Commonwealth Private

October 2024

Market Outlook.

Don't Fight the Fed.

On your marks ...

We have been optimistic on financial markets through 2024 and have been rewarded with solid gains across both fixed income and equity markets. While we have had to wear a lot of volatility and some agonising declines, including the flash-crash in early August, the resiliency of equity markets has been impressive, particularly given ongoing economic uncertainties, inflation concerns, and a baseline of elevated geopolitical risk.

We don't think it's time to surrender our optimistic view on the global economy and with policy rates now moving lower, neither are we prepared to soften our positive view on equity markets which we think will continue to push higher into year-end as easier financial conditions help stabilise economic momentum and support consumer and business confidence.

We recognise that the recent 50 basis point cut by the Fed has re-introduced a degree of uncertainty around the state of the US economy and what this means for equity markets. Investors are trying to determine whether the Fed knows something they don't know and why they chose to cut more aggressively than consensus expected if the path to a soft landing was still intact.

We cannot ignore the implied signal sent by the Fed. But the implications are not around what the Fed has done, but whether it is "ahead" of the curve in supporting growth and ensuring a recession is avoided. Based on the data heading into the rate decision (being weak but still modestly expansionary), we think they are, despite a heightened level of uncertainty and pondering by market experts.

It is important for investors to calibrate historical experience when the Fed begins to cut rates and what this means for the investment backdrop. It is true that, on average, equity markets have fallen in the period directly following the start of a Fed rate cut cycle. However, the key differentiating factor is whether the US economy has a soft or hard landing.

If a recession is avoided, then the outlook for markets is solid. If not, then markets remain optimistically priced and a rotation towards more defensive vis-a-vis cyclical stocks will gather momentum. At this stage we still believe there is enough evidence to support a soft-landing scenario and so we retain our pro-cyclical stance on equity markets.

For investors, the start of the rate cut cycle has important implications even if there are some areas which will require more time to build up conviction:

- 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.
- Balance traditional portfolio allocations with alternative exposures such as private markets (both credit and equity) and liquid alternatives such as hedge funds which provide downside protection and uncorrelated returns.
- Be more valuation "aware" within equities until confidence in growth emerges. Structural themes (such as AI and the energy transition) should supplement cyclical exposures. Look to gradually lean into small and value areas as confidence in policy makers increases.

For now, there is enough uncertainty around the economic growth outlook, the US election and geopolitics to keep some investors on the sidelines and markets oscillating between expectations of whether or not the Fed has done enough to provide "insurance" for a soft landing. This will keep volatility elevated until there is clear air around the outlook, which might not come until year end. We remain positioned for a recovery, but it won't come overnight.

Jason Todd, CFA
Chief Investment Officer
Commonwealth Private

Global Economics:

Central Banks shift the focus to growth

- The global rate cut cycle is now firmly underway following the Fed's September cut.
- US recession risks are not insignificant but indicators still point towards a soft landing.
- China is now stimulating, but traction remains modest; more is required to stablise 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.

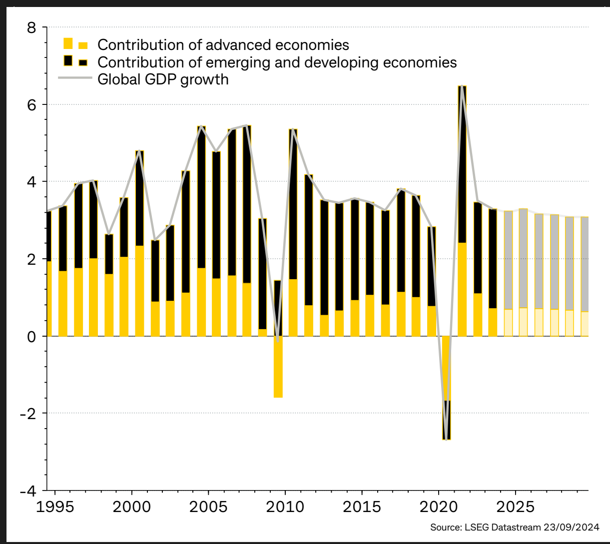
Recent labour market data out of the US is now suggesting that the economy has not yet bottomed, and is likely to require a more aggressive policy stance from the US Federal Reserve, which is now underway.

While debate on the pace of rate cuts will remain intense, the Fed is on a data dependent path which still aligns with a gradual pace despite concerns stemming from weaker than expected labour market prints and a deterioration in manufacturing indicators. At this stage we maintain our view that the 2nd half of 2024 will be the weakest patch for the US economy, with growth gradually picking up into 2025.

Alongside the Fed, other key central banks including the European Central Bank and Bank of England are now firmly in rate cut territory as they attempt to stave off a deeper economic downturn. Euro area growth estimates have continued to decline in recent months with Germany at the forefront of the weakness, due to a softening consumer outlook.

Growth bouncing around trend levels

Global GDP Growth (% YoY)



Despite ongoing policy support, China remains a drag on global growth momentum with a notable bifurcated economy. On the one hand you have a booming exports sector, but on the other hand, this is being dragged down by ongoing weakness across property, retail, and to a lesser extent infrastructure.

While policy support is ongoing, it has thus far failed to put a floor under cyclical activity, with the Chinese economy now tracking at its slowest pace since the COVID contraction and well short of the government's 5% target. While policy makers are focused on supply side policies, we doubt they can tolerate much more growth slippage and it's likely that greater support is coming.

While both Europe and China are tracking slightly below expectations, our base case of a moderate global slowdown remains intact, with increased policy support helping to stablise momentum and provide increased consumer support into the coming year.

Australia Economics:

Consumers succumbing to rate hikes

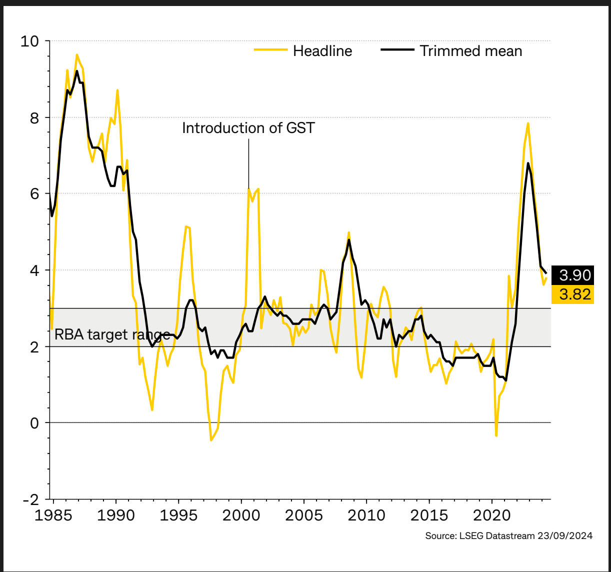
- The economy has slowed to stall speed as rate hikes have driven a material slow down in consumer spending.
- Per capita GDP has fallen for the past 6 quarters, with recession only avoided via elevated population growth.
- Inflation concerns continue to fall, with CBA expecting one 25bp rate cut in late 2024 with a gradual path to easing throughout 2025.

Australia's economic outlook has continued to soften through recent months as excess savings have fallen and consumers have dialed back discretionary spending.

While recent spending data has come in well below market expectations, the RBA has maintained a hawkish bias, highlighting limited progress on bringing underlying inflation down over the past year. Specifically, the Governor has reiterated her message from the August Board meeting that they do not expect to be in a position to cut rates in the near term.

CPI not at levels that allow rate cuts

Australian CPI %YoY



Unfortunately, we appear to be running out of time for the RBA to follow other key central banks in cutting rates in late 2024. CBA now believe a firmer disinflationary pulse is a necessary ingredient to see the RBA commence an easing cycle this calendar year. But the evolution of the unemployment rate will also play a big role in when the central bank joins its global peers in cutting rates.

At this stage, the RBA has not seen enough weakness in the labour market to gain comfort that wages growth will slow to levels that it deems comfortable. While the unemployment rate has risen in the past 6 months, its August print of 4.2% from the ABS may well be enough to push the RBA to commence an easing cycle before year end.

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. On a positive note, ongoing declines in the oil price are aiding a global disinflationary pulse and helping to dampen local cost push inflation.

Despite inflation concerns, we remain optimistic on the economic outlook. Growth has been resilient to rate hikes due to strong population growth, although tax relief has provided a relatively small and short dated boost. We think the economic trajectory will improve into the 1st half of 2025, albeit gradually as consumer confidence takes time to recover.

Our central scenario for the RBA is currently in broad agreement with money market pricing. We expect ~125bp of policy easing by the end of 2025 that would take the cash rate to 3.10%. Fiscal policy remains a key source of uncertainty, particularly as we head into an election year.

Equities:

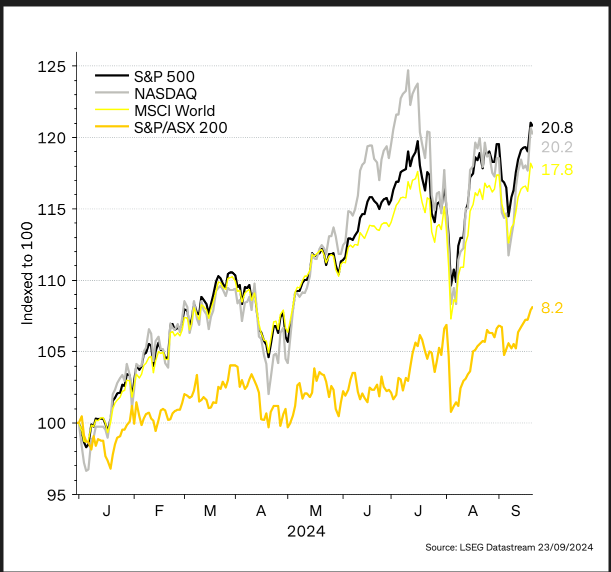
Moving higher on policy rate cuts

- Equity markets are looking through near term growth risks and towards upcoming rate support.
- While valuations are elevated for global equities, we do not see them preventing further upside as bond yields fall and confidence in growth picks up.
- Cyclical improvement will support small caps and value stocks into 2024 but relative outperformance will be modest and short-dated.

Equity markets are trading like they are teflon, with nothing seeming to stick. Growth risks have come and gone, fatigue in AI-related stocks emerged and then quickly disappeared, valuation hurdles have been poured over and then dismissed while earnings disappointment have been treated as idiosyncratic rather than systemic.

Equity market correction modest to date

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



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 alongside increased confidence that the US economy achieves a soft landing, is likely to push global markets higher into the year end.

However, with "growth" heavy equity market valuations already at elevated levels, we think the upside will be driven by earnings rather than valuations, outside of deeply discounted cyclical laggards. Over recent months we have already seen equity market breadth improve as yesterday's winners have been used as a partial funding source for rotation into small caps and value stocks.

We think this rotation is still in the early stages and will continue to gather momentum as the Fed (and other key central banks) move further into rate cut territory. Historically equity markets like soft landings and this offers the prospect of further stock gains alongside stable long bond yields and a modestly low volatility environment.

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:

Rates moving lower

- We remain constructive on the outlook for fixed income across both government bonds and credit spread products.
- Despite recent moves, government bonds still offer reasonable yields and provide protection against downside risks.
- Global credit spreads are still relatively tight, thus we prefer taking exposure to higher-quality issuers.

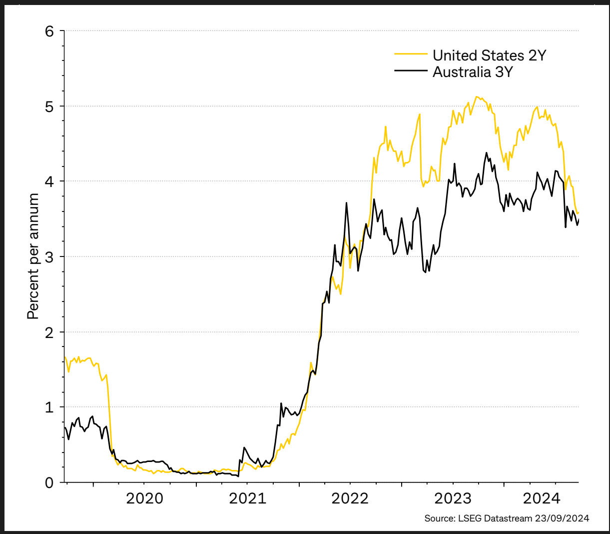
Despite the recent sharp fall in interest rates, we remain constructive on fixed income and maintain bonds should play a key part in a diversified portfolio, firstly for their reasonable yields, and secondly for providing a hedge against downside risks.

We remain sanguine on the US economy, with the Federal Reserve's 0.5% interest rate cut adding support to our US soft landing base case expectation. The differing pace of economic growth and interest rate cuts across key regions is creating divergences in global fixed income markets, though this is a constructive backdrop for investors.

With multiple central banks having embarked on policy easing, market yields have sharply declined, with the short-term pricing of rate cuts seemingly overdone. While the RBA remains an outlier, local market yields have followed suit with term deposit rates also trending lower. In our view, the window for moving out of cash-like products, locking in decent longer-term yield potential and reducing reinvestment risk will soon be closing.

US bonds pricing in weaker growth

Government Bond Yields %



Despite some widening in August, global credit spreads are not pricing in much margin for error. Together with the divergence in economic and credit fundamentals across the globe, we prefer higher quality, investment-grade credit issuers. Furthermore, this environment highlights the increasing benefits of investing through an actively managed, diversified fixed income credit portfolio.

In a surprise announcement, Australia's financial regulator is proposing to gradually phase out hybrid bank capital, in favour of subordinated (Tier 2) debt and a small amount of core equity capital (for larger banks). Margins for ASX-listed hybrids reacted positively to APRA's move, as did bank equity investors, given the positive implications for the re-distribution of excess franking credits to equity holders (if the hybrid proposals proceed).

Alts & Real Assets:

A lot to like in this space

- The idiosyncratic nature of alternative assets presents a broad investment opportunity set.
- Private Credit offers strong yields while Private Equity provides non-cyclical value-added capabilities.
- We like Infrastructure assets as a hedge against inflation but also as one of the cleanest ways to play the energy transition.

Alternative assets form an important part of a diversified portfolio. The idiosyncratic nature of investments available within the alternative asset sleeve provides investors with access to a broad opportunity set which has lower correlation with traditional asset classes while, in many instances, also providing an attractive yield.

We break alternative assets into liquid alternatives (Hedge Funds) and private markets (Equity and Credit). We like each of these sub-verticals and think there are attractive options across all three areas at present.

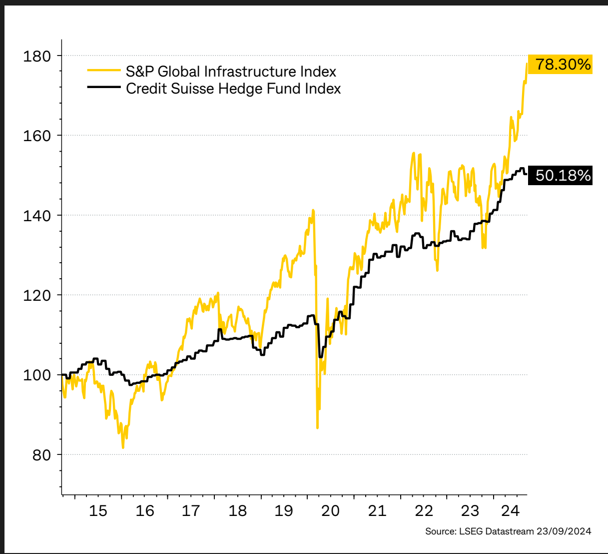
Hedge Funds: Provide an important risk diversifier for portfolios when macro uncertainty and two-way volatility is high. However, returns to hedge funds as an asset class have been steadily declining over the past 2 decades with significant performance dispersion amongst managers. This means manager selection and fund diversification are important considerations, with the intention of reducing market (systematic) risks.

Private Markets: Private Equity (PE) 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 is still struggling but should begin to pick up as markets thaw. We like established PE players who have a long track record of generating "through the cycle" returns.

Selective Private Credit opportunities look attractive given the higher interest rate environment, with floating rate yields still appealing. Uncertainty and tighter credit conditions have caused traditional lenders to retreat, and private lending remains appealing.

Alternative investment return

USD Total Return %



Real assets (both listed and unlisted) are a growing component of everyday investing. We see attractive opportunities within the sector and the unique nature of these investments means there is something to suit almost all investors.

Property: 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. For those with a longer-term lens, we think the start of a policy easing cycle will provide valuation support.

Infrastructure: For a significant part of 2023 and into 2024, global listed infrastructure has had difficulty 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 are structural tailwinds for infrastructure, via strong and stable earnings growth, attractive valuations and dividends.