February 2023

Sticky inflation suggests more interest rate increases

INFORMATION CONTAINED IN THIS REPORT CURRENT AS AT 15TH MARCH 2023

Markets have become volatile once again as investors grapple with the dual threats of stickier inflation and uncertainty over systemic risk after the collapse of Silicon Valley Bank (SVB). Events around SVB are likely to continue dominating the attention of investors as the extent of the fallout is measured. In the US, the 2-year bond yield decreased 0.48% in two days. It recorded 5.07% before falling back to 4.59% effectively removing the expectation that the Federal Reserve's next move was likely to be an increase of 50 basis points. That move at the time of writing had been priced out of the interest rate market. The US 10yr bond yield fell 0.29% to 3.45%.

> Although depositors have been protected and have access to their funds, the demise of SVB does not reflect general weakness in the U.S. economy or in the banking system.

Rather SVB's unusual mix of assets and liabilities made it particularly vulnerable to the Federal Reserve's aggressive tightening. There is however the possibility of some contagion risk to other financial institutions which markets will try to ferret out in the days and weeks ahead.

Outside of the recent SVB collapse, the strength of the US economy surprised markets. Whilst activity in manufacturing continued to contract, the services sector appeared to have grown robustly. Consumer prices increased by 6% over the year which was a slower pace than the 6.4% annualised gain in January but still far off the Federal Reserve's target of 2%.

> The core CPI remained elevated and suggests that further interest rate rises will be required.

The payroll report for February was also strong and continued to point to a tight labour market with wage growth contained. However, company announcements of redundancies suggest some loosening and average hourly earnings may be understated. There has been more noticeable evidence layoffs in sectors like technology finally appearing in hard labour market data (even if they have not been reflected in jobless claims). Information sector employment has fallen by 50 thousand jobs in the last two months, while employment in leisure and hospitality has risen by about 220 thousand jobs. The information sector has the highest average wage while leisure and hospitality have the lowest. The shift away from higher-than-average to lower-than-average employment will bias total average hourly earnings lower. US retail sales also showed strength - increasing by 3% in January. The latest reading was one of

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the highest increases in the past 20 years and beat economists' forecasts of a 1.8% rise. It showed that despite rising inflation, US consumers are still spending.

In Europe, the downward revisions of German GDP growth in the fourth quarter have shown that the eurozone might not have avoided recession after all. And even though confidence indicators have improved, still weak current assessments and the high inventory build-up simply preclude too much optimism. Headline inflation in the Eurozone fell for the fourth successive month to 8.5%. However, the decrease was less than the market expectation of a fall to 8.2%. It reinforced the hawkish tone from the European Central Bank. While the pace of energy prices declined, food price inflation accelerated. Core inflation recorded 5.6% during the month, up from 5.3% in January, although this was, to some extent, presaged by the increase in both French and Spanish inflation earlier in the week. The ECB indicated that it will likely continue to raise rates beyond March as it was "much too early to declare victory" over inflation.

> Policymakers still believe that the risks to inflation are on the upside and there is currently little danger of over-tightening given the surprising resilience of the economy.

China's economic reopening appears to be a gradual one. Consumption was very strong in January but was more subdued in February. Despite the lifting of the Covid-19 restrictions, China's imports entered a deeper contraction reflecting a slower pace of infrastructure recovery and lower than expected domestic demand. Despite the economic lethargy, consumption strength is likely to increase following an improving jobs market and an increase in wages. There will be a lot of attention on the Two Sessions given that it is a year of new government personnel even though President Xi Jinping remains the leader.

> The Two Sessions will give us many hints on policy direction, and how that will affect different sectors.

In Japan, annual consumer inflation climbed from 4.0% in December to a 41-year high of 4.3% in January, primarily due to higher imported raw material prices and the effects of the yen's weakness. Core inflation posted a similar increase, driving the yield on the 10-year government bond above the 0.5% cap imposed by the Bank of Japan (BoJ). The central bank has been actively buying bonds to protect the 0.5% cap as part of its yield curve control policy. However, many investors expect it to abandon this policy once the newly elected governor Ueda takes up the reins from Kuroda in April. The unemployment rate stood at 2.4% in January (vs 2.5% in December), the lowest since the pre-pandemic level in February 2020. The jobs-to-applications ratio fell to 1.35 (vs 1.36 in December), marking the first decline since August 2020. We believe that the employment situation is improving, especially in the service industry such as accommodation and restaurant services, thanks to the recovery of tourism demand due to the government's travel voucher – essentially a gift card given to Japanese residents to use on domestic travel – and the return of foreign tourists. However, manufacturing jobs will likely decline as exports are expected to be sluggish. Although some companies face labour shortages, they are reluctant to hire for new positions because their margins have been squeezed with higher input costs.

> If inflation remains elevated and the yield curve control remains in place, it could lead to a period of further weakness for the yen.

Domestically, the Reserve Bank Board raised the cash rate by 0.25% to 3.6% at the March meeting. The Westpac/Melbourne Institute reading of consumer sentiment remained at deeply pessimistic because of tighter monetary policy whilst business conditions have held up according to the NAB Business Survey. There is growing evidence that goods prices are easing as supply chain disruptions and shipping costs normalise.

NAB notes there is little evidence to suggest services prices are easing for customers.

Demand remains fairly resilient in the services sector in early 2023. Australian property prices, as measured by CoreLogic's National Home Value Index, fell by 0.14% in February which is the smallest amount since rate hikes commenced in May 2022. Sydney property prices were firmer. Whilst households are increasingly concerned for their financial situation, the actual performance of mortgage or asset backed loan books is still strong with arrears and other distress metrics remaining below pre-Covid levels. Credit growth is slowing and credit card loan balances are declining suggesting the economy is likely to record below trend growth in 2023.

The S&P/ASX 200 Total Return Index decreased 2.45% in February as the higher interest rates continued to squeeze the economy. Utilities (+3.4%) was the best performing sector over the month while Financials (-3.1%) and Materials (-6.7%) lagged the broader market. At a stock level, the best performers included Orora Limited (+18.5%), Medibank Private (+13.6%), and Steadfast Group (+11.3%) while Domino's Pizza (-34.0%), AMP Limited (-22.5%) and The Star Entertainment (-17.5%) were amongst the biggest laggards.

We continue to expect that the US Federal Reserve and the Reserve Bank of Australia have not finished tightening policy this cycle, however, both are likely to be less aggressive as a consequence of the collapse of Silicon Valley Bank.

As mentioned last month, there is no doubt that inflation is on a lower trajectory globally following the sharp spike in 2022. However, core inflation will be the measure to watch in 2023 as wage pressures continue due to low unemployment.

Returns

28th February 2023

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 28TH FEBRUARY 2023

	1 Month	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Australian Cash	0.26	0.81	1.53	2.17	0.77	1.09	1.67
Australian Bonds	-1.32	-0.69	0.39	-6.37	-3.44	0.82	2.44
International Bonds Hedged	-1.80	-1.04	-2.62	-9.40	-4.05	0.02	2.30
Australian Listed Property	-0.26	3.43	3.89	-6.52	0.66	6.27	8.12
International Property Hedged	-3.75	0.11	-4.04	-12.96	-0.47	3.77	5.81
Australian Shares	-2.45	0.30	6.37	7.16	7.93	7.90	7.95
International Shares	2.09	-0.65	5.73	-0.48	8.27	10.06	13.59
Emerging Market Shares	-2.28	-1.20	-0.66	-8.84	-0.53	1.01	5.84

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