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EVIDENTIA GROUP

Monthly Market Update

January 2023

MARKETS SUMMARY

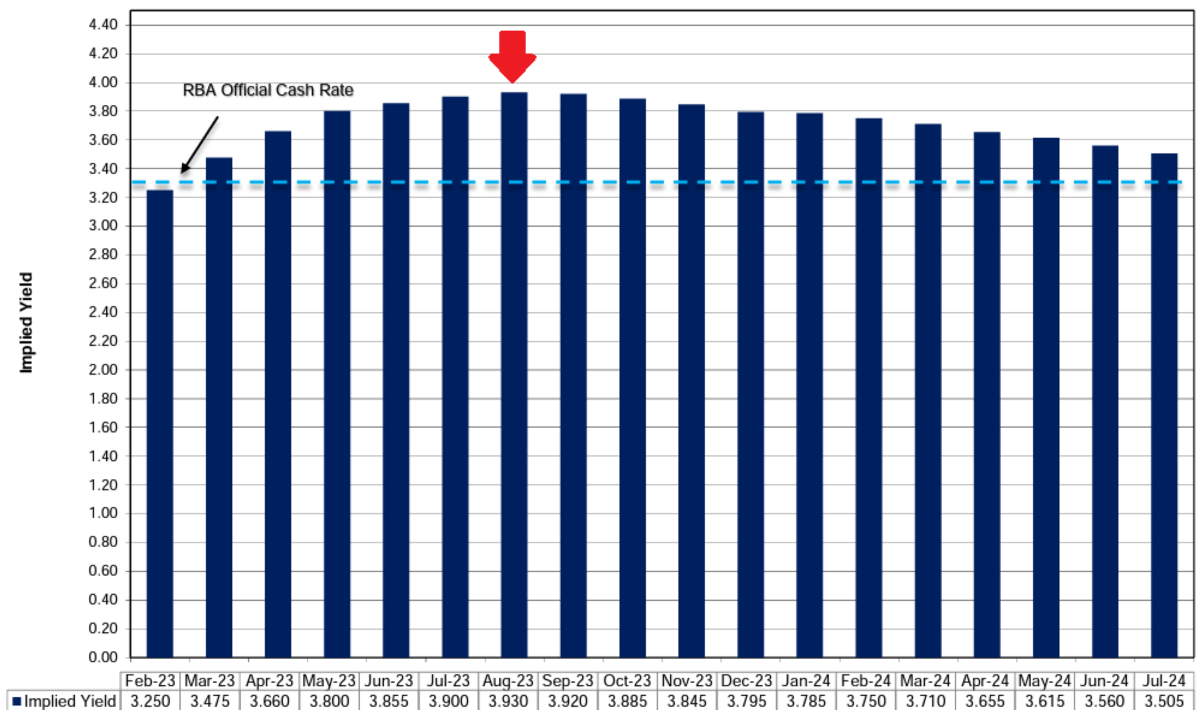
Key Markets - Trailing Total Returns (%)						
As at 31 January 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	6.2	9.6	12.2	6.0	8.5	8.8
Australian Small Cap Shares	6.6	7.6	-4.4	2.4	4.4	5.4
International Shares (Hedged)	6.2	7.2	-8.2	5.5		
International Shares	3.1	0.7	-8.0	5.0	8.5	12.6
Developed Markets Shares (Hedged)	6.2	6.3	-7.9	6.2	6.2	10.4
Developed Markets Shares	3.0	-0.5	-7.5	5.8	9.5	13.4
Emerging Markets Shares (Hedged)	6.2	15.5	-11.3	0.7		
Emerging Markets Shares	3.8	10.9	-12.1	-0.3	1.3	6.2
Australian Property	8.1	9.7	-5.0	-0.9	5.6	8.5
International Property (Hedged)	8.0	9.0	-13.3	-3.6	1.4	5.0
International Infrastructure (Hedged)	1.4	4.6	-0.1	0.7	5.3	8.5
Australian Fixed Interest	2.8	2.2	-6.3	-2.7	1.1	2.6
International Fixed Interest (Hedged)	2.1	3.2	-8.9	-3.1	0.3	2.6
Cash - Bank Bills	0.3	0.8	1.5	0.6	1.0	1.7

Financial markets enjoyed an impressive start to 2023 with gains across all major asset classes. Further signs that global central bank rate tightening cycles may be nearing an end as inflation falls, raised hopes that a soft landing is achievable and that the downturn in corporate earnings may be gentler than initially feared. China's zero-Covid U-turn also helped to propel the advance in markets. A strong performance in January has historically supported strong share market performance for the remainder of the year, which could be a positive sign for Australian and International shares which enjoyed particularly strong starts to the year. Returns from fixed interest (bond) markets also benefited from lower interest rate expectations as bond yields fell, meaning bond prices rose.

Australia

Australia bucked the global trend of moderating inflation, with the December quarter CPI print coming in higher than expected. Inflation rose 1.9% over the quarter, and 7.8% over the year, its highest rate since 1990 and ahead of the 7.6% consensus estimates. The Reserve Bank of Australia's (RBA) preferred measure – trimmed mean CPI, lifted 6.9% over the year versus consensus expectations of 6.5%, still well above the central bank's 2-3% target. The next wave of inflation is being driven by services rather than the supply-side issues of 2021-22, and perhaps unsurprisingly, the most significant contribution to December CPI came from domestic holiday travel & accommodation as 'revenge travel' surged.

While inflation data was stronger than expected, activity-based measures like the December NAB Business Survey, which measures business conditions, showed that the economy began losing some momentum late last year. Labour market conditions also eased from very tight levels in the previous month, with the number of employed people in Australia falling by 14,600 and the unemployment rate remaining steady at 3.5%, missing expectations for a fall to 3.4%. In weighing up all the data at its disposal, the RBA hiked the cash rate by 25 bps in its February meeting to 3.35% as was widely expected, but confirmed further increases would be needed over the months ahead to ensure that inflation returns to target. Following its February meeting, the futures market was pricing in a peak cash rate of 3.93% to be reached in August, suggesting at least two more 25 bps rate rises.



	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24	Jul-24
Implied Yield	3.250	3.475	3.660	3.800	3.855	3.900	3.930	3.920	3.885	3.845	3.795	3.785	3.750	3.710	3.655	3.615	3.560	3.505

Source: ASX

US

Inflation in the US cooled for the sixth successive month in December, with headline CPI dropping from 7.1% to 6.5% over the last 12 months, mainly due to energy and food cost moderation. The Personal Consumption Expenditures price index (PCE), the Fed's preferred inflation gauge, fell from 5.5% in November to 5% in December. Economic data elsewhere was mixed but encouraging. As measured by the S&P Flash Composite PMI, manufacturing and services activity improved in January but remains in contraction territory, and GDP grew at an annual rate of 2.9% in the December quarter, beating estimates. In its early February meeting, the US Federal Reserve (Fed) raised the federal funds rate by 25 bps to 4.50-4.75%, marking its smallest rate hike since March 2022. Although expected to slow the pace of its rate hikes, the Fed continues to err on the side of caution with inflation. Chair Jerome Powell reiterated that "the job is not fully done" and that the Fed would continue to raise rates for the foreseeable future to combat stubbornly high inflation and would not consider rate cuts until it was confident that inflation was moving towards its 2% target.

Released after the Fed's rate decision, the US jobs report was much stronger than expected. Despite layoffs in the technology sector becoming an almost daily occurrence, January nonfarm payrolls increased by 517,000, the biggest increase in six months and smashing estimates of 187,000 and December's gain of 260,000. The unemployment rate fell from 3.5% back to 3.4%. Fearing the prospect of higher for longer rates following the shock employment print, futures markets began pricing in a higher peak rate of just over 5% in mid-2023 before a pause and eventual cut in December. As a potential risk to market stability over the coming months, the US Treasury announced that it had technically hit its Congress-approved debt ceiling and is expecting to run out of money by the middle of the year unless an increase is agreed. Late July/early August is considered the crunch time for Congress, with some sort of last-minute compromise the best-case scenario.

Europe

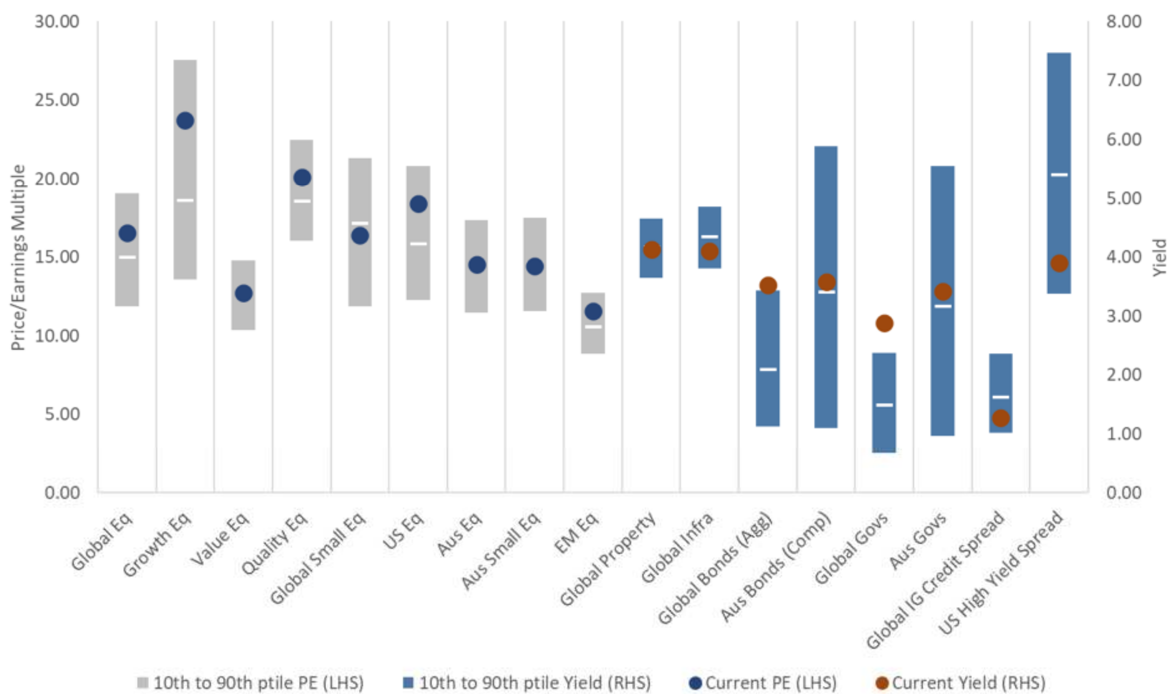
The outlook for economic activity in Europe continues to look less dire. The eurozone economy eked out 0.1% of GDP growth in the December quarter, and forward-looking indicators like flash PMI, which registered a seven-month high above the 50 expansionary level in January, have raised hopes that the region may continue to avoid recession. Inflation moved lower again in January, with the annual inflation rate falling from 9.2% in December to 8.5%, compared to estimates of 9%. The highest contribution to inflation came from food, alcohol and tobacco, with energy in second place as natural gas prices remained below their elevated levels of 2022 due to a mild winter. The European Central Bank (ECB) raised its key interest rate by 50 bps to 3% in early February and warned that further interest rate rises would still be needed to return inflation to the 2% target. The Bank of England (BoE) also raised its rate by 50 bps to 4% but suggested rates may have peaked.

Asia

December CPI inflation rose to 4% in Japan, a fresh 40-year high that is now double the Bank of Japan's (BOJ) 2% target. But this was not yet considered severe enough to trigger any policy change by the BOJ, which in mid-December surprised markets by announcing an adjustment to its yield curve control policy (a policy under which it caps long-term interest rates at around zero). Developments in China also boosted investor sentiment in the region. This included the ongoing reopening of the Chinese economy, a loosening of the regulatory crackdown on the country's technology companies, and more policy support for the property market. Despite recent weakness in economic data, December is widely seen as the bottom for Chinese growth. PMI rebounded strongly from 47.0 in December to 50.1 in January, and other high-frequency indicators like subway passenger flows, point to a quick recovery in economic activity as Covid infections peak.

ASSET CLASS REVIEW

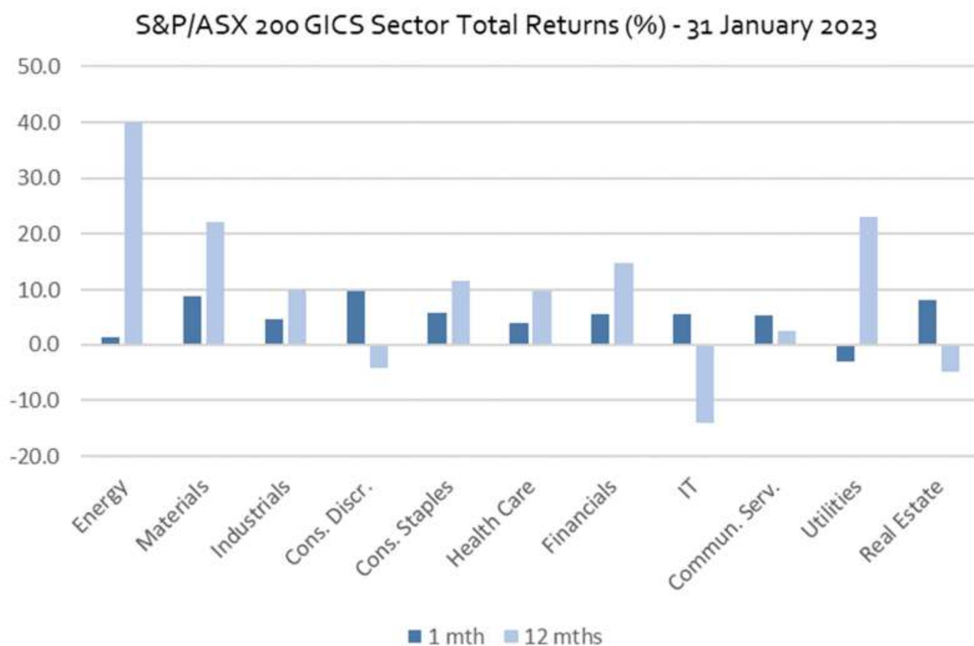
The following chart compares current valuations (dots) against the 15-year historical valuation ranges (bars) for different asset classes. Price/earnings multiples are used as the valuation method for shares (equities), while yield is used as the valuation method for other asset classes.



Source: Evidentia.

Australian Shares

Easing inflationary pressure, signs that a global recession might be avoided, and a faster-than-expected reopening of China, helped drive Australian shares higher in the first month of the new year. Enjoying its strongest start to a calendar year since the S&P/ASX 200 Index was created in 2000, the local market rose 6.2% in January and surprisingly pushed 12-month rolling returns into double figures at 12.2%. A recovery in the small companies' sector continued, with the S&P/ASX Small Ordinaries Index lifting +6.6% in January. Although ten out of eleven sectors contributed positively to the monthly returns, only consumer discretionary (+9.9%), materials (+8.9%) and real estate (+8.1%) outperformed the broader market. At the other end of the spectrum, utilities (-3.0%) and energy (+1.3%) took a breather, and the defensive health care (+3.9%) sector also lagged behind the broader market as investors favoured more growth-oriented sectors.



Source: Evidentia

> *"The reopening of China has had a particularly pronounced effect on the Australian market. Despite high infection rates, Chinese consumers have adapted quickly, and we are seeing fast normalisation in activity levels. The market impact of that adaptation has been immediately felt in the iron ore price and is now flowing through to other commodities too. Australia has many tentacles in China. The most obvious one is resources, but many other companies will benefit from increased tourism, increased student flow, and increased migration as a result of China's reopening."*
>
> *Pendal Group*

International Shares

The improving inflation and interest rate outlook also set the tone for international shares in January. The MSCI AC World Hedged Index jumped 6.2% in the month, while unhedged global shares finished up 3.1%, which reflected the ongoing weakness in the US dollar. Hedged developed and emerging market shares performed in line with one another, finishing the month up 6.2%. Expectations that central banks will end their rate hiking cycles sooner rather than later saw bond yields fall at the longer end of the curve, helping to lift the long-duration growth parts of the market at the expense of value-style companies, in a significant reversal of the prevalent theme in 2022. Growth-oriented sectors like technology (+9.9%) and communication services (+12.7%) outperformed, as did the consumer discretionary (+14%) sector, which benefited from the large influence of mega-cap constituents Amazon and Tesla. Traditional defensive sectors like utilities (-0.4%), consumer staples (+0.4%), and health care (-1.1%), on the other hand, were snubbed by investors.

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

As at 31 January 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	6.2	9.6	12.2	6.0	8.5	8.8
US	6.3	5.8	-8.2	9.9	9.5	12.7
Europe	9.9	15.4	2.3	6.9	5.4	7.1
UK	4.3	10.1	8.0	5.8	4.6	6.1
Japan	4.4	2.6	7.0	8.0	3.9	10.1
China	11.7	50.3	-8.8	-2.2	-4.6	3.3
Asia (Ex-Japan)	6.9	22.4	-7.0	3.8	0.8	5.3
Latin America	5.9	1.2	6.1	3.8	4.8	5.9

US shares kept pace with global markets, with the S&P 500 up 6.3%. As the US fourth-quarter reporting season neared its halfway point at the end of January, 70% of companies had reported earnings (albeit declining earnings) above estimates, which was down slightly on historical averages but has been better than feared. European shares advanced +9.9% and were among the best regional performers as economic data raised hopes that the region may continue to avoid recession. Top performing European sectors again included economically-sensitive areas of the market such as technology and consumer discretionary. UK shares posted a gain of +4.3%, which was more muted than for other markets but did help propel the FTSE 100 Index to a record high. The Chinese market was the standout performer globally, with the MSCI China Index up 11.7% in January. Chinese shares have continued to ride a wave of positive investor sentiment since Beijing loosened its Covid-19 restrictions that have constrained the country's economic growth since early 2020.

"There are large swaths of the equity market that are likely to be relative beneficiaries should inflation moderate, in a way that cash and fixed income assets cannot be. The cyclical nature of parts of the equity market are also likely to rally in the event of a more moderate recession once the growth outlook improves. It's never possible to predict the market for the next 12 months but current lower priced markets, areas of inflation protection and areas that have become particularly cheap all create pockets of opportunity that were not as evident at the beginning of the year."
Royal London Asset Management

Property & Infrastructure

Infrastructure recorded a positive return of 1.4% in January. Still, it underperformed international shares more broadly as defensive assets fell out of favour as more growth-style assets were bid up in the risk-on environment. Property rallied hard in January, with lower interest rate expectations the catalyst for the interest rate-sensitive asset class to move higher. Australian and global property benchmarks performed similarly over the month, with the local S&P/ASX 200 A-REIT Index jumping 8.1% and the global S&P Global REIT Index lifting 8%.

"Valuations remain attractive on a medium to long-term excess return basis for both infrastructure and utilities. Forward-looking EV/EBITDA multiples and dividend yields are beginning to normalise for infrastructure stocks (especially airports and passenger rail) as the traffic and earnings recovery continues. The essential nature of utility cashflows, however, allows for far more predictability in outcomes, especially in times of significant economic slowdown."
ClearBridge Investments

Fixed Interest

Fixed Interest - Rates, Yields & Spreads					
As at 31 January 2023	month end	1 mth earlier	3 mths earlier	12 mths earlier	10 yr average
Australian RBA Cash Rate	3.10	3.10	2.60	0.10	1.50
Australian 10 Year Bond Yield	3.55	4.05	3.76	1.90	2.47
Australian Corporate Bond Spread	1.75	1.91	2.16	1.11	1.21
US Fed Funds Rate	4.50	4.50	3.25	0.25	0.97
US 10 Year Bond Yield	3.51	3.88	4.05	1.78	2.14
US Corporate Bond Spread	1.17	1.30	1.58	1.06	1.25
US High Yield Bond Spread	4.20	4.69	4.64	3.42	4.31
Bloomberg AusBond Comp 0+ Yrs Yield	3.69	4.09	3.87	1.65	2.32
Bloomberg International Aggregate Yield	3.47	3.73	3.82	1.55	1.69

In January, stabilising global growth and easing inflation pressures were reflected in falling bond yields (and rising bond prices) in fixed interest markets. The local Bloomberg AusBond Composite 0+ Yr Index advanced 2.8%, while its global equivalent, the Bloomberg Global Aggregate Index Value Hedged Index, rose 2.1%. The yield on Australian 10-Year Government Bond yields fell by 50 bps to 3.55%, while the US 10-Year Treasury yield dropped 37 bps to 3.51%. At the shorter end of the yield curve, Australian and US 2-Year Bond yields ended the month lower at 3.17% and 4.42%. US and European high yield and investment-grade credit markets outperformed government bonds as spreads tightened. The Australian short-term money market remained volatile, with the higher-than-expected inflation reading pushing the 3-month bank bill swap rate (widely used to set lending rates) higher to 3.37%. The US dollar was weaker against most other developed market currencies. In contrast, the Australian dollar was the strongest performer among G10 currencies following stronger-than-expected inflation and optimism around China's reopening.

> *"The value we saw building up in the sharp lift in government bond yields over late December was released as yields fell over January. While we currently see yields as fairly valued, we would regard periods of higher yields, as we enter into the maturing phase of the current tightening cycle, as potential opportunities to add duration."*
> *Janus Henderson*

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