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MORROWS PRIVATE WEALTH MARKET & STRATEGY UPDATE AUGUST 2023

Your financial future, tailored your way

MPW Market & Strategy Update - August 2023

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The purpose of this presentation is to provide you general advice and insight into MPW's current market outlook and investment philosophy.

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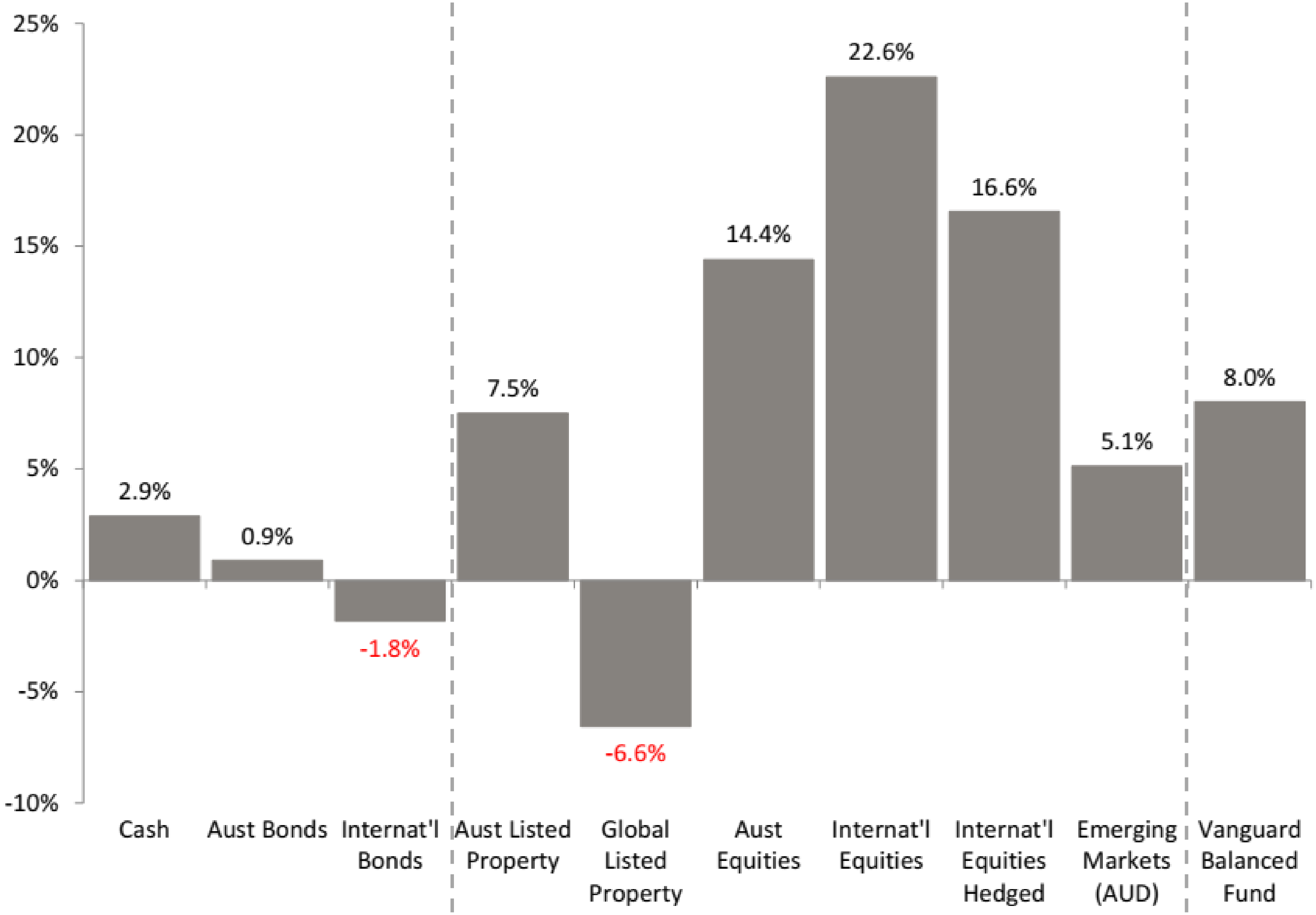
Asset Class Returns 12 Months to 30th June 2023



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But Markets Have Gone Nowhere For 19 Months

Share markets have performed very strongly so far in 2023 and are now within the vicinity of their December 2021 peak. Japan's Nikkei is the only major market to be at new cycle highs.

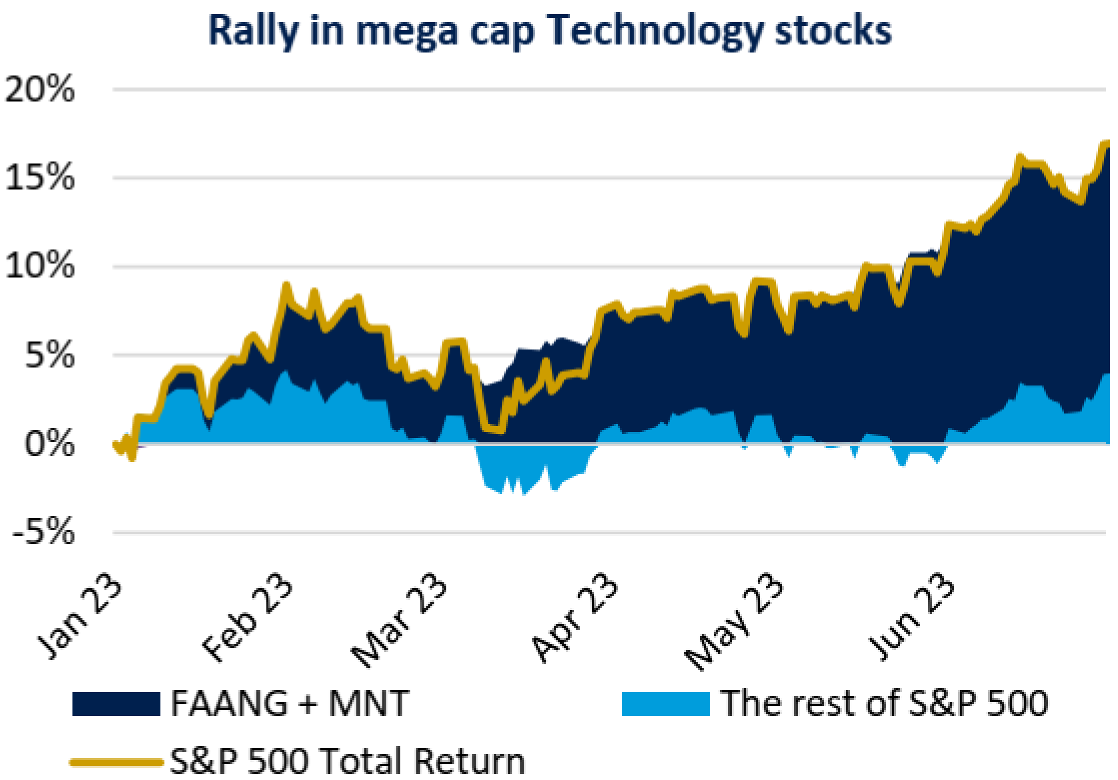
	US S&P500	US Nasdaq	MSCI Europe	Japan Nikkei	China SSE	Aust ASX 200
As at 31 Dec 2021	4,766	15,645	162	28,792	3,640	7,445
As at 31 Dec 2022	3,840	10,466	143	26,095	3,089	7,039
Price fall over calendar 2022	**-19%**	**-33%**	**-12%**	**-9%**	**-15%**	**-5%**
As at 31 Dec 2022	3,840	10,466	143	26,095	3,089	7,039
As at 31 July 2023	4,589	14,346	158	33,172	3,291	7,410
Price gain CYTD 2023	**20%**	**37%**	**11%**	**27%**	**7%**	**5%**
31 July 23 vs 31 Dec 21	**-4%**	**-8%**	**-2%**	**15%**	**-10%**	**0%**

Source: Bloomberg

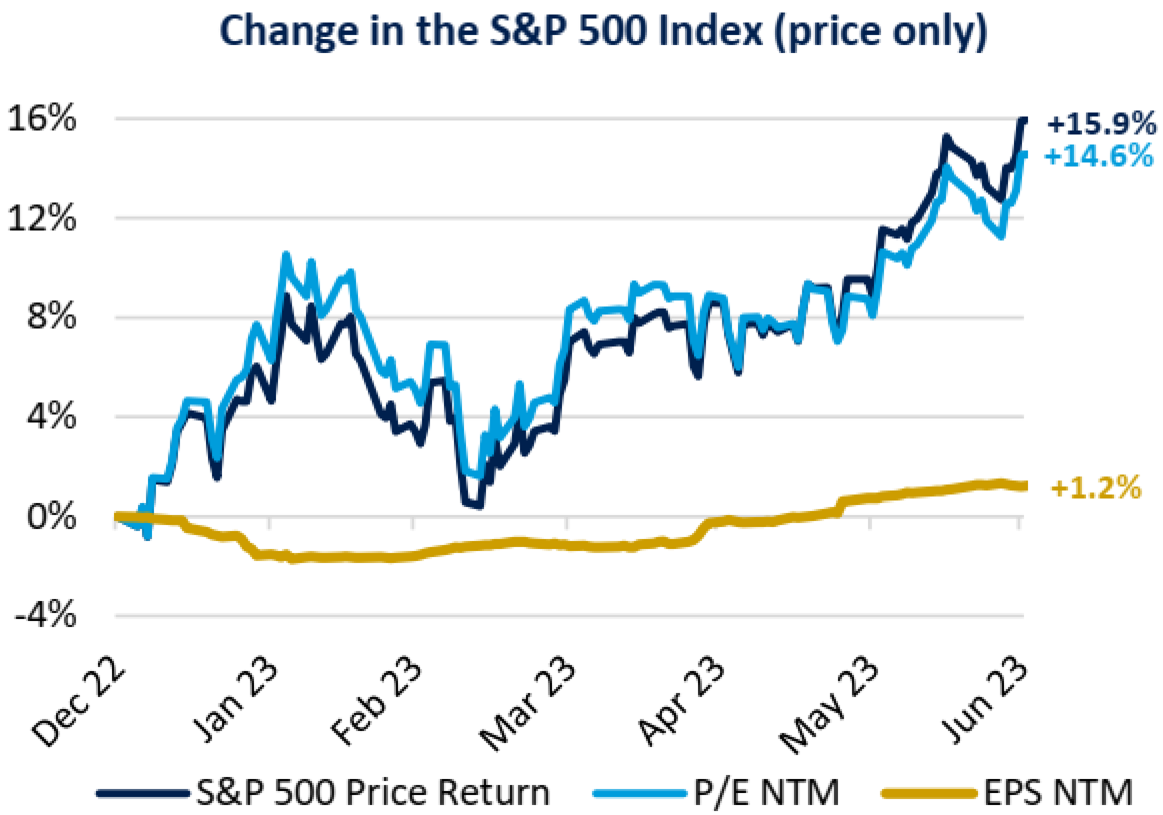
The US Market Rally Is Narrow & Multiple Driven

The **8 largest mega-cap companies** in the US have driven 80% of the index gains over the 2023 calendar year. The remaining 492 stocks have added 3.9% to index returns.

The rally has been driven almost entirely by **PE multiple expansion**, with prices increasing while Earnings have barely moved. This is not sustainable.



Source: Goldman Sachs Investment Research as at 30 Jun 2023. FAANG = Facebook/Meta, Apple, Amazon, Netflix and Google/Alphabet. MNT = Microsoft, Nvidia and Tesla.

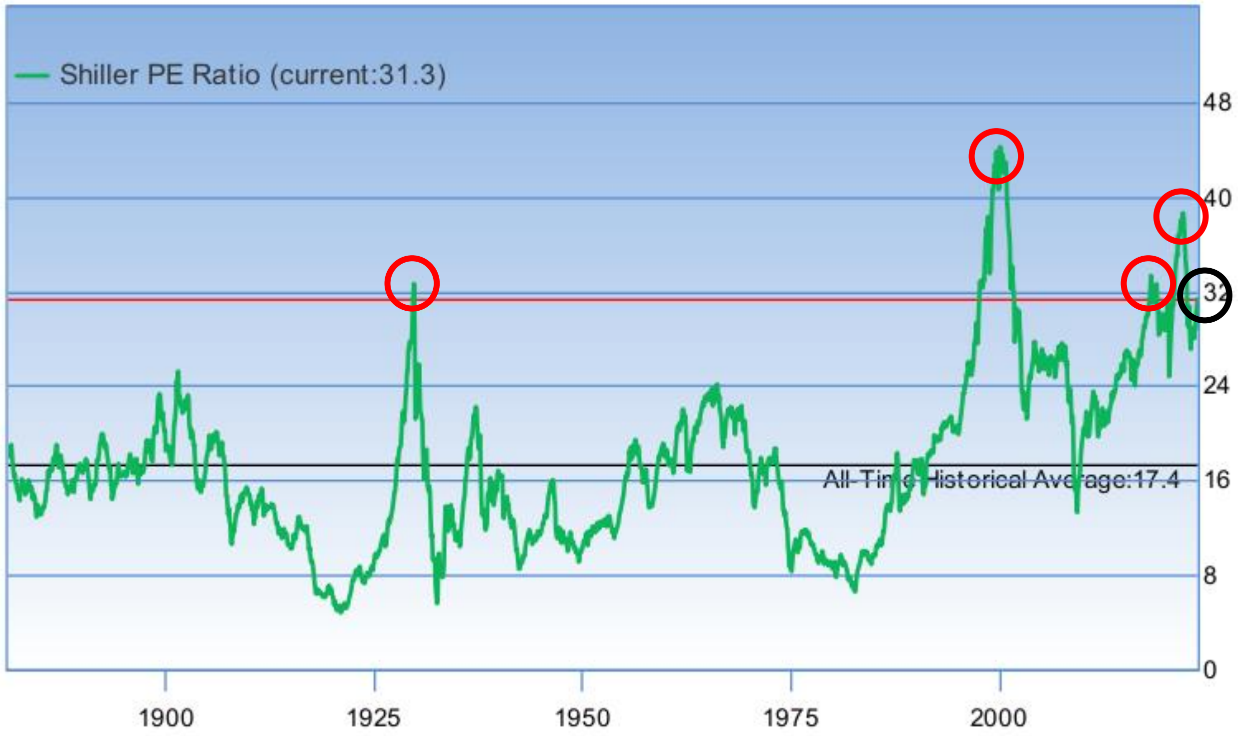


Source: Goldmans Sachs Investment Research as at 30 Jun 2023

US Markets Are Historically Very Expensive

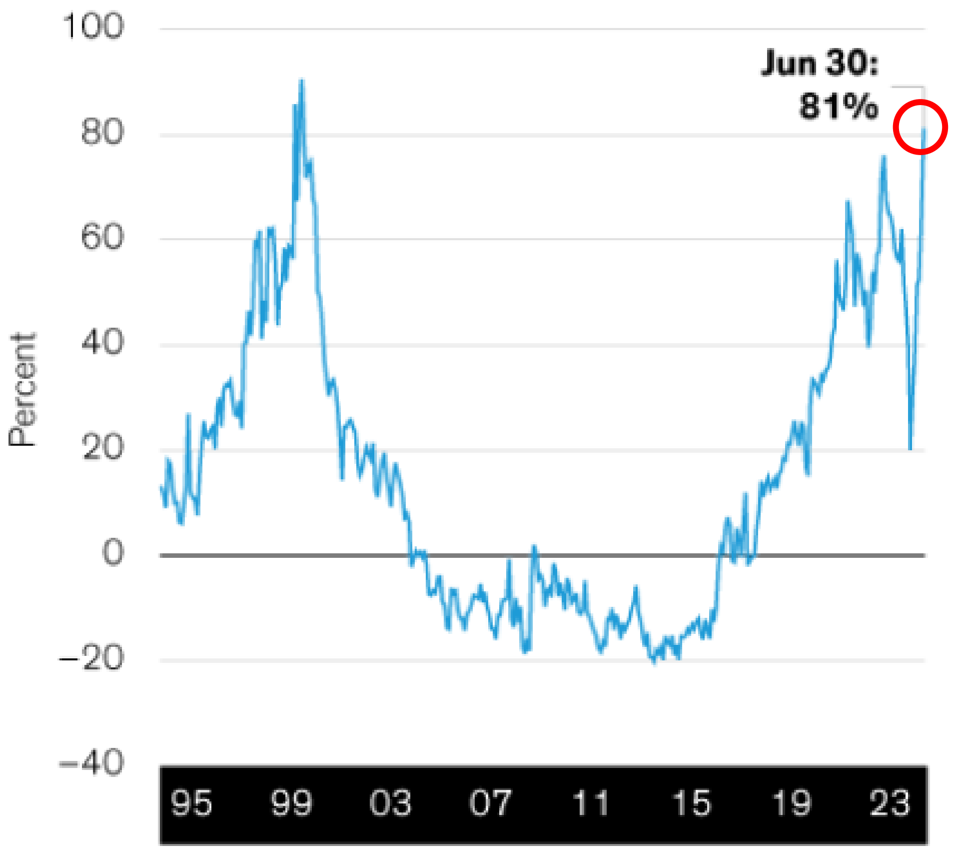
The **US Shiller PE ratio** at 31.3 is very expensive on a historical basis, having been above this level only 4 times in history.

The **valuation premium** for the 10 biggest US stocks is also approaching the dotcom bubble levels.



Valuation Premium of 10 Largest Stocks vs. Rest of the Index*

Price/Forward Earnings (Next 12 Months)

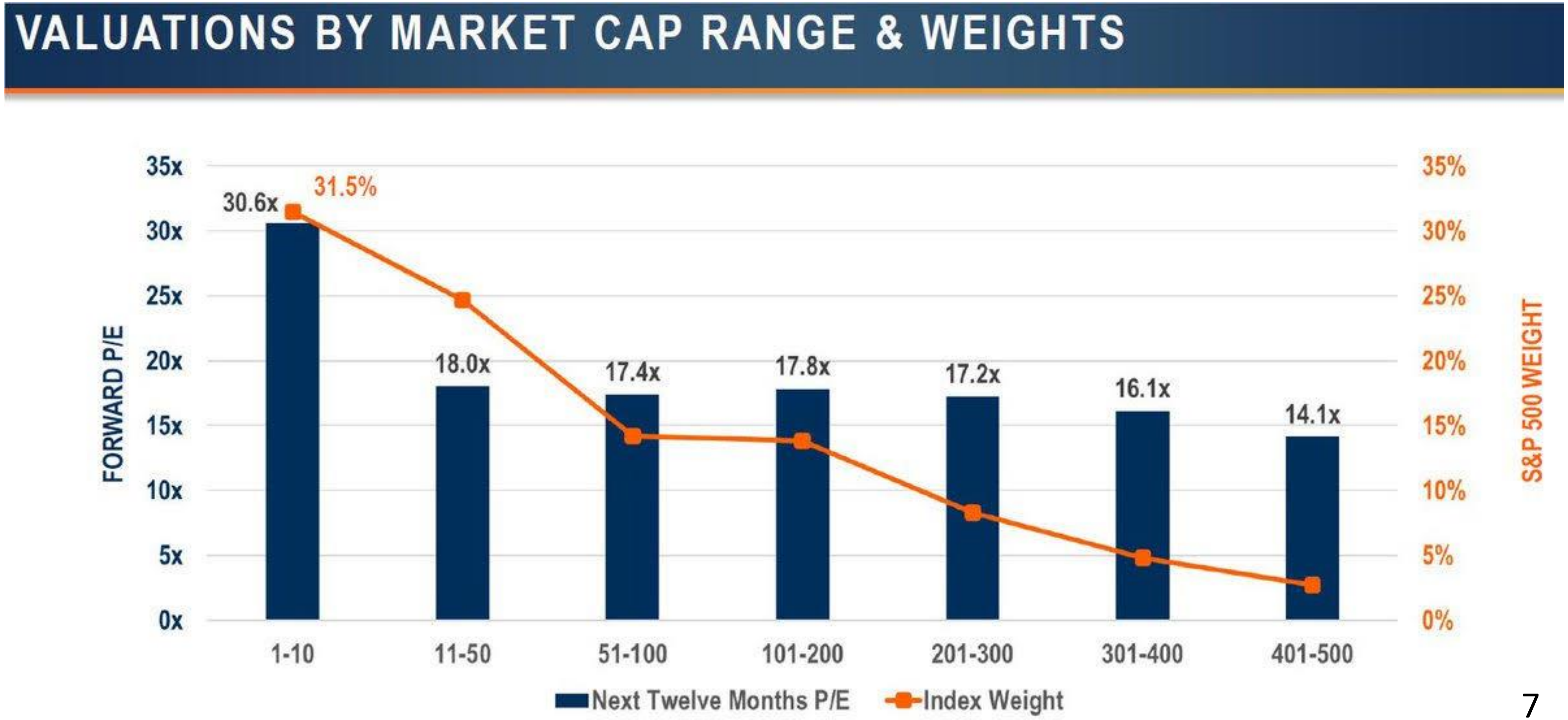


As of June 30, 2023

Source: Compustat, FactSet, I/B/E/S, S&P and AB

Outside of Mega Caps, Valuations Look Better

Excluding the 10 best performers, the US market's valuation is much more reasonable. This highlights the benefits of being selective and opportunistic rather than investing into broad market indices. This is not US centric.



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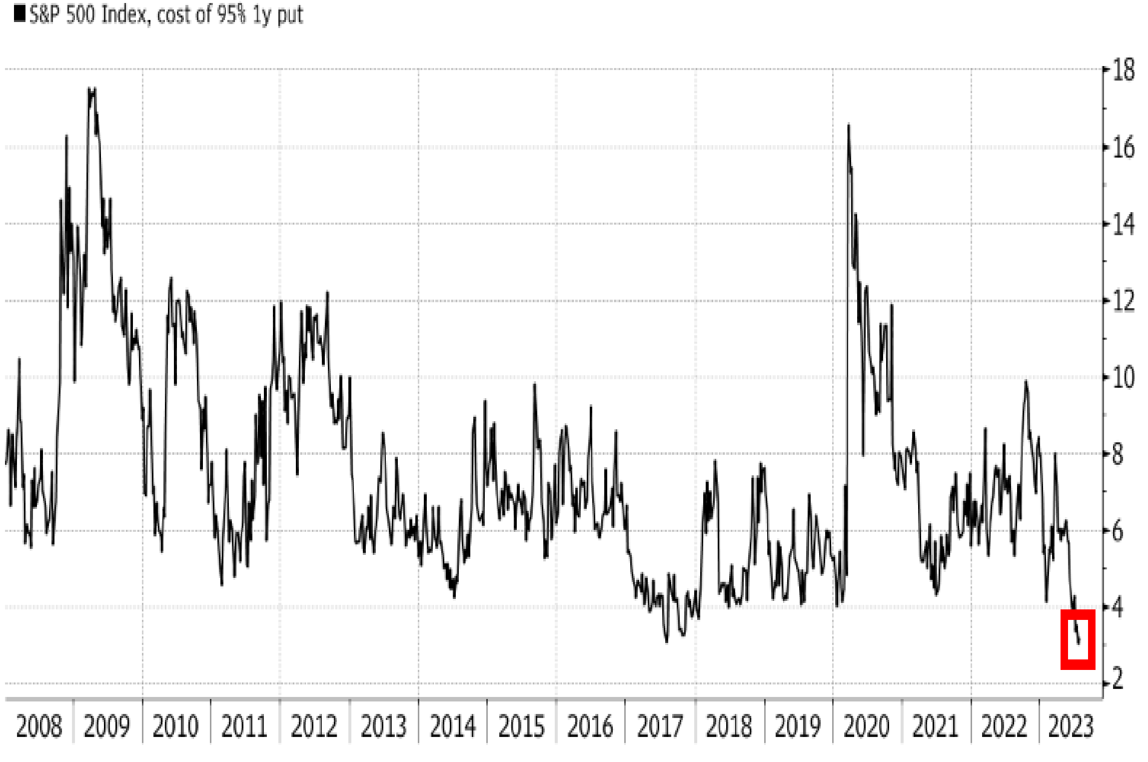
Now Is Not The Time To Be Complacent

Based on speculative positioning **investors are as bullish as we have seen in the last 15 years**. In our view this is not a time to be complacent or to 'chase' the herd, rather it is a time to focus on reward for risk.

The Cheapest Hedge You Have Ever Seen

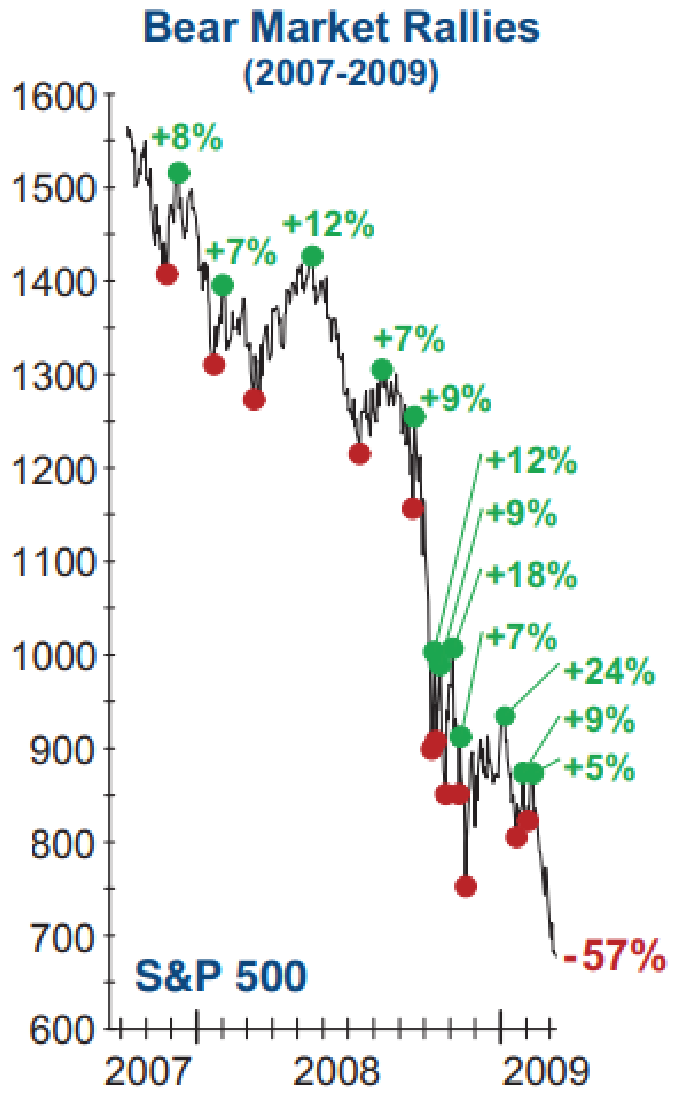
Cost of buying a put has fallen to lowest level on record



Source: Bloomberg

Market euphoria like today is usually followed by a market peak and correction

Bear Market Rallies Are Common – Tread Carefully



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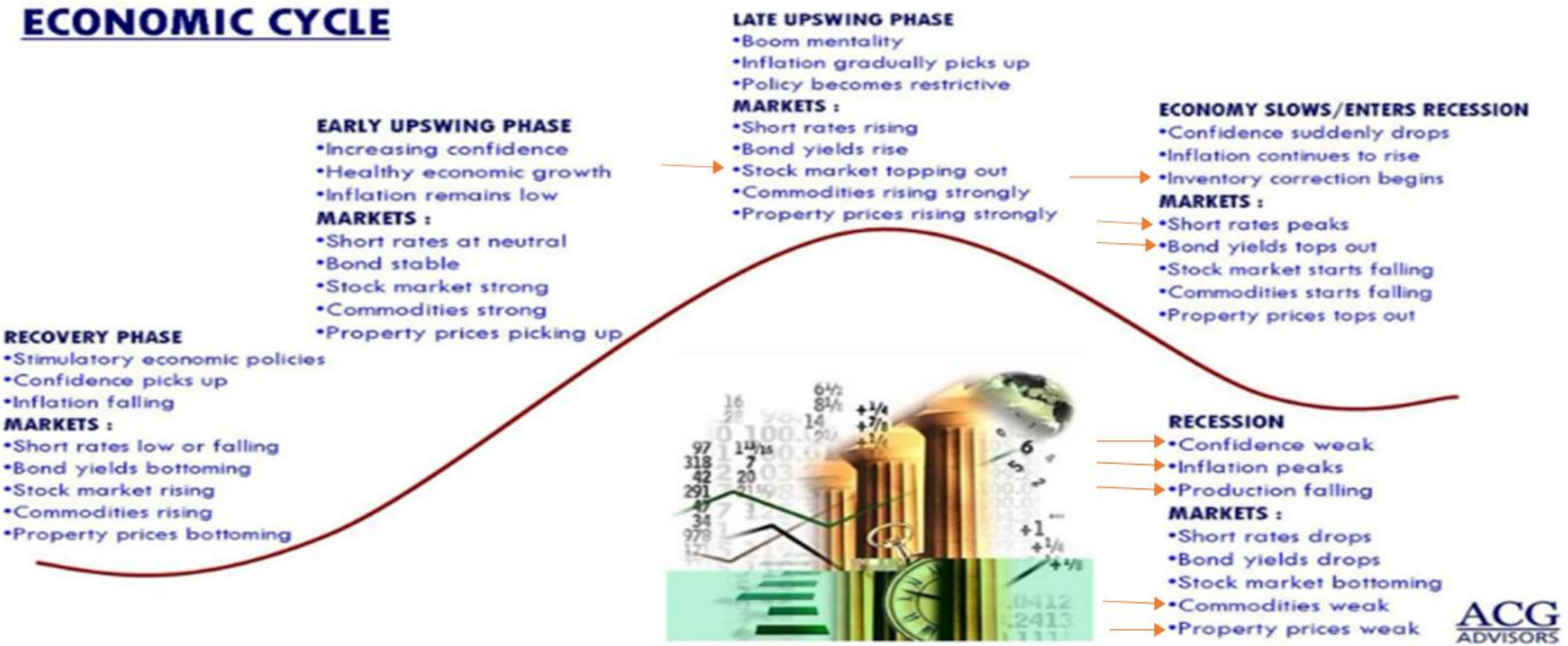
Where Are We In The Economic Cycle?



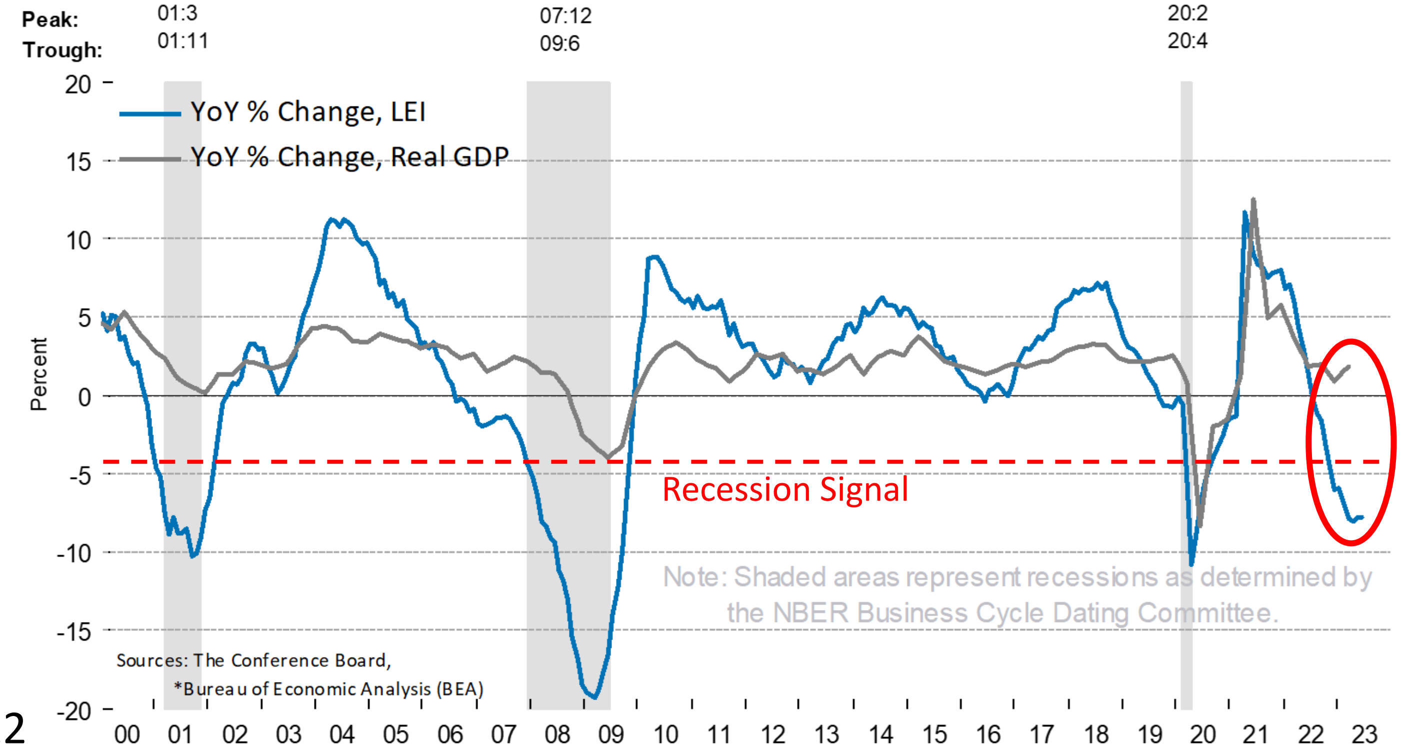
MPW Outlook & Likely Recession Ahead

1. Hard Landing: Global Recession MPW Probability = High	2. Soft Landing: Mid-Cycle Slowdown MPW Probability = Medium	3. Strong Growth: New Bull Market MPW Probability = Low
• Inflation remains stubbornly high	• Inflation moderates towards targets	• Inflation moderates more quickly
• Central banks tighten too much	• Central banks pivot and cut rates	• Central banks cut rates more quickly
• Unemployment rises 1-2%	• Unemployment rises marginally	• Employment growth remains strong
• Savings rates evaporate	• Savings rates are neutral	• Savings rates remain elevated
• Economic data deteriorates	• Economic data stabilises	• Economic data pivots to growth
• Corporate earnings fall further	• Higher revenues offset higher costs	• Companies improve productivity
• Geopolitical risks intensify (wars)	• No further sanctions or conflict	• Russia and China pivot their stance
• Oil price spike magnifies the above	• Supply issues don't spike oil prices	• Oil prices stabilise at lower levels
Markets are <u>not</u> priced for this, expect further decline from here (~-20% plus)	**Markets <u>are</u> priced for this, value can be selectively found at current levels**	**Markets are <u>not</u> priced for this, risky assets will perform very strongly**

Traditional Indicators Point To Recession Ahead

A **negative yield curve** has been an excellent predictor of prior recessions, and it remains the most inverted we have seen since the 1980's.

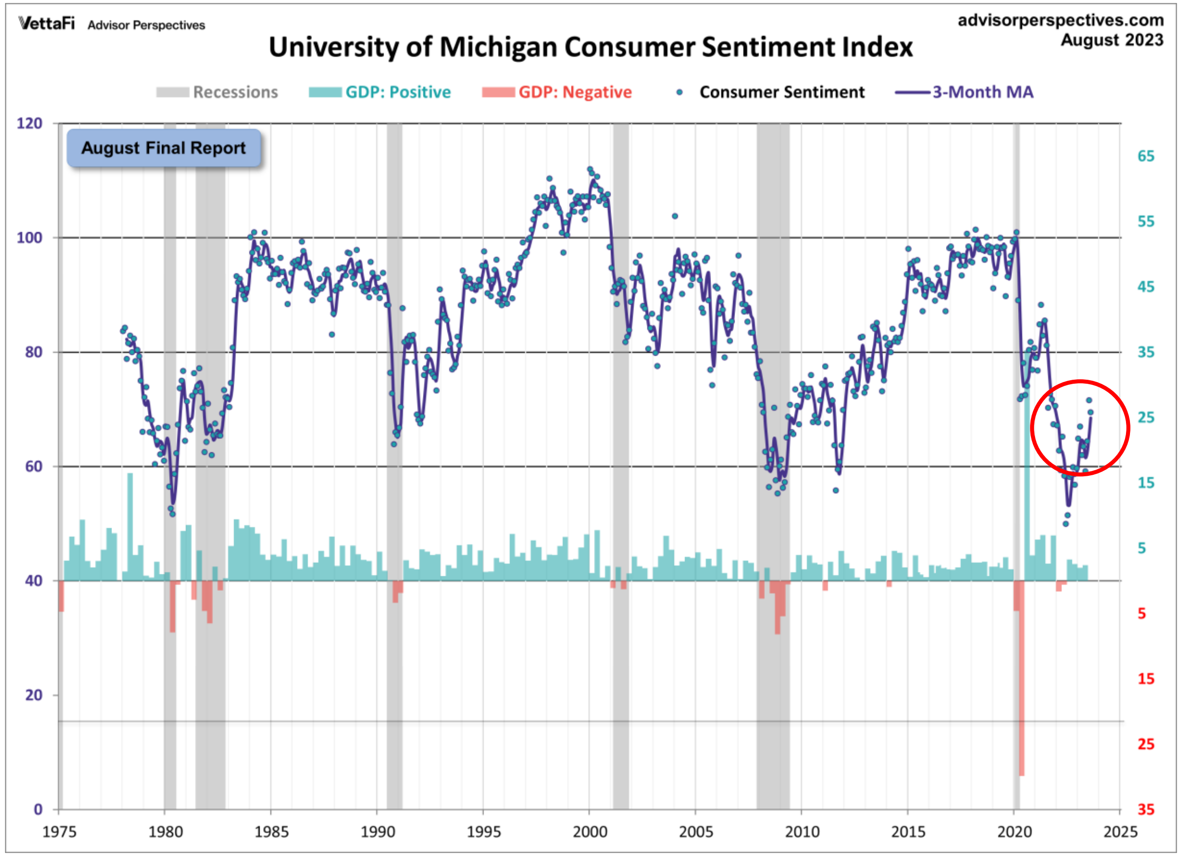
US Leading Economic Indicators (LEI's) are priced well below previous recession levels and suggest that GDP growth will turn negative in the next year.

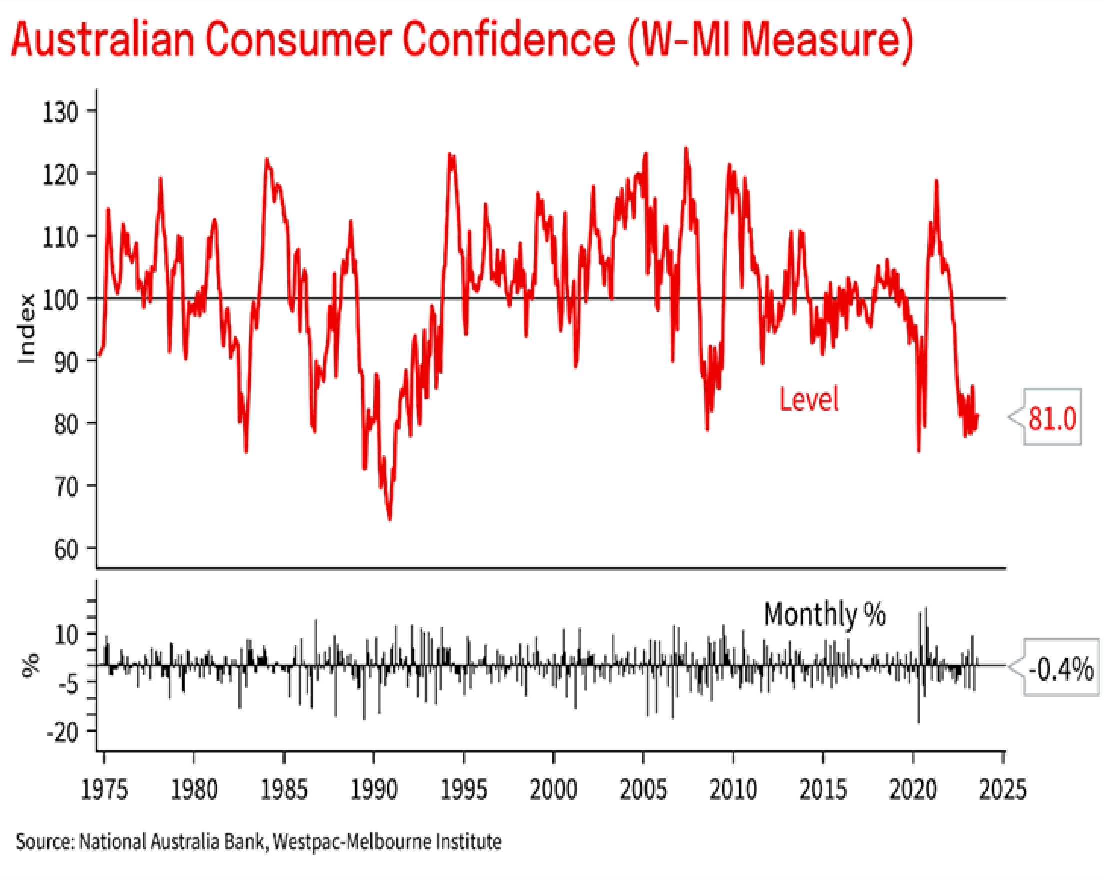


US and Australian Consumer Confidence Is Low

US consumer confidence has recently bounced off recessionary levels as rate hikes were paused.

Australian consumer confidence levels remain at recessionary levels given higher rates and inflation.

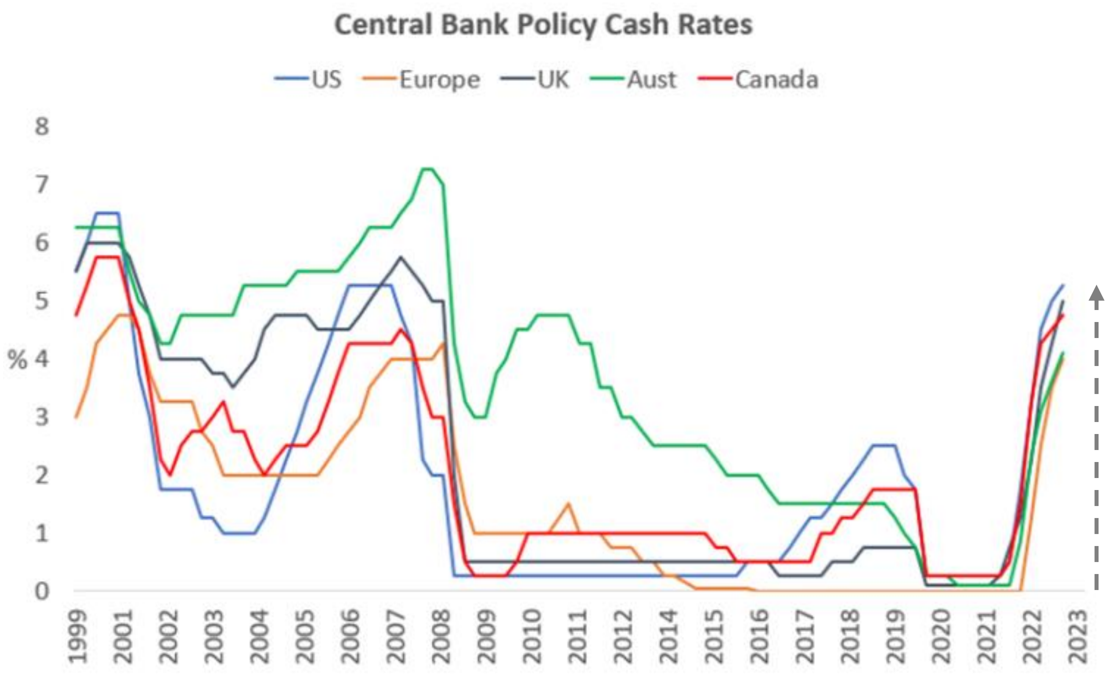




Higher Global Interest Rates & Stubborn Inflation

Global **interest rates** have risen at a historically fast pace in the last 18 months and are likely nearing their cycle peak. Potentially 1-2 more hikes still to come.

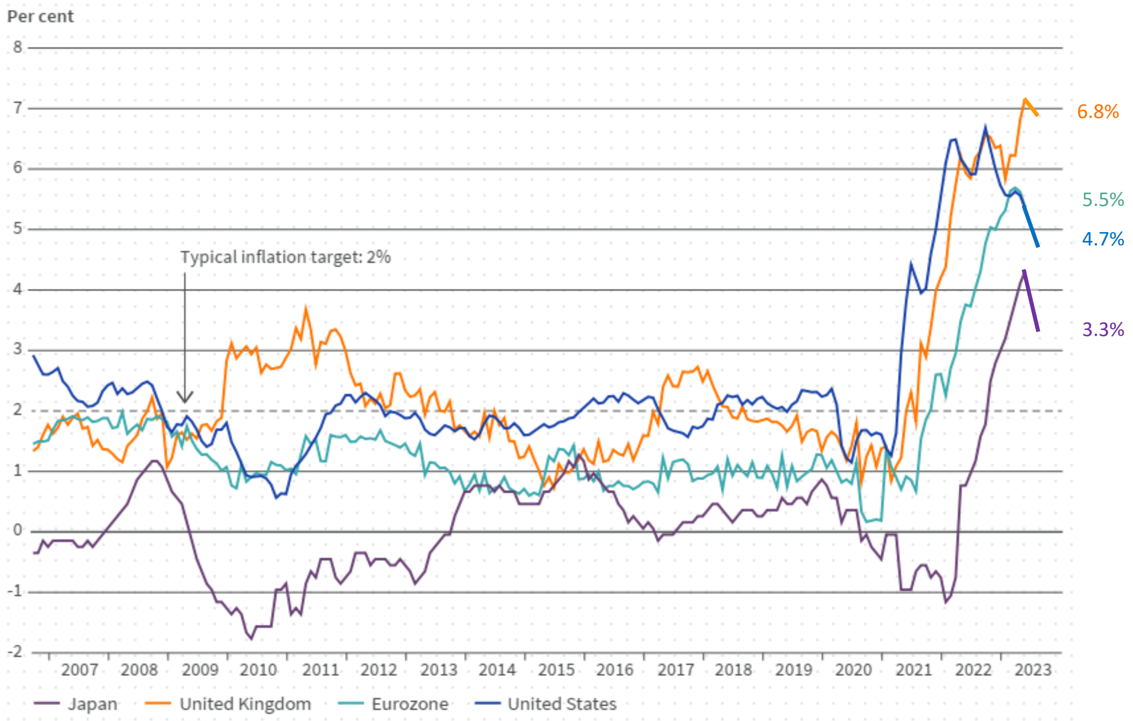
Global inflation peaked mid-2022, but it is a long way from central banks' target 2-3% range. Services inflation remains 'sticky' and **Core inflation** is falling at a slow pace.



Source: Bloomberg

Figure 6. **Core inflation in the major advanced economies**

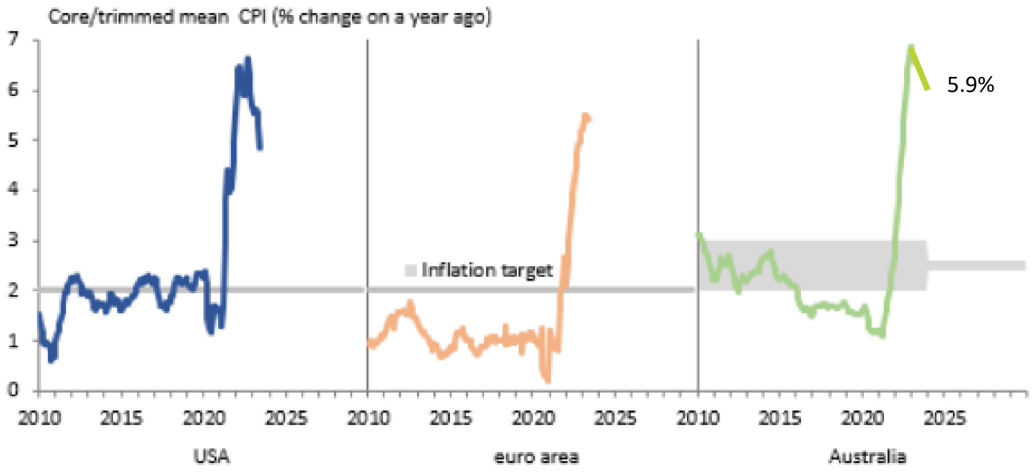
Proving far more difficult to shift



Source: Aviva Investors, Macrobond as at 30 June 2023.

Goods Inflation Falling, Services Inflation More Sticky

Figure 1: Core CPI inflation in the US, euro area and Australia



- Core inflation has peaked in most advanced economies and should fall sharply given goods inflation has subsided as global supply-chain disruptions have been resolved and the surge in shipping costs has dissipated.

- However, there is the risk that inflation takes longer to sustainably return to central bank targets in a timely fashion given services inflation is high and relatively sticky.

Figure 2: Core goods inflation in the US, euro area and Australia

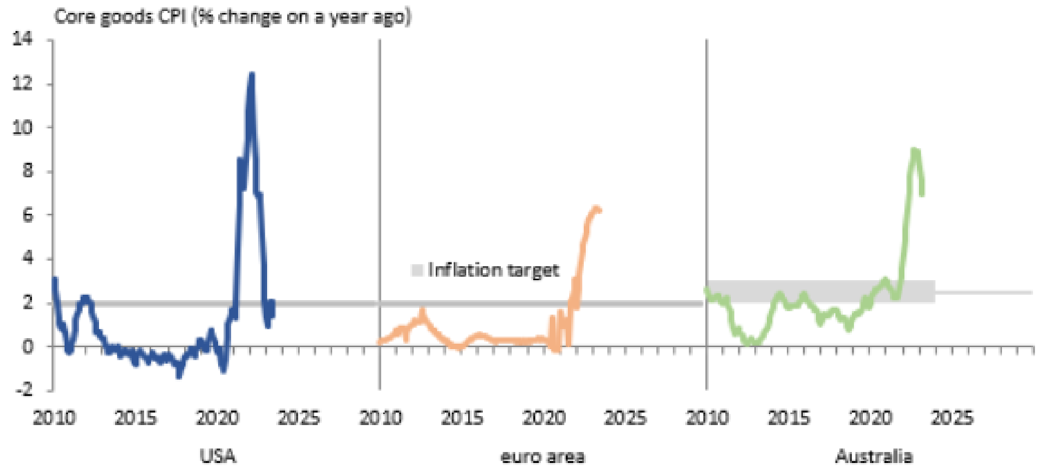
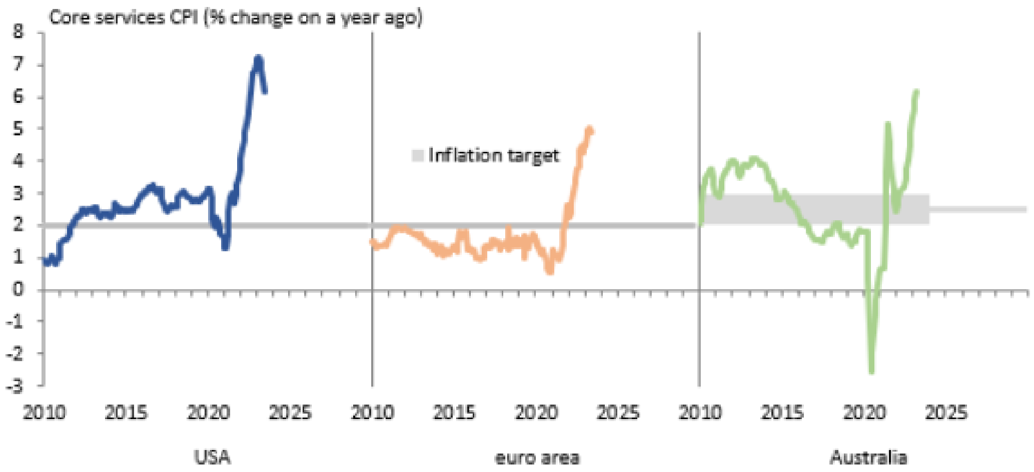


Figure 3: Core services inflation in the US, euro area and Australia



Source: Eurostat, Federal Reserve Bank of St Louis, Reserve Bank of Australia, CCI, as at July 2023

Source: Coolabah Capital Investments

Services Inflation Is High Due To Wages Growth

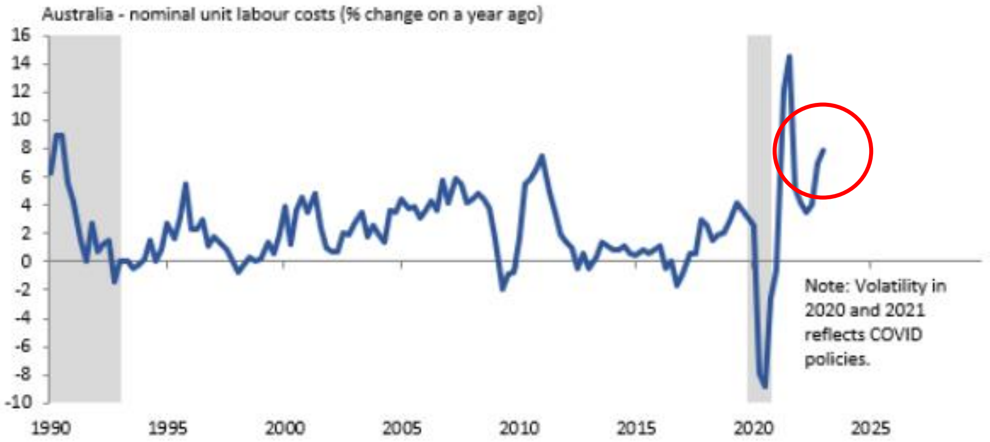
Figure 1: Unit labour costs are growing strongly in the US ...

- Services inflation, excluding rents, reflects strong growth in unit labour costs (labour costs adjusted for labour productivity).
  - US unit wages (5.3%) have grown at fastest rate since early 1980s.
  - Euro area unit wages (6.4%) have grown at their fastest rate since the global financial crisis (excluding COVID policy distortions).
  - Australian unit labour costs (7.9%) have grown at fastest rate since late 1980s due to poor productivity (ex COVID policy distortions).

Figure 2: ... and in the euro area ...

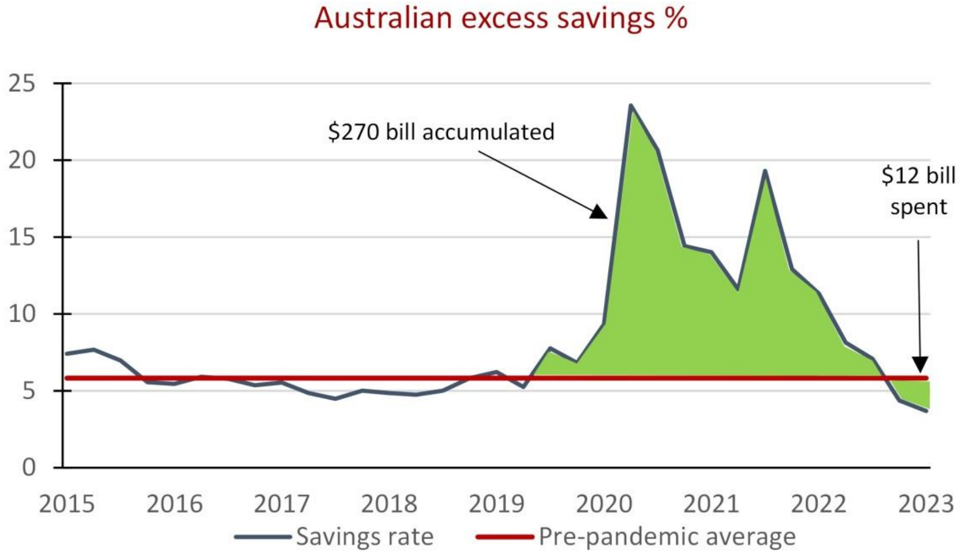
Source: Eurostat, Federal Reserve Bank of St Louis, Australian Bureau of Statistics, CCI, as at July 2023

Figure 3: ... and Australia



Source: Coolabah Capital Investments

Australian Economic Data Has Been Resilient in 2023

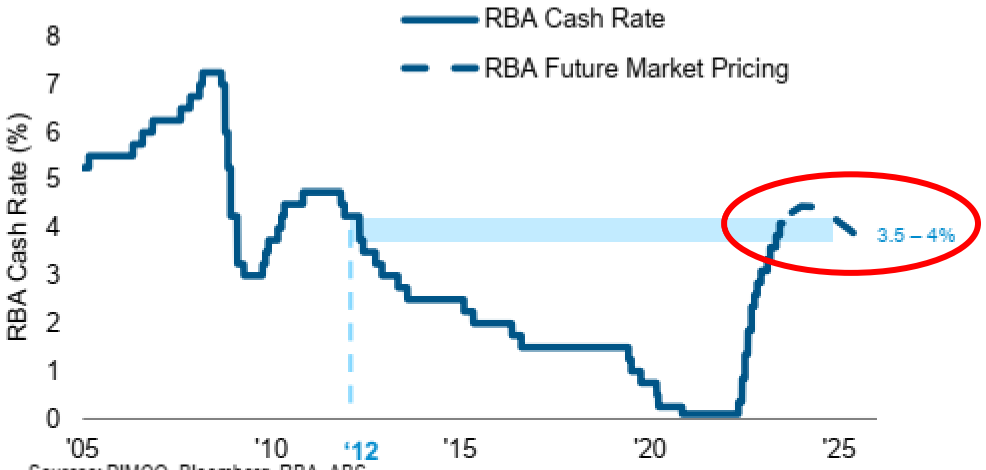


Source: Refinitiv, Evans & Partners

There is still a **lot of excess savings** held by Aussie households, and whilst it is falling it has already delayed the recession timeline.

With **unemployment levels at 50-year lows** how can the RBA consider pausing rates let alone cutting them?

The RBA cash rate at 4.10% RBA is a level we haven't seen since 2012…



Sources: PIMCO, Bloomberg, RBA, ABS.

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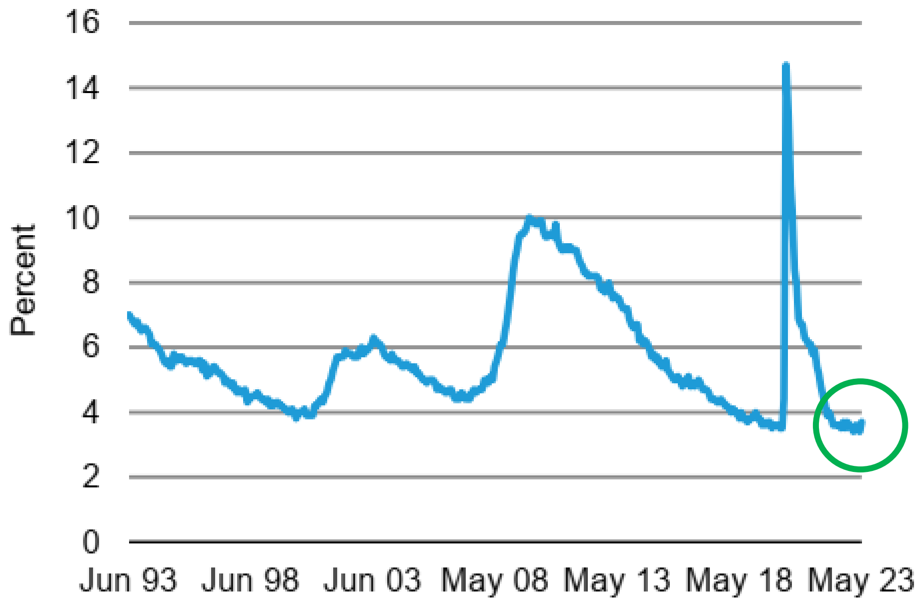
US Economic Data Has Been Resilient in 2023

US unemployment remains at a 50-year low. A very tight labour market means employed people will continue to spend and this is inflationary.

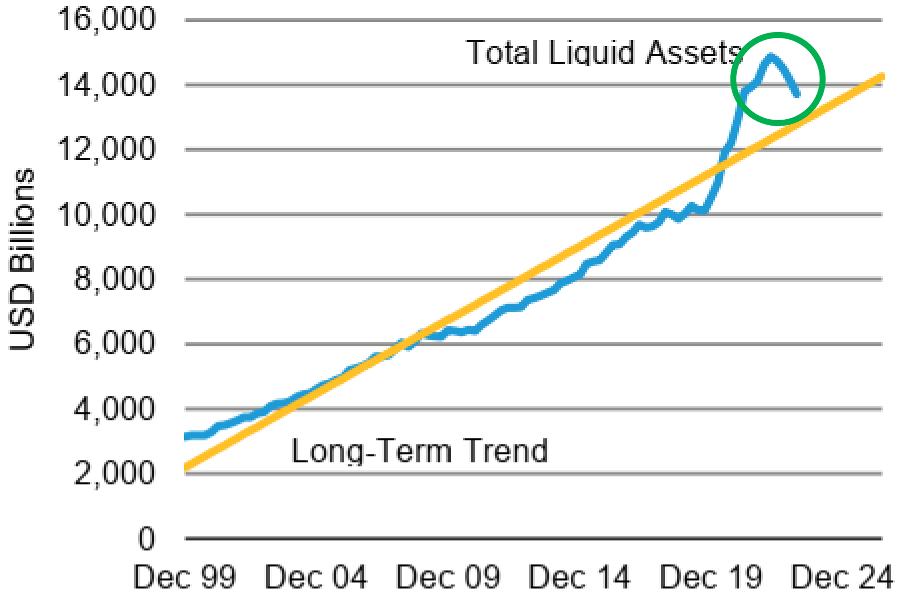
There is still **excess savings** held by US households, and whilst it is expected to be depleted by Q4 2023, it has already delayed the recession timeline.

Unemployment Rate



As of June 30, 2023
Source: Refinitiv Datastream

Household Excess Savings

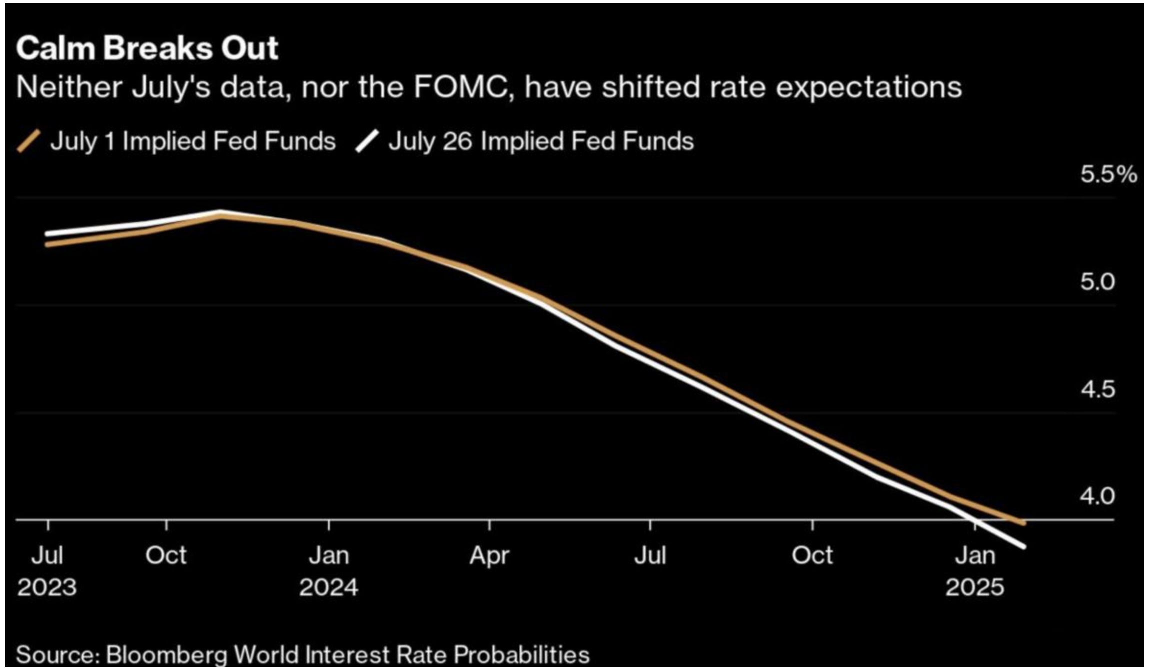


As of June 30, 2023
Source: Refinitiv Datastream

US Markets Are Pricing Fed Rate Cuts In 2023-24

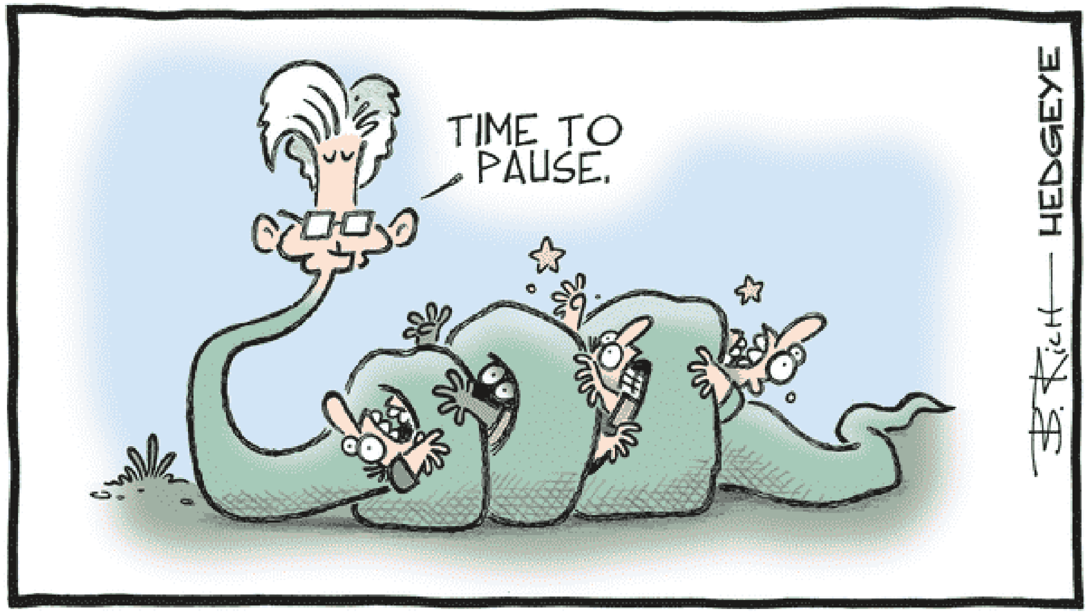
US Markets are **pricing interest rates to start falling** later this year and into 2024. That is a big ask when the US has full employment and Core inflation at 4.7%.

We think the Fed is more likely to pause with high rates and see what damage is being done to the economy.



In our view, **for the Fed to cut interest rates** they would need to see one of three things happen:

1. **Core Inflation falling faster**
2. **A credit crisis**
3. **A deep recession**

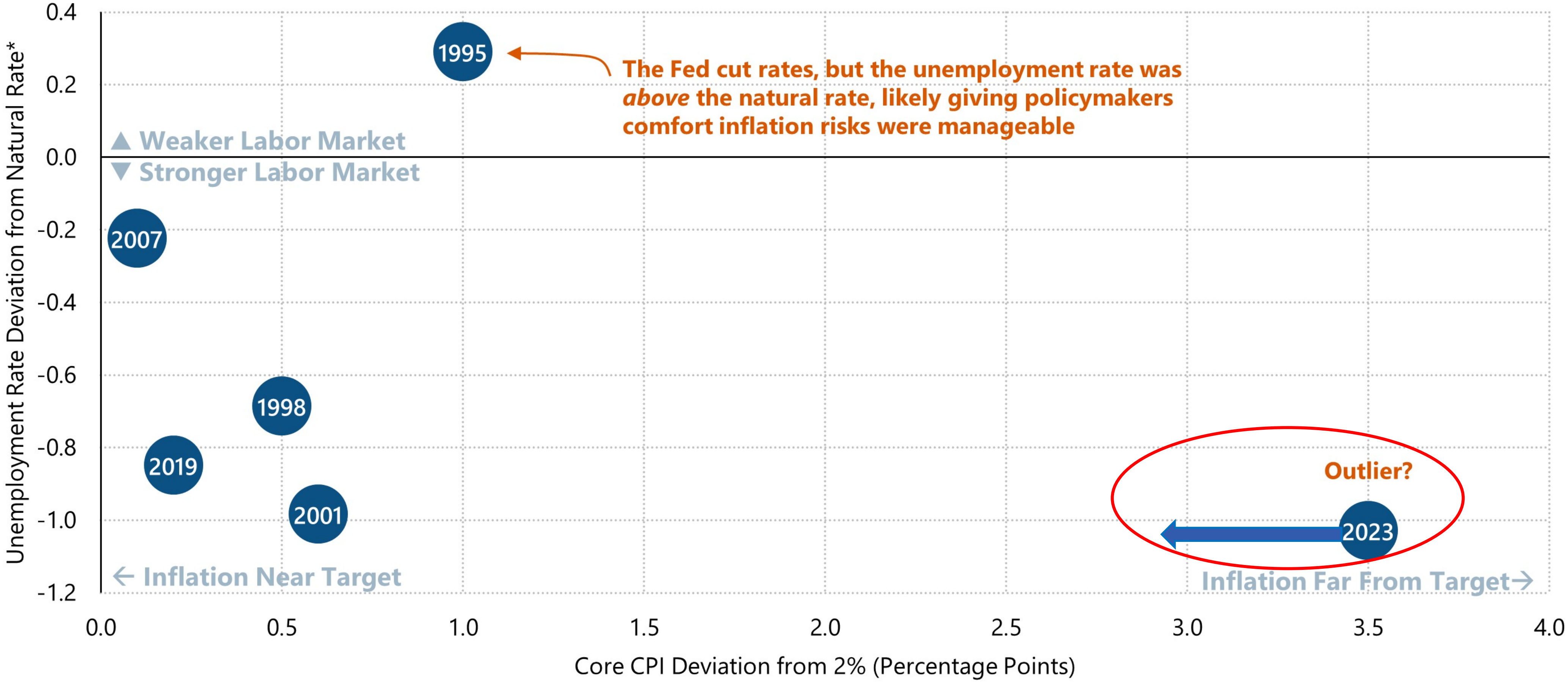


How Realistic Are Rate Cuts Into 2024?

One Of These Is Not Like The Others

Unemployment Rate and Core Inflation At First Rate Cut In Cycles Since 1994

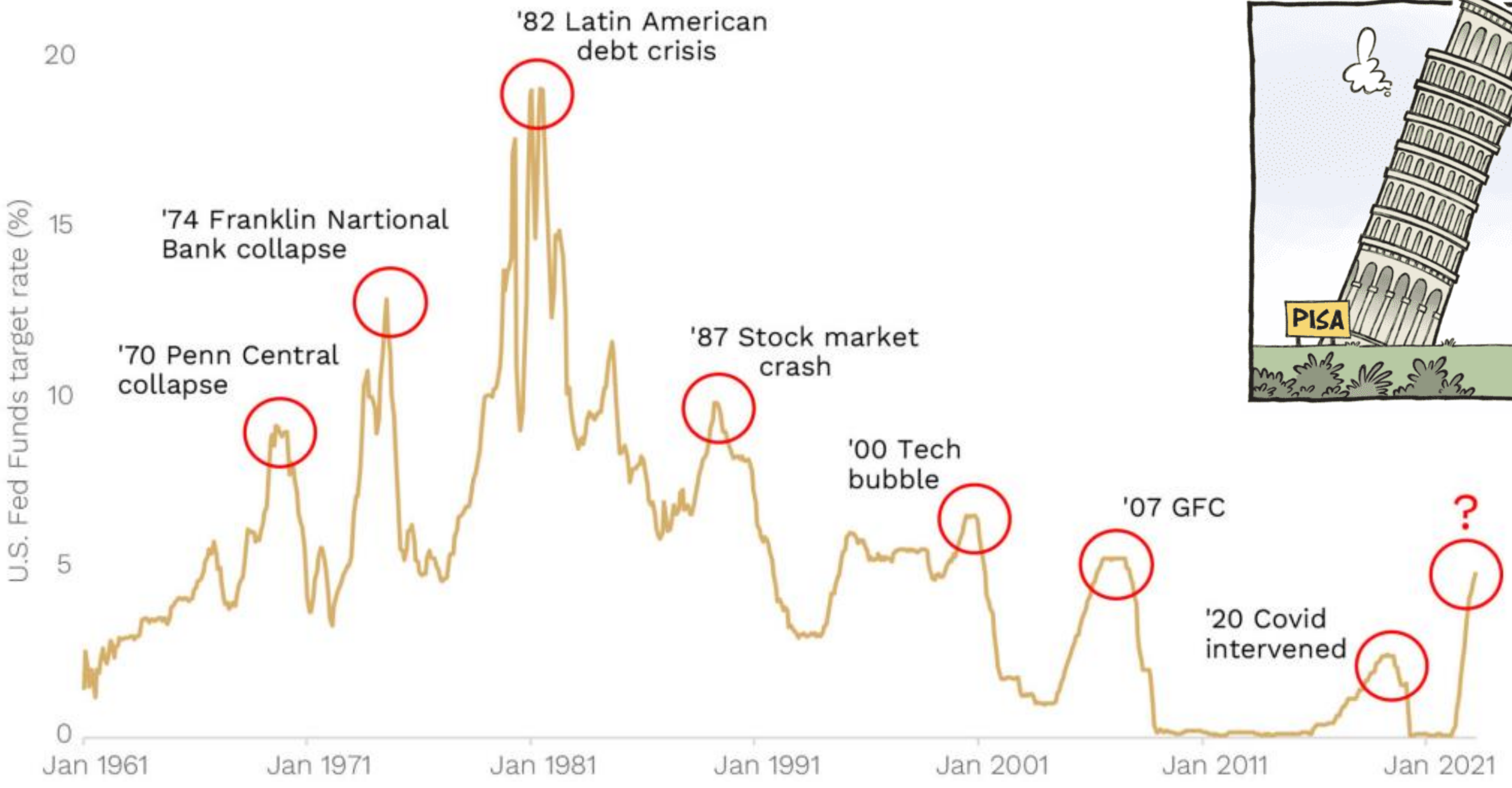
For The Week Ending 05/19/2023



Source: Bureau of Labor Statistics, CBO, Deutsche Bank, Payden Calculations **An unemployment rate above the natural rate suggests labor market conditions are non-inflationary.*

Tightening Cycles Last Until Something Breaks

This has been the **fastest rate-tightening cycle** in the US since the 70s/80s, cracks are starting to appear.



Source: Ophir, Factset

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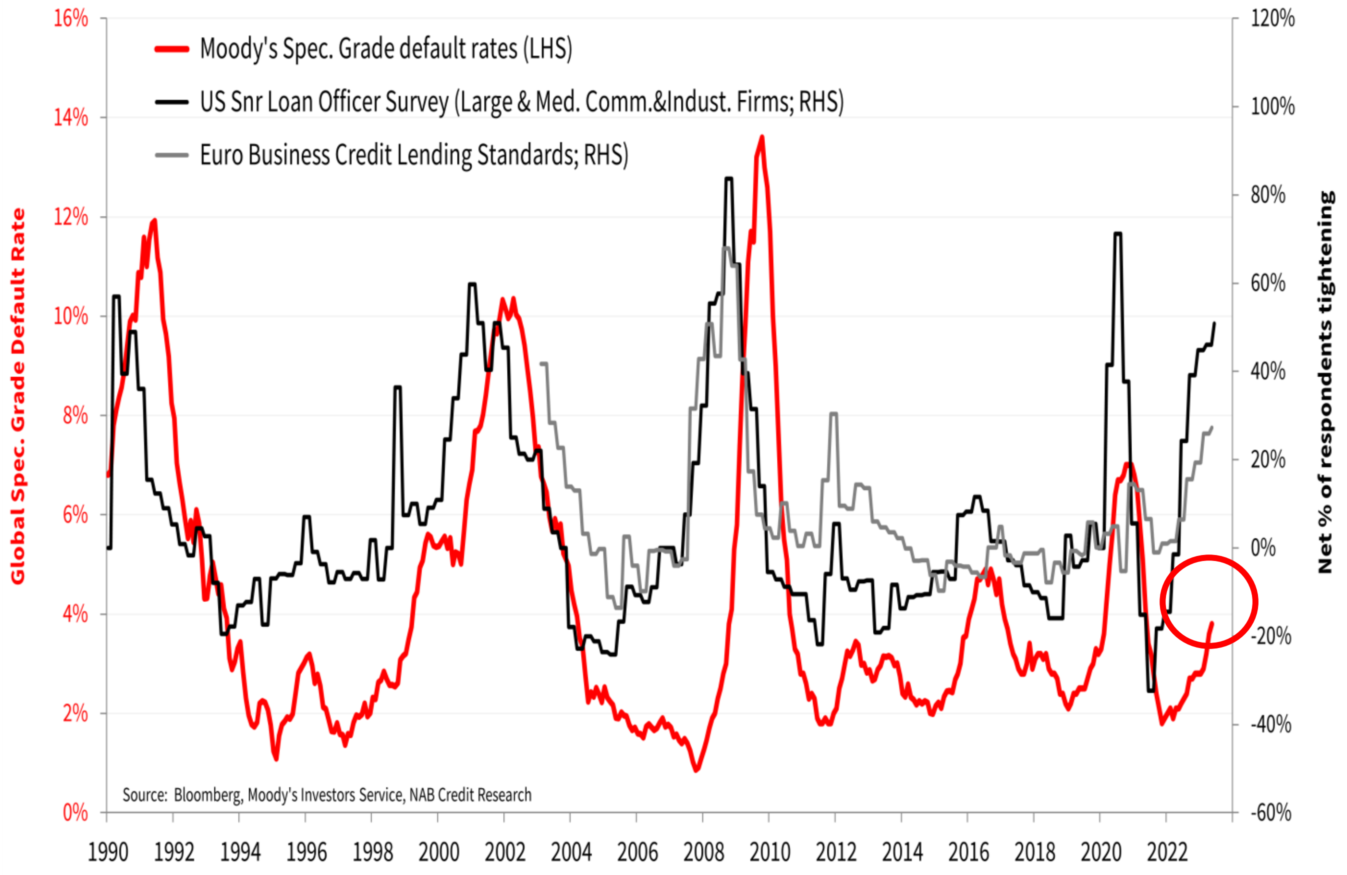
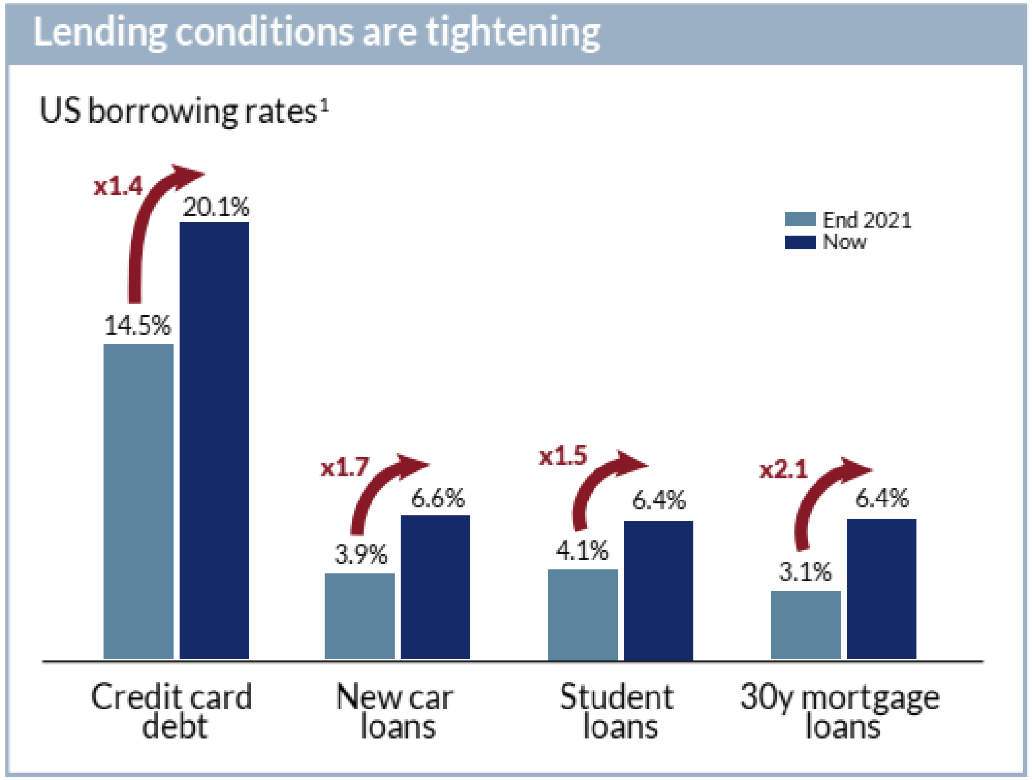
Tight Lending Conditions Lead Defaults

Tighter lending conditions lead to slower bank lending on a lagging basis, and historically this has led to a recession. <u>Monetary policy runs on a lag</u> so we are yet to see the real impact of higher rates and restrictive lending… **more defaults**.

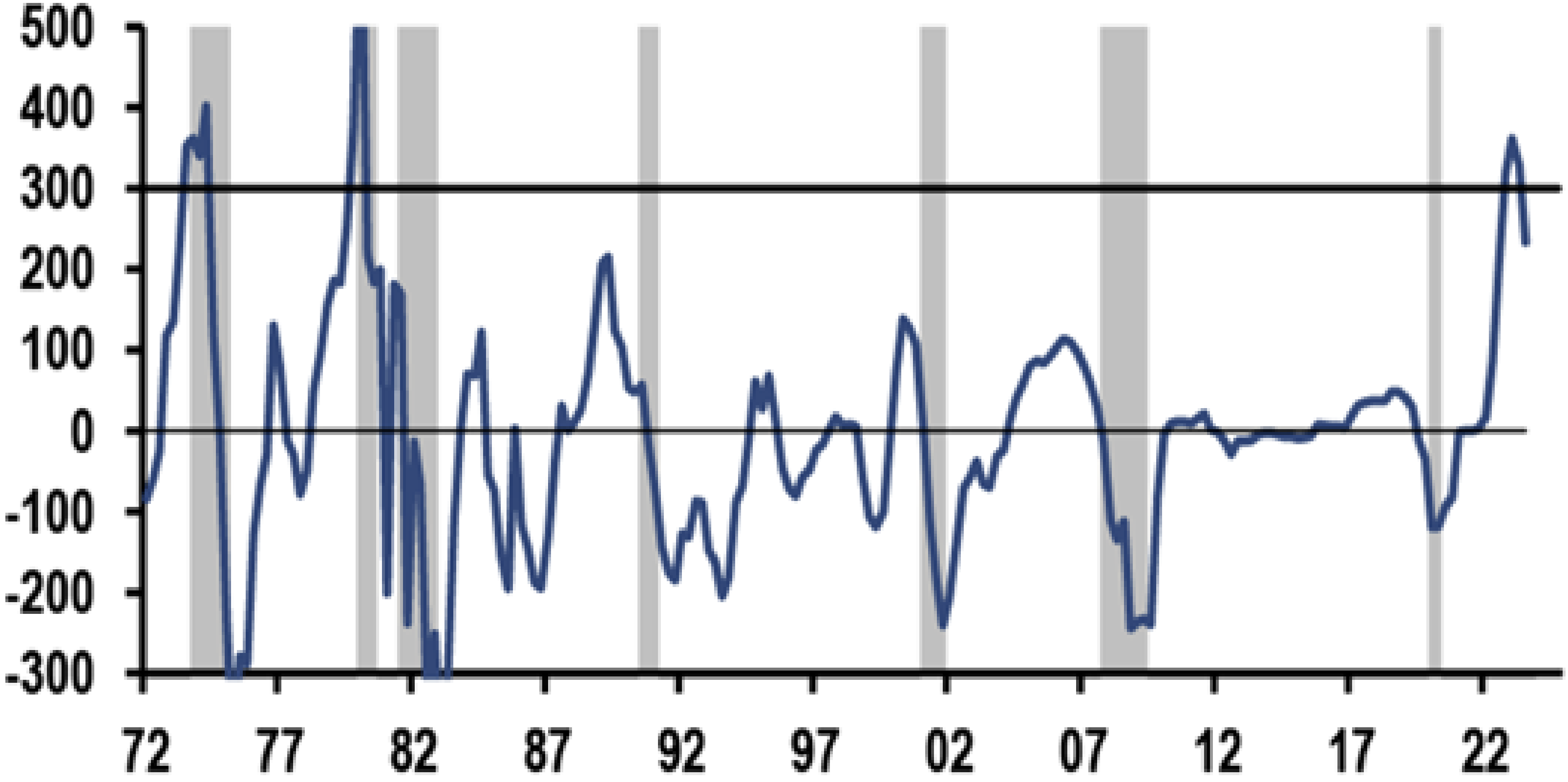




Source: Partners Group, Federal Reserve (May 2023).
[1] Student loans are the average interest rate for all federal loans, and the mortgage rate is for fixed mortgages.

Tight Lending Conditions Pre-empt Recessions

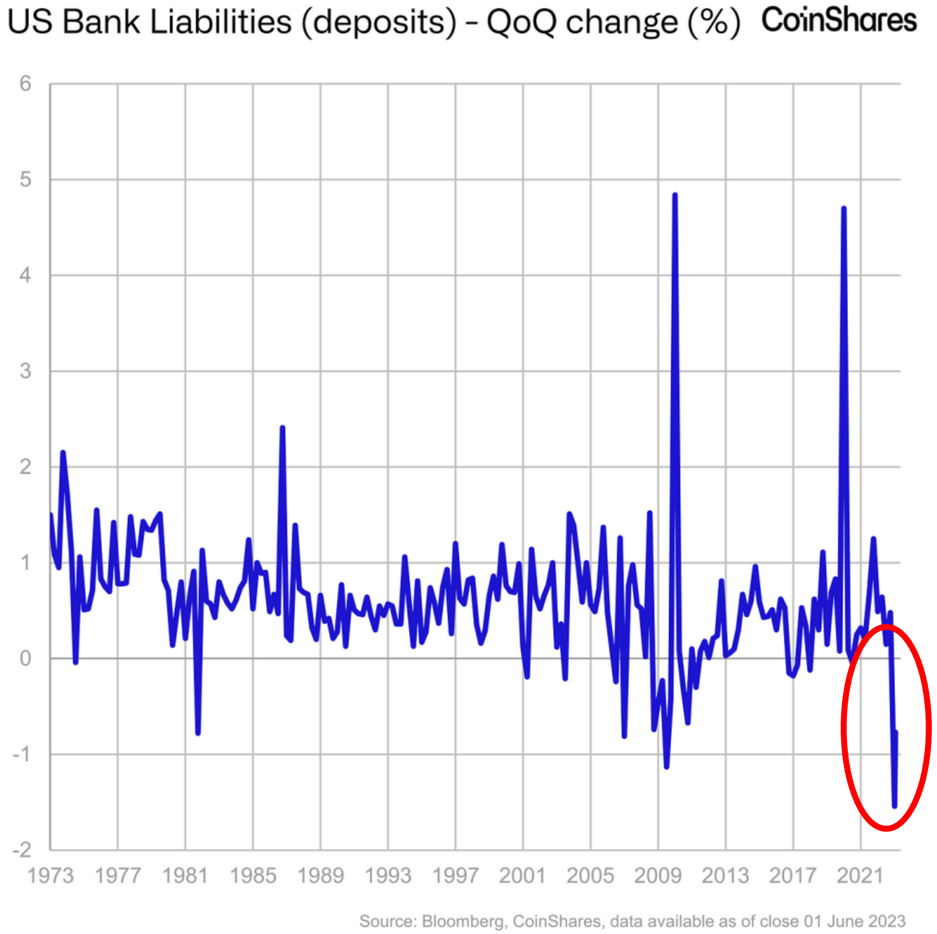
Tighter lending conditions as measured by the blue line are typically **followed by recession** as noted by the grey shaded bars. We need to go back to the 1970-80's to have conditions this tight.

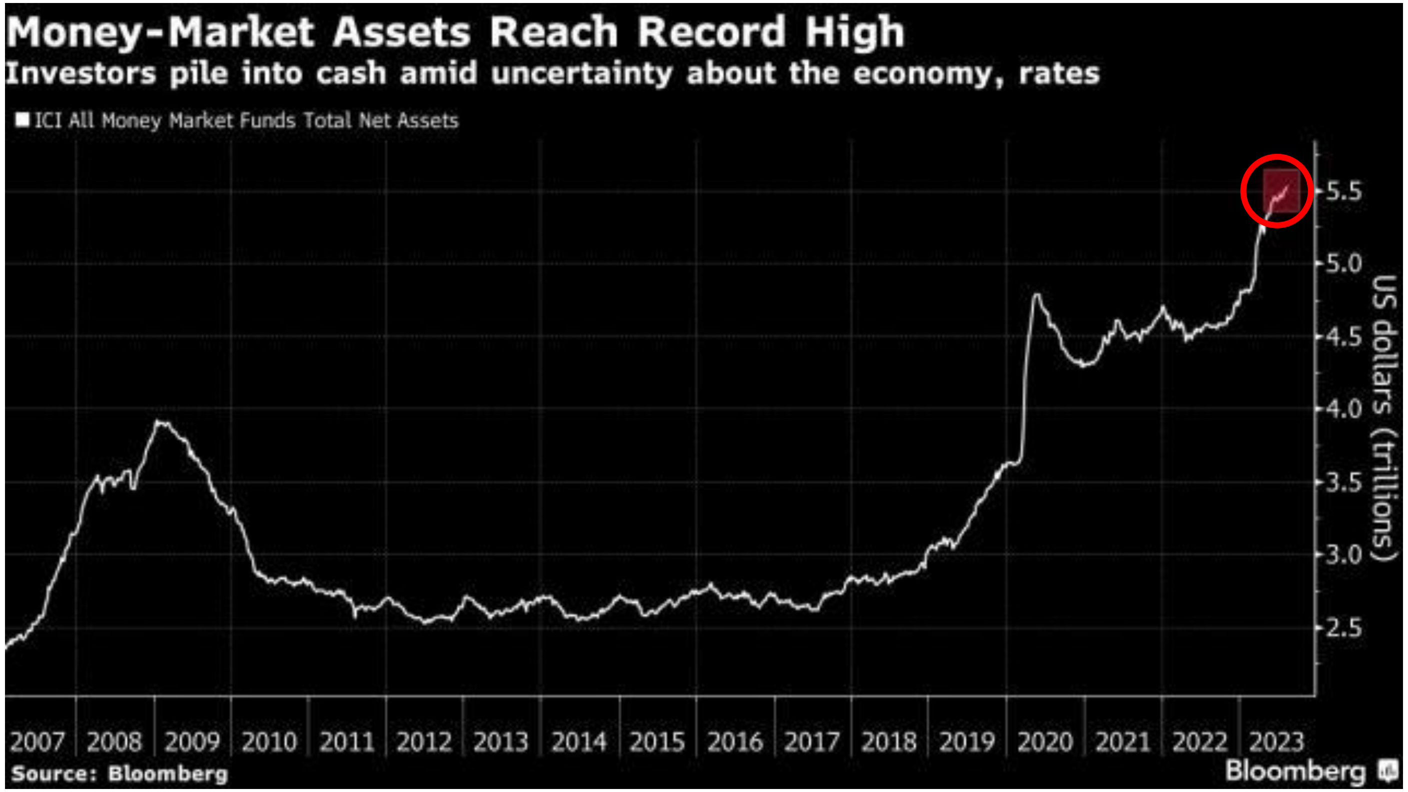


Source: National sources, J.P. Morgan. Details on request.

US Bank Deposits Have Fallen Sharply

Falling bank deposits impact the ability for banks to lend money = credit contraction. As money flows out of banks it flows into money market funds earning higher interest rates than bank deposits.

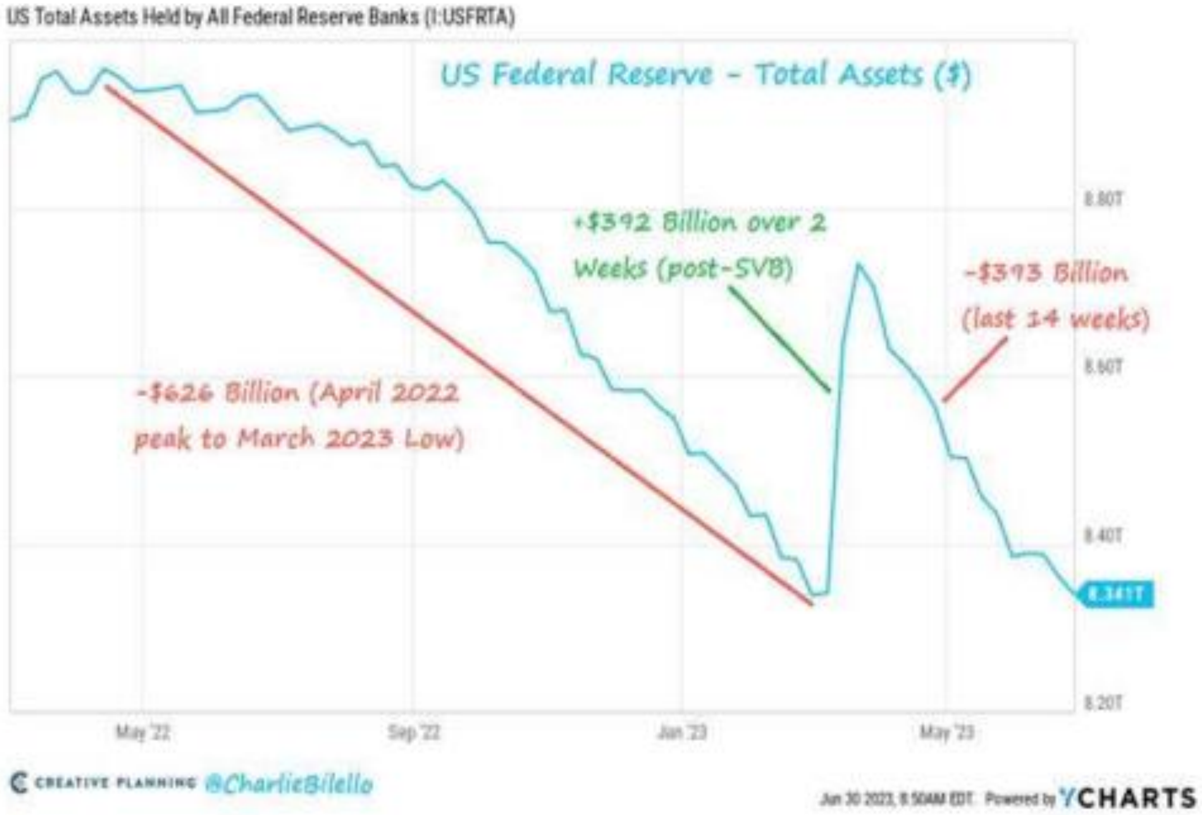


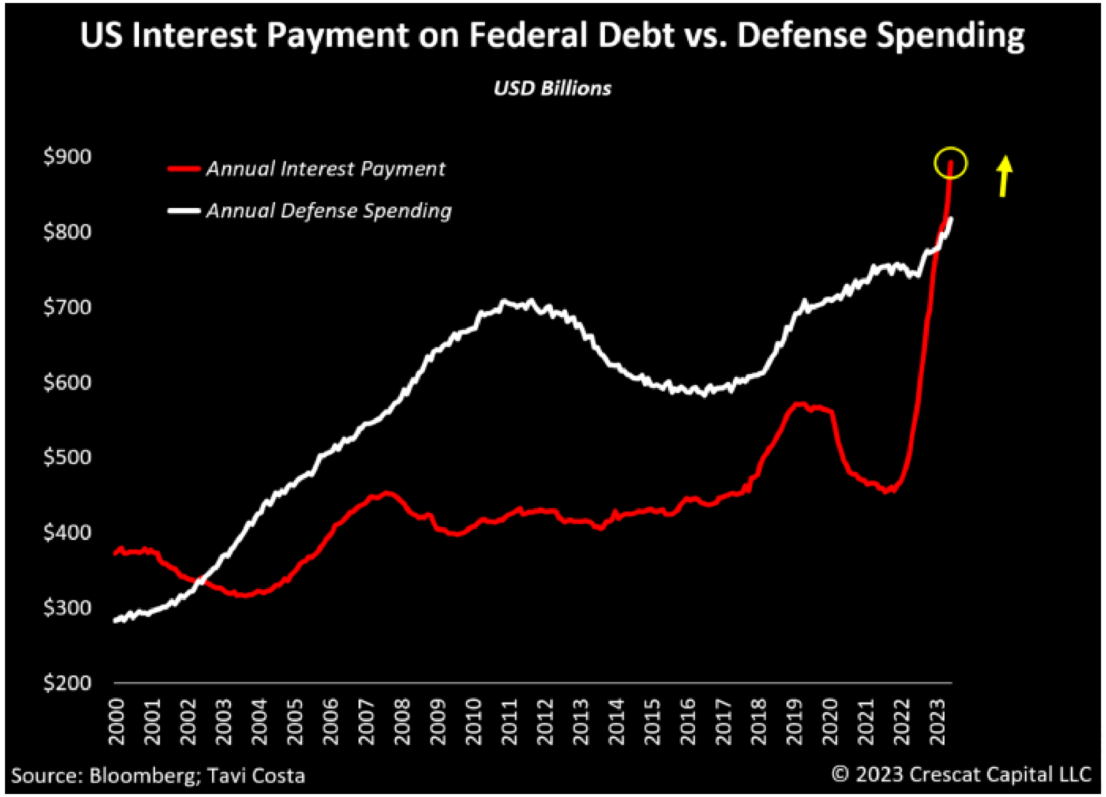


Liquidity Is Being Withdrawn & Costs Are Rising

Central banks continue to **reduce their balance sheets** despite concerns around the US banking system.

US Government debt interest repayments are ballooning higher than defence spending.

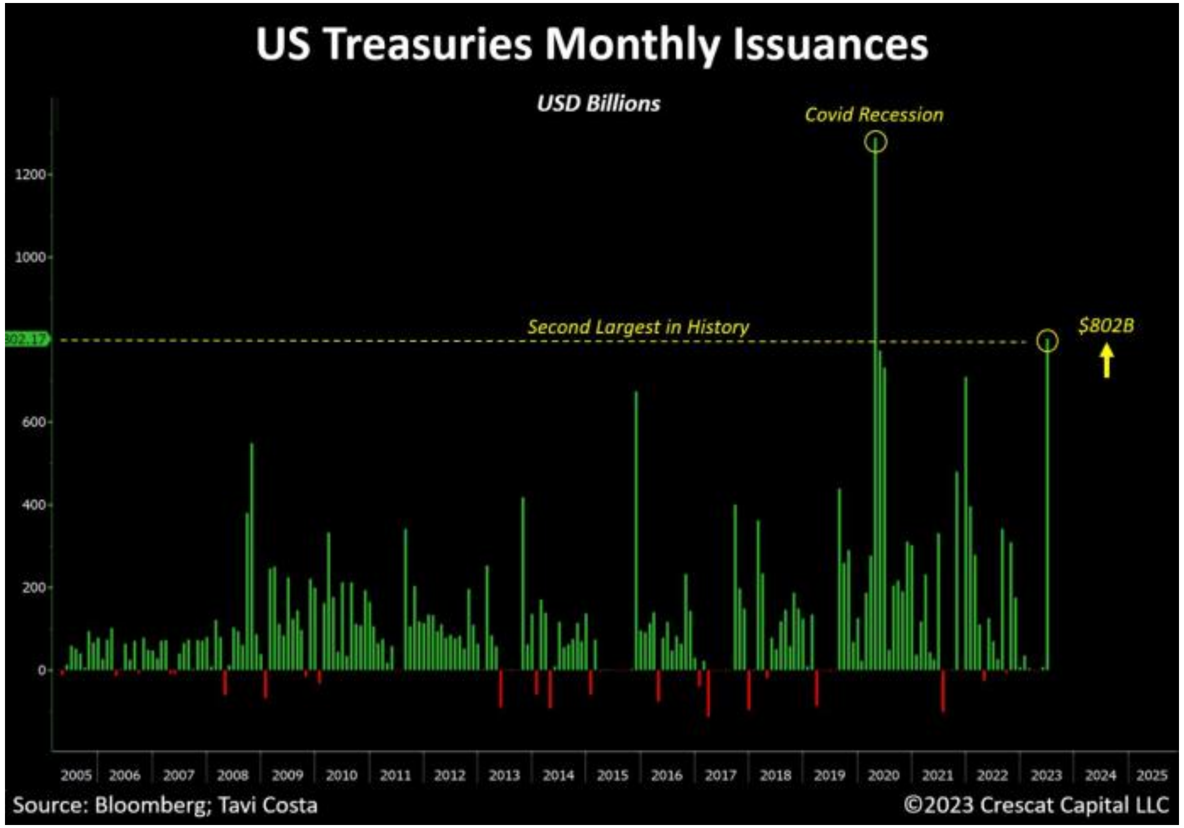


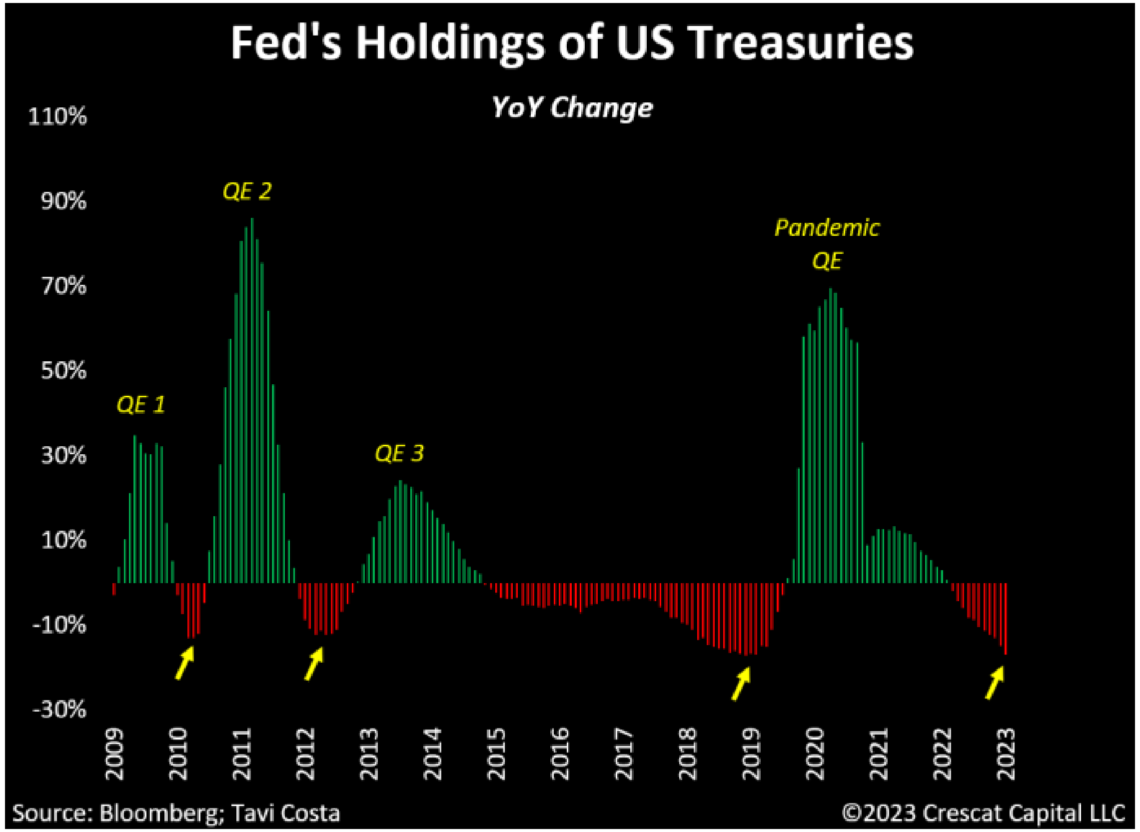


Who Is Going To Buy US Government Bonds?

The US is issuing a massive amount of **treasury bonds** to fund ongoing costs and deficits.

If the Fed is no longer the buyer of last resort, does that mean **bond yields move higher**?





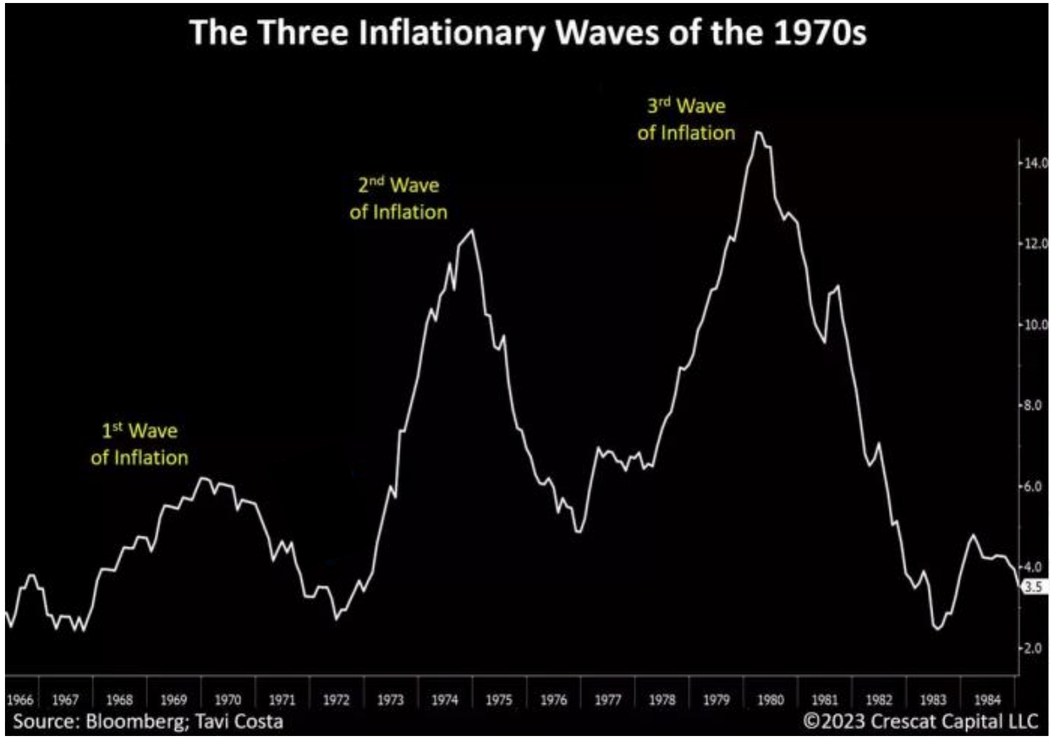
So What Does This Mean For Markets?

Will central banks pivot from rate hikes to interest rate cuts in late 2023 and throughout 2024?

OR

Will central banks learn from the mistakes of the 1970-80s and keep rates higher for longer, no cuts?

A Fed Pivot = A Soft Landing
Action: Selectively buy assets

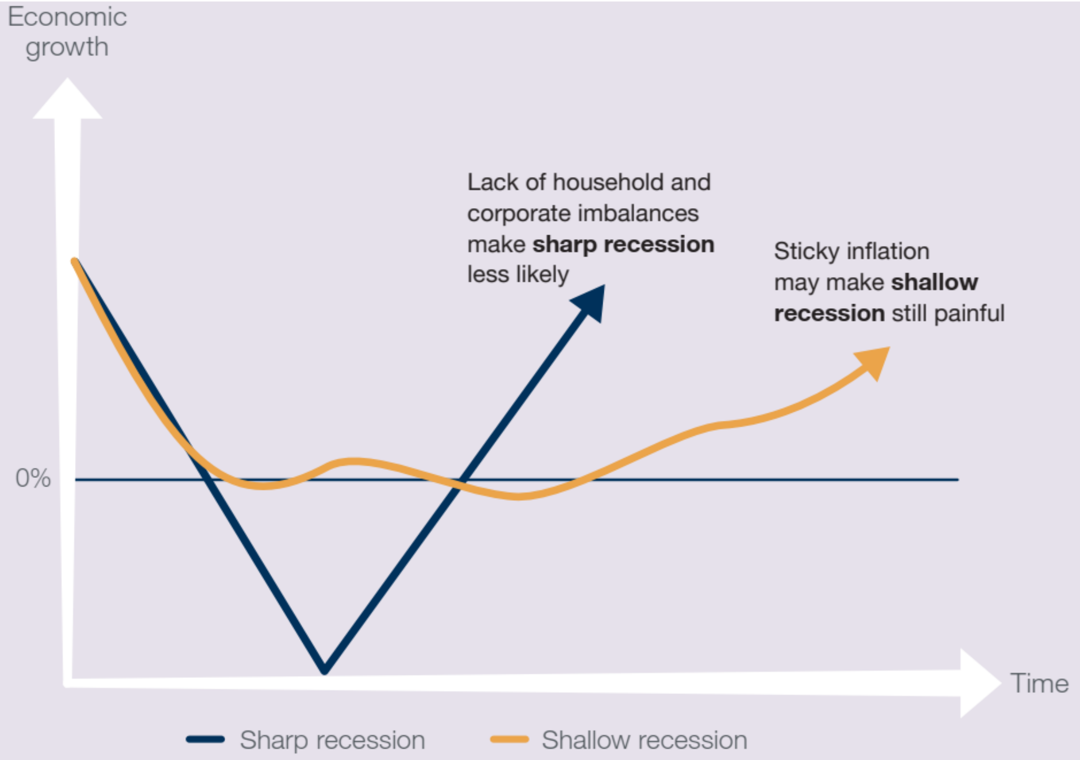


A Fed Hike & Pause = A Hard Recession
Action: Stay defensively positioned

Even A Mild Recession Could Be Painful

Sticky inflation may contribute to higher nominal corporate earnings and wages growth, but it also makes it less likely that the Fed will cut rates or fiscal spending will step in.

The Fed's two mandates of price stability and full employment are not behind us. They will **not risk a double peak in inflation** given a second hiking cycle would be even more painful.



Source: New York Life Investments Multi-Asset Solutions, June 2023.

Conditions for a Fed pivot	Signposts	Condition achieved?	Would a shallow recession achieve this condition?	Would a more severe recession achieve this condition?
Price stability Bring inflation closer to target	Well-anchored inflation expectations	Yes	Yes	Yes
	Core inflation near target (2.0%)	No	No	Yes
Full employment Keep the labor market from overheating	Wage gains consistent with price stability	No	Maybe	Yes
	Unemployment rate above 4.0%	No	Yes	Yes

Opinions of the New York Life Investments Multi-Asset Solutions team, June 2023.

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If you are interested in learning more about Morrows Private Wealth and our investment strategies, please reach out to your Morrows advisor.


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