Logical Thoughts

LOOKING BACKWARD AND LOOKING FORWARD

What have been the investment lessons from 2022 and what's in store for 2023?

For those of our clients who prefer the abridged version and some key messages, please read on…

Key take outs

- Australia's official cash rate hit 3.10% in December 2022, the highest level since 2012. Inflation is 6.1% the highest level since 1990. In 2022, this upward trend in interest rates and inflation was mirrored across the globe, resulting in significant volatility across listed asset classes such as equity and bond markets.
- At the time of writing, it is looking like 2022 will be the first year that US stocks and long-term bonds are both down more than 10% in the last 150 years. In fact, high quality US bonds have had their worst year in nearly 100 years.
- 2022 was indeed a wild ride, and yet another year when it paid to maintain an intelligently diversified portfolio. Strategies that were able to take advantage of rising inflation and interest rates held up well. It also illustrated how effective the inclusion of "value style" equity managers and quality unlisted assets can play in a portfolio when the listed markets have experienced unusually high levels of volatility.

- At the end of 2022, we are encouraged by the attractive valuations across domestic and global high-quality bonds. We expect rate hikes in the US and Australia will likely end in the first quarter of 2023, creating an environment in which bond yields should fall and thus bond prices should rise – a good environment for positive bond returns.
- In 2023 we expect global equity markets to underperform in the first half of the year due to concerns surrounding global growth and a downturn in company earnings. Yet as the year progresses, the peak in policy rates in developed markets and stabilization in economic data should see a refocus on equities, so we would expect global equities to bounce based on attractive valuations and corporate action.
- In 2023, we expect a moderate capital gain for the ASX 200 and similar dividend income levels of 2022. A better outcome is possible if China implements looser monetary policy, relaxes their zero COVID approach and stabilise their property market. In addition, a weaker USD (and stronger AUD) will support many of our commodity companies.
- Inflation remains stubbornly high across most global regions, consumer confidence is at low levels, quantitative tightening continues, M2 (Money Supply) turned negative for the first time in known history and China's economy is stuck in first gear. The multitude of challenges paints a complicated investment backdrop heading into next year, and we expect volatility to remain high for some time. However, we continue to believe, and as 2022 has highlighted, that active investment management and intelligent diversification continue to be important investment principles that drive above benchmark portfolio returns in volatile markets.

For those of our clients who enjoy a more in-depth dive into key issues, please read on…

A Deeper Look at 2022

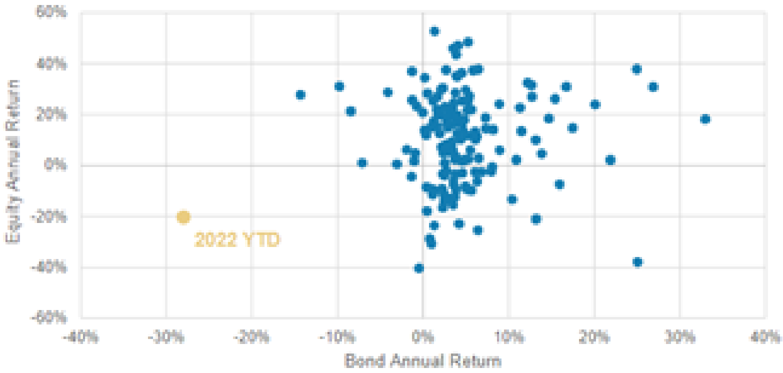
There were three key investment themes from 2022 which strengthened one of the most fundamentals of portfolio construction – the need for intelligent diversification. Bonds and equity performance demonstrated the need for diversification across different asset classes, unlisted assets helped protect against inflation and interest rate rises, and the difference between growth and value stocks demonstrated how different investment styles can impact performance in different market cycles.

Bonds and Equities

2022 will go down as the year in which central banks finally got serious about inflation. It's not that long ago that the official cash rate in Australia was 0.10% (April 2022) and inflation (trimmed mean) was 1.1% (September 2021). Fast forward to the end of 2022 and the official cash rate is now 3.10%, the highest level since 2012 and inflation is 6.1%, the highest level since 1990.

The chart below highlights how unusual the investment landscape has been. In the chart below, if the year ended on the 9th November 2022, it would certainly be an outlier based on the last 150 years, with both bond and equity markets down by well over 10%.

Figure 1: Underperformance in both bonds and equities is very rare



Source: Bloomberg, NBER, Jorda-Schularick-Taylor Macrohistory Database, Morgan Stanley Research, Note: Data back to 1871. Bond return is return on long maturity UST. As at November 9, 2022.

Portfolios that had allocations to other asset classes such as unlisted property, floating rate strategies, infrastructure, credit and cash generally performed better.

<u>Fund manager styles – Value vs Growth</u>

2022 also demonstrated the importance of having diversification in fund manager investment style.

A fund manager's investment style is the 'method' adopted by the manager in selecting companies for their portfolio. A growth manager for instance looks for stocks that are likely to grow earnings at a faster rate than its peers and the "market". A value manager tends to look for stocks that seem to have been neglected by investors and appear to be cheap in valuations, such as a low price to earnings ratio.

The argument over which investment style is likely to outperform over time is heavily dependent on market conditions, economic growth cycles and the performance period in review. As it is simply too difficult to pick the turning points of when one style will outperform another, we typically blend best of breed growth and value managers and this should provide more consistent performance over the long term.

2022 highlighted a significant rotation away from growth-orientated companies such as technology and "new world", and into value-orientated companies such as materials and energy. As the table below highlights, in the last 12 months the Australian equity large value total return benchmark generated a total return of +1.78% and the comparable growth benchmark fell -10.47%.

End October 2022	1 month (%)	3 months (%)	6 months (%)	1 year (%)
Equity Australian Large Growth	5.26	-0.92	-6.10	-10.47
Equity Australian Large Value	+5.86	+1.41	-4.41	+1.78

Unlisted assets

Late 2021 and 2022 were times that investors needed to rethink their defensive and growth components of their portfolios. They needed to find a solution that diversified their traditional bond and equity exposure and hedge against rising interest rates and inflation.

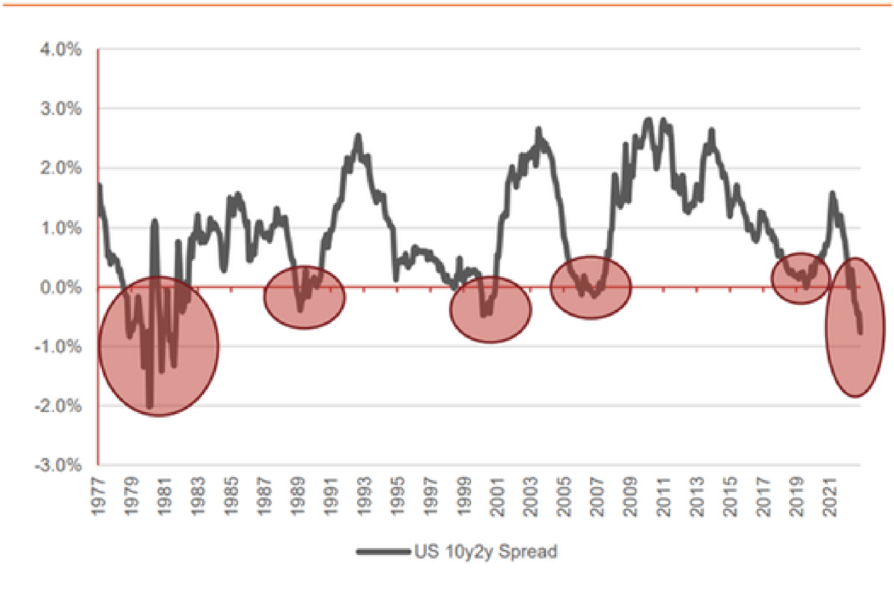
In many portfolios, Logical attempted to hedge the bond exposure by diversifying into a defensive strategy that holds a book of direct corporate loans. Corporate loans pay a variable or floating rate of return. This investment is better off in an inflationary environment, as the interest rate paid is adjusted periodically to reflect market rates. As interest rates rise, the interest paid on the corporate loans should also increase which minimises any capital value losses on their book of loans. This is exactly what has happened in 2022.

In the growth component of the portfolio, high quality unlisted direct property continued to perform well, providing income adjusted by rental increases and positive six-monthly capital revaluations. This offset to some extent the volatility of equities over 2022.

What's in store for investing in 2023?

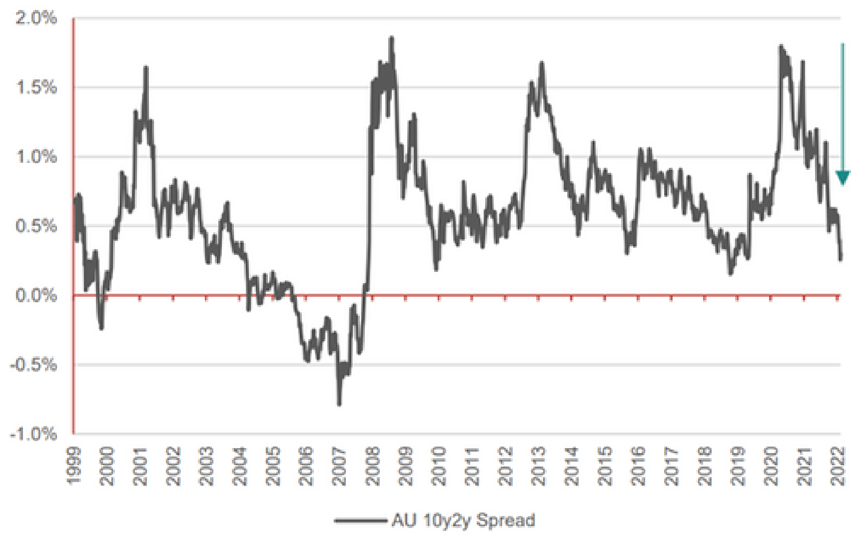
The most important theme, in our view, for the year ahead is the coming end of the central bank hiking cycles in both the US and Australia. Inflation has peaked in the US and in the process of doing so locally. There are signs of a slowing macro backdrop, including aggregate demand and economic growth which is likely to end in a recession among developed economies (there will be considerable divergence across economies).

A well-known indicator of a recession is an inversion of the yield curve (i.e. 10 yr bonds yielding less than 2 yr bonds). In the US currently, the curve (chart below) is inverted to a level not seen in 40 years.



Source: BondAdviser, Bloomberg. As at 13 December 2022.

Locally, it remains steep (chart below) relative to the rest of the developed world. The takeaway here is that whilst markets are pricing in weaker forward prospects locally, Australia is again priced to be lucky in performing better against peers in a global downturn. This is a fair assumption predicated on: (1) immigration providing positive capital flows and growth, and (2) commodity prices remaining high versus the past decade. Whilst the first of those assumptions is likely, as has been signalled by the new Labour government, the second is based on China's economic activity bouncing back to pre-COVID levels, following their failed zero Covid policy.



Source: BondAdviser, Bloomberg. As at 13 December 2022.

Also, Australian and US central banks have acknowledged that monetary policy works with a lag, so it is prudent to slow/stop hiking soon to assess the effects. In the US we expect the Fed to raise rates by 0.5% in both December and February, taking the rate to 5%. In Australia, we expect the RBA to raise rates by a further 0.5% - 0.75%, at 25 basis point increments in February and March. However, the risks to our forecasts are to the upside. There will be several implications of an end to the current hiking cycle and a number of economies entering a recession as we outline below.

<u>Better Returns for Bonds</u>

We believe 2023 will be a very different year for bonds. We expect rate hikes will likely end in the first quarter of next year on the back of slowing inflation and softening aggregate demand and as a result yields should gradually grind lower (bond returns up). This is a positive environment for bonds given the attractive starting valuations due to this year's poor performance (unit prices are trading at a large discount).

We believe investors should gradually increase duration exposure as global economies slow. History indicates investors are more likely to rotate into bonds and out of equities as we move into a recession.

Moderate to flat equity returns

The outlook for Aussie equities in 2023 is a mediocre one. In 2023 investors will need to contend with the headwind of a moderating profits outlook. We forecast a moderate capital gain for the ASX 200 in 2023 but similar dividend income levels of 2022.

We believe, if the Chinese economy implements looser Monetary policy, relaxes its zero COVID approach and stabilises their property market, it will be a positive for the Australian share market and provide upside to our view on capital gains for the ASX 200 in 2023.

In the US, a tighter monetary policy and global liquidity conditions outweighed our higher commodity prices, resulting in a stronger USD relative to AUD. We expect a weaker USD will eventuate as we approach the end of the Fed tightening cycle, the currency may be already weakening.

Globally we expect near-term economic challenges and an earnings recession in 2023 resulting in elevated volatility in risky assets, such as equities. Yet, as the year progresses, the peak in policy rates in developed markets and stabilization in economic data should see a refocus on equities based on attractive valuations (second half of the year) and possible corporate action. The early-recovery phase of an economic cycle typically presents the strongest return prospects and as discussed above, a bounce back in the equity price index.

This view is supported by Morgan Stanley Asset Management (MSAM). MSAM believe 2023 bottom-up US consensus earnings are materially too high due to slower aggregate demand and higher costs. They have a price target on the S&P 500 (US market) of 3,000 – 3,300. The S&P 500 price index is currently at 3,941, from here that's at least a 16% fall in the index. However, they believe after hitting the low point, the index will finish the calendar year at 3,900.

Implications for clients

- We believe high quality bonds are still better value now and investors should be rewarded in the next 12-18 months as bonds mature at par value and new bonds are purchased at much higher yields.
- The higher interest rates will likely drive aggregate demand in the US lower and result in an output and earnings recession. This will have a negative impact on the equities component of portfolios in the next 3-6 months BUT should be positive for bonds.
- We continue to be concerned about what is happening in the unconventional monetary policy sphere – that of quantitative tightening (QT) – the shrinking of the Fed’s central bank’s balance sheet. If that transpires, it will be tantamount to a de facto increase in interest rates of around 3.0%.
- We remain hopeful that China will fully re-open their economy in 2023 which will be a positive for the global economy and particularly Australia. In combination with a loose monetary and fiscal policy, this will drive demand for global commodities and assist with supporting global aggregate demand. For example, recently, China announced the relaxation of some Covid restrictions and as a result iron ore prices rallied and the share prices of BHP, RIO and FMG have followed.
- We remained concerned about the US M2 Money Supply turning negative in 2022 (first time in history or since the data was collected in 1959). A study carried out by Wenzel, showed that large drops in Money Supply could be a sign of share market pullbacks. His theory, derived from Murray Rothbard, states that when the market experiences a shrinking growth rate of Money Supply (or even negative), it can create liquidity issues in the markets, leading to a sell-off. While not a perfect predictive tool, many of the dips in Money Supply precede market dips.
- For those living off investment income, say in retirement mode, we expect good levels of gross investment income generated by our portfolios (including franking tax credits).
- For those accumulating for some years prior to needing to rely on personal wealth to support lifestyle, reinvesting your investment income distributions and dividends provides a great opportunity to purchase additional units or shares at lower prices. This means that when the eventual recovery returns, these portfolios recover far quicker in value. We have already seen this strategy in play for 2022 with great success…although capital values fell, portfolio investment income was strong allowing more units to be purchased when reinvested.

And finally….

2023 could be a year of greater variations in economic performance and policy response. The multitude of challenges paints a complicated investment backdrop heading into next year, and we expect volatility to remain high for some time. However, we continue to believe, as 2022 has highlighted, that active investment management and intelligent diversification continue to be important investment principles that drive above benchmark portfolio returns in volatile markets.

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Gavin has been an investment specialist for more than 20 years and is the head of Investment Research at Logical.

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