August 2024

Market Outlook.

A Reality Check

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It was a tumultuous month for financial markets with global equities selling off sharply - led by the tech-heavy Nasdaq which entered correction territory – and US short rates collapsing as fears of a recession returned. There were several factors that contributed to the rapid change in investor sentiment and deteriorating market conditions throughout the month. This included:

1. **Soft technology sector earnings.** Several disappointing earnings results, combined with high valuations drove a swift bout of tech sector profit taking that led broader equity indices lower.
2. **Weak US labour market data.** A larger than expected rise in unemployment and weaker job creation raised fears that the US will not escape a hard landing.
3. **A disappointing US Federal Reserve (Fed).** There was hope that the Fed might push through a surprise rate cut following the worst than expected labour market data and continued inflation progress. It did not. The failure to act is igniting fears that they are already behind to curve in keeping policy conditions too tight.

Alongside these factors, positioning has also played a large part in exacerbating recent market moves. Equities had not suffered a 5% correction for more than a year with volatility also benign despite the global economy being in a transition phase and geopolitical risks elevated.

We think the current patch of weaker than expected economic data is a reminder that recoveries take time to become entrenched, and we don't see a bumpy period as enough to alter the outlook outside of the need for the Fed (and by association other central banks including the Reserve Bank of Australia (RBA)) to act with a bit more urgency in addressing a softening economic outlook.

In fact, we think its healthy for markets to purge some obvious excesses such as extreme valuations, heavy concentration and positioning as well as overly tight credit spreads. But, we don't think the data nor price action are early warnings signs that the uptrend has been permanently broken or won't reassert itself over coming months for a number reasons.

First, the US economy is slowing, but it has not stopped. Generally, expansions don't die of old age and with rates already at peak and likely to move lower in coming months, conditions should get better rather than worse. Second, trend inflation continues to decelerate across the developed world despite areas of stickiness. Inflation was never expected to fall in a straight line so bumps in the path lower are part of the deceleration process. And third, we think economic weakness requires a more urgent response from the Fed, but that progress in lowering inflation now allows them this scope.

Our base case of a gradual economic recovery alongside further inflation deceleration and modest rate cuts remains intact. Economic data might now drive more urgency from the Fed, but the rapid decline in bond yields is also balancing off the need for a deep and/or sustained correction in risk assets.

We don't think the dust has settled and it's likely that we may see some further weakness as the market reassesses the magnitude of a potential policy response. But, a reset that removes complacency and restores some reality back into expectations is healthy as long as the broader trends remain in play, which we think is the case.

Jason Todd, CFA
Chief Investment Officer
Commonwealth Private

Global Economics:

More rates support needed

- Economic growth has been resilient to higher rates but is now in need of accelerated policy support, particularly from the US.
- The global rate cut cycle is now underway but will be modest given lingering inflation risks and the need to avoid reigniting inflation embers.
- China is now stimulating, but traction remains modest. More is required to stabilise the outlook.

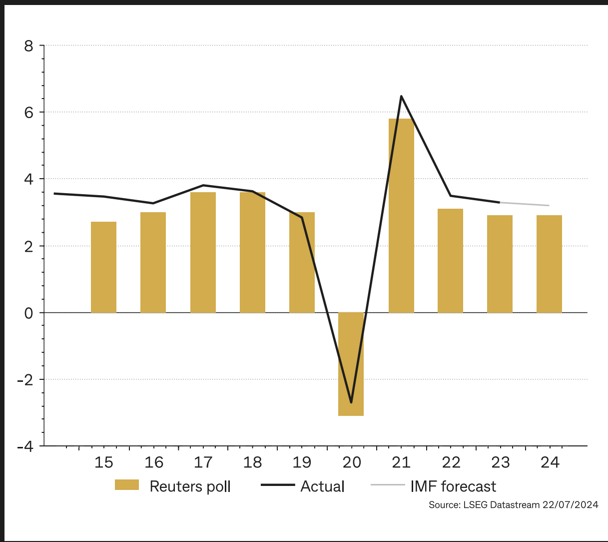
The global economic slowdown continues but at a gradual pace. There are pockets of stress emerging across the developed world as households run down pandemic supported savings, but for the most part, there is a notable absence of systemic concerns.

Recent labour market data out of the US is now suggesting that the economy has not yet bottomed and is likely to require a more aggressive policy stance by the Fed. Chairman Powell stated that the FOMC does not want to see further (material) cooling in the labour market and we believe that this is a strong signal that they are prepared to act with more aggression.

At this stage, we do not think a month of weaker than expected data is signalling that a hard landing is on the cards with consumption still resilient to rate hikes and investment running at healthy levels. Progress in lowering inflation should allow a more aggressive path of policy rate cuts in coming months, a stance that is now consistent with comments coming out of the FOMC.

Global growth bouncing around trend

Global GDP (% yoy)



More broadly, progress in lowering inflation continues across both developed and emerging economies and is now at levels that have allowed central banks to begin cutting rates. We expect this trend to gather momentum into 2H24 as the Fed joins in. While expectations are that the global policy easing cycle will be modest, their is a rising chance that the Fed will lead a more aggressive stance with other central banks left to follow.

We think an improving economic outlook will be underpinned by the US as we move into 2025, with China, Japan and Europe also providing incremental upside to the global economy. We are encouraged by China's recent property related policy announcements and rate cuts although at this stage they do not appear to be enough to drive a meaningful improvement in the economic outlook. Nevertheless, it does represent the first step in trying to put a floor in an area that has broad systemic implications for sentiment and the economic outlook.

Australia Economics:

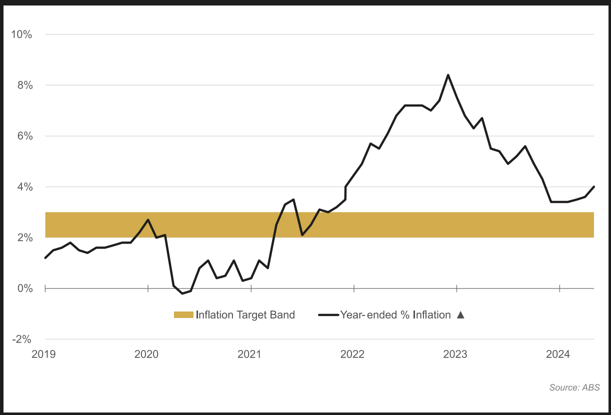
Inflation still a constraint to rate cuts

- The economy has slowed to stall speed as rate hikes have driven a material slow down in consumer spending.
- Inflation remains sticky and at uncomfortable levels for the RBA, but is unlikely to require further rate hikes.
- CBA expects only one 25bp rate cut in late 2024 but an accelerated rate cut cycle by the Fed would potentially lower the RBA's hurdle as we move into 2H24.

Australia's economic outlook is not too dis-similar to other market developed regions albeit with a lag as it exited lockdowns and started its rate hike cycle. At this stage, we think the RBA has done a great job of lowering inflation without driving a large rise in unemployment or a significant economy-wide slowdown, but the risk is that it holds monetary conditions too tight as it continues to focus on lowering inflation.

CPI not at levels that allow rate cuts

% yoy



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

Australia's problem is not growth but sticky inflation with recent prints showing a modest uptrend after strong declines over recent quarters. The most recent June quarter reading was better than expected and this has removed expectations for another rate cut, but outside of international growth risks, the RBA is likely to remain on hold out through year end.

It is unusual for Australia to be out-of-sync with the US rate cycle and we think recent developments that have raised the prospect of a more aggressive rate cut cycle by the Fed will also lower the hurdle for the RBA versus current market expectations of only one 25bps cut by year end. However, the RBA will not want to re-ignite inflation and/or exacerbate an already red-hot housing sector with premature rate cuts.

Despite inflation concerns, we remain optimistic on the economic outlook. Growth has been resilient to rate hikes due to strong population growth, but tax relief and the prospect of rate cuts will help steady the economic outlook. We think the economic trajectory will improve into 2H24/1H25 albeit gradually as consumer confidence takes time to recover.

Equities:

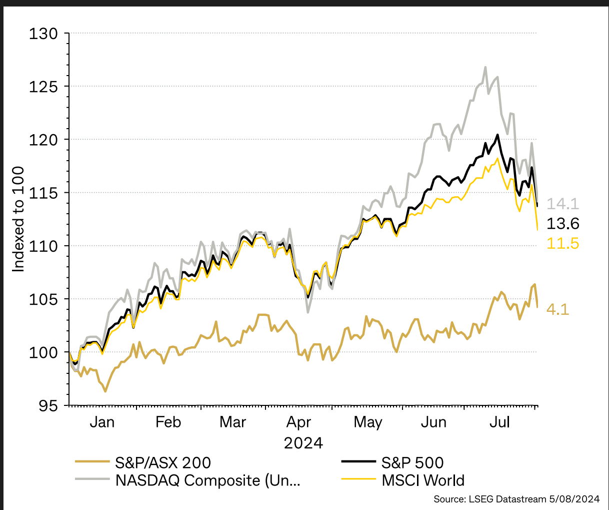
A purge of excesses underway

- Equity markets are resetting to more realistic (lower) economic growth expectations.
- Lower bond yields will provide some support for valuations, but will not be enough to prevent further downside if near term earnings expectations weaken.
- We don't expect the current wave of market uncertainty to persist. Elevated cash levels alongside an gradually improving cyclical backdrop will ensure the bull market remains intact.

Equities have climbed a wall of worry since bottoming in 4Q22. Despite elevated inflation, the fastest rate hike cycle since the mid 1990's and a steady deterioration in earnings, markets have been willing to look through risks fuelled on by record cash levels, a hyped up AI thematic, expectations that the economic slowdown would be modest and that easier monetary policy was (forever) just around the corner.

Equity market correction modest to date

Price performance (indexed to 100 as at 31-Dec-23)



However, equity markets are not bullet proof and the higher valuations have moved (particularly for technology), the more vulnerable to disappointment they become. Things came to a head in July, as US recession fears re-emerged at the same time that richly valued and heavily overweight technology stocks reported disappointing earnings.

The result saw a dramatic sell-off in the tech heavy Nasdaq with global indices following their lead lower. We don't think the bull market has been broken, but it may take a bit of time for equities to reset and find a floor as we enter a period of weaker economic data and until we get greater transparency on how aggressive the Fed will be in easing monetary conditions.

On a positive note, US bond yields have fallen dramatically in response to the latest economic data scare and this is providing some offsetting support for equities, but it is unlikely to be enough until the path of policy rates resets. We don't think the AI thematic is broken and we continue to believe in the longer-term structural growth potential. But, squeezing some of the short-term hype out of share prices is a (painful) but healthy exercise for longer term sustainability.

For Australia, we continue to think the equity market will remain a play on the direction of off-shore markets despite an out-of-sync economic and rates cycle. We don't see as much valuation risk for Australian equities, but this appeal is balanced by a more modest earnings growth outlook due to a high allocation in low growth value industries (banks, property and resources). We think investors should remain wary of short term risks and elevated volatility, but we remain confident that an improving cyclical backdrop will be supportive for equities into 2025.

Fixed Income:

A downside hedge to growth risks

- We like the outlook for fixed income as a hedge against downside growth risks and as a way to add solid risk-adjust yield to portfolios.
- We expect the Fed to lead global short rates lower with long rates already well down from cycle peak and likely to move lower.
- We think concerns around private credit are overdone at a micro level. Credible issuers with long track records and who operate in their sweet spot remain our preference.

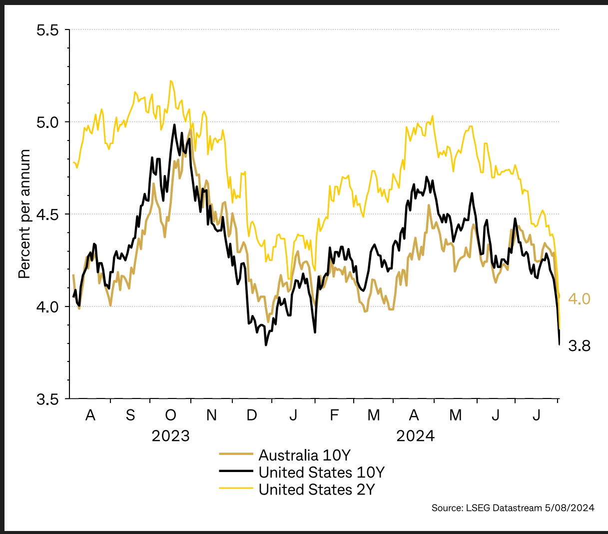
We remain positive on fixed income but continue to stress the importance of locking in longer dated yields which are already in the process of following global short rates lower as near term growth risks pick up.

While the global policy rate cut cycle is already underway, it took a step up in the final week of July as disappointing US labour market data added pressure on the Fed to accelerate, and potentially front load, rate cuts into the back half of the year. In effect, the market has moved on from "when will the Fed cut" to "how much will the Fed cut" with the market now closer to pricing in a 50bps move in September.

At this stage, its not clear whether the deterioration in data has been sufficient to warrant such a move, but as we have seen throughout this cycle, the market has been prepared to price in the worst and adjust back should fundamentals come in ahead of expectations. The rapid repricing has seen the US 2-year bond yield fall from 5.05% at the end to only 3.83% with long bond yields following a similar path lower.

US bonds pricing in weaker growth

10-yr government bond yield %



Against a backdrop where there is such elevated growth and policy uncertainty, we think fixed income provides a strong hedge against growth uncertainty. We have been pushing the view that the window for locking in peak bond yields was set to close and there is no doubt yields are now well below their cycle highs and likely to move lower.

Despite the move lower in short rates, we think there are still attractive opportunities at below benchmark duration with floating rate exposures still providing a small uplift to traditional cash in the bank albeit this is now harder to find. The exponential growth of private credit has brought on fears that it is in a bubble. However, while there will always be red flags within any asset class, we think highly rated private credit (direct lending) where credit worthiness and seniority are tightly controlled by the lender mitigates a lot of the concerns that some may have. Finally, with credit spreads already at tight levels, we believe it is important to avoid moving down the "quality" spectrum until the economic recovery is entrenched

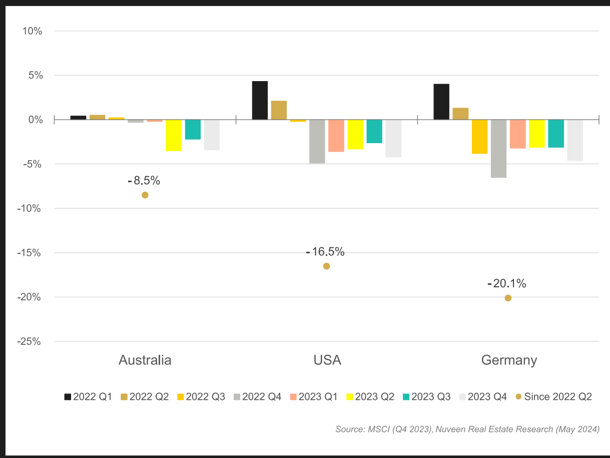
Alternative and Real Assets:

A portfolio must

- 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. 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.
- 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 & data centres).

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.

Quarterly Change In Private Real Estate Values



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.

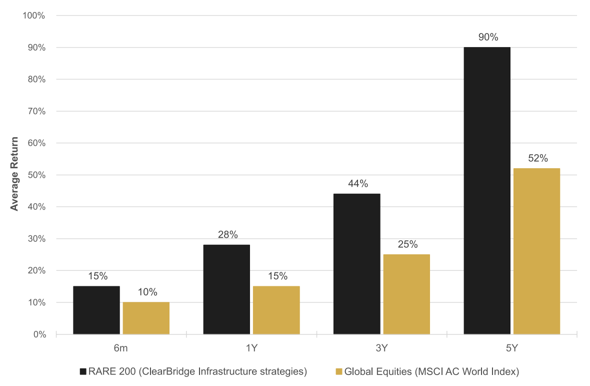
Private Markets: Private markets continue to offer attractive diversification benefits. While a higher cost of debt and lower capital market activity present some challenges, the overall picture is more nuanced, with 2023 the seventh-largest fundraising year in history. Private equity has seen a welcome 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.

Alternative and Real Assets continued:

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.

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.

Infrastructure Performance Following Last Fed Rate Hikes



As of 31 March 2024. Source: ClearBridge, FactSet, Bloomberg

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. However, property is an idiosyncratic sub-asset class and while we are cautious on commercial and residential, we like the structural tailwinds for industrial such as logistics and warehousing. We think an allocation to global listed property remains warranted in a diversified portfolio despite areas of concern.