May 2023

Monthly Market Update

Financial conditions will likely remain tight for the remainder of 2023

INFORMATION CONTAINED IN THIS REPORT CURRENT AS AT 13 JUNE 2023

In May, investment markets were unsettled by the continuing brinkmanship over the US debt ceiling, talks of a US recession and lingering inflation. As we wrote in last month's update, we had no doubt that the ceiling would be raised, as it eventually was, however the cost would come in the form of higher interest rates on government debt. The Australian share market returned -2.5% driven by the banks and resource companies. NAB decreased 11.03% over the month whilst Fortescue Metals was -8.26% lower. The primary risk facing Australian banks remains a shrinking net interest margin (NIM) due to intense competition in the mortgage and deposit market, concerns about commercial property, and disruptive FinTech solutions like Apple's new merchant acceptance system. Global shares increased 1.2%. **The increase was narrow, driven predominantly global technology giants including Alphabet, Microsoft and Amazon.** Nvidia - a dominant supplier of artificial intelligence hardware and software, receive "incredible orders" for its chips and software used in data centres to power the computing-intensive requirements of generative AI. The increasing popularity of applications, such as Chat-GPT and Bard, has led to the remarkable growth in orders.

In the US, the Federal Reserve maintained its hawkish rhetoric that interest rates would increase further as the economy remained resilient and inflation high. Retail sales excluding motor vehicles, building materials and food services rebounded strongly, while factory production and homebuilding picked up. Home sales for April hit a 13-month high. The first quarter GDP growth was revised upwards to +1.3% (vs. 1.1% previously), whilst core Personal Consumption Expenditure (PCE) – the Federal Reserve's preferred measure of inflation, was revised up to +5.0% from +4.9% previously. Lastly, the most recent read on the labour market showed that the employment market remains buoyant. Together, these factors resulted in the US 10-year bond yield increasing from 3.3% to a high point of 3.82% before settling back to 3.64% at the end of May. Short dated bond yields also moved higher (prices lower) on expectations of further tightening in monetary policy.

The Australian bond market decreased -1.2% (bond yields moved higher) despite GDP data showing a slowing economy. Australian GDP slowed to a tepid 0.2% in the first quarter to be 2.3% over the year as the headwinds of high inflation and rising interest rates led to a decline in real household disposable income and a resulting deceleration in consumer spending. Government spending rose and remains at an elevated share of GDP, albeit off the highs reached during the pandemic. **The continued economic slowdown underscores our cautious outlook on the Australian share market.** The Australian consumer continues to come under intense pressure. The trilogy of

Emmanuel Calligeris
Chairman of the Investment Committee

inflation, higher interest rates and fiscal tightening is seeing the biggest annual contraction in real disposable incomes in forty years, with no let-up in sight. 'Big ticket' discretionary spending (appliances and furniture) is being wound back sharply. The offsetting gains in the quarter centred on utilities and transport (including tourism-related travel). Notably, spending has now recorded two material quarterly declines in per capita terms. The spending that has been seen, has been funded by lower savings and a run-down of the large reserves accumulated during the pandemic. This looks to have less scope to provide support going forward as the savings rate has now fallen to 3.7% from over 20% during the pandemic.

Despite the economic slowdown to date and further slowing expected over the next six months, the Reserve Bank Board raised the cash rate by 0.25% to 4.1% at its June Board meeting and there is a high probability of a further increase. The Governor's focus is on the damage associated with high inflation and inflationary expectations becoming entrenched in the economy. Governor Lowe pointed out that services price inflation is still very high and that unit labour costs are rising briskly whilst productivity growth remains subdued. The Fair Work Commission's 5.75% pay rise for about one-quarter of the workforce's minimum and award wage workers was "just one of the factors" for the RBA's decision, along with high inflation, federal and state government wage increases and rising house prices. Following the interest rate rise, the probability of recession has increased to a better than even chance.

In China, a gradual normalisation of growth is continuing as the country adapts to a landscape without COVID-era restrictions. The recovery appears likely to fall short of other countries' reopening experiences, while future trend growth rates will also likely be lower than the country's pre-COVID rate. Retail sales and mobility numbers for the first quarter look strong, although the type of post-lockdown "revenge" spending that many forecast did not materialize. Household cash levels remain high but lag the excess savings dynamic in the United States through the pandemic. Structural problems in China's property sector undermine confidence in a key investment asset of Chinese households. Furthermore, weak employment figures have dampened confidence in job security and income prospects. These drivers help explain why the rebound in consumption is more a normalisation from the zero-COVID period than a sustainable boom. Government policy response is supportive but restrained.

> Hence, we will not see the type of past Chinese economic growth that fuelled global demand for commodities, especially industrial metals and other capital goods imports, that in turn elevated global growth.

Europe has fallen into a mild technical recession following the release of the first quarter GDP. The decline of 0.1% in both the fourth and first quarters is minimal and importantly the labour market remains strong. The stagnation of the economy does mark a clear cut from the recent post-pandemic boom. The significant downward revision was mainly due to Germany revising down its growth rate and fuels the idea that March activity was very weak, making a quick rebound in the second quarter unlikely. With May survey data being weak across the board, it is likely that we only get a modest uptick after the two quarters of downturn. Overall, the eurozone economy is very much back to muddling through, as monetary policy starts to weigh more heavily on activity and post-pandemic spending fades. Headline inflation has continued to fall. Core inflation was down more than expected, falling from 5.6 to 5.3% in May. But this is still too high. A downward trend in goods inflation is widely expected given falling producer prices, easing input shortages and weak demand, which resulted in a drop from 6.2 to 5.8%. Services inflation also fell from 5.2 to 5%, which was more of a surprise given the better performance of the service sector.

> The main concern around inflation at the moment is that wage growth is trending higher.

In the first quarter, negotiated wage growth increased to 4.3% year-on-year and more collective agreements are in the pipeline, especially as the labour market continues to run hot despite GDP broadly stagnating. Unemployment fell again in April from 6.6 to 6.5%, meaning that wage pressures are continuing. This could add to a situation where inflation trends back to 2% at a slower pace.

Consequently, the ECB has committed to a June hike but thereafter it will likely become data dependent as is the case in the US.

We continue to anticipate a further slowdown in global economic activity and remain cautious that the breadth of the rise in the US share market is very narrow as it was in the late 1990's. The Federal Reserve continues to reduce the size of its balance sheet suggesting that financial conditions will remain tight for the remainder of 2023. In Australia the RBA cited persistent inflationary pressures in the economy and warned that further tightening may be needed.

Policy will remain a headwind for the remainder of the year.

Returns

31st May 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 31ST MAY 2023

	1 Month	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Australian Cash	0.33	0.93	1.74	2.98	1.06	1.18	1.69
Australian Bonds	-1.21	2.11	1.40	1.73	-2.77	1.00	2.52
International Bonds Hedged	-0.54	1.97	0.90	-2.62	-3.43	0.25	2.43
Australian Listed Property	-1.75	-3.57	-0.26	-3.01	7.62	3.94	7.57
International Property Hedged	-3.35	-5.05	-4.94	-14.15	5.18	1.03	4.90
Australian Shares	-2.53	-0.89	-0.58	2.90	11.43	7.47	8.12
International Shares	1.18	8.43	7.72	13.37	11.90	11.29	13.08
Emerging Market Shares	0.40	4.36	3.10	1.44	4.35	2.49	5.98

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