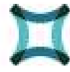


WATERSHED

FUNDS MANAGEMENT

Market Update - "Waiting for the right shot"

Summary:

- Markets have rallied in recent months, optimistic about declining inflation and the end of the interest rate tightening cycle and are pricing a “soft landing”.
- We believe that Central Banks will move from one huge mistake to another and hold rates too high for too long, leading to a ‘classic’ end of cycle recession.
- While there have been several earnings downgrades of late, we are only at the start of the economic and earnings downturn and current market forecasts for a mild decline followed by an earnings recovery next year are too optimistic.
- Watershed Multi-Asset Portfolios have continued to deliver strong outperformance over the past year, but we are continuing to reduce equity market exposure (and reduce exposure to cyclical or economically sensitive sectors and companies), build cash and progressively increase government bond exposure.
- With significant cash available we are now waiting for the right shot and the best time to buy growth assets is during a recession.

What we have been doing:

Since November last year, when we increased Fixed Income and reduced Equities across our multi-asset portfolios, we have made minimal investment changes. We slightly reduced exposure to resources during the January China re-opening rally and recently reduced exposure to discretionary retail companies and now sit at or close to maximum cash across our equity portfolios.

On a look-through basis, our exposure to cash in the Balanced Portfolio is currently at ~15%, with underlying sector sleeve cash exposures outlined below:

- Australian Share: 20%
- Emerging Leaders: 28%
- International Share: 19%
- International Share ETF: 19%

Consequently, we are underweight equities (approximately 45% vs the neutral 60% setting for a Balanced Portfolio) and have a skew towards defensive sectors.

Conversely, the Fixed Income Sleeve is fully invested, with the strongest return outlook we have seen for almost 15 years.

We have been busy monitoring our portfolios closely from both a top-down (macroeconomic and general sector and market valuation) and bottom-up (latest company earnings guidance/results), identifying opportunities and targets for future investment.

Why we are cautious:

While we bought the market dips three times last year, to date this year we have avoided pulling the trigger on increasing equity exposure, and remain concerned that the potential for further market volatility and selloffs remains high:

1. The Global Economy is showing clear signs of slowdown:

The most recent Global Manufacturing Index (PMI) readings show a clear deterioration across all major regions, with China's latest figure surprising markets on the downside:

The expected recovery in Chinese economic activity this year has stalled, with a stressed property sector, poor consumer and business confidence, high youth unemployment and a dearth of foreign investment due to geo-political tensions. Markets have recently been buoyed by the expectation that China will now stimulate, but a large property and infrastructure package looks unlikely this time.

While Europe avoided a deep recession over winter, growth remains anaemic, and parts of Europe are now in recession. New Zealand has technically entered recession. The US and Australia have to date been saved by strong services spending, but we are now starting to see early signs of slowdown as the aggressive series of interest rate increases over the past year start to bite.

2. Despite this, central banks are still raising rates and are likely to hold rates too high for too long, leading to a 'classic' end of cycle recession:

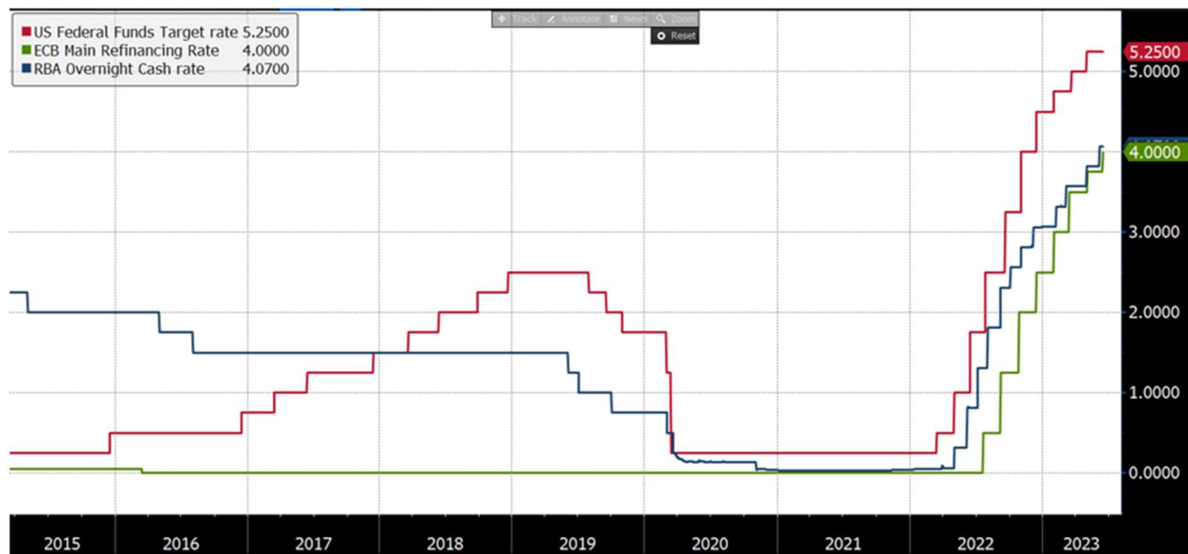
The commentary from both US and Australian central banks over the last several months has been clear about their determination to bring inflation under control – and that a move to cut rates would be very unlikely until this had clearly been achieved. In the US, there remains strong memories of the 'Burns pivot', when Fed Chairman Arthur Burns cut rates prematurely in the 70s – leading to entrenched inflation and a painful rate hike cycle in the 80s.

Here in Australia, Phil Lowe appears to be in lockstep, and while conscious of our economy's higher sensitivity to interest rates, the RBA has consistently stated that:

"The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that."

From one huge policy error to another: Only this time last year, most of the world's central banks were still at or very near zero rates after a period of unprecedented fiscal stimulus.

In a typical cycle, the economic indicators that central banks follow lag in their ability to confirm an economic slowdown, which leads to overtightening and eventual recession.



The chart above shows that in the past year, the US, Europe and Australia have moved from zero rates to 5.25% and 4% respectively and with the *long and variable* effects of monetary policy, we will not see the full extent of this tightening through the economy until next year. And this is where the current disconnect lies. Markets are pricing a slowdown in earnings this year, followed by a rebound next year which in our view will see the earning trough.

3. Earnings forecasts remain too optimistic

While we have observed companies starting to downgrade guidance (with recent downgrades coming through from several retailers including Adairs, Baby Bunting, Michael Hill Jewelers and Domino's Pizza) and analysts trimming their numbers over the course of this year, overall the market remains too optimistic on the earnings outlook for the remainder of 2023 and 2024.

The Australian Share Market (ASX 200) consensus earnings expectations (red line) in Australia have pulled back from high single digit growth expected at the start of the year to now flat earnings this year and next. In a mild recessionary environment however, earnings are likely to decline around 10%. We need to be further through this revision before becoming more constructive.

The positive however is that this has been a widely anticipated slowdown and most investors are cautiously positioned, meaning that valuations are in line with long run averages. The ASX 200 is trading on a PE multiple of approximately 14.8 with a dividend yield of 4.3% which should somewhat cushion the downside.

However, on a global basis excitement around the potential of Generative Artificial Intelligence has fueled a rally in mega-cap tech names, driving positive performance in global markets over recent months. While we also see significant potential from AI to improve productivity and company efficiency over the longer-term – on its own we do not believe it sufficient to mitigate tighter financial conditions and a broad-based, general economic slowdown.

The US market is now trading back on a PE multiple of 20. Like in Australia, analysts have pulled back earnings expectations for this year by around 6% but forecast earnings to rebound 10% next year. This is way too optimistic in our view and completely at odds with the interest rate and economic cycle. Last week we again initiated a small short S&P 500 position within the International ETF sleeve.

What we are looking out for:

In conclusion, our base case remains for the global economy to enter a 'mild' recession late 2023/early 2024, and that tightening financial conditions will lead to better market entry points over the coming 6-12 months. Over the shorter term, as interest rates approach their peak, a pause in tightening and speculation of rate cuts could see markets rally further. This would see some underperformance of our multi-asset portfolio's but would in our view be a market pricing in a soft landing just as the recession is about to begin.

In the meantime, we are prepared to be patient and 'wait for the right shot'.

Portfolio Performance May 2023:

Net Performance %	1 m	3 m	6 m	1 yr	2 yrs	3 yrs	4 yrs	5 yrs	Inception	Date
WFM Conservative	-0.46%	1.43%	2.17%	4.21%	3.13%	6.44%	5.50%	5.55%	6.38%	1/06/2016
FE UT PG Multi Asset Moderate Index	-0.54%	1.47%	1.51%	1.48%	-0.50%	2.29%	1.96%	2.45%	2.83%	
Relative Performance	**0.08%**	**-0.04%**	**0.65%**	**2.73%**	**3.63%**	**4.16%**	**3.53%**	**3.10%**	**3.55%**	
WFM Balanced	-0.10%	2.05%	2.35%	5.07%	4.31%	8.06%	7.00%	6.64%	7.21%	1/05/2016
FE UT PG Multi Asset Balanced Index	-0.73%	1.56%	1.73%	2.34%	0.61%	4.94%	3.73%	4.01%	4.58%	
Relative Performance	**0.63%**	**0.49%**	**0.63%**	**2.73%**	**3.71%**	**3.13%**	**3.27%**	**2.63%**	**2.63%**	
WFM Growth	0.27%	2.70%	2.56%	5.90%	5.37%	9.25%	8.37%	7.74%	8.84%	1/05/2016
FE UT PG Multi Asset Growth Index	-0.93%	1.57%	1.91%	2.32%	1.31%	6.90%	4.99%	5.04%	6.01%	
Relative Performance	**1.20%**	**1.13%**	**0.65%**	**3.58%**	**4.06%**	**2.35%**	**3.39%**	**2.70%**	**2.83%**	
WFM High Growth	0.53%	2.96%	2.54%	6.17%	6.55%	10.57%	10.13%	9.09%	10.56%	1/07/2016
FE UT PG Multi Asset Aggressive Index	-0.82%	1.90%	2.34%	2.94%	1.90%	8.93%	6.25%	6.03%	7.28%	
Relative Performance	**1.35%**	**1.05%**	**0.21%**	**3.23%**	**4.65%**	**1.64%**	**3.88%**	**3.06%**	**3.27%**	

Net Performance %	1 m	3 m	6 m	1 yr	3 yrs	5 yrs	7 yrs	10 yrs	Inception	Date
WFM Australian Share	-1.22%	1.19%	1.02%	5.98%	12.53%	7.68%	8.43%	8.24%	7.40%	5/08/2010
S&P/ASX 200 Accum	-2.53%	-0.89%	-0.59%	2.91%	11.43%	7.47%	8.29%	8.12%	8.16%	
Relative Performance	**1.32%**	**2.07%**	**1.61%**	**3.08%**	**1.10%**	**0.21%**	**0.13%**	**0.12%**	**-0.76%**	
WFM Income Portfolio	-1.14%	0.21%	1.78%	2.09%	3.36%	2.59%	3.59%	3.39%	4.30%	30/08/2010
WFM Including Franking	-	-	-	2.99%	4.61%	3.95%	4.94%	4.74%	5.65%	
UBS Bank Bill Index	0.29%	0.87%	1.64%	2.62%	0.91%	1.13%	1.32%	1.69%	2.28%	
Relative Performance	**-1.43%**	**-0.67%**	**0.13%**	**0.36%**	**3.71%**	**2.82%**	**3.61%**	**3.06%**	**3.37%**	
WFM International Share	3.37%	11.11%	8.40%	12.04%	10.23%	11.95%	12.17%	14.52%	14.40%	31/01/2010
MSCI World Index Ex Aus (AUD)	1.18%	7.91%	7.72%	13.37%	11.89%	11.29%	11.36%	13.08%	11.70%	
Relative Performance	**2.19%**	**3.21%**	**0.68%**	**-1.34%**	**-1.66%**	**0.66%**	**0.80%**	**1.44%**	**2.70%**	

Net Performance %	1 m	3 m	6 m	1 yr	3 yrs	5 yrs	7 yrs	9 yrs	Inception	
WFM Emerging Leaders	-0.85%	-3.01%	-4.68%	0.04%	8.62%	6.88%	7.90%	9.67%	10.43%	6/08/2013
S&PASX Small Ords Accum	-3.26%	-1.29%	-2.48%	-5.78%	4.45%	2.46%	5.61%	5.98%	5.91%	
Relative Performance	**2.41%**	**-1.72%**	**-2.20%**	**5.82%**	**4.17%**	**4.42%**	**2.29%**	**3.68%**	**4.52%**	

Our May Monthly reports can be viewed here.

If you would like to receive a copy of the report please contact our BDM Shantelle Lay:

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Watershed Funds Management

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An investment in a Watershed SMA provides professional and active investment management with full transparency of holdings, transactions and structure. Watershed seeks to form a collaborative relationship with advisers, actively communicating portfolio strategy in the current market environment so that advisers are better equipped to communicate with their clients.

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Data sourced from Fe Analytics and investment platforms

The FE Peer Group Multi-Index Indices offer average returns across circa 150 funds with a similar risk mandate, i.e Balanced.