

Higher rates, tighter credit, and less liquidity matter

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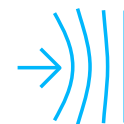


Key takeaways



Maybe it's different this time?

We believe contributors to market resilience, including fiscal support, artificial intelligence (AI)-led equities, and quantitative easing (QE), seem poised to fade, as does "maybe it'll be different."



Brace for impact

The long and variable lags of significant monetary, credit, and liquidity tightening are converging. It's only a matter of time.



QT - the straw that broke the (bond) market's back?

With the US Federal Reserve implementing quantitative tightening (QT) again, bond markets are asking "who will buy bonds now?" The market is disconnecting from fundamentals.



Higher for longer? Well, until something breaks

"Higher for longer," in such an indebted system, is not celebratory. The longer rates stay higher, the more inevitable financial market dislocation.



Take an in-depth look

Investment themes



Maybe it's different this time?

- Evidence supporting the likelihood of a recession has continued to build, yet financial markets have continued to perform well, seemingly embracing the soft or no recession scenario.
- Key contributors to this year's market resilience include stronger-than-expected fiscal policy, the pronounced influence of the seven mega technology firms which are referred to as the "Magnificent Seven" on equity markets, and the absence of QT.
- With the roll off of significant fiscal support policies, rising concerns over equity valuations, and the shift back to QT, these factors appear set to diminish in our view.
- As such, we believe the narratives of "more resilient economy," "higher for longer," and "maybe it's different this time" also seem poised to fade.



Brace for impact

- We are experiencing the fastest, broadest, and steepest hiking cycle in 40 years. Noting, monetary policy typically takes 12-18 months to show the full effects.
- We are also experiencing a significant shift toward liquidity contraction and/or QT, following more than 10 years of constant positive liquidity support via QE.
- Since March, financial institutions have tightened lending standards. Similar to monetary policy's long and variable lags, this level of tightening has typically led to recessions, with the onset lagging by approximately 6-9 months.
- Ultimately, higher rates matter. Tightening of credit conditions matters. QT matters. The long and variable lags have these three significant forces converging in Q42023 and into Q12024. **It's only a matter of time.**



QT - the straw that broke the (bond) market's back?

- The increase in US government borrowing has led to increased issuance of US bonds. This is while the Fed is attempting to implement QT again. Meaning, the previously largest buyer of US Treasuries, the Fed, is not a buyer anymore.
- As such, bond markets are increasingly concerned about "who will buy?" all the new issuance.
- We believe the imbalance will be further impacted by other significant buyers of US Treasuries, including China, Russia, and Japan, who are increasingly absent.
- Fundamentally, the bond market appears to be disconnecting from the softening economic cycle, and if this drift higher in yields continues, it will place even further pressure on the economy and financial markets.



Higher for longer? Well, until something breaks

- Our base case is for a cyclical recession, such as experienced in 2001. However, financial markets are not the economy, and like the 2001 "tech crash," we note the potential for a harder landing for financial markets this cycle.
- We would caution that "higher for longer" is not something to celebrate. "Higher for longer," particularly in such an indebted system, is not conducive to a soft landing at all. The more time that goes past, the more likely things will break in the financial system and the more likely a hard landing occurs, in our view.
- We do not believe the central banks will realise their aspirations of "higher for longer," given the converging of considerable monetary, credit, and liquidity tightening inevitably triggering further financial market dislocation.

Investment implications



Our investment outlook

- A **volatile (but delayed)** risk environment for markets is expected, necessitating a **prudent** investment approach.
- Our focus remains on defensive investment positioning, watchful for shifts in **liquidity** that could suddenly arise.
- **History** guides that bond yields decline once the hiking cycle has clearly peaked, and thus we remain **positive on bonds**.
- Global **credit** markets have been resilient, but we maintain a **cautious** outlook as valuations are pricing limited downside scenarios.



Rates/duration view

- Central banks are likely **near the end** of their hiking cycles, though remain highly “**data dependent**” as to the path ahead.
- While further rate hikes may be possible should resilience in key data (e.g. in US labour markets) remain, the restrictive nature of tightening to date combined with a consistent decline in inflation suggests **bond valuations are attractive** and are supportive of elevated duration exposure.
- We **favour the front-end** of curves, where yields are relatively insulated from bond supply and demand-related concerns, as we approach the end of the cycle.



Credit view

- **Credit spreads** do not reflect the heightened volatility backdrop for markets and the uncertain economic outlook, and as such we **remain cautious** on the broad sector.
- We believe the lagged effect of significant tightening will impact the broader economy, leading to **earnings and ratings pressure**.
- Our **outlook** for credit **remains defensive**, however, nuances across markets are providing individual opportunities to add value. We expect to add to credit exposures at more attractive levels.



Emerging markets debt view

- The **global backdrop** continues to be the **main driver** for the asset class, with spreads on hard currency debt remaining stable compared with same-rated global credit.*
- Corporates with proactive balance sheet management, and reform-minded sovereigns with buffers are favoured, although **valuations remain tight**.
- We maintain a **neutral view** on the asset sector and look to increase exposure as valuations/environment improve.



Structured products view

- Fundamentals bottomed in the wake of the historic tightening of the monetary policy, however, we believe a **sustainable recovery is underway** in US housing.
- We see opportunities in mortgage-backed securities (MBS), especially **US agency-backed MBS**, which we feel are **offering attractive spreads** backed by robust structures and stronger credit fundamentals.
- **Commercial MBS** spreads remain at historical wides, though face challenged fundamentals.*



Currency view

- **USD** – The US dollar has been caught in a range unlikely to be resolved in the near term, though our medium-term view is for structural weakness to present.
- **EUR** – Widening EU-US yield differentials and weakening external sentiment are likely to weigh on valuation of the euro.
- **AUD** – Decoupling from global equity markets has occurred, and further weakness in the Australian dollar is expected while Chinese economic weakness persists.
- **JPY** – Yield curve control adjustments have impacted the Japanese Yen, though a broader shift of monetary policy is required to halt the decline.

Source: Macquarie. Views as of September 2023, subject to change without notice. This market commentary does not constitute legal, tax accounting or investment advice. US dollar (USD), Euro (EUR), Australian dollar (AUD), Japanese yen (JPY). *Bloomberg, 2023.

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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.

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.

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.

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.

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.

Investments in collateralized loan obligations (CLOs) may involve risks. CLOs are securities backed by a pool of debt, often low-rated corporate loans. Investors receive scheduled debt payments from the underlying loans but assume most of the risk in the event that borrowers default.

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 U.S. 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.

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.

Quantitative easing is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increased the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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.

Economic trend information is sourced from Bloomberg unless otherwise noted.

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