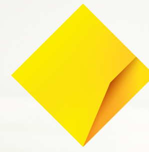


Commonwealth Private

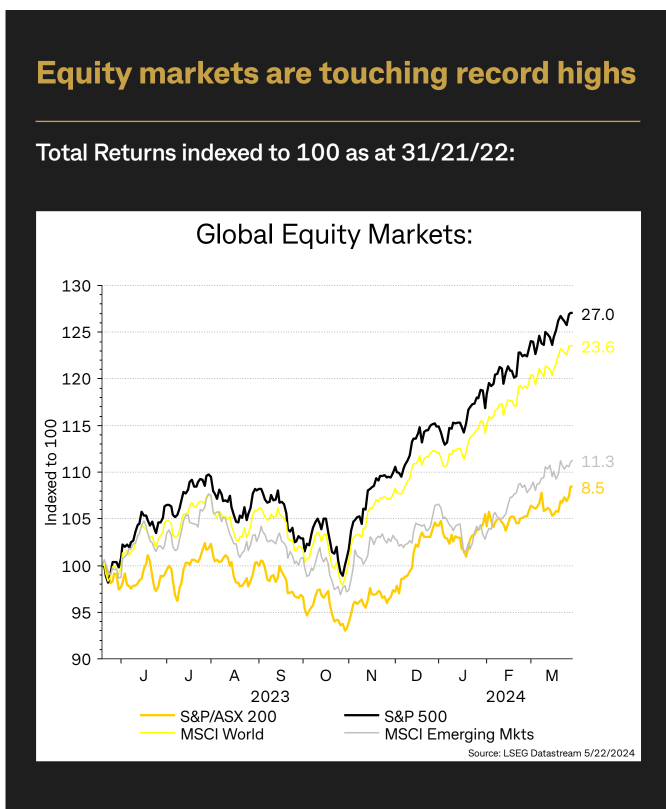
June 2024

Market Outlook.

A bumpy path to a soft landing.

Economic transitions are fraught with uncertainty and rarely go smoothly. Across the developed world, we've experienced an extended period of above-usual policy support which has culminated in policy rates being taken to near 0% levels. It was widely thought that the current transition would be equally disruptive – but it hasn't. Moreover, there are very few areas of *"Main"* Street or *"Wall"* Street, as it is more commonly known, that have not performed better than expected since policy began to tighten.

This has left many market commentators scratching their heads because models have not given outcomes that would align with history. The global economy was supposed to be in recession. The consumer was supposed to have stopped consuming. Businesses were supposed to have laid off workers and markets were supposed to be lower, as higher rates crimped valuations and cyclical pressures pushed corporate profits down.



As we look ahead, there is a risk that the bear case has just been delayed. However, we think reality is a little brighter and that despite the existence of many factors which could drive economic and financial market disappointment in the coming months and quarters ahead, we are in the camp of an economic muddle through, and this should be enough to sustain risk assets as the "zone of comfortable outcomes" begins to widen rather than narrow.

Markets are in an unstable equilibrium and remain susceptible to reverberations from both the pandemic and policy tightening that may emerge as the global economy *feels* its way towards a sustainable base. On this basis, we don't think investors should be fearful of the outlook, but a high degree of macro uncertainty suggests that the base case should be supplemented by sufficient insurance against tail risk outcomes. This means portfolios should be well diversified across and within assets and regions, having a combination of both public and private market exposures as well as having a tactical mindset to respond to changing circumstances. Enough could go wrong to mean having all eggs in one basket (i.e., risk-on or risk off) is not prudent at this stage.

Our key views can be summarised as follows:

1. CommBank's base case is for a shallow and relatively short global economic slowdown that is de-synchronized across countries with a high degree of variation depending on the state of household balance sheets, the level of fiscal support and the path of policy rates.

2. Australia's economy continues to grow at a reasonable pace, with headline figures gaining support from elevated immigration, masking much weaker growth levels on a per capita basis. However, we expect the economic outlook to begin improving as we move into 2025, albeit at a modest pace with gradual policy support.

3. Bond yields, have in all but a bear case, seen its cycle peaks and while lingering inflation may limit the decline from this point forward, we see sovereign bonds as providing a solid yield with downside protection against growth disappointment for investors who are looking to edge out of cash. We like the outlook for Australian government bonds vis-à-vis international bonds but would stay modestly underweight duration (i.e.,

somewhere in the belly of the curve).

4. Equity markets are trading richly but provided growth and/or inflation does not materially disappoint, can go higher into year-end as the tailwind from rate cuts become a reality and the economic outlook firms up. However, investors should look for ways to lower "equity-beta" risks via exposure to structural themes (i.e., technology and decarbonisation) as well as balancing region, style and size bets. Australia is likely to be a low beta play on the direction of global equities – neither rising strongly, nor falling heavily.

5. Alternative and Real Assets should be key allocations within a multi-asset portfolio. Hedge funds are a solid ballast against two-way market volatility while private markets (credit in particular) offer elevated return potential on a highly differentiated basis. We think it's too early to chase residential and retail sensitive real estate which will continue to feel the long tail of rising rates and defaults but like exposure into commercial (logistics and data centres). We think infrastructure has a multi-decade tailwind via the decarbonisation theme and see it as an integral component of a multi-asset portfolio.

Jason Todd, CFA
Chief Investment Officer
Commonwealth Private and Wealth

Global Economics: Growth slowing but at a gradual pace.

- Economic growth is slowing but recession is now a low probability risk.
- Key central banks are getting close to the policy-easing zone. However, the pace of rate cuts will be modest outside of meaningful growth disappointment.
- China is now attempting to put a floor in the housing market and in turn the growth backdrop. This is positive for global sentiment.

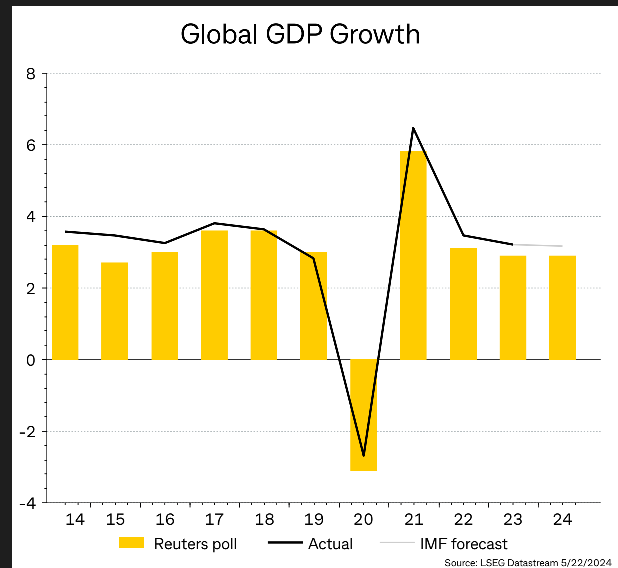
The global economic slowdown continues but at a gradual pace. Pockets of stress are emerging across the developed world as households run down pandemic supported savings, but for the most part, there is a notable absence of systemic concerns.

The inflation beast has not yet been slain and this will see key central banks approach the easing cycle with caution, for fear of reigniting any inflation embers. However, financial conditions are restrictive, and lower policy rates are around the corner even if the pace of rate cuts will be gradual.

We are encouraged by China's recent property related policy announcements. While it's is unlikely that they will be enough to drive a sustainable turnaround, or remove the risk of further developer defaults, it represents a first step in trying to put a floor in an area that has broad systemic implications for sentiment and the economic outlook.

Global growth is steady

% Annual:



We are less worried about geopolitical risks than the consensus narrative. We agree that we live in a more uncertain world, but we think geopolitical risks are always present and provided they remain contained, they don't tend to have lasting impacts on the outlook. For now, we think the outlook is for a "muddle through", where global growth continues to soften, inflation declines but not in a straight line, and key central banks begin to provide some monetary policy support.

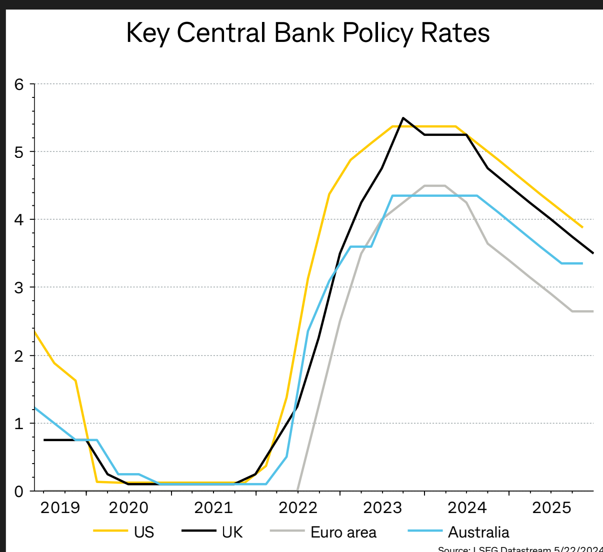
Australian Economics: Inflation still a constraint to rate cuts.

- Australia's economic outlook remains relatively robust. We expect growth to slow through 2H24 but thereafter gradually recover.
- It will take time for inflation to fall back into the Reserve Bank of Australia's (RBA) 2-3% range but the trend is down, even if not in a straight line.
- CommBank expects only one 25bp rate cut in late-2024 before the cash rate glides down to 3.1% by early-2025. This is not an aggressive rate cut cycle, but neither growth set to collapse.

The economic outlook in Australia is not too dis-similar to other developed market regions, albeit with a lag as it exited lockdowns and started its rate hike cycle. Growth has remained more resilient than expected due to a large stockpile of savings and record levels of immigration.

Rates have peaked, Cuts are coming

Policy forecasts based on Reuters Poll:



While there are pockets of stress as cost-of-living pressures drive a consumption pull-back and rising borrowing costs drive a small increase in defaults and forced home sales, there is no evidence that these cracks are at risk of becoming systemic with the labour market so far resilient to tighter financial conditions.

Expectations for an early start to an RBA rate cut cycle have been extinguished as inflation prints have trended sideways in recent months. In fact, the RBA revised its inflation forecast to 3.8% by December 2024 from 3.2% and has assumed that the cash rate remains around its current level until mid-2025 before declining to 3.8% by the middle of 2026.

CommBank Economics, however, have not changed their base case and see the cash rate gradually cut from November 2024 to reach 3.10% at the end of 2025 (a level they believe is just above neutral). In our view, the cash rate will most likely remain at current levels for the rest of 2024 and into early-2025.

Equities: Tailwinds remain in place.

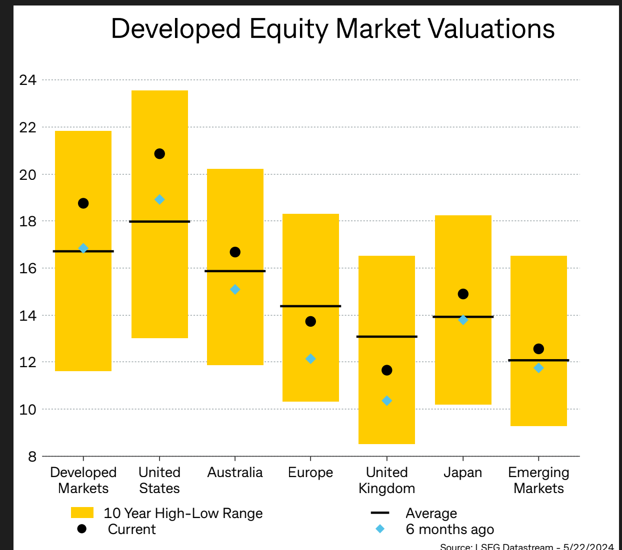
- Key equity benchmarks are touching highs despite a soft macroeconomic backdrop.
- Potential rate cuts, better than expected earnings, optimistic sentiment, and a large cash pile (ready to buy the dips) remain positive tailwinds.
- Valuations mean equities are vulnerable to disappointment – should it come. Expect further gains but prepare for elevated volatility.

Despite a multitude of headwinds, equity markets have confounded the sceptics and are up nearly double digits through the first five months of the year (MSCI World +9.6%). With economic fundamentals continuing to weaken into rising valuations, the equity bears are arguing that risk assets are ahead of reality and a due meaningful correction.

We think the outlook is more balanced. While equities are expensive and fundamentals have deteriorated, equity investors are always glass half full (versus bond investors who are always glass half empty) and they are being comforted economic growth that has not collapsed, recession fears that have abated and that inflation which is still trending down (albeit a bit haphazardly).

Equity valuations are elevated

Price to Forward earnings ratios:



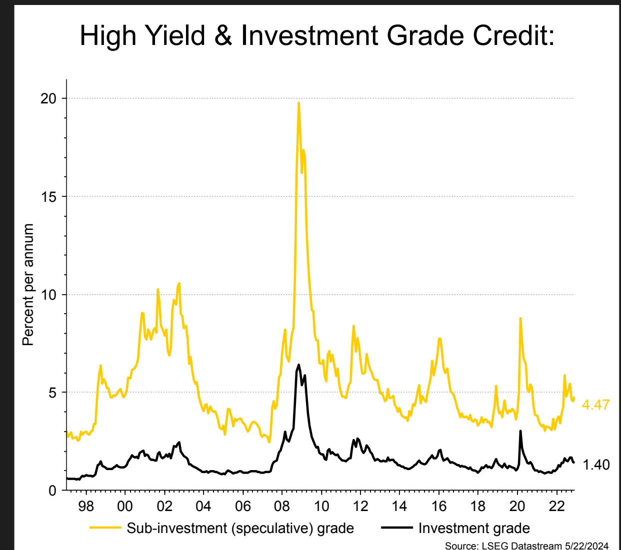
If the backdrop continues to weaken but at a gradual pace, then we think equities can push higher, fuelled by the prospect of interest rate cuts, a bottoming out in earnings growth over coming quarters, and an extremely large cash pile sitting on the sidelines. Investors should be prepared to weather some volatility and bouts of profit taking as the economic backdrop evolves (especially as the global economy has not yet reached a glide path), but there remains a strong willingness to buy into weakness with risk-taking behaviour is alive despite valuation and earnings concerns.

Fixed Interest - Time to lock in yields.

- We like the outlook for fixed income. It is possible for investors to tightly control their risk exposures while benefiting from a "modest" to an "elevated" yield pick-up.
- Given macroeconomic uncertainties, we are not prepared to chase duration but prefer to focus on: 1) Short dated floating exposures; and 2) High quality private credit.
- For investors who want to lock in longer dated returns, holding a government bond to maturity can now provide a risk-less (ex-sovereign default) return in the range of 4-7%.

Credit spreads are tight

US credit spreads relative to US Treasuries:



We like the outlook for fixed income. For more than a decade, investors have complained that fixed income did not provide enough yield for those seeking income and/or diversification benefits for a multi-asset portfolio because yields were too low. This has now changed, and investors have a window of opportunity for locking in yields before central banks begin their next rate cut cycle.

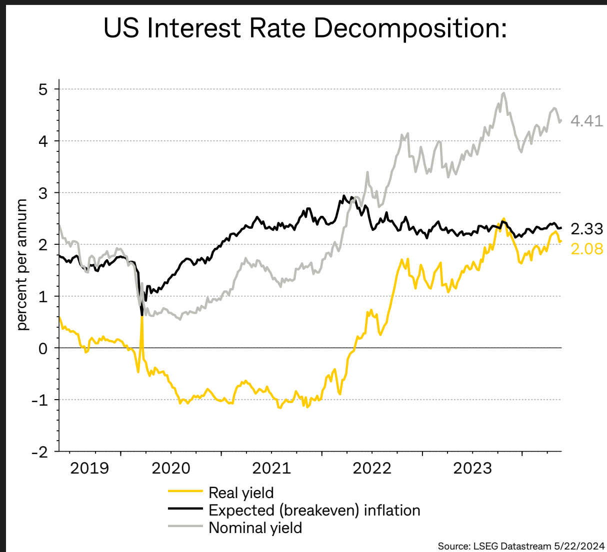
Our base case is for a moderate economic slowdown, with inflation continuing to decline but at a gradual pace which allows key central banks the ability to begin a slow easing stance. Against this backdrop, we believe sovereign yields have peaked and will resume its role as a hedge against downside economic risks. However, a combination of higher real rates, higher inflation, and a higher-term premiums (the additional return required to move out the yield curve) mean long bond yields may not decline much relative to prior cycles and uncertainty around the outlook imply investors do not need to take on duration risk at this stage.

Instead, we feel there are attractive opportunities within short-dated fixed income instruments such as floating rate exposures that can provide an uplift to traditional cash in the bank, as well as higher rated private credit (direct lending) where credit worthiness and seniority are tightly controlled by the lender.

With credit spreads already at tight levels, we believe it is important to avoid moving down the "quality" spectrum as economic fundamentals are set to weaken further and before the cycle has sustainably turned up. While we don't expect to see a systemic increase in corporate defaults rates, we think there will be a bifurcation between lenders who remain focused on good quality (resilient) business models.

Inflation expectations have remained anchored

10 year treasury bonds and break even inflation:



Finally, we think bond yields are now at levels that provide a decent cushion against adverse macroeconomic moves. This means fixed income returns are not likely to be wiped out by a small move higher in bond yields relative to when there was convergence towards zero rates.

Similarly, we think equities are at greater risk from macro disappointment than bonds given where relative valuations sit, and with fixed income portfolio returns now in the range of ~4%-14% versus the old normal of ~1%-8%, highly attractive yields are on offer with limited additional risk. Private markets continue to offer attractive diversification benefits despite the mounting economic headwinds. The higher cost of debt and lower capital market activity do however, present some challenges.

Alternative Assets: A must have portfolio addition.

- Alternative assets are a must have either as stand-alone investments or as part of a multi-asset portfolio.
- Hedge funds offer strong diversification benefits against traditional assets but manager selection is key. We like long-short and macro funds.
- Private markets face some challenges (PE – VC), but we like private credit for its yield enhancement and limited market risk exposure.

We see alternative and real assets as providing three key attributes for portfolios:

- First, hedge funds are a strong ballast for financial market volatility and uncertainty given low correlation with traditional assets (equities and bonds);
- Second, high quality private credit can provide significant yield enhancement versus traditional fixed income assets; and,
- Third, selected areas of infrastructure (decarbonisation) and property (logistics, data centres) provides access to strong structural thematics which are increasingly important when cyclical tailwinds are less pervasive.

Hedge Funds: The idiosyncratic nature of alternatives and in particular hedge funds provide an important risk diversifier for portfolios when macro uncertainty and two-way volatility is high. However, returns to hedge funds as an asset class have been steadily declining over the past two decades with significant performance dispersion amongst managers. This means manager selection and fund diversification are important considerations when selecting hedge funds with the intention of reducing market (systematic) risks.

Private Markets: Private markets continue to offer attractive diversification benefits. While a higher cost of debt and lower capital market activity present some challenges, the overall picture is more nuanced, as 2023 was the seventh-largest fundraising year in history. Private equity has seen a welcome decline in entry valuations, with secondaries seeing attractive discounts as markets become more challenging and some existing investors require liquidity. Venture Capital continues to struggle as more companies are now approaching the stage where they can no longer delay new funding rounds which is creating a reset of valuations.

Selective private debt, especially senior debt opportunities, look attractive given the higher interest rate environment with floating rate yields rising. Uncertainty and tighter credit conditions have caused traditional lenders, like banks, to retreat, thereby creating better opportunities for private lenders.

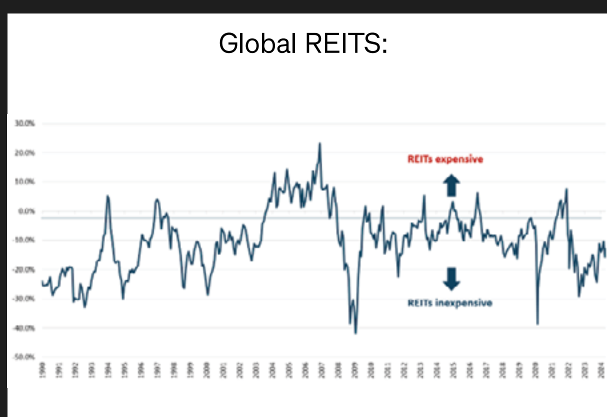
Real Assets: Structural tailwinds rising.

- Real assets provide an inflation hedge as well as a predictable income stream.
- Strong structural tailwinds raise the appeal of infrastructure (decarbonisation) and selected areas of property (healthcare, logistics and data centres).
- We think it remains too early to chase more cyclical sensitive areas of real assets (residential and retail sensitive property). The shimmer on gold is beginning to fade.

Infrastructure: For a significant part of 2023 and into 2024, global listed infrastructure has had a difficult period keeping pace with the risk-on sentiment of the broader equity market. Rising interest rates and the more defensive characteristics of infrastructure have been head winds. However, there is a rising structural tailwind for infrastructure via strong and stable earnings growth, attractive valuations and a demonstrable dividend stream.

Listed property is inexpensive

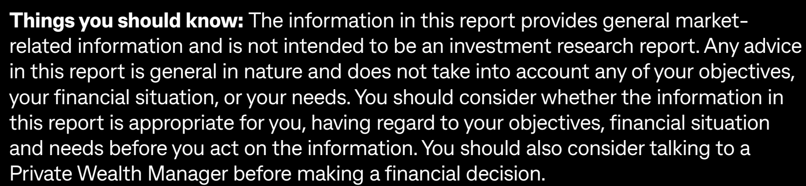
Premium / Discount to NAV:



Property: In the past few years, global listed property returns have been diluted by rising interest rates and structural overhangs afflicting retail (bricks and mortar), office (high vacancy rates) and commercial. Added to this has been more hawkish interest rate expectations by major central banks.

The office sector currently only represents a 10% allocation in the FTSE EPRA NAREIT Developed Index, down from 22% in February 2007, and has been replaced with long term secular growth trends in data centres, healthcare and logistics.

Since the global financial crisis, the asset class has shifted to lower financial leverage, well staggered debt maturities and diversified sources of debt. With this backdrop, asset class valuations are relatively attractive, trading at a discount to private market real estate values and, in some cases, below replacement costs. An allocation to global listed property remains warranted in a diversified portfolio.



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