Q1 FY25

Quarterly Investment Report.

September 2024

Back on Track

Commonwealth Private

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Foreword

Jason Todd

Chief Investment Officer
Commonwealth Private

The past few weeks have been a roller coaster for markets. In August, equities sold off sharply only to bounce back and recover these losses by month end. While the size of these swings was far from normal, the correction itself was not.

August was a reminder of where economies and markets are. Growth expectations are not set in stone, rather they are data dependent and can oscillate wildly. Similarly, correction and recovery periods are a normal feature of markets rather than outliers. This is especially the case when herd behavior is driving concentrated positioning, and valuations leave thin cushion for the unexpected.

While a lot has happened since our last monthly update, not a lot has changed. There is no doubt some complacency had creeped into the markets and the correction helped squeeze out some excesses. However, our base case has not changed. We think the US economy remains on track for a soft landing, with the global economy set to bottom out and gradually improve into 2025. Inflation across the developed world continues to decelerate and the trajectory is now allowing central banks to begin easing policy rates. While there is an open debate on how long the Reserve Bank of Australia (RBA) will remain an outlier and keep rates on hold, we don't think the difference of a few months will materially change the domestic outlook.

Equities have run hard into soft landing expectations and despite pockets of concern (particularly around valuations and positioning), an improving economic backdrop alongside lower borrowing rates should help kick earnings growth higher over the coming 12 months. We still like Global over Australian equities for both growth and cyclical exposure.

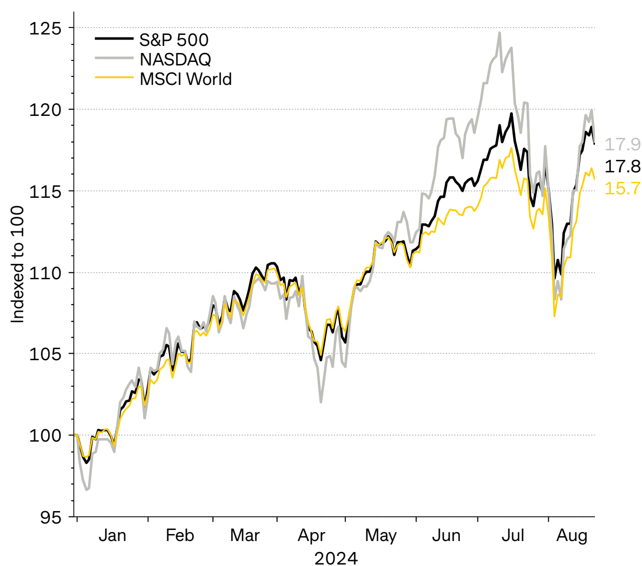
There is now a strong valuation discount for small cap stocks across the world (including Australia) and an improving cyclical pulse should see this sub-asset class play some catch up through 2025. Finally, every portfolio should have at least a benchmark allocation towards fixed income which offers solid yields and strong downside growth protection. However, the window to lock in longer dated yields (before they fall alongside short rates), is getting shorter. We remain constructive on the macroeconomic backdrop but are reminded that economic recoveries take time to become entrenched and always come with (unwanted) volatility. Stay the course.

Global Equities

- We are positive on global equities which are set to benefit from an improving cyclical outlook.
- Improving earnings growth and easier monetary conditions will become strong tailwinds.
- Valuations and geopolitical risks are headwinds but are not enough to disrupt the uptrend.

Equities bounce back from sell-off

Total returns



We remain positive on the near-term equity market outlook and think global markets can rise another 5-10% through year end as confidence in an economic recovery improves and policy rate cuts gather momentum.

We don't see "blue sky" upside given the run that markets have had since the start of the year. However, we are confident that fundamentals will improve enough to offset lingering headwinds from elevated valuations, geopolitical uncertainty, sticky inflation, and a modest desynchronised economic recovery.

For equity investors, continued progress on lowering inflation back within key central bank target ranges will allow rate cut momentum to pick up as we move into the back half of the year. Importantly, the US Federal Reserve (Fed) is signaling that its next move will be down, and this will help ease concerns that US equities have moved too far ahead of fundamentals.

While the upswing is not likely to be strong enough to prevent ongoing equity market volatility, we think risk taking behavior remains intact and in combination with large cash piles sitting on the sidelines (US money market fund balances still sit at above $6tn US) this should help limit correction episodes and ensure that a *"buy the dip"* mentality remains.

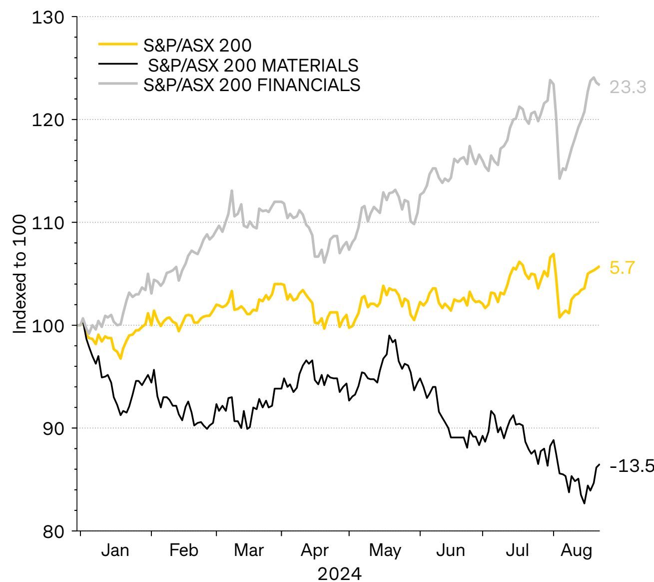
At a regional level, we still like US equities despite valuation concerns, but think that cyclical markets (led by Japan and Europe) have a small window for outperformance as cyclical momentum picks up. There is a strong relative valuation argument for small cap stocks (vis-à-vis large caps) and like other cyclical markets, we think they can play some catch up, but we don't think the upswing will be strong enough to drive a sustained period of outperformance, or for the valuation discount to permanently close.

Australian Equities

- Australian equities should be a solid performer into H1FY25 as earnings relent bottoms and policy easing supports cyclicals.
- Resources have been a major drag on the benchmark, but we think Chinese economic momentum is close to a bottom.
- High single-digit earnings growth, along with world beating dividend yields, should support returns over coming years.

Significant sector dispersion

ASX Sector price performance



Source: LSEG Datastream 23/08/2024

We see solid upside for the Australian equity market over the coming six to 12 months supported by a gradual improvement in corporate earnings and some (modest) easing in monetary conditions. In addition, the pulse from the global economy should turn more positive with the drag from China close to its nadir.

We do not think that the relative valuation appeal of Australian versus US equities will lead to a period of catch-up performance. Instead, we think this reflects the relative earnings growth outlook which in Australia is capped by the large weighting of mature industries, such as banks and real estate, which are expected to post low to mid-single-digit growth rates.

We do expect better performance from the resources sector which has been a major drag on the market over the past year, but this is contingent on whether China takes a more aggressive stance towards supporting its economy, which to date has been disappointing.

Historically the Australian equity market has been tightly correlated with the direction of global equities (US equities in particular) and we don't think this relationship is at risk of breaking down. However, the pace at which the RBA eases monetary conditions will be important for how the consumer facing sectors of the market perform, including discretionary retail.

Unfortunately, Australia does not have a large technology sector so investors should understand what they are getting when they allocate towards the local bourse – great run companies, a solid earnings growth outlook and a world beating dividend yield (more than 4% before franking).

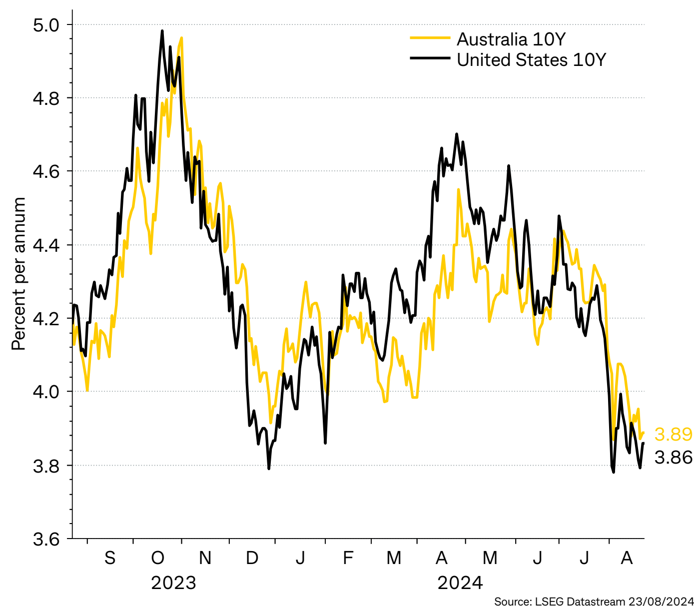
If investors want exposure to the world's fastest growing structural trends (such as AI), then they will need to seek this exposure in global markets or via thematic plays. For those who are comfortable investing close to home, we think a less volatile but steady growing market remains appealing in a world full of unknowns.

Fixed Income

- We like the outlook for fixed income across both government bonds and spread products.
- Government bonds offer solid yields with downside protection against growth risks. We are targeting above benchmark duration.
- Credit spreads are tight, and we prefer the high-quality end despite expected cyclical improvement.

Long bond yields have collapsed

US vs Aus 10-year bond yields



Source: LSEG Datastream 23/08/2024

We remain positive on fixed income and believe bonds should play a key part in a diversified portfolio given their ability to hedge against downside risks while at the same time offering reasonable yields.

Our base case is for a US soft economic landing with inflation risks now largely in the rear-view mirror. This opens scope for policy easing to proceed at a pace that matches any deterioration in the outlook - modest if growth consolidates but more aggressive if signs of weakness pick up. The desynchronised pace of rate cuts across the globe is likely to create divergences in global fixed income markets which is an appealing backdrop for investors.

We think investors have a short window for moving out of short dated fixed income (cash) and locking in longer dated returns before rate cut cycles begin to gather momentum. In Australia, this window might be a little longer given the RBA's rate cut stance, but we would recommend the same strategy on the basis that yields have already peaked.

Because there are wide divergences in economic fundamentals across the world, we prefer to stick with higher quality bond markets and in particular credit issuers where spreads are already tight. In this regard, we believe it is important to avoid moving down the "quality" spectrum until the economic recovery is entrenched.

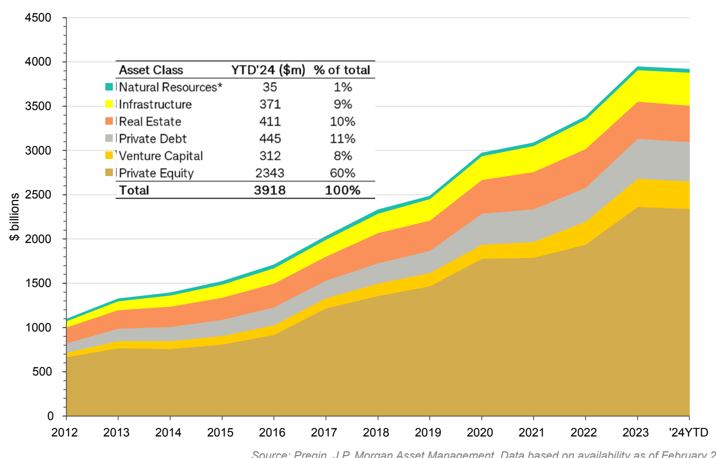
The exponential growth of private credit has brought on fears that it is in a bubble. However, while there will always be red flags within any asset class, we think highly rated private credit (direct lending) where credit worthiness and seniority are tightly controlled by the lender mitigates a lot of these concerns.

Alternatives

- The idiosyncratic nature of Alternative assets presents a broad investment opportunity set.
- Hedge funds offer strong risk diversification across multiple strategies.
- Private credit offers strong yields while private equity provides non-cyclical value-added capabilities.

Global 'dry powder' by asset class

Cumulative 'dry powder', USD



Asset Class	YTD'24 ($m)	% of total
Natural Resources*	35	1%
Infrastructure	371	9%
Real Estate	411	10%
Private Debt	445	11%
Venture Capital	312	8%
Private Equity	2343	60%
Total	**3918**	**100%**

Source: Preqin, J.P. Morgan Asset Management, Data based on availability as of February 2

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 investment options across all three areas at present. We like the yield on offer within private credit, the non-cyclical value-added capabilities of private equity (PE) and the non-correlated return potential (and downside risk mitigation) of hedge funds.

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. We prefer long/short and global macro strategies at present.

Private Markets: 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.

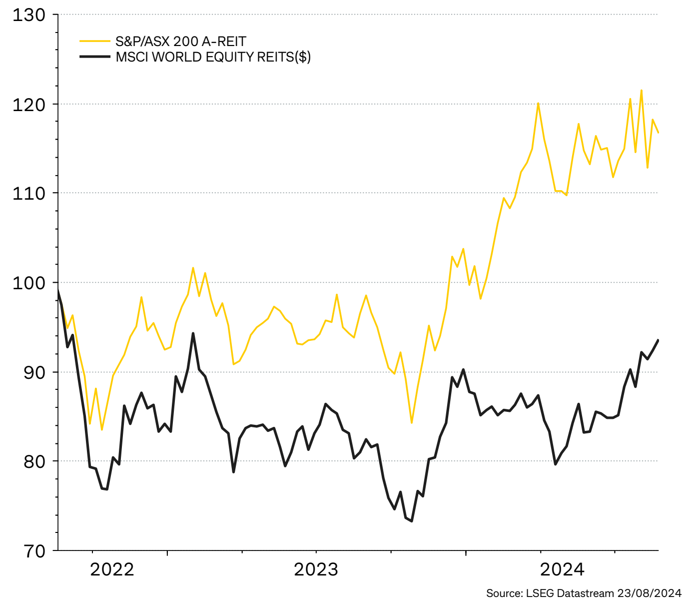
Selective private debt, especially senior debt, looks attractive given the higher interest rate environment with floating rate yields still appealing. Uncertainty and tighter credit conditions have caused traditional lenders to retreat, and private lending remains appealing.

Real Assets

- Real assets offer strong diversification benefits as well as a stable return profile.
- We like infrastructure assets as a hedge against inflation but also as one of the cleanest ways to play the energy transition.
- Property is not one asset class. Structural tailwinds support logistics and warehousing while cyclical headwinds will cap rate sensitive residential and office.

MSCI Property vs Australia Property

Real estate performance



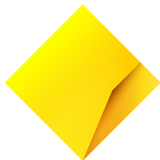
Real assets (both listed and unlisted) are a growing component of everyday investing. We think there are attractive opportunities within the real assets space and the idiosyncratic nature of these investments means it is possible to find something that suits almost all investors.

Historical analysis suggests that real assets have the potential to improve the risk-adjusted returns of a traditional stock-bond portfolio and diversify away some of the risks associated with these traditional assets. In addition, we think that real assets are an option for getting around some of the more structural concerns that investors have, such as high inflation or decarbonisation.

Most investors are focused on property (both listed and unlisted) as well as infrastructure (unlisted) as their primary options for real asset exposures. However, other options such as farmland, timberland and agricultural commodities are increasingly available for investors.

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. 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 our areas of concern. For those with a longer 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 had difficulties keeping pace with the risk-on sentiment of the broader equity market. Rising interest rates and the more defensive characteristics of infrastructure have been headwinds. However, there is a rising structural tailwind for infrastructure via strong and stable earnings growth, attractive valuations and a demonstrable dividend stream.



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Source: All data referred to in this report is taken from the following sources; Iress, Morningstar, Bloomberg, Refinitiv Datastream unless otherwise stated.