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How a soft landing could right the ship for global stocks?

Concerns about the rate hike cycle could prove unfounded and provide a buying opportunity - so long as the Fed can deliver a soft landing.

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MICHAEL SMITH
Head of Research and
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How a soft landing could right the ship for global stocks

Concerns about the rate hike cycle could prove unfounded and provide a buying opportunity - so long as the Fed can deliver a soft landing

Recent months have been difficult for the stock market, and following a series of rate hikes, the path is certainly no clearer. Lingering uncertainty about the pace at which rates are rising has damaged investor sentiment. Principally, this has hurt rate-sensitive growth stocks.

In conjunction with anxieties about rampant inflation, these factors have acted as a headwind in dragging down other stocks that might have once been considered as less sensitive to interest rate movements - for example, take the banks.

But the reason these names are feeling the pressure this time around is because investors are worried monetary policy tightening could take place too quickly, and in turn give rise to the prospect of a global recession.

In our view, however, if central banks, led by the Federal Reserve can manage this rate hike cycle prudently, there are enough signs that suggest stock valuations are increasingly getting more attractive.

Three rounds of rate hikes

This month we've seen the Reserve Bank of Australia make a drastic shift to tighten monetary policy. While RBA Governor Philip Lowe previously set a 2024 timeline for the first rate hike, and subsequently watered that down to 2023, the nation's central bank was forced into a spectacular backflip at the start of May.

Representing the first rate hike in Australia for over a decade, the RBA lifted the official cash rate by 25 basis points to 0.35%.

This was driven by the first-quarter inflation reading, which came in at 5.1%. It was a worrying sign given the RBA had ample opportunity to look abroad to the challenges that would no doubt drive inflation higher.

With that said, although the RBA might be behind the eight-ball, the US Federal Reserve has hardly been on top of the game with regards to combating inflation.

Shifting significantly from its "transitory" remarks, the Fed, led by Jerome Powell, raised rates for the first time in four years back in March, but it has since upped the ante.

Just days after the RBA hiked rates, the Fed pushed through a 50 basis point hike, its biggest in 22 years. At the same time, it has also signalled that 50 basis point hikes could be on the agenda at each of its meetings over the coming months.

Not to be outdone, the Bank of England also pushed through a rate hike in the same week. The BOE has been more proactive in moving rates higher, on this occasion delivering its fourth consecutive hike, but it has also sounded the alarm that it still expects inflation to potentially accelerate from here and reach double-digits.

Don't fight the Fed

The biggest reaction to the week's three rounds of rate hikes was arguably saved for the Bank of England and its warnings on inflation and the risk of a recession. However, we feel this setback is confined to the region, largely driven by a more direct impact arising from the war.

Furthermore, this should not take away from the immediate response to the Fed's rate hike, which was treated somewhat positively and initially led to a relief rally. As the world's most-watched central bank, we believe it is their policy response that will largely dictate how equity markets respond over the coming months.

After all, the Fed kick-started a bull run in the midst of the pandemic through its ultra-loose accommodative monetary policy, even as other central banks followed suit. This is one of the factors that has been at the heart of the common catch-cry in financial markets - “don’t fight the Fed”.

It is for this reason, we’re taking particular note in the Fed’s intention to deliver a soft landing as it lifts rates. Markets were relieved that the Fed opted to deliver a 50 basis point hike instead of 75 points as some had feared.

The fact that the central bank is prepared to deliver a series of more-proportioned hikes, as opposed to playing a quick catch-up program, gives rise to some confidence that it can effectively manage the rate hike cycle while taking in any new developments as they occur.

What we must also note, is that rates were pushed to rock-bottom levels in a fashion that we had never seen before. The Fed implemented emergency cuts back in 2020, while doing so from what was already a relatively modest starting point.

But in the grand scheme of things, long-term interest rates have occupied much higher levels over time. It would be unsustainable for central banks, let alone the Federal Reserve, to maintain rates at or near current levels, especially with inflation showing no signs of abating following the impact of the war in Ukraine.

For this reason, we expect rates to return to more ‘normalised’ levels, and the benchmark rate of 2.5% is often cited as a “neutral” level for the economy. In targeting this level, we take confidence in Jerome Powell’s commentary that effectively ruled out the prospect of 75 basis point hikes moving forward.

What’s more, Powell has also voiced confidence in the ability to deliver a soft landing for the economy, citing the prospect of restoring price stability given the underlying strengths in the US economy. This has been led by a resilient labour market that can afford to see slower jobs growth that caps wages growth as well.

The central bank has also hinted that the share market will be a consideration, among others, as part of a broader measure of “financial conditions” when framing the pace and scale at which it lifts rates.

With this in mind, we feel the Fed has no interest in unnerving investors, as this could flow through to having an impact on the economy at large.

Money flow between asset classes

Another factor that we believe supports equities at this time is the likely ramifications for the property market.

As rates increase, we expect to see cooling demand for property. The property market tends to lag the stock market when it comes to performance, so the set-back we’ve seen unfold across equities to start 2022 could reach property assets as borrowers and would-be borrowers start to feel the direct impact of rate hikes.

It is our view that higher borrowing costs could have a negative impact on sentiment in the housing market and drive investors to other asset classes.

With stock prices recently recalibrating in response to rate hike concerns, including a near 25% drop in the Nasdaq from its peak, a growing number of stocks are starting to look ‘cheap’ for the long-term.

In the growth category, a number of high-quality names are largely shielded from higher rates, notwithstanding the impact on businesses with distant cash-flow or those yet to turn a profit.

As we detailed in our January newsletter, the initial shock amid a new rate hike cycle is nothing new. In fact, history suggests the post rate-hike cycle has historically turned positive five months after the first increase, before accelerating from there.

With more and more opportunities emerging by the day, it leads us to believe that astute buying could prove rewarding over the long-term, especially as money flows back into equities from other assets.

Mike Smith
Managing Partner

International

MICHAEL SMITH
Head of Research and
Senior Investment Advisor

George Wong
Senior Financial Advisor

Performance:

Index	*April Performance*	*2022 Performance*
Dow Jones	**-4.9%**	**-9.2%**
NASDAQ	**-13.3%**	**-21.2%**
S&P 500	**-8.8%**	**-13.3%**
Global Growth Portfolio	**-1.4%**	**-15.0%**

Top 10 Holdings:

Code	*Company Name*	*Weighting %*
COST	**Costco**	**7.3%**
BRKB	**Berkshire**	**6.2%**
MSFT	**Microsoft**	**6.2%**
GOOGL	**Google**	**5.7%**
TGT	**Target**	**4.3%**
V	**Visa**	**4.2%**
PFE	**Pfizer**	**4.2%**
PG	**P & G**	**4.0%**
ISRG	**Intuit**	**3.2%**
TSM	**Taiwan Semi**	**3.2%**

International Growth Portfolio

During April, NAV for the Global Growth Portfolio declined by 1.4%, extending the difficult start to the year. Although the headline result is disappointing, we must view the result in the context of the broader landscape.

On that note, the tech-heavy Nasdaq index plummeted 13.3% last month, posting its worst monthly result since the GFC. The Dow Jones and S&P 500 both struggled as well, falling 4.9% and 8.8% respectively, which is their worst monthly result in two years, since the start of the pandemic.

A major driver in our relative outperformance last month was a favourable move in the USD/AUD exchange rate. In previous months this has proved a headwind, but during April the forex rate increased from 1.3363 to 1.416, providing a strong backdrop to support the Portfolio.

We have held the view that the Aussie dollar rallied with too much optimism given broader macroeconomic concerns in play at the moment. This includes ongoing lockdowns across major cities in China. As such, we feel this adjustment represents a convergence towards a more 'normal' rate.

Given the broad-based sell-off across the market, the stocks that fared best were those that held up in value amid the shift in sentiment. This meant 'defensive' names performed best for the Portfolio last month, including blue-chip healthcare name UnitedHealth Group (UNH), and defence duo Lockheed Martin (LMT) and Northrop Grumman (NOC).

Beyond that, some of the most-pronounced losses across our core holdings in the Portfolio were concentrated among mega-tech names. Investors have been nervous about soaring inflation and the prospect of an aggressive rate hike cycle, so tech names have been susceptible to weakness.

An underwhelming, if not poor earnings season for some of the market's biggest names also weighed on sentiment, with the likes of Alphabet (GOOGL) dragging on the Portfolio.

Despite the poor market environment witnessed last month, we made the decision to refrain from making any trades. In our view, the extent of the sell-off, and the pace at which it has taken place, appear to be overdone. Reducing our stake or selling out of key names that have already been sold-off sharply may not be a prudent move, as it could see us lock in losses and potentially risk upside on a rebound.

Our unrealised gains across the Portfolio shrunk modestly during April, representing approximately 10% at month's end. While there are a number of watch-points for investors to keep an eye on, we believe the Fed's latest rate hike should provide a calibration point for the market to take stock of a number of discounted opportunities, something that could support the broader market.

George Wong
Senior Financial Advisor

MICHAEL SMITH
Head of Research and
Senior Investment Advisor

Performance:

Index	*April Performance*	*2022 Performance*
ASX 200	-0.9%	-0.1%
ALLORDS	-0.8%	-0.7%
Conservative Portfolio	-0.4%	-1.4%

Hub 24 - Conservative

Conservative Portfolio

NAV for the Conservative Portfolio declined by 0.4% in April, compared with a 0.9% drop across the ASX 200.

Given overseas markets were down by as much as double-digits, the result is a fair outcome in light of the circumstances, as it means the Portfolio is performing as intended insofar as preserving capital when markets turn volatile.

Blue-chip names were the bedrock of the Portfolio last month, providing a solid base to deliver an outperformance relative to the broader market.

Transurban (TCL), up 5.8% last month, and Woolworths (WOW), up 3.4%, were the best-performing names in the Portfolio. In our view, each of the duo are cornerstone holdings in a portfolio with a conservative tilt, offering a blend of income and modest growth, but also functioning as 'defensive' holdings leveraged to core themes of infrastructure and consumer staples.

Telstra (TLS) and Macquarie Group (MQG) were two of the other stocks that had a solid if not unspectacular month. We like the outlook for both as we head into a rate hike cycle.

On the other hand, the biggest drag on the Conservative Portfolio in April was BHP (BHP), Rio Tinto (RIO) and our modest exposure to international equities.

In the case of the iron ore majors, China's ongoing lockdown is denting sentiment, with concerns about a slowdown in growth that could dampen appetite for iron ore. The duo also reported quarterly production figures that probably met expectations, but didn't go much further than that.

Our base case is that the Chinese government will gradually pivot from what is an unsustainable covid-zero policy, and at that time we would expect significant stimulus and policy support to underpin the economic recovery. Since we view this as a temporary set-back, we are content holding these names knowing they can continue to support large dividends.

Meanwhile, the VanEck MSCI International Quality ETF (QUAL) dragged on the Portfolio due to the poor performance of stocks in overseas markets, and that was a similar fate for our Global Bond and Credit Funds, which shed around 3% each.

In light of the conditions during April, we deployed some of our cash into a one-year term deposit at a rate of 1.85% per annum, otherwise there were no changes. We anticipate greater clarity following the twin rate hikes home and abroad, but our goal is to shield the Portfolio from any further volatility.

George Wong
Senior Financial Advisor

Samuel Waldron
Financial Analyst

Performance:

Index	*April Performance*	*2022 Performance*
ASX 200	**-0.9%**	**-0.1%**
ALLORDS	**-0.8%**	**-0.7%**
Balanced Portfolio	**-2.1%**	**-7.2%**

Hub 24 - Balanced

Balanced Portfolio

With negative headwinds coming from overseas, our Balanced Portfolio faced some difficulties last month, and that led to a 2.1% decline in NAV.

By way of comparison, the ASX 200 performed slightly better, recording a negative return of 0.9% for the month. This was largely supported by the robust performance from several of the big banks, and some other blue-chip stalwarts that represent a large portion of the market.

When we look at the core holdings in the Portfolio, CSL (CSL) was one that held up well amid the market sell-off. The biotech giant has slowly been trending higher since mid-February, and we believe the recent acquisition of Vifor Pharma is potentially transformational for the company over the mid-to-long-term thanks to its drug portfolio.

With lockdowns now out of the way, we're looking to see plasma collections gradually improve and bolster CSL's operational performance. This should provide another tailwind to support share price appreciation.

Goodman Group (GMG) also fared well, increasing by 4.8% across the course of the month. The stock has since pulled back on concerns around the interest rate outlook, but we see the company's resilience coming from what we believe is a paradigm shift in e-commerce that will continue to support a warehouse real estate play like Goodman Group into the future.

In terms of underperformers, the Betashares Nasdaq 100 ETF (NDQ) fell by 7.5% last month, which was a poor result given we look to ETFs to provide a little more stability by way of their inherent diversity. With that said, the underlying Nasdaq index was down by more than 13%, so there was some protection on account of favourable movements in the greenback.

It was a similar story for the ETFS FANG+ ETF (FANG), which was hit harder, tumbling 14.4%. We do have a smaller weight assigned to this holding, so we didn't feel the full effects of the sell-off. However, combined with modest losses in other funds like the Hyperion Global TMF (HYGG), VanEck MSCI International Quality ETF (QUAL) and Vanguard US Total Market (VTS), our international exposure was ultimately the dominant factor in underperforming the ASX.

Having recently increased our weighting in more defensive assets, we expect this will help us weather the storm in terms of any near-term volatility, but we also believe our international exposure will offer the potential for outperformance when overseas markets turn higher.

George Wong
Senior Financial Advisor

Samuel Waldron
Financial Analyst

Performance:

Index	April Performance	2022 Performance
ASX 200	-0.9%	-0.1%
ALLORDS	-0.8%	-0.7%
Growth Portfolio	-2.9%	-8.0%

Hub 24 - Growth

Growth Portfolio

The Growth Portfolio recorded a negative return of 2.9% last month, with NAV let down by our exposure to international markets, which hit a wall during April.

The ASX 200 outperformed the Portfolio, easing by 0.9%, but this was mostly attributable to a large drop in blue-chip tech stocks in the US. We expect to see some of this underperformance reverse once overseas markets rebound.

In terms of highlights in the Growth Portfolio, Fortescue Metals (FMG) had a solid month, gaining 4.7%. The company defied the trend among other iron ore miners, overcoming concerns about a slowdown in appetite for iron ore amid the lockdowns currently weighing on China's economy.

The upside for FMG was largely due to a strong quarterly production report, where the company upgraded its full-year guidance. We are also looking at the company's progress in the green energy space, and while it is very early days, we feel there could be long-term upside here that closes the gap with miners from other segments leveraged to renewables.

With growth stocks out of favour, both home and abroad, the biggest drag on the Portfolio came from stocks deemed more susceptible to the rising interest rate environment.

Aristocrat Leisure (ALL) shed 8.3% of its market cap throughout April, touching its lowest level in a year. While disappointing, since the drop seems to be due to slowing demand for its digital video games, the recent drop has repositioned the stock into territory that we feel suggests the sell-off is overdone.

Lynas Rare Earths (LYC) is another stock that found itself under pressure, falling 14.9%. Although the stock has pulled away from its recent multi-year highs, we see the company being a pivotal leader in the global decarbonisation movement thanks to its rare earth minerals exposure.

The sell-off in Lynas has been driven by concerns over labour costs, profit taking and a shift in sentiment away from growth names. In our view, none of these factors force a change in our investment thesis at this time.

There were also negative contributions from the likes of the T.Rowe Price Global Equity Fund, ETFS FANG+ ETF (FANG), BetaShares Nasdaq 100 ETF (NDQ), Hyperion Global TMF (HYGG) and Ophir High Conviction Fund (OPH), plus other funds holding international stocks. In our view, these are short-term worries, and a clearer rate policy from the Fed, along with the recent recalibration in equity valuations should underpin long-term buying support.

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