KEY FINANCIAL PLANNERS
WEALTH SPECIALISTS

NEWSLETTER

Spring Edition

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What's happening in the markets

After a benign June month for the world's share markets, July saw a bounce back driven by easing fears of central banks' over-tightening of monetary policy, stronger consensus on peak inflation and a solid Q2 reporting season out of the US, which all helped shape a good month for markets in the face of still evolving geopolitical tensions.

Market Update

Global Inflation and Interest Rates

At its meeting earlier this month, the Reserve Bank of Australia (RBA) increased the cash rate by 50bps, from 0.85% to 1.35%. This followed May and June's interest rate hikes of 25 and 50bps respectively. The RBA has now increased the cash rate by 125bps in three consecutive meetings, from a record low of 0.10%. The recent hikes represent the fastest pace of tightening in a three-month window since 1994, when the RBA tightened by 200bps in the three months to December 1994.

Following on from this news, we learnt soon after how the aggressive rate hikes from the RBA, and how expectations of further tightening on the horizon, are affecting the mood among households and businesses.

Recent correspondence from the RBA has highlighted the importance of anchoring inflation expectations and the need to maintain confidence in the Bank's ability to achieve its inflation target.

As the month came to a close, we saw the June quarter consumer price index (CPI) release gaining 1.78%. This increase was

the second highest since the introduction of the GST and follows on from a 2.1% increase in the March quarter. The annual inflation pace lifted from 5.1% to 6.1%, matching the fastest yearly increase when the GST was introduced (6.1%yr June 2001) and still significantly faster than the mining boom peak in September 2008 of 5.0%yr.

Turning to the details, the most significant price rises were for new dwelling purchases by owner-occupiers (5.6%) and automotive fuel (4.2%). What was a surprise to economists was the strength of the gains for food (2.0%), clothing & footwear (3.5%) and household furnishings, equipment & services (2.5%).

Looking overseas, a key release over the month was the US CPI for June. The annual inflation rate in the US accelerated to 9.1% in June, the highest since November of 1981, from 8.6% in May and above market forecasts of 8.8%. Energy prices rose 41.6%, the most since April 1980, boosted by petrol (59.9%, the largest increase since March 1980), fuel oil (98.5%), electricity (13.7%, the largest increase since April 2006), and natural gas (38.4%, the largest increase since October 2005). Food costs surged 10.4%, the most since February 1981, with food at home jumping 12.2%, the most since April 1979. Prices also increased significantly for shelter (5.6%, the most since February 1991), household furnishings and operations (9.5%), new vehicles (11.4%), used cars and trucks (1.7%), and airline fares (34.1%). Core CPI, which excludes food and energy, increased 5.9%, slightly below 6% in May though still above forecasts of 5.7%.

At the European Central Bank's (ECB) Central Banking forum over July, President Lagarde recognised the tight bind that policy makers are in. Citing the strength of the labour market in their justification, the ECB looked set to raise policy rates by 25bps at the upcoming July meeting. Given the pace of inflation and associated uncertainties, the ECB is then expected to follow up with a 50bp hike in September, another 50bp in November, and a final 25bp hike in December, taking the refi rate to a peak of 1.50%.

As these rate hikes take place, targeted reinvestment of PEPP coupons will occur in the hope of avoiding a 'fragmentation' of financial markets across the continent. With the Russian invasion of Ukraine impacting energy prices across Europe, these supply issues associated with the conflict have clearly also generated intense inflationary pressures. June's flash CPI indicates annual headline inflation is at a record 8.6%yr, with energy up an extraordinary 41.9%yr. The recent broadening of price pressures outside energy also warrants close attention, though core inflation's small fall in June to 3.7%yr holds promise.

Developments in the global economy
Australia

July saw the Westpac Melbourne Institute Index of Consumer Sentiment fall 3.0% to 83.8 from 86.4 in June, marking the seventh consecutive monthly fall. The survey, covering 1200 respondents, was conducted over the four days from July 4th to July 7th. Last month we noted the Index was already around levels that, since the beginning of the survey in 1974, had only been seen during periods of major disruption in the Australian economy, including the COVID pandemic, the Global Financial Crisis, the recession in the early 1990s, the slowdown in the mid–1980s, and the recession of the early 1980s. This fall in July means that the pace of the sentiment deterioration is now also in line with these infamous periods. The Index has now fallen 19.7% since December 2021, a precipitous tumble comparable to the two–month plunge during COVID (–20.8%), the six–monthly declines seen heading into the Global Financial Crisis (–29.7%), the early 1990s recession (–20.5%), the mid–1980s downturn (–23.8%), and early 1980s recession (–18.8%).

As the RBA takes the Australian cash rate higher, discussion and risks around a

recession in Australia will also rise. In recent weeks, references to the 'R word' have had a workout in the media. It is not the BT Economics Team's core view that Australia will enter a recession, though we do think that the cash rate will peak at a higher level than previously expected, resulting in a sharper economic slowdown.

Indeed, the fresh information on the jobs market and remarks from both the Governor and Deputy Governor suggest the cash rate could now peak with a '3' handle. Our Group's house view on the peak cash rate has been upgraded, from 2.60% previously to 3.35%. The timing of the peak remains unchanged at February 2023, but there are risks the peak could occur sooner.

To get to this peak, we believe the profile will consist of a 50bp hike in August (which has occurred at time of writing), followed by another of this size in September, and then 25bp hikes at each Board meeting from October through to, and including, February. The RBA does not meet in January.

Our view somewhat echoes that of interest-rate markets. Markets expect the cash rate in Australia to peak near 3.65% within the next 12 months, with rate cuts beginning in the second half of next year. We also anticipate that the RBA will turn to rate cuts, though with our anticipated timing being early 2024.

As for the growth outlook, with the RBA hiking the cash rate the pace of consumer spending will ease, flowing on to slower economic growth. Pent-up demand and elevated savings are still helping to underpin growth at this stage, but momentum will dissipate as the year goes on.

Indeed, as we move through 2023 with a much higher cash rate, economic growth is likely to be sluggish. We anticipate GDP growth of 4-4.5% this year, followed by only 1% next year (well below the long-run average) as the weight of much tighter monetary policy takes hold.

Note that Australia's exceptionally low unemployment rate will help moderate stresses to the aggregate household sector amid these tighter monetary policy conditions. Various labour market indicators suggest to us that the unemployment rate could fall to 3.0% or lower by the end of this year. But given the sharper slowdown in economic growth that we now envisage for 2023, we are likely to see unemployment move higher over next year to finish 2023 between 4 and 4.5% - closer to the natural rate.

July saw reporting that Australian dwelling prices are losing altitude quickly. The CoreLogic home value index, covering the eight major capital cities, fell 1.4% in July, following on from a 0.8% decline in June and a 0.3% dip in May. July's fall is the largest monthly decline since 1983. That said, prices are still up 5.4% year-on-year, with the retracement to date only taking prices back to the level they were at in October 2021. The detail in the CoreLogic index showed the price correction being worse in Sydney and Melbourne, with Brisbane, Hobart, Canberra, and most regions also recording material declines. Turnover continues to decline as well, with sales on a rolling 3-month basis down 15.6%yr nationally (Westpac estimates of seasonally adjusted sales). Sydney and Melbourne are leading the way here too, although it should be noted that sales in these markets were coming off a much higher starting point due to post-COVID catch-up activity. Sales are now running well below new listings in these markets.
The price correction is likely to continue deepening and broadening as the RBA delivers more rate hikes in coming months. Conditions will only improve once policymakers are convinced that the inflation threat has passed.

United States

GDP fell in the US over the June quarter, which means that by some measures the US is arguably in a technical recession

following the March quarter's fall. Reports stated that June's decline was driven by a fall in domestic demand resulting from higher petrol and general transportation prices, which are key factors in the upward pressure the US is encountering on the inflation front.

The Fed lifted rates by 75bp at its meeting on July 26th-27th, taking the fed funds rate to 2.25-2.50%. This is the second Fed meeting in a row that ended in a 75bp rate hike, with further rate increases remaining firmly on the agenda. Feb Chair Powell noted that, having indicated they would move 'expeditiously' back to neutral, this has now been achieved. He also stated that "As the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases while we assess how our cumulative policy adjustments are affecting the economy and inflation". He also stated that there has been "some progress on supply and demand getting back into alignment".

The US unemployment rate was unchanged at 3.6% in June (in line with market expectations), remaining the lowest since February 2020. The number of unemployed people decreased by 38'000 to 5.912 million, while employment fell by 315'000 to 158.111 million. Meanwhile, the labour force participation rate edged down to 62.2% in June from 62.3% in May.

Asia

A Reuters report released at the end of July provided insights into the Chinese economy that covered a number of key measures and observations, including the results of a private poll by Caixin that showed manufacturing activity grew more slowly than expected over the month, after surging in June once widespread COVID lockdowns were lifted. Also, a poll by China Index Academy, one of the country's largest independent real estate research firms, showed property sales by floor area in 17 tracked cities slumped 33.4% month-on-month in July versus the 88.9% post-lockdown jump in June, as buyers shunned a market increasingly filled with desperate sellers.

Second-quarter GDP in China grew just 0.4% on-year, but authorities have so far refrained from massive stimulus despite fears of a global recession, uncertainties from the Ukraine war, and the prospect of recurring COVID lockdowns at home.

Retail sales improved in June, up 3.1% for the year after lockdowns were lifted in some cities, including China's financial hub and most populous city Shanghai. The jobless rate also eased to 5.5% from 5.9% in May, but consumer sentiment remained fragile due to widespread uncertainty over jobs. In the Caixin survey, an index for factory jobs dived to the lowest in 27 months. Companies attributed the staff shedding to cost-cutting, subdued sales, and the non-replacement of voluntary leavers.

Japan's economy rebounded in the June quarter from contraction in the previous quarter, thanks to solid consumer spending in face-to-face services no longer hindered by coronavirus curbs. However, analysts are concerned about risks for the current quarter, including the possibility of a global economic slowdown and a resurgence of COVID-19 cases in Japan.

The world's third-largest economy grew at an annualised 2.5% in April-June, rebounding from a 0.5% contraction in the first quarter, according to economic consensus. Second-quarter expansion was driven largely by a projected 1.3% rise in private consumption, which accounts for more than half of Japan's GDP.

Capital expenditure expanded 0.9%, according to the poll, which also suggested external demand had added 0.1% to GDP growth.

During July Japan's current account reported a shift to a deficit of JPY 132.4 billion in June 2022 from a surplus of JPY 739.6 billion in the same month of the previous year.

This was the first current account gap since January, with the goods account reversing to a shortfall of JPY 1,114 billion from a surplus of JPY 633.6 billion as exports rose by 20.4 percent while imports jumped 49.2 percent.

Europe

Private-sector activity in the Euro area unexpectedly shrank for the first time since the pandemic lockdowns of early 2021, adding to signs that a recession might be on the horizon.

A survey of purchasing managers by S&P Global dropped to a 17-month low in July, dipping beneath the level that signals contraction. The downturn was driven by worsening output among manufacturers and a near-stalling of service-sector growth. Economists had expected a mild expansion.

“A steep loss of new orders, falling backlogs of work and gloomier business expectations all point to the rate of decline gathering further momentum,” said Chris Williamson, an economist at S&P Global. “Of greatest concern is the plight of manufacturing, where producers are reporting that weaker-than-expected sales have led to an unprecedented rise in unsold stock.

The data underscores the vulnerability of the Eurozone economy that is now facing abrupt stimulus withdrawal after the ECB’s half-point interest-rate increase in late July, the first hike in more than a decade.

“We understand that these decisions are expected to mean slower economic growth due to more expensive loans and, unfortunately, uncreated and sometimes lost jobs,” ECB Governing Council member Madis Muller said in a recent blog post. “But the consequences of persistently too-fast price increases would be even worse.”

Signs of slowing growth will reinforce the growing chorus of economists predicting a recession in the 19-member currency bloc later this year. Energy supplies are a major worry as Russia reduces natural gas flows in response to Western sanctions over its invasion of Ukraine.

An index earlier showed German activity unexpectedly shrinking, while a French report also signalled concerns of an economic slump.

European bonds rallied over July, with short-dated German debt leading the gains. The two-year yield fell 22bps, set for the biggest slide in the month. Traders have since priced in 110bps of ECB hikes by year-end, and also pared bets for a hike in September. ECB President Christine Lagarde stated over the month that it’s important to prevent expectations of higher prices from becoming entrenched, though she conceded that the economy is weakening.

Forecasters surveyed by the ECB earlier in July cut their outlook for growth next year to 1.5% from 2.3%, where they also raised their longer-term inflation estimate to 2.2%.

Over to the UK, after a strong post-pandemic recovery, the economy is facing slower growth with rising inflation and labour shortages, exacerbated by Russia’s war of aggression against Ukraine.

The Bank of England (BOE) raised its main rate by 50bps to 1.75% during its August 2022 meeting, the sixth consecutive rate hike, pushing borrowing costs to their highest levels since 2009. It is the biggest rate increase since 1995, though was largely anticipated by market consensus.

A near doubling of wholesale gas prices since May fed through to retail energy prices and will exacerbate the fall in real incomes for UK households by further increasing UK CPI inflation in the near term, the central bank said. According to new BOE projections, CPI is expected to rise to 13.3% in October and will remain at very elevated levels throughout much of 2023, before falling to the 2% target within two years.

The S&P Global/CIPS UK Composite PMI was revised lower to 52.1 in July from a preliminary reading of 52.8, down from 53.7

in June. The latest reading signalled the slowest rate of expansion since February 2021.

New orders increased only marginally in July, reflecting subdued demand in both domestic and overseas markets. Latest data signalled a renewed decline in export sales, largely reflecting a reduction in new work from abroad across the manufacturing sector. UK private sector firms signalled another steep rise in their average cost burdens during July. Softer input price pressures and subdued customer demand contributed to the least marked rise in average prices charged since February.

As for growth, the UK is now projected to enter a recession in 2022.s fourth quarter, which is expected to last for five quarters.

Developments in financial markets
Australian Equities

Despite the number of news headlines including the words ‘possible recession’, markets bounced back considerably over July after a tumultuous end to the 2022 financial year. There is still large debate whether this rebound is a dead cat bounce or whether the lows have been met and the downtrend is over.

The S&P/ASX300 Accumulation Index clawed back some previous losses by posting a 5.95% gain in July, bringing the 1-year rolling return to -2.31%.

As for size, large caps rallied with the S&P/ASX100 closing the month up 5.31%, and small cap investors found some solace after the previous quarter, with the ASX Small Ordinaries Accumulation Index reclaiming some of those earlier losses to end July up 11.43%, though the 1-year rolling return is still in the red at -10.93%.

The vast majority of Australian sectors closed in the green. Tech stocks trumped the month to finish July up 13.80%, though the sector still holds the lowest 1-year return of -21.64%. Real estate came in second for the month at 9.22%, then Healthcare at 7.57%, closely followed by Consumer Discretionary at 7.34%.

In the face of the relatively small July movements in Energy (-0.33%) and Utilities (+0.12%) sectors, both maintain substantial 1-year gains of 30.03% and 38.00% respectively.

International Equities

Most global share indices finished positively too. Overall, the MSCI World Ex Australia (unhedged) returned 6.40% in July, which gives the global markets (excluding Australia) a 1-year return of -4.39%.

As for the USA, the S&P500, the NASDAQ, and the Dow Jones Industrials Average all posted impressive gains in July. They closed the month up 9.22%, 12.39%, and 6.82% respectively. Annual returns are, however, still in red territory at -4.64%, -14.95% and -4.14%.

European markets shared the same sentiment through July. The Europe 600 STOXX ended the month up 7.64%, the German DAX up 5.48%, and the UK’s FTSE100 closing at 3.54%. The French CAC 40 almost perfectly reversed June’s 8.44% fall to finish July up 8.87%.

Asian markets painted a more mixed picture, with the Korean KOSPI ending July up 5.10% and the Japanese Nikkei 225 up 5.35%. The Chinese Shanghai Composite and Hong Kong’s Hang Seng reversed June’s gains, ending July down 4.28% and 7.79% respectively, and are still under pressure for the year with their 1-year rolling returns at -4.24% and -22.36% respectively.

Fixed Interest

Even though inflation and interest rates continued to be at the forefront of investors’ minds, with markets paying close attention to most central banks tightening their monetary policy regimes, rates markets posted positive results through July.

Domestically, the Bloomberg AusBond Composite (0+Y) ended the month up a

comfortable 3.36%, though its 1-year return is still negative at -9.10%.

International markets saw the Barclays Global Aggregate TR Hedged index gain 2.49% over the month, translating into a -8.23% 1-year rolling return.
The Australian 10-yr bond yield ended July at 3.03% shedding 3bps over the month. The US 10-yr yield at 2.58% fell 8bps, and the Chinese 10-yr moved in the same direction, yielding 2.73%, also with a 3bp fall.

Foreign Exchange

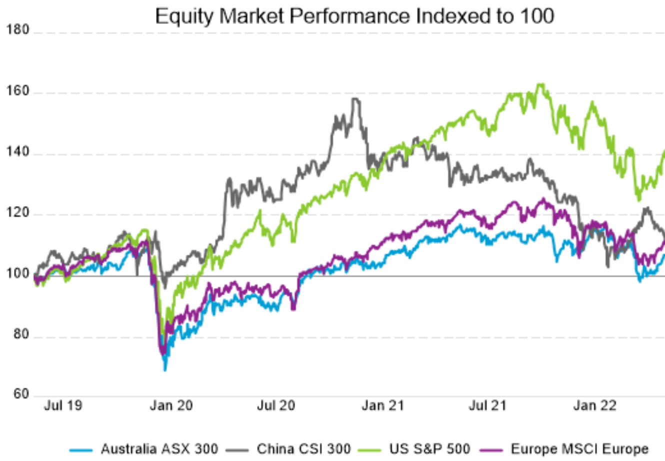
The USD cooled its previous trend in the FX markets over July, as global risk sentiment eased to a degree and the reserve currency's safe haven status played a less important role. The Australian dollar gained 1.19% against the USD to end the month at 0.6985.

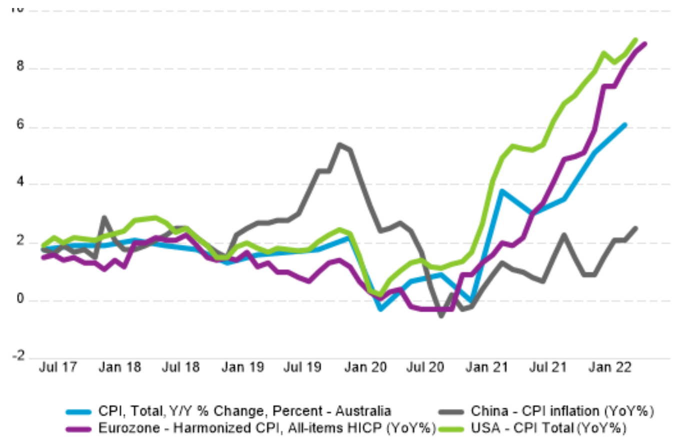
The Japanese Yen played to a similar tune, gaining against the USD with the USD/JPY pair ending the month down 1.81%, closing at 133.27. However, other major currencies continued to fall against the USD with the EUR and GBP ending the month down 2.52% and 0.06% respectively, to 1.022 and 1.2171.

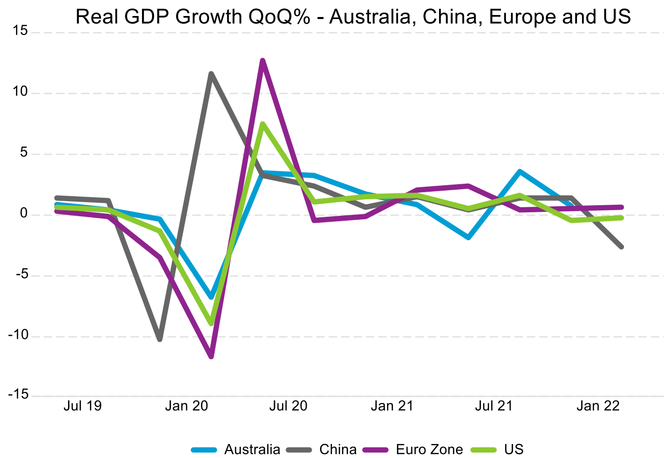
Commodities

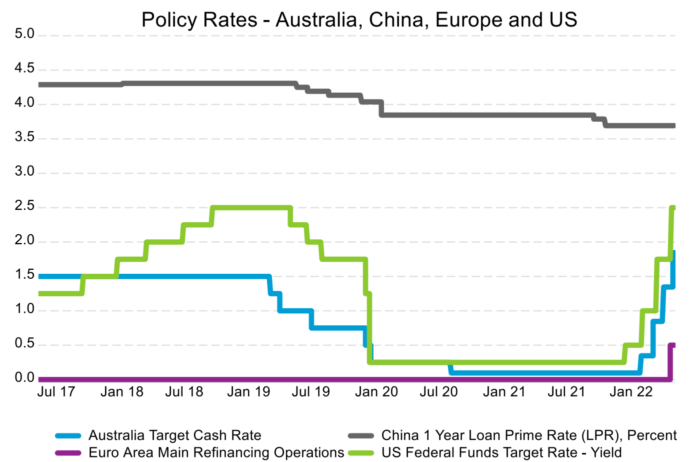
Commodities had a mixed month. The Bloomberg Commodity Index, which tracks a broadly diversified set of energy, grains, metals, softs, and livestock futures, closed July up 4.08% (posting a whopping 26.54% 1-year return).
The energy sector's bull run continued to stumble, with Brent Crude down 4.18%, closing at USD$110.01. Metals also fell, with Gold losing 2.29% over July to finish at US$1765.94/oz, and Iron Ore falling 9.70% to close at USD$104.32 per tonne.

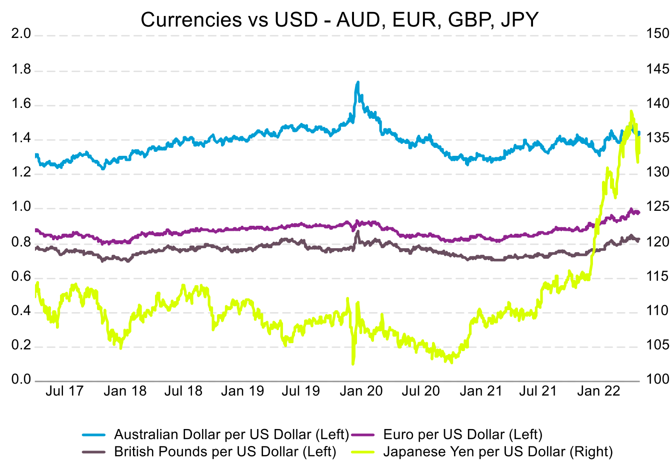
Market Charts

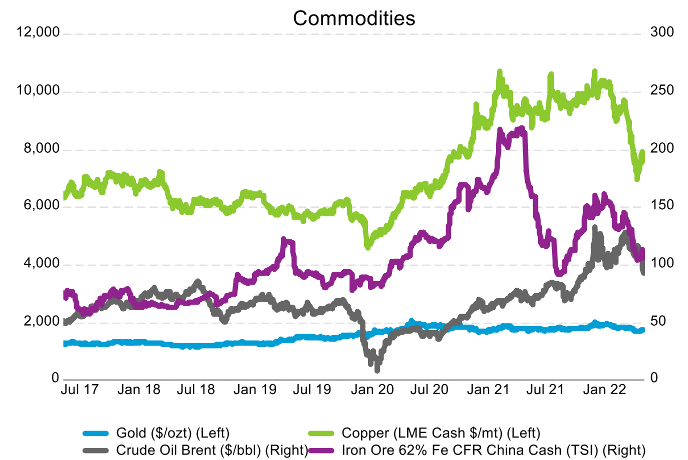












Value? Growth? Or both?

By Georgdie Asprey

Some asset managers are pinned to growth. Others are locked into value.

At Elston, we're not value or growth. We're both.

In industry terms we are what could best be described as style-neutral.
Being style-neutral means that we're not limited to one style within portfolios. We do this because we believe that pinning ourselves to one style makes it harder for investors to access the wide range of opportunities that generate consistent returns over the longer term.

Financial markets are dynamic. Accordingly, the drivers of a portfolio's return will evolve over time. So, it's important to be able to move with the markets.
Our portfolios are built using a style-neutral approach. A style-neutral manager constructs their portfolio to reflect changing market conditions and avoids adhering to a restrictive, strictly value, quality or growth-based approach for equities or credit and/or interest rate sensitivity within fixed income. This approach provides access to a broader opportunity set of inefficiencies within markets and allows portfolios to better navigate the volatility that arises as different styles come into or fall out of favour.

To us, a style-neutral portfolio is one in which we can objectively identify and assess opportunities without bias. We examine the factors that are likely to impact future returns from all perspectives.

Single style-driven investing can cause investors to be constantly exposed to one style's performance volatility. A style-neutral can help you to avoid this, and we believe that provides an allocation advantage.

There have certainly been periods when growth managers have done well. And there have been times when value managers have been happy. However, when you look at performance, on average, style-neutral managers have delivered consistency over the long term.

Single style investing is cyclical. It works for a while (potentially for prolonged periods) and then it doesn't. That's something we've certainly observed with growth investing recently. For those on the wrong side of the trade, when the reversion to the mean finally comes, the drawdown can be painful.

The objective of Elston is to deliver repeatable and sustainable outcomes for our investors. We believe a style-neutral approach offers the flexibility to explore a more comprehensive opportunity set. It allows for genuine diversity, while assisting in the preservation of capital by avoiding risks endemic in single style investing. Moreover, we gain a research and informational advantage by understanding the changing fundamentals across asset classes giving us the best opportunity to deliver on this objective.

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KEY FINANCIAL PLANNERS
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RBA Board Meeting

The Inflation Fight Is On

- The Reserve Bank's fight against inflation continued with another rate hike of 50 basis points delivered today to take the cash rate to 2.35% - the highest rate since January 2015.
- The RBA has taken a two-pronged approach to fighting inflation – raising rates and talking tough on its commitment to quell inflation.
- The RBA has made it clear that fighting inflation is its number one commitment and has flagged that more rate rises are on the way.
- The statement implied that today's increase takes the cash rate near estimates of the "neutral" level, perhaps suggesting the size of future rate hikes will step down to 25 basis points. But this is no done deal. Much will depend on how the data evolves.
- One piece of data the RBA will be eyeing closely is inflation expectations. The RBA is staying alert to any signs of inflation expectations accelerating, which would make the task of taming inflation tougher.
- Rising inflation expectations could materially increase the outlook for wages growth. The RBA flagged that labour costs are increasing briskly in pockets with unemployment at a 50- year low and more than one job vacancy per unemployed person.
- Fighting inflation comes with a trade-off to growth. But the RBA sees inflation as the bigger evil. We do not expect rate hikes to end until the RBA has compelling evidence that inflation is decelerating. This commitment is fanning fears of a recession.
- We remain comfortable with our view that the RBA will hike again in October and take the cash
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- rate to 3.10% by the end of this year. Markets have almost 3.25% priced in by year's end.

The Reserve Bank's fight against inflation continued with another rate hike of 50 basis points delivered today to take the cash rate to 2.35% - the highest rate since January 2015.

The RBA has taken a two-pronged approach to fighting inflation – raising rates and talking tough on its commitment to quell inflation.

The RBA has now tightened by a total of 225 basis points since it began this rate-hiking cycle in early May – the most tightening in a 5-month window since late 1994, which underscores the inflation challenge the RBA is taking on.

Inflation was running at an annual rate of 6.1% in the June quarter and is headed to nearly 8% in the final quarter of this year on the RBA's own forecasts. Price pressures of this magnitude mean that getting inflation down will not be easy.

Not surprisingly, the RBA has signaled more rate increases are on the way. The final paragraph of its statement highlights the Board expects to increase interest rates further over the months ahead". The question boils down to how much more tightening can we expect.

The current cash rate appears to have neared "neutral" with the RBA no longer describing rate rises as further steps in normalising policy. The neutral rate is the rate that is not acting as a brake on economic activity and that is not stimulating conditions.

The suggestion that the cash rate is nearing neutral suggests the RBA could choose to scale back the size of tightening from 50 basis point steps to 25 basis point steps. However, this is by no means a done deal and, in fact, is likely to be a close call.

The RBA will be watching the data very closely, especially on inflation expectations. The RBA remains alert to the possibility of inflation expectations rising, which would make the task of taming inflation tougher. Inflation expectations over the medium term are currently well anchored, but this has the potential to change.

Rising inflation expectations could materially increase the outlook for wages growth. The RBA inserted a new paragraph this month on wages, describing a pickup in

wages growth from very low rates of recent years. It highlighted there are pockets where labour costs are "increasing briskly".

The very tight labour market and the upstream price pressures, means the RBA board will watch how labour costs evolve and the price-setting behaviour of firms in the period ahead. The feedback from our business customers suggests they are still feeling the pressure to lift prices to the end consumer.

Fighting inflation comes with a trade-off to growth. But the RBA sees inflation as the bigger evil. The trade-off in fighting inflation is one that involves balancing an economic outlook hampered by growing costs and labour shortages against the vulnerability of heavily indebted households.

One of the major sources of uncertainty is the behaviour of household spending. Consumer confidence has fallen, house prices are declining and the "full effects of higher interest rates (are) yet to be felt in mortgage payments". But people are finding jobs, hours worked are growing, wages growth is rising, and many households continue to build up financial buffers.

The trade-off means fears are fanning that the resolve to slow inflation will result in a recession. These recession risks are more pronounced in the US and Europe. Our core view is that a soft landing will materialise in Australia, but the higher the RBA takes the cash rate to slow inflation, the greater the risk of a hard landing.

As long as inflation remains the top priority, we do not expect the rate-hike cycle to end until the RBA has compelling evidence - a series of data releases - showing decelerating inflation. At that point, the RBA would likely pivot toward a more balanced dual focus of growth and inflation.

We remain comfortable with our view that the RBA will hike again in October and take the cash rate to 3.10% by the end of this year. Markets have almost 3.25% priced in by year's end. A cash rate of 2.85% - near the top end of the neutral zone – seems a done deal. Whether our forecast is accurate and how much further the RBA takes the cash rate above 2.85% will depend heavily on the data and on the actions of other major central banks around the world.

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