

Multi-asset review Q3 2023



Here our Multi-Asset team discusses Russell Investments' performance in the September quarter and their outlook for the remainder of 2023.

What drove markets during the third quarter of 2023?

The September quarter was a challenging one for financial markets amid concerns that global interest rates will need to stay higher for longer to combat inflation. Growth assets largely underperformed their defensive counterparts over the period.

Several events helped shape market movements over the quarter:

1. US Federal Reserve raises rates, flags one more. The US Federal Reserve (Fed) raised interest rates just once over the period; the Bank lifting its benchmark fed funds rate by 0.25% to a target range of between 5.25% and 5.50% in July. The Fed left rates on hold when it met again in September but flagged one more increase in 2023, with the Bank's latest projections implying the benchmark rate will peak this year at a target range of between 5.50% and 5.75%; or 0.25% above the current range. Whilst inflation in the US has fallen sharply since its June 2022 peak, it nonetheless remains well above the Fed's 2.0% target, while growth and the labour market have so far proven remarkably resilient to sharply higher interest rates. Adding to the hawkish tone were expectations that interest rates will remain higher for longer, with officials now projecting just two rate cuts next year. This is down on the four rate cuts the Fed forecast back in June. Elsewhere, both the European Central Bank (ECB) and the Bank of England (BoE)

raised interest rates in the third quarter. The ECB lifted its main refinancing rate from 4.00% to 4.50% but signalled that its latest (September) move will likely be its last for this cycle. The BoE raised its benchmark interest rate from 5.00% to 5.25% in August before hitting the pause button at its September gathering amid evidence that growth and inflation in the region are cooling. Meanwhile, the Bank of Japan (BoJ) left its key short-term interest rate unchanged at -0.10%; though the Bank did surprise the market by loosening its yield curve control policy in July.

2. Reserve Bank of Australia leaves rates on hold. The Reserve Bank of Australia (RBA) left the official cash rate unchanged at 4.10% throughout the period. Having raised interest rates by 4.00% since May last year, the Bank hit the pause button for a second time in July, with officials noting that higher interest rates are working to establish a more sustainable balance between supply and demand in the economy (and will continue to do so). Leaving rates on hold will also provide some time to assess the impact of the material increase in interest rates to date and the economic outlook. In its September post-meeting statement, the RBA said that whilst inflation in Australia has passed its peak, it's still too high and will remain so for some time yet. The Bank's central forecast is for inflation to continue to decline and to be back within its 2-3% target range in late 2025. In terms of the economy, the RBA acknowledged that the current

period of below-trend growth is expected to continue for some time, while conditions in the labour market remain tight; though they have eased a little. The unemployment rate, which currently sits at 3.70%, is now expected to rise gradually to around 4.50% late next year. The RBA concluded its September meeting by saying some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe; though that will continue to depend upon the data and the evolving assessment of risks. *[Note: the RBA left the official cash rate unchanged at 4.10% following its early October meeting.]*

Global shares fell 2.7%¹ in the September quarter. Australian shares were also weaker; though they did outperform their global peers, returning -0.8%². Much of the decline was driven by increasing speculation that interest rates may need to rise further and remain higher for longer amid stickier-than-expected inflation. The local market was also impacted by weakness across the major miners, which together comprise a large part of the index, a series of mostly softer domestic economic data and concerns over China's growth prospects. Emerging market equities achieved a modest absolute return of 0.1%³ for the quarter. However, they outperformed their developed counterparts over the period.

The Australian dollar (AUD) fell in the third quarter, with the Australian Trade-Weighted Index closing the period down 1.0%⁴.

Interest rate sensitive assets were also weaker, with global and domestic listed property, global listed infrastructure and global and Australian bonds all underperforming over the period.

Credit markets were mixed. Spreads on US and European investment-grade debt narrowed over the period, as did spreads on European high-yield debt. However, spreads on US high-yield debt were wider; though only slightly. Both

hard and local currency emerging markets debt underperformed.

How did Russell Investments' active multi-asset portfolios perform in the September quarter? What was rewarded by the market and what wasn't?

Absolute returns. The Russell Investments Balanced Fund returned -1.5%⁵ for the quarter on a net of fees and tax basis. Performance was driven primarily by negative absolute returns from the Fund's equity and traditional fixed income exposures; both of which moved lower in response to a more hawkish Fed and higher bond yields.

Returns relative to fund benchmark. The Russell Investments Balanced Fund underperformed its strategic benchmark by 0.5% on a net of fees and tax basis.

Positive contributors included:

- Positive excess returns from global equity sector funds.
- Positive absolute returns from extended fixed income assets such as private credit and floating rate loans, which outperformed cash.

Negative contributors included:

- Negative excess returns from Australian equity sector funds.
- An overweight to duration; positioning which was impacted by higher bond yields.

What is Russell Investments' outlook for the remainder of 2023? How is it impacting your active multi-asset positioning?

Markets have faced multiple concerns in the past 12 to 24 months; including Russia's invasion of Ukraine, surging inflation, central bank tightening, a slowing Chinese economy and regional banking

¹ Global shares measured by the MSCI World ex Australia Net Accumulation Index (in local currencies)

² Australian shares measured by the S&P/ASX 300 Accumulation Index

³ Emerging markets measured by the MSCI Emerging Markets Index Net (in AUD)

⁴ The trade-weighted index for the AUD is an indicator of movements in the average value of the AUD against the currencies of our trading partners. Source: Reserve Bank of Australia.

⁵ Source: Russell Investments. Past performance is not a reliable indicator of future performance.

crises in the US and Europe. Despite these events and more, the US economy has so far proven remarkably resilient, with markets continuing to price in a 'soft landing'; though we are seeing several leading economic indicators flash warning signs.

Our composite contrarian indicator, which measures overbought versus oversold levels for the US S&P 500 Index via a range of technical, positioning and survey indicators, has continued to soften as equity markets moved higher and is no longer at oversold levels. It's currently sitting close to neutral after the equity market pullback we experienced in August.

The main uncertainty for markets is the outlook for the US economy. Whilst economic data so far this year has proven more resilient than markets initially expected, our base case remains that a recession in the US is more likely than not. The upside risk for the US economy and markets comes from the possibility that US core inflation has peaked. This, combined with some softening in the labour market, could allow the Fed to become less hawkish later this year and into 2024.

Non-US developed equities are relatively cheaper than US equities and likely to benefit from weakness in the US dollar (USD) should the Fed become less hawkish. However, until the Fed does become less hawkish, we maintain a neutral preference for non-US developed equities. Within the equities space, we prefer the quality factor,

which tracks stocks that have low debt and stable earnings growth.

For fixed income assets, we believe US, UK and German government bonds offer reasonable value. In the US, the spread between two- and 10-year government bond yields is close to an extreme. The yield curve has steepened in recent months, which we had anticipated given that this tends to happen when the Fed finishes raising interest rates and markets start looking toward rate cuts. Meanwhile, Japanese government bonds look expensive despite the BoJ's recent announcement regarding their yield curve control policy.

In the currency space, the USD has strengthened over the past couple of months amid speculation that US interest rates will remain higher for longer. At current levels, the USD is expensive in real, trade-weighted terms. Meantime, the Japanese yen looks attractive from a cycle, value and sentiment perspective, while the euro appears significantly undervalued in terms of purchasing power parity.

The bottom line is that investors are worried about slowing growth and the potential for an aggressive Fed to cause a recession; though these concerns have softened of late. Recent indicators support our view that US core inflation can trend lower through the remainder of 2023, but the key question is by how much. A sustained move lower would ease fears around excessive Fed tightening and a deep recession. However, until this becomes apparent, markets are likely to remain volatile.

For more information, please contact your Russell Investments representative



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