Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio
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Market Review

The US economy continued to perform better than expected in Q2 2023, as GDP expanded +0.6% QoQ and +2.6% YoY, well above consensus forecasts, while real growth for Q1 2023 was revised higher to +0.5% QoQ and +1.8% YoY. The figures released by the Bureau of Economic Analysis on July 27th ward off the spectre of an upcoming recession and strengthen the case for a so-called “soft landing”. Looking under the hood, consumption spending cooled from the spike recorded earlier in the year as durable goods purchases normalized and growth in demand for services was muted. Conversely, business investment in equipment and structures, including manufacturers’ spending on construction (factories), exploded on the back of the various fiscal packages passed by the Congress, namely the Bipartisan Infrastructure Law, the CHIPS and Science Act and the Inflation Reduction Act. The so-called “fiscal impulse” has continued to boost economic growth in the past 12 months, after having been a detractor in H2 2021 and in H1 2022. In fact, direct increases in government expenditures have contributed to roughly 25% of GDP growth over the last four quarters.

The procyclical deficit spending on the part of the government is happening at a time the unemployment rate is not too far from its lowest level in 50 years, an unusual combination which represents a clean break with the Post War, Keynesian tradition. In the “orthodox” countercyclical model, fiscal stimulus is meant to act as a stabilizer at times of economic hardships. When the economy enters into a recession, the unemployment rate increases while tax receipts collected by the government fall. In addition, fiscal stimulus kicks in, that is, the government boosts its expenditures to fill the void left by the private sector. Those two dynamics (lower tax receipts and higher outlays) cause the budget deficit to swell. However, as the economy recovers, the unemployment rate decreases, tax revenues rise and the government gradually reduces its support, passing the baton of primary driver of economic activity back to the private sector. Thus, historically there has been a clear, positive correlation between unemployment rate and deficit spending. When the former rises, the latter rises in response and vice versa.

The relationship was at work during the pandemic and in its aftermath. When the unemployment rate shot up to 14.7% in April 2020, the US government unleashed the largest fiscal stimulus in history, and in the space of 2 months the budget deficit expanded to -15.2% of GDP. Successive relief packages drove the budget deficit to a peak of -18.3% of GDP in March 2021. By then, the economy was already on the mend, with the unemployment rate having more than halved to 6.1%. In the 15 months that followed, tax receipts ballooned while government spending first stabilized, then started to gradually decrease at the margin. In July 2022, the unemployment rate dropped to 3.5%, while the budget deficit shrank to -3.7%. That is when “Bidenomics” started to unfold its powerful stimulative effects, with subsidies earmarked and put to work irrespective of the particular stage of the economic cycle. As a result, the budget deficit started to deteriorate again, despite a humming economy and a stable unemployment rate. From November 2022 until today, the US government has been running a budget deficit greater than -5% of GDP with an unemployment rate lower than 4% for the first time in modern history. Another anomaly is that, because the US government is spending trillions in a growing rather than a recessionary economy, it is issuing a huge amount of debt at a time interest rates are high, further adding to the budget deficit. In fact, the interest rate bill for the calendar year 2023 is on track to reach 1 trillion USD, which could equate to almost 15% of the entire US government spending over the same period of time. In short, under the Biden administration, the US government has gone “Chinese” with its infrastructure initiatives, supporting the economy in the short term, but adding to the debt load in the long run. “American productivity renaissance” or “Japanification” the jury is out.

International Equities

US equities continued their relentless ascent in July, with the S&P 500 (+3.11% in USD terms) and the Nasdaq 100 (+3.81%) rallying for the 5th consecutive month. Gains were widespread as the Russell 2000, which tracks the performance of smaller companies, outperformed the major averages for the second month in a row. The “Old economy” heavy Dow Jones Industrial (+3.35%) posted its longest daily winning streak since January 1987, rising for 13 consecutive sessions between July 10th and July 26th. The S&P Regional Banks Select Industry Index TR jumped +19.38%, recording its 2nd best month ever, on the back of a better than expected earnings season for the group. All sectors ended July in the black, with energy, communication services, financials and materials topping the list and healthcare, utilities, consumer staples and real estate lagging. Technology and consumer discretionary, the best performing sectors since the beginning of the year, underperformed vis-à-vis the general index. In general, investors reacted to rising long term bond yields by rotating into cyclicals and away from growth stocks and defensives. US equities underperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) as the Dollar Index (DXY) fell for the 5th month out of 7 since the beginning of the year. During the month, the measure of the greenback value briefly dipped below the psychological barrier of 100 for the first time since April 2022. Europe and Japan lagged the general index as well. Emerging markets were the only region to outperform on the back of the resurgence in Chinese equities. The CSI Overseas China Internet, which tracks the performance of the largest Chinese Big Tech firms, was up double digit, recording its 5th best month ever. All in all, the MSCI AC World Daily TR was up +3.66% in USD terms and +2.80% in AUD terms as the Australian Dollar strengthened against the US Dollar, but softened vis-à-vis the other major and developed currencies.

Australian Equities

Australian equities rallied smartly in July, supported by better than expected inflation data. The S&P/ASX 300 TR added +2.89% following the release of the Australian Bureau of Statistics’s report, which saw the headline CPI rise +0.8% QoQ and +6.0% YoY, missing expectations of +1.0% and +6.2% respectively. Energy was the best performing sector as the price of oil broke above 80 USD per barrel, an increase of 10 USD in just one month. Technology, utilities, consumer discretionary and telecom outperformed the general index, while healthcare and consumer staples bucked the trend, driven lower by the respective indices’ heavyweights, ending

the month in the red. Financials posted strong gains, led higher by banks and A-REITs. Mid-caps and smaller companies strongly outperformed the Top 20, while value stocks bested growth stocks. Finally, the MSCI Daily TR Net Australia marginally outperformed the MSCI AC World Daily TR, ending a five-month losing streak.

Global Fixed Income

Most major central banks that held a meeting during the month hardened their monetary stance, except for the Reserve Bank of New Zealand (RBNZ); the latter held rates at 5.50% at its July 6th meeting, noting that the cash rate had reached a restrictive level, constraining domestic spending and reducing inflationary pressure “as anticipated and required”. On July 12th, the Bank of Canada (BOC) increased its policy rate by 25 Bps to a 22-year high of 5%. Minutes showed that policymakers debated whether to raise interest rates at that meeting or “to wait for more evidence to solidify the case for further tightening” eventually opting for the first option amid fears the decline in inflation “could stall.” On July 26th, the FED increased its target rate for the 11th time in 12 meetings, bringing it to a range of 5.25%-5.50%. The 25 Bps move was widely expected by market participants. During his press conference, Chairman Powell stated that the central bank’s staff are "no longer forecasting a recession" given the resilience of the economy, but expects a slowdown in growth at the back end of the year. He also said that he sees core inflation returning to the 2% target only in 2025. One day later, the European Central Bank (ECB) delivered another 25 Bps increase, lifting its deposit rate from 3.50% to 3.75%, its highest level in 23 years. Finally, on July 28th, the Bank of Japan (BOJ) left the short term interest rate unchanged at -0.10%, but unexpectedly revised its yield curve control (YCC) policy, allowing the 10 year yield to rise above the 0.5% ceiling by renaming it “point of reference” instead of “upper limit”. In practical terms, the central bank raised the cap to 1%. The Bloomberg Barclays Global Aggregate Index hedged back to AUD was almost unchanged for the month, on the back of government bond yields higher at the back end but lower at the front end and generally tighter credit spreads.

Australian Fixed Income

On July 4th, the RBA held the cash rate at 4.10%, delivering its second pause since May. It was only the second board meeting in the last 14 in which the central bank did not hike. In the accompanying statement, Governor Lowe drew attention to the property market once more, stating that “while housing prices are rising again and some households have substantial savings buffers, others are experiencing a painful squeeze on their finances.” On July 14th, the Albanese Government announced the appointment of Michele Bullock as the 9th Governor of the RBA for a seven-year term beginning on September 18th. She will be the first woman to lead the central bank in its 63-year history. Ms Bullock has risen through the ranks of the RBA following her start as an analyst in 1985. She will assume her new role after 15 months as the deputy governor. The Australian yield curve un-inverted abruptly in July, with the 2 and the 5 year yield falling 28 Bps and 10 Bps to 3.94% and 3.85% respectively, and the 10 year yield adding 3 Bps to 4.06%. The Bloomberg AusBond Composite 0+ Yr rose +0.52% for the month, ending a three-month losing streak vis-à-vis the Bloomberg Barclays Global Aggregate Index hedged back to AUD.

Real Assets

Global property was up +3.37% in USD terms and +2.50% in AUD terms for the month. Europe rallied sharply on signs of continued disinflation in the region, while Asia lagged due to underwhelming consumer spending in Hong Kong. Australia outperformed the general index, led higher by office and retail. The CoreLogic - Median City Values rose for the 5th month in a row to its highest level since September 2022. Global infrastructure added +1.57% in USD terms and +0.73% in AUD terms in July. Water utilities performed strongly, while telecom infrastructure lagged. The winning streak for the Dow Jones Transportation Average continued despite North American rail companies reporting disappointing results. The S&P Global Infrastructure TR underperformed the FTSE EPRA Nareit Developed TR for the third consecutive month.

Market Outlook

On August 1st, Fitch Ratings downgraded the US’ Long-Term Ratings to 'AA+' from 'AAA'. In its commentary, the agency listed three key drivers for its action.

1. “Expected fiscal deterioration over the next three years”. Fitch expects the budget deficit to remain above -6% of GDP in 2023-2025 on the back of weaker GDP growth, lower federal revenues, new spending initiatives and a higher interest burden. In addition, the rating agency does not expect any change to the current trajectory as “substantive” fiscal consolidation on the part of the government is deemed unlikely ahead of the 2024 presidential elections.
2. “A high and growing general government debt burden”. Fitch notes that, at 112.9% in 2023, the US debt-to-GDP ratio is “over two-and-a-half times higher than the 'AAA' median of 39.3% of GDP”. In addition, US is expected to pay a higher interest rate bill than its (former) top rated peers given the size of its debt load and “sustained higher interest rates compared with pre-pandemic levels”. Its interest-to-revenue ratio is expected to reach 10% by 2025, which compares to 1% for the 'AAA' median. Australia is a member of the shrinking “triple A” club of countries with the highest credit rating at S&P, Fitch and Moody’s, together with Germany, Denmark, Netherlands, Sweden, Norway, Switzerland, Luxembourg and Singapore.
3. “The erosion of governance”. The third reason provided by Fitch is perhaps the most interesting one. The agency notes that the US government “lacks a medium-term fiscal framework, unlike most peers”. As a result, debt has increased in

the past decade on the back of “several economic shocks as well as tax cuts and new spending initiatives”, while medium-term challenges related to the aging population and rising healthcare costs have been neglected. In addition, “repeated debt-limit political standoffs” have been dealt with through “constant political brinkmanship” and “last minute-resolutions”. According to Fitch, suspending or eliminating the debt ceiling “would help”.

Moody's remains the last of the “Big Three” credit rating agencies to maintain a top rating for the US. Fitch’s decision to lower the sovereign rating echoes that taken by S&P exactly 12 years ago. Back then, the first-ever downgrade of the US prompted 3 months of market turmoil during which time the S&P 500 fell almost -20%. However, over the same period of time interest rates dropped sharply, with the 10 year yield moving from 2.8% to 1.8% (-100 Bps), while the Dollar Index (DXY) rallied almost +10%. In other words, the unprecedented decision to downgrade the US debt prompted a flight to quality into… US government bonds and the greenback. In fact, those assets constitute the foundation of the international financial system, as the US Dollar is the global reserve currency, and no decision by any credit rating agency can alter that fact, or the market mechanics deriving from it. When uncertainty hits markets, investors will sell riskier investments and seek refuge into the most liquid, “pristine” and safe assets, whether AAA rated or AA+ rated. The same dynamic is at play today. At the time of writing of this note (August 18th), the S&P 500 is down -4.51% and the DXY is up +3.57% following the news. However, the 10 year yield has moved higher, from 4.02% to 4.27% (+25 Bps), and not lower. In our view, rising long term yields are not a consequence of the downgrade, but they are reflective of the symptoms described by Fitch in its report. The US Treasury has been able to issue new debt to replenish its dwindling “Treasury General Account” (TGA), the operating account that it maintains at the FED to spend money in the economy, since the debt ceiling resolution. In June and in July it has done so primarily by issuing bills, which have been readily scooped up by a variety of domestic (money market funds) and foreign (sovereign entities) investors. Starting from August, the government has ramped up its issuance of “coupons”, that is, longer dated bonds. Those instruments carry interest rate risk, hence, for investors to be able to absorb the new issuance at the going rate, there has to be an increased demand for duration. Unfortunately for Uncle Sam, it appears that investors have taken note of the deteriorating state of affairs flagged by Fitch, and they are asking for higher yields. The issue is compounded by the fact that the “soft landing” narrative has gathered momentum in the last couple of months, so in the absence of a recession and with the prospects of an out of control deficit spending, a supply and demand imbalance has developed in the Treasury markets.

We think that higher long-term yields will be the proverbial nail in the coffin of the current economic cycle, and, as such, they will prove to be temporary. We see a window of opportunity in August and September to make use of the spike in yields to lengthen the duration of our portfolios. Contrary to consensus, we expect the “resilient economy” narrative to give way to deteriorating macroeconomic data in the following months, until a sharp spike in unemployment puts an end to the cycle and the “recession that never came” finally materializes in Q4 2023. US GDP growth has been buoyed by a procyclical deficit spending on the part of the government, but the costs of the stimulus are finally starting to become apparent. Higher yields are the obvious one. In an extremely financialized economy, they exert downward pressures on growth assets, tightening financial conditions. In fact, equities don’t seem to like when the 10 year yield goes above 4%. However, we contend that the recent fiscal profligacy will have a higher, though less evident, price tag. As the government has been stimulating the economy at a time the FED was trying to slow it down to curb inflation, a case can be made that the central bank may have gone further than what it would have otherwise in a traditional cycle. Because the public sector has been insensitive to the restrictive monetary policy, interest rates may have been brought to a level in which the rebalancing of the economy has solely become a function of private demand destruction. In short, if and when the US government decides (or is forced) to take the foot off the pedal, we may find out that the private sector was not in such good shape after all, and that the monetary stance was too tight. In fact, following the last hike, the midpoint of the FED target rate is 5.375%, while the US CPI came out at +3.2% in July. The difference between the two, the so-called “real yield”, is equal to 2.175%. The last time that spread was above 2% for a sustained period of time was between June 2006 and August 2007. It went negative shortly afterwards, in January 2008, and never looked back. Since then, real yields have been below zero for an average of 10 months per calendar year for 15 consecutive years. In March 2022 they reached an all-time low of -8.125%. Today’s debt level is way more elevated than it was before the GFC, so we think that something has to give: either inflation reaccelerates, or rates will have to come down. Or, put differently, either we get a “soft landing” or a recession. We lean towards the latter scenario, but we do not see particular reasons to reduce our exposure to growth assets too far ahead of the time. We expect the rotation into sectors that tend to perform better at times of rising yields, such as energy and financials, to persist. Traditional defensives are starting to see inflows as well, signalling that investors may be concerned about what lies a quarter ahead. Our portfolios remain positioned accordingly.

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Important information

The Morningstar Historical Corporate Sustainability Score is a weighted average of the trailing 12 months of Morningstar Portfolio Corporate Sustainability Scores. Historical portfolio scores are not equal-weighted; rather, more-recent portfolios are weighted more heavily than older portfolios. Combining the trailing 12 months of portfolio scores adds consistency while still reflecting portfolio managers' current decisions by weighting the most recent portfolio scores more heavily.

ESG pillar scores are displayed as a number between 0 and 100 with most scores range between 0 and 25. It is the asset-weighted average of the company environmental, social, governance risk scores for the covered corporate holdings in a portfolio. The scores measure the degree to which a company's economic value may be at risk driven by environmental, social, and governance factors. The risk represents the unmanaged risk exposure after taking into account a company's management of such risks.

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