Lonsec Client Newsletter - June 2023

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Summary of Key Views

Insights from our CIO: Cloudy skies and left tails

Inflation is likely to ease substantially in the coming months as base effects roll off and tighter credit conditions hit consumption and aggregate demand. Services inflation, rent rises and wage pressures however persist, meaning inflation could remain sticky and above central bank target ranges for some time. Financial conditions are therefore likely to remain tight as central banks keep a foot on the brake while managing pockets of stress via targeted liquidity support. Domestically, a large number of home borrowers will roll off ultra-low fixed rate home loans onto significantly higher mortgage rates in the coming months. This means there is more tightening to come for the Australian household sector irrespective of how much higher the RBA takes the cash rate.

Consumer confidence remains weak both here and in the US, and with the cash buffers built up during the pandemic largely eroded, signs that economic growth has begun to slow have emerged. US GDP came in well below expectations at +1.1% (annualised) for the first quarter.

The ongoing debate on raising the US debt ceiling, while closer to resolution at the time of writing, is not yet a done deal and represents additional left-tail risk to an already clouded outlook. Our base case is that this issue will be resolved, allowing the US government to meet its financial obligations. However, the combative nature of the current US political arena means a stalemate cannot be ruled out entirely. Failure to reach agreement would have severe ramifications across equity, bond and currency markets.

On a positive note, valuations are looking more appealing across a range of asset classes. Australian equity valuations are almost looking as attractive as they were during the peak stresses of the pandemic on a P/E basis. 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 notwithstanding the more attractive valuations we are seeing.

We remain cautious, and close to benchmark with a slight underweight in global equities. In the current environment, a focus on quality investments, liquidity, active portfolio management, diversification and risk control become even more critical for portfolio constructors. We continue to monitor developments regarding inflation, monetary policy and the global economy, and will adjust our portfolios, as necessary, to navigate through the challenges and opportunities ahead.

Market developments during May 2023 included:

Australian Equities

In May the S&P/ASX 200 Accumulation Index finished with a loss of 2.5%. Rising costs have begun to materialise for consumers as retail turnover plateaued, with another RBA hike and a fall in the iron ore price also impacting returns. Information Technology (I.T.) shares rose significantly (+11.6%), with Utilities making the only other meaningful jump (+1.1%). Consumer Discretionary (-6.1%) and Staples (-4.6%) were noteworthy laggards. Materials (-4.4%) and Financials ex-Property (-3.3%) also dragged on the Index. In total, 7 of the 11 sectors posted losses. I.T. advanced on the positive news from some of its names, while attention on the rise of artificial intelligence also aided gains. Meanwhile, retail spending data led to investors positioning for a slowdown, as cost of living pressures saw consumers pull back on non-essential shopping. As doubts linger around the economic recovery in China, the sliding price of iron ore hampered Materials. Financials ex-Property were pushed down by poor US banking sentiment, as well as concerns about the domestic outlook for earnings and margins.

In May, all Factors performed negatively. Growth (-2.8%) and Momentum (-2.7%) were the worst performers. Over 12 months, Quality (+5.2%) and Value (+4.8%) have been the best performing Factors in the Index.

Global Equities

Global equities ended with a predominantly negative month with declining economic data. Emerging markets underperformed developed market counterparts returning 0.4% (MSCI Emerging Markets Index (AUD)) versus a 1.2% gain according to the MSCI World Ex Australia Index (AUD).

The U.S. markets had mixed results, with the debt ceiling debate being suspended on top of another expected rate hike. Lower unemployment and promising developments in the technology sector, particularly artificial intelligence and chipmakers, led a positive gain of 0.4% in the S&P500 Index (in local currency terms).

Equities across Asia were also mixed, Japanese stocks became more attractive for investors with sound earnings results with share buyback announcements for large cap stocks. The Nikkei 225 Index reached new highs with a gain of 7.0% for the month (in local currency terms). China's economic growth recovery continued to perform beneath investors' expectations with demand also decreasing. This was reflected by the Hang Seng Index and the CSI 300 Index, returning -7.9%

and -5.6% respectively (in local currency terms) for the month. Investors are waiting for stronger indications of an economic recovery in China, potentially led by the technology sector.

Fixed Interest
Credit markets saw a decline as interest rates rose again in May when the Reserve Bank of Australia increased the official cash rate from 3.60% to 3.85%, leading to a -1.21% return of the Bloomberg AusBond Composite 0+ Yr Index. Over the course of the month, spreads widened as Australian 2Y and 10Y Bond yields rose by 50bps and 27bps, respectively. Persistent inflation pressures along with a strong labour market and rising wages have the potential to keep inflation rates above the RBA target for an extended period.

Global markets were taken aback in early March by the unexpected failure of three small- to mid- size US banks, followed by the collapse of Credit Suisse. The effects from the March turmoil continue to affect markets with the Bloomberg Barclays Global Aggregate Index (AUD hedged) returning -0.54% over May. In a decision widely expected by markets, the U.S Federal Reserve again increased rates by 25bps bringing the federal funds rate to a target of 5.0%-5.25%. Bond yields continued to grow with US 2Y and 10Y Treasury Note yields rising 45bps and 22bps, respectively.

REITs (listed property securities)
The S&P/ASX 200 A-REIT Accumulation index regressed in May after a strong rally in April, with the index finishing the month –1.8% lower. Global real estate equities (represented by the FTSE EPRA/NAREIT Developed Ex Australia Index (AUD Hedged)) also regressed, returning -3.8% for the month. Australian infrastructure continued its positive momentum during May, with the S&P/ASX Infrastructure Index TR advancing +1.5% for the month.

May was relatively quiet across the A-REIT sector. Some activity includes Abacus Property Group (ASX:ABP) announcing their intentions to conduct a de-stapling, creating a new ASX-listed, Self-Storage REIT. The new REIT will be known as Abacus Storage King (ASX: ASK), with Abacus to remain listed on the ASX under a new ticker, ABG. Growth Point Properties (ASX: GOZ) completed an on market buy-back, acquiring over 19 million securities (2.5% of shares on issue) for a total consideration of $60.5 million.

The Australian residential property market experienced an increase by +1.4% 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 in the month for the first time in over two years.

Alternatives
Preliminary estimates for May indicate that the index decreased by 6.9 per cent (on a monthly average basis) in SDR terms, after decreasing by 5.1 per cent in April (revised). All sub-indices decreased. In Australian dollar terms, the index decreased by 6.8 per cent in May. Over the past year, the index has decreased by 22.2 per cent in SDR terms, led by lower coking coal, thermal coal, iron ore and liquified natural gas prices. The index has decreased by 17.5 per cent in Australian dollar terms.