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MACQUARIE ASSET MANAGEMENT

Delayed reaction, liquidity contraction

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Executive summary

As we begin 2023, financial markets are embracing a much-improved sentiment. This shift can be traced back to October 2022, which saw US inflation peak, and has many postulating that both the worst of inflation is behind us and the significant monetary policy tightening cycle may also be reaching its end. Could it be, due to the unusual pandemic-impacted economic environment, that central banks are in the process of achieving a seamless and almost immaculate monetary policy tightening cycle? Or is it possible, being acutely aware that monetary policy works with long and variable lags, that economies are in the twilight zone of the cycle, the gap between action and reaction? Yes, inflation may be abating, although the significant tightening of monetary policy we experienced in 2022 is yet to fully reveal its impact on the global economy and, more importantly, financial markets. Is it a case of go with recent sentiment and join the "dash for trash" or, as is usually the case with tightening cycles, mind the lags?

State of play

Reflecting on our first Strategic Forum for 2023, which brought together more than 130 investment professionals to set our medium-term views, we observed a strong linkage and continuing relevance of our previous notes, "The bigger they are, the harder the fall" and "Central banks are hiking, quantitative tightening (…very, very frightening?)." Rather than repeat those insights, we have summarised the current state of play below.

We have been, *and still are,* experiencing the most aggressive monetary policy tightening cycle since US Federal Reserve Chair Paul Volcker's hiking cycle in 1980. Simultaneously, we are also experiencing a significant shift toward liquidity (money) contraction and/or quantitative tightening (QT), following more than 10 years of constant positive liquidity support via quantitative easing (QE).

This combination has resulted in stark changes to prevailing conditions, featuring a much higher cost of capital, much higher levels of volatility, and a significant shift from an ongoing ultra-easy liquidity injection to liquidity contraction that is expected to increase in intensity as the year progresses.

We have previously highlighted that similarly aggressive tightening cycles of the past, such as Volcker's 1980s policy action, were into economic conditions drastically different from today's indebted modern economy. Past similar cycles featured little indebtedness; this cycle is occurring in one of the most indebted global environments of all time. High debt and higher yields do not mix well.

We also know that the monetary policy reaction function occurs with long and variable lags, and therefore it would seem rational to anticipate that one of the most aggressive and rapidly implemented tightening cycles (a succession of 75 basis point hikes per meeting without pause) will eventually reveal significant impacts on the economy.

Most importantly, and quoting from our previous note, *"We remind readers, if it was financial markets, ever more so than the economy, that thrived during the prior decade of financialisation, trillions and trillions of dollars of liquidity injections, and next-to-zero cost of borrowing, isn't it financial markets that are of greatest vulnerability to this significant change in rhetoric, messaging, and actions that are markedly affecting the investing environment?"*

We additionally highlight that many of the hallmarks, indicators, and even narratives leading up to economic growth slowdowns and recessions, such as yield curve inversion through to patterns of central bank rhetoric, afford considerable supporting evidence that "it's *never* different this time." It has the usual fingerprints of a recession, and they are all there in plain sight.

In such a short time, we find the key consideration for investors has shifted away from inflation – while not surprising to us, it is still quite incredible how quickly inflation has fallen out of focus – toward economic growth. The key question for market participants now pertains to what has become the "most forecasted recession." Will the recession be hard or soft? Could it be possible that the post-pandemic economy is different from the past and indeed more resilient to aggressive monetary policy tightening? In other words, are we not appreciating that "it is different this time"?

Inflation, it's so last year

Reflecting on 2022, the focus of discussion and debate was all about inflation. With the peak in inflation now clearly visible in the rear-view mirror, protracted high levels of inflation and the accompanying market narrative are starting to lose steam. We have long held the view that the majority of inflation experienced over the last couple of years was caused by twin supply shocks originating from the pandemic and then the war in Ukraine. While those supply issues took longer to heal, our view was that ultimately supply would improve, and the inflation pulse would abate. Transitory after all?

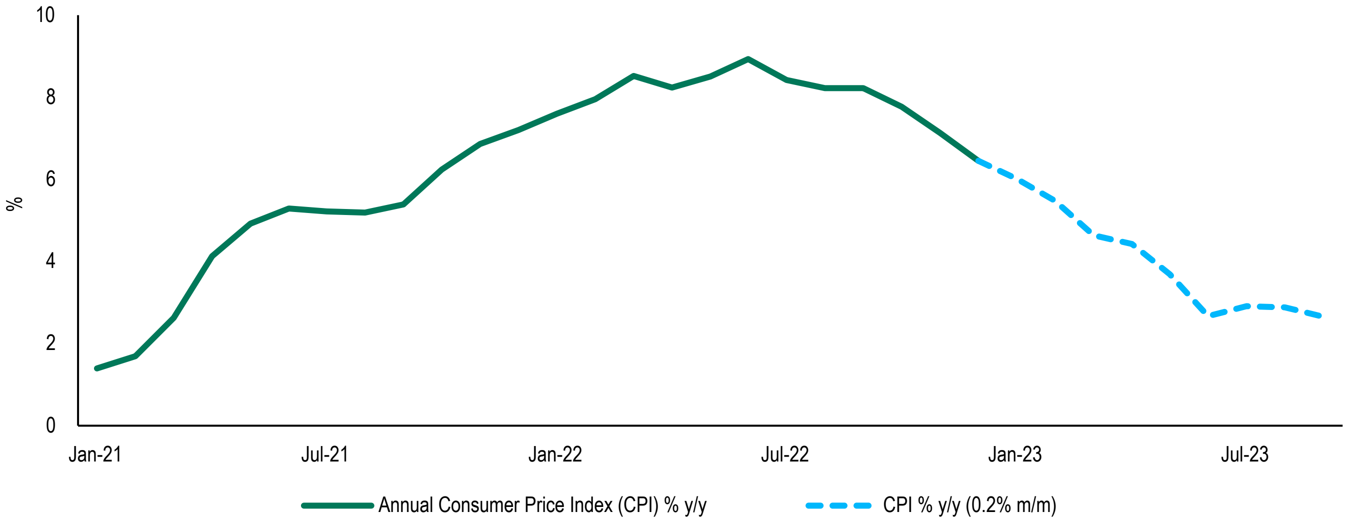
In early 2023, it is clear that supply is recovering and is returning toward normal. Barring any further shocks, it is unlikely that supply issues will remain a feature in the inflation outlook. As such, inflation is on its way back to the target band and a path to deflation even emerging.

This was likely always going to happen; it just took longer than expected. Given the aggressive central bank action targeting demand destruction, the inflation outlook is now also being affected by reducing demand.

The combination of improving supply and reducing demand should reveal itself in much lower levels of inflation. Indeed, as base effects roll off, we could find ourselves back in the target band before the middle of the year and perhaps even lower, as seen in Chart 1.

In prior notes, we have talked about a number of the future themes that may find inflation oscillate higher, but for the current outlook period, it appears that inflation may no longer be an issue. And so, much of the concern around inflation that has existed for the past two years, appears to be dissipating quickly.

Chart 1:
US Inflation path based on 0.2% m/m scenario



Source: Macrobond; y/y = year over year, m/m = month over month.

The most anticipated recession – hard, soft, or "it's different this time"?

Given the importance of getting this call right, we completed a thorough examination of the economic growth outlook, seeking to answer the key question, will there be a recession? And if so, what type of recession is likely?

We undertook a thorough review of household and business sector health, the ability of the economy to weather a recession, and ultimately questioned could a recession be skirted, will we experience a normal cyclical recession, or, perhaps, will it be something harder? Our recession alert process starts by identifying whether any of the three major causes of recession are in play: policy tightening, external supply-side shock, and financial market crisis. As we have all observed, there have been two supply shocks in this current cycle: the first a result of the pandemic and the second a result of the war in Ukraine. The good news is that the pandemic supply shock has largely corrected, and a significant part of the energy price shock has also dissipated. However, we are still in a twin policy tightening environment, with both monetary and fiscal policy tightening. From our analysis, the starting point for the global economy is stronger than past cycles for both households and businesses, suggesting that the prevailing conditions may soften the blow of any impending recession, as such a financial-market-crisis-induced recession is less likely.

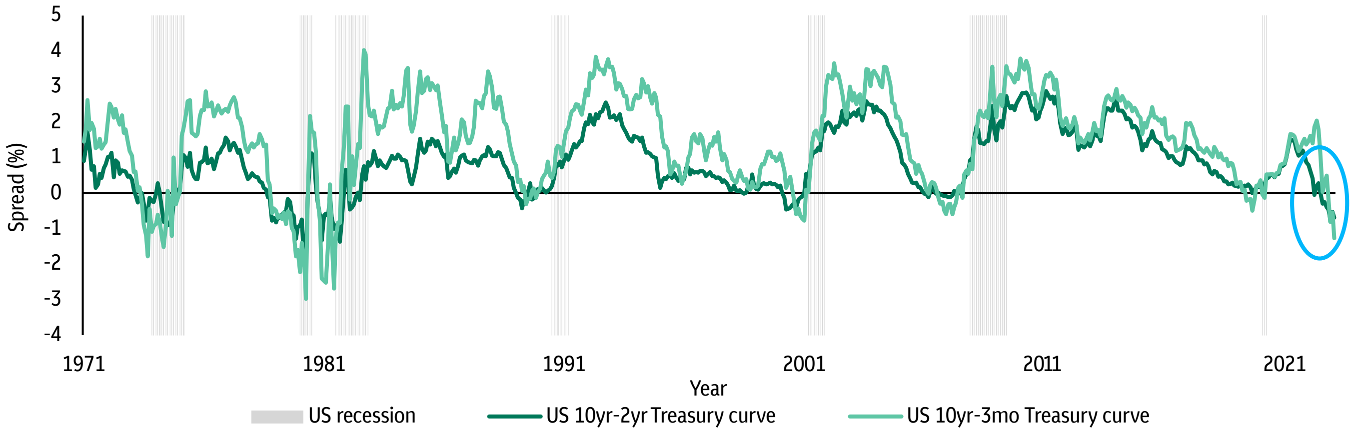
Our recession alert process is clearly pointing to a recession in 2023. The debate therefore centres on the depth of recession. Ultimately, this will be determined by the interaction of a gradual rebalancing of supply shocks with the impact of an impending demand shock resulting from significant policy tightening on households and businesses. Net accumulated wealth should help cushion the impact on households; however, household vulnerability will increase if the employment outlook deteriorates. For households, demand deceleration will become worse if people lose jobs. For businesses, many thrived in 2022, using the "charge more, sell less, earn more" model. However, in 2023, profits are likely to be under threat as "sell even less" becomes the theme.

China further clouds the picture on both the growth and inflation front, with much debate that growth may be better supported and inflation higher. Questions also arise surrounding the differences to prior slowdowns in which China considerably stimulated and supported global growth. However, in this episode, the Chinese stimulus is much more targeted to support the domestic recovery following an extended period of lockdowns, and it is unclear whether this will make any dent on the global slowdown.

Ultimately, our analysis suggests that global growth is slowing, and a recession is likely to occur by the end of 2023. Currently, we lean more toward a cyclical shallow recession; however, we highlight that risks are more to the downside and could drift to becoming a harder recession than many currently anticipate. Our examination of the patterns of prior cycles appears very similar – it pays to take heed of these signals and not get swayed into thinking perhaps "it's different this time" as so many often do at this juncture of the cycle. The pattern suggests it won't be different this time.

Chart 2:

Inverted yield curves in the US are clear recession indicators



Source: Federal Reserve Economic Data.

Central bank action

Further adding weight to this is an appreciation that the current cycle is characterised by global central banks fighting inflation, with their past experiences warning that it may be better to err on the side of caution and keep conditions tighter for longer rather than ease up early only to see inflation flare up again. This is very different to the prior 10 years when central banks were constantly required to be ultra-easy, supporting growth for longer, concerned that if they withdrew too soon, economies would roll over. This suggests a central bank pivot is still some way off, and indeed if markets continue to perform well and economies hold in, then it is more likely that central banks would be emboldened by the success of tightening so far. Without seeing a clear impact, it is unlikely central banks will return to a more accommodative stance.

With this backdrop, we find ourselves asking, why is everyone so focused on the economy? Will a recession occur and, if so, will it be a soft or hard recession? The real question should be, will financial markets have a soft or hard landing? There may be a soft landing in the economy, but that does not necessarily mean the same for markets.

Liquidity contraction

Financial markets, as we have outlined in prior notes, were significant beneficiaries of lower and lower almost-zero interest rates or cost of capital and incredible amounts of liquidity (QE) that suppressed volatility and supported asset prices.

As we enter 2023, we are acutely aware that those easing conditions are no longer in place. There is a much higher cost of capital with unknown impacts on economic growth. While in financial markets, volatility is much higher, and we are also experiencing significant liquidity contraction.

While much has changed in the backdrop, it seems one factor has been consistent: the desire of investors to "look through" the challenges and revert to the last decade of dip-buying. The strongest performers in the rebound so far are the prior beneficiaries of zero rates and endless liquidity: technology stocks, CCC-rated credit, and government bonds.

We have made the case in prior reports that it is indeed this component – the liquidity, application or contraction – that is the most important thing to the performance of financial markets. Our outlook of a recession for the real economy (given much higher cost of capital) only amplifies this.

"Recessions see bond yields decline, credit spreads widen, and risk assets falter, and this recession also has a backdrop of liquidity contraction. The reaction may be delayed, but we are paying attention and appreciate the long and variable lags of monetary policy tightening cycles."

It is difficult not to have concerns that perhaps the current improved sentiment in financial markets is temporary, particularly considering the lagged impacts of aggressive monetary policy tightening that are yet to be revealed. Financial markets may have gotten ahead of themselves in believing that the worst of the inflation and the monetary policy tightening cycle is behind us.

Delayed reaction

In conclusion, we are of the belief that while the current move in financial markets has comforted many, it is quite normal at this point to underappreciate the long and variable lags of monetary policy. Our view is that while inflation peaked in October 2022, and this has encouraged markets considerably, this swell of better sentiment has lessened, or even masked, concerns around the inevitable lags.

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Fixed income investment implications

The theme for financial markets over the recent period has been one of significant volatility, particularly in fixed income markets, where we experienced some of the most dramatic moves in yields for over a decade.Financial markets are driven largely by central bank reaction to persistent levels of inflation and the pricing in of potential recession risk. It is the interaction of these factors that will determine how the markets will play out in the coming months.

Our view is that markets may still be responding in lag to the level of change in liquidity and borrowing costs with the broader impact on economies yet to be fully evidenced. In this period, the risk of a policy "mistake" remains high, and our attention remains focused on downside risks at this point in the cycle. With bond yields now much higher and with inflation and interest rates closer to peaking (or have peaked), we see this as an attractive asset class to manage through this market environment. We are more cautious on the outlook for credit markets though see a range of opportunities presenting across global markets where a flexible and dynamic approach is required.

- **Rates:** Bond markets experienced significant volatility and heavy losses over the past 12 months to levels rarely witnessed. We see volatility remaining heightened over the shorter term, driven by uncertainty over central bank policy and the path for inflation ahead. However, the outlook looking through the noise is much more positive, with bonds offering an attractive investment proposition both in terms of a recession hedge and as outright yield for a defensive asset class. Our preference remains across geographical regions, to favour Australia given the steepness of the curve and extreme sensitivity of the Australian economy to higher interest rates.
- **Credit:** Our outlook for credit is relatively defensive, as we balance healthy fundamentals and strong technical factors against limited value in credit markets and a weaker economic outlook. Corporate earnings and margins have been extremely strong but will move to a headwind going forward. Liquidity withdrawal and rate hikes also reflect a totally different environment from prior periods of robust credit market performance. Valuations in credit markets likely do not adequately reflect these risks and as such our preference is to reserve dry powder for more appropriate opportunities. Industry sector preferences are toward less-cyclical areas, such as utilities and communications, as well as energy. Nuances across markets and capital structures are providing some opportunities to add value in an otherwise limited market, and we expect to continue capitalising on these as they arise.
- **Emerging markets debt (EMD):** We have shifted to a more neutral position in EMD over the course of the second half of last year though still retain some dry powder to take advantage of the expected volatility and better tactical entry points. EM sovereign and corporate credit fundamentals are mixed. China reopening is supportive of the asset class, and technicals are positive given the reduced allocations. Overall, we expect EMD to continue to perform broadly in line with similar risk assets in developed markets.
- **Structured:** US housing fundamentals have weakened significantly due to higher borrowing rates. Declining volatility and 10-year US Treasury rates have repriced agency mortgage-backed securities (MBS) to the middle of the spread range, where we are more neutral. We would be constructive on adding to this sector on further weakness. Among collateralized loan obligations (CLOs), commercial mortgage-backed securities (CMBS), asset-backed securities (ABS), and Australian residential mortgage-backed securities (RMBS), we see these at close to fair value given expected volatility. Australian RMBS present some value given outright spread moves, though we would primarily focus on higher-quality issues.
- **Currency:** The US dollar has likely peaked for the cycle, but this process is likely to take some time to play out and tends to be volatile. Relatively strong fundamentals in Australia and positivity around China reopening have been support factors for the Australian dollar of late. However, elevated recession risks for the year ahead make it vulnerable to periods of sharp underperformance. The dynamics playing out in the Japanese market are particularly interesting as the Bank of Japan finally joins the global tightening cycle. We see this trend adding upward momentum to the Japanese yen as central bank policy convergence and safe-haven demand are both likely yen supportive.

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Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

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Currency risk is the risk that fluctuations in exchange rates between the US dollar and foreign currencies and between various foreign currencies may cause the value of an investment to decline. The market for some (or all) currencies may from time to time have low trading volume and become illiquid, which may prevent an investment from effecting positions or from promptly liquidating unfavourable positions in such markets, thus subjecting the investment to substantial losses.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Demand destruction is when persistently high prices for a certain good lead to less demand for that good.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

Liquidity risk is the possibility that securities cannot be readily sold within seven days at approximately the price at which a fund has valued them.

Quantitative easing (QE) is a form of monetary policy in which a central bank, like the US Federal Reserve, purchases securities from the open market to reduce interest rates and increase the money supply.

Quantitative tightening (QT) refers to when central banks raise the federal funds rate. In a tightening monetary policy environment, a reduction in the money supply is a factor that can significantly help to slow or keep the domestic currency from inflation.

Recession is a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in gross domestic product (GDP) in two successive quarters.

A Treasury yield refers to the effective yearly interest rate the US government pays on money it borrows to raise capital through selling Treasury bonds, also referred to as Treasury notes or Treasury bills depending on maturity length.

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year US Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. It is also used to predict changes in economic output and growth.

The shape of the yield curve is closely scrutinized because it helps to give an idea of future interest rate change and economic activity. There are three main types of yield curve shapes: normal, inverted and flat (or humped). A normal yield curve is one in which longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time. An inverted yield curve is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of upcoming recession. A flat (or humped) yield curve is one in which the shorter- and longer-term yields are very close to each other, which is also a predictor of an economic transition. The slope of the yield curve is also seen as important: the greater the slope, the greater the gap between short- and long-term rates.

Yield curve inversion is when coupon payments on shorter term Treasury bonds exceed the interest paid on longer-term bonds .

The **US Consumer Price Index (CPI)** is a measure of inflation representing changes in prices of goods and services purchased for consumption by households.

Index performance returns do not reflect any management fees, transaction costs or expenses.

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