The Monthly Market Report

ISSUE 115 | September 2023

Asset Class Returns September 2023

Asset Classes	Month % chge	3 Month % chge	6 month % chge	FYTD%	YTD %	1 year % chge	3yr return pa	5yr return pa	10yr return pa
Australian Shares (ASX 200 Accumulation)	-2.84	-0.77	0.24	-0.77	3.71	13.46	11.00	6.67	7.43
Global Shares (MSCI World ex Aust-net(USD))	-4.34	-3.46	3.27	-3.46	11.37	22.10	8.07	7.31	8.40
Global Shares (MSCI World ex Aust ,net, AUD)	-4.01	-0.43	7.16	-0.43	17.02	21.64	11.92	9.80	12.49
MSCI World ex Australia 100% hedged to AUD Index (Net)	-3.77	-2.87	3.98	-2.87	11.40	19.39	8.13	6.50	9.50
Australian Property (S&P/ASX 200 - Property Trusts (TR)m)	-8.58	-2.93	0.37	-2.93	0.89	12.49	4.68	2.48	7.33
Global REITs (FTSE EPRA Nareit DEV HEDGED IN AUD L - TOT RETURN IND)	-5.57	-5.18	-4.36	-5.18	-4.27	-0.39	1.09	-1.66	3.32
Australian Cash (Bloomberg AusBond Bank Bill Index)	0.34	1.08	1.99	1.08	2.80	3.56	1.36	1.28	1.73
Australian Bonds (Bloomberg AusBond Composite 0+ yr Index)	-1.53	-0.28	-3.22	-0.28	1.23	1.61	-3.92	0.34	2.29
Global Bonds (Barclays Global Aggregate (AUD Hedged))	-1.84	-2.14	-2.44	-2.14	-0.11	0.53	-4.55	-0.24	2.17

Sub Asset classes	Month % chge	3 Month % chge	6 month % chge	FYTD%	YTD %	1 year % chge	3yr return pa	5yr return pa	10yr return pa
MSCI All Country ex Aust(net, AUD)	-3.80	-0.37	6.43	-0.37	15.64	20.34	11.05	9.19	11.84
US Shares (S&P 500 Total Return Index)	-4.77	-3.27	5.18	-3.27	13.07	21.51	10.15	9.92	11.85
Australian Small Caps (ASX Small Ords Accum (Ex 100))	-4.04	-1.94	-2.47	-1.94	-0.64	6.85	2.57	1.63	5.13
Global Small Caps (MSCI Small Cap Index (USD, net))	-5.25	-4.39	-1.31	-4.39	2.92	14.00	6.23	3.11	6.29
Global Small Caps ex-Aust (MSCI World Small Caps ex Aust (NI) AUD)	-4.88	-1.84	2.65	-1.84	8.28	15.01	9.80	5.45	10.34
Global Emerging (MSCI Emerging Markets (USD))	-2.62	-2.93	-2.05	-2.93	1.82	11.70	-1.73	0.55	2.07
Global Emerging (MSCI Emerging Markets (AUD, net))	-2.28	0.12	1.64	0.12	6.99	11.28	1.77	2.88	5.93
Global Infrastructure (FTSE Global Core Infrastructure 50/50 Index - AUD Hedged NR)	-4.15	-7.35	-8.22	-7.35	-8.55	-2.72	2.58	2.78	6.41
Global Credit (Barclays Global Aggregate Credit (AUD Hedged))	-1.98	-1.97	-2.34	-1.97	0.13	2.81	-4.90	-0.01	2.57
Global High Yield (Barclays Global Aggregate High Yield TR Hedged AUD)	-1.17	0.16	1.71	0.16	4.06	10.25	-0.35	0.83	3.91
Australian Govt Bonds (Bloomberg AusBond Infl Govt 0+ yr Index (d))	-2.20	-0.61	-3.31	-0.61	3.29	7.13	-1.72	1.99	3.26
Treasury Yields (Bloomberg Treasury Index)	-1.88	-0.80	-4.40	-0.80	0.27	0.51	-4.66	0.10	2.08
Australian Credit (Bloomberg AusBond Credit Bond Index (d))	-0.58	1.26	0.10	1.26	3.54	4.69	-1.26	1.67	3.14
Australian Floating Rate Bonds (Bloomberg AusBond Credit FRN 0+ Yr Index)	0.37	1.30	2.53	1.30	3.68	4.63	1.93	2.08	2.63
AUD-USD (m)	-0.42	-2.59	-3.78	-2.59	-4.68	-0.68	-3.15	-2.21	-3.59
Trade Weighted Index of AUD (AUD TWI(m))	0.83	-0.97	1.33	-0.97	-0.49	-0.65	0.22	-0.36	-1.52
US Broad Dollar Index -- Nominal, Monthly	1.45	2.02	1.09	2.02	-0.06	-2.69	1.63	1.37	2.71

1. Markets

GLOBAL DEVELOPED EQUITIES

- Global equity markets declined 4.3% per cent in September, taking the September quarter loss to 3.5 per cent following a strong first half. The surge in bond yields was the major driver, in particular the rise in US real yields from 1.59 per cent back in June to 2.27 per cent by quarter-end.
- Markets have been blindsided by the better than expected US economy which has so far coped with the 500 basis point rate hiking cycle. During the first half of the year, the focus was the positive impact of resilient growth on earnings and for a time, equity markets largely ignored the rise in bond yields. However, with a soft-landing largely priced in, markets have since turned their attention to the associated lift in Fed funds projections, incorporating the "higher for longer" interest rate narrative into valuations.
- Although the rapid decline in inflation to date has led to calls that the tightening cycle is close to over, the resilient economy has prompted markets and the Fed to remove some of the easing that was being projected for 2024 and 2025. At the June FOMC meeting the dot plots implied the Fed funds rate would be at 4.6 per cent at end-2024 although by the September FOMC meeting, a lift in the growth outlook prompted a lift in the end-2024 Fed funds estimate to 5.1 per cent. Meanwhile, market pricing over the same period has moved from 4.16 per cent at end-2024 to 4.72 per cent. Although the Fed has maintained that the so-called neutral rate is probably still around 2.5 per cent, the fact that growth has not yet slowed despite current rate settings and that they are projecting a higher Fed funds rate out to 2025 suggests that the neutral rate may be higher.
- The bond market has also been troubled by the doubling in the US fiscal deficit, the associated surge in new debt issuance and concerns over potential government shutdowns.
- At close to 4 per cent, the US equity risk premium, based on consensus earnings, is close to the lowest level since 2007. And while the rise in AI-related mega-tech stocks was largely responsible for the rise in markets in the first half, the recent surge in real yields has prompted a contraction in PE multiples.
- Earnings projections remain relatively optimistic at around 10 per cent for the year ahead, despite an expected slowing in nominal GDP growth and continued elevated wages growth. The positive earnings outlook implies the cycle is about to turn higher. Indeed, the evidence from the US ISM index may support this view with the ISM manufacturing index rising to 49, its highest level in 12 months. Meanwhile, the services sector ISM remains well above the 50 level, supported by continued solid consumer spending.
- On the inflation front, August saw a rise in headline CPI due to higher energy costs. The core measures, particularly over the past five months, suggest core inflation is back below 3 per cent. Inflation also appears to be falling faster than anticipated in Europe while in the UK inflation is now around 6 per cent while wages growth is an extraordinary 8 per cent. Unlike the US, however, activity indicators are much more muted, particularly in Germany. In Japan, activity has so far held up reasonably well and although inflation seems to be sustaining above the 3 per cent level, the Bank of Japan remains tied to its accommodative policy stance, unlike the rest of the developed world.
- Across regions, the UK was the best performer in USD terms in the month, down just 0.8 per cent while Japan was down 2.1 per cent. Europe ex-UK was off 4.9 per cent, the US down 4.7 per cent. Only Norway produced positive performance, bolstered by rising oil prices. For the year to date, Italy, Ireland, and Spain have led the way.
- On a factor basis Value stocks were the best performers, not surprising given the rise in interest rates, down just 2.8 per cent. For the quarter Value was down 1.9 per cent while growth declined 4.9 per cent. Quality stocks dropped 2.9 per cent. Finally, on a sector basis, energy was one of the few positive sectors for the month and quarter while REITs, consumer discretionary and IT were down more than 5 per cent.

AUSTRALIAN EQUITIES

- The Australian equity market lost 2.8 per cent in the month, and -0.8 per cent for the quarter, slightly ahead of US markets. For the year to date, the domestic market is up just 3.7 per cent, well below global markets. As was the case globally, the theme was higher bond yields and a contraction in PE multiples. However, unlike the US market, the earnings outlook for Australia is very subdued with consensus EPS growth for the next 12 months around -2 per cent.
- For the quarter the bank sector managed to rise 4.4 per cent while energy was up more than 11 per cent and insurance 1 per cent. However, REITs, materials and IT were all softer.
- As was the case in the US, markets lifted the trajectory for cash rates over the course of September although much less so than in the US. Recognising the fact that the transmission of higher cash rates through to mortgage rates is much faster and more direct it should not surprise that Australian cash rates have not had to rise as much as US rates to have an impact. This has clearly been a factor behind AUD weakness.
- The RBA chose not to lift rates at the September meeting, Philip Lowe's last meeting as governor. In her first meeting as RBA governor in early October, Michele Bullock also chose to keep the cash rate steady, a nod to the fact that the bank was giving itself more time to assess the impact of the 4 percentage points of interest rate hikes delivered since May 2022. Market pricing implies a high probability of one more move to 4.35 per cent with no easing expected until late 2024 or early 2025.
- On the inflation front, the August CPI data showed inflation rising 0.6 per cent for the month and 5.2 per cent for the year, up from 4.9 per cent in July. Core inflation eased to 5.5 per cent.

EMERGING MARKETS

- Emerging markets declined 2.6 per cent in USD terms and 2.3 per cent in AUD terms in September. For the quarter, emerging markets were flat in AUD terms, slightly outperforming developed market equities. For the year to date, emerging markets continue to lag other markets, largely due to the poor performance from China.
- The ailing property sector, a subdued emergence from Covid-lockdowns, a reluctance to employ significant stimulus and policy uncertainty have all combined to undermine Chinese equity market performance. The Chinese equity market now trades on a PE multiple below 10 times, placing it at a 40 per cent discount to global developed markets, close to the lowest levels since the late 1990's. The recent data has been weak and the policy response to date has been muted. However, credit growth lifted in August and the manufacturing PMI rose above the key 50 level for the first time since April.
- Korea and Taiwan were both down more than 6 per cent in the quarter while India continued to provide some diversification, rising 2.7 per cent in the quarter. The MSCI EM Asia index dropped 2.9 per cent for the quarter while Latin America dropped 4.8 per cent.
- In terms of the outlook for EM it all rests on US rates and the USD. If US rates have peaked and if markets begin to factor in modest easing, then the cyclical and USD headwinds for EM may begin to abate.

REITS AND INFRASTRUCTURE

- The sharp lift in real yields hit infrastructure and REITs harder than most equity sectors during September. With REITs already discounting sizeable declines in property valuations, REITs showed tentative signs of improvement in the first half of the year. However, the renewed surge in real yields over the quarter, particularly in September, saw the sector drop sharply. AREITs declined 8.6 per cent in September taking the loss for the quarter to 2.9 per cent. GREITs fell 5.3 per cent, for a 4.4 per cent decline for the quarter.
- Global infrastructure was down 4.2 per cent in September and 7.4 per cent for the quarter as the almost 70 basis point lift in US 10 year TIPs yields undermined valuations.

GLOBAL FIXED INTEREST

- Global bond yields surged in September with the US 10-year yield ending the month at 4.62 per cent, an 82 basis point rise for the quarter, producing a loss in the Barclays Global Aggregate (AUD hedged) index of 2.1 per cent. Since peaking at the end of 2020, the bond index has dropped almost 14 per cent.
- There are several factors contributing to the rise in bond yields. First and foremost, a better than expected US economy in the face of a 500 basis point rate hiking cycle to date has led to a reassessment of the outlook for Fed funds beyond 2023. While the more rapid decline in inflation has seen markets and policy makers signal the end to the tightening cycle, the resilient economy has prompted markets and the Fed to remove some of the easing that was being projected for 2024 and 2025. At the time of the June FOMC meeting the dot plots implied the Fed funds rate at 4.6 per cent at end-2024. At the September FOMC meeting, a lift in the growth outlook prompted a lift in the end-2024 Fed funds estimate to 5.1 per cent. Market pricing over the same period has moved from 4.16 per cent at end-2024 to 4.72 per cent. Interestingly, the Fed's projected long term Fed funds rate (an indication of the so-called neutral rate) has remained steady at 2.6 per cent, seemingly too low in light of the resilience of the economy and the higher Fed funds estimates for 2024-25.
- The doubling in the US fiscal deficit from around US$1 trillion to US$2 trillion (8 per cent of GDP) over the past year at a time when the economy is already running above capacity, the associated surge in new debt issuance and concerns over potential government shutdowns has added to the bond sell-off. The so-called "term premium", the return investors receive for locking funds up for the long term, which had turned negative over recent years amidst central bank bond purchases and investors clamouring for safe-haven yield, has returned to positive territory. Along with the re-pricing of the trajectory for Fed funds, the lift in the term premium has seen real yields (10-year TIPs yields) rise from negative levels in early 2022 to 1.59 per cent in June and 2.27 per cent as at the end of September.
- On the data front, the US CPI rose in August to 3.7 per cent, largely as a result of rising oil prices, while measures of sticky price inflation have fallen over recent months, suggesting that the Fed is tracking towards the 2-3 per cent range, still slightly above target. US manufacturing appears to be stabilising as measured by the ISM index while the labour market remains tight with job openings rising and growth in payrolls, although lower than 2022, still exceeding estimates required to keep unemployment steady.
- In Europe, inflation dropped to 4.3 per cent in September, continuing the rapid descent from the 10.6 per cent peak almost a year ago. Activity remains very weak, particularly in Germany where the IFO business climate index has deteriorated in recent months. UK inflation dropped to 6.7 per cent in August although wages growth is around 8 per cent. Bond markets in Europe and the UK also saw a lift in yields.
- Over the past 6 months US credit spreads narrowed as the prospect of a soft-landing came into view. However, with spreads at 380 basis points for high yield and 122 basis points for investment grade, a soft-landing was largely factored in. The ongoing re-pricing of Fed funds for 2024-25 has returned focus on refinancing risk in credit markets over coming years, leading to a widening of spreads. High yield spreads ended September at 403 basis points, still well below long term averages and well short of pricing any strong likelihood of recession risk.

AUSTRALIAN FIXED INTEREST

- Australian bond yields ended the September quarter at 4.5 per cent, up almost 50 basis points in the month to reach their highest level since 2011. The surge was largely based on the US bond market although the dynamics are similar in as far as the economy is proving more resilient than expected and the hurdle for any policy easing over 2024 has been raised. However, Australia's fiscal position is much sounder than the US with the budget swinging into a surprise surplus on the back of strong commodity prices, and higher personal and business tax revenue reflecting strong wages growth and corporate profits.

- As noted, markets pushed up the expected trajectory for the RBA cash rate over the course of September although compared with late June 2023 estimates, markets have actually removed some tightening expectations, largely as a result of the decision of the RBA to hit the pause button. This contrasts with the US rate outlook and explains the decline in the AUD over the quarter.

- The RBA chose not to lift rates at the September meeting, Philip Lowe's last meeting as governor, although he noted the possibility of further tightening should inflation remain high. In her first meeting as RBA governor, Michele Bullock opted to keep the cash rate steady , a nod to the fact that the bank was giving itself some time to assess the impact of the 4 per cent of interest rate rises delivered since May 2022. Market pricing implies a high probability of one more move to 4.35 per cent with no easing expected until late 2024 or early 2025.

- On the inflation front, the August CPI data showed inflation rising 0.6 per cent for the month and 5.2 per cent for the year, up from 4.9 per cent in July. Key drivers over the year include fuel costs (up 13.9 per cent) and electricity (12.9 per cent). The core measure showed a modest decline from 5.8 per cent to 5.5 per cent.

- In other data, the economy gained 64,000 jobs in August and the unemployment rate remained at 3.7 per cent. Job vacancies declined although the labour market remains tight with new wage agreements registering wages increases of 4.7 per cent according to Fair Work Australia. Meanwhile the NAB business conditions index remains above average while cost pressures remain elevated.

COMMODITIES

- The extension of OPEC production curbs over recent months continues to support oil with the price of Brent crude up a further 9.8 per cent to US$95.34 a barrel. Indeed, the price of oil has risen by 27.3 per cent in the September quarter, a move that has contributed to slightly higher implied inflation expectations and rising bond yields. In early September it was announced that Saudi Arabia would cut oil production by a million barrels per day through December, while Russia would reduce output by 300,000 barrels per day prompted a further rise in oil.
- Despite weakness in China, and in the property sector in particular, the price of iron ore managed to rise more than 5 per cent for the quarter to US$119.5 a tonne. Slightly improved data on credit growth for August and the September PMI back above 50 helped. The price of copper was broadly flat for the quarter.
- Gold continued to decline in the face of rising real yields and a stronger USD, ending the month at US$1870.5 an ounce, a decline of 3.7 per cent for the month.
- A solid gain for the month left the RBA commodity price index slightly down for the quarter and almost 17 per cent lower for the year.

CURRENCY

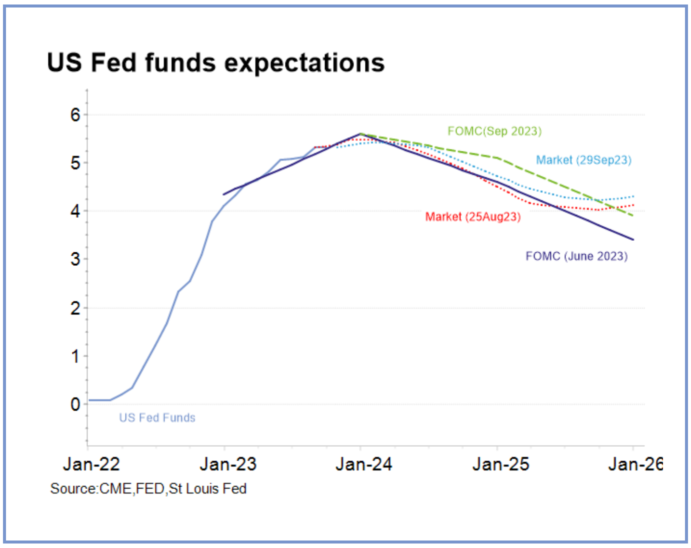
- On a trade weighted basis, the USD rose a further 1.5 per cent in September, largely reflecting the re-pricing of the "higher for longer" US Fed funds scenario. The euro lost 2.5 per cent in the month, reaching 1.057 while the yen ended just shy of 150 to the USD, a decline of 2.6 per cent for the month. The pound dropped 3.8 per cent to 1.22.

- Although the AUD fell to 64.1 cents it managed to rise on a trade weighted basis. For the AUD the dominant factor in 2023 has been the lift in expectations for Fed funds across 2024 and 2025 although there has also been an upward adjustment for the RBA cash rate over that period. Commodity prices appear to be holding, and certainly iron ore has defied expectations given the relatively poor performance of the Chinese economy. Valuations have improved with the AUD arguably cheap to the tune of 5-10 per cent based on Purchasing power parity.

2. Key Economic Releases

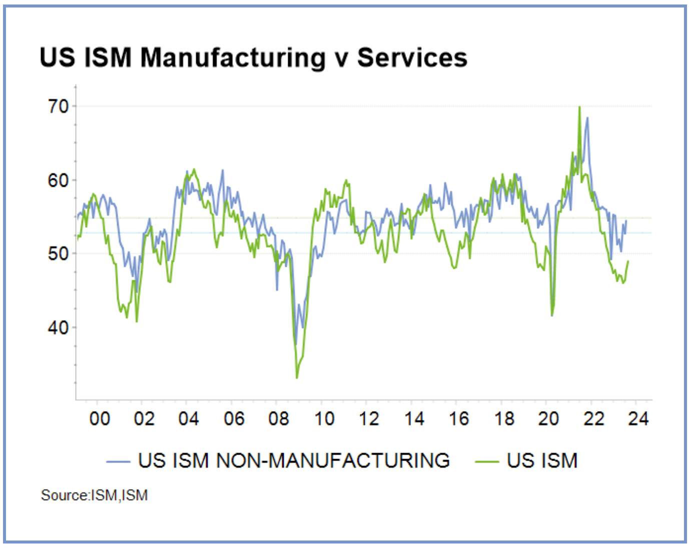
FED FUNDS PROJECTIONS

- At the time of the June FOMC meeting the dot plots implied the Fed funds rate at 4.6 per cent at end-2024. At the September FOMC meeting, a lift in the growth outlook prompted a lift in the end-2024 Fed funds estimate to 5.1 per cent. Market pricing over the same period has moved from 4.16 per cent at end-2024 to 4.72 per cent.



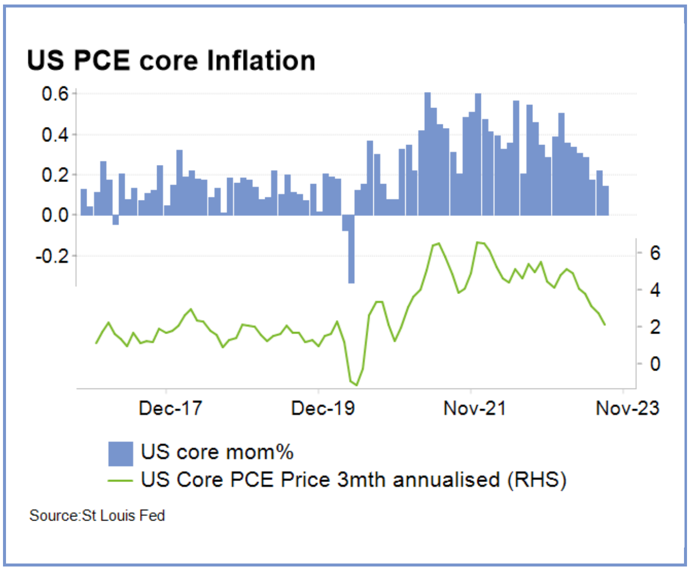
US ISM TROUGH?

- The US ISM manufacturing index rose to 49 in September, still in contraction zone but the best reading in 12 months. Meanwhile, the service sector ISM remains comfortably above the 50-level.



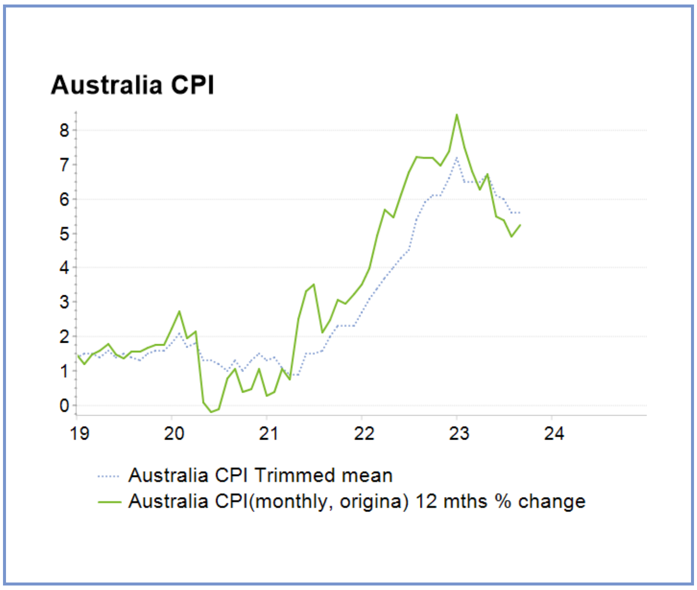
US INFLATION

- US inflation as measured by the core PCE price index, rose just 0.14 per cent in August, following monthly results of 0.2, 0.2, 0.3 and 0.3 per cent. Although the annual rate is 3.9 per cent, down from last month's 4.3 per cent, the last five months are annualising at closer to 2.6 per cent.



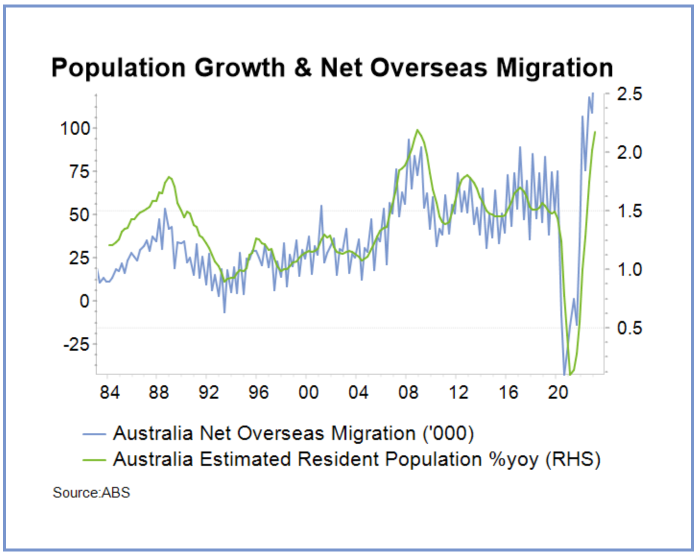
AUSTRALIAN INFLATION

- The August CPI showed inflation rising 0.6 per cent for the month and 5.2 per cent for the year, from 4.9 per cent. Key drivers over the year include fuel costs (up 13.9 per cent), electricity (12.9 per cent), bread and diary (up more than 10 per cent), insurance and financial services (up 8.8 per cent) and rents (up 7.8 per cent). The trimmed measure rose 5.5 per cent, down from 5.8 per cent. The RBA is forecasting 3.9 per cent by year-end for core inflation, requiring results of less than 0.9 per cent per quarter, or 0.3 per cent per month.



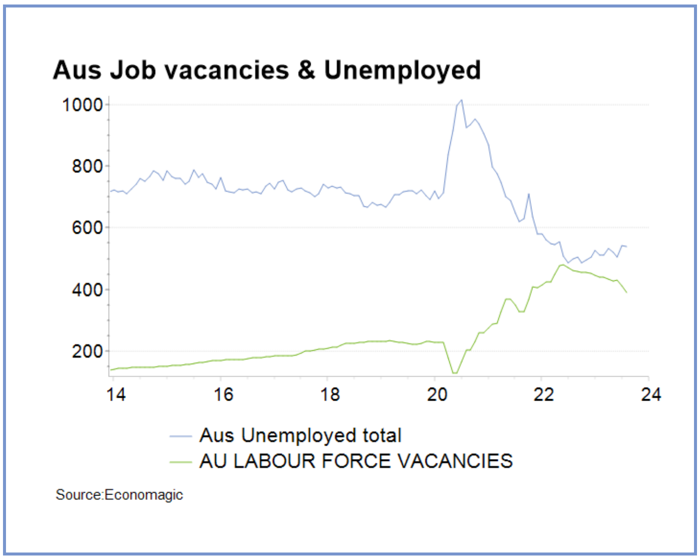
POPULATION GROWTH ADDS TO GROWTH

- Australia notched up a record inflow of 454,000 migrants for the year to March 2023, pushing annual population growth to 2.2 per cent, one of the fastest rates of growth in the developed world.



JOB VACANCIES

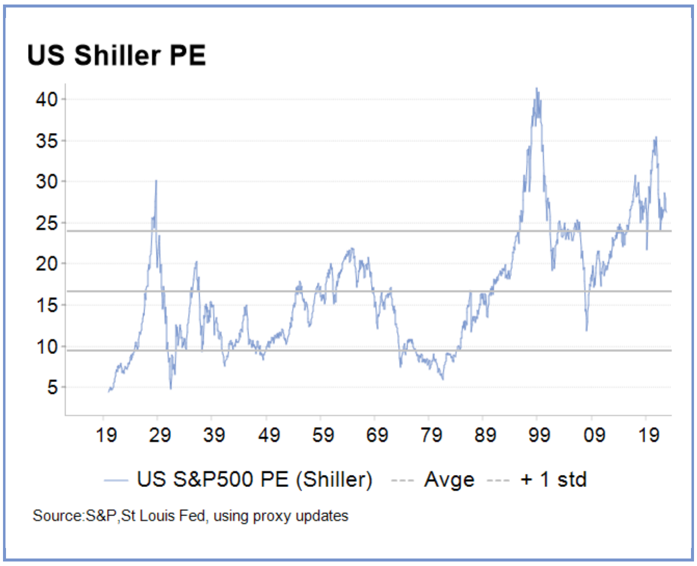
- Job vacancies fell almost 9 per cent in the August quarter to 390,000 (peak was 479,000 in mid-2022). While this suggests a softening in the labour market, total vacancies are still 70 per cent above pre-Covid levels, indicating the labour market is still relatively tight. Average pay rises in new collective agreements over August 12-25 rose to a high of 4.7% according to Fair Work Commission data.



3. Valuations: Overseas

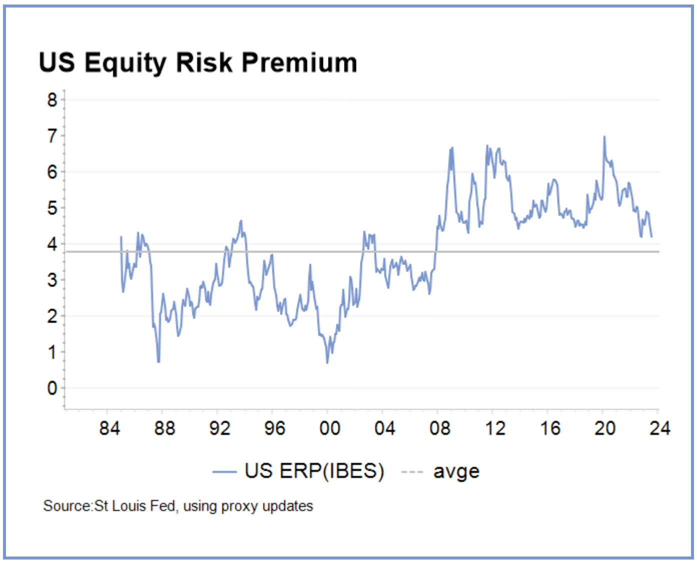
LONG TERM CYCLICALLY ADJUSTED PE

- The long term cyclically adjusted P/E is sitting at 26 times, well down from 37 times in late 2021 but is still well above average levels (17.5) and the low inflation regime average of around 23 times. The high inflation average is close to 15 times.



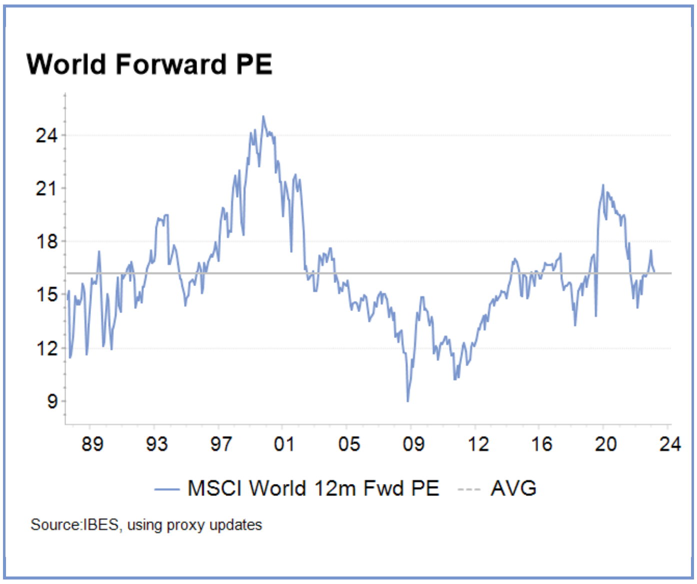
US EQUITY RISK PREMIUM

- The US Equity risk premium based on a 3-stage dividend discount model, using consensus earnings is around 4 per cent at present.
- This is at the low end of the 2008-2023 range, suggesting equities are expensive against bonds. The longer term average ERP is just under 4 per cent and in the period 1985 to 2008 averaged around 3 per cent.



WORLD FORWARD PE

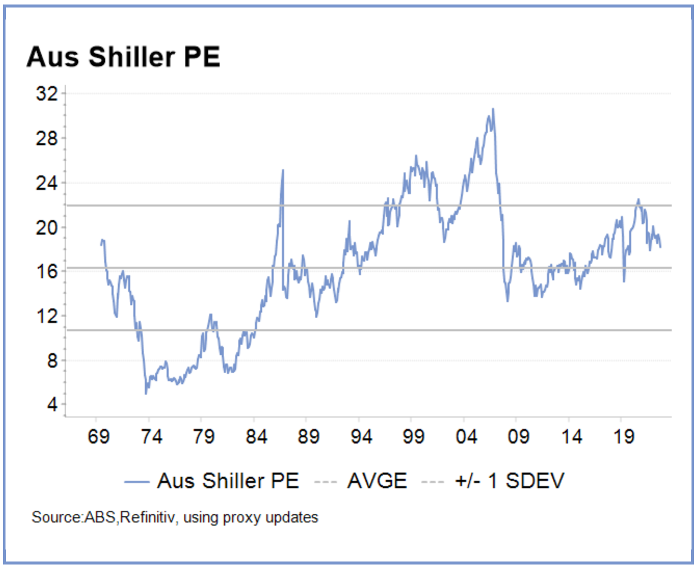
- Developed markets 12 month forward PE sits at 16.3 times, in line with the average of 16.2.



4. Valuations: Australia

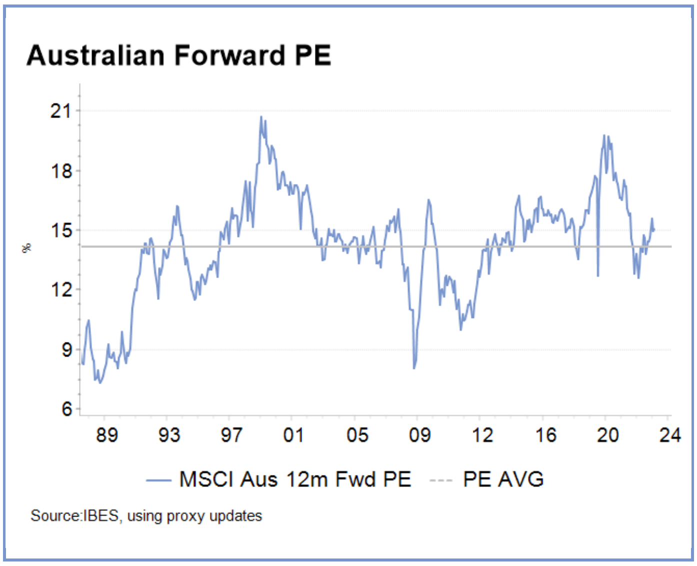
AUSTRALIAN LONGER-TERM VALUATIONS

- Using a Shiller method for calculating PE's the market is at 18 times (compared with the average of 16).



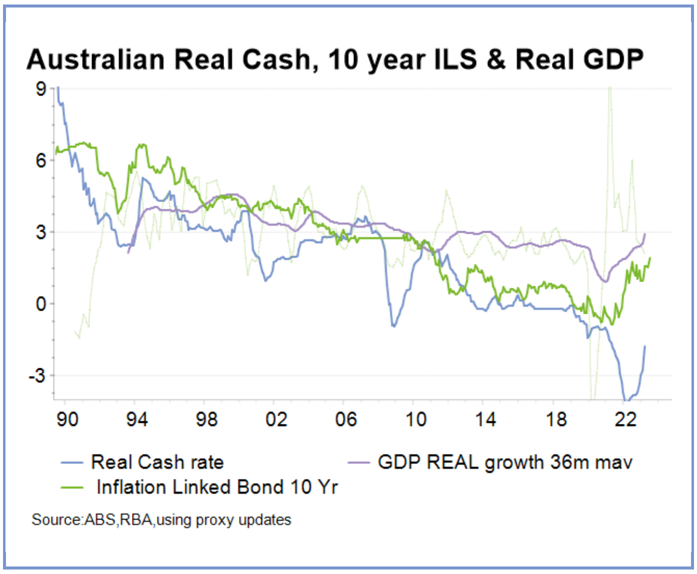
AUSTRALIAN PE

- The Australian PE sits at 14.8 times, slightly above the long-term average of 14 but well down on the recent 20 times in 2020.



REAL RATES AND GDP

- The 10 year inflation linked bond yield ended the month at 1.45 per cent, still well below the trend real GDP growth rate of closer to 3 per cent. Real cash rates are closer to -1.5 per cent.



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