MarketSay

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What You Need to Know

Month of February: The resilience demonstrated by the US and Australian economies in 2023 has continued in the first two months of the year and combined with the softer inflationary outlook, has seen equity markets surge to record highs. While a lot of the focus of the rally been centred around the US Mega-cap companies benefitting from the growth in artificial intelligence, we have begun to see some broadening out of the rally into the Japanese and European markets.

Policy Watch: Central banks remained on hold in February, however central bank speakers continued to push back on aggressive interest rate cut pricing and stressed the importance of consistency in data points would allow them to ease policy.

Inflation Watch: The Australian Monthly CPI number brought little surprises for January. However, US CPI and Producer Price measures both came in hotter than expected, the Fed's preferred measure of inflation, the PCE Deflator came in-line with expectations but at a higher level than previous months. This seems to suggest that the path to target inflation is unlikely to be smooth.

Risk Budget: Equity market volatility remained subdued in February; bond volatility remains more elevated

Our Portfolio: Our underlying investments performed well during the month, with a strong USD and rising bond volatility working well for us. However, remaining underweight equities detracted somewhat.

Outlook: Central bankers continue to exercise caution of the timing and speed of rate cuts, although it is clear the next move is down, but the timing remains uncertain. We believe that it may take longer than the market is pricing for rate cuts to come through and for them to be less numerous than expected as inflation data remains volatile.

The very concentrated equity market rally to date, has broadened out somewhat. However, small and mid-cap stocks remain well down on their highs and have been left behind in the AI (Artificial Intelligence) rally.

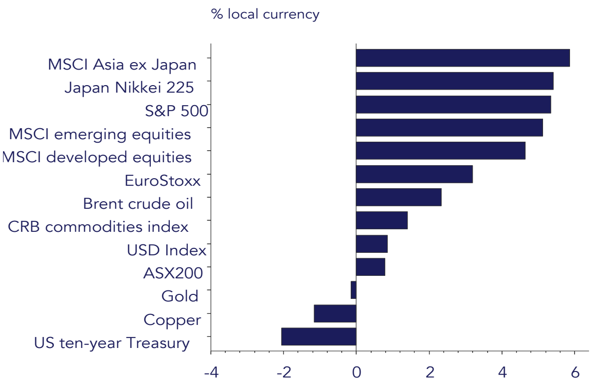
How to Position: There has been an element of "fear of missing out" in the equity rally year to date. While earnings were solid, it remains difficult to jump into the rally at this point. Economic growth is slowing and, in some geographies, faltering which is not a positive for earnings. There are elements of the AI induced rally that are over-hyped, while focus has been and remains on the big players in this space, there are other ways to play the theme at all points of the semiconductor supply chain where valuations are more reasonable.

Date of Publication: 8 March 2024 (Monthly)
Sayers Wealth Pty Ltd | ABN 61 642 217 007 | AFSL No. 525093

Markets in February

After a modest month in January, equity markets broke record levels around the world. No more spectacular than in Japan, where the record high for the Nikkei 225 index had stood unbroken since early 1990.

Chart 1: February Asset Class Performance



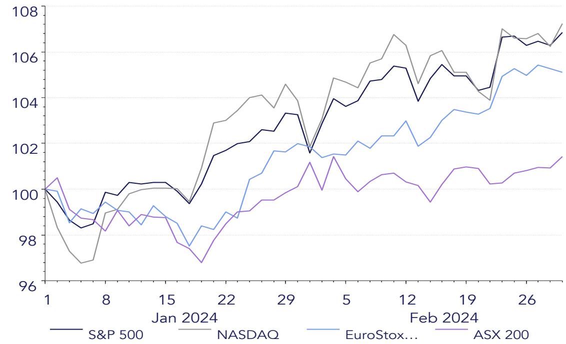
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The MSCI World Index increased by 4.6% in February, but it didn't perform as well as emerging market equities, which saw a 5.1% rise due to a recovery in the Chinese and Hong Kong markets. The ASX 200 index in Australia saw a modest rise of 0.8% in February, which was significantly lower than the 1.7% increase seen by small-cap stocks.

The information technology sector saw a remarkable increase of 19.5%, followed by consumer discretionary at 9.1% and real estate at 4.2%. The energy sector experienced the largest decline (-5.9%), closely followed by materials (-5.0%). Healthcare (-2.7%) and consumer staples (-0.6%) were the other two sectors that ended the month with losses.

The ASX 200 lagged other markets, which benefited from advancements in artificial intelligence. The S&P 500 saw a 5.3% increase, while MSCI Europe and Japan rose by 2.4% and 4.9% respectively over the month, and 13.1% for the year. Growth outperformed value.

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



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The yield on 10-year Australian government bonds ended the month at 4.14%, up 12 basis points, and the 2-year bond yield similarly increased to 3.80%, resulting in a relatively steep yield curve by international standards. The US 10-year Treasury yield saw a more significant increase of 29 basis points to 4.24%, as unexpectedly high January CPI figures led to reduced expectations of a Federal Funds rate cut in the first half of the year. The yield on the policy-sensitive two-year bond increased by 41 basis points to 4.63%.

Brent oil prices remained steady over the month at USD $84 per barrel, but natural gas prices fell by 11%, indicating a shift in perceptions of supply constraints and softer demand. Commodity prices weakened, with copper falling 1.2%, iron ore dropping to USD $125 per ton (-7%), and gold declining 0.3%.

The U.S. dollar index increased by approximately 0.9%, while the Australian dollar depreciated by 1.5% against the U.S. dollar.

Key Themes

Cost Management dominates ASX Reporting Season

Cost management was the primary focus this ASX reporting season, with most companies still reporting that they are facing high and persistent costs. Although, the peak rate of cost growth may have passed. Earnings calls were dominated by discussions on cost control, with management teams outlining their strategies for further cost reductions.

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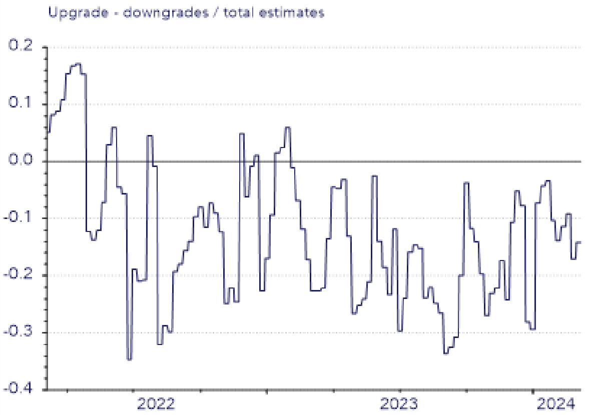
Companies were able to protect margins by passing on costs in a fully employed economy with sufficient end demand. However, this demand is not as buoyant as it was a year ago, leading companies to aggressively cut costs. As a result, about three-quarters of the reporting companies were able to expand or maintain profit margins.

Management teams described a customer base struggling with cost-of-living pressures and higher interest rates, leaving little room for increased spending. Interest rates remain a headwind for both for corporates and consumers.

Despite earnings beats, more ASX companies have had consensus earnings downgrades, than upgrades coming out of reporting season. The bar was set quite low going in to reporting season and has been set lower again for next half.

Chart 3: ASX200 EPS Sentiment



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Tech and AI dominate US 4Q Earnings

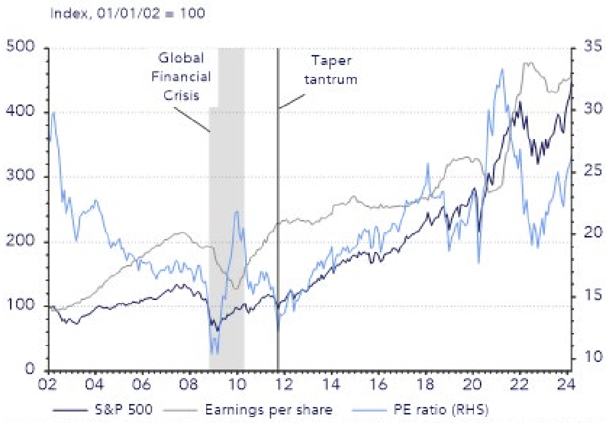
As at the end of February 97.8% of the S&P 500's market cap had reported. Despite mixed expectations leading into the reporting period, 4Q expectations are for revenues to grow 3.6% and EPS by 10.3%. 70% of companies topped projections.

Like Australian corporates, S&P500 revenue growth was subdued but earnings and margins were strong. While growth among groups varies significantly. Unsurprisingly, technology led the EPS growth grains at an astonishing 42% growth. While Health Care at -9.8% and Energy and Materials -21.4% were the weakest. Energy and commodity prices have been weak, while the health care industry has been struggling to pass on rising costs.

Valuations in Focus

Valuations are coming into critical focus, justified only by falling risk free rates or higher expectations of earnings growth. In the U.S., there are growing comparisons to bubble periods. Current market dynamics differ from other bubble periods and actual earnings are more solid. Better growth and still resilient earnings suggest momentum is with the equity markets, for now at least.

Chart 4: S&P500, EPS and P/E



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The ASX 200 ended the month trading at a forward price-to-earnings ratio of 16.5, which is high to history but relatively low compared to the 20.4x in the US.

Outlook

The resilience demonstrated by the US and Australian economies in 2023 has continued in the first two months of the year and combined with the softer inflationary outlook, has seen equity markets surge to record highs. While a lot of the focus of the rally been centred around the US Mega-cap companies benefitting from the growth in artificial intelligence, we have begun to see some broadening out of the rally into the Japanese and European markets. Market momentum has not really extended to small caps at this stage.

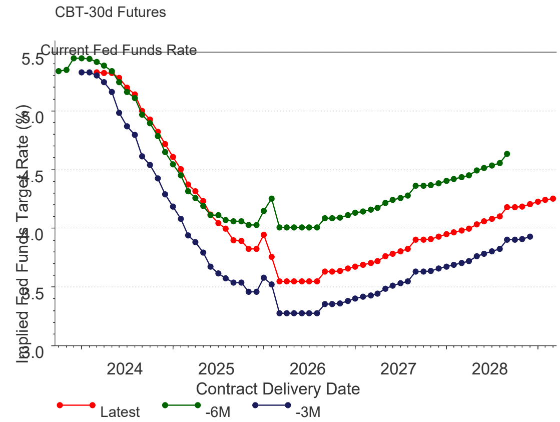
Most major central banks currently view their policy rates as restrictive, anticipating a return to target inflation levels within the next year or so. Projections suggest global growth will be more tepid over the next couple of years.

Australia's economic growth is forecasted to remain subdued in the near term due to persistent inflationary pressures and higher interest rates dampening demand. Projections for GDP growth in 2024 have been revised downward primarily reflecting a dimmer outlook for household consumption in the short run. Softer commodities are also undermining the countries income. However, growth is anticipated to gradually pick up from late 2024 as inflation subsides and pressures on household incomes alleviate.

Labor market conditions are expected to ease further, aligning broadly with full employment objectives over the next few years. Nominal wages growth is anticipated to remain robust initially before gradually tapering off.

Over recent weeks, we have seen markets push out the timing of interest rate cuts and long bond yields have risen from sub 4 per cent at the start of the year to around 4¼ per cent currently. Central banks have cautioned about declaring victory over inflation too early but admit that the broad measures are showing signs of moderating towards their target levels.

Chart 5: Fed Fund Rate Futures Curve



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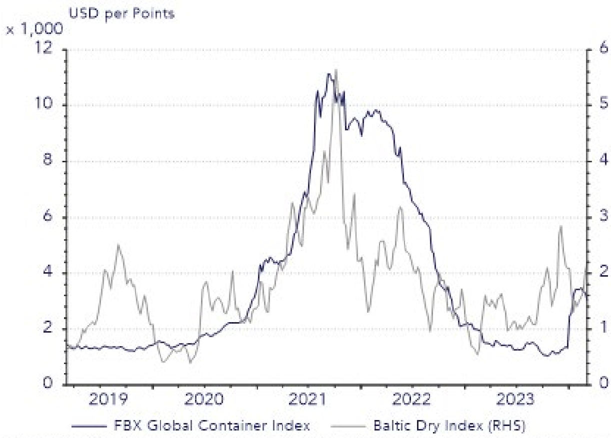
The RBA now expects inflation to return to the target range of 2–3% by 2025, reaching the midpoint by 2026. These projections are based on the assumption that the cash rate will remain stable until mid-2024. The pace of inflation decline is anticipated to accelerate slightly due to lower-than-expected goods price inflation and softer domestic demand. However, services inflation remains elevated and the path lower is more uncertain. If inflation takes longer to return to target, it could prove costly in terms of both employment and inflation objectives, particularly if it leads to upward drifts in inflation expectations.

Chart 6: Rising Shipping Costs



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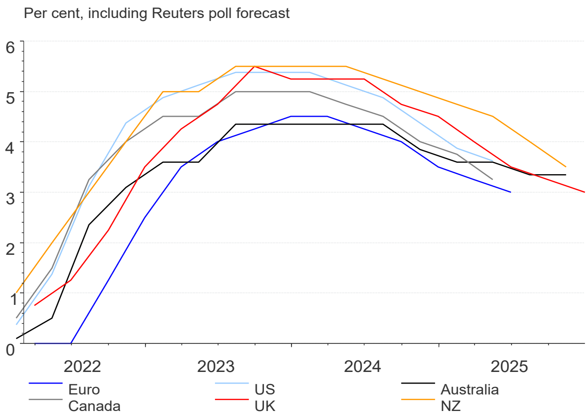
Geopolitical tensions continue to simmer, with potential disruptions to supply chains posing the risk of surprise inflationary shocks. Heightened tensions globally, particularly in the Middle East, suggest the possibility of encountering more negative shocks throughout the year. This would typically be played out via higher oil prices, but this has not been the case so far. There has been a spike in shipping costs which may push some price measures higher should it persist.

How to Position

Cash Rates

While cash rates are presumed to have peaked, central banks are expected to proceed cautiously with rate cuts, awaiting more favourable signals on services inflation. Term deposit rates may continue to face downward pressure as credit growth remains subdued.

Chart 7: Cash Rates with Reuters Forecast



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Government Bonds

US bond supply dynamics are poised to elevate long-end yields, steepening the bond curve. Opportunities to bolster long-duration fixed income holdings are expected to emerge throughout the year. This can be done by owning bonds directly or via a manager. We also favour gaining exposure through structured notes that limit downside.

Corporate Bonds

With credit spreads hovering around historical averages, a preference for investment-grade bonds over riskier high-yield options persists. The prolonged period of elevated cash rates may pose challenges for the debt serviceability of lower-quality corporates. AUD floating rate exposure remains appealing, offering returns in the 6-8% range.

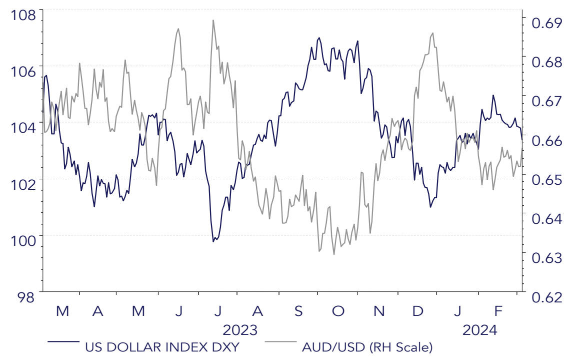
Equities

There has been a real fear of missing out in this rally. AI has driven great returns for the mega cap technology stocks which have started to show its impacts through stronger revenue growth. Small caps have not had a strong start to 2024 and are likely to benefit later in the year.

Currency

The USD's strength is anticipated to persist amid growing caution in the market outlook. Subdued growth in China and persistent weakness in commodity prices are likely to exert further downward pressure on the Australian dollar.

Chart 8: USD Index & AUD/USD Exchange Rate



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8 March 2024

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