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EVIDENTIA GROUP

Quarterly Market Update

June 2023

The Highlights:

- Further easing in inflation pressures enabled the Reserve Bank of Australia (RBA) to leave its cash rate target on hold at a decade high 4.10% at its early July meeting, but the door remains open to resuming rate hikes in August.
- Receding inflation in the United States (US) allowed the Federal Reserve (Fed) to hold the federal funds rate at 5.00-5.25% at its June meeting, however, resilient economic data may force the Fed to raise rates again over the coming months.
- Global shares made gains in the quarter. The advance was led by developed markets, most notably the US, while emerging markets lagged behind on further weakness in China. Mega-tech companies again led the rally, boosted by enthusiasm over artificial intelligence (AI). A lack of exposure to the technology sector weighed on Australian shares relative to global shares.
- Fixed interest (bond) markets were weaker over the quarter as government bond yields rose and bond prices fell. Australian and the United Kingdom (UK) markets underperformed, due to higher-than-expected inflation. Global high yield outperformed investment-grade credit as immediate recessionary concerns were pared back.

Key Markets - Trailing Total Returns (%)

As at 30 June 2023	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	1.8	1.0	4.5	14.8	11.1	7.2	8.6
Australian Small Cap Shares	0.0	-0.5	1.3	8.4	5.2	2.3	6.8
International Shares (Hedged)	5.3	6.3	13.3	14.6	10.2	7.4	n/a
International Shares	2.9	6.8	16.1	20.4	12.2	10.4	12.3
Developed Markets Shares (Hedged)	5.5	6.9	14.5	16.5	11.5	8.3	10.5
Developed Markets Shares	3.1	7.5	17.2	22.4	13.4	11.4	13.0
Emerging Markets Shares (Hedged)	3.2	1.2	4.2	0.5	1.4	0.6	n/a
Emerging Markets Shares	0.9	1.5	6.9	5.1	3.5	3.1	6.3
Australian Property	0.0	3.4	3.9	8.1	8.1	3.5	7.7
International Property (Hedged)	2.8	0.9	1.0	-5.9	3.1	-0.6	4.0
International Infrastructure (Hedged)	1.8	-0.9	-1.3	-3.0	5.5	4.5	7.6
Australian Fixed Interest	-2.0	-2.9	1.5	1.2	-3.5	0.5	2.4
International Fixed Interest (Hedged)	-0.2	-0.3	2.1	-1.2	-3.6	0.2	2.5
Cash - Bank Bills	0.3	0.9	1.7	2.9	1.0	1.2	1.7

OUTLOOK FOR INVESTMENT MARKETS

The first half of 2023 provided further evidence investment markets are beginning to build comfort around the notion of persistent inflation and higher-for-longer interest rates. Global shares, led by the United States (US) and Europe, shrugged off the US regional banking turmoil to mostly move higher. The MSCI All Country World Unhedged Index is up 16% this year, with close to half of those gains coming in the June quarter. Fixed interest (bond) markets also advanced over the past six months, although expectations interest rates have further to run weighed on bonds over the quarter.

A key driver of these market movements has been the resilience in global economic activity, consumer demand, and labour markets. While positive for the broader economy and shares in the near term as a recession is pushed further into the future — it will likely result in a more challenging conclusion to the current cycle as rates need to rise further to tame inflation. Another aspect of the recent rally in shares has been the concentration in only a handful of mega-tech companies — the so-called 'Magnificent Seven' of Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia and Tesla. Although true these companies stand to benefit from an artificial intelligence (AI) boom, they have also been benefactors of a bounce back following large declines in 2022 and are seen as an obvious home for investors seeking safety and quality.

To date, the global economy has weathered rising rates well. Still, leading indicators suggest weaker activity is ahead as the 'long and variable lags' of the current Central Bank tightening cycle take full effect. A mild US recession seems probable over the coming six to 12 months, and while Australia and Europe may avoid a recession, they will still likely face a significant slowdown. In a slowing economic environment where demand fades, and earnings come under downward pressure, we favour high-quality companies with stable and cyclically resilient earnings, low debt, and dominant market positioning.

That said, markets are forward-looking, so is the current economic outlook already reflected in valuations? Historically, bear markets (a sustained period of downward trending share prices – using a 20% decline) have occurred as an economy approaches a recession, providing opportunities to enter the market at attractive valuations as or when an economy enters a recession. If we are circa six months out from a US recession, this would normally be a reasonable entry point if it was not for the fact we have not seen a devaluation — investors appear to be pricing in a very 'soft landing' where a recession is avoided, or no slowdown occurs at all. While market valuations in aggregate look stretched, we are seeing pockets of value emerge, like in global small and mid-sized sectors, banks, energy, and property. We remain cognisant that while some of these areas offer genuine opportunities, others are cheap for a reason. An active approach when seeking value-based opportunities is, therefore, critical.

Despite our base case being a conceptually favourable soft landing, valuations already reflect this, company earnings are under pressure, and we see limited upside for shares in a soft landing scenario. In contrast, we still see a material risk of two alternate scenarios that warrant more caution in positioning. Under alternate scenario one ('hard landing'), rate hikes take longer than expected to gain traction, resulting in an overtightened economy that triggers a deep recession. Alternate scenario two ('persistent inflation') involves a stubbornly high level of entrenched inflation, requiring higher rates to break the back of rising prices and wages, also resulting in a deeper recession than expected.

Until the picture of inflation and interest rates becomes clearer, we remain cautious about the outlook for investment markets. Regarding portfolio positioning, we continue to favour defensiveness across and within asset classes. In fixed interest, we prefer duration (government bonds) over credit (corporate bonds) and higher quality investment grade credit over lower quality high yield credit. For shares, resilient quality-focused companies are best placed to weather weaker demand. While cautious, we are also mindful markets are notoriously difficult to time. This is why retaining exposure to growth assets remains essential and why we believe a neutral weighting is appropriate in the current environment.

ECONOMIC REVIEW

Australia

Recent data has demonstrated resilient economic growth and sticky inflation, and highlighted Australia remains some six to nine months behind the US in terms of its interest rate trajectory. While appearing to have bottomed, Australia's job market remains strong. Having ticked up to 3.7% in April, the unemployment rate unexpectedly dropped to 3.6% in May, with the local economy adding 76,000 jobs — well above estimates. Retail sales were also stronger than expected in May.

The monthly Consumer Price Index (CPI) indicator pointed to further easing in inflation pressures. Annual headline inflation fell from 6.8% in April to 5.6% in May — well below the market consensus of 6.1%. At first glance, the slowdown in inflation is encouraging, but falls in the prices of volatile items such as petrol, food, and holiday travel made large contributions to the softer inflation numbers. Stripping out these volatile items, the inflation slowdown was less noticeable, dropping from an annual rate of 6.5% in April to 6.4% in May.

Against this backdrop, the RBA left its cash rate target on hold at a decade high 4.10% at its July meeting. RBA Governor Philip Lowe said the pause would allow the Central Bank more time to assess incoming economic data and left the door open to resuming rate hikes in August. The market predicts at least two more 0.25% rate rises, implying rates could peak at 4.60% over the coming months.

US

Overall, solid US economic data points to a remarkably resilient economy where businesses and consumers are growing less worried about a recession and the impact of higher interest rates. House prices and construction picked up, while consumer confidence in June beat forecasts. First quarter GDP was revised up to 2% annualised, from 1.4% previously, and US initial jobless claims fell 26,000 in May, reversing the previous rising trend.

Despite strong economic data, US Personal Consumption Expenditures (PCE) inflation data for May supported the idea inflation pressures are continuing to retreat. The 3.8% annual headline growth was the lowest headline reading since April 2021 and was a big drop from the 4.3% result in April. Core PCE was 4.6% year-on-year, versus 4.7% in April and 4.7% expected. While encouraging, this remains too high for the Fed. Following a long-anticipated pause at its June meeting — leaving the federal funds rate at a 5.00-5.25% range — the Fed has signalled two more rate hikes over coming months, pushing the peak rate to 5.60% according to futures markets.

Europe

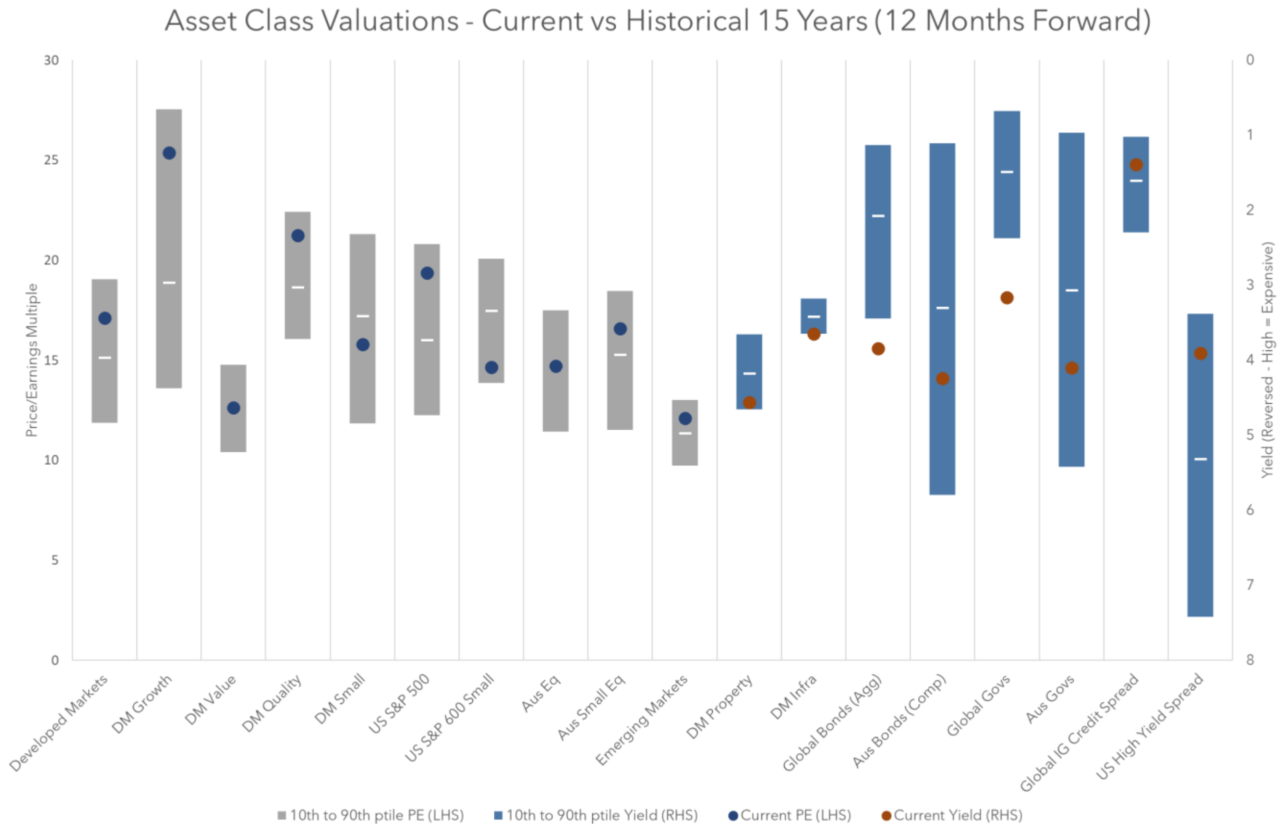
The UK economy has been much more resilient than expected and is one of the last major economies where inflation is still rising. Core CPI inflation rose by 7.1% in May, up from 6.8% in April and is the highest rate since March 1992. Even with growing concerns inflation is becoming entrenched, the Bank of England (BoE) surprised markets with a large 0.50% rate hike to 5.00% in June and indicated further hikes would be necessary. Meanwhile, Europe continues its battle with price rises despite the economy contracting in the last two quarters. In June, the European Central Bank (ECB) raised its key rate by 0.25% to 3.50% and discussed the prospects of further rate rises, with one all but guaranteed in July.

Asia

China's economy has struggled to recover after lifting its COVID restrictions at the end of last year. Manufacturing in the country contracted for a third month in June, while softer CPI inflation data is also concerning. Despite ongoing rumours around a substantive stimulus package in the offering, little has been forthcoming. On a positive note, US-China tensions cooled following trips from Treasury Secretary Janet Yellen and Secretary of State Antony Blinken to ease recent strains over trade, technology, and Taiwan. In contrast to the comments from other major central banks, the Bank of Japan (BoJ) remains an outlier, keeping monetary policy easy (ultra-low interest rates) as underlying inflation remained below its 2% target. Headline inflation is above 3%.

ASSET CLASS REVIEW

The following chart compares current (12-month forward) 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

A faltering Chinese reopening and the renewed prospect of further RBA rate hikes have weighed on the local market in 2023, which has trailed its major developed market peers. The rally in global technology companies, an underrepresented sector on the ASX, has also contributed to relative underperformance. The S&P/ASX 200 Index still made gains, finishing the quarter up +1.0%, while small companies trailed large companies — the S&P/ASX Small Ordinaries Index fell -0.5%.

There was a significant divergence in the performance of sectors over the three months. Information technology (+21.1%) enjoyed a strong quarter, continuing to benefit from global enthusiasm for AI-related companies. Well behind technology, the next best-performing sectors were utilities (+5.5%), energy (+3.6%), and industrials (+3.1%). Health care (-3.2%) retreated, dragged down by the performance of heavyweight CSL, which announced a currency-related downgrade. The materials (-2.6%) sector continues to be impacted by a stalling Chinese recovery story.

What Fund Managers are saying….

"The current interest rate hiking cycle has been one of the steepest on record. Yet despite this, a question remains as to whether the economy has become less sensitive to interest rate increases. On the surface, it seems households and corporates have been able to navigate the pressures relatively well, with growth sustaining and retail sales slowing but not collapsing. But there are signs of cracks. The Silicon Valley Bank collapse and Credit Suisse takeover were a clear signal that the hiking cycle has exposed some frailties in the system.

*Despite this uncertainty, Australia is well-placed in the global context. Firstly, the RBA has been more cautious than their Central Bank peers in raising rates, such that Australia has the lowest real interest rates amongst the major economies. Secondly, growth should continue to outpace the global averages supported by our linkages with a reopening of China and an abundance of natural resources. Thirdly, the Australian banking system is arguably the strongest globally, and unlikely to see significant contagion from events in the US or Europe. This is critical in periods of slower growth as weak banks lend less and further constrain growth. Finally, Government policies are generally expansionary with strong immigration inflows a key highlight." — **Fidelity International***

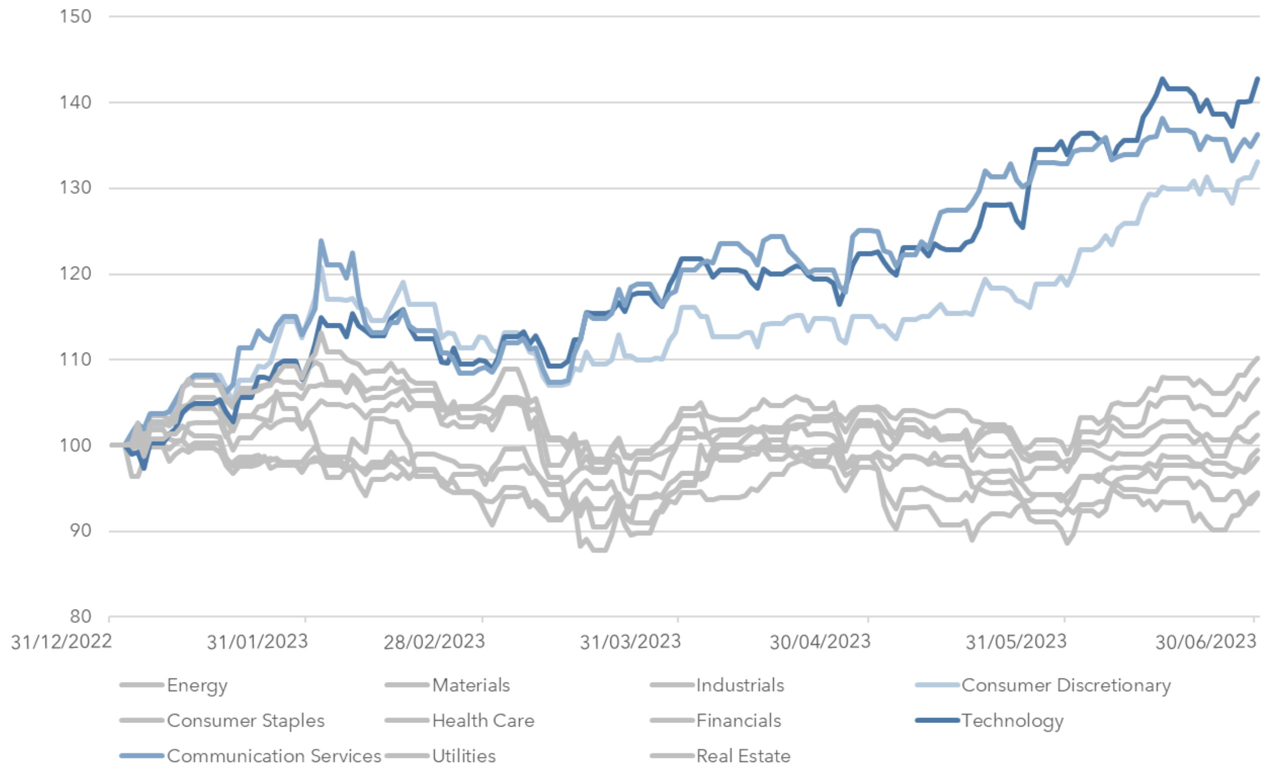
International Shares

Following a difficult 2022, the first half of 2023 was kinder for global share markets. The MSCI All Country World Unhedged Index delivered +16.1% year-to-date and +6.8% over the quarter. A weaker Australian dollar resulted in a slight lag for hedged global shares, which lifted +13.3% and +6.3% over six and three months, respectively.

While the June quarter was positive across most developed market sectors, there was wide dispersion. Tech-heavy sectors like information technology (+15.0%) and communication services (+10.2%) were again winners, benefiting from the AI boom. Consumer discretionary (+11.3%), heavily weighted to Amazon and Tesla, was also a standout. Financials (+5.2%) rallied at the quarter end on the Fed's annual banking system stress test results, which confirmed banks remain well-capitalised and strong enough to handle a severe recession. At the other end of the spectrum, energy (-1.0%), materials (+0.1%), consumer staples (+0.3%), and real estate (+1.0%) barely moved the dial.

US shares shrugged off potential fragility and contagion risk in the US regional banking system to post impressive gains in the June quarter. The S&P 500 Index rose +8.7% as better-than-expected economic growth and excitement surrounding AI drove the shares in technology companies higher. This year's market rally has been unusually concentrated. Large-sized companies have outperformed mid and small-sized companies, and powered by the AI boom, seven companies — Apple, Microsoft, Nvidia, Amazon, Meta, Alphabet, and Tesla — have been responsible for approximately three-quarters of the overall market's gains. In the process, Apple became the first company in the world to reach a market value of $3 trillion. Its shares have gained more than 5,800% since it unveiled the iPhone in 2007.

The best-performing major market over the quarter was Japan (+14.4%), supported by weakness in the Yen as the BoJ continued to resist the urge to lift interest rates. European shares (+3.7%) were more muted over the quarter but, along with Japan, have been one of the best places to invest in 2023. Emerging markets (+1.5%) trailed developed markets (+7.5%), and were held back by China (-9.0%), where shares struggled on fading optimism following the country's initial reopening-driven rally.



Source: Bloomberg/Evidentia.

What Fund Managers are saying….

"The effects of AI (artificial intelligence) could occur faster than in previous technological revolutions such as the introduction of electricity, roads and the internet. These previous episodes depended on scale and network effects to become transformative. The use of AI, by contrast, is increasing quickly, and the effects on growth and productivity may occur in years rather than decades.

Identifying the investment winners and losers from AI is not clear-cut. AI runs on computer processing power and data, so specialized chipmakers are likely to be beneficiaries, as well as companies that have access to large amounts of computing power, cloud storage and data. There are also likely to be losers as existing technologies are rendered obsolete. Another issue is whether AI will produce the monopoly power and profits that the current tech giants enjoy from networking effects and scale of economies. The gains may end up more evenly shared between the users and creators of AI.

*There is also the question of whether AI will turn into a speculative mania in the manner of the 1990s tech bubble. The gains for companies such as Nvidia and Meta this year can in part be explained by large increases in their earnings expectations. Aggressive Fed tightening and the risk of recession are likely to keep the lid on AI euphoria for now. The return of low interest rates and easy money in the next cycle could be the trigger for an episode of speculative excess. AI is still in its infancy and will be one of the key investment themes to monitor going forward.." — **Russell Investments***

International Shares - Trailing Total Returns (%) All Local Currency							
As at 30 June 2023	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	1.8	1.0	4.5	14.8	11.1	7.2	8.6
US	6.6	8.7	16.9	19.6	14.6	12.3	12.9
Europe	4.3	3.7	18.4	30.6	13.4	7.8	8.1
UK	1.4	-0.3	3.2	9.1	10.9	3.6	5.9
Japan	7.5	14.4	22.7	25.7	16.4	8.3	9.7
China	4.4	-9.0	-4.4	-15.7	-9.7	-5.0	3.3
Asia (Ex-Japan)	2.9	-0.2	4.3	0.8	2.8	2.1	5.6
Latin America	6.8	9.0	7.5	16.9	10.4	7.4	7.3

Property and Infrastructure

Property shrugged off the prospects of higher-for-longer interest rates and investor scrutiny about office real estate valuations to post positive returns over the June quarter. The local S&P/ASX 200 A-REIT Index rose +3.4% over the quarter, while global property, measured by the FTSE EPRA Nareit Developed Index (Hedged), edged up +0.9%. Global Infrastructure had a strong June but retreated over the quarter, with the FTSE Global Core Infrastructure 50/50 (Hedged) Index falling -0.9%.

Fixed Interest

A weak June dragged down fixed interest markets over the quarter, with peak rates re-pricing the overriding concern for investors. This drove bond yields higher and bond prices lower. A spike in government bond yields was particularly severe in Australia, sending the local fixed composite market — as measured by the Bloomberg AusBond Composite 0+ Yr Index — down -2.9% over the quarter and -2.0% in June. Global fixed interest markets fared better, with the Bloomberg Global Aggregate Hedged Index slipping -0.3% over the quarter.

Short and longer-dated government bond yields rose sharply. 2-Year and 10-Year Australian Government Bond yields ended the quarter significantly higher at 4.20% and 4.02%, the highest levels in more than a decade. The Australian Government Bond yield curve inverted last quarter — the 2-Year yield rose more than the 10-Year yield — which has long been associated with a pending recession. The US Treasury yield curve remains deeply inverted as well. 2-Year and 10-Year US Treasury yields also rose, ending the quarter at 4.87% and 3.84%, respectively.

Global Credit (corporate bond) markets posted positive returns for the quarter. High yield credit — less sensitive to interest rates because of their wider spreads (higher yields than those offered on government bonds) — outperformed investment-grade credit as immediate recessionary concerns were pared back. Australian investment-grade credit, which tends to closely track the performance of government bonds given the high quality and high duration characteristics they share, retreated during the quarter.

The Australian short-term money market remained volatile over the quarter, with the three-month bank bill swap rate (widely used to set bank lending rates) rising from 3.72% to 4.25% as interest rate expectations were reset higher. The Australian dollar remains largely range-bound between 0.66-0.68 against the US dollar.

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Fixed Interest - Rates, Yields & Spreads

As at 30 June 2023	month end	1 mth earlier	3 mths earlier	6 mths earlier	12 mths earlier	10 yr average
Australian RBA Cash Rate	4.10	3.85	3.60	3.10	0.85	1.53
Australian 10 Year Bond Yield	4.02	3.61	3.30	4.05	3.66	2.48
Australian Corporate Composite Bond Spread	1.72	1.81	1.92	1.91	1.84	1.23
US Fed Funds Rate	5.25	5.25	5.00	4.50	1.75	1.17
US 10 Year Bond Yield	3.84	3.65	3.47	3.88	3.02	2.21
US Corporate Bond Spread	1.23	1.38	1.38	1.30	1.55	1.24
US High Yield Bond Spread	3.90	4.59	4.55	4.69	5.69	4.30
Bloomberg AusBond Comp 0+ Yrs Yield	4.38	3.87	3.52	4.09	3.55	2.34
Bloomberg International Aggregate Yield	3.84	3.66	3.54	3.73	2.91	1.77

What Fund Managers are saying….

“We think the path of least regret involves owning bonds and being active in how we manage that risk. Recession doesn’t even have to form our base case to like bonds. Disinflation is sufficient. It is underway and there will be more to come. Our income strategies have taken up their interest rate exposures in recent months, positioned actively following the US banking crisis, and await confirmation from the data to lean in further.

*In our composite and government strategies, we have also leaned long versus the benchmarks and positioned for the curve to flatten. That positioning has paid off in recent weeks as the Australian yield curve contemplates inversion. In credit, we remain conservatively positioned and patiently await better opportunities. We value quality, seniority, and liquidity. At this point in the cycle, we have conviction that credit fundamentals will deteriorate offshore and spreads in our markets will be dragged wider as a result. We would rather be too early in our cautious call than too late and fall victim to illiquid markets.” — **Pendal Group***

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