Commonwealth Private

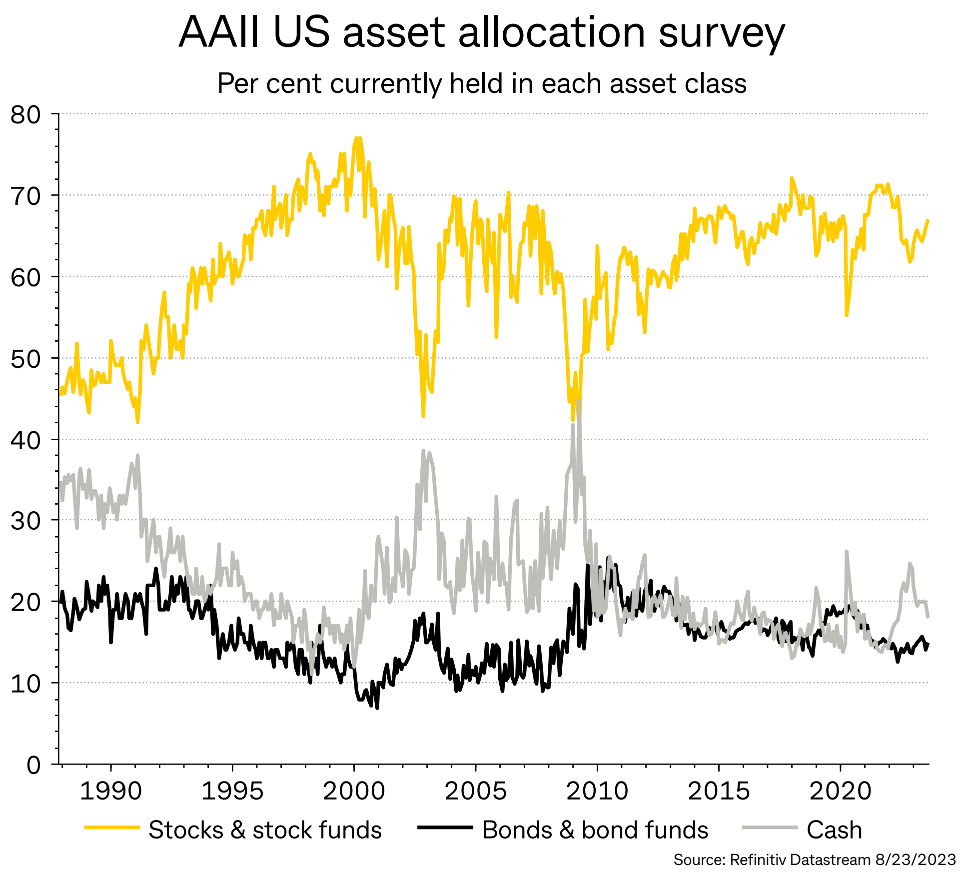
Market Outlook.

September 2023

Since our last Market Outlook, investor optimism has moved into high gear as markets shifted from recession-bearishness to pricing in a soft landing for the US economy, and a more positive global outlook. At the same time, the level of divergence of economic and market views has never been higher as investors mull over central bank wording and mixed leading indicator data. As equity markets reach new highs, one positive development is that the global equity rally has broadened, with more cyclical sectors and mid-to-smaller caps outperforming overpriced technology names. Nonetheless, equity market valuations have moved even higher leaving less scope for disappointment as we enter a seasonally volatile part of the year.

Divergence in market view at all-time highs

In anticipation of a global slowdown in the second half of 2023, institutional investors remained cautious with the majority being underweight equities, overweight cash and fixed interest. To date, this scenario has not eventuated, and the strength of the US and global economy has surprised most. This has resulted in one of the widest divergences in equity market views since 2003. According to Bloomberg[1], there is an almost 50% difference between the most bullish forecast on the S&P 500 and the most bearish. The last time we experienced a similar level of divergence was in 2009, following the global financial crisis. Despite remaining cautious, several strategists have increased their price targets to take into consideration better than expected company earnings and economic data. As such, we have seen investors playing catch-up by reducing some of their cash holdings and selectively allocating more to fixed interest and equities.



[1]Source: Bloomberg July 2023, Wall Street Soothsayers Are Bewildered About What's Next.

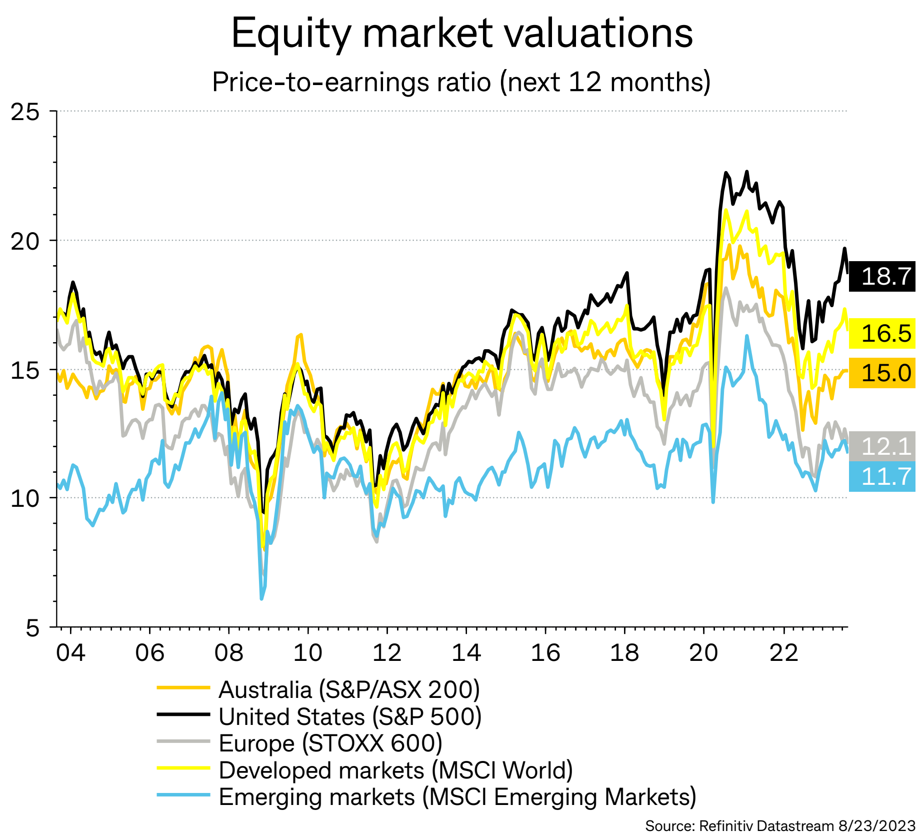
Economists have also revised their views; the global growth contraction has been pushed out from later this year into early 2024, and by lower amount than previously anticipated. An enduring labour market and economic resilience led economists polled by The Wall Street Journal[2] to lower the probability of a recession in the next 12 months to 54% from 61%. While that probability is still high by historical comparison, it represents the largest month-over-month percentage-point drop since August 2020, as the economy was recovering from a short but sharp recession induced by the Covid-19 pandemic. The change in views also reflects the fact that the economy has kept growing, even as the Federal Reserve (Fed) raised interest rates and inflation declined. Economists are also pushing back their estimates for when the Fed will eventually start cutting rates. In the Wall Street Journal survey, only 10.6% of economists expected a rate cut in the second half of this year, down from 36.8% in its last survey. The majority of economists, nearly 79%, expected the Fed will cut rates in the first half of 2024 – in line with an increase in the unemployment rate. Almost half (42.4%) expected that the first cut will come in the second quarter.

In Australia, we see a similar trend with a wide divergence in economic views and the probability of recession. For example, when reviewing the Reserve Bank of Australia's (RBA) seven Board meetings throughout 2023, a Bloomberg survey of economists found the median cash rate to be incorrectly forecast 43% of the time, compared to a historical 10% error rate. Commonwealth Private's Investments and Research team believes the Australian economy is somewhat more vulnerable to a downturn due to its more cyclical outlook and industry profile, predominantly concentrated in mining, financial services and property. In addition, Australian consumers have a lower level of excess savings and those with mortgages are particularly vulnerable to higher interest rates.

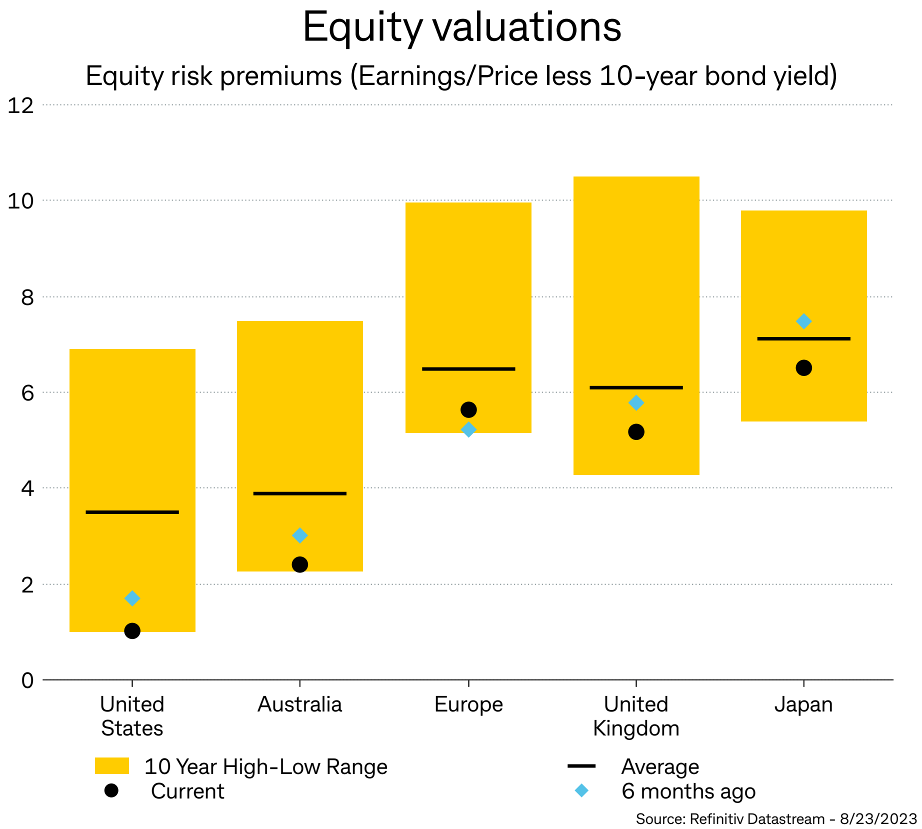
[2]Source: WSJ July 2023, Economists Are Cutting Back Their Recession Expectations

Equity Valuations have moved even higher

Relatively better than excepted financial news-flow since the end of June has driven equity markets even higher and the subsequent rally has also broadened away from the narrow technology-based Artificial Intelligence (AI) thematic. At the start of the second quarter reporting season, it was the blue-chip Dow Jones Index that delivered record consecutive gains - its longest winning streak since 1987. So far this year it has been valuation expansion or in other words share prices moving ahead of earnings growth that has accounted for the majority of equity market performance. To illustrate this point, the S&P 500 P/E (Price/Earnings) multiple has risen from 17x to 18.7x, and in Australia, the S&P/ASX 200 has expanded more modestly from 13.9x to 14.9x. The seven largest stocks in the S&P 500 account for more than 60% of the index's 19% year-to-date return. In aggregate, these stocks trade at a P/E of 31x vs. 18.7x for the aggregate index. The remaining 493 companies' trade at a multiple closer to 17x which is still relatively high compared to the index's history.

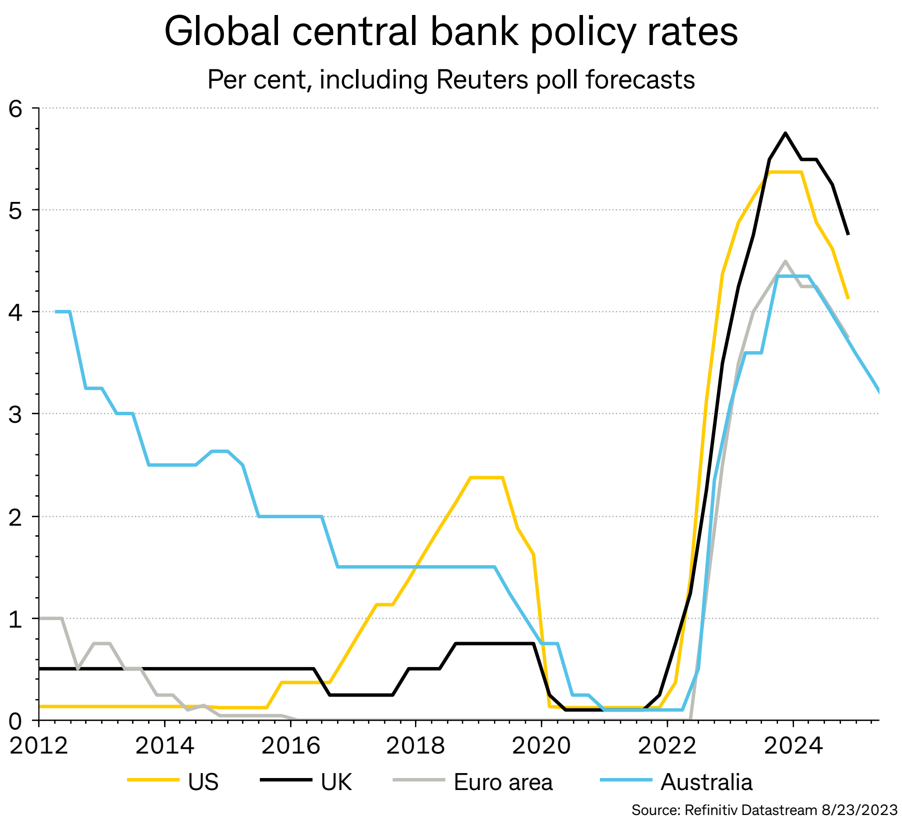


Trends in other developed markets have been similar and, in most instances, the cheaper valuations are more of a reflection of weaker fundamentals and a smaller technology sector. Importantly, bond yields have also risen across the board making relative valuations even less attractive as the additional return from holding equities has diminished.



Central bankers keep their options open

Central banks might be approaching the end of their tightening cycle but that does not mean that automatic rate cuts are on the cards by mid-2024, as implied by financial markets. The Fed delivered a much-anticipated July interest rate hike that takes benchmark borrowing costs to their highest level in more than 22 years. The decision to increase by 0.25% was unanimous. The quarter percentage point increase brings the fed funds rate to a target range of 5.25%-5.5%. The midpoint of that target range would be the highest level for the benchmark rate since early 2001. The increase is the 11th time the Federal Open Market Committee (FOMC) has raised rates in a tightening process that began back in March 2022. The only pause occurred when the FOMC decided to skip the June meeting as it assessed the impact of its rate hikes on the economy. In his July post-meeting press conference, Chair Jerome Powell acknowledged that June inflation data was positive. However, he also expressed some concern that tight labour markets and strong real economic activity could halt inflation's decline before it returns to target. He specifically noted that, historically, at least some degree of labour market deterioration is required to return inflation to target, but that Fed staff are no longer forecasting a US recession. In terms of outlook, he added "it's not an environment where we want to provide a lot of forward guidance" about future rate actions, and whether the Fed hikes again will be determined by where the data stands at the time at future policy gatherings. In our view, the Fed's hawkish stance remains given that they keep emphasising that rates will need to stay higher for longer and that rate cuts are further away than what is anticipated by the market.



The European Central Bank (ECB) raised interest rates by 25 basis points in July, a ninth consecutive rate hike, saying inflation is still expected to remain too high for too long, despite the recent slowdown. This brought the rate on main refinancing operations to 4.25%, the highest since October 2008. The most important takeaway from the meeting is the absence of forward guidance. ECB President, Christine Lagarde, said policymakers are "open minded" about upcoming decisions and the bank might hike or hold rates steady in September. Similarly, the Bank of England (BoE) raised its policy interest rate by 25 basis points to 5.25% during its August 2023 meeting, marking a 14th consecutive increase, and bringing borrowing costs to fresh 2008-highs, as the central bank continues to battle high inflation. The Monetary Policy Committee voted 6-3 in favour of the quarter-point hike, with two members preferring a second-straight 50 bps increase and one member voting to keep rates unchanged. Policymakers noted that, given the significant increase in interest rates since the start of the tightening cycle, the current monetary policy stance is restrictive. The UK's efforts to curb inflation remains a work in progress and the tight labour market contributes to this trend. The annual growth rate of average wages in the UK, excluding bonuses, unexpectedly jumped to 7.8% in June, the fastest growth rate since records began in 2001, according to the Office for National Statistics. The increase is attributed to companies bidding up compensation to retain employees. These developments continue to suggest that the BoE will deliver a 0.50% hike at the September meeting and that it will lift the Bank Rate to 6% by the end of the year.

In Australia, rate hikes are starting to have a more marked impact given the greater sensitivity to variable mortgage rates. The RBA held interest rates at 4.1% for a second consecutive month in July as it buys time to assess the impact of previous hikes, while warning of further hikes in the future. The decision to hold rates steady comes as inflation in Australia slowed to 6% in the second quarter, down from 7% in the first quarter, but still well above the RBA's stated target of 2%-3%. The RBA has hiked interest rates by a cumulative 4.0% since May last year, to its highest point in 11 years. The RBA noted that some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but again that will depend upon the data and the evolving assessment of risks. The lags associated with policy transmission are another reason the RBA is moving cautiously.

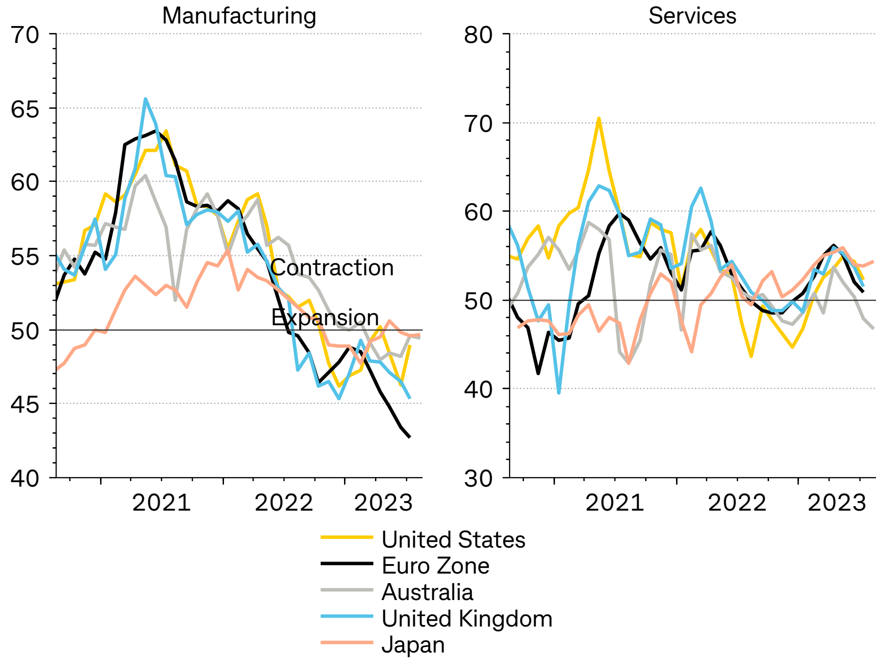
A large number of home loans, fixed at record-low rates during the pandemic are set to expire shortly, which remains a dark cloud on the horizon. Around 90% of fixed rate mortgages rolling off this year will see repayments increase by 30% or more, RBA research shows. In the RBA minutes, which were released in mid-August, the forward guidance was altered to "members agreed that it was possible that some further tightening of monetary policy might be required to ensure that inflation returns to target in a reasonable timeframe". This updated use of the word possible has given the RBA some optionality, however in our view, the RBA retains a tightening bias with potentially one more 0.25% rate increase on the cards.

Conclusion and Portfolio Positioning

As we enter a more uncertain financial market regime in the third quarter, we believe the benefits of running a more cautious investment strategy will become increasingly apparent. High starting valuations across most developed equity markets and increasing evidence that the global economic environment is weakening supports our more defensive stance. Global equity markets have moved to a level where valuations have reached extreme levels - both from an absolute and relative level – compared to other asset classes. More recently, long-term US bonds have also moved higher due, in part, to the Fitch Ratings downgrade of the US government's credit rating from AAA to AA+, citing expected fiscal deterioration over the next three years as well as growing government debt. In addition, the slowing economic environment is gaining traction and the recent developments of a weakening Chinese economy, and the prospect of rising energy prices pose further risks. Manufacturing activity keeps falling and now we are also observing weakness in services activity. We expect the global economic slowdownto materialise, however the time taken for it to come to full effect has been pushed out.

Business activity

Markit Purchasing Manager Indices (PMIs)



Source: Refinitiv Datastream 8/23/2023

In our view markets are not fully pricing the heightened level of uncertainty that central banks still face and it is too early to discount away the prospects of recession. Markets are pricing in a soft landing, while central bankers continue to emphasise a cautious and slightly hawkish tone, confirming they are data dependant. Monetary policy affects the economy with long and variable lags making it particularly challenging for central bankers to engineer a soft landing - with history not being on their side. Potential tighter policy for longer will be a more material headwind for corporate profits and markets and as such risks to the downside are building given very high equity valuations.

As such, our DAA positioning has been revised and we have moved to further reduce our exposure to growth assets by reducing our allocation to international equities in addition to maintaining our existing underweight to Australian equities. We envision higher levels of volatility in the coming months which will likely lead to more attractive entry points for investors, and we have decided to move overweight cash. We favour allocating to cash at this point in the cycle as it provides optionality for us to quickly deploy funds to where we see better opportunities when the time comes. Cash returns are relatively attractive at current levels providing an income return in conjunction with capital stability. We are neutral fixed interest as we are receiving stronger income returns from holding bonds as well as the potential for capital appreciation in the event central banks do cut interest rates in 2024, or if equity markets suffer a material fall. We are also neutral property and overweight Alternative Investments which we believe will continue to deliver attractive risk adjusted returns.

Asset Class	Portfolio Weight	Comments
Cash	Overweight	Cash returns are relatively attractive at current levels providing an income return in conjunction with capital stability.
Fixed Interest	Neutral	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.