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MACQUARIE ASSET MANAGEMENT

Recession: Everything and all at once?

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Key takeaways

- State of play | The impact of higher rates and monetary tightening is already starting to be felt. As the liquidity tide recedes, we are wary of what could break next. The risk of further credit tightening shouldn't be discounted.
- Consensus versus financial markets | Economic consensus anticipates a recession, but financial markets (valuations) are not yet fully pricing this in.
- What could counter the "consensus" | There are several factors that may explain why markets' "delayed reaction" continues to exist: the possibility of a central bank pivot, offsetting fiscal policy, the opaque role and proliferation of private credit, and the promise of the artificial intelligence (AI) revolution – although we remain wary of the likely misplaced optimism.
- Everything and all at once? | As the effects of the long and variable lags of monetary policy and credit tightening as well as liquidity contraction start to eventually materialise, we ponder whether a recession and its impact on financial markets will, as they often do, hit everything, everywhere and all at once.

Investment themes

State of play: Game of musical chairs

- The impact of much higher rates and quantitative tightening (QT) are beginning to be felt and will intensify as the long and variable lags of tighter monetary policy appear.
- As the monetary tide recedes further and the "game of musical chairs" gains pace, bigger things in financial markets are breaking (Silicon Valley Bank, First Republic Bank, Signature Bank, Credit Suisse).
- "Things breaking" in the US banking system has effectively triggered a form of credit crunch, with lending standards and risk positioning tightening considerably.
- The risk of further credit tightening shouldn't be discounted, and we remain alert for what may break next.

Consensus sees recession, markets not so much?

- Economic forecast consensus anticipates a recession, but it's not so much the case in financial markets.
- There are several counterpoints to the consensus, which may explain why markets' "delayed reaction" continues to exist: the central bank pivot, offsetting fiscal policy, the opaque role and proliferation of private credit, and the promise of the AI revolution.
- However, we remain wary of the likely misplaced optimism in financial markets.

Patience – the long and variable lags

- In light of these potential reasons for a more resilient economy and markets, we are reminded by history that both monetary policy and credit tightening work with long and variable lags.
- Liquidity is also forecasted to drain, and the impacts from liquidity contraction are yet to be fully realised.
- As the effects of these pressures eventually materialise, we ponder whether a recession and its impact on financial markets will, as they often do, hit everything, everywhere and all at once.

In the spotlight: Generative AI

- GenAI is a type of AI that can generate new content like a human. Its impacts remain unclear, but we believe it's on track to be among the greatest of any technological trends in recent decades.
- We point to possible fundamentals implications: 1) increased productivity, but also possibly a deflationary force; 2) uncertain impact on labour markets; 3) corporate margins potentially increasing, albeit with dispersion.
- Implications for investors *may* include: 1) a boost to equities; 2) tighter credit spreads for companies handling this transition well; 3) increased short-term volatility but lower long-term volatility; 4) downward pressure on interest rates.
- Putting it all together, we anticipate credit, industry, and asset class selections (driven by fundamental analysis) to be even more vital as GenAI realities unfold over the next few years.

Source: Macquarie. Views as of June 2023, subject to change without notice.

Investment implications

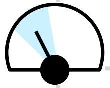
Our investment outlook

- Our approach dictates caution in a pre-recessionary environment.
- We believe utilising **duration, hedging strategies,** and **sector selection** to express that caution is key.
- As tightening monetary policy, liquidity, and credit standards ripple their way through the economy, we remain **positive on bonds** and **more cautious on credit / risk markets.**

Source: Macquarie. Views as of June 2023, subject to change without notice. MBS = mortgage-backed securities. US dollar (USD), euro (EUR), Australian dollar (AUD), Japanese yen (JPY).

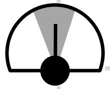
Rates/Duration

- We are at or near peak monetary tightening, and duration continues to present **strong long-term value**. Accumulate more if yields rise further.
- Geographical duration view – favour the US given we expect the US economy to require more and faster rate cuts going forward.



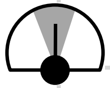
Credit

- The relative scarcity of issuance has supported credit resilience to date. However, we **remain conservatively positioned** as recessionary forces and credit tightening are not yet priced into valuations. This positioning provides **room to progressively add exposures** on wider spreads.
- Industry sector preferences – less cyclical areas with sound fundamentals, e.g. utilities, communications, and energy.



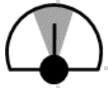
Emerging markets debt

- As the economic and market headwinds are not centred on emerging markets (EM), we expect **EM to behave in line with equivalent quality developed market sectors**.
- Global monetary loosening and likely USD weakness will be structurally supportive. A large underweight investor base provides supportive technical.
- Looking to increase EM exposure when valuations compensate for the additional country risks.



Structured products

- Commercial MBS remain challenged, while residential MBS continue to benefit from solid financial conditions and improved loan-to-value ratios.
- We have increased exposure to MBS, particularly **US agency AAA MBS**, which are offering attractive spreads backed with robust structures and strong credit fundamentals.



Currency

- **USD** – we believe USD is close to its near-term peak but expect it to exhibit a topping pattern for the next few quarters.
- **EUR** – neutral outlook. A hawkish European Central Bank supports EUR, though EUR is more broadly a beneficiary of global growth.
- **AUD** – potentially supported by China's service sector strength broadening into the goods sector, but sensitive to growth and risk sentiment.
- **JPY** – the Bank of Japan's unwinding of yield curve control may see a sharp snap higher in JPY, though the timing of this is uncertain.

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Diversification may not protect against market risk.

Important information

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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.

Natural or environmental disasters, such as earthquakes, fires, floods, hurricanes, tsunamis, and other severe weather-related phenomena generally, and widespread disease, including pandemics and epidemics, have been and can be highly disruptive to economies and markets, adversely impacting individual companies, sectors, industries, markets, currencies, interest and inflation rates, credit ratings, investor sentiment, and other factors affecting the value of the Strategy's investments. Given the increasing interdependence among global economies and markets, conditions in one country, market, or region are increasingly likely to adversely affect markets, issuers, and/or foreign exchange rates in other countries. These disruptions could prevent the Strategy from executing advantageous investment decisions in a timely manner and could negatively impact the Strategy's ability to achieve its investment objective. Any such event(s) could have a significant adverse impact on the value and risk profile of the Strategy.

International investments entail risks including fluctuation in currency values, differences in accounting principles, or economic or political instability. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility, lower trading volume, and higher risk of market closures. In many emerging markets, there is substantially less publicly available information and the available information may be incomplete or misleading. Legal claims are generally more difficult to pursue.

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.

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.

IBOR risk is the risk that changes related to the use of the London interbank offered rate (LIBOR) or similar rates (such as EONIA) could have adverse impacts on financial instruments that reference these rates. The abandonment of these rates and transition to alternative rates could affect the value and liquidity of instruments that reference them and could affect investment strategy performance.

Economic trend information is sourced from Bloomberg unless otherwise noted.

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