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MACQUARIE ASSET MANAGEMENT

Delayed reaction, liquidity contraction

Macquarie Fixed Income Strategic Forum 2023 | Issue 01

Key takeaways

- **Delayed reaction**: Inflation is slowing across the globe and central banks have been slowing down the magnitude of the rate hikes. However, the significant tightening of monetary policy in 2022 has yet to reveal its impact on the economy and markets…**mind the lags.**
- **Inflation, it's so last year**: Inflation has peaked with supply recovering while demand has cooled amid the most aggressive monetary policy tightening in decades.
- **Most anticipated recession:** The global economy heads into the highly anticipated recession in a stronger position than past cycles (resilient balance sheets and savings), hence it could be a cyclical shallow recession. However, there are more downside risks as the effects of the significant tightening have yet to be felt. Consensus is expecting a recession this year, but the real question is whether it will be a soft or hard landing for financial markets.
- **Liquidity:** We had a very long period of quantitative easing (QE), with ample liquidity and significantly low interest rates and cost of capital, which supported asset prices. We are currently in the opposite environment of quantitative tightening (QT), high levels of interest rates and cost of capital, **but asset prices have not readjusted lower**. Because of this, we are mindful of a **liquidity contraction.**

Investment themes

Delayed reaction

- To bring inflation under control, central banks, led by the US Federal Reserve, have undertaken the most aggressive tightening cycle in decades, coupled with quantitative tightening (QT). The Fed in particular has done so without waiting for the impact of the significant rate hikes to take effect.
- Aggressive tightening cycles of the past, such as former Fed Chair Volcker's 1980s policy action, were into economic conditions drastically different from today's indebted modern economy, i.e. this cycle is occurring in one of the most indebted global environments of all time. High debt and higher yields do not mix well.
- We are in the twilight zone, where there is a gap between the action and the reaction…mind the lags!

Inflation, it's so last year

- The focus and discussion in 2022 was all about inflation, but the peak in inflation is now clearly visible and behind us.
- Our view is that the majority of inflation experienced was caused by twin supply shocks from the pandemic and then the war in Ukraine. In early 2023, it is clear that supply is and is returning toward normal. Barring any further shocks, it is unlikely that supply issues will remain.
- Given the aggressive central bank action targeting demand deceleration, the inflation outlook is now also being affected by reducing demand.
- The combination of improving supply and reducing demand should result in much lower levels of inflation. As a result, much of the concern around inflation that has existed for the past two years appears to be disappearing.

The most anticipated recession

- Our recession alert process is clearly pointing to a recession in 2023. The debate therefore centres on the depth of recession.
- This will be determined by the interaction of a gradual rebalancing of supply shocks with the impact of an impending demand shock resulting from significant policy tightening on households and businesses.
- Ultimately, we believe global growth is slowing, and a recession is likely by the end of 2023 – maybe a cyclical shallow recession; however, the risks are more to the downside and could drift to becoming a harder recession than many currently anticipate.
- But the real question should be, will financial markets have a soft or hard landing? There may be a soft landing in the economy, but that does not necessarily mean the same for markets.

Liquidity contraction

- Financial markets were significant beneficiaries of lower and almost zero interest rates or cost of capital and incredible amounts of liquidity (QE) that suppressed volatility.
- But as we enter 2023, we have a much higher cost of capital with unknown impacts on economic growth. While in financial markets, we have much higher volatility, and we are also experiencing significant liquidity contraction.
- This environment is a significant adjustment for global economies and financial markets, which have grown very accustomed to zero rates, low cost of capital, and ongoing liquidity support since the global financial crisis.
- It is difficult not to have concerns that perhaps the current improved sentiment in financial markets is temporary, particularly considering the lagged impacts of aggressive monetary policy tightening that are yet to be felt.

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

Investment implications

Our investment outlook

- Remain **focused on downside risks** – markets are still responding in lag to the level of change in liquidity and borrowing costs.
- **Bonds are now an attractive** asset class in this environment, particularly given our outlook for recession.
- **Maintain a cautious outlook on global credit markets** but also recognise pockets of opportunities presented.

Constructive: Rates/Duration

Bonds are offering an **attractive investment proposition** both as a **recession hedge** and as an **outright source of yield for a defensive asset allocation,** although short-term volatility may remain.

Cautious: Risk markets

Defensive outlook – market valuations across the credit spectrum, including credit, structured securities, and emerging market debt, have likely **not fully reflected downside risks** such as a weaker economic outlook and liquidity withdrawals.

Constructive: Cash

Heightened importance of reserving dry powder for pockets of opportunities

We are conservatively positioned given the delayed reaction to monetary policy as well as liquidity contraction, which we anticipate will impact financial markets.

Source: Macquarie. Views as of Q1 2023, subject to change without notice.

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Diversification may not protect against market risk.

Important information

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt. This includes prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

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.

SUMM-MFI-SF-2023-ISU1-USR (**2715246** – 01/23)