Commonwealth Private

Market Outlook.

June 2023

In this month's Market Outlook, we take a look at current industry challenges, inflation and monetary policy, and what they might mean for the future outlook of the market.

It's not all smooth sailing

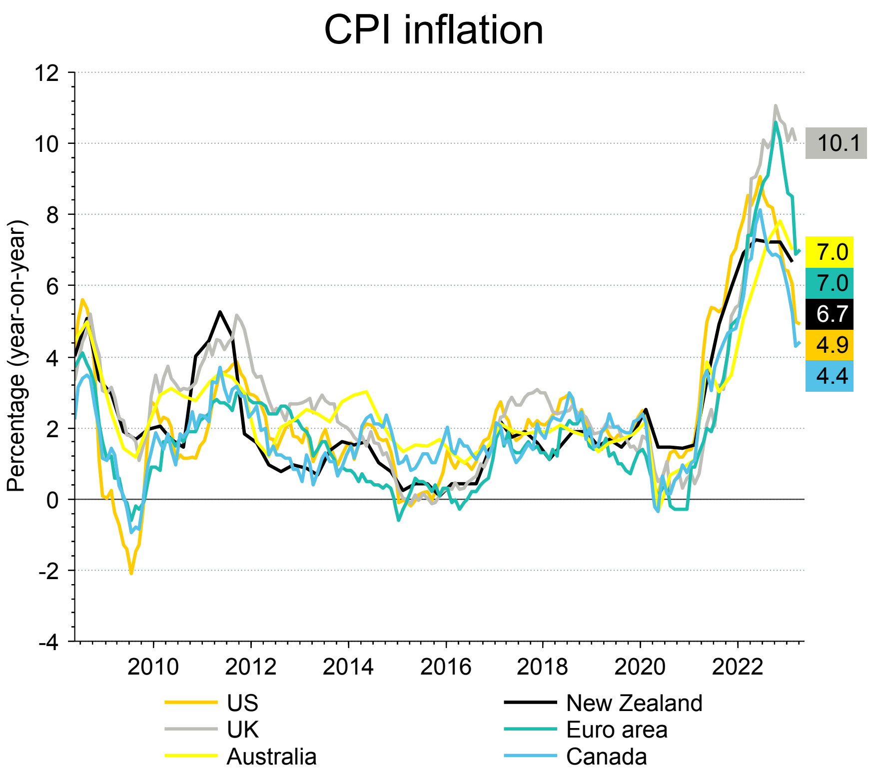
Equity and bond markets have maintained their strong start to 2023. Inflation pressures have eased and the peak in the tightening cycle looks closer than it has for the past 12 months, whilst employment has so far remained strong and earnings have not collapsed at the rate forecast as we came into 2023. However, the aggressive policy tightening undertaken over the past 12 months has caused some casualties with the US banking crisis one that continues to play out as part of the fallout.

Inflation

In the United States, the annual pace of inflation has fallen from 6.5% at the start of the year to now be 4.9% and back under 5% for the first time since April 2021, however the core measure has remained sticky at 5.6%. The shelter component continues to be one of the largest contributors to the monthly increase in the core CPI index, however this has shown some signs of deceleration recently from 0.6% m/m to 0.4% m/m in April. Importantly, leading indicators of shelter inflation like rents on new leases reported by Zillow, indicate that shelter inflation will continue to moderate. The core services ex-shelter component which Fed Chair Jay Powell has focused on as a metric of underlying price pressures eased sharply in April. Recent inflation readings in other countries, including Australia, have painted a similar picture with headline inflation coming down sharply due to the fall in energy prices, whilst core inflation measures have remained elevated.

The RBA's preferred measure of underlying inflation, trimmed mean inflation rose 1.2% over the quarter, after a 1.7% lift in the prior quarter, to be up by 6.6% over the year, which would suggest that inflation did in fact peak in the December quarter and the 375bp of rapid hikes since May 2022 are working. Goods disinflation continues to fall, while services inflation has accelerated. The annual rate of goods inflation dipped from 9.5% to 7.5%, with discounting on furniture, appliances and clothing in Q1 23, as well as lower petrol prices helping drag the rate of goods inflation lower. The annual pace of services inflation however is the strongest since 2001 at 6.1%/yr. The main drivers of services inflation are holiday travel, medical services, rent and dining out.

In the Eurozone headline CPI inflation has also dropped quite significantly from its peak, however an easing of base effects from energy inflation has driven this decline. Meanwhile, the core inflation gauge recently rose to a fresh all-time high of 5.7% yoy. The breakdown by main expenditure categories showed services inflation rose to 5.0% yoy, whilst non-energy industrial goods inflation fell to 6.6% yoy. Of the non-core components, energy inflation fell 14.6 pp to -0.9% yoy.

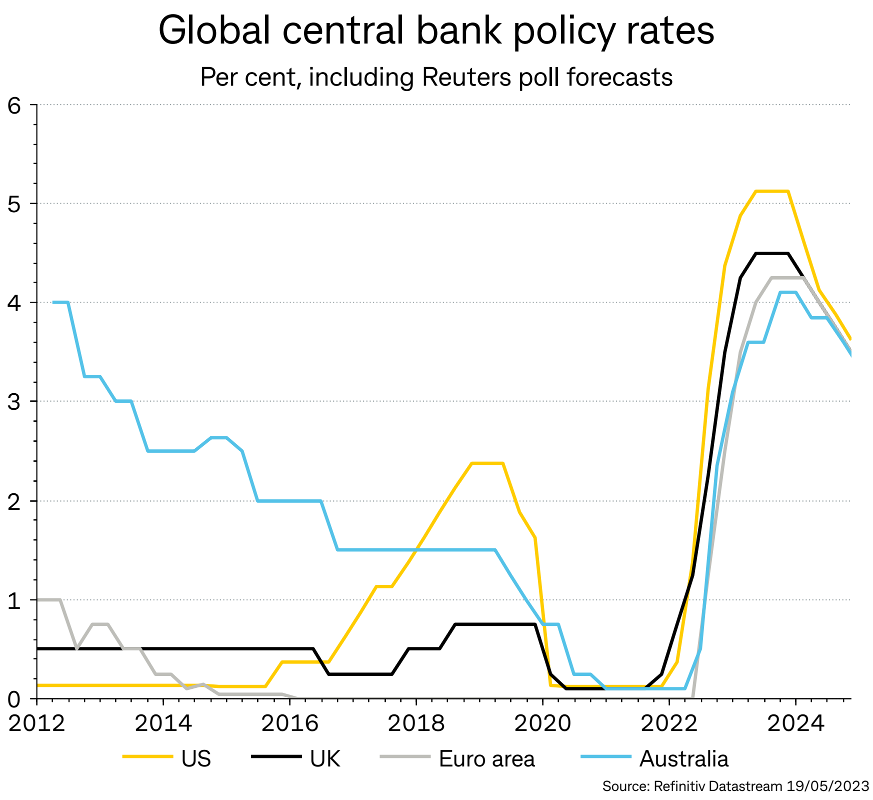


Source: Refinitiv Datastream 19/05/2023

Monetary policy

The major central banks, including the US Fed, ECB, BoE and the RBA have now begun to slow or pause their hiking cycles. We forecast no more Fed or RBA hikes, one more ECB hike, and one more hike from the BoE. Of course, while the possibility of outcomes is wide and pauses followed by subsequent hikes is plausible, our base case is that the major central banks will in general complete their hiking cycles relatively soon, before ultimately needing to lower rates in years to come. The timeframe at which central banks are expected to move from aggressive monetary policy tightening to policy easing is relatively short this time around. Bond markets have moved quickly from expecting zero interest rate cuts to up to four cuts before the end of the year in the Unites States. In Australia, markets are pricing in the potential for one interest rate cut in 2023, while in the Eurozone markets are pricing no cuts before the end of 2023.

The current cycle is notable for the level of prevailing inflation, not only during the hiking cycle but now, just as the peak of the cycle is expected to be reached. We have noted that recent cycles have never ended with core inflation so far above target, and that you need to go back to the 1970s and 1980s to find comparable levels of inflation at peak rates, implying some risks to forecasts.



That said, based on the current market pricing, the US is already or soon will be in a recession. The Fed has tightened policy aggressively and is clearly concerned by rising bank failures, slowing job creation, and falling market interest rates. The next move in rates is likely down in the US, however, if the economy continues to grow, the unemployment rate remains below 4%, and underlying inflation comes down only slowly, as we expect, Fed officials are likely to keep rates unchanged at what they view as a restrictive level into 2024. The risks to this baseline forecast are clearly to the downside, as the funds rate is much more likely to go from the current 5% to 3% than to 7%. But even on a probability-weighted basis, we think markets are pricing too much easing in late 2023 and 2024.

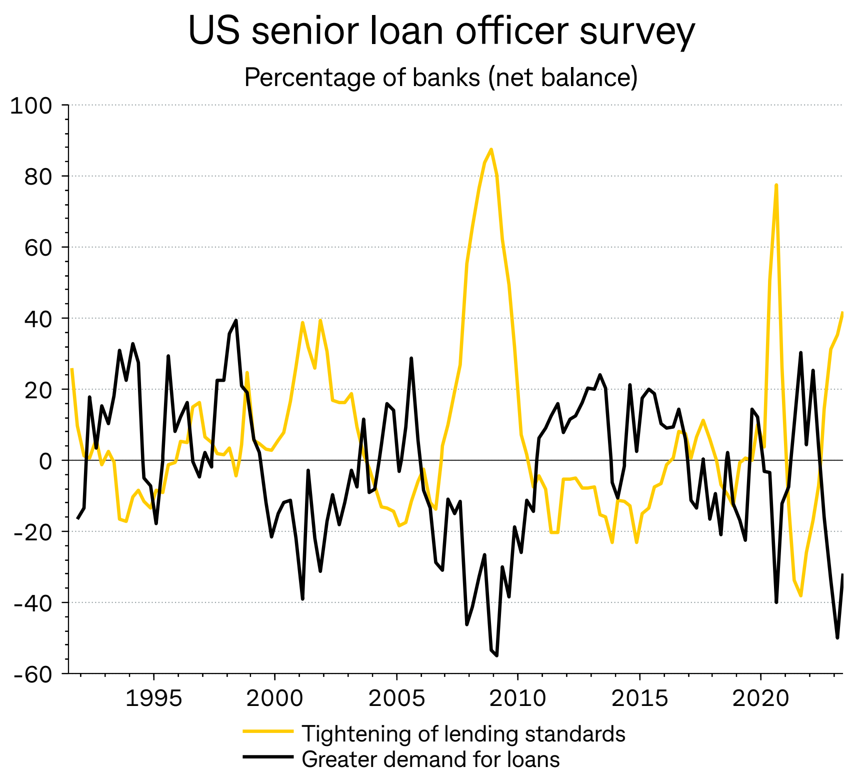
In contrast, the European central bank has work to do because the level of rates remains lower than in the US, and the evidence for wage and price deceleration remains less compelling. We see rate risks in the Euro area tilted to the upside, supported by our assumption that the recent weakness in industrial activity will prove temporary and core inflation remains elevated.

While in Australia, the RBA's May Statement on Monetary Policy reiterated a clear tightening bias, noting that "some further tightening of monetary policy may be required." The macro forecasts were broadly in line with expectations, featuring modest near-term downgrades to growth and inflation, a somewhat surprising modest downgrade to the wages outlook, and unchanged medium-term forecasts for inflation, only returning to around 3% yoy by mid-2025. The latter coupled with the RBA's characterisation of services inflation "expected to be more persistent" underpins the ongoing tightening bias, although in our view the statement provided little additional clarity on the near-term policy outlook.

Banking crisis

Although the recent banking turmoil in the US and Europe seems to have calmed, regional bank stocks continue to come under pressure with JP Morgan recently rescuing First Republic Bank with a takeover. This follows the SVB collapse and forced merger of Credit Suisse and UBS in Europe. So far this year, banks with more than $US530 billion in assets have failed, already exceeding the 2008 GFC total after adjusting for inflation. Whether this stress will resurge, and its implications for growth, monetary policy, and markets along with the banking industry itself remains. Regardless, the continued decline in regional bank shares in general, and the meltdown in PacWest, Western Alliance amongst others, combined with an increasing number of banks tightening lending standards supports the end of Fed monetary tightening, even though Jay Powell retained a hawkish bias in his recent remarks. Further expansion of the banking crisis has the potential to push the Fed towards easing sooner than later.

From a macro perspective, Fed policy has much to do with the regional banking crisis. Quantitative tightening (QT) has caused a sharp contraction in broad money, of which bank deposits are an important part. Bank deposits have shrunk coincidently with QT. Specifically, demand and other liquid deposits held by banks had already shrunk by more than $2 trillion since April 2022. In addition, the Fed's aggressive rate hikes have inverted the yield curve, crushing banks' net interest margins. There is an unintended benefit from the banking crisis and its resulting credit crunch, which is, it will lead to rapid cooling in economic activity and possibly a much faster fall in inflation than previously anticipated.

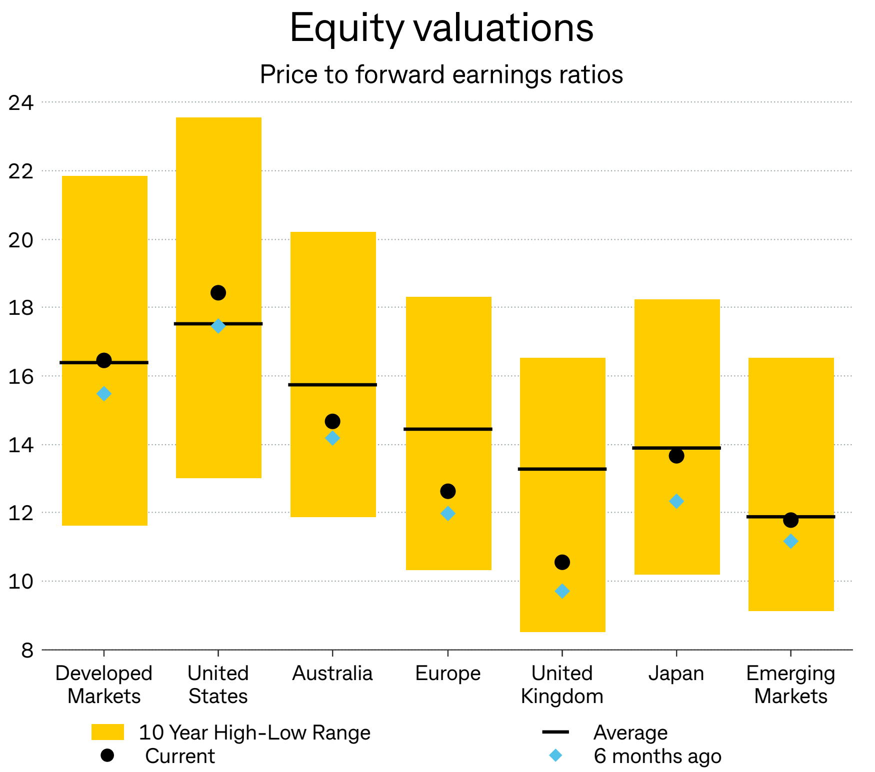


Source: Refinitiv Datastream 19/05/2023

Conclusion

Global and domestic equities have both risen this year and whilst this is a positive signal that risk sentiment is improving, recent data along with equity dynamics indicate that the rally is running out of steam and the pace of gains has slowed considerably. Central banks have continued to hike, with the most recent hike in May potentially marking the peak of the Fed hiking cycle with the debate turning to if and when the Fed will begin to ease policy. The US Inflation outlook remains a key debate in respect of the outlook for interest rates, the economy and the equity market. We expect evidence that inflation is decelerating to continue as the year progresses. All things being equal, this should provide positive support for both bond and equity markets in the coming months.

Australia should also see a slowdown in activity through the balance of the year but a recession is not certain given low unemployment, strong migration and a robust terms of trade position. We expect that the May rate hike was the top for the Australian rate cycle, though the RBA left the door open for further tightening if required. Additionally, China is experiencing a pick-up in economic activity post Covid lockdowns. The current China recovery cycle is likely to be less commodity intensive than previous cycles but stronger activity will still be supportive for both the global and domestic economy.



Source: Refinitiv Datastream - 19/05/2023

In our view investors should remain cautious over the second half of 2023. We continue to expect that equities will remain volatile but ultimately fairly range bound as we have seen in the first half. Post-pandemic, profits have held up pretty well, with companies able to boost prices and keep nominal revenues growing. But those exceptional profit margins have started to decline. In the US for example we have now seen two consecutive quarters of earnings decline, and we expect profit margin erosion to persist throughout 2023. We expect the outlook for bonds to improve over the second half of 2023 as lower inflation or recession leads to lower rates in 2024.

We continue to maintain our overweight position to alternative asset classes as a diversifier of risk and a return driver. As always, should market conditions or our outlook change, we would recommend adjustments to portfolio positioning to take advantage of opportunities, or conversely reduce risk, where we no longer feel it is rewarded.