

Income investors welcome tighter monetary policy. The December 2023 Trust Investor Quarterly Market Update

By Perpetual Wealth Management

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The December 2023 Perpetual Private Quarterly Market Update dives into recent interest rate rises and why they're good news for investors seeking income. You can watch the video above, download our full report, or read our concise review below.

Please note: except where otherwise noted or quoted, the views in this article are those of Perpetual Private's Investment Research Team.

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December Quarter 2023: What happened?

- Markets were surprisingly robust throughout 2023 and global economies managed to avoid the recession that many commentators expected. Despite this strength, we still believe a short, shallow recession in the months ahead is possible.
- Local share markets finished the year up 8% with global markets delivering similarly impressive returns of 5%. Higher interest rate expectations also helped push US 10-year bond yields to their highest levels since 2007, before inflation optimism drove them back down as we came through November and December.

- Fixed income assets broadly, are delivering better yields with higher cash rates providing a floor for income producing assets.
- Geopolitical conditions deteriorated throughout the year, however neither Russia's invasion of Ukraine nor the ongoing Israel-Gaza conflict have had a significant medium-term impact on markets. The likelihood of additional regional conflicts flaring up in 2024 may briefly drive a spike in volatility but this is unlikely to have lasting impact.

Despite much consternation, 2023 proved to be a surprisingly good year for markets. Early predictions of recession failed to crystalise, tighter monetary policy improved income yields for many assets, and a rally in AI-linked tech stocks drove markets and bolstered sentiment.

The December quarter marked a strong finish to an unusual year, with Australian stocks generating more than 12% over 12 months. Global stock markets also generated an impressive 21%. While that's certainly a nice note to end the year on, it's by no means the whole story. Although the quarter was generally positive, there were significant gaps between the market winners and losers. In Australia, listed property gained 16.5% while energy stocks lost 8%. A similar story played out in global markets, where listed property gained 9% while energy lost 8%.

Turning of tides raises hopes for income

The past decade has been an arduous one for income investors. Following the Global Financial Crisis in 2007–08, efforts to repair global economies largely rested on rate cuts – a decision driven in part by the fact inflation wasn't particularly high at the time, nor did it increase much afterwards.

But even as rates scraped lower and lower and circled uncomfortably close to negative levels in several countries, this strategy was still being recycled in a bid to stimulate economies.

To put into context why this had such a harmful effect on income investors, we need to consider the way fixed income assets are valued.

When official interest rates are lowered, they have the effect of increasing the capital value of fixed income assets without a corresponding change in income generated. This means the percentage of income to capital drops, and income investors effectively receive a drop in the level of income they earn.

As rates got closer and closer to zero, the defensive assets we've previously relied on to produce income have been providing only around 2% in yield, forcing income investors to move higher up the risk curve.

That's now starting to change.

In 2022 we started to see official interest rates rise and the income to capital ratio shift back towards where it used to be. Importantly, beneficiaries are yet to realise the full benefit of these

changes as tax rules and some structural features of the market create a lag between higher rates and improved incomes.

Over time, rising income levels will flow through portfolios and into beneficiaries' accounts. The worst is now behind us.

Soft landings are hard to come by

Investors widely expected to endure a recession in 2023, but the Australian economy proved surprisingly robust and avoided that fate. Some investors are even now talking about a 'soft landing', in which central bank policy manages to cool the economy without tipping into recession.

Looking at the data, we think the likelihood of a soft landing has certainly increased but remains unlikely. Soft landings are exceedingly rare, because the lag between rate rises and their impact is both long and variable, making it difficult for central bank governors to know when their policy changes have had the desired effect.

Our central case is for a short and shallow recession in the year ahead, driven by a drop off in consumer spending.

Let's explain that in some more detail. Typically, companies only lay off staff when their earnings are falling. Healthy consumer spending throughout 2023 supported corporate earnings and helped keep the economy ticking over. However, if consumer spending slows, some workers may face the prospect of losing their jobs, and these layoffs would have knock-on effects on consumer confidence.

For example, if just one person in a group of five friends loses their job, it may prompt the others to cut back on their spending, fearing that they too could find themselves out of work. Cutting back on spending would then likely hurt corporate earnings, leading to further layoffs, creating a cycle.

How fast this cycle spins determines how severe a recession could be. A small number of layoffs, prompting only a small cut in spending would be relatively benign – this is our core case. Although, if those layoffs cascade more quickly, we will start to see some genuine risks emerging.

Perpetual Private's Quarterly Investment Update for December 2023 covers the changing nature of investment dynamics and looks at the outlook for shares, fixed income, real estate, currency and alternatives.

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