JBWere

The CIO View

Issue date: 17 April 2024

Putting Wealth To Work For Generations

Sally Auld
Chief Investment Officer

The CIO View – Markets and macro

JBWere View

The very supportive backdrop for both fixed income and equity markets in Q124 is starting to unravel. In large part, this has been driven by a run of three consecutive stronger-than-expected US inflation data releases. This week, the Fed Chair validated the market's expectation that the easing cycle will no longer likely begin mid-year. Markets are thus currently digesting the impact of a higher-for-longer rates backdrop. In this week's publication, we run through recent developments and think about what might lie in store in 2025. While our modal forecast is unchanged, the distribution of risks either side of this forecast now reflects a greater range of outcomes (that is, more uncertainty).

Key Points

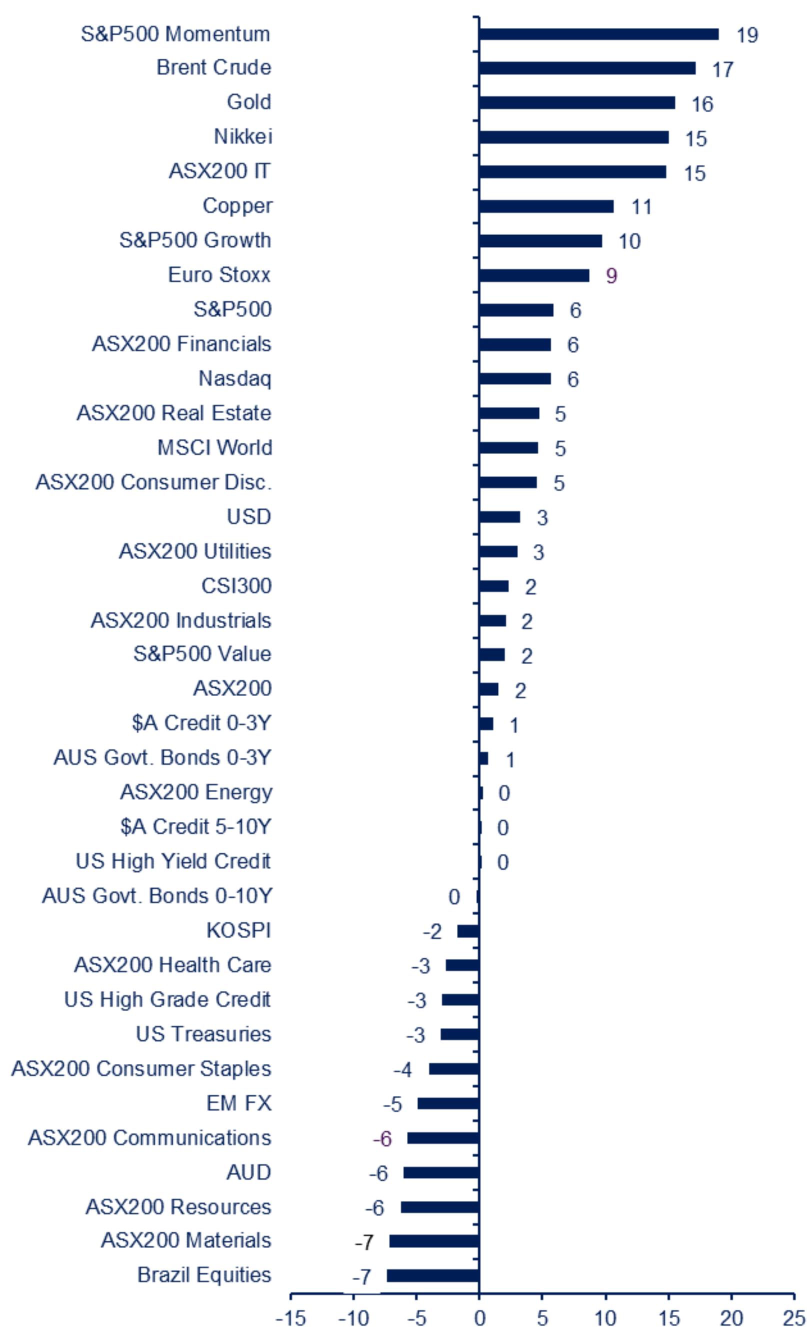
- The past couple of weeks have seen US equity markets retrace (DJIA -5%, S&P500 and Nasdaq -4%, local currency terms) as the supportive foundations that drove a friendly first quarter for both growth and defensive asset classes become more challenging. In the wake of a run of stronger-than-expected US inflation numbers, markets are now having to digest the prospect of a higher for longer rates environment.
- Bond yields are rising as the market both pushes back and pares expectations around the coming easing cycle in the US, the USD is rallying vs. G10 peers and there has been a broad and significant rise in commodity prices and inflation breakevens. Forecasters have been revising both global growth and developed market inflation forecasts higher. And at the same time, geo-political risks appear to be escalating.
- By any measure, this is not an easy environment to navigate. Perhaps most importantly, it raises the prospect of a wide range of possible outcomes into 2025. Our modal forecast (central case scenario) remains one in which the lags associated with significant monetary tightening eventually pressure the private sector, such that margins compress, labour markets loosen, economic growth slows and inflation returns to target. Hence our conviction around more defensive portfolio positioning, at both an asset class and whole of portfolio level.
- But recent developments have also increased uncertainty around other possible outcomes, in our view. These range from a world in which the US neutral rate is considerably higher thanks to sustained positive supply side developments, to one in which the Fed needs to resume the tightening cycle in order to force the last leg of disinflation via recession.

Commodities are having a solid year so far, with gold and oil performing strongly amid heightened geo-political risks

Market summary

The past fortnight has delivered a remarkable turn in sentiment, with equities and bond markets retracing, the USD strengthening and both gold and oil making new year-to-date highs. This shift has been driven by a third consecutive higher-than-expected inflation number in the US, and comments from the Fed Chair that the start of the easing cycle is now further away than FOMC members previously thought. Major US equities indicies are up 6% so far this year, US Treasuries are down 3% and the AUD is now off 6% for the year. Brent is up 17% and Gold is up 16%, with gains in the latter driven in part by investors' perceptions of heightened geo-political risk. The Nikkei remains the best performing developed economy equity market, up 15% so far.

Chart 1: Year-to-date returns, selected financial assets (local currency); %



Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance. ASX200 is TR Index.

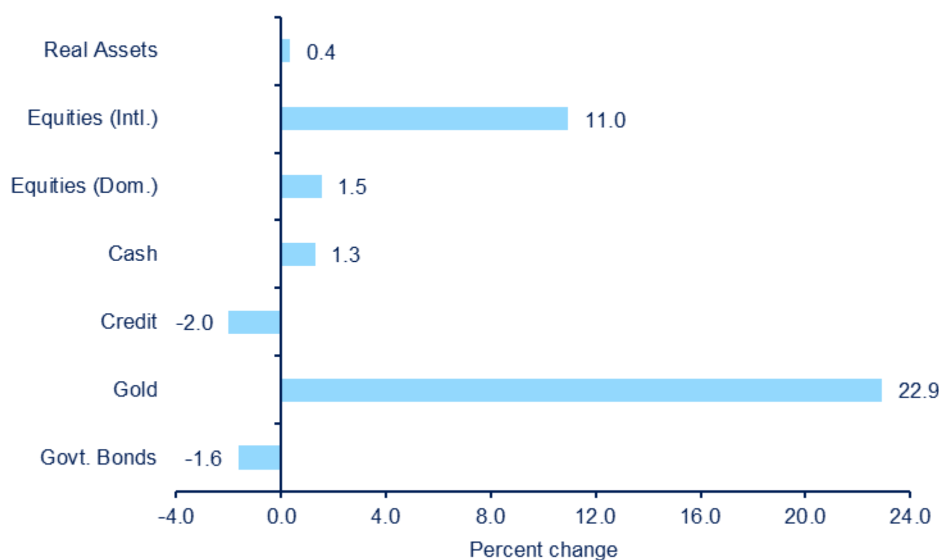
Chart 2 shows the seven asset classes we use in our Strategic Asset Allocation (SAA) at JBWere and illustrates year-to-date performance for these seven asset classes. As a reminder, the benchmarks for each asset class are as follows:

- **Cash**: weighted average of the Bloomberg AusBond Bank Bill Index (50%) and the Australian Banks' Term Deposit 1-year rate (50%)
- **Government Bonds**: Bloomberg Barclays Global Aggregate Treasuries Total Return Index, hedged into AUD
- **Credit**: Bloomberg Barclays Global Aggregate Credit Total Return Index, hedged into AUD
- **Domestic Equities**: ASX200 Total Return Index
- **International Equities**: MSCI ACWI Gross Total Return Index, AUD unhedged
- **Real Assets**: weighted average of the FTSE EPRA/NAREIT Global Index Total Return, AUD unhedged (50%) and the FTSE Developed Core Infrastructure 50/50 Total Return Index, AUD unhedged (50%)
- **Uncorrelated Assets**: we proxy using the $A price of gold

For $A multi-asset investors, global equities and gold have been the best performing assets so far this year

The combination of a rising gold price and falling AUD has been very favourable for holders of Gold in $A terms, such that Gold is now the best performing part of the multi-asset portfolio for an Australian domiciled investor. Elsewhere, international equities continue to perform well, up 11% for the year as losses in the AUD continue to provide a cushion for this asset class. Other asset classes – real assets, domestic equities, cash, government bonds and credit – have registered small gains or losses so far this year.

Chart 2: Strategic Asset Allocation – Year-to-date $A returns



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Both growth and inflation forecasts have been revised higher so far this year, and PMI data in recent months have reduced some of the starker divergences that plagued the global economy last year

Markets and Macro

There have been a lot of moving parts to the macro and markets backdrop of late. On macro, there have been a number of key developments:

- **Globally, data have generally printed on the stronger side of expectations**, forcing upward revisions to the growth outlook. Forecasts for global growth have been lifted in recent months (**Chart 3**), helped by an acceleration in Chinese growth in 1Q, some signs of green shoots in Europe (for example, the composite PMI has lifted almost 4 index points since October) and still robust growth in the US.

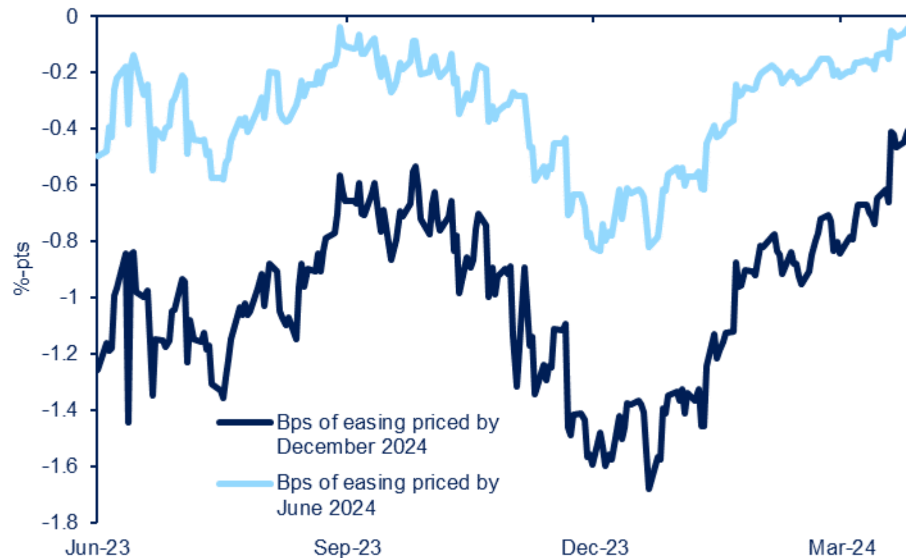
Chart 3: Both global growth and developed market CPI forecasts have been revised higher

Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

- **PMI data in recent months have reduced some of the starker divergences that plagued the global economy last year**. The gap between services and manufacturing PMIs has narrowed, as has the gap between European and US PMIs.
- **Forecasts for inflation have also been lifted so far this year**, reflecting some stickiness in global core inflation (**Chart 3**). The decline in global goods prices appears to have stalled, while still tight labour markets have likely hampered material progress on services disinflation. Last week's third consecutive strong inflation print in the US is a stark reminder that major disinflationary episodes have not occurred without a significant cost to output and employment.
- **Some central banks have continued to guide towards a mid-year start to the easing cycle, such as the ECB**. Markets are also reasonably comfortable with a mid-year start to the easing cycle in Canada and Sweden. **Elsewhere, particularly in the US, markets have pared back the magnitude of tightening expected in the second half of this year and pushed back the expected start of the easing cycle** (**Chart 4**). This move towards less easing was exacerbated last week in the wake of stronger-than-expected inflation numbers and was validated by comments from the Federal Reserve Chair this week, where he noted that:

  "Given the strength of the labor market and progress on inflation so far, it is appropriate to allow restrictive policy further time to work and let the data and the evolving outlook guide us..."

Chart 4: The market has repriced the US front-end quite considerably in 2024



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

In Australia, data give the RBA no reason to consider higher rates, but nor do they give the central bank immediate cause to ease

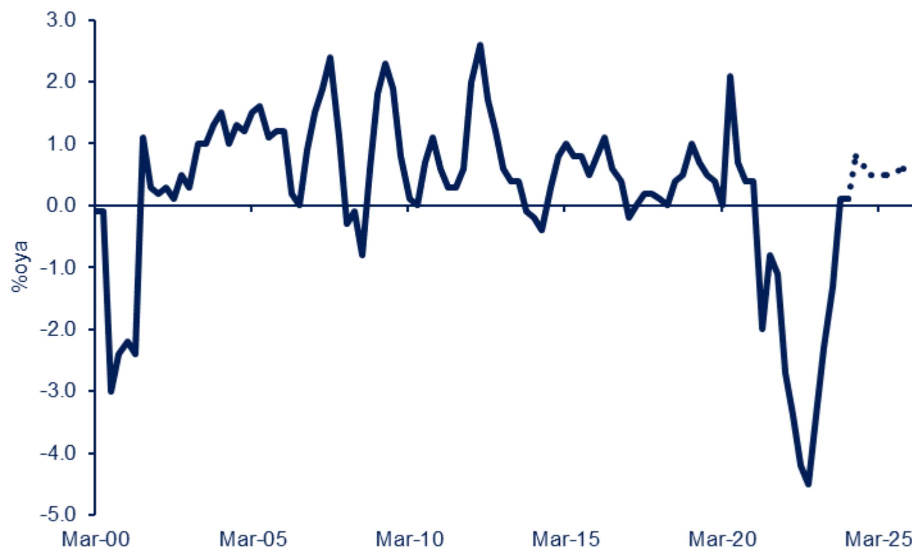
- **In Australia**, data of late have revealed **1)** signs of stability in forward indicators of labour demand and perceptions of the labour market (SEEK job ads, WBC-MI unemployment expectations); **2)** rising house prices in most capital cities; **3)** stability in measures of business confidence and conditions; **4)** evidence of a moderation in price pressures in 1Q (NAB business survey); **5)** rising home loan demand but weakness in building approvals and **6)** still soggy consumption.
- **This set of data are consistent with the RBA's approach of "not ruling anything in or out"**. Strength in house prices (**Chart 5**), mortgage demand and labour market indicators will prevent the RBA from cutting rates anytime soon, while evidence of moderation in price pressures and softness in consumption for the time being will prevent the RBA from considering the need for higher rates.

Chart 5: There are tentative signs of a trough in house prices in Australia

Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

- Looking ahead, the RBA will be mindful of the impact of Stage 3 tax cuts, rising real incomes (**Chart 6**) and stronger global growth on the economy. **The RBA will also be watching the US experience very closely, given the consistent lag between US and Australian economic outcomes since the beginning of the pandemic**.

Chart 6: Real wages will rise in 2H24 (dotted line is RBA forecast)



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

In terms of key developments in markets:

- **Markets and forecasters are now starting to attribute a higher probability to a "higher-for-longer" rates outlook**, and are thus placing less probability on a return to pre-pandemic rate settings.
- **Equity markets have retraced in the past week**, as the prospect of restrictive monetary policy for longer starts to percolate through investors' thinking. This comes against a backdrop where the equity risk premium looks low, relative to history (**Chart 7**) and valuations are on the higher side of long-term averages. This, combined with still elevated interest rates, means that the risk/return curve remains very flat.

The equity risk premium remains low, and valuations are still elevated in US stock markets

Chart 7: US equity risk premium (S&P500)

Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

- **Commodity prices have rallied of late**; Brent prices are up 17% so far this year, Gold continues to appreciate and Bloomberg's index of industrial metals has rallied over 7% in USD terms so far this month. Usually, a broad-based rally in commodities tends to reflect broadening optimism about the growth outlook.
- **Breakevens have rallied too**, as markets price in the impact of higher commodity prices (particularly oil); see **Chart 8**.
- **Financial conditions have eased considerably** in recent months (credit spreads tighter, equity markets higher etc.); typically looser financial conditions prove to be supportive for earnings and growth in coming quarters.

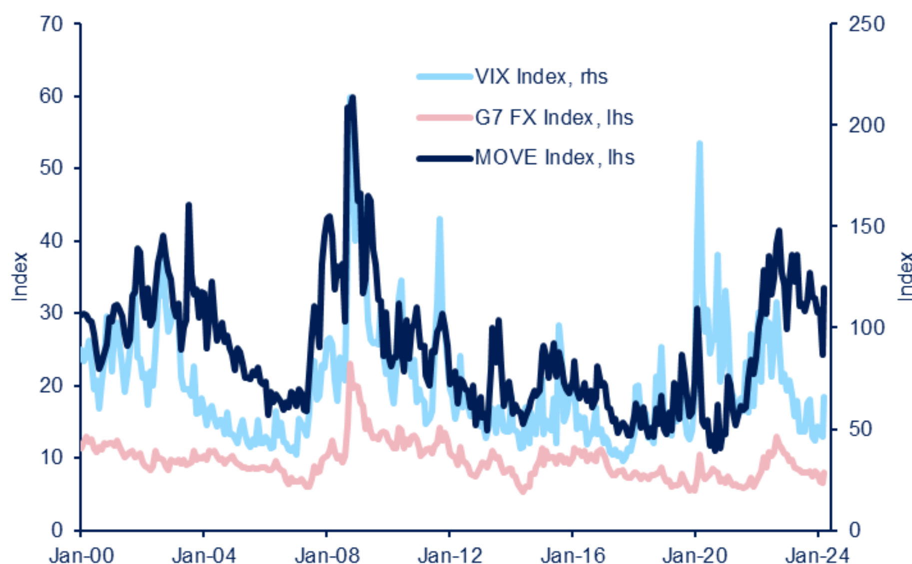
Chart 8: US breakevens have rallied so far this year

Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Measures of implied volatility across markets are rising as the implications of a "higher for longer regime" are absorbed

- **Implied volatility has lifted but still remains relatively low** across most markets, particularly so in equities and foreign exchange but less so in bond markets (**Chart 9**).

Chart 9: Measures of implied volatility across markets remain low, but are rising



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Taken together, this set of circumstances doesn't really reflect the notion that economies are late cycle, that growth is likely to slow and unemployment rates are likely to rise. It also doesn't appear to be consistent with the more defensive positioning we have adopted in our multi-asset portfolios in recent quarters. Indeed, rising PMIs, rallying commodity prices, stronger breakevens and elevated equity markets are all usually consistent with an optimistic growth outlook.

One explanation for this outcome is that the health of the private sector – as measured by the state of household and corporate balance sheets, profits growth and nominal incomes growth – has been more robust to higher rates than expected. Ordinarily, it might be expected that high-for-long policy stances would weigh on growth through tighter financial conditions and increasing debt service costs. However, as we noted above, financial conditions have eased significantly.

In addition, favourable supply side developments have also contributed to better growth outcomes. In the US, population growth has been boosted by strong immigration, and productivity outcomes have looked good of late.

Scenario planning[1]

While it is relatively easy to understand the dynamics behind growth outcomes of late, it is nonetheless the case that greater certainty about the near-term outlook (still solid growth, less easing etc.) belies greater ambiguity about the outlook beyond 2024. Below, we outline some scenarios that could play out into 2025 and consider briefly their implications for asset allocation.

Reasonable certainty about the near-term outlook belies greater uncertainty about the outlook beyond 2024

Scenario 1: Robust growth, still tight labour markets and sticky inflation ultimately force a resumption of the central bank tightening cycle, which eventually short circuits the expansion and delivers recession in 2025. We would suggest a 15% probability for his scenario. Effectively this scenario would see both duration and equities to under-perform near term; own higher cash and commodity weightings.

Scenario 2: Robust growth and sticky inflation and higher-for-longer rates eventually break the private sector (via tighter financial conditions, margin compression, weaker labour market etc.) as neutral rates haven't shifted meaningfully higher. We would ascribe a 45% probability to this scenario; keep current portfolio positioning.

Scenario 3: The immaculate disinflation continues, allowing central banks to cut rates back towards pre-pandemic levels and leaving growth still solid (that is, soft landing). We'd attach a 25% scenario to this outcome, which is largely priced at present, although perhaps with some scope for duration to perform as rates can fall by more than currently priced. Actively rebalance portfolios in order to prevent drift towards higher growth asset allocations.

Scenario 4: Finally, economic growth and falling inflation are sustainable at current levels of rates as a result of positive supply shocks (that is, the neutral rate of interest is now much higher). We'd attach a 15% probability to this scenario, bearing in mind that high rates of immigration growth are usually not sustainable, and nor are cyclical bounces in productivity. Nonetheless, this scenario would require a re-allocation of investment capital towards equities (higher profits due to positive supply side shocks), but also would retain a higher allocation to fixed income relative to history given a higher term structure of rates.

Readers will be aware that the sum of the probabilities of Scenarios 1 and 2 is 60%. This is essentially why we remain defensively positioned in our asset allocation and in our within asset class strategies as we see it likely that either financial markets or the Fed (or both) tighten financial conditions.

[1] Our scenarios take inspiration from the JPMorgan *Global Data Watch* of 12 April.

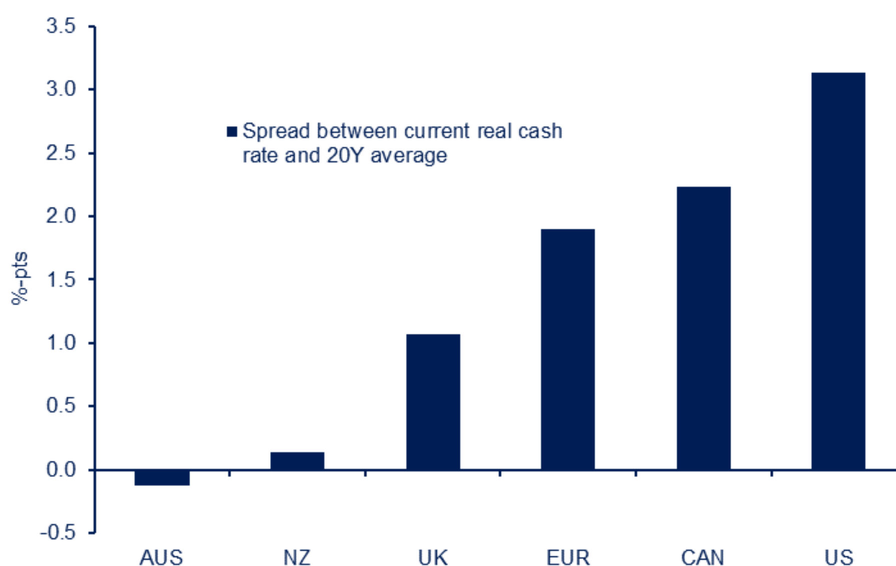
The level of the neutral cash rate in the US is a key uncertainty

Key questions

Uncertainty about the outlook is not unusual, but it seems exacerbated by ambiguity on a number of key issues.

A key issue is whether the neutral rate of interest is really higher, or alternatively, to what extent will positive supply side developments be sustained? This question is key to the issue of whether policy is not as restrictive as most economists (and the Fed) currently believe. For example, the current nominal policy rate target of 5.25%-5.50% is well above the FOMC's long run estimate of the nominal neutral rate (2.6%). On any measure, the spread between these two indicators is suggestive of a restrictive setting to monetary policy (**Chart 10**).

Chart 10: Relative to the last 21 years, US monetary policy looks very restrictive



Source: JBWere and IMF. Past performance is not a reliable indicator of future performance.

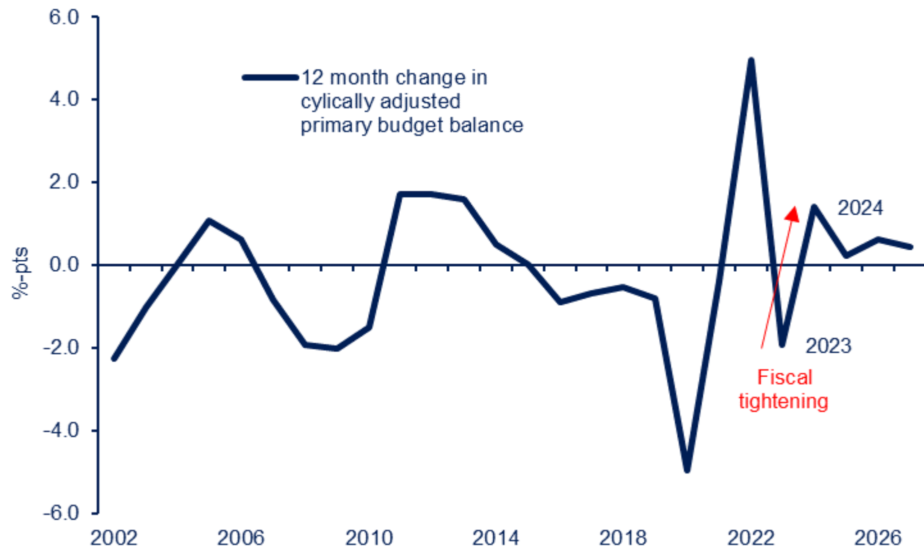
The argument in favour of a higher neutral rate of interest would be that in the light of improved productivity growth and higher labour supply growth in the US, trend growth for the US economy is now higher. Of course, this argument relies upon the notion that both of these developments are sustained beyond the near term. While we suspect it is too soon for policy makers to make a call on this, we do nonetheless believe that the adoption of Artificial Intelligence will deliver sustained productivity benefits to the US economy over the next decade and beyond. All else equal, this is a positive supply side shock which will lift trend economic growth, the neutral interest rate and potentially, depending on how the additional surplus is shared between labour and capital, profits too.

But we don't think it significant enough to force a meaningful rethink of monetary policy settings in the near term. Neutral might be a bit higher than the Fed's current 2.6% assumption, but not by such a magnitude that would render a policy rate of 5.25-5.50% not restrictive.

Another issue that our prior research has discussed is the impact of US fiscal policy in recent US growth outcomes. Expansionary fiscal policy can be a driver of growth, and the change in the cyclically adjusted primary balance year to year is one simple way to get a sense of the extent to which fiscal policy is a tailwind or headwind to growth. This balance excludes interest payments from the deficit, and also adjusts for the state of the economy. To that extent, it gives a measure of discretionary (that is, deliberate) fiscal decisions. **Chart 11** shows that between 2022 and 2023, the cyclically adjusted primary deficit increased by 1.9%-pts.

On IMF forecasts, US fiscal policy will tighten from 2023 to 2024

Chart 11: Measures of implied volatility across markets remain low



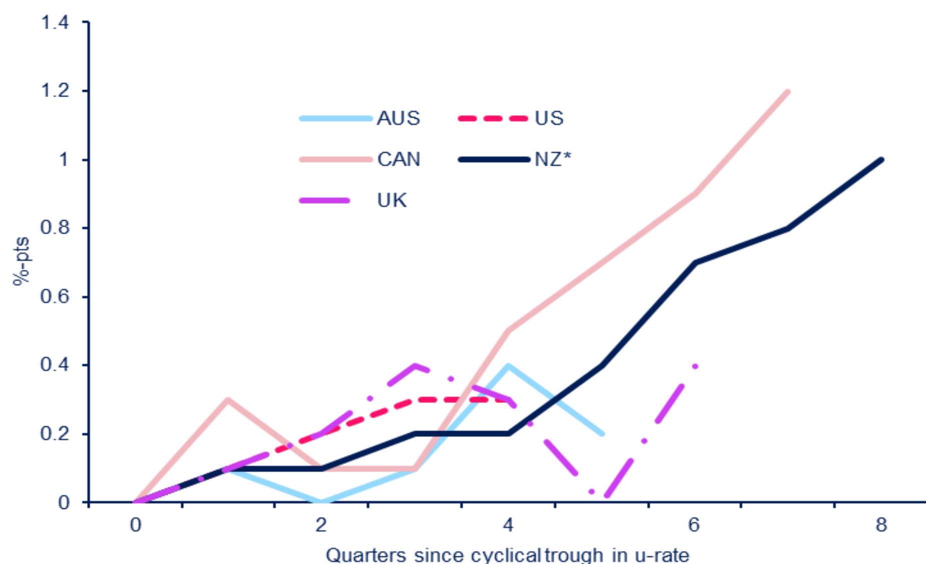
Source: JBWere and IMF. Past performance is not a reliable indicator of future performance.

Looking ahead, the IMF forecasts a significant contraction in the cyclically adjusted primary balance in the US from 2023 to 2024, suggesting that fiscal policy will be less supportive for growth this year. This may see growth slow (as per consensus forecasts) and underscores why the cumulative probability of Scenarios 1 and 2 remains above 50%, in our view.

Finally, whether the myth of the soft landing is one worth subscribing to. Historically, soft landings are unusual, but not impossible (this article - ***Landings, Soft and Hard: The Federal Reserve, 1965–2022 (aeaweb.org)*** - presents a good summary). As the author notes, the Fed's dual mandate (price stability and full employment) effectively pushes it to achieve a soft landing. But the so-called "long and variable lags" associated with monetary policy have more often than not meant that the Fed has over tightened, forcing the economy into recession. In our analysis above, we have attributed a 25% chance to a soft landing. Some might argue this is too low given recent events, but the experience in New Zealand (double-dip recession) and Canada (unemployment rate +120bps from cyclical low) are instructive.

Labour markets have loosened a lot in NZ and Canada already; does this portend a similar outcome in the UK, US and Australia?

Chart 12: Are Canada and NZ telling the UK, US and Australia something?



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance. *Assumes Mar-24 unemployment rate of 4.2%

Any advice in this report has been prepared without taking into account your objectives, financial situation or needs. You should consider the appropriateness of the advice in light of your own financial circumstances. Where relevant, offers of units in any of the investment vehicles referenced in this document are made under a product disclosure statement which is available from your JBWere adviser. We recommend that you consider the product disclosure statement in deciding whether to acquire units in relation to any particular product mentioned in this report.

Prepared by the Investment Strategy Group

JBWere Offices

Melbourne T (03) 9906 5000

Sydney T (02) 9325 2600

Brisbane T (07) 3258 1111

Adelaide T (08) 8407 1111

Perth T (08) 9212 7900

Canberra T (02) 6218 2000

Email Investment.strategy@jbwere.com

Sally Auld Chief Investment Officer

Disclaimers and general disclosures

Important Notice

This report has been prepared by JBWere Limited (JBWere) and comprises general advice only. In preparing it, JBWere did not take into account your investment objectives, financial situation or particular needs. Before acting on any advice contained in this report, you should consider whether the advice is appropriate in light of your financial circumstances or contact your adviser. JBWere recommends that you consider the relevant Product Disclosure Statement or other disclosure document, where relevant, before making investment decisions in relation to any particular product mentioned in this report.

JBWere's advisers and other professionals may provide oral or written market commentary or trading strategies to clients that reflect opinions that are contrary to the opinions expressed in this report, and they may make investment recommendations that are inconsistent with the recommendations or views expressed in this report.

Ownership and Material Conflicts of Interest

JBWere requires all research personnel to disclose to JBWere any material investment position or financial interest in issuers that they review. Research personnel are paid in part based on the profitability of the National Australia Bank Limited group (**NAB Group**), which includes JBWere.

No business units within the NAB Group which provide corporate advisory services, including JBWere's markets division (which provides capital raising services) have any input into determining the budget decisions, bonuses or allocations of resources for any business units within JBWere which produce research. The revenue and results of JBWere's markets division are not taken into account when determining JBWere's research budgets or expenses.

In the last twelve months, JBWere has played a role in transactions for certain entities which may be referred to in this report. For details, go to ***Deal Flow Participation***.

JBWere's research analysts may from time to time hold financial products that are the subject of a JBWere research report.
The ***Managing Conflicts of Interest and Maintaining the Integrity of Research Policy*** sets out how JBWere manages these conflicts. Please refer to the ***list of financial products currently held by JBWere's research analysts***.

The NAB Group and associates, may have provided, provides or seeks to provide investment banking, capital markets and / or other services, to the issuers and their associates mentioned in this report.

Our research process

Further information about the methodology applied by JBWere in preparing research reports is available on the JBWere website.

General Disclosures

This report is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The information contained in this report is subject to change without notice. The price and value of the investments referred to in this report and the income from them may fluctuate. Past performance is not a guide to future performance. Future returns are not guaranteed and a loss of original capital may occur.

Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors.

In producing research reports, members of JBWere's Investment Strategy Group may attend site visits and other meetings hosted by the entities mentioned in those reports. In some instances the costs of such site visits or meetings may be met in part or in whole by the issuers concerned if JBWere considers it is appropriate and reasonable in the specific circumstances relating to the site visit or meeting.

JBWere's research is disseminated primarily electronically, and, in some cases, in printed form. Electronic research is generally made available simultaneously to all clients.

General Disclaimer

So far as laws and regulatory requirements permit, JBWere, its related companies, associated entities and any officer, employee, agent, adviser or contractor thereof (**JBWere Group**) does not warrant or represent that the information, recommendations, opinions or conclusions contained in this report (**Information**) is accurate, reliable, complete or current and it should not be relied on as such. The Information is indicative and prepared for information purposes only and does not purport to contain all matters relevant to any particular investment or financial instrument. Subject to any terms implied by law and which cannot be excluded, the JBWere Group shall not be liable for any errors, omissions, defects or misrepresentations in this report (including by reasons of negligence, negligent misstatement or otherwise) or for any loss or damage (whether direct or indirect) suffered by persons who use or rely on the Information. If any law prohibits the exclusion of such liability, the JBWere Group limits its liability to the re-supply of the Information, provided that such limitation is permitted by law and is fair and reasonable.

Research Analyst Disclaimer

The Information accurately reflects the personal views of the author(s) about the securities, issuers and other subject matters discussed, and is based upon sources reasonably believed to be reliable and accurate. The views of the author(s) do not necessarily reflect the views of JBWere. No part of the compensation of the author(s) was, is, or will be, directly or indirectly, related to any specific recommendations or views expressed in this report.

Other Research Providers

This report may contain a restatement, summary or extract of a report prepared by UBS Securities Australia Limited (**UBS**) or a related body corporate (**UBS Report**). Please contact your JBWere adviser if you would like a copy of the UBS Report. For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research, please visit ***www.ubs.com/disclosures.***

This report has been prepared for distribution only to clients of JBWere (and potentially to clients of other financial advisers). It may not be reproduced or distributed without the consent of JBWere. Please refer to the full details of the important disclosures, available in the ***Disclosures section of the JBWere Limited website.***

Issued by JBWere Ltd ABN 68 137 978 360 AFSL 341162.

Distribution in New Zealand

This report has been produced for Australian clients where Australian macro-economic factors have been considered (in addition to global ones). Please be aware of this if reading this report outside of Australia.