Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio
As of 31/10/2023

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Market Review

The rout in bond markets continued in October, dragging US stocks lower despite a better-than expected-reporting season which saw Q3 earnings on track to turn positive YoY. Losses for the iShares 20+ Year Treasury Bond ETF, a popular benchmark to track the performance of long duration strategies, exceeded those suffered by the SPDR S&P 500 ETF for the third consecutive month, also, the volatility of the former topped that of the latter by more than 4%, the highest in 18 years, as, in a repeat of what happened in 2022, bonds failed to provide diversification, exacerbating risk rather than hedging it. However, two announcements from the US Department of the Treasury on the very last days of October provided some needed relief to fixed income investors.

First, the preliminary Quarterly Refunding Announcement ("QRA") estimated a reduced borrowing for Q4 2023, projecting 776 Bil USD of new issuances compared to the 852 Bil USD forecasted in July. The decrease is not prompted by a drop in spending, but by a surge in receipts, as deferred income tax payments from California and other states impacted by natural disasters are starting to flow into the federal government's coffers. The new estimate, if realized, would surpass the borrowing in any previous Q4, including the 689 Bil USD recorded in 2021 at the height of the COVID-19 relief outlays. However, it is still 76 Bil USD lower than expected and, and all things equal, it will mean less issuance of debt at a time in which a supply and demand imbalance appears to have developed in the Treasury markets.

The second positive news came from the quarterly report released by the Treasury Borrowing Advisory Committee ("TBAC"), an advisory group tasked with "providing recommendations on a variety of technical debt management issues". Its suggestion was to skew "increases in issuance towards tenors which have less sensitivity to term premium increases, and ones that benefit from greater liquidity". In plain English, the TBAC recommended that, going into the end of the year, the US Treasury finance its spending primarily by issuing bills, as it did in June and July, rather than by issuing "coupons", that is, longer dated bonds. In fact, the former instruments are more likely to be scooped up by a variety of domestic (money market funds) and foreign (sovereign entities) investors, while the latter carry interest rate risk and, as such, their absorption has required sharply higher rates in recent months given the profligacy of Uncle Sam.

At the end of September, bills were already accounting for 20.43% of the US total marketable government debt outstanding, above the 20% (soft) cap that the TBAC has long advised as most ideal, and above the 19.43% average over the past 20+ years. The advisory group has consistently recommended that "the Treasury, over the medium to longer term, strive to maintain T-bills in a range of 15 to 20% of outstanding debt". Not this time. In its latest report, the TBAC "supported meaningful deviation" from its historical recommendation, effectively greenlighting a fresh deluge of bills in the following months. As a result, the bills' share of debt outstanding will continue to rise to levels historically observed only during recessions, when the government needs to raise cash quickly to stabilize the economy. To illustrate, during the COVID-19 recession, the economy shrank by -9.1% and the ratio grew from a low of 14.18% in January 2020 to a peak of 25.52% in June of the same year. By contrast, at the end of Q3 2023, US GDP had just experienced its fourth consecutive quarter of expansion, adding a whopping +1.2% QoQ (+2.9% YoY), and yet, despite the positive momentum in the economy, the ratio had grown from 15.44% at the end October 2022 to 20.43% 11 months later.

Finally, to "retain flexibility", the Treasury will concentrate its issuance of "coupons" "in belly tenors", that is 2, 3 and 5 year bonds. In summary, a more muted issuance of Treasury Bonds in the following months may help alleviate the upward pressure on the long end of the curve.

International Equities

US equities declined for the third consecutive month, with the S&P 500 (-2.20% in USD terms) and the Nasdaq 100 (-2.08%) entering into correction territory at one point, down -10.92% and -11.76% from their July highs. The Dow Jones Industrial (-1.36%) outperformed the S&P 500 for the second month in a row. Conversely, the S&P 500 Equal Weight Index (-5.26%) was weighed down by its higher exposure to smaller companies, as the Russell 2000 (-6.88%) broke below its October 2022 lows. In general, investors continued to prefer the relative safety of mega and large caps across the board, as evidenced by the Nasdaq 100 outperforming the Nasdaq 100 Next Generation. After struggling in the previous two months of market decline, traditional defensive sectors returned to be defensive, with utilities bucking the trend and consumer staples curbing losses. Technology and communication services held up better in relative terms, while consumer discretionary, energy, industrials, healthcare, financials and materials underperformed the general index. Volatility rose to its highest point since March 2023, the month Silicon Valley Bank collapsed, but still far away from levels indicative of serious concerns, let alone panic. Mega cap growth outperformed the general index, while the S&P 500 Low Volatility TR outperformed the S&P 500 High Beta TR by the largest amount since June 2022. US equities topped the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) as the Dollar Index (DXY) hit new 2023 highs. However, the real drivers of the "American exceptionalism" were once again the so-called "Magnificent Seven" tech stocks, that is, Apple, Microsoft, Nvidia, Meta (Facebook), Amazon, Alphabet (Google) and Tesla, which ended the month only modestly negative. Those names accounts for 26.89% of the MSCI Daily USA TR, which includes 626 constituents, and, over time, they have also come to dominate the benchmarks for international shares. In fact, at the end of October, they made up 16.85% of the MSCI AC World Daily TR, which includes 2,948 constituents. All in all, the reference index was down -3.01% in USD terms and -1.45% in AUD terms for the month, as Europe, emerging markets and Japan all underperformed. The GDP of the Old Continent fell -0.1% in Q3, but despite that setback Germany's economy remains on track to surpass Japan's to become the world's third largest by the end of the year according to the International Monetary Fund (IMF).

Australian Equities

Australian equities dropped the most since September 2022, erasing all gains since the start of the year. The S&P/ASX 300 fell -3.80% with widespread weakness across sectors. Quality names trading at premium multiples were hit the hardest, with technology and healthcare posting the steepest losses. Industrials and consumer discretionary underperformed the general index, while utilities ended the month in positive territory on the back of the decision of the Australian Competition and Consumer Commission (ACCC) to conditionally approve Brookfield and MidOcean's acquisition of Origin Energy. Financials were a mixed bag, with insurance companies curbing losses, while A-REITs entered into correction territory in the space of just two months. Within resources, metals and mining outperformed, while the double-digit decline of the oil price weighed on energy. Finally, value stocks slightly underperformed growth stocks, while mid-caps and smaller companies underperformed the Top 20 for the second month in a row.

International Fixed Income

Every major global central bank that met during the month left interest rates unchanged. Those include the Reserve Bank of New Zealand (RBNZ), the Bank of Canada (BOC), the European Central Bank (ECB) and the Bank of Japan (BOJ). The latter hardened its stance at the margin on October 31st by allowing more flexibility in its yield curve control (YCC) policy. In essence, the central bank transposed the interest rate corridor higher, indicating that it will allow the 10 year yield to move between 0% to 1% going forward, whereas before the meeting it could fluctuate plus and minus 0.5% from its 0% target level. However, the decision was read as a dovish surprise by market participants, who were anticipating a more substantial change. As a result, the Japanese Yen (JPY) tumbled, closing at its lowest monthly level since May 1990 against the US Dollar. As a number of analysts remarked, "central banks may be done, but market rates are not". In the US, the yield curve "bear-steepened" for the fourth month in a row, that is, longer-dated yields rose faster than shorter-dated yields. The 2, 5 and 10 year yield rose to 5.09%, 4.85% and 4.93%, their highest levels since June 2006, July 2006 and June 2007 respectively. The 30 year yield shot up above 5% for the first time since June 2007. However, government bonds moved in the opposite direction in Europe. There the curve experienced a "bull-steepener", that is, shorter-dated yields fell faster than longer-dated yields. Credit spreads were generally wider, with corporate investment grade and high yield the biggest losers, while emerging markets and leveraged loans exhibited more resiliency. The Bloomberg Barclays Global Aggregate Index hedged back to AUD fell -0.83% to its lowest level since October 2022.

Australian Fixed Income

On October 3rd, the RBA held the cash rate at 4.10% for the fourth consecutive month. In the accompanying statement, the new Governor Bullock reaffirmed a hawkish bias, stating that "some further tightening of monetary policy may be required" and that the interest rate path will remain data dependent. A few days later, in its semi-annual Financial Stability Review, the central bank noted that "a small but rising share of borrowers are on the cusp, or in early stages of financial stress". Finally, on October 26th, following the release of the Australian Bureau of Statistics' report which saw the headline CPI rise more than expected (+1.2% QoQ and +5.4% YoY), the central bank stated that inflation was "pretty much where we thought it would come out". The Australian yield curve transposed higher in response as the cash futures added one hike before the end of the year. The 2, 5 and the 10 year yield jumped 38 Bps, 39 Bps and 44 Bps to 4.46%, 4.53% and 4.93%, while the Bloomberg AusBond Composite 0+ Yr fell -1.85%, entering into negative territory since the beginning of the year.

Real Assets

Global property was down -4.48% in USD terms and -2.94% in AUD terms for the month. All regions posted losses, with Japan topping the list and Australia underperforming the general index. In the US, the Housing Affordability Composite Index fell to its lowest level on record on the back of elevated prices and higher mortgage rates.

Global infrastructure dropped -2.73% in USD terms and -1.17% in AUD terms in October. Utilities bucked the trend, driven higher by the UK water sector, which benefited from a projected increase in investments and growth. European renewables caught a bid following a challenging third quarter, outperforming the general index. Conversely, transportation and telecommunication infrastructure lagged.

Alternatives

Alternatives (-0.95%) outperformed global equities in October. Long/Short equities managers ended the month in negative territory despite recording their 7th consecutive month of positive alpha generation. CTA and managed futures successfully navigated market volatility in the second half of the month, partly recovering previous losses.

Market Outlook

The accumulation of government debt and persistent budget deficits can lead to “fiscal dominance”, a situation in which the central bank’s range of options to keep inflation low is effectively constrained by the need of the government to fund its deficits on the margin at no cost. According to Claudio Borio, the Head of the Monetary and Economic Department at the Bank for International Settlements (BIS), there are two types of “fiscal dominance”, one which operates through “political economy” and one which is purely “economic dominance”. The first form typically manifests itself in emerging markets when the government openly forces its central bank to support public debt by monetizing it and/or not hiking, or even lowering rates, instead of tightening to combat inflation and/or defend the value of the currency. The second form is subtler, and it entails a de-facto reduced effectiveness of interest rates as a tool of monetary policy. Put simply, the central bank is unable to bring inflation back to target despite a progressively hardening stance. We have argued for the past two years that the FED has been relegated to the back seat by the unprecedented amount of deficit spending unleashed by the government in response to the pandemic first, and by “Bidenomics” afterwards. As a result, it had to enable the largesse of the government via its quantitative easing program, then delay the start of its hiking cycle advancing the “transitory inflation” thesis, and finally, after 500 Bps of tightening, contend with a CPI which appears to have settled in the 3-4% range. The US has not entered an “economic dominance” regime yet, as the FED retains the power to bring inflation back to the 2% target should it want to, however, the amount of tightening that would be required given the procyclical deficit spending on the part of the government would likely crash the economy and the financial system. In short, fiscal is in charge while monetary has to follow, and the FED has to resort to increased “coordination” with the US Treasury in managing its monetary affairs.

The US budget deficit shrank to -6.26% of GDP in Q3, but it continues to be greater than -5% with an unemployment rate lower than 4%, which is an anomaly. Also, such conditions have been consistently met since September 2022, and neither the Democrats, nor the Republicans seem interested in cutting spending. As a result, the insatiable funding needs of the government has started to put pressure not only on the FED, but also on the Treasury. Consider the latest quarterly recommendation given by the Treasury Borrowing Advisory Committee (“TBAC”). The good news for fixed income investors is that most of the debt that will be issued in the next two quarters will be in the form of bills. However, the reasons for such a choice are ominous. In an unusually candid report, the advisory group states that “the growing imbalance between supply of and demand for US Treasury debt may also have contributed to the sell-off” of the bond markets in recent months. It also notes that “demand for US Treasuries may have softened among several traditional buyers”, with the FED “allowing 60 Bil USD in US Treasuries to run off its balance sheet each month” (Quantitative Tightening), while “some foreign central banks may consider liquidating Treasury securities in the process of defending their currencies” (think China). In addition, “some investors” (think commercial banks saddled with unrealized losses on their portfolios resulting from the sharp increase in interest rates) “had already extended the duration of their fixed-income portfolios – meaning they now have limited capacity to add more interest rate exposure”.

So who has been buying all the Treasuries? The answer is “households (which includes hedge funds)” have been absorbing the majority of the recent increases, but they are “price sensitive investors” who “may now require an additional yield or term premium to hold longer-term debt” and because “the bulk of the long end yield moves were driven by increased term premium” in Q3, the TBAC “favoured relatively larger increases in more liquid parts of the curve”, that is, bills and short term bonds. At the time of writing this note (November 16th), the US yield curve remains inverted, with the 3 month yield at 5.38% and the 10 year yield at 4.44%. What that means is that tapping the short end rather than the long end of the curve comes with an additional cost at a time when the net interest payment on the more than 33 trillion USD in federal debt is at record highs (659 Bil USD in the fiscal year 2023). Hence, it is plausible that the FED may have decided to pause again at its November meeting, despite having indicated at its previous gathering that one more hike was coming before the end of the year, to avoid further increasing the burden on public finance. The government may also be thinking that it will not have to pay such high rates for an extended period of time. In fact, the central bank may be done hiking, but, if our thesis is correct, its commitment to “higher for longer” will suffice to push the economy into a recession in the not too distant future. At that point, the FED will be in a position to cut rates while the demand for duration will increase, allowing the Treasury to tap the long end of the curve in size once again.

Putting it all together, US yields may have peaked for this cycle. After touching 5%, the 10 year has abruptly dropped 50 Bps on the back of the lessened expectations for the future supply of duration risk. Absent a recession, we do not think there is much scope for further decline, while inflation remains stubbornly elevated. For that reason, we expect long term yields to be range bound going forward, and, after having been underweight for the past two years, we plan to add duration during bouts of bond market weakness. Bond volatility continues to hover around historically high levels despite the MOVE Index, which calculates the future volatility in US Treasury yields implied by the option market, having entirely retraced the spike recorded in October. Conversely, during the first week of November, equity volatility got crushed, with the VIX Index, the measure which estimates the expected volatility of the S&P 500, falling by the most since December 2021. US equities have rallied for 8 consecutive days, their longest winning streak since November 2021, as investors see lower yields as a justification for increasing the stock market’s valuation. We think that the positive momentum for equities may persist in Q4, as hopes for a soft landing increase on the back of the stabilization in yields, while analysts keep upgrading earnings expectations for 2024. However, the valuation of Treasuries is getting increasingly attractive compared to equities as, in our view, the probability of a recession has increased rather than decreased since July, with the unemployment rate rising from 3.5% to 3.9% in the past few months. Ultimately, we expect investors to shift their allocation from mega cap growth to fixed income when the economy finally buckles. In other words, we anticipate that the correlation between stocks and bonds will flip back to negative, that is, when yields break down out of their trading range, that will be the signal to reduce, and not to increase, our exposure to growth assets. But that is a story for another day.

AZ Sestante

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E: invest@azsestante.com | www.azsestante.com

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