



ESCALA
PARTNERS

March 2022

MONTHLY AGENDA - THE LONG AND WINDING ROAD

The long and winding road

The road to a recession is long and winding. The journey typically begins in the bond market, then passes through the equity market, influencing the rate hike cycle along the way before finally arriving at a recession anywhere from 7 to 24 months later.

We haven't quite embarked on this journey just yet, the bond market at this stage is still pointing to slower growth but not a recession, but we may not be too far from it. What should investors expect when the final boarding call is made?

The path that leads to a recession is reflected in the table below. The table documents past yield curve inversions and the time from those inversions to an equity market peak, a rate hiking cycle peak and ultimately a recession.

Yield curve inversion	Recession start	Months after inversion	S&P500 peak	Months after inversion	S&P500 % change inversion to peak	Fed Funds peak post inversion	Months after inversion
Dec-56	Aug-57	8	Jul-57	7	4.6	Oct-57	10
Sep-59	Apr-60	7	Dec-59	3	6.2	Oct-59	1
Dec-67	Dec-69	24	Dec-68	12	11	Aug-69	20
Mar-73	Nov-73	8	Jan-73	-2	-3.5	Sep-73	6
Aug-78	Jan-80	17	Jan-80	17	19.8	Mar-80	19
Sep-80	Jul-81	10	Nov-80	2	12.9	Jan-81	4
Jan-89	Jul-90	18	May-90	16	30.6	Feb-89	1
Feb-00	Mar-01	13	Aug-00	6	4.9	May-00	3
Dec-05	Dec-07	24	Jan-07	13	14.5	Jun-06	6
		14.3			8.2	11.2	7.8

Three points can be made about the table:

- First, the bond market is a good leading indicator of recession in the economy. On average, the yield curve has given a 14 month heads up of a recession ahead but can range from 7-24 months.
- Second, an inversion is not necessarily immediately bad for equities. On average, the S&P500 has risen by 11.2% after the curve inverts.
- Third, in each of the past episodes, the US Federal Reserve has continued to raise interest rates past the point of inversion. It could be argued that this was the policy mistake that ultimately led to a recession. In the modern era the Fed has been more sensitive to the signals being sent by the bond market. On average, the rate hike cycle has ended just over 3 months after the inversion in the past 30 years compared with 10 months in the 40 years prior. Of course the difference now is inflation, the current high level of which may mean the Fed is less responsive to an inversion this time.

That is the history, what should we expect in this current rate hike cycle?

The bond market starting point

Credit is the blood that flows through the economy that makes it grow. The cost of that credit is determined by the bond market being the conduit as it is for central bank monetary policy decisions. It is for this reason, when looking for what is ahead for the economy, investors should always begin with the bond market.

What is the bond market telling us at the moment?

Certainly the market has been warning of slower growth ahead for some time. The chart below shows how the steepness of the yield curve (the difference between long-term



yields (10-year) and short-term yields (2-year)) has changed through time. When the yield curve is steepening, as was the case for the 12 months from the bottom of the pandemic in March 2020, it suggests faster economic growth ahead. When the curve is flattening, as it has been doing since March 2021, it suggests slower growth ahead.

Chart 1: US yield curve flattening pointing to slower economic growth ahead (bpts)



Source: Bloomberg

An “inverted” yield curve is when long-term yields fall below short-term rates - the chart above moves below zero. Under such circumstances, the bond market is suggesting growth in the future is going to be so weak that interest rates in the future will need to be reduced – in other words, a recession. With just one exception (1966) every yield curve inversion has led to a recession in the US.

There are a couple of interesting points to make about the above chart.

- First, it shows we are closer to the point of inversion than at anytime in the past two-and-a-half years.
- Second, the yield curve normally begins to flatten *after* the central bank begins to raise interest rates. The last rate hike cycle in the US began in December 2015 and continued to December 2018. The curve began flattening once the rate hike cycle had been underway for a year and continued up to 3 months before the Fed stopped raising interest rates. This time, the curve has been flattening for a full year *before* the rate hike cycle began. Clearly, the bond market feels the Federal Reserve is late to the rate hike cycle.

The Federal Reserve now seems to have gotten this message. We should expect to see it act faster in raising interest rates than it has done in the past.

The concern is, whenever something travels at speed there is a risk of an accident. Markets prefer to be gradually guided down the rate hike path, not jolted down it. In the past six months, the Federal Reserve has done just that. Jolting the market by lifting its expectations of rate hikes from zero in September, to three in December, to now 7 in March. The Fed Chair is even talking about lifting rates in much larger increments than traditionally has been the case.

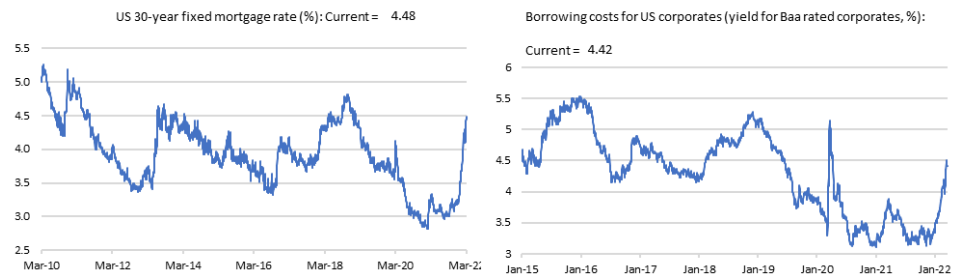
The chart below shows how this jolt is affecting markets. The chart shows how the cost of borrowing has risen significantly for both households and corporates just in the past three months. The move, particularly for households, has been large and rapid.

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Chart 2: The cost of borrowing for households (left) and corporates (right) (%)



Source: Bloomberg

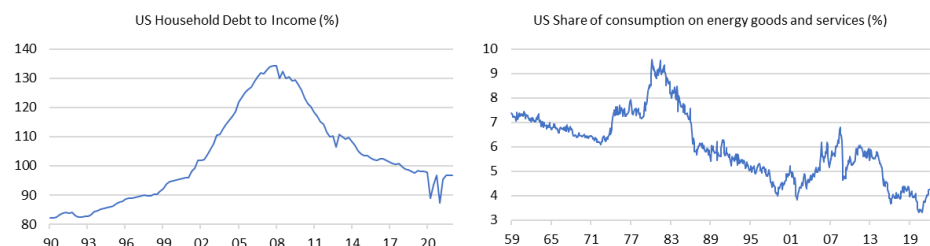
The equity market and policy peak along the way

Equity markets typically peak after the yield curve has inverted because it takes time for the higher cost of borrowing to feed into changes in corporate and household behaviour.

The jolt in rate hike expectations that we have seen from the Fed in the past 6 months has piled on significant pressure for households and corporates in a relatively short period of time. Fortunately, households and corporates are well placed to absorb this jolt.

Unlike in Australia, US households have a relatively low level of debt-to-income. The chart shows US household debt is back to levels last seen in 2001. So while interest rates are rising, the impact on the household budget will be small relative to history.

Chart 3: US household exposure to interest rates and energy prices



Source: Bloomberg

While the war in Ukraine is putting upward pressure on energy prices, the chart on the right above shows the share of total US consumption spent on energy goods and services is low at just 4.2%. This is well down from the peak of 9.5% in 1980 and comes despite record gasoline prices.

The labour market in the US also remains robust meaning anyone who would like a job can get one. Indeed, there are more job openings in the US currently than there are people to fill them.

US corporates are similarly in a healthy position with cash on balance sheet at record highs (as reflected in Amazon's recently announced \$10 billion buyback plan) and leverage ratios at record lows.

Corporate profit margins are also at record highs. While the higher costs of transport, labour and energy will pressure that, for the most part, margins are holding up. Bloomberg have noted that 62% of reporting companies have beaten forecasts for net income margin - though less than half did on operating margin. Bloomberg also find that fourth quarter earnings growth is expected to come in at 28%.



Recessions' door

The final destination on this long and winding road is recession. In the past 65 years that has been as long as 24 months after the inversion.

The change in behaviour that results from higher borrowing costs for corporates and households is a reduction in spending and or a cut in costs. This is when the economy begins to be affected. Unemployment begins to rise, business investment begins to fall, consumption eases and ultimately corporate earnings fall.

In our view we are still some way from recessions' door. Unemployment has been falling since April 2020 and now stands at 3.8%. US households' still have two trillion in excess savings as a cushion.

There is still a need to be cautious, however, and to be active in your investment style as idiosyncratic risk is high. How a company is performing depends more than ever on how well it has managed its inventory cycle and its supply chain; how exposed it is to higher commodity prices and labour costs; and how it has managed its debt levels.

Such is the case with vehicle manufacturers (hit by ongoing semiconductor shortages) and with food and beverage manufacturers (hit by higher input costs).

Even within industries, idiosyncrasies are present. In the home improvement sector Lowe's reported a stronger margin due to improved productivity while Home Depot reported a decline in margin and is struggling to meet high demand given its low inventory levels.

Not all retailers are the same either. Target has not been able to pass on all costs and its margin has fallen as a result. Walmart on the other hand beat fourth quarter earnings estimates and announced a share buyback of at least \$10 billion. The company said it navigated supply chain costs well and a decline in Covid costs helped offset other costs. Walmart avoided a margin decline despite higher transportation, labour and merchandise costs.

The longer higher input costs, including higher wages, transport and commodity prices remain, the more likely it is that behaviour will change in a way that impacts the economy. Navigating the long and winding road is hard enough. The global pandemic and now the war in Ukraine has made that task so much harder.

Be active in your investment style

At the very least, we expect volatility to remain a feature of listed markets this year.

Overall, we are now slightly underweight listed equities but with a preference for Australia.

Investment implications

At the very least, we expect volatility to remain a feature of listed markets this year. We have been careful to only take on the investment risks worth taking. In this regard we have avoided fixed rate bond duration risk preferring shorter dated and floating rate bonds. We have reduced our allocation to emerging markets, small cap companies and to European large caps. We have hedges in place if commodities and inflation remain elevated and have most recently increased our allocation to private equity out of public equity. Overall, we are now slightly underweight listed equities but with a preference for Australia.

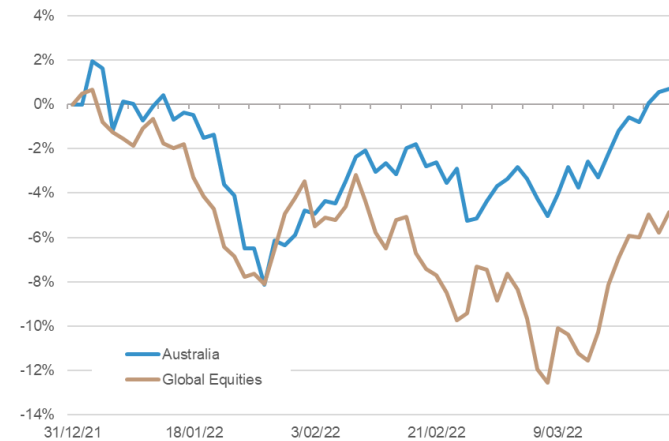
We remain 100% unhedged in our listed international equities exposure as we see this as a safety net in the event global equities fall (as the USD tends to rise in that event). We believe private markets will be a less volatile part of the market while still giving us exposure to equity risk.



Asset Class View

Australian Equities

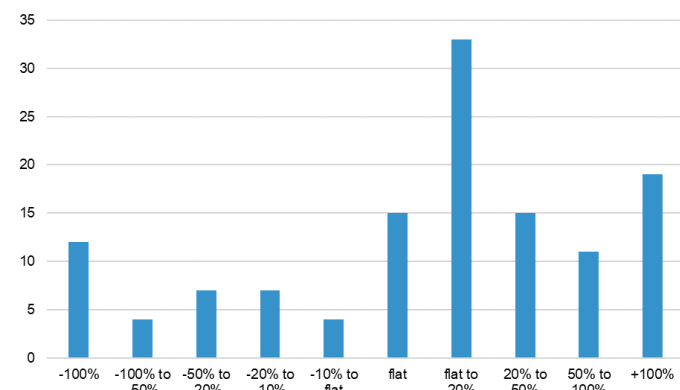
Chart 4: Australian equities – in positive territory for 2022



Source: Bloomberg

Despite the negative macro headwinds of tightening monetary policy and geopolitical events, the Australian equity market is one of the few regions in positive territory for 2022. Domestic equities have been supported by a solid half year reporting season and strong commodity prices. The latter factor has been even more significant over the last several weeks following the disruption triggered by the conflict in Ukraine.

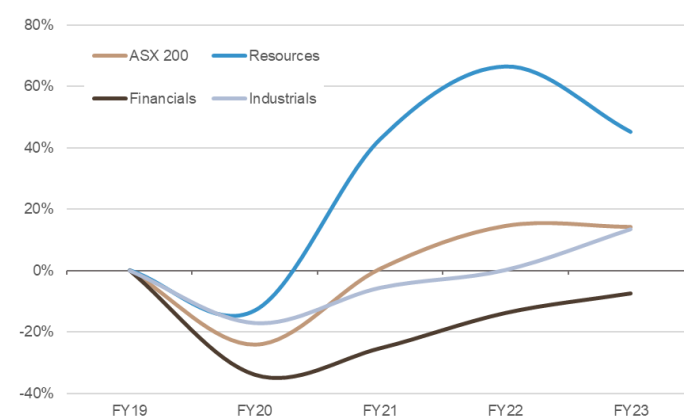
Chart 5: Dividend recovery continues through reporting season (dividend change – no. of companies)



Source: Iress

The dividend recovery continued through February's half year reporting season, with a significant number of companies increasing their dividend from last year. Large dividend increases were driven by the resources sector, which has been the beneficiary of buoyant commodity markets. Key stocks to cut their dividends were largely those companies who had inflated earnings through the COVID lockdowns of the last two years, particularly in the retail sector.

Chart 6: ASX 200: Cumulative EPS growth



Source: Goldman Sachs

While all key sectors of the Australian equities market have participated in the earnings recovery from the height of the COVID crisis, resources have continued to provide material support through this period. For FY22, earnings from the resources sector are now expected to be more than 60% higher than pre-COVID levels, before moderating in FY23.



Asset Class View

International Equities

Chart 7: Russian invasion bad for European banks



Source: Bloomberg

For the first six weeks of 2022, banks were the best-performing sector in Europe. In recent weeks, they've been the worst. A year-to-date gain of as much as 16% in the Stoxx Banks Index has become a drop of 14% as optimism over the benefits of rising bond yields has been displaced by concern over the impact of war in Ukraine and what that may mean for monetary policy normalization and rate hikes. The decline has been most pronounced for those with the biggest Russian exposure with Austria's Raiffeisen plunging 54% in that time, and Societe Generale losing 37%. The tailwind provided by yields earlier in the year is fading as traders reprice the odds of central banks raising rates.

Chart 8: Higher commodity prices should support emerging markets



Source: Bloomberg

Meantime, grain markets are jumping, with wheat and corn surging. Ukraine and Russia account for more than a quarter of the global trade in wheat, about a fifth of corn sales and 80% of sunflower oil exports. Drought in South America is also dimming the outlook for soybean supplies, while palm oil is rising amid a labour shortage in Malaysia.

Fertilizer shortages loom too, as Russia is a low-cost, high-volume global producer, and it's the world's second-largest potash producer after Canada. And of course oil is skyrocketing.

Chart 9: Chinese equities struggling (CSI 300 index)



Source: Bloomberg

Investor angst has been high for months about China's tech, property and education sectors, which have been mired in regulatory crackdowns. The latest on new regulations is that China will ask car-hailing apps to set limits on commissions. This comes after the news that top state economic planners have demanded Meituan and its peers to lower the fees they charge restaurants in pandemic-hit regions.

Adding to the unease are tensions with the US where the SEC is expanding its list of issuers under the Holding Foreign Companies Accountable Act, potentially making Chinese companies delisting from U.S. exchanges.



Asset Class View

Fixed Income

Chart 10: US 2-year bond yields price an aggressive Fed (%)



Source: Bloomberg

St. Louis Fed President Jim Bullard wants to go way back to 1994, the last time the Fed executed a 'soft' landing, to model the central bank's current policy moves. Bullard said that he sees the neutral rate at 2.0% and therefore, he wants to go to 3.0% this year to be mildly restrictive. Bond investors have responded to the more aggressive stance adopted by the US Federal Reserve in recent weeks by pushing 2-year bond yields sharply higher.

Chart 11: But the risk is it sends the economy into recession (US 2-10 yield curve (bpts))



Source: Bloomberg

The move by bond investors to send 2-year bond yields sharply higher is causing the yield curve, the difference between 2 and 10-year yields to flatten. Since the start of the year, the curve has fallen from around 90bpts to 17bpts currently. Historically, whenever the difference between 2 and 10-years has turned negative, a recession has followed, albeit with a lag as much as 24 months.

Chart 12: Australian bonds also looking for higher rates from the RBA (3-year yield (bpts))



Source: Bloomberg

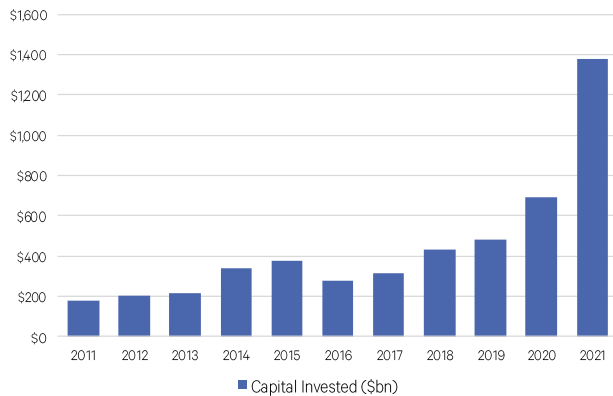
Jay Powell's comments that the U.S. central bank is prepared to hike 50 bps if necessary saw the Australian market lift 3-year yields to levels not seen since 2018. The market is currently expecting the Reserve Bank to raise rates 6.5 times this year with the first rate hike to be delivered in June.

That's all fine, but RBA governor Phil Lowe has made wage growth central to the Australian path to policy normalization. The March quarter wage print on May 18 now looks far away as markets continue to show zero patience with Lowe's patient stance.

Asset Class View

Alternatives

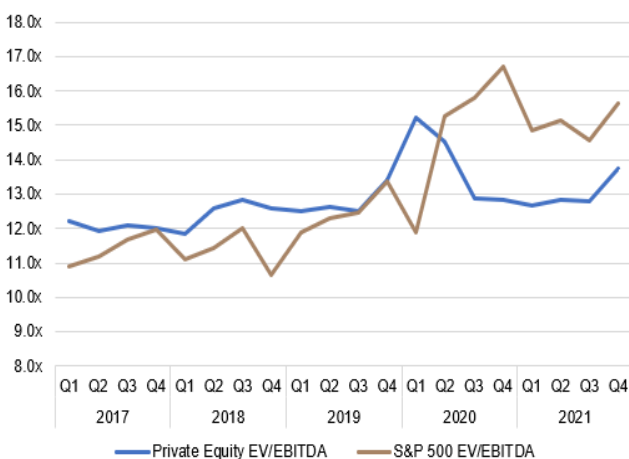
Chart 13: Hedge fund participation in private markets



Source: Morgan Stanley Research

Hedge funds participated in a record number (circa 1,400) of private markets deals in 2021, or two times the 2020 level, and nearly three times 2019. In aggregate, hedge funds, along with other investors, deployed \$180 billion in private transactions; that accounted for 15% of total private markets deployment versus historical hedge fund participation in the low single digits. Opportunities from hedge funds ramping up participation in privates include the expectation of higher returns, enables participation in faster growing private markets and the reduction of overall fund return volatility.

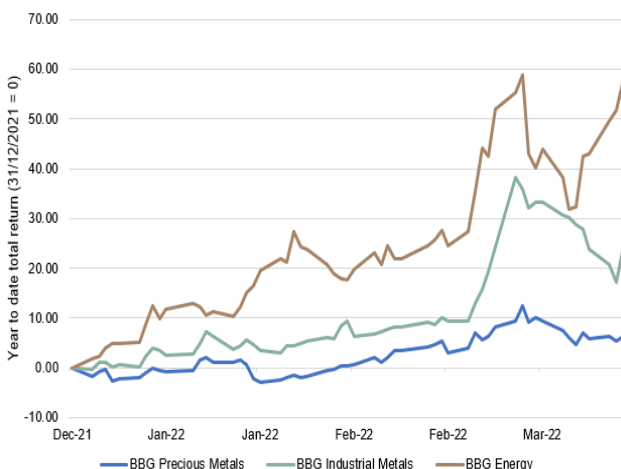
Chart 14: Private equity valuations attractive versus public



Source: Pitchbook

PE company Enterprise Value to Earnings (EV/EBITDA) multiple valuations remain below their public equivalent as the median valuation for PE markets was 13.7x compared to 15.6x for the S&P 500. At a time of rising valuations across all markets as we saw throughout 2021, many PE managers are pursuing value creation strategies such as buy-and-build and add-on approaches where they will look to buy market leaders in industries with strong tailwinds and acquire smaller competitors at lower valuation multiples to build global platform style businesses at a cheaper cost to public listed comparable companies.

Chart 15: Commodities continue to push higher



Source: Bloomberg

Commodity markets have been some of the best performing markets year to date with the Bloomberg Commodities Energy sub-Index up 57.2% and the Industrial Metals sub-Index up 27.4% whilst Precious Metals have lagged up just 8.1%. Research has shown that commodities have performed strongly during previous Federal Reserve tightening cycles with energy and industrial metals performing the best during these periods. Adding to current strength in these markets is the ongoing geopolitical uncertainty in Russia and Ukraine causing prolonged supply disruptions to many markets and a pick up in demand for many industrial metals from China in recent months which may keep commodity prices elevated for some time.

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