Q3 FY2024

Quarterly Investment Report.

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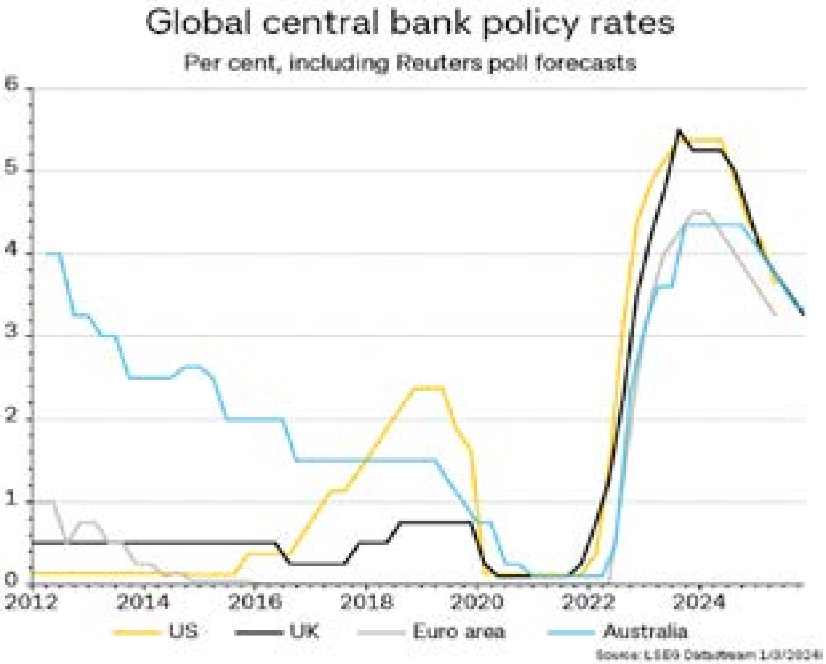
Executive Summary

Financial markets across the globe produced a strong rally in the December quarter following a shaky start to October. In particular, November and December produced strong monthly gains in both equites and bonds with the catalyst of this coming from an expectation that central banks had reached the end of its rate hiking cycle. The US Federal Reserve (Fed) initially set the dovish tone in December, however markets quickly started to reprice the outlook for the other major central banks to follow suit. We will explore this in further detail in the sections to follow.

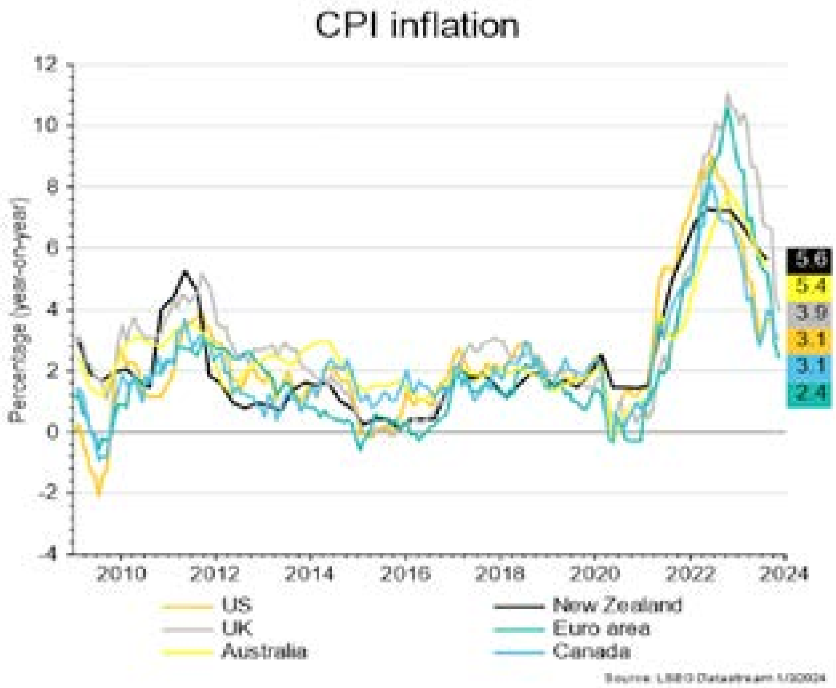
2023 was a good year for asset prices, particularly equities. In the first half of the year, equity markets feared the recession that never came, a US regional banking crisis was averted, the consumer remained resilient and broadly speaking, corporate earnings were better than expected. In the second half, global yields moved to their highest levels in 16 years before a significant pullback, and we faced heightened geopolitical tensions. On an overall basis, the market's dwindling expectation of a recession, stable earnings, and the ability for companies to cushion the impact of weaker nominal growth on margins underpinned the rally in equities, which produced one of the strongest yearly gains in the US. The S&P500 rose 24.2% for the year and the Nasdaq soared 43%, driven by gains in big technology companies, such as Nvidia, Amazon and Microsoft. Outside the US, the ASX200 finished the year up 12.4% after a strong rally in December, while China and Hong Kong stocks ended 2023 as the worst performers among the world's major indices, dragged down by geopolitical risks, a sluggish economic recovery and policy uncertainties. The China benchmark blue-chip CSI300 Index slumped 11% in 2023 and Hong Kong's Hang Seng Index tumbled 14%.

The Fed's shift in tone following its December meeting was also interpreted as a signal for Federal Funds Rate cuts in 2024. Within the fixed income asset class, this also saw international fixed income assets respond with a strong rally into year end with High Yield bonds returning 7.1% in the December quarter, along with investment grade credit having a similarly strong performance.



As we enter 2024, a more cautious investment stance is warranted as the level of market uncertainty will only increase until there is a clearer impact of interest rate hikes to date and the degree of economic slowdown. Such caution is particularly the case with many equity indices trading near all-time highs. In the United States, markets are pricing in interest rate cuts in the first half of the year as the economy slows and a potential recession causes the Fed to pivot from a single-minded battle against inflation to supporting employment and economic activity with rate cuts. Similar economic views exist for Europe and Australia with interest rates having peaked, followed by anticipated rate cuts in the second half of the year as unemployment rises and inflation recedes.

Markets have effectively priced a 'soft-landing' scenario for the global economy. However, with the global growth forecast to drift below-trend, the ability for companies to deliver on the consensus 10% earnings growth will be challenging. Disinflationary forces will make it harder for companies to maintain pricing power compared to when inflation was rising. Furthermore, geopolitics risks will remain with the Ukraine and Middle East conflicts and politics will loom large in 2024, especially with the US presidential election as markets are traditionally weaker into the run-up to the election.



Based on current market valuations, we remain relatively comfortable with our underweight position to equities and neutral position in fixed interest which we have had in place over much of 2023. 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 risk of price falls as outlined above, we feel that growth assets such as equities can still provide positive, albeit lower, returns this year. In our view, there is a low likelihood that we see a repeat of the large losses in fixed interest with the end of the interest rate hiking cycle and, despite recession fears, most economies remain in relatively good shape.

In the event that equities stage another strong rally, it may be appropriate to reduce exposure to growth assets further as it would be likely that the relative equity valuations would not be fully reflecting economic fundamentals, namely the soft earnings outlook and elevated recession risks. Equity valuations, particularly in the US, are already not particularly cheap relative to longer term history. In addition, comparing current cash and government bond yields, equity valuations are expensive in the US and Australia suggesting fixed interest may offer better value. Moreover, equity valuation multiples tend to trough in a recession at much lower levels than those we see currently.

When it comes to fixed interest markets, while bond yields have risen materially following the rapid interest rate rises in 2022 and 2023 this means improved yields are on offer for fixed interest, as well as the opportunity for capital appreciation in the event central banks do cut interest rates in 2024. We would also expect that in a recessionary environment, longer-dated fixed interest securities would decouple from equities and return to providing the portfolio insurance that they have in prior recession-driven equity bear markets.

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, it would be prudent to consider diversified portfolios as a form of insurance. We also continue to further diversify with portfolios through the increased use of alternative asset classes complimenting the traditional asset mix.

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.

Australian Equities

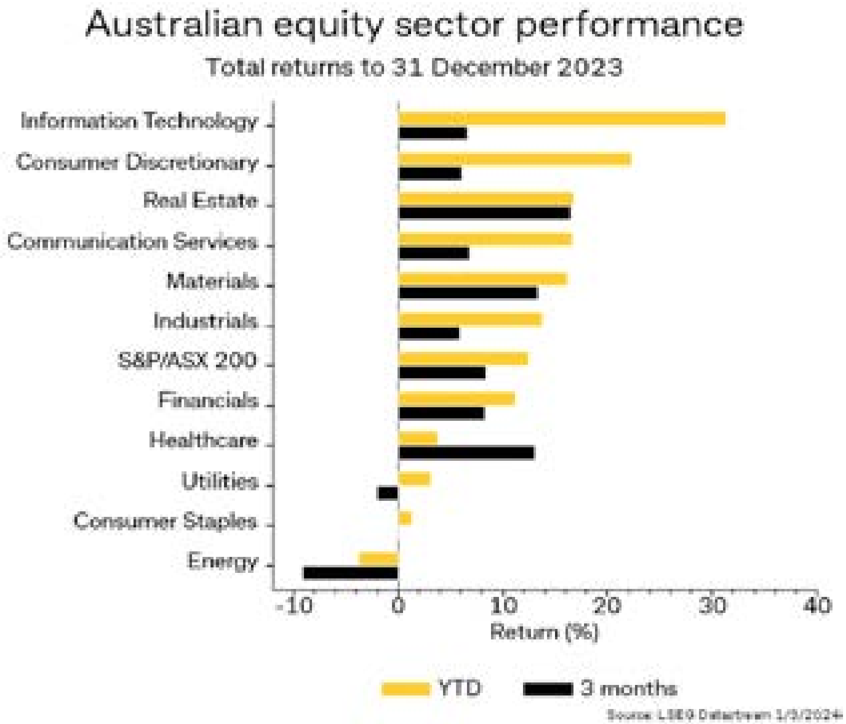
The Australian stock market rallied in November and December and finished CY23 on a strong note. The S&P/ASX 200 Accumulation Index recorded a total return of 8.4% for the December quarter, bringing the CY23 total return to 12.42%, reversing the loss of 1.08% in CY22. Almost all the annual return was generated in the last two months of the year, amid rising hopes that inflation is cooling, and central banks may cut interest rates earlier and deeper than previously thought, as well as falling bond yields.

Interest-rate-sensitive sectors, such as Real Estate and Healthcare, led the rally in the December quarter, up 15.8% and 13.1% respectively. In addition to the positive impact from lower long-term bond yields, the Healthcare sector also enjoyed valuation multiple expansion due to easing of concerns over how weight loss drugs – such as Ozempic – would disrupt the target market of some existing healthcare companies, such as ResMed and CSL. Materials also outperformed the broader market with a total return of 13.4%, as seaborne iron ore prices broke out to new highs for the year.

Despite sluggish domestic steel demand due to the struggling property sector, Chinese steel mills have been producing more volume in 2023 than the prior year, thanks to surging export volumes. Rio Tinto's share price jumped 19.5%, while BHP's was 13.9% higher. Only two GICS sectors recorded a loss for the quarter, namely Energy (-9.1%) and Utilities (-2.1%), amid a weakening global oil market. The Brent Oil futures price finished the year at US$77/barrel, down approximately 20% from the previous peak seen in late-September, as fears of major oil supply disruptions in the Middle East subsided.

Over the full calendar year, IT followed the lead from the US market and performed the best with a rebound of 31.3%, which wasn't quite enough to recover the 33.7% decline in CY22. Consumer Discretionary, with a total return of 22.3%, was the second best performing GICS sector, despite the concerns on soft consumer sentiment and retail sales. The "not-as-bad-as-feared" earnings results and the relatively undemanding valuation levels have both contributed to the stellar performance number for Consumer Discretionary. Despite this, over a two-year period, both IT and Consumer Discretionary remained in the negative return territory, at -12.9% and -2.6% respectively. Communication Services ranked third among all the GICS sectors with a 16.6% return in CY23, primarily boosted by the 50%+ share price increases in REA Group, CAR Group and NextDC. Consumer Staples (1.3%), Utilities (3.2%) and Healthcare (3.8%), the conventional defensive sectors, were the major laggards in CY23, albeit all finishing with a small gain for the year.

Earnings sentiment across the Australian equity market was weak throughout the year. The aggregate 12-month forward earnings per share of the S&P/ASX 200 Index declined almost 10%, driven by Resources and Financials. Heading into the half-yearly equity reporting season in February, we expect the market to shift more of its focus from macroeconomic factors towards individual companies' earnings performance and outlook statements. Upgrades or downgrades of forward earnings guidance will be a primary share price driver.



International Equities

As mentioned above, global equities had a strong calendar year, driven by gains in the fourth quarter. The S&P 500, with its growth tilt, was the best performing major equity index over the quarter delivering 11.7% total return, its best quarterly performance for three years. Returns for the full year were dominated by the 'magnificent seven' tech and AI stocks, which contributed around 80% of the index returns. But over the quarter, the rally broadened with 33% of the index reaching new 52-week highs in December due to expectations of imminent rate cuts. Top performing sectors were those most sensitive to interest rates including information technology, real estate and consumer discretionary. The energy sector posted a negative return with crude oil prices weaker over the quarter.

European equities also delivered strong returns of 6.7%, with index composition the primary driver of underperformance relative to the US. Top gaining sectors included real estate and information technology, while healthcare and energy were the two main laggards, registering negative returns.

In the UK, equities rose over the quarter and small and mid-cap indices outperformed the broader market as domestically focused stocks performed very strongly. This occurred as hopes built further that interest rates may have peaked and amid a continued pick-up in overseas "inbound" bids for smaller UK companies.

Emerging market equities delivered a 7.9% increase despite being hamstrung by weak Chinese performance. Mounting growth concerns meant Chinese equities fell by 4.8%, but this was offset by strong returns elsewhere, particularly in Latin America where the MSCI EM LATAM Index delivered 17.8% (in US dollar terms) over the quarter.

Japanese equities, benefitting less than other markets from central bank tailwinds, were the worst performing equity market at 2.0% over the quarter. The overall macroeconomic conditions in Japan continued to improve, despite somewhat sluggish Q3 GDP data driven by higher inflation associated with slower wage growth. However, the Bank of Japan tankan survey released in December showed continuous improvement in business sentiment for both the manufacturing and non-manufacturing sector.

Alternatives & Listed Property

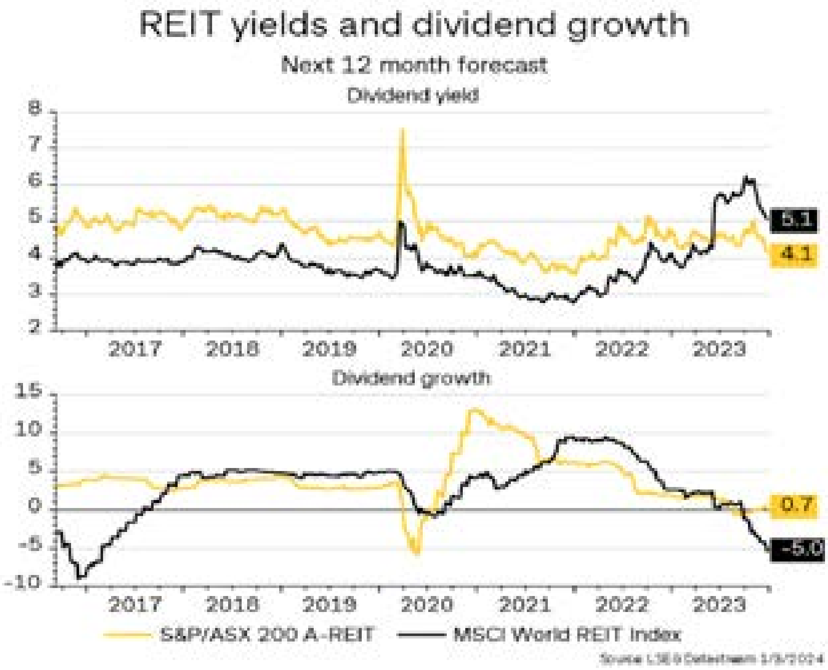
Hedge funds increased by 3.59% during the December quarter, according to the HFRI Fund Weighted Composite Index, delivering strong absolute returns albeit short of strong equity indices. Dispersion of performance between hedge fund strategies decreased over the quarter. Event Driven strategies had a strong quarter, with the standout sub-strategy being Activist funds, which produced double digit returns. Merger Arbitrage also contributed positively to gains. More muted performance was seen in Uncorrelated Macro Strategies which posted a narrow gain as bond yields and commodities fell while risk tolerance increased.

Private markets continue to provide attractive absolute return outcomes even in a higher interest rate environment. According to Hamilton Lane data, Private Infrastructure funds had the strongest quarterly performance, producing a return of 2.87% for the quarter ending September 2023. Infrastructure assets have a direct link to inflation which has benefited their performance in recent years. Private credit remains the stalwart with the higher rate backdrop, returning 2.17% in the September 2023 quarter. The importance of remaining selective of strategy, manager and sector composition remains crucial in maintaining this performance through the market cycle. On the opposite end of the spectrum, Venture Capital continues to struggle in the higher interest rate setting, generating a performance of -2.67% for the September quarter. More Venture Capital companies are now approaching the stage where they can no longer delay new funding rounds which is creating a reset of valuations. Private Real Estate funds also struggled during the quarter, producing a return of -1.77% according to Hamilton Lane data, with the main detractor being Office properties.

Infrastructure rallied at the tail end of 2023, driven by the expected decline in interest rates. Economically sensitive sectors such as airports, rails and toll roads performed well, while renewables and communication towers also increased as interest rate pressures abated. Energy infrastructure, while making positive gains, underperformed as oil prices fell. Global listed infrastructure, as measured by the S&P Global Infrastructure Index (hedged AUD), rose by 7.83% over the December 2023 quarter as increased consensus of interest rate cuts were likely in 2024.

The global listed property index, namely the FTSE EPRA NAREIT Developed Index (hedged AUD) returned 12.71% for the quarter. The strong return for the quarter was generated in November (9.03%) and December (8.24%), with expectations of lower interest rates providing a favourable tail wind. Strength and recovery have been demonstrated in Europe and the United Kingdom, assisted by weakening inflation figures, with these regions returning 19.97% and 17.46%, respectively. At a country level, Germany was once again among the best performer countries rising 21.69%. At sector level, German residential, self-storage and logistics performed well. The United States (9.63%), Canada (6.92%), New Zealand (7.60%) and Developed Asia (2.83%) all generated positive returns.

Again, at a sector-level perspective, Self-Storage, Hotels and Industrials were the strongest performers with returns of 16.93%, 13.29% and 10.74%, respectively. The performance of self-storage was driven by the expectation that lower treasury yields will result in lower mortgage rates in the US, leading to greater home buying activity and thus a stronger demand outlook for 2024. In Australia, the S&P/ASX 200 Property Accumulation Total Return Index returned 16.56% in the December quarter, with performance strong in November (11.00%) and December (11.51%).



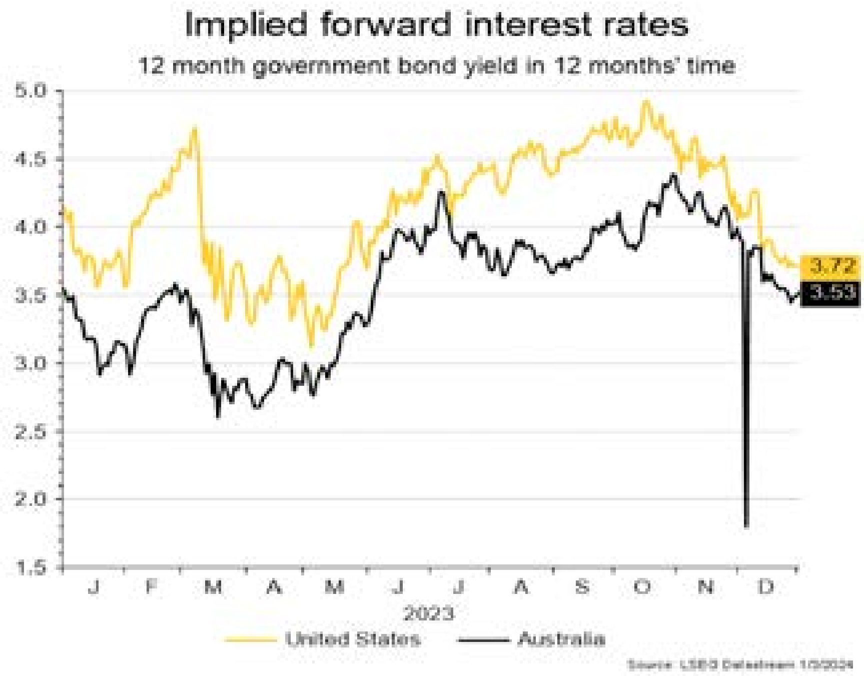
Fixed Interest

The fourth quarter of 2023 began with US Treasury (UST) yields pushing higher in October, as 30- and 10-year yields surpassed the 5% mark for the first time since the global financial crisis. As discussed in our introduction, US economic data had surprised to the upside and this—coupled with concerns over the supply and demand for US debt—acted as the main catalysts behind the surge in UST yields. This was reversed during November and December when UST yields plummeted due to stronger evidence of disinflation along with more balanced comments from central bankers. Early in the quarter, some Fed officials commented that higher long-term interest rates might be serving to tighten financial conditions along with the currently restrictive level for the fed funds rate. Optimism that major global central banks have succeeded in sufficiently tightening monetary policy while averting an economic "hard landing" and the prospect of monetary easing next year, lifted risk assets and tightened credit spreads.

As expected, the Federal Open Market Committee (FOMC) kept the fed funds target rate range at 5.25% to 5.50% during its November and December meetings. Earlier in the quarter, comments from Fed speakers suggested that the bar might be set quite high for any further rate hikes. In November, although Fed Chair Jerome Powell kept the door open to another rate hike, he reinforced a message first communicated in October that higher long-term interest rates might be serving to tighten financial conditions along with the currently restrictive level for the fed funds rate.

In Europe, with several policy rate cuts priced in by markets for 2024, central bank policymakers resisted being drawn in on the timing and scale of such reductions. In the UK, the Bank of England's (BoE) monetary policy committee voted 6-to-3 to maintain its key rate at 5.25%. In a welcome sign for the BoE, UK inflation decelerated more sharply than forecast in November. In Japan, the Bank of Japan (BoJ), as broadly expected, held all policy measures stable. The BoJ acknowledged that inflation is returning to target, but that given the limited volume of new data before its next meeting it is unlikely that policy will be adjusted in January either.

October was a difficult month for fixed interest, however November and December were positive months, ensuring favourable December quarter outcomes for the asset class, as growing expectations that interest-rate increases were over and that cash rates would fall in 2024. The key trigger has been inflation, which continues to edge lower in the U.S. and Europe, in combination with generally weaker metrics on economic momentum. Australian fixed interest, as measured by the Bloomberg AusBond Composite Index, generated a return of 3.79% for the December quarter. It's global fixed interest counterpart, namely the Bloomberg Global Aggregate Total Return Index (hedged AUD) posted a return of 5.43%. The 10-year US Treasury yield declined from a high of 4.99% to end the quarter at 3.87%, with the Australian 10-year yield also declining from a high of 4.96% to end the quarter at 3.97%.



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

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