Commonwealth Private

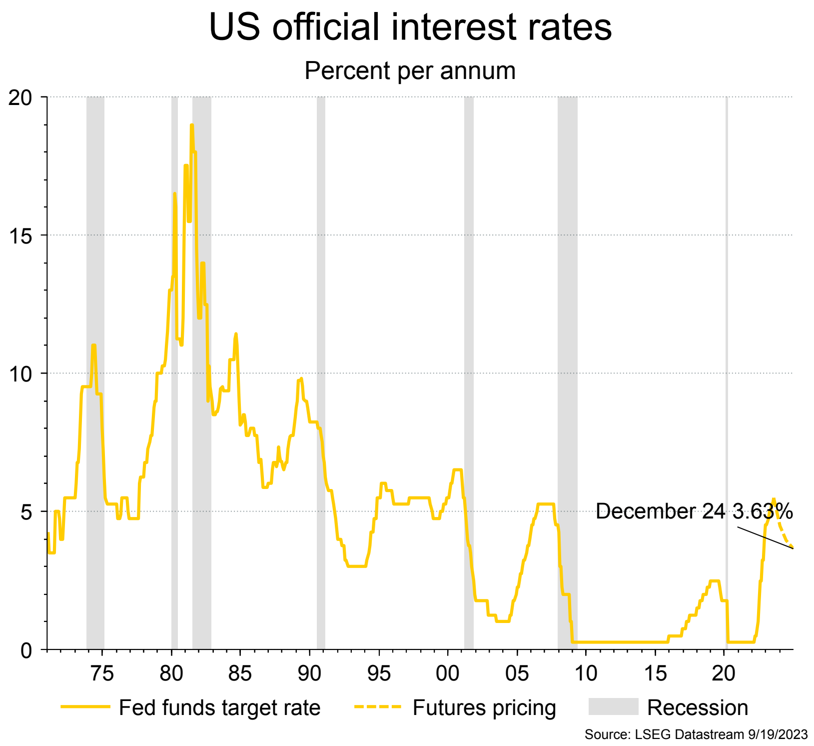
Market Outlook.

October 2023

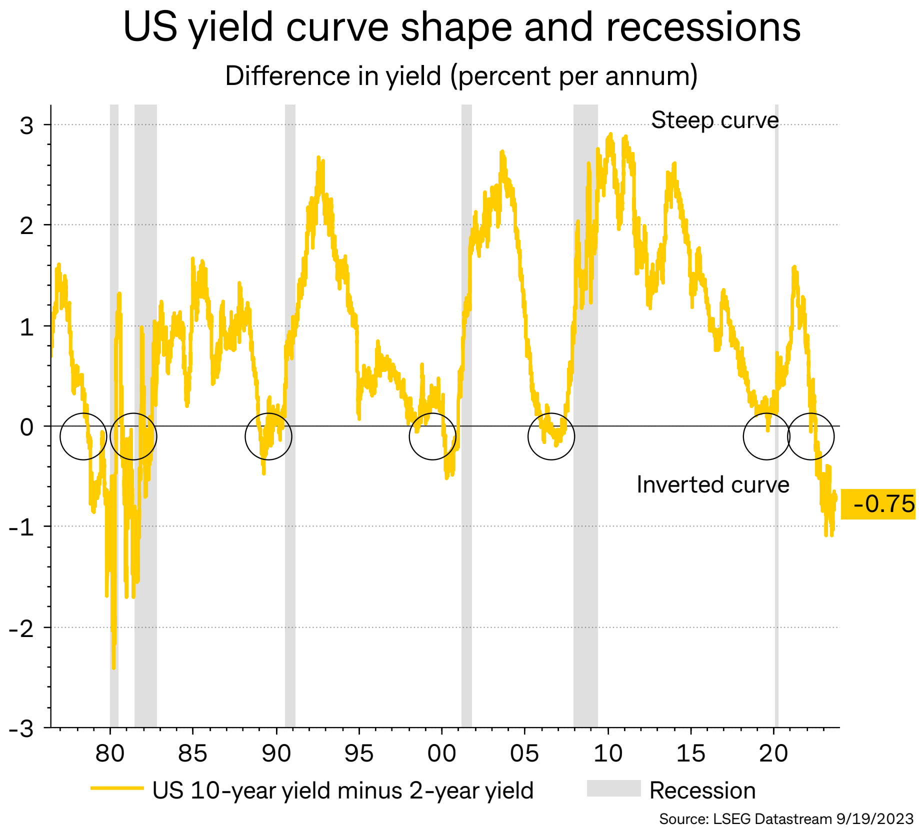
As we enter the final quarter of 2023, the Australian and global economy has fared better than expected in the face of a dramatic interest rate hiking cycle by the Reserve Bank of Australia (RBA) and other major central banks. We are also seeing a tale of two markets, on one hand equity markets have continued its grind higher pricing in a 'soft landing', whilst higher yields and increased volatility in fixed interest markets signal that economic realities might be somewhat more challenging. In the US the 10-year treasury yield hit 4.34%, its highest level since November 2007. At this level of interest rates, equity markets have historically traded at around Price–earnings (P/E) multiples that are around 15-17% lower and as such, supporting our more cautious portfolio positioning.

The ‘soft landing’ narrative revisited

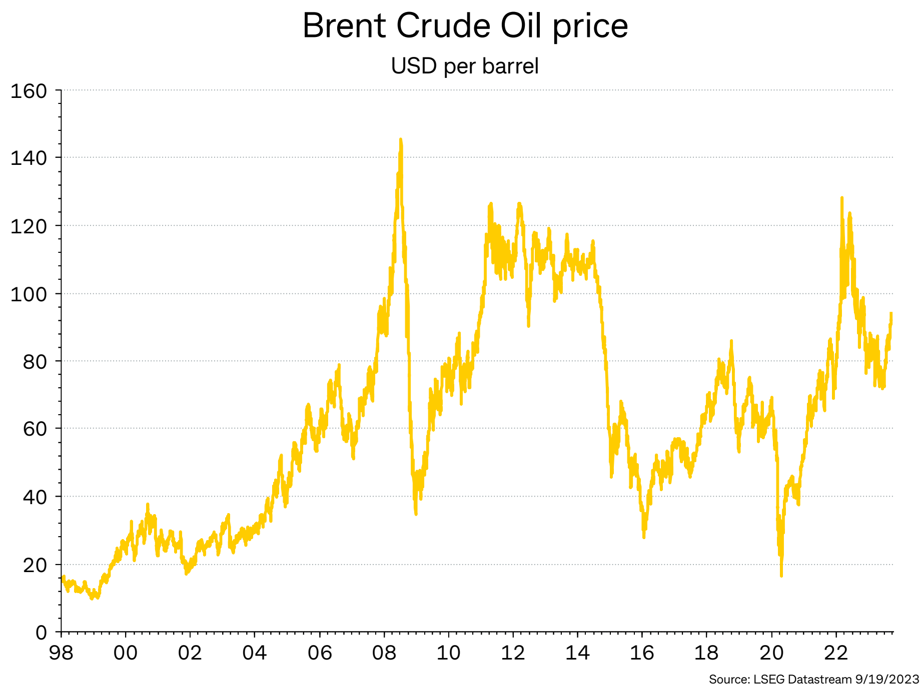
In recent months, market enthusiasm has increased on the idea that the US economy might be able to achieve a ‘soft landing’ scenario, implying the economy will slow down sufficiently in order to reduce inflationary pressures without causing a recession or significant rise in the unemployment rate. The term ‘soft landing’ gained traction during the tenure of former US Federal Reserve (Fed) chair Alan Greenspan, widely credited with engineering one in 1994-1995. By doubling interest rates over the course of a year, the Greenspan-led Fed succeeded in reducing inflation while keeping the job market at what was then considered full employment. That accomplishment helped pave the way for another six years of economic expansion, aided by the tailwind of an internet-driven productivity boom. While the economy avoided recession, many bond investors suffered sharp losses in 1994 and towards the end of that year equity markets followed suit. The casualties included California’s Orange County, which filed for what was then the largest municipal bankruptcy in US history, and Mexico, which had to devalue its currency and seek a debt bailout from both the US and the International Monetary Fund. Now, current Fed Chair Jerome Powell has suggested the Fed achieved soft landings in 1965 and 1984 and was on course for another one in 2020 before the Covid-19 pandemic intervened.



However, the vast majority of interest rate hiking cycles actually end up as ‘hard landings’ or recessions. As monetary policy affects the economy, with long and variable lags, it is particularly challenging for central bankers to engineer a soft landing. The risks of overtightening are rising as the last few rate rises (often seen as insurance) tend to spark some unforeseen negative spill-over effects in financial markets or the real economy.



The general idea of markets pricing in a soft landing could actually end up being self-defeating for a number of reasons, including: lower interest rate expectations and stronger financial markets fuelling more positive business and consumer sentiment. In turn, this could lead to demand driven inflation reaccelerating. The other medium-term challenge facing central bankers is the increasing prospect that while inflation will come down to the four per cent level, it will take far longer than anticipated to get to target levels of around two per cent.

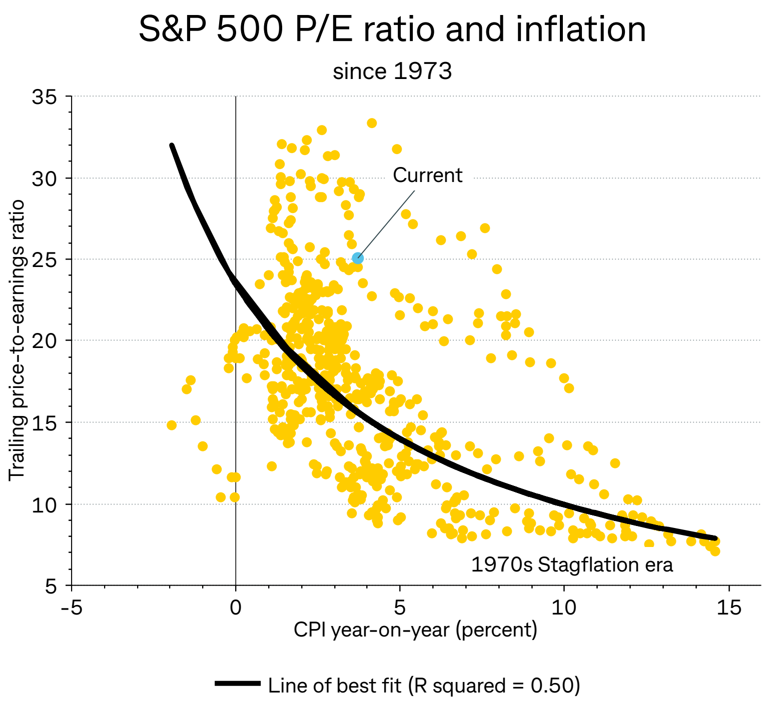


Also adding to the complexity is the fact that energy prices are starting to rise as Organization of the Petroleum Exporting Countries (OPEC) and its allies are adopting group-wide supply cuts supplemented by additional, voluntary reductions. The production restraints have been implemented just as the International Energy Agency (IEA) estimates that global crude consumption is running at a record pace. Oil inventories in developed nations are about 115 million barrels below their five-year average. According to the IEA, global stockpiles are set to deplete by a hefty 1.7 million barrels a day in the second-half of the year, and preliminary data appears to confirm declines in both July and August.

In our view, given all these considerations achieving a soft landing is a relatively tall order and the risk of policy error increase which could prompt the Fed and other central banks to proceed carefully from here. The US is potentially the best placed to achieve a soft landing given the strength of the economy driven, in part by the relatively more stimulatory fiscal policy, such as the Inflation Reduction and CHIPs Acts, and the fact that the US consumer is less impacted by short term interest rate increases. The chance of a soft landing is greatly reduced in Australia and Europe given the fact that these economies are already decelerating, their greater sensitivity to short term interest rates and the fact that they are more directly impacted by the Chinese slowdown.

Reporting season echoes better than expected – however expectations remain very high for 2024

In the US we saw another resilient quarter on the earnings front, as analysts were quite conservative with their estimates going into the second quarter with expectations that the S&P 500 would deliver negative earnings growth of -7.0% with actual the actual number being revised up to -4.1%. In aggregate, 79% of companies [in the S&P 500] exceeded earnings estimates compared to the 5-year average of 75%. Consumer discretionary was the dominant sector delivering a 54% earnings growth. Our biggest takeaway from this quarter is that for the first time since the Covid-19 pandemic, we saw fewer companies beat revenue expectations which will be a concern given the debate around corporate pricing power and how long that will last post-pandemic. Furthermore, real revenue growth (adjusted for inflation) was negative for the third consecutive quarter.

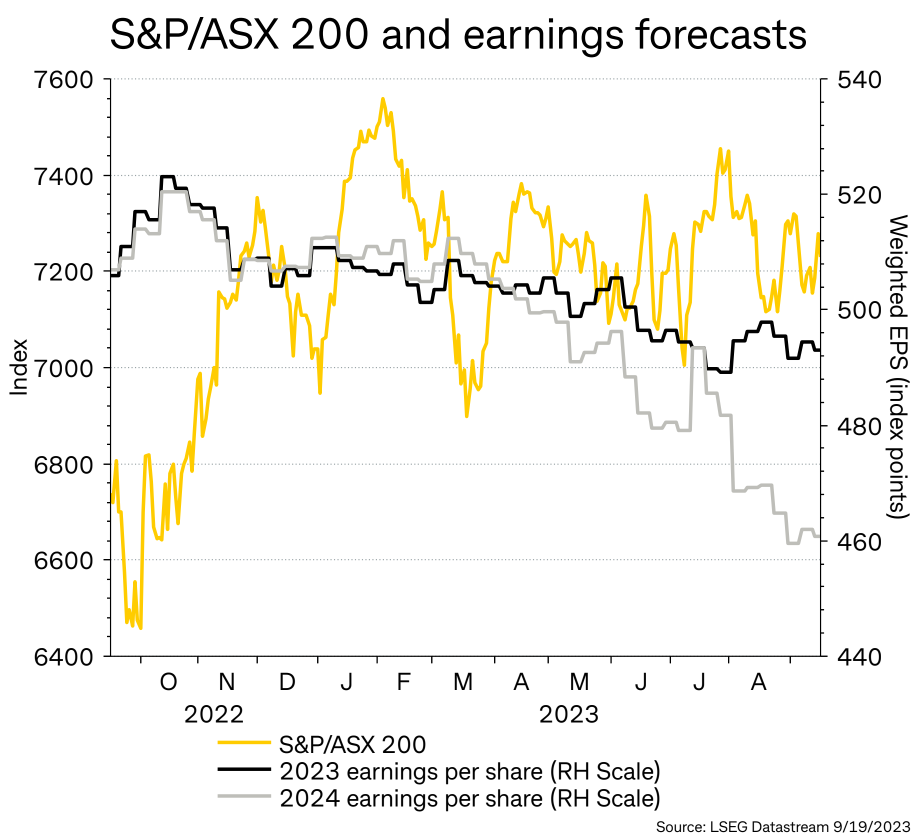


Source: LSEG Datastream 9/19/2023

For the third quarter of 2023, the earnings outlook for the S&P 500 is more positive compared to the rest of the year. While the percentage of companies issuing negative earnings guidance is in line with historical averages, analysts have increased earnings estimates in aggregate for the first time in nearly two years. As a result, the index is expected to report positive year-over-year growth in earnings for the first time since Q3 2022. Eight of the 11 sectors are projected to report year-over-year earnings growth, led by the Communication Services and Consumer Discretionary sectors. On the other hand, three sectors are predicted to report a year-over-year decline in earnings, led by the Energy and Materials sectors. In the third quarter of 2023, S&P 500 companies are expected to report year-over-year earnings growth of 0.5% and a year-over-year revenue growth of 1.6%. For calendar year 2023, analysts are projecting earnings growth of 1.2% and revenue growth of 2.4%.

From a valuation perspective, the forward 12-month P/E ratio for the S&P 500 is 18.6. This P/E ratio is just below the 5-year average of 18.7 and above the 10-year average of 17.5. However, as we have noted valuations look rich compared to the level of interest rates – particularly if rates stay higher for longer. We also believe that projected earnings growth for calendar year 2024 of 12.2% and revenue growth of 5.6% is an ambitious target given that the US economy is slowing down, even if the economic downturn is less severe than initially expected.

In Australia, reporting season was more mixed reflecting the more cyclical nature of the companies that comprise the S&P/ASX 200 Index. According to Goldman Sachs Research's estimate, the beat/miss ratios for the reporting season indicated a rather solid outcome, where 37% of ASX 200 firms beat consensus and 36% missed, both only slightly worse than long-run averages, and a marked improvement over the past two and a half years. While some companies have demonstrated relatively strong pricing power and managed to increase prices by double digits over FY23, most companies were unable to move prices quick and high enough to maintain the margins in previous periods. Additionally, while commodity related input costs, such as fuel, electricity, freight and lumber, have started easing, the labour shortage have increased wages particularly for mining, energy, retail and healthcare. Companies with interest-bearing debt are watching the rising interest rates closely, which is expected to have more marked impact on their financial cost going forward.

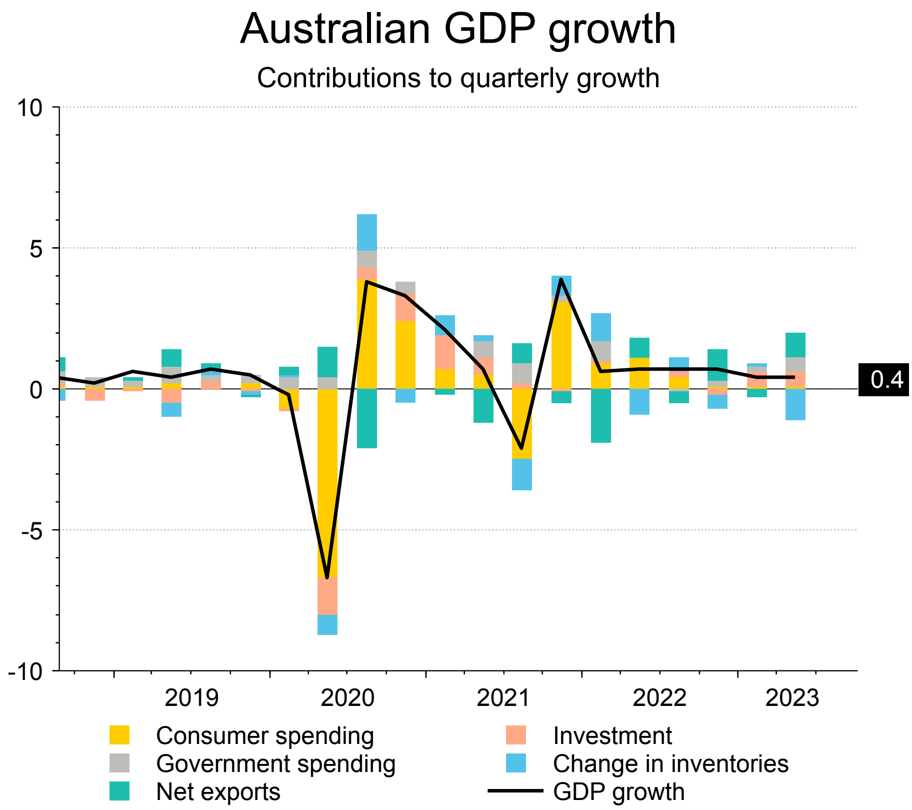


We are also seeing companies build up their cash reserves given the cautious view on the economy and the higher risk of project cost overruns. Combined with the fact that companies are also prioritising debt repayment will potentially result in lower dividend payouts for shareholders. Whilst the Australian equity market is relatively more attractive from a valuation perspective when compared to the US, we are far more vulnerable to an economic downturn and further weakness from China.

Looking past the headline Australian GDP

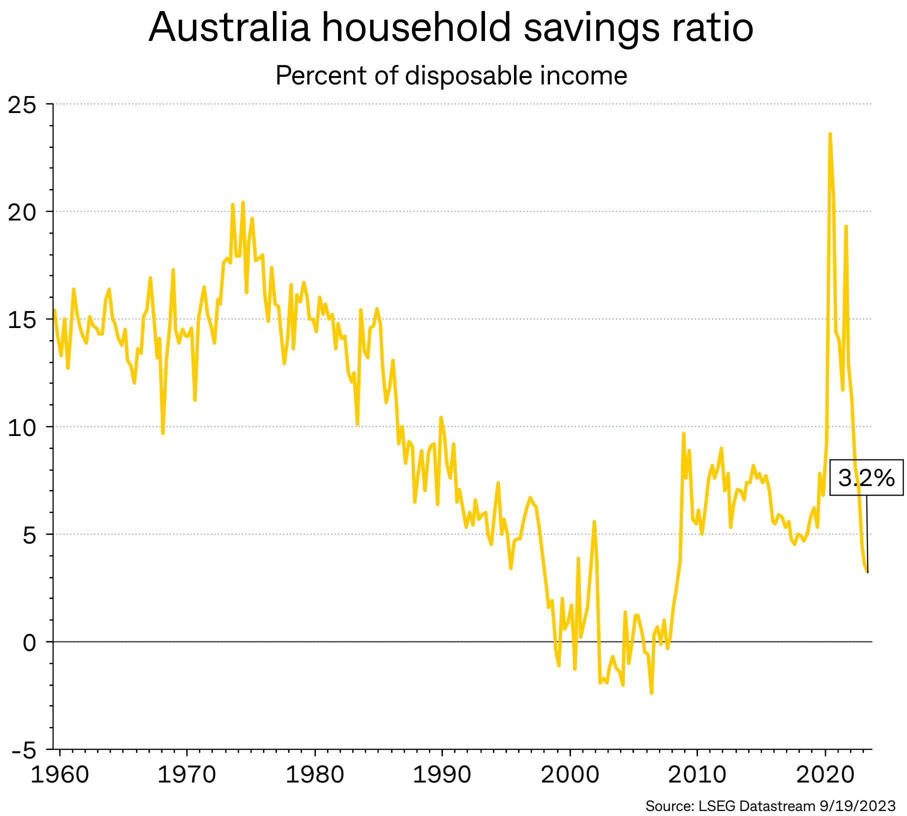
At the headline level, the Australian economy appears to be absorbing the 12 interest rate hikes rather well. However, net migration, government expenditure and some favourable international trade outcomes, the economic data indicates that the economy is starting to slow markedly.

In the second quarter of 2023, Australia's Gross Domestic Product (GDP) rose 0.4%, its seventh consecutive rise, slightly beating forecasts of 0.3%. Exports and investment were the primary contributors to GDP growth this quarter, partly offset by changes in inventories. The annual growth rate was at 2.1%, above expectations for 1.8%. The gross operating surplus, which measures economy-wide profits, fell 4.5%, the largest quarterly decline since the early 1990s recession.



Source: LSEG Datastream 9/19/2023

Household spending slowed 0.1% further this quarter, impacted by pressures on household budgets from inflation and interest rate rises. These pressures have resulted in a continued shift away from discretionary spending towards essential categories. Household consumption accounts for over 50% of the economy when measured by expenditure. Consumers continued to save less in the face of high costs of living and rising mortgage repayments which jumped by another 11% over the quarter. The household saving ratio declined from 3.6% to 3.2%, the seventh consecutive fall and is now at its lowest level since June 2008. Savings fell as the rise in nominal household consumption outweighed a softer rise in gross disposable income. Output per hour worked, a proxy for labour productivity, fell another 2% in June and by 3.6% over the past year, pushing productivity down to March 2016 levels. Unit labour costs – the difference between wages and productivity – increased by 7.5% in the 12 months to June, well above the 3% limit that the RBA has previously stated was necessary to engineer a return to the 2%-3% inflation target.



While the headline economic growth figures were a little better than economists' expectations, GDP per capita and a proxy for living standards, fell 0.3% as the population grew faster than the economy as a whole. Outside the pandemic, it was the first time since 2006 the measure has fallen for two consecutive quarters. In our view, the GDP numbers provide further evidence that the Australian economy is quite vulnerable given the fact that the GDP per capita numbers are negative for a second quarter and consumers are drawing on their excess savings. Economists now see about a 50% chance Australia's $2.5 trillion economy will slip into recession over the next 12 months.

Conclusion and Portfolio Positioning

As we approach the likely final phase of the interest rate tightening cycle, our Investments and Research team believes that markets are not fully pricing the heightened level of uncertainty that central banks still face and it is too early to discount away the prospects of recession. Equity markets, in particular, are pricing in a soft landing, while central bankers continue to emphasise that they are data dependant and need to proceed cautiously from here. Potential tighter policy will be a more material headwind for corporate profits and markets, as such risks to the downside are building given very high equity valuations.

We are maintaining our more cautious stance with our underweight in international and Australian equities. Equity markets have been trying to move higher but mixed data has resulted in some modest consolidation and range trading to-date. We envision higher levels of volatility as the effects of higher interest rates make a more material impact on economic growth, likely leading to more attractive entry points for investors. We favour allocating to cash at this point as it provides optionality to quickly deploy funds to where we see better opportunities when the time comes. Cash returns are relatively attractive at current levels providing an income return in conjunction with capital stability.

We are neutral on fixed interest as we are receiving stronger income returns from holding bonds, as well as the potential for capital appreciation in the event central banks do cut interest rates in mid-2024 or if equity markets suffer a material fall. We are also neutral on property and overweight on Alternative Investments which we believe will continue to deliver attractive risk adjusted returns.

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.