MARKET COMMENTARY – June. 2024

Quarter-End Commentary

Overview

- Major global equity markets continued their climb, with stocks related to artificial intelligence (AI) continuing to lead the way.
- Some emerging risks weighed on the local market, producing negative returns for the quarter.
- Inflation remains above RBA's target band with an expectation that rate cuts will now come later and be shallower than previously expected.

Asset class recap to end of June 2024

Global shares

The MSCI World Ex-Australia NR Index returned 3.11% over the quarter in local currency terms, with the 12-month return coming in at +21.46%. In Australian dollar terms, quarterly and annual returns were +0.28% and +19.92%, respectively, as the AUD resurgence continued during Q2 2024 against most major currencies.

The quarter showcased a robust performance across various sectors in local currency terms:

Information Technology led the way with +11.69% over the quarter and +38.78% over the last 12 months. Communication Services and Utilities were the only other sectors to produce positive returns with +8.42% (38.20%) and 3.53% (5.69%) returns over the quarter and (year). Healthcare and Financials were relatively flat over the quarter; however, the 12-month numbers show growth at 11.90%, and 24.99%. Industrials (-1.40%), Energy (-1.13%), Consumer Discretionary (-1.63%) and Materials (-3.17%) struggled over the quarter but overall have performed positively for the year at 17.66%, 16.40%, +11.02%, 9.44% respectively. Consumer Staples lagged over the quarter and last 12 months returning 0.40% and 2.79%.

Australian shares

Australian shares declined this quarter, with the S&P/ASX200 accumulation index returning -1.05% for Q2 2024 but has remained positive over the year with the 12-month number returning +12.10%.

Utilities were the only sector to return double digits this quarter at +13.27% taking the 12-month number to 12.54%. A-Reits (-5.66%/+23.49%), Financials (+3.99%/+29.00%), Information Technology (+2.40%/+28.19%), and Healthcare (+1.86%/+8.72%) all produced positive returns over the quarter/year, while Consumer Staples were relatively flat over the quarter, but produced negative returns over the year with -3.67%.

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Energy produced negative returns over the quarter/year with -6.66%/-0.96% while Materials again weighed down the index declining further this quarter with -5.92%/-2.94% as well as Telecommunications (-5.25%/-10.41%). Industrials (-4.32%/+4.35%), and Consumer Discretionary -3.58%/+22.34% also produced negative returns over the quarter, however their 12-month number remain positive.

Bonds

Improving news on the global economy caused yields to inch higher, with US 10-year bond yields rising over the quarter from 4.21 to 4.41% providing a headwind for fixed income asset classes. Key 10-year treasury yields in local currency terms (30 June 2024): Australia: 4.36%.

Global property & infrastructure

Domestic listed property (-5.66%) produced negative returns over the quarter alongside global property (-1.80%) whilst the 12-month number remained positive at +23.79% and +4.45% respectively.

Currencies

The AUD gained value against the USD, EUR, JPY, amongst others, over the quarter. As such, broadly speaking, hedged currency exposure outperformed unhedged positions.

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Market outlook

After an unexpectedly strong March quarter, some emerging risks weighed on the local market. The S&P/ASX 200 Index declined about 2% to finish the June quarter at close to 7,770. The materials sector, which accounts for about 21% of the index, underperformed, with the big iron ore miners dragging down the index. Fortescue was a big loser, down 17% in the June quarter after falling 13% in the March quarter.

The other big driver of the Australia-listed equity market is financials, making up more than 30% of the ASX 200 Index. The Big Four banks alone account for more than 20% of the index. The majors continued to power ahead in the June quarter, buoyed by rising rates and the prospect of less margin pressure. Value is thin on the ground, with only ANZ and Westpac at modest discounts to our fair value estimates. Specific risks to the banks appear to have lessened. The downside risk would be a persistent reinvigoration of inflationary pressures, which could force central banks to raise rates materially, thus risking a hard landing. However, although inflation appears to be volatile, the overall trajectory appears to be downward. There's much to be said for incredibly strong immigration rates, with a dearth of housing and falling new starts placing upward pressure on house prices. While painful for renters and would-be first-time homebuyers, this bodes well for the quality of bank home loan books. Relatively low bad debts, coupled with stabilising margins, are important tailwinds.

In global markets, the second quarter of 2024 delivered positive outcomes for many asset classes, with generally low volatility. The major equity markets continued their climb, with stocks related to artificial intelligence (AI) leading the way. Bonds were a mixed bag over the quarter, however, and have started finding some stability after an extended period of uncertainty. As a result, many multi-asset portfolios have added to their first-quarter gains and are sitting on positive returns for the year to date—with the prospect of interest rate cuts fuelling investor expectations.

For the quarter, a few dominant forces were driving market sentiment. Perhaps the most prominent driver is activity among central banks, with rate cuts commencing in Europe and Canada, although the shifting rhetoric is that rate cuts will be later and shallower than previously expected. Elsewhere, political instability continues, with elections taking place across much of the world, resulting in a changing of the guard.

Of course, there are other fundamental factors playing into proceedings. The global economy has been resilient and corporate profits remain robust in key markets, with record-high profit margins a feature of the U.S. market rally. That said, valuations are starting to stretch beyond fair value, given the all-time high prices, requiring some caution.

For equities, there is wide dispersion beneath, offering the opportunity to think and act selectively. Large-cap stocks are running well ahead of small-cap stocks, especially for AI-related companies. The same can be said for growth versus value stocks, with growth outpacing value by a healthy margin in the quarter. In fact, such is the influence of the mega caps such as NVIDIA, the U.S. market was negative in equal-weighted terms. Emerging

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markets have also been a mixed bag but contributed positively. China, the largest index component, enjoyed a bit of a rebound from its recent travails, while Taiwan's chip-led market was boosted by its connection to the AI story. India contributed a strong return as well.

For fixed-income investors on the global stage, it has been a muted period. Government bonds and corporate bonds were practically neck and neck for the quarter. Looking within though, short-dated bonds outperformed longer-dated bonds by a reasonable margin. Credit-sensitive bonds continued to benefit from strong equity market sentiment, but that left credit spreads even narrower than they already were, making their valuations look unusually rich by some metrics.

Economic outlook

The market's forecast for the Reserve Bank of Australia's cash rate shifted significantly in recent weeks. Back in mid-April, the futures market expected a 40% chance of a cut at the RBA Board meeting in August 2024. Fast forward to the end of June, and the market now prices a 50% chance of a rate hike. Hotter-than-expected monthly CPI data for May 2024 upended cash-rate expectations. Headline inflation was at 4%, above the previous corresponding period and missing economists' expectations of a 3.8% rise. Inflation remains firmly above the RBA's 2%-3% target band, and May is the fifth consecutive month when annual inflation either tracked sideways or drifted up. Services inflation is a persistent thorn in the RBA's side. The fastest-growing categories in the consumption basket include insurance, education, health, and housing (namely rents). The RBA must prevent expectations of higher inflation becoming embedded, which could spark a wage-price spiral. Inflation is now higher in Australia than many developed markets. Commentators argue this is because the RBA kept rates lower than global central bank peers. The cash rate of 4.35% is below policy rates in the US, the UK, Canada, and New Zealand. Whether the RBA can defend this will in part depend on the June-quarter CPI, due a week before the August board meeting. If we get another upside surprise, it becomes much harder for the RBA to sit on its hands.

In late June, the RBA estimated the "neutral" cash rate—the rate at which monetary policy is neither expansionary nor contractionary—was around 3.5%. If its estimate is accurate, then the current 4.35% cash rate is restrictive. And without any further hikes, demand will keep softening and inflation should fall. The slowdown in economic activity supports the RBA's view that monetary policy is indeed contractionary. Real GDP lifted a meager 0.1% in the June quarter, and this was on population growth of 0.7%. In per capita terms, June marked the fifth consecutive quarter of outright declines in real GDP. The labour market, while tight by pre-pandemic standards, is also gradually softening. The unemployment rate was 4.0% in April 2024, up from the recent trough of 3.5% in May 2023. Further, the last of the low fixed-rate mortgages will roll onto variable rates this year. The RBA estimates this will add 20 basis points to the average outstanding mortgage rate. In essence, for mortgage holders in aggregate, there is almost a full rate hike to feed through before year-end. The RBA is reluctant to raise interest rates further, as it could jeopardize the employment gains since the pandemic. Based on its latest

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forecasts, the bank is expecting annual CPI growth of 3.8% in June. If June inflation comes in at or below 3.8%, we think the RBA would interpret this as evidence that the economy remains on the narrow path to a soft landing and keep rates unchanged in August. However, a material upside surprise could force the RBA into another 25-basis-point hike.

Bringing this together, we face an interesting period that requires careful longer-term positioning. The positive returns are always welcome, although risk management is playing an important role. With technology and AI-related sentiment continuing to run hot, inflationary pressures still vexing, elections in full swing, and a still-combustible atmosphere in the Middle East, it remains pivotal to balance the risk and return drivers in portfolios.

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