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April 2023 Quarterly Market Update: Interest rate indigestion

By Perpetual Private

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In the **April 2023 Perpetual Private Quarterly Market Update** we look at recent market moves, the search for a soft landing and the effect a year of rate rises has on weaker companies. You can download our full report – or read our concise review below.

Please note: except where otherwise noted or quoted, the views in this article are those of Perpetual Private and its staff.

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March 2023 quarter: What happened?

- 2023 got off to a good start with the Australian market rising on positive inflation news and the possibility rates could ease at year end. Later in the first quarter some nasty but quickly contained bank failures shut down the rally. However, Australian shares still generated a 3% quarterly return.
- Major global markets also had a strong start to 2023. In local currency terms, French and German markets were up well over 10% for the quarter. Globally, tech stocks rallied while energy companies fell. That reversed last year's trend.
- Bond markets emerged from their slump. Global bonds rose 2.4% for the quarter and local fixed income did even better, posting a return of 4.6%, partly in recognition of the

strength of Australia's banking sector.

- The most recent data point in the great 'investment style' debate saw local Growth shares beat Value in the March quarter. However, Value now outpaces Growth over all other time periods out to five years.

Indices referenced: S&P/ASX 300 Index, German DAX Index, French CAC 40 Index, MSCI Australia Value Index, MSCI Australia Growth Index, Bloomberg Global Aggregate Index, Bloomberg AusBond Composite (0+Y) Index. All performance numbers for March 2023 quarter unless otherwise stated.

According to Perpetual Private Investment Director, Emily Barlow, the first three months of 2023 were "a quarter of two halves." With some evidence that inflation was easing, share markets rose handily, reflecting the potential for rate cuts in late 2023 or early 2024. As we moved into March, the narrative changed, with bank failures in the US and Switzerland eroding confidence.

It's easy to blame some rogue banks for the sudden reversal. Silicon Valley Bank (SVB) – the self-styled 'financial partner of the innovation economy' was under-hedged and over-exposed to start-ups and technology companies that were hammered by rising rates. Credit Suisse had struggled for years with risk controls and finding the right business model.

Central banks stepped in quickly to reduce the risk these local flare-ups would damage the global banking system. Stability has returned to the system and the Reserve Bank Governor recently wrote, "Australian banks are well regulated, well capitalised, profitable and highly liquid; they are in a strong position to continue lending to domestic households and businesses."[1]

So SVB and Credit Suisse are less current threats than reminders of what the world is dealing with in 2023 – interest rate indigestion.

More expensive money is hard to swallow

It's easy to forget that as recently as 2021, inflation in Australia was 2.9%[2]. Today it's 7.8%. To rein in that runaway inflation, our central bank pushed up interest rates by 3.5% since last May. It's a pattern we've seen weaved around the world.

Those rate rises are making life hard for businesses and consumers. But for two groups it's causing a particular kind of indigestion.

Firstly, central banks are struggling to assess what effect their rate rises are having. The lagged effect of rate rises means it's hard to know whether they've tightened too much, too little or just right.

In Australia, the calculation is more difficult because many households still have plenty of lockdown-soothing cash in their bank accounts. And because many Aussies' mortgages are fixed rate, we won't know what effect rate rises have on indebted homebuyers till they're at the end of those fixed rate terms and have to refinance at sharply higher rates. Or, to put it more dramatically, "fall off the mortgage cliff."[3]

The other group badly struggling with interest rate indigestion are companies that have relied on benign economic condition and cheap money. It's why the long run of rate rises has claimed some of the world's weaker banks. It's why the price of barely profitable technology companies have tanked. And why we're seeing businesses dependent on a free-spending consumer – like online food deliverers – hit the wall.

The upside

There is some good news. Inflation, while not slain, has at least stopped advancing. Supply chain tangles are easing. In Australia, some car yards are selling cars you can drive away *now*. The Federal Reserve Bank of New York's Global Supply Chain Pressure Index is back to near-normal levels. And in Australia and the US, unemployment is still low.

Investors can embrace these positives, knowing that central banks are trying to find what RBA Governor Lowe calls the 'narrow path' to a soft landing – an economy where inflation is moving back to target without crashing growth.

Interest rate indigestion means company performance will be more differentiated. As Emily Barlow puts it: "For years, cheap money lifted all boats. But an economic environment where rates are higher for longer asks different questions. We always assess companies' markets, their management and their competitive advantage. When it comes to debt, we ask - can they cover rising interest costs? Have they *managed* their debt well – structuring the terms, rates and timing so that it aligns with their cashflows and business model?"

This differentiated investment environment is one that suits investors focused on quality and value – like Perpetual Private.

From corporate credit to government bonds

The reshaped economic environment, one where interest rates are higher for longer, is driving changes in the fixed income part of Perpetual Private portfolios.

We invest in both government bonds and corporate debt (debt issued by companies including banks and corporates like BHP).

Over the past few years, Perpetual Private investors benefited from our overweight position in corporate debt (sometimes called credit). Government bond rates were very low, indeed, they were negative in some countries, so our credit holdings helped generate better returns.

Credit securities also have a shorter time horizon and floating rates, which meant that as interest rates started to rise, they provided some downside protection. By contrast, when rates rise, government bonds typically fall in value because their **fixed** rates become less attractive. “In the environment we lived through over the past few years, credit investing was good for returns and helped reduce downside risk,” say Emily Barlow.

Now the plates have shifted. Perpetual Private has been moving money from credit into bonds, a decision we think works on a number of levels.

- As interest rates stabilise at higher levels, longer-dated government bonds are more attractive sources of income.
- Because these bonds are backed by governments (and their unlimited taxing powers) they’re more defensive than shorter-term credit securities issued by companies. That helps protect the portfolio if we fall into a recession.
- Corporate credit securities are affected by the same forces that affect company shares while government bonds are less correlated to equity markets. So investing in government bonds improves diversification and reduces risk.

Perpetual Private’s Quarterly Market Update for April 2023 covers the lagged effect of the past year’s rate rises and what that means for investors. It details the outlook for equities, fixed income, real estate, currency and alternatives.

Download the report

Sources:

[1] RBA, *Financial Stability Review* April 2023.

[2] https://www.worlddata.info/australia/australia/inflation-rates.php

[3] The RBA recently paused its string of rate rises to assess the impact of past hikes. But that pause could be temporary.

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