November 2024

Market Outlook.

Remaining Positive

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Markets like soft economic landings and as growth risks have incrementally eased, risk assets have incrementally moved higher. The rise in equity markets has been impressive given it has also occurred against valuations that look increasingly stretched as well as ongoing and elevated geopolitical uncertainty.

Since early-2023, we have been optimistic on financial markets and while the direction is not surprising, we must admit that even our most optimistic expectations have been surpassed by US and, in particular, large-cap equities. Encouragingly, key central banks are now starting a global rate cut cycle that we expect will add further fire power to the rally in equities (and by association other risk assets) but the front-end loading of returns is likely to mean that the next leg higher will be more volatile and modest in comparison to the same starting point in previous rate cut cycles.

Looking forward into 2025, it is easy to be distracted by the lengthy list of potentially negative or disappointing developments for markets. Expensive valuations, an unexpected creep higher in long bond yields, slower than expected policy rate cuts, (geo)political risks and for Australia, sticky inflation that delays the start of its rate cut cycle. However, we think these risks, while not insignificant as potential headwinds, are reasons why markets will remain data dependent, volatile, and will rise only gradually into 2025, with every few steps forward accompanied by a step backwards until conviction in the outlook solidifies.

While it feels like our optimistic view on markets is getting long in the tooth, it is time to become more realistic rather than more cautious on the outlook. China's well co-ordinated and meaningful policy stimulus further reduces downside economic growth risks and with the Peoples Bank of China (PBoC) joining the US Federal Reserve (Fed) and the European Central Bank (ECB) in cutting rates (the big three), we think investors should keep leaning into markets rather than turning more defensive.

However, the key qualification is that *relative* value is likely to be a more important driver of positioning as investors look for more cushion against potential disappointment in cheaper assets and/or equities. If our view on growth bottoming (and now beginning to pick up) materialises, then the rotation towards more cyclically exposed areas will gather momentum. It might seem perverse to add what are considered "riskier" investments when uncertainty is high, but (relative) valuation tends to be an important driver of positioning when all assets look expensive. For investors this means:

- Interest rates are in decline and may fall (a lot) further if growth disappoints. Investors should be looking to deploy cash into more income secure investments including quality credit, diversified fixed income and equity income.
- Traditional portfolio allocations should be balanced with alternative exposures, such as private markets (both credit and equity) and liquid alternatives, such as hedge funds which provide downside/non-correlated returns.
- Valuation awareness is vital within equities until confidence in growth emerges. Structural themes (such as AI and energy transition) should supplement cyclical exposures. Look to gradually lean into small and value areas as confidence in policy makers increases.

For now, a well-diversified portfolio remains the best hedge against uncertainty and potential negative triggers. There is significant fire power sitting on the sidelines that we think will get deployed into risk assets as comfort around the political and economic backdrop improves, and while we accept that valuations across most assets are not appealing, this is unlikely to stop a shift from cash into higher returning assets.

Commonwealth Private

Global Economics:

Central banks shift the focus to growth

- The global rate cut cycle is now firmly underway with PBoC now joining the Fed, ECB and other key central banks in reducing policy rates.
- US recession risks continue to decline following stronger than expected growth and labour market prints.
- Geopolitical uncertainty – US presidential election and tensions in the Middle East – have remained well contained but pose tail risks to the outlook.

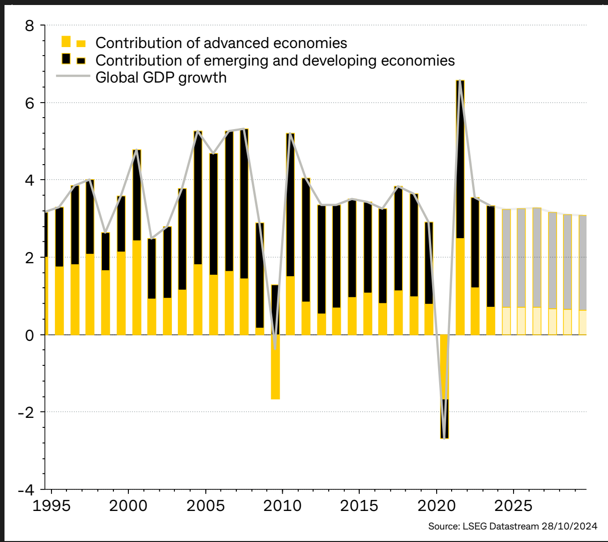
The global economic backdrop remains on a solid footing and continues to defy growth sceptics. This is led by the US, where both economic growth and the labour market has been stronger than expected despite domestic political uncertainty and continued weakness in the housing sector.

The biggest surprise over the past month was a well co-ordinated and meaningful set of policy announcements made by the upper levels of the Chinese government, with the promise of more to come. To be clear, policy stimulus is coming against significant cyclical (consumer and employment) and structural (property, leverage, demographics, and geopolitical) headwinds, but it was enough to drive a significant rally in Chinese risk assets and further lessens the risks to the global growth backdrop as we move into 2025.

We now have the three most important central banks – the Fed, ECB and PBoC – in policy easing mode, alongside the Bank of England, Bank of Canada and various emerging market central banks. We are confident inflation is no longer a constraint towards adding more policy stimulus should growth conditions deteriorate faster than expected.

Dowside growth risks falling

Global GDP Growth (% YoY)



As we head into the final week of the US Presidential election, the race remains too close to call. Elevated political uncertainty and an escalation in Middle East tensions (Israel/Iran) pose downside risks to the backdrop, particularly if a decision around the US Presidential election is delayed. However, both business and consumer sentiment, and oil prices, have been resistant to geopolitical uncertainty.

We are confident that global growth is set to pick up into 2025 as global monetary conditions ease and relief flows to household spending. While both Europe and China are still tracking slightly below expectations, increased policy support will help to stabilise momentum and add to other economies (both developed and emerging) which are also facing similar outlooks. The recent rise in long bond yields is concerning but has not been enough to dislodge our optimistic outlook.

Australia Economics:

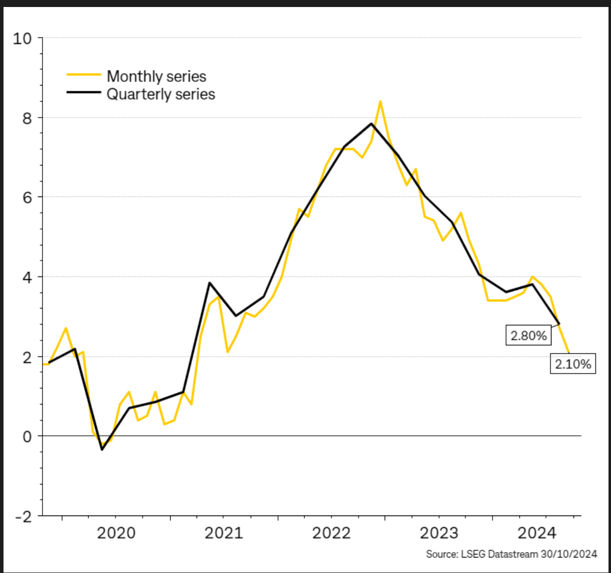
2024 rate cuts a “coin toss”

- The economy has slowed to stall speed as rate hikes have driven a material slow-down in consumer spending.
- A disinflationary trend persists, but a stronger than expected labour market is hampering the potential for 2024 rate cuts.
- CBA expects one 25bp rate cut in late-2024 with a gradual path to easing throughout 2025.

Australia’s economic outlook has continued to soften through recent months as consumers continue to dial back discretionary spending, despite the recent tax cuts. Consumer price gauges released over the September quarter also point to a firming disinflationary pulse, but it remains uncertain as to whether this has been strong enough for the Reserve Bank of Australia (RBA) to begin cutting rates in December or whether rate relief will not arrive until early-2025.

Modest disinflation persists

Australian Consumer Price Index (% YoY)



At this stage, the RBA continues to balance a stronger than expected labour market with a gradual but still elevated inflation rate. The most recent labour market data showed jobs growth has been remarkably strong, although a rising participation rate means the unemployment rate has trended sideways. Labour market strength, in large part, defies the signal sent by the weakness in GDP growth, with little evidence the weakness in private demand growth has spilled over to job losses in any discernible way.

The RBA has the dual mandate of price stability, as defined by the 2-3% inflation target, and full employment. There is no numerical target around what constitutes full employment but, unfortunately, we appear to be running out of time for the RBA to follow other key central banks in cutting rates this side of 2025.

More broadly, there are obvious pockets of weakness spread across the economy as cost-of-living pressures and rents remain elevated and corporate failures high. However, geopolitical uncertainty (both out of the US and the Middle East) has the potential to weigh on sentiment should developments turn less friendly (such as a spike in oil prices).

Despite inflation concerns, we remain optimistic on the economic outlook. Growth has been resilient to rate hikes due to strong population growth, and we think the economic trajectory will improve into 1H25, albeit gradually, as consumer confidence takes time to recover. CBA still expects the RBA to cut in December, but this is against market pricing for early-2025. We expect ~125bp of policy easing by the end of 2025 which would take the cash rate to 3.10%.

Equities:

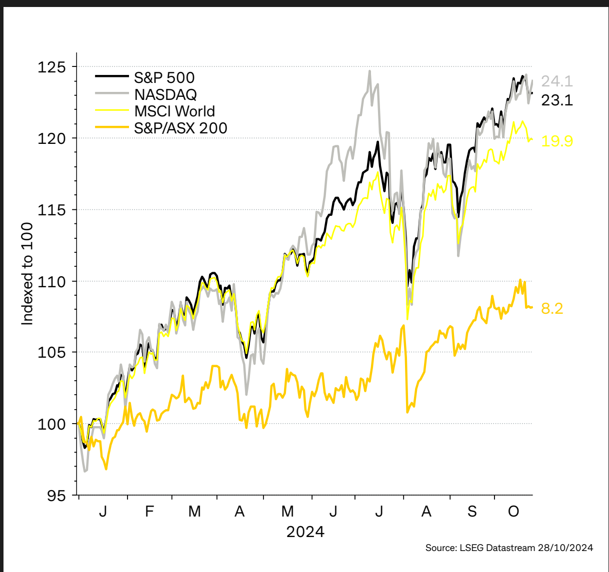
Tailwinds remain solid

- Equity markets remain well supported by solid corporate earnings and increased central bank policy support.
- While valuations are elevated, we do not see them preventing further upside even against slightly-higher long bond yields.
- China stimulus has further reduced downside growth risks. Cyclical improvement will support small caps, value stocks and emerging markets into 2025.

Global equity markets are continuing their remarkable run throughout 2024, led most recently by a sharp, policy-supported spike from China and further incremental gains by the US. After starting the year on a cautious note, US equities have been led higher by a rampant tech sector, as suggestions the share price momentum of the "Magnificent 7" has run its course appearing to have fallen on deaf ears.

Equity markets back to fresh highs

Price Peformance (Indexed to 100 as at 31 Dec 2023)



It is hard not to be impressed by the resiliency of equity markets and while they are not 'risk-less', we do think falling policy rates, increased confidence the US economy can land softly, and strong corporate earnings will continue to support equity markets into the new year, despite rising valuation concerns (made worse by the recent jump in long bond yields).

While the US Presidential election is a dead heat (according to nationwide polls), the betting markets now have (ex) President Trump firmly ahead, and we think this is adding to the tailwinds for markets, given potential for corporate tax cuts and a leaner regulatory policy stance.

At this stage, we have seen some rotation into laggards, such as small cap, value stocks and emerging markets (China in particular), but this appears modest in relation to the extent of underperformance in recent years, and this can be expected to pick up as cyclical tailwinds and policy easing picks up. Historically equity markets like soft landings and this offers the prospect of further stock gains provided long bond yields do not rise too far, or fast, and there is no sustained increase in political uncertainty that undermines confidence.

For Australia, we think the equity market will remain a play on the direction of offshore markets despite an out-of-sync economic and interest rates cycle. We do not see as much valuation risk for Australian equities, even if there are some pockets of concern. This is particularly the case given recent stimulus out of China which has seen some rotation into the resources sector. We do not think a delay in domestic rate cuts poses a big drag on the market. While more supportive conditions will be welcome news for consumer facing sectors, we think it is just a matter of time before more stimulus arrives.

Fixed Income:

Long rates push higher

- A move higher in long bond yields reinforces the role of bonds in a diversified portfolio as a yield enhancer and as growth insurance.
- Despite a back-up in long bond yields, the global policy easing cycle remains firmly intact.
- Credit spreads are relatively tight and drive a preference for higher quality issuers and actively managed fixed income credit exposures.

Market yields moved higher in October as investors re-assessed the longer-term outlook for Fed monetary policy following reassuring US economic data. Since late-September, US markets have moved from pricing in around 2.25% of Fed rate cuts by the end of 2025, to only ~1.60%.

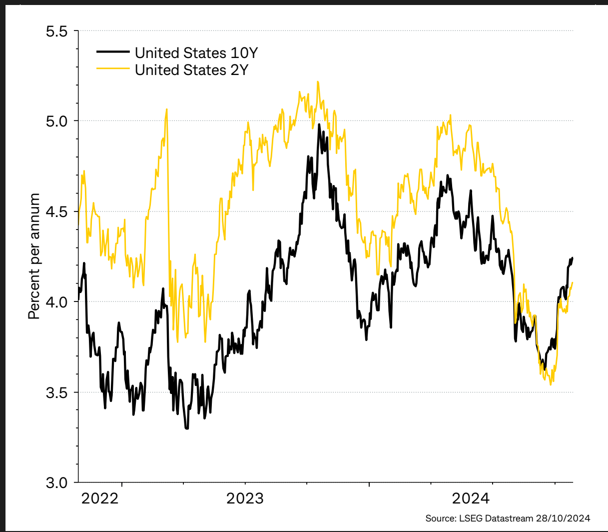
With US bond yields recently rising between 0.50-0.60% (despite most central banks in easing mode), the higher yield potential on offer underscores the role that bonds should play in a diversified portfolio, while also providing a hedge to downside risks.

US economic data continues to point to a soft landing, in line with our base case expectation. However, with other key regions such as China, Europe and Canada lagging, the divergence in growth and fixed income markets globally, is providing a constructive backdrop for investors.

Notwithstanding recent moves higher in market yields, the global rate cut cycle remains on track, with several central banks commencing monetary easing. The RBA is remaining steadfast but when it follows, it will impact rates on offer for cash and cash-like products, including term deposits. Thus, the scope for investors to move from short-term products to lock in longer-term yield is diminishing.

US bonds tick higher on stronger growth

US Government Bond Yields %



With October proving to be another supportive month for global credit markets, credit spreads remain historically tight, especially in the US. As a result, we retain a preference for higher quality, investment-grade credit issuers. We believe this environment of elevated bond market volatility, lower credit spreads, and differing regional economic and credit fundamentals is a reminder of the benefits of investing through a diversified fixed income credit portfolio manager that manages interest rate and credit spread risks.

In primary credit markets, both domestic and global supply remains robust, providing fixed income investors with sound choices to deploy capital. Subordinated debt issuance was a feature of this domestic credit supply last month, partly as bank issuers pivoted to Tier 2 markets following Australian Prudential Regulation Authority (APRA)'s surprise proposal in September to gradually phase out hybrid bank capital (refer to our October 2024 monthly report). With industry submissions to APRA's proposals due on 8 November, the market will likely receive an update from the regulator by year-end.

Real Assets and Alternatives:

A lot to like in this space

- Real Assets such as Property and Infrastructure provide long-term investment stability.
- Within Alternative Assets, Private Credit offers enhanced yields, Private Equity provides access to value-added opportunities and participation in developing businesses and technologies, while Hedge Funds aim to provide returns that are de-correlated to traditional assets.

Real Assets: While most Australian investors are well-versed in residential real estate, other Real Assets (including commercial property and infrastructure) are a less explored (but growing) component of everyday investing.

Certain commercial property sectors have been challenged after a period of above-trend returns (e.g. commercial office), however other sectors have shown robust returns (e.g. data centres).

Over the past 18 months, global listed infrastructure performance has lagged the broader equity market, as investors sought growth-style assets, particularly within IT-related sectors. However, we retain our positive outlook for Real Assets, due to their defensive characteristics and structural tailwinds, which combine to provide the potential for long-term growth and income distributions.

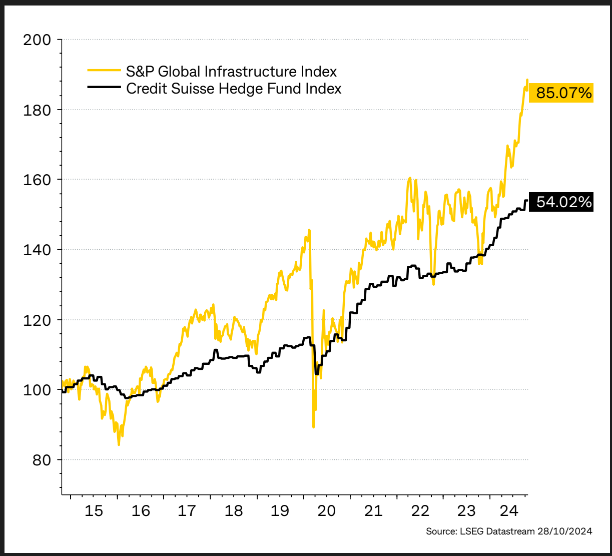
Alternatives: We break Alternative into Private Markets and other alternatives (Hedge Funds).

Private Markets: Well-chosen private debt investments continue to provide attractive returns, which can be structurally higher than traditional liquid debt investments.

Private Equity (PE) markets have, overall, experienced declines in valuation multiples over the past 18 months, as listed-market investors rejected high-valuation IPOs, particularly with regards to pre-profit companies (since early-2022 when interest rates began to normalise).

Alternative investment return

USD Total Return



As such, PE investments are starting to present better investment opportunities, in both primary and secondary markets (including the liquidity demands of existing investors which are providing attractive discounts). We continue to favour established PE managers who have proven track-record through multiple investment cycles.

Hedge Funds: Hedge Fund index returns have declined over the past two decades. However, individual managers can provide strong returns with diversified (and de-correlated) return drivers.

Conclusion: Well-selected Real Assets and Alternatives provide sound investment opportunities, both as standalone investments, and as part of diversified portfolios.

Investment selection is paramount, as the risk characteristics of each strategy vary significantly and require specialised investment expertise to consider and mitigate the inherent risks. We believe the current market environment and position in the monetary easing cycle will be conducive to the generation of returns across these asset classes over the medium term.