

Sally Auld
Chief Investment Officer

The CIO View – The RBA gets serious



JBWere View

The RBA continued the string of hawkish central bank surprises this week, delivering an unexpected 50bp rate increase. We think this development signals a sense of urgency to move policy to a more appropriate setting. Consequently, we think it prudent to adopt a more neutral stance on the relative attractiveness of domestic equities vs. international equities.

Key Points

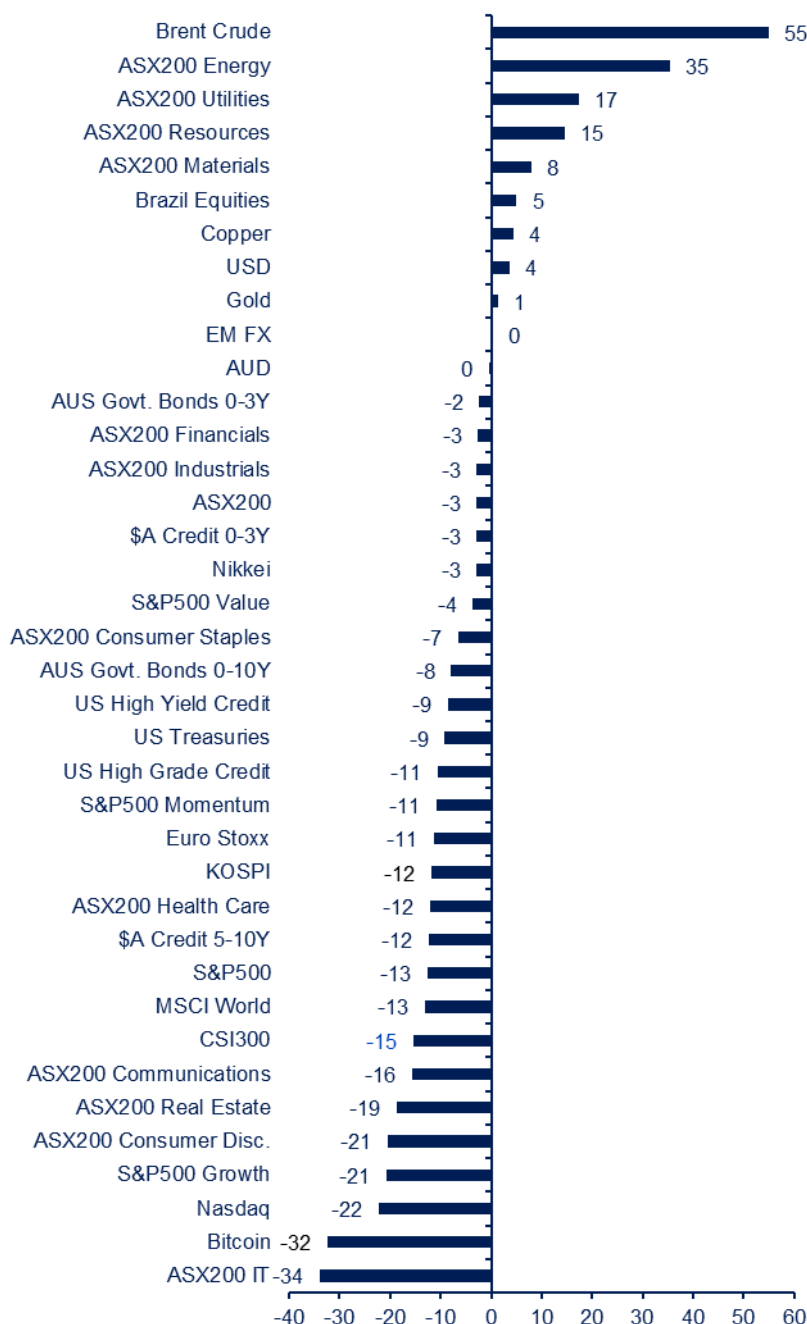
- Recent data are consistent with the view that while global growth has downshifted in the second quarter, a recession is not imminent. Solid labour market and consumption data in the US, stability in the global manufacturing PMI and better data in China have likely helped support equity markets of late. However, looking further ahead we remain cautious on the outlook. Central banks are facing into a steep trade-off between inflation and growth and a number of leading indicators portend a further deceleration in growth. We think this outlook is consistent with our recent move towards a more defensive positioning in multi-asset portfolios.
- The RBA is the latest central bank to deliver a 50bp rate increase as it faces into stronger than expected inflationary pressures, above trend GDP growth and a very tight labour market. In our view, this week's rate decision marks a significant shift in the RBA's approach to policy normalisation. The market has responded to this development and is now priced for a cash rate of 3.1% by the end of the year.
- The ASX200 has significantly out-performed the S&P500 since the beginning of 2022. Our analysis suggests that almost all of this out-performance can be attributed to banks and miners. But a more hawkish RBA gives us reason to question the sustainability of this dynamic; it is possible the banks may struggle to out-perform while there is uncertainty around the contours of the RBA's tightening cycle. And although the consensus already expects slower credit growth in the year ahead, recent data on mortgage approvals together with the RBA's newly discovered sense of urgency suggest risks to this forecast lie to the downside.
- As such, we think it is prudent to adopt a more neutral stance on the outlook for domestic equities relative to international equities. For most of this year, we have articulated a marginal preference for the local market. Recent developments suggest it may be sensible to hold a more impartial view on the relative attractiveness of domestic vs. international equities.

So far, positive returns in 2022 have been limited to commodities and not much else

Market wrap

The universe of assets that have delivered positive year-to-date returns in 2022 is small, and shrinking. As has been the case for most of this year, this sub-set is largely leveraged to the commodity story. In contrast, the list of under-performing financial assets continues to grow, with defensive assets such as US Treasuries now losing as much or more than as some major equity markets (such as the Nikkei). The tech sector continues to under-perform most other financial assets. Bitcoin remains close to the bottom of our table, down 32% year-to-date.

Chart 1: Calendar year-to-date returns, selected financial assets (local currency); %



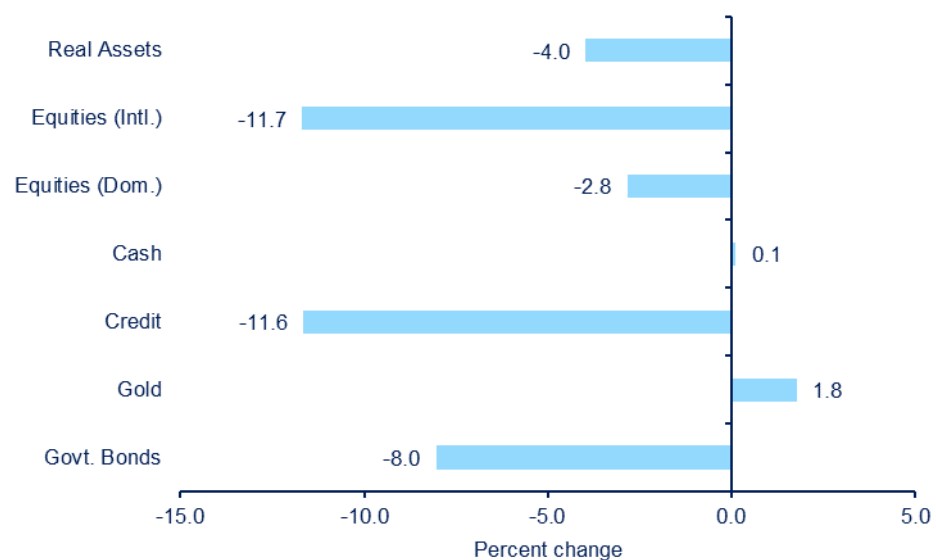
Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance.

Chart 2 shows the seven asset classes we use in our Strategic Asset Allocation (SAA) and illustrates both monthly and year-to-date performance for these seven asset classes. As a reminder, the benchmarks for each asset class are as follows:

- **Cash:** weighted average of the Bloomberg AusBond Bank Bill Index (50%) and the Australian Banks' Term Deposit 1-year rate (50%)
- **Government Bonds:** Bloomberg Barclays Global Aggregate Treasuries Total Return Index, hedged into AUD
- **Credit:** Bloomberg Barclays Global Aggregate Credit Total Return Index, hedged into AUD
- **Domestic Equities:** ASX200 Total Return Index
- **International Equities:** MSCI ACWI Gross Total Return Index, AUD unhedged
- **Real Assets:** weighted average of the FTSE EPRA/NAREIT Global Index Total Return, AUD unhedged (50%) and the FTSE Developed Core Infrastructure 50/50 Total Return Index, AUD unhedged (50%)
- **Uncorrelated Assets:** we proxy using the \$A price of gold

Returns so far this year show a disappointing performance across the board, with only gold (in \$A) delivering positive returns. This is likely to be of little comfort given the very modest allocations to this asset in most portfolios. Both growth and defensive assets have underperformed this year, delivering a difficult start to 2022 for multi-asset investors. International equities (in \$A) have been the worst performing asset class so far this year, with little protection afforded thus far from unhedged currency exposure. The fact that credit – a defensive asset in our framework – has delivered losses on par with equities is a reflection of the difficult investment environment facing investors at present.

Chart 2: Strategic Asset Allocation – Year-to-date asset class returns in \$A



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Recent data have been decent, and have helped to support equity markets of late

Central banks continue to deliver hawkish surprises

Recent data have provided some confidence that the global economy is unlikely to enter recession anytime soon. US retail sales and payrolls data were robust, Chinese economic data have turned positive as major cities exit lockdown and the government continues to provide policy support and the global manufacturing PMI for May held close to recent levels. A number of governments (UK, Australia, NZ) are providing fiscal support for households in the face of continued cost of living pressures. This appears to have provided some stability to equity markets of late; global equities have rallied 6% from recent lows.

However, we are more worried about the outlook for growth in the year ahead. In recent weeks central banks have continued to surprise market participants on the hawkish side of expectations, with the RBA, BoC and RBNZ delivering 50bp rate hikes and signalling scope for more. The Fed is widely expected to deliver two consecutive 50bp rate hikes at its June and July FOMC meetings and has started the process of balance sheet reduction this week.

Generally speaking, the economic backdrop to this dynamic hasn't been overly favourable – inflation forecasts continue to be revised up while growth forecasts are revised down (Chart 3). This speaks to the more explicit trade-off facing central banks at the moment – in order to bring inflation back to target, there will be costs to growth. Usually, economists think of these costs in terms of the labour market (a rising unemployment rate). Interestingly, the consensus forecasts for the US unemployment rate in 2H23 are now being revised *higher*, not lower.

Chart 3: Inflation forecasts have been revised higher and growth forecasts have been revised lower even as central banks have become more hawkish



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

But looking ahead, we think central banks are facing into a difficult trade-off

For markets, the “steepness” of this trade-off is key to the outlook; effectively, markets are grappling with how much growth needs to be sacrificed to bring inflation back towards more acceptable levels. If it's only a modest growth slowdown of the mid-cycle variety, then US equities are likely already fully priced for this outcome. But if it turns out to be something a little more sinister (that is, a recession), then our sense is that the relative performance of equities vs. government bonds has further to move in favour of the latter. A material tightening of financial conditions is likely to drive slower growth – one way that we can see this is to look at the relationship between the global manufacturing PMI and the Goldman Sachs measure of US financial conditions.

Tighter financial conditions will slow growth, possibly by more than markets expect at present

Chart 4: Tighter financial conditions are suggesting further declines in the global manufacturing PMI



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance. *Positive growth in the FCI reflects tighter financial conditions

Chart 4 shows that the tightening in US financial conditions (higher bond yields, stronger currency, weaker equity markets and wider credit spreads) is suggesting that the PMI will continue to decline from here. And as **Chart 5** illustrates, this should support out-performance of government bonds vs. equities. This underscores the rationale for our recent Strategic Asset Allocation (SAA) change, in which we adopted a more defensive positioning in portfolios via allocating capital towards government bonds from international equities, real assets and credit.

This underscores our recently stated preference to adopt a more defensive positioning in multi-asset portfolios

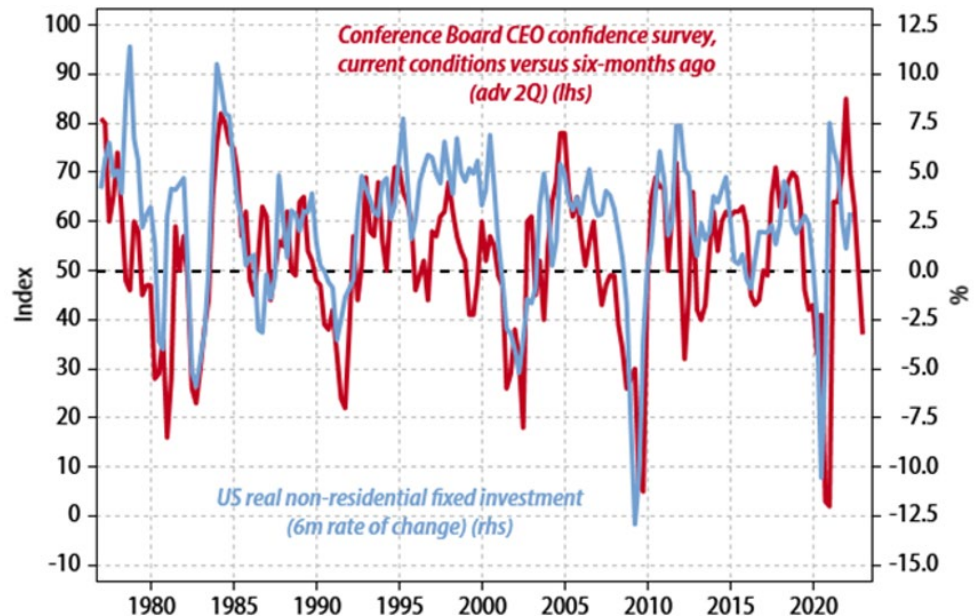
Chart 5: If the global manufacturing PMI declines further, so will the relative performance of US equities vs. bonds



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Moreover, leading indicators are suggesting that key aspects of the US growth dynamic are starting to rollover. **Chart 6** suggests downside risks to US capex spend in coming months.

Chart 6: Leading indicators of capex are softening

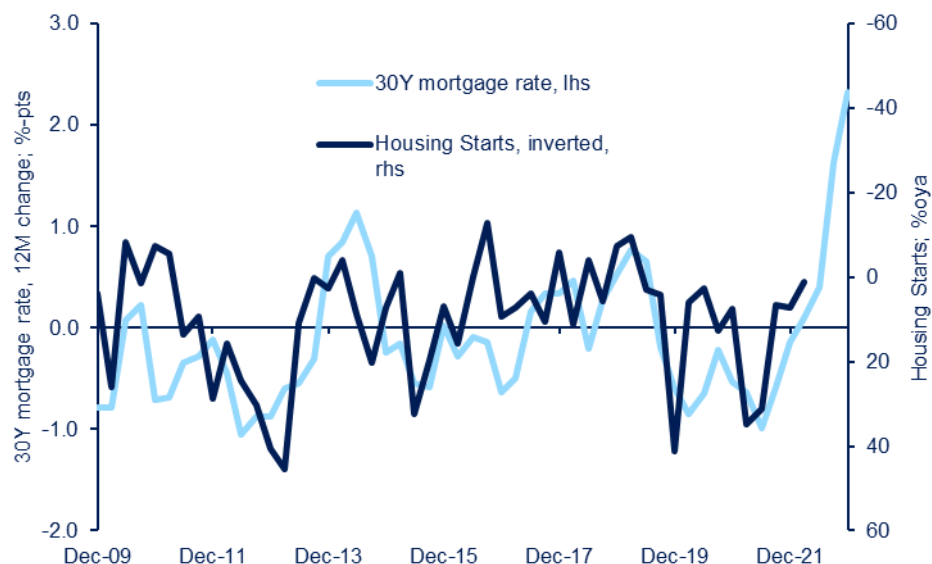


Source: Gavekal Research. Past performance is not a reliable indicator of future performance.

In the US, forward indicators are pointing to weakness in private capex; in this context, the path of household consumption will be key

Chart 7 suggests that growth in housing starts (residential investment) will also decline in coming quarters given the recent lift in 30Y mortgage rates. This leaves – in terms of private demand growth – household consumption as the key driver of growth. On this front, the interplay between real wages growth, the drawdown in accumulated savings on balance sheets and the path of household wealth will be key to the outlook.

Chart 7: Mortgage rates and housing starts



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

RBA shifts up a gear

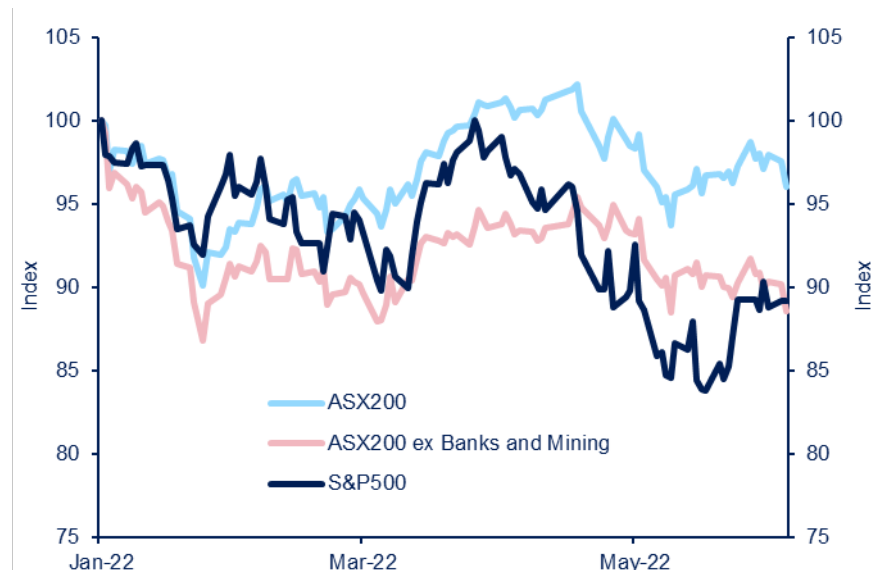
In Australia, most economic indicators ex housing continue to print on the stronger side of expectations, reflecting strength in the real economy. The RBA has delivered the second of what is likely to be at least 4-5 interest rate hikes before year end, in an effort to bring inflation back towards levels consistent with the target. The 50bp rate rise was largely

The RBA finally discovered its hawkish credentials this week

unexpected by markets and effectively represents an acknowledgement that inflation is higher than expected, the labour market is tight and GDP growth is running above trend, all while rates are low. The RBA appears to have finally discovered its hawkish credentials.

We think there are some meaningful implications from this development for the relative performance of domestic equities vs. international equities. As **Chart 8** illustrates, Australian financials (and miners) have helped the domestic market out-perform its US counterpart. But with the RBA shifting more hawkish, we think the environment for the banks could become more challenging sooner than perhaps expected. Typically rising short term interest rates leads to margin expansion for banks, but the prospect of a more aggressive tightening cycle and implications for bad debts could see investors reluctant to add exposure to this sector until there is some comfort or certainty on where the rate cycle is likely to peak out in Australia.

Chart 8: Banks and miners have been responsible for most of the recent out-performance of the ASX200 vs. S&P500 (in \$A)



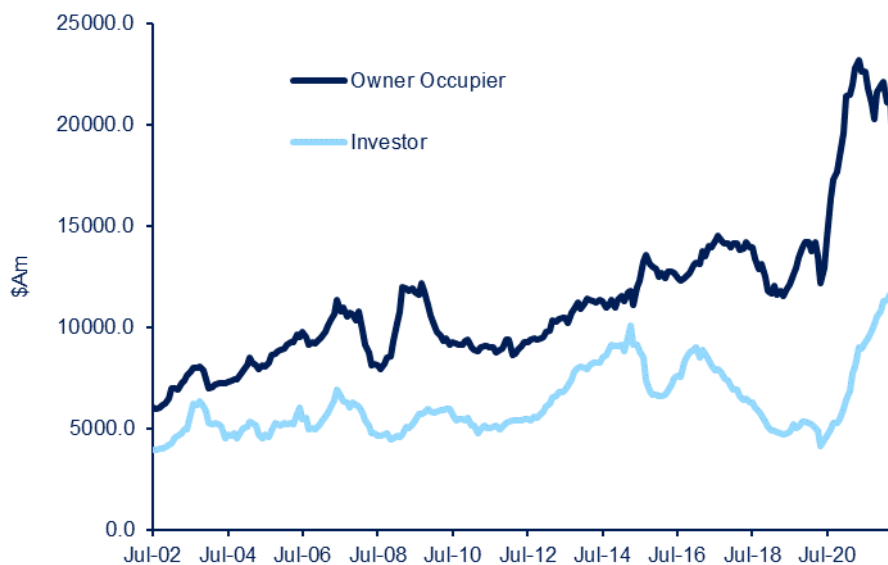
Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

...This could prompt the market to question the outlook for bank stocks

Moreover, a sharper rise in borrowing costs could drive a more rapid deceleration in credit growth; indeed, housing finance data for April (ahead of the first rate rise in May) were much weaker than expected (**Chart 9**). Mortgage approvals for owner occupied housing have declined almost 10% from their peak, and this decline has occurred prior to the RBA starting its tightening cycle. While the consensus already expects a slowing in credit growth, risks to this forecast are biased to the downside.

As a consequence, we think it prudent to turn neutral on AUS equities relative to international equities

Chart 9: The flow of mortgage demand has already turned, ahead of the rate hike cycle



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

So after retaining a marginal preference for Australian equities over International equities for some months now, we now think it prudent to return to a neutral stance. What might drive a preference for international over domestic? In our view, a less constructive outlook for the mining sector. To the extent that performance of the Australian miners has also helped the local market out-perform of late, a shift in fundamentals for this sector would likely prompt a more explicit relative preference for international stock exposure. For investors looking for more analysis on this topic, we will have more to say on the relative performance of Australian equities in our next *Portfolio Strategy* document.

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Prepared by the Investment Strategy Group

JBWere Offices

Melbourne T (03) 9906 5000

Sydney T (02) 9325 2600

Brisbane T (07) 3258 1111

Adelaide T (08) 8407 1111

Perth T (08) 9212 7900

Canberra T (02) 6218 2000

Email Investment.strategy@bwere.com

Sally Auld Chief Investment Officer

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