Monthly Market Update

May 2023

The Highlights:

- The Reserve Bank of Australia (RBA) unexpectedly increased its target cash rate to 4.1% at its June meeting as a resilient economy added to concerns about the stickiness of inflation.
- A deal on the United States (US) debt ceiling was eventually reached at month-end – negotiations had previously dominated headlines and weighed on investment markets for much of May.
- Global shares were mostly lower over the month, led by China whose faltering economic recovery, intensifying geopolitical tensions and weaker yuan keep investors away. US and Japanese markets were exceptions, both moving higher. Enthusiasm over the future potential for AI (artificial intelligence) boosted shares in technology companies.
- Fixed interest (bond) markets fluctuated during May on the back of US debt ceiling negotiations but ended weaker as bond yields pushed higher (prices fell) as investors lowered their expectations for rate cuts in response to continued signs of economic resiliency and persistent inflation.

Key Markets - Trailing Total Returns (%)

As at 31 May 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	-2.5	-0.9	2.9	11.4	7.5	8.1
Australian Small Cap Shares	-3.3	-1.3	-5.8	4.5	2.5	6.0
International Shares (Hedged)	-0.4	3.4	0.5	9.4	6.3	
International Shares	1.0	7.8	11.8	11.0	10.2	12.1
Developed Markets Shares (Hedged)	-0.3	3.8	1.5	10.3	7.2	9.6
Developed Markets Shares	1.1	8.2	13.1	11.9	11.2	12.9
Emerging Markets Shares (Hedged)	-1.2	0.0	-7.2	2.4		
Emerging Markets Shares	0.4	4.4	1.4	4.4	2.5	6.0
Australian Property	-1.8	-3.6	-3.0	7.6	3.9	7.6
International Property (Hedged)	-3.8	-5.7	-15.7	2.9	-0.7	3.5
International Infrastructure (Hedged)	-4.7	-0.5	-9.5	4.0	4.6	7.2
Australian Fixed Interest	-1.2	2.1	1.7	-2.8	1.0	2.5
International Fixed Interest (Hedged)	-0.5	2.0	-2.6	-3.4	0.2	2.4
Cash - Bank Bills	0.3	0.9	2.6	0.9	1.1	1.7

ECONOMIC REVIEW

Australia

Although the data flow has been mixed and inconclusive, a resilient local economy is starting to see the first impacts of higher interest rates beginning to take hold. Retail sales are slowing back to normal levels, with the growth being driven by prices, not volumes. The surprising strength in February and March's employment data reversed in April. The unemployment rate rose from 3.5% to 3.7% and 4,300 jobs were lost. The NAB business survey for April suggested business conditions continued to ease, albeit at elevated levels. But after three promising quarterly declines, Consumer Price Index (CPI) inflation rebounded from 6.3% in March to 6.8% in April.

The higher-than-expected CPI figure forced the RBA's hand at its June meeting, when it raised the target cash rate by another 0.25% to 4.1%. Concerned about services inflation remaining stubbornly high because of rising wages (not helped by the long-awaited Fair Work Commission wage recommendations) and low productivity growth, Governor Philip Lowe reinforced the Central Bank's intention to keep lifting rates if needed to ensure inflation returns to its 2-3% target range even if it stretched households and companies. The Federal Budget provided little in the way of expansionary or overly contractionary policies, and as such was largely ignored by the market.

US

The US debt ceiling debate was resolved in a far more bipartisan and benign way than most in the market expected, with the impact of the spending cuts on the economy relatively limited. The month kicked off with the US Federal Reserve (Fed) announcing its 10th interest rate hike in little over a year — raising the federal funds rate by 0.25% to a range of 5.00-5.25%. The US labour market remains tight, with 339,000 jobs added in May, well ahead of expectations. While wages growth is running at +2.8% year-on-year and is still too strong for the Fed's comfort regarding inflation, it also suggests there is no imminent sign of recession. Annual core personal consumption expenditure (PCE) inflation — the Fed's main measure of inflation — edged higher to 4.7% in April and remains well above its 2% target. While no longer pricing in repeated rate cuts this year — a sign that markets are beginning to grasp inflation's persistence — a pause in the Fed's rate hikes in its June meeting appears the most likely outcome.

Europe

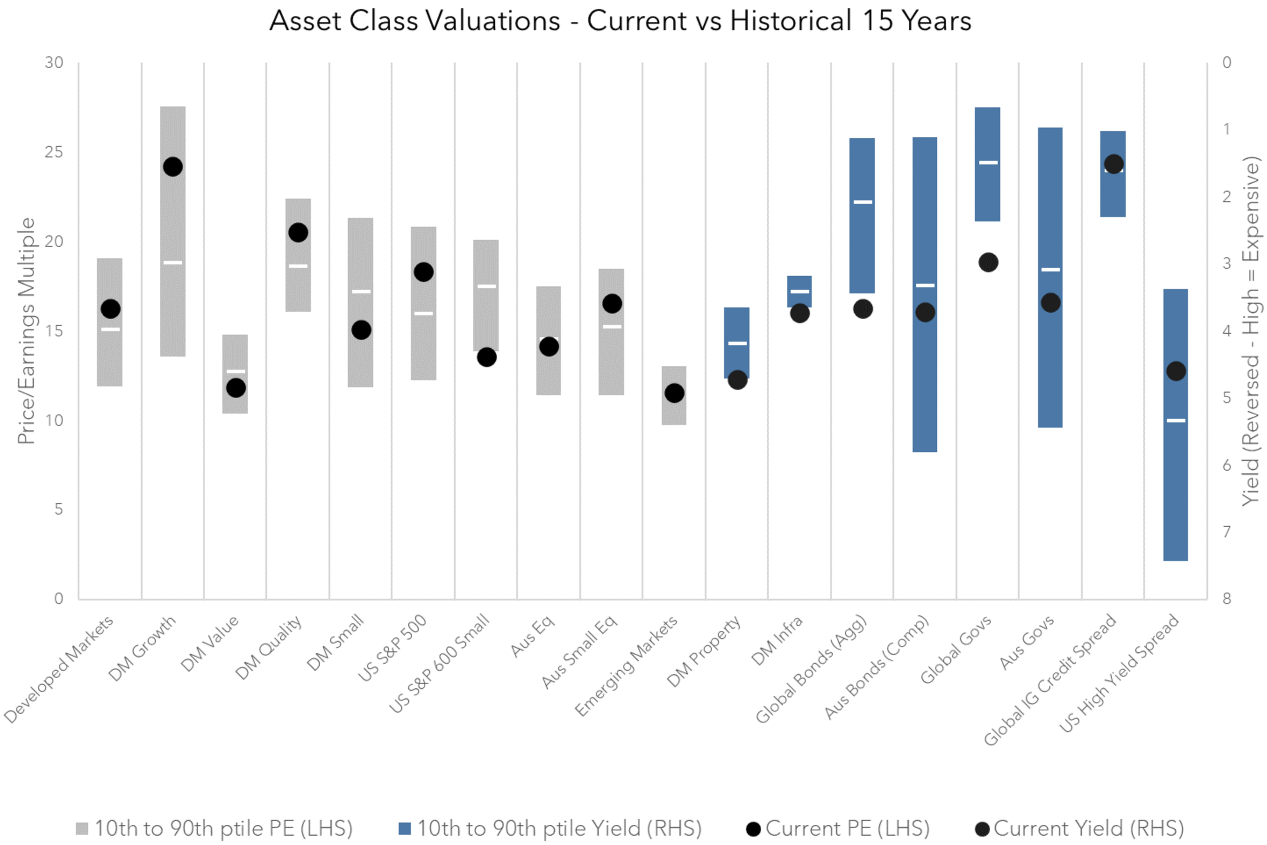
Annual core inflation — closely watched by the European Central Bank (ECB) — eased from 5.6% in April to 5.3% in May as services inflation was offset by a move down in the prices of goods. Against this inflation setting, the ECB delivered an expected 0.25% rate hike in May to 3.25%. Markets currently expect two further rate hikes before peaking at 3.75%, with the next one likely to come in its June meeting. The Bank of England (BoE) announced a 12th consecutive rate rise in May, increasing the base rate from 4.25% to 4.5% and indicating further hikes would be needed. Annual core CPI inflation in the United Kingdom (UK) accelerated from 6.2% in March to 6.8% in April — now at its highest rate since 1992 — causing markets to re-price rate expectations to peak at 5.5%.

Asia

After the end of its zero-COVID policy and a strong first quarter, April manufacturing and import data indicated a slowdown in economic activity in China. Service sector activity, while still positive, expanded at the weakest pace in four months in May. Declines in the Chinese property market also accelerated. In Japan, first quarter GDP growth was positive with solid domestic demand being driven by COVID-reopening and inbound tourism. Annual core CPI inflation also accelerated with the Bank of Japan's (BoJ) key inflation measure rising 4.1% year-on-year in April — the biggest rise since 1981.

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

Australian shares declined through May, with the S&P/ASX 200 Index finishing down -2.5%. Weaker investor sentiment on the back of China and the US debt ceiling negotiations, combined with a surprise rate rise by the RBA weighed on the local market. Small companies trailed large companies — the S&P/ASX Small Ordinaries Index fell -3.3%. In terms of sector performance, information technology (+11.6%) had a stellar month riding the wave created by global investor interest in AI. Utilities (+1.1%), energy (+0.2%) and health care (+0.1%) also recorded positive moves. Consumer discretionary (-6.1%) and consumer staples (-4.6%) sectors reacted negatively to an upward revision to the expected path for interest rates. Materials (-4.4%) fell as miners were impacted by sliding commodity prices triggered by a stalling Chinese recovery story. Financials (-3.2%) also underperformed the broader Index as brokers downgraded the earnings outlook for the major banks, following their recent half-yearly results announced in May.

International Shares

International shares moved lower in May. The MSCI All Country World Hedged Index fell -0.4%, while unhedged shares rose +1.0% following further weakness in the Australian dollar (AUD). Performance was mostly negative at a sector level. Energy (-9.4%) and materials (-5.9%) fell on a weaker outlook for global demand. Consumer staples (-5.8%) and real estate (-4.6%) also moved lower on concerns about higher interest rates. Information technology (+8.5%) and communication services (+4.0%) were the standout winners over the month, boosted by the enthusiasm around the future potential of AI and a boom in related technology, like chipmaking and cloud services.

Despite the debt ceiling debate, US shares added +0.4% in May, but this was again largely due to a resurgence in the technology sector. Just a handful of companies have been responsible for the S&P 500 Index's year-to-date gain. They have also powered a 35% rally in the technology-focused NASDAQ which climbed to a 13-month high, and a 75% surge in the FANG+ Index. Meanwhile, the US volatility index — the VIX, has fallen to its lowest level since the start of 2020, and pre-pandemic.

European shares (-2.2%) were weaker in May after a generally positive year so far, with all sectors falling aside from information technology. UK shares (-4.9%) fared even worse, due largely to the Index's overweight exposure to the underperforming energy and financials sectors, and very few listed technology companies. Investors are increasingly optimistic that Japan is on the way out of the deflationary stagnation of the past. The Topix Total Return Index returned +3.6% in May, the best performance among the major markets, with momentum also helped by a weaker Yen. China (-8.2%) was one of the worst-performing markets in May, as investor optimism seen earlier in the year faded with weaker economic data than had been expected.

International Shares - Trailing Total Returns (%) All Local Currency

As at 31 May 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	-2.5	-0.9	2.9	11.4	7.5	8.1
US	0.4	5.7	2.9	12.9	11.0	12.0
Europe	-2.2	1.3	14.2	14.2	6.9	7.0
UK	-4.9	-4.1	1.7	10.9	3.2	5.2
Japan	3.6	8.2	14.5	13.6	6.6	8.9
China	-8.2	-9.1	-13.9	-8.5	-6.8	2.1
Asia (Ex-Japan)	-1.5	-0.3	-5.0	4.3	0.8	4.8
Latin America	0.1	0.3	-1.8	10.6	5.7	5.9

What Fund Managers are saying….

*"In our view, structural shifts in the technology landscape often create attractive investment opportunities for long-term investors who can position portfolios to take advantage of these shifts. The 'Age of AI' is fast approaching, and we believe that these changes will make AI integral to everyday life, interwoven in how we interact with computers. However, like many technologies, we believe the adoption will be moderate at first and build over time. Technology will continue to improve. Investment will grow, and more applications will be built on the platforms. Enterprises and consumers will realise the benefits of the tools built based on this new technology. We are excited by the tremendous opportunities that AI, ChatGPT and other large language models bring and will continue to search for opportunities for our strategies to invest in the revolution." — **Franklin Templeton***

Property and Infrastructure

Property backed up its brief relief rally in April with a disappointing performance in May, again burdened by prospects of higher-for-longer interest rates. The local S&P/ASX 200 A-REIT Index slipped -1.8% over the month, while global property, measured by the FTSE EPRA Nareit Developed Index (Hedged), dropped -3.8%. Global office REITs (real estate investment trusts) are trading at their lowest level since 2009 as the trend toward remote work leaves desks empty and economic pressures tighten company budgets. Global Infrastructure — also highly sensitive to higher interest rates — underperformed hedged international shares by a considerable margin, with the FTSE Global Core Infrastructure 50/50 (Hedged) Index down -4.7%.

What Fund Managers are saying….

*"It's difficult to know the timing and depth of a recession, and at what point the market may turn more risk-friendly. But we believe longer-term investments like infrastructure assets are especially prudent. They may include both regulated utilities and more GDP-sensitive assets, offering essential service defensive exposure and structural growth that many other asset classes would not offer. Longer-term themes infrastructure investors can benefit from include decarbonisation, onshoring/reshoring and the explosion of data demand. Infrastructure regulatory regimes and concession agreements are designed to produce outcomes over long periods. As such, in downturns and economically weak environments listed markets should provide plentiful opportunities to find good liquid infrastructure companies at attractive valuations." — **ClearBridge Investments***

Fixed Interest

Despite a late month-end rally in fixed interest markets on news that an agreement on the US debt ceiling had been reached, bond yields rose (and bond prices fell) in May on overriding concerns about inflation and a re-pricing of peak interest rates. Against this backdrop, the Australian fixed interest market, measured by the Bloomberg AusBond Composite 0+ Yr Index, fell -1.20%. At the same time, the Bloomberg Global Aggregate Hedged Index eased back -0.5% in May.

Short and longer-dated government bond yields rose sharply after last month's modest moves. 2-Year and 10-Year Australian Government Bond yields ended the month higher at 3.56% and 3.61%, going close to inverting (when shorter-term yields exceed long-term yields). 2-Year and 10-Year US Treasury yields were higher, ending May at 4.41% and 3.65%.

Credit markets were mixed over the month. Australian credit declined as spreads widened with rising government bond yields. Europe outperformed US credit in both investment grade and high yield markets due to weaker economic data in the eurozone pointing to the possibility of a lower peak in rates. The Australian short-term money market suggests one further move in the cash rate after the 0.25% rise in June, with the three-month bank bill swap rate (widely used to set lending rates) currently sitting near 3.18%. The Australian dollar remains largely range-bound between 0.66-0.68 against the US dollar.

Fixed Interest - Rates, Yields & Spreads

As at 31 May 2023	month end	1 mth earlier	3 mths earlier	12 mths earlier	10 yr average
Australian RBA Cash Rate	3.85	3.60	3.35	0.35	1.52
Australian 10 Year Bond Yield	3.61	3.34	3.85	3.35	2.47
Australian Corporate Bond Spread	1.81	1.85	1.65	1.61	1.23
US Fed Funds Rate	5.25	5.00	4.75	1.00	1.13
US 10 Year Bond Yield	3.65	3.43	3.92	2.85	2.20
US Corporate Bond Spread	1.38	1.36	1.24	1.30	1.25
US High Yield Bond Spread	4.59	4.52	4.12	4.06	4.30
Bloomberg AusBond Comp 0+ Yrs Yield	3.87	3.55	4.05	3.18	2.33
Bloomberg International Aggregate Yield	3.66	3.52	3.84	2.59	1.76

What Fund Managers are saying….

"With inflation coming down and the economy softening, we think the Fed is in a position to pause its rate hikes. We understand, however, why investors may remain reasonably nervous about potential downside economic risks and upside yield risks given the Fed's "hawkish pause" rhetoric. In this environment, we favor higher-quality credit that should still capture meaningful upside, and that can also prove resilient should more challenging economic headwinds prevail. We've also moved our duration more to the front end of the yield curve believing that the fundamentals strongly suggest a hard landing is both improbable and unnecessary." — ***Western Asset***

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