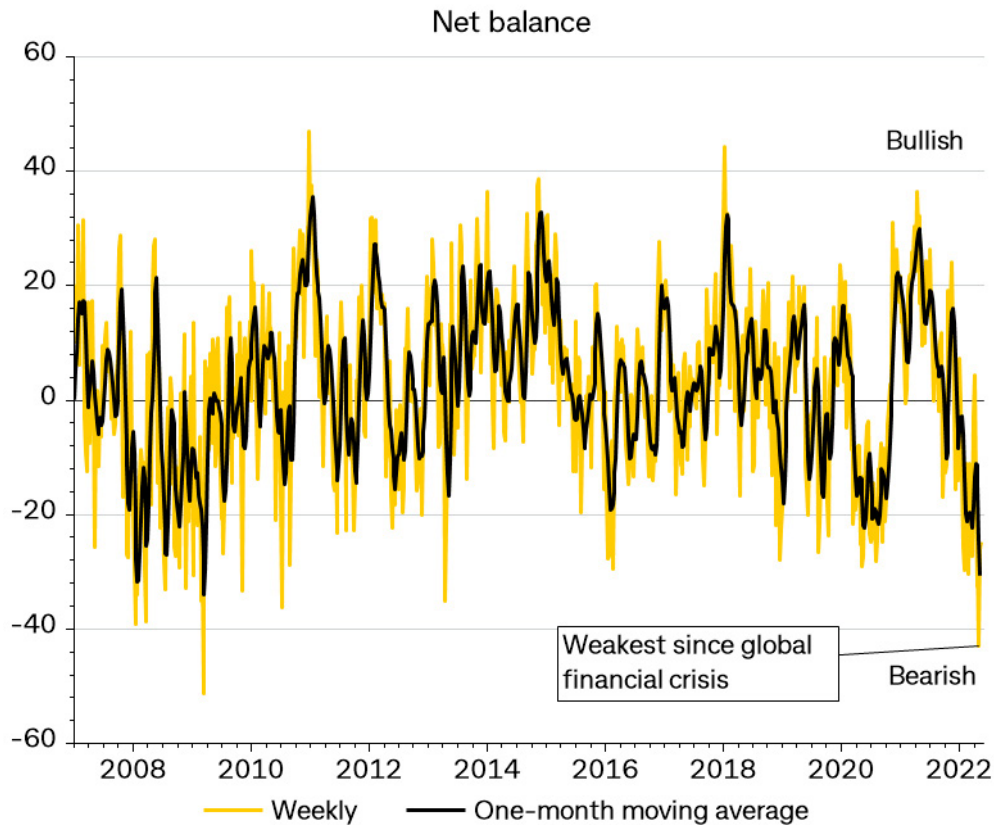


Conclusion

The rise in economic volatility has led to sharp rises in expected interest rates and slower economic growth forecasts that has impacted equity and bond valuations. Investor and consumer sentiment has unsurprisingly weakened to the lowest levels since the global financial crisis, despite low unemployment and strong business activity. While we don't expect a recession, a mid-cycle economic slowdown now appears likely and, along with further interest rate rises over coming months, this should be sufficient to see inflation slow assuming no further supply shocks. With

greater evidence of falling inflation, bond yields should stabilise which should see equity valuation multiples also find support. This will allow investor sentiment to improve and the focus to shift back to the earnings outlook, which is ultimately the key driver of equity prices.

US investor sentiment



Source: Refinitiv Datastream 19/05/2022

While financial markets should remain volatile until inflation begins to ease, we wouldn't expect to see further large declines in equity and bond prices after the recent 15% correction in global equity prices. Equity bear markets, or declines of more than 20%, are unusual outside recessions and as described above, we see risks to bond and equity valuations as being more balanced. As always, should market conditions or our outlook change, we would recommend adjustments to portfolio positioning to take advantage of any opportunities, or avoid any risks that emerge.