Commonwealth Private

Market Outlook.

December 2023

As the festive season approaches, equity markets have experienced a resurgence and staged a recovery from the lows of October. Historically, the final quarter of the year tends to be a seasonally positive one - especially when markets have performed strongly throughout the year and as we look back at 2023, it has been a good year for global equities. In the first half of the year, we feared the recession that never came, a banking crisis was averted, consumers remained resilient and corporate earnings were better than expected. In the second half, interest rates moved to 16-year highs and we faced heightened geopolitical tensions. Throughout the year, the application of Artificial Intelligence became more widespread, thanks to a significant boost from large language models such as ChatGPT becoming more embedded with the promise of delivering significant productivity gains in future years. As we enter 2024, a more cautious stance is warranted as the level of uncertainty will only increase until we see a clearer impact of the interest rate hikes to date and the degree of economic slowdown that they bring.

Despite being close to their peak, the future path of interest rates remains uncertain

Central banks have made considerable progress in curbing headline inflation from last year's multi-decade highs - although some core elements of inflation remain persistent which is in part due to tight labour markets and housing related costs. There is also some inflation divergence amongst different regions. For example, the Eurozone is decelerating rapidly, whereas the UK and Australia are falling far more gradually. In the US, the consumer price index (CPI) was flat in October from the previous month and increased 3.2% from the same time last year. Excluding volatile food and energy prices, the core CPI rose 0.2% and 4%, against the forecast of 0.3% and 4.1%. Recent data shows that labour markets are beginning to weaken across the globe and even with a slight increase, unemployment levels remain at historic lows. In the US, the headline unemployment rate has risen from a recent low of 3.4% to 3.9%. In Australia, the unemployment rate moved back up to 3.7% in October. It's worth noting that the unemployment rate has been hovering within a tight band of 3.4%-3.7% since October 2022. Wages growth rose by 1.3% in the September quarter to be up 4.0% for the year - the largest quarterly increase on record (since the late 1990s). This was largely driven by the Fair Work Commission's decision to increase Award & minimum wages by +5.8% (on a weighted-average basis) in July following its annual review process. Now, current Fed Chair Jerome Powell has suggested the Fed achieved soft landings in 1965 and 1984 and was on course for another one in 2020 before the Covid-19 pandemic intervened.

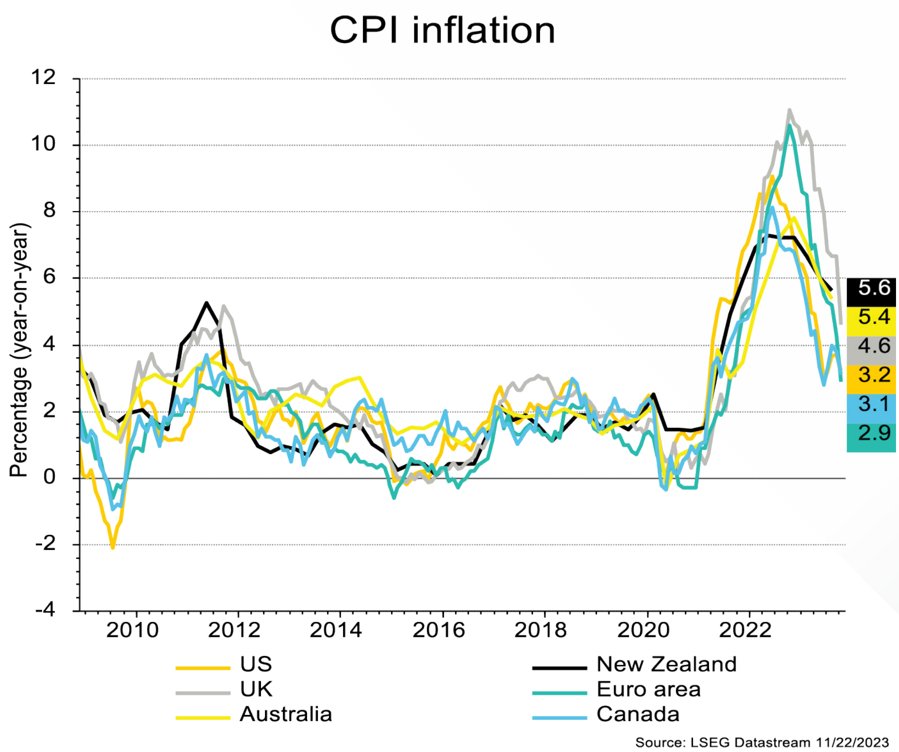

Figure 1

Nonetheless it remains particularly challenging to determine whether the current level of interest rates set by central banks is enough to get core inflation back to the target range within the next two years. In previous hiking cycles, the unemployment rate has reached much higher levels than anticipated and as such policymakers are proceeding carefully from this point trying not to repeat the mistakes from the past.

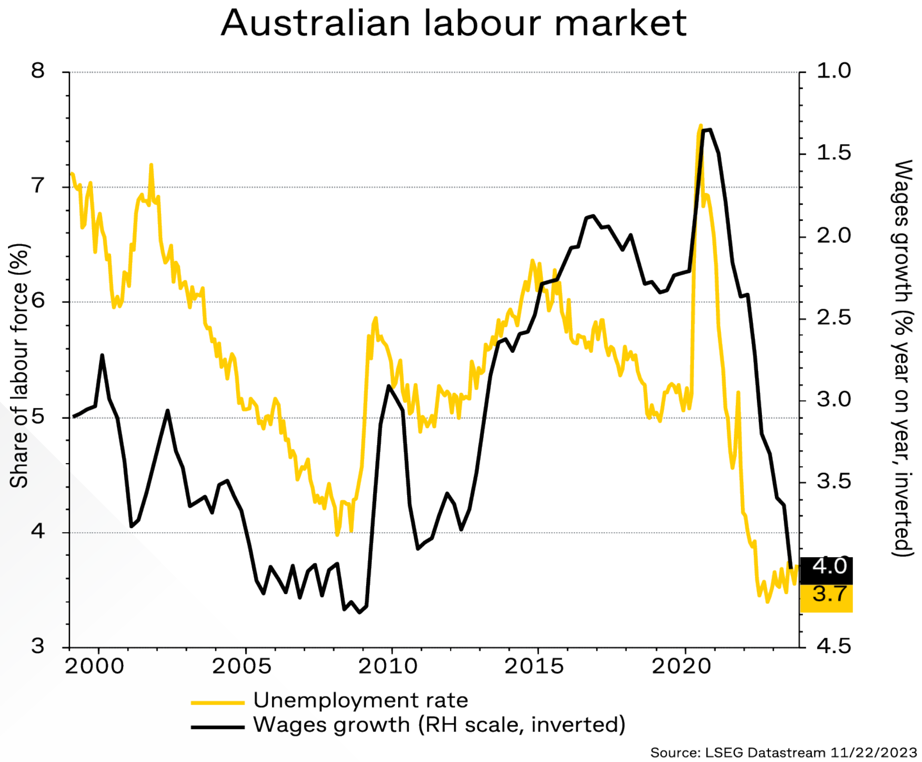

Figure 2

The Reserve Bank of Australia (RBA) lifted the cash rate to a 12-year high of 4.35% at its November meeting after holding the cash rate steady for four consecutive meetings. Since its August meeting, the RBA has received updated information on inflation, the labour market and economic growth, and the weight of this information suggests that the risk of inflation remaining higher for longer has increased. The RBA noted that inflation in Australia has passed its peak but is still too high and proving more persistent than expected a few months ago. The latest reading on CPI inflation indicates that while goods price inflation has eased further, the prices of many services are continuing to rise briskly. While the central forecast predicts CPI inflation to decline, progress looks to be slower than earlier expected. CPI inflation is now expected to be approximately 3.5% by the end of 2024 and within the target range of 2-3% by the end of 2025. While the Australian economy is experiencing a period of below-trend growth, it has been stronger than expected over the first half of the financial year. Underlying inflation remains higher than the RBA's forecasts, including across a broad range of services. Conditions in the labour market have eased but they remain tight and housing prices are continuing to rise across the country.

CBA Economics see the RBA leaving monetary policy on hold from here. It also acknowledges the risk in the short run sits with another interest rate increase, particularly given the RBA retains a tightening bias. The probability of an additional 0.25% rate hike in December is quite low, as in our view, there will be not enough evidence released over the next month to make the case for back-to-back rate increases. February 2024 looks more likely for a rate hike as the Board will have the Q4 23 CPI and more current economic forecasts by then.

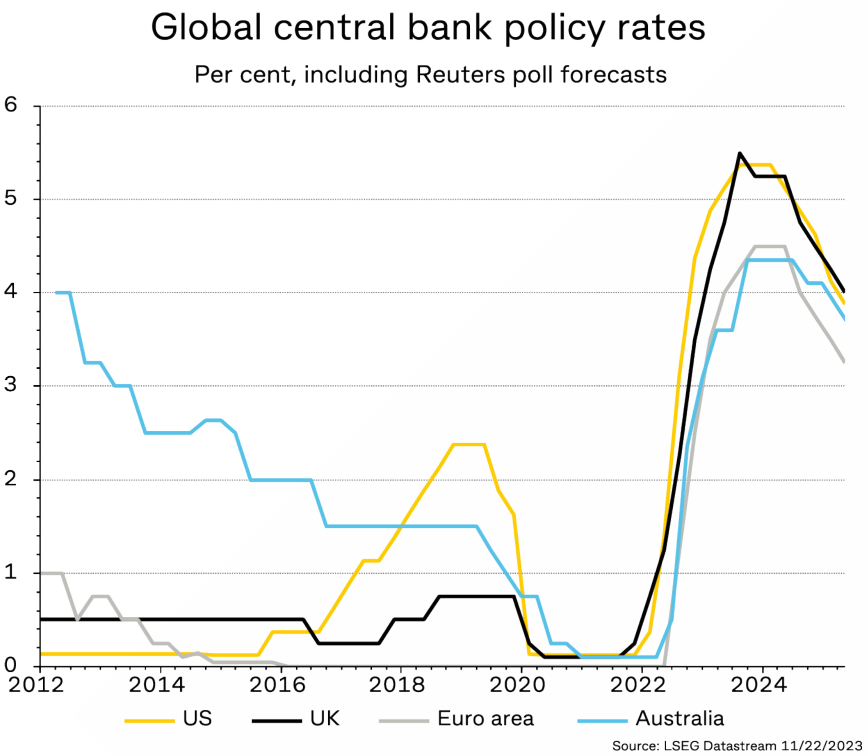

Figure 3

Elsewhere, the US Federal Reserve (Fed) held interest rates steady in the target range of 5.25%-5.50% at its November meeting amid a backdrop of a growing economy, tight labour market and inflation that is still well above its target. This was the second consecutive meeting that the Federal Open Market Committee chose to hold, following a string of 11 rate hikes, including four throughout 2023. It was noted that household and small business balance sheets may be stronger than originally expected.

At a recent International Monetary Fund (IMF) conference Fed Chair Jerome Powell said, "if it becomes appropriate to tighten policy further, we will not hesitate to do so". He also stressed that the central bank hasn't considered rate cuts, and it won't until inflation is brought under control. The key takeaway is that if the disinflationary trend is intact and economic growth moderates in the fourth quarter, the Fed is likely to keep policy on hold over the coming months. Similar comments were echoed by the European Central Bank (ECB) President, Christine Lagarde, who said it will take more than "the next couple of quarters" for the ECB to start cutting rates. The Bank of England (BoE) held interest rates at a 15-year high of 5.25% for the second consecutive meeting but warned that rates would have to stay at a restrictive level for "an extended period of time." BoE Governor Andrew Bailey, said the bank "will be watching closely to see if further interest rate increases are needed, but even if they are not needed, it is much too early to be thinking about rate cuts."

In our view, the unanswered question is not whether we need an additional rate hike but how long interest rates will stay higher and what will be the path to a more neutral setting. We believe that a clearer picture will unfold by mid-2024 and that it is very likely (given prevailing trends) that interest rates will stay higher. There is also the possibility that we may get a delayed and more uneven rate cut cycle than what is currently priced in by markets.

Reporting season delivered yet again - but the outlook becomes clouded

In the US, third quarter reporting season provided a much-needed tailwind to get equity markets out of their rout and post a strong recovery in November. With over 92% of the companies in the S&P 500 having reported actual results for third quarter, 81% reported actual earnings above estimates, which is above the five-year average of 77% and above the 10-year average of 74%. This marks the highest percentage of S&P 500 companies reporting a positive earnings surprise since the third quarter of 2021. In aggregate, companies have reported earnings that were 7.1% above estimates, which is below the five-year average of 8.5% but above the 10-year average of 6.6%. A more distinctive trend is the fact that companies have seen the largest negative price reaction to lower than expected earnings results since 2011. Companies that have reported negative earnings surprises have seen an average price decrease of 5.2% two days before the earnings release through two days after the earnings release. This percentage decrease is much larger than the five-year average price decrease of 2.3% and marks the largest average negative price reaction to negative earnings surprises since the second quarter of 2011. The main explanation for this price behaviour is the fact that analysts have been lowering their earnings estimates of the fourth quarter of 2023 as higher interest rates and slowing demand is becoming more apparent. Revenue growth is also starting to be more elusive with the lowest percentage of companies beating revenue estimates since the first quarter of 2020. From a valuation perspective, the forward 12-month P/E ratio for the S&P 500 is 18.5 - below the five-year average of 18.7 but above the 10-year average of 17.5. However, as we have noted, valuations look rich compared to the level of interest rates - particularly if rates stay higher for longer. We also believe that projected earnings growth for calendar year 2024 of 11.2% and revenue growth of 5.5% is an ambitious target given that the US economy is slowing, even if the economic downturn is less severe than expected.

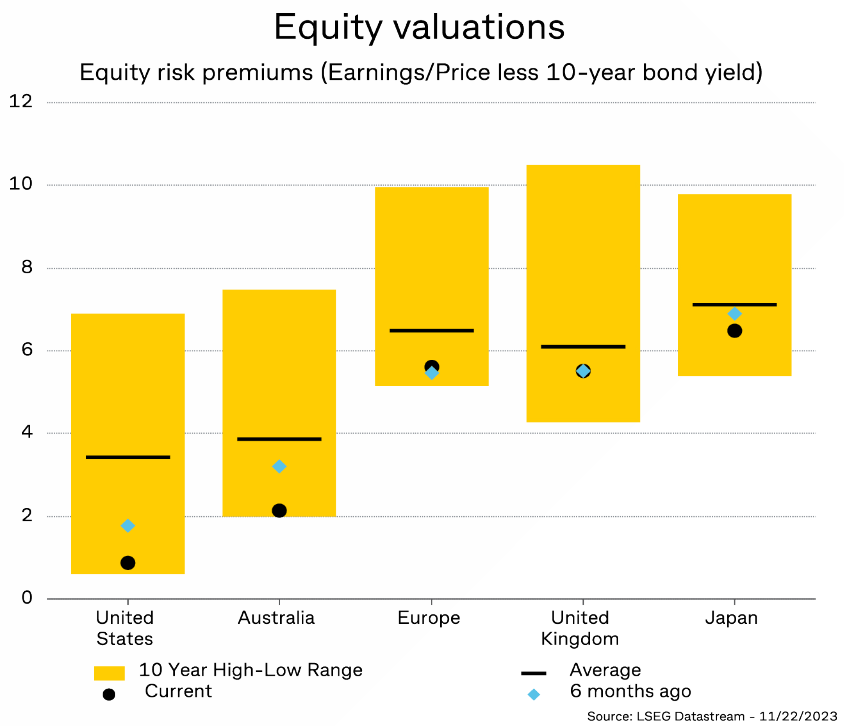

Figure 4

The effects of higher interest rates and slowing demand has been even more evident in Europe where luxury and consumer discretionary companies are delivering lower than expected earnings, with more muted guidance from management. Naturally there are always exceptions, such as pharmaceutical companies in the Euro Stoxx 600 that are driving earnings based on production of weight-loss drugs.

In Australia, the recent reporting and AGM season has been more muted reflecting the more cyclical nature of the companies that comprise the S&P/ASX 200 Index. Contracting net interest margins (NIM) over the six months to September have been a feature in the major banks reporting season. The NIM for the majors was 1.9% in the first half of the year, but this decreased to 1.84% in the second half amid strong home loan competition, and as banks pay more to depositors. As such, bank profits have likely peaked in the six months to the end of September, as competition for loans and deposits has tempered the benefit of rising rates and inflationary pressures on the costs side. We haven't seen many surprises emerge from the AGM season and quarterly updates, as most companies have maintained guidance for FY24 and indicated consistent trends shared during the August reporting season. Companies with interest-bearing debt are all watching the rising interest rates closely, which is expected to have more marked impact on their financial cost going forward. Companies are also building up their cash reserves given the cautious view on the economy and the higher risk of project cost overruns. Together with the fact that companies are also prioritising debt repayment will potentially result in lower dividend payouts. Whilst the Australian equity market is relatively more attractive from a valuation perspective, when compared to the US, we are far more vulnerable to an economic downturn and further weakness from China. Our domestic companies have also been in a weaker position to exert pricing power than some global peers reflected in weaker earnings share estimates when you compare the S&P/ASX 200 to the US and internationally.

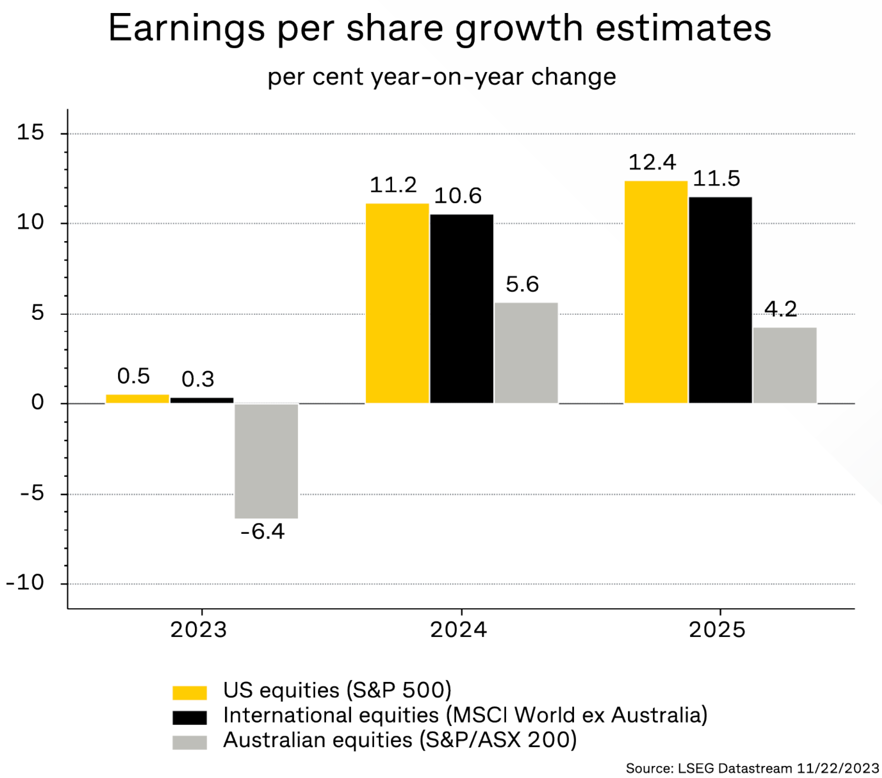

Figure 5

2024 – Key trends and economic signposts

The initial outlook for 2024 looks challenged as this will be the year that we will see whether central banks can engineer a soft landing or whether history will repeat and the slowdown will end up more severe.

Here are some of the key trends and economic signposts that we believe will shape the year:

- The Reserve Bank of Australia (RBA) will move from 11 meetings to 8. While less meetings will allow the RBA to gain more economic data points it will be interesting to see the effectiveness of communication around more volatile periods.
- The path of interest rates is likely to be the main driver of equity market performance. Market sentiment will wane once the economic environment starts to slow more meaningfully triggering higher levels of volatility. Companies that don't deliver to market expectations will be subject to stern repricing given current valuation levels.
- US elections will come into full swing. Markets are traditionally weaker into the run-up of the election as investors are faced with uncertainty. However, in the 12-months after an election, the market's performance tends to be stronger than usual, regardless of which party is in office.
- Geopolitical risks will remain in the forefront. It is difficult to predict whether the Ukraine and Middle East conflicts will evolve further. Russia will have its elections and while the outcome is certain, how it is politically perceived is of vital importance to Putin. Taiwan will also be having elections which will potentially impact relations with China.
- The spotlight will be on China and how effective it will be in containing the weakness in the property market which is fuelling weaker consumer sentiment and demand. At the same time weakening global demand for manufactured goods and the broadening of supply chains will no doubt continue.

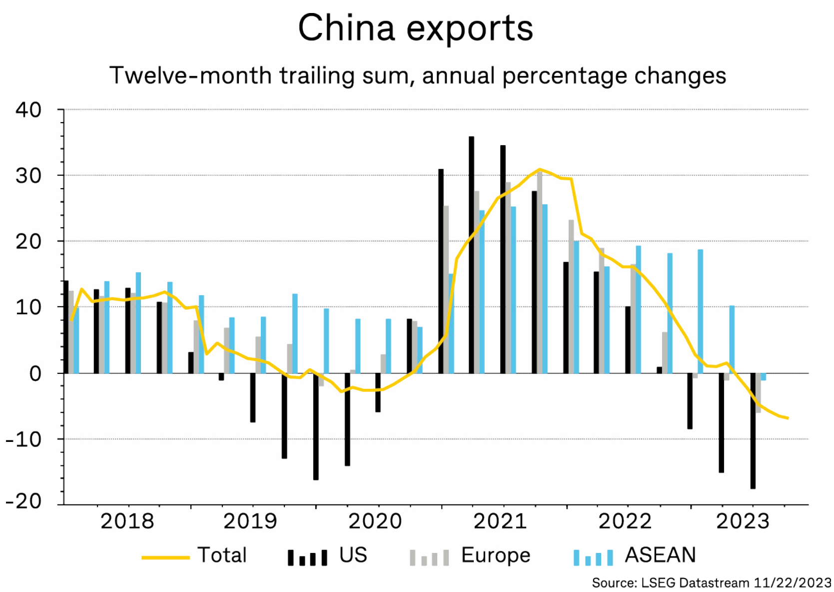

Figure 6

- In Australia, the stage three tax cuts will bring some potential stimulus in the second half of 2024.
- Financial market conditions will likely to be more challenging in 2024 but should improve in the third quarter and onwards once we gain a more definite sense as to whether inflation has been contained and the prospects of rate cuts increase

Conclusion and Portfolio Positioning

Even if the rate hike cycle is near its conclusion, with interest rates potentially staying higher and economic momentum slowing, we believe that the earnings expectations for 2024 are too optimistic. We are maintaining our more cautious stance with our underweight in international and Australian equities. Volatility is likely to increase with further risks to the downside once the transmission effects of higher interest rates make a more material impact on economic growth. This will likely lead to more attractive entry points for investors. We favour allocating to cash at this point as it provides optionality 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 on 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 start to cut interest rates in mid-2024 or if equity markets suffer a material fall. 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 market conditions or our outlook change, we would recommend adjustments to portfolio positioning in order to take advantage of any opportunities, or avoid any risks emerging from any changes.