Endorphin Wealth

October 2023

Asset Allocation Report

Oreana Portfolio Advisory Service
https://portfolio-advisory.com/
portfolio.advisory@oreana.com

Endorphin Wealth

Endorphin Wealth
endorphinwealth.com.au
advice@endorphinwealth.com.au

Endorphin Wealth

Asset Allocation Report

October 2023

Table of Contents

Monthly Market Review 3

Monthly Market Movements 4

Global Equities 5

Sovereign Debt 6

Corporate Credit 7

Foreign Exchange 8

Disclaimer 9

Source: Bloomberg LP, Oreana Portfolio Advisory Service

Endorphin Wealth

Monthly Market Review

Central banks have shifted commentary to a 'wait and see' narrative. The Federal Reserve, Reserve Bank of Australia, Bank of England and Bank of Japan all left rates unchanged in September. The European Central Bank delivered a 0.25% rate hike in September but President Lagarde hinted that it could be the last hike in the cycle. The Fed reiterated its higher for longer stance, indicating there may be one more hike this year and projecting only two potential rate cuts next year. The People's Bank of China cut the Reserve Requirement Ratio by 0.25% which was well received by markets that had been screaming for further stimulus.

Markets have started to accept the 'higher rates for longer' narrative, rattling both bond and equity markets. US equities suffered the worst month of the year so far, with the S&P 500 falling 4.9% in September. Australian stocks did marginally better with a 3.5% drop over the month. Chinese and Hong Kong stocks fell 2.0% and 3.1% respectively. Longer dated bond yields jumped to new cycle highs. The US 10 year soared 0.46% over the month. Better-than-expected data, US Treasury issuance, and the higher-for-longer narrative have pushed rates to highs not seen for over a decade.

Another US government impasse weighed on market sentiment, narrowly avoiding another partial shutdown with a bipartisan agreement signed at the end of the month. Core PCE - the Fed's preferred inflation measure - rose only 0.1% in August, and 3.9% over the 12 months, lower than forecasted.

US employment data in the US came in well above expectations with 336k jobs added compared with expectations of 170k – the highest addition since January. But under that blowout headline level, the unemployment rate held steady at 3.8% and wage growth nudged slightly lower.

The resurgence in oil prices poses a significant risk to global inflation and the economic outlook. Oil surged 9.7% over the month to its highest level since Q1 this year. That may signal increased physical demand for oil and would coincide with economic data, particularly out of China, coming in stronger than expected.

Monthly Market Movements

Interest rates (%)	Close	1 month	1 year	YTD
RBA cash	4.10	0.00	1.75	1.00
3-year Aus bond yield	4.08	0.34	0.56	0.58
10-year aus bond yield	4.49	0.46	0.60	0.44
Fed Funds rate	5.50	0.00	2.25	1.00
2-year US Treasury yield	5.04	0.18	0.76	0.62
10-year US Treasury yield	4.57	0.46	0.74	0.70
ECB rate	4.00	0.25	3.25	2.00
2-year German Bund yield	3.20	0.22	1.44	0.44
10-year German Bund yield	2.84	0.37	0.73	0.27
US IG Credit spread	1.35	0.02	-0.45	-0.12
US HY Credit spread	4.22	0.12	-1.80	-0.80

Commodities	Close	1 month	1 year	YTD
Brent Oil (USD/bbl)	95	9.7%	8.4%	10.9%
Gold (USD/oz)	1849	-4.7%	11.3%	1.3%

Equities	Close	1 month	1 year	YTD
S&P/ASX200 (Australia)	7049	-3.5%	8.9%	0.1%
S&P500 (US)	4288	-4.9%	19.6%	11.7%
FTSE 100 (UK)	7608	2.3%	10.4%	2.1%
DJ Stoxx 600 (Europe)	450	-1.7%	16.1%	6.0%
Nikkei 225 (Japan)	31858	-2.3%	22.8%	22.1%
CSI 300 (China)	3690	-2.0%	-3.0%	-4.7%
Hang Seng (HK)	17810	-3.1%	3.4%	-10.0%
MSCI World	2853	-4.4%	20.0%	9.6%

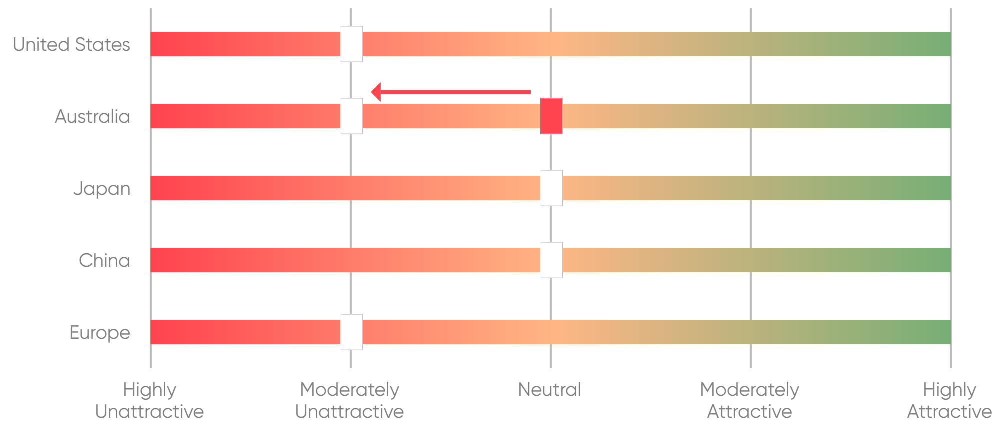
Currencies	Close	1 month	1 year	YTD
AUD/USD	0.6435	-0.8%	0.5%	-5.5%
EUR/USD	1.0573	-2.5%	7.9%	-1.2%
USD/JPY	149.3700	2.6%	3.2%	13.9%
GBP/USD	1.2199	-3.7%	9.2%	1.0%
USD/RMB	7.2980	0.5%	2.6%	5.8%
USD Index	106.1740	2.5%	-5.3%	2.6%

Source: Bloomberg LP, Oreana Portfolio Advisory Service

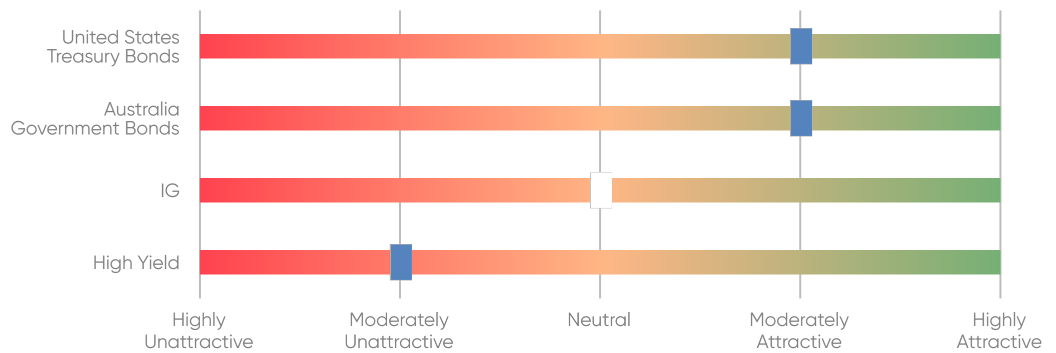
Asset Allocation Review

Endorphin Wealth

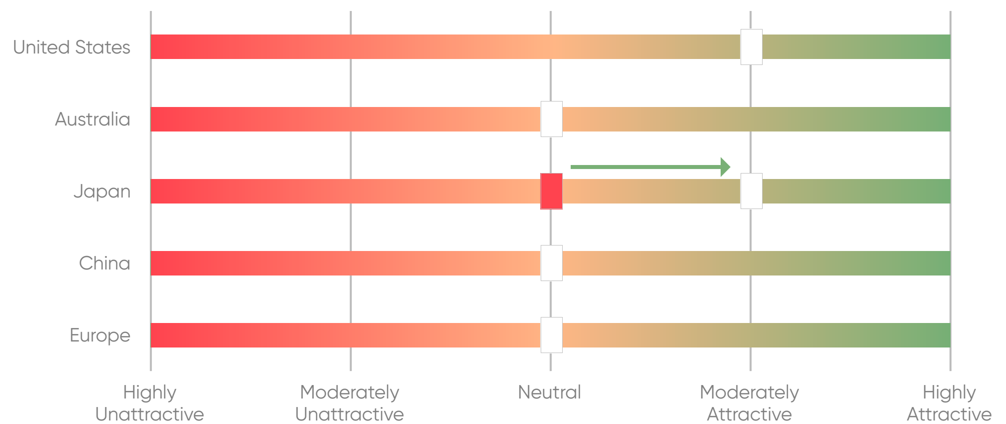
Equities



Fixed Income



Currency



The colour represents strength of conviction.

- Strong Conviction
- Moderate Conviction
- Low Conviction
- Represents a change from previous month's rating

Source: Bloomberg LP, Oreana Portfolio Advisory Service

Global Equities

Review: Global equities extended the bearish momentum further in September. US equities were down 4.9% in the month. The energy sector continued to be the only one in green while the 10 other sectors were in red. Improving economic data, resilient inflation number, and strong labour data has driven investors to price in a hawkish rate stance from the Fed. The Fed has been reiterating the determination to bring the inflation to the Fed's target of 2%,. There is a growing consensus that rates will likely be staying elevated for longer. The Fed did not hike in September, but forecasted another rate hike by the end of 2023. Investors are skeptical of economic sustainability given higher rates for long period of time, with cracks started showing in credit quality and demand. A government shutdown was barely avoided with a last-minute deal. This bought a focus on the US debt level and increased Treasury issuance, further lifting Treasury yields and causing equities to reprice lower with a higher discount rate.

Outside of the US, major equity markets also fell. Australian market dropped -3.5% while Chinese equities outperformed. Chinese economic data improved. High frequency data has shown strong demand. The Chinese government introduced stimulus to support the economy. Yet, the market kept its focus on weak recovery path in the property sector.

Our view: We expect volatility will persist in the near-term. The ongoing tightening of credit standards is a risk to the US economy. The economy is growing below trend and slowing inflation will likely result in a protracted earnings recession. An economic recession still seems more likely than not. WIth multiples and valuations at elevated levels, companies with earning misses will be at risk of being punished. We expect the US equities market rally is overdone and may struggle to deliver returns in line with historic norms over the near-term. Australian equities could follow the weakness with its economic reliance on commodities.

Recommendations:

- Downside risks remain material. We think quality value can contribute to portfolio resilience in this environment.
- We think geographical diversification can help smooth returns if there is a sudden downturn in equities.
- We have moved Australian equities from Neutral to Moderately Unattractive.

Chart 1. We expect equity returns will be somewhat weak relatively to history.

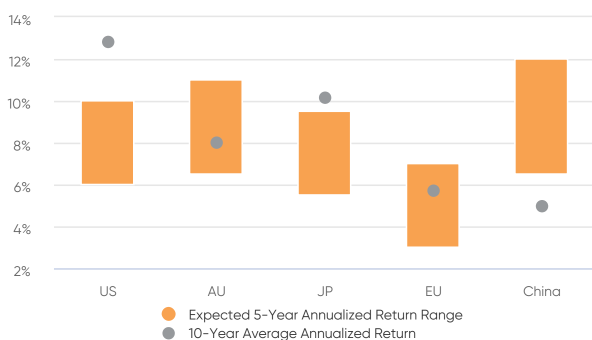
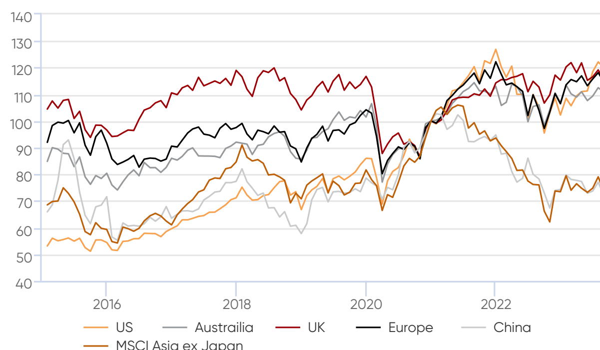


Chart 2. Global equities went lower in September.



Sovereign Debt

Endorphin Wealth

Review: Government bond yields soared last month as continued resilience in economic data meant markets started to accept the higher-for-longer narrative from central banks. Most banks have shifted to a wait and see approach with the Fed, RBA, Bank of England, and Bank of Japan all holding rates steady in September. The ECB delivered a 0.25% rate hike but signaled it may be the last in the cycle. Solid jobs data, rising oil prices, and solid industrial production out of China indicated that global demand has been somewhat resilient to rate hikes and inflation. Inflation has continued to trend lower across most developed economies. Shorter dated yields rose less than at the longer end, continuing to steepen the yield curve. We are keeping a close eye on that as the normalization of the yield curve (from inversion) has historically coincided with a recession.

Our view: The steepening of the yield curve signals markets are pricing the end of the rate hike cycle – a view we suspect will be proven correct as global inflation continues to moderate. Although sovereign debt has proved volatile over the first half of this year dragging somewhat on performance, yields have backed up to a level where government bonds offer significant scope for downside protection. Shorter dated yields are at a level where the income on coupons is substantial, whether there are significant moves in yields in either direction. While there is duration risk in longer-dated bonds, we expect yields to fall in case of a recession or economic downturn. Yields are at a rate now that if they do fall rapidly, they could provide equity-like returns over the next 12 months. We expect that the Fed is at - or close to - the end of the rate hike cycle. But the risk of policy error remains high especially in case of a resurgence in oil prices.

Recommendations:

- Allocating to sovereign bonds offers good risk-adjusted returns in the current uncertain environment.They provide significant downside protection in case of a recession, and reasonable income and diversification in a soft-landing scenario.
- We favour shorter-dated US Treasury yields at current levels, although some exposure to longer-dated yields is also useful protection against a deeper recession.
- At an asset class level, we recommend a moderately overweight allocation to soverign debt relative to Strategic Asset Allocation.

Chart 1. US and Australian government bond expected returns are much higher than recent history.

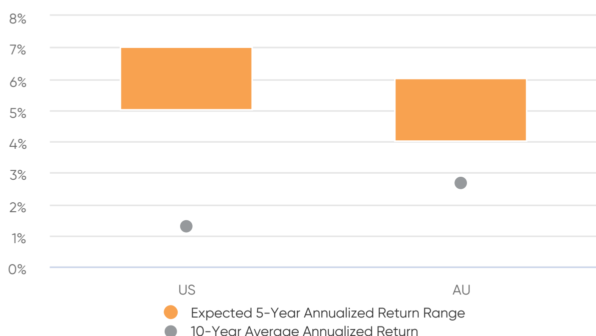
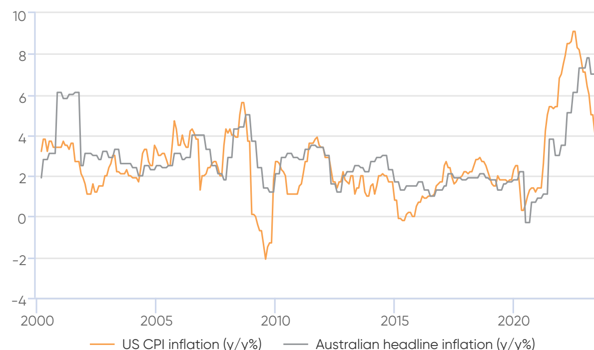


Chart 2. Headline inflation has ticked higher due to rising energy prices.



Corporate Credit

Review: Investment grade spreads were flat over the month while high yield widened. Returns were negative despite the relatively small moves in spreads on the back of the Treasury sell-off and markets settling in to higher rates for longer. The resurgence in oil prices may be starting to weigh on consumers. Economic weakness and persistent inflation continue to be a risk to the ability to service debt costs globally. Positive policy support in China helped improve sentiment in September and allowed Asian HY to outperform. But there are signs that developed market high yield markets are suffering reduced credit quality and a worrying increase in defaults in some credit markets.

Our view: The labour market has been a key pillar for investors pointing to a resilient US economy. That resilience has been downgraded in August as jobs growth was revised lower. The elevated Fed Funds rate and cooling economy has increased the risk of a recession in 2024. Weaker economic growth will likely prove a challenge to companies that are forced to refinance in 2024, even though spreads remain narrow so far. Current spread levels do not compensate investors for the growing risk of credit rating downgrades and defaults. This is especially the case in the lower high yield credit universe. That leaves significant downside risk to total returns in the near- to medium-term. Investment grade may remain somewhat insulated. But credit quality in investment grade has also deteriorated over recent years and we think there is risk of spread widening that could materially reduce prospective returns for these assets.

Recommendations:

- We retain a preference for higher credit quiality and shorter spread duration.
- We suggest investors focus on selecting experienced credit managers who have a proven ability through different economic cycles including recession.

Chart 1. Expected returns for investment grade credit are higher than they have been for several years.

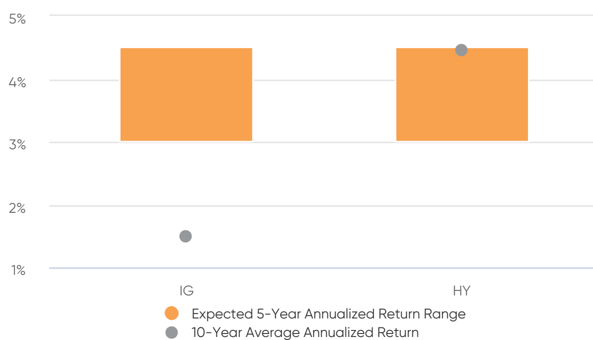
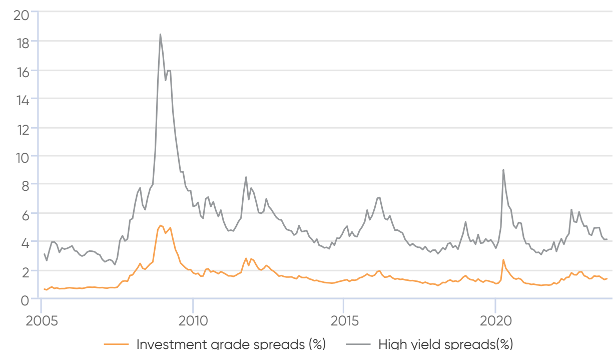


Chart 2. Credit spreads have remained in a tight range for several months.



Foreign Exchange

Endorphin Wealth

Review: The US dollar strengthened modestly against major currencies with rising yields attracting capital inflows to higher interest rate differentials. The currency has also been supported as a safe-haven as markets were rattled across asset classes last month. The GBP slid 3.7% against the USD on recession concerns as inflation has held up well above target and the economy showed signs of slowing. The AUD was supported with positive sentiment and policy stimulus in China. In Japan, the Yen remains weak and approached an important level at 150 versus the US dollar. This increased speculation that the Bank of Japan could intervene to prevent further weakness in the Yen.

Our view: The global rate hike cycle is nearing its end. Rising yields in the US has increased the attractiveness of the USD. Despite a resurgence in oil prices keeping headline inflation rates sticky, we expect a November hike from the Fed would be an error. A pause from the Fed could take some steam out of the US dollar in the near term. But the prospect for weaker global growth, and disappointing outcomes for investors that have predicted a soft landing, could support the USD. Investor uncertainty could keep rate differentials volatile in the near-term and that could drive voaltility for investors exposed to foreign currency. The Yen could benefit from safe haven flows if cracks do begin to appear in the global economy, particularly given the Japanese currency is near multi-decade lows.

Recommendations:

- We recommend hedging international fixed income exposures where possible.
- We retain a bias for USD and suggest USD investors overhedge their international exposures.
- AUD investors shoudl consider reducing their hedge ratios with a bias towards being underhedged.

Chart 1. The USD strengthened against most currencies through September.

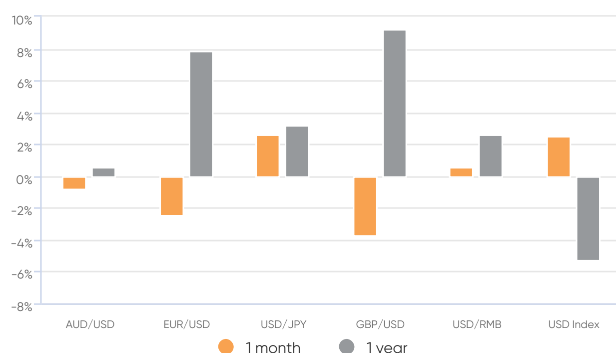
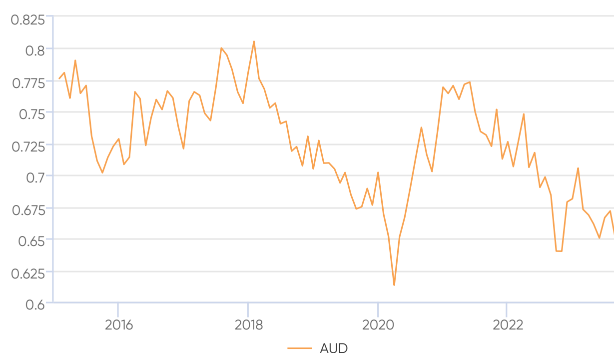


Chart 2. The Australian dollar has weakened 5.5% against the US dollar year-to-date.



Disclaimer

Endorphin Wealth

Disclaimer: This presentation has been prepared by the Oreana Portfolio Advisory Service, a division of Oreana Financial Services (Oreana) for general information purposes only, without taking into account any potential investors' personal objectives, financial situation or needs. This information consists of forward-looking statements which are subject to known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements to be materially different from those expressed or implied. Past performance is not a reliable indicator of future performance. Neither this document nor any of its contents may be used for any purpose without the prior consent of Oreana.

Anyone reading this report must obtain and rely upon their own independent advice and inquiries.

Limitation of liability: Whilst all care has been taken in preparation of this report, to the maximum extent permitted by law, Oreana will not be liable in any way for any loss or damage suffered by you through use or reliance on this information. Oreana's liability for negligence, breach of contract or contravention of any law, which cannot be lawfully excluded, is limited, at Oreana's option and to the maximum extent permitted by law, to resupplying this information or any part of it to you, or to paying for the resupply of this information or any part of it to you.