Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

The bond market selloff gathered momentum in September as the "higher for longer" narrative on interest rates took hold in investors' minds, together with heightened concerns about the sustainability of the US debt. The 10-year and 30-year Treasury yield broke above the 4.5% level for the first time since September 2007 and March 2011 respectively, ending the month at 4.57% and 4.70%. As a result, the bear market in US fixed income entered its 38th month, the longest on record. At the end of September, the market value of the Bloomberg Global Aggregate Index, the broadest measure of global investment grade, publicly tradable debt, had declined to 60 trillion USD from 69.18 trillion USD in July 2021. To put the numbers in context, that drop is equivalent to almost 9% of the entire world GDP in 2022 (101 trillion USD). The iShares 20+ Year Treasury Bond ETF, a popular benchmark to track the performance of long duration strategies, fell to its lowest level since March 2014, erasing almost 10 years of total returns. The meltdown in selected, so-called "ultralong" government bonds reached a magnitude comparable to that of the losses suffered by technology companies in the early 2000s or by crypto currencies in the past 2 years. A chart of the recent performance of the now infamous "century bond" issued by the Austrian government in 2017 made the rounds, accompanied by the declaration that the "bond bubble has burst". The Republic of Austria 2117 was issued with a fixed coupon of 2.1% and a duration of 42 years at a price of 100. It peaked at 248.7 in March 2020, when interest rates hit rock bottom, while its duration increased to 60 years. It then proceeded to crash to a (so far) trough of 61.94 at the end of September, a drawdown of -71.72% in EUR terms from its highs.

An interview with Jamie Dimon published by the Times of India on September 26th fanned the flames of fear. In it, the CEO of JP Morgan, stated that the bank is urging clients to prepare for a worst-case scenario of interest rates hitting 7% along with stagflation. Two days later, legendary Hedge Fund manager Ray Dalio doubled down in an interview with CBNC, saying that he is watching closely the "risky" US fiscal situation and warning that "we're going to have a debt crisis in this country". Yet, despite all the gloom and doom, value across the curve finally started to emerge in US government bonds, at least according to a number of traditional fixed income metrics. The real yield on 10-year Treasuries, which measures the return above the rate of inflation that investors stand to make on Treasury Inflation Protected Securities (TIPS), surpassed the 2% threshold for the first time since February 2009. In addition, the so-called "term premium" which is the compensation required to buy and hold a 10-year Treasury as opposed to simply rolling over short term paper at prevailing rates, turned positive for the first time in two years, after having spent most of the past decade in negative territory. Finally, the 10-year yield took another step to close the gap with the annualised nominal growth (that is, real GDP growth plus the rate of inflation) average over 10 years, which is considered to be one of the best guides to assess the attractiveness of government bonds. At the end of the month, the latter was tracking at +4.9%, only 33 Bps above the former. Likewise, the midpoint of the FED target rate (5.375%) was not too far from the Bloomberg consensus estimates for nominal GDP growth in Q3 (+5.9%). In short, the "normalization" of interest rates seems to have largely occurred and, as such, US Treasuries, while certainly not offering a "risk-free rate", can no longer be considered a "rate-free risk" investment.

International Equities

US equities declined for the second consecutive month, with the S&P 500 (-4.87% in USD terms) and the Nasdaq 100 (-5.07%) recording their worst drop since December 2022. The Dow Jones Industrial (-3.50%) outperformed the S&P 500 for only the 3rd month out of 9 since the beginning of the year. Conversely, the S&P 500 Equal Weight Index (-5.26%) was dragged lower by its higher exposure to smaller companies, as the relative performance of the Russell 2000 (-6.03%) vis-à-vis the Russell 1000 (-4.80%) fell to its lowest level since April 2003. The stock market weakened without a substantial increase in volatility. In fact, on September 18th the S&P 500 closed for the 100th straight session without a drop of at least 1.5%, a resiliency milestone it last achieved in 2018. Energy was the only sector to end the month in the black, repeating its August feat. Communication services, healthcare and financials held up better in relative terms, while real estate, technology, industrials, utilities and consumer discretionary lagged. Mega cap growth trailed the general index, while the S&P 500 Low Volatility TR outperformed the S&P 500 High Beta TR for the second month in a row. On September 13th, Arm Holdings went public, raising 4.87 Bil USD in this year's biggest IPO. It was the largest listing in the US since the 13.7 Bil USD offering of shares of the electric vehicle manufacturer Rivian Automotive back in October 2021. The stock jumped +24.69% in its debut, giving the chip designer a market value of more than 65 Bil USD, 90% of which remains controlled by SoftBank Group, the Japanese tech titan founded by visionary billionaire Masayoshi Son. Following the initial pop, Arm Holdings declined -20.14% in the following weeks, but managed to end September above its listing price. US equities underperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) despite the Dollar Index (DXY) climbing to its highest level since August 2022. The Australian Dollar was only slightly negative against the greenback, while it rebounded sharply vis-à-vis all major and developed currencies. All regions ended the month in the red. Japan topped the list on the back of the strong performance of banks triggered by the steepening of the domestic yield curve. Emerging markets outperformed the general index, with India and Turkey bucking the trend and Brazil and Taiwan curbing losses. China continued to provide mixed signals, with the economy exhibiting early signs of stabilization but foreign investors dumped record amounts of mainland listed stocks. The malaise reverberated across Europe, negatively affecting the luxury sector. The STOXX Europe Luxury 10 EUR TR which includes, among others, LVMH and Ferrari, recorded its 2nd worst month ever on concerns about lower consumer spending in Asia. All in all, the MSCI AC World Daily TR was down -4.14% in USD terms and -3.69% in AUD terms.

Australian Equities

Australian equities outperformed their international peers in September owing to a greater exposure to financials and resources. The S&P/ASX 300 declined -2.89%, led lower by A-REITs, technology, healthcare, industrials and consumer discretionary. The "WAAAX" group of stocks suffered its 10th worst month ever, while the property sector, whose performance had been held up by Goodman Group up until the end of August, fell hard as the index heavyweight gave back part of its YTD gains. Energy and insurance were the only groups to end the month in positive territory, the former on the back of oil prices breaking above 90 USD per barrel, while investors rotated into the latter on expectations that they will benefit from "higher for longer" interest rates. The negative momentum for the telecom sector started by Telstra's decision in mid-August to shelve its plans to sell a stake in its infrastructure business, Infraco, continued in September. Finally, value stocks underperformed growth stocks by the most since November 2021, while mid-caps and smaller companies underperformed the Top 20 for the second month in a row.

International Fixed Income

5 of the 8 major global central banks that met in September left interest rates unchanged. Those include the FED, the Bank of England (BOE), the Bank of Canada (BOC), the Bank of Japan (BOJ) and the Swiss National Bank (SNB). Conversely, the European Central Bank (ECB), the Riskbank, Sweden's central bank, and the Norges Bank, Norway's central bank, continued to harden their stance, each one hiked by 25 Bps to 4%, 4% and 4.25% respectively. The trajectory of monetary policies pursued by major emerging market economies continued to diverge in September. On the one hand, the Central Bank of the Republic of Turkey (CBRT) hiked by 500 Bps in a single move, increasing the interest rate from 25% to 30%, and the Bank of Thailand (BOT) unexpectedly raised its policy rate by 25 Bps, from 2.25% to 2.50%. On the other hand, the Central Bank of Brazil (BCB) cut its key Selic rate by 50 Bps for the second consecutive month, from 13.25% to 12.75%. More surprisingly, the National Bank of Poland delivered a "bazooka" cut of 75 Bps to bolster its slowing economy. The benchmark rate was reduced from 6.75% to 6% in the context of an annualized rate of inflation of +10.1% at the end of August. Government bond yields were generally higher in September, while credit spreads widened marginally. In the US, the yield curve "bear-steepened" for the third month in a row, that is, longer-dated yields rose faster than shorter-dated yields. The Bloomberg Barclays Global Aggregate Index hedged back to AUD (-1.84%) recorded its 6th worst month ever, completely erasing its YTD gains.

Australian Fixed Income

On September 5th, the RBA held the cash rate at 4.10% for the third consecutive month. The minutes of the meeting showed that the central bank considered an increase, but then opted to stay put, implicitly raising the bar for further monetary tightening. The Australian economy grew +0.4% MoM and +2.1% YoY in Q2, from an upwardly revised +0.4% MoM and +2.4% YoY in Q1. Net exports and public investment were the main positive contributors, while inventories were the biggest drag, as companies lightened their warehouses. Elevated inflation and tighter financial conditions curtailed private consumption, while GDP per capita declined for the second quarter in a row. The yield curve "bear steepened", with the 2, 5 and the 10-year yield adding 28 Bps, 35 Bps and 46 Bps to 4.08%, 4.14% and 4.49%, and the Bloomberg AusBond Composite 0+ Yr fell -1.53%.

Real Assets

Global property was down -6.21% in USD terms and -5.78% in AUD terms for the month. Europe and Japan outperformed the general index, while US and Australia lagged. In US, the rate for a 30-year US home fixed mortgage rose to 7.74%, its highest level since July 2000. Global infrastructure dropped -4.85% in USD terms and -4.42% in AUD terms in August. Utilities, transportation and renewables were all down. Nextera Energy, the largest benchmark constituent at approximately 4.5%, posted a double-digit decline after Nextera Energy Partners, the so-called "yieldco" formed to own and manage some of the integrated electric utility's clean energy projects, sharply reduced its expected dividend growth rate.

Alternatives

Alternatives (-0.17%) were slightly negative for the month, strongly outperforming global equities. Long/Short equities managers recorded their worst month since February, while CTA and managed futures gained from their short positions in bonds.

Market Outlook

On top of being one of the most successful investors of all times, George Soros is also a brilliant thinker and philosopher. In 1984, he penned an article for the Financial Times in which he introduced the concept of the "imperial circle", a policy that allows the US to "to finance a high budget deficit at the expense of the debtor nations". Here is how it works. The US government increases its public spending while reducing taxation. "The budget deficit keeps interest rates higher than they would be otherwise. High interest rates […] suck in funds from all over the world". "The budget deficit stimulates the economy" and "combined with high interest rates and the influx of foreign capital, tends to keep the dollar strong". The above perfectly encapsulates the macroeconomic predicament the US and the rest of the world currently find themselves in, with the addition of some twists. In the fiscal year 2023, the budget deficit has exploded primarily because of significantly lower tax receipts compared to 2022. At the same time, the outlays have increased 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. As a result, the deficit over the first 11 months of fiscal year 2023 (from October 2022 to August 2023) has ballooned to 1.5 trillion USD, up 600 Bil USD from last year, and almost twice as large relative to GDP. Another difference compared to the 80s is the net energy position of the US. From 1958 to 2018, energy consumption in US was higher than energy production in every single year, however, thanks to the so-called "shale revolution", the US has been an annual net total energy exporter since 2019. As a result, its economy is less vulnerable to increases in oil prices to the extent that having become the world's largest liquefied natural gas exporter in 2022, the US Dollar seems to have achieved the status of "commodity currency". In practice, nowadays when the oil price rises, the greenback tends to appreciate in unison. This novel relationship reinforces the "imperial circle" because countries which are net importers of oil are hit by the double whammy of rising commodities (priced in USD), together with a higher US Dollar. As the cost of their energy bill increases, their growth prospects deteriorate, and their economy underperforms the US, causing additional weakening of their currencies.

We think that the emergence of the above dynamic explains the resiliency of the US economy and the relentless ascendance of the S&P 500 during H1 2023 in the face of the fastest tightening cycle in decades. Investors (including ourselves) have consistently overestimated the effectiveness of monetary policy and underestimated the potency of fiscal policy, when in reality the latter has acted like a stimulus, counteracting the former. US GDP growth has been buoyed by a procyclical deficit spending on the part of the government, warding off a recession. As such, the rate hikes administered by the FED have been less successful than in the past in slowing down the economy. However, they have generated significant volatility in the bond market, with the result that, in our opinion, the large capital flows reaching the US shores have preferred to pile in mega cap growth stocks rather than in Treasuries. As a result, the correlation between equities and bonds that in 2022 flipped to positive, with both asset classes losing money, has reverted back to negative in the first half of 2023, with the S&P 500 rallying double digit and the Bloomberg US Aggregate Index falling for the third consecutive year. In hindsight, it is a trade that makes sense. One could argue that "Big tech" companies are the safest place where to park money in an environment characterized by heightened geopolitical and financial risk but positive economic growth. However, things may change once the US economy rolls over, as the "Magnificent Seven", that is, Apple, Microsoft, Nvidia, Meta (Facebook), Amazon, Alphabet (Google) and Tesla, are cyclical stocks after all. However for that to happen the "imperial circle" has to break, either because the US government decides to take the foot off the pedal or because markets force a reckoning. The second scenario seems increasingly probable in our view, and the decision of the FED to pause its hikes may have counterintuitively accelerated its unfolding.

At the September FOMC meeting, the central bank left its target rate unchanged, but reinforced its hawkish guidance with the release of the new Dot Plot, which projected one more hike before the end of the year to 5.625% (no change), and only 50 Bps of cuts in 2024 (versus 100 Bps previously). It also upgraded its median projections for real GDP growth in 2023 and in 2024, from +1.0% to +2.1% and from +1.1% to +1.5%, while reducing its median unemployment rate forecasts from +4.1% to +3.8% and from +4.5% to +4.1% respectively. Finally, core inflation was expected to gradually decline to +3.3% in 2023 and to +2.5% in 2024. Reading through those numbers, the two key takeaways were that the FED no longer anticipates a recession and it intends to let real yields rise further in 2024, from 2.325% to 2.625% (calculated as the difference between the projected target rate and core inflation). It is important to bear in mind that the Dot Plot and the summary of economic projections are part of the "forward guidance" tools employed by the FED to influence markets, so they have to be read as a statement of intent, rather than a forecast. In other words, the central bank is conveying a message aimed at prompting a market reaction that will produce the desired outcome. Our interpretation of its latest communication is that the FED has implicitly acknowledged that fiscal policy is in charge and, as a result, monetary policy, after having done its part, has to take a back seat and let markets do the tightening. Investors have responded accordingly, repricing the term structure of interest rates. The 10 year and the 30-year yields have gone ballistic, while oil prices and the US Dollar have reached new highs and with that the "imperial circle" has entered its final phase. From an economic standpoint, those abrupt movements represent a real tightening that is going to weigh on growth. From a market point of view, the valuation of Treasuries is getting increasingly attractive compared to equities, at a time the probability of a recession has increased rather than decreased. Buying long term bonds today certainly feels like catching a falling knife. Also, we have no visibility on the level yields (and oil) will have to reach before the economy buckles. That said, we believe that when the moment finally arrives, investors will start to shift their allocation from mega cap growth to fixed income. In other words, we expect the correlation between stocks and bonds to remain negative, that is, when yields finally stabilize and start to decline, that will be the signal to reduce, and not to increase, our exposure to growth assets. Our portfolios remain positioned in a mix of cyclicals, which tend to perform well at times of sticky and accelerating inflation and traditional defensives, 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 has been performing relatively better in the last quarter, 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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