MarketSay

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What You Need to Know

Month of January: After the "everything rally" period at the tail end of last year, January provided a more mixed month for asset classes. Some equity markets still managed to rally on strong economic data supporting equity earnings, but emerging markets were weak. Bond yields also rose (prices lower) on pushback from central bank speakers against aggressive interest rate expectations in the market.

Policy Watch: While most central banks did not meet in January, speakers were out in force. In contrast to the dovish tone set by the US Fed in December, most members pushed back on aggressive market pricing for rate cuts to start at its March meeting. European central bankers did much the same.

Inflation Watch: In Australia, Quarterly inflation for the final three months of 2023 came in lower than the RBA expected. This reading, like others around the world, shows that the heat is coming out of goods inflation, but services inflation remains more stubborn.

Risk Budget: Equity market volatility remained subdued in January, with lower volumes subduing market swings.

Our Portfolio: We were better positioned for the market dynamics in January than the rip higher we saw in December. It is difficult to buy into the equity markets at these levels when other assets continue to work well for us.

Lessons from 2023: Most strategists got 2023 wrong. Equity markets ended the year higher and there was no US recession. There were also no rate cuts. It proved a reminder of how much faster markets are moving in this cycle to price in "what's next." The potential impact of AI, low inflation and policy changes were priced, arguably, too quickly.

Outlook for 2024: We believe that central bankers will be more patient than markets expect, waiting for a lengthy period of confirmation that inflation is back within, or close to target bands. This may be a harder task than appreciated, with services inflation in many economies still too high.

It appears likely, in our view, that the US and Australia, despite higher interest rates will achieve an economic 'soft-landing' – slower growth, but no recession. Europe is likely to experience a shallow recession. China's economic outlook at present is uncertain. Geopolitical risks are numerous, with ongoing conflicts that threaten to spread and around 50% of the world's population in 76 countries face general elections this year, including the US Election in November.

How to Position: Last year saw vastly different performances across different sectors and regions. Diversification remains a key focus for 2024, and being tactical about opportunities is likely to be important.

Equity valuations and earnings expectations are high, cash rates are likely to fall modestly, and the bond market is likely to have a period of volatility as the path to sustainable lower inflation is bumpy. Equity market indices may close the year broadly unchanged, but underneath the surface, there is likely to be a wide spread of returns.

Robust and uncorrelated returns are likely to exist in alternatives like private debt/credit, agriculture, and structures linked to more volatile equities and other assets.

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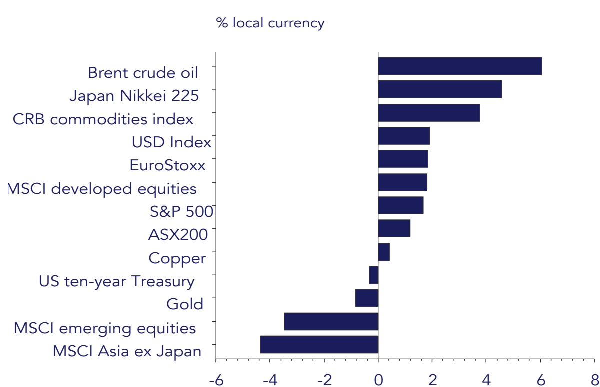
Markets in January

In January, the narrative shifted slightly from the end of 2023. Investors now are not sure about the path of interest rates, especially in the US. Central bankers pushed back on market expectations of earlier rate cuts, which weighed on bond market returns. Equity returns were more modest for the month, still supported by strong economic data.

Chart 1: January Asset Class Performance



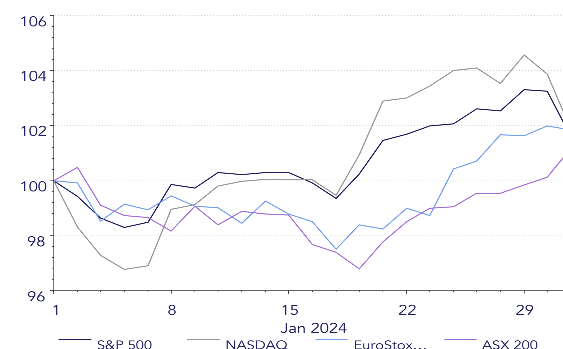
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The MSCI Developed Market Equities Index rose (+1.8%) in January, while the S&P 500 continues its robust performance (+1.7%) in USD terms. The S&P/ASX 200 underperformed rising (+1.2%). Emerging markets struggled and underperformed, falling (-3.0%), driven largely by Chinese market weakness. Japan was the standout, rising 7.8%.

In Australia, on a sector basis, Energy (+5.2%), Financials (+5.0%), and Health Care (+4.3%) lead the market. Consumer Staples (-0.0%), Utilities (-1.5%), and Materials (-4.8%) sectors were the worst performers.

Australian 10-year government bond yields rose 6 basis points over the month to 4.01%. This trend mirrored what was seen in US Treasuries, where yields rose by 7bps to 3.95%. However, unlike in Australia, the yield curve in the U.S. remains inverted, suggesting an aggressive path to lower interest rates.

Chart 2: Selected Equity Markets YTD Relative Performance (100 = 1 Jan 2024)



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Commodity markets remain difficult to read and were mixed in January. Brent Oil rose by US$4.67 to US$81.71/bbl., with the potential widening of conflict in the Middle East an ongoing concern.

Iron Ore prices fell by US$9.50 to US$133.00/Mt. Gold also slipped over the month, falling by US$25.15 to US$2,053, with the price weighed down by tempered interest rate cut expectations and a strong US Dollar.

The Australian dollar depreciated by 3.1% against the greenback to $0.66 and was down by a smaller 0.8% against a basket of trading partner currencies.

As of the end of January, 65% of the U.S. S&P 500 had reported quarterly results. Earnings growth was flat compared to a year ago, but down 9.3% on the quarter. Reinforcing their dominance of the market, the top 10 stocks, had reported earnings growth of 26%, compared to -5.8% for the rest of the benchmark. The better economic environment meant revenue surprise was running higher than earnings surprise.

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Lessons from 2023

Most strategists got 2023 very wrong, calling for flat to negative equity markets and a US recession.

Last year was a reinforcement of how much faster markets are moving in this cycle to price in "what's next." Investors were incredibly quick to extrapolate what impact Artificial Intelligence may have on the technology sector and beyond, that inflation would drop quickly and stay low and that rate cuts would immediately follow the low prints.

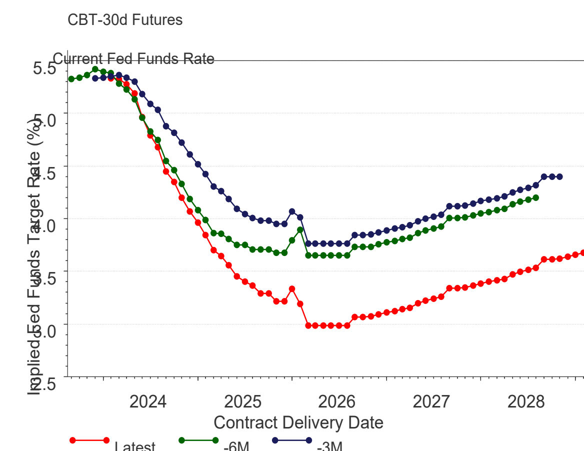
The question now for us is, have markets priced all this too quickly and are too exuberate? Or have they got this right and we are headed for another period of low inflation, driven by technology improvements and productivity gains?

Outlook for 2024

Interest Rate Cuts

Markets have priced in aggressive interest rate cuts while central bankers have cautioned that the pace will be slower. The debate about the extent and pace of rate cuts will be constant throughout the year. We would expect investors to continue to reprice expectations on the back of economic data and comments from central bankers. In our view, this is likely to cause periods of elevated volatility in bond markets, spilling over to equities especially if bond yields head materially higher once more.

Chart 3: Fed Fund Rate Futures Curve

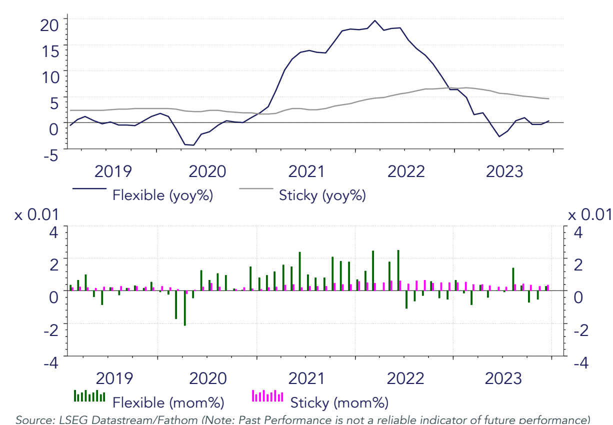


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Inflation

While the pace of inflation has moderately dramatically, much of the hard work so far has been done by declining goods prices. We believe that services inflation will remain more stubborn than currently expected as workers attempt to claw back lost purchasing power through wage increases. While base effects will be helpful, the most difficult leg down to lower inflation may still be ahead of us, in our view.

Chart 4: Atlanta Fed Sticky and Flexible Inflation



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Australia has a homegrown inflation problem due to migration surge and rental inflation. As a result, we expect the pace and scale of rate cuts to continue getting pushed out.

Soft Economic landings in Australia and the USA

Higher interest rates are still working their way through the system and their effects will be felt through to the middle of the year in our view. We believe that the US and Australia will avoid a recession but should show more signs of economic slowing, while companies will be more aggressive in reducing their staffing levels and looking for efficiencies to protect margins. We believe that China's growth will continue to be muted as they deal with a difficult property market impacting wealth levels and confidence, while Europe may slip into a mild recession.

Geopolitical risks

Geopolitical tension appears to be spreading and their impacts could result in surprise inflation shocks should supply chains be disrupted. Shipping lines in the Middle East remain the

current focal point but heightened tensions across the globe suggest that this could be a year of more negative shocks. A further escalation of the Israel-Gaza conflict is a possibility, China is likely to keep its strong rhetoric on reunification, while the conflict in Ukraine continues.

Approximately 4 billion people or 50% of the global population will vote in 76 elections throughout 2024. The US election in November is top of mind, but there are general elections scheduled to be held in the EU, UK, South Korea, Indonesia, and many developing nations.

The US Presidential election will likely be the most consequential of these. Markets see the race between Trump and Biden as evenly split at present. It is too early to predict what policy changes would result from a Trump Presidency 2.0 and what that may mean for markets. The temptation is to predict a repeat of the aftermath of Trump's 2016 victory. However, the economy is now in a vastly different position. We are much later in the cycle, fiscal spending is under pressure, bond yields are higher, as are earnings expectations and risk premia much lower. A rise in bond yields from increased spending and the prospect of inflation reigniting could quickly dilute any equity market optimism.

How to Position

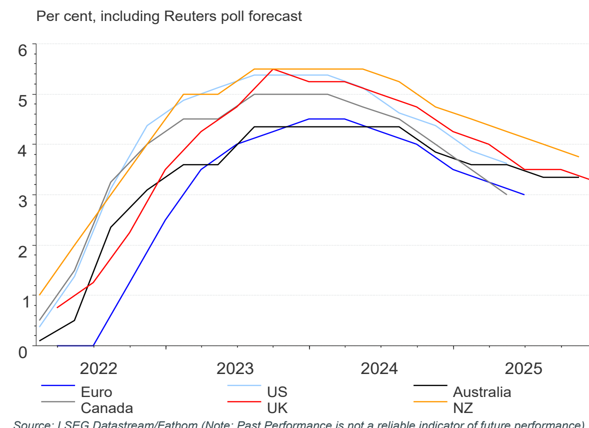
Being Selective

The past year taught investors to be selective in their asset allocation choices, as different sectors and regions had markedly different performance outcomes. Diversification remains a key focus for 2024, and being tactical about opportunities is likely to be important. We expect the hurdle for equity markets to continue performing remains relatively high and expect overall returns in 2024 to be muted.

Cash Rates

We expect that cash rates have peaked and the next move in most developed economies is down. Despite market pricing, we continue to believe that central banks will be reluctant to embrace cuts until they are more confident about the outlook for services inflation. Term deposit rates are likely to come under renewed downward pressure as bank funding requirements ease and credit growth remains muted.

Chart 5: Cash Rates with Reuters Forecast



Bond Market

US bond supply is likely to add to a lift in long-end yields and the bond curve should continue to steepen as short-duration yields head lower over the year as interest rate cuts are priced in. We believe there will be opportunities to add to long-duration fixed income during the year.

Corporate Bonds

Credit spreads are close to historical averages as markets have priced a softer economic backdrop in 2024. Our preference remains for better quality investment grade bonds over the riskier high yield opportunities. Cash rates that are higher for longer could challenge the debt serviceability of lower-quality corporates. We believe AUD floating rate exposure remains attractive with cash rates likely to come later than expected. While selectively adding fixed coupon exposure when bond yields rise will reward nimble investors. Subordinated debt is offering returns in the 6 – 7 per cent range and looks good value versus less defensive instruments.

Equities

We remain cautious about equity markets in 2024. Lofty valuations, currently near multi-year highs, leave little room for error as an economic slowdown is likely. Earnings growth expectations feel a little high as consumer spending is expected to slow. This mismatch between price and fundamentals

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could trigger a correction, especially if sentiment sours.

Technology companies have enjoyed a strong run on the extraordinary opportunities that artificial intelligence can create, investors will be increasingly focussed on how companies are likely to monetise the opportunity. Missing expectations might come with a higher level of investor backlash. Rotation between sectors is likely as some sectors have lagged the broader market rally.

We prefer exposure to the US as we see stronger economic growth relative to other developed economies. Japan also remains of interest, despite its recent outperformance, with structural reforms around corporate governance having a significant impact on company performance.

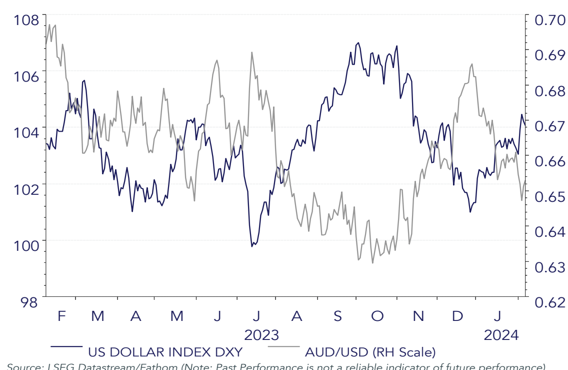
Emerging markets remain attractive on a long-term view, but in the short-term are incredibly difficult to call. Particularly on Chinese equities, where the economy is faltering, the consumer is not spending and government stimulus has not been as forthcoming as many expected,

Being selective and nimble is our focus for 2024. We would not be surprised to see market indices close the year broadly unchanged.

Currency

We have seen USD strength in early 2024 and expect that to continue as the outlook becomes more cautious. We expect that subdued China's growth and continued weakness in commodity prices should put further pressure on the AUD. We are targeting US$0.62 before hedging.

Chart 5: USD Index & AUD/USD Exchange Rate



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Private Credit / Debt

We are likely to see more opportunities in the private credit/debt markets as banks continue to retreat from this area due to regulatory issues and uneconomic capital requirements. Private credit covers a broad spectrum of opportunities and risk-return profiles.

While there can be a trade-off in liquidity, a shift from a borrower's market to one more in favour of lenders has meant added protections via stricter covenants and lower loan-to-value ratios. We are particularly focused on secured; short-tenor property deals with no/minimal construction risk that can offer returns over 10 per cent per annum.

Private Equity

Private equity offers exposure to private companies that are not accessible through public markets. We are likely to see more founder-led businesses come up for sale as baby boomers move towards retirement and exit. We favour some listed private equity opportunities that are trading at a discount to net asset value. Funds that are more focused on smaller buyouts are favoured versus the massive buyout firms that focus on taking listed companies private. We expect this vintage of private equity funds deploying cash over the next couple of years should be strong as they are likely to be buying at incredibly attractive valuations.

Structured Notes

Higher cash rates and stock volatility have opened a window to explore structured notes. We are particularly focused on underlying assets we know well and structures that line up with our investment views. Structures that provide a level of capital protection while giving a high chance of participating in the upside are favoured. Our focus is on notes that generate returns in the order of 8-12 per cent per annum on a one-year view.

Agriculture

We have a particular focus on agriculture investment in 2024 as the sector deals with intriguing opportunities and lingering challenges. While 2023 saw mixed results, with fluctuating commodity prices and weather concerns, the demand for food and sustainable practices remains

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paramount. We particularly like investments with an ag tech angle that can enhance the productivity of outcomes. Timing entry levels is paramount as geopolitical tensions, climate change, and supply chain disruptions pose risks that quickly change the landscape.

James Wright, Luke Hansen, and James Marchetti
Sayers Investment Solutions Team

9 February 2023

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