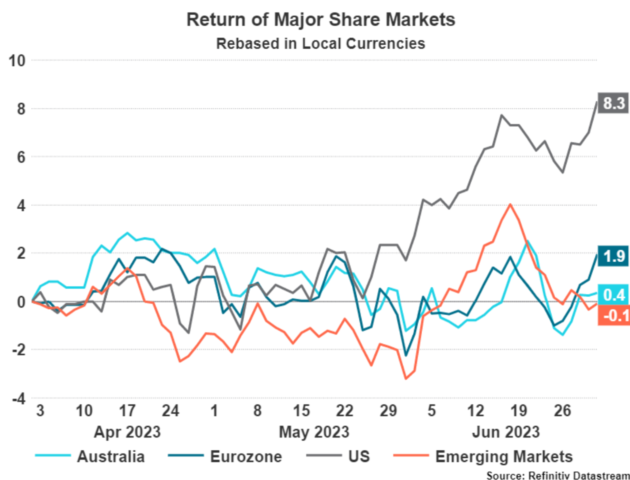
MARKET AND ECONOMIC UPDATE

June Quarter 2023

1. MARKETS IN REVIEW

In a year that seems to have no dull moments, equity markets stayed relatively flat for most of the last quarter of the 2023 Financial Year.

However, in late May and June, it was entirely different for the United States (U.S.), which saw an 8.3% increase for the quarter. Europe (1.9%), Australia (0.4%), and Emerging Markets (-0.1%) experienced much more subdued changes to close out the Financial Year.



The drivers of these late-quarter returns were initially the mega-cap growth stocks in the U.S. However, a broader rally across various sectors, sizes, and styles of stocks took place through June, buoyed by growing confidence in the U.S. economy. The NASDAQ set a record for half-yearly returns since its inception in 1985, achieving approximately a 39% increase during the first half of 2023 - a remarkable feat given the backdrop of an uncertain economic environment. Companies like Apple, Microsoft, Tesla, Netflix, and Amazon were primarily responsible for this surge, illustrating the trend that 'the big keep getting bigger'. Meanwhile, other markets remained flat as the focus stayed firmly on the uncertain monetary policy.

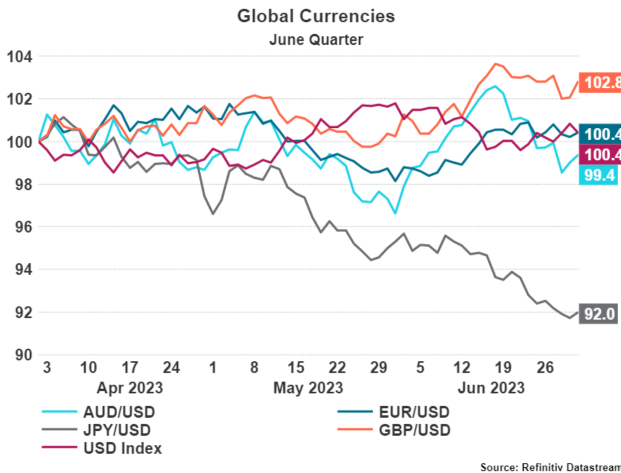
2. AUSTRALIAN SECTOR RETURNS

Once again, Australian returns were somewhat lacklustre compared to the U.S. and Europe, with the heavily weighted sectors of materials and financials providing -2.5% and 0.8% returns, respectively. Technology caught the tailwinds of the global technology rally that occurred during the quarter, gaining 21.2%, with utilities (4.9%) and real estate (4.2%) following at a distance.

Domestically, consumer discretionary, a highly economically sensitive sector, fell by 2.5%. However, consumer discretionary stocks remained quite strong in global markets. This contrast could indicate that Australian households are feeling the impact of higher interest rates, which has implications for household spending as mortgages shift to variable rates and repayments increase significantly.

3. FOREIGN EXCHANGE MARKETS

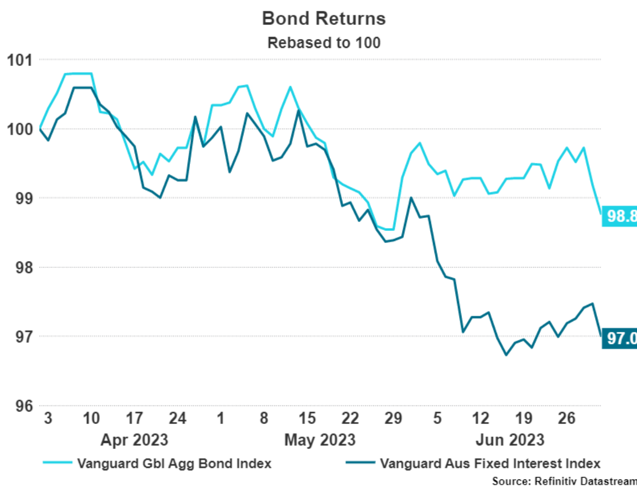
Currency markets were relatively stable during the quarter, except for the Japanese Yen (JPY), which fell a significant 8% against the United States Dollar (USD). The Australian Dollar (AUD) fell 0.6%, while both the USD Index and the Euro rose 0.4%.



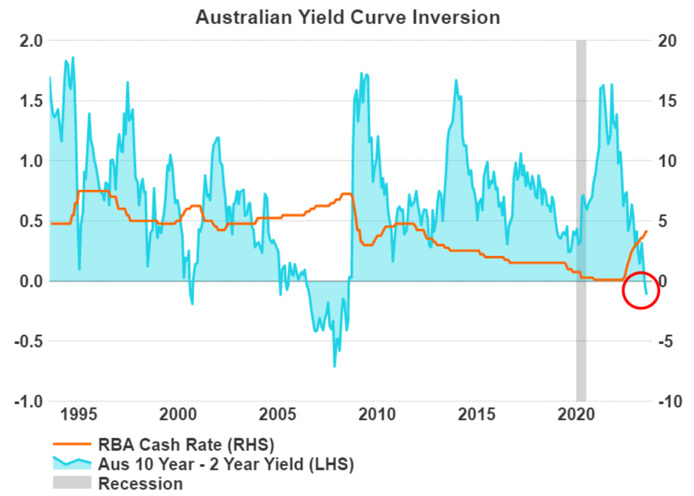
The Bank of Japan's refusal to substantially increase interest rates in the face of a global inflation tidal wave has caused significant devaluation of their currency. Investors have since moved capital into overseas markets to secure better interest rates. Since the beginning of 2022, the Yen has lost over 20% of its value in U.S. Dollars.

4. FIXED INCOME MARKETS

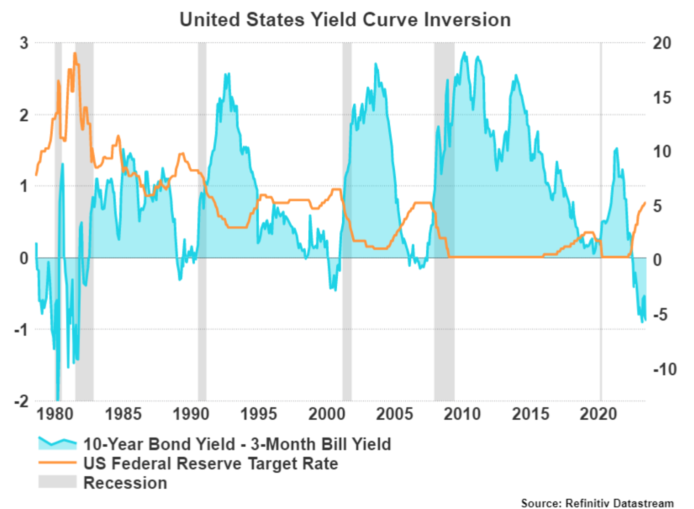
Both domestic and international fixed income markets had a challenging quarter, with Australian bonds returning -3% and international bonds -1.2%.



Australian bonds were negatively affected by the anticipation of higher interest rates over a longer period. This occurred more on the short end of the yield curve than the long end, resulting in Australia's first yield curve inversion in the past 15 years. This means that interest rates on the two-year bond are now higher than those on the ten-year bond, a situation often seen as a precursor to a recession.



The inversion on United States government bonds has now reached extreme levels, unseen since the 1970s/80s, and much deeper than that of the Australian curves.

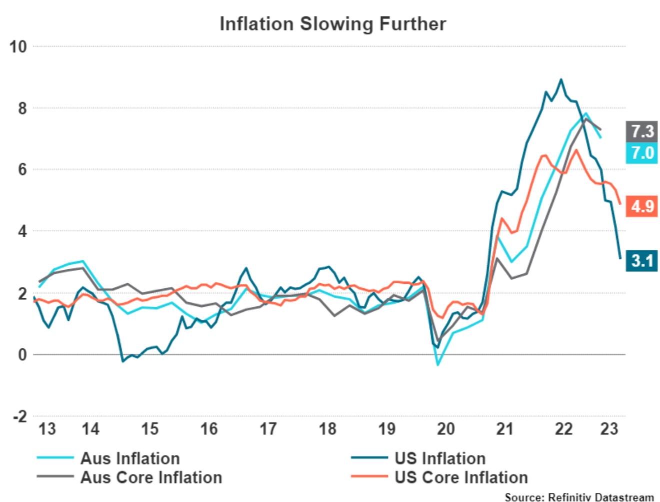


When these curves invert, it typically suggests that markets anticipate much slower economic growth in the future due to high short-term interest rates.

5. OUTLOOK

The global macroeconomic picture continues to be marred by the already evident and future impacts from the record-breaking interest rate hiking cycle that has taken place in most major economies (except Japan). As we've stated for some time now, the impacts on economic growth will continue to be felt in economies until central banks shift their focus more towards rate cuts. However, that could still be a while away.

Interestingly, there is substantial evidence suggesting that the worst of the inflationary crisis is behind us.



As we've previously discussed in webinars and masterclasses, we anticipated inflation would start to ease due to signs of both supply coming back online and demand cooling. The U.S.'s headline inflation rate (including volatile food and energy prices) is now sitting at 3.1%. This is nearly a full retracement from the 9.1% figure seen last year. Core inflation, which excludes food and energy, remains high but is trending downward. In Australia, we lagged the U.S. on the way up and will likely do the same on the way down. We expect this number to continue to gradually fall from the current elevated 7% level.

Before the war on inflation can be declared 'won', central banks will need to see these numbers fall and stay low. There's a good chance we may see some unexpected inflationary spikes as we journey back towards 2% (the central bank targets).

So, where does this leave fixed income, equity markets, and the economy as a whole?

Fixed income remains suppressed, but in our opinion, provides good value at these prices. If the global economy continues to slow, which we anticipate it will, bonds should offer some protection against this. The key point to remember is that interest rates can't stay at these elevated levels forever. Some relief will have to come in the future.

Equity markets are a mixed bag as falling rates would be seen as positive, but economic slowdowns will reduce earnings. We remain generally cautious here and believe different pockets of the market will perform better than others at different times. We didn't expect a 39% increase in the Nasdaq this year, though. Keep in mind that this was primarily driven by the FAANG stocks, which soared on the back of cooling inflation and AI-mania.

Maintaining diversification across regions, styles, and sectors should be employed here due to the unpredictability of future outcomes. Our research indicates that it's wise to have a low-volatility manager within both domestic and international equity allocations to cushion against future volatility. We are pairing this with both value and growth managers who focus on high-quality companies that tend to stay more resilient during economic downturns.

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