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EVIDENTIA GROUP

Monthly Market Update

February 2023

MARKETS SUMMARY

Key Markets - Trailing Total Returns (%)						
As at 28 February 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	-2.4	0.3	7.2	7.9	7.9	8.0
Australian Small Cap Shares	-3.7	-1.2	-8.0	4.2	3.6	4.9
International Shares (Hedged)	-2.0	-0.9	-7.7	7.7		
International Shares	1.5	-0.7	-1.3	7.2	8.9	12.5
Developed Markets Shares (Hedged)	-1.7	-0.9	-6.9	8.7	6.6	10.1
Developed Markets Shares	2.0	-0.6	-0.3	8.3	10.0	13.4
Emerging Markets Shares (Hedged)	-5.0	-1.3	-13.7	0.4		
Emerging Markets Shares	-2.3	-1.2	-8.8	-0.5	1.0	5.8
Australian Property	-0.3	3.4	-6.5	0.7	6.3	8.1
International Property (Hedged)	-3.6	0.1	-14.3	-2.0	2.0	4.4
International Infrastructure (Hedged)	-4.0	-5.3	-3.3	2.3	5.5	7.8
Australian Fixed Interest	-1.3	-0.7	-6.4	-3.4	0.8	2.4
International Fixed Interest (Hedged)	-1.8	-1.0	-9.4	-4.1	0.0	2.3
Cash - Bank Bills	0.2	0.8	1.8	0.7	1.1	1.7

After a strong market advance in January driven by falling inflation and hopes of an end to central bank rate hikes, an improvement in the near-term global economic outlook in February shifted the narrative yet again. While resilient economic data would usually be interpreted as a positive for markets, investors looking forward to the prospect of rate cuts were disappointed to learn that the road back to target inflation was likely longer and harder than they expected. Risk appetite waned as a result, with bond yields rising sharply over the month (as bond prices fell) and declines experienced across most major global share markets. The ongoing uncertainty about the trajectory of inflation and interest rates and their impact on consumers and businesses will likely mean that market volatility will persist in the short term. Nevertheless, the rally in January reminded us that markets are forward-looking and can pivot quickly at any moment. New signals that inflation is moderating and the central bank monetary tightening cycle is nearing an end are likely catalysts for an upswing in returns from bonds and shares.

ECONOMIC REVIEW

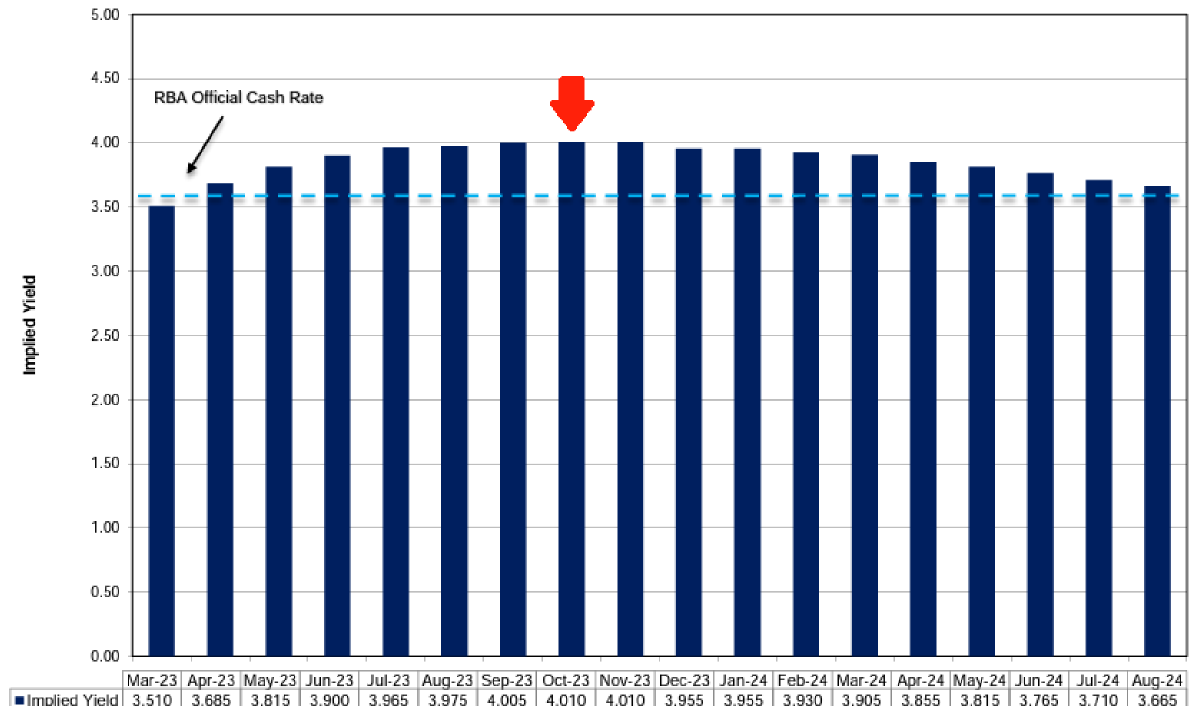
Australia

Recent activity-based data indicated that the local economy had lost the momentum gained early in the new year. Labour market conditions continued to ease from tight levels, with employment falling modestly for the second month and the unemployment rate lifting to 3.7%. The Wage Price Index (WPI) for the December 2022 quarter came in at 3.3% year on year, which was a benign outcome given how low the unemployment rate has been. The WPI data shows that Australia is not currently facing a wage-price spiral, which the Reserve Bank of Australia (RBA) has been keen to prevent. Australia's annual CPI inflation rate for January was 7.4%, compared with 8.4% for December and significantly lower than the 8.1% forecasted.

As expected, the RBA lifted its cash rate by 0.25% to 3.6% in its early March meeting, delivering its 10th consecutive rate increase since the tightening cycle began in May 2022. A recent string of softer-than-expected economic data had also led to market speculation that the RBA would weaken its guidance around future interest rates, and it did not disappoint. The RBA struck a softer tone, signalling that one more rate rise was planned, which sent the Australian dollar down and the share market up in early March. The RBA's comments on the labour market were also instructive, suggesting that while still tight, conditions had "eased a little". The more aggressive language on leading indicators such as job ads was abandoned, and it watered down the perceived threat of a wage-price spiral forming. The futures market is now pricing in a peak cash rate of around 4% in October, suggesting one or two more 0.25% rate rises before a potential cut in December.

ASX 30 Day Interbank Cash Rate Futures Implied Yield Curve

As at market close on 7 March 2023



	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	Aug-24
Implied Yield	3.510	3.685	3.815	3.900	3.965	3.975	4.005	4.010	4.010	3.955	3.955	3.930	3.905	3.855	3.815	3.765	3.710	3.665

Source: ASX

US

US economic data remains stubbornly resilient. The January labour market report was much stronger than expected, with the unemployment rate falling back to 3.4%. Retail sales also surprised to the upside in January after a slow December, posting an increase of 3% month-on-month. Services PMI also came in better than expected at 55.1 for February. At its February meeting, the US Federal Reserve (Fed) voted unanimously to raise the federal funds rate by 0.25% to 4.50-4.75% and indicated that policy intervention was starting to work on curbing inflation. Later in the month, however, Fed Chair Jerome Powell warned that the process of reducing inflation had a long way to go and that rates were likely to peak at a higher point.

Inflation data for January confirmed this narrative. Core Personal Consumption Expenditure (PCE) inflation, the Fed's preferred inflation gauge, came in very strong, accelerating 4.7% year-on-year, beating market estimates and the 4.6% reported in December. This was the first increase in core PCE since September 2022 and was a reminder that the road to normal inflation could be bumpy. Weather disruptions in December and a CPI-adjusted lift in social security payments are two possible explanations for the surprise boost in consumption in January, but market sentiment turned negative anyway. The futures market is now pricing in 0.25% rate rises at the Fed's next three meetings and the rate to peak near 5.4% by July.

Europe

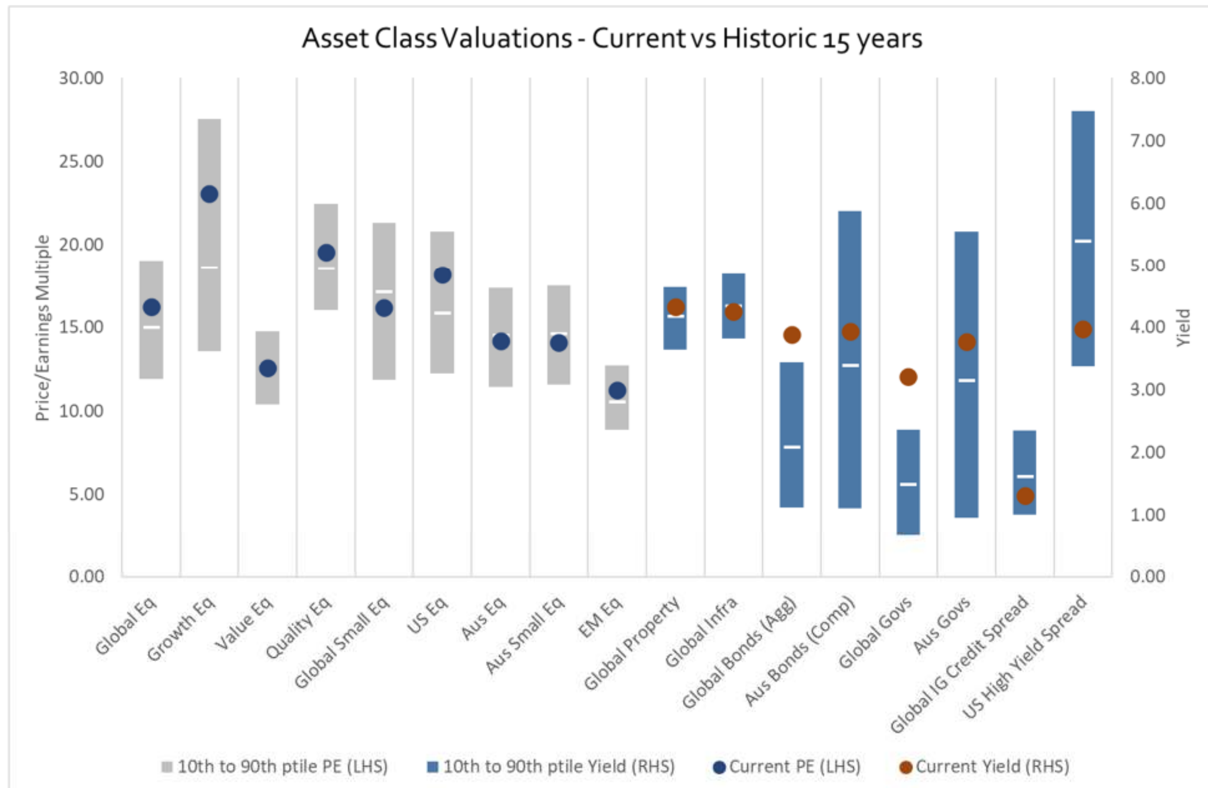
Driven by lower energy prices, headline inflation fell from 8.6% in December to 8.5% in January, while core inflation, which removes volatile items like food and energy, remained at 5.2%. The fall in energy prices has positively affected households and businesses, with forward-looking data painting an encouraging picture of the region's economy. Consumer confidence has rebounded from extremely low levels in late 2022 and is consistent with a possible pick-up in consumption over the coming months. Manufacturing and services data measured by the PMI index reached 52.3 in February, indicating the strongest expansion of business activity since the middle of last year. The European Central Bank (ECB) raised its key policy rate by 0.50% to 3% in February and confirmed its intention to stay the course in increasing interest rates at a steady pace and keeping them at levels that are sufficiently restrictive to ensure a timely return of inflation to its 2% target. Another 0.50% rise in March looks likely. The market expects interest rates to peak at 3.9% by the end of the year.

Asia

Inflation in Japan has been steadily picking up with year-on-year CPI for January of 4.3%, the highest level in the last 40 years and more than double the Bank of Japan's (BoJ) 2% target. Hesitant to raise rates after decades of deflation, the Japanese government and BoJ have been calling on companies to raise wages to help households cope with the high inflation. It was announced at the National People's Congress that China would target economic growth of 5% in 2023, which was down on last year's 5.5% target but up from the 3% growth achieved in 2022. China has managed to deal with inflationary pressures with various government measures, with CPI rising by 2% year-on-year in 2022, well below its annual 3% target. The post-lockdown re-opening of China and huge amounts of accumulated household savings are expected to fuel a rapid consumption-driven recovery in the local economy. A rebound in the services sector and Services PMI data for January to 52.9 (from 48), showed the first glimpse of this recovery.

ASSET CLASS REVIEW

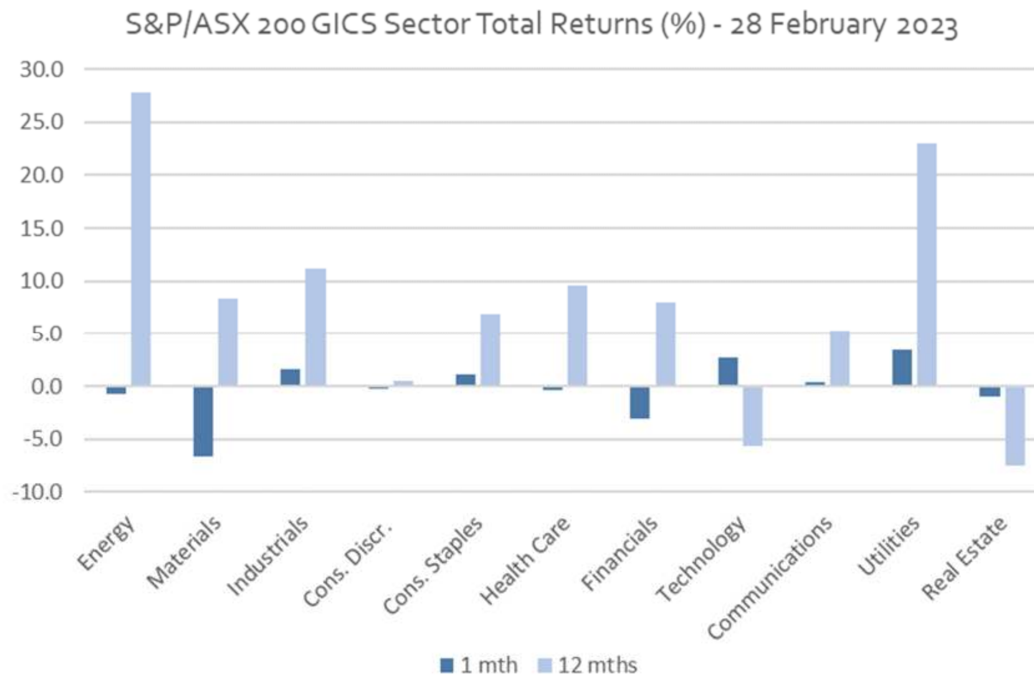
The following chart compares current valuations (dots) against the 15-year historical valuation ranges (bars) for different asset classes. Price/earnings multiples are used as the valuation method for shares (equities), while yield is used as the valuation method for other asset classes.



Source: Evidentia.

Australian Shares

Australian shares gave back a portion of their January gains in February. The S&P/ASX 200 finished down -2.4% and the S&P/ASX Small Ordinaries Index fell -3.7% on more aggressive commentary from the RBA earlier in the month. Index heavyweights materials (-6.6%) and financials (-3.1%) drove the downward pressure at a market level. Major mining companies fell on weaker commodity prices, while the banks fell after the Commonwealth Bank suggested net interest margins had peaked with increases in deposit rates now outstripping increases in loan rates. The utilities sector (+3.4%) outperformed on the back of a revised bid for Origin Energy, whilst technology (+2.7%), industrials (+1.5%), consumer staples (+1.1%) and communication services (+0.4%) were the other sectors to deliver positive returns. In the half-year reporting season just concluded, backward-looking results reflected a resilient economy to date, but net downgrades to forward earnings estimates and cautious outlook statements point to early signs that earnings are beginning to moderate.



Source: Evidentia

> *"While a local recession is possible in 2023, we believe Australia should be able to avoid a technical recession due to three key reasons: 1. Australia has been a net beneficiary of global commodity shortages. The consequence has been strong national income growth, profits growth and an improving underlying fiscal position.*
>
> *2. Although we expect higher interest rates and higher living expenses to have an impact, we believe a combination of rising wage growth and a run down in the level of household savings buffer will continue to support consumption spending.*
>
> *3. Low levels of spare productive capacity, strong profit and low corporate debt have contributed to robust capital investment intentions."*
>
> ***Yarra Capital Management***

International Shares

Global shares declined in February in local currency terms as resilient economic data suggested a pause in interest rate rises may still be some way off. The MSCI All Country World Hedged Index fell -2.0% in the month, but a sharp rise in the US dollar against the Australian dollar resulted in unhedged global shares gaining +1.5%. Emerging Markets (EM) underperformed Developed Markets as a re-escalation in US-China tensions weighed on sentiment. At the same time, prospects of further rate hikes in the US and a stronger US dollar were additional headwinds for EM. Information technology (+0.3%) and industrials (+0.4%) were the only sectors to post positive returns. Interest rate-sensitive sectors like real estate (-5.0%) and utilities (-3.8%) underperformed, as did materials (-3.9%) and energy (-3.9%) as cost pressures and weaker commodity prices weighed on the sectors.

US shares delivered a lacklustre performance in February as investors hit the brakes after January's large rally. The S&P 500 dropped -2.4%. December 2022 quarter US earnings season wrapped up, and on the whole, the results were broadly in line with low expectations. Although earnings declined 2.8% year-on-year, revenue grew 5.3% over the same period showing that tight labour markets, rising input costs, and higher debt servicing costs have squeezed profit margins. European shares bucked the global trend, gaining +1.9% as risks of a deep recession decreased, and markets interpreted signs of easing inflation to mean the pace of rate hikes could soon moderate. UK shares also held up well during February, with the FTSE 100 up +1.8% to hit a new record high. Chinese shares fell -9.9%, with escalating geopolitical tensions driving some profit-taking after the market's 35% rally from its October 2022 lows.

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

As at 28 February 2023	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	-2.4	0.3	7.2	7.9	7.9	8.0
US	-2.4	-2.3	-7.7	12.1	9.8	12.3
Europe	1.9	7.2	10.8	10.7	6.8	7.6
UK	1.8	4.6	9.6	9.8	5.7	6.1
Japan	0.9	0.6	8.5	12.3	4.9	9.8
China	-9.9	5.5	-14.4	-5.9	-5.3	2.6
Asia (Ex-Japan)	-5.0	0.7	-9.7	2.7	0.6	4.8
Latin America	-5.2	-3.6	-1.9	4.8	4.1	5.6

"The consensus view heading into 2023 was for a recession around the world. The energy crisis in Europe would lead to energy rationing, weak business investment and a heavily restrained consumer. In the US, the fiscal-induced sugar high was coming to an end and rising costs of living were to curb consumption. Meanwhile, China was expected to struggle as it slowly edged out from the heavy mobility restrictions.

What materialised was a warmer European winter and an economy that was able to diversify its energy imports. The US consumer has continued to spend in the face of rising costs and a strong labour market, and Chinese policymakers have thrown the covers off the economy.

All of this has led to a surprising resilience in the global economy and stronger than expected economic data and means the odds of an imminent recession have declined. The downside is that stronger demand means inflation pressures will be slower to abate and rates must either get more restrictive or stay restrictive for longer."

JPMorgan Asset Management

Property & Infrastructure

A pivot to a higher-for-longer interest rate outlook was a headwind for rate-sensitive Global Property, with the FTSE EPRA Nareit Developed Index (Hedged) retracing -3.6% in February. Australian Property again outperformed global property, with the S&P/ASX 200 A-REIT Index down just -0.3%, possibly reflecting softer inflationary conditions in Australia, which have been lower and taken longer to accelerate than many other countries around the world. Global Infrastructure experienced a difficult month, with the FTSE Global Core Infrastructure 50/50 (Hedged) Index falling -4.0% as raised interest rate expectations dampened investor enthusiasm for the asset class.

> *"Picking companies in industries well positioned to grow as recessions loom will be paramount for investors, as most countries expect to experience an economic slowdown in 2023. When we are looking at taking advantage of valuation opportunities in G-REITs, we are focusing on assets with low economic sensitivity, ones with resilient cash flows and inflationary, hedge characteristics, as well as relatively strong balance sheets. If economic slowdowns begin to bite, certain sectors and industries will hold up better than others. Student accommodation, data centres, convenience retailers, land-lease communities as well as REITs within the healthcare sector – these are all areas likely to have resilient cashflows if things get tough and spending is reigned in."*
>
> ***First Sentier Investors***

Fixed Interest

Fixed Interest - Rates, Yields & Spreads

As at 28 February 2023	month end	1 mth earlier	3 mths earlier	12 mths earlier	10 yr average
Australian RBA Cash Rate	3.35	3.10	2.85	0.10	1.50
Australian 10 Year Bond Yield	3.85	3.55	3.53	2.14	2.47
Australian Corporate Bond Spread	1.65	1.75	2.01	1.21	1.22
US Fed Funds Rate	4.75	4.50	4.00	0.25	1.01
US 10 Year Bond Yield	3.92	3.51	3.61	1.83	2.16
US Corporate Bond Spread	1.24	1.17	1.33	1.22	1.25
US High Yield Bond Spread	4.12	4.20	4.48	3.59	4.30
Bloomberg AusBond Comp 0+ Yrs Yield	4.05	3.69	3.69	1.88	2.32
Bloomberg International Aggregate Yield	3.84	3.47	3.53	1.76	1.71

Stubborn inflation and aggressive central bank commentary led to higher yields as fixed interest markets moved to discount further monetary tightening. Against this backdrop, the Australian Fixed Interest market, as measured by the Bloomberg AusBond Composite 0+ Yr Index, fell -1.3% after gains of 2.8% the previous month. Global Fixed Interest didn't fare any better, with the Bloomberg Global Aggregate Index Value Hedged Index giving up -1.8%. Government bond yields were higher in February. The 2-Year and 10-Year Australian Government Bond yields ended the month higher at 3.66% and 3.85%. While the 2-

Year and 10-Year US Treasury yields climbed even steeper, rising to 4.81% and 3.92%, above where they started the year. The rise in bond yields created headwinds for fixed interest markets more broadly. Global investment grade credit went backwards as spreads widened, while high yield credit also recorded losses but outperformed investment grade given that improvements in economic data have reduced credit risk concerns. The Australian short-term money market remained volatile as monetary tightening expectations pivoted on RBA signalling, pushing the 3-month bank bill swap rate (widely used to set lending rates) 0.19% higher to 3.56%. Repricing of the rates outlook created a favourable tailwind for the US dollar against most other developed market currencies, including the Australian dollar which fell -4.5% to end February at US$0.67.

> *"With the RBA clearly anxious about the inflation outlook and indicating that work still needs to be done, this has led us to factor in a 4.1% peak in the cash rate by mid-year. Given the change to our cash rate forecasts, we currently see yields as broadly fairly valued. While we have remained cautious on adding duration, we are on the lookout for opportunities to add duration on spikes in yields as we enter the more mature phase of the tightening cycle."*
>
> ***Janus Henderson***

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