Lonsec Client Newsletter - July 2023

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Summary of Key Views

Insights from our CIO: Keeping it in perspective
Global equities have rallied over the last 6 months, with the MSCI AC World ex Australia TR Index AUD returning 7.5% since the start of the year. The recovery in global risk assets has however, been quite narrow and heavily concentrated in a small number of US mega stocks. In fact, if we zoom in on the US for a moment, 7 of the largest US tech names are up around 50% year to date, while the rest of the US equity market is flat. The launch of artificial intelligence technologies such as ChatGPT, has created enormous buzz and excitement around potential productivity gains and outsized future earnings of companies across the tech value chain. Unfortunately, when equity recoveries have been this narrow in the past, they have rarely been sustained.

We remain patient and cautious in our positioning. The economic challenges that have been building over the course of the year have not dissipated, rather we think have only been pushed out into the second half of the year. Cost of living pressures (in the form of higher mortgage costs, food & energy prices) are likely to eventually take their toll on the consumer, and ultimately company earnings as the year progresses. New Zealand and Germany have already entered a technical recession, with two consecutive quarters of negative growth, while Australia and the US are also staring down weaker growth prospects. Yield curves in both countries are inverted, historically a pretty reliable indicator of impending recession.

Financial conditions are likely to remain tight as central banks keep a foot on the brake via quantitative tightening and continue their hawkish rhetoric, signalling the potential for further rate rises. While valuations are looking more appealing across a number of asset classes including Australian equities, tight financial conditions coupled with a weakening cyclical environment lead us to believe that the second half of 2023 continues to present some headwinds for risk assets.

While our models are not yet anticipating a deep recession, a period of sub-trend growth warrants a slightly more defensive portfolio positioning. We have neutralised our slightly underweight position in global fixed income, funded by closing out our slightly overweight positions in global listed infrastructure and alternatives. From a valuation perspective, bonds are now looking closer to fair value, and we support the view that traditional fixed income can once again play a defensive role in a diversified the portfolio. We believe that building in some extra defence into the portfolios is prudent as we move into a period of weaker growth.

Market developments during July 2023 included:

Australian Equities
The S&P/ASX 200 Accumulation Index finished June up 1.8%. Materials led all sectors, finishing up 4.8%. Information Technology (I.T.) rose again (+3.5%), with Financials (+3.1%), Utilities and Consumer Staples (both +2.9%) also posting healthy gains. Health Care (-6.6%) fell significantly, dragged down by an announcement from its largest constituent, CSL, that forthcoming foreign currency headwinds were expected to be higher than previously estimated. Despite an extensive list of economic headwinds, the Index finished the Financial Year up 14.8%.

I.T. shares continued to ride the artificial intelligence (AI) wave and followed the gains that were seen globally in the sector; through the Financial Year it led all sectors, gaining 38%.

Chinese data releases solidified the weakening activity there and led to action to further stimulate the economy, helping Materials to lead the month. Meanwhile, a tight labour market and sticky inflation have seemingly increased the likelihood of further RBA cash hikes, mitigating the gains in those sectors sensitive to interest rates.

In May, all Factors performed positively led by Dividend Opportunities (+4.0%), which was also a strong gainer over the Financial Year (+15.6%). Momentum (+2.8%) and Quality (+2.6%) were other strong performing Factors in June.

Global Equities
Global equities had another positive month, while emerging markets underperformed developed market counterparts returning 0.9% (MSCI Emerging Markets Index (AUD)) versus a 3.1% gain according to the MSCI World Ex Australia Index (AUD).

The U.S had one of its better performances of the year, driven in part by the Federal Reserve holding interest rates steady for the first time in over 12 months. This was supplemented with sustained strides in the technology sector. Large caps led a gain of 6.6% in the S&P500 Index (in local currency terms).

Equities across Asia were relatively strong, Japanese stocks continued to rally with sound economic data around production levels across industries. The Nikkei 225 Index reached new highs again with a gain of 7.6% for the month (in local currency terms) despite potential concerns around inflation and yield curve control. China’s economic growth recovery efforts see optimistic levels of manufacturing and industrial production, with the Central Bank releasing cuts to lending rates. This was reflected by the Hang Seng Index and the CSI 300

Index, returning 4.5% and 2.1% respectively (in local currency terms) for the month.

Fixed Interest
For the first time in over a decade the Australian yield curve has inverted, with growing market concern around the possibility of a recession. The RBA continues to tighten monetary policy and has lifted the cash rate by 25bps in its June 6 meeting, bringing the target cash rate to 4.1%. The cash rate is now 375bps higher than what it was 12 months ago. The market responded with Australian 2-Year and 10-Year bond yields rising by 66bps and 68bps respectively, their highest levels in a decade. Higher yields led to losses in fixed income markets, with the Bloomberg AusBond Composite 0+ Yr Index returning -1.95% over the month.

In the US, the Federal Reserve voted to maintain the May federal funds rate of 5%-5.25%. Despite the reprieve of a rate hike, fixed income markets fell, and US 10-Year and 2-Year Treasury yields rose by 49bps and 41bps, respectively. Globally, fixed income markets performed largely the same with the Bloomberg Barclays Global Aggregate Index (AUD) returning -2.79% over June. Yield curve inversion seems to be a major trend with looming threats of further rate hikes, weak consumer confidence, and recession.

REITs (listed property securities)
The S&P/ASX 200 A-REIT Accumulation index was relatively neutral in June finishing the month 5bps lower. Global real estate equities (represented by the FTSE EPRA/NAREIT Developed Ex Australia Index (AUD Hedged)) performed strongly, returning 3.2%, driven by a surge in the office sector (+10.4%), following a positive reception of a New York transaction. Australian infrastructure continued its positive momentum during June, with the S&P/ASX Infrastructure Index TR advancing +0.6% for the month.

June saw a range of M&A and capital-raising activity across the A-REIT sector. Abacus Property Group (ASX:ABP) successfully launched their Abacus Storage King (ASX: ASK) REIT raising $225mn in the first stage. Centuria Capital Group (ASX: CNI) announced the acquisition of the Busselton Boulevard Shopping Centre in WA for $16mn which will underpin a new single-asset closed-ended wholesale property fund. Dexus (ASX: DXS) announced the sale of two major assets. The first of which is 44 Market St Sydney for a price of $393mn which represents a 17.2% discount to the December valuation. The second sale was Axxess Corporate Park, Mount Waverly, Victoria for $306.2mn, reflecting a 7.4% discount to its December valuation. The two sales bring the total divestments announced during FY23 for Dexus to $1.5bn.

The Australian residential property market experienced an increase by +1.3% Month on Month (as represented by CoreLogic's five capital city aggregate). Sydney was the biggest riser (+1.8%) alongside Brisbane (+1.4%) also performing strongly. All five capital cities performed positively for the second consecutive month.

Alternatives
Preliminary estimates for June indicate that the index increased by 0.2 per cent (on a monthly average basis) in SDR terms, after decreasing by 6.0 per cent in May (revised). The non-rural sub-index increased in the month, while the rural and base metals sub-indices decreased. In Australian dollar terms, the index decreased by 1.3 per cent in June.

Over the past year, the index has decreased by 21.5 per cent in SDR terms, led by lower thermal coal, coking coal, liquified natural gas and iron ore prices. The index has decreased by 18.1 per cent in Australian dollar terms.

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