

Quarterly Market Update

March 2023

MARKETS SUMMARY

Key Markets - Trailing Total Returns (%)						
As at 31 March 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	-0.2	3.5	0.1	16.5	8.7	8.2
Australian Small Cap Shares	-0.7	1.9	-13.2	13.1	3.9	5.2
International Shares (Hedged)	2.4	6.6	-7.6	14.0	-	-
International Shares	3.8	8.7	3.8	11.9	9.9	12.9
Developed Markets Shares (Hedged)	2.5	7.1	-7.4	15.1	7.6	10.0
Developed Markets Shares	3.8	9.1	4.3	13.0	11.0	13.8
Emerging Markets Shares (Hedged)	2.0	3.0	-9.3	6.0	-	-
Emerging Markets Shares	3.7	5.3	0.1	4.6	1.8	6.6
Australian Property	-6.8	0.5	-13.9	13.6	4.8	7.7
International Property (Hedged)	-3.9	0.1	-21.3	5.7	0.7	3.7
International Infrastructure (Hedged)	2.3	-0.4	-7.4	8.6	5.8	7.7
Australian Fixed Interest	3.2	4.6	0.3	-2.4	1.3	2.8
International Fixed Interest (Hedged)	2.1	2.4	-5.5	-2.8	0.3	2.4
Cash - Bank Bills	0.3	0.8	2.0	0.7	1.1	1.7

Despite wild fluctuations in investment markets, almost all asset classes ended the March quarter in positive territory. The year started with a strong rally in shares and fixed interest (bonds) markets in January, encouraged by signs of inflation easing and the prospect of a pause or end to central bank interest rate hikes. The narrative shifted negatively in February, as shares and bonds were weighed down by robust economic data and forced investors to reassess interest rate expectations.

In March, volatility flared again with the collapse of several United States (US) regional banks and the forced sale of Credit Suisse to its Swiss rival, UBS, which elicited rapid support measures and a fall in bond yields. This fall in bond yields led to a rally in interest rate-sensitive growth shares, at the expense of value shares which were also weighed down by the banking sector and ended the quarter only marginally up. Longer-dated government bonds rallied, benefitting from flight-to-safety flows. All market sectors then regained composure and rallied into the end of the month following coordinated support from central banks and regulators.

OUTLOOK FOR INVESTMENT MARKETS

For the better part of 2023, share markets have remained sanguine about the economic outlook, despite the US banking issues and the forced takeover of Credit Suisse. But bond markets appear far from relaxed. The 10-Year US Treasury yield has fallen below 3.5% and is significantly lower than the federal funds rate of 5.0%, while the Australian 10-Year Government Bond yield is well under the Reserve Bank of Australia's paused cash rate of 3.60%. Both markets suggest we are close to commencing a monetary policy easing (rate cuts) cycle.

One way to reconcile the divergent views of bond and share markets is that they anticipate a soft landing where inflation rolls over and rates come down, but company earnings hold up – this should be positive for shares. This view would be supported by the reopening of China and the release of pent-up domestic demand, which will boost global growth and potentially offset some of the weakness in developed markets. It would, however, appear optimistic in light of the apparent stickiness in inflation and the US Federal Reserve's rhetoric suggesting rates will need to be higher for longer.

An alternate interpretation is that bond markets see a more aggressive slowdown in economic activity following the unprecedented speed of policy tightening and given the unintended impacts on the US banking sector and lending standards. In this scenario, inflation moves lower with weak economic activity and monetary policy moves into an easing cycle. What does this scenario mean for share markets? Lower interest rates are generally supportive of growth assets like shares. We have already seen shares rally hard over the March quarter, particularly in growth-oriented sectors like technology, which materially underperformed value-style sectors in 2022 as interest rates were ratcheted higher. But this view focuses on valuation only and discounts the impact that higher rates are likely to have on company earnings. A slowdown in activity would see elevated company margins and earnings come under pressure, and shares would likely underperform.

Complicating the investment outlook is a scenario where bond markets are proven wrong, and inflation remains more persistent than expected. This would result in a higher-for-longer interest rate environment, which would also be negative for shares, particularly those considered lower quality. We have already seen this happen a couple of times during the current tightening cycle when bond yields fell (and shares rallied), only to reverse when inflation took another leg up.

With the uncertainty around the impact of higher interest rates on company earnings and the added risk of tighter bank lending conditions stemming from the US banking issues, we remain cautious about the outlook for investment markets. The recent rally in shares, which are now expensive relative to bonds, only reinforces this conservative view that we are heading into a more modest return environment. Regarding portfolio positioning, we continue to build greater defensiveness across and within asset classes. In fixed interest, we still prefer duration (government bonds) and are avoiding lower quality high yield in favour of investment grade credit. For shares, we favour resilient quality-focused companies exhibiting strong profit margins and growing earnings. Despite our caution, we are mindful that when markets turn, they turn quickly — markets have been remarkably resilient over the past six months in the face of considerable economic uncertainty. This is why retaining exposure growth assets remains critical and why we believe having a neutral weighting is appropriate in the current environment.

ECONOMIC REVIEW

Australia

Interest rate expectations were quickly pared back in March, following the fallout of overseas banking issues and a lower-than-expected monthly inflation reading. Consumer Price Index (CPI) inflation rose 6.8% in the 12 months to February and was a surprise drop on the 7.4% annual growth recorded in January. This marked the second consecutive month of lower annual inflation — also known as ‘disinflation’.

Retail trade — another essential data source for the Reserve Bank of Australia (RBA) — also came in weak and implied a spending slowdown was underway. However, robust employment data and persistently low unemployment, suggest there is still momentum in the economy. Despite this, the RBA — having already signalled it was near the end of its cycle of increasing interest rates to control inflation — decided to pause the cash rate at 3.6% in its early-April meeting, acknowledging “monetary policy operates with a lag and the full effect of this substantial increase in interest rates is yet to be felt”. At the beginning of the month, markets had been pricing in another three to four 0.25% rate rises in 2023, however, by the end of the month, the market was predicting a year-end cash rate of 3.4%, implying a 0.25% cut later in the year.

US

Economic growth in the US has generally surprised positively during the March quarter. This stronger growth is perhaps best illustrated by a rebound in the Composite Purchasing Managers’ Index (PMI) business surveys since the start of the year, with lower energy and oil prices playing an important role in improving business sentiment. The labour market remains resilient, with the number of jobs created in February growing by a stronger than expected 311,000. Although, average hourly earnings rose by just 0.2% month-on-month (4.6% year-on-year), suggesting wage pressures are gradually decelerating.

Following a cooler February CPI report and amid uncertainty created in the banking sector, the US Federal Reserve (Fed) voted unanimously to raise the federal funds rate by 0.25% at its March meeting to a target range of 4.75% - 5.00%. The Fed also took the opportunity to endorse the health of the US banking system but cautioned that recent developments were likely to result in tighter credit conditions and weigh on economic activity. The core Personal Consumption Expenditure (PCE) Index — the Fed’s preferred measure of inflation — then came in at 4.6% for the 12 months to February. Even though this was a deceleration from the 4.7% recorded in January, it remains more than twice the 2% target and is probably not low enough for the Fed to feel comfortable pausing rates when it meets again in May. Markets now expect the Fed to hike interest rates once more before rates peak mid-year, then begin cutting into the year’s end.

Europe

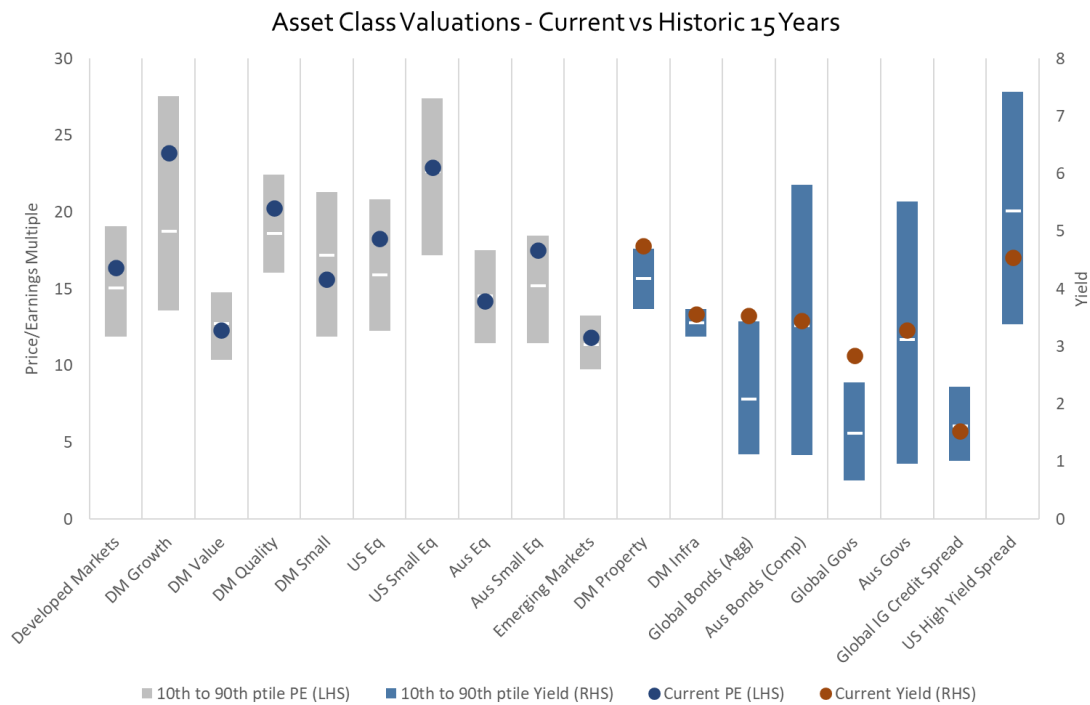
Despite rapidly rising interest rates and the March banking sector turmoil, European economic activity also surprised on the upside throughout the quarter on the back of falling energy prices and the resilience of services activity. Business sentiment has been strong, with the momentum almost entirely driven by the service sector. Core inflation increased to 5.6% in February, compared with a year earlier, delivering a third straight month of acceleration. With growth more resilient than expected and core inflation stubbornly high, the European Central Bank (ECB) increased its deposit rate by 0.50% to a 15-year high of 3% in March and said the door remains open to future rate hikes. Commenting on the failure of Credit Suisse, the ECB gave its reassurance that it “stands ready to respond as necessary to preserve price stability and financial stability in the euro area”.

Asia

The People’s Bank of China (PBoC) announced it would cut its Reserve Requirement Ratio (RRR) — the portion of bank deposits retained rather than lent out or invested — in a surprise move that will inject almost US\$75 billion of liquidity into the banking system. Early indications are mobility and economic activity have started to normalise following the easing of COVID restrictions in China. Retail sales rebounded in the first two months of the year, having declined in the three previous months, and China’s Service Production Index rose 5.5% year-on-year. China’s recent PMI report showed that the manufacturing sector also strengthened in February. Large companies showed the highest PMI readings, but small and medium-sized companies had the most significant month-on-month gains, suggesting broad momentum. Despite this solid economic momentum and credit growth, China’s February CPI came in below expectations, rising only 1% year-on-year.

ASSET CLASS REVIEW

The following chart compares current valuations (dots) against the 15-year historical valuation ranges (bars) for different asset classes. Price/earnings multiples are used as the valuation method for shares (equities), while yield is used as the valuation method for other asset classes.



Source: Bloomberg/Evidentia

Australian Shares

Although Australian shares were marginally lower over the month (-0.2%), a strong finish in the last week of March helped push the local S&P/ASX 200 Index up +3.5% for the quarter. At a sector level, consumer discretionary (+11.4%) benefited from resilient household spending, while growth sectors — communication services (+9.4%), and information technology (+8.1%) — were also outperformers over the quarter. Falling bond yields, which reflect market expectations that interest rates are likely to come down, are generally positive for growth-oriented sectors because they tend to reduce borrowing costs for companies, making it more affordable for them to invest in growth initiatives while also boosting consumer spending. China's re-opening continues to be a positive for materials (+7.7%), while energy fell (-1.0%) on weaker oil prices and financials (-2.7%) were caught in the crossfire of the banking issues. The small company sector again underperformed its larger peer group, mainly due to its cyclical nature, higher growth characteristics and heightened exposure to deteriorating consumer sentiment. The S&P/ASX Small Ordinaries Index down -0.7% in March but up +1.9% over the quarter.

What Fund Managers are saying....

"In the case of the Australian banks, most would agree that they have some natural advantages. Capital ratios are higher – and that is a good thing – but by itself this is not a necessary or sufficient reason to avoid contagion. The real security of the big four Australian banks is fivefold:

- 1. The Australian banks have transformed to be primarily home loan lenders.*
- 2. Australia's banks are homogenous.*
- 3. The banks co-invest in each other.*
- 4. Government backing is clearer in Australia.*
- 5. Australian banks have stable funding sources."*

Yarra Capital Management

International Shares

International Shares - Trailing Total Returns (%) All Local Currency						
As at 31 March 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	-0.2	3.5	0.1	16.5	8.7	8.2
US	3.7	7.5	-7.7	18.6	11.2	12.2
Europe	2.0	14.2	13.5	18.2	7.7	7.8
UK	-2.5	3.6	5.4	14.3	5.6	5.7
Japan	1.7	7.2	5.8	15.3	5.7	9.2
China	4.3	5.1	-3.3	-2.3	-3.9	3.5
Asia (Ex-Japan)	2.9	4.5	-5.2	8.0	1.5	5.2
Latin America	-1.7	-1.3	-9.6	14.7	3.8	5.4

International shares put in a strong performance over the quarter. The MSCI AC World Index jumped +8.7% over the March quarter, while the currency-hedged equivalent finished up +6.6%, reflecting a weaker Australian dollar. At a sector level, performances were mixed. Growth sectors like communication services (+17.9%) and information technology (+21.0%) were buoyed by falling bond yields. Concerns about the banking sector hit global bank shares in March. The financials sector, which is dominated by banks, dropped -8.4% in March and was down -1.9% over the quarter. In terms of investment style, lower bond yields favoured growth (+14.8%) and quality (+10.3%) companies, with banks weighing on value (+0.6%).

US shares rallied in the second half of March, after market confidence was restored following the banking issues, and the latest inflation reading came in cooler than expected. The S&P 500 index rose +7.5%, while the tech-heavy Nasdaq Composite Index led the pack with a stunning gain of +17.0% its best quarter for nearly three years. Despite the hit to bank shares in March, European shares outperformed, delivering +14.2% over the quarter. Large weightings to the underperforming financials and energy sectors resulted in United Kingdom shares lagging most global markets, with the FTSE 100 Index returning +3.6%. Chinese shares advanced a solid +5.1%, more or less in line with the wider MSCI Emerging Markets Index, of which China contributes a third of the weighting.

What Fund Managers are saying....

“U.S. authorities have acted quickly to help prevent wider contagion by protecting depositors from the bank failures. But we see knock-on effects for the economy – reinforcing our expectation of recession. We see financial conditions and credit supply tightening, especially in sectors such as tech. These developments are also likely to hurt confidence and increase risk aversion. Moreover, we don’t see these developments allowing the Fed to halt its rate hike campaign – this is a very different environment from 2008 when all monetary policy levers were used to support the economy. Instead, by shoring up the banking system, the Fed can focus monetary policy on bringing inflation down to its 2% target.”

BlackRock

Property & Infrastructure

Recent banking problems have put the spotlight on how deteriorating financial conditions in one area of the economy can have knock-on effects on another. Listed property is one area where pressures could mount, with higher interest rates and more conservative lending conditions increasing tenant risk and impacting the sector’s ability to renew maturing debt. Despite a difficult March, when it dropped -6.8%, the local S&P/ASX 200 A-REIT Index finished the quarter positively up +0.5%. International property fared better in March, with the FTSE EPRA Nareit Developed Index (hedged) falling -3.9%, and managed to end the quarter up +0.1%. International infrastructure held up well in March, with the FTSE Global Core Infrastructure 50/50 (hedged) Index rising +2.3% in line with hedged international shares, although a weaker month in February, caused by concerns of higher interest rates, weighed on its returns over the quarter, which finished down -0.4%.

Fixed Interest

Fixed Interest - Rates, Yields & Spreads

<i>As at 31 March 2023</i>	month end	1 mth earlier	3 mths earlier	12 mths earlier	10 yr average
Australian RBA Cash Rate	3.60	3.35	3.10	0.10	1.50
Australian 10 Year Bond Yield	3.30	3.85	4.05	2.84	2.47
Australian Corporate Bond Spread	1.92	1.65	1.91	1.40	1.22
US Fed Funds Rate	5.00	4.75	4.50	0.50	1.05
US 10 Year Bond Yield	3.47	3.92	3.88	2.34	2.18
US Corporate Bond Spread	1.38	1.24	1.30	1.16	1.25
US High Yield Bond Spread	4.55	4.12	4.69	3.25	4.30
Bloomberg AusBond Comp 0+ Yrs Yield	3.52	4.05	4.09	2.59	2.32
Bloomberg International Aggregate Yield	3.54	3.84	3.73	2.15	1.72

The Australian fixed interest market enjoyed a strong quarter, with the Bloomberg AusBond Composite 0+ Year Index up +4.6%. This was primarily due to a very strong March (+3.2%) as investors rushed to safe-haven government bonds in the wake of the banking issues, pushing bond prices up and bond yields down. As regulators moved in to provide support, market confidence returned and bond yields recovered. The same fluctuations were also evident in international fixed interest markets, with the Bloomberg Global Aggregate Index Value Hedged Index lifting +2.1% in March and +2.4% over the quarter.

The two-year and 10-year Australian Government Bond yields ended the quarter significantly lower at 2.97% and 3.30%. Similarly, the two-year and 10-year US Treasury yields dropped to 4.03% and 3.47%. Credit markets also gripped by banking issues. Corporate credit spreads (the difference in yield between bonds of similar maturity but with different credit quality, initially widened but have started narrowing again. The Australian short-term money market remained volatile as markets moved from pricing in further interest rate rises at the start of March, to pricing a high chance of a 0.25% cut in the cash rate by year's end. The three-month bank bill swap rate (widely used to set bank lending rates) ended 0.15% higher at 3.72%, a little over the prevailing cash rate.

What Fund Managers are saying....

"Corporate credit spreads widened in response to the banking crisis but have started narrowing again. This reflects improved confidence in US banks.

Australia's corporate bond market was effectively closed to new issuance and secondary liquidity for two weeks due to concerns about the overseas banking sector. But swift action by policymakers seems to have restored confidence, and the local corporate bond market has re-opened. Last week ANZ issued a large three-and-five-year deal. Toyota Australia issued \$625 million of debt. Volkswagen Australia and Worley (WOR) are also looking to issue new bonds." **Pendal**

This publication is produced by Evidentia Group Pty Ltd ABN 39 626 048 520 AFSL 511802 (Evidentia Group) and has been prepared solely as an information service. This material is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation. This material is limited to factual information and commentary about broader market conditions. It does not constitute legal, financial or other professional advice. Nothing in this publication should be interpreted as financial product advice. Before making any investment decision, Evidentia Group recommends obtaining financial product advice from a qualified financial adviser. Past performance is not a reliable indicator of future performance. This publication is based on information considered to be reliable. Our commentary is based on our judgement at the time of issue and is subject to change. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the factual information presented in this document. Except for liability which cannot be excluded. Evidentia Group, its directors, employees, agents, and related corporate bodies disclaim all liability in respect of any error or inaccuracy in, or omission from, this document and any person's reliance on it.