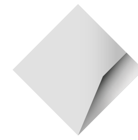
Q2 FY2024
Patience is key



Commonwealth Private

Quarterly Investment Report.

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Executive Summary

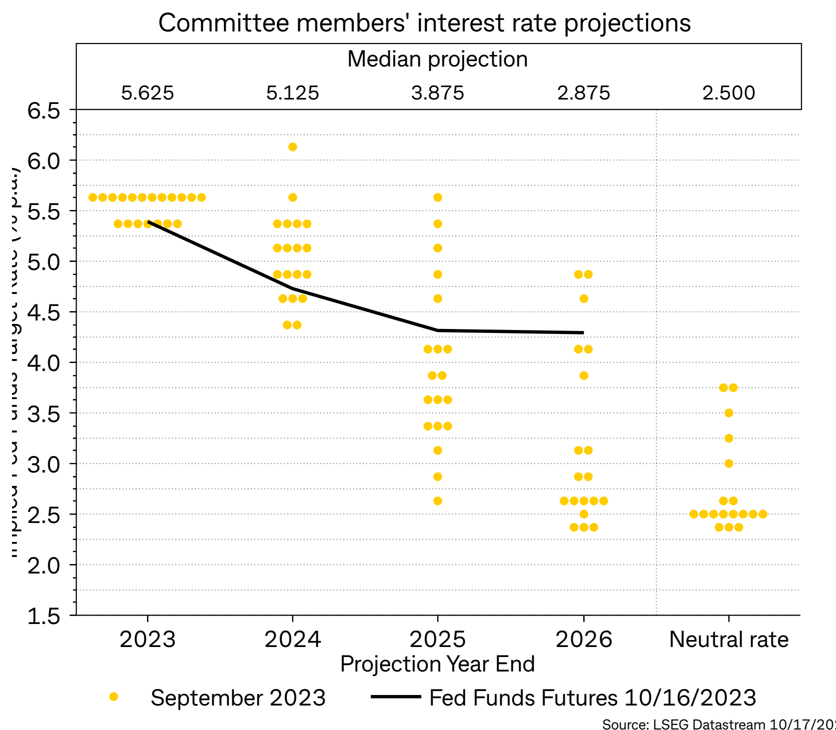
The old adage "ignore the market noise" certainly rings true when we look at the last quarter where we have seen markets move from being bearish, to pricing a soft landing (given positive economic data) and then back to being concerned about higher for longer interest rates. During the past quarter, we saw global bond yields extend their sell-off, with the US 10-year Treasury yield pushing above 4.6% at one stage, its highest level since 2007. On the home front, Australian government bonds also moved higher with the 3-year and 10-year yields at their highest levels in about a decade.

In times like these, it is important to have a disciplined investment framework and context around the business-cycle which will provide a better roadmap and potentially a smoother investment outcome for investors. Equity valuations remain elevated especially if we do get a higher for longer interest rate scenario. Globally, the economic outlook is also becoming a more mixed picture, which is making it particularly difficult for central bankers to navigate a clear path forward. Geopolitical tensions are building adding another layer of complexity. Finally, investor sentiment is increasingly wavering, adding to already higher than average levels of market volatility. In this Quarterly Report, the Commonwealth Private Investments and Research Team will examine some of the drivers of return, the yardsticks we are looking for and how we are positioning our portfolios for the final quarter of calendar year 2023.

In our previous Quarterly Investment Report and Market Outlook Reports, we provided commentary that it was a tall order for central bankers to engineer a soft landing, and the heightened risks of overtightening as the last few rate rises (often seen as insurance) tend to spark some unforeseen negative spill-over effects in financial markets or the real economy. As is the case now, on the eve of recessions in 1990, 2001 and 2007, many market economists were too early to proclaim that the US was on the cusp of achieving a soft landing. The major challenge facing central bankers is the increasing prospect that while inflation will come down to the four per cent level, it will take far longer than anticipated to get to target levels of around two per cent.

The other challenge is the recent volatility in oil prices. Supply shocks such as climbing oil prices present the US Federal Reserve (Fed) with a dilemma, as they simultaneously boost inflation and curb economic growth, leaving policymakers at times uncertain about whether to tighten or loosen credit in response. Historically, surging energy costs played a role in tipping the US into recession in the mid-1970s, as well as the early-1980s and 1990s, as they drove up inflation and deprived consumers of purchasing power. Today, driven by cutbacks in supply by Saudi Arabia and Russia, oil prices have surged by almost 30% since June, with benchmark US crude topping $91 a barrel. Though prices are still well below their 2022 highs, the latest rise poses risks as the Fed seeks to return inflation to its 2% target without triggering an economic downturn. Traditionally, central banks tend to play down the impact of higher oil prices on inflation, viewing the effect as transitory. However, policymakers will be on high alert for a petrol-driven rise in inflation expectations, as they fear it could lead to a more broad-based increase in prices.

Our belief is that the September Federal Reserve Open Market (FOMC) meeting painted a somewhat more realistic scenario, as it indicates what lies ahead for interest rates going forward. In Figure 1 below, we illustrate the Fed's dot plot projections which showed the likelihood of one more interest rate increase this year, followed by two cuts in 2024 - two fewer than were indicated during the last update in June. That would put the funds rate around 5.1%. The projection for the Fed funds rate also moved higher for 2025, with the median outlook at 3.9%, compared with 3.4% previously. Over the longer term, Fed members pointed to a funds rate of 2.9% in 2026, well above what the Fed considers the "neutral" rate of 2.5% that is neither stimulative nor restrictive for growth.



In Australia, recent economic and market developments have also caused economists to revise their interest rate expectations. The Australian Financial Review's survey of 42 economists now suggests the Reserve Bank of Australia (RBA) will cut interest rates in August 2024, according to the median forecaster, compared with previous expectations of May. Late last year, the survey had forecast the first monetary easing in February 2024.

As we approach the most critical phase of this interest rate tightening cycle, our Investments and Research Team believes that 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 a recession. Potentially, higher for longer interest rates make equities particularly vulnerable at current valuation levels, as companies will be faced with higher funding costs and softening demand for their goods and services.

As such, we are maintaining a more cautious stance with our underweight in international and Australian equities. Equity markets have been trying to move higher but mixed data has resulted in some consolidation and range trading to-date. We would not be surprised to see another quarter or two of earnings reports coming in better than market expectation given the fact that stock analysts have been too conservative throughout 2023. This could lead to some positive equity market performance in the short term. However, with interest rates potentially staying higher and economic momentum slowing, we believe that the earnings expectations for 2024 are too optimistic. Patience is key as we envision higher levels of volatility once the transmission effects of higher interest rates make a more

material impact on economic growth – and in turn, present 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 thanks to stronger income returns from holding bonds, as well as the potential for capital appreciation if central banks do cut interest rates in mid-2024 or equity markets suffer a material fall.

We will explore this more in the coming section. 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.

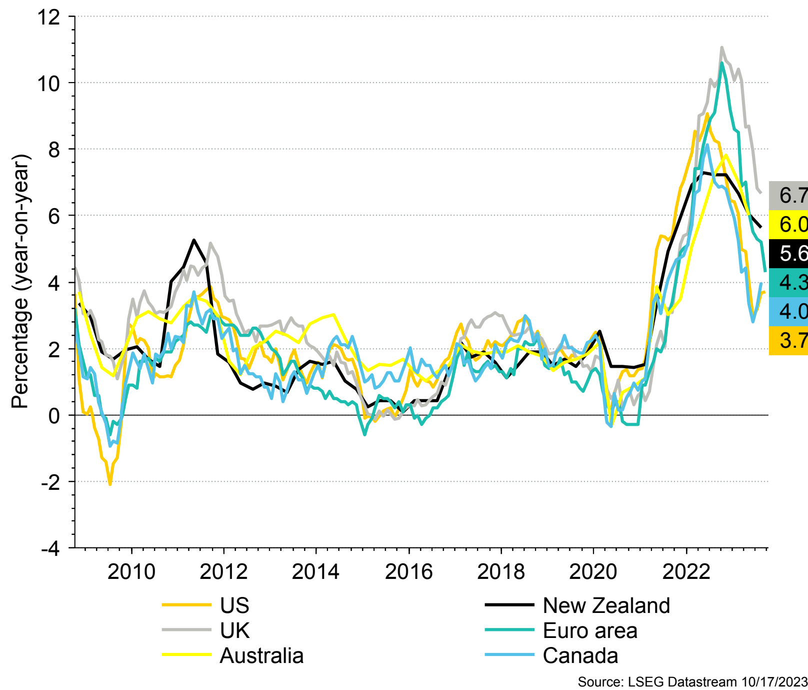
Asset Class	Portfolio Weight	Comments
Cash	Overweight	Cash returns are relatively attractive at current levels providing an income return in conjunction with capital stability.
Fixed Interest	Neutral	Improved yields on offer for fixed interest, as well as the opportunity for capital appreciation in the 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.

Fixed Interest

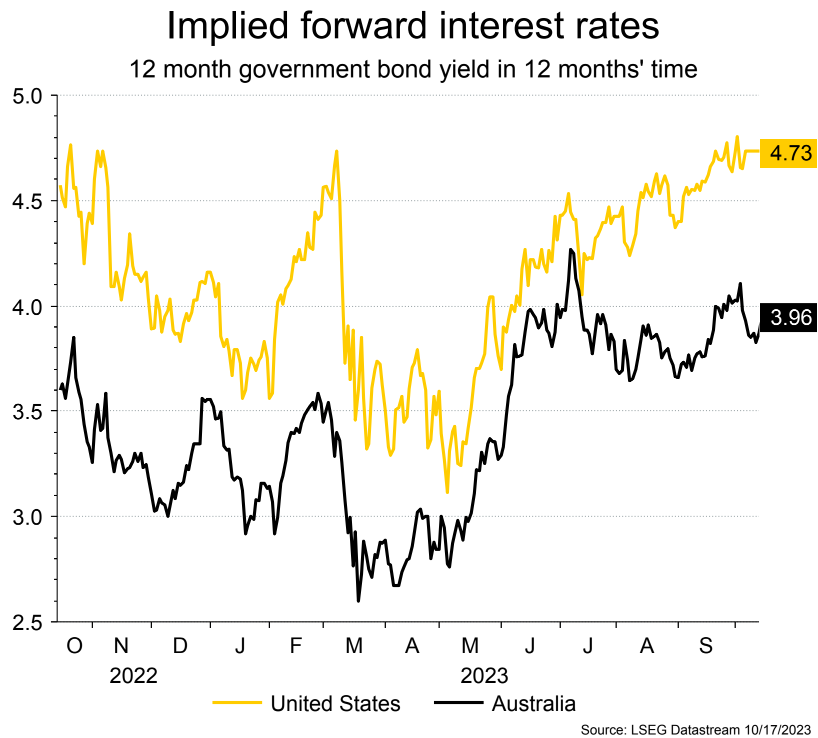
Fixed interest assets were again weaker over the last quarter as central bankers signalled that, despite the fact they are close to the end of the hiking cycle, interest rates might have to stay higher for longer to effectively curtail core inflation. The Bloomberg Barclays Global Aggregate Bond Index Hedged AUD returned -2.14% over a volatile quarter while the 2-year US Treasury bond yield rose from 4.92% to 5.04% per annum. The 10-year US Treasury yield also increased from 3.88% to 4.54% per annum, while 10-year bund yields in Germany rose from 2.39% to 2.91% per annum.

The Fed held the benchmark rate at 5.25%-5.50% but stressed they would remain tough against an inflation fight which could last into 2026. The European Central Bank (ECB) and Bank of England (BoE) also stated that further rate hikes cannot be ruled out and that they will keep interest rates sufficiently higher for long enough to ensure that they get the desired outcome. Similarly, the RBA kept its key interest rate unchanged over the quarter while retaining a tightening bias as the new Governor, Michele Bullock, gauges the impact of four percentage points of hikes going forward. The RBA noted that growth in the Australian economy was a little stronger than expected over the first half of the year. Despite this, the economy is still experiencing a period of below-trend growth and this is expected to continue for a while. High inflation is weighing on Australian's real incomes and household consumption growth is weak, as is dwelling investment. Notwithstanding this, conditions in the labour market remain tight, although they have eased a little. The central bank reiterated its significant uncertainties around the outlook. Services price inflation has been surprisingly persistent overseas and the same could occur in Australia. There are also uncertainties regarding the lags in the effect of monetary policy and how firms' pricing decisions and wages respond to the slower growth in the economy at a time when the labour market remains tight. Importantly the RBA is hoping that any increase in the unemployment rate, currently sitting at 3.7%, will be gradual and limited to the central bank's forecast of 4.5% by the end of 2024.

In Australia, government bond yields followed the US lead by rising over the quarter. The 3-year Australian government bond yield rose from 4.05% to 4.08% per annum even as the RBA moderated its hawkish stance and the economic data is more mixed. The 10-year government bond yield also rose from 4.01% in June to 4.49% per annum at the end of September. The Bloomberg AusBond Composite Index returned -0.28% over the three months to September. Australian cash returns, as measured by the Bloomberg AusBond Bank Index, returned 1.08% for the September quarter as the RBA kept the cash rate steady at 4.10% over the quarter. Market pricing suggests the chance of a hike in November is now only 36%, compared with 44% before. A potential rate hike is not expected until May next year, according to market pricing.



Fixed interest markets have repriced expectations quite dramatically 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 the thinking of monetary authorities. In most developed economies, we anticipate maybe one more rate rise, but that interest rates will stay higher with rate cuts more likely to begin in the middle of 2024 and only if the global economy is subject to a pronounced slowdown. As such, despite the weak short-term performance, the outlook for fixed interest returns is more compelling as we look forward.



Although bond prices have lagged over the last quarter, the 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. For this reason, we are not inclined to abandon the long-term diversification or portfolio insurance benefits from owning government and high-quality corporate bonds simply because they have provided lower diversification benefits in more recent times.

Alternatives and Property

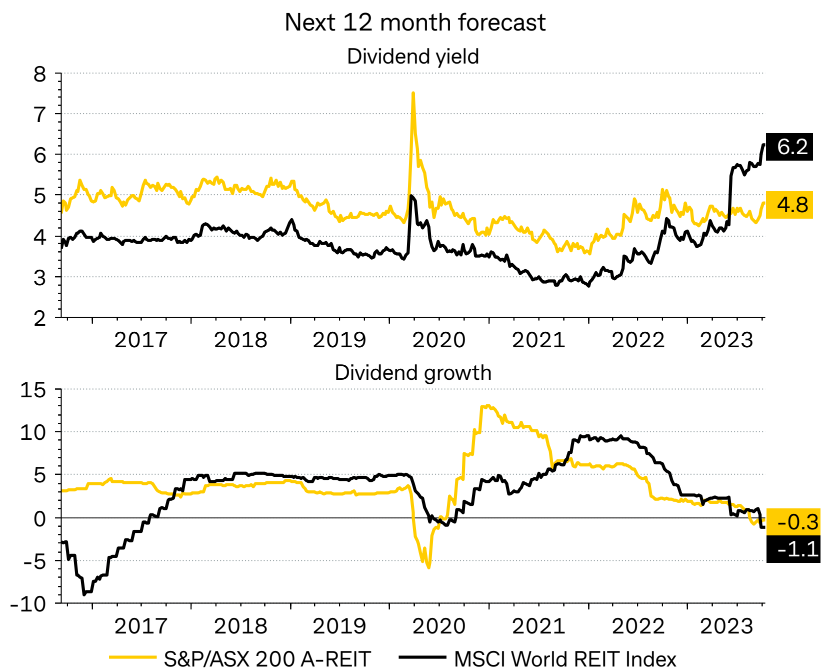
During the September quarter, hedge funds increased by 0.84% according to the HFRI Fund Weighted Composite Index, delivering a better outcome than both equity and fixed interest rate benchmarks. Macro-based strategies had a positive quarter despite experiencing heightened volatility and performance dispersion. Gains were led by fundamental, commodity, and quantitative trends following Commodity Trading Advisors (CTA) and multi-strategy sub-strategies. Event-driven strategies, which often focus on out-of-favour, deep-value equity exposures and speculation on M&A situations, delivered positive returns over the quarter driven by merger arbitrage and credit arbitrage sub-strategies. Shareholder activist funds, however, delivered a negative return over the quarter. Equity hedge funds, which invest long and short across specialised sub-strategies, posted declines in the September quarter with negative contributions from technology, fundamental growth and fundamental value exposures. This was marginally offset with sub-strategies specialising in energy and basic materials, delivering a positive outcome. Fixed-Income Relative-Value based deliver an overall positive outcome over the quarter despite interest rates increasing and inflationary pressures remaining persistent.

Private markets continue to offer attractive diversification benefits despite the mounting economic headwinds. The higher cost of debt and lower capital market activity do present some challenges. However, private equity has seen a welcome decline in entry valuations, with secondaries seeing attractive discounts as markets become more challenging and some existing investors require liquidity. 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 selection and vintage selection becomes more important.

Global listed infrastructure, as measured by the S&P Global Infrastructure Index (hedged AUD) declined by -6.49% in the September quarter as the prospect of higher interest rates for longer 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. Generally favourable passenger volume trends for Japanese passenger rail, and European and Latin America airport stocks helped the railroads and airports sectors to limit their losses. The bond yield-sensitive Towers sector came under pressure as the US 10-year treasury yield increased to 4.54% during the quarter. Water, waste, utilities and renewables stocks were also affected by the rise of the 10-year treasury yield. Toll Roads gave up ground as investors took profits, following healthy share price increases in the first half of the year.

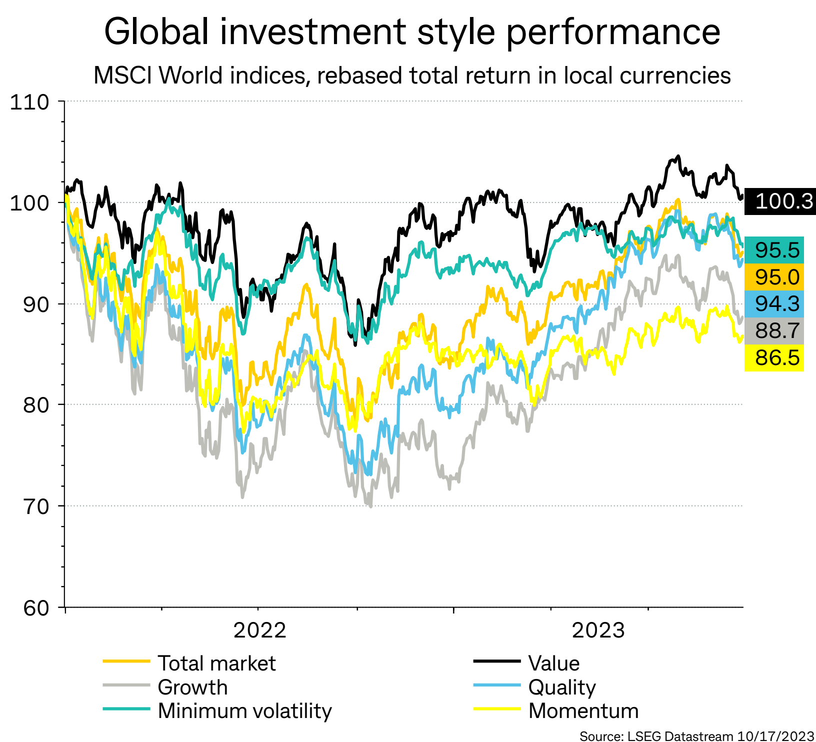
Within infrastructure, we retain our preference for listed over private infrastructure for core assets due to the valuation discount. While higher interest rates have impacted short-term performance, infrastructure has a demonstrated history of performing well during periods of higher inflation due to 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.



The global-listed property index, namely the FTSE EPRA NAREIT Developed Index (hedged AUD) returned -5.18% 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 listed real estate markets during the quarter were Germany, Japan, Sweden and Spain. Countries that declined included Hong Kong, the US and Canada. 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 is well placed over the medium to long term as it is an integral part supporting the growth of the digital economy. Also, the risk adjusted returns offered by the residential-for-rent sector (which includes apartments, detached housing, manufactured homes and student housing) are compelling, as residential assets typically deliver very stable cash flows through the cycle. Commercial property remains a challenge but modern 'green' buildings built in the 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 -2.93% in the September quarter. The decline in the quarter was primarily driven by macro factors, including a shift to a 'higher-for-longer' view on interest rates.

International Equities

At the start of the quarter, global equities performed strongly on the back of better-than-expected earnings results announced during reporting season and optimism around the increasing prospect of a soft landing. However, as the quarter progressed, the prospect of higher interest rates and seasonal weakness drove equity markets lower. Over the three months to September, international equities as measured by the MSCI World ex-Australia AUD Index, returned -0.43%. The currency-hedged version of the index posted returns of -2.56% over the quarter due to the falling dollar impacting.



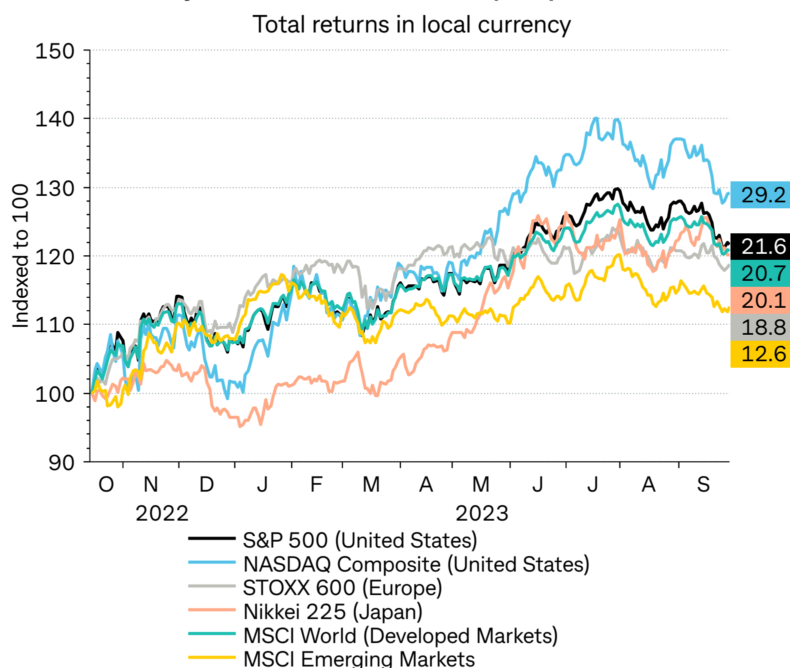
In the US, the S&P 500 index fell -3.27% over the quarter on the back of heightened interest rate volatility but remains up 5.18% over the six months. Utilities, real estate and consumer staples were the weakest sectors with energy and communication services being the only two sectors to post a positive return. Despite this, the US saw another resilient quarter on the earnings front, as analysts were quite conservative with their estimates going into the second quarter, with expectations that the S&P 500 would deliver negative earnings growth of -7.0% with the actual number being revised to -4.1%. Our biggest takeaway from this quarter is that for the first time since the Covid-19 pandemic, we saw fewer companies beat revenue expectations - which will be a concern given the debate around corporate pricing power and how long that will last post-pandemic. Furthermore, real revenue growth (adjusted for inflation) was negative for the third consecutive quarter.

European shares fell as the economic backdrop continued to weaken and interest rates remain high. The pan European Stoxx 600 closed -2.11% lower, with France's CAC 40 and Germany's DAX falling -3.58% and -4.71% respectively over the quarter. We are seeing some of the recent strong drivers of equity market returns such as the luxury conglomerates and weight loss companies starting to falter given high valuations and weakening prospects.

The UK's FTSE 100, however, delivered a positive return of 1.02% driven by higher oil prices and the latest inflation read being lower than expected.

Asian equities have continued to struggle as China's economy lost momentum and stimulus measures are yet to take effect. Industrial output, retail sales, and fixed asset investment grew at a slower-than-expected pace. The Shanghai Composite index closed -2.86% lower with the Hang Seng index down -5.85% over the quarter. More bad news from China's debt-ridden property sector also weighed on sentiment. Country Garden, one of the country's largest property developers, missed interest payments on two dollar-denominated bonds due to liquidity problems. China Evergrande Group, another major developer that is already in default, unveiled more losses and postponed credit meetings. Singapore and Indian equity markets delivered positive returns of 0.36% and 1.71% respectively given relatively stronger economic fundamentals.

The Japanese equity market faired relatively better at the start of the quarter with the Nikkei 225 hitting a 30-year high before succumbing to the global risk-off sentiment and finishing the quarter down -4.01%. The Japanese economy grew at an annualised 4.8% in the second quarter of the year, far higher than expectations of 3.1%. However, the weak yen and increased bond market volatility is increasing expectations that the Bank of Japan will need to pursue monetary policy normalisation sooner rather than later.



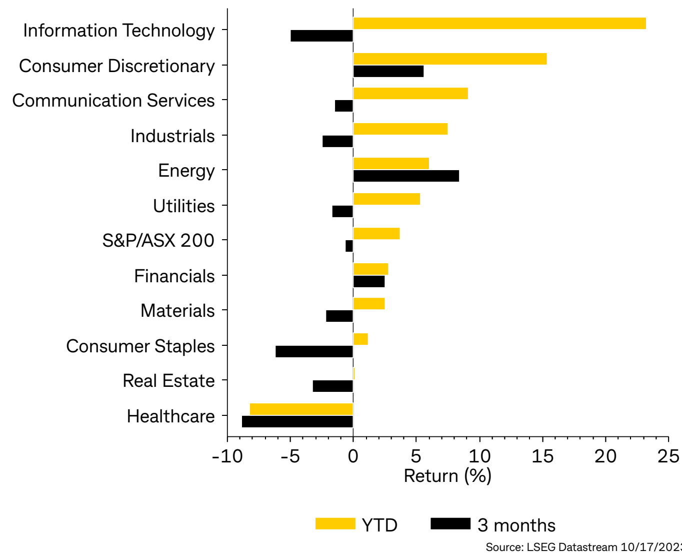
Australian Equities

The domestic equity market ended slightly lower for the September quarter with the S&P/ ASX200 Accumulation Index (the "benchmark") down -0.77%. The S&P/ASX Small Ordinaries, which tracks stocks 101-300 of the S&P/ASX 300, fell by -1.94% confirming large caps (i.e. the top-100 companies) drove most of the market returns during the quarter. The key event during the quarter was the Australian company reporting season. Overall, 37% of ASX 200 firms beat consensus expectations whilst 36% missed, which is slightly below long-run averages. Share price reactions were abnormally large where one out of every eight stocks moved more than +/-10% on their result release, nearly double the long run average, highlighting the uncertainty preceding each earnings result and given current company valuations. Companies with interest-bearing debt are watching the rising interest rates closely, which is expected to have more marked impact on their financial cost going forward. While some companies have demonstrated relatively strong pricing power and managed to increase prices by double digits over FY23, most companies were unable to move prices quick and high enough to maintain the margins in previous periods. Additionally, while commodity related input costs, such as fuel, electricity, freight and lumber, have started easing, the labour shortage have increased wages particularly for mining, energy, retail and healthcare.

We are also seeing companies build up their cash reserves given the cautious view on the economy and the higher risk of project cost overruns. Combined with the fact that companies are also prioritising debt repayment will potentially result in lower dividend payouts for shareholders. The September quarter was also the first quarter where no interest rate rises were recorded from the RBA since the rate hiking cycle commenced in May 2022.

Energy was the standout winner among all the GICS sectors, having a total return of 11.16%, well ahead of the second-best sector, Consumer Discretionary, which was up 5.33%. Healthcare and Consumer Staples were the two largest laggards, down -8.59% and -5.88% respectively as defensive sectors underperformed. Brent Crude oil was up ~34% in Australian dollar terms during the quarter following supply cuts from OPEC+, whilst Consumer Discretionary also rallied particularly during the August reporting season after results were not as bad as feared.

Finally, 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. The aggregate 12-month forward price–to-earnings multiple stayed relatively steady 14.9 times, while the forward dividend yield fell from 4.6% to 4.2%.



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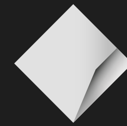

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