SALT GLOBAL OUTLOOK

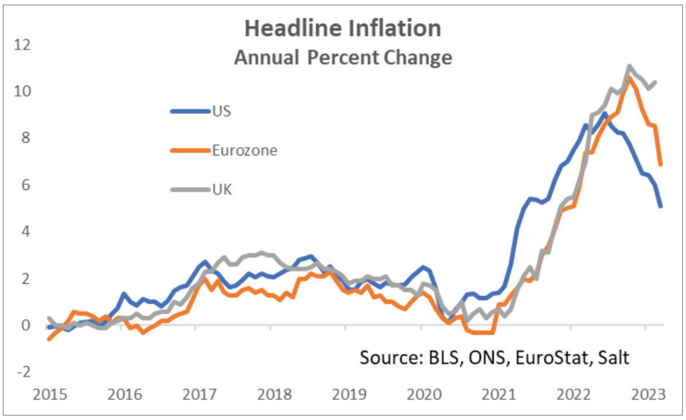
April 2023

By: Bevan Graham, Paul Turnbull and Greg Fleming.

Nearly there

Despite surprising economic resilience at the start of the year, there are growing signs more recently across the key developed economies that tighter monetary conditions are starting to bite. Furthermore, the lagged effects of tightening already delivered and likely a bit more still to come, will continue to impact on households and businesses, and stresses and strains will continue to emerge. We have seen this most recently in the banking and finance sectors of the US and Europe.

Headline inflation is moderating along with the retreat in energy prices, though as we have long expected, core inflation is proving stickier. Central banks now face something of a conundrum as demand slows, strains are emerging in the finance sector, but inflation remains too high. The critical question is when to pause and allow the lags to do the rest of the job over the coming months.



We believe we are close to a rate hiking pause from the key developed country central banks, though this may not be the peak. That will depend on the extent to which economic activity and inflation play out relative to expectation. But neither do we envisage early interest rate cuts. As central banks pause, forward guidance will likely shift to emphasising the "considerable time" before interest rate reductions are likely.

Finance sector wobbles

We do not see any of the recent banking and finance sector developments in the United States or Europe as systemic, or signalling any kind of generalised finance sector malaise, but rather as symptomatic of the broad tightening in financial conditions and idiosyncratic factors relevant to each institution.

The US and European banking systems are better capitalised than was the case leading up to the GFC and regulatory oversight is better, though we acknowledge no regulatory regime will ever be completely watertight. As a result, institutions in aggregate should be able to better withstand losses on the asset side of their balance sheets.

Nevertheless, the failure of several regional banks in the US has prompted the authorities to indicate that all deposits at Federal Deposit Insurance Corporation (FDIC) insured institutions would be safe. Authorities also introduced a new lending program, the Bank Term Funding Program (BTFP), to allow banks, savings associations, credit unions and other eligible depository institutions to secure loans of up to one year.

In Europe, Credit Suisse received liquidity support from the Swiss National Bank, before it was ultimately taken over by rival bank UBS, with the latter being granted 100 billion francs in liquidity assistance from the Swiss central bank, and 9 billion francs in guarantees from the Swiss government for potential losses.

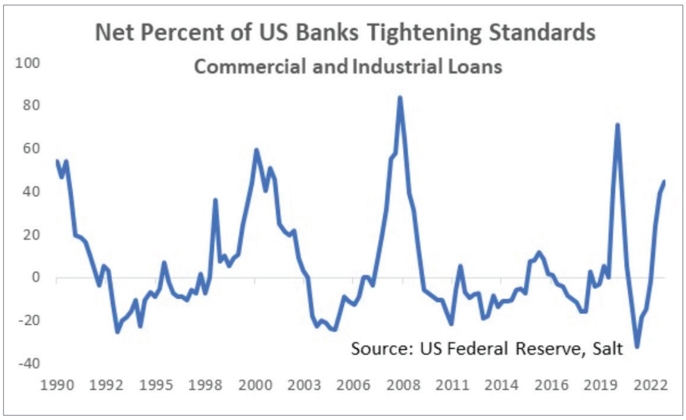
Lags and tightening credit conditions

While we don't expect a repeat of the Global Financial Crisis, over the years we have often warned about the dangers and costs of a long period of super-easy monetary policy, including excessive asset price inflation (relative to fundamentals), rising inequality and potentially poor decision-making borne of historically low interest rates and abundant liquidity.

Indeed, the full implications of over a decade of super-stimulatory monetary followed by an aggressive tightening path will take time to be fully realised and will ultimately expose businesses, and not just financial institutions, with poor balance sheets.

More recently, we have argued that while monetary policy may tighten a bit further, central banks need to be cognoscente of the lags between monetary policy actions and those actions impacting on the real economy. Recent finance sector wobbles are a helpful reminder that those lags also apply to the financial sector too.

Tighter bank lending has always been part of the economic slowdown story. The question now is the extent to which the now higher cost of funding and reduced risk appetite leads to tighter lending standards, slowing lending (and overall) growth even further.



Economic resilience is waning

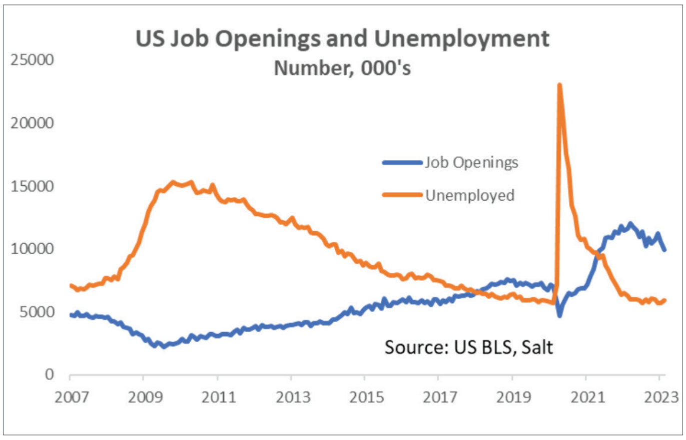
The turn of the year saw two opposing forces at play. Energy prices had moved lower which provided key support in areas such as Europe by providing less of a drag on household incomes and leading the retreat in global inflation, at least at the headline level. But monetary policy was continuing to tighten, and it wouldn't be long before the positive of lower energy prices was subsumed by tighter financial conditions.

In the United States, data was so good through January that many commentators started musing on the possibility of not only a "soft landing", but perhaps a "no landing" scenario. Of course, such an outcome would only be acceptable to the US Federal Reserve (the Fed) if it was consistent with the return of inflation to 2%! Not likely.

The US labour market was particularly upbeat, at least relative to expectations. January saw a massive gain in non-farm payrolls employment of 472,000, though that has now slowed sharply with February and March printing at 326,000 and 236,000 respectively. The unemployment rate remains low at 3.5% but, in something of a conundrum, wage growth is slowing.

At risk of putting too much emphasis on a three-month trend, it appears the monthly jobs gain may dip under the replacement rate of 90,000 per month in the next few months. That is the rate of jobs growth that stabilises the unemployment rate for a given participation rate. As jobs growth moves lower than that level, we expect to see more sustained increases in the unemployment rate.

In other supporting labour-market-slowdown evidence, job openings continue to fall, coming in under 10 million for the first time in nearly two years in February. However, the job openings to unemployed ratio remains at 1.7.



More generally latest Purchasing Manager Indices from the Institute of Supply Management support a story of a broadening slowdown. The March manufacturing PMI fell to 46.3 (from 47.7 in February), the lowest level since May 2020, while it was the first time since 2009 that all subcomponents of the manufacturing PMI fell below the 50 threshold that separates contraction (under 50) from expansion (over 50). The services index remains higher at 51.2 (55.1 in February) but is also slowing.

So tighter financial conditions are starting to bite. The cumulative effects of the aggressive tightening in financial conditions plus a (little) bit still to come present a significant economic headwind. We long thought the weakest point in the cycle would be around the middle of this year. While the strength in the economy at the start of the year may push the bottom of the cycle out a few months, our initial assessment won't be far wrong.

Europe avoids recession, so far

The Eurozone economy avoided contraction in the last quarter of last year, and given the rise in Eurozone PMIs in recent months, it's possible the region could avoid contraction in the March quarter of this year as well.

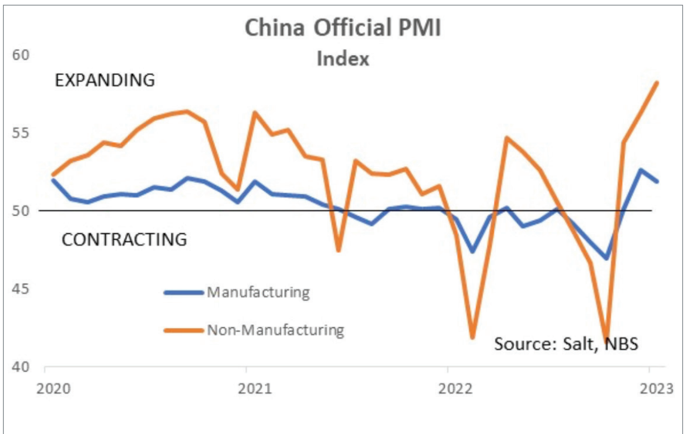
However, better today may mean worse tomorrow. The contraction in activity that was expected last year was based on the inflation shock that was exacerbated in Europe by the energy crisis. Warm weather and lower prices meant that contraction was averted.

But that still leaves the economy to weather the shock of restrictive monetary policy. Policy may end up being more restrictive because recession has been averted thus far. The bottom line is that better news on the economic front now means that we shift the likely weak point in the cycle to later this year or perhaps even early 2024.

China recovery looks sustainable

In China, the lifting of Covid-Zero restrictions and the reopening of the economy has seen a solid bounce in activity. The positive signals from China's PMI indices in was confirmed by activity data for the January-February period, showing stronger growth in both retail sales industrial output.

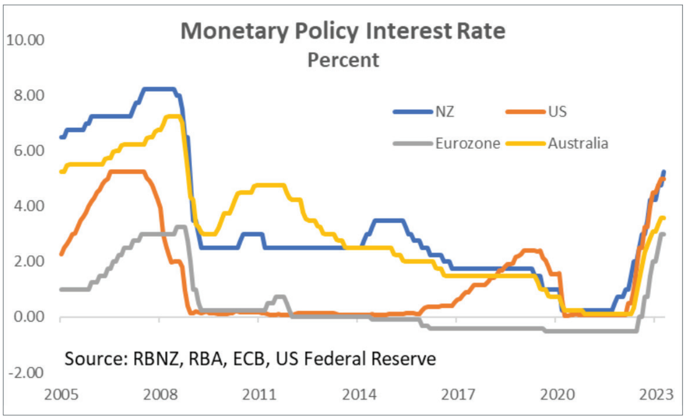
The non-manufacturing (services) PMI climbed for the third month to a record high of 58.2 (vs. 56.3 in Feb.), with a greater-than 60 reading in the retail sub-index. The manufacturing PMI moderated but remained robust at 51.9, with 13 out of 21 industries surveyed reporting a higher reading in March. On the construction front, strong infrastructure capex and incremental improvement in property led the construction PMI to a record-high of 65.6.



A surprise cut in the Reserve Requirement Ratio by the People's Bank of China should also support consumer and service sector activity going forward. However, despite low inflation, we don't see aggressive stimulus in the period ahead as 2023 is the first time in four years that economic, regulatory and Covid policies have been aligned in a pro-growth, pro-business fashion.

Global central banks resolute, or are they?

Major developed central banks continued their tightening path in March, with the Fed, the European Central Bank (ECB) and the Bank of England (BoE) all delivering the expected increase in their respective policy rates. That seemed to suggest the central banks were all continuing to prioritise inflation over other concerns: growth initially but now finance sector stability.



Excluding the UK, which was already closer to a pause than the Fed or the ECB, you don't have to dig too deep however to find hints the latter two central banks may be a little more concerned about finance sector developments than they appeared at first blush.

In Europe, the ECB offered strong forward guidance at their prior policy meeting in January, signalling that a follow-up 50bp hike in March was as guaranteed as its possible to guarantee any pending central bank decision. While this hike was subsequently delivered, forward guidance was silent on what happens next.

In the US, in his testimony to a Senate committee shortly before events unfolded at Silicon Valley Bank (SVB), Fed Chairman Jay Powell indicated that insufficient progress was being made in returning inflation to target. He added that the rate setting committee (the Federal Open Market Committee or FOMC) was open to a reacceleration of rate hikes and the prospect of a higher terminal rate than the 5.1% that was flagged in the December Summary of Economic projections (the infamous "dot plot").

After that testimony, some forecasters upped their expectations for the March meeting to a 50bp hike. But as events unfolded at SVB and other regional banks, those rate hikes were wound back with markets pricing only a 60% chance of a 25bp as the meeting started. A hike of 25bp was delivered, taking the range for the Fed fuds rate to a range of 4.75-5.00%, while the median dot for the terminal rate remained unchanged at 5.1%.

Pushing pause

The inflation story is playing out much as expected. Headline inflation rates continue to recede, primarily on the back of lower energy prices and improving global supply chains leading to sharply lower goods price inflation, and in some cases outright goods price deflation. But core services inflation continues to prove sticky as labour markets remain tight and wage inflation elevated. Labour is typically the key input into services.

Central banks have done a lot of work already over a very short time. Continuing to push rates higher because there has been little sign of retreat in core inflation pressures risks overdoing the tightening. We don't buy the argument that it is better for central banks to go too far in tightening because they can always cut later. The whole point of inflation targeting is to avoid undesirable volatility in economic output and employment.

Despite the tightening to date, inflation remains uncomfortably high. However, there are increasing signs that growth in activity is slowing, and labour market strength is moderating.

All things considered we believe we are close to a pause in the rate hiking cycle. We expect one more 25bp hike in the United States, while the BoE is probably finished already. Of the three, the ECB has furthest still to go with another two or three 25bp hikes before pausing. All further hikes are predicated on a view of no further finance sector disruption.

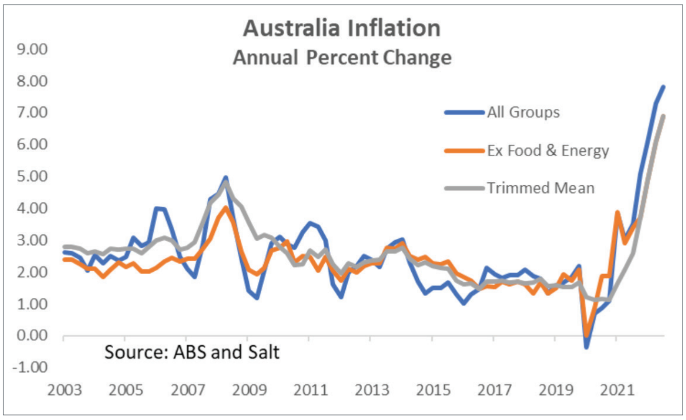
It is not guaranteed, however, that the pause will prove to be the peak. Once individual banks hit pause, they will have views of how they expect activity and inflation to play out in the period ahead. If those expectations are not met, they could resume tightening.

However, don't expect early interest rate cuts. As they pause, central banks are likely to shift their forward guidance from a focus on rate hikes to the "considerable period" over which they expect rates to remain elevated. Any hope of interest rate cuts anywhere in the developed world this year will likely be disappointed.

RBA first to blink?

Almost on cue, the Reserve Bank of Australia paused their interest rate hiking cycle in April, holding the cash rate at 3.6%. This was in line with market expectations, or at least expectations following the release of the minutes of the March meeting that indicated a pause was being actively considered.

While the Australian economy is slowing, like many developed economies, the labour market remains tight. Regardless of this the banks decision to pause was justified by the desire to assess the lagged impact of the "substantial increase" in interest rates to date and given the environment of "considerable uncertainty".



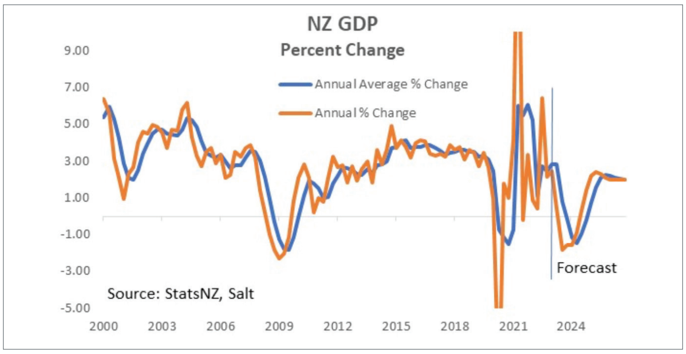
Notwithstanding this pause, the RBA retained its tightening bias, noting that "some further tightening may well be needed" and that they would be assessing "when and how much further interest rates need to increase".

We agree that more tightening will be required. Our forecasts for the Australian cash rate saw a peak at 4.1%, so two more 25bp hikes from the current 3.6%. But having paused, we think there is now a high bar for the data to push the bank back to tightening. If this proves to be it, it means a slower retreat in inflation pressures and a longer period before rate cuts might be considered.

New Zealand growth surprises on the downside…

Latest GDP growth data came in softer than expected for the December quarter at -0.6 q/q. That was weaker than market expectations of around -0.2% and an RBNZ forecast of +0.7%. To be fair to the RBNZ, they did not have the benefit of being able to revise their forecast, or at least announce any revision publicly) as all the weak partial data came out.

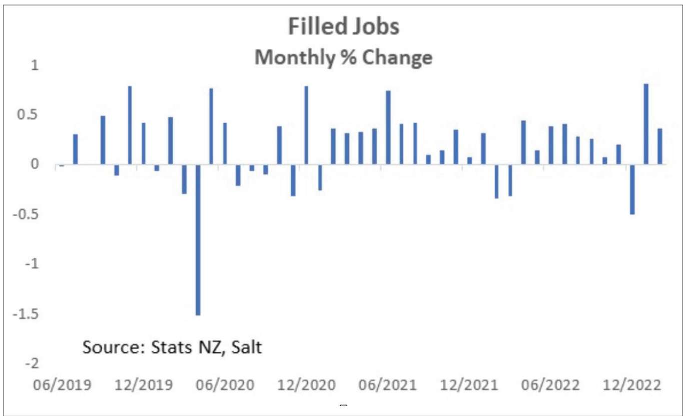
There were several factors at play in the data, including changed seasonal factors and residual Covid "noise". We know Q3 data probably overstated the strength of demand, but knowing that, the RBNZ was still forecasting +0.7% q/q.



Importantly, there is enough in this release to suggest there is a genuine slowdown in economic activity underway. This is supported by more recent partial activity data including retail sales and residential building consents and soft business opinion surveys pointing to harder times ahead.

At the same time, there are emerging signs of a slowdown in the labour market. Employment barely expanded in the December quarter of last year and the unemployment rate nudged higher to 3.4%, admittedly still well below the level the RBNZ would see as consistent with 2% inflation. More recently there has been growing, admittedly anecdotal evidence, of job losses in a number of high-profile businesses.

Latest filled jobs data seems to run counter to the softening story. Total filled jobs data looks to be signalling a reacceleration in the NZ labour market. We don't see it that way.



We have recently come through a period where the labour market has been severely supply-constrained as net migration turned briefly negative at a time when jobs were plentiful. As net migration has turned positive, supply conditions have improved and some of those jobs are now being filled.

Somewhat counter-intuitively, this may take pressure off wages, as there is less poaching from other businesses to fill vacancies. However, higher inward migration will add to overall demand pressures in the economy through population growth.

The recent floods and the devastation wrought by Cyclone Gabrielle have caused, and will continue to cause, considerable disruption. It is difficult to be precise in assessing the full economic impact, but it will take many years for a full recovery.

...while hawks take flight

We don't often admit to being gobsmacked, but gobsmacked we were in the aftermath of the RBNZ's April Monetary Policy Review where the bank lifted the Official Cash Rate (OCR) 50 basis points to 5.25%. This was counter to market and analyst expectations of a 25bp hike.

We are at the point in the cycle where the general expectation is for a degree of nuance and fine-tuning in policy making. To state the obvious, a 50bp hike after such an aggressive tightening cycle already does not meet the definition of nuance or fine tuning.

It also appears to give no import to what we see as clear signs of economic slowdown and labour market weakness before many households still on low fixed rate mortgages have seen the impact of prior rate increases, even before the latest salvo.

Two factors possible drove the renewed hawkishness. Firstly, bond yields have drifted lower over recent weeks, driven by the rally in global markets. However, an aggressive tightening at the peak of the cycle could be counter productive as it reinforces expectations of recession and earlier interest rate cuts. A better approach might be to start emphasising how long interest rates are expected to remain at the peak.

Secondly, they may be becoming more concerned about the inflationary impact of the rebuild from the recent extreme weather events. The rebuild has barely started (the RBNZ told us in February they would look through the immediate impacts) and is going to take many years. This seems to us to be a reason why interest rates will stay elevated for longer, rather than needing to go even higher now.

Perhaps this move was the last hurrah, or perhaps there's more to come. The Bank has thus far seemed unmoved by anything that has happened since they projected a 5.5% terminal OCR rate back in November last year. It therefore seems prudent to expect a final 25 basis point hike at the May 24th Monetary Policy Statement.

Squaring the fiscal circle

Governments around the world are facing into ever increasing fiscal challenges. The list of fiscal priorities, demands and expectations is seemingly endless This includes maintaining and enhancing core social services, maintaining a secure safety net for those in need, maintaining current pension entitlements, closing the inequality gap(s), closing the infrastructure deficit and building back better when existing assets fail, meeting commitments to Net Zero by 2050, lowering (or at least not increasing) taxes, all at the same time as maintaining prudent debt levels.

Some are grappling with these challenges from a position of already high public debt and its associated high debt servicing costs. In this situation, over-promising without the necessary funding plans will be met with suitable derision from financial markets. We saw this recently in the United Kingdom where after a period of market turmoil, Liz Truss became the UK's shortest-ever serving Prime Minister.

Priorities need to be set which may require the winding back or adjustment of existing policy parameters. That is easier said than done as we have just seen in France as President Macron is trying to lift the age of entitlement to State funded pensions from 62 to 64 amid widespread rioting.

We are in a better fiscal situation here in New Zealand with low public debt levels by international standards. At first blush that seemingly makes our challenges easier to meet.

Not really. It's important we maintain some fiscal head room or buffer. We are a small open trading country which makes it necessary for us to have a better fiscal position than the rest of the world.

Furthermore, we regularly use that buffer. In fact, we have used it three times in the last dozen years in responding to the Canterbury earthquakes, Covid, and now the rebuilding of communities following Cyclone Gabrielle. All those responses would have been different without a strong fiscal starting point.

Some commentators have argued that we should relax our fiscal prudence and settle for a higher debt level. Firstly, it's important to remember that higher debt comes with higher debt servicing costs. Secondly, any use of fiscal headroom without any intention to return debt to its prior level can only be used once, so better make it count. Thirdly, global rating agencies don't just look at public debt, but total debt. Our household debt level is worryingly high.

We should absolutely use that headroom when times call for it. But it should always be returned to where it started to get ready for the next emergency.

The better though more challenging route is to do a better job of setting our priorities. Governments can't do everything, and that becomes an even greater truism the shorter the period you want it all done in.

Most developed countries are facing into some hard choices. That means acknowledging Government can't do everything, especially all at once. We need to do a better job of setting priorities.

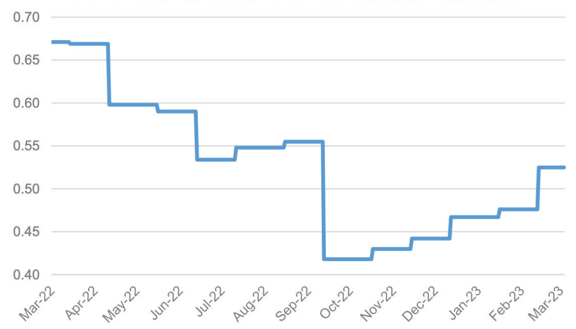
Too often here in New Zealand we have impassioned debates about maintaining current entitlements to retirement incomes, while in a different conversation we condemn our lack of progress in achieving better outcomes in reducing child poverty. Perhaps we should be having a single conversation about the relative merits of both?

Outlook for New Zealand Equities

The New Zealand equity market delivered solid returns in the March quarter, advancing +3.6% despite growing evidence of a deteriorating economic outlook. Local equities once again lagged broader market performance, with the MSCI World Index posting a +7.7% return in the period. The gain in NZ equities followed a +3.7% return in the prior quarter, with the negative return on a 12-month rolling basis narrowing to just -1.9%.

Key performance themes of the December quarter also repeated at a stock specific level in the March quarter, with Fisher & Paykel Healthcare (FPH, +17.9%) once again leading the performance of NZX50 constituents. This followed a positive mid-January trading update that saw the consensus upgrade revenue and earnings forecasts on the back of Covid surges in China, normalisation of the US flu season and stronger OSA mask growth post successful new product launches. Discussions with FPH also highlighted a belief that a post-Covid equipment destocking phase was nearing an end, with distributor inventory back to pre-Covid levels. These factors combined with stronger pricing growth as customers renew contracts and margins recover on positive operating leverage should support a positive outlook for a resumption of compounding earnings growth and continued delivery of strong excess return on capital.

FPH 12 mth forward EPS - consensus forecasts



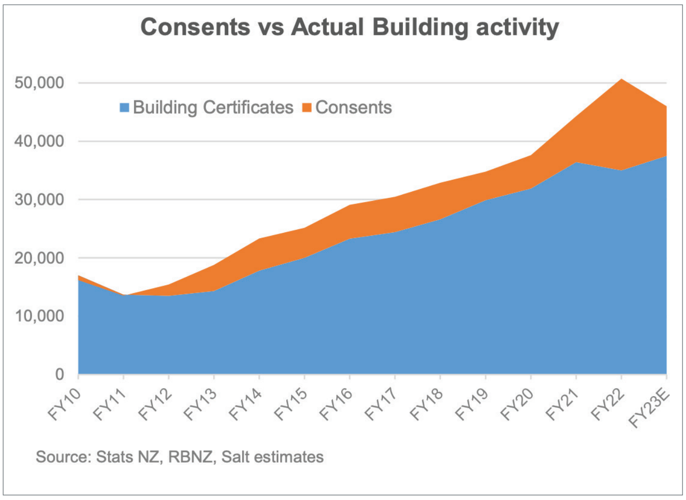
Source: Thomson Reuters Eikon

While the performance of FPH was supported by clear fundamental catalysts, the drivers of outperformance of other large cap names Mercury (MCY, +13.5%) and Auckland Airport (AIA, +11.4%) in the March quarter were less obvious to us. MCY's return in the quarter was in stark contrast to industry peers Meridian (MEL, +0.2%) and Contact (CEN, +0.4%), and we believe may have been influenced by a non-cash accounting treatment change that some investors may have mistaken for positive underlying earnings per share momentum. AIA's outperformance has likely been supported by upgrades to aeronautical capital investment that, once commissioned, will earn a regulated return and drive growth in operating earnings (pre depreciation and interest expense). Our view is that while this does generate modest valuation upside, it doesn't come close to bridging the gap between the current elevated share price and fair value.

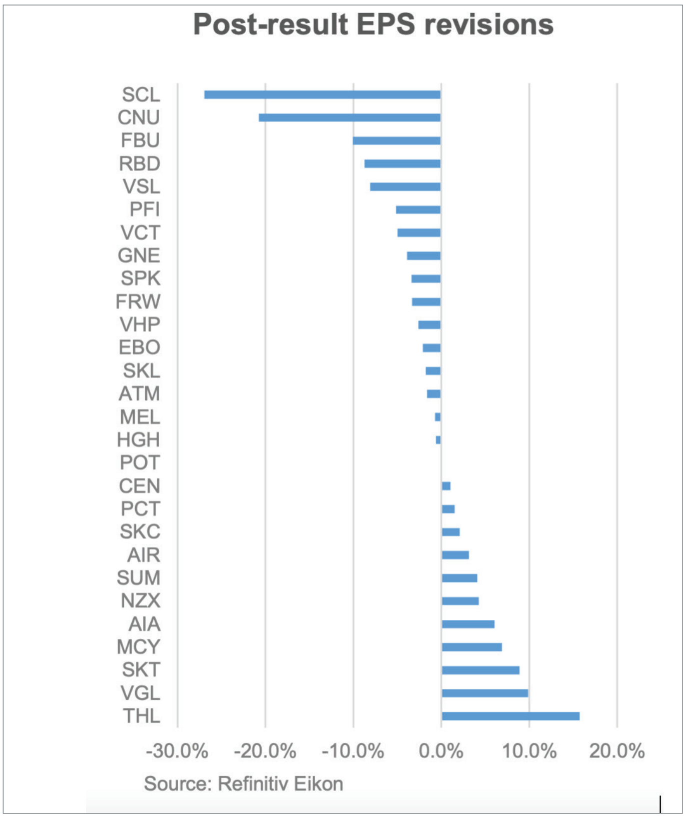
Underperformance in the quarter was dominated by small & mid-cap constituent names such as Synlait (SML, -39.7%), Warehouse (WHS, -28.8%) and Scales (SCL, -21.0%) who each saw significant negative revisions to consensus earnings estimates in the period. However large cap names A2 Milk (ATM, -15.4%) and Fletcher Building (FBU, -7.6%) also failed to keep pace with benchmark returns.

ATM saw minimal revisions to near-term earnings in the March quarter, while negative risks to the investment thesis including declining birth rates in China and elevated SG&A spend to support market penetration aspirations should not have been new news for investors. However, the month of March saw both the completion of ATM's $150m on-market share buyback program as well as a significant profit warning from infant formula manufacturer SML that could imply downside risk to ATM's volume growth path. These events coincided with the ATM share price retracing back towards our estimate of fair value.

FBU revised FY23 earnings guidance lower in February, citing weather disruption, and in particular the Auckland floods and Cyclone Gabrielle, as key drivers of the downgrade. While we accept that weather will have been a headwind to performance, we put greater blame on weak unit sales within FBU's Residential Development division. Building consents are gradually coming off cyclical peak levels as the impact of higher interest rates take hold, however we believe that industry capacity constraints and the subsequent build up of the work-in-progress pipeline could provide some protection to short-term operating performance and delay FBU earnings from hitting cyclical lows until FY25.



The March quarter included the major interim reporting season in February that saw modest net-negative earnings revisions, with consensus downgrading EPS forecasts by at least 2% for 43% of companies and upgrading for 32%. Revisions were slightly more balanced in Australia, with 44% downgrading and 38% upgrading.



Given the increasingly difficult economic backdrop, some market commentators viewed the reporting round as a success, choosing to focus on the net positive revenue surprise delivered by companies. However, we remain less enthused about the short to medium-term outlook for earnings. Key themes of the result season included elevated cost inflation, higher pricing to offset costs, post-Covid normalisation of consumer behaviour and guidance commentary that referenced further weakening in consumer activity.

We expect cost inflation to remain stubbornly high, at least for the next 12 months, with the lagged impact of ongoing significant wage inflation a key negative risk to profit margins. Up to this point companies have for the most part been successful in leveraging their pricing power to pass these higher costs on to customers. However, we believe that cost pass through will be increasingly more difficult to achieve as the delayed impact of higher rates drive economic activity progressively lower. While we would expect oligopoly industry structures to provide some protection for NZ company margins, we believe that a scenario of lower volume demand resulting in excess manufacturing or service capacity could still present significant downside risk to earnings expectations.

On the balance of probabilities, we believe that an earnings downgrade cycle will play out across CY23 with a broad earnings trough potentially some time in CY24. Based on previous cycles, we would expect that equity markets will price these downgrades in ahead of actual consensus revisions. Previous cycles would also suggest that markets will rally ahead of the earnings cycle bottoming out. However, even with positive support in the form of the post-Covid China reopening, we believe that equities are, for the most part, yet to adequately price in that future downside risk to earnings.

We look for pricing power, market share growth option value and sustainable competitive advantage that will support excess return on capital generation when setting conviction overweight positions. Against the current challenging economic backdrop earnings certainty is more important than ever and we therefore continue to favour reasonably priced defensive and secular growth exposures in preference to cyclical names that offer relative value on mid-cycle earnings, however, present negative short-term momentum risk.

Implications for Investors

The positive, though volatile, market environment in the First Quarter of this year has not erased the sentiment impact of the last 18 months' pattern of weak and erratic investment returns. Uncertain trends in many asset classes and major swings in bond yields have challenged asset allocators and led to elevated risk aversion in many quarters. With brief respites, most global asset markets, whether they be equities, bonds, metals, or currencies, have been caught in sharp adjustments and frequently, reversals of direction, as news flows on inflation and interest rates carry conflicting investment implications. This degree of uncertainty is characteristic of a transition into a lower-growth period and so the focus is increasingly on whether asset prices are adequately reflecting the risk scenario of a deeper recession commencing before inflation has been fully contained.

Consequently, the temptation for investors in early 2023 has been to "sit on the sidelines" or to hold on to cash, particularly given the ramping up of term deposit rates that has accompanied RBNZ tightenings. We see that as understandable, but also unwise. Bear in mind that while cash has the advantage of a fixed terminal value, the rate of inflation expected over the next two years is quite likely to exceed the offered deposit rates from banks, so keeping funds on term deposit will lock in a negative real return. That is a high price to pay for certainty. Particularly given that, if the interest rate environment shifts, the bank-imposed costs of breaking term deposits ahead of a scheduled maturity would further dilute the total return to be expected.

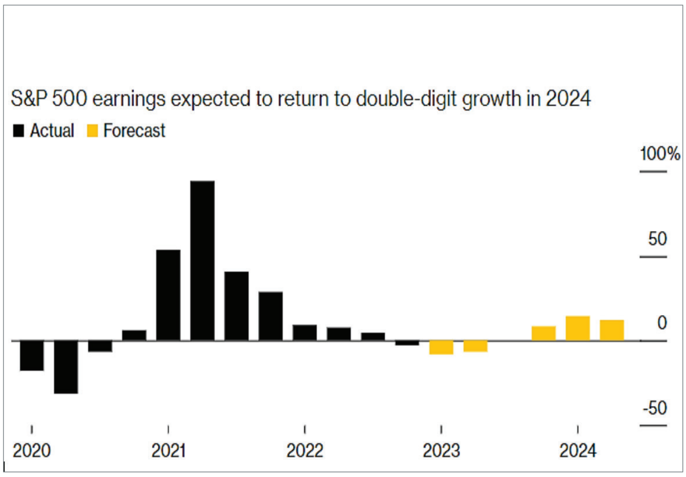
Is the "wall of worry" climbable, or still too slippery?

Given the lack of overall clarity presently, it is suggestive that markets have produced generally robust returns in the first three months of this year, a welcome development which has persisted so far into April. The key point to bear in mind is that there is very little surprise element to most of the market-negative information which has emerged, and that therefore investors have the capacity to reward "better-than-expected" news flows. This is consistent with the low current expectations for corporate profit performance, which have led to a long sequence of analyst downgrades to earnings forecasts, across many industries. Investor cash balances are high, so opportunistic price points for purchasing quality securities which show inflation- and recession-resilient properties can draw funds quickly back into asset markets at times.

The critical corollary to this is, of course, investments made in individual companies (rather than in whole industries or indexes) are the only viable method investors have to exploit very specific positive pricing factors. There is little to be gained by an undifferentiated or passive approach; the stocks or bonds that will reward investor attention to undue pessimism in their pricing need to be selected one-by-one.

As this is the Salt Funds Management approach, we are therefore comfortable with expecting another difficult year for share market indices as a whole, but that does not mean that the equities in our own portfolios have deteriorating expected returns. Quite the contrary. Many of the selections in our funds (both domestic and international) are chosen with particular attention to their capacity to weather economic downturn. Balance sheet strength, pricing power and technical adaptability to new market segments are crucial distinguishing qualities and tend to be common factors among securities that ride out low-growth and recessionary periods best.

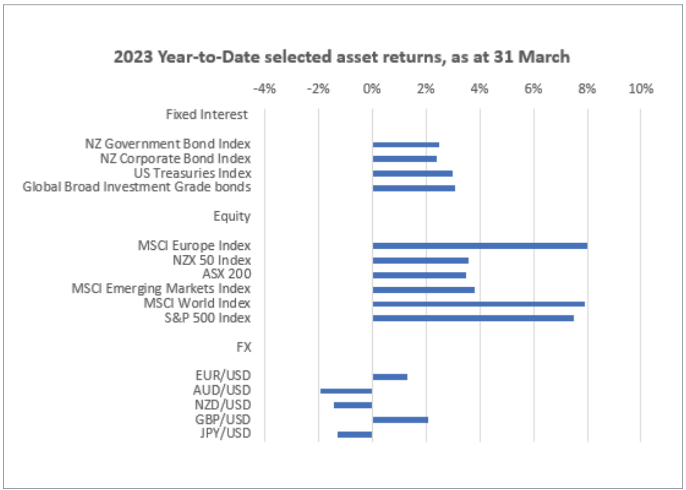
Markets appear sanguine about a mild earnings recession



Source: Bloomberg

2023 began with widespread positive asset returns

The stabilisation and uptick in investment returns across a range of major asset types continued from later 2022 into the March quarter. Bonds gained between 2-4% and equities, between 3-8% in the quarter.



Source: Morgan Stanley, S&P Global (data to 31 March 2023, shown in local currency terms)

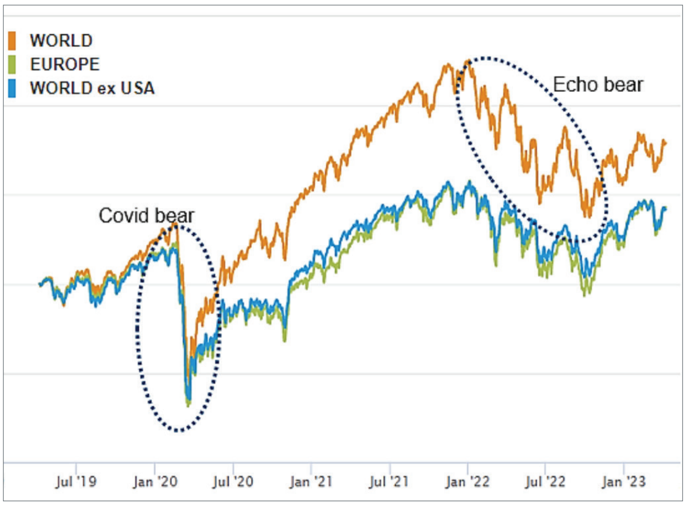
Working back uphill after a bear year

Thus, for the first quarter as a whole, markets held up surprisingly well given the variety of headwinds that are still unresolved. The interruption of bank solvency risk as a topic on investors' radar has certainly cooled any complacency that may have been building. This is useful, to the extent that fundamental factors do not yet, in our view, yet support a substantial and undifferentiated rally in the asset types we monitor. Nor, however, do fundamentals really justify a flight out of the equity component of portfolios. We believe that equities are entering a protracted period of "stress-testing" due to the impact of inflation on profits and of monetary and credit tightening, on customer behaviour.

This testing period should see more positively-differentiated returns performance from the quality-assessed selections in our international portfolios, and a greater investor appetite for the traditionally defensive or recession-resilient types of equity. It is increasingly likely that the performance of the main headline equity indices will be lower than the returns accumulated by these more resilient companies.

As we noted at the end of 2022 in our previous "Global Outlook," traditional assets have re-entered a price range where the fundamentals-based investor no longer needs to overcome serious valuation reservations. It is now possible to re-establish suitable portfolio holdings at complementary diversifying weightings, making prudent portfolio construction more achievable than it had been in the years surrounding 2020's covid-induced downward shock to interest rates.

World equities' volatile trajectory since Covid explained by US impact



Source: Salt, NDR

The chart above reveals that both the surge into over-valuation and bubble territory which followed the emergency response to Covid-19, and the severity of the "echo bear" market reaction last year, were amplified by the high US weighting in global equities indices, and by implication, the marked interest rate sensitivity of "mega-capitalisation" US technology stocks. The comparatively subdued performance of European stocks has been more in line with what would be customary for a macroeconomic regime of shock and recovery: a +/- 20% path around the pre-shock index value. Another aspect of this bifurcation between the US market's dynamics and those of other major regions is the much-noted "narrowness" of the US equity market's recovery rally this year. The attribution of the dominant share of the 2023 year-to-date gain in the US market to just seven tech or new economy companies (Alphabet, Apple, Meta, Nvidia, Amazon, Microsoft and Tesla) clearly shows that the first quarter rally was influenced by investors "bargain hunting US tech at beaten down prices." Price gains in the seven companies account for 88% of the 7% overall gain in the S&P 500 Index in the first quarter. Note that the equally weighted S&P 500 Index has a year-to-date return almost 5% lower than the market-cap weighted Index (+2.2% versus +7.0%, respectively.)

While this high attribution to the "Supercharged Seven" stocks – which all gained more than 20% – is partly a simple mathematical consequence of those companies' dominant market capitalisation, it does suggest a naivety on the part of some market participants, as the respective profitably profile of those tech enterprises varies widely. Some will not be immune to cyclical downturn.

In this regard, our global equities partner Morgan Stanley Investment Management (MSIM) has recently warned that that historical data does not support the idea that holding big tech companies is inherently a defensive strategy, as their gains in recent weeks may suggest, cautioning against investing in the sector until there's a clear bottoming among the broader market. Tech stocks performed in line with the broader market during the GFC but underperformed it during the early 2000s recession – much depends on the nature of the slowdown and the business model of the individual tech company as well as its valuation.

We agree, that while specific technology companies have defensive characteristics of great value in difficult economic phases (not least, in their huge cash reserves and sticky subscription billing models) there needs to be a broadening in participation into mid-size companies to confirm that the current equity rally can endure and not prove to be another false dawn.

However, for now the trend is positive

A range of cost, demand and interest rate-driven headwinds are still expected to overshadow international corporate earnings for the 2023 year. On the other hand, since the global equity market reached Bear low points in mid-October 2022, it is important to note that substantial rebound rallies have been underway. As at the time of writing, in mid-April, the US S&P 500 had rallied 15% from its October low logged six months ago, while the EuroStoXX 50 has gained a remarkable 30% over the same period.

Of course, there remain several quarters of earnings downgrades and potentially disappointing corporate profit news ahead, so the resumed monetary policy peak-based optimism could well prove premature, and will face tests through the months to come, even as headline inflation figures gently diminish.

The "healthy revaluation" aspect of the Bear equity phase was central to its character and its likely future path. MSIM remains among the most cautious of the major international houses regarding equity market prospects. However, the MSIM team have noted that over the next three months, more signposts will emerge that can determine the scope for a more vigorous recovery later in 2023, for international share markets. They take a balanced view of the likely dynamics, as there are two scenarios depending on whether central banks manage to engineer a "soft landing," with growth trimmed but not crushed, in the fight to lastingly lower inflation risk. We are anticipating the deceleration of a hot economy, a regime that is historically challenging for equities and supportive of high-grade bonds. Further tightening of bank lending standards, and US interest rate strategists' expectation of eventual bull steepening in the yield curve after easing commences, remain consistent with this more difficult environment.

A recently-strong economy that is cooling is a time for caution

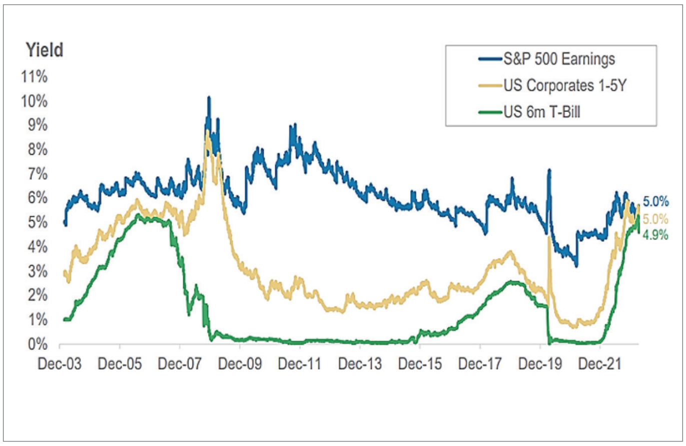
Yield curves, PMIs, leading indicators, and credit conditions all support our view that Developed Market growth is set to slow (potentially toward stall-speed) throughout 2023. Tighter credit conditions are especially germane, given US mid-cap banking sector stress, and should act as another form of lagged policy tightening on the US economy. Other economies may avoid recession, but near-zero GDP growth is on the cards and until monetary conditions ease again, few catalysts are visible to recharge activity.

In practice, these forces are widely appreciated, and this explains the difficulty the main market indices have shown in advancing sustainably beyond their immediate post-bear recovery rebound levels.

Specifically, we are concerned that five tests for anticipating weakening equity market returns are currently satisfied: 1) US Forward earnings estimates falling; 2) a substantial prior US Treasury yield curve inversion; 3) a sub-50 level on the US Manufacturing Purchasing Managers Index; 4) below-average unemployment; and 5) over 40% of bank senior loan officers tightening lending standards.

That said, the implied below-average returns outlook for equities does not necessarily argue for a re-allocation away from shares and into bonds. Fixed Interest has recorded a positive returns profile this year, in anticipation of earlier monetary policy down the track. However, the magnitude of bond market returns that were experienced during the Quantitative Easing – low Inflation epoch are an historical outlier and cannot form a credible expected return from the asset class going forward. Indeed, the old rule of thumb that a bond securities' current yield is a robust proxy for its expected total return should apply, leading to sub-5% per annum best-case nominal returns outlook for broad Fixed Interest indices.

Bond yield jump undermines Equities' earnings yield & risk premium advantages



Source: Morgan Stanley Investment Management

The Equity Risk Premium is obviously very low at present. However, until inflation is running sustainably below 5%, there is an argument to tolerate equity volatility, in the service of purchasing power preservation. Put simply, both shares and bonds real yields may be negative, but shares offer the potential for capital gain over the medium-term (3-4 year) period similar to the duration of a typical bond portfolio.

However, one should note that markets are forward-looking and at times can prove capable of looking through a degree of near-term profit weakness, if investors regain confidence that the medium-term future contains new catalysts for growth.

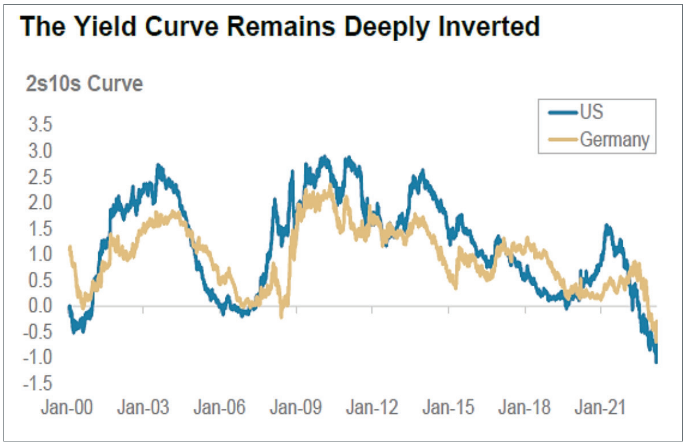
Given the uncertain macroeconomic landscape and the room for policy errors, we continue to advocate for a portfolio of high-quality compounders. The combination of these companies' recurring revenues and pricing power should protect revenues and margins in the unfolding economic downturn, providing asset owners with earnings resilience and relative predictability through more volatile times which may last years, rather than months.

Range-trading bonds more probable than any enduring rally from here

In our "Global Outlook" reports from the second half of 2022, we commented that bond yields had likely peaked and that a rally was possible if inflation pressure continued to appear to be lessening across the board. This has proved to be the case, and the lower yields on longer-dated bonds that have emerged have triggered recent gains in the value of interest-rate sensitive securities after a difficult 2022.

At the same time, the positive returns from bonds have accrued quickly, and may not be extended much further given how persistent core inflation is proving. Aggressive central bank policy rate hikes have simply deepened the inversion in the yield curve, as investors price in a somewhat deeper contraction and easing cycle, somewhat further into the future. The magnitude of future US interest rate cuts currently priced into markets by mid-2024, which is more than -1.75%, is larger than is typical for an economic soft landing.

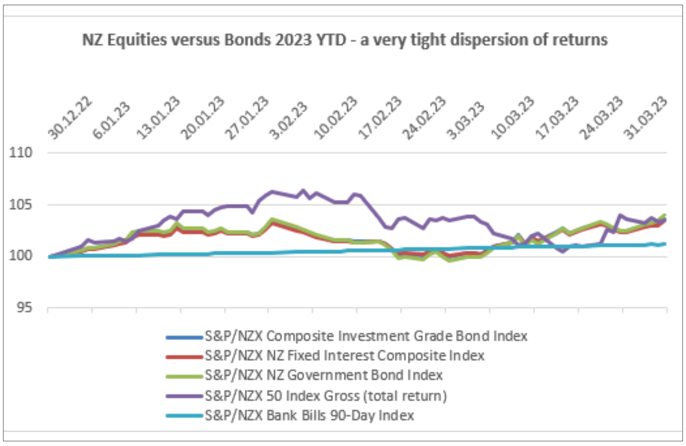
As can be seen below, the extreme inversion of Developed Market bond yield curves is persisting, although it has closed up to -0.6% in April in the US for the 2-10 year differential. With respect to the 3-month-10 year yield differential, though, the curve has steepened further to -1.6% at the time of writing.



Source: Morgan Stanley Investment Management, St Louis Fed.

Taken together with the lagged impact of already-implemented monetary tightenings, there seems to be limited further scope for capital gains on medium- and longer-term government bonds as much anticipated central bank "dovishness" is evidently already reflected in their prices.

In New Zealand, our still-hawkish central bank has engineered a comparably steep curve of -0.6% as at mid-April. Nevertheless, whilst NZ government bond securities have performed well in 2023 to date, they have not yet overtaken the total return from domestic equities, with both at +3.8% as of April 12th.



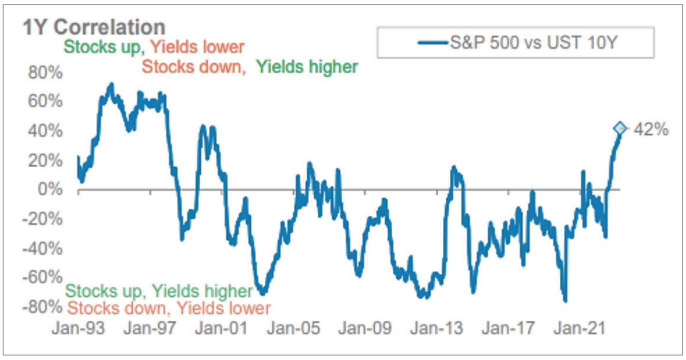
Source: S&P Global Indices

What we expect to see in 2023 is more differentiation between returns from different credit qualities, as borrowers are strained by low- or nil-growth economies and persisting higher costs.

Thus, we were willing to increase our allocations to the Fixed Interest asset class in mid-February, but with an important caveat. We require our bond holdings to be differentiated by issuer objectives, structures and sustainability-linked outcomes, instead of scaling holdings by the size of an entity's rolling deficit or re-financing obligations. To this end, we introduced the Salt Sustainable Global Fixed Income Opportunities Fund in February to wholesale investors, which is now incorporated in both the Salt Sustainable Income and Salt Sustainable Growth Funds. The Fund is specifically focused on low carbon and climate-friendly bond issuers, as well as those agencies involved with projects aligned with the UN Sustainable Development agenda, in addition to broader acceptable corporate and sovereign issuers.

Diversifying powers of bonds have weakened

Finally, in considering the relative merits of bonds and equities within diversified portfolios for the coming period, it is important to take diminishing diversification benefits into account. The positively correlated price movements in equities and bonds in recent months have recently accelerated, and on some measures the positive correlation is at a 25-year high.



Source: Morgan Stanley Investment Management to 31.03.2023

Needless to say, the present situation is the inverse of the negative correlation regime that persisted between 2000 and 2020, and which delivered substantial portfolio diversification benefits from a judicious mixture of equity and fixed interest; whereby bonds provided portfolio ballast through the most severe economic weakness phases whilst stocks participated in upside returns capture.

Looking forward, therefore, it may well prove too much to expect any resumption of strong diversification benefits from Fixed Interest as a broad asset class (distinct from a carefully-selected portfolio of targeted debt securities.) Therefore, while we have lifted our Fixed Income exposures overall, we do not feel that we should substantially lower our global equity holdings in order to move into a classically defensive posture via aggressive overweighting of the bond asset group for the present. Rather, we focus on the defensive characteristics of the equity components of our portfolios, including particularly our Infrastructure holdings, as well as on the special sustainability aspects and advantageous valuations currently evident in the Global Fixed Income Opportunities Fund.

Strategy conclusions

We retain our central market views for mid-2023, reprised below:

- Equities (as a whole) will potentially see average annual returns close to their long-term norms in the next three years with interim weaker periods; selected equity sectors and markets still have scope for resilience and desirable investment features. There are all-weather stocks that have lagged in recent years.
- For instance, listed real assets have superior, defensible yields, in a fraught macroeconomic and geopolitical phase. Real Asset's historical sensitivity to bond yields (as they trend down) may be supplemented by their cashflow surety, inflation-hedging qualities and (for Infrastructure) non-cyclical defensive merit. Bond yields have adjusted well, and may now plateau, which is positive for real estate looking forward one year, while Infrastructure has already benefited.
- Within the broader market sectors, thematic and valuation support in Utilities and Consumer Staples, Healthcare, and Software as a Service (SaaS) Information Technology enjoy pricing power which assists them to ride out sentiment storms and hedge against economic slowdown
- De-rating in very overvalued equities (specific companies, rather than sectors) is now advanced after interest rates moved up substantially. We do not anticipate a resumed bubble.
- Expect more M&A based on strong USD "war-chests" and some abandoned corporate courtships as conditions shift and distressed firms multiply.
- After the global bond sell-off of 2022, we see better compensation for duration risk. Within fixed income, thematic support is ready to be a prime differentiator. We acknowledge sustainable or "green" bonds as a valuable emerging theme.
- Default risk and credit quality are now on the radar and are likely to become a market focus later in 2023-4 and set off portfolio re-allocations within and beyond bonds.

This will set the stage for a global slowdown throughout the later part of 2023 as the lagged impacts of tightening of policy around the world continues to impact the real economy, and asset markets adapt to protect existing capital gains by allocating funds toward "all-weather" securities. Such desirable investments, which we are actively seeking out across all our asset classes, are resilient to both inflation and to profit challenges in a less stimulus-based, capital spending and productivity-led phase of economic growth.