MLC ASSET MANAGEMENT

Market selloff emphasises that this cycle isn't finished

September 2022

The news overnight, Tuesday 14 September, Australia-time, of a sharp Wall Street sell-off, was a stinging reminder that the equity and bond market correction cycle, which began towards the end of last year, still has a way to go.

This inconvenient truth was masked by the July/August 'head fake' when markets staged a bear market rally causing some to think the worst was over and normal service was returning.

But as we said in our June commentary, on the heels of the financial market dive that month, markets tend to bottom and then begin to recover after dramatic events – such as the October 1987 crash, the 1994 bond market sell-off, the bursting of the tech bubble in 2000, the 2008/09 GFC, and the March 2020 COVID-crash – when central bank (and government) policies become more sympathetic.

As things currently stand, central banks would be condemned if they changed direction to support financial markets.

While annualised US inflation was a nosebleed 9.1% in June, the latest US Consumer Price Index reading of 8.3%, over the year to August,[1] was both barely better in comparison, as well as being worse than expected.

Markets were especially spooked by the breadth of cost increases. Oil prices have cooled a little, but measures tracking rent, baby clothes, alcohol, car insurance, furniture, and medical costs rose 6.1% in August from a year ago, the biggest jump in 40 years.[2]

Moreover, inflation across the world's wealthy countries, including Australia, is at levels not seen for decades. The Reserve Bank of Australia has forecast inflation here to reach around 7.75% by the end of 2022.[3] You have to go back to the 1980s since we last experienced that level of inflation in Australia.

Aggressive central bank rate hikes are going to be needed to bring price pressures under control, and that most likely means choppy markets ahead.

US Federal Reserve has been clear about rate rises

We can't say we haven't been warned. Chairman of the US Federal Reserve, Jerome Powell, recently said,[4] in part (we've highlighted key words):

"The Federal Open Market Committee's (FOMC) overarching focus right now is to **bring inflation back down to our 2 percent goal**.

Restoring price stability will take some time and requires using our tools **forcefully** to bring demand and supply into better balance. Reducing inflation is likely to **require a sustained period of below-trend growth**. Higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some **pain to households and businesses**."

The 2% inflation goal referenced by Mr Powell is similar to most industrialised country central banks' inflation targets. Given the wide gap between that figure and inflation momentum, it's inescapable that interest rates will be going higher, and investors are going to have to steel themselves for their impact.

1 *US inflation rise sees Wall Street make biggest loss in two years on fears of more large rate hikes*. Sue Lannin, 14 September 2022, https://www.abc.net.au/news/2022-09-14/asx-to-follow-wall-st-down-on-us-inflation-figures/101436998

2 *Why horror US inflation data panicked markets*, Chanticleer column, September 14, 2022, US inflation: Why horror US inflation data panicked markets (afr.com)

3 *Statement by Philip Lowe, Governor: Monetary Policy Decision*, 2 August 2022, Statement by Philip Lowe, Governor: Monetary Policy Decision | Media Releases | RBA

4 *Monetary policy and price stability*, Chair Jerome H. Powell, At "Reassessing Constraints on the Economy and Policy," an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 26, 2022, Speech by Chair Powell on monetary policy and price stability – Federal Reserve Board

Share and bond market implications: 'something's gotta give'

High inflation and rising interest rates are headwinds for shares as well as traditional bonds and erodes the complementary attributes the two asset classes generally provide portfolios.

Usually, bonds offer portfolio resilience when shares fall. However, when inflation is the driving force in markets, there is a positive correlation between the two, and as both fall, portfolios suffer.

As it is, despite large downward share market moves since late last year, share market valuations, as conveyed by price-earnings (P/E) ratios,[5] remain high in the United States (**Chart 1**), and other developed world markets, particularly when compared against today's high levels of inflation.

Rising interest rates explain most of the downward share market price moves, and there has not yet been much of a downgrading of companies' earnings expectations that you would typically see as economies enter downturns.

It's as if markets have been pricing a Goldilocks scenario for the US economy where inflation comes down quickly and the US Federal Reserve somehow avoids inducing an earnings recession despite rate hikes.

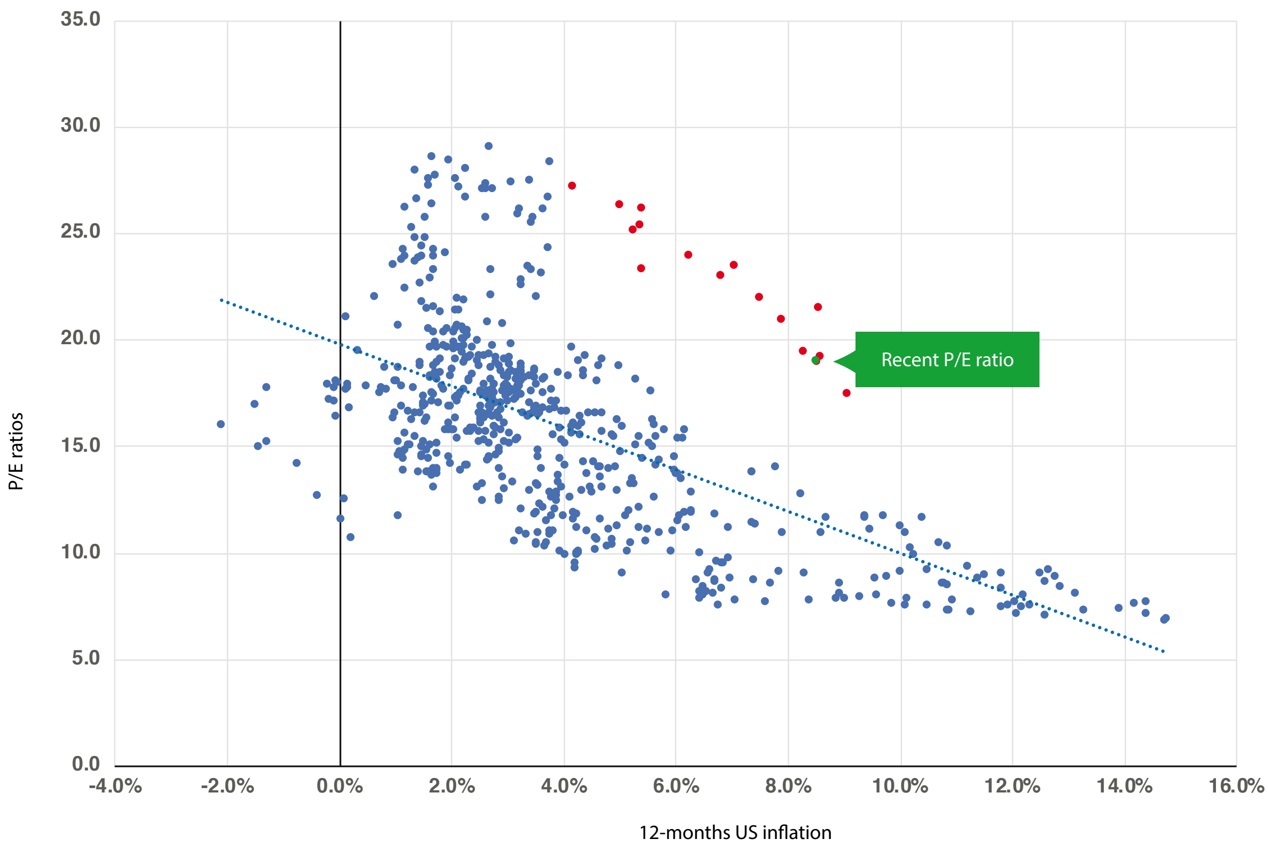
A scan of US equity bear markets since the 1960s suggests that situations where share prices are down double digits, but P/E ratios are still quite elevated, amid high inflation, is unusual.

In other words, we're in a 'something's gotta give' situation if P/E ratios are to stay around their present above long-term levels (**Chart 1**).

Either company earnings are going to grow in the face of higher inflation, higher interest rates and the likelihood of a slowing economy, or share prices are going to have to fall further.

Chart 1: US share market valuation remains high despite high inflation

S&P 500 average price/earnings ratios and 12-months inflation rates



Through July 2022
Source: IBES via Datastream

5 The Price Earnings Ratio (P/E Ratio) is the relationship between a company's share price and earnings per share (EPS). It is a popular ratio that gives investors a better sense of the value of a company.

Time-tested investment principles steering clients' portfolios

Most investment professionals have grown up in an era of low and falling interest rates, and so the present high inflation dynamic does present a new challenge. However, our investment team has already steered clients' portfolios through other testing times, including the 2008/09 Global Financial Crisis and 2020's COVID episode.

Furthermore, we believe that by sticking by time-tested investment principles, like diversification, we can steer portfolios through what lies ahead.

Times of market volatility also creates opportunities as stressed investors can feel compelled to sell quality assets at attractive prices. Our portfolios' ample liquidity equips them to be able to participate in buying opportunities that may emerge.

Our investment team prepared for the inflationary upswing ahead of its full materialisation and that's reflected in how we are managing and positioning portfolios, as discussed below.

MLC diversified retail portfolios

The *Investment Futures Framework* (**Chart 2**) underpins the management of MLC Asset Management's diversified retail funds.[6] Rather than trying to guess the future, the Investment Futures Framework means we are constantly considering 40 possible scenarios and a range of outcomes, including return outcomes across asset classes.

Moreover, an explicit stagflation scenario (scenario 3), and three inflation-related scenarios (scenarios 4, 7, and 22) mean the possibility of inflation is ever-present in our thinking and analysis.

Chart 2: Explicitly stagflation and inflationary scenarios (3, 4, 7, and 22) captured in the Investment Futures Framework

1	2	3	4	5	6
Steady stats	Deflation – productivity driven boom	Stagflation (generic)	Rising inflation / shock (reverse of disinflation)	Debt-driven growth	Disinflation
7	**8**	**9**	**10**	**11**	**12**
Inflationary growth	Investor pessimism-rise in risk premiums	Prolonged global growth and productivity boom	Strong growth, Australia and resources boom	Australia-only bust (world economy not weak)	Australian economic crisis (world weak)
13	**14**	**15**	**16**	**17**	**18**
Profit share	Credit / monetary expansion	Credit / monetary contraction	Steady / trend growth with mean reversion	Slowdown	Recession
19	**20**	**21**	**22**	**23**	**24**
Recovery	Australian deflation – destructive (Japan 1990s)	Global depression stagnation (1930s)	Severe inflation risk	Financial collapse risk	Oil price shock – geopolitical risk
25	**26**	**27**	**28**	**29**	**30**
Global pandemic	Global catastrophe	Global catastrophe adverse economic environment	Global war / conflict	Protectionism –adverse growth and inflation	Exogenous risk drives investor uncertainty
31	**32**	**33**	**34**	**35**	**36**
China and emerging market risk aversion (yield bubble burst)	Multi-speed world	Adverse productivity shock	Asian growth leadership	Paradigm shift – lower values for shares (higher return potential)	Paradigm shift – higher values for equities (lower return potential)
37	**38**	**39**	**40**		
Speculative bubble	Bubble bursts (economy okay)	Central banks' inflation mistake	Slow debt deflation		

Source: MLC Asset Management Services Limited

6 Diversified retail funds are The MLC Wholesale Inflation Plus, MLC Wholesale Horizon and MLC Wholesale Index Plus funds. The Product Disclosure Statement (PDS) for each of the MLC Wholesale Funds is available via https://www.mlcam.com.au/institutional-clients/mlc-wholesale/resources.

Mindful of the supply-demand imbalances built-up during COVID shutdowns across economies, inflation resilience has been a feature of our multi-asset portfolios for a number of years.

Given the vulnerability of conventional bonds to rising interest rates, we sought diversification and defensiveness for our MLC Horizon and Index Plus portfolios in different places, including inflation-linked bonds, shorter duration fixed income, defensive alternative assets and foreign currency.

Long term allocations to inflation-linked bonds have reduced exposure to inflationary risks while protecting against expectations of lower economic growth. This has been important in the recent period where rising inflation has battered traditional fixed income prices.

Horizon and Index Plus portfolios have long maintained an underweight position to the most interest rate and inflation sensitive fixed income securities, and instead allocated more to fixed income with a shorter maturity debt profile. This active positioning reduced the impact of the bond market sell-off on the portfolios.

We have been reducing this duration underweight, recently, on the back of dramatically higher yields (falling bond prices). This is because the bond sell-off is improving bond valuations and thus their future return potential.

Alternative allocations to insurance-related investments exposed to natural peril reinsurance risks rather than swings in shares and bond asset prices has proven an important diversifier. Returns generated by accepting risk related to a well-diversified portfolio of potential natural perils around the world, have historically shown low or no correlation to shares or bond prices.

Alternative allocations to the Low Correlation Strategy, managed by MLC's Alternatives Strategies team, offering exposures to niche and often complex private credit, specialty finance and skill-based strategies, have continued to provide important diversification by generating positive returns against severe market sell-offs.

For many years an overweight to foreign currency has been utilised by the Horizon and Index Plus portfolios to fill the diversification void left by unattractive traditional fixed income prices. This position has proven effective in cushioning the portfolios during large falls in share markets, where the Australian dollar (AUD) was expected to be in less demand for commodity purchases as global growth expectations fell.

Of late, we have been reducing the AUD unweight, as the local currency lost ground, while persisting with the foreign currency overweight.

MLC Inflation Plus portfolios' positioning

The MLC Inflation Plus portfolios are underpinned by flexibility in growth/defensive allocations, and have been able to avoid exposure to developed market government bonds. Instead, the portfolios have held a collection of inflation-linked bonds, Chinese government bonds, foreign currency, gold, defensive alternatives and a range of innovative derivative structures to control risk and maintain some income.

- Inflation-linked bonds provide a duration substitute without direct inflation risk, meaning that in the case that yields continue to rise (bond prices fall), the portfolios would likely benefit, while at the same time being somewhat insulated from the impact of rising inflation on fixed income.
- Chinese government bonds help to diversify the portfolios' fixed income exposure by accessing a market where the country's central bank, the People's Bank of China, is easing policy. This contrasts with many other central banks, such as the US Federal Reserve and the Reserve Bank of Australia, which are on aggressive rate hiking paths.
- Foreign currency helps to diversify as it is defensive from an AUD point of view, given the tendency of the AUD to rise in tandem with shares and fall when shares sell-off.
- Gold helps the strategy diversify against shocks while also providing a potential hedge against inflation.

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