# Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio
As of 31/08/2023

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**MARKET REVIEW**

Contrary to what one might expect, the 2% inflation target widely adopted by major central banks all over the world has no academic basis. It originated from a comment given in 1988 during a television interview by the then New Zealand's Finance Minister, Roger Douglas. At that time, the Kiwi economy had just entered a severe recession, the stock market had crashed -60% from its peak in October 1987, and inflation had fallen from 15% to 9%. However, the government wanted to convince the public of the seriousness of its disinflation drive, and to make clear that it would not be content with inflation settling at around 5% to 7%. As such, Mr. Douglas declared that he was looking to reduce inflation to "around 0%, or 0-1%" over the next couple of years. Following his remarks, the Reserve Bank of New Zealand (RBNZ) determined that there tended to be an "upward bias" in inflation calculations quantifiable to 0.75%, which it rounded to 1%, providing a target boundary of 2%. That rate was promptly adopted by the central bank and the 2% inflation target was born. The Bank of Canada (BOC) and the Bank of England (BOE) followed suit, as did other central banks. In 1996, FED policymakers privately agreed that their target for inflation was 2%, but the policy became official only in January 2012, at the urging of then Chair Ben Bernanke.

The "magic number" came under scrutiny in August following the publication of an op-ed penned for the Wall Street Journal by Jason Furnam, former Chair of the Council of Economic Advisers (CEA) during the Obama administration. The American economist argued that, today, "if the Fed were adopting an inflation target from scratch, it would likely choose a target above 2%". He reasoned that "we have spent nearly half of the past 20 years with interest rates at the zero lower bound" and, as a result, the central bank should "consider something higher, like 3%" to have "more scope to cut interest rates and thereby stimulate the economy" in times of recession. However, to achieve a "successful transition", the central bank should "continue to focus on lowering inflation" and it "shouldn't stop until the annual rate of inflation is running below 3% for at least six months". "Then, it would be well positioned to shift to something like an explicit 2% to 3% target range for inflation when it reviews its policies around 2025". The winner of the 2008 Nobel Prize in Economics Paul Krugman doubled down by tweeting that, not only he agrees that the inflation target should be raised, the FED should also "declare victory" instead of continuing to tighten, arguing that "if 2% was a mistake, how many people should lose their jobs for a mistake?". Another thought leader, Mohamed A. El-Erian, former CEO and Co-CIO at bond fund giant PIMCO, stated that "it is time to consider the appropriateness over time of the 2% inflation target, considering both past policy experience and the structural economic outlook."

The debate was (tactically) initiated one week ahead of the annual Jackson Hole Economic Policy Symposium on August 24-26. However, on that occasion, FED Chairman Jerome Powell started his speech by stressing that the central bank's job is "to bring inflation down to our 2% goal, and we will do so" as "2% is and will remain our inflation target". He noted that the process of bringing down inflation "has a long way to go" and that "a period of below-trend economic growth as well as some softening in labor market conditions may be required". He concluded by stating that the goal of the FED is to restore price stability, and that, whether its achievement will entail further tightening or holding the policy rate constant, "we will keep at it until the job is done". In short, it appears that the calls for a change has (so far) fallen on deaf ears.

**International Equities**

US equities declined in August, with the S&P 500 (-1.77% in USD terms) and the Nasdaq 100 (-1.62%) breaking a five-month winning streak. The Dow Jones Industrial (-2.36%) and the S&P 500 Equal Weight Index (-3.37%) underperformed the S&P 500 as market breadth narrowed once again during the month, with healthcare, technology, consumer discretionary and communication services holding up better in relative terms, while utilities, consumer staples and materials got crushed. Energy was the only sector to end the month in the black, an event last occurred in April 2022. Between July 27th and August 18th, the S&P 500 completed its second correction greater than -5% in 2023, following the one recorded between February 2nd and March 13th. Risk appetite waned, causing a stunning reversal of fortune for the most speculative stocks typically traded by retail investors; the Solactive Roundhill Meme Stock Index TR, the GS Non-Profitable Tech and the GS Liquid Most Short were all down between -10% and -20% in USD terms, after having rallied between +25% and +35% in the previous two months. The S&P 500 High Beta TR underperformed the S&P 500 Low Volatility TR for the first time since April, while the Russell 2000, which tracks the performance of smaller companies, took a beating.

US equities outperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) as the Dollar Index (DXY) rallied for six consecutive weeks between mid-July and the end of August. All regions ended the month in the red when measured in USD; however, US and Japan posted gains when translated in AUD, boosting the MSCI AC World Daily TR, which was down -2.79% in USD terms but up +1.03% in AUD terms. Conversely, Europe and emerging markets underperformed the general index; the latter group was driven lower by a sell-off in Chinese stocks as concerns about a potential unravelling of the country's property and shadow banking sectors gripped investors. The Australian Dollar softened across the board, dropping to multiyear lows against the Sterling Pound (GBP), the Euro and the Swiss Franc.

**Australian Equities**

Australian equities were down for the better part of August, shedding more than -4% at one point; however, a sudden rally during the very last trading sessions of the month helped the S&P/ASX 300 (-0.76%) curb losses. A-REITs, energy, and consumer discretionary were the only groups to post gains for the month; the latter sector topped the list, outperforming the general index by the largest amount since August 2020. Industrials lagged, led lower by Qantas, as the airline company was sued by Australia's competition

watchdog for allegedly selling seats on thousands of cancelled flights. Utilities and consumer staples were the worst performing sectors on the back of disappointing results, followed by resources and technology. Financials performed in line with the benchmark despite the decision of the Australian Competition & Consumer Commission to block ANZ's acquisition of Suncorp. Mid-caps and smaller companies underperformed the Top 20, while growth stocks bested value stocks.

**Global Fixed Income**

The trajectory of monetary policies pursued by major economies diverged in August. In the developed world, the Bank of England's (BOE) and the Norges Bank, Norway's central bank, continued to harden their stance; the former hiked the official bank rate by 25 Bps to 5.25%, its highest level since April 2008, while the latter decided to raise the policy rate by 25 Bps to 4%, its highest level since December 2008. Conversely, the Reserve Bank of New Zealand (RBNZ) paused for a second consecutive meeting, holding rates steady at 5.50%.

In the emerging markets space the contrast was even more pronounced. On the one hand, the Central Bank of the Republic of Turkey (CBRT) hiked by 750 Bps in a single move, increasing the interest rate from 17.5% to 25%; at the end of August, headline inflation was running at +59% YoY in Turkey and the Turkish Lira (TRY) had lost a third of its value vis-à-vis the greenback since the beginning of the year. On the other hand, after a 12-month pause the Central Bank of Brazil (BCB) inaugurated its loosening cycle with a 50 Bps cut, reducing its key Selic rate from 13.75% to 13.25%. At the end of August, headline inflation in Brazil had declined to +4.6% from a peak of 12.1% in April 2022, and the Brazilian Real (BRL) had appreciated by +7% against the USD in the first 8 months of 2023. Brazil was one of the first country to tighten its monetary policy, with its central bank delivering the first hike as early as in March 2021.

Government bond yields were generally higher in August, while credit spreads remained resilient. In US, the yield curve "bear-steepened" for the second month in a row, that is, longer-dated yields rose faster than shorter-dated yields. The 10-year yield rose 15 Bps to 4.11%, closing above the 4% threshold on a monthly basis for the first time since October 2022; the 5-year yield was also higher at 4.25% (+8 Bps), while the 2-year yield ended August almost unchanged at 4.86% (-1 Bps). Long dated government bonds came under pressure following increased and front-loaded issuance on the part of the US Treasury and the decision of Fitch Ratings to downgrade the US' Long-Term Ratings to 'AA+' from 'AAA'. Bear steepeners are a rare event as historically they tend to occur less than 10% of the time. The Bloomberg Barclays Global Aggregate Index hedged back to AUD (-0.27%) extended its losing streak to four consecutive months, but it remained in positive territory since the beginning of the year (+1.76%).

**Australian Fixed Income**

On August 1st, the RBA held the cash rate at 4.10% amid a "reassuring" decline in inflation, extending its pause to a second month. The minutes of the meeting showed that the central bank expects the economy "to grow well below its trend pace over 2023 as cost-of-living pressures and higher interest rates weigh on demand". On August 11th, outgoing Governor Lowe appeared before Parliament for his final semi-annual testimony; in that occasion, he observed that the monetary policy had moved into restrictive territory only in 2023 and that it had now entered a "a calibration phase" under which the board will likely only need to make "small adjustments". Macroeconomic data released during the month validated the central bank's decision, with the Australia Monthly CPI rising +4.9% YoY, missing expectations of a +5.2% increase, and the unemployment rate climbing more than expected to 3.7%.

The yield curve "bull-steepened" for the second month in a row, with the 2, 5 and the 10-year yield falling 14 Bps, 6 Bps and 3 Bps to 3.80%, 3.79%, and 4.03%. The Bloomberg AusBond Composite 0+ Yr rose +0.74%, taking a 100 Bps lead vis-à-vis the Bloomberg Barclays Global Aggregate Index hedged back to AUD since the beginning of the year.

**Real Assets**

Global property was down -3.26% in USD terms but up +0.56% in AUD terms for the month. Europe, Japan, and Australia outperformed the general index, while US and Hong Kong lagged. The strong showing of the domestic market was entirely attributable to the double-digit rally of Goodman Group, which represents over 30% of the index, while several A-REITs continued to trade at depressed levels.

Global infrastructure dropped -4.66% in USD terms and -0.90% in AUD terms in August. Utilities, transportation, and renewables were all down; the latter group fell sharply on the back of Danish developer Orsted announcing impairments to its US offshore wind portfolio.

Returns for Alternatives (+0.18%) were mixed across strategic mandates in August. Merger arbitrage and credit arbitrage strategies posted gains, while Long/Short equities, discretionary macro, managed futures, and CTA ended the month lower.

## MARKET OUTLOOK

Benoit Mandelbrot, a Polish-born, French and American mathematician, revolutionised our understanding of markets and risk in the early 2000s when he demonstrated the existence of so-called "volatility clusters". Without delving into details, his observation was that "tame" market days, that is, those occurring when the price changes less than 3%, tend to be followed by other "tame" days, while "wild" days, those occurring when the price changes more than 3%, tend to be followed by other "wild" days. The key insight here is that volatility is a leading indicator of price. In fact, it does not really matter whether the market swings higher during a "wild" day. In general, a big up or down day is not a positive sign for the market as it indicates that the volatility has increased, and clusters of elevated volatility tend to manifest during or close to a correction or a bear market. The opposite holds true: low and/or declining volatility tends to be associated with bull markets. As a result, investors targeting risk-adjusted returns (like ourselves) would do well to scout markets to identify asset classes on a slow and steady uptrend, not experiencing large daily fluctuations; today, equities, oil and government bond yields are all exhibiting those characteristics.

At the time of writing of this note (September 18th), the S&P 500 is in a bull market, up +27.55% from its October lows. Over the same period, the VIX Index, the measure which estimates the expected volatility of the US stock market, has crashed from 33.87 to 14 (-58.67%) and is currently trading at its lowest level since December 2019. In addition, the S&P 500 has just closed for the 100th straight session without a drop of at least -1.5% for the first time since 2018. Oil has entered a bull market very recently; its price has risen +36.44% since June 28th, while the OVX Index, the measure which estimates the expected volatility of crude, is currently trading at 26.56, its lowest level since August 2018. Finally, in the last five months, the US 10-year yield has risen from 3.25% to 4.30% (+105 Bps), while the MOVE Index, which calculates the future volatility in US Treasury yields implied by the option market, has declined to its lowest level since January 2023. That spells trouble for the bond market, as a bull market in yields translates into a bear market in prices given the inverse relationship between the two variables. In summary, looking at market movements through the lens of risk, we get a picture of a sustainable move higher in stocks and oil, and a sustainable move lower in long term government bonds. From a macroeconomic perspective, these three conditions are generally consistent with an economic recovery and a central bank at the end of a loosening, rather than a tightening cycle; as such, several commentators have started to argue that the US economy may have experienced a recession in 2022 after all, as it contracted for two consecutive quarters from January to June of that year. The consensus that was predicting a recession with a 70% probability at the beginning of 2023 has made a U-turn and it is now calling for an outright reacceleration of the economy, not even a "soft landing".

In our opinion, expectations of GDP growth taking off will be disappointed in the following months. Also, we think that, in terms of hikes, the FED has done as the so-called "real yield", that is, the difference between the midpoint of the FED target rate and the US CPI, is at its highest level since August 2009. That spread has just started to restrain economic activity having moved into positive territory only in May. However, there have been and continue to be forces counteracting the policy tightening administered by the central bank, thus supporting the economy. In the first 11 months of the fiscal year 2023 (which started in October 2022), the US government has stimulated the economy by spending 1.5 trillion USD more than it has collected. To finance such largesse, it has issued a huge amount of debt at a time interest rates are high, with the result that, according to the data provided by the Treasury, at the end of August "it costs 808 Bil USD to maintain the debt, which is 15% of the total federal spending". But it does not end here. The FED has hiked rates aggressively in the past 12 months, but it has been very slow in reducing its bloated balance sheet via Quantitative Tightening (QT). As a result, commercial banks and money market funds (through the "Overnight Reverse Repo Facility" – ON RRP), are still holding 3.3 trillion USD and 1.4 trillion USD respectively at the central bank, on which they receive an annualized 5.40% and 5.30% in interest rates. Those interest payments are a direct transfer of resources from the public sector to the private sector and, as such, they have boosted the coffers of corporations and wealthy individuals holding cash balances. "Big tech" companies have been one of the many beneficiaries of that trend, having issued debt at fixed, rock-bottom interest rates in 2020 and 2021. Microsoft, for example, is currently sitting on a pile of cash and short-term investments on which, as reported by the Wall Street Journal, in the latest quarter it earned 905 mil USD; that amount dwarfs the 492 mil USD that it paid in interest over the same period.

The US national debt does not seem to be on a sustainable path; it has just surpassed 33 trillion USD, having added 1 trillion USD in the last 3 months alone. We posit that the procyclical deficit spending unleashed by the US government to prop up GDP growth (and neutralize the negative impulse of monetary policy) has finally entered a self-defeating phase. Starting from August, the government has ramped up its issuance of "coupons", that is, longer dated bonds; but as we have detailed above, investors have written off a recession and do not see the need to load up on duration, so they are asking for higher yields to oblige. Even worse, they have been piling into oil and energy stocks in the belief that the US economy is on the cusp of an acceleration, rather than a recession. For the same reason, earnings are expected to materially increase in 2024 and in 2025, justifying ever expanding stock market valuations. In our view, the probability of a recession has increased rather than decreased since the beginning of the year. The economy is in a fragile state, and we doubt that it can take the additional tightening represented by the combo of rising oil price / rising long term yields without buckling. That said, those trends may continue to persist in the short term, and that is why we do not see particular reasons to reduce our exposure to growth assets too far ahead of the time. Our portfolios remain positioned in a mix of cyclicals, which tend to perform well at times of accelerating growth (and inflation), and traditional defensives and factors, whose moment to shine may be just a couple of months away. In the fixed income space, we remain underweight duration and continue to prefer the Australian market, which should perform better in the event of a spike in yields; however, we are ready to reverse course by increasing our exposure to benchmark duration global fixed income should government bonds experience a (final) washout.

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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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