MarketSay"

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What You Need to Know

Month of March: March was again a strong month for risk assets, but the rally was not confined just to equities and commodities; the USD and oil also recorded solid gains. The main driver for investor optimism was strong economic data, not just in the United States but also some positive surprises in Europe and China, which is finally showing signs of recovery. Again, the dominant theme was expectations on interest rate movements, with central bankers and inflation prints moving markets.

Policy Watch: The Swiss National Bank became the first developed market bank to cut rates in March. Meanwhile, the Bank of Japan increased its interest rates for the first time in 17 years, abandoning the negative interest rate policy, yield curve control and the purchase of exchange-traded funds in a big yet well-flagged policy shift. The RBA left rates unchanged at its March meeting and would not be drawn on forward guidance. The RBA appears to be in no hurry to cut rates, seeking confirmation that inflation will fall to target over its forecast horizon. The Fed, too, left rates on hold in March and updated its "dot-plot", showing that members expect three rate cuts in 2024. Comments from Fed Speakers since that meeting, however, have been more hawkish and have pushed back on the market pricing for cuts.

Inflation Watch: The Australian Monthly CPI report was unchanged at 3.4% from the prior month. US CPI was broadly in line with expectations, while the PCE index was slightly lower than expected. The downward trend in inflation remains intact, but momentum is slowing, adding to the caution of central bankers.

Risk Budget: Equity market volatility was low again in March, but bond volatility remains elevated as doubt persists about the quantum and pace of rate cuts.

Our Portfolio: Our underlying investments performed well in March, with a strong USD, further tightening of credit spreads and robust performance from our Australian and Global equity managers, all driving gains. Our strategic decision to maintain an underweight position in fixed income and duration contributed positively to our performance, although our underweight position in equities had a detracting effect.

Outlook: Equity market valuations in Australia and the US are above their historical averages, and bond yields are rising as central bankers push back on market pricing for interest rate cuts. US corporates must deliver solid earnings growth in the 1Q earnings season in April-May to justify the current market levels.

We anticipate central banks continuing to exercise patience and emphasise the importance of further moderation in price pressures before initiating rate cuts. The US Federal Reserve (the Fed) is unlikely to rush, given the economy's resilience and the potential for inflation to reaccelerate if financial conditions ease.

How to Position: Considering the current levels and valuations of equity markets, we believe the risk versus reward trade is not attractive enough to neutralise our underweight. As our portfolio performance in March demonstrated, strong returns can still be generated from other sources, including alternatives and credit. While a significant pullback seems unlikely, the US earnings season in April-May and inflation prints will be crucial in shaping investor sentiment and price action.

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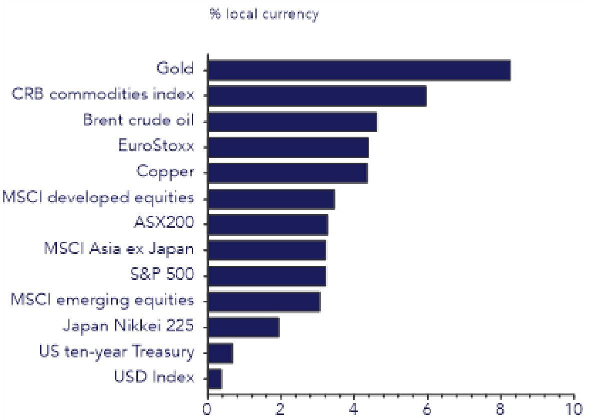
Markets in March

March was another month when almost everything rallied. Equity markets rose as hopes firmed that the US and Australian economies would avoid recessions.

Chart 1: March Asset Class Performance



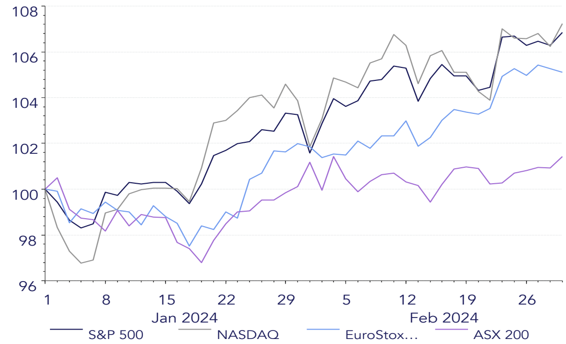
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Investors focused on the strong economic data as good news rather than the implications for interest rate policies. The MSCI World Index rose 3.4% in March and 10.1% for the quarter. Emerging market equities performance started to turn late in the quarter as the MSCI EM Index rose by 3.1% in March.

The S&P500 increased 3.2% in March, making new all-time highs. European equities recorded a strong month, with the STOXX 600 index climbing 3.65% and the FTSE 100 index up 4.23% in March. Japanese equities were more muted with the Nikkei 225 index, up 1.15%, but they remain one of the year's strongest performers with year-to-date gains of over 20%.

Globally, the Energy (+9.2%), Materials (+6.5%), and Utilities (+5.9%) sectors outperformed while returns in consumer discretionary (+0.9%), IT (+1.7%), and Consumer Staples (+2.4%) sectors were more muted.

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



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The Australian 10-year government bond yield decreased 17 bps over the month to 3.97%. US yields also decreased, stepping down 4 bps to 4.20%.

Commodity prices were mixed in March. Brent Oil rose by US$3.86 to US$87.48/bbl, whilst China macro concerns saw Iron Ore prices fall by US$15.50 to US$102/Mt. Over the month, gold was one of the top-performing assets as prices hit another record high, increasing by US$166.30 to US$2,214.35 per ounce.

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

The ASX 200 is trading on a forward price-to-earnings multiple of ~16.6x, the highest level excluding the COVID period. While the S&P500 forward P/E is 20.7x versus a long-run average of ~18x.

Key Themes

Rate cuts are coming, but later and less than expected.

Since its very dovish meeting in December 2023, members of the US Federal Reserve (the Fed) have repeatedly pushed back on market pricing for a quick and aggressive cutting cycle. At the start of the year, markets had priced in just short of seven 25 basis point cuts from the Fed during 2024, starting in June. That now stands closer to 3 rate cuts, with the timing being pushed out.

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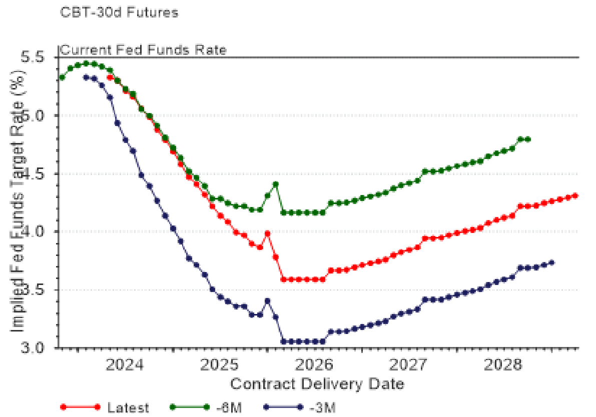
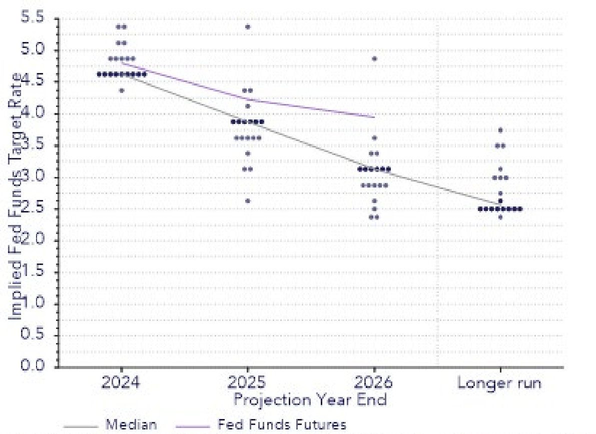
Chart 3: Fed Funds Futures Curve



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

At its March meeting, the Fed published its own forecast of the future path of interest rates, known as the "Dot Plot." Each dot represents the view of each member of the Fed's Open Market Committee. At the time, most members expected to cut the cash rate three times in 2024. However, recent comments from Fed officials following strong economic data prints and stickier inflation readings have put this number at risk.

Chart 4: FOMC Dot Plot

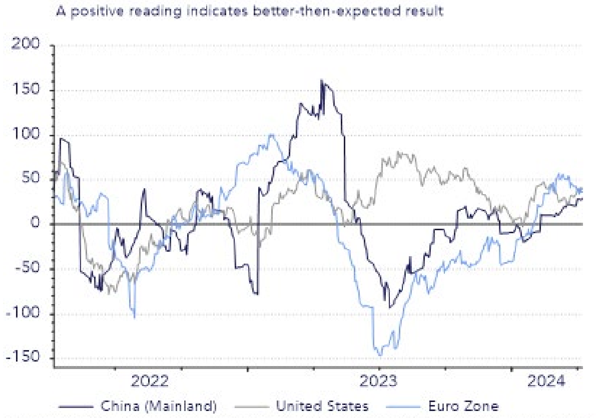


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

A Resilient Global Economy

The US economy remains in rude health, with growth reaccelerating, consumer spending, and the labour market moderating, but it is still very tight. Economic and activity readings continue to surprise to the upside, an environment that supports equity earnings growth but also for interest rates to stay higher for longer, as the Fed does not need to support a weakening economy by cutting rates.

Chart 5: Citi Economic Surprise



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

Eurozone data is now also surprising to the upside, despite its economy not being anywhere near as strong as the US. This provides a similar challenge to European monetary policymakers this year.

Chinese economic growth and activity appear to have turned a corner. Manufacturing activity readings have surprised markets and re-entered expansion territory following the Lunar New Year celebrations in February. A stronger Chinese economy is likely to provide continued support to commodity and energy markets.

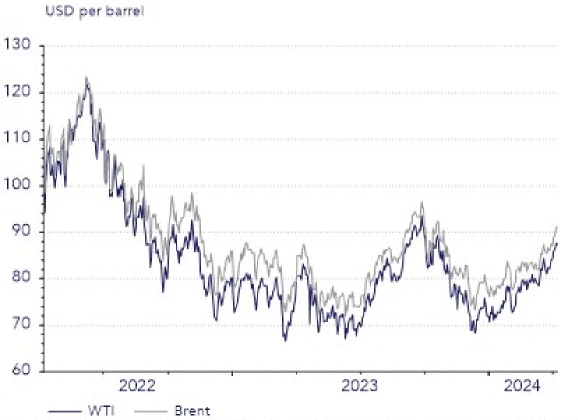
Outlook

The continued strength of the global economy and some stickiness in inflation readings (particularly in the US) present a risk for central banks. Given how strong the labour market is and consumer demand is still solid, we believe that the US Fed is likely to be increasingly wary of cutting too early and causing inflation to reaccelerate.

While a rate cut from the European Central Bank in June appears likely, there could be a longer-than-anticipated pause after this move to wait for more data. The RBA is playing the long game, too, with inflation yet to fall back in touch with the bank's target band and unlikely to do so until 2025 or potentially later. The RBA may be one of the last banks to change policy settings late this year, as Australia appears to be about 6 months behind the rest of the world in the fight against inflation.

We may see a similar move in the US, or bankers may opt for more data releases to confirm the downward path of inflation before cutting rates later in the year. Fed speakers have been increasingly cautious about changing policy settings lately, even if Chair Powell has reinforced that rate cuts are coming. It's an environment that can potentially upset the current rally in equity markets, put further upward pressure on bond yields and see an increase in volatility in both markets. Positioning in alternatives is likely to be critical in such an environment.

Chart 6: WTI & Brent Crude Oil



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

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. Oil prices have steadily risen since the start of the year and have recently accelerated as conflict in the Middle East threatens to spread.

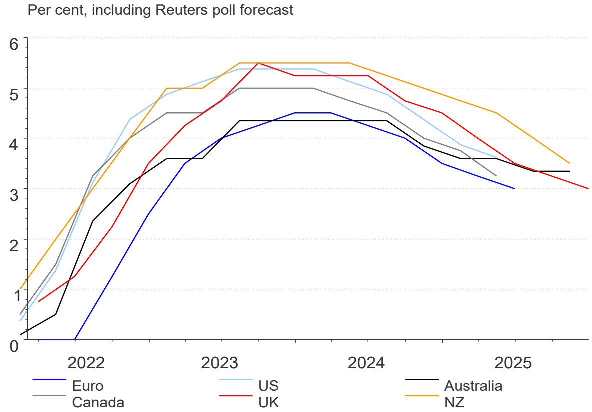
April will bring the start of the US 1Q Quarterly Earnings Season. Last quarter, EPS was estimated to grow 4.1%, but results came in closer to 10.5%. Earnings are forecasted to grow by 4.0%, but given how strong the economy is, this number could have an upside risk.

How to Position

Cash Rates

Cash rates are likely to fall, but not as quickly or to the extent as investors previously thought. While deposit rates are falling due to slowing credit growth and strong bank balance sheets, we believe maintaining exposure to floating rate credit is another way to play higher cash rates for longer.

Chart 7: Cash Rates with Reuters Forecast



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Government Bonds

The pricing out of interest rate cuts has put upward pressure on bond yields. While we are unlikely to see US 10-year Treasuries rise over 5% again, we believe there is likely still some upside to yields. Opportunities to bolster long-duration fixed-income holdings are expected to emerge throughout the year, but it's a little too early in our view.

Corporate Bonds

Conditions for credit remain supportive with strong economic growth and a corporate sector that's in good shape. Given credit spreads continue to tighten towards cyclically tight levels, we prefer investment-grade bonds over riskier high-yield options persists. Corporate defaults are not currently dominating headlines. However, there are signs of stress and dislocation, particularly in Europe, starting to emerge. The prolonged period of elevated cash rates may challenge the debt serviceability of lower-quality corporations.

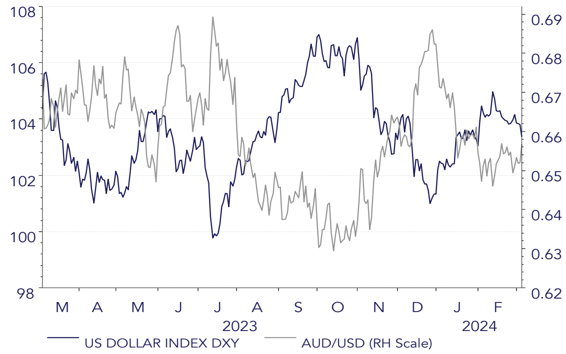
Equities

Equity market performance has been strong in 2024, driven by technology earnings and AI tailwinds. Equity market valuations now appear stretched and are at multi-year highs. While a large pull-back appears unlikely, we do not believe equities represent a good risk-reward trade. Strong earnings growth is needed from here to support valuations in a rising bond yield environment.

Currency

The USD's strength is anticipated to persist, but its strength against the AUD may moderate from here as Chinese data appears to improve.

Chart 8: USD Index & AUD/USD Exchange Rate



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

10 April 2024

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