Market Update – January 2023

Asset class total return to 31/01/2023	1M (%)	3M (%)	6M (%)	1Y (%)	3Y (% p.a.)	5Y (% p.a.)	Current Yield (%)
Cash	0.3	0.8	1.3	1.7	0.7	0.9	3.4
Fixed Term Deposits	0.3	1.0	1.9	3.2	1.9	1.6	4.0
Australian Bonds	2.8	2.2	-0.9	-6.3	-2.7	1.1	3.8
Australian Bank Hybrids	0.0	3.3	4.4	2.9	2.9	3.4	4.4
Australian Property	8.1	9.7	0.4	-4.6	-0.3	6.1	4.5
Australian Shares	6.2	9.6	10.3	12.2	6.0	8.5	5.4
Global Shares (unhedged)	3.0	-0.7	0.9	-7.9	5.8	9.5	1.8
Global Infrastructure (hedged)	2.7	5.8	-4.3	2.0	1.5	6.4	3.1

Source: Refinitiv, RBA cash rate, 12M Term deposit, Australian Composite Bonds, Hybrids cash yield to call, Property ASX 300 AREIT, Australian Shares S&P/ASX 200, Global Shares MSCI World ex-Aust unhedged, Global Infrastructure FTSE Developed Core 50/50, hedged

Financial Indicator movement	31/01/23	1M	3M	6M	1Y
AUD/USD (cents)	0.71	0.02	0.07	0.01	0.00
Aust. 10-year bond yield (%)	3.56	-0.48	-0.20	0.48	1.66
Gold (US$/oz)	1,923	5.4%	17.7%	8.9%	6.7%
Brent oil (US$/bbl)	84	-1.7%	-9.4%	-23.2%	-7.4%
Iron ore (US$/t)	123	5.3%	33.1%	14.7%	-6.1%
Copper (US$/lb)	4.23	11.1%	23.9%	18.0%	-2.1%

Note: Past performance is not a reliable indicator of future performance.

Global

The new year has started with a bout of optimism, which seems to be mostly related to China relaxing its COVID restrictions, Europe avoiding an energy crisis and hopes that the US economy can avoid a hard landing.

The 'China reopening trade' has seen emerging markets rally, along with commodity prices. In turn the Australian market has also rallied, with resources making up over 30% of the local market. European markets have been strong over the past quarter, after an energy crisis was avoided, due to LNG imports and a relatively mild winter. In the US, headline inflation has been falling and there is hope that the US Federal Reserve (the Fed) is nearing the end of its rate hiking cycle.

The Fed seems headed for a ~5.00% cash rate by mid-2023 but the trajectory of inflation remains uncertain and there is still a fair way to go to target (6.5% to 2%). There is a risk that the Fed goes higher and for longer than the market expects. Meanwhile, the US will soon hit its self-imposed public debt limit of US$31.4 trillion, paving the way for another 'showdown' between the Democrats and the Republicans over the US budget deficit. This debate seems to get more bitter each time, but something does need to be done about the never-ending budget deficits, particularly now the cost of public debt has risen with higher bond yields.

Despite US growth and employment remaining robust to date, the US yield curve is clearly inverse, meaning long term interest rates are lower than short term interest rates. Over the past 50 years, an inverse yield curve has always correctly predicted that a US recession is ahead. In addition, EPS growth for the S&P 500 companies has just turned negative, which is another warning sign. As you might have guessed, we remain cautious on this bout of January optimism and think there are going to be some challenges ahead in the inflation battle.

Australia

Australia continues to benefit from strong demand for key commodities (iron ore, coal and LNG) and it also has the clean energy metals the world needs (copper, nickel, rare earths and lithium). There are also signs that diplomatic relations are improving between Australia and China, with coal restrictions recently eased and hope that other tariffs will soon be lifted (wine, beef, lobster).

The Australian economy has been resilient thus far, boosted by commodity export windfalls and resilient consumer spending. But interest rates have been rising at a rapid pace and households are yet to face the full impact of higher home loan rates coupled with rising energy costs and expenses generally.

To some extent the resilience of the Australian economy is a problem for the Reserve Bank of Australia (RBA) as it is likely to keep inflation high. Headline inflation recently printed at 7.8%, while core inflation was 6.9%, both uncomfortable readings for the RBA. In turn, the RBA has lifted the cash rate to 3.35% and has flagged further rate hikes ahead. The market now expects the terminal cash rate to be 4.25% by October 2023. This is well above previous expectations (3.60%) and will add further pressure on households via the variable home loan rate.

Outlook

The US, Europe and Australian economies are proving resilient thus far and China's reopening seems a major positive. However, buoyant growth and commodity prices are not good for the inflation outlook and are likely to cause Central Banks to go 'higher for longer' on interest rates.

We think the market is cheering the growth story but is ignoring the interest rate story. Our major concern is that the full impact of higher interest rates and costs are yet to fully impact households, due to a drawdown in savings. We think the full impact will arrive by the second half of 2023 and consumer spending will fall significantly (as Central Banks intend). Consumption makes up ~70% of demand in developed economies and will have a material impact on economic growth.

Accordingly, we expect challenging conditions ahead before inflation returns to target. We think interest rates will stay high for most of 2023 and won't be eased until 2024. We remain invested but positioned defensively and will be on the lookout for opportunities as they arise.

The next key events on the calendar include:

Australian 1H23 reporting season – February 2023

RBA meeting – 7 March 2023

Fed meeting – 21/22 March 2023

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