Commonwealth Private

Market Outlook.

March 2024

With equity markets rallying in the first two months of 2024, and all-time highs being reached throughout the US, Europe, Japan and Australia, is this a case of 'as good as it gets'? Following the lows of October 2023, the S&P 500 has made gains in 14 of the last 15 weeks, making it the most consistent rally since 1972. In Australia, the ASX 200 eclipsed the previous record of 7628.9 points it reached in August 2021 thanks to positive sentiment behind a better than anticipated economic environment. Inflationary pressure is also subsiding somewhat faster than expected, as lower oil prices and weaker demand for consumer goods is making a more pronounced effect.

In our view, financial markets are too optimistic in pricing the number and timing of interest rate cuts in 2024. We believe a more cautious stance is warranted, despite the amount of good news priced into global equity markets, as levels of uncertainty are likely to increase until a clearer impact of the interest rate hikes to date and the degree of economic slowdown is understood. In our first Market Outlook this year, we examine the recent inflation trends, analyse decisions from the central bank, and the outlook for 2024 and how companies are performing and their outlooks into 2024.

Inflation is coming down - but we are not quite there yet

Recent data shows that inflation is decreasing quicker than initial expected by economists and central bankers, falling from 6.4% at the start of 2023, to 3.4% by December in the US and to 4.1% in Australia. This was pleasantly surprising given the widely anticipated rise in unemployment or even recession never occurred, leading to a hope that achieving the US Federal Reserve's (Fed) 2% target would also be relatively easier. Even the Fed's preferred inflation gauge, core personal consumption expenditure (PCE) price index, increased 2.9% in December from a year ago – the first time it's been lower than 3% in two-and-a-half years. Core PCE inflation, on a six-month annualised basis, registered at 1.9% in December, trailing the Fed's 2% target for a second month. January's data however, showed that inflation in the US increased as stubbornly high dwelling prices weighed on consumers. The US consumer price index (CPI), a broad-based measure of the prices consumers face for goods and services across the economy, increased 0.3% for the month, the Bureau of Labour Statistics reported. On a 12-month basis, that came out to 3.1%, down from 3.4% in December. Economists surveyed by Dow Jones had been looking for a monthly increase of 0.2% and an annual gain of 2.9%. Excluding volatile food and energy prices, the so-called core CPI accelerated 0.4% in January – up 3.9% from a year ago and unchanged from December 2023. The forecast had been for 0.3% and 3.7%, respectively. Housing and shelter prices, which comprise about one-third of the CPI weighting, accounted for much of the rise. The index for that category climbed 0.6% on the month, contributing more than two-thirds of the headline increase. On a 12-month basis, shelter rose 6%. Cooling prices for newly signed leases should eventually translate into lower costs. Food prices moved higher as well, up 0.4% on the month. Energy helped offset some of the overall increase, down 0.9% due largely to a 3.3% slide in petrol prices. The worrying trend is that the US economy is strong and that elements of economic activity, consumer confidence and some employment data is reaccelerating which risks spilling over into inflationary expectations. Energy prices are also lower and could recover sharply once the OPEC oil production cuts come into effect and tensions in the Middle East protract.

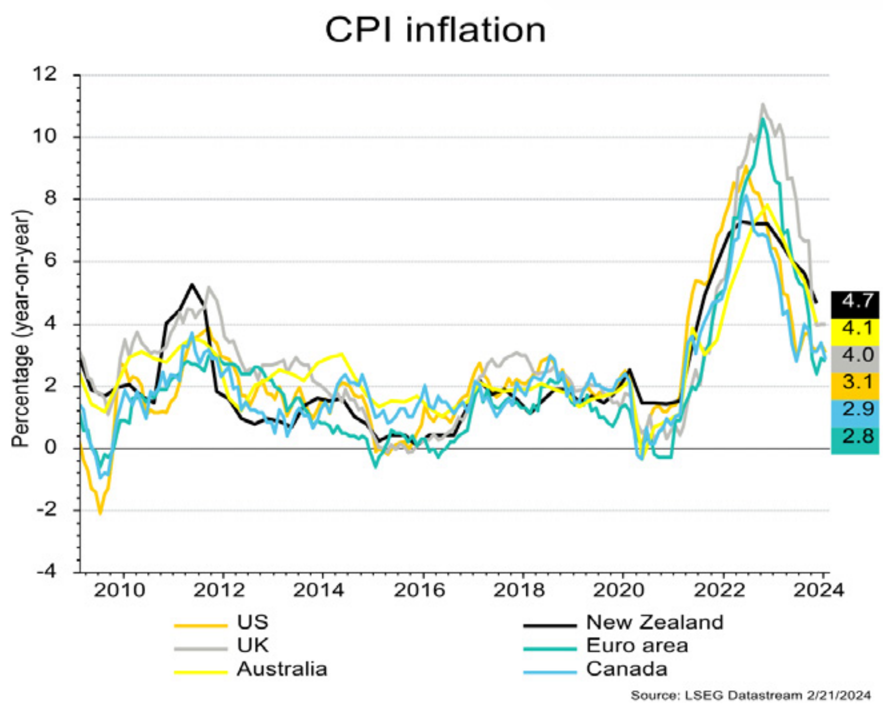

Figure 1

Meanwhile in Australia and Europe, inflation data has been more recently positive but similar underlying trends in services driven inflation and labour pressures persist. Australia's CPI rose 0.6% in the December 2023 quarter and 4.1% annually, according to the latest data from the Australian Bureau of Statistics (ABS). This was the smallest quarterly rise since the March 2021 quarter and lower than the 4.3% that markets had expected. This is also down from the peak of 7.8% in December 2022 and its lowest reading since the 2021 December quarter (3.5%).

In previous cycles, the unemployment rate reached much higher levels to bring inflation down to its target range. We believe it is too early to discount the risks of a recession – particularly in Australia – as economic activity indicators, retail sales and underlying elements in the employment market point to a softening trend.

Central bankers and markets remain at odds

Back in the US, markets drastically repriced rate-cut expectations and at one stage implied up to seven rate cuts in 2024, with the first one occurring as soon as March, after some commentary from the Fed in December.

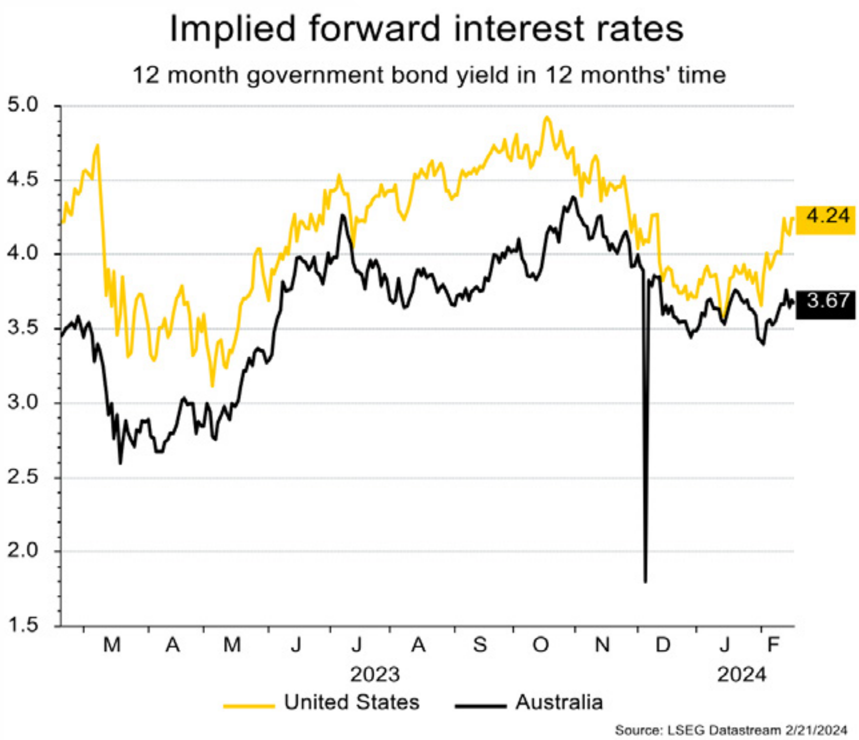

Figure 2

As recently as mid-to-late January, markets had fully priced in a rate cut in May and 1.75% of potential easing by the end 2024. After the US CPI data release in mid-February, the odds of a rate cut in May dropped by about half, to 32% from 64% before the inflation data release, with fewer than 0.90% of rate cuts now anticipated this year. In Australia, money markets are now pricing in the first Reserve Bank of Australia (RBA) rate cut in November, from earlier bets of August or September.

At the Fed's Federal Open Market Committee (FOMC) meeting in January, where it held rates steady, the Committee observed that the lower inflation readings over the second half of 2023 were welcome, but they still need to see continuing evidence that inflation is moving down sustainably toward the target level in order to build confidence. Fed Chairman, Jerome Powell, stated "almost every participant on the Committee does believe that it will be appropriate to reduce rates, but what we're trying to do is identify a place where we're really confident about inflation getting back to 2% so that we can then begin the process of dialling back the restrictive level." In a subsequent interview, Powell again confirmed that the US is in a strong position with growth, that the labour market is strong and inflation is coming down. He specifically stated that "… with the economy strong, we feel like we can approach the question of when to begin reducing interest rates carefully." In our opinion, the Fed would ideally have six more months of data to prove that inflation is trending lower before making any policy change.

In Australia, the RBA was surprisingly hawkish at its February meeting. While we believe the RBA needs to take a deliberately tougher stance to maintain credibility, its concerns on inflation are justifiable. The updated economic forecasts show a downward revision to the growth outlook for 2024 compared to previous projections released in November 2023. The RBA now expects a real GDP growth of 1.3% in June 2024 (down from 1.8%) and 1.8% by December 2024 (versus 2% previously). The forecast for GDP growth is softer than three months ago, largely reflecting a weaker outlook for household consumption in the near term. Similarly, the inflation forecast was downgraded with the RBA now expecting CPI inflation at 3.2% by the end of the year – down from its earlier estimate of 3.5%. Underlying inflation is forecast to fall 3.1% over the period (from 3.3%). Inflation is expected to be back around the midpoint of the target band by mid-2026, noting that updated economic forecasts assume the cash rate remains around its current level of 4.35% until mid-2024 before declining to around 3.25% by mid-2026. The RBA has revised its unemployment rate forecasts upwardly and now expects to end the year at 4.3% before peaking at 4.4% in mid-2025. Australia's services price inflation remains high and is expected to cool gradually, an outcome that's crucial to the central bank meeting its objectives. Firms in the RBA's liaison program continue to state that they face pressure from higher labour and non-labour costs like professional services, logistics and insurance. Given the extended timeframe for inflation to return to target, our view is that the RBA will maintain its current stance on rates remaining at elevated levels. As such, we anticipate that Australia is now likely to be one of the dollar bloc economies to begin easing.

In our view, given the extended timeframe for inflation to return to target suggests the RBA will stick to its view that rates need to remain at elevated levels for some time. Australia is now likely to be one of the last dollar bloc economies to begin easing.

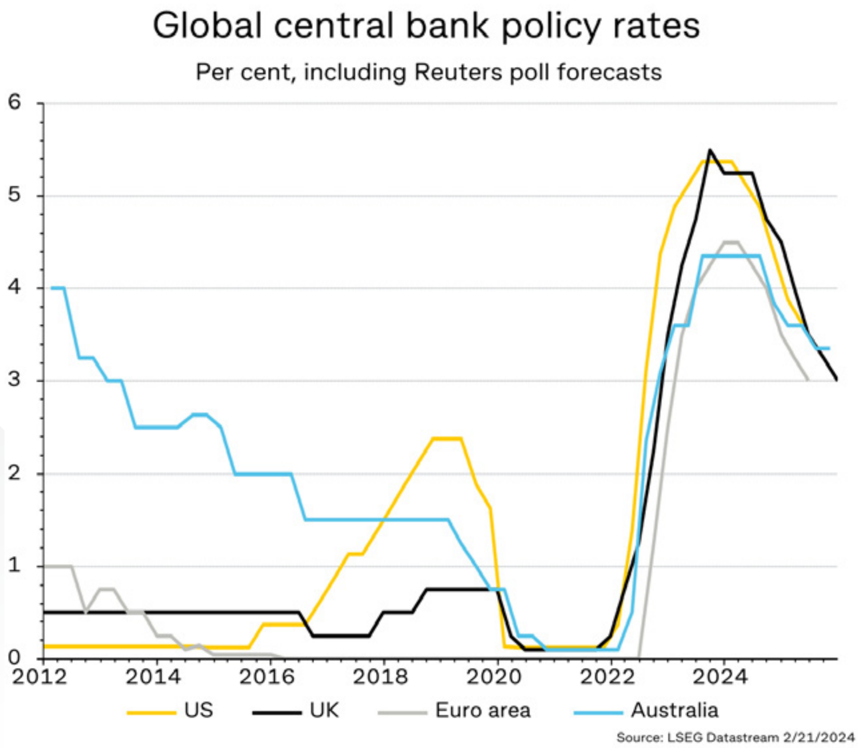

Figure 3

We believe that a clearer picture will unfold by the middle of 2024 and that it is very likely (given prevailing trends) that interest rates will stay higher. Recent data in the US and Australia confirm that price pressures remain sticky and a chance that it might reaccelerate – especially in the US – given the economic momentum. In comparison inflation pressures are decreasing more rapidly in Europe and Japan as those economies are already signalling a technical recession and China is in a deflationary cycle. There is an increasing possibility that we may get a delayed and more uneven rate cut cycle than what is currently priced in by markets.

How realistic are company earnings expectations in 2024 and implications for equity markets

In the US, earnings results for the fourth quarter of 2023 have been released and the outcome is mixed, despite positive headlines. Overall, 79% of the companies in the S&P 500 have reported actual results for the fourth quarter 2023 to date. Of these companies, 75% have reported actual earnings per share (EPS) above estimates, which is below the 5-year average of 77%. In aggregate, companies are reporting earnings that are 3.9% above estimates, which is below the 5-year average of 8.5% and below the 10-year average of 6.7%. Importantly, in terms of revenues, 65% of S&P 500 companies have reported actual revenues above estimates, which is below the 5-year average of 68% but above the 10-year average of 64%. These results deserve a measure of scrutiny by the mere fact that the “Magnificent seven” (Nvidia, Amazon, Meta, Alphabet, Microsoft, Apple and Tesla) account for about half of the gains in the entire S&P 500 so far this year and that despite Tesla’s fall, these companies account for more than a quarter of the index’s entire market capitalisation. Rather than trading at a price/earnings (P/E) ratio of 20.4x the S&P 500 would trade at only 18.1x forward earnings if one excluded the Magnificent seven. However, six of these stocks (Tesla disappointed) are expensive for a reason, they registered earnings growth of 54% in Q4 over the same quarter a year earlier, whereas the other 494 stocks saw earnings contract by 10.5%.

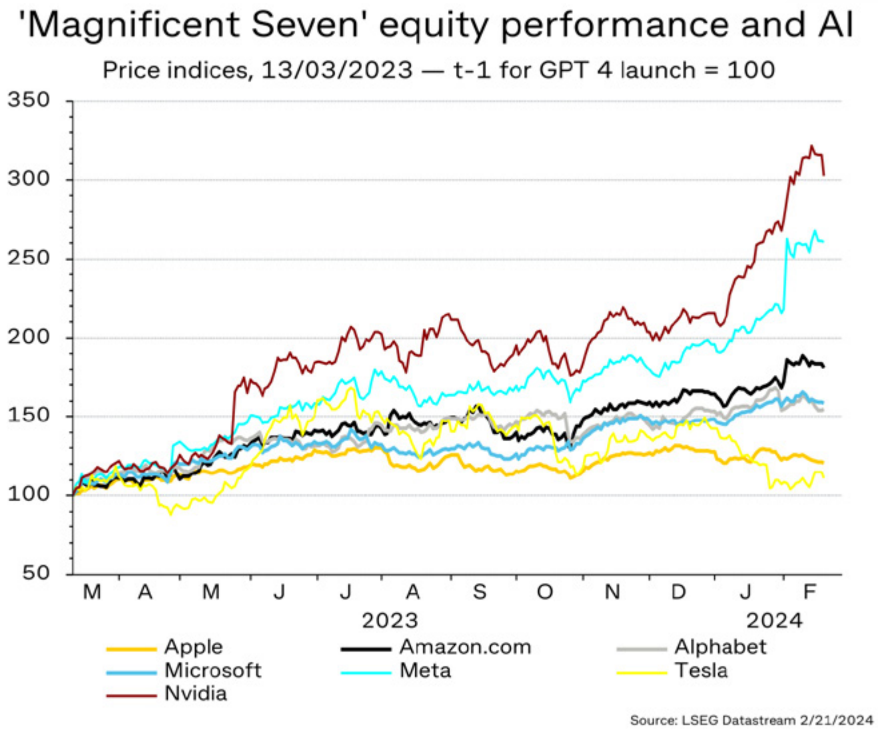

Figure 4

Index concentration is even more extreme in Europe, where just three stocks (ASML, Novo Nordisk and SAP) account for the majority of the gains in the Stoxx 600 this year and excluding them, that index would actually be down by 0.3%. Reporting season in Australia is just beginning and already is exceeding expectations, especially in the consumer discretionary sector. Despite this, outlook statements are becoming more muted indicating that a slowdown is materialising.

We are somewhat more concerned about the level of earnings growth being priced in by markets so far this year. Currently, the 2024 earnings growth in the US is around 9.6%, with even higher expectations implied over the next two years. These are the highest earnings growth expectations since FactSet began tracking earnings number in 1996. It is well-known that analysts tend to be bullish at the start of the year and have overestimated earnings in 17 of the 25 years by around 6.9%. These analysts are particularly challenged in their predictions during recessionary years (2000, 2008), the recovery in 2009, and also when significant events occurred (such as September 11, 2001 and the beginning of the Covid-19 pandemic in 2020). Given current valuations and record high earnings expectations, we believe that these assumptions will be placed under greater scrutiny by markets as the year progresses, especially if central banks don't cut interest rates or the economic environment deteriorates more materially than anticipated.

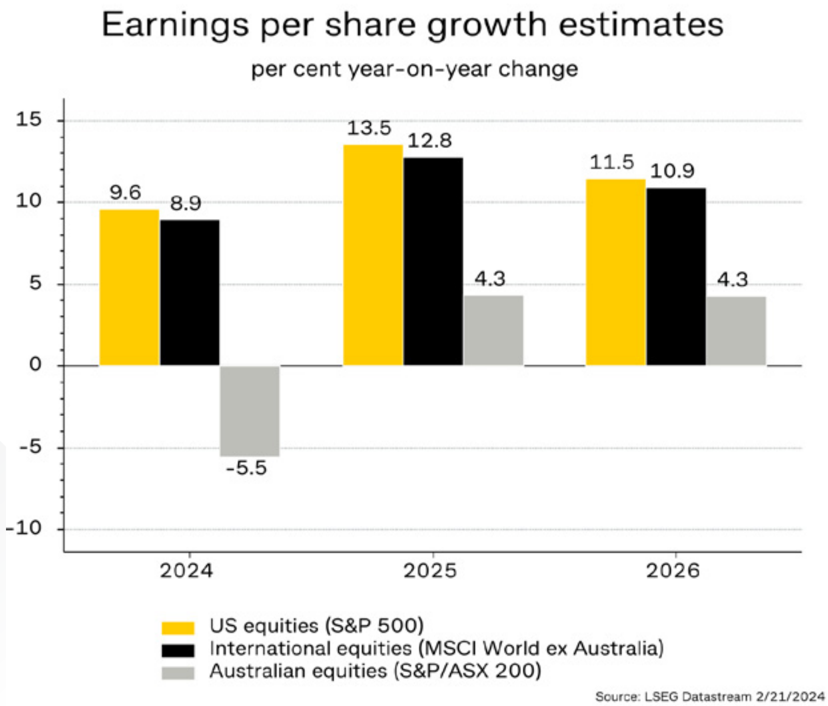
Earnings per share growth estimates
per cent year-on-year change
15
10
5
0
-5
-10
9.6
8.9
-5.5
13.5
12.8
4.3
11.5
10.9
4.3
2024
2025
2026
US equities (S&P 500)
International equities (MSCI World ex Australia)
Australian equities (S&P/ASX 200)
Source: LSEG Datastream 2/21/2024

Figure 5

Conclusion and Portfolio Positioning

While we acknowledge that recent data has been positive on the inflation front and economic conditions remain encouraging, our Investments and Research Team believes that 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. Potentially, delayed rate cuts make equities particularly vulnerable given recent record levels as companies will be faced with higher funding costs and softening demand for their goods and services.

- The rally has pushed valuation levels even higher increasing our conviction in our underweight position to equities and neutral position in 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 can still provide positive (after some mid-year volatility) returns this year especially if rate cuts eventuate.
- Patience is key as we envision higher levels of volatility which 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 do 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.

Finally, many market commentators have written about the death of traditional balanced portfolios comprising 60:40 equities to fixed interest. While balanced portfolios have had a volatile couple of years, given almost every asset class except cash has been negatively impacted by rising interest rates, we continue to consider our diversified portfolios as a prudent form of insurance. We also continue to further diversify portfolios through the increased use of alternative asset classes complimenting the traditional asset mix.

As always, should market conditions or our outlook change, we will propose appropriate portfolio positioning to take advantage of any opportunities or avoid any risks emerging from any changes.