GPS Wealth

GPS Wealth Monthly Market Update

# The Unusually Wide Distribution of Outcomes

INFORMATION CONTAINED IN THIS REPORT CURRENT AS AT 17 OCTOBER 2022

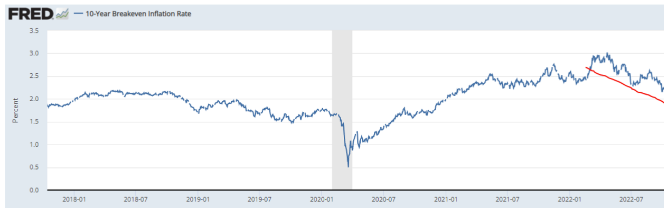
September was a difficult month for financial markets. Bond, share and property markets continued to endure severe volatility within their continued downtrend. In the US, the S&P 500 returned -9.4% over the month, driven by the stronger than expected US inflation data which saw a rise in core inflation. It raised expectations that the central bank would need to raise interest rates by more than had previously been anticipated by market analysts. The Federal Reserve subsequently raised the official cash rate, known as the Fed Funds rate, by 0.75% to 3.25%. However, the FOMC dot plot which outlines what each U.S. central banker thinks will be the appropriate Fed Funds rate at the end of each calendar year three years into the future, it was raised to reflect that the committee expected more tightening would be necessary. The higher rates go, the higher the probability of recession which will ultimately reflect poorly on company profits in the future. The forward paths of inflation, economic growth, interest rates, profits and valuations are changing daily with a wide distribution of potential outcomes in 2023 and it is the wide distribution of potential outcomes that are keeping financial markets volatile.

> The good news is that economic data in the US is slowing suggesting that the central bank will soon pause and assess the economy for signs of whether it has done enough to cool the economy without a recession.

The Conference Board's Leading Economic Index, an indicator of what the economy will look like in 6-9 months time, declined for the sixth consecutive month in August confirming our anticipated slowdown. Housing has been driven into recession by the spectacular surge in mortgage rates and it is hard to believe that companies are not going to cut costs, given the surge in borrowing expense due to higher interest rates. Whilst the labour market remains robust, it is potentially starting to show some early signs of weakness. Companies' job postings have fallen sharply, layoffs are creeping up and job creation has slowed to its lowest level in nearly 18 months.

Market-based indicators are also signalling that economic conditions are worsening. The yield difference between the 10-year and 2-year bond is currently -0.43%, consistent with a recessionary signal. There are even a wide range of indicators that suggest a decline in inflation is already in the pipeline like the breakeven inflation rate which has been retreating all year as shown in the graph below. The breakeven inflation rate provides a look at possible inflation trends in the future.

**Emmanuel Calligeris**
Chairman of the Investment Committee




*Source: The Federal Reserve Bank of St Louis*

The New York Federal Reserve's own inflation gauge is in retreat also, and as mentioned last month, the fall in commodity prices usually correlates well with a drop in inflation. The National Federation of Independent Business report (the voice for small business in the US) show firms losing pricing power quickly, and the collapse in money growth has been as significant as last year's surge. All this means that the official Fed Funds rate will pause and this may give relief to oversold asset markets.

In Australia the Reserve Bank Board raised the cash rate by 0.25% to 2.60% at its October meeting. This was a lower increase than many expected and reflects the view that growth is slowing and the Governor's current assessment that inflation pressures, particularly wages growth are much more subdued in Australia than overseas. The recent pulse of the housing sector was consistent with a general economic slowdown. The correction in house prices deepened and broadened across Australia, with capital city prices falling by 1.4% in September, rounding out a 4.3% decline over the third quarter. Indeed, housing finance approvals also continued to mirror the broader correction to date, with further declines across investor and owner-occupier loans signalling a clear moderation in housing credit moving into year end. On a positive note, the Westpac- Melbourne Institute index of consumer sentiment seemed to find a base over the quarter, rising 3.9% to 84.4 in the September month, the first increase since November 2021.

> The Index remains at weak levels reflecting consumer cautiousness around the outlook for interest rates and increase in the fuel excise although labour market conditions appear to be providing some support.

The Chinese economy has recovered slightly due to more flexible Covid measures which have resulted in shorter quarantine periods and more localised lockdowns, which have had less impact on the labour force than the measures imposed a few months ago. Consumers have shown a willingness to buy electric vehicles with government subsidies and are also eating out more although the data suggests that they are still reluctant to buy luxury items. Retail sales increased in the latest month to 5.4%. However, the real estate crisis will put pressure on economic growth if home sales do not pick up. In the real estate market, some local governments have been pairing with property developers to finish uncompleted projects. However, an improvement in market sentiment will only occur if some of the larger projects are finished to a high standard.

Infrastructure stimulus has yet to impact growth as local government spending has been split between finishing uncompleted homes and infrastructure investment. Facing both a Covid crisis and a real estate crisis, local governments with limited fiscal resources had to prioritise what to deal with first. For most of them, the more urgent problem has been the stagnation in housing starts - and thus the drop in land auctions, which have traditionally provided local governments with the revenue they need to run their projects. This explains the delay in infrastructure projects despite completed funding for the projects. Despite the central government calling for an increase in infrastructure investment, only a few local governments have accelerated spending preferring to invest in existing projects, as opposed to new ones.

Europe remains in the grip of an energy crisis, with the suspected sabotage of the Nord Stream pipelines virtually ensuring a shortage of natural gas this winter and sharply rising costs for consumers.

> There is a real risk of recession, placing the ECB in a dilemma and it remains to be seen how much pain it is willing to inflict in its pursuit of lower inflation which hit 10% in September.

With the uncertainty caused by the UK front of mind, European lawmakers now know what can happen when jittery markets are presented with poor communication, mixed messaging, and poor execution.

In the UK, the government's unfunded mini budget has put the Bank of England in a bind. The bond market reaction was so severe that the Bank of England was forced to step in to purchase bonds to stem the fall in prices and stave off a threatening insolvency of multiple pension funds. A swift about-face from the government has relieved some of the pressure on the GBP and the bond market however trust issues with the new PM and Chancellor will linger for some time. Investors are pricing that the Bank Rate will reach over 5% by March 2023 (currently 2.25%) and over 1% worth of interest rate increase is priced in for the November meeting alone. If the Bank follows through with this amount of tightening, then there's a clear risk of turbulence for borrowers. Two-year mortgage rates are already tipping over 5%, and at the very least that's likely to see a dramatic slowdown in housing transactions. The unemployment rate fell to a post-1970s low of 3.5%, while wage growth accelerated. Although long term sickness continues to draw people away from the labour market – explaining the employment picture, the Bank of England will ultimately view this through the lens of labour shortages and tighten at the cost of the housing market.

As mentioned above bond share and property markets all retreated in September with volatility high as macroeconomic and geopolitical concerns continued to weigh on investor sentiment. International shares fared better than Australian Shares as the Australian dollar weakened against the US dollar.

> Financial markets are likely to remain volatile as investors continue to assess the risk of rising interest rates and high inflation onto 2023.

While company profits, generally remain strong, rising interest rates are likely to lead to reduced consumer spending and lower demand, which will impact the profits of many companies - particularly companies exposed to cyclical sectors such as home building and discretionary retail including Harvey Norman, Wesfarmers and JB Hi-Fi.

# Returns

30th September 2022

## ASSET CLASS RETURNS ARE BASED ON

**Australian Cash**
RBA Bank accepted Bills 90 Days

**Australian Bonds**
Bloomberg AusBond Composite 0+ Yr TR AUD

**International Bonds Hedged**
BarCap Global Aggregate TR Hdg AUD

**Australian Listed Property**
S&P/ASX 200 A-REIT TR

**International Property Hedged**
FTSE EPRA/NAREIT Dv REITS TR Hdg AUD

**Australian Shares**
S&P/ASX 200 TR

**International Shares**
MSCI World Ex Australia NR AUD

**Emerging Market Shares**
MSCI EM GR AUD

## RETURNS TO THE 30TH SEPTEMBER 2022

| | 1 Month | 3 Months | 6 Months | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|---|
| Australian Cash | 0.22 | 0.59 | 0.84 | 0.88 | 0.46 | 0.97 | 1.66 |
| Australian Bonds | -1.36 | -0.64 | -4.43 | -11.36 | -3.42 | 0.75 | 2.31 |
| International Bonds Hedged | -3.50 | -3.78 | -8.27 | -12.81 | -3.63 | -0.17 | 2.43 |
| Australian Listed Property | -13.60 | -6.72 | -23.22 | -21.48 | -5.28 | 2.61 | 7.68 |
| International Property Hedged | -12.06 | -10.27 | -24.48 | -18.20 | -5.66 | 0.77 | 5.98 |
| Australian Shares | -6.17 | 0.39 | -11.56 | -7.69 | 2.67 | 6.76 | 8.41 |
| International Shares | -3.23 | 0.35 | -8.11 | -9.79 | 6.33 | 9.65 | 13.59 |
| Emerging Market Shares | -5.87 | -5.42 | -8.54 | -19.24 | -0.49 | 2.18 | 6.03 |

GPS Wealth Ltd | AFSL 254 544

Level 7, 115 Pitt Street, Sydney NSW 2000

+61 2 8074 8599

info@gpswealth.com.au

www.gpswealth.com.au

**Prepared by DWA Managed Accounts Pty Ltd**

ABN 89 104 065 250 | AFSL 264 125

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