Commonwealth Private

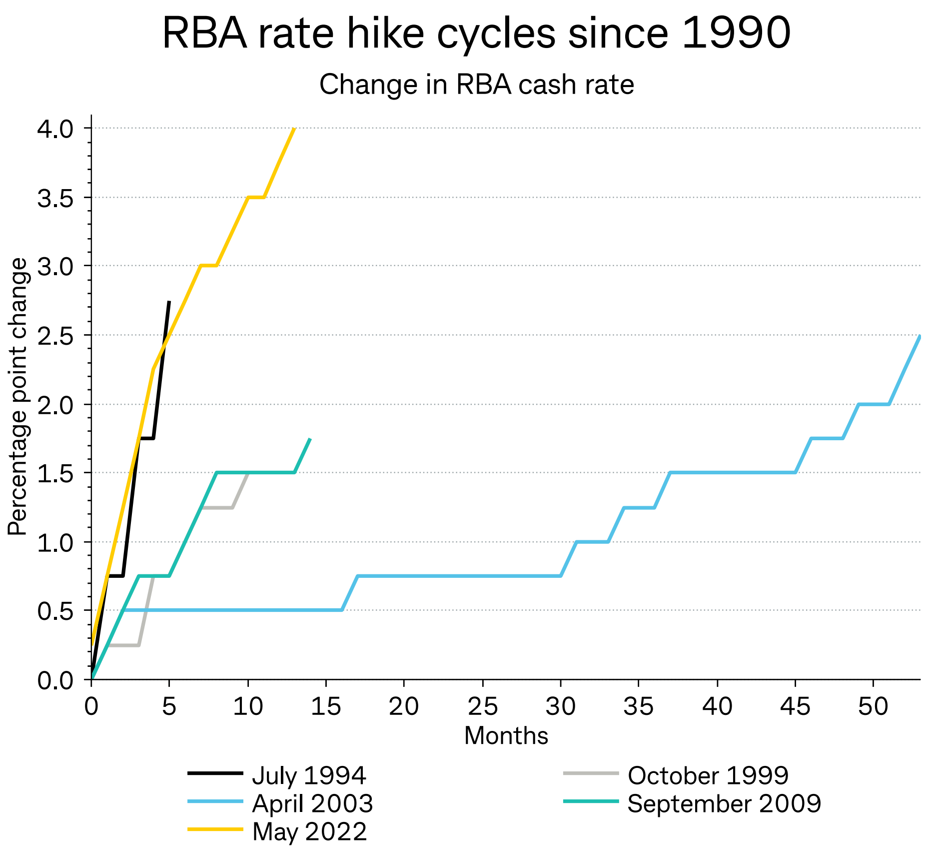
Market Outlook.

July 2023

Despite a bleak initial outlook for the year, markets have delivered a better than expected outcome, against a background of a weakening economic environment and more hawkish central banks. The United States in particular, has overcome several challenges such as the banking crisis and debt ceiling deadline. In this Market Outlook, we examine some of the crucial factors that have driven equity markets, namely better than expected earnings and the productivity potential of Artificial Intelligence (AI). Economically, the environment is slowing and financial conditions are tightening but labour markets have remained resilient. We would note that the effect of the dramatic interest increases over the last 12 months will begin to have a marked impact on the economy over the next six-to-nine months. This effect will also spill over into equity markets with volatility anticipated to increase.

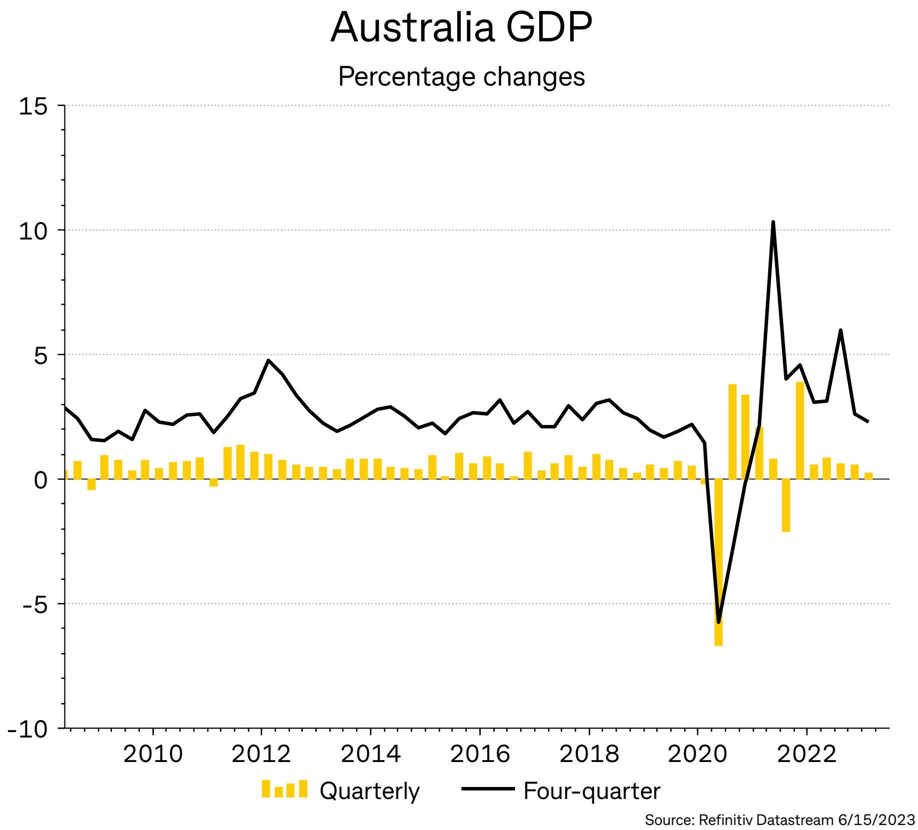
The RBA treads a hawkish path

In Australia, the Reserve Bank of Australia (RBA) has now delivered its 12th rate hike in 13 months, increasing the cash rate by 0.25% from 3.85% to 4.10% in June. The two most recent rate hikes, in particular, have taken the majority of economists by surprise as the RBA signals its determination to bring down inflation and maintain its course towards its longer-term targets. In its June statement, the RBA noted that the Australian economy has started to slow and that the labour market is starting to ease with unemployment increasing to 3.7% in April.



Source: Refinitiv Datastream 6/15/2023

The Australian economy slowed more than expected in the March quarter as aggressive policy tightening weighed on household spending and construction. GDP advanced 0.2% from the prior quarter, the weakest three-month expansion since September 2021 and below a forecast 0.3% gain. Compared to the previous year, the economy grew 2.3%, slowing from a downwardly revised 2.6%. Consumer spending growth outpaced the rise in gross disposable income, showing the savings-ratio fell to the lowest level in nearly 15 years.

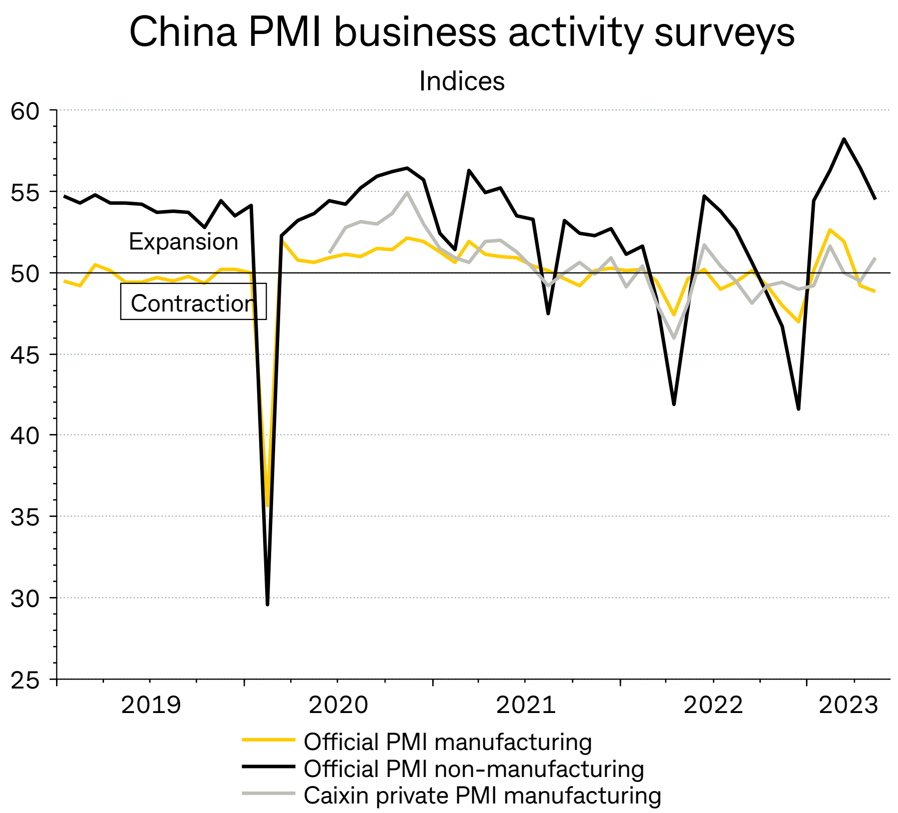


Lack of productivity growth seems to be one of the RBA's key concerns. When combined with the fact that the Fair Work commission increased pay rates for 2.4 million people in awards by 5.75%, these concerns seem valid. To further reinforce this, the 5.75% increase marks the largest increase in awards pay since 2009, and comes in addition to a 4.6% to 5.2% increase last year. Last month, the RBA stated that it "remains alert to the risk that expectations of ongoing high inflation contribute to larger increases in both prices and wages, especially given the limited spare capacity in the economy and the still very low rate of unemployment." In his address on 7 June 2023, RBA Governor, Philip Lowe, noted that recent information has suggested greater upside risks to the Bank's inflation outlook. Services price inflation is proving persistent here and overseas, and the recent data on inflation, wages and housing prices were higher than had been factored into their forecasts.

Economists from CBA, similar to a number of other market economists, have now revised their forecasts and expect one further 25bp increase in the cash rate – for a peak of 4.35%. CBA believes the hike will most likely occur during the August Board meeting (the risk is a 25bp rate hike in July). There is also a risk of 25bp rate rises in both July and August, which would take the cash rate to 4.6%. CBA economists also believe any rate cuts will be pushed back from Q4 2023 to Q1 2024. Throughout 2024, we expect 125bp of easing which would take the cash rate to 3.10% by the end of 2024. This policy easing would be required in their view to avoid the unemployment rate increasing strongly. In our view, Australia's predominant floating rate mortgage market (and even our relatively shorter fixed rates) could lead to an increased risk of overtightening and a sharper economic slowdown. We will get further evidence of this in Q4 2023 and early-2024.

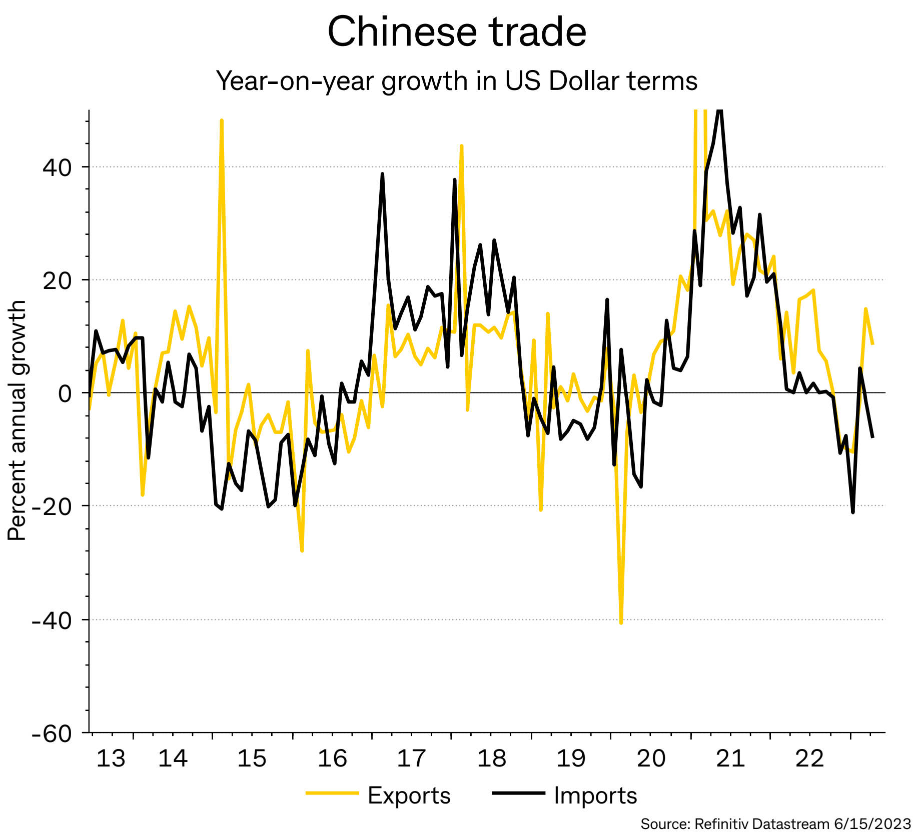
China's stalling reopening recovery

A bright spot in the global outlook was the expectation that the Chinese economy was going to recover strongly after its stern zero-Covid policy. The country's recovery was expected to be more consumer and services led, however, confidence and activity appear to be waning. The latest National Bureau of Statistics (NBS) Purchasing Managers Index (PMI) release showed the composite PMI dropped from 54.4 to 52.9 in May, the lowest since January. Importantly, the Manufacturing PMI unexpectedly fell deeper into contraction territory from 49.2 to 48.8. Similarly, the Non-manufacturing PMI showed a moderation in economic activity, with the index losing 1.9 points to 54.4. Sub-components of both the Manufacturing and Non-manufacturing PMIs paint a similar picture. On the Manufacturing side, production fell below the 50 boom-bust line for the first time since January. Moreover, new orders, new export orders, and employment declined at a faster pace. On the Non-manufacturing side, new orders and new export orders both fell below 50. And, although the Business Activities Expectation index remains elevated at 60.4, it has been moderating since March. In our view, a Chinese rebound is unlikely without government intervention, which could weigh on global growth and demand for commodities.



Source: Refinitiv Datastream 6/15/2023

In May, Chinese exports fell for the first time in three months, adding risks in the world's second-largest economy as global demand weakens. Official data showed that overseas shipments shrank 7.5% from a year ago to $284 billion, worse than the median forecast for a 1.8% drop. Exports to most destinations contracted, with double-digit declines to places including the US, Japan, Southeast Asia, France and Italy. Imports too, declined 4.5% to $218 billion, although this was better than the expected drop of 8%, and left a trade surplus of $66 billion. Chinese purchases from most regions declined in May, with contractions of more than 20% in imports from Taiwan and South Korea — a sign of weakness in demand for global electronics.



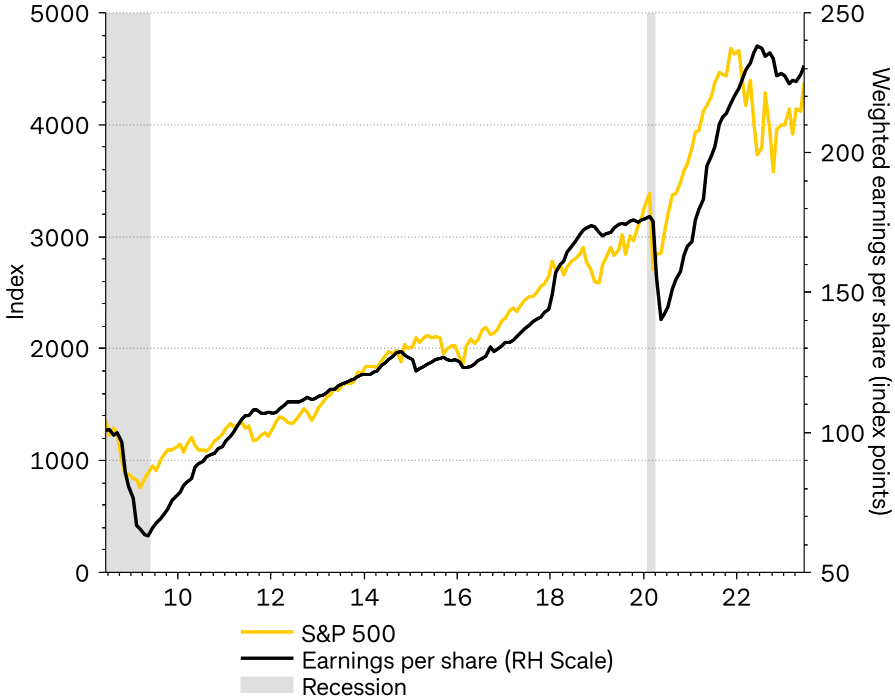
On a positive note, China's soft economic recovery has kept a lid on inflation and headline CPI inflation is now the weakest amongst the major economies. At just 0.2% from a year earlier China's CPI inflation is now at risk of becoming deflationary. Producer prices declined 4.6% on the back of lower commodity prices and weak domestic and foreign demand. This development is a short term tailwind to help reduce inflation globally but it does not bode well for the Chinese economy and its contribution to global growth. In mid-June, China unexpectedly cut key interest rates and announced tax breaks for businesses, as weakening credit growth added to signs a post-Covid recovery in the world's second-largest economy was losing steam. In our view Chinese policy makers will have to become even more proactive in stimulating demand and keeping recovery on track to deliver the 5.0% growth target.

Company earnings have remained resilient

As we entered 2023, company analysts in Australia and across the globe were noticeably reducing their earnings expectations in anticipation of a meaningful economic slowdown following dramatic rate rises. In the US, first-quarter reporting season reached its conclusion and S&P 500 companies recorded its best performance relative to analyst expectations since Q4 2021. Earnings only declined 2.1% in Q1 2023, compared to the anticipated decline of 6.7%. Positive earnings reported by companies in multiple sectors (led by information technology, consumer discretionary, and health care) have led to the decrease in the overall earnings decline. In terms of revenue, 75% of S&P 500 companies have reported actual revenues above estimates, which is above the five-year average of 69% and above the 10-year average of 63%. We have seen many companies, particularly in the technology space, dramatically reducing the size of its workforce late last year, and business conditions have been better than anticipated. We have also seen a smaller than average reduction to analyst earnings estimates for the second-quarter and some tentative upward revisions in some of the smaller more cyclically sensitive companies. The anticipated productivity benefits of AI have also played an important part in boosting sentiment.

S&P 500 and earnings forecasts

Consensus earnings over next 12 months



Source: Refinitiv Datastream 6/15/2023

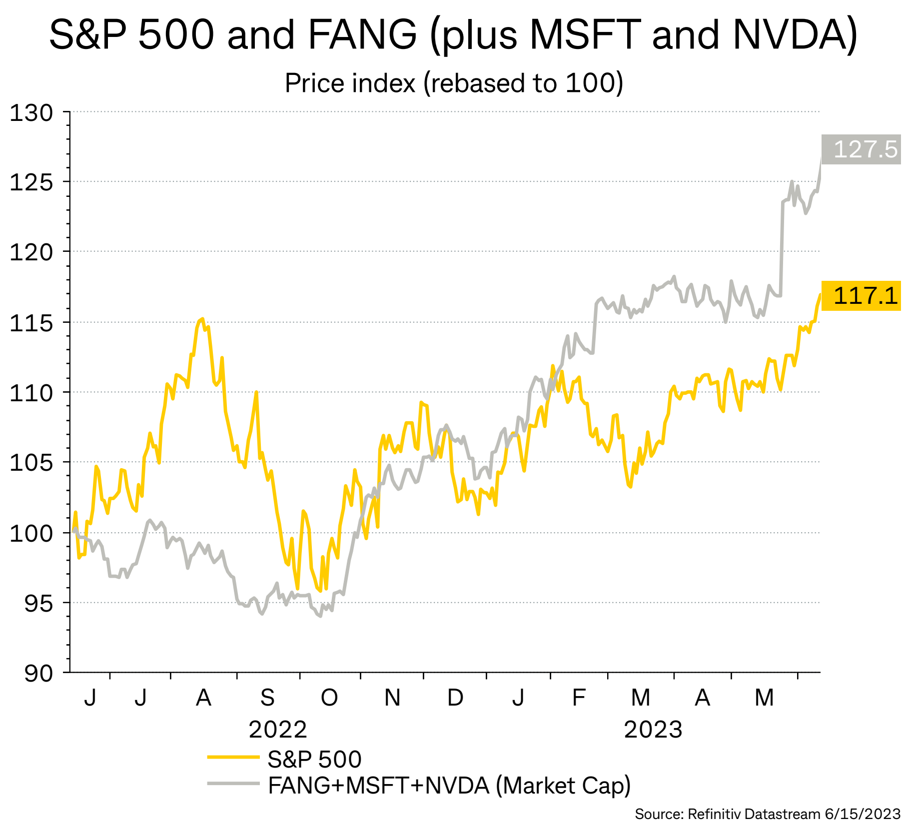
European companies have delivered even stronger outcomes partly due to the more cyclical nature of those markets and also some standout performances in the luxury goods sector. The Japanese equity market is seeing a strong revival reaching 33-year highs, as earnings have been more upbeat and a large number of company stock buy backs are anticipated. Other positive drivers that increased foreign interest are; an increasing focus on corporate governance, relative valuations and an expectation that monetary policy will remain relatively more benign. However, we do observe that the Japanese equity market has had a number of false starts as these drivers have been historically short-lived and given that a large portion are exporters that might be vulnerable if China's economic recovery proves to be weak.

The Australian equity market has not fared as well as overseas markets. This is due to fact that the country has a high allocation to banks which, despite delivering positive results, are expected to have seen a peak in net-interest margins. Additionally, Australia's commodity producers are subjected to falling commodities prices as China's recovery is somewhat more muted. We are also observing some more cautious outlooks in the consumer discretionary sectors.

In our view, corporate earnings resilience has surprised to the upside and might do so in the immediate term, however tighter lending conditions and further deterioration in the global economic outlook will prove to be more challenging for companies later this year. This increases the risk that earnings expectations will need to be revised lower towards the end of 2023 and into 2024.

Narrowing equity market leadership is a concern

Since March, equity market returns are being increasingly driven by a handful of the mega cap U.S. technology companies. The seven largest constituents have surged 53% compared to the remaining 493 stocks being relatively flat. NVDA, GOOGL, and MSFT, which are the leading beneficiaries of the AI revolution, have soared by 194%, 40%, and 41% year-to-date. Excluding these three stocks, the S&P 500 P/E multiple would be 1x lower than the current valuation of 18x. Some of the market performance can be justified on the back of strong cost discipline exercised by technology companies such as Meta and the transformative investment and adoption of AI applications such as Chat GPT.

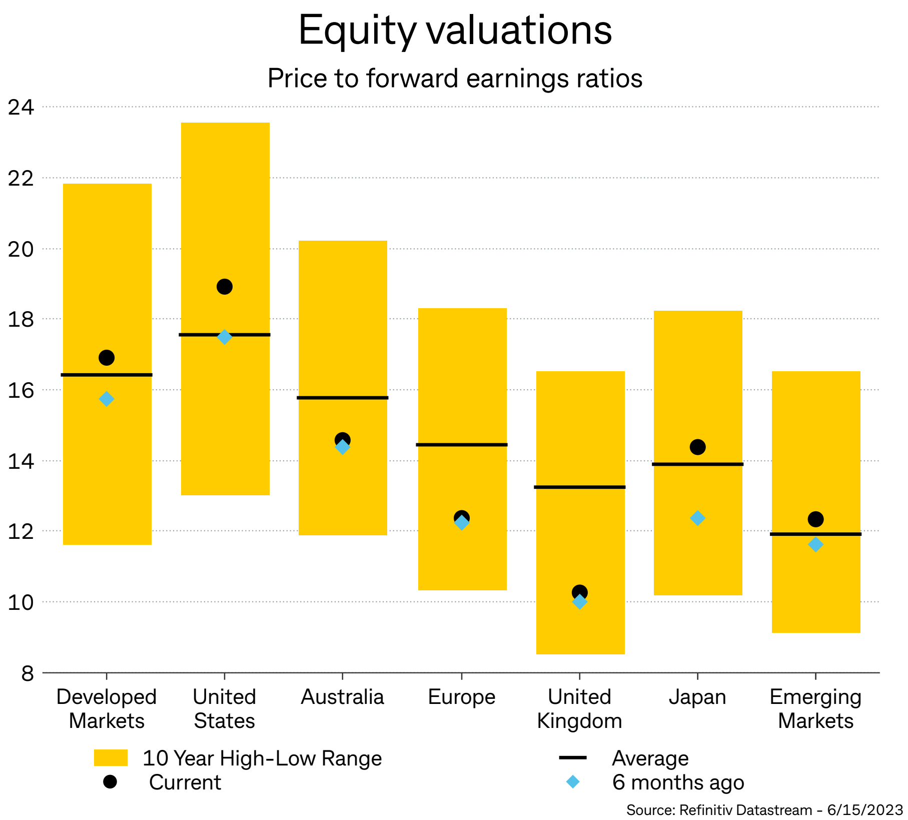


Narrow market rallies tend not to be sustainable unless we continue to see a number of positive catalysts. AI applications will no doubt lead to significant productivity gains but if history provides any useful guidance the benefits will prove to take somewhat longer and evolve in a different manner than what is currently expected. Over the next 10 years as indicated by Goldman Sachs[1], AI could increase productivity by 1.5% per year. This would translate into an S&P 500 profits increase of 30% or more over the next decade.

[1]Source: Goldman Sachs US Investment Strategy May 2023

Conclusion

The global economic environment and equity markets have been somewhat more resilient than initially anticipated. For the most part, economic indicators are starting to slow down with some regions being more affected than others. Employment has proven to be more robust than expected. Central banks have continued to increase rates and we are close to the peak as headline inflation is falling. For example, in the US economic data, the consumer price index increased by 0.1% in May (survey: +0.1%). The annual growth rate fell from 4.9% to 4% in May (survey: 4.1%), the lowest level since March 2021. However, some core components of inflation such as wages growth and services have been more persistent which present central banks with additional challenges in coming months. The probability of a mild technical recession (i.e. two quarters of negative growth) is increasing and the Eurozone is the first region to confirm the trend. It is important to note that a slight pause in economic growth should be seen as a positive outcome if it contains inflation and most importantly anchors lower inflation expectations.



In our view investors should remain cautious over the second-half of 2023. We expect increasing equity volatility given, high starting valuations, and the strong but narrow rally as the transmission effect of higher interest rates becomes more tangible. Historically it takes six-to-nine months for the lagged impact of aggressive interest rate tightening to eventually weigh down on the labour market, consumer spending, and corporate profits. We expect the outlook for bonds to improve over the second-half of 2023, as either the likelihood of 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 return.

As always, should market conditions or our outlook change, we would recommend adjustments to portfolio positioning in order to take advantage of any opportunities, or avoid any risks emerging from any changes.