RIPPL Investment Commentary

JUNE QUARTER 2023

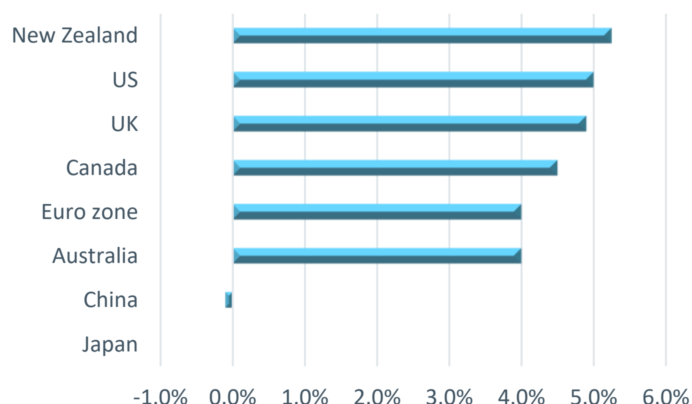
Persistent inflation and rate hikes by global central banks have influenced market behaviour through the first half of the year. Although headline inflation has been falling, core inflation is a key concern and remains high, leading central banks to raise rates. The real economy is slowing, but investors are hoping and anticipating the peak of the rate hiking cycle. Equity markets have subsequently risen despite the rate increases.

CENTRAL BANK ACTIONS

China's economic momentum slowed in the second quarter, with weak data in industrial output, retail sales, private fixed-asset investment, and property investment. The People's Bank of China (PBOC) reduced the 7-day reverse repo rate by 10 basis points to 1.90% in June, the third reduction during the current phase of economic easing.

Meanwhile, the Reserve Bank of Australia (RBA) surprised markets with a second consecutive cash rate hike in June, raising rates to 4.1%. March inflation data supported the RBA's decision, but lower inflation numbers released for May tempered expectations of further hikes. The RBA kept rates on hold at the 4th of July meeting but kept a tightening bias. The Australian government bond yield increased to over 4% in June following the RBA hikes, after being as low as 3.2% earlier in the quarter. The RBA's more hawkish approach compared to the US Federal Reserve, along with the Fed's pause on their cash rate in June, contributed to the bond yield's movement during the quarter. The higher RBA cash rate also led to the Australian dollar appreciating by almost 4 cents against the US dollar.

Figure 1. Central Banks Actions Since Start of Hiking Cycle



The Reserve Bank of New Zealand raised interest rates twice in the quarter, reaching 5.5%. Uncertainty remains over future rate changes, with some predicting more hikes while others think the RBNZ has done enough. The New Zealand economy experienced a technical recession with a -0.1% GDP contraction in the March quarter. The current account deficit improved slightly to 8.5% of GDP from 9% in the previous quarter.

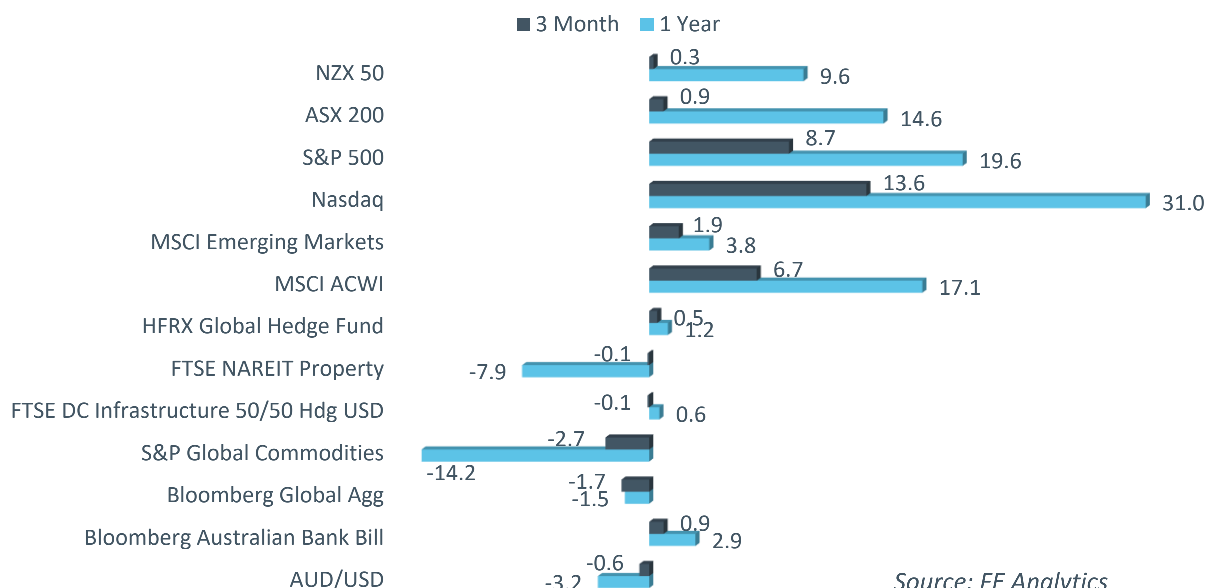
In Canada, the Bank of Canada surprised markets by increasing the cash rate to 4.75% in June. Headline inflation rose to 4.4%. Meanwhile, the Bank of Japan kept rates unchanged due to concerns about inflation falling below 2%.

UK inflation exceeded expectations, with core inflation reaching a 31-year high at 7.1% and headline inflation at 8.7% for the year. This led the Bank of England (BoE) to increase the policy rate by 0.50% to 5.0% in their late June meeting. The BoE has now raised rates at 13 consecutive meetings.

Similarly, the European Central Bank (ECB) raised rates for the 8th consecutive meeting, bringing the deposit facility rate to 3.5%, the highest in 22 years. The ECB also signalled another rate hike in late July due to persistently high inflation. Uncertainty remains about the transmission of rate hikes through the economy.

In June, the US Federal Reserve decided to pause interest rate hikes, keeping the Fed Funds rate at 5.00-5.25%, due to softer headline inflation data. However, the Fed maintained a bias towards tightening. Throughout the quarter, US Treasury rates fluctuated due to uncertainty over inflation and the Fed's actions. The yield curve inversion, along with other indicators such as a decrease in money supply, new orders, housing permits, and average weekly hours in manufacturing, suggested a potential recession. The US debt ceiling issue was temporarily resolved when President Biden enacted the Fiscal Responsibility Act, providing relief to the markets.

Figure 2. Market Indices in Local Currency Terms



Source: FE Analytics

The US equity market performance in 2023 has been dominated by a few large technology stocks, leading to a significant difference between the standard S&P 500 index and the equal-weighted S&P 500 index. The market-cap weighted standard index, influenced by companies like Apple, Microsoft, Amazon, Nvidia, and Alphabet, returned nearly 17% in the first six months, while the equal-weighted index returned just over 7%. The Nasdaq index, mostly comprising technology stocks, had its best-ever return of over 37% in the first half of the year. Apple reclaimed its position as the first $3 trillion company, with Microsoft trailing behind. The remarkable performance of these mega cap stocks is attributed in part to the artificial intelligence thematic, which has excited many investors. However, it is important to consider the extent to which future growth is already reflected in stock prices. In other markets, global bond yields rose, resulting in a slight decline in global bonds. Overall, the sentiment during the quarter was risk-on, as evidenced by positive returns from various equity indices, although the ASX 200 had only a small positive return for the quarter.

What's next?

In 2023, high inflation and central bank actions have greatly influenced market movements. The divergence in data and central bank responses to inflation are notable. The future of inflation is uncertain across economies, as central banks approach the end of their hiking cycles at different stages. As inflation becomes entrenched, monetary policy loses effectiveness in addressing it, increasing the risk of inflation staying above central bank targets. This uncertainty will lead to increased market volatility in the next 6-12 months.

A broader trend that complicates central banks' efforts to control inflation stems from geopolitical issues. Many countries are reevaluating their trade policies, and events like the Russian invasion of Ukraine and concerns about China's actions towards Taiwan and the semiconductor sector have added to this trend. A fragmented global economy with less trade diversification and higher costs will make it more challenging for central banks to tame inflation.

Investors should pay attention to offshore currency exposure. In risk-off environments, the Australian Dollar (AUD) and New Zealand Dollar (NZD) tend to weaken, providing some protection against the unrealised value of foreign asset exposure. While higher interest rates offer a more solid foundation for generating returns, the source of those returns will become less certain as the real economy slows, and the overall market environment becomes less supportive.

Given the ongoing risks posed by inflation to households and businesses, caution is advised. Tighter lending standards are expected to persist throughout 2023, and companies with weaker balance sheets will face pressure on their profits. Regular risk assessment and diligent evaluation of portfolios are crucial for navigating the extended phase of market instability in 2023 and achieving investment objectives.

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