Q4 FY2024

Commonwealth Private

Quarterly Investment Report.

May 2024
Will the dream run last?

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Executive Summary

In the first quarter of 2024, investor sentiment hit a crescendo on the back of resilient corporate profits, enthusiasm around artificial intelligence (AI) and hopes that the US Federal Reserve (Fed) and other leading central banks will start to cut rates this year.

In Australia, we have reached the peak in interest rates and focus has now shifted towards when interest rate cuts will commence. The Reserve Bank of Australia (RBA) has also become more dovish in its recent commentary but there is still market uncertainty as to the timing of the first rate cut.

Meanwhile, in the US, Fed Chair, Jerome Powell, suggested that the Fed is getting close to the confidence it needs to start lowering interest rates. Similarly, the European Central Bank (ECB) President, Christine Lagarde, indicated that policymakers may be in a position to lower interest rates in June. However, just as markets became comfortable, wholesale prices in the US accelerated and consumer-price data showed underlying inflation exceeded forecasts for a third month in 2024. Recent jobs data has also been strong which indicates that the US economy has created the most jobs since May 2023. US nonfarm payrolls rose a stronger-than-expected 303,000 in March 2024, while the payrolls for the prior two months were revised up 22,000. The unemployment rate dropped to 3.8% (0.1% drop). Average hourly earnings were in line with forecasts, rising 0.3% month over month and 4.1% year over year. The odds of a Fed interest rate cut in June eased after the strong report, with the first cut now fully priced for September. Markets now anticipate fewer than the three forecast by Fed policymakers throughout the year. The result of this is an uneven path for the Fed in its fight against inflation and reaffirms expectations it will be in no rush to reduce interest rates.

Equity market investors traditionally expect an 8-10% per annum return over the longer term. The fact that this has occurred already in 2024 is cause for celebration and consideration. An equity bull market with almost daily new-highs and low volatility presents its own set of challenges, as economic data and corporate performance is subjected to heightened scrutiny and can result in a harsh repricing of even great companies.

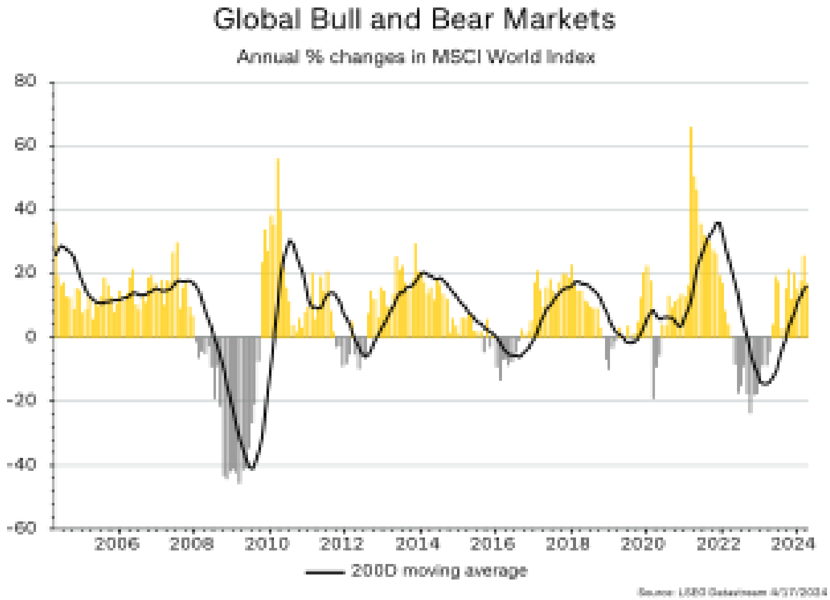

Figure 1

Only two out of the "magnificent seven" have been able to sustain their market leadership on the back of the AI thematic. We've previously mentioned that narrow market rallies tend to not be sustainable unless there are a number of positive catalysts.

After the fourth quarter of the 2023 US reporting season and the increasing talk of rate cuts, investors are diversifying away from the market leaders into more economic sensitive sectors and mid-to-smaller companies.

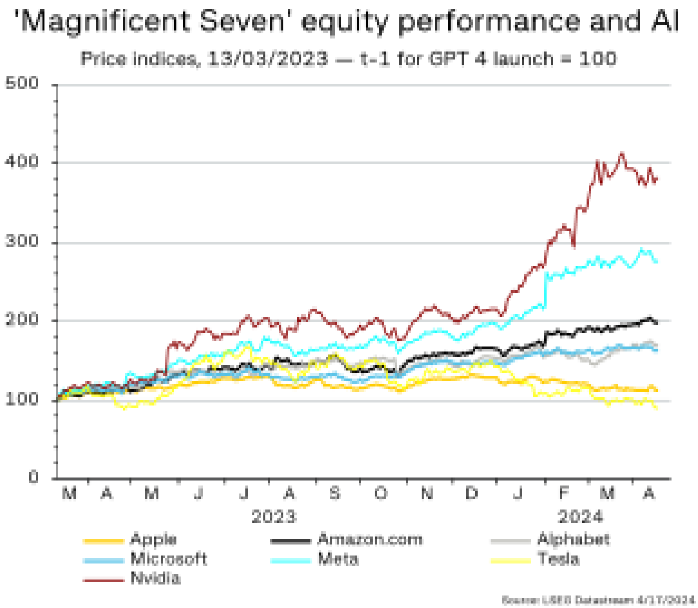

Figure 2

This trend is in line with Commonwealth Private's portfolio positioning but the next three-to-six months will be critical in sustaining this rotation, as the economic environment needs to be supportive and any further slowdown needs to be in line with market expectation. Mid-to-smaller companies tend to have higher debt levels and, as such, are more prone to disappoint if the 'higher for longer' interest rate scenario persists. Volatility is also likely to increase if the 'soft-landing' narrative does not play out as currently anticipated by markets. In this Quarter's Report, we will examine some of the drivers of return, the yardsticks we are looking for and how we are positioning our portfolios for the mid 2024.

New all-time-high records have been achieved across most developed equity markets and other risky assets. While recent inflation and economic conditions data has been positive, we reaffirm that we believe markets are not fully pricing the current level of uncertainty that central banks still face and it is too early to discount the prospects of recession. The escalation of tensions in the Middle East is another risk and if oil prices rise, this will have potentially negative spill-over effects on the inflation front.

Potentially delayed rate cuts make equities particularly vulnerable given the recent record levels as companies will be faced with higher funding costs and softening demand for their goods and services. Our stance is:

- The rally has pushed equity valuation levels even higher increasing our conviction in our underweight position and we have increased our allocation to fixed interest. Our dynamic asset allocation views are based on a 12-18 month investment period rather than trying to time shorter term market moves. While there is short-term risk to the downside from current levels, we feel that growth assets such as equities could still provide positive (after potential mid-year volatility) returns this year, especially once rate cuts eventuate.

- Patience is key. We envision higher levels of volatility to follow and could likely lead to more attractive entry points for investors.
- We have increased our allocation to fixed interest (from cash) as bond yields have risen materially following the rapid interest rate rises in 2022 and 2023. This now means improved yields are on offer for fixed interest, as well as the opportunity for capital appreciation once central banks do start cutting interest rates.
- We would also expect that if a more severe economic downturn were to eventuate, at current levels longer-dated fixed interest securities will decouple from equities and return to providing the portfolio insurance that they have in prior recession-driven equity bear markets.
- We are also neutral on property and overweight on Alternative Investments which we believe will continue to deliver attractive risk adjusted returns.

As always, should our outlook change, we would recommend adjustments to client's portfolio positioning in order to take advantage of any opportunities, or avoid any risks emerging from any changes.

Asset Class	Portfolio Weight	Comments
Cash	Neutral	Cash returns are relatively attractive at current levels providing an income return in conjunction with capital stability.
Fixed Interest	Overweight	Improved yields on offer for fixed interest, as well as the opportunity for capital appreciation in the event central banks are forced to cut interest rates in 2024.
Australian Equities	Underweight	High interest rates and the sensitivity to rates for the Australian economy will see the macro environment further deteriorate.
International Equities	Underweight	High starting valuations across most developed equity markets and mounting evidence that the global economic environment is weakening increases the risk of earnings disappointment in 2024.
Property	Neutral	Valuation outlook improved with bond yields nearer fair value and inflation-linked rents more attractive.
Alternatives	Overweight	Infrastructure benefitting from inflation-linked income streams. Hedge funds providing returns less linked to bond and equity markets.

Australian Equities

The domestic equity market ended higher for the March quarter with the S&P/ASX 200 Accumulation Index (the "benchmark") rising 5.33%, with more recent market volatility resulting in those returns being given back. The S&P/ASX Small Ordinaries, which tracks stocks 101-300 of the S&P/ASX 300, fell by -1.94%. This confirms large caps (i.e. the top-100 companies) drove most of the market returns during the past quarter. In general, ASX companies posted better-than-expected earnings during February's Australian reporting season. In fact, 40% of ASX 200 firms beat consensus, while 32% missed, in line with long-run averages. Revenue growth averaged 6% in the half, implying modest volumes given a 4.7% increase in Consumer Price Index (CPI).

While revenues slowed in-line with expectations, a greater focus on cost control helped companies deliver on earnings. During the quarter, Information Technology was the standout winner among all the Global Industry Classification Standard (GICS) sectors, with a total return of 24.36%. This was well ahead of the second-best sector, Real Estate (up 15.31%), Consumer Discretionary (+12.88%) and Financials (12.03%), the latter led by the Bank subsector which rallied 11.88%. Materials was the only sector to fall in the quarter, down by 6.2%, driven primarily by a significant fall in the seaborne iron ore price. The remaining sectors experienced minimal gains.

Better than expected consumer spending, tight cost-management, inflation moderation and positive economic outlooks typified commentary from Australia's biggest companies. Those companies that could pass on price increases certainly did, particularly in the insurance, healthcare and consumer staples sectors. The consumer discretionary sector was the big surprise, given more resilient top line sales relative to previous conservative assumptions and largely reflective of the strength of the Australian economy in 2023.

The big four banks provided guidance with signs that the downward pressures are easing while margin drivers remain mixed, amid a very competitive market dynamic in both lending and deposit-taking. Despite the surprisingly resilient iron ore prices towards the end of 2023, large miners struggled to grow profit, as the commodity markets remained volatile and weaker and inflationary cost pressure remained high.

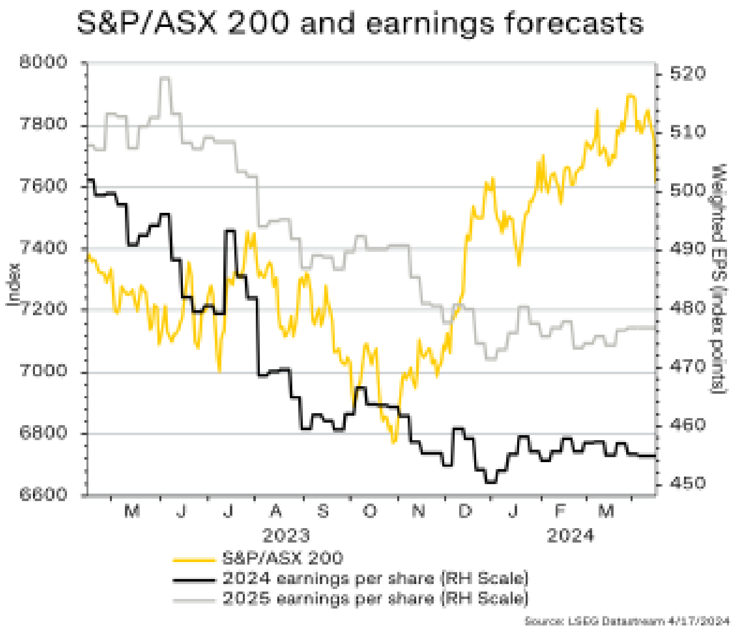

Figure 3

Cash flow generation was sound and healthy balance sheets were maintained, supporting dividend payments and future capital expenditures. Company guidance was muted given the uncertain economic environment with companies eager to downplay expectations. After-reporting season earnings have been revised slightly lower going forward given the fact that economic momentum is slowing.

The Australian equity market is trading around all-time highs, with the valuation multiple (price to 12-month forward earnings (P/E) multiple of a high-16 times) expanding to the highest level in two years and above historical-average level of mid-14 times, while the forward dividend yield fell from 4.2% to 3.9%.

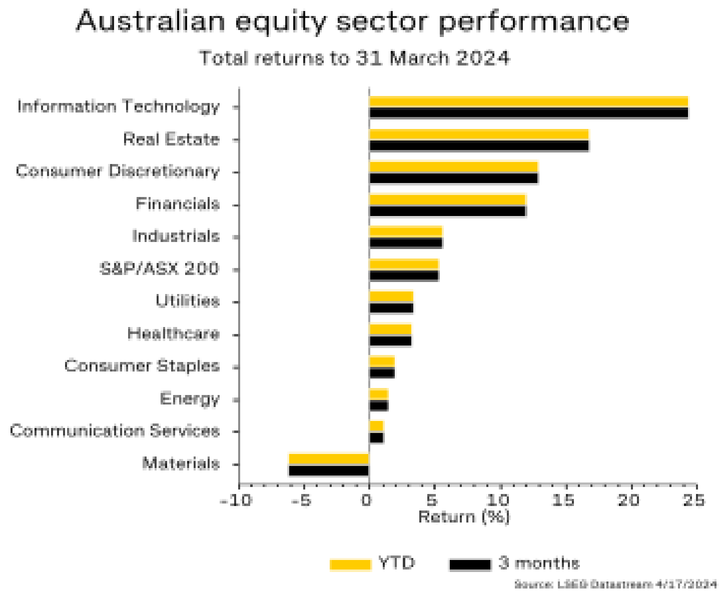

Figure 4

International Equities

Developed international equity markets delivered a record first quarter. Similar to Australia, better-than-expected earnings results announced during reporting season, moderating but resilient global growth and optimism around the prospect of central bank rate cuts supported this.

In the first three months of 2024, international equities as measured by the MSCI World ex Australia Index, returned 13.31%, and an overall 26.70% return throughout the year. The currency-hedged version of the index posted returns of 9.46% over the quarter (due to slight rise of the $A dollar) and delivered a 23.14% return over the year.

Figure 5

In the US, the S&P 500 index added 10.2% and achieved its best first-quarter gain since 2019. The 30-stock Dow advanced 5.6% during this period and also recorded its strongest first-quarter performance since 2021 and the Nasdaq ended the quarter with a rise of 9.1%. We have also seen five months of straight gains for the three indexes. The S&P 500 also finished two consecutive quarters with gains of more than 10%, the last time this occurred was in 2012 and, according to Bespoke Investment Group, has only happened seven times since 1945. Leading the gains this quarter has been Nvidia, last year's market leader, due to increasing demand for its AI chip technology. The stock soared 82.5% for the quarter and gained 14.2% in March alone. Meanwhile, Tesla fell 29% in the first quarter, making the electric vehicle manufacturer the S&P 500's worst-performing stock in the quarter to date.

European shares fell as the economic backdrop continued to weaken and interest rates remain high. The pan European Stoxx 600 closed +6.43%, with France's CAC 40 and Germany's DAX rising 10.39% and 8.78% respectively over the quarter. Information Technology, Consumer Discretionary, Financials and Healthcare were the main sectors contributing to performance. The UK's FTSE 100, also managed to deliver a positive return of 2.84%, driven by higher oil prices and the latest inflation read being lower than expected.

Asian equities have continued to struggle, thanks to China's economic momentum slowing and stimulus measures not yet taking effect. The Shanghai Composite index closed 2.23% higher over the quarter, after government intervention to support the mainland equity market. However, the Hang Seng index was down -2.97% over the quarter. Chinese equities have fallen in excess of 40%, implying that a lot of the bad news may already be priced in. Policy initiatives to date simply have not been sufficient in restoring a great degree of confidence and recent attempts to support the equities markets has resulted in a short-term bounce.

In our opinion, greater proof of a stabilising economy and improved relations with the US is required to attract foreign investors back to Chinese equity markets in a meaningful and sustained way. Attractive valuation levels have resulted in some early positioning from contrarian investors, however, we would advocate a more stock specific strategy at this point.

Elsewhere, the Japanese equity market was a standout over the quarter rising 20.62%, with the Nikkei 225 hitting another 30-year high. The weakening yen which is now at +30-yearlows was the major catalyst for this relative outperformance (as ultra-low interest rates encouraged investors to search for higher returning assets offshore) coupled with stronger than expected earnings and the prospects of ongoing corporate reforms. Japanese semi-conductor stocks and exporters have been the main drivers of performance. Reforms at the Tokyo Stock Exchange are also being credited with helping to increase investor interest in the Japanese equity market. Companies listed on the exchange are being compelled to share greater details of their plans to boost shareholder value, part of a concerted government effort to increase transparency and attractiveness to overseas investors. Additionally, Singapore ended -0.50% and Indian equity markets delivered returns of +1.95%.

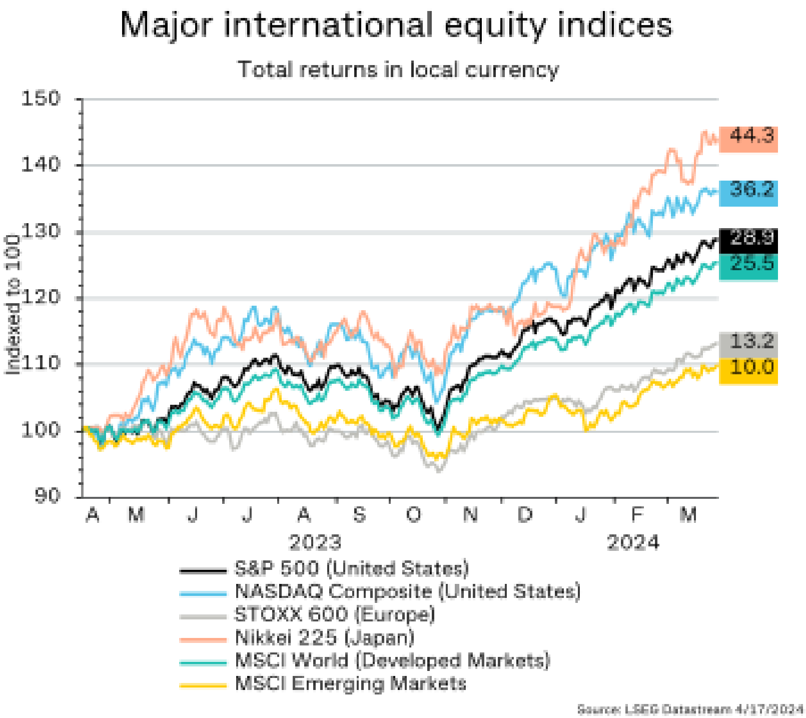

Figure 6

Although global equity markets have recorded historic levels, we see more challenging times ahead through the middle of 2024, especially if rate cuts get delayed and companies do not deliver on expected earnings outcomes. While analysts lowered first quarter earnings, estimates for S&P 500 companies by a smaller margin than average, the number of companies starting to issue negative guidance is already above the five- and ten-year averages.

In fact, this quarter ties the mark with Q2 2019 and Q1 2016 for the second-highest number of S&P 500 companies issuing negative Earnings Per Share (EPS) guidance for a quarter since FactSet began tracking this metric in 2006.

Fixed Interest

Fixed interest assets experienced another volatile quarter as market participants were trying to determine how many Fed rate cuts are likely to occur this year. At the dawn of 2024, investors expected six cuts throughout the year but by the end of March, that figure dropped to three with final rates at 4.5%-4.75%. The Bloomberg Barclays Global Aggregate Bond Index Hedged AUD returned -0.3%, while the two-year US Treasury bond yield rose from 4.27% to 4.62% per annum. The 10-year US Treasury yield also increased from 3.84% to 4.20% per annum, while 10-year bund yields in Germany rose from 2.01% to 2.30% per annum.

At the March meeting, Fed policymakers stuck to their expected path of interest-rate cuts despite facing some obstacles on the road to low and steady inflation. Officials decided unanimously to leave the benchmark federal funds unchanged, for a fifth-straight meeting, at 5.25% to 5.5%, the highest since 2001. The increase in inflation across early-2024 did not sway Jerome Powell (Fed Chair) that price pressures will continue to ease or that it will be appropriate to lower rates at some point this year. A narrow majority of US central bank officials signalled they still expect to cut rates three times in 2024. Nearly half of Fed officials, however, would prefer two or less rate reductions this year, according to updated economic projections from the central bank.

In our view, policymakers need more data confirming a downward inflation trend before they lower borrowing costs. Projections for inflation and economic growth for 2024 were updated, the forecast for underlying inflation was increased to 2.6% from 2.4%, and the growth forecast was boosted to 2.1% from 1.4%. The 'higher for longer' narrative stays intact with regards to the US inflation outlook and we would not be surprised if rates cuts get pushed out yet again given current economic momentum.

In Europe, there is a somewhat more promising outlook, as Switzerland's central bank unexpectedly cut rates by 0.25%, The Bank of England (BoE) held rates steady and ECB policymaker, Pablo Hernandez de Cos, said rate cuts could come as early as June.

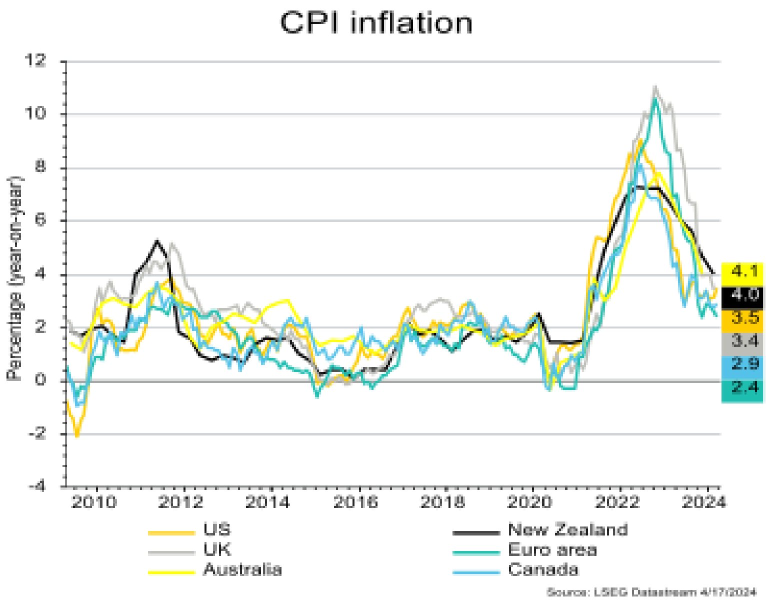

Figure 7

In Australia, government bond yields rose over the quarter. The three-year Australian government bond yield rose slightly from 3.60% to 3.62% per annum even as the RBA adopted a more neutral stance and economic data was largely weaker than expected. The 10-year government bond yield was volatile but ended flat at 3.97% per annum, with the lower relative yield, when compared to the 10-year US Treasury yield, being another factor that is placing downward pressure on the $A. The Bloomberg AusBond Composite Index returned 1.03% over the three months to March. Australian cash returns, as measured by the Bloomberg AusBond Bank Bill Index, returned 1.09% for the March quarter.

Fixed interest markets have dramatically repriced expectations towards the end of the quarter, which in our view is a more realistic assessment of the interest rate cycle and closer in line with our thinking. At this stage, it looks like the Eurozone is in the best position to begin rate cuts. In the US, rate cuts are likely to be pushed out towards the end of the year but there is a possibility of a ‘token rate cut’ occurring before the US elections between July and early November. In Australia, a November rate cut is most likely unless the economy substantially deteriorates.

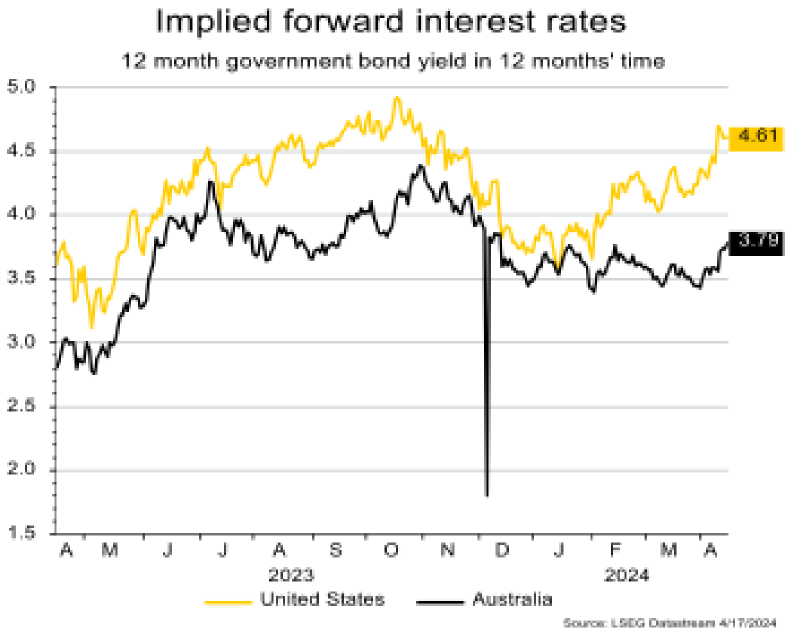

Figure 8

We have increased our allocation to fixed interest towards the end of the quarter as higher starting yields are providing more attractive income in portfolios, whilst also having the capacity to deliver downside protection if there are any unanticipated or more pronounced shocks to the global and Australian economy.

Alternatives and Property

Hedge funds increased by 4.95% during the March quarter, according to the HFRI Fund Weighted Composite Index, delivering a better outcome than both fixed interest rate benchmarks and close to Australian equity market returns over the quarter. Macro strategies, led the returns delivering the strongest quarter in over 20 years. Industry-wide gains were driven by trend-following Commodity Trading Advisers (CTAs), Energy, Multi-Strategy, Healthcare, and cryptocurrency exposures. Uncorrelated macro strategies surged to lead industry-wide gains, as investors positioned for moderating inflation, falling interest rates, and an improving economic outlook, despite significant ongoing geopolitical uncertainty.

Equity Hedge funds, which invest long and short across specialised sub-strategies, also posted strong performance in the March quarter, with gains led by Energy, Quantitative Directional, and Healthcare exposures. Event-Driven strategies, which often focus on out-of-favour, deep value equity exposures and speculation on M&A situations, also delivered positive returns with gains led by Special Situations, Distressed, and Activist exposures. Fixed income-based, interest rate-sensitive strategies also gained as investors positioned for moderating inflation, falling interest rates and an improving economic outlook.

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. Private markets fundraising indeed remains challenged although, the overall picture is more nuanced, with 2023 shaping up to be the seventh-largest fundraising year in history. Also, Hamilton Lane's Private Wealth Survey showed that nearly 75% of respondents plan to increase their allocation from the prior year.

Private equity has also seen a welcome decline in entry valuations, with secondaries seeing attractive discounts as markets become more challenging and some existing investors require liquidity. Single asset general partner led secondaries historically have a tighter return band, and much lower loss ratios than co-investments. 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.

In our view, return dispersion typically widens substantially in challenging investment backdrops, so manager and vintage selection becomes more important.

Global listed infrastructure, as measured by the S&P Global Infrastructure Index (hedged AUD) rose by 2.60% in the March quarter as the prospect of rate cuts positively impacted the valuations of infrastructure companies. Energy storage and pipeline stocks held up relatively well, supported by rising energy prices and a positive demand outlook for energy storage and transportation services. Solid earnings numbers and a healthy outlook for passenger volumes helped airport stocks move higher. Railroads gained on activist investor interest, and the anticipation of volume and margin improvements for North American freight rail operators. However, water stocks lagged as concerns for debt levels at unlisted UK operator, Thames Water, weighed on the country's listed water utilities. Towers also lagged, as market consensus around the likely timing of future interest rate cuts was extended.

Within infrastructure, we retain our preference for listed (over private infrastructure) for core assets due to the valuation discount. While higher interest rates have impacted short term performance, infrastructure has a demonstrated history of performing well during periods of higher inflation due to inflation linked cash flows. Regulated and contracted utilities provide strong defensive characteristics given their essential service nature and supportive regulatory structure which allows for inflation cost pass through. Global under-investment has made certain economically sensitive user-pays infrastructure assets attractive at current valuations.

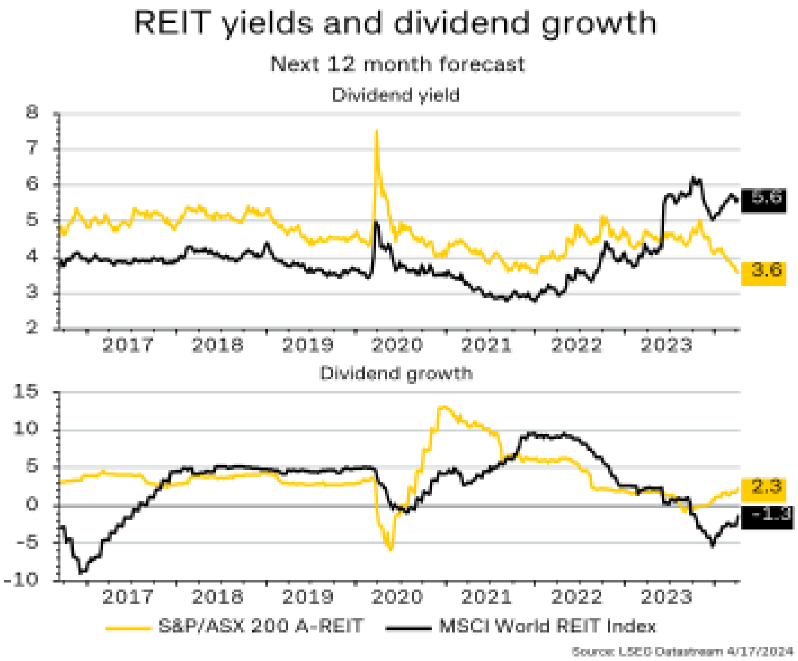

Figure 9

The global-listed property index, namely the FTSE EPRA NAREIT Developed Index (hedged AUD) returned -0.10% for the quarter. Over the last 12 months, listed property has been dramatically re-priced to reflect the higher cost of the capital environment and is now trading at a meaningful discount to the direct real estate market.

The best performing regions included Australia, Japan and Sweden, while the laggards included Hong Kong, Singapore and Spain. Apart from Australia, Japan was the second strongest performer driven by positive economic sentiment, with Japanese landlord developers being the best performers given the favourable feed-through for rental growth and asset appreciation. Higher cost of debt and tighter financial conditions continue to put pressure on real estate values. However some sectors such as data centres are well placed, as replacement values continue to rise increasing barriers to entry which should support rental growth.

The sector performed well due to robust fourth quarter 2023 earnings, a healthy 2024 earnings outlook and strong AI tailwinds as the sector forms an integral part supporting the growth of the digital economy. The lifestyle and communities sector detracted from performance in the quarter. The sector underperformed because of economic growth surprising to the upside and funnelling investors to more cyclically levered sectors such as shopping centres and hotels. Commercial property remains a challenge in the US and across the globe but modern 'green' buildings built in sought-after locations that have relevant amenities, command a premium even in the current market. Selective retail property exposures are starting to look more appealing as construction activity has been very low over the last 10 years. In Australia, the S&P/ASX 200 Property Accumulation index returned a healthy 16.75% in the March quarter. The rise in the quarter was primarily driven by investors re-entering the sector because of attractive valuations and positive macro factors, including better than expected business conditions and the prospect of rate cuts.

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

Commonwealth Private

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