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EVIDENTIA GROUP

Quarterly Market Update

September 2023

The highlights:

- The Reserve Bank of Australia (RBA) continued its cautious pause in its October meeting, leaving the cash rate at 4.1% for the fourth month in a row. While inflation had passed its peak, incoming RBA Governor Michelle Bullock signalled further tightening might be required to bring inflation down to its 2-3% target in a reasonable timeframe. Markets are not pricing in a rate cut until 2025.
- The United States (US) Federal Reserve (Fed) left rates unchanged at 5.25%-5.00% in its September meeting, but upwardly revised forecasts for interest rates and a strong September jobs report caused markets to consider alternative scenarios to a soft-landing, like one where higher-for-longer interest rates are needed to combat elevated and persistent inflation.
- Global markets were universally weaker over the quarter, with selling pressure accelerating in September as expectations of rate cuts were pushed further out and a spike in oil prices stoked fears of a reacceleration in inflation. Bond yields moved sharply higher in response, triggering losses for global fixed interest and share markets.

Key Markets - Trailing Total Returns (%)

As at 30 September 2023	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	-2.8	-0.8	0.2	13.5	11.0	6.7	7.4
Australian Small Cap Shares	-4.0	-1.9	-2.5	6.8	2.6	1.6	5.1
International Shares (Hedged)	-3.6	-2.7	3.4	18.0	7.0	5.8	n/a
International Shares	-3.8	-0.4	6.4	20.3	10.7	8.9	11.6
Developed Markets Shares (Hedged)	-3.7	-2.8	3.9	19.3	8.2	6.5	9.4
Developed Markets Shares	-4.0	-0.4	7.0	21.5	11.9	9.7	12.4
Emerging Markets Shares (Hedged)	-1.9	-1.9	-0.7	8.2	-1.8	0.3	n/a
Emerging Markets Shares	-2.3	0.1	1.6	11.3	1.8	2.9	5.9
International Small Cap Shares	-4.9	-1.4	2.5	13.8	10.1	5.5	10.4
Australian Property	-8.6	-2.9	0.4	12.5	4.7	2.5	7.3
International Property (Hedged)	-5.6	-5.2	-4.4	-0.4	1.1	-1.7	3.3
International Infrastructure (Hedged)	-4.1	-7.3	-8.2	-2.7	2.6	2.8	6.4
Australian Fixed Interest	-1.5	-0.3	-3.2	1.6	-3.9	0.3	2.3
International Fixed Interest (Hedged)	-1.8	-2.1	-2.4	0.5	-4.6	-0.2	2.2
Cash - Bank Bills	0.3	1.1	2.0	3.6	1.4	1.3	1.7

Outlook for Investment Markets

As we head into the final quarter of 2023, the optimistic mood that buoyed markets for most of the year has stumbled. A defiantly resilient US economy and signs of sticky inflation have raised the likelihood the Fed will need to keep interest rates 'higher for longer' after they stop hiking. Further rate rises are now priced in, and the timing of subsequent cuts has been pushed out. This has triggered a sharp rise in longer-term bond yields. 10-year US Treasury yields, one of the most influential numbers in finance, rose 0.48% in September alone to end the quarter at a 16-year high of 4.57% and has continued to march upwards.

Conventional wisdom tells us that higher bond yields can be problematic for shares. Higher bond yield translates to higher borrowing costs, dampening company earnings and their ability to expand. Higher bond yields also mean the returns from bonds become more attractive relative to shares. For shares to continue to offer a risk premium in returns over bonds at current yields, valuations on shares, in theory, need to move lower. The difference between earnings yield on shares over bond yields (a proxy for the 'equity risk premium') is less than 1%, the lowest level since 2007. This imbalance suggests a heightened possibility of a pullback for share markets. Higher yields (combined with moderating inflation) should set the scene for better future returns from fixed interest, which has missed out on the rebound enjoyed by shares in the year to date.

Valuations aside, global economic growth remains resilient and appears to be slowing in an orderly manner. While labour markets remain tight and wage growth stubbornly high, inflation has peaked and is heading in the right direction. Given this relatively positive backdrop, the rapid rise in bond yields was somewhat unexpected. If bond yields are going up because growth is surprisingly resilient, there is a case to argue that share prices do not need to pull back from here, or if they do, the pullback will be short and shallow.

As we have done all year, we recognise three market scenarios that remain in play over the coming 12 months. Bond markets appear to be signalling a shift from the preferred soft landing scenario — where economic growth gradually slows and inflation is tamed without any significant shocks or disruptions — to a scenario where inflation remains persistent, and central banks need to maintain higher interest rates for a prolonged period. While a hard landing scenario appears out of mind for markets, understanding the effects of higher interest rates can take time to work through the system, leaves us more cautious.

Regarding portfolio positioning, we continue to favour quality and defensiveness across and within asset classes as the best protection against volatility. 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 economic activity. Despite remaining cautious, it is important to acknowledge that longer-term return expectations are improving, not deteriorating. Looking past any short-term volatility and retaining exposure to growth assets is essential, which is why we believe a neutral weighting is appropriate in the current environment.

Economic Review

Australia

The Australian economy has demonstrated resilience in recent months, but weakness is beginning to appear under the surface. The unemployment rate was steady in August at 3.7%, while the number of employed rose by a larger-than-expected 65,000. At the same time, the participation rate edged higher. While gains in the labour market are viewed as a hurdle to slowing inflation, an expanding working population, mainly due to migration, is easing the supply-side constraints. Retail sales continue to hold up but are likely to be impacted over coming months as mortgages for many Australians roll over onto higher fixed rates.

Another big data point was the monthly Consumer Price Index (CPI) rising 5.2% in August, the first gain in four months due to surging fuel prices. After stripping out these volatile items, core CPI fell from 5.8% to 5.5%. While still high, a moderation in core inflation — which dropped from 5.8% to 5.5% — has allowed the RBA to monitor rather than react at this stage. As expected, the RBA left the cash rate on hold at 4.1% at its October meeting for the fourth month in a row. In her first meeting as the new RBA Governor, Michelle Bullock, signalled inflation had passed its peak but was still too high and that further rate hikes were still possible if inflation proved more stubborn than anticipated. The first rate cut has now been pushed out to 2025.

US

The US economy continues to defy once-consensus views a recession was all but inevitable. Jobs gains reported in September were much stronger than expected, reversing the recent softening trend. 336,000 jobs were added, twice as many as was forecast, while the unemployment rate remained unchanged at 3.8%. But a continued downtrend in wage growth — currently 4.2% year over year, suggests the strength of the labour market may be driven by expanding supply — higher participation and population gains — rather than demand. Inflation, while ticking up in August, remains on a downward trend. The September CPI report, set to be released later in October, is expected to show a slight decrease in headline inflation to 3.6%.

While the Fed left interest rates unchanged in September, the interpretation of Chair Jerome Powell's corresponding remarks that the Fed intends to keep interest rates higher for longer shook markets. Despite the surprise jobs report, the Fed is unlikely to change its current trajectory for rates, with inflation data carrying the most weight. Additionally, the large runup in bond yields in September will have the same effect as monetary tightening (rate hikes). The market expects the Fed to hold rates steady at the current range of 5.25%-5.50% when it meets in late October.

Europe

Higher interest rates are having the desired effect on economic growth in Europe. Although the composite Purchasing Manager Index (PMI), which measures manufacturing and services activity, edged up in September to 47.1, it continues to point to the region experiencing a broad-based downturn. Headline inflation saw a spectacular drop in September, declining from 5.2% to 4.3%, its lowest level in two years and raised hopes the European Central Bank (ECB) will not need to raise rates further. Earlier in the month, the ECB increased rates from 4.25% to 4.5%, the highest level since the launch of the euro.

There was good news at last on the inflation front in the United Kingdom (UK). Against forecasts of a modest rise in CPI inflation, the headline rate dropped for the third consecutive month to 6.7% on weaker food prices. Core CPI and services inflation, which were looking sticky, also fell. This enabled the Bank of England (BoE) to leave rates on hold at 5.25%

Asia

China's lacklustre economic recovery finally picked up steam in August as recent government stimulus boosted retail sales and industrial production. Chinese authorities continue to struggle to develop appropriate policies to arrest the deepening problems in the country's property sector.

Asset Class Review

Australian Shares

A spike in bond yields acted as a significant drag on shares in September, with almost all sectors except for energy going backwards during the month, tipping the local market into negative territory over the quarter. The S&P/ASX 200 Index dropped -2.8% in September and finished the quarter down -0.8%. More sensitive to higher interest rates, the small companies sector fared worse — the S&P/ASX Small Ordinaries Index fell -4.0% in September and -1.9% over the quarter.

Energy (+11.2%) was the standout sector over the quarter as global oil prices surged almost 30%, reflecting supply tightness and economic resilience. Financials (+2.4%) held up well as investors perceived higher interest rates as a positive for bank net interest margins and profitability. Despite a challenging September, consumer discretionary (+5.3%) performed well over the three months following a better-than-feared reporting season. All other sectors posted losses. Falls in sector heavyweights dragged healthcare (-8.6%) and consumer staples (-5.9%) lower, while technology (-5.8%) suffered a torrid September with higher rate expectations reversing some of the impressive gains the growth sector has banked over the past 12 months.

What Fund Managers are saying….

"The rapid rise in inflation and interest rates that occurred during 2022 hit small-cap stocks harder than the top 100. This is consistent with history: small-caps tend to get hit harder when the economy is weakening, and the market is selling off. On average, smaller stocks have fewer dominant positions within their industries, much lower profit margins and less pricing power to pass on rising costs. Small-cap stocks also tend to have higher forecast growth than large-cap stocks. In the same way that the price of a bond falls as interest rates rise, the present value of a high-growth stock is reduced more by rising rates than that of a low-growth stock. Finally, small-cap stocks are less liquid than large-cap stocks. In times of uncertainty, there is a flight to liquidity, which tends to reduce the demand by investors for smaller stocks.

Australia is now seeing a fall from peak inflation and a stabilisation of interest rates. This sets the conditions for reversing the underperformance of undervalued small-cap stocks, in Monash's opinion. As the economy improves, some small-cap stocks could recover the profit margins that they lost. And with less uncertainty, there could be a flight to growth by some investors. That could improve the liquidity of small-cap stocks, making them more investible."

Monash Investors

International Shares

Following a strong rally in the first half of 2023, the third quarter provided something of a reality check for markets as higher bond yields sapped risk appetite and weighed on shares. The MSCI All Country World Hedged Index retreated -3.6% in September and -2.7% over the quarter. Unhedged shares had a similarly poor September, down -3.8%, but held up better over the quarter, finishing -0.4% lower after a sharp fall in the Australian dollar in August against the US dollar. Performance was negative across all developed market sectors with the exception of energy in September. Over the quarter, only energy (+12.5%), communication services (+2.0%), and financials (+0.4%) made gains. The interest rate-sensitive real estate sector (-6.5%) was hit hard, as was information technology (-5.8%) as heavyweight constituents Apple and Nvivida — part of the 'magnificent seven' which have provided the market with most of its gains — suffered double-figure losses in September.

US shares posted their biggest monthly percentage falls of the year in September on the prospect of a sustained period of higher rates, sending the S&P 500 Index -3.3% lower over the quarter and the technology-heavy Nasdaq down -3.9%. Higher-for-longer rate expectations combined with worsening economic data caused the Euro Stoxx 50 Index to sink -4.9%. The UK and Japan were the only major markets to buck the trend and post gains over both the month and quarter. The UK's FTSE 100 Index advanced +2.2%, benefiting from its large exposure to energy and materials sectors and higher oil and commodity prices. The Japanese Topix Total Return Index rose +2.5%, driven by the more domestically oriented mid and small-cap company sector and a weaker Yen.

Despite a strong start, emerging markets ended the quarter lower, albeit ahead of developed markets. The MSCI Emerging Markets Index (hedged) gave back -1.9%, with higher US interest rates, which increase the cost of borrowing for emerging market countries, and ongoing weakness in the Chinese economy and property sector, having a negative impact.

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

As at 30 September 2023	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	-2.8	-0.8	0.2	13.5	11.0	6.7	7.4
US	-4.8	-3.3	5.2	21.6	10.2	9.9	11.9
Europe	-2.8	-4.9	-1.4	29.0	11.9	6.7	6.4
UK	2.4	2.2	1.9	14.7	13.2	4.2	5.6
Japan	0.5	2.5	17.3	29.8	15.4	7.6	9.3
China	-2.8	-2.0	-10.8	5.5	-13.6	-3.9	1.9
Asia (Ex-Japan)	-2.0	-2.1	-2.3	10.5	-0.9	1.9	4.8

What Fund Managers are saying….

"A significant shift is underway in Japan, and equity markets are taking notice. It may not have been obvious to U.S. dollar-based investors, but in local currency terms, Japanese equities as measured by the MSCI Japan Index have climbed 25% year to date (as of August 31, 2023).

The wave of optimism has been driven by two key factors: inflation and reforms. While inflation has been challenging for many developed economies, it's a welcome sign in Japan, which has been battling deflation for three decades. Sustained and healthy inflation could change the mindset in Japan from saving to investing.

In terms of reforms, there is tremendous emphasis on improving corporate governance, and companies are focusing more on shareholder returns. In a recent move, the Tokyo Stock Exchange asked all listed companies to enact policies to improve profitability, long-term returns and valuations. About 39% of companies in the TOPIX (an index comprising Japanese stocks) trade below book value, compared to just 5% for companies in the S&P 500 Index."

Capital Group

Property and Infrastructure

Rising interest rates and the prospect of weakening economic growth played havoc with the listed property sector in September. The local S&P/ASX 200 A-REIT Index sunk -8.6% during the month, erasing the strong gains from July and August to end the quarter -2.9% lower. Global property suffered as well, with the FTSE EPRA Nareit Developed Index (Hedged) falling -5.2%. Not only are shrinking yield spreads (the income differentials compared to risk-free 10-year US Treasuries) making the income returns from property less attractive to investors, but low office space occupancy rates and high debt levels have raised concerns around pockets of the US commercial real estate market. Higher rate expectations were also a drag on global listed infrastructure, which had a challenging quarter as the FTSE Global Core Infrastructure 50/50 (Hedged) Index fell -7.3%.

Fixed Interest

Bond yields jumped higher at the start of September and just kept on going as investors braced themselves for an extended period of elevated interest rates. With bond prices inversely correlated to bond yields, fixed interest markets endured a challenging September, dragging the asset class into negative territory for the quarter. The Australian Boomberg AusBond Composite 0+ Yr Index retreated -1.5% in September, leaving it -0.3% over the quarter. The sell-off in international fixed interest markets intensified, with the Bloomberg Global Aggregate Bond Hedged Index down -1.8% in September and -2.1% over the quarter.

The spike in bond yields was particularly severe for longer-dated government bonds, which investors demand greater compensation to hold and are more sensitive to movements in interest rate expectations. This resulted in a sharp steepening of the Australian yield curve and a flattening of the US yield, as yields on longer-dated bonds rose at a faster rate than for shorter-term bonds. The yield on 10-year Australian Government Bonds rose 0.46% in September to 4.49%, while the 2-year Australian Government Bond yield lifted 0.29% to 4.10%. The 10-year US Treasury yield soared 0.46% to a new cyclical high of 4.57%, while the 2-year US Treasury yield lifted 0.18% to 5.03%.

Rising government bond yields squeezed credit (corporate bonds) market returns, eroding the higher interest rates (coupons) on offer. Australian investment-grade credit fell -0.6% in September, but performed better than global investment-grade credit which dropped -2.3% and global high yield credit which declined -0.7%. Against the current cash rate of 4.10%, the Australian three-month bank bill swap rate (widely used to set lending rates) ended September fractionally higher at 4.14%, while longer-dated swap rates point to the possibility of one further cash rate hike.

Fixed Interest - Rates, Yields & Spreads

As at 30 September 2023	month end	1 mth earlier	3 mths earlier	6 mths earlier	12 mths earlier	10 yr average
Australian RBA Cash Rate	4.10	4.10	4.10	3.60	2.35	1.57
Australian 10-Year Government Bond Yield	4.49	4.03	4.02	3.30	3.89	2.48
Australian Corporate Composite Bond Spread	1.52	1.58	1.72	1.92	1.90	1.24
US Fed Funds Rate	5.50	5.50	5.25	5.00	3.25	1.30
US 10-Year Treasury Yield	4.57	4.11	3.84	3.47	3.83	2.25
US Corporate Bond Spread	1.21	1.18	1.23	1.38	1.59	1.24
US High Yield Bond Spread	3.94	3.72	3.90	4.55	5.52	4.28
Bloomberg AusBond Comp 0+ Yrs Yield	4.53	4.19	4.38	3.52	3.99	2.36
Bloomberg International Aggregate Yield	4.22	3.91	3.84	3.54	3.70	1.82

What Fund Managers are saying….

"We currently see market pricing of one hike and easing in 2025 as underestimating the economic headwinds in 2024. We currently see the Australian yield curve as under-valued at points in the curve. We remain on the lookout for tactical opportunities to add further duration on spikes in yields triggered by central bank signalling and data flows. In recognition of the complex investment environment, our credit strategy remains skewed towards high-quality, investment-grade issuers with resilient business models, solid earnings power and conservative balance sheets. We have been actively and selectively taking advantage of the attractive yields on offer in highly rated corporate bonds and structured credit."

Janus Henderson